



photochannel™

PHOTOCHANNEL NETWORKS INC.

2nd Quarter Report

March 31, 2001

PhotoChannel Networks Inc.
Consolidated Balance Sheet
(Expressed in US Dollars)
(Unaudited - Prepared by Management)

ASSETS	<u>March 31, 2001</u>	<u>March 31, 2000</u>
Current assets		
Cash and cash equivalents	\$ 1,610	\$ 121,670
Short term deposits	6,279	-
Accounts receivables	130,538	1,117,123
Inventory	106,477	11,326
Prepaid expenses & deposits	87,101	23,369
	<u>332,005</u>	<u>1,273,488</u>
Capital assets, cost	4,722,423	598,924
Less amortization	(1,158,617)	(347,549)
	<u>3,563,806</u>	<u>251,375</u>
Intangible assets	1,428,246	334,961
	<u>\$ 5,324,057</u>	<u>\$ 1,859,824</u>
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities		
Trade accounts payable	\$ 2,595,371	\$ 394,082
Accrued liabilities	36,786	-
Current portion of obligation under capital lease	177,069	-
	<u>2,809,226</u>	<u>394,082</u>
Long term obligation under capital lease	181,266	-
Shareholders' equity		
Capital stock	12,140,472	7,681,778
Special warrants	6,066,561	-
Warrants	3,057,063	-
Convertible notes	100,462	1,855,798
Deficit	(19,030,993)	(8,071,834)
Total shareholder's equity	<u>2,333,565</u>	<u>1,465,742</u>
	<u>\$ 5,324,057</u>	<u>\$ 1,859,824</u>

See accompanying notes to the consolidated financial statements

Consolidated Statements of Loss and Deficit
(Expressed in US Dollars)
(Unaudited - Prepared by Management)

	Quarter Ended		Six Months Ended	
	March 31, 2001	March 31, 2000	March 31, 2001	March 31, 2000
Revenue				
Product Sales	\$ 2,711	\$ 25,840	\$ 18,431	\$ 45,581
Photofinishing	9,281	-	15,154	-
Net Revenues	11,992	25,840	33,585	45,581
Cost of goods sold	18,009	1,919	33,558	3,513
Gross profit	(6,017)	23,921	27	42,068
Operating expenses				
Research & development	323,619	234,045	683,049	332,978
Sales & marketing	292,015	(33,660)	1,184,752	78,376
General & administration	1,879,010	462,964	4,382,118	652,501
Amortization	1,310,198	14,827	1,724,705	29,460
Total expenses	3,804,842	678,176	7,974,624	1,093,315
Loss from operations	(3,810,859)	(654,255)	(7,974,597)	(1,051,247)
Interest and miscellaneous income	(11,369)	8	28,725	75
Loss for the period	(3,822,228)	(654,247)	(7,945,872)	(1,051,172)
Translation Loss	(152,766)	543	(130,784)	(203)
Deficit, beginning of period	(15,804,364)	(7,418,130)	(11,702,702)	(7,020,459)
Deficit, end of period	\$ (19,779,358)	\$ (8,071,834)	\$ (19,779,358)	\$ (8,071,834)
Loss per share for the period	\$ 0.13	\$ 0.04	\$ 0.26	\$ 0.06
Weighted average number of common shares outstanding	30,464,393	16,143,046	30,464,393	16,143,046

PhotoChannel Networks Inc.
Consolidated Statements of Cash Flows
(Expressed in US Dollars)
(Unaudited - Prepared by Management)

	Six Months Ended	
	March 31, 2001	March 31, 2000
Cash flows from operating activities		
Loss for the period	\$ (7,945,872)	\$ (1,051,172)
Items not affecting cash		
Amortization	1,724,705	29,460
Net change in non-cash working capital items		
Accounts receivable	266,282	(1,117,123)
Inventory	(79,278)	2,989
Prepaid expenses & deposits	582,561	(14,794)
Trade accounts payable	1,706,223	(21,329)
Accrued liabilities	(34,338)	(38,215)
	(3,779,717)	(2,210,184)
Cash flows from investing activities		
Purchase of capital assets	(831,626)	(40,045)
Short term deposits	496,202	-
Website development costs	-	(334,961)
	(335,424)	(375,006)
Cash flows from financing activities		
Issuance of convertible notes	100,462	1,734,083
Obligation under capital lease	(28,888)	-
Issuance of common shares, net of expenses	673,181	866,026
Translation Adjustment	(111,952)	2,570
	632,803	2,602,679
Increase in cash during the period	(3,482,338)	17,489
Cash, beginning of period	3,483,948	104,181
Cash, end of period	\$ 1,610	\$ 121,670

PhotoChannel Networks Inc.
Notes to Consolidated Financial Statements
(Expressed in US Dollars)
(Unaudited - Prepared by Management)

Unaudited information

The balance sheet as at March 31, 2001 and the statements of loss and deficit, and cash flows for the six months ended March 31, 2001 and 2000, including the related notes, are unaudited. This unaudited information reflects all adjustments that are, in the opinion of management, necessary to present a fair statement of the results for the interim periods presented. All such adjustments are of a normal recurring nature.

PhotoChannel Networks Inc. ("PhotoChannel" or the "Company") is an e-commerce and Internet infrastructure company catering to members of The PhotoChannel Network to meet the needs of their film and digital photography customers. The Company is headquartered in Vancouver, British Columbia, Canada and trades on the Montreal Exchange in Canada (symbol-PNI) and quoted on the OTC-BB (symbol- PHCHF) in the United States.

Company highlights during the quarter include

- On January 3, 2001, the company announced that wolfXpress, a wholly owned subsidiary of Wolf Camera Inc, would be available as the camera and photography product fulfillment source for PhotoChannel customers and available as an option for members of The PhotoChannel Network.
- On January 4, 2001, the company announced wolfXpress.com, a wholly owned subsidiary of Wolf Camera Inc operating 550 specialty photo retail locations across the US, will become a member of The PhotoChannel Network. Membership in The PhotoChannel Network will allow PhotoChannel to list wolfXpress as a print fulfillment member of the Network and will make available to customers of PhotoChannel and other members of The PhotoChannel Network the option of ordering prints and other photofinishing products from wolfXpress.
- On January 22, 2001, the company announced that the Photographic Research Organization Inc. (PRO), a cooperative group of North America's leading independent photo specialty retailers representing over 400 storefront locations nationwide, has issued a letter of intent to select PhotoChannel to develop and deploy the PRO Online Imaging Network in conjunction with The PhotoChannel Network.
- On March 16, 2001, the company announced that it has reorganized the operational management team and its board of directors. Both the Chairman of the Board, President & CEO and the Vice President, Chief Strategy Officer & General Counsel have resigned along with two other board members. Peter Scarth has taken on the position of Chairman and CEO and Kyle Hall has been promoted to President and COO of the Company.
- On March 29, 2001, the company announced that the company has made significant strides in its restructuring plan. Steps completed include the negotiation of a bridge loan from senior management and prominent shareholders. The funds from this bridge loan will assist the company in meeting its short-term financial obligations. In order for the company to meet its long-term financial obligations, further financing is necessary. In addition the company has taken steps to reduce its operation costs including reducing its employee count by 50 per cent.

Results of Operations

Revenue for the second quarter ended March 31, 2001 was \$11,992 versus \$25,840 the same quarter last year. Year to date revenue for the six months ended March 31, 2001 was \$33,585 versus \$45,581 for the six months ended March 31, 2000. Revenue decreased 26% from the six months ended March 31, 2000 due to Slides & Sound Plus no longer being sold as of January 31, 2001. Revenue generated from the online photo print service has not grown as quickly as had been expected.

Managements' strategy for the Company as an e-commerce and internet infrastructure company is to generate substantially all future revenue from fees charged to members of The PhotoChannel Network.

The Company recorded a quarterly loss of \$3,822,228 (\$0.13 per share) compared to a loss of \$654,247 (\$0.04 per share) in the same quarter last year. The year-to-date loss for the six months ended March 31, 2001 was \$7,945,872 (\$0.26 per share), an increase of 656% as compared to the 2000 year-to-date loss of \$1,051,172 (\$0.06 per share). The increase in the net loss is a result of increased expenditures for a sales and marketing campaign and administration and operation expenditures required with the commercial launch of PhotoChannel's online photo print service and the write down of the value of the certain assets.

During the quarter ended March 31, 2001, the Company has expensed almost \$320,000 of research & development costs, and for the current six-month period, these expenses have increased 105% over the same period last year to

\$683,049. This increase is a result of, among other things, the costs associated with additional staffing and consultants.

Sales and marketing expenses increased \$1,106,376 to \$1,184,752, a 1412% increase over the comparable six months of 2000. This increase was due to the launch of an advertising campaign introducing PhotoChannel's new online photo print service.

General and administration expenses for the second three months of fiscal 2001, increased 306% over the comparable period in 2000 to the result of higher legal expenses, travel expenses, salary and consulting expenses, and general corporate administration associated with the commercial launch of the Company's online photo print service.

During the quarter ended March 31, 2001, the company has written the value of some of its assets down by almost \$870,000.

As at March 31, 2001, the Company had a working capital deficiency of \$2,477,221 compared to a working capital surplus of \$879,405 at March 31, 2000. The cash on hand at March 31, 2000 was \$1,610. As a start-up company without any predictable revenue stream, the Company's main source of funds has been, and will continue to be for some time, the sale of equity capital.

Subsequent Events

Since the change of management control on March 16, 2001, the company has focused its operational efforts on deploying the PhotoChannel Network within retail partner locations. The on-line photofinishing operation located at www.photochannel.com, while still being functionally active, has ceased to be the major focus of the company's go forward plan. The cash savings from the decrease in personnel and the elimination of costs associated with driving new customers to a business to consumer website has been substantial.

"Peter Scarth"

Peter Scarth
Chairman & CEO

May 30, 2001

"Kyle Hall"

Kyle Hall
COO & President