

PhotoChannel Networks Inc.

Consolidated Financial Statements
September 30, 2006, 2005 and 2004
(expressed in Canadian dollars)

Auditors' Report

To the Shareholders of PhotoChannel Networks Inc.

We have audited the consolidated balance sheets of **PhotoChannel Networks Inc.** as at September 30, 2006 and 2005 and the consolidated statements of shareholders' equity (deficiency), loss and deficit and cash flows for each of the years in the three-year period ended September 30, 2006. 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 generally accepted auditing standards in Canada. 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, 2006 and 2005 and the results of its operations and its cash flows for each of the years in the three-year period ended September 30, 2006 in accordance with generally accepted accounting principles in Canada.

(signed) PricewaterhouseCoopers LLP

Chartered Accountants

Vancouver, B.C., Canada
December 11, 2006

PhotoChannel Networks Inc.

Consolidated Balance Sheets

As at September 30, 2006 and 2005

(expressed in Canadian dollars)

	2006 \$	2005 \$
Assets		
Current assets		
Cash and cash equivalents	2,022,015	187,318
Accounts receivable (note 3)	1,311,867	417,766
Prepaid expenses	156,476	133,093
	<u>3,490,358</u>	<u>738,177</u>
Property, plant and equipment (note 4)	1,235,789	870,075
Deferred charges	<u>157,157</u>	<u>-</u>
	<u>4,883,304</u>	<u>1,608,252</u>
Liabilities		
Current liabilities		
Accounts payable and accrued liabilities (note 5)	1,221,948	1,138,203
Deferred revenue - current portion	179,647	181,140
	<u>1,401,595</u>	<u>1,319,343</u>
Deferred revenue - long-term portion	<u>46,947</u>	<u>6,900</u>
	<u>1,448,542</u>	<u>1,326,243</u>
Shareholders' Equity		
Capital stock (note 6)	49,115,790	43,625,343
Contributed surplus	9,958,544	9,303,378
Loans receivable (note 6)	-	-
Warrants (note 6)	338,314	698,873
Deficit	<u>(55,977,886)</u>	<u>(53,345,585)</u>
	<u>3,434,762</u>	<u>282,009</u>
	<u>4,883,304</u>	<u>1,608,252</u>
Nature of operations and going concern (note 1)		
Commitments (note 15)		
Approved by the Board of Directors		
_____ (signed) Peter Fitzgerald _____ Director	_____ (signed) Cory Kent _____ Director	

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

PhotoChannel Networks Inc.

Consolidated Statements of Shareholders' Equity (Deficiency)

For the years ended September 30, 2006, 2005 and 2004

(expressed in Canadian dollars)

	Capital stock				Other capital accounts					
	Number of shares	Amount \$	Contributed surplus \$	Loans receivable \$	Number of warrants	Amount \$	Number of Limited Partnership units	Amount \$	Deficit \$	Total shareholders' equity (deficiency) \$
Balance - September 30, 2003	127,313,538	31,826,678	6,976,915	(122,206)	13,294,471	2,168,522	1,610	-	(40,176,059)	673,850
Issuance of shares for cash from exercised options	1,080,333	162,050	-	-	-	-	-	-	-	162,050
Private placement of 9,600,000 units	9,600,000	794,575	-	-	9,600,000	279,176	-	-	-	1,073,751
Shares and warrants issued on redemption of Limited Partnership units	16,100,000	4,242,000	-	-	13,650,000	2,269,063	(1,610)	-	(6,511,063)	-
Shares issued on exercise of warrants relating to Limited Partnership	13,150,000	3,500,949	-	-	(13,150,000)	(2,185,949)	-	-	-	1,315,000
Expiry of Limited Partnership warrants	-	-	83,114	-	(500,000)	(83,114)	-	-	-	-
Shares issued on exercise of warrants	9,103,470	1,176,352	-	-	(9,103,470)	(259,045)	-	-	-	917,307
Employee loan	-	-	-	104,606	-	-	-	-	-	104,606
Loss for the year	-	-	-	-	-	-	-	-	(3,052,485)	(3,052,485)
Balance - September 30, 2004	176,347,341	41,702,604	7,060,029	(17,600)	13,791,001	2,188,653	-	-	(49,739,607)	1,194,079
Issuance of shares for cash from exercised options	385,000	57,750	-	-	-	-	-	-	-	57,750
Modification of existing warrants (note 6)	-	-	-	-	-	144,000	-	-	(144,000)	-
Stock-based compensation adjustment (note 2)	-	-	314,011	-	-	-	-	-	(314,011)	-
Compensation expense for options vested	-	-	124,338	-	-	-	-	-	-	124,338
Private placement of 24,973,500 units	24,937,500	1,589,718	-	-	12,468,750	258,791	-	-	-	1,848,509
Expiry of warrants	-	-	1,805,000	-	(2,100,001)	(1,805,000)	-	-	-	-
Shares issued on exercise of warrants	1,845,000	275,271	-	-	(1,845,000)	(87,571)	-	-	-	187,700
Employee loan	-	-	-	17,600	-	-	-	-	-	17,600
Loss for the year	-	-	-	-	-	-	-	-	(3,147,967)	(3,147,967)
Balance - September 30, 2005	203,514,841	43,625,343	9,303,378	-	22,314,750	698,873	-	-	(53,345,585)	282,009
Compensation expense for options vested	-	-	215,084	-	-	-	-	-	-	215,084
Private placement of 44,500,000 units	44,500,000	3,735,406	-	-	22,250,000	338,314	-	-	-	4,073,720
Expiry of warrants	-	-	440,082	-	(9,846,000)	(440,082)	-	-	-	-
Shares issued on exercise of warrants	12,468,750	1,755,041	-	-	(12,468,750)	(258,791)	-	-	-	1,496,250
Loss for the year	-	-	-	-	-	-	-	-	(2,632,301)	(2,632,301)
Balance - September 30, 2006	260,483,591	49,115,790	9,958,544	-	22,250,000	338,314	-	-	(55,977,886)	3,434,762

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

PhotoChannel Networks Inc.
Consolidated Statements of Loss and Deficit
For the years ended September 30, 2006, 2005 and 2004

(expressed in Canadian dollars)

	2006 \$	2005 \$	2004 \$
Revenue (note 9)	4,075,151	2,116,503	763,140
Expenses			
Research and development (note 10)	2,299,859	1,621,544	1,279,238
Network delivery (note 10)	1,800,882	898,639	327,189
General and administration (note 10)	1,472,957	1,764,686	1,421,419
Sales and marketing (note 10)	738,013	695,536	642,006
Amortization	402,600	303,859	171,476
	<u>6,714,311</u>	<u>5,284,264</u>	<u>3,841,328</u>
	(2,639,160)	(3,167,761)	(3,078,188)
Interest and other income	33,655	7,088	6,775
Foreign exchange (loss) gain	<u>(26,796)</u>	<u>12,706</u>	<u>18,928</u>
Net loss for the year attributed to common shareholders	(2,632,301)	(3,147,967)	(3,052,485)
Deficit - Beginning of year	(53,345,585)	(49,739,607)	(40,176,059)
Redemption of Limited Partnership units	-	-	(6,511,063)
Modification of existing warrants (note 6)	-	(144,000)	-
Stock-based compensation adjustment (note 2)	<u>-</u>	<u>(314,011)</u>	<u>-</u>
Deficit - End of year	<u>(55,977,886)</u>	<u>(53,345,585)</u>	<u>(49,739,607)</u>
Basic and fully diluted net loss per share	<u>(0.01)</u>	<u>(0.02)</u>	<u>(0.02)</u>
Weighted average number of common shares	<u>228,047,118</u>	<u>178,682,855</u>	<u>148,741,599</u>

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

PhotoChannel Networks Inc.
Consolidated Statements of Cash Flows
For the years ended September 30, 2006, 2005 and 2004

(expressed in Canadian dollars)

	2006 \$	2005 \$	2004 \$
Cash flows from operating activities			
Net loss for the year attributed to common shareholders	(2,632,301)	(3,147,967)	(3,052,485)
Items not affecting cash			
Amortization	402,600	303,859	171,476
Stock-based compensation expense	215,084	124,338	-
Loss (gain) on disposal of property, plant and equipment	3,452	(6,819)	-
	(2,011,165)	(2,726,589)	(2,881,009)
Net change in non-cash working capital items (note 8)	(952,342)	363,159	(648,908)
	(2,963,507)	(2,363,430)	(3,529,917)
Cash flows from investing activities			
Purchase of property, plant and equipment	(777,479)	(523,595)	(536,241)
Proceeds from disposal of property, plant and equipment	5,713	6,819	-
	(771,766)	(516,776)	(536,241)
Cash flows from financing activities			
Issuance of common shares and warrants	4,073,720	1,848,509	1,073,750
Decrease in cash held in trust	-	-	345,000
Issuance of common shares on exercise of warrants and options	1,496,250	245,450	2,394,357
Repayment of loans receivable	-	17,600	104,606
	5,569,970	2,111,559	3,917,713
Increase (decrease) in cash and cash equivalents	1,834,697	(768,647)	(148,445)
Cash and cash equivalents - Beginning of year	187,318	955,965	1,104,410
Cash and cash equivalents - End of year	2,022,015	187,318	955,965
Supplementary information			
Interest paid	4,244	3,811	51,657
Interest received	23,362	4,558	6,520
Taxes paid	-	-	-
Non-cash activities consist of			
Redemption of Limited Partnership units	-	-	6,511,023
Expiry of warrants	440,082	1,805,000	55,413
Issuance of common shares on exercise of warrants	258,791	87,571	1,716,416

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

PhotoChannel Networks Inc.

Notes to Consolidated Financial Statements

For the years ended September 30, 2006, 2005 and 2004

(expressed in Canadian dollars)

1 Nature of operations and going concern

PhotoChannel Networks Inc. (the company), through the PhotoChannel Network, electronically connects the photo-finishing retailer and its customers through the Internet and provides digital image delivery, hosting, storage and financial reporting for the photo-finishing retailer.

While these financial statements have been prepared using Canadian accounting standards applicable to a going concern, which assumes the realization of assets and settlement of liabilities in the normal course of business as they become due, there are conditions and events that cast substantial doubt on the validity of this assumption. At September 30, 2006, the company had an accumulated deficit of \$55,977,886 (2005 - \$53,345,585; 2004 - \$49,739,607). During the year ended September 30, 2006, the company used cash of approximately \$2,967,000 (2005 - \$2,357,000; 2004 - \$3,530,000) to fund operations while obtaining approximately \$5,570,000 (2005 - \$2,112,000; 2004 - \$3,918,000) from financing activities. The company has capital requirements in excess of its currently available resources and is dependent upon the proceeds of future financings to further finance the development and implementation of its business objectives. 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 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 if further financing is required, there is no assurance that the necessary financing can be obtained or on what terms it may be obtained. 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.

2 Significant accounting policies

Basis of consolidation

These consolidated financial statements are prepared in accordance with generally accepted accounting principles (GAAP) in Canada, and include the accounts of the company and each of its wholly owned or controlled subsidiaries, PhotoChannel Capital Inc. and PhotoChannel Management Inc.

The consolidated financial statements also included the accounts of PhotoChannel Networks Limited Partnership (the PhotoChannel LP) for all periods that the PhotoChannel LP was in existence up until the redemption of the Limited Partnership units in April 2004 (note 7). The accounts of the PhotoChannel LP had been consolidated in view of the existence of the company's option to acquire the PhotoChannel LP units from the limited partners and certain common ownership and management of the company and the PhotoChannel LP.

PhotoChannel Networks Inc.

Notes to Consolidated Financial Statements

For the years ended September 30, 2006, 2005 and 2004

(expressed in Canadian dollars)

All material intercompany balances and transactions are eliminated upon consolidation.

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 the 30-month period of the contract.

PhotoChannel Networks Inc.

Notes to Consolidated Financial Statements

For the years ended September 30, 2006, 2005 and 2004

(expressed in Canadian dollars)

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 and professional fees are recognized as the services are 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 the 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. 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

For the years ended September 30, 2006, 2005 and 2004

(expressed in Canadian dollars)

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 loss per share is 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 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

For the years ended September 30, 2006, 2005 and 2004

(expressed in Canadian dollars)

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 substantively 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, where necessary, to conform with the presentation adopted in the current year.

3 Accounts receivable

	2006 \$	2005 \$
Trade receivables	1,311,867	394,095
GST receivable	-	23,671
	<hr/> 1,311,867	<hr/> 417,766

4 Property, plant and equipment

	<hr/> 2006		
	Cost \$	Accumulated amortization \$	Net \$
Computer equipment	4,236,600	3,008,004	1,228,596
Software	272,992	272,992	-
Furniture and office equipment	156,640	153,064	3,576
Leasehold improvements	71,205	67,588	3,617
	<hr/> 4,737,437	<hr/> 3,501,648	<hr/> 1,235,789

PhotoChannel Networks Inc.

Notes to Consolidated Financial Statements

For the years ended September 30, 2006, 2005 and 2004

(expressed in Canadian dollars)

	2005		
	Cost	Accumulated amortization	Net
	\$	\$	\$
Computer equipment	3,499,995	2,639,305	860,690
Software	250,825	250,825	-
Furniture and office equipment	153,442	152,571	871
Leasehold improvements	71,205	62,691	8,514
	<u>3,975,467</u>	<u>3,105,392</u>	<u>870,075</u>

Amortization of property, plant and equipment for 2006 was \$402,600 (2005 - \$303,859; 2004 - \$171,476).

5 Accounts payable and accrued liabilities

	2006	2005
	\$	\$
Trade payables	749,931	578,049
Trade accruals	238,138	141,145
Accrued payroll taxes	159,207	158,717
Due to employees and consultants	74,672	135,292
Due to former employees	-	125,000
	<u>1,221,948</u>	<u>1,138,203</u>

6 Capital stock, stock options, special warrants, warrants and loans receivable

a) Capital stock

Common shares

Authorized

Unlimited (2005 - Unlimited; 2004 - 500,000,000) common shares without par value

Issued

260,483,591 (2005 - 203,514,841; 2004 - 176,347,341) common shares without par value

PhotoChannel Networks Inc.

Notes to Consolidated Financial Statements

For the years ended September 30, 2006, 2005 and 2004

(expressed in Canadian dollars)

Preferred shares

Authorized

Unlimited (2005 - Unlimited; 2004 - 10,000,000) preferred shares without par value

Details of the material common stock, stock option and warrant transactions are as follows:

- i) Pursuant to a non-brokered private placement during the year ended September 30, 2006, the company issued 27,500,000 units for net proceeds of \$2,540,720. Each unit consisted of one common share and one-half of one common share purchase warrant. Each whole common share purchase warrant entitles the holder to purchase one additional common share of the company at a price of \$0.15 per share for a period of one year from the date of closing. The net proceeds of \$2,540,720 were allocated: \$2,363,460 to common shares issued and \$177,260 to the common share purchase warrants. The value allocated to the common share purchase warrants was determined using the Black-Scholes option pricing model with the following weighted average assumptions: dividend yield of \$nil; expected volatility of 69%; risk-free interest rate of 4.17%; and expected life of one year. The common share purchase warrants expire on May 30, 2007. During the year ended September 30, 2006, none of the common share purchase warrants were exercised.
- ii) Pursuant to a non-brokered private placement during the year ended September 30, 2006, the company issued 17,000,000 units for net proceeds of \$1,533,000. Each unit consisted of one common share and one-half of one common share purchase warrant. Each whole common share purchase warrant entitles the holder to purchase one additional common share of the company at a price of \$0.15 per share for a period of one year from the date of closing. The net proceeds of \$1,533,000 were allocated: \$1,371,946 to common shares issued and \$161,054 to the common share purchase warrants. The value allocated to the common share purchase warrants was determined using the Black-Scholes option pricing model with the following weighted average assumptions: dividend yield of \$nil; expected volatility of 80%; risk-free interest rate of 3.74%; and expected life of one year. The common share purchase warrants expire on November 15, 2006. During the year ended September 30, 2006, none of the common share purchase warrants were exercised.
- iii) At the company's annual general meeting held on March 24, 2005, the company's shareholders approved an increase in the authorized share structure to an unlimited number of common shares and an unlimited number of preferred shares.

PhotoChannel Networks Inc.

Notes to Consolidated Financial Statements

For the years ended September 30, 2006, 2005 and 2004

(expressed in Canadian dollars)

- iv) Pursuant to a non-brokered private placement during the year ended September 30, 2005, the company issued 24,937,500 units for net proceeds of \$1,848,509. Each unit consisted of one common share and one-half of one common share purchase warrant. Each whole common share purchase warrant entitles the holder to purchase one additional common share of the company at a price of \$0.12 per share for a period of one year from the date of closing. The net proceeds of \$1,848,509 were allocated: \$1,589,718 to common shares issued and \$258,791 to the common share purchase warrants. The value allocated to the common share purchase warrants was determined using the Black-Scholes option pricing model with the following weighted average assumptions: dividend yield of \$nil; expected volatility of 80%; risk-free interest rate of 3.03%; and expected life of one year. The common share purchase warrants expire on September 20, 2006. During the year ended September 30, 2006, all of the common share purchase warrants were exercised for proceeds of \$1,496,250.
- v) Pursuant to a non-brokered private placement during the year ended September 30, 2004, the company issued 9,600,000 units for net proceeds of \$1,073,751. Each unit consisted of one common share and one common share purchase warrant. Each common share purchase warrant entitles the holder to purchase one additional common share of the company at a price of \$0.15 per share for a period of one year from the date of closing. The net proceeds of \$1,073,751 were allocated: \$794,575 to common shares issued and \$279,176 to the common share purchase warrants. The value allocated to the common share purchase warrants was determined using the Black-Scholes option pricing model with the following weighted average assumptions: dividend yield of \$nil; expected volatility of 100%; risk-free interest rate of 4%; and expected life of one year. The expiry date of these warrants was subsequently extended as noted immediately following.
- vi) During the year ended September 30, 2005, the expiry date of common share purchase warrants issued as part of the private placement during the year ended September 30, 2004 was extended by one year to July 7, 2006. This amendment resulted in an additional allocation to the common share purchase warrant in the amount of \$144,000, charged directly to the deficit in fiscal 2005 as a distribution. The value allocated to the common share purchase warrants was determined using the Black-Scholes option pricing model with the following weighted average assumptions: dividend yield of \$nil; expected volatility of 80%; risk-free interest rate of 3.03%; and expected life of one year. During the year ended September 30, 2006, all of the common share purchase warrants expired unexercised.

PhotoChannel Networks Inc.

Notes to Consolidated Financial Statements

For the years ended September 30, 2006, 2005 and 2004

(expressed in Canadian dollars)

vii) Pursuant to a call option agreement with the limited partners of the PhotoChannel LP, the company exercised its right to acquire all of the Limited Partnership units from the limited partners during the year ended September 30, 2004 (note 7). Under the terms of the call option agreements, the company issued 16,100,000 of its common shares and 13,650,000 common share purchase warrants. Each common share purchase warrant entitled the holder to purchase one additional common share of the company at a price of \$0.10 up to June 30, 2004. The 16,100,000 common shares issued to acquire the Limited Partnership units were attributed a value of \$4,242,000, which was determined by taking the value of the common shares as quoted on the TSX Venture Exchange on the date of issuance. The 13,650,000 common share purchase warrants were attributed a value of \$2,269,063, which was determined using the Black-Scholes option pricing model with the following weighted average assumptions: dividend yield of \$nil; expected volatility of 100%; risk-free interest rate of 4%; expected life of 2.5 months. During the year ended September 30, 2004, 13,150,000 common share purchase warrants were exercised for proceeds of \$1,315,000 and the remaining 500,000 common share purchase warrants expired unexercised.

viii) Pursuant to a non-brokered private placement during the year ended September 30, 2003, the company issued 5,669,470 units for net proceeds of \$566,947. Each unit consisted of one common share and one common share purchase warrant. Each common share purchase warrant entitled the holder to purchase one additional common share of the company at a price of \$0.10 per share for a period of one year from the date of closing. The net proceeds of \$566,947 were allocated: \$406,414 to the common shares issued and \$160,533 to the common share purchase warrants. During the year ended September 30, 2004, all of the common share purchase warrants were exercised for proceeds of \$566,947.

b) Stock options

The company initially adopted a stock option plan (the Plan) in 1997. At the company's annual general meeting held on March 10, 2004, the number of common shares reserved under the Plan was increased to 18,000,000 common shares. At the company's annual general meeting held on March 6, 2006, the Plan was amended to allow for a "rolling" number of shares rather than the past "fixed" number of shares. The amended Plan now allows for a maximum of 10% of the issued and outstanding common shares be reserved for issuance, less any previously outstanding options. As at September 30, 2006, the company has reserved 26,048,359 common shares (2005 - 18,000,000; 2004 - 18,000,000) under the Plan. The options, which expire five years after the date granted, are subject to various vesting requirements. Under the original terms of the Plan, the majority of options vest one-third on the date of grant and one-third on each of the first and second anniversaries of the date of grant. However, at an extraordinary general meeting of the company's shareholders held on December 7, 2001, the Plan was amended to include a change in the vesting period, permitting vesting of one-eighteenth of the options granted each month, with the first eighteenth vesting on the date of grant. Typically, options vest over an 18-month period.

PhotoChannel Networks Inc.

Notes to Consolidated Financial Statements

For the years ended September 30, 2006, 2005 and 2004

(expressed in Canadian dollars)

The following table summarizes activity under the company's stock option plan as of September 30, 2004, 2005 and 2006:

Stock options	Number of options	Weighted average exercise price of outstanding options \$	Weighted average exercise price of exercisable options \$
Outstanding - September 30, 2003 (11,692,818 shares exercisable)	13,065,000	0.16	0.17
Granted	3,775,000	0.31	
Expired	(1,080,333)	0.15	
Outstanding - September 30, 2004 (12,893,001 shares exercisable)	15,759,667	0.20	0.18
Granted	4,700,000	0.15	
Expired	(930,396)	0.38	
Forfeited	(1,587,500)	0.32	
Cancelled	(2,200,000)	0.19	
Exercised	(385,000)	0.15	
Outstanding - September 30, 2005 (12,373,438 shares exercisable)	15,356,771	0.16	0.17
Granted	6,150,000	0.13	
Expired	(4,140,000)	0.15	
Cancelled	(1,596,667)	0.17	
Outstanding - September 30, 2006 (12,373,438 shares exercisable)	15,770,104	0.14	0.15

The following table summarizes information about stock options outstanding and exercisable at September 30, 2006:

Exercise price \$	Options outstanding			Options exercisable	
	Number outstanding	Weighted average remaining contractual life (years)	Weighted average exercise price \$	Number exercisable	Weighted average exercise price \$
0.13	6,150,000	4.4	0.13	2,022,222	0.13
0.15	9,620,104	2.2	0.15	8,770,104	0.15
0.13 - 0.15	15,770,104	3.1	0.14	10,792,326	0.15

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

During the year ended September 30, 2006, the company recognized compensation expense of \$215,084 for stock options issued to employees (2005 - \$124,338; 2004 - \$314,011).

During the years ended September 30, 2006, 2005 and 2004, no stock options were provided to consultants for services rendered.

The fair value of each stock option is estimated on the date of grant using the Black-Scholes pricing model. Stock-based compensation expense arising from grants of options to employees and non-employees was estimated using the Black-Scholes option pricing model assuming no dividend yield and the following weighted average assumptions for options granted:

	2006	2005	2004
Expected volatility	74%	63%	100%
Risk-free interest rate	4.17%	3.25%	4%
Expected life (in years)	5	5	5

c) Warrants

- i) During the year ended September 30, 2003, the company retained First Associates Investments Inc. (First Associates) to assist in raising funds for the company. On September 16, 2003 and pursuant to the private placement of 25,200,000 common shares of the company, the TSX Venture Exchange approved the issuance of 500,000 common share purchase warrants, with immediate vesting, for services provided. The common share purchase warrants are exercisable on or before October 7, 2005, at a price of \$0.14. The common share purchase warrants were assigned a value of \$34,364, which has been included as a share issue cost and recorded in equity. The value was determined using the Black-Scholes option pricing model with the following weighted average assumptions: dividend yield of \$nil; expected volatility of 100%; risk-free interest rate of 4%; and expected life of 1.25 years. During the year ended September 30, 2006, the remaining 246,000 common share purchase warrants expired unexercised (2005 - 80,000 exercised for proceeds of \$11,200; 2004 - 174,000 exercised for proceeds of \$24,360).
- ii) During the year ended September 30, 2002, the company retained TELUS Communications Inc. (TELUS) to provide consulting services to the company, under an agreement dated June 4, 2002. As consideration, the company had agreed to issue TELUS up to 2,100,000 common share purchase warrants, which were to be provided as earned during and under the terms of the agreement on February 27, 2003 in lieu of fees of \$105,000 for services provided to January 4, 2003. The common share purchase warrants were issued with immediate vesting and are exercisable on or before February 27, 2005, at a price of \$0.10. These common share purchase warrants were assigned the value of \$105,000, which has been included as a general and administrative expense and recorded in equity. During the year ended September 30, 2005, all of these common share purchase warrants expired unexercised.

PhotoChannel Networks Inc.

Notes to Consolidated Financial Statements

For the years ended September 30, 2006, 2005 and 2004

(expressed in Canadian dollars)

- iii) During the year ended September 30, 2002, the company retained NBJ Enterprises Ltd., dba Skana Photo-Lab Products (Skana), to act as a distributor for the company's products in Canada, under an agreement dated February 1, 2002. Amongst other consideration, the company had agreed to issue Skana up to 2,000,000 common share purchase warrants, which were to be provided as earned during and under the terms of the agreement. The common share purchase warrants were issued on January 22, 2003 and are exercisable on or before January 22, 2005, at a price of \$0.10. The common share purchase warrants were assigned a value of \$93,000, which has been included as a sales and marketing expense and recorded in equity. During the year ended September 30, 2005, the remaining 1,765,000 common share purchase warrants were exercised for proceeds of \$176,500 (2004 - 235,000 exercised for proceeds of \$23,500).
- iv) During the year ended September 30, 2002, the company issued to Discovery Capital Corporation (Discovery) 4,325,000 common share purchase warrants for financial advisory services to the company, and 700,000 common share purchase warrants for a finder's fee on the private placement of units of PhotoChannel LP as consideration. The company issued these common share purchase warrants to Discovery on July 26, 2002, which were exercisable on or before July 26, 2004, at a price of \$0.10.

The common share purchase warrants were assigned a value of \$125,625, which has been included as an expense and recorded in equity. During the year ended September 30, 2004, the company issued 3,025,000 common shares of the company for proceeds of \$302,500 upon exercise of the remaining common share purchase warrants (2003 - 2,000,000 exercised for proceeds of \$200,000).

- v) On May 11, 2000, the company granted a common share purchase warrant, exercisable for a period of five years, to purchase up to 1,000,000 common shares of the company at a price of US\$1.75 per share. The common share purchase warrant was assigned a value of \$1,700,000, which was recorded in equity. During the year ended September 30, 2005, this share purchase warrant expired unexercised.

d) Loans receivable

During the year ended September 30, 2002, the company made loans totalling \$227,470 to employees, which were secured by common shares of the company. As at September 30, 2006, loans totalling \$nil (2005 - \$nil; 2004 - \$17,600) were outstanding and have been recorded as a charge to shareholders' equity. The loans were non-interest bearing and were repayable on demand.

PhotoChannel Networks Inc.

Notes to Consolidated Financial Statements

For the years ended September 30, 2006, 2005 and 2004

(expressed in Canadian dollars)

7 Limited Partnership equity

On February 14, 2002, the PhotoChannel LP was formed under a Limited Partnership Agreement to carry on the sales, marketing and deployment of the PhotoChannel Network in specified market segments. The partnership initially sold 1,250 Limited Partnership units in June 2002, 115 units in December 2002; and 245 units in September 2003 at a price of \$1,000 per unit, raising a total of \$1,610,000. The company had granted to the PhotoChannel LP a software license to commercially exploit the PhotoChannel Network in Canada.

Pursuant to an operating agreement, the company received payments for services provided to the PhotoChannel LP from the software license agreement and management and operating services agreements (representing software rights, management, personnel and facilities and equipment that the company had agreed to provide to the PhotoChannel LP), which enabled the company to continue its development, deployment and exploitation of its digital imaging network software in other market segments.

A condition of the PhotoChannel LP agreement was that each limited partner enters into an agreement with the company, pursuant to which the company had a call option to acquire all, but not less than all, of the Limited Partnership units from the limited partners, at any time on or before June 30, 2004. Under the call option, each of the Limited Partnership units would be exchanged for 10,000 units of the company, with each unit comprising of one common share and one common share purchase warrant. Each common share purchase warrant entitled the holder to purchase one additional common share of the company, at a price of \$0.10 per share, at any time on or before the earlier of two years from the date of issue of the Limited Partnership units and June 30, 2004.

Given the existence of the company's option to acquire the Limited Partnership units from the limited partners, certain common ownership and management of the company and the Limited Partnership, and the company's effective control over the PhotoChannel LP, the partnership equity was presented as a separate class of equity within shareholders' equity of the company. The accounts of the partnership were consolidated with those of the company since the inception of the PhotoChannel LP.

The company also entered into a support agreement, pursuant to which the company agreed to provide financing to the Limited Partnership, in connection with operational and capital costs, once substantially all equity generated from the Limited Partnership units was utilized. Losses incurred by the Limited Partnership in 2002 and 2003 were allocated first to the Limited Partnership units to the extent of their equity investment and thereafter to the company.

In April, 2004, the company exercised its call options with the limited partners thereby acquiring all of the Limited Partnership units. Under the terms of the call option agreements the company issued 16,100,000 common shares and 13,650,000 common share purchase warrants. Each common share purchase warrant entitled the holder to purchase one additional common share of the company at a price of \$0.10 per share up to June 30, 2004. The company recorded the redemption of the PhotoChannel LP at the fair value of the common shares and common share purchase warrants (note 6(a)(vii)), with the offsetting amount recorded as an increase in its deficit.

PhotoChannel Networks Inc.

Notes to Consolidated Financial Statements

For the years ended September 30, 2006, 2005 and 2004

(expressed in Canadian dollars)

8 Net change in non-cash working capital items

	2006	2005	2004
	\$	\$	\$
Accounts receivable	(894,101)	(96,617)	(224,399)
Prepaid expenses	(23,383)	(114,854)	1,125
Deferred charges	(157,157)	-	-
Accounts payable and accrued liabilities	83,745	562,359	(541,403)
Deferred revenue	38,554	12,271	115,769
	<hr/>	<hr/>	<hr/>
	(952,342)	363,159	(648,908)
	<hr/>	<hr/>	<hr/>

9 Revenue

The following is a breakdown of the company's revenue for the years ended September 30, 2006, 2005 and 2004:

	2006	2005	2004
	\$	\$	\$
Transaction commission fees	1,687,204	708,438	361,350
Installation fees	1,239,930	676,274	187,940
Membership fees	751,408	519,037	96,519
Archive fees	111,561	107,515	57,091
Professional fees	285,048	105,239	60,240
	<hr/>	<hr/>	<hr/>
	4,075,151	2,116,503	763,140
	<hr/>	<hr/>	<hr/>

PhotoChannel Networks Inc.

Notes to Consolidated Financial Statements

For the years ended September 30, 2006, 2005 and 2004

(expressed in Canadian dollars)

10 Expense details

	2006 \$	2005 \$	2004 \$
Research and development			
Salaries and consulting	2,088,592	1,523,716	1,219,808
Miscellaneous	89,595	83,142	59,430
Stock-based compensation expense	121,672	14,686	-
	<hr/> 2,299,859	<hr/> 1,621,544	<hr/> 1,279,238
Network delivery			
Laboratory system installation	1,010,850	366,852	52,288
Salaries and customer service	334,591	214,633	100,810
Telecommunication costs	232,039	207,210	128,873
Other	220,271	107,007	45,218
Stock-based compensation expense	3,131	2,937	-
	<hr/> 1,800,882	<hr/> 898,639	<hr/> 327,189
General and administration			
Salaries and consulting	784,434	1,011,249	754,439
Office and miscellaneous	300,613	258,427	287,797
Accounting and legal	140,887	169,127	123,932
Stock-based compensation expense	70,156	85,176	-
Rent	93,639	84,499	68,994
Investor relations	42,798	67,500	90,000
Interest and penalties	4,244	66,159	78,157
Bad debt	8,720	29,368	18,100
Loss (gain) on sale of property, plant and equipment	27,466	(6,819)	-
	<hr/> 1,472,957	<hr/> 1,764,686	<hr/> 1,421,419
Sales and marketing			
Salaries and consulting	554,270	566,770	549,797
Printing, advertising and promotion	87,468	48,950	49,284
Miscellaneous	76,150	58,277	42,925
Stock-based compensation expense	20,125	21,539	-
	<hr/> 738,013	<hr/> 695,536	<hr/> 642,006

PhotoChannel Networks Inc.
Notes to Consolidated Financial Statements
For the years ended September 30, 2006, 2005 and 2004

(expressed in Canadian dollars)

11 Income taxes

The company is subject to Canadian federal and provincial taxes.

The company has non-capital losses for Canadian income tax purposes of approximately \$17,548,000, which are available for carry forward to reduce future years' taxable income. These income tax losses expire as follows:

	\$
Year ending September 30	
2007	5,391,000
2008	2,630,000
2009	-
2010	2,119,000
2011	2,821,000
2012	2,323,000
2016	<u>2,264,000</u>
	<u>17,548,000</u>

The tax effect of temporary differences that give rise to significant portions of future income tax assets and future income tax liabilities is as follows:

	2006 \$	2005 \$	2004 \$
Net operating loss carry-forwards	6,334,000	6,180,000	6,384,000
Property, plant and equipment	2,171,000	2,001,000	1,896,000
Share issue costs	262,000	216,000	159,000
Deferred revenue	82,000	67,000	-
Unpaid amounts	89,000	96,000	-
	<u>8,938,000</u>	<u>8,560,000</u>	<u>8,439,000</u>
Valuation allowance	<u>(8,938,000)</u>	<u>(8,560,000)</u>	<u>(8,439,000)</u>
Net future income tax assets	<u>-</u>	<u>-</u>	<u>-</u>

Management believes there is sufficient uncertainty regarding the realization of future income tax assets such that a full valuation allowance is appropriate.

PhotoChannel Networks Inc.

Notes to Consolidated Financial Statements

For the years ended September 30, 2006, 2005 and 2004

(expressed in Canadian dollars)

The income tax recovery for the year ended September 30, 2006 differs from the amount obtained by applying the applicable statutory income tax rates to loss before income taxes as follows:

	2006	2005	2004
Combined statutory income tax rate	36%	36%	36%
	\$	\$	\$
Income tax recovery based on combined statutory rate	(950,294)	(1,121,306)	(1,098,895)
Expiration of tax losses	745,321	969,092	1,232,140
Effect of change in tax rates	12,635	-	30,525
Non-deductible expenses and other differences	(185,662)	31,214	(270,432)
Change in valuation allowance	378,000	121,000	106,662
	-	-	-

12 Related party transactions

During the year ended September 30, 2006, the company incurred consulting fees to companies controlled by directors and officers of the company of approximately \$77,366 (2005 - \$137,500; 2004 - \$179,167). The fees were recorded in general and administration expense.

As at September 30, 2006, there was \$21,632 (2005 - \$31,250; 2004 - \$nil) due for consulting fees owed to such companies.

13 Segmented information

The company's 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:

	2006	2005	2004
	\$	\$	\$
Canada	3,465,661	1,750,679	567,211
United States	592,124	361,610	187,850
Other	17,366	4,214	8,079
	4,075,151	2,116,503	763,140

PhotoChannel Networks Inc.

Notes to Consolidated Financial Statements

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(expressed in Canadian dollars)

Revenue is attributable to the geographic location of the company's customer. At September 30, 2006, 2005 and 2004, all of the company's property, plant and equipment were located in Canada.

Major customers, representing 10% or more of sales, include:

	2006	2005	2004
	\$	\$	\$
Customer A	2,605,549	1,140,564	177,523
Customer B	296,238	255,693	-
Customer C	-	233,583	-
Customer D	-	-	108,983
Customer E	-	-	89,318
Customer F	-	-	76,063

14 Financial instruments

a) Fair values

The fair values of cash and cash equivalents, accounts receivable, deferred charges, and accounts payable and accrued liabilities approximate their carrying amounts due to the near-term maturity of these instruments.

b) Credit risk

Financial instruments that potentially subject the company to significant concentrations of credit risk consist primarily of cash and cash equivalents and accounts receivable. The company limits its exposure to credit risk by placing its cash and cash equivalents with high credit quality financial institutions and corporations. The company does not have a significant exposure to any individual customer or counter party. The company provides its services on credit in the normal course of conducting its business.

c) Foreign exchange risk

The company is subject to foreign exchange risk for sales and purchases denominated in foreign currencies. Foreign currency risk arises from the fluctuation of foreign exchange rates and the degree of volatility of these rates relative to the Canadian dollar. The company does not actively manage this risk.

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(expressed in Canadian dollars)

15 Commitments

Commitments

The company has entered into agreements to lease premises and services for periods to 2007. The annual rent for premises includes minimum rent plus realty taxes and operating expenses. Minimum payments for each of the next three years are as follows:

	\$
2007	319,939
2008	78,396
2009	78,396
	<hr/>
	476,731
	<hr/>