

Avalon Works Corp.
(Formerly Danek & Associates Inc.)
Consolidated Financial Statements
August 31, 2001

October 4, 2001

Auditors' Report

To the Shareholders of Avalon Works Corp.

We have audited the consolidated balance sheets of **Avalon Works Corp.** as at August 31, 2001 and 2000 and the consolidated statements of operations, shareholders' equity and cash flows for the years ended August 2001, 2000 and 1999. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the Company as at August 31, 2001 and 2000 and the results of its operations and its cash flows for the years ended August 31, 2001, 2000 and 1999, in accordance with Canadian generally accepted accounting principles.

PricewaterhouseCoopers LLP

Chartered Accountants

(1)

Avalon Works Corp.

Consolidated Balance Sheets

	2001 \$	2000 \$
Assets		
Current assets		
Cash and cash equivalents	687,403	278,660
Accounts receivable	1,090,885	516,564
Unbilled receivables	—	348,226
Other receivables (note 2)	50,000	50,000
Prepaid expenses	43,280	4,171
	<hr/>	<hr/>
	1,871,568	1,197,621
Due from shareholders (note 2)	307,733	305,432
Future income tax asset (note 3)	56,000	31,328
Note receivable (note 4)	—	75,000
Capital assets (note 5)	456,013	187,060
Loan and advances receivable (note 6)	383,779	—
Goodwill and intangible assets	1,118,911	—
	<hr/>	<hr/>
	4,194,004	1,796,441
Liabilities		
Current liabilities		
Accounts payable and accrued liabilities	855,978	633,658
Income taxes payable	319,048	234,327
Current portion of capital lease obligations	4,682	—
Current portion of note payable	5,787	—
	<hr/>	<hr/>
	1,185,495	867,985
Capital lease obligations	1,661	—
Note payable	15,865	—
Future income tax liability (note 3)	9,064	15,528
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	1,212,085	883,513
Shareholders' equity		
Capital stock (note 7)	1,622,940	145,369
Retained earnings	1,358,979	767,559
	<hr/>	<hr/>
	2,981,919	912,928
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	4,194,004	1,796,441
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(The accompanying notes form an integral part of these consolidated financial statements.)

Approved by the Board of Directors

_____ Director

_____ Director

Avalon Works Corp.
Consolidated Statements of Operations

	2001	2000	1999
	\$	\$	\$
Revenue	5,456,759	3,961,636	3,975,942
Expenses			
Advertising and promotion	9,214	21,079	30,255
Amortization	124,824	44,253	3,983
ASP expense	24,098	-	-
Bad debts	47,513	68,147	59,697
Bank charges and interest	5,424	4,370	5,580
Commissions	18,338	-	84,899
Conferences	15,908	12,400	4,383
Computer hardware purchased for resale	14,595	-	-
Donations	10,410	-	16,000
Loss on sale of investment	-	-	24,500
Office and miscellaneous	92,861	109,924	30,046
Professional fees	77,252	38,950	1,500
Rent	65,288	42,894	10,382
Salaries and benefits	1,532,327	400,670	155,418
Subcontractors	2,475,772	2,780,017	3,196,787
Telephone	135,404	34,390	6,892
Travel and lodging	75,511	44,052	33,728
	4,724,739	3,601,146	3,664,050
Income before income taxes	732,020	360,490	311,892
Provision (recovery) for income taxes			
Current	101,736	153,000	123,978
Future	38,864	(16,000)	-
	140,600	137,000	123,978
Net income for the year	591,420	223,490	187,914
Earnings per share			
Basic	0.04	0.02	0.02
Diluted	0.04	0.02	0.02
Weighted average number of common shares outstanding (000's)			
Basic	13,467	11,660	11,321
Diluted	14,002	11,719	11,321

(The accompanying notes form an integral part of these consolidated financial statements.)

Avalon Works Corp.

Consolidated Statements of Shareholders' Equity

	Class A Common Shares		Class B Common Shares		Common Shares		Retained Earnings \$	Total Shareholders' Equity \$
	#	\$	#	\$	#	\$		
Balance – August 31, 1998	7,924,528	70	3,396,226	30	–	–	356,155	356,255
Net income for the year	–	–	–	–	–	–	187,914	187,914
Balance – August 31, 1999	7,924,528	70	3,396,226	30	–	–	544,069	544,169
Issuance of common shares for cash	339,623	72,000	–	–	–	–	–	72,000
Issuance of common shares for the purchase of Crosshands (net of share issuance costs)	339,623	73,269	–	–	–	–	–	73,269
Net income for the year	–	–	–	–	–	–	223,490	223,490
Balance – August 31, 2000	8,603,774	145,339	3,396,226	30	–	–	767,559	912,928
Issuance of common shares for the reverse takeover (net of share issuance costs)	(8,603,774)	(145,339)	(3,396,226)	(30)	16,400,000	682,440	–	537,071
Issuance of common shares for the purchase of Warnetwork (net of share issuance costs)	–	–	–	–	960,000	940,500	–	940,500
Net income for the year	–	–	–	–	–	–	591,420	591,420
Balance – August 31, 2001	–	–	–	–	17,360,000	1,622,940	1,358,979	2,981,919

(The accompanying notes form an integral part of these consolidated financial statements.)

Avalon Works Corp.

Consolidated Statements of Cash Flows

	2001 \$	2000 \$	1999 \$
Cash flows from (used in)			
Operating activities			
Net income for the year	591,420	223,490	187,914
Items not affecting cash			
Amortization	124,824	44,253	3,983
Future income tax provision (recovery)	38,864	(16,000)	–
Loss on sale of investment	–	–	24,500
Net change in operating components of working capital (net of assets acquired through the acquisition of companies during the period)	(23,055)	(143,602)	245,971
	<hr/> 732,053	<hr/> 108,141	<hr/> 462,368
Investing activities			
Purchase of capital assets	(40,131)	(146,812)	(7,689)
Note receivable	–	(75,000)	–
Purchase of Crosshands, net of cash acquired	–	31,107	–
Purchase of eHaven, net of cash acquired	–	(67,051)	–
Proceeds from reverse takeover	545,211	–	–
Purchase of Warnetworks, net of cash acquired	(162,779)	–	–
Purchase of Glen-net & Iosphere, net of cash acquired	(200,000)	–	–
Loan and advances to WorldChart	(383,779)	–	–
	<hr/> (241,478)	<hr/> (257,756)	<hr/> (7,689)
Financing activities			
Capital lease repayments	(2,311)	–	–
Repayment of note receivable	(2,240)	–	–
Issuance of capital stock	–	73,269	–
Common share issue costs	(77,281)	–	–
Advances to shareholders	–	–	(209,385)
	<hr/> (81,832)	<hr/> 73,269	<hr/> (209,385)
Net change in cash for the year	408,743	(76,346)	245,294
Cash and cash equivalents – Beginning of year	278,660	355,006	109,712
Cash and cash equivalents – End of year	<hr/> 687,403	<hr/> 278,660	<hr/> 355,006

(The accompanying notes form an integral part of these consolidated financial statements.)

Avalon Works Corp.

Notes to Consolidated Financial Statements

1 Significant accounting policies

Basis of presentation

Avalon Works Corp. (the “Corporation” or “AWC”) was incorporated pursuant to the provisions of the Canada Business Corporation Act on April 6, 2000 and was previously classified as a Capital Pool Company as defined pursuant to Policy 2.4 of the Canadian Venture Exchange (“CDNX”). The CDNX approved the Corporation’s purchase, by issuance of common shares, of all the issued and outstanding shares of Danek & Associates Inc. (“DAI”) as discussed in note 10. As such, the Corporation is no longer considered a Capital Pool Company.

These consolidated financial statements have been prepared by management in accordance with accounting principles generally accepted in Canada (“Canadian GAAP”) and include all assets, liabilities, revenues and expenses of AWC and its wholly-owned subsidiaries, DAI, Crosshands Group Inc. (“Crosshands”), eHaven Inc. (“eHaven”), and Warnetworks Telecom Inc. (“Warnetworks”). AWC and its wholly-owned subsidiaries are collectively referred to as the “Company”.

Cash and cash equivalents

Cash equivalents are defined as highly liquid investments that are readily convertible to known amounts of cash and which are subject to insignificant risk of changes in value.

Capital assets

Capital assets are stated at cost and are amortized over their estimated useful lives at the following annual rates:

Computer hardware	30% declining balance
Computer software	30% declining balance
Furniture and equipment	20% declining balance
Leasehold improvements	5 years straight line
Vehicle	30% declining balance

Goodwill and other intangible assets

Goodwill, which represents the purchase price paid for an acquired business in excess of the fair value assigned to identifiable assets is amortized on a straight-line basis over its established useful life of 10 years. Other intangibles which consist of customer lists are amortized on a straight-line basis over their estimated useful life of 2 years.

The Company’s policy is to review the carrying amounts of goodwill and other intangible assets whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Such events or circumstances might include a significant decline in market share, a significant decline in profits, rapid changes in technology, significant litigation or other items. In evaluating the recoverability of goodwill and other intangible assets, management’s policy is to compare the carrying amounts of such assets with the undiscounted estimated future operating cash flows.

Avalon Works Corp.

Notes to Consolidated Financial Statements

In the event an impairment exists, an impairment charge would be determined by comparing the carrying amounts of the asset to the applicable undiscounted estimated future cash flows. In addition, the remaining amortization period for the impaired asset would be reassessed and revised if necessary. Management does not believe the carrying amounts of goodwill and other intangible assets are impaired at August 31, 2001.

Income taxes

The Company follows the asset and liability method for determining income taxes. Under this method, future tax assets and liabilities are recognized for the estimated tax recoverable or payable, which would arise if assets were recovered and settled at the financial statement carrying amounts. Future tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which temporary differences are expected to be recovered or settled. Changes to these balances are recognized in income in the period in which they occur.

Revenue recognition and unbilled receivables

The Company provides professional services under level-of-effort, cost-based and fixed-price contracts. Unbilled receivables are valued at estimated net realizable value. Under level-of-effort contracts, revenue is recorded as services are provided. For cost-based contracts, revenue is recorded as reimbursable costs are incurred. Revenue from fixed-price contracts is recorded using the percentage-of-completion method, whereby revenue and profit are based on a ratio of costs incurred to total estimated costs of the project. Losses, if any, on fixed-price contracts are recognized during the period they are determined.

The Company recognizes revenue when persuasive evidence of an agreement exists, the terms are fixed or determinable, services are performed and collection is probable.

Stock-based compensation

The Company has a stock option plan as described in note 9. No compensation expense is recognized when shares or stock options are issued to employees. Any consideration paid by employees on the exercise of stock options is credited to share capital. If shares or stock options are repurchased from employees, the excess of the consideration paid over the carrying amount of the shares or stock options cancelled is charged to retained earnings.

Use of estimates

The preparation of financial statements in conformity with Canadian 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 dates of the financial statements and the reported amounts of revenues and expenses during the reporting periods. Actual results could differ from these estimates.

Avalon Works Corp.

Notes to Consolidated Financial Statements

2 Related party transactions

Other receivables is comprised of a \$50,000 loan to an employee in the form of a non-interest bearing promissory note repayable August 31, 2001. The note was repaid subsequent to year end.

The amount due from shareholders represents amounts loaned to shareholders who are also officers of the Company. The loans are non-interest bearing with no fixed terms of repayment.

3 Income taxes

A reconciliation of the combined Canadian federal and provincial income tax rate with the Company's effective income tax rate is as follows:

	2001 %	2000 %	1999 %
Statutory tax rate	42.1	42.0	44.0
Small business deduction	—	(4.0)	(4.0)
Utilization of prior years losses	(24.3)	—	(0.3)
Other	1.4	—	—
Effective tax rate	19.2	38.0	39.7

Temporary differences and carry forwards which give rise to future tax assets and liabilities are as follows:

	2001 \$	2000 \$
Future income tax assets		
Share issuance costs	56,000	—
Tax loss carryforward	—	31,328
Future income tax liabilities		
Asset based differences	9,064	15,528

4 Note receivable

On August 31, 2000, eHaven Inc. entered into an agreement with Warnetworks to market their products and services to their existing and potential clients on a non exclusive basis. Under the agreement, the venturers were to share equally in the profits or losses from the partnership. No expenses or revenues were incurred. In fiscal 2000, DAI, advanced to Warnetworks a sum of \$75,000 in consideration for a six-month promissory note, expiring March 2, 2001, bearing interest at 4.25% per annum.

On April 30, 2001, AWC acquired 100% of the outstanding shares of Warnetworks as further discussed in note 8. As part of the acquisition the joint venture agreement was terminated and the note receivable was settled.

Avalon Works Corp.

Notes to Consolidated Financial Statements

5 Capital assets

	2001		2000	
	Cost \$	Accumulated amortization \$	Cost \$	Accumulated amortization \$
Computer hardware	480,208	117,347	198,368	49,070
Computer software	26,015	13,469	18,887	5,863
Furniture and equipment	68,622	16,782	31,146	9,333
Leasehold improvements	3,250	975	3,250	325
Vehicles	29,435	2,944	—	—
	607,530	151,517	251,651	64,591
Less: Accumulated amortization	<u>151,517</u>		<u>64,591</u>	
Net book value	<u>456,013</u>		<u>187,060</u>	

Assets under capital leases and their related accumulated amortization included in capital assets are as follows:

	2001	
	Cost \$	Accumulated amortization \$
Computer hardware	8,111	811
Furniture and equipment	17,552	1,170
Vehicles	29,435	2,944

There were no capital leases in fiscal 2000.

6 Loan and advances receivable

On June 8, 2001, the Company entered into a share exchange agreement with Galaxy Online Inc. and its subsidiary The Online Source Inc. ("Worldchat") to purchase 100% of the issued and outstanding securities of Worldchat. The Company agreed to fund Worldchat's operations between the date of the share exchange agreement and the closing date. Accordingly, as at August 31, 2001, the Company has advanced \$383,000, \$200,000 in the form of a loan and \$183,000 in the form of advances.

The loan of \$200,000 is repayable on demand, and bears interest at the prime lending rate as quoted by the Royal Bank of Canada plus 1%. The assets of WorldChat have been pledged as collateral on the loan through a general security agreement.

The advances of \$183,000 are not interest bearing, have no fixed terms of repayment, and are unsecured.

Avalon Works Corp.

Notes to Consolidated Financial Statements

7 Capital stock

The authorized capital stock of the Corporation consists of an unlimited number of common shares with no par value.

On March 7, 2000, 30,000 Class A common shares of DAI were issued to an employee in exchange for cash consideration of \$72,000. These shares have not been fully paid for by the purchaser.

On February 29, 2000, 30,000 Class A common shares of DAI were issued in exchange for 100% of the outstanding shares of Crosshands, which were assessed at a fair market value of \$73,269 as discussed in note 8.

On September 1, 2000, there was a share split of 10,000-to-1. The effect of this split has been reflected throughout these financial statements.

On December 21, 2000, AWC issued by way of an initial public offering as a CDNX Capital Pool Company, 2,500,000 common shares.

On April 30, 2001, AWC purchased 100% of the outstanding shares of DAI for 12,000,000 common shares of AWC as further discussed in note 8. As a result of this transaction, the former shareholders of DAI became the majority shareholders of the Corporation and accordingly the acquisition was accounted for as a reverse takeover, using the purchase method.

On April 30, 2001, the Company issued 960,000 common shares of AWC for 100% of the outstanding shares of Warnetwork as further discussed in note 8. These shares received regulatory approval subsequent to year end.

Avalon Works Corp.

Notes to Consolidated Financial Statements

8 Acquisitions

Reverse takeover of AWC

On April 30, 2001, AWC purchased 100% of the outstanding shares of DAI for total consideration of \$605,170, consisting of 12,000,000 common shares of AWC.

As a result of the issuance of 12,000,000 AWC shares, the former shareholders of DAI constitute a majority of the shareholders of AWC after the acquisition, owning 73% of AWC. This form of business combination is referred to as a “reverse take-over”. Legally, AWC is regarded as the parent entity; however, in accordance with Canadian GAAP, since the former shareholders of DAI now control AWC after the merger, DAI is identified as the acquirer and AWC is treated as the acquiree. Being the acquiring entity, the assets and liabilities of DAI are included in the balance sheet at cost and the assets and liabilities of AWC are included at their fair market value.

The net assets acquired were as follows:

Cash	\$ 545,211
Deferred acquisition costs	59,959
	<hr/>
	605,170
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Included in cash acquired was \$117,790 of cash held in escrow for professional fees relating to the acquisition of DAI.

Warnetworks

On April 30, 2001, AWC purchased 100% of the outstanding shares of Warnetwork for total consideration of \$1.2 million, consisting of \$960,000 common shares of AWC, cash of \$165,000 and settlement of the \$75,000 note receivable from Warnetworks. The acquisition was accounted for using the purchase method.

Warnetworks operating results have been included in the consolidated financial statements from the date of acquisition.

The allocation of the purchase price is as follows:

Cash	\$ 2,221
Accounts receivable	137,330
Capital assets	55,098
Accounts payable	(112,556)
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Net identifiable assets acquired	82,093
Goodwill	1,117,907
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Total consideration	1,200,000
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Avalon Works Corp.

Notes to Consolidated Financial Statements

Glen-net and Iosphere

On May 23, 2001, AWC purchased the assets of Glen-net and Iosphere for \$200,000 in cash. This acquisition was accounted for using the purchase method.

The allocation of the purchase price is as follows:

	\$
Capital assets	248,723
Accounts payable	<u>(79,784)</u>
Net identifiable assets acquired	168,939
Goodwill	<u>31,061</u>
Total consideration	<u>200,000</u>

Crosshands

Effective February 29, 2000, DAI purchased 100% of the outstanding shares of Crosshands from its sole shareholder in exchange for a 3% interest in DAI. The acquisition has been accounted for using the purchase method. Crosshands' operating results have been included in the consolidated financial statements from the date of acquisition.

The allocation of the purchase price is as follows:

	\$
Cash	31,107
Accounts receivable	55,535
Capital assets	27,351
Accounts payable and accrued liabilities	<u>(40,724)</u>
Total consideration	<u>73,269</u>

Avalon Works Corp.

Notes to Consolidated Financial Statements

eHaven

Effective August 1, 2000, DAI purchased 100% of the outstanding shares of eHaven in exchange for cash consideration of \$64,451. The acquisition has been accounted for using the purchase method. eHaven's operating results have been included in the consolidated financial statements from the date of acquisition.

The allocation of the purchase price is as follows:

	\$
Cash	609
Accounts receivable	702
Capital assets	41,700
Accounts payable and accrued liabilities	(3,424)
Future income tax asset	24,864
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Total consideration	64,451
	<hr/>

9 Stock option plan

Effective March 31, 2000, the Company adopted an employee stock incentive plan. The Board of Directors has set aside 10% of the outstanding shares of AWC to be awarded to the Company's employees, subject to approval by the Quebec Securities Commission ("QSC"). As at August 31, 2001, 955,200 options issued under this plan were pending approval from the QSC.

The option exercises price for all options issued under the plan is based on the fair value of the underlying shares on the date of grant. The options will vest in two equal instalments at the first and second anniversary of their initial award date and must be exercised within a four-year period from the date of grant or upon cessation of employment.

As additional consideration to the agent involved in the initial public offering of the Company's shares, the Company granted the agent non-transferable share purchase options entitling the agent to acquire up to an aggregate of 250,000 common shares at an exercise price of \$0.20. These options became exercisable December 21, 2000 and expire 18 months from the exercise date. None of these options have been exercised as at August 31, 2001.

Avalon Works Corp.

Notes to Consolidated Financial Statements

Information with respect to stock options is as follows:

	Number of shares	Weighted average exercise price
Outstanding at August 31, 1999	–	\$ –
Granted – June 30, 2000	440,000	0.20
Exercised	–	–
Cancelled	–	–
<hr/>		
Outstanding at August 31, 2000	440,000	0.20
Granted	1,249,200	0.81
Exercised	–	–
Cancelled	44,000	0.20
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Outstanding at August 31, 2001	1,645,200	0.66
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Exercisable at August 31, 2001	690,000	0.20
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Information with respect to stock options outstanding at August 31, 2001 is as follows:

Exercise Price	Number outstanding	Weighted average exercise price	Weighted average life in years
0.20	690,000	0.20	3.04
1.00	955,200	1.00	3.72
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	1,645,200	0.66	3.44
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The Company adopted CICA 3500 “Earnings Per Share” during the year ended August 31, 2001 and has retroactively stated earnings per share, where required, for all periods presented. The calculations of the earnings per share are based on the weighted daily average number of shares outstanding during the year. The calculation of diluted earnings per share assumes that all outstanding options and warrants have been exercised at the later of the beginning of the fiscal period or the option issuance date.

The dilutive effect of the weighted average share calculation results from the potential exercise of stock options.

Avalon Works Corp.

Notes to Consolidated Financial Statements

10 Financial instruments

The carrying amounts of cash and cash equivalents, accounts receivable, unbilled receivables, other receivables, due from shareholders, accounts payable, accrued liabilities, capital lease obligations, and note payable approximate their respective fair values unless otherwise noted.

Financial instruments which potentially subject the Company to concentrations of credit risk consists principally of accounts receivable. Credit risk with respect to accounts receivable is limited since the majority of accounts receivable are collectible from government agencies. The Company believes that an adequate provision has been made for the possibility of receivables proving uncollectible and continually monitors and adjusts the allowance as necessary.

11 Commitments

As at August 31, 2001, the Company was obligated under long-term leases for premises and equipment with minimum annual payments as follows:

Year ending August 31,	2002	\$ 57,000
	2003	27,000
	2004	25,000

The Company has provided a demand guarantee of \$41,000 as collateral for certain accounts payable.

12 Segmented information

Operating segments are defined as components of an enterprise about which separate financial information is available that is evaluated regularly by the Company's chief decision maker in deciding how to allocate resources and assessing performance. The Company's chief decision maker is the Chief Executive Officer.

The Company has two reportable segments: consulting services and internet services. The Company's long-lived assets are all located in Canada. The Company evaluates operating segment performance based on operating revenue from external customers, and expenses.

The accounting policies of the Company's operating segments are the same as those described in note 1. The Company does not use a measure of segment assets to assess performance or allocate resources. As a result, segmented asset information is not presented.

Avalon Works Corp.

Notes to Consolidated Financial Statements

A reconciliation of the totals reported for the operating segments to the applicable line items in the consolidated financial statements is as follows:

	Consulting services \$	Internet services \$	Other \$	Total \$
Revenue	5,058,051	228,350	170,358	5,456,759
Expenses	4,378,477	226,945	119,317	4,724,739
Income before income taxes	679,574	1,405	51,041	732,020
Income taxes	132,600	–	8,000	140,600
Net income	546,974	1,405	43,041	591,420

In prior years, the Company's operating segments were comprised solely of consulting services.

Consulting revenues from The Powell Group, which sub-contracts government work to DAI, represents approximately 67% of total revenues.

13 Subsequent events

On September 27, 2001, AWC announced that it had entered into an arm's length agreement to acquire all of the issued and outstanding shares of Information Gateway Services ("IGS") for total consideration of \$1.5 million consisting of 1,000,000 common shares of AWC and \$500,000 cash. This acquisition will be accounted for using the purchase method, and IGS's results of operations will be included in the consolidated financial statements from the date of acquisition.

