

PhotoChannel Networks Inc.
Interim Financial Statements for the period ended June 30, 2007

PhotoChannel Networks Inc.

Consolidated Balance Sheets

Unaudited – Prepared by Management

(expressed in Canadian dollars)

	<u>June 30, 2007</u>	<u>September 30, 2006</u>
Assets		
Current assets		
Cash and cash equivalents	\$ 19,584,534	\$ 2,022,015
Cash held in trust	53,838	-
Accounts receivable	1,157,963	1,311,867
Inventory	82,194	80,190
Prepaid expenses	262,602	76,286
	<u>21,141,131</u>	<u>3,490,358</u>
Capital assets	1,610,568	1,235,789
Deferred charges	816,198	157,157
	<u>\$ 23,567,897</u>	<u>\$ 4,883,304</u>
Liabilities		
Current liabilities		
Accounts payable and accrued liabilities	\$ 1,439,687	\$ 1,221,948
Deferred revenue – current portion	144,314	179,647
	<u>\$ 1,584,001</u>	<u>\$ 1,401,595</u>
Deferred revenue – long-term portion	47,470	46,947
	<u>1,631,471</u>	<u>1,448,542</u>
Shareholders' Deficiency		
Capital stock	\$ 65,388,225	\$ 49,115,790
Contributed surplus	9,908,992	9,958,544
Warrants	5,011,481	338,314
Deficit	(58,372,272)	(55,977,886)
	<u>21,936,426</u>	<u>3,434,762</u>
	<u>\$ 23,567,897</u>	<u>\$ 4,883,304</u>

Approved by the Board of Directors

“Peter Fitzgerald” Director

“Cory Kent” Director

The accompanying notes are an integral part of these financial statements.

PhotoChannel Networks Inc.
Consolidated Statements of Loss and Deficit
Unaudited – Prepared by Management
(expressed in Canadian dollars)

	Three Months Ended		Nine Months Ended	
	June 30, 2007	June 30, 2006	June 30, 2007	June 30, 2006
Revenue	\$ 1,272,962	\$ 1,310,520	\$ 4,112,147	\$ 2,684,380
Expenses				
General and administration	446,619	524,042	1,384,193	1,224,795
Sales and marketing	150,662	347,356	519,438	699,412
Network delivery	306,763	617,118	1,078,671	1,233,402
Research and development	699,530	759,851	2,024,256	1,734,103
Amortization	128,465	106,677	361,162	263,054
	<u>1,732,039</u>	<u>2,355,044</u>	<u>5,367,720</u>	<u>5,154,766</u>
Net loss from operations	(459,077)	(1,044,524)	(1,255,573)	(2,470,386)
Other Income (loss)				
Foreign exchange gain (loss)	(1,369,179)	10,625	(1,371,158)	2,006
Interest and miscellaneous income	188,605	8,263	232,345	21,483
	<u>(1,180,574)</u>	<u>18,888</u>	<u>(1,138,813)</u>	<u>23,489</u>
Net loss and comprehensive loss for the period	(1,639,651)	(1,025,636)	(2,394,386)	(2,446,897)
Deficit - beginning of period	(56,732,621)	(54,766,846)	(55,977,886)	(53,345,585)
Deficit - end of period	<u>\$ (58,372,272)</u>	<u>\$ (55,792,482)</u>	<u>\$ (58,372,272)</u>	<u>\$ (55,792,482)</u>
Basic and fully diluted net loss per share	\$ (0.05)	\$ (0.04)	\$ (0.08)	\$ (0.11)
Weighted average number of common shares outstanding	<u>32,404,197</u>	<u>22,988,297</u>	<u>28,721,894</u>	<u>22,077,308</u>

The accompanying notes are an integral part of these financial statements.

PhotoChannel Networks Inc.

Consolidated Statements of Cash Flows

Unaudited – Prepared by Management

(expressed in Canadian dollars)

	Three Months Ended		Nine Months Ended	
	June 30, 2007	June 30, 2006	June 30, 2007	June 30, 2006
Cash flows from operating activities				
Net (loss) gain for the period	\$ (1,639,651)	\$ (1,025,636)	\$ (2,394,386)	\$ (2,446,897)
Items not affecting cash				
Amortization	128,465	106,677	361,162	263,054
Stock-based compensation expense	167,964	97,284	488,633	142,817
Foreign exchange loss	1,369,179	(10,625)	1,371,158	(2,006)
	25,957	(832,300)	(173,433)	(2,043,032)
Net change in non-cash working capital items	(1,635,040)	(642,539)	(17,272)	(560,653)
	(1,609,083)	(1,474,839)	(190,705)	(2,603,685)
Cash flows from investing activities				
Cash held in trust	17,402,679	-	(53,838)	-
Deferred charges	(319,844)	-	(477,177)	-
(Purchase) Disposal of property, plant and equipment	(125,806)	(194,066)	(735,941)	(491,061)
	16,957,029	(194,066)	(1,266,956)	(491,061)
Cash flows from financing activities				
Issuance of common shares and warrants – net proceeds	-	2,540,720	16,185,674	4,073,720
Issuance of common shares on exercise of warrants and options	2,382,558	-	4,221,743	-
	2,382,558	2,540,720	20,407,417	4,073,720
Effect of foreign exchange on cash and cash equivalents	(1,392,104)	(2,520)	(1,387,237)	(2,716)
Increase (decrease) in cash and cash equivalents	16,338,400	869,295	17,562,519	976,258
Cash and cash equivalents - beginning of period	3,246,134	294,281	2,022,015	187,318
Cash and cash equivalents - end of period	\$ 19,584,534	1,163,576	\$ 19,584,534	\$ 1,163,576

The accompanying notes are an integral part of these financial statements.

PhotoChannel Networks Inc.

Notes to Consolidated Financial Statements

Unaudited – Prepared by Management

(expressed in Canadian dollars)

1. Summary of significant accounting policies

General

These unaudited interim consolidated financial statements have been prepared in accordance with generally accepted accounting principles (GAAP) in Canada, using the same accounting policies as outlined in Note 2 to the most recent audited consolidated financial statements for the year ended September 30, 2006, except for comprehensive income and financial instruments outlined below. These unaudited interim consolidated financial statements do not include all disclosures required for annual financial statements and should be read in conjunction with the audited consolidated financial statements for the year ended September 30, 2006. Certain comparative figures in the unaudited interim consolidated financial statements have been reclassified to conform to the current period presentation.

In the opinion of management, all adjustments (which include reclassifications and normal recurring adjustments) necessary to present fairly the consolidated financial position, consolidated loss, and consolidated cash flows as at June 30, 2007 and for all periods presented, have been made. The loss for the nine months ended June 30, 2007 is not necessarily indicative of the results of operations for the full year ending September 30, 2007. All amounts herein are expressed in Canadian dollars unless otherwise noted.

All material inter-company balances and transactions are eliminated upon consolidation.

Nature of operations

The company has a limited operating history and the successful implementation of its business strategy may depend on numerous factors including economic, competitive and other conditions and uncertainties, the ability to hire and retain qualified personnel, the ability to obtain financing for continued development and commercialization of its products. Adverse economic or competitive conditions or the failure to hire and retain qualified personnel or obtain financing if required could affect the company's operations in the future.

Changes in Accounting Policies

Comprehensive income and financial instruments

On October 1, 2006, the Company adopted the recommendations included in the CICA Handbook sections 1530, Comprehensive Income, 3251, Equity, 3855, Financial Instruments - Recognition and Measurement, 3861, Financial Instruments - Disclosure and Presentation and 3865, Hedges.

Section 1530 requires the presentation of comprehensive income and its components in a new financial statement. Comprehensive income is the change in the Company's net assets that results from transactions, events and circumstances from sources other than the Company's shareholders and includes unrealized gains and losses arising from the translation of the financial statements of self-sustained foreign operations, as well as the portion of gains or losses on the hedging item that is determined to be an effective hedge of net investments in self-sustaining foreign operations. The adoption of this standard had no impact on the Company's financial statements.

Section 3251 requires that a company presents separately the changes in and the balances of the following components of equity: retained earnings, accumulated other comprehensive income, contributed surplus, capital stock and reserves.

Sections 3855 and 3861 establish the standards for the recognition, measurement, disclosure and presentation of financial assets, financial liabilities and non-financial derivatives. These standards prescribe when to recognize a financial instrument in the balance sheet and at what amount. On initial recognition, all financial

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instruments included in the scope of Section 3855 are measured at fair value. Depending on their balance sheet classification, fair value or cost-based measures are used to measure financial instruments after initial recognition. They also prescribe the classification of gains and losses on financial instruments. Based on financial instrument classification, gains and losses on financial instruments are recognized in net income or other comprehensive income. All embedded financial instruments are carried at fair value in the consolidated balance sheet, including those derivatives that are embedded in other contracts but are not considered to be closely related to the host contract. The Company has made the following classification for its financial instruments:

- Cash equivalents and cash held in trust are classified as an "Asset held for trading". They are measured at fair value and any gains or losses resulting from subsequent measurements, at the end of each period, are recognized in net earnings;
- Accounts receivable are classified as "Loans and receivables" and are recorded at cost, which upon their initial measurement is equal to their fair value. Subsequent measurement of trade receivables is at amortized cost, which usually corresponds to the amount initially recorded less any allowance for doubtful accounts; and
- Accounts payable and accrued liabilities are classified as "Other financial liabilities". They are initially measured at fair value and the gains and losses resulting from their subsequent measurement, at the end of each period, are recognized in net loss.

The adoption of these new standards had no effect on the Company's financial statements.

Research and development

Research costs are expensed in the period incurred. Where, in the opinion of management, the deferral criteria established under GAAP are satisfied in all material respects, development costs are capitalized and amortized over the estimated life of the related products. Otherwise, development costs are charged as an expense in the period incurred. To date, no development costs have been deferred.

Property, plant and equipment

Property, plant and equipment are recorded at cost less accumulated amortization. Amortization of property, plant and equipment is charged over the estimated useful lives of the assets at the following annual rates:

Computer equipment	30% straight-line
Software	33% - 100% straight-line
Furniture and office equipment	20% straight-line
Leasehold improvements	life of the lease

The Company assesses the carrying value of long-lived assets for recoverability whenever events or changes in circumstances indicate that the carrying value may not be recoverable from future undiscounted cash flows. An impairment loss equal to the difference in the asset carrying value and its fair value is recognized in the period in which the determination is made.

Leases

Leases in which a significant portion of the risk and rewards of ownership are retained by lessor are classified as operating leases. Payments made under operating leases are charged to the statement of operations and deficit on a straight-line basis over the term of the lease.

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Deferred charges

During fiscal 2006, the Company entered into a contract with a customer which included the provision for a cash rebate of transactional revenues billed over a fixed period of time. This amount is presented as deferred charges and is being amortized on a straight-line basis over a 30-month period.

During the period, the Company entered into arrangements and incurred professional fees associated with the potential acquisition of Pixology plc and such costs have been recorded as deferred charges.

Revenue recognition

Revenue is earned from the provision of the PhotoChannel Network to electronically connect photo-finishing retailers to their customers through the Internet. Revenue received in advance from installation services for the set-up of a customer website is recorded as deferred revenue and is recognized into income over the estimated term of the customer relationship period. Revenue from monthly membership fees from photo-finishing retailers for the connection to the PhotoChannel Network is recognized as the service connection is provided. Revenue from commissions earned on transactions processed by the photo-finishing retailers, utilizing the PhotoChannel Network, is recognized at the time the digital image processing services are provided to the end customer. Revenue from archive fees from online image storage is recognized as the service is provided.

Vendor consideration given to a customer

On October 1, 2005, the Company adopted Emerging Issues Committee Abstract 156, "Accounting by a Vendor for Consideration Given to a Customer (Including a Reseller of a Vendor's Products)" (EIC-156). In 2005 and 2006, the Company entered into sales agreement(s) with certain customer(s) where there are provisions for cash consideration if certain sales thresholds are met. Cash consideration due from the Company to a customer is recorded as a reduction in sales revenue in the Company's income statement.

EIC-156 was retroactively applied with no impact on prior year sales revenue.

Share issue costs

Direct costs associated with an issue of capital stock or special warrants are deducted from the related proceeds at the time of the issue.

Stock-based compensation plan

The Company has a stock option plan, which is described in note 6 to the most recent audited consolidated financial statements for the year ended September 30, 2006. Options issued are accounted for in accordance with the fair value method of accounting for stock-based compensation as defined in the provisions of CICA Handbook Section 3870 "Stock-Based Compensation and other Stock-Based Payments". The cost of the options is charged to operations with an offsetting amount recorded to contributed surplus based on an estimate of the fair value determined using the Black-Scholes option pricing mode. The section applies to certain awards outstanding on the date of adoption, being October 1, 2004 for the Company, and relates to all awards granted on or after October 1, 2002. As a result, the Company applied the recommendations with retroactive application and recorded an adjustment to opening deficit of \$314,011 in the fiscal year of 2005. Previously, the Company disclosed the pro forma effect of employee stock-based compensation expense in the notes to the financial statements.

Net loss per share

Basic net loss per share is computed using the weighted average number of common shares outstanding during the period. The treasury stock method is used for the calculation of diluted net loss per share. Under the

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Notes to Consolidated Financial Statements

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treasury stock method, the weighted average number of common shares outstanding for the calculation of diluted net loss per share assumes that the proceeds to be received on the exercise of dilutive stock options and warrants are applied to repurchase common shares at the average market price for the period. Stock options and warrants are dilutive when the average market price of the common shares during the period exceeds the exercise price of the options and warrants.

At June 30, 2007, 4,857,147 warrants (2006 – 4,431,875) and 1,624,026 options (2006 – 2,089,177) were outstanding and could potentially dilute basic earnings per share, but were excluded from the calculation of diluted shares as their effects would anti-dilutive.

Foreign currency transactions and translation

Monetary assets and liabilities of the Company denominated in foreign currencies are translated into Canadian dollars at the exchange rate prevailing at the balance sheet date. Revenue and expenses denominated in foreign currencies are translated at the exchange rate prevailing at the transaction date. Exchange differences are included in the statement of loss as they arise.

Use of estimates and measurement uncertainty

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amount of assets and liabilities and other reported amounts in the consolidated financial statements and the related notes. Significant estimates and assumptions are necessary in the determination of the recoverable amounts for property, plant and equipment and in the determination of the value ascribed to the components of stock-based transactions. Actual results may differ from those estimates.

Cash and cash equivalents

Cash and cash equivalents consist of cash on deposit and highly liquid short-term interest bearing securities with maturities at the date of purchase of three months or less.

Fair values

The fair values of cash and cash equivalents, cash held in trust, accounts receivable, and accounts payable and accrued liabilities approximate their carrying amounts are due to the near-term maturity of these instruments.

Income taxes

The Company uses the liability method of accounting for income taxes. Under the liability method, future tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax balances. Future tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on future tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the date of enactment. A valuation allowance is recognized to the extent the recoverability of future income tax assets is not considered more likely than not.

Comparative amounts

Comparative amounts have been reclassified, when necessary, to conform to the presentation adopted in the current year.

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Notes to Consolidated Financial Statements
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2. Accounts receivable

	As at June 30, 2007		As at September 30, 2006	
Trade accounts receivable	\$	1,155,794	\$	1,311,867
GST Receivable		2,169		-
Total	\$	1,157,963	\$	1,311,867

3. Capital stock and stock options

a) Capital stock

	Capital stock			Other capital accounts			
	Number of Shares (1)	Amount \$	Contributed surplus \$	Number of warrants (1)	Amount \$	Deficit \$	Total shareholders' equity (deficiency) \$
Balance - September 30, 2006	26,048,376	49,115,790	9,958,544	2,225,000	338,314	(55,977,886)	3,434,762
Issuance of shares for cash from exercised options	603,117	1,422,428	(538,185)	-	-	-	884,243
Compensation expense for options vested	-	-	488,633	-	-	-	488,633
Private placement of 4,430,588 units	4,430,588	11,174,193	-	4,857,147	5,011,481	-	16,185,674
Shares issued on exercise of warrants	2,225,000	3,675,814	-	(2,225,000)	(338,314)	-	3,337,500
Loss for the period	-	-	-	-	-	(2,394,386)	(2,394,386)
Balance June 30, 2007	33,307,081	65,388,225	9,908,992	4,857,147	5,011,481	(58,372,272)	21,936,426

- (1) On November 2, 2006, the Company implemented a consolidation of its common shares on a one-new-common-share-for-10-old-common-shares basis. The number of common shares, outstanding warrants and common stock options have been adjusted to reflect the post consolidated amount at September 30, 2006 for comparison purposes.

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(expressed in Canadian dollars)

b) Options

The Company has a stock option plan (the “Plan”) which is described in note 6 to the most recent audited consolidated financial statements for the year ended September 30, 2006. The Plan grants to directors and certain employees of the Company the option to common shares of the Company. The Plan allows for a maximum of 10% of the Company’s issued and outstanding common shares be reserved for issuance. As at June 30, 2007, the Company has reserved 3,330,708 common shares. The exercise price of each option is determined by the market price of the Company’s stock on the date of the grant and an options’ maximum term is five years. Options generally vest over eighteen (18) months. During the nine months ended June 30, 2007, 745,000 options (2006 – 615,000) were granted to employees.

c) Warrants

Pursuant to a brokered private placement during the nine month period ended June 30, 2007, the Company issued 4,430,588 units for net proceeds of \$16,185,674. Each unit consisted of one common share and one common share purchase warrant. Each common share purchase warrant entitles the holder to purchase one additional common share of the company at a price of US\$4.00 per share for a period of two years from the date of closing. The net proceeds of \$16,185,674 were allocated: \$11,174,193 to common shares issued and \$5,011,481 to the common share purchase warrants. The value allocated to the common share purchase warrants was determined using the Black-Scholes option pricing model with the following weighted average assumptions: dividend yield of \$nil; expected volatility of 72%; risk-free interest rate of 3.95%; and expected life of two years. The common share purchase warrants expire on March 30, 2007. During the period ended June 30, 2007, none of the common share purchase warrants were exercised.

4. Business segment information

The Company only reportable segment is the provision of digital image delivery, hosting, storage and financial reporting for photo-finishing retailers.

The Company’s sales by geographical area are as follows:

Revenue	Canada	US	Other
For the nine months ended June 30, 2007	\$ 3,085,672	\$ 1,011,824	\$ 14,651
For the nine months ended June 30, 2006	\$ 2,377,182	\$ 306,604	\$ 594

Revenue is attributable to the geographic location of the Company’s customer. As at June 30, 2007 and 2006, all of the Company’s property, plant and equipment were located in Canada.

5. Revenue

Description	Nine Months June 30, 2007	Nine Months June 30, 2006
Installation fees	\$ 574,871	\$ 842,816
Membership fees	667,037	525,620
Transaction commission fees	2,571,253	1,026,611
Archive fees	45,011	90,298
Professional fees	253,975	199,035
Total	\$ 4,112,147	\$ 2,684,380

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6. Expense details

	June 30, 2007	June 30, 2006
General and administration		
Accounting and legal	\$ 127,141	104,249
Investor relations	25,183	40,000
Office and miscellaneous	231,864	193,488
Public company fees	72,639	38,041
Salaries	395,700	335,274
Consulting	193,823	270,497
Stock-based compensation expense	241,032	142,817
Interest	469	2,801
Rent	96,342	64,894
Bad Debt	-	8,720
Loss due to decline in inventory	-	24,014
	<u>\$ 1,384,193</u>	<u>1,224,795</u>
Sales and marketing		
Salaries	\$ 233,101	232,228
Consulting	101,867	206,584
Printing, advertising and promotion	32,103	219,656
Travel and Miscellaneous	83,494	40,944
Stock-based compensation expense	68,873	-
	<u>\$ 519,438</u>	<u>699,412</u>
Network Delivery		
Telecommunication costs	\$ 162,610	171,933
Customer Service	300,786	256,123
Lab system installation	442,458	680,234
Other	183,414	125,112
Stock-based compensation expense	6,072	-
Expense Recovery	(16,669)	-
	<u>\$ 1,078,671</u>	<u>1,233,402</u>
Research and development		
Salaries	\$ 999,990	754,595
Consulting	710,424	897,925
Miscellaneous	141,186	81,583
Stock-based compensation expense	172,656	-
	<u>\$ 2,024,256</u>	<u>1,734,103</u>

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7. Reconciliation to accounting principles generally accepted in the United States of America

The financial statements have been prepared in accordance with Canadian generally accepted accounting principles (“Canadian GAAP”), which differ in certain respects from those principles and practices that the Company would have followed had its financial statements been prepared in accordance with accounting principles and practices generally accepted in the United States (“US GAAP”).

The reconciliation of the loss for the year based on Canadian GAAP to US GAAP is as follows:

The financial information set out below as at June 30, 2007 and for the three months ended June 30, 2006 is unaudited: however, such information reflects all adjustments, consisting only of normal recurring adjustments, necessary for a fair presentation of the financial information for the periods presented.

(a) The reconciliation of the loss for the period based on Canadian GAAP to US GAAP is as follows:

	June 30, 2007 (Unaudited) \$	June 30, 2006 (Unaudited) \$
Net loss for the period under Canadian GAAP	1,639,651	1,025,636
Compensation expense (i)	-	-
Unrealized gain (loss) on warrants outstanding	(1,572,245)	-
Net loss and comprehensive loss for the period under U.S. GAAP (ii)	<u>67,406</u>	<u>1,025,636</u>
Basic and fully diluted loss per share under U.S. GAAP	<u>0.00</u>	<u>0.05</u>

(b) The reconciliation of the balance sheet between Canadian GAAP and U.S. GAAP is as follows:

	2007 \$	2006 \$
Warrants liability (iii)		
Canadian GAAP	-	-
U.S. GAAP	3,439,236	-
Goodwill (iv)		
Canadian GAAP	-	-
U.S. GAAP	6,511,063	6,511,063

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(c) The reconciliation of shareholder's equity between Canadian GAAP and U.S. GAAP is as follows:

	Capital stock \$	Contributed surplus (i) \$	Warrants \$	Deficit (i), (iii) and (iv) \$	Total shareholders equity \$
Balance – June 30, 2006					
Canadian GAAP	47,360,750	9,463,102	1,020,279	(55,792,482)	2,051,649
U.S. GAAP	47,252,590	11,821,103	1,020,279	(51,531,260)	8,562,712
Balance – June 30, 2007					
Canadian GAAP	64,850,040	10,447,177	5,011,481	(58,372,272)	21,936,426
U.S. GAAP	64,741,880	12,805,178	-	(52,538,805)	30,019,734

(i) Stock-based compensation

Under US GAAP, effective October 1, 2006, the Company adopted Financial Accounting Standards Board Statement (“FAS”) 123(R) “Share-Based Payment”, a revision to FAS 123 “Accounting for Stock-Based Compensation.” FAS 123(R) requires the Company to recognize in the income statement the grant date fair value of share-based compensation awards granted to employees over the requisite service period. Compensation expense recognized reflects estimates of award forfeitures and any change in estimates thereof are reflected in the period of change.

Pursuant to the provisions of FAS 123(R), the Company applied the modified prospective transition method. Under this method, the fair value provisions of FAS 123(R) is applied to new employee share-based payment awards granted or awards modified, repurchased, or cancelled after October 1, 2006. Measurement and attribution of compensation costs for unvested awards at October 1, 2006, granted prior to the adoption of FAS 123(R) are recognized based upon the provisions of FAS 123(R), after adjustment for estimated forfeitures as discussed below.

Since the Company did not previously estimate forfeitures in the calculation of employee compensation expense under their previous policy, upon adoption of FAS 123(R), the Company determined the cumulative effect of a change in accounting principle to reflect the estimated forfeitures for unvested stock options outstanding at September 30, 2006 was immaterial for adjustment.

At June 30, 2007, the total compensation cost related to non-vested awards not yet recognized was \$510,841, which will be recognized over the remaining vesting period of 11 months.

Prior to FAS 123(R), the Company followed U.S. GAAP policy of FASB Statement No. 123 “Accounting for Stock-Based Compensation” (FAS 123), which are substantially harmonized with the Company's existing Canadian GAAP recommendations. Therefore, there were no GAAP differences for stock-based compensation and awards granted in fiscal 2006.

FAS 123 required the Company to provide pro forma information regarding net loss and loss per share as if compensation for the Company's stock option plans had been determined in accordance with the fair value based method prescribed in SFAS 123.

The weighted average fair value of options granted during the third quarter of fiscal 2007 was \$0.08 (2006 - \$0.04) and was calculated using the Black-Scholes option pricing model following the same assumptions disclosed under Canadian GAAP. The effect of pro forma compensation expense on the Company's loss and loss per share is as follows:

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	2007	2006
	\$	\$
Loss per U.S. GAAP	67,406	1,025,636
Stock-based compensation expense included in above	(167,963)	(97,284)
Stock-based compensation expense had the fair value method been applied to all awards	167,963	89,133
	<hr/>	<hr/>
Pro forma loss	67,406	1,017,485
	<hr/>	<hr/>
Pro forma basic and diluted loss per share	0.00	0.05
	<hr/>	<hr/>

(ii) Warrant Liability

Under US GAAP, the SEC determined that it is not possible to treat as equity, warrants whose exercise price currency denomination is different from the functional currency of the entity. The SEC generally views such instruments as derivative liabilities. Therefore the Company applied FAS No. 133, "Accounting for Derivative Instruments and Hedging Activities", and allocated the fair value of warrants issued whose exercise price currency denomination is different that the Company's functional currency as a liability, to be carried at fair value, with changes in fair value to be recorded in earnings. The change in fair value of these warrants for the period ended June 30, 2007 was \$1,572,245 and was charged to operations.

(iii) Redemption of Limited Partnership units

As described in note 7 of the Company's annual consolidated financial statements included in its Annual Report on Form 20-F, for Canadian GAAP purposes, the redemption of the Limited Partnership units was recorded as a charge to deficit. Under US GAAP, the Company applied SFAS No. 141, "Business Combinations", and allocated the cost of issuing the common shares and share purchase warrants to goodwill, after first considering any allocation to tangible and intangible assets acquired. This resulted in an increase of \$6,511,063 in goodwill and shareholders' equity. Under U.S. GAAP, goodwill is subject to an annual impairment test. The Company applies SFAS No. 142, "Goodwill and other intangible assets", in determining if there is any impairment in value. As at June 30, 2007, no impairment in value has been recorded to date.

(iv) Cash flow statement

The Canadian accounting standard for the preparation of cash flow statements is consistent with the guidance provided by International Accounting Standard (IAS) 7, and accordingly, the cash flow statements presented herein have not been reconciled to U.S. GAAP under the accommodation provided by the Securities and Exchange Commission of the United States (SEC).

(v) Accounts receivable

No allowance for doubtful accounts has been included in accounts receivable in third quarter of fiscal 2007 and 2006.

(vi) Commitments:

During the third quarter of fiscal 2007, the Company incurred operating lease expenses of \$30,443 (2006 - \$24,391).

(vii) Recent U.S. announcements

PhotoChannel Networks Inc.

Notes to Consolidated Financial Statements

Unaudited – Prepared by Management

(expressed in Canadian dollars)

SFAS accounting changes and error corrections

SFAS 159 "The Fair Value Option for Financial Assets and Financial Liabilities – Including an amendment of FASB Statement No. 115" permits entities to choose to measure many financial instruments and certain other items at fair value. The objective is to improve financial reporting by providing entities with the opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. This Statement is expected to expand the use of fair value measurement, which is consistent with the Board's long-term measurement objectives for accounting for financial instruments and becomes effective for fiscal years beginning on or after November 15, 2007. The Company has not yet determined the impact of this statement.

Staff Accounting Bulletin (SAB) 108 expresses the view of Securities Exchange Commissions (SEC) staff on prior year misstatements and their effect in current year financial statements. The bulletin addresses how the effects of the carryover or reversal of prior year misstatements should be considered in quantifying a current year misstatement and is effective for years ending after November 15, 2006. There was no impact on the Company's financial statements.

FASB Interpretation 48: Accounting for uncertainty in income taxes

Prescribes a recognition and measurement model for tax positions taken or expected to be taken in a tax return, and provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. Effective for fiscal years beginning after December 15, 2006. The Company is currently determining the impact, if any, of this interpretation.

FAS 157: Fair value measurements

FAS 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. These definitions would be applied effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. The Company is currently determining the impact of this statement.

(viii) Recent Canadian GAAP announcements

CICA HB 1506: Accounting changes

The revision establishes criteria for changing accounting policies, together with the accounting treatment and disclosure of changes in accounting policies and estimates, and correction of errors, replacing former CICA 1506. These changes are effective for interim and annual financial statements relating to years beginning on or after January 1, 2007. The Company does not expect this revision to impact the financial statements.

CICA HB Section 3031: Inventories

This revision aligns Canadian GAAP with International Financial Reporting Standards. It establishes four basic principles: Inventory should be measured at the lower of cost and net realizable value; the cost of inventory includes costs directly attributable to its acquisition as well as an appropriate portion of fixed and variable production overheads; if the units in inventory are interchangeable, their cost should be determined using either a FIFO or weighted average cost formula; and write-downs of inventory to its net realizable value should be reversed if the value subsequently recovers. This section applies to interim and annual financial statements for years beginning on or after January 1, 2008. The Company expects there to be minimal impact on the financial statements.

PhotoChannel Networks Inc.

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(expressed in Canadian dollars)

8. Subsequent events

On April 25, 2007, the Company announced that it had reached an agreement with the board of directors of Pixology PLC (“Pixology”) on a recommended all cash offer by the Company for all of the issued and to be issued shares of Pixology. On July 2, 2007 the Company announced that it had received acceptances from the holders of over 94% of the outstanding Pixology shares, and had determined to complete the acquisition of Pixology under the proposed terms originally announced on April 25, 2007. The Company will take-up Pixology shares as they are tendered by Pixology shareholders. The Company anticipates the acquisition of all Pixology shares will approximate \$17,650,000, which will be funded from existing cash. PhotoChannel assumed immediate control of Pixology effective July 2, 2007, at which time the Company acquired the current cash in Pixology which approximated \$8,100,000. As a result of this acquisition the Company’s client base has been expanded to include Tesco (online and kiosk solutions), Jessops (kiosk), Asda (Wal-Mart UK – online solution), Boots (online solution), and Costco US, Canada and Mexico (kiosk solution).

The Company’s allocation of the purchase price is not yet complete pending a review of what amounts should be allocated to deferred revenue, intangible assets and goodwill, if any.

As part of the Company’s previously announced private placement for total proceeds of \$15,064,000 (U.S.), which closed in two tranches on March 30 and April 2, 2007, the Company, concurrently with entering into the Share Purchase Agreement with the investors, entered into a Registration Rights Agreement with the investors. Under the Registration Rights Agreement, the Company agreed to file a preliminary prospectus in Canada and a registration statement in the United States by May 30, 2007, and a final prospectus in Canada and a registration statement in the United States by July 28, 2007 to qualify the re-sale of the shares and shares underlying the warrants sold to the investor(s). The Company filed the preliminary prospectus and registration statement on May 29, 2007, however, did not file the final prospectus and registration statement by July 28, 2007, and paid the investors an aggregate of US\$150,639.99 in liquidated damages. The final prospectus was filed and received on August 13, 2007 and registration statement on August 15, 2007.