

**NOTICE THAT FINANCIAL STATEMENTS HAVE NOT BEEN REVIEWED BY AN AUDITOR**

**PhotoChannel Networks Inc.**  
**Interim Financial Statements for the period ended December 31, 2006**

The Issuer's auditors have not reviewed or been involved in the preparation of these financial statements.

# PhotoChannel Networks Inc.

## Consolidated Balance Sheets

Unaudited – Prepared by Management

(expressed in Canadian dollars)

	<u>December 31, 2006</u>	<u>September 30, 2006</u>
<b>Assets</b>		
<b>Current assets</b>		
Cash and cash equivalents	\$ 3,303,847	\$ 2,022,015
Accounts receivable	1,021,319	1,311,867
Inventory	84,937	80,190
Prepaid expenses	313,492	76,286
	<u>4,723,595</u>	<u>3,490,358</u>
<b>Capital assets</b>	1,565,734	1,235,789
<b>Deferred charges</b>	140,319	157,157
	<u>\$ 6,429,648</u>	<u>\$ 4,883,304</u>
<b>Liabilities</b>		
<b>Current liabilities</b>		
Accounts payable and accrued liabilities	\$ 1,194,380	\$ 1,221,948
Deferred revenue – current portion	163,759	179,647
	<u>\$ 1,358,139</u>	<u>\$ 1,401,595</u>
<b>Deferred revenue – long-term portion</b>	36,959	46,947
	<u>1,395,098</u>	<u>1,448,542</u>
<b>Shareholders' Deficiency</b>		
Capital stock	\$ 50,809,040	\$ 49,115,790
Contributed surplus	10,078,028	9,958,544
Warrants	162,559	338,314
Deficit	(56,015,077)	(55,977,886)
	<u>5,034,550</u>	<u>3,434,762</u>
	<u>\$ 6,429,648</u>	<u>\$ 4,883,304</u>

### Approved by the Board of Directors

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"Peter Fitzgerald" Director      \_\_\_\_\_ "Cory Kent" Director

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

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

	<b>Three Months Ended</b>	
	<b>December 31, 2006</b>	<b>December 31, 2005</b>
<b>Revenue</b>	\$ 1,521,262	\$ 542,714
<b>Expenses</b>		
General and administration	390,414	322,382
Sales and marketing	150,421	155,507
Network delivery	330,320	205,082
Research and development	594,530	395,659
Amortization	109,967	77,088
	<u>1,575,652</u>	<u>1,155,718</u>
Net loss from operations	(54,390)	(613,004)
<b>Other Income (loss)</b>		
Translation gain (loss)	(572)	(3,515)
Interest and miscellaneous income	17,771	1,153
	<u>17,199</u>	<u>(2,362)</u>
<b>Net loss for the period</b>	(37,191)	(615,366)
<b>Deficit - beginning of period</b>	(55,977,886)	(53,345,585)
<b>Deficit - end of period</b>	<u>\$ (56,015,077)</u>	<u>\$ (53,960,951)</u>
<b>(Loss) Gain per share attributable to common shareholders</b>	<u>\$ (0.00)</u>	<u>\$ (0.00)</u>
<b>Weighted average number of common shares outstanding</b>	<u>24,149,268</u>	<u>18,764,765</u>

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

# PhotoChannel Networks Inc.

## Consolidated Statements of Cash Flows

### Unaudited – Prepared by Management

(expressed in Canadian dollars)

	Three Months Ended	
	December 31, 2006	December 31, 2005
<b>Cash flows from operating activities</b>		
Net (loss) gain for the period	\$ (37,191)	\$ (615,366)
Items not affecting cash		
Amortization	109,967	77,088
Stock-based compensation expense	119,483	-
	192,259	(538,278)
Net change in non-cash working capital items	11,989	(353,302)
	204,248	(891,580)
<b>Cash flows from investing activities</b>		
(Purchase) Disposal of property, plant and equipment	(439,912)	(268,665)
	(439,912)	(268,665)
<b>Cash flows from financing activities</b>		
Issuance of common shares and warrants – net proceeds	-	1,533,000
Issuance of common shares on exercise of warrants and options	1,517,495	-
	1,517,495	1,533,000
<b>Increase (decrease) in cash during the period</b>	1,281,832	372,755
<b>Cash and cash equivalents - beginning of period</b>	2,022,015	187,318
<b>Cash and cash equivalents - end of period</b>	\$ 3,303,847	\$ 560,073

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

# **PhotoChannel Networks Inc.**

## **Notes to Consolidated Financial Statements**

### **Unaudited – Prepared by Management**

(expressed in Canadian dollars)

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#### **1. Summary of significant accounting policies**

##### **General**

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

In the opinion of management, all adjustments (which include reclassifications and normal recurring adjustments) necessary to present fairly the consolidated financial position, consolidated earnings, and consolidated cash flows as at December 31, 2006 and for all periods presented, have been made. The earnings for the three months ended December 31, 2006 are not necessarily indicative of the earnings for the full year ending September 30, 2007. All amounts herein are expressed in Canadian dollars unless otherwise noted.

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

##### **Nature of operations and going concern**

The company may have capital requirements in excess of its currently available resources. The company may be dependent upon the proceeds of future financings to further finance the development and implementation of its business objectives. While these unaudited interim consolidated financial statements have been prepared on the going concern basis, which assumes the realization of assets and the settlement of liabilities in the normal course of operations, there may be conditions that cast doubt on the validity of this assumption. The company's ability to continue its operations may be 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 in the foreseeable future.

Management is implementing a plan to address these uncertainties and to enable the company to continue as a going concern through the end of fiscal year 2007 and beyond. This plan may include obtaining debt or equity financing in amounts sufficient to sustain operations, expanding the company's customer base, and increasing revenues from operations. However, there is only a limited operating history with the existing business model, and there is no assurance that the necessary financing can be obtained or on what terms it may be obtained, if required. The accompanying financial statements do not include any adjustments, which may be material, to reflect the possible future effects on the recoverability and classification of assets or the amount and classification of liabilities that may result from the outcome of this uncertainty.

**PhotoChannel Networks Inc.**  
**Notes to Consolidated Financial Statements**  
**Unaudited – Prepared by Management**  
(expressed in Canadian dollars)

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**Research and development**

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

**Property, plant and equipment**

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

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

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

**Leases**

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

**Deferred charges**

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

# **PhotoChannel Networks Inc.**

## **Notes to Consolidated Financial Statements**

### **Unaudited – Prepared by Management**

(expressed in Canadian dollars)

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#### **Revenue recognition**

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

#### **Vendor consideration given to a customer**

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

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

#### **Share issue costs**

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

#### **Stock-based compensation plan**

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

# **PhotoChannel Networks Inc.**

## **Notes to Consolidated Financial Statements**

### **Unaudited – Prepared by Management**

(expressed in Canadian dollars)

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#### **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. Where a financial instrument contains both a debt and equity component, the instruments are presented at their component fair values at the time they were originally issued.

#### **Net loss per share**

Basic net earnings (loss) per share are computed using the weighted average number of common shares outstanding during the year. The treasury stock method is used for the calculation of diluted net earnings (loss) per share. Under the treasury stock method, the weighted average number of common shares outstanding for the calculation of diluted net earnings (loss) per share assumes that the proceeds to be received on the exercise of dilutive stock options and warrants are applied to repurchase common shares at the average market price for the period. Stock options and warrants are dilutive when the average market price of the common shares during the period exceeds the exercise price of the options and warrants.

#### **Foreign currency transactions and translation**

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

#### **Use of estimates and measurement uncertainty**

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

#### **Cash and cash equivalents**

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

**PhotoChannel Networks Inc.**  
**Notes to Consolidated Financial Statements**  
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(expressed in Canadian dollars)

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**Income taxes**

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

**Comparative amounts**

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

**2. Accounts receivable**

	<u>As at December 31, 2006</u>		<u>As at September 30, 2006</u>
Trade accounts receivable	\$ 1,021,319	\$	1,311,867
Total	<u>\$ 1,021,319</u>	<u>\$</u>	<u>1,311,867</u>

**3. Capital stock, stock options and loans receivable**

**a) Capital stock**

<b>Issued</b>	<u>As at December 31, 2006</u>		<u>As at September 30, 2006</u>
Common shares	27,204,038		26,048,359 <sup>(1)</sup>
Amount	\$ 50,809,040	\$	49,115,790

(1) On November 2, 2006, the Company implemented a consolidation of its common shares on a one-new-common-share-for-10-old-common-shares basis. This number has been adjust to reflect the post consolidated amount at September 30, 2006 for comparison purposes.

**PhotoChannel Networks Inc.**  
**Notes to Consolidated Financial Statements**  
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**(expressed in Canadian dollars)**

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**b) Options**

The Company has a stock option plan (the “Plan”) which is described in note 6 to the most recent audited consolidated financial statements for the year ended September 30, 2006. The Plan grants to directors and certain employees of the Company the option to common shares of the Company. The Plan allows for a maximum of 10% of the Company’s issued and outstanding common shares be reserved for issuance, less any previously outstanding options. As at December 31, 2006, the Company has reserved 2,706,120 common shares. The exercise price of each option is determined by the market price of the Company’s stock on the date of the grant and an options’ maximum term is five years. Options generally vest over eighteen (18) months. During the three months ended December 31, 2006, 745,000 options (2005 – nil) were granted to employees.

**4. Business segment information**

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

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

<b>Revenue</b>	<b>Canada</b>	<b>US</b>	<b>Other</b>
For the three months ended December 31, 2006	\$ 1,129,220	\$ 383,178	\$ 8,864
For the three months ended December 31, 2005	\$ 514,499	\$ 27,841	\$ 374

Revenue is attributable to the geographic location of the Company’s customer. As at December 31, 2006 and 2005, all of the Company’s property, plant and equipment were located in Canada.

**5. Revenue**

<b>Description</b>	<b>Three Months December 31, 2006</b>	<b>Twelve Months September 30, 2006</b>
Installation fees	\$ 143,063	\$ 1,239,930
Membership fees	232,479	751,408
Transaction commission fees	1,044,195	1,687,204
Archive fees	15,007	111,561
Professional fees	86,518	285,048
<b>Total</b>	<b>\$ 1,521,262</b>	<b>\$ 4,075,151</b>

**PhotoChannel Networks Inc.**  
**Notes to Consolidated Financial Statements**  
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(expressed in Canadian dollars)

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**6. Expense details**

	<b>December 31, 2006</b>
<b>General and administration</b>	
Accounting and legal	\$ 30,876
Investor relations	8,394
Office and miscellaneous	66,007
Public company fees	12,785
Salaries	112,948
Consulting	71,731
Stock-based compensation expense	52,144
Interest	74
Rent	35,455
	<u>\$ 390,414</u>
<b>Sales and marketing</b>	
Salaries	\$ 65,624
Consulting	50,444
Printing, advertising and promotion	-
Travel and Miscellaneous	19,235
Stock-based compensation expense	15,118
	<u>\$150,421</u>
<b>Network Delivery</b>	
Telecommunication costs	\$ 50,532
Customer Service	90,085
Lab system installation	124,682
Other	63,370
Stock-based compensation expense	1,651
	<u>\$ 330,320</u>
<b>Research and development</b>	
Salaries	\$ 268,544
Consulting	236,428
Miscellaneous	38,988
Stock-based compensation expense	50,570
	<u>\$ 594,530</u>