

Photochannel Networks Inc.

(formerly InMedia Presentations Inc.)

Consolidated Financial Statements
September 30, 1999 and 1998

December 10, 1999

Auditors' Report

To the Shareholders of Photochannel Networks Inc.

We have audited the consolidated balance sheets of **Photochannel Networks Inc.** (formerly InMedia Presentations Inc.) as at September 30, 1999 and 1998 and the consolidated statements of loss and deficit and cash flows for the years then ended. These financial statements are the responsibility of the company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the company as at September 30, 1999 and 1998 and the results of its operations and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles. As required by the British Columbia Company Act, we report that, in our opinion, these principles have been applied on a consistent basis.

PricewaterhouseCoopers LLP

Chartered Accountants

Photochannel Networks Inc.

(formerly InMedia Presentations Inc.)

Consolidated Balance Sheets

As at September 30, 1999 and 1998

	1999 \$	1998 \$
Assets		
Current assets		
Cash	152,855	—
Cash in trust (note 3)	—	165,420
Accounts receivable and prepaid expenses	12,476	113,196
Inventory	20,827	30,266
	<u>186,158</u>	<u>308,882</u>
Capital assets (note 4)	350,489	443,357
Other assets	73	73
	<u>536,720</u>	<u>752,312</u>
Liabilities		
Current liabilities		
Bank indebtedness (note 6)	—	105,539
Accounts payable and accrued liabilities	659,982	877,564
Note payable (note 7)	—	20,000
Convertible debenture (note 8)	177,083	250,000
	<u>837,065</u>	<u>1,253,103</u>
Shareholders' Deficiency		
Convertible notes (note 9)	—	168,950
Capital stock (note 10(a))	10,000,072	7,336,891
Special warrants (note 10(b))	—	97,000
Deficit	<u>(10,300,417)</u>	<u>(8,103,632)</u>
	<u>(300,345)</u>	<u>(500,791)</u>
	<u>536,720</u>	<u>752,312</u>

Nature of operations and going concern (note 1)

Approved by the Board of Directors

"Geoffrey Briant" Director

"Stuart McNeill" Director

Photochannel Networks Inc.
(formerly InMedia Presentations Inc.)
Consolidated Statements of Loss and Deficit
For the years ended September 30, 1999 and 1998

	1999	1998
	\$	\$
Revenues	160,560	356,321
Cost of sales	10,583	93,369
Gross profit	<u>149,977</u>	<u>262,952</u>
Operating expenses		
Research and development	647,803	820,363
Sales and marketing	247,078	1,345,766
General and administration	1,346,175	1,026,930
Amortization	115,181	176,481
	<u>2,356,237</u>	<u>3,369,540</u>
Loss from operations	2,206,260	3,106,588
Interest and other (income) expense	(9,475)	26,267
Employee loan written off (note 5)	—	93,150
Loss for the year	2,196,785	3,226,005
Deficit – Beginning of year	<u>8,103,632</u>	<u>4,877,627</u>
Deficit – End of year	<u>10,300,417</u>	<u>8,103,632</u>
Loss per share	<u>0.18</u>	<u>0.56</u>
Weighted average number of common shares outstanding	<u>12,112,461</u>	<u>5,724,653</u>

Photochannel Networks Inc.
(formerly InMedia Presentations Inc.)
Consolidated Statements of Cash Flows
For the years ended September 30, 1999 and 1998

	1999 \$	1998 \$
Cash flows from operating activities		
Loss for the year	(2,196,785)	(3,226,005)
Items not affecting cash		
Amortization	115,181	176,481
Loss on sale of capital assets	13,713	41,108
Employee loan written off	–	93,150
Interest on convertible debenture (note 8)	–	31,250
	<u>(2,067,891)</u>	<u>(2,884,016)</u>
Net change in non-cash working capital items	(107,423)	169,354
	<u>(2,175,314)</u>	<u>(2,714,662)</u>
Cash flows from investing activities		
Purchase of capital assets	(54,359)	(18,489)
Proceeds from sale of capital assets	18,333	9,350
	<u>(36,026)</u>	<u>(9,139)</u>
Cash flows from financing activities		
Note payable and convertible notes	(5,000)	188,950
Issuance of common shares – net of expenses	1,850,020	905,547
Convertible debenture	(72,917)	250,000
Issuance of special warrants	–	188,989
Conversion of share purchase warrants to common shares	532,211	–
	<u>2,304,314</u>	<u>1,533,486</u>
Increase (decrease) in cash	92,974	(1,190,315)
Cash – Beginning of year	59,881	1,250,196
Cash – End of year	<u>152,855</u>	<u>59,881</u>
Cash consists of:		
Cash	152,855	–
Cash in trust	–	165,420
Bank indebtedness	–	(105,539)
	<u>152,855</u>	<u>59,881</u>
Non-cash transactions consist of:		
Investing activities		
Net loans to employees (note 6)	–	125,000
Financing activities		
Shares issued in settlement of note payable	(15,000)	–
Repurchase of common shares	–	125,000
Shares issued on exercise of special warrants	97,000	–
Shares issued on conversion of convertible note	168,950	–

Photochannel Networks Inc.

(formerly InMedia Presentations Inc.)

Notes to Consolidated Financial Statements

September 30, 1999 and 1998

1 Nature of operations and going concern

Photochannel Networks Inc. (formerly InMedia Presentations Inc.) (the company) was incorporated on December 1, 1995 in British Columbia and commenced active business operations on January 1, 1996. Initially, the company was primarily engaged in the business of developing and marketing multimedia presentation software products.

During the year ended September 30, 1997, the company completed an initial public offering and, on April 21, 1997, obtained a public listing of its securities on the Montreal Exchange.

During the 1998 fiscal year, the company wound down the operations of its two wholly owned subsidiaries, InMedia Presentations America Inc. (IPA) and InMedia Presentations Europe Limited (IPE). IPA was incorporated in March 1997 in the State of Delaware, USA. It commenced active business operations in May 1997 and was primarily a sales support centre for the North American sales and marketing efforts of the company. IPE was incorporated in April 1997 in Ireland. It commenced active business operations in June 1997 and was responsible for call centre customer support in Europe.

During the year ended September 30, 1999, the company changed its name from InMedia Presentations Inc. to Photochannel Networks Inc. The company launched its new website which will provide an on-line medium for digital photo development and selling of its presentation software products.

At September 30, 1999, the company has a shareholders' deficiency of \$300,345 (1998 – \$500,791 deficiency) and current liabilities exceed current assets by \$650,908 (1998 – \$944,221). Subsequent to September 30, 1999, the company has raised \$543,000 (note 17), however, this is not expected to be sufficient to provide for ongoing operations during the coming year. Accordingly, the company will need to raise additional financing to carry on its operations and repay its creditors in the normal course of operations.

These consolidated financial statements have been prepared on the going concern basis. The company's ability to continue its operations is dependent upon the continued support of its shareholders, obtaining additional financing and generating revenues sufficient to cover its operating costs in an industry characterized by rapid technological change. There is no assurance that the company will be successful in achieving any or all of these objectives over the coming year and, accordingly, it is possible that the company will be unable to continue as a going concern.

2 Significant accounting policies

Basis of consolidation

These consolidated financial statements include the accounts of the company and each of its wholly owned subsidiaries, IPA and IPE.

Photochannel Networks Inc.

(formerly InMedia Presentations Inc.)

Notes to Consolidated Financial Statements

September 30, 1999 and 1998

Research and development

Research costs are expensed in the period incurred. Where, in the opinion of management, the deferral criteria established by the Canadian Institute of Chartered Accountants are satisfied in all material respects, development expenditures are capitalized and amortized over the estimated earning life of the related products. To date, no development expenditures have been capitalized.

Capital assets

Capital assets are recorded at cost less accumulated amortization. Amortization is charged over the estimated useful lives of the assets and is provided at the following annual rates:

Computer equipment	30% declining balance
Furniture and office equipment	20% declining balance
Software	100% straight line
Leasehold improvements	2% straight line

Amortization is calculated at one-half of the above rates in the year of acquisition, except for software which is depreciated 100% in the year of acquisition.

Inventory

Inventory consists of the company's software application *Slides and Sound Plus*. Inventory is stated at the lower of average cost and net realizable value.

Revenue recognition

The company recognizes revenue once proceeds are received for upgrades performed on customer's software.

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.

Financial instruments

Financial instruments are classified in accordance with the substance of the contractual arrangement. Financial liabilities, which are defined as any contractual obligation to deliver cash or another financial asset to another party, are classified as liabilities.

Loss per share

Loss per share figures are calculated using the weighted average number of shares outstanding during the year. Fully diluted loss per share information is not presented where the effect would be anti-dilutive.

Photochannel Networks Inc.

(formerly InMedia Presentations Inc.)

Notes to Consolidated Financial Statements

September 30, 1999 and 1998

Foreign currency translation

a) Foreign operations

The company's foreign subsidiaries are treated as integrated operations whereby monetary items are translated at the exchange rate in effect at the balance sheet date, non-monetary items at historical exchange rates, and revenue and expenses at average exchange rates for the year. Exchange differences arising on translation are included in income.

b) Foreign currency transactions and balances

Monetary assets and liabilities 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 income as they arise.

Use of estimates

The preparation of financial statements in conformity with generally accepted accounting principles 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. Actual results may differ from those estimates.

3 Cash in trust

Cash in trust balance as at September 30, 1999 is \$nil. Cash in trust of \$165,420 as at September 30, 1998 represented cash received from the issue of convertible notes (note 9). At September 30, 1998, release of cash in trust was subject to regulatory approval and this approval was received on October 6, 1998.

4 Capital assets

	1998		
	Cost	Accumulated amortization	Net
	\$	\$	\$
Computer equipment	530,141	211,694	318,447
Furniture and office equipment	147,105	39,714	107,391
Software	102,740	102,740	-
Leasehold improvements	25,027	7,508	17,519
	<hr/> 805,013	<hr/> 361,656	<hr/> 443,357 <hr/>

Photochannel Networks Inc.

(formerly InMedia Presentations Inc.)

Notes to Consolidated Financial Statements

September 30, 1999 and 1998

			1999
	Cost	Accumulated	Net
	\$	amortization	\$
		\$	
Computer equipment	527,807	287,768	240,039
Furniture and office equipment	157,466	59,529	97,937
Software	103,195	103,195	—
Leasehold improvements	25,027	12,514	12,513
	813,495	463,006	350,489

5 Employee loan written off

On November 1, 1996, the company entered into loan agreements with three officers of the company for \$125,000 each. The funds were used to purchase 50,000 common shares of the company at a price of \$2.50 per share. Each loan was repayable on or before the earlier of its five-year term ending November 15, 2001 and the termination of employment. During the year ended September 30, 1997, two of the officers resigned and the company accepted the 70,000 shares held as security in full settlement of the loans aggregating \$250,000.

During the year ending September 30, 1998, the company wrote off the remaining loan of \$125,000 accepting the 35,000 shares held as security in full settlement. The assigned value of the shares received was \$31,850, and the excess of cost over the carrying value of \$93,150 has been charged to income as this loan had previously been recorded as an asset by the company.

6 Bank indebtedness

At September 30, 1999, the company had a \$nil (1998 – \$150,000) revolving demand bank operating line, of which \$nil (1998 – \$15,000) was drawn on. This facility was collateralized by joint and several personal guarantees of two of the company's directors and shareholders and by a mortgage of \$170,000 on a real estate property owned by one of the directors and shareholders. No consideration was given by the company to these individuals in respect of the provision of this security. The operating line bears interest at prime plus 1.75%.

7 Note payable

The demand promissory note for \$20,000 bears interest at the Royal Bank of Canada of prime rate plus 3% per annum. In October 1998, \$5,000 of the outstanding balance was repaid in cash. In January 1999, the remaining \$15,000 was repaid by issuing 48,387 common shares of the company.

Photochannel Networks Inc.

(formerly InMedia Presentations Inc.)

Notes to Consolidated Financial Statements

September 30, 1999 and 1998

8 Convertible debenture

The convertible debenture has a five-year term and matures on March 1, 2003. Conversion is at the option of the holder at any time to maturity. The conversion rate is \$0.84 per share. Interest is at the Bank of Nova Scotia prime rate plus 4% or a minimum of 12% per annum, payable monthly. Security pledged consists of a subordinated floating charge on all assets of the company.

The company began payment on the principal amount of the convertible debenture on March 1, 1999. An amount of \$10,417 is payable monthly. However, as the company is in breach of certain covenants relating to the convertible debenture, allowing the holder to make immediate demand on the principal amount outstanding, the company has classified the entire principal amount as a current liability.

The convertible debenture is presented in its component parts. These components have been measured at their respective fair values at the time they were originally issued. Capital stock was increased by \$31,250 in 1998 (note 10) to reflect the equity component of the conversion option. A similar amount was recognized as the discount on the issue of the liability component and initially deducted from the face amount of the convertible debenture. Given that the convertible debenture was classified as a current liability, the discount was fully amortized in 1998, and the full face amount of the convertible debenture was shown as due for consolidated financial statement purposes.

9 Convertible notes

The convertible notes were issued to a director and an officer of the company in connection with a private offering in the year ending September 30, 1998 (note 10(a)(iii)). The notes were convertible into units of the company at a price of \$0.40 per unit upon approval of issuance by the shareholders at the next general meeting. If approval had not been received then the notes were payable in cash on the first business day after the general meeting. Approval of the issuance of the common shares was granted at the general meeting on March 10, 1999.

During the year ended September 30, 1999, the notes were converted into 422,375 common shares.

Photochannel Networks Inc.

(formerly InMedia Presentations Inc.)

Notes to Consolidated Financial Statements

September 30, 1999 and 1998

10 Capital stock and special warrants

a) Capital stock

Authorized

100,000,000 common shares without par value

Issued

	1999		1998	
	Shares	Amount \$	Shares	Amount \$
Balance – Beginning of year	9,849,888	7,336,891	5,622,336	5,098,880
Issued in the year				
Issued for cash	3,627,344	1,850,020	3,054,906	905,547
Shares issued on exercise of special warrants	121,250	97,000	1,207,646	1,333,064
Shares issued on exercise of share purchase warrants	1,330,527	532,211	–	–
Shares issued in settlement of note payable	48,387	15,000	–	–
Shares acquired in settlement of loans	–	–	(35,000)	(31,850)
Value of conversion option component of convertible debenture (note 8)	–	–	–	31,250
Shares issued on conversion of convertible notes	422,375	168,950	–	–
Balance – End of year	15,399,771	10,000,072	9,849,888	7,336,891

- i) During the year ended September 30, 1997, the company acquired 70,000 common shares in full settlement of repayable employee share purchase loans amounting to \$250,000. These shares were cancelled by the company. The assigned carrying value of the shares purchased was \$63,000 and the excess of acquisition cost over the carrying value of \$187,000 was charged to the deficit.

During the year ending September 30, 1998, the company accepted 35,000 shares held as security in full settlement of the remaining repayable employee share loan of \$125,000 (note 5).

- ii) Pursuant to private offerings during the year ended September 30, 1999, the company issued 3,627,344 common shares for gross proceeds of \$1,943,939 less offering expenses of \$93,919.

Photochannel Networks Inc.

(formerly InMedia Presentations Inc.)

Notes to Consolidated Financial Statements

September 30, 1999 and 1998

- iii) Pursuant to a private offering in the year ended September 30, 1998, the company issued 3,054,906 units for gross proceeds of \$947,021 less offering expenses of \$41,474. Each unit consists of one common share and one-half of a redeemable, transferable share purchase warrant. The holders thereof are entitled to exercise their warrants into an aggregate of 1,527,453 common shares for an additional consideration of \$0.40 per share. These warrants expired one year after issuance. During the year ended September 30, 1999, 1,330,527 warrants were exercised for 1,330,527 common shares. The 144,426 unexercised warrants expired.
- iv) During the year ended September 30, 1997, the company adopted a stock option plan. The options, which expire five years after the date granted, are subject to various vesting requirements as outlined in the plan.

During the year ended September 30, 1998, the exercise price of these options was reduced from a range of \$2.50 to \$4.50 per share to \$1.13 per share. During the year ended September 30, 1999, the exercise price was further reduced to \$0.50 per share.

At September 30, 1999, 3,138,000 (1998 – 270,000) options were granted over common shares and 3,138,000 (1998 – 2,462,472) common shares were reserved under the plan.

b) Special warrants

On September 29, 1997, the company filed for approval with the regulatory authorities an offering of up to 2,400,000 special warrants for maximum gross proceeds of \$3,000,000. Each special warrant is exercisable into one unit consisting of one common share and one redeemable, transferable share purchase warrant. Each share purchase warrant entitles the holder to acquire one additional common share for \$1.50 per share. The share purchase warrants expire one year after issuance. The company received regulatory approval on October 20, 1997, and completed a first closing of the offering, issuing 1,092,146 special warrants for gross proceeds of \$1,241,075 on that date.

During the year ended September 30, 1998, further closings of the offering were completed and the company issued a further 236,750 special warrants for gross proceeds of \$228,250. Subsequently, 1,207,646 special warrants were exercised, and accordingly, 1,207,646 common shares were issued. At September, 1998, 121,250 special warrants representing proceeds of \$97,000 remain unexercised. During the year ended September 30, 1999, the remaining 121,250 special warrants were exercised.

Photochannel Networks Inc.

(formerly InMedia Presentations Inc.)

Notes to Consolidated Financial Statements

September 30, 1999 and 1998

11 Income taxes

The company has accumulated tax losses that may be deducted from taxable income in future years. The potential tax benefit that may result from application of the losses is not reflected in these consolidated financial statements. Management's best estimate of tax losses is as follows:

	Amount \$	Year of expiry
Period ending September 30, 1996	594,800	2003
Year ending September 30, 1997	3,520,400	2004
Year ending September 30, 1998	2,629,900	2005
Year ending September 30, 1999	2,067,800	2006

12 Related party transaction

During the year ended September 30, 1999, the company paid consulting fees of approximately \$400,000 to three directors and an officer of the company. During the year ended September 30, 1998, the company paid consulting fees of approximately \$100,000 to a director and officer of the company. The consulting fees were incurred in the normal course of operations.

13 Operating lease arrangements

The company has entered into an agreement to lease premises for periods to 2002. The annual rent for premises includes minimum rent plus realty taxes and operating expenses. Minimum rent payable for each of the next three years is as follows:

	\$
2000	82,896
2001	82,896
2002	55,264
	<hr/>
	221,056
	<hr/>

14 Segmented information

The company derives all of its business and revenue from its software development and licensing operations in North America. All losses are attributable to this business segment.

Photochannel Networks Inc.

(formerly InMedia Presentations Inc.)

Notes to Consolidated Financial Statements

September 30, 1999 and 1998

15 Financial instruments

a) Fair values

The fair values of accounts receivable, bank indebtedness and accounts payable approximate their carrying amounts due to the near-term maturity of these instruments. The fair values of the convertible debenture has been omitted because it is not practicable to determine fair value with sufficient reliability.

b) Credit risk

The company does not have a significant exposure to any individual customer or counter party. The company reviews a new customer's credit history before extending credit and conducts regular reviews of its existing customers' credit performance.

16 Uncertainty due to the Year 2000 Issue

The Year 2000 Issue arises because many computerized systems use two digits rather than four to identify a year. Date-sensitive systems may recognize the year 2000 as 1900 or some other date, resulting in errors when information using year 2000 dates is processed. In addition, similar problems may arise in some systems which use certain dates in 1999 to represent something other than a date. The effects of the Year 2000 Issue may be experienced before, on, or after January 1, 2000, and, if not addressed, the impact on operations and financial reporting may range from minor errors to significant systems failure which could affect an entity's ability to conduct normal business operations. It is not possible to be certain that all aspects of the Year 2000 Issue affecting the company, including those related to the efforts of customers, suppliers, or other third parties, will be fully resolved.

17 Subsequent events

On October 27, 1999, the company received regulatory approval for the private placement of up to 836,154 units. On the same date, the company issued 836,154 common shares for gross proceeds of \$543,000. Each unit consists of one common share and one transferable common share purchase warrant. The holders thereof are entitled to exercise their warrants at an exercise price of \$1.00 per warrant share. The share purchase warrants expire one year after issue.

On October 28, 1999, a strategic alliance was established with ShopNow.com, a leader in business-to-business and business-to-customer e-commerce services. As a part of this strategic alliance, ShopNow.com subscribed for 812,722 common shares of the company for total proceeds of U.S. \$250,000. ShopNow.com was also granted the right to acquire additional common shares that have an aggregate value of U.S. \$5,000,000. The issuance is subject to regulatory approval and will only be issued in exchange for marketing services in accordance with a Marketing Services Agreement entered into between the two companies.

Photochannel Networks Inc.

(formerly InMedia Presentations Inc.)

Notes to Consolidated Financial Statements

September 30, 1999 and 1998

Subsequent to September 30, 1999 options to acquire 404,000 shares were cancelled upon the failure of two previous employees to exercise their options within 30 days following the termination of their employment.

The company's website opened an online camera store in November 1999. The website is not fully completed as not all of the products are available online. The expectation is that the website will be fully functional by the first quarter of calendar 2000.

18 Contingency

The company is currently involved in legal proceedings brought against it by the former president of the company and certain consultants engaged by the former president. The legal proceedings involve potential claims for unpaid services not exceeding \$150,000. The company is vigorously defending these proceedings; and is in the process of counter-claiming. Management is of the opinion that the claim is without merit, however, an amount of approximately \$58,000 has been provided for in the consolidated financial statements for this contingency liability.

