

## MANAGEMENT DISCUSSION & ANALYSIS

### SECOND QUARTER 2007

This discussion and analysis is a review of the operating results, financial condition, and business risks of PhotoChannel Networks Inc. (“PhotoChannel” or the “Company”). This discussion should be read in conjunction with the Management’s Discussion and Analysis presented in PhotoChannel’s 2006 Annual Report and the consolidated financial statements and accompanying notes for the six months ended March 31, 2007 and 2006. The financial information reported herein has been prepared in accordance with Canadian Generally Accepted Accounting Principles (“GAAP”) and is presented in Canadian dollars, unless otherwise noted.

This discussion and analysis may contain forward-looking statements. Statements which are not historical facts reflect the Company’s views at May 30, 2007 with respect to future events and are subject to certain risks, uncertainties and assumptions. These risks and assumptions include, but are not limited to, changes in the market for our services, changes in the economy, increasing competition in our market, the risk of loss of current customers, risks related to changes in technology, employee retention, inability to deliver on contracts, failure of customers to adequately market the online photo-finishing services they provide, foreign exchange, and risks with respect to our financial capacity. These risks are set out in greater detail in our Form 20F filed for the year ended September 30, 2006, available on the SEC’s website at <http://www.sec.gov/edgar.shtml>. The Company’s actual results could differ materially from those expressed or implied by such forward-looking statements.

We are pleased to provide you with an update on the progress PhotoChannel made in its second quarter of fiscal 2007, represented by the period ended March 31, 2007.

#### Business Highlights

For Q2 – FY07 PhotoChannel reports that:

- Record revenues for the Company’s first six months of fiscal 2007 (the period ended March 31, 2007) of \$2,839,185, up 107% or \$1,465,326 over the corresponding period of 2006.
- Revenues were driven by an increase in transaction fees, which increased by 224% for the six month period ended March 31, 2007 over the corresponding period of fiscal 2006. Professional, membership and installation fees, also showed continued growth of 121%, 42% and 14%, respectively, over the corresponding second quarter of fiscal 2006.
- Organic transactional growth, from retailers using the PhotoChannel solution for over twelve (12) months, grew 139% during the second quarter of fiscal 2007 versus the corresponding quarter of fiscal 2006.
- It signed an agreement with Sears Holdings Corporations’ Kmart division and has launched Kmart’s online photo service, located at [www.kmart.com](http://www.kmart.com).
- It launched its integration with Windows Vista Online Print Wizard. The new service is currently live for all 6,000 plus CVS locations.
- It has partnered with Wal-Mart to launch the latest version of Wal-Mart Canada’s marketing-leading online photo service located at [www.walmartphotocentre.ca](http://www.walmartphotocentre.ca).

- It partnered with PhotoTHIS to launch a new photo gifting site for Red Hat Society, [www.redhatsociety.com](http://www.redhatsociety.com). The new Online Photo Gifting website is located at [www.redhatsocietystore.com](http://www.redhatsocietystore.com).
- It announced a private placement of 4.4 million Units at a price of US\$3.40 per Unit for total gross proceeds of US\$15,064,000. Each such Unit comprising one common share of the Company and one common share purchase warrant (“Warrant”). Each warrant entitling the purchase of one additional common share (“Warrant Share”) of the Company at a price of US\$4.00 per share for a period of two years from the date of close. The Warrants include an acceleration provision pursuant to which, if the volume weighted average price of the common shares over a period of 30 consecutive trading days exceeds US\$6.00 per share, the Company will have the right to accelerate the expiry of the Warrants to a date which is 20 business days after the date the Company provides written notice of the acceleration of the Warrant and on the Accelerated Expiry Date (i) the Warrants have been outstanding for at least four months and (ii) the Warrant Shares are the subject to a four month hold period in Canada which expires on July 31, 2007.

### Subsequent Events

- On April 25, 2007, it has reached an agreement with the board of director of Pixology PLC (“Pixology”) on a recommended all cash offer by the Company for all of the issued shares of Pixology for 40.0 pence per Pixology share (approximately Cdn\$0.90 per Pixology share).
- Eastman Kodak and CVS/pharmacy announced on May 22, 2007, that Kodak Gallery is now offering customers the ease and convenience of ordering digital prints through Kodak Gallery for same-day printing and pick-up at CVS/pharmacy locations nationwide. This new service is enabled by the PhotoChannel Network solution.

### RESULTS OF OPERATIONS

	Six month ended March 31, 2007	Six month ended March 31, 2006
Revenue	\$ 2,839,185	\$ 1,373,859
Loss from operations	(796,496)	(1,425,863)
Net loss	(754,735)	(1,421,261)
Basic and diluted net loss per share	\$ (0.03)	\$ (0.07)

The Company has four main sources of revenue derived from the provision of the PhotoChannel Network (the “Network”) to electronically connect photo-finishing retailers to their customers through the Internet: installation revenue; membership fees; transaction fees; and archive fees. For further information on the Company’s revenue recognition policies, see Critical Accounting Estimates, Revenue Recognition, below in this report.

Network revenue increased 107% to \$2,839,185 for the six month period ending March 31, 2007 compared to the same period last year. Revenue from Canadian retailers increased 69% or \$886,175 from the same period last year. The increase was attributable to three factors: organic growth in usage of the Network from customers of the Company’s photo-finishing retailers; the Company’s retailers commencing to print in-store; and additional customers using the Network. Revenue from US retailers

increased 704% or \$569,777 from the same period last year. This increase was primarily due to new customers using the Network and US retailers commencing to print in-store.

Increases were seen in transaction, professional, membership and installation fees, which increased 224%, 121%, 42% and 14%, respectively, for the period six months ending March 31, 2007. Transaction revenue for the six month period ended March 31, 2007 was up 224% from the comparable period of fiscal 2006 from \$543,673 to \$1,761,784. This quarter, transactional revenue comprised 54% of total revenue, up from 37% of total revenue during the second quarter of fiscal 2006. The Company believes that the increase in transactional revenue signals growing adoption of the use of the Network.

Professional fees were up 121% or \$85,816 from the corresponding six month period of fiscal 2006, as the Company provided more marketing assistance to its retailer base. Installation fees increased by 14% from the same period of fiscal 2006 from \$370,177 to \$423,119, as a result of customers connecting stores directly to the Network to facilitate in-store printing of photos and installation of CD burning devices in certain Wal-Mart locations, which will allow Wal-Mart to produce picture CD's in-store, as well as music CD's in the future. These installation fees are offset by the cost of installing the locations in the amount of \$339,082. As a result of past and new installations, membership fees also increased 42% or \$138,629 over the same period of fiscal 2006. With the increased number of installations, the Company expects to see membership fees remain constant or to increase as stores of new and existing customers continue to be connected to the Network.

The costs of operations for the six month period ended March 31, 2007 were \$3,635,681, up 30% or \$835,959 when compared to the same period of fiscal 2006. This increase was primarily attributable to: an increase in research and development as the Company continues to enhance its current product offering and develop a new music platform, and an increase in Network delivery costs as a result of installation of hardware and software upgrades.

Research and development expenses for the six months ended March 31, 2007 increased by \$350,474 to \$1,324,726, an increase of 36% from the comparable period of 2006. This increase was primarily due to an increase in staffing and consultants to develop the next generation multi-media Digital Content distribution platform and a stock-based compensation expense resulting from the distribution of stock options, as incentive, to the development team. The completion of the new platform allows the Company to offer both a one hour in-store printing solution and music component to existing and new customers.

Network delivery expenses for the six months ended March 31, 2007 increased by \$155,624 to \$771,908, an increase of 25% from the comparable period of 2006. This increase was primarily due to an increase of \$69,702 or 26%, related to the installation of lab systems required for direct to in-store printing and CD burning equipment. As well, customer service costs increased by \$26,104 to \$190,362, an increase of 16% from the comparable period of 2006 due to additional staffing required as transaction volume generated by the Company's new and existing customers increased.

General and administration expenses for six months ended March 31, 2007 increased by \$236,821 to \$937,574, an increase of 34% from the comparable period of 2006. This increase was primarily due to a charge for stock-based compensation, but also from increases in accounting and legal, office and miscellaneous, public company fees and rent, while being partially offset by a reduction in consulting fees paid.

Sales and marketing expenses for the six months ended March 31, 2007 increased by \$16,720 to \$368,776, an increase of 5% from the comparable period of 2006. This increase was primarily due to a charge for compensation expense, along with increases travel and miscellaneous, while being partially offset by a reduction in printing, advertising and promotion.

Amortization expense for the six months ended March 31, 2007 increased by \$76,320 to \$232,697, an increase of 49% from the comparable period of 2006. This increase was due to the purchase of additional equipment and software to handle the growing transactional volume, along with new PC's related to existing and additional staffing.

The Company recorded a six month net loss attributable to common shareholders of \$754,735 or \$0.03 per share compared to \$1,421,261 or \$0.07 per share in the same period last year. This decrease of 47% was primarily due to increases in revenues as the volume of network transactions conducted through the Network continues to increase.

### **Contingencies**

As of May 20, 2007, there were no legal proceedings material to the Company to which the Company or its subsidiaries are a party or to which their property is subject, nor to the best of the knowledge of management, are any such legal proceedings contemplated.

### **FINANCIAL CAPABILITY**

As at March 31, 2007, the Company had working capital of \$19,033,012 compared to working capital deficiency of \$571,412 as at March 31, 2006. The cash and cash equivalents on hand, including cash held in trust, at the period ended were \$20,702,651. As a start-up, which continues to strive for profitability, the Company's main source of funds to meet cash shortfalls has been, and may continue to be, the sale of equity capital. If additional capital is necessary and requisite funding on acceptable terms cannot be attracted in a timely fashion, the Company may be forced to delay activities and, possibly, lose market opportunities to competitors. Similarly, delayed financing could force reductions in planned marketing, product deployment and development expenditures, resulting in delays in meeting its business objectives. The Company does not have any immediate cash requirements for its ongoing operations.

The contractual obligations and payments due for each of the next three years have not materially changed from the Management's Discussion and Analysis presented in the 2006 Annual Report.

### **TAXATION AND OTHER NON-OPERATING ITEMS**

Since inception PhotoChannel has sustained significant tax losses and continues to strive to generate sufficient revenues to cover its operating costs in an industry characterized by rapid technological change.

### **FUTURE ACCOUNTING CHANGES**

In January 2005, the Canadian Institute of Chartered Accountants ("CICA") released new Handbook Section 3855, "Financial Instruments - Recognition and Measurement", effective for annual and interim periods beginning on or after October 1, 2006. This new section prescribes when a financial instrument is to be recognized on the balance sheet and at what amount, sometimes using fair value and other times using cost-based measure. It also specifies how financial instrument gains and losses are to be presented and defines financial instruments to include accounts receivable and payable, loans, investments in debt and equity securities, and derivative contracts. The Company is in the process of determining the impact of the adoption of this standard on its consolidated results of operations or financial position.

## **CRITICAL ACCOUNTING ESTIMATES**

PhotoChannel prepares its financial statements in accordance with GAAP. The preparation of consolidated financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Estimates are based upon historical experience and various other assumptions that are believed to be reasonable under the circumstances. These estimates are evaluated on an ongoing basis and form the basis for making judgments regarding the carrying values of assets and liabilities and the reported amount of revenues and expenses. Actual results may differ from these estimates under different assumptions.

### **Revenue recognition**

Revenue is earned from the provision of the PhotoChannel Network which enables photo-finishing retailers to electronically connect 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. Revenue for professional fees from development and marketing are recognized as the service is provided.

### **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.

## **BUSINESS RISKS**

The business risks described in the Management's Discussion and Analysis presented in the 2006 Annual Report have not materially altered.

## **MANAGEMENT'S STATEMENT OF RESPONSIBILITY**

The consolidated financial statements contained in this report have been prepared by management in accordance with generally accepted accounting principles and have been approved by the Board of Directors. The integrity and objectivity of the consolidated financial statements are the responsibility of management. In addition, management is responsible for all other information in this report and for ensuring that this information is consistent, where appropriate, with the information contained in the consolidated financial statements.

Management maintains a system of internal accounting controls to provide reasonable assurance that the Company's assets are safeguarded and accounted for, and to facilitate the preparation of relevant, reliable, and timely financial information. Where necessary, management uses its best judgment to make estimates required to ensure fair and consistent presentation of this information.

The Company's management, including the Chief Executive Officer and Chief Financial Officer, believe that any disclosure controls and procedures or internal controls and procedures, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. Because of the inherent limitations in all control systems, they cannot provide absolute assurance that all control issues and instances of fraud, if any, within the Company have been prevented or detected. These inherent limitations include the realities that judgments in decision-making can be faulty, and that breakdowns can occur because of a simple error or mistake. Additionally, controls can be circumvented by the individual acts of some persons, by collusion of two or more people, or by unauthorized override of the control. The design of any systems of controls also is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions. Accordingly, because of the inherent limitations in a cost effective control system, misstatements due to error or fraud may occur and not be detected.

There has been no change in the Company's internal control over financial reporting during the Company's second quarter of fiscal 2007, ended March 31, 2007 that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

The Board of Directors is responsible for ensuring that management fulfills its responsibilities for financial reporting and internal control, and exercises this responsibility principally through the Audit Committee. The Audit Committee includes three directors, two of whom are not involved in the daily operations of the Company. The functions of the Audit Committee are to review the quarterly and annual consolidated financial statements; review the adequacy of the system of internal controls; review any relevant accounting, financial and security regulatory matters; and recommend the appointment of external auditors.

## **QUARTERLY FINANCIAL INFORMATION**

The following table provides selected quarterly information for PhotoChannel's eight most recent quarters. This information is unaudited, but reflects all adjustments of a normal, recurring nature which are, in the opinion of management, necessary to present a fair statement of PhotoChannel's results of operations for the periods presented. Quarter-to-quarter comparisons of PhotoChannel's financial results are not necessarily meaningful and should not be relied upon as an indicator of future performance.

	Jun. 30, 2005	Sep. 30, 2005	Dec. 31, 2005	Mar. 31, 2006
Revenue	\$ 564,775	\$ 556,372	\$ 542,714	\$ 831,146
Net loss from operations	892,617	1,046,061	613,004	812,858
Net loss for the period	896,780	1,030,701	615,366	805,895
Basic and diluted net loss per share	\$ 0.01	\$ 0.01	\$ -	\$ -

  

	Jun. 30, 2006	Sep. 30, 2006	Dec. 31, 2006	Mar. 31, 2007
Revenue	\$ 1,310,520	\$ 1,390,771	\$ 1,521,262	\$ 1,317,923
Net loss from operations	1,044,524	168,774	54,390	742,106
Net loss for the period	1,025,636	185,404	37,191	717,544
Basic and diluted net loss per share	\$ -	\$ 0.01	\$ -	\$ 0.03

#### QUARTERLY REVENUE BREAKDOWN

	Jun. 30, 2005	Sep. 30, 2005	Dec. 31, 2005	Mar. 31, 2006
Revenue	\$	\$	\$	\$
Installation fees	245,846	153,236	79,017	291,160
Membership fees	132,093	142,276	158,655	170,358
Transaction commission fees	134,863	181,797	233,733	309,940
Archive fees	30,637	31,011	30,056	30,123
Professional fees	21,336	48,052	41,253	29,564
Total Revenues	564,775	556,372	542,714	831,145

	Jun. 30, 2006	Sep. 30, 2006	Dec. 31, 2006	Mar. 31, 2007
Revenue	\$	\$	\$	\$
Installation fees	472,639	397,114	143,063	280,056
Membership fees	196,607	225,788	232,479	235,163
Transaction commission fees	482,938	660,593	1,044,195	717,589
Archive fees	30,119	21,263	15,007	15,000
Professional fees	128,218	86,013	86,518	70,115
Total Revenues	1,310,521	1,390,771	1,521,262	1,317,923

**OUTSTANDING SHARE INFORMATION AS AT MAY 30, 2007**

**Authorized**

Common shares	Unlimited
Preferred shares	Unlimited

**Issued and outstanding**

Common shares	33,295,259
---------------	------------

<b>Options Outstanding</b>	1,644,808
----------------------------	-----------

<b>Warrants Outstanding</b>	4,857,147
-----------------------------	-----------

---

---

**Caveat**

The statements that are not historical facts contained in this release are forward-looking statements that involve risks and uncertainties. PhotoChannel's actual results could differ materially from those expressed or implied by such forward-looking statements. Factors that could cause or contribute to such differences include, but are not limited to, technological shifts, employee retention, contract inability to deliver on contracts, failure of customers to continue marketing the online solution, competition, general economic conditions, foreign exchange and other risks detailed in the Company's annual report and other filings. Additional information related to the Company can be found on SEDAR at [www.sedar.com](http://www.sedar.com).

**Notice of no auditor review of interim consolidated financial statements**

Under National Instrument 51-102, Part 4, subsection 4.3 (3)/(a), if an auditor has not performed a review of the interim financial statements, they must be accompanied by a notice indicating that the financial statements have not been reviewed by and auditor.

The interim consolidated financial statements of the Company, as at and for the period ended March 31, 2007, have been prepared by and are the responsibility of the Company's management.

The Company's independent auditor has not performed a review of these financial statements in accordance with standards established by the Canadian Institute of Chartered Accountants for a review of interim financial statements by an entity's auditor.

---

**ADDITIONAL INFORMATION**

Additional information related to the Company can be found on SEDAR at [www.sedar.com](http://www.sedar.com).