

IP Applications Corp.

Consolidated Financial Statements
December 31, 2006 and 2005

April 23, 2007

Auditors' Report

To the Shareholders of IP Applications Corp.

We have audited the consolidated balance sheets of IP Applications Corp. as at December 31, 2006 and 2005 and the consolidated statements of operations and deficit and cash flows for the year ended December 31, 2006 and the nine-month period ended December 31, 2005. 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 December 31, 2006 and 2005 and the results of its operations and its cash flows for the year ended December 31, 2006 and the nine-month period ended December 31, 2005 in accordance with Canadian generally accepted accounting principles.

PricewaterhouseCoopers LLP

Chartered Accountants

IP Applications Corp.
Consolidated Balance Sheets
As at December 31, 2006 and 2005

	2006 \$	2005 \$
Assets		
Current assets		
Cash	70,193	434,690
Restricted cash (note 5)	-	300,000
Accounts receivable	877,962	841,895
Prepaid expenses	97,038	140,423
	<u>1,045,193</u>	<u>1,717,008</u>
Property and equipment (note 6)	911,077	1,189,102
Intangible asset (note 7)	-	1,323,734
	<u>1,956,270</u>	<u>4,229,844</u>
Liabilities		
Current liabilities		
Accounts payable and accrued liabilities	1,292,216	1,475,963
Customer deposits	-	33,941
Unearned revenue	42,201	44,546
Current portion of loss on lease commitment (note 16)	71,540	83,121
Current portion of leasehold inducement (note 15)	29,935	29,935
Current portion of obligations under capital lease (note 9)	244,944	336,973
	<u>1,680,836</u>	<u>2,004,479</u>
Lease commitment (note 16)	55,026	126,566
Leasehold inducements (note 15)	238,233	268,168
Convertible debenture (note 8)	646,379	178,379
Obligations under capital lease (note 9)	60,541	96,224
	<u>2,681,015</u>	<u>2,673,816</u>
Shareholders' Deficiency		
Capital stock (note 10(b))	8,965,825	8,935,930
Warrants (note 10(c))	851,142	803,526
Contributed surplus (note 11)	1,431,968	906,799
Deficit	<u>(11,973,680)</u>	<u>(9,090,227)</u>
	<u>(724,745)</u>	<u>1,556,028</u>
	<u>1,956,270</u>	<u>4,229,844</u>
Nature of operations and going concern (note 1)		
Commitments (note 18)		
Subsequent events (note 19)		

Approved by the Board of Directors

"Kelly Edmison" Director

"David Roberts" Director

IP Applications Corp.

Consolidated Statements of Operations and Deficit

	Year ended December 31, 2006 \$	Nine-month period ended December 31, 2005 \$
Revenue	9,283,182	6,335,187
Direct costs	6,092,290	3,980,473
	<u>3,190,892</u>	<u>2,354,714</u>
Operating expenses		
Amortization of intangible asset	714,741	410,519
Amortization of property and equipment	554,283	301,258
Foreign exchange loss	66,012	32,705
General and administration	2,052,396	2,157,441
Interest on capital lease obligations	32,871	30,324
Accretion of convertible debenture	206,260	-
Marketing and selling	966,132	929,932
Stock-based compensation	297,976	383,572
Technical and development	565,644	459,143
	<u>5,456,315</u>	<u>4,704,894</u>
Loss before the under-noted items	(2,265,423)	(2,350,180)
Writedown of property and equipment	(23,398)	(307,116)
Writedown of intangible asset	(608,993)	(44,844)
Lease commitment	-	(209,687)
Other income	14,361	34,590
	<u>(2,883,453)</u>	<u>(2,877,237)</u>
Loss for the year	(2,883,453)	(2,877,237)
Deficit - Beginning of year	(9,090,227)	(6,212,990)
	<u>(11,973,680)</u>	<u>(9,090,227)</u>
Deficit - End of year	(11,973,680)	(9,090,227)
Loss per share - basic	(0.19)	(0.21)
Weighted average number of common shares used in the calculation of loss per share	<u>15,027,283</u>	<u>13,624,931</u>

IP Applications Corp.

Consolidated Statements of Cash Flows

	Year ended December 31, 2006 \$	Nine-month period ended December 31, 2005 \$
Cash flows from operating activities		
Loss for the year	(2,883,453)	(2,877,237)
Items not affecting cash		
Accretion on convertible debenture (note 8)	206,260	-
Amortization of intangible asset (note 7)	714,741	410,519
Amortization of property and equipment	554,283	301,258
Employee share compensation (note 10(b)(ii))	-	130,336
Loss on lease commitment (note 16)	-	209,687
Reduction of loss on lease commitment (note 16)	(83,121)	-
Stock-based compensation	297,976	383,572
Leasehold inducement amortization (note 15)	(29,935)	(1,247)
Warrants issued (note 10(b)(iv))	-	29,242
Writedown of intangible asset (note 7)	608,993	44,844
Loss on writedown of property and equipment	23,398	307,116
	(590,858)	(1,061,910)
Changes in non-cash working capital items		
Accounts receivable	(36,067)	(64,597)
Prepaid expenses	43,385	36,040
Accounts payable and accrued liabilities	(183,747)	284,732
Customer deposits	(33,941)	-
Deferred revenue	(2,345)	44,546
Convertible debenture interest	77,789	-
	(725,784)	(761,189)
Cash flows from investing activities		
Release (increase) in restricted cash	300,000	(300,000)
Purchase of property and equipment	(100,632)	(199,424)
Acquisition of PacificNet (note 4(a))	-	(310,156)
Acquisition of intangible asset (note 7)	-	(220,098)
	199,368	(1,029,678)
Cash flows from financing activities		
Payments under capital leases	(326,736)	(190,837)
Proceeds from the issuance of convertible debenture (note 8)	411,144	500,000
Proceeds from private placements (note 10(b)(i), (iii) and (v))	100,000	1,700,000
Capital raising costs	(22,489)	(25,024)
	161,919	1,984,139
(Decrease) increase in cash	(364,497)	193,272
Cash - Beginning of year	434,690	241,418
Cash - End of year	70,193	434,690
Supplemental disclosure of cash flow information		
Interest received	14,361	34,590

IP Applications Corp.

Notes to Consolidated Financial Statements
December 31, 2006 and 2005

1 Nature of operations and going concern

IP Applications Corp. (the “Company”) incorporated under the laws of British Columbia, provides outsourced Internet applications and solutions to Internet service providers (ISP), telecommunications companies or other corporate clients either to resell these applications to their customers and end users or for their own internal corporate use.

The accompanying consolidated financial statements are prepared on a going-concern basis, which assumes the realization of assets and the settlement of liabilities in the normal course of business. Certain conditions cast substantial doubt on this assumption. The Company’s current level of revenues are not sufficient to solely fund operations. The Company has financed its operations principally through equity and debt financing. External financing will be required by the Company in order to fund its future operations and pursue other potential opportunities.

The ability of the Company to continue as a going concern and meet its commitments and ongoing operating expenses will depend upon raising further funds in the near term either through the issue of equity financing, pursuit of debt financing and ultimately the generation of profitable operations. There is no assurance that the Company will be successful in achieving these goals.

The consolidated financial statements do not include any adjustments, if any, relating to the recoverability and classification of recorded asset amounts or to the amounts and classification of liabilities that might be necessary should the entity not continue as a going concern.

2 Basis of presentation

The consolidated financial statements have been prepared in accordance with Canadian generally accepted accounting principles (“GAAP”) and include the accounts of IP Applications Corp. and its wholly owned subsidiaries, IP Applications (Canada) Corp., IP Applications Soft Tracks Ltd. and IP Applications Remote Services Ltd. All intercompany balances and transactions are eliminated.

In July 2005 the board of directors of the Company approved a change of fiscal year end of the Company from March 31 to December 31.

3 Significant accounting policies

Use of estimates

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amount of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amount of revenues and expenses during the reporting period. Financial results as determined by actual events could differ from those estimates.

IP Applications Corp.

Notes to Consolidated Financial Statements

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Foreign exchange

Foreign currency transactions and balances are translated into Canadian dollars as follows:

- a) Revenues and expenses at average exchange rates for each period;
- b) Monetary items at the rates of exchange prevailing at balance sheet dates;
- c) Non-monetary items at the historical exchange rates; and,
- d) Exchange gains and losses arising from translation are included in the determination of earnings for each year.

Cash and cash equivalents

Cash and cash equivalents comprise cash, term deposits and treasury bills, with original maturity of less than 90 days.

Property and equipment

Property and equipment are amortized on a straight-line basis at the following rates per annum:

Computer equipment	3 years
Office equipment	5 years
Computer software	2 years
Leasehold improvements	straight line over the term of the lease

Leases

Leases are classified as either capital or operating. Leases, which transfer substantially all the benefits and risks of ownership, are accounted for as capital leases. All other leases are accounted for as operating leases wherein rental payments are expensed as incurred.

Intangible asset

Intangible assets with finite lives acquired in a business acquisition or other transaction, are amortized on a straight-line basis over their estimated useful lives as follows:

Customer contracts	2 - 3 years
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IP Applications Corp.

Notes to Consolidated Financial Statements

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Impairment of long-lived assets

The company reviews long-lived assets for impairment when events or changes in circumstances indicate that the carrying amount may not be recoverable. If the sum of the discounted future cash flows expected to result from the use and eventual disposition of a group of assets is less than its carrying amount, it is considered to be impaired. An impairment loss is measured as the amount by which the carrying amount of the group of assets exceeds its fair value.

Leasehold inducements

Leasehold inducements received in connection with the leasing of premises are amortized on a straight-line basis over the initial term of the lease. Such amortization is recorded as a reduction of rent expense.

Income taxes

Income taxes are accounted for under the asset and liability method. Under this method, future tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying value and the tax basis of assets and liabilities.

Future tax assets and liabilities are measured using the enacted or substantively enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on future tax assets and liabilities of a change in tax rates is recognized in income in the period during which the change in rates is considered to be substantially enacted.

Revenue recognition

The Company earns revenue from the provision of services and solutions to ISPs and from the setup of customers on the Company's system.

Revenues from the provision of services are recognized when the related service has been rendered, the fee is fixed or determinable and collectibility is reasonably assured.

Cash received in advance of the delivery of services is recorded as deferred revenue until such services are rendered.

Stock-based compensation

The Company has a stock-based compensation plan, which is described in note 10 (d). Under the plan, options are granted at market value. Any consideration paid by the directors and employees on exercise of share purchase options is credited to share capital.

The Company records compensation associated with stock options granted to consultants, directors and employees using a fair value measurement basis and records the expense as the options vest with the recipients.

IP Applications Corp.

Notes to Consolidated Financial Statements

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Loss per share

Loss per share computations are based upon the weighted average number of common shares outstanding during the year. The Company uses the treasury stock method to compute the dilutive effect of options, warrants and similar instruments. Under this method, the dilutive effect on earnings per share is recognized on the use of the proceeds that could be obtained upon the exercise of options and warrants. It assumes that the proceeds would be used to purchase common shares at the average market price during the period. Fully diluted loss per share is not disclosed, as the effect of conversion of outstanding options and warrants is anti-dilutive.

4 Acquisition of PacificNet

On June 7, 2005, the Company acquired the net assets of Dapac L.L.C., dba PacificNet, for net cash consideration \$310,156. The acquisition is accounted for by the purchase method whereby the results of operations of PacificNet since the date of acquisition, are included in the consolidated financial statements of the Company.

Details of the net assets acquired at fair values at the acquisition date are as follows:

	\$
Current assets	125,367
Property and equipment	27,436
Customer contracts	760,616
Less: Current liabilities assumed	<u>(603,263)</u>
Consideration - cash	<u>310,156</u>

5 Restricted cash

Restricted cash of \$300,000 was pledged as collateral to a chartered bank for certain credit facilities. On February 24, 2006, the Company entered into an agreement with Export Development Canada ("EDC") whereby in exchange for a one-time fee, EDC provided a performance security guarantee to the chartered bank holding the restricted amounts, thereby allowing the Company full access to the funds.

IP Applications Corp.

Notes to Consolidated Financial Statements

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6 Property and equipment

	2006		
	Cost	Accumulated amortization	Net
	\$	\$	\$
Computer equipment	1,219,331	788,992	430,339
Office equipment	52,867	18,815	34,052
Computer software	124,758	93,217	31,541
Leasehold improvements	428,431	13,286	415,145
	1,825,387	914,310	911,077
	2005		
	Cost	Accumulated amortization	Net
	\$	\$	\$
Computer equipment	1,023,077	358,409	664,668
Office equipment	62,565	13,303	49,262
Computer software	114,567	46,334	68,233
Leasehold improvements	409,950	3,011	406,939
	1,610,159	421,057	1,189,102

Included in property and equipment are assets financed by capital leases with a cost of \$1,078,067 and accumulated amortization of \$712,142 (as at December 31, 2005 cost was \$879,045 and accumulated amortization \$310,080). New capital leases acquired during the year ended December 31, 2006 amounted to \$199,022.

IP Applications Corp.

Notes to Consolidated Financial Statements
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7 Intangible asset

	\$
Balance - March 31, 2005	557,233
Additions:	
PacificNet customer contracts purchased (note 4(a))	760,616
SourceNet customer contracts purchased	461,248
Partial write down of SourceNet customer contracts	(44,844)
Amortization	<u>(410,519)</u>
Balance - December 31, 2005	1,323,734
Writedown of intangible assets	(608,993)
Amortization	<u>(714,741)</u>
	<u>-</u>

On June 7, 2005, the Company purchased a customer contract from SourceNet Telecom (“SourceNet”). The aggregate purchase price was \$461,248 and was paid through a combination of cash of \$220,098 and 455,000 common shares of the Company with a value of \$241,150.

Effective December 31, 2006, it was determined by management to write down the customer contracts acquired in 2004 and 2005. Due to the circumstances that a majority of the contracts associated with the acquisitions now represent a smaller and declining proportion of the existing customer base it was decided to write down the remaining value of these intangible assets to nil.

8 Convertible debenture

- a) On December 19, 2005, the Company completed a convertible debt financing for total gross proceeds of \$500,000. The convertible debt had a term of 18 months, was due on May 17, 2007, and was unsecured and bore interest at an annual rate of 12%, payable quarterly. These debentures were convertible at \$0.40 per unit into units consisting of one common share and one-half common share purchase warrant at the holders’ option.

In conjunction with this convertible debenture, the company also issued 1,250,000 share purchase warrants that have a term of 2 years, expiring on November 19, 2007, and an exercise price of \$0.50 for a period of 12 months and \$0.55 for the period of 13-24 months from the date of issue.

The Company recorded the proceeds of the convertible debenture between debt and equity based on the relative fair values of the debt, conversion option and warrants. The fair value of the debt component was \$178,379 and the fair value of the warrant component was \$85,153. The fair value of the conversion option was \$236,468; this amount was being accreted on a straight line basis over the term of the debt.

IP Applications Corp.

Notes to Consolidated Financial Statements

December 31, 2006 and 2005

The fair value of the warrants was estimated using the Black-Scholes model using the following assumptions:

Expected dividend yield	0%
Stock price volatility	93.0%
Risk-free interest rate	3.69%
Expected life of warrants	2 years

Effective September 18, 2006, this debenture was rolled over into a new convertible debenture (see note 8(b)).

- b) Effective September 18, 2006, the Company completed a convertible debt financing totalling \$960,130. This financing consisted of a) \$411,144 in cash and b) a roll-over of the \$548,986 owing under the debentures issued on December 19, 2005.

This convertible debenture is due 18 months from the date of issuance with an interest rate of 12% per annum calculated and paid quarterly in cash. At the holders' option, the debentures may be converted into units consisting of one common share and one-sixth of a common share purchase warrant anytime after April 1, 2007. The conversion price is at the lesser of: a) market price at the time of conversion (not less than \$0.25); b) the price of a Qualifying Financing; or c) \$0.40. Each full warrant is exercisable into one common share at a price of \$0.50 for a period of 12 months from issuance and at a price of \$0.55 for the period 13-24 months from issuance. Should the Company complete a financing in excess of net proceeds of \$500,000 before June 30, 2007 ("Qualifying Financing"), each debenture holder will have the right to either convert its debentures on the same terms and conditions as the Qualifying Financing or have its debentures repaid in full by the Company.

The 1,250,000 share purchase warrants associated with the December 2005 debenture will remain outstanding, with an expiry of December 19, 2007 and exercisable at \$0.55 per share.

The Company has recorded the proceeds of the debenture between debt and equity based on the relative fair values of the debt and conversion option. The fair value of the debt component was \$183,951, and the fair value of the conversion option was \$227,193; this amount is being accreted on a straight-line basis over the term of the debt.

	\$
Balance - December 31, 2005	178,379
Interest expense	77,789
Accretion of interest	206,260
Convertible debenture	<u>183,951</u>
Balance - December 31, 2006	<u>646,379</u>

IP Applications Corp.

Notes to Consolidated Financial Statements

December 31, 2006 and 2005

9 Obligations under capital lease

	2006 \$	2005 \$
Lease payable in semi-annual instalments of \$26,750 including interest at an imputed rate of 0% until August 16, 2006, secured by a charge over equipment	-	53,395
Lease payable in monthly instalments of \$12,094 including interest at an imputed rate of 6.44% until October 1, 2006, secured by a charge over equipment. The buyout on October 1, 2006, was further financed in monthly instalments of \$7,737 including interest at an imputed rate of 3.70% until September 1, 2007.	68,808	189,308
Lease payable in monthly instalments of \$9,507 including interest at an imputed rate of 12.0% until September 13, 2007, secured by a charge over equipment	93,151	190,494
Lease payable in two instalments of \$3,084 and \$29,834 including interest at an imputed rate of 12.0% by February 16, 2007, secured by a charge over equipment	27,908	-
Lease payable in monthly instalments of \$3,286 including interest at an imputed rate of 3.9% until December 1, 2008, secured by a charge over equipment	88,790	-
Lease payable in monthly instalments of \$1,686 including interest at an imputed rate of 6.0% until March 1, 2008, secured by a charge over equipment	26,828	-
	<hr/>	<hr/>
	305,485	433,197
Less: Current portion	(244,944)	(336,973)
	<hr/>	<hr/>
	60,541	96,224

Future minimum lease payments for the respective period ends based on the fiscal year-end are as follows:

	\$
2007	256,399
2008	61,949
	<hr/>
	318,348
Less: Imputed interest	(24,925)
	<hr/>
	293,423

IP Applications Corp.

Notes to Consolidated Financial Statements

December 31, 2006 and 2005

10 Capital stock

- a) Authorized
100,030,000 common shares without par value
- b) Issued

	Number of shares	Amount \$
Balance - March 31, 2005	9,166,751	7,118,801
Shares issued for purchase of intangible asset (note 7)	455,000	241,150
Private placement for cash (note 10(b)(i))	2,424,242	714,977
Shares issued as employee compensation (note 10(b)(ii))	407,300	130,336
Private placement for cash (note 10(b)(iii))	1,999,998	637,143
Exercise of warrants (note 10(b)(iv))	333,333	118,549
Capital raising costs	-	(25,026)
Balance - December 31, 2005	14,786,624	8,935,930
Private placement for cash (note 10(b)(v))	300,000	52,384
Capital raising costs	-	(22,489)
Balance - December 31, 2006	15,086,624	8,965,825

- i) During the nine months ended December 31, 2005, the Company completed a non-brokered private placement for 2,424,242 common shares at \$0.33 per share for total gross proceeds of \$800,000. A total of 2,205,150 warrants held by participants in the private placement were surrendered for cancellation on a one-to-one basis with each new warrant entitling the holder to acquire one additional common share at a price of \$0.35 per share for the first twelve months and \$0.40 in the second twelve months. The net fair value of the warrants issued was \$85,023, with the fair value of the new warrants estimated on the issuance date using the Black-Scholes valuation model with the following assumptions:

Expected dividend yield	0%
Stock price volatility	95.0%
Risk-free interest rate	3.15%
Expected life of warrants	2 years

- ii) During the nine months ended December 31, 2005, the Company approved the payment of bonus compensation to certain officers and employees by way of issuance of a total of 407,300 shares at a price of \$0.32 per share in lieu of cash, for a total of \$130,336.

IP Applications Corp.

Notes to Consolidated Financial Statements

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- iii) During the nine months ended December 31, 2005, the Company completed a non-brokered private placement for 1,999,998 units at \$0.45 per unit for gross proceeds of \$900,000. Each unit consists of one common share, one-half of one warrant, with each full warrant entitling the holder to acquire one additional common share at a price of \$0.50 per share in the first twelve months and at \$0.55 per share for the second twelve months from the closing date. The fair value of the warrants issued was \$262,857, using the Black-Scholes valuation model with the assumptions noted below.

Expected dividend yield	0%
Stock price volatility	101.0%
Risk-free interest rate	3.04%
Expected life of warrants	2 years

- iv) During the year ended March 31, 2005, the Company completed a private placement of 1,000,000 units at a price of \$1.00 per unit. Each unit consisted of one common share, one-half call warrant and one cashless put warrant. The cashless put warrants become exercisable once certain conditions were met. In conjunction with the private placement described in note 9(b)(i) above, the conditions required to allow for the exercise of the cashless put warrants were waived and all cashless put warrants were exercised resulting in the issuance of 333,333 shares. The fair value of these cashless put warrants was \$118,549. During the year ended December 31, 2005, these warrants were exercised.
- v) On March 9, 2006, the Company completed a non-brokered private placement for 300,000 units at \$0.33 per unit for gross proceeds of \$100,000. Each unit consists of one common share and one warrant. Each warrant entitles the holder to purchase an additional common share at a price of \$0.40 during the 24 month period from closing.

The fair value of the warrants issued was \$47,616 using the Black-Scholes valuation model with the assumptions noted below.

Expected dividend yield	0%
Stock price volatility	92.62%
Risk-free interest rate	4.10%
Expected life of warrants	2 years

IP Applications Corp.

Notes to Consolidated Financial Statements

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- vi) During the nine months ended December 31, 2005, the Company entered into a banking arrangement with a Canadian Chartered Bank under which the Company obtained credit facilities in the total amount of \$650,000, including a \$250,000 operating line of credit ("LOC"). As security for the credit facilities, the Company and its operating subsidiary, IP Applications (Canada) Corp., granted the bank a general security agreement over their assets. As part of the banking arrangement, a key shareholder of the Company provided a \$200,000 guarantee to the bank. As compensation for providing the guarantee, the Company issued a warrant to the key shareholder entitling it to purchase 100,000 common shares of the Company during a period of five years from the date of issue at a price of \$0.53 per share in the first two years, \$0.58 per share in the third year, \$0.64 per share in the fourth year and \$0.70 per share in the fifth year. The fair value of the warrants issued was \$29,242 using the Black-Scholes valuation model with the assumptions noted below:

Expected dividend yield	0%
Stock price volatility	92.6%
Risk-free interest rate	3.11%
Expected life of warrants	3 years

c) Warrants

At December 31, 2006, the following share purchase warrants are outstanding:

Number of warrants outstanding and exercisable	Exercise price \$	Expiry date
2,205,150 (note 10(b)(i))	0.40	May 2, 2007
999,999 (note 10(b)(iii))	0.55	June 13, 2007
1,250,000 (note 8)	0.55	November 19, 2007
300,000 (note 10(b)(v))	0.40	February 6, 2008
<u>100,000 (note 10(b)(vi))</u>	0.53 - 0.70	July 14, 2010
<u>4,855,149</u>		
		\$
Balance - December 31, 2005	803,526	
Private placement (note 10(b)(v))	<u>47,616</u>	
Balance - December 31, 2006	<u>851,142</u>	

IP Applications Corp.

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d) Stock options

The Company's fixed Stock Option Plan (the Plan) allows for 18% of the issued share capital to reserved for issuance to executive officers and directors, employees and consultants. The Board of Directors of the Company may terminate the Plan at any time provided that the termination does not alter the terms or conditions of any option or impair the right of any shareholder. Vesting provisions of the Plan provide for 25% of the options upon the Grant Date and 12 ½% every quarter thereafter until fully vested. The current number of shares reserved for issuance under the Plan is 2,624,935. As at December 31, 2006, 695,035 options are available for future grant.

Stock option transactions for the nine-month period ended December 31, 2005 and the year ended December 31, 2006 are summarized as follows:

	2006		2005	
	Number of stock options outstanding	Weighted average exercise price \$	Number of stock options outstanding	Weighted average exercise price \$
Opening balance	1,002,500	0.56	1,192,720	0.69
Granted	1,285,600	0.33	658,112	0.55
Exercised	-	-	-	-
Expired	(3,600)	0.55	-	-
Forfeited	(354,600)	0.52	(848,332)	0.74
Closing balance	1,929,900	0.41	1,002,500	0.56

The fair values of the options granted during the twelve months ended December 31, 2006 have been determined using the Black-Scholes option pricing formulae with the following factors and are being recognized as an expense over the three year vesting period:

Expected dividend yield	0%
Stock price volatility	93.4% -97.4%
Risk-free interest rate	4.2% - 4.4%
Expected life of options	3 years
Fair value of the options granted	\$284,088

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At December 31, 2006, the following stock options are outstanding:

Number of stock options outstanding	Exercise price \$	Expiry date	Number of stock options exercisable
50,000	0.55	June 16, 2008	50,000
6,000	0.55	September 8, 2008	6,000
16,000	0.55	September 30, 2008	16,000
4,000	0.55	November 15, 2008	4,000
74,000	0.55	February 27, 2009	62,900
164,000	0.55	May 27, 2009	161,900
321,000	0.55	May 2, 2010	206,770
56,000	0.55	September 22, 2010	49,263
1,138,000	0.33	February 28, 2011	723,875
75,000	0.34	April 20, 2011	37,500
25,000	0.34	April 20, 2011	25,000
<u>1,929,000</u>			<u>1,343,208</u>

On May 2, 2005, the Company re-priced a total of 1,026,620 previously granted stock options exercisable at prices ranging from \$1.00 - \$4.00 to \$0.55 per share. On September 22, 2005, the Company re-priced an additional of 11,500 previously granted stock options exercisable at prices ranging from \$1.00 - \$1.75 to \$0.55 per share.

11 Contributed surplus

	2006 \$	2005 \$
Opening balance	906,799	286,759
Stock-based compensation	297,976	383,572
Equity component of convertible debenture	227,193	236,468
Closing balance	<u>1,431,968</u>	<u>906,799</u>

IP Applications Corp.

Notes to Consolidated Financial Statements

December 31, 2006 and 2005

12 Income taxes

The Company's provision for income taxes differs from the amounts computed by applying the combined Canadian federal and provincial income tax rates to the loss as a result of the following:

	2006	2005
Statutory rates	34.1%	35.6%
	\$	\$
Income tax recovery computed at statutory rates	(983,833)	(1,024,872)
Permanent differences	161,209	130,137
Temporary timing differences	-	-
Change in valuation allowance	(175,426)	645,393
Change in tax rate	382,583	-
Tax benefit not recognized on current year's losses	615,467	249,342
Provision for income taxes	-	-

The tax effects of temporary timing differences that give rise to significant components of the future tax assets and future tax liabilities are as follows:

	2006	2005
Statutory rates	31.0%	35.6%
	\$	\$
Future tax assets		
Non-capital loss carry-forwards	2,572,708	2,636,831
Other	201,566	312,870
Total gross future income tax assets	2,774,274	2,949,701
Less: Valuation allowance	(2,774,274)	(2,949,701)
Net future income tax assets	-	-

IP Applications Corp.

Notes to Consolidated Financial Statements

December 31, 2006 and 2005

At December 31, 2006, the Company has non-capital losses of approximately of \$7,402,669, which may be carried forward to apply against future years income for Canadian income tax purposes, subject to final determination by taxation authorities expiring as follows:

	\$
2007	420,332
2008	1,289,819
2009	761,939
2010	1,388,419
2013	2,035,662
2015	1,390,181
2016	1,012,706
	<hr/>
	8,299,058
	<hr/>

13 Related party transactions

- a) As part of a banking arrangement made in July 2005, whereby the Company obtained credit facilities from a Canadian chartered bank aggregating to \$650,000, a shareholder and company managed by an officer and director provided a \$200,000 guarantee to the bank. As compensation for providing the guarantee, the Company issued warrants to purchase 100,000 common shares over a five-year period at prices ranging from \$0.53 to \$0.70. Subsequent to year end, the Company obtained credit facilities from a different chartered bank, thereby allowing cancellation of the \$200,000 guarantee required from the previous bank.
- b) The \$960,130 convertible debenture described in note 8(b) was solely funded by shareholders and companies' managed by two directors.

14 Financial instruments

Fair values

The fair values of the Company's cash, accounts receivable, restricted cash, accounts payable and accrued liabilities approximate their carrying amounts because of the immediate or short-term maturity of these financial instruments.

Interest and foreign exchange rate risk

The Company is required to make certain payments in US dollars and has not entered into forward currency contracts or other financial derivatives to hedge exchange risk. To mitigate exchange risk, the Company maintains US dollar bank accounts for all US dollar sales and payments.

IP Applications Corp.

Notes to Consolidated Financial Statements

December 31, 2006 and 2005

Credit risk and concentration of sales

The Company is subject to credit risk and concentration of sales as it earns revenues from a limited number of customers.

The following tables summarize the extent to which the Company's sales are concentrated with a limited number of customers:

	Number of customers	Related amount \$
Revenue		
Twelve-month period ended December 31, 2006	4	5,542,958
Nine-month period ended December 31, 2005	2	2,072,220
Accounts receivable		
December 31, 2006	2	383,321
December 31, 2005	2	316,745

15 Leasehold inducements

	2006 \$	2005 \$
Opening balance	298,103	-
Additions	-	299,350
Amortization	(29,935)	(1,247)
	268,168	298,103
Less: Current portion	(29,935)	(29,935)
	238,233	268,168

During the period ended December 31, 2005, the Company entered into a lease agreement for new office premises. In connection with the lease, the Company received lease inducements of \$299,350 relating to leasehold improvements. These inducements are being amortized over the initial ten year term of the lease.

IP Applications Corp.

Notes to Consolidated Financial Statements
December 31, 2006 and 2005

16 Loss on lease commitment

	2006 \$	2005 \$
Opening balance	209,687	-
Additions	-	209,687
Amortization	(83,121)	-
	<hr/>	<hr/>
Less: Current portion	126,566 (71,540)	209,687 (83,121)
	<hr/>	<hr/>
	55,026	126,566

During the period ended December 31, 2006, the Company entered into a sublease agreement for its former office space in New Westminster. As at December 31, 2005, the Company recorded a loss of \$209,687 representing the difference paid to the landlord and received from the subtenant during the period of January 1, 2006 to the expiration of both lease and sublease agreements on September 30, 2008.

17 Segmented information

	2006 \$	2005 \$
Revenue		
Canada	1,840,299	1,503,103
United States	7,442,882	4,832,084
	<hr/>	<hr/>
	9,283,181	6,335,187

All of the Company's employees and assets are located in Canada.

IP Applications Corp.

Notes to Consolidated Financial Statements

December 31, 2006 and 2005

18 Commitments

The Company is party to certain operating leases for office premises under which the future minimum lease payments in aggregate based on the fiscal year-end of the Company are approximately as follows:

	\$
2007	472,480
2008	470,674
2009	355,388
2010	340,920
2011	367,142
Thereafter	<u>1,468,775</u>
	<u>3,475,379</u>

19 Subsequent events

- a) On December 20, 2006 IP Applications (Canada) Corp. changed its name to IP Applications Solutions Inc. and continued from the federal jurisdiction to British Columbia. Effective January 1, 2007, in order to simplify its corporate structure and reduce administrative workload and cost, the Company's three wholly-owned subsidiaries completed an amalgamation. IP Applications Solutions Inc. is now the sole operating subsidiary of the Company.
- b) In March 2007, the Company concluded a banking arrangement with a Canadian chartered bank, whereby credit facilities aggregating to \$720,000 were obtained. This facility consists of a \$320,000 standby letter of credit (which replaces the \$400,000 letter of credit issued by a previous chartered bank) and a \$400,000 revolving line of credit.