

Financial Statements of

**Q9 NETWORKS INC.**

Three and six months ended April 30, 2004 and 2003  
(Unaudited)

# Q9 NETWORKS INC.

Balance Sheets  
(In thousands)  
(Unaudited)

	April 30, 2004	October 31, 2003
<b>Assets</b>		
Current assets:		
Cash and cash equivalents	\$ 17,950	\$ 2,195
Short-term investments (note 2)	53,900	39,638
Accounts receivable	1,906	1,959
Unbilled revenue	406	223
Prepaid expenses	710	378
	<u>74,872</u>	<u>44,393</u>
Restricted cash	1,320	2,270
Capital assets	37,769	38,572
	<u>\$ 113,961</u>	<u>\$ 85,235</u>
<b>Liabilities and Shareholders' Equity</b>		
Current liabilities:		
Accounts payable and accrued liabilities	\$ 5,396	\$ 2,040
Deferred revenue	2,906	2,517
Current portion of leasehold inducements	195	175
Notes payable	209	467
	<u>8,706</u>	<u>5,199</u>
Deferred gain on sale of property	1,325	1,364
Long-term portion of leasehold inducements	886	779
Shareholders' equity:		
Capital stock:		
Common shares (note 3)	177,750	420
Preference shares (note 3)	—	148,472
Contributed surplus	19	—
Deficit	(74,725)	(70,999)
	<u>103,044</u>	<u>77,893</u>
	<u>\$ 113,961</u>	<u>\$ 85,235</u>

See accompanying notes to financial statements.

## Q9 NETWORKS INC.

Statements of Operations and Deficit  
(In thousands, except per share amounts)  
(Unaudited)

	Three months ended		Six months ended	
	April 30,		April 30,	
	2004	2003	2004	2003
Revenue:				
Co-location	\$ 2,230	\$ 1,486	\$ 4,189	\$ 2,949
Managed bandwidth	1,606	1,385	3,179	2,596
Managed services	2,281	1,507	4,646	2,850
Set-up fees	155	153	319	284
	6,272	4,531	12,333	8,679
Cost of revenue	5,181	5,301	10,097	10,271
Gross margin	1,091	(770)	2,236	(1,592)
Expenses:				
Sales and marketing	1,090	1,096	2,018	2,224
General and administrative	1,222	1,425	2,609	2,951
Lease termination costs (note 9)	1,571	—	1,571	—
Amortization	134	204	267	413
	4,017	2,725	6,465	5,588
Loss from operations	(2,926)	(3,495)	(4,229)	(7,180)
Interest expense	(3)	(16)	(3)	(35)
Accretion of interest on redeemable convertible preference shares	—	(3,672)	—	(7,344)
Interest income	252	276	539	509
Amortization of deferred financing costs	—	(119)	—	(238)
	249	(3,531)	536	(7,108)
Loss before income taxes	(2,677)	(7,026)	(3,693)	(14,288)
Income taxes	12	22	33	43
Loss for the period	(2,689)	(7,048)	(3,726)	(14,331)
Deficit, beginning of period	(72,036)	(50,947)	(70,999)	(43,664)
Deficit, end of period	\$ (74,725)	\$ (57,995)	\$ (74,725)	\$ (57,995)
Basic and diluted loss per share (note 5)	\$ (3.21)	\$ (17.72)	\$ (6.05)	\$ (36.03)
Basic and diluted weighted average number of common shares outstanding (note 5)	838	398	615	398
Pro forma basic and diluted loss per share (note 5(b))	\$ (0.16)	\$ (0.21)	\$ (0.22)	\$ (0.42)
Pro forma basic and diluted weighted average number of shares outstanding (note 5(b))	16,407	16,320	16,363	16,320

See accompanying notes to financial statements.

# Q9 NETWORKS INC.

Statements of Cash Flows  
(In thousands)  
(Unaudited)

	Three months ended		Six months ended	
	2004	April 30, 2003	2004	April 30, 2003
Cash provided by (used in):				
Operating activities:				
Loss for the period	\$ (2,689)	\$ (7,048)	\$ (3,726)	\$ (14,331)
Items not involving cash:				
Amortization	1,776	2,120	3,554	4,261
Deferred gain	(19)	(13)	(39)	(13)
Amortization of leasehold inducements	(33)	(26)	(67)	(52)
Accretion of interest on redeemable convertible preference shares	–	3,672	–	7,344
Amortization of deferred financing costs	–	119	–	238
Stock-based compensation expense	19	–	19	–
Change in non-cash operating working capital (note 8)	1,778	293	2,047	(347)
	832	(883)	1,788	(2,900)
Financing activities:				
Issuance of notes payable	105	274	105	274
Repayment of notes payable	(191)	–	(363)	–
Repayments of long-term debt	–	(114)	–	(223)
Increase in leasehold inducements	–	–	194	–
Issuance of shares, net of issue costs (note 3)	28,858	–	28,858	–
	28,772	160	28,794	51
Investing activities:				
Proceeds on sale of property and building	–	12,500	–	12,500
Purchase of capital assets	(1,144)	(1,356)	(1,515)	(2,430)
Increase in short-term investments and restricted cash, net	(14,568)	(12,534)	(13,312)	(8,619)
	(15,712)	(1,390)	(14,827)	1,451
Increase (decrease) in cash and cash equivalents	13,892	(2,113)	15,755	(1,398)
Cash and cash equivalents, beginning of period	4,058	3,996	2,195	3,281
Cash and cash equivalents, end of period	\$ 17,950	\$ 1,883	\$ 17,950	\$ 1,883
Supplemental cash flow information:				
Interest received	\$ 181	\$ 191	\$ 697	\$ 778
Interest paid	3	16	3	35
Income taxes paid	127	360	127	360
Supplemental disclosure of non-cash financing and investing activities:				
Acquisition of capital assets in accounts payable	1,514	188	1,514	188

See accompanying notes to financial statements.

# Q9 NETWORKS INC.

Notes to Financial Statements

(In thousands, except for per share amounts)

Three and six months ended April 30, 2004  
(Unaudited)

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Q9 Networks Inc. (the "Company") is a Canadian provider of outsourced Internet infrastructure and managed services for companies with mission-critical Internet operations. On April 29, 2004, the Company completed its initial public offering of common shares (note 3). The Company's common shares are listed on the Toronto Stock Exchange under the symbol "Q".

## 1. Significant accounting policies:

The interim financial statements have been prepared in accordance with Canadian generally accepted accounting principles. Certain information and note disclosures normally included in the annual financial statements prepared in accordance with generally accepted accounting principles have been condensed to include only the notes related to elements which have significantly changed in the interim period. As a result, these interim financial statements should be read in conjunction with the Company's audited financial statements and notes thereto for the fiscal year ended October 31, 2003. The financial information included herein reflects all adjustments, consisting only of normal recurring adjustments, which, in the opinion of management, are necessary for a fair presentation of the results for the interim periods presented. The results of operations for the six months ended April 30, 2004 are not necessarily indicative of the results to be expected for the full year.

These interim financial statements are prepared following accounting policies consistent with the Company's audited annual financial statements and notes thereto, except for the following accounting policies adopted in the period:

# Q9 NETWORKS INC.

Notes to Financial Statements (continued)  
(In thousands, except for per share amounts)

Three and six months ended April 30, 2004  
(Unaudited)

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## 1. Significant accounting policies (continued):

### (a) Stock-based compensation:

Effective November 1, 2003, the Company adopted the revised Canadian Institute of Chartered Accountants' ("CICA") Handbook Section ("HB") 3870, "Stock-based Compensation and Other Stock-based Payments", which requires that a fair value method of accounting be applied to all stock-based compensation payments to both employees and non-employees. In accordance with the transitional provisions of HB 3870, the Company has prospectively applied the fair value method of accounting for stock option awards to employees granted after November 1, 2003 and, accordingly, has recorded compensation expense for such awards. Prior to November 1, 2003, the Company accounted for its employee stock options using the settlement method and no compensation expense was recognized. Under the settlement method, any consideration paid by employees on the exercise of stock options is credited to share capital. For awards granted to employees from November 1, 2002 to October 31, 2003, the standard requires the disclosure of pro forma loss and loss per share information as if the Company had accounted for employee stock options under the fair value method. The pro forma effect of awards granted to employees prior to November 1, 2002 has not been included in the pro forma loss and loss per share information.

The estimated fair value of the options is amortized to expense over the vesting period, on a straight-line basis. Prior to becoming a public company, the Company used the minimum value method using the following assumptions to determine the fair value of the stock options:

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Risk-free interest rate	3.47%
Dividend yield	—
Weighted average expected life of the options	5 years

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# Q9 NETWORKS INC.

Notes to Financial Statements (continued)  
(In thousands, except for per share amounts)

Three and six months ended April 30, 2004  
(Unaudited)

## 1. Significant accounting policies (continued):

Pro forma disclosures giving effect to the fair value for awards granted to employees from November 1, 2002 to October 31, 2003:

	Three months ended April 30,		Six months ended April 30,	
	2004	2003	2004	2003
	(Unaudited)		(Unaudited)	
Loss for the period, as reported	\$ (2,689)	\$ (7,048)	\$ (3,726)	\$ (14,331)
Stock-based compensation expense	(3)	(2)	(6)	(4)
Pro forma loss	\$ (2,692)	\$ (7,050)	\$ (3,732)	\$ (14,335)
Loss per share, basic and diluted, as reported	\$ (3.21)	\$ (17.72)	\$ (6.05)	\$ (36.03)
Pro forma loss per share, basic and diluted	(3.21)	(17.72)	(6.06)	(36.04)

The weighted average estimated fair value at the date of grant for options granted for the six months ended April 30, 2004 and 2003 was \$8.44 and \$1.33, respectively.

### (b) Revenue recognition:

Effective February 1, 2004, the Company adopted the new CICA Emerging Issues Committee Abstracts 141 and 142 that were issued in December 2003 regarding the measurement and timing of revenue recognition and the classification of certain items as revenue or expense. The adoption of these standards did not have any impact on the financial statements.

# Q9 NETWORKS INC.

Notes to Financial Statements (continued)  
(In thousands, except for per share amounts)

Three and six months ended April 30, 2004  
(Unaudited)

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## 1. Significant accounting policies (continued):

(c) Generally Accepted Accounting Principles:

Effective November 1, 2003, the Company adopted CICA HB 1100, "Generally Accepted Accounting Principles" ("GAAP"). HB 1100 establishes standards for financial reporting in accordance with Canadian GAAP. It describes what constitutes Canadian GAAP and its sources, and also provides guidance on sources to consult when selecting accounting policies and determining appropriate disclosures when the primary sources of Canadian GAAP are silent. The adoption of this standard did not have a material impact on the financial statements.

## 2. Short-term investments:

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	April 30, 2004	October 31, 2003
Bankers' Acceptances	\$ 12,364	\$ —
Treasury Bills	14,919	—
Government Investment Certificates	3,980	3,030
Government and Crown Corporation Bonds	5,156	20,799
Corporate Bonds	17,256	15,426
Accrued interest	225	383
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	\$ 53,900	\$ 39,638

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Short-term investments are recorded at cost. Interest bearing instruments are recorded at cost plus accrued interest.

# Q9 NETWORKS INC.

Notes to Financial Statements (continued)  
(In thousands, except for per share amounts)

Three and six months ended April 30, 2004  
(Unaudited)

### 3. Capital stock:

Authorized:

Unlimited common shares

Issued and outstanding:

	Common shares		Class C common shares		Class A preference shares		Class B preference shares		Class C preference shares	
	Number	Amount	Number	Amount	Number	Amount	Number	Amount	Number	Amount
Balance, October 31, 2003	–	\$ –	398	\$ 420	2,159	\$ 11,489	2,344	\$ 14,913	7,375	\$ 122,070
Conversion of Class A, Class B and Class C preference shares and Class C common shares into a new class of common shares	16,320	148,892	(398)	(420)	(2,159)	(11,489)	(2,344)	(14,913)	(7,375)	(122,070)
Issuance of common shares upon initial public offering	3,810	28,823	–	–	–	–	–	–	–	–
Issuance of shares upon exercise of stock options	5	35	–	–	–	–	–	–	–	–
Balance, April 30, 2004	20,135	\$ 177,750	–	\$ –	–	\$ –	–	\$ –	–	\$ –

Prior to the closing of the Company's initial public offering for its common shares on April 29, 2004, the Company reorganized its share capital. Concurrently with the closing of the initial public offering, the articles of the Company were amended to, among other things, remove the Class C preference share provisions, including all liquidation rights attached to such shares, and reclassify the share capital of the Company through the conversion of all of the Class C common shares, Class A preference shares, Class B preference shares and Class C preference shares into a new class of common shares on the basis of one common share for each Class C common share, Class A preference share and Class B preference share, and 1.5483871 common shares for each Class C preference share; to remove the authorized but unissued Class C common shares, Class A preference shares, Class B preference shares and Class C preference shares and all rights, privileges, restrictions and conditions attached thereto; and consolidate the common shares on a five-to-one basis ("share capital consolidation"). In addition to the foregoing, all outstanding options and warrants were consolidated on a five-to-one basis in accordance with the terms of the agreements governing these securities. Consequently, at the time of the closing of the initial public offering, the Company was authorized to issue an unlimited number of common shares.

# Q9 NETWORKS INC.

Notes to Financial Statements (continued)  
(In thousands, except for per share amounts)

Three and six months ended April 30, 2004  
(Unaudited)

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### 3. Capital stock (continued):

The impact of the share capital consolidation has been reflected retroactively in these financial statements and the accompanying notes.

The Company completed its initial public offering of common shares, resulting in the issuance of 3,810 common shares at a price of \$8.50 per common share for gross proceeds of \$32,385 and net proceeds of \$28,823. Issuance costs of \$3,562 have been recorded as a reduction of share capital, net of the related income tax benefit of nil.

### 4. Stock-based compensation plans:

The Company modified the terms of its stock option plan for officers, directors, employees and consultants as a consequence of its initial public offering. The common shares reserved for issuance under the option plan will be 2,300. For each option granted prior to the closing of the initial public offering on April 29, 2004, with the exception of those options granted with a nominal exercise price, one-third of such option vest one year after the date of grant of the option and 1/24 of the remaining two-thirds vest each month thereafter. These options expire seven years after the date of the grant. For all options granted subsequent to the closing of the initial public offering on April 29, 2004, the exercise price of these options will be based on the weighted average trading price of each of the five trading days immediately preceding the date of grant and will expire eight years after the date of grant. One-quarter of the option grants will vest one year after the date of grant and the remaining three-quarters of the options will vest evenly over the next 12 quarters. All options vest immediately upon a change of control of the Company. During the six months ended April 30, 2004 and 2003, all outstanding options were granted to employees of the Company.

Details of stock options outstanding at April 30, 2004 is as follows:

	Number	Weighted average exercise price
Outstanding, October 31, 2003	1,014	\$ 6.99
Granted	814	0.06
Cancelled	(9)	(11.97)
Exercised	(5)	(6.40)
Outstanding, April 30, 2004	1,814	3.86

# Q9 NETWORKS INC.

Notes to Financial Statements (continued)  
(In thousands, except for per share amounts)

Three and six months ended April 30, 2004  
(Unaudited)

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## 4. Stock-based compensation plans (continued):

Prior to the closing of the initial public offering, 813 options were issued by the Company to executive officers and employees at a nominal exercise price of \$0.05 per common share. These options will vest equally at each of the first, second and third anniversary of the date of grant and will expire seven years from such date. As these options have a nominal exercise price, they are accounted for as direct awards of shares. Accordingly, the fair value of these options, based on the share price on closing of \$8.50, will be recorded as compensation cost in the Company's statements of operations ratably over the vesting period. Compensation expense for these options for the six months ended April 30, 2004 is \$19.

## 5. Loss per share:

### (a) Loss per share:

Basic and diluted loss per share gives effect to the share capital consolidation described in note 3. As the Company experienced a loss for the three and six months ended April 30, 2004 and 2003, all potential common shares outstanding are considered anti-dilutive and are excluded from the calculation of diluted loss per share.

### (b) Pro forma loss per share:

The following table presents a reconciliation of the numerators and denominators used in the calculations of basic and diluted pro forma loss per share. The pro forma amounts are adjusted to retroactively reflect the conversion of the Class A preference shares and Class B preference shares on the basis of one common share for each Class A and Class B preference share and Class C preference shares on the basis of 1.5483871 common shares for each Class C preference share and the share capital consolidation described in note 3.

	Three months ended April 30,		Six months ended April 30,	
	2004	2003	2004	2003
Pro forma loss:				
Loss for the period	\$ (2,689)	\$ (7,048)	\$ (3,726)	\$ (14,331)
Preference share accretion	—	3,672	—	7,344
Amortization of deferred financing costs	—	119	—	238
	<u>\$ (2,689)</u>	<u>\$ (3,257)</u>	<u>\$ (3,726)</u>	<u>\$ (6,749)</u>

## Q9 NETWORKS INC.

Notes to Financial Statements (continued)  
(In thousands, except for per share amounts)

Three and six months ended April 30, 2004  
(Unaudited)

### 5. Loss per share (continued):

	Three months ended April 30,		Six months ended April 30,	
	2004	2003	2004	2003
Pro forma weighted average number of common shares outstanding:				
Common	838	398	615	398
Class A preference shares	2,111	2,159	2,136	2,159
Class B preference shares	2,292	2,344	2,318	2,344
Class C preference shares	11,166	11,419	11,294	11,419
	<u>16,407</u>	<u>16,320</u>	<u>16,363</u>	<u>16,320</u>
Basic and diluted: Pro forma basic and diluted loss per share	\$ (0.16)	\$ (0.21)	\$ (0.22)	\$ (0.42)

### 6. Related party transactions:

The Company provided services in the normal course of business to five and four customers that are affiliates of directors and officers of the Company, for the three and six months ended April 30, 2004 and 2003, respectively. Revenue from these customers for the three and six months ended April 30, 2004 and 2003 was \$772, \$510, \$1,553 and \$1,050, respectively. Accounts receivable from such customers as at April 30, 2004 was \$38.

# Q9 NETWORKS INC.

Notes to Financial Statements (continued)  
(In thousands, except for per share amounts)

Three and six months ended April 30, 2004  
(Unaudited)

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## 7. Segmented information:

Management has determined that the Company operates in a single reportable operating segment, which involves the provision of outsourced Internet infrastructure and managed services to enterprises whose Internet operations are critical to their business.

The Company markets its products primarily in Canada.

The Company's service offerings include the provision of physical space within its high Internet data centres, high availability Internet connectivity and a comprehensive suite of managed services. The Company makes decisions and evaluates financial performance primarily based on these service offerings, which are disclosed in the statements of operations and deficit.

Substantially all of the Company's identifiable assets as at April 30, 2004 and 2003 are located in Canada.

During the six months ended April 30, 2004 and 2003, one customer accounted for 12% and 10% of revenue, respectively.

## 8. Change in non-cash operating working capital:

	Three months ended April 30,		Six months ended April 30,	
	2004	2003	2004	2003
Accounts receivable	\$ 248	\$ 59	\$ 53	\$ 54
Unbilled revenue	(216)	(16)	(183)	(30)
Prepaid expenses	(246)	(23)	(332)	(26)
Accounts payable and accrued liabilities	1,727	(31)	2,120	(607)
Deferred revenue	265	304	389	262
	<u>\$ 1,778</u>	<u>\$ 293</u>	<u>\$ 2,047</u>	<u>\$ (347)</u>

## 9. Lease termination:

During February 2004, the Company terminated the operating lease at its Ottawa premises and vacated such premises, and incurred lease termination costs of \$1,571.