

Financial Statements of

**Q9 NETWORKS INC.**

Three months ended January 31, 2007 and 2006  
(Unaudited)

# Q9 NETWORKS INC.

Balance Sheets  
(In thousands)  
(Unaudited)

	January 31, 2007	October 31, 2006
<b>Assets</b>		
Current assets:		
Cash and cash equivalents	\$ 8,539	\$ 5,961
Short-term investments (note 2)	46,978	61,448
Accounts receivable	4,878	4,330
Unbilled revenue	325	345
Future tax asset (note 10)	983	667
Prepaid expenses	1,031	866
	<u>62,734</u>	<u>73,617</u>
Restricted cash	230	230
Other assets	756	766
Future tax asset (note 10)	5,503	6,393
Property and equipment (note 3)	68,744	58,592
	<u>\$ 137,967</u>	<u>\$ 139,598</u>
<b>Liabilities and Shareholders' Equity</b>		
Current liabilities:		
Accounts payable and accrued liabilities	\$ 8,073	\$ 11,830
Deferred revenue	4,907	4,731
Notes payable	693	434
	<u>13,673</u>	<u>16,995</u>
Deferred revenue	710	755
Deferred gain on sale of property	1,109	1,128
Leasehold inducements	1,395	1,378
Asset retirement obligation	957	930
Other long-term liabilities	1,278	1,158
Shareholders' equity:		
Capital stock (note 4):		
Common shares	140,276	139,427
Contributed surplus	4,330	3,949
Deficit	(25,761)	(26,122)
	<u>118,845</u>	<u>117,254</u>
Commitments and contingencies (note 9)		
	<u>\$ 137,967</u>	<u>\$ 139,598</u>

See accompanying notes to financial statements.

## Q9 NETWORKS INC.

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

	Three months ended January 31,	
	2007	2006
Revenue:		
Co-location	\$ 6,064	\$ 5,147
Managed services	4,660	3,823
Managed bandwidth	1,839	1,646
Set-up fees	249	331
	<u>12,812</u>	<u>10,947</u>
Cost of revenue	<u>8,406</u>	<u>7,471</u>
Gross margin	4,406	3,476
Expenses:		
Sales and marketing	1,509	1,091
General and administrative	2,307	1,928
Amortization of property and equipment	234	359
	<u>4,050</u>	<u>3,378</u>
Income from operations	356	98
Investment income, net	592	519
Income before income taxes	948	617
Income tax expense (note 10):		
Current	-	7
Future	574	-
Net income	<u>\$ 374</u>	<u>\$ 610</u>
Earnings per share:		
Basic	\$ 0.02	\$ 0.03
Diluted	0.02	0.03
Weighted average number of shares outstanding:		
Basic	20,264	20,274
Diluted	21,040	20,876

See accompanying notes to financial statements.

# Q9 NETWORKS INC.

Statements of Cash Flows  
(In thousands)  
(Unaudited)

	Three months ended January 31,	
	2007	2006
Cash provided by (used in):		
Operating activities:		
Net income	\$ 374	\$ 610
Items not involving cash:		
Amortization of property and equipment	2,323	2,368
Amortization of other assets	10	14
Gain on sale of property	(19)	(20)
Accretion expense	27	18
Unrealized gain on short-term investments	(8)	-
Net non-cash rent expense	137	247
Stock-based compensation expense	576	468
Future income taxes	574	-
Change in non-cash operating working capital (note 8)	121	980
	4,115	4,685
Financing activities:		
Issuance of notes payable	490	241
Repayment of notes payable	(231)	(250)
Repurchase of shares	(27)	(630)
Issuance of shares	27	93
	259	(546)
Investing activities:		
Purchase of property and equipment	(16,009)	(1,959)
Purchase of short-term investments	(106,049)	(58,134)
Sale of short-term investments	120,262	57,651
Increase in other assets	-	(11)
	(1,796)	(2,453)
Increase in cash and cash equivalents	2,578	1,686
Cash and cash equivalents, beginning of period	5,961	7,843
Cash and cash equivalents, end of period	\$ 8,539	\$ 9,529
Supplemental cash flow information:		
Interest received	\$ 848	\$ 769
Income taxes paid	-	-
Supplemental disclosure of non-cash financing and investing activities:		
Effect of acquisition of property and equipment in accounts payable and accrued liabilities	3,534	(650)
Effect of repurchase of shares in accounts payable and accrued liabilities	-	140

See accompanying notes to financial statements.

# Q9 NETWORKS INC.

Statements of Shareholders' Equity  
(In thousands)  
(Unaudited)

	Common shares Number	Common shares Amount	Contributed surplus	Deficit	Total
Balance, October 31, 2005	20,262	\$ 139,276	\$ 3,092	\$ (36,090)	\$ 106,278
Issuance of shares upon exercise of stock options (note 5)	251	610	–	–	610
Stock-based compensation (note 5)	–	–	2,153	–	2,153
Compensation cost of options exercised	–	1,296	(1,296)	–	–
Repurchase of shares (note 4(c))	(255)	(1,755)	–	(796)	(2,551)
Net income	–	–	–	10,764	10,764
Balance, October 31, 2006	20,258	\$ 139,427	\$ 3,949	\$ (26,122)	\$ 117,254
Issuance of shares upon exercise of stock options (note 5)	127	668	–	–	668
Stock-based compensation (note 5)	–	–	576	–	576
Compensation cost of options exercised	–	195	(195)	–	–
Repurchase of shares (note 4(c))	(2)	(14)	–	(13)	(27)
Net income and comprehensive income	–	–	–	374	374
Balance, January 31, 2007	20,383	\$ 140,276	\$ 4,330	\$ (25,761)	\$ 118,845

See accompanying notes to financial statements.

# Q9 NETWORKS INC.

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

Three months ended January 31, 2007 and 2006  
(Unaudited)

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Q9 Networks Inc. (the "Company") is a leading Canadian provider of outsourced data centre infrastructure for organizations with mission-critical IT operations. The Company's common shares are listed on the Toronto Stock Exchange under the symbol "Q".

## 1. Significant accounting policies:

### (a) Basis of presentation:

These 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 Canadian 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, 2006.

These interim financial statements are prepared following accounting policies consistent with the Company's audited annual financial statements and notes thereto for the year ended October 31, 2006, except as described in note 1(b). 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 three months ended January 31, 2007 are not necessarily indicative of the results to be expected for the full year.

### (b) Changes in accounting policies:

#### (i) Financial instruments:

Effective November 1, 2006, the Company adopted the new recommendations of the Canadian Institute of Chartered Accountants (CICA) Handbook Section 1530, Comprehensive Income; Section 3251, Equity; Section 3855, Financial Instruments – Recognition and Measurement; and, Section 3865, Hedges, retroactively without restatement. These new Handbook Sections, which apply to fiscal years beginning on or after October 1, 2006, provide requirements for the recognition and measurement of financial instruments and on the use of hedge accounting. Section 1530 establishes standards for reporting and presenting comprehensive income, which is defined as the change in equity from transactions and other events from non-owner sources. Other comprehensive income refers to items recognized in

# Q9 NETWORKS INC.

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

Three months ended January 31, 2007 and 2006  
(Unaudited)

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## 1. Significant accounting policies (continued):

comprehensive income that are excluded from net income calculated in accordance with generally accepted accounting principles. Under the new standards, policies followed for periods prior to the effective date generally are not reversed and therefore, the comparative figures have not been restated. The adoption of these Handbook Sections had no impact on opening deficit.

Under Section 3855, financial instruments must be classified into one of these five categories: held-for-trading, held-to-maturity, loans and receivables, available-for-sale financial assets or other financial liabilities. All financial instruments, including derivatives, are measured in the balance sheet at fair value except for loans and receivables, held-to-maturity investments and other financial liabilities which are measured at amortized cost. Subsequent measurement and changes in fair value will depend on their initial classification, as follows: held-for-trading financial assets are measured at fair value and changes in fair value are recognized in net income; available-for-sale financial instruments are measured at fair value with changes in fair value recorded in other comprehensive income until the investment is derecognized or impaired at which time the amounts would be recorded in net income.

Upon adoption of these new standards, the Company designated its cash, cash equivalents, restricted cash and short-term investments as held-for-trading, which are measured at fair value. Accounts receivable are classified as loans and receivables, which are measured at amortized cost. Accounts payable, accrued liabilities and notes payable, are classified as other financial liabilities. The Company had neither available for sale, nor held to maturity instruments during the three months ended January 31, 2007.

The Company had no "other comprehensive income or loss" transactions during the three months ended January 31, 2007 and no opening or closing balances for accumulated other comprehensive income or loss.

Changes in the fair value of the Company's short-term investments (which are comprised of debt securities) are included in investment income each period.

# Q9 NETWORKS INC.

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

Three months ended January 31, 2007 and 2006  
(Unaudited)

## 1. Significant accounting policies (continued):

### (ii) Non-monetary transactions:

Effective November 1, 2006, the Company adopted the new recommendations of CICA Handbook Section 3831, Non-monetary Transactions prospectively. This standard requires all non-monetary transactions be measured at fair value unless they meet one of four criteria. Commercial substance replaces culmination of the earnings process as the test for fair value measurement. A transaction has commercial substance if it causes an identifiable and measurable change in the economic circumstances of the entity. The adoption of this standard had no significant impact on the Company's financial statements.

## 2. Short-term investments:

Effective November 1, 2006 short-term investments are reported at fair value based on quoted market prices.

	January 31, 2007	October 31, 2006
Guaranteed Investment Certificates	\$ 789	\$ 782
Government and Crown Corporation Bonds	41,136	8,336
Corporate Bonds	5,053	52,330
	<u>\$ 46,978</u>	<u>\$ 61,448</u>

At October 31, 2006, the investments were carried at the lower of cost and market value and the carrying value of short-term investments approximated the market value.

## 3. Property and equipment:

January 31, 2007	Cost	Accumulated amortization	Net book value
Computer hardware	\$ 17,275	\$ 13,572	\$ 3,703
Computer software	1,719	1,621	98
Furniture and equipment	1,747	587	1,160
Leasehold improvements	91,544	27,761	63,783
	<u>\$ 112,285</u>	<u>\$ 43,541</u>	<u>\$ 68,744</u>

# Q9 NETWORKS INC.

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

Three months ended January 31, 2007 and 2006  
(Unaudited)

## 3. Property and equipment (continued):

October 31, 2006	Cost	Accumulated amortization	Net book value
Computer hardware	\$ 15,676	\$ 12,956	\$ 2,720
Computer software	1,700	1,551	149
Furniture and equipment	1,724	501	1,223
Leasehold improvements	80,710	26,210	54,500
	<u>\$ 99,810</u>	<u>\$ 41,218</u>	<u>\$ 58,592</u>

The net carrying amount of leasehold improvements and equipment related to data centres not yet in use and therefore not being amortized as at January 31, 2007 and October 31, 2006 was \$35,425 and \$24,800, respectively.

## 4. Capital stock:

### (a) Authorized:

The Company's authorized capital stock includes an unlimited number of common shares.

### (b) Deficit reduction:

On March 18, 2005, at the Company's Annual General and Special Meeting of Shareholders, shareholders approved a special resolution authorizing the reduction in stated capital by \$39,275, which also resulted in the reduction of the Company's deficit by the same amount.

### (c) Repurchase of shares:

On October 30, 2006, the Company renewed its Normal Course Issuer Bid ("NCIB"). Under the terms of the NCIB, the Company may, during the twelve month period ending October 31, 2007, purchase on the Toronto Stock Exchange, up to a maximum of 1,012,870 or 5% of the issued and outstanding common shares. Common shares purchased under the NCIB will be cancelled. During the three months ended January 31, 2007, the Company repurchased and cancelled a total of 2,000 shares under the NCIB, at an average cost of \$13.25 per share at a total cost, including commissions, of \$27 of which \$13 was charged to deficit and \$14 was charged to common shares.

# Q9 NETWORKS INC.

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

Three months ended January 31, 2007 and 2006  
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## 4. Capital stock (continued):

(d) Earnings per share:

Basic earnings per share has been computed by dividing the net income for the period by the weighted average number of common shares outstanding for the period. Diluted earnings per share is computed based on the weighted average number of common shares outstanding for the period plus common share equivalents consisting of shares subject to stock options. The calculation of diluted earnings per share for the three months ended January 31, 2007 and 2006 excludes the effect of the potential exercise of 45,500 and 197,388 stock options, respectively, because the effect would be anti-dilutive.

## 5. Stock-based compensation plans:

During the three months ended January 31, 2007, all options granted were to employees of the Company. Details of stock options outstanding at January 31, 2007 are as follows:

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	Number (in thousands)	Weighted average exercise price
Outstanding, October 31, 2006	1,592	\$ 5.07
Granted	46	12.45
Exercised	(127)	5.24
Cancelled	(1)	7.46
Outstanding, January 31, 2007	1,510	\$ 5.28

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The weighted average estimated fair value at the date of grant for options granted for the three months ended January 31, 2007 and 2006 was \$4.81 and \$4.19, respectively.

## Q9 NETWORKS INC.

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

Three months ended January 31, 2007 and 2006  
(Unaudited)

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

The estimated fair value of each option granted to employees and directors was estimated on the date of the grant using the Black-Scholes option-pricing model with the following assumptions:

	Three months ended January 31,	
	2007	2006
Risk-free interest rate	3.98%	3.86%
Dividend yield	—	—
Weighted average expected life of the options	5 years	5 years
Weighted average volatility	34%	39%

Prior to the closing of the Company's initial public offering for its common shares on April 29, 2004, 813,200 options were issued by the Company to executive officers and employees at a nominal exercise price of \$0.05 per common share. These options vest equally on each of the first, second and third anniversary from the date of grant and expire seven years from such date. As these options have a nominal exercise price, they were accounted for as direct awards of shares. Accordingly, the fair value of these options, based on the share price on closing of \$8.50, is being recorded as compensation cost in the Company's statements of operations ratably over the vesting period. The compensation expense related to these options was \$495 and \$418 for the three months ended January 31, 2007 and 2006, respectively.

The Company's total compensation expense for the three months ended January 31, 2007 was \$576 with a corresponding increase to contributed surplus. Such compensation expense is included in the statement of operations as follows: \$72 in cost of revenue, \$116 in sales and marketing expense and \$388 in general and administration expense.

The Company's total compensation expense for the three months ended January 31, 2006 was \$468 with the corresponding increase to contributed surplus. Such compensation expense is included in the statement of operations as follows: \$62 in cost of revenue, \$100 in sales and marketing expense and \$306 in general and administration expense.

# Q9 NETWORKS INC.

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

Three months ended January 31, 2007 and 2006  
(Unaudited)

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## 6. Related party transactions:

The Company provided services in the normal course of business to five and eight customers that are affiliates of directors and officers of the Company, for the three months ended January 31, 2007 and 2006, respectively. Revenue from these customers for the three months ended January 31, 2007 and 2006 was \$156 and \$1,318, respectively. Accounts receivable from such customers as at January 31, 2007 were \$51 and as at October 31, 2006 were \$62. These transactions have been recorded at the exchange amount which is the amount agreed upon between the parties.

## 7. Segmented information:

Management has determined that the Company operates in a single reportable operating segment, which involves the provision of outsourced data centre infrastructure and managed services to organizations with mission-critical IT operations.

The Company markets its products primarily in Canada. Substantially all of the Company's identifiable assets as at January 31, 2007 and October 31, 2006 are located in Canada.

The Company's service offerings include the provision of physical space within its high security data centres, a complete suite of managed services and high availability Internet connectivity. The Company makes decisions and evaluates financial performance primarily based on these service offerings.

During the three months ended January 31, 2007, one customer accounted for 11% of revenue. During the three months ended January 31, 2006 two customers accounted for 14% and 11% of revenue, respectively.

## Q9 NETWORKS INC.

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

Three months ended January 31, 2007 and 2006  
(Unaudited)

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

	Three months ended January 31,	
	2007	2006
Interest receivable on short-term investments	\$ 265	\$ 250
Accounts receivable	93	(127)
Unbilled revenue	20	(92)
Prepaid expenses	(165)	(193)
Accounts payable and accrued liabilities	(223)	895
Deferred revenue	131	247
	<u>\$ 121</u>	<u>\$ 980</u>

### 9. Commitments and contingencies:

Future minimum obligations for contracts related to operating leases for premises and bandwidth and carrier circuits commitments are as follows:

Twelve-month period ending January 31:

2008	\$ 6,152
2009	5,402
2010	5,333
2011	5,364
2012	4,947
Thereafter	26,533
	<u>\$ 53,731</u>

In addition, the Company is contractually obligated to capital expenditures of \$1,782 as at January 31, 2007, primarily related to the expansion of its data centre facilities.

### 10. Income Taxes:

In the fourth quarter of fiscal 2006, the Company recorded a future income tax benefit of \$7,060.

# Q9 NETWORKS INC.

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

Three months ended January 31, 2007 and 2006  
(Unaudited)

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## 10. Income Taxes (continued):

In making an assessment of whether future income taxes are more likely than not to be realized, management regularly prepares information regarding the expected use of such assets by reference to its internal income forecasts. Based on management's estimates of the expected realization of future income tax assets, during 2006 the Company reduced the valuation allowance to reflect that it is more likely than not that certain future income tax assets will be realized.

For the three months ended January 31, 2007, the Company recorded a non-cash future income tax expense of \$574, which resulted primarily from the utilization of non-capital loss carryforwards, the benefit of which had previously been recognized.

## 11. Comparative figures:

Certain comparative figures have been reclassified to conform with the financial statement presentation adopted in the current period.