

PhotoChannel Networks Inc.

Consolidated Financial Statements
September 30, 2008, 2007 and 2006
(expressed in Canadian dollars)

MANAGEMENT'S REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING

Management is responsible for establishing and maintaining adequate internal control over financial reporting. Internal control over financial reporting is a process designed by, or under the supervision of, the Chief Executive Officer and the Chief Financial Officer and effected by the Board of Directors, management and other personnel to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. It includes those policies and procedures that:

- (a) Pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the Company;
- (b) Provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the Company are made only in accordance with authorizations of management and the directors of the Company; and
- (c) Provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the Company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Management has assessed the effectiveness of our internal control over financial reporting as at September 30, 2008 using criteria established in *Internal Control – Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission.

A material weakness is a deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the Company's annual financial statements will not be prevented or detected on a timely basis.

Based on our evaluation, management identified the material weakness described below:

We did not maintain effective control over our financial closing and reporting processes with respect to the accounting for goodwill and intangible assets. Specifically, we failed to perform an analysis of sufficient depth to arrive at the appropriate allocation of goodwill and intangible assets across the reporting units. The control deficiency identified could result in misstatements of the Company's goodwill, intangible assets, foreign exchange and accumulated other comprehensive income balances and would result in a material misstatement to the consolidated financial statements that would not be prevented or detected.

Based on this evaluation, the Company's management has concluded that the Company's internal control over financial reporting was not effective as at September 30, 2008.

The effectiveness of the Company's internal control over financial reporting as at September 30, 2008 has been audited by PricewaterhouseCoopers LLP, our independent auditors, as stated in their report which appears herein.

"Kyle Hall"

Kyle Hall
Chief Executive Officer
Vancouver, BC, Canada
January 12, 2009

"Robert Chisholm"

Robert Chisholm, CMA
Chief Financial Officer
Vancouver, BC, Canada
January 12, 2009

Independent Auditors' Report

To the Shareholders of PhotoChannel Networks Inc.

We have completed integrated audits of PhotoChannel Networks Inc.'s 2008 and 2007 consolidated financial statements and of its internal control over financial reporting as at September 30, 2008 and an audit of its 2006 consolidated financial statements. Our opinions, based on our audits, are presented below.

Consolidated financial statements

We have audited the accompanying consolidated balance sheets of PhotoChannel Networks Inc. as at September 30, 2008 and September 30, 2007, and the related consolidated statements of loss and comprehensive loss, cash flows and shareholders' equity for each of the years in the three year period ended September 30, 2008. 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 of the Company's financial statements in accordance with Canadian generally accepted auditing standards and the standards of the Public Company Accounting Oversight Board (PCAOB). Those standards require that we plan and perform an audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit of financial statements includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. A financial statement audit also includes assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of the Company as at September 30, 2008 and September 30, 2007 and the results of its operations and its cash flows for each of the years in the three year period ended September 30, 2008 in accordance with Canadian generally accepted accounting principles.

As described in note 2 to these consolidated financial statements, the Company changed its accounting for financial instruments effective October 1, 2006.

Internal control over financial reporting

We have also audited PhotoChannel Networks Inc.'s internal control over financial reporting as at September 30, 2008, based on criteria established in *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management's Report on Internal Control over Financial Reporting. Our responsibility is to express an opinion on the Company's internal control over financial reporting based on our audit.

We conducted our audit of internal control over financial reporting in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. An audit of internal control over financial reporting includes obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, testing and evaluating the design and operating effectiveness of internal control based on the assessed risk, and performing such other procedures as we consider necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are

subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

A material weakness is a deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the Company's annual financial statements will not be prevented or detected on a timely basis. As at September 30, 2008, the following material weakness has been identified and described in the accompanying Management's Report on Internal Control over Financial Reporting:

The Company did not maintain effective controls with respect to the accounting for goodwill and intangible assets. Specifically, the company did not perform an analysis of sufficient depth to arrive at the appropriate allocation of goodwill and intangible assets across reporting units.

We considered this material weakness in determining the nature, timing and extent of audit tests applied in our audit of the September 30, 2008 consolidated financial statements, and our opinion regarding the effectiveness of the Company's internal control over financial reporting does not affect our opinion on those consolidated financial statements.

In our opinion, the Company did not maintain, in all material respects, effective internal control over financial reporting as at September 30, 2008 based on criteria established in Internal Control – Integrated Framework issued by the COSO.

Signed *PricewaterhouseCoopers LLP*

Chartered Accountants

Vancouver, Canada

January 12, 2009

COMMENTS BY AUDITORS ON CANADA-U.S. REPORTING DIFFERENCE

Reporting standards of the Public Company Accounting Oversight Board (United States) require the addition of an explanatory paragraph following the opinion paragraph when the financial statements are affected by conditions and events that raise substantial doubt about the Company's ability to continue as a going concern, such as those described in note 1 to the consolidated financial statements. Generally accepted auditing standards in Canada do not permit a reference to such events and conditions in the auditors' report when these are adequately disclosed in the financial statements.

Signed *PricewaterhouseCoopers LLP*

Chartered Accountants

Vancouver, Canada

January 12, 2009

PhotoChannel Networks Inc.

Consolidated Balance Sheets

As at September 30, 2008 and 2007

(expressed in Canadian dollars)

	<u>September 30, 2008</u>	<u>September 30, 2007</u>
Assets		
Current assets		
Cash and cash equivalents	\$ 2,670,988	\$ 7,405,034
Accounts receivable (note 4)	4,019,286	4,045,035
Prepaid expenses and other current assets	430,616	523,356
	<u>7,120,890</u>	<u>11,973,425</u>
Property and equipment (note 5)	6,786,650	2,760,545
Deferred expenses	52,882	89,804
Intangible assets (note 6)	5,164,492	6,067,614
Goodwill (note 7)	1,498,539	4,867,231
	<u>\$ 20,623,453</u>	<u>\$ 25,758,619</u>
Liabilities		
Current liabilities		
Accounts payable and accrued liabilities (note 8)	\$ 7,480,801	\$ 7,510,751
Current portion of deferred revenue	658,045	344,833
Current portion of capital lease obligations (note 14)	490,072	-
Loan payable (note 15)	969,886	-
	<u>9,598,804</u>	<u>7,855,584</u>
Deferred revenue	363,108	171,210
Long-term portion of capital lease obligations (note 14)	375,875	-
Asset retirement obligations (note 9)	22,009	120,699
	<u>10,359,796</u>	<u>8,147,493</u>
Shareholders' Equity (note 11)		
Share capital	\$ 65,614,347	\$ 65,293,214
Warrants	4,961,826	4,961,826
Contributed surplus	11,611,165	10,215,777
	<u>82,187,338</u>	<u>80,470,817</u>
Deficit	(70,767,148)	(62,050,122)
Accumulated other comprehensive loss	(1,156,533)	(809,569)
	<u>(71,923,681)</u>	<u>(62,859,691)</u>
	10,263,657	17,611,126
	<u>\$ 20,623,453</u>	<u>\$ 25,758,619</u>

Approved by the Board of Directors

"Cory Kent" Director

"Peter Fitzgerald" Director

Nature of operations and going concern (note 1)

Commitments (note 16)

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

PhotoChannel Networks Inc.

Consolidated Statements of Loss and Comprehensive Loss For the Years Ended September 30, 2008, 2007 and 2006 (expressed in Canadian dollars)

	<u>2008</u>	<u>2007</u>	<u>2006</u>
Revenue (note 12)	\$ 17,049,587	\$ 7,511,328	\$ 4,075,151
Expenses			
Network delivery	7,409,525	2,523,174	1,800,882
Software development	6,914,291	4,178,111	2,299,859
General and administration	4,603,450	3,199,727	1,462,664
Sales and marketing	1,140,028	1,134,350	738,013
Amortization	5,259,053	1,223,454	402,600
	<u>25,326,347</u>	<u>12,258,816</u>	<u>6,704,018</u>
Net loss from operations before the undernoted	(8,276,760)	(4,747,488)	(2,628,867)
Foreign exchange gain (loss)	461,041	(1,718,164)	(26,796)
Interest income	134,848	393,416	23,362
(Loss) on disposal of property, plant & equipment	(35,698)	-	-
Gain on settlement of asset retirement obligation (note 9)	86,120	-	-
Goodwill impairment (note 7)	(1,086,577)	-	-
	<u>(440,266)</u>	<u>(1,324,748)</u>	<u>(3,434)</u>
Net loss	(8,717,026)	(6,072,236)	(2,632,301)
Other comprehensive loss:			
Unrealized foreign exchange loss on translation of self-sustaining foreign operations	(346,964)	(809,569)	-
Comprehensive loss	<u>\$ (9,063,990)</u>	<u>\$ (6,881,805)</u>	<u>\$ (2,632,301)</u>
Basic and fully diluted net loss per share	\$ (0.26)	\$ (0.20)	\$ (0.12)
Weighted average number of common shares outstanding	33,383,866	29,877,739	22,804,712

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

PhotoChannel Networks Inc.
Consolidated Statements of Shareholders' Equity
For the Years Ended September 30, 2008, 2007 and 2006
(expressed in Canadian dollars)

	Share capital		Other capital accounts				Total shareholders' equity
	Number of Common Shares	Amount	Contributed surplus	Warrants	Deficit	Accumulated other comprehensive loss	
Balance - September 30, 2005	20,351,501	\$ 43,625,343	\$ 9,303,378	\$ 698,873	\$ (53,345,585)	\$ -	\$ 282,009
Issuance of shares and warrants, net of issue costs	4,450,000	3,735,406	-	338,314	-	-	4,073,720
Issuance of shares on exercise of warrants	1,246,875	1,755,041	-	(258,791)	-	-	1,496,250
Reclassification on expiry of unexercised warrants	-	-	440,082	(440,082)	-	-	-
Stock-based compensation recorded in net loss	-	-	215,084	-	-	-	215,084
Net loss	-	-	-	-	(2,632,301)	-	(2,632,301)
Balance - September 30, 2006	26,048,376	\$ 49,115,790	\$ 9,958,544	\$ 338,314	\$ (55,977,886)	\$ -	\$ 3,434,762
Issuance of shares and warrants, net of issue costs	4,430,588	11,063,482	-	4,961,826	-	-	16,025,308
Issuance of shares on exercise of options	611,572	1,438,128	(542,517)	-	-	-	895,611
Issuance of shares on exercise of warrants	2,225,000	3,675,814	-	(338,314)	-	-	3,337,500
Stock-based compensation recorded in net loss	-	-	799,750	-	-	-	799,750
Net loss	-	-	-	-	(6,072,236)	-	(6,072,236)
Other comprehensive loss	-	-	-	-	-	(809,569)	(809,569)
Balance - September 30, 2007	33,315,536	\$ 65,293,214	\$ 10,215,777	\$ 4,961,826	\$ (62,050,122)	\$ (809,569)	\$ 17,611,126
Issuance of shares on exercise of options	148,896	321,133	(116,116)	-	-	-	205,017
Stock-based compensation recorded in net loss	-	-	1,511,504	-	-	-	1,511,504
Net loss	-	-	-	-	(8,717,026)	-	(8,717,026)
Other comprehensive loss	-	-	-	-	-	(346,964)	(346,964)
Balance September 30, 2008	33,464,432	\$ 65,614,347	\$ 11,611,165	\$ 4,961,826	\$ (70,767,148)	\$ (1,156,533)	\$ 10,263,657

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, 2008, 2007 and 2006
(expressed in Canadian dollars)

	<u>2008</u>	<u>2007</u>	<u>2006</u>
Cash flows from operating activities			
Net loss for the year	\$ (8,717,026)	\$ (6,072,236)	\$ (2,632,301)
Items not affecting cash			
Amortization	5,259,053	1,223,454	402,600
Stock-based compensation expense	1,511,504	799,750	215,084
Unrealized foreign exchange (gain) loss	(407,223)	50,944	9,680
Allowance for doubtful accounts	122,659	-	-
Loss on disposal of property, plant & equipment	35,698	-	-
Gain on settlement of asset retirement obligations	(86,120)	-	-
Goodwill impairment	1,086,577	-	-
Other	5,186	2,229	3,452
	<u>(1,189,692)</u>	<u>(3,995,859)</u>	<u>(2,001,485)</u>
Net change in non-cash working capital items (note 17)	654,098	1,151,268	(952,342)
Payments made to settle asset retirement obligations	(36,311)	-	-
	<u>(571,905)</u>	<u>(2,844,591)</u>	<u>(2,953,827)</u>
Cash flows from investing activities			
Purchase of property and equipment	(4,762,168)	(1,127,371)	(777,479)
Proceeds on disposal of property, plant & equipment	25,652	9,176	5,713
Acquisition of Pixology PLC, net of cash acquired	-	(10,511,308)	-
	<u>(4,736,516)</u>	<u>(11,629,503)</u>	<u>(771,766)</u>
Cash flows from financing activities			
Proceeds on exercise of options and warrants	205,017	4,233,111	1,496,250
Issuance of common shares and warrants – net proceeds	-	16,025,308	4,073,720
Loans received	943,450	-	-
Repayment of capital lease obligations	(382,517)	-	-
	<u>765,950</u>	<u>20,258,419</u>	<u>5,569,970</u>
Effect of changes in foreign exchange rates on cash and cash equivalents	(191,575)	(401,306)	(9,680)
(Decrease) Increase in cash and cash equivalents during the period	<u>(4,734,046)</u>	<u>5,383,019</u>	<u>1,834,697</u>
Cash and cash equivalents - beginning of year	<u>7,405,034</u>	<u>2,022,015</u>	<u>187,318</u>
Cash and cash equivalents - end of year	<u>\$ 2,670,988</u>	<u>\$ 7,405,034</u>	<u>\$ 2,022,015</u>

Supplementary cash flow information is included in note 17

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

PhotoChannel Networks Inc.

Notes to Consolidated Financial Statements

September 30, 2008, 2007 and 2006

(expressed in Canadian dollars)

1. Nature of operations and going concern

PhotoChannel Networks Inc. (the "Company") offers the photofinishing retailer and its customers an online and in-store solution for producing prints and gifting products from their digital images. The Company's online platform electronically connects the photofinishing retailer and its customers through the internet and provides digital image delivery, hosting, transaction processing and storage. The Company, through its wholly-owned subsidiary, Pixology Limited, provides the photofinishing retailer with kiosk software which allows consumers to offload digital images from their digital media and order prints and gifting products within the retailer's locations. The kiosk software is also connected to the Company's online platform permitting customers in-store to order gifting products from the kiosk, which are then transmitted from the kiosk to a remote fulfillment facility via the online platform.

At September 30, 2008 the Company had a working capital deficiency of \$2,477,913 and an accumulated deficit of \$70,767,148 (2007 - \$62,050,122) and has suffered losses since inception. During the year ended September 30, 2008, the Company used cash of approximately \$600,000 to fund operations and \$4,800,000 to acquire items of property and equipment. At September 30, 2008 the Company was committed to purchasing additional items of property and equipment with a cost of \$1,487,000.

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, the conditions described above may cast significant doubt on the validity of this assumption.

Management has considered the Company's current financial situation and major investments made during the year ended September 30, 2008. The Company added a number of significant new customers during the year. The results reported in these financial statements reflect significant costs associated with the launch of these new customers. Revenues from the new customers were not generated until the later part of the year.

Management has prepared a detailed plan which covers the period through the end of fiscal 2009 and beyond which includes measures to increase revenues, improve quality and contain costs.

The Company's ability to continue as a going concern is dependent upon meeting its plans, which is dependent upon its ability to continue to generate revenues sufficient to recover its operating costs and capital requirements in an industry that is characterized by rapid technological change. There is no assurance that the Company will be successful in achieving these objectives.

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

September 30, 2008, 2007 and 2006

(expressed in Canadian dollars)

2. Summary of significant accounting policies

a) 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 subsidiaries, PhotoChannel Capital Inc., PhotoChannel Management Inc., Pixology Limited, Pixology Software Limited and Pixology Incorporated.

All material intercompany balances and transactions are eliminated upon consolidation.

b) Use of estimates and measurement uncertainty

The preparation of consolidated financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Significant areas requiring the use of estimates and assumptions include the determination of the fair value of assets and liabilities acquired in a business combination, the determination of the recoverable amounts for property and equipment, the determination of the asset retirement obligation, the determination of impairment of goodwill and other intangible assets, the determination of future income taxes and the determination and classification of stock-based transactions. Actual results may differ from those estimates.

c) Reporting currency and foreign currency translation

These consolidated financial statements are reported in Canadian dollars. Foreign currency denominated revenues and expenses are translated using average rates of exchange during the year. Foreign currency denominated assets and liabilities are translated at the rate of exchange in effect at the balance sheet date.

The Company translates the assets and liabilities of self-sustaining foreign operations to Canadian dollars at the rate of exchange prevailing at the balance sheet dates and revenues and expenses of those operations are translated using the average rates of exchange during the year. Gains and losses resulting from these translation adjustments for self-sustaining foreign operations are recorded in accumulated other comprehensive income, a component of shareholders’ equity, until there is a realized reduction in the net investment in the foreign operation.

d) 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. Investments with an original maturity of more than three months are considered short-term investments which are measured at fair value with changes in fair value recorded in net loss. As at September 30, 2008, 2007 and 2006, the Company had no investments in interest bearing securities with original terms to maturity of greater than three months.

PhotoChannel Networks Inc.

Notes to Consolidated Financial Statements

September 30, 2008, 2007 and 2006

(expressed in Canadian dollars)

e) Property and equipment

Property and equipment are recorded at costs less accumulated amortization. Amortization is provided over the estimated useful lives of the assets at the following rates:

Computer equipment	30% declining balance
Software	33-1/3 % - 100% straight-line
Furniture and office equipment	20% declining balance
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.

f) Deferred expenses

Cash rebates paid on entering into certain revenue arrangements, based on transactional revenue over a fixed period of time are deferred and amortized as a reduction of revenue on a straight-line basis over the term of the related contracts or the estimated term of the customer relationship period.

Direct costs incurred in relation to acquisitions undertaken or contemplated by the Company are initially capitalised and carried on the balance sheet as deferred expenses, until such time as the acquisition closes or a decision is made by the Company not to proceed any further. At such time, costs which have previously been capitalised are either treated as part of the final purchase price of the acquisition, or expensed through the statement of loss.

g) Goodwill

Goodwill represents the excess of the purchase price of an acquired enterprise over the fair values assigned to the assets acquired and liabilities assumed in a business combination. Goodwill is not amortized and at least annually is subject to an impairment test. If the carrying amount exceeds the fair value of the goodwill, an impairment loss is recognized equal to that excess through the statement of loss.

h) Intangible assets

Intangible assets acquired in a business combination that meet the specified criteria for recognition, apart from goodwill, are initially recognized and measured at fair value. Intangible assets with finite useful lives, including acquired software and customer relationships, are amortized on a straight-line basis over their estimated useful lives of three years. The amortization methods and estimated useful lives of intangible assets are reviewed annually.

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. If the carrying amount exceeds the fair value of the intangible asset, an impairment loss is recognized equal to that excess through the statement of loss.

PhotoChannel Networks Inc.

Notes to Consolidated Financial Statements

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(expressed in Canadian dollars)

i) Asset retirement obligations

The Company recognizes asset retirement obligations with respect to the restoration of leased office premises at the end of the lease term back to their original condition. The Company estimates fair value by determining the current market cost required to settle the asset retirement obligation, adjusts for inflation through to the expected date of the expenditures and discounts this amount back to the date when the obligation was originally incurred. As the liability is initially recorded on a discounted basis, it is increased each period until the estimated date of settlement. The Company reviews asset retirement obligations on a periodic basis and adjusts the liability as necessary to reflect changes in the estimated future cash flows and timing underlying the fair value measurement.

j) 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 bases. 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 substantive enactment. A valuation allowance is recognized to the extent the recoverability of future income tax assets is not considered more likely than not.

k) Share issue costs

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

l) Revenue

The Company provides online digital photo solutions to retailers and content providers through its PhotoChannel Network. The PhotoChannel Network services can include installation of personal computers to connect to the retailers' in-store digital printing device and hosting and management services for its internet based digital imaging network solution for the storage, editing, distribution and/or printing of photographs. The software services include maintenance, upgrades and technical support and, in some arrangements, the Company has the obligation to maintain the personal computers that it has supplied to a retailer. Fees for these services are paid through variable and fixed fees. The variable fees may be based on a percentage of fees collected by the customer, number of prints, number of uploaded images and/or fees charged on certain per unit bases such as number of locations. The Company also provides storage and archiving of digital images on the Company's servers based on storage capacity used over a defined period. Under certain arrangements with customers, the Company provides for additional professional services to make changes to the customer's website and branded environment and to provide email marketing programs to customers. In other situations, the Company sells software to retailers, which is resold to end users to edit, share and order prints from digital images.

PhotoChannel Networks Inc.

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(expressed in Canadian dollars)

The Company's arrangements with its customers related to the PhotoChannel Network are multiple element arrangements. The Company considers the unit of accounting under these arrangements to be the PhotoChannel Network internet and software services (including the provision of any software, hosting, management, maintenance of software and hardware and support services), services to install customer acquired hardware, storage and archiving services, as well as various professional services. Certain arrangements include service level agreements which may require the Company to refund a portion of the fee earned.

Revenue is recognized when persuasive evidence of an arrangement exists, delivery has occurred or services have been rendered, the price is fixed or determinable and collectability is reasonably assured. Cash received on accrued billings from customers prior to the related revenue being earned is recorded as deferred revenue.

Fixed upfront fees related to the PhotoChannel Network internet services are recognized on a straight-line basis over the life of the agreement, or where the agreement with the customer is on a month-to-month basis, over the estimated terms of the customer relationship period, and are included in installation fees. Monthly fixed fees per connected location are recognized over the period to which the fees relate and are included in membership fees. Fees based on a percentage of the customer's revenues, per print or per upload are recognized at the time the service is provided and are included in transaction fees. Fees for storing and archiving digital images for customers are recognized based upon storage capacity needs as the service is provided, and are included in archive fees. Professional fees are recognized when the services are performed and included in other services. Revenue from sales of end-user software to retailers are recognized when the software is delivered to the retailers and are included in other services.

The Company offers volume and other rebates and discounts to certain customers which are recognized as a reduction of revenue at the date the related revenue is recognized or the date the offer is made for previously recognized revenue. The amount of rebates is based on estimates of the expected rebates to be paid based on historical and expected trends or on the maximum potential rebates that could be earned by a customer if the Company is unable to reasonably estimate the expected rebate. The Company accounts for cash consideration offered to customers, including annual volume discounts, as a reduction in sales revenue.

All revenues are reported net of sales and value added taxes.

m) Software development costs

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, including customer-specific software developments are charged as an expense in the period incurred. To date, no development costs have been deferred; all costs have been expensed through software development.

PhotoChannel Networks Inc.
Notes to Consolidated Financial Statements
September 30, 2008, 2007 and 2006
(expressed in Canadian dollars)

n) Stock-based compensation

The Company grants stock options to directors and certain employees of the Company as an element of compensation. The cost of the service received as consideration is measured based on an estimate of fair value at the date of the grant. The grant-date fair value is recognized as compensation expense over the related service period with a corresponding increase in contributed surplus. On exercise of stock options, the Company issues common shares from treasury and the consideration received together with the compensation expense previously recorded to contributed surplus is credited to share capital.

The Company uses the Black-Scholes option pricing model to estimate the fair value of each stock option. The Black-Scholes option pricing model requires the Company to estimate the expected term of the options granted, the volatility of the Company's common shares and an expected dividend yield. The Company estimates the expected term of the options granted by calculating the average term after considering the Company's historical experience involving stock option exercise; cancellations, forfeitures and expiries; volatility is estimated with reference to historical volatility data; and the Company does not currently anticipate paying any cash dividends in the foreseeable future and therefore has used an expected dividend yield of zero as detailed in note 11(f). The Black-Scholes model also requires the Company to input a risk-free interest rate and the Company uses the Bank of Canada marketable bond rates.

o) Leases

Leases entered into are classified as either capital or operating leases. Leases that transfer substantially all of the benefits and risks of ownership of property to the Company are accounted for as capital leases. Property acquired under capital leases is recorded as an asset on the balance sheet and depreciated over the life of the lease.

Leases in which a significant portion of the risk and rewards of ownership are retained by the lessor are classified as operating leases. Payments made under operating leases are charged to operations on a straight-line basis over the term of the lease. The benefits of lease inducements provided to the Company are recognized on a straight-line basis over the term of the lease agreement.

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p) Financial instruments

Classification of financial instruments

The Company has made the following classifications for its financial instruments:

- Cash and cash equivalents are classified as "Assets held-for-trading" and are measured at fair value at the end of each period with any resulting gains or losses recognized in operations;
- Accounts receivable are classified as "Loans and receivables" and are recorded at amortized cost using the effective interest rate method. Subsequent measurement of trade receivables is at amortized cost, less an allowance for doubtful accounts;
- Accounts payable and accrued liabilities are classified as "Other financial liabilities" and are measured at amortized cost using the effective interest rate method;
- Loan payable, including accrued interest is classified as a financial liability and is measured at amortized cost using the effective interest rate method;
- Transaction costs incurred to acquire or issue financial instruments are recorded through the statement of loss

q) Net loss per share

Basic net loss per share is computed using the weighted average number of common shares outstanding during the period. The treasury stock method is used for calculation of diluted net 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 and the unrecognized portion of the fair value of stock options 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.

At September 30, 2008, 4,857,147 warrants (2007 – 4,857,147) and 2,883,869 options (2007 – 1,602,265) were outstanding. These were excluded from the calculation of diluted loss per share as their effects would be anti-dilutive.

r) Changes in accounting policies

Comprehensive income and financial instruments

On October 1, 2006, the Company adopted the recommendations included in the Canadian Institute of Chartered Accountants ("CICA") Handbook sections 1530, Comprehensive Income; 3251, Equity; 3855, Financial Instruments - Recognition and Measurement; 3861, Financial Instruments - Disclosure and Presentation; and 3865, Hedges.

Section 1530 requires the presentation of comprehensive income and its components in a new financial statement. Comprehensive income is the change in the Company's net assets that results from transactions, events and circumstances from sources other than the Company's shareholders.

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Other comprehensive income refers to items recognized in comprehensive income that are excluded from net income calculated in accordance with generally accepted accounting principles and includes unrealized gains and losses arising from the translation of the financial statements of self-sustaining foreign operations as well as unrealized gains and losses on available-for-sale investments. Accordingly, gains and losses arising from the translation of the Company's self-sustaining subsidiaries are recognized through the statement of other comprehensive income. The adoption of this standard had no further impact on the Company's financial statements.

Section 3251 requires that a company present separately the changes in and the balances of the following components of equity: retained earnings, accumulated other comprehensive income, contributed surplus, capital stock and reserves. Sections 3855 and 3861 establish the standards for the recognition, measurement, disclosure and presentation of financial assets, financial liabilities and non-financial derivatives. These standards prescribe when to recognize a financial instrument in the balance sheet and at what amount. On initial recognition, all financial instruments included in the scope of Section 3855 are measured at fair value. Depending on their balance sheet classification, fair value or cost-based measures are used to measure financial instruments after initial recognition. Derivative instruments that are embedded in other contracts but are not considered to be closely related to the host contract are also measured at fair value.

The adoption of these new standards had no effect on the Company's financial statements.

Capital Disclosures

Effective October 1, 2007, the Company adopted CICA handbook, Section 1535, Capital Disclosures. The new standard requires disclosure of qualitative and quantitative information that enables users of financial statements to evaluate the Company's objectives, policies and processes for managing capital. The additional disclosures, required as a result of the adoption of these standards, have been included in Note 19, Capital management.

Financial Instruments

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

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

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

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

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Accounting Changes

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

Determining whether a contract is routinely denominated in a single currency

Effective October 1, 2007, the Company adopted CICA Emerging Issues Committee (EIC) 169, Determining whether a contract is routinely denominated in a single currency. EIC 169 provides guidance on how to interpret one particular requirement of CICA Handbook Section 3855, Financial Instruments – Recognition and Measurement relating to the accounting for contracts entered into which are denominated in a foreign currency. The adoption of this EIC had no impact on the Company's consolidated financial statements.

Inventories

Effective October 1, 2007, the Company adopted CICA Handbook Section 3031, Inventories, which has replaced Section 3030 with the same title. This Section aligns Canadian GAAP with International Financial Reporting Standards ("IFRS") and establishes four basic principles: Inventory should be measured at the lower of cost and net realizable value; the cost of inventory includes costs directly attributable to its acquisition as well as an appropriate portion of fixed and variable production overheads; if the units in inventory are interchangeable, their cost should be determined using either a first-in first-out or weighted average cost formula; and write-downs of inventory to its net realizable value should be reversed if the value subsequently recovers. The adoption of this Handbook Section had no impact on the Company's consolidated financial statements.

s) Recently issued accounting standards

CICA Handbook Section 1400, General Standards of Financial Statement Presentation

In June 2007, the CICA amended Handbook Section 1400, General Standards of Financial Statement Presentation, to include additional requirements to assess and disclose an entity's ability to continue as a going concern. Section 1400 is effective for interim and annual reporting periods beginning on or after January 1, 2008. The adoption of this standard will have no impact on the Company's operating results or financial position and management expects that this standard will only impact the Company's financial statement disclosure.

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CICA Handbook Section 3064, Goodwill and Intangible Assets

In February 2008, the CICA issued Handbook Section 3064, Goodwill and Intangible Assets which will replace Handbook Section 3062, Goodwill and Other Intangible Assets and Section 3450, Research and Development Costs. This revision aligns Canadian GAAP with IFRS and establishes standards for the recognition, measurement, presentation and disclosure of goodwill and intangible assets. This section applies to fiscal years beginning October 1, 2008 and will be adopted by the Company on that date. The Company is currently assessing the impact on the Company's operating results or financial position.

3. Acquisition of Pixology PLC

On July 2, 2007, the Company acquired all of the outstanding shares of Pixology PLC ("Pixology"), a company incorporated in England and Wales and a provider of software and online solutions for the digital photography industry. The Company paid cash of \$18,657,729 including transaction costs of \$1,170,441.

The acquisition of Pixology gives the Company increased opportunities in the delivery of solutions for online printing. In addition, it expands the Company's product offerings into the important kiosk software market providing access to well established market-proven technology that could otherwise take up to two years to develop at an estimated cost of \$2,000,000.

The purchase price allocation summarizing the estimated fair value of the assets acquired and liabilities assumed at the date of the acquisition is as follows:

Cash and cash equivalents	\$	8,146,421
Other current assets		4,055,415
Property and equipment		462,104
Intangible assets – acquired software		4,060,000
Intangible assets – customer relationships		5,240,000
Goodwill		2,777,647
Current liabilities		(5,959,518)
Asset retirement obligations		(124,340)
Net identifiable assets and liabilities acquired for cash	\$	18,657,729

The factors that contributed to the recognition of goodwill included securing access to development synergies, cost saving opportunities, access to additional markets around the world and the acquisition of a talented workforce.

During the year ended September 30, 2008, management finalized their valuation of certain intangible assets acquired as part of this business combination. As a result of the finalization of the intangible asset valuation, the amount of goodwill previously recorded was reduced by \$2,357,835, the value assigned to acquired software increased by \$136,384 and the value assigned to customer relationships increased by \$2,221,451.

None of the goodwill arising on the acquisition of Pixology is deductible for tax purposes.

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4. Accounts receivable

	As at September 30, 2008	As at September 30, 2007
Trade accounts receivable	\$ 4,080,966	\$ 3,927,420
Allowance for doubtful accounts	(145,000)	-
	<u>3,935,966</u>	<u>3,927,420</u>
Goods and services tax recoverable	65,306	45,443
Other	18,014	72,172
Total	<u>\$ 4,019,286</u>	<u>\$ 4,045,035</u>

Reconciliation of changes in allowance for doubtful accounts:

	2008	2007
Balance, beginning of year	\$ -	\$ -
Increase in allowance for doubtful accounts	145,000	-
Balance, end of year	<u>\$ 145,000</u>	<u>\$ -</u>

5. Property and equipment

2008	Cost	Accumulated amortization	Net book value
Computer equipment	\$ 12,932,185	\$ (6,434,424)	\$ 6,497,761
Software	648,097	(600,978)	47,119
Furniture and office equipment	621,954	(414,759)	207,195
Leasehold improvements	129,988	(95,413)	34,575
	<u>\$ 14,332,224</u>	<u>\$ (7,545,574)</u>	<u>\$ 6,786,650</u>

2007	Cost	Accumulated amortization	Net book value
Computer equipment	\$ 5,741,371	\$ (3,574,785)	\$ 2,166,586
Software	342,114	(279,009)	63,105
Furniture and office equipment	741,212	(219,064)	522,148
Leasehold improvements	84,266	(75,560)	8,706
	<u>\$ 6,908,963</u>	<u>\$ (4,148,418)</u>	<u>\$ 2,760,545</u>

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Included within Computer Equipment, are assets with a net book value of \$1,051,185 (2007 - \$nil) which were acquired using a capital lease.

For the year ended September 30, 2008, amortization of property and equipment was \$2,044,145 (2007- \$649,270; 2006 - \$402,600), of which \$212,706 (2007 - \$nil; 2006 – nil) related to assets held under capital leases.

6. Intangible assets

2008	Acquired software	Customer relationship	Total
Balance, September 30, 2007	\$ 3,429,332	\$ 2,638,282	\$ 6,067,614
Adjustment on finalization of purchase price allocation	136,384	2,221,451	2,357,835
Amortization	(1,281,238)	(1,933,670)	(3,214,908)
Impact of foreign currency translation	(176,653)	130,604	(46,049)
Balance, September 30, 2008	\$ 2,107,825	\$ 3,056,667	\$ 5,164,492

2007	Acquired software	Customer relationship	Total
Balance, September 30, 2006	\$ -	\$ -	\$ -
Acquisition of Pixology PLC (note 3)	3,923,616	3,018,549	6,942,165
Amortization	(324,521)	(249,663)	(574,184)
Impact of foreign currency translation	(169,763)	(130,604)	(300,367)
Balance, September 30, 2007	\$ 3,429,332	\$ 2,638,282	\$ 6,067,614

The acquired software and the customer relationship are being amortized on a straight-line basis over a three year period.

During the year ended September 30, 2008, the preliminary purchase price allocation relating to the acquisition of Pixology PLC during the year ended September 30, 2007 was finalised, which resulted in an adjustment of \$2,357,835 to the amounts previously recorded as intangible assets.

Expected amortization for the years ending September 30, 2009 and 2010 is \$2,951,138 and \$2,213,354, respectively.

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7. Goodwill

2008	Amount	
Balance, September 30, 2007	\$	4,867,231
Adjustment on finalization of purchase price allocation		(2,357,835)
Impairment		(1,086,577)
Impact of foreign currency translation		75,720
Balance, September 30, 2008	\$	1,498,539

2007	Amount	
Balance, September 30, 2006	\$	-
Acquisition of Pixology PLC (note 3)		5,135,490
Impact of foreign currency translation		(268,259)
Balance, September 30, 2007	\$	4,867,231

During the year ended September 30, 2008, the preliminary purchase price allocation relating to the acquisition of Pixology PLC during the year ended September 30, 2007 was finalised, which resulted in an adjustment of \$2,357,835 to the amounts previously recorded as goodwill.

Upon acquisition, the goodwill was allocated on a relative fair value basis to Pixology (63%) and to PhotoChannel (37%).

During the year ended September 30, 2008 a review of the carrying value of goodwill was completed and it was determined that the amount allocated to Pixology was impaired and that \$1,086,577 should be written off. This impairment arose as a result of planned development synergies not materializing to the extent assumed at the time of the acquisition; cost reductions implemented subsequent to acquisition resulting in the operations reaching a break-even position, but being insufficient to result in the Company being able to sustain profitable operations on a recurring basis; and the loss, subsequent to acquisition of a number of customers.

8. Accounts payable and accrued liabilities

	As at September 30, 2008	As at September 30, 2007
Trade payables	\$ 2,923,543	\$ 4,702,195
Amounts due to customers	3,348,986	1,156,282
Trade accruals	640,235	775,506
Accrued payroll and other taxes	305,157	546,226
Due to employees and consultants	262,880	330,542
Total	\$ 7,480,801	\$ 7,510,751

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9. Asset retirement obligation

The following table summarizes the changes in the balance of asset retirement obligation during the year ended September 30, 2008:

Balance, September 30, 2007	\$	120,699
Payments made to settle asset retirement obligations		(36,312)
Recognition of gain on settlement of asset retirement obligation		(86,120)
Liability incurred during the period		21,214
Accretion expense included in general and administration expenses		3,091
Impact of foreign currency translation		(563)
Balance, September 30, 2008	\$	22,009

During the year ended September 30, 2008, the Company's property lease which previously gave rise to an asset retirement obligation was terminated. Costs incurred to restore the leased premises to their original condition upon termination of the lease totalled \$36,312. As a result of settling the liability for less than originally anticipated, a gain of \$86,120 has been recognised through the statement of loss.

During the year ended September 30, 2008, the Company entered into a lease agreement for new premises. The lease agreement entered into, which has a term of five years, requires the Company to restore the leased premises to their original condition at the end of the lease term. Accordingly, an asset retirement obligation relating to this requirement has been calculated. At September 30, 2008, the total undiscounted cash flows which are estimated to be required to settle the asset retirement obligation are \$35,512 and the credit-adjusted risk free interest rate at which the estimated cash flows have been discounted is 9%.

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10. Income taxes

a) Income tax expense (recovery)

The Company is subject to income taxes in Canada and the United Kingdom. The income tax expense (recovery) differs from the amount obtained by applying the applicable statutory income tax rate to loss before income taxes as follows:

	2008	2007	2006
Canadian statutory income tax rate	31.91%	34.1%	36.1%
Income tax recovery based on statutory income tax rate	\$ (2,781,603)	\$ (2,071,847)	\$ (950,294)
Difference in foreign tax rates	92,173	91,918	-
Expiration of tax losses	1,420,273	1,320,000	745,321
Non-deductible expenses	571,630	233,457	12,635
Impact of change in foreign currency rates on future tax assets	538,431	275,304	-
Items deductible for tax not flowing through earnings	-	(455,306)	(185,662)
Adjustments in respect of prior year returns	540,184	646,428	-
Rate changes on current year items	205,157	127,479	-
Other	-	267	-
Change in valuation allowance	(586,245)	(167,700)	378,000
Income tax expense (recovery)	\$ -	\$ -	\$ -

The Company's net loss before tax includes \$8,136,394 (2007 - \$3,841,223; 2006 - \$2,632,301) from domestic operations and \$580,632 (2007 - \$2,231,013; 2006 - \$Nil) from foreign operations.

b) Future income tax assets and liabilities

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

Future income tax assets

	2008	2007	2006
Net operating loss carry-forwards	\$ 11,881,567	\$ 13,623,675	\$ 6,334,000
Property and equipment	1,799,245	1,441,625	2,171,000
Share issue costs	412,936	509,000	262,000
Other	437,968	383,000	171,000
	14,531,716	15,957,300	8,938,000
<i>Future income tax liabilities</i>			
Intangible assets	(1,437,026)	(1,699,000)	-
Related party interest accrued	(94,079)	-	-
Net future tax asset	13,000,611	14,258,300	8,938,000
Valuation allowance	(13,000,611)	(14,258,300)	(8,938,000)
Future income tax assets, net	\$ -	\$ -	\$ -

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The following table summarizes the changes in the valuation allowance during each year of the three-year period ended September 30, 2008:

	2008	2007	2006
Balance, beginning of year	\$ (14,258,300)	\$ (8,938,000)	\$ (8,560,000)
Acquisition of Pixology PLC	-	(5,488,000)	-
Future tax benefits not recognized	(1,446,001)	(1,746,472)	(938,000)
Expiration of tax losses	1,420,273	1,320,000	745,321
Impact of change in foreign exchange rates	538,434	275,304	-
Impact of changes in tax rates	1,322,364	1,197,522	-
Items deductible for tax not flowing through earnings	-	(455,306)	(185,321)
Adjustments in respect of prior year returns	(577,381)	(423,348)	-
Balance, end of year	\$ (13,000,611)	\$ (14,258,300)	\$ (8,938,000)

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

As at September 30, 2008, the Company had \$17,665,000 (2007 - \$20,307,000) of net operating loss carry-forwards in Canada available to reduce taxable income in future years. These income tax losses expire as follows:

2009	\$ 2,839,000
2010	2,560,000
2014	2,928,000
2015	1,836,000
2026	2,073,000
2027	3,121,000
2028	2,308,000
	\$ 17,665,000

The Company has \$23,975,000 (£12,706,000) of future losses for tax purposes in the United Kingdom that do not have an expiry date and which are available to reduce taxable trading income in future periods.

11. Share capital

a) Share consolidation

On November 2, 2006, the Company consolidated its common shares on a ten-for-one basis. The net loss per share computations and information regarding the number of shares, options and warrants reflect the share consolidation for all periods presented in these consolidated financial statements.

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b) Authorized

Unlimited number of common shares without par value

Unlimited number of preferred shares without par value

As at September 30, 2008, the Company had 33,464,432 common shares (2007 – 33,315,536) issued and outstanding. There are no preferred shares issued or outstanding at September 30, 2008, 2007 or 2006.

c) Private placements

i) Year ended September 30, 2007

During the year ended September 30, 2007, the Company issued 4,430,588 units pursuant to a brokered private placement for net proceeds of \$16,025,308 and issued 426,559 warrants to agents in consideration for services received. 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 US\$4.00 per share before expiry on March 30, 2009. The net proceeds of \$16,025,308 were allocated \$11,063,482 to common shares issued and \$4,961,826 to the common share purchase warrants on a relative fair value basis. 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 72%; risk-free interest rate of 3.95%; and expected life of two years. All warrants remain outstanding at September 30, 2008.

ii) Year ended September 30, 2006

During the year ended September 30, 2006, the Company issued 2,750,000 units pursuant to a non-brokered private placement 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 entitled the holder to purchase one additional common share of the Company at a price of \$1.50 per share before expiry on May 30, 2007. 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 on a relative fair value basis. 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.

During the year ended September 30, 2006, the Company issued 1,700,000 units pursuant to a non-brokered private placement 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 \$1.50 per share before expiry on November 15, 2006. 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

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yield of \$nil; expected volatility of 80%; risk-free interest rate of 3.74%; and expected life of one year.

During the year ended September 30, 2007, 2,225,000 share purchase warrants issued during the year ended September 30, 2006 were exercised.

d) Warrants

The following table summarizes activity related to the Company's issued share purchase warrants during the years ended September 30, 2008, 2007 and 2006:

	Number of warrants	Average exercise price
Balance, September 30, 2005	2,231,475	\$ 1.20
Warrants issued related to private placement of units	2,225,000	1.50
Cancelled on expiry date	(984,600)	1.20
Common shares issued on exercise	(1,246,875)	1.20
Balance, September 30, 2006	2,225,000	1.50
Warrants issued related to private placement of units	4,857,147	4.00
Common shares issued on exercise of warrants	(2,225,000)	1.50
Balance, September 30, 2007	4,857,147	\$ 4.00
Balance, September 30, 2008	4,857,147	\$ 4.00

e) Options

The Company provides stock options to directors and certain employees of the Company pursuant to a stock option plan (the "Plan"). The Plan authorizes a maximum of 10% (3,346,443) of the Company's issued and outstanding common shares to be reserved for issuance. The term of the options granted under the plan is five years and options are subject to various vesting requirements. Under the terms of the Plan one-eighteenth of the options granted vest each month with the first eighteenth vesting on the date of grant.

The following table summarizes activity under the Company's stock option plan for the years ended September 30, 2008, 2007 and 2006:

	Number of options	Average exercise price
Balance, September 30, 2005 (1,237,344 options exercisable)	1,535,677	\$ 1.60
Granted	615,000	1.30
Expired	(414,000)	1.50
Forfeited	(159,667)	1.70
Balance, September 30, 2006 (1,079,233 options exercisable)	1,577,010	1.40
Granted	745,000	2.32
Exercised	(611,572)	1.46
Forfeited	(108,173)	1.34

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Balance, September 30, 2007 (1,273,609 options exercisable)	1,602,265	1.81
Granted	1,465,300	3.35
Exercised	(148,896)	1.38
Forfeited	(34,800)	3.11
Balance, September 30, 2008	2,883,869	\$ 2.60

The following table summarizes information about stock options outstanding and exercisable at September 30, 2008:

Options outstanding				Options exercisable		
Exercise price	Number outstanding	Weighted average remaining contractual life (years)	Weighted average exercise price	Number exercisable	Weighted average exercise price	
\$ 1.25	311,376	2.43	\$ 1.25	311,376	\$ 1.25	
\$ 1.50	420,000	1.47	\$ 1.50	420,000	\$ 1.50	
\$ 2.32	713,993	3.20	\$ 2.32	713,993	\$ 2.32	
\$ 3.35	1,434,500	4.45	\$ 3.35	521,181	\$ 3.35	
\$ 3.65	4,000	4.54	\$ 3.65	1,332	\$ 3.65	
\$1.25 - \$3.65	2,883,869	3.49	\$ 2.60	1,967,882	\$ 2.25	

The total intrinsic value of options exercised during the year ended September 30, 2008 was \$356,392 (2007 - \$1,673,865; 2006 - \$Nil). The intrinsic value is calculated as the difference between the market value on the date of exercise and the exercise price of the shares.

	Number of shares	Weighted average exercise price	Weighted average remaining contractual life (years)	Aggregate intrinsic value
As at September 30, 2006				
Options outstanding	1,577,010	\$ 1.40	3.10	\$ 1,809,611
Options vested and expected to vest	1,577,010	\$ 1.40	3.10	\$ 1,809,611
Options exercisable	1,079,233	\$ 1.50	2.60	\$ 1,173,639
As at September 30, 2007				
Options outstanding	1,602,265	\$ 1.81	3.46	\$ 2,692,645
Options vested and expected to vest	1,602,265	\$ 1.81	3.46	\$ 2,692,645
Options exercisable	1,273,609	\$ 1.68	3.30	\$ 2,303,478
As at September 30, 2008				
Options outstanding	2,883,869	\$ 2.60	3.49	\$ 458,160
Options vested and expected to vest	2,883,869	\$ 2.60	3.49	\$ 458,160
Options exercisable	1,967,882	\$ 2.25	3.04	\$ 458,160

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f) Stock-based compensation

The fair value of each stock option is estimated on the date of grant using the Black-Scholes option pricing model. The following table provides the weighted average grant-date fair value and the weighted average assumptions used in applying the Black-Scholes option pricing model for the years ended September 30, 2008, 2007 and 2006:

	2008	2007	2006
Expected volatility	77%	72%	74%
Risk-free interest rate	3.35%	3.86%	4.17%
Expected life (years)	4.0	3.0	1.5
Expected dividend yield	0%	0%	0%
Weighted average grant-date fair value (\$ per share)	\$ 1.98	\$ 1.41	\$ 0.46

The total fair value of stock options granted during the year ended September 30, 2008 was \$2,896,237 (2007 - \$1,052,570; 2006 - \$282,900).

During the year ended September 30, 2008, the Company recognized compensation expense of \$1,511,504 (2007 - \$799,750; 2006 - \$215,084) for stock options issued to employees. The total income tax benefit recognized in the statement of loss for stock-based compensation is \$Nil for all periods presented.

12. Revenue

Description	2008	2007	2006
Transaction fees	\$ 11,635,172	\$ 4,823,523	\$ 1,687,204
Installation fees	3,933,413	1,362,452	1,239,930
Membership fees	802,105	866,082	751,408
Archive fees	210,901	60,010	111,561
Professional fees	467,996	399,261	285,048
Total	\$ 17,049,587	\$ 7,511,328	\$ 4,075,151

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13. Segment information

The Company has two operating segments that have similar economic characteristics which are aggregated into a single reportable segment based on the manner in which the Company has organized its operations and provision of financial information to senior management.

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

Description	2008	2007	2006
Canada	\$ 4,161,178	\$ 3,921,042	\$ 3,465,661
United States	4,384,105	1,460,170	592,124
United Kingdom	8,441,973	2,119,190	-
Other	62,331	10,926	17,366
Total	\$ 17,049,587	\$ 7,511,328	\$ 4,075,151

Revenue is attributable to the geographic location of the Company's customer. As at September 30, 2008 and September 30, 2007, the Company's assets by geographical location are as follows:

	Canada	United Kingdom	Total
September 30, 2008			
Property and equipment	\$ 6,484,044	\$ 302,606	\$ 6,786,650
Goodwill and intangible assets	\$ 4,083,209	\$ 2,529,822	\$ 6,663,031
September 30, 2007			
Property and equipment	\$ 2,354,737	\$ 405,808	\$ 2,760,545
Goodwill and intangible assets	\$ 1,800,875	\$ 9,133,970	\$ 10,934,845

Major customers representing 10% or more of the Company's sales for the year are as follows:

Description	2008	2007	2006
Customer A	\$ 4,982,339	\$ 3,251,591	\$ 2,605,949
Customer B	\$ 1,806,567	\$ 1,147,221	-
Customer C	\$ 3,621,110	\$ 982,741	-
Customer D	\$ 2,550,398	\$ 918,537	-

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14. Capital lease obligations

During the year ended September 30, 2008, the Company entered into a capital lease to acquire certain items of computer equipment. The amount outstanding under this capital lease at the period end is as follows:

	<u>2008</u>	<u>2007</u>
Computer equipment under capital lease, bearing interest at 20.51% per annum	\$ 865,947	\$ -

Minimum payments

Future minimum lease payments at September 30, 2008 are as follows:

	<u>2008</u>	<u>2007</u>
2009	\$ 490,072	\$ -
2010	490,072	-
2011	122,518	-
	<u>1,102,662</u>	<u>-</u>
Less: Amounts representing interest	(236,715)	-
Present value of lease obligation	<u>865,947</u>	<u>-</u>
Less: Current portion	(490,072)	-
Long-term portion of lease obligation	<u>\$ 375,875</u>	<u>\$ -</u>

15. Loan payable

During the year-ended September 30, 2008, the Company was provided with an unsecured loan from a Director and Officer totalling £500,000 (\$943,450). The loan, which is denominated in Sterling bears interest at a rate equal to the Bank of England base rate, plus 3.2% and falls due for repayment on May 15, 2009. At September 30, 2008, the total amount, including interest of this loan balance was \$969,886. During the year ended September 30, 2008, interest expense of \$20,152 was recorded relating to this loan.

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16. Commitments

The Company has entered into agreements to lease premises and services for periods to 2013. The annual rent for premises includes minimum rent plus realty taxes and operating expenses. Minimum payments for each of the remaining five years are as follows:

	Property leases	Other service agreements	Total
2009	\$ 303,672	\$ 1,381,187	\$ 1,684,859
2010	152,440	1,303,891	1,456,331
2011	152,440	1,098,132	1,250,572
2012	152,440	1,047,552	1,199,992
2013	88,923	261,888	350,811
	\$ 849,915	\$ 5,092,650	\$ 5,942,565

During the year ended September 30, 2008, the Company incurred operating lease expenses of \$1,796,582 (2007 - \$217,848).

At September 30, 2008, the Company was committed to purchasing items of equipment with a cost of \$1,487,260.

17. Supplementary cash flow information

Net change in non-cash working capital items

	2008	2007	2006
Accounts receivable	\$ (218,707)	\$ 257,414	\$ (894,101)
Prepaid expenses and other current assets	71,768	546,608	(23,383)
Accounts payable and accrued liabilities	221,924	(23,327)	83,745
Changes in deferred expenses	36,922	67,353	(157,157)
Changes in deferred revenue	542,191	303,220	38,554
	\$ 654,098	\$ 1,151,268	\$ (952,342)

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	<u>2008</u>	<u>2007</u>	<u>2006</u>
Interest paid	\$ 103,989	\$ (3,347)	\$ (4,244)
Interest received	\$ 134,848	\$ 394,535	\$ 23,362
Taxes paid	\$ -	\$ -	\$ -
Non-cash activities consist of:			
Increase in accounts payable related to acquisition of equipment	\$ 123,798	\$ 613,799	\$ -
Equipment purchased through capital leases	\$ 1,248,464	\$ -	\$ -
Expiry of unexercised warrants	\$ -	\$ -	\$ 440,082
Non-cash portion of common shares issued on exercise of options and warrants	\$ 116,116	\$ 880,831	\$ 258,791

18. Financial instruments

The Company is exposed to a number of risks related to changes in foreign currency exchange rates, interest rates, collection of accounts receivable, settlement of liabilities and management of cash and cash equivalents.

Credit risk

Financial instruments that potentially subject the Company to concentrations of credit risk consist of cash and cash equivalents and accounts receivable. The Company aims to protect its cash and cash equivalents from undue risk by holding them with various high credit quality financial institutions located in Canada and the United Kingdom. The Company's cash equivalents consist primarily of deposit investments with commercial banks in the United Kingdom. Of the amounts held with financial institutions on deposit, \$258,435 is covered by either the Financial Services Compensation Scheme in the United Kingdom or the Canada Deposit Insurance Corporation, leaving \$2,412,553 at risk should the financial institutions with which the deposits are held cease trading.

The Company's accounts receivable are all from large, well-known retailers located in Canada, the United States and the United Kingdom. Credit risk from accounts receivable encompasses the default risk of retail customers. The Company manages its exposure to credit risk by only working with larger, reputable companies and prior to accepting new customers; the Company assesses the risk of default associated with a particular company. In addition, on an ongoing basis, management monitor the level of accounts receivable attributable to each customer and the length of time taken for amounts to be settled and where necessary, takes appropriate action to follow up on those balances considered overdue.

Management does not believe that there is significant credit risk arising from any of the Company's customers; however, should one of the Company's main customers be unable to settle amounts due, the impact on the Company could be significant. The maximum exposure to loss arising from

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accounts receivable is equal to their total carrying amounts. At September 30, 2008, four customers each account for 10% or more of total trade accounts receivable (2007 – four customers).

Financial assets past due

At September 30, 2008, the Company has a provision of \$145,000 against trade accounts receivable, the collection of which is considered doubtful.

The following table provides information regarding the ageing of financial assets that are past due but which are not impaired.

At September 30, 2008

	Financial assets that are past due but not impaired				Carrying value on the balance sheet \$
	Neither past due nor impaired	31 – 60 days	61 – 90 days	91 days +	
Trade accounts receivable	2,748,760	277,793	131,361	778,052	3,935,966
Other	18,014	-	-	-	18,014

The definition of items that are past due is determined by reference to terms agreed with individual customers. Of the 91 days+ balance outstanding at September 30, 2008, 74% has been subsequently collected as at December 16, 2008. None of the amounts outstanding have been challenged by the respective customer(s) and the Company continues to conduct business with them on an ongoing basis. Accordingly, management has no reason to believe that this balance is not fully collectable in the future.

The Company reviews financial assets past due on an ongoing basis with the objective of identifying potential matters which could delay the collection of funds at an early stage. Once items are identified as being past due, contact is made with the respective company to determine the reason for the delay in payment and to establish an agreement to rectify the breach of contractual terms. At September 30, 2008, the Company had a provision for doubtful accounts of \$145,000 which was made against trade accounts receivable in excess of twelve months old and where collection efforts to date have been unsuccessful. All amounts neither past due nor impaired are collectible from large, well-known retailers located in Canada, the United States and the United Kingdom. The Company is not aware of any information suggesting that the collectability of these amounts is in doubt.

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Liquidity risk

Liquidity risk is the risk that the Company will not be able to meet its financial obligations as they fall due. The Company's objective to managing liquidity risk is to ensure that it has sufficient liquidity available to meet its liabilities when due.

At September 30, 2008, the Company has a short-term credit facility of £1,000,000 (\$1,886,900), of which £500,000 (\$943,450) had been drawn at September 30, 2008 (note 15) and has utilized a capital lease to acquire items of equipment. The lease obligation that remained outstanding at September 30, 2008 was \$865,947 (note 16). The Company uses this short-term loan facility and cash and cash equivalents to settle its financial obligations as they fall due. The ability to do this relies on the Company collecting its accounts receivables in a timely manner and by maintaining sufficient cash on hand.

Traditionally, the quarter ended December 31 each year is the busiest of the year for the Company with a large increase seen in the number of transactions processed through both the online and in-store solutions offered to the Company's retail customers. It is expected that additional cash generated throughout the period ended December 31, 2008 will result in a strengthening of the balance sheet position and will help fund operations in future periods.

At September 30, 2008, the Company's accounts payable and accrued liabilities were \$7,480,801, of which \$4,329,635 are denominated in UK£, all of which fall due for payment within normal terms of trade which is generally between 30 and 60 days.

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

Although the global economy, and in particular the economic conditions in both North America and the United Kingdom our two most significant markets, has suffered significant downturns in recent months, with consumer confidence being reported to be at record lows, the Company has not, to date, experienced any decline in consumer purchasing through their hosted websites. Further weakening of global economic conditions could impact the achievement of management's plans to the extent that our retail partners are negatively impacted, resulting in an overall decline of printed photographs and gift products.

In past years, the Company has relied on its ability to raise additional financing through the sale of common shares in order to fund its rapid expansion and growth plans. The recent problems seen in the global credit markets has resulted in a drastic reduction in the ability of companies to raise capital through the public markets and while management does not plan on raising any additional funds through this channel, should circumstances change in the future, its ability to do so may be impaired.

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Market risk

Market risk is the risk to the Company that the fair value or future cash flows of financial instruments will fluctuate due to changes in interest rates and foreign currency exchange rates. Market risk arises as a result of the Company generating revenues and incurring expenses in foreign currencies, holding cash and cash equivalents which earn interest and having operations based in the United Kingdom in the form of its wholly owned subsidiary, Pixology.

Interest rate risk

The only financial instruments that expose the Company to interest rate risk are its cash and cash equivalents and its loan payable. The Company's objectives of managing its cash and cash equivalents are to ensure sufficient funds are maintained on hand at all times to meet day-to-day requirements and to place any amounts which are considered in excess of day-to-day requirements on short-term deposit with the Company's banks so that they earn interest. When placing amounts of cash and cash equivalents on short-term deposit, the Company only uses high quality commercial banks and ensures that access to the amounts placed can be obtained on short-notice.

The Company's loan payable bears interest at a rate based on the United Kingdom Base Rate plus a premium of 3.2%. The Company does not have in place any financial instruments to mitigate the possible adverse effects of an increase in the underlying Base Rate.

Currency risk

The Company generates revenues and incurs expenses and expenditures primarily in Canada, the United States and the United Kingdom and is exposed to risk from changes in foreign currency rates. In addition, the Company holds financial assets and liabilities in foreign currencies that expose the Company to foreign exchange risks. The Company does not utilise any financial instruments or cash management policies to mitigate the risks arising from changes in foreign currency rates.

At September 30, 2008, through its wholly owned subsidiary, the Company had cash and cash equivalents of \$2,320,800, accounts receivable of \$1,175,880 and accounts payable of \$4,329,635 which were denominated in UK £. In addition, at September 30, 2008, the Company had cash and cash equivalents of \$309,519, accounts receivable of \$2,243,358 and accounts payable of \$910,300 which were denominated in US\$ as well as a UK £ denominated loan outstanding of \$969,886.

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Sensitivity analysis

The Company has completed a sensitivity analysis to estimate the impact on net loss for the period which a change in foreign exchange rates or interest rates during the year ended September 30, 2008 would have had.

This sensitivity analysis includes the following assumptions:

- Changes in individual foreign exchange rates do not cause foreign exchange rates in other countries to alter
- Changes in market interest rates do not cause a change in foreign exchange rates

The results of the foreign exchange rate sensitivity analysis can be seen in the following table:

	Impact on net loss
	\$
Change of +/- 10% in US\$ foreign exchange rate	+/- 164,175
Change of +/- 10% in UK£ foreign exchange rate	+/- 685,661

A change of 1% in the United Kingdom Base Rate would have an annual impact of approximately \$9,400 on the Company's net loss.

The above results arise primarily as a result of the Company having US\$ denominated trade accounts receivable balances, trade accounts payable balances and bank account balances as well as a UK£ denominated loan balance.

Limitations of sensitivity analysis

The above table demonstrates the effect of either a change in foreign exchange rates or interest rates in isolation. In reality, there is a correlation between the two factors.

Additionally, the financial position of the Company may vary at the time that a change in either of these factors occurs, causing the impact on the Company's results to differ from that shown above.

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19. Capital management

The Company considers its share capital, warrants, contributed surplus, capital lease obligations and loans payable, as capital, which at September 30, 2008 totalled \$84,023,171.

The Company manages its capital structure in order to ensure sufficient resources are available to meet day to day operating requirements; to allow it to enhance existing product offerings as well as develop new ones and to have the financial ability to expand the size of its operations by taking on new customers. In managing its capital structure, the Company takes into consideration various factors, including the seasonality of the market in which it operates the growth of its business and related infrastructure and the upfront cost of taking on new clients.

The Company's Officers and senior management take full responsibility for managing the Company's capital and do so through quarterly meetings and regular review of financial information. The Company's Board of Directors are responsible for overseeing this process.

Methods used by the Company to manage its capital include the issuance of new share capital and warrants which has historically been done through private placements primarily with institutional investors.

The Company is not subject to any externally imposed capital requirements.

20. Related Party Transactions

During the year ended September 30, 2008, the Company advanced loans to officers of the Company in the amount of \$68,000 with interest payable at a rate of 7% per annum. Included in accounts receivable at September 30, 2008 is \$18,014, comprising an amount of \$17,000 representing a portion of the principal which remains outstanding and \$1,014 representing interest accrued on that principal. This amount falls due for repayment within one year from the date of issue. At September 30, 2007, an amount of \$48,615 was due from an officer of the Company. This amount was repaid in full on October 25, 2007. During the year ended September 30, 2008, interest income of \$3,931 was earned on these loan balances.

During the year ended September 30, 2008, the Company incurred legal fees of \$134,480 (2007 - \$280,094) for services provided by a law firm of which a director of the Company is a partner. Accounts payable and accrued liabilities at September 30, 2008 included \$23,217 (2007 - \$47,334) related to these services.

During the year ended September 30, 2008, the Company incurred expenses in relation to setting up e-mail marketing campaigns on behalf of a number of our retail customers of \$70,685 (2007 - \$26,760) with a company of which a director of the Company is Chairman and Chief Executive Officer. Accounts payable and accrued liabilities at September 30, 2008 included \$9,844 (2007 - \$8,920) related to these services. The amounts charged were recorded at their exchange amount, which is the amount of consideration established and agreed to by the related parties and having normal trade terms.

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21. Pension plan

The Company has a defined contribution pension plan with respect to certain employees in the United Kingdom where the Company's obligation is limited to making regular contributions on behalf of the eligible employees. During the year ended September 30, 2008, the Company made contributions of \$82,249 (2007 - \$69,162) into this plan.

22. Reconciliation to accounting principles generally accepted in the United States of America

The financial statements have been prepared in accordance with Canadian generally accepted accounting principles ("Canadian GAAP"), which differ in certain material respects from those principles and practices that the Company would have followed had its financial statements been prepared in accordance with accounting principles and practices generally accepted in the United States ("US GAAP").

a) Statements of loss and comprehensive loss

Net loss from operations, separately identifying revenue earned from the sale of tangible products and the sale of services, together with the respective costs associated with those sales is as follows:

	2008	2007	2006
Revenue			
Service revenue	\$ 11,994,709	\$ 6,289,455	\$ 4,075,151
Product revenue	5,054,878	1,221,873	-
	<u>17,049,587</u>	<u>7,511,328</u>	<u>4,075,151</u>
Expenses			
Network delivery – service revenue	3,647,579	1,580,025	1,800,882
Network delivery – product revenue	3,761,946	943,149	-
Software development	6,914,291	4,178,111	2,299,859
General and administration	4,603,450	3,199,727	1,462,664
Sales and marketing	1,140,028	1,134,350	738,013
Amortization	5,259,053	1,223,454	402,600
	<u>25,326,347</u>	<u>12,258,816</u>	<u>6,704,018</u>
Net loss from operations	<u>\$ (8,276,760)</u>	<u>\$ (4,747,488)</u>	<u>\$ (2,628,867)</u>

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The reconciliation between Canadian GAAP and US GAAP of the net loss for the year is as follows:

	<u>2008</u>	<u>2007</u>	<u>2006</u>
Net loss for the period under Canadian GAAP	\$ (8,717,026)	\$ (6,072,236)	\$ (2,632,301)
Change in fair value of embedded foreign currency derivatives relating to warrants (d)	4,671,206	268,089	-
Net (loss) for the year under U.S. GAAP	<u>(4,045,820)</u>	<u>(5,804,147)</u>	<u>(2,632,301)</u>
Other comprehensive loss:			
Unrealized foreign exchange loss on translation of self-sustaining foreign operations	(346,964)	(809,569)	-
Comprehensive loss under U.S. GAAP	<u>\$ (4,392,784)</u>	<u>\$ (6,613,716)</u>	<u>\$ (2,632,301)</u>
Basic and fully diluted loss per share under U.S. GAAP	<u>\$ (0.12)</u>	<u>\$ (0.19)</u>	<u>\$ (0.12)</u>

b) Balance sheets

	<u>2008</u>		<u>2007</u>	
	<u>Canadian GAAP</u>	<u>U.S. GAAP</u>	<u>Canadian GAAP</u>	<u>U.S. GAAP</u>
Assets				
Current assets	\$ 7,120,890	\$ 7,120,890	\$ 11,973,425	\$ 11,973,425
Intangible assets	5,164,492	5,164,492	6,067,614	6,067,614
Goodwill (note f)	1,498,539	8,009,602	4,867,231	11,378,294
Other long-term assets	6,839,532	6,839,532	2,850,349	2,850,349
Total assets	<u>\$ 20,623,453</u>	<u>\$ 27,134,516</u>	<u>\$ 25,758,619</u>	<u>\$ 32,269,682</u>
Liabilities & Shareholders' Equity				
Liabilities				
Current liabilities	\$ 9,598,804	\$ 9,598,804	\$ 7,855,584	\$ 7,855,584
Warrants liability (note d)	-	22,531	-	4,693,737
Long-term liabilities	760,992	760,992	291,909	291,909
Shareholder's Equity				
Share capital	65,614,347	65,506,187	65,293,214	65,185,054
Warrants (note d)	4,961,826	-	4,961,826	-
Contributed surplus (note d)	11,611,165	13,969,166	10,215,777	12,573,778
Deficit (note d, f)	(70,767,148)	(61,566,631)	(62,050,122)	(57,520,811)
Accumulated other comprehensive loss	(1,156,533)	(1,156,533)	(809,569)	(809,569)
	<u>\$ 20,623,453</u>	<u>\$ 27,134,516</u>	<u>\$ 25,758,619</u>	<u>\$ 32,269,682</u>

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(c) Stock-based compensation

Effective October 1, 2004, the Company adopted Financial Accounting Standard (“FAS”) No. 123, Accounting for Stock-Based Compensation, as subsequently revised by FAS No. 123(R) (“FAS 123(R)”), Share-Based Payment, effective October 1, 2006. The adoption of FAS 123(R), effective October 1, 2006 under the modified prospective method, had no material impact on the Company’s financial position or results of operations. Under US GAAP, the Company recognizes the grant-date fair value of stock-based compensation awards granted to employees and directors over the requisite service period for all awards granted, modified, repurchased or cancelled after October 1, 2004 and the unvested portions of outstanding awards as at October 1, 2004. The Company also adopted CICA Handbook Section 3870, Stock-Based Compensation and Other Stock-Based Payments effective October 1, 2004 for awards granted on or after October 1, 2002.

As a result of these new accounting standards in Canada and the United States, there are no material GAAP differences related to the Company’s stock-based compensation awards during the period ended June 30, 2008 and 2007.

At September 30, 2008, the total compensation cost related to non-vested awards not yet recognized was \$1,800,048, (2007 - \$467,809) which will be recognized over the remaining vesting period of 11 months.

(d) Warrants Liability

Under US GAAP, the Securities Exchange Commission (“SEC”) determined that it is not possible to treat as equity, warrants whose exercise price currency denomination is different from the functional currency of the entity. The SEC generally views such instruments as derivative liabilities. Therefore, the Company applied EITF 07-5 “Determining Whether an Instrument (or Embedded Feature) is Indexed to an Entity’s Own Stock”, and allocated the fair value of warrants issued whose exercise price currency denomination is different than the Company’s functional currency as a liability, to be carried at fair value, with changes in fair value to be recorded in operations. The change in fair value of these warrants for the year ended September 30, 2008 was \$4,671,206 (2007 - \$268,089) and was recognised through the statement of loss.

(e) Cash flow statements

The Canadian accounting standard for the preparation of cash flow statements is consistent with the guidance provided by International Accounting Standard (IAS) 7, and accordingly, the cash flow statements presented herein have not been reconciled to US GAAP under the accommodation provided by the SEC.

(f) Redemption of Limited Partnership units

During the year ended September 30, 2004, the Company redeemed limited partnership units and recorded the cost as a charge to deficit for Canadian GAAP purposes. Under US GAAP, the

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Company applied SFAS No. 141, “Business Combinations”, and allocated the cost of issuing the common shares and share purchase warrants to goodwill, after first considering any allocation to tangible and intangible assets acquired. This resulted in an increase of \$6,511,063 in goodwill and shareholders’ equity. The Company applies SFAS No. 142, “Goodwill and Other Intangible Assets”, in determining if there is any impairment in value. As at June 30, 2008, no impairment in value has been recorded to date.

(g) Income taxes

The Company follows the liability method with respect to accounting for income taxes. Deferred tax assets and liabilities are determined based on temporary differences between the carrying amounts and the tax basis of assets and liabilities. Deferred income tax assets and liabilities are measured using enacted tax rates that will be in effect when these differences are expected to reverse. Deferred income tax assets are reduced by a valuation allowance, if based on the weight of available evidence; it is more likely than not that some portion or all of the deferred tax assets will not be realized.

In July 2006, the Financial Accounting Standards Board (the “FASB”) issued Financial Interpretation No. 48, Accounting for Uncertainty in Income Taxes, or “FIN 48”, which clarifies the accounting for uncertainty in income taxes recognized in a company’s financial statements in accordance with Statement of Financial Accounting Standards No. 109, Accounting for Income Taxes. FIN 48 prescribes a recognition threshold and measurement process for recording in the financial statements uncertain tax positions taken or expected to be taken in a tax return. Additionally, FIN 48 provides guidance on the de-recognition, classification, interest and penalties, accounting in interim periods, and disclosure requirements for uncertain tax positions. The Company adopted the provisions of FIN 48 beginning October 1, 2007.

We file income tax returns in the U.S., Canada and the United Kingdom. We are subject to income tax examination by tax authorities in all jurisdictions from our inception to date. Our policy is to recognize interest expense and penalties related to income tax matters as tax expense. At September 30, 2008, we do not have any significant accruals for interest related to unrecognized tax benefits or tax penalties. Based on the Company’s evaluation, there are no significant uncertain tax positions requiring recognition or measurement in accordance with FIN 48.

(h) Recent U.S. announcements

FASB 157 – Fair Value Measurement

FAS 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. These definitions would be applied effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. The Company is currently assessing the impact of this statement.

FASB Staff Position 157-1, Application of FASB Statement No. 157 to FASB Statement No. 13 and Other Accounting Pronouncements That Address Fair Value Measurements for Purposes of Lease

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Classification or Measurement under Statement 13

Issued in February 2008, this FASB Staff Position (FSP) amends FASB Statement No. 157, Fair Value Measurements, to exclude FASB Statement No. 13, Accounting for Leases, and other accounting pronouncements that address fair value measurements for purposes of lease classification or measurement under Statement 13. However, this scope exception does not apply to assets acquired and liabilities assumed in a business combination that are required to be measured at fair value under FASB Statement No. 141, Business Combinations, or No. 141 (revised 2007), Business Combinations, regardless of whether those assets and liabilities are related to leases. The Company is currently evaluating the impact of FSP FAS No. 157-1 on its consolidated financial position and results of operations

FASB Staff Position 157-2, Effective Date of FASB Statement No. 157

Issued in February 2008, this FASB Staff Position (FSP) delays the effective date of FASB Statement No. 157, Fair Value Measurements, for non-financial assets and non-financial liabilities, except for items that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually) to fiscal years beginning after November 15, 2008, and interim periods within those fiscal years.

FASB 159 – The Fair Value for Financial Assets and Financial Liabilities

In February 2007, the FASB issued FAS No. 159, The Fair Value for Financial Assets and Financial Liabilities ("FAS No. 159"). FAS No. 159 permits entities to choose to measure financial assets and liabilities, with certain exceptions, at fair value at specified election dates. The objective is to improve financial reporting by providing entities with the opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. A business entity shall report unrealized gains and losses on items for which the fair value option has been elected in earnings at each subsequent reporting date. FAS No. 159 is effective for the Company in fiscal years beginning October 1, 2008. The Company is currently evaluating the impact of FAS No. 159 on its consolidated financial position and results of operations.

FASB 141(R) – Business Combinations

In December 2007, the FASB issued FAS No. 141(R), Business Combinations ("FAS 141(R)"). FAS 141(R) establishes principles and requirements for how the acquirer of a business recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, and any non-controlling interest in the acquiree. FAS 141(R) also provides guidance for recognizing and measuring the goodwill acquired in the business combination and determines what information to disclose to enable users of the financial statements to evaluate the nature and financial effects of the business combination. FAS 141(R) is effective for the Company in fiscal years beginning October 1, 2009. This standard will only be applicable to acquisitions after October 1, 2009. The Company has not yet evaluated this statement for the future impact of FAS 141(R).

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

FASB 160 – Non-controlling Interests in Consolidated Financial Statements

In December 2007, the FASB issued FAS No. 160, Non-controlling Interests in Consolidated Financial Statements. FAS 160 requires ownership interests in subsidiaries held by other parties to be classified as equity in the consolidated financial statements and changes in ownership interests in a subsidiary to be accounted for as equity transactions. Deconsolidation of a subsidiary is to be accounted for at fair value. FAS 160 is applicable for fiscal years beginning on or after December 15, 2008 on a prospective basis, except for the presentation and disclosure requirements which are to be applied to all periods presented. The Company does not currently have any partially owned subsidiaries and does not expect, based on its current structure, the adoption to have any significant impact.

FASB 162 – The Hierarchy of Generally Accepted Accounting Principles

In May 2008, the Financial Accounting Standards Board (FASB) issued FASB Statement No. 162, The Hierarchy of Generally Accepted Accounting Principles (“FAS 162”). The new standard is intended to improve financial reporting by identifying a consistent framework, or hierarchy, for selecting accounting principles to be used in preparing financial statements that are presented in conformity with U.S. generally accepted accounting principles (GAAP) for non-governmental entities. For non-governmental entities, the guidance in FAS 162 replaces that prescribed in Statement on Auditing Standards (SAS) No. 69, The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles and becomes effective 60 days following the SEC's approval of the Public Company Accounting Oversight Board Auditing amendments to AU Section 411, The Meaning of Present Fairly in Conformity with Generally Accepted Accounting Principles. The Company does not expect the adoption of FAS No. 162 to have a significant impact on its consolidated financial position and results of operations

FASB Staff Position 142-3, Determination of the Useful Life of Intangible Assets

This FASB Staff Position (FSP) amends the factors that should be considered in developing renewal or extension assumptions used to determine the useful life of a recognized intangible asset under FASB Statement No. 142, Goodwill and Other Intangible Assets. The intent of this FSP is to improve the consistency between the useful life of a recognized intangible asset under Statement 142 and the period of expected cash flows used to measure the fair value of the asset under FASB Statement No. 141 (revised 2007), Business Combinations, and other U.S. generally accepted accounting principles (GAAP).

This FSP shall be effective for financial statements issued for fiscal years beginning after December 15, 2008, and interim periods within those fiscal years. Early adoption is prohibited. The guidance for determining the useful life of a recognized intangible asset in paragraphs 7–11 of this FSP shall be applied prospectively to intangible assets acquired after the effective date. The disclosure requirements in paragraphs 13–15 shall be applied prospectively to all intangible assets recognized as of, and subsequent to, the effective date.