# PhotoChannel Networks Inc.

Management's Discussion & Analysis
For the Three Months Ended December 31, 2007

**February 29, 2008**

This discussion and analysis is a review of the operating results, financial condition, and business risks of PhotoChannel Networks Inc. ("PhotoChannel", the "Company", "we" or "our"). This discussion should be read in conjunction with the Management's Discussion and Analysis included in PhotoChannel's 2007 Annual Report and our consolidated financial statements and accompanying notes for the year ended September 30, 2007 and for the three months ended December 31, 2007. 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 our views at February 29, 2008 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. Our actual results could differ materially from those expressed or implied by such forward-looking statements.

## Business Highlights

*First quarter financial highlights*

- Total revenue for the quarter of $4,298,594 compared to $1,521,262 for the first quarter of 2007.
- Net loss for the period of $1,082,600 compared to $37,191 in same period of fiscal 2007.
- Non-GAAP net loss, excluding non-cash items (amortization and stock based compensation) of $117,483, compared to a non-GAAP net profit of $192,259 for the first quarter of 2007.
- Cash and cash equivalents at December 31, 2007 of $5,582,280.

*Operational highlights and subsequent events*

- Announced on November 13, 2007 that an agreement in principle had been reached with Costco USA to provide and operate their online photo service, commencing 2008.

- Migration of Costco data onto the Company's systems in preparation for PhotoChannel to begin providing services at an advanced stage as at February 29, 2008.

- Integration of Pixology operations into the PhotoChannel group progressing in line with expectations.

- PNI Connected Kiosk, the first product showcasing the integration of Pixology technology with PhotoChannel's market leading online photo platform showcased at the Photo Marketing Association, PMA 2008 Annual Convention between January 31 and February 2, 2008 in Las Vegas.

- Announcement on February 6, 2008 that an agreement has been signed with Sam's Club USA, a division of Wal-Mart Stores, Inc., to provide and operate the Sam's Club online photo service.

- Announcement on February 7, 2008 that the Company has signed an agreement with and recently launched online photofinishing services for Wal-Mart Argentina.

- Completed development of a second Canadian datacentre on or around February 15, 2007, which will allow the Company to better meet expected future growth.

## Business Overview

PhotoChannel has created and manages the open standard PhotoChannel Network environment. The PhotoChannel Network is currently utilized by major photofinishing retailers and wireless carriers to provide their consumers with online image printing and picture messaging services. There are more than 9,000 retail locations worldwide now fulfilling print and gifting items from digital images received through the PhotoChannel Network. For more information on the Company visit www.photochannel.com.

In addition to this, on July 2, 2007, the Company acquired all of the outstanding shares of Pixology PLC ("Pixology"). Pixology has created and manages a network environment similar to ours, but also has developed and manages a kiosk software solution. Pixology's solutions are now being used by more than 3,000 retail locations.

The Company provides its photofinishing retailers with a customer branded online solution, which allows consumers the ability to easily upload and order prints and gifting items from their digital images and pick up these products at the selected retailer location. The Company's kiosk software allows retailers' consumers to offload and print digital images and gifting products from their digital media in-store at retail locations.

PhotoChannel provides all of these services through two third-party hosting facilities, one of which is located in Canada and the other in the United Kingdom. The Company's infrastructure and models permit managed growth while keeping authority and responsibility within its operational teams that deliver the services.

Our strategy for growth is to:

- Contract or partner with established retail chains in the photofinishing industry;
- Contract or partner with web portals which offer their customers the ability to order prints and gifting products from our retail partners,
- Maintain service and product excellence for strong customer retention and development;
- Maintain a close relationship with our customers by providing marketing solutions that encourage new users to the online solution; and
- Provide a workplace conducive to attracting and retaining talented people.

## Seasonality of operations

Demand for photofinishing products is highly seasonal, with a significant proportion of recurring revenues being generated during the Company's first fiscal (fourth calendar) quarter. The Company's limited operating history, coupled with its rapid growth may have overshadowed seasonal or cyclical factors which might have influenced business to date. Due to the seasonal nature of our business, the results of operations for any interim period are not necessarily indicative of the results of operations to be expected for the fiscal year.

## Market Segmentation

The Company's only reportable segment is the provision of digital image delivery, hosting and storage for photofinishing retailers.

## Revenue by geographic region

Prior to the acquisition of Pixology, the Company's sales were primarily in Canada and the United States. The acquisition, however, has positioned the Company such that it is able to gain exposure to the United Kingdom marketplace through already established business arrangements and customer relationships. As a result of this, the percentage of total company revenue generated from North America has fallen from 99% in the first quarter of fiscal 2007 to 40% in the first quarter of fiscal 2008. 60% of the Company's revenue was earned in the United Kingdom during the period.

## Results from operations

## Revenue

| Description | Three Months Ended December 31, 2007 | Three Months Ended December 31, 2006 | Change | % Change |
|---|---|---|---|---|
| Transaction fees | $ 3,018,482 | $ 1,044,195 | $ 1,974,287 | 189 % |
| Installation fees | 973,063 | 143,063 | 830,000 | 580 % |
| Membership fees | 170,322 | 232,479 | (62,157) | (27) % |
| Professional fees | 136,727 | 86,518 | 50,209 | 58 % |
| Archive fees | - | 15,007 | (15,007) | (100) % |
| Total | $ 4,298,594 | $ 1,521,262 | $ 2,777,332 | 183 % |

Revenues for the first quarter of fiscal 2008 were $2,777,332 or 183% greater than in the same period of fiscal 2007. While a significant element of this was as a result of acquiring Pixology in the latter part of 2007, underlying revenue from existing operations prior to the acquisition have continued to increase period on period to $1,661,361, with the largest increase being seen in transaction based revenue.

Transaction fees represent 70% of total revenue for the first quarter of fiscal 2008 compared to 68% in fiscal 2007. Excluding the results of Pixology for the quarter, transaction fees represent 77% of the total revenue of the operations that were in existence prior to the acquisition and show a 23% increase over those generated during the first quarter of fiscal 2007. Growth in this area is in line with management's long-term goal of moving to a transactional fee based model and came primarily from continued organic growth in the usage of the PhotoChannel network by the customers of our retail partners. Pixology currently has a slightly different revenue model to that of PhotoChannel and in addition to earning revenue based on the level of activity over its network, earns a significant portion of its revenue from the licensing of kiosk software solutions. Transaction fees represented 66% of Pixology's total revenue for the quarter.

Installation fees increased by $830,000 in the first quarter of fiscal 2008 compared to fiscal 2007. This was due to the acquisition of Pixology and the revenue earned through them relating to license fees charged to customers that allow for continued use and access to kiosk software solutions. These license fees usually cover a defined period of time and are recognized into revenue over the period to which access to kiosk software solutions is provided. Installation fees in PhotoChannel were $69,885 lower in the first quarter of fiscal 2008 compared to fiscal 2007. This is a direct result of a number of our customers who were actively connecting their stores to the PhotoChannel Network during the first quarter of 2007, compared to 2008 where the level of activity in this area was lower due to the majority of our customer's sites already being connected.

Membership fees, representing monthly fixed fees charged to customers based on the number of locations they have connected to the PhotoChannel network decreased in the first quarter of fiscal 2008 compared to fiscal 2007 by 27% to $170,322. This decrease is a result of amendments made to contracts with certain customers since the first quarter of fiscal 2007 which reduce the amount charged each month on a per store basis but which places the Company in a position where it will be able to benefit from and share in, transactional growth achieved by those customers.

Professional fees have increased by 58% to $136,727 in the first quarter of fiscal 2008 compared to fiscal 2007 primarily as a result of a number of e-mail marketing campaigns carried out on behalf of a number of customers. We have seen that e-mail marketing by our retail partners leads to increases in the number of orders placed by their customers and a related increase in transactional fees to us. We expect to continue assisting our customers in the future in order to drive additional orders through the PhotoChannel Network.

No archive fees were earned during the period ending December 31, 2007. During the period ending December 31, 2006, archive fees of $15,007 were earned from one customer. Archive fees do not form a significant element of the revenue earned by the Company and are not expected to occur on a regular or systematic basis.

## Expenses

| Description | | Three Months Ended December 31, 2007 | | Three Months Ended December 31, 2006 | | Change | % Change |
|---|---|---|---|---|---|---|---|
| Network delivery | $ | 1,823,117 | $ | 330,320 | $ | 1,492,797 | 452 % |
| Research and development | | 1,494,036 | | 594,530 | | 899,506 | 151 % |
| General and administration | | 1,077,729 | | 390,414 | | 687,315 | 176 % |
| Sales and marketing | | 270,243 | | 150,421 | | 119,822 | 80 % |
| Amortization | | 789,657 | | 109,967 | | 679,690 | 618 % |
| Total | $ | 5,454,782 | $ | 1,575,652 | $ | 3,879,130 | 246 % |

Expenses increased by $3,879,130, or 246% during the first quarter of fiscal 2008 compared to fiscal 2007. 81% of this increase was as a result of the costs incurred by Pixology during the period. The remaining increase of 19%, or $743,903 was incurred by PhotoChannel.

Network delivery costs increased $1,492,797, or 452% during the first quarter of fiscal 2008. 93% or $1,387,978 of this increase can be attributed to costs incurred by Pixology during the period. The remaining $104,819 of increased costs, which were incurred by PhotoChannel, are as a result of an increase in customer service salaries of $228,000 as staff numbers were increased to better service the Company's growing customer base and an increase in e-mail marketing costs in line with the increase in revenue generated from this area. Offsetting these increases was a decrease in installation costs incurred, corresponding with the fall experienced in installation revenues during the period.

The main components of Pixology's network delivery costs relate to charges incurred for sending data over the internet and employee costs. The cost of sending data over the internet will vary depending on the level of transactions undertaken by customers of our retail partners.

Research and development expenses increased $899,506 or 151% period over period. 54% or $489,814 of this increase relates to costs incurred by Pixology. The remaining increase of $409,693 can be attributed to PhotoChannel, representing an increase of 69% in like for like expenditures in this area compared to the first quarter of fiscal 2007. This entire increase is due to increased salary and consulting costs incurred as a result of the Company successfully winning new business towards the latter part of fiscal 2007 and the early part of fiscal 2008 and having to incur costs up-front to develop the online solution to be provided to the customer. Up-front costs incurred in this way are recovered through the normal generation of revenue from customers throughout the term of the contract. The Company continues to contract with technology consultants, when necessary, to extend its operational capacity. These consultants augment our resource pool with specialists, as needed without the liability of longer-term commitment.

Research and development expenses incurred by Pixology consist of salary and consultant expenses. While an element of costs arose during the period as a result of dedicated full-time research and development employees, a proportion of the costs were incurred as a result of consultants being hired to work on the development of the next generation of kiosk software. Throughout the period, as the development of this second generation software was concluded, the services of certain consultants were no longer required and they left the Company. This led to a reduction in the monthly research and development costs towards the end of the period.

General and administration expenses increased $687,315 or 176% period over period. $492,054, representing 72% of this increase related to costs incurred by Pixology. Of the remaining $195,261 increase, $85,922 was as a result of increased accounting, audit, legal and investor relation fees, $45,595 due to an increase in non-cash stock based compensation expense, a $25,639 increase in salary costs, $20,100 increase in travel expenses and $56,000 of increased office running costs. These period over period cost increases were offset by cost savings realized through the reduced use of contractors.

General and administration costs incurred by Pixology consist of salaries, legal and professional fees, rent and other office running costs. Rent expense for the quarter included a one-time cost of $77,000 relating to a break fee paid upon the early termination of the Company's property lease in the United Kingdom. The Company is currently in the process of sourcing new space to occupy through the current landlord which is expected to result in a lower monthly rental expense in future periods.

Sales and marketing expenses increased by 80% or $119,822 in the first quarter of fiscal 2008 compared to 2007. Costs incurred by Pixology during the quarter totaled $166,573, offsetting a period over period decrease of $45,751, or 31% by PhotoChannel. This decrease was as a result of lower salary and consulting costs incurred in the period, offset by a small increase in non-cash stock based compensation expense.

Sales and marketing costs incurred by Pixology relate primarily to salary and other employee costs.

Amortization increased by 618% period over period to $789,657. Approximately $544,000 of this increase relates to amortization of intangible assets acquired when the Company purchased Pixology. The remaining increase is a combination of amortization expense incurred by Pixology and a small increase seen by PhotoChannel as a result of assets acquired during the latter part of fiscal 2007.

**Cash flows**

The Company recorded cash outflows from operations of $806,778 during the three months ended December 31, 2007 compared to cash inflows of $204,248 during the same period in the prior year. The primary reason for this is changes seen in non-cash working capital items during the period, including an increase in accounts receivable and prepaid expenses and other current assets offset by a decrease in deferred revenue.

Cash outflows from investing activities were $786,526 during the current quarter, compared to $439,912 during the first quarter of fiscal 2007. This expenditure during the first quarter of 2008 represents a significant investment being made by the Company to establish a second Canadian datacentre located in Toronto, Ontario. The establishment of this second Canadian datacentre will span several months and is expected to be completed and operational by the end of March 2008. Once completed, it will provide the Company with the necessary capacity to meet expected growth over the foreseeable future.

Movements in foreign exchange rates impacted cash and cash equivalent balances in the current quarter by $258,266, primarily as a result of the operations of Pixology being conducted in the United Kingdom.

At December 31, 2007 the Company had cash and cash equivalents of $5,582,280 compared to $3,303,847 at December 31, 2006.

**Contingencies and commitments**

As of February 29, 2008, 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.

As at December 31, 2007, the Company had made commitments to purchase items of equipment with a cost of $3,004,824. This equipment will be used in the Company's new datacentre in Toronto, Ontario.

**Financial capability**

As at December 31, 2007, the Company had working capital of $3,104,663 compared to working capital of $4,117,841 as at December 31, 2006. The cash and cash equivalents on hand, at the period ended were $5,582,280.

The Company does not have any borrowing or debt facilities and settles its financial obligations out of cash and cash equivalents. The ability to do this relies on the Company collecting its accounts receivables in a timely manner and by maintaining sufficient cash on hand.

The Company manages liquidity risk through ongoing review of accounts receivable balances and the following up of amounts past due and the management of its cash and cash equivalents and their allocation between cash on hand and short-term deposit.

The Company began generating revenues in July 2001 through its Network solution. Since 2001, the Company has continued to grow its business through organic growth and signing of new contracts with large photofinishing retailers primarily in Canada and the United States.

During fiscal 2007, the Company completed its acquisition of Pixology. Pixology has excellent proven and tested in-store kiosk software which has been well received by its customers and which complements the technology developed by PhotoChannel. When we acquired Pixology, we stated that the acquisition would allow both companies access to an expanded customer base as part of the enlarged group and that by operating as a larger group would allow us to compete with major competitors more effectively than on an independent basis. We believe that this statement is being proven to be correct through our announcements in November 2007 regarding the agreement in principle with Costco USA to provide and operate the Costco online photo service to all Costco USA locations and our announcement in February, 2008 of the agreement signed with Sam's Club USA, a division of Wal-Mart Stores, Inc., to provide and operate the Sam's Club USA online photo centre.

Notwithstanding the above, the Company has a limited operating history and successful implementation of our business strategy depends 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 when required could affect our operations in the future.

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 2007 Annual Report.

**Related Party Transactions**

During the period ended December 31, 2007, the Company advanced loans to officers of the Company in the amount of $68,000 with interest payable at a rate of 7% per annum. Included in accounts receivable at December 31, 2007 is $68,761, comprising the principal amount and accrued interest. These loans fall due for repayment within one year from the date of issue. At September 30, 2007, an amount of $48,615 was due from an officer of the Company. This amount was repaid in full on October 25, 2007.

During the period ended December 31, 2007, the Company incurred legal fees of $22,558 (period ended December 31, 2006 - $29,082) for services provided by a law firm of which a director of the Company is a partner. Accounts payable and accrued liabilities at December 31, 2007 included $9,044 (September 30, 2007 $47,334) related to these services.

During the period ended December 31, 2007, the Company incurred expenses in relation to setting up e-mail marketing campaigns on behalf of a number of our retail customers of $23,860 (Period ending December 31, 2006 - $nil) with a company of which a director of the Company is Chairman and Chief Executive Office. Accounts payable and accrued liabilities at December 31, 2007 included $13,000 (September 30, 2007 - $nil) related to these services. The amounts charged were recorded at their exchange amount, which is the amount of consideration established and agreed to by the related parties and having normal trade terms.

**Income taxes**

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. In fiscal 2007, given sufficient uncertainty regarding the realization of future income tax assets, and in line with its current accounting practices, PhotoChannel determined that it was appropriate to take a full valuation allowance against the future income tax assets, rather than to recognize the future benefit of these assets in the financial statements.

## Condensed quarterly financial information

The following table provides selected quarterly information for our 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 our results of operations for the periods presented. Quarter-to-quarter comparisons of our financial results are not necessarily meaningful and should not be relied upon as an indicator of future performance.

| | Dec 31, 2007 | Sep 30, 2007 | Jun 30, 2007 | Mar 31, 2007 |
|---|---|---|---|---|
| Revenue | $ 4,298,594 | $ 3,399,181 | $ 1,272,962 | $ 1,317,923 |
| Net loss for the period | 1,082,600 | 3,677,850 | 1,639,651 | 717,544 |
| Basic and diluted loss per share | 0.03 | 0.11 | 0.06 | 0.03 |
| | **Dec 31, 2006** | **Sep 30, 2006** | **Jun 30, 2006** | **Mar 31, 2006** |
| Revenue | $ 1,521,262 | $ 1,390,771 | $ 1,310,520 | $ 831,146 |
| Net loss for the period | 37,191 | 185,404 | 1,025,636 | 805,895 |
| Basic and diluted loss per share | - | 0.01 | - | - |

## Quarterly revenue breakdown

| | Dec 31, 2007 | Sep 30, 2007 | Jun 30, 2007 | Mar 31, 2007 |
|---|---|---|---|---|
| Transaction fees | $ 3,018,482 | $ 2,252,270 | $ 809,469 | $ 717,589 |
| Installation fees | 973,063 | 787,581 | 151,752 | 280,056 |
| Membership fees | 170,322 | 199,045 | 199,395 | 235,163 |
| Professional fees | 136,727 | 145,286 | 97,342 | 70,115 |
| Archive fees | - | 14,999 | 15,004 | 15,000 |
| | $ 4,298,594 | $ 3,399,181 | $ 1,272,962 | $ 1,317,923 |
| | **Dec 31, 2006** | **Sep 30, 2006** | **Jun 30, 2006** | **Mar 31, 2006** |
| Transaction fees | $ 1,044,195 | $ 660,593 | $ 482,938 | $ 309,940 |
| Installation fees | 143,063 | 397,114 | 472,639 | 291,160 |
| Membership fees | 232,479 | 225,788 | 196,607 | 170,358 |
| Professional fees | 86,518 | 86,013 | 128,218 | 29,564 |
| Archive fees | 15,007 | 21,263 | 30,119 | 30,123 |
| | $ 1,521,262 | $ 1,390,771 | $ 1,310,521 | $ 831,145 |

## Outstanding share information

The following table provides outstanding share information for the Company as at December 31, 2007 and February 29, 2008.

| | Feb 29, 2008 | Dec 31, 2007 |
|---|---|---|
| **Authorized** | | |
| Common shares | Unlimited | Unlimited |
| Preferred shares | Unlimited | Unlimited |
| **Issued and outstanding** | | |
| Common shares | 33,335,238 | 33,335,238 |
| Preferred shares | - | - |
| **Options** | | |
| Outstanding | 1,579,563 | 1,579,563 |
| Exercisable | 1,418,192 | 1,377,238 |
| **Warrants** | | |
| Outstanding | 4,857,147 | 4,857,147 |
| Exercisable | 4,857,147 | 4,857,147 |

## Changes in accounting policies

During the period ended December 31, 2007, the Company adopted a number of new accounting standards.

*Capital Disclosures*

Effective October 1, 2007, the Company adopted the recommendations included in the Canadian Institute of Chartered Accountants ("CICA") handbook, section 1535, Capital Disclosures. The new standard requires disclosure of qualitative and quantitative information that enables users of financial statements to evaluate the Company's objectives, policies and processes for managing capital.

*Financial instruments*

On October 1, 2007, the Company adopted CICA Handbook Section 3862, Financial Instruments – Disclosures and section 3863, Financial Instruments - Presentation.

Section 3862 requires disclosure about the significance of financial instruments for an entity's financial position, the nature and extent of risks arising from financial instruments to which the entity is exposed and how the entity manages those risks.

Section 3863 establishes standards for presentation of financial instruments and non-financial derivatives.

Sections 3862 and 3863 replace Section 3861, Financial Instruments – Disclosure and Presentation.

The additional disclosures, required as a result of the adoption of these standards, have been included in Note 7, Financial Instruments of the consolidated financial statements for the three months ended December 31, 2007.

*Accounting Changes*

On October 1, 2007, the Company adopted the recommendations of CICA Section 1506 Accounting Changes. This Handbook section provides for expanded disclosures to be made relating to changes in accounting policies, accounting estimates and corrections of errors. Under the new standard, accounting changes should be applied retrospectively unless otherwise permitted or where impracticable to determine. As well, voluntary changes in accounting policy are made only when required by a primary source of GAAP or the change results in more relevant and reliable information. The Company has not had any such changes which impact the interim financial statements.

**Recent Canadian GAAP pronouncements**

In March 2007, the CICA issued Handbook Section 3031, Inventories, which has replaced Section 3030 with the same title. 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 first-in first-out 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 no impact on the consolidated financial statements as a result of implementing the requirements of this standard.

In February 2008, the CICA issued Handbook Section 3064, Goodwill and Intangible Assets which will replace Handbook Section 3062, Goodwill and Other Intangible Assets and Section 3450, Research and Development Costs. This revision aligns Canadian GAAP with International Financial Reporting Standards and establishes standards for the recognition, measurement, presentation and disclosure of goodwill and intangible assets. This section applies to fiscal years beginning October 1, 2008 and will be adopted by the Company on that date. Management is currently in the process of determining the impact of this standard on the Company's consolidated financial statements.

In January 2006, the CICA Accounting Standards Board ("AcSB") adopted a strategic plan for the direction of accounting standards in Canada. As part of that plan, accounting standards in Canada for public companies will be required to converge with International Financial Reporting Standards ("IFRS") for fiscal years beginning on or after January 1, 2011 with comparatives presented on the same basis. The impact of the transition to IFRS on the Company's consolidated financial statements has not yet been determined.

In January 2008, the CICA Emerging Issues Committee issued EIC 169, Determining whether a contract is routinely denominated in a single currency. This abstract provides guidance on how to interpret one particular requirement of CICA Handbook Section 3855, Financial Instruments – Recognition and Measurement relating to the accounting for contracts entered into which are denominated in a foreign currency. This abstract is applicable for interim and annual periods ending on or after March 2008 and must be applied retrospectively. The Company will adopt this abstract in the second quarter of fiscal 2008, commencing January 1, 2008. Management is currently in the process of determining the impact of this abstract on the Company's consolidated financial statements

## Recent US GAAP pronouncements

In September 2006, the Financial Accounting Standards Board ("FASB") issued 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 assessing the impact of this statement.

In February 2007, the FASB issued FAS No. 159, The Fair Value for Financial Assets and Financial Liabilities ("FAS No. 159"). FAS No. 159 permits entities to choose to measure financial assets and liabilities, with certain exceptions, at fair value at specified election dates. 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. A business entity shall report unrealized gains and losses on items for which the fair value option has been elected in earnings at each subsequent reporting date. FAS No. 159 is effective for the Company in fiscal years beginning October 1, 2008. The Company is currently evaluating the impact of FAS No. 159 on its consolidated financial position and results of operations.

## Critical accounting estimates

PhotoChannel prepares its financial statements in accordance with Canadian Generally Accepted Accounting Principles ("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.

*Stock-based compensation*

The Company grants stock options to directors, employees and consultants of the Company as an element of compensation. The cost of the service received as consideration is measured based on an estimate of fair value at the date of grant. The grant-date fair value is recognized as compensation expense over the related service period with a corresponding increase in contributed surplus. On exercise of stock options, consideration received together with the compensation expense previously recorded to contributed surplus is credited to share capital. The Company uses the Black-Scholes option pricing model to estimate the fair value of each stock option.

*Goodwill and intangible assets*

Intangible assets acquired both individually or with a group of other assets are initially recognized and measured at cost. The cost of a group of intangible assets acquired in a transaction, including those acquired in a business combination that meet the specified criteria for recognition apart from goodwill, is allocated to the individual assets acquired based on their relative fair values. Intangible assets with finite useful lives are amortized over their estimated useful lives. The amortization methods and estimated useful lives of intangible assets are reviewed annually. Intangible assets with indefinite useful lives are not amortized and are tested for impairment annually or more frequently if events or changes in circumstances indicate that the asset might be impaired. The impairment test compares the carrying amount of the intangible asset with its fair value, and an impairment loss would be recognized in income for the excess, if any.

Intangible assets with finite useful lives, including acquired software and customer relationships, are amortized over their estimated useful lives of three years.

Goodwill is the residual amount that results when the purchase price of an acquired business exceeds the sum of the amounts allocated to the assets acquired, less liabilities assumed, based on their fair values. Goodwill is allocated as of the date of the business combination to the Company's reporting units that are expected to benefit from the synergies of the business combination. Goodwill is not amortized and is tested for impairment annually or more frequently if events or changes in circumstances indicate that the asset might be impaired. Goodwill of the reporting unit is considered to be impaired when the carrying amount of the reporting unit exceeds its fair value. An impairment loss, if any, would be recognized as a separate line item in the statement of earnings.

The process of determining the nature and amount of the individual intangible assets calls for considerable use of judgment, and requires all parties involved to make estimates and assumptions regarding future cash flow projections, future operating costs and appropriate discount rates to be used in the calculations. These determinations impact the amount that is initially recorded as goodwill or other intangible assets and the amortization expense to be recognized in future periods over the estimated useful lives of the intangible assets. Changes in estimates and assumptions can affect the reported value of goodwill and other intangible assets with indefinite useful lives.

*Future income taxes*

The Company follows the asset and liability method of accounting for income taxes. Under this method, future income tax assets and liabilities are recognized for the expected future tax consequences attributable to differences between the tax basis of assets and liabilities and their respective reported amounts, and tax losses carried forward. The resulting changes in the net future income tax asset or liability are included in income. Future income tax assets and liabilities are measured using substantively enacted tax rates expected to apply to taxable income in the years in which temporary differences are expected to be recovered or settled. The effect on future income tax assets and liabilities of a change in tax rates is included in income when a change in tax rates is substantively enacted. Future income tax assets are evaluated periodically and if realization is not considered "more likely than not" a valuation allowance is provided.

At the end of the Company's latest fiscal year, it had non-capital losses for Canadian tax purposes of approximately $20,307,000 that are available for carry forward to reduce taxable income in future years. In addition, the Company had $25,600,000 (£12,600,000) of losses for tax purposes in the United Kingdom which are available to reduce taxable income in future periods. The Company believes there is sufficient uncertainty regarding the realization of future income tax assets such that a full valuation allowance is appropriate.

**Business risks**

PhotoChannel is subject to various risks and uncertainties that can significantly affect its financial performance. Key risks include the following:

*Market and competition*

There are inherent risks in the market for technological solutions. With the recent mass acceptance of the digital camera and camera cellular phone, the photography industry is quickly moving to employ an online technology, such as that offered by the Company. PhotoChannel's primary competition consists of very large, established corporations which can afford to meet the ever changing demands of this marketplace. To the extent that PhotoChannel does not have, or cannot continue to raise, the funds necessary to expand its market offering or to penetrate this market in a timely and cost effective manner, or achieve cost-effective pricing for its services, the Company's business growth could be adversely affected.

*Changes in technology*

The markets in which PhotoChannel operates are characterized by changing technology and evolving industry standards. The Company's ability to anticipate changes in technology, technical standards and service offerings is a significant factor in its ability to compete or expand into new markets. With limited experience in meeting customer requirements, there can be no assurance that the Company will be successful in continuing to identify, develop and market service offerings that will respond to technological change, evolving standards or individual customer standards and requirements.

*Dependence on key people*

PhotoChannel's growth and continued success depend on its ability to attract, retain, train and motivate highly skilled people. There can be significant competition for such people. There can be no assurance that the Company can retain its current key employees or attract and retain additional employees as needed. The loss of certain key employees could have an adverse impact upon the Company's growth, business and profitability.

*Potential for liability*

There is a risk that the Company's systems may contain errors or defects or fail to perform. The Company currently contractually limits its liability for damages arising from its provision of services. While this is true of the vast majority of the Company's contracts today, such limitations of liability may not have been included in all of the Company's contractual arrangements in the past. Where such limitations have been included, there can be no assurance that they will be enforceable in all circumstances and will protect the Company from liability for damages. Furthermore, litigation regardless of contracts could result in substantial cost to the Company, divert management's attention and resources from the Company's operation, and result in negative publicity that may impair the Company's ongoing marketing efforts.

*Currency exchange risk*

The Company has customers in the United States and the United Kingdom and is therefore exposed to fluctuations in the value of the U.S. dollar and U.K. pound against the Canadian dollar. At this time the Company does not employ a hedge program. However, if there is a material change in circumstances and if the Company's expansion into either the U.S. or U.K. marketplaces place results in either a significant increase in revenues or expenses, then the level of the Company's risks to changes in the exchange rate could become important. Monetary assets and liabilities denominated in a currency that is not the primary or functional currency of the related subsidiary are translated to the functional currency of the subsidiary at the rate of exchange in effect at the balance sheet date with any resulting gain or loss included in the statement of loss. The Company translates the assets and liabilities of self-sustaining foreign operations to Canadian dollars at the rate of exchange prevailing at the balance sheet dates. Gains and losses resulting from these translation adjustments for self-sustaining foreign operations are recorded in accumulated other comprehensive income, a component of shareholders' equity, until there is a realized reduction in the net investment in the foreign operation.

**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.

In response to management's assessment of internal control over financial reporting as of September 30, 2007 and the identification at that time of certain weaknesses, as documented in 'Management's Report on Internal Control Over Financial Reporting', which was included in the Company's consolidated financial statements for the year ended September 30, 2007, the Company took steps during the first quarter of fiscal 2008 to employ additional resources with financial reporting experience. In this regard, an offer of employment was made to an individual towards the end of the first quarter, which was accepted. This new person commenced employment with the Company during January 2008, reporting directly to the Chief Financial Officer. It is expected that in future months, the addition of this resource will allow the Company's internal controls over financial reporting to be improved.

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 four directors, three 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.

## Forward looking statements

This Management's discussion and analysis contains statements about expected future events and financial and operating results of PhotoChannel Networks Inc. that are forward-looking. By their nature, forward-looking statements require the Company to make assumptions and are subject to inherent risks and uncertainties. These forward-looking statements are based on current expectations. There is substantial risk that forward-looking statements will not prove to be accurate. Readers are cautioned not to place undue reliance on the Company's forward-looking statements as a number of factors including, but 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 could cause actual future results, conditions, actions or events to differ materially from targets, expectations, estimates or intentions expressed in the forward-looking statements; many of which are beyond the Company's control.

Future events and results may vary significantly from what the Company currently foresees. We are under no obligation to update or alter the forward-looking statements whether as a result of new information, future events or otherwise. For a more detailed discussion of factors that may affect actual results, see the section entitled "Business Risks".

## Additional information

Additional information related to the Company can be found on SEDAR at www.sedar.com and on the SEC's website at www.sec.gov/edgar.shtml