

**PEER 1 NETWORK ENTERPRISES INC.**

**CONSOLIDATED FINANCIAL STATEMENTS**

**For the Year Ended June 30, 2005 and 2004**

**PEER 1 NETWORK ENTERPRISES INC.**

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**AUDITORS' REPORT**

To the Shareholders of **Peer 1 Network Enterprises Inc.:**

We have audited the consolidated balance sheet of Peer 1 Network Enterprises Inc. as at June 30, 2005 and 2004, and the consolidated statements of operations and deficit, and cash flows for the years then ended. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated 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 consolidated financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated 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 June 30, 2005 and 2004, and the results of its operations and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

**Comments by Auditors for U.S. Readers on Canada - United States Reporting Differences**

United States reporting standards for auditors require the addition of an explanatory paragraph (following the opinion paragraph) when the financial statements are affected by conditions and events that cast substantial doubt on the Company's ability to continue as a going concern, such as those described in Note 1 to the financial statements. Our report to the shareholders dated September 9, 2005 is expressed in accordance with Canadian reporting standards which do not permit reference to such conditions and events in the auditors' report when these are adequately disclosed in the financial statements.

United States reporting standards also require the addition of an explanatory paragraph when the financial statements reflect a change in accounting policy, such as described in Note 3 for stock-based compensation.

“Cinnamon Jang Willoughby & Company”

Chartered Accountants

Burnaby, BC  
September 9, 2005

**PEER 1 NETWORK ENTERPRISES INC.**  
**Consolidated Balance Sheet**  
**June 30, 2005**  
(in thousands of Canadian dollars)

<b>Assets</b>	<b>2005</b>	<b>2004</b>
<b>Current:</b>		
Cash and cash equivalents	\$ 358	\$ 855
Restricted cash (Note 4)	613	121
Accounts receivable	2,991	2,139
Inventory	103	-
Prepaid expenses	461	306
	<b>4,526</b>	<b>3,421</b>
Other assets (Note 6)	1,274	795
Property and equipment (Note 7)	12,489	5,301
Goodwill (Note 8)	731	-
Licences (Note 9)	5,134	-
	<b>\$24,154</b>	<b>\$9,517</b>
<b>Liabilities</b>		
<b>Current:</b>		
Accounts payable and accrued liabilities	\$ 5,629	\$2,202
Deferred revenue	1,396	571
Shareholder notes payable (Note 10)	2,756	1,315
Current portion of deferred lease inducements	60	12
Current portion of notes payable	13,468	510
	<b>23,309</b>	<b>4,610</b>
Deferred lease inducements (Note 11)	385	151
Notes payable (Note 12)	119	3,319
	<b>23,813</b>	<b>8,080</b>
<b>Shareholders' Equity</b>		
Capital stock (Note 13)	11,246	9,914
Equity component of convertible notes (Note 12)	436	436
Contributed surplus	636	220
Deficit, per Exhibit "B"	11,977	9,133
	<b>341</b>	<b>1,437</b>
Nature of Operations and Future Operations (Note 1)		
Commitments (Note 18)		
Subsequent Events (Note 21)		
	<b>\$24,154</b>	<b>\$9,517</b>
<b>Approved by the Directors:</b>		
<u>"Lance Tracey"</u>		
<u>"Geoff Hampson"</u>		

- See accompanying notes -

**PEER 1 NETWORK ENTERPRISES INC.**  
**Consolidated Statement of Operations and Deficit**  
**For the Year Ended June 30, 2005**  
(in thousands of Canadian dollars, except per share amounts)

	2005	2004
Revenue	<b>\$24,113</b>	\$13,588
Cost of sales	<b>14,727</b>	8,622
Gross Profit	<b>9,386</b>	4,966
Operating expenses	<b>8,200</b>	5,003
Operating Income (Loss) before other items	<b>1,186</b>	(37)
Other Items:		
Amortization of licences	<b>790</b>	-
Integration of SeverBeach	<b>385</b>	-
Loss from investment accounted for on an equity basis	<b>218</b>	-
Foreign exchange (gain) loss	<b>(328)</b>	2
Interest expense	<b>2,635</b>	953
	<b>3,700</b>	955
Loss before income taxes	<b>2,514</b>	992
Future income taxes (Note 14)	<b>-</b>	-
Net Loss	<b>2,514</b>	992
Deficit, beginning	<b>9,133</b>	8,141
Less: Adjustment for prior years' stock based compensation (Note 3)	<b>330</b>	-
Deficit, ending, to Exhibit "A"	<b>\$11,977</b>	\$ 9,133
Basic and diluted loss per share (Note 13)	<b>\$ 0.05</b>	\$ (0.02)

- See accompanying notes -

**PEER 1 NETWORK ENTERPRISES INC.**  
**Consolidated Statement of Cash Flows**  
**For the Year Ended June 30, 2005**  
**(in thousands of Canadian dollars)**

	2005	2004
<b>Operating Activities:</b>		
Net Loss, per Exhibit "B"	\$ (2,514)	\$ (992)
Adjustments for -		
Amortization of property and equipment	2,237	867
Amortization of licences	790	-
Increase in accrued interest and accretion of convertible debt	913	313
Stock-based compensation and other	86	-
	<b>1,512</b>	188
Changes in non-cash working capital -		
Increase in accounts receivable	(852)	(521)
Increase in inventory	(103)	-
Increase in prepaid expenses	(155)	(77)
Increase (Decrease) in accounts payable and accrued liabilities	3,427	(360)
Increase in deferred revenue	825	262
Cash flows (used in) operating activities	<b>4,654</b>	(508)
<b>Investing Activities:</b>		
(Increase) Decrease in restricted cash	(492)	325
Investment in other assets	(479)	(379)
Acquisition of property and equipment	(9,425)	(2,591)
Acquisition of licenses	(5,924)	-
Acquisition of goodwill	(731)	-
Proceeds on disposition of equipment	-	3
Increase (Decrease) in deferred lease inducements	282	(12)
Cash flows (used in) investing activities	<b>(16,769)</b>	(2,654)
<b>Financing Activities:</b>		
Proceeds from shareholder notes payable	1,214	706
Repayment of obligations under capital leases	-	(133)
Proceeds from notes payable, net of repayments	9,072	1,290
Issuance of capital stock	1,332	1,969
Share issuance costs	-	(20)
Cash flows from financing activities	<b>11,618</b>	3,812
Increase (Decrease) in Cash and Equivalents	(497)	650
Cash and Equivalents, beginning	855	205
Cash and Equivalent, ending	<b>\$ 358</b>	\$ 855

Supplemental Disclosure of Cash Flow Information (Note 15)

- See accompanying notes -

**PEER 1 NETWORK ENTERPRISES INC.**  
**Notes to Consolidated Financial Statements**  
**June 30, 2005**  
**(tabular dollar amounts are presented in thousands of**  
**Canadian dollars, except number of shares and per share amounts)**

**1. Nature of Operations and Future Operations:**

Peer 1 Network Enterprises Inc. (the Company) was incorporated under the laws of British Columbia. The Company provides high performance internet bandwidth and co-location facilities to web-centric and enterprise customers across North America. The Company has established local offices and co-location facilities in Vancouver, Toronto, Montreal, New York, San Jose and Seattle, and also points of presence in Chicago, Los Angeles, Ashburn, Virginia and London, UK. The Company also provides dedicated servers from locations in San Antonio and Ashburn.

To date, the Company has generated losses from operations and has a net working capital deficiency. These consolidated financial statements have been prepared on a going concern basis, which presumes that the Company will be able to realize its assets and discharge its liabilities in the normal course of business for the foreseeable future. The ability to do so is dependent upon its ability to obtain additional sources of financing and achieve future profitable operations, the outcome of which cannot be predicted at this time. These consolidated financial statements do not include any adjustments that might be necessary should the Company be unable to continue as a going concern.

**2. Significant Accounting Policies:**

a) Basis of Consolidated Financial Statements -

These consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries, Peer 1 Network Inc., Peer 1 Network (USA) Inc., Peer 1 Network (Seattle) Inc., Peer 1 Network (San Jose) Inc., Peer 1 Network (New York) Inc., Peer 1 Network (LA) Inc., ServerBeach GP Inc., ServerBeach LP Inc., ServerBeach Ltd. (formerly P1 Acquisition, Ltd.), Data Centre Technologies IP Inc., Colobrokers.com Inc., and 585065 B.C. Ltd.

These comparative consolidated financial statements also include the Company's share (50%) of the accounts of the incorporated joint venture, Symmetric Broadband Inc. (Symmetric) on the proportionate consolidation basis for the prior fiscal year and until December 31, 2004 in the current fiscal year. For the period January 1, 2005 to June 30, 2005, the statements include operating results recorded on the equity basis, as the basis of accounting for Symmetric changed during the year. (See Note 5)

b) Cash and Cash Equivalents -

Cash and cash equivalents consist of cash and short-term deposits with maturities at the date of purchase of three months or less.

c) Inventory -

Inventory is recorded at the lower of cost and market on a first-in, first-out basis.

**PEER 1 NETWORK ENTERPRISES INC.**  
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**2. Significant Accounting Policies: (Continued)**

d) Property and Equipment -

The following assets are recorded at cost. Amortization is provided on a declining balance basis at the following annual rates:

Co-location equipment	20%
Computer equipment	30%
Computer software	100%
Furniture and fixtures	20%
Network equipment	20%

Servers rented to customers as part of the dedicated server business unit are amortized straight line over their expected useful life, which varies from 24 to 36 months.

Amortization of leasehold improvements is provided on a straight-line basis over the terms of the respective leases.

When the net carrying amount of the property and equipment exceeds estimated net recoverable amount, the asset is written down to its estimated fair value and a charge is recorded in the consolidated statement of operations.

e) Goodwill -

Goodwill is recorded at the amount originally recognized. (See Note 8). Goodwill is tested for impairment in value on an annual basis. Fair value is determined based on the present value of discounted cash flows. Following the impairment test at year-end, management has concluded that there has been no impairment in the value of goodwill.

f) Licenses -

Licenses are recorded at cost. Amortization is provided on a straight-line basis over five years, the term of the licenses.

g) Deferred Lease Inducements -

Lease inducements, including rent free periods, are deferred and accounted for as a reduction of rent expense over the term of the related leases on a straight-line basis.

**PEER 1 NETWORK ENTERPRISES INC.**  
**Notes to Consolidated Financial Statements**  
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**2. Significant Accounting Policies: (Continued)**

h) Debt Instruments -

Where the Company issues debt instruments with detachable warrants or conversion options in connection with a debt instrument, the estimated fair market value of the warrants and conversion feature are credited to shareholders' equity. The reduced liability component of the debt is accreted by a charge to interest expense.

i) Future Income Taxes -

Income taxes are calculated using the liability method of tax allocation. Temporary differences arising from the difference between the tax basis of an asset or liability and its carrying amount on the balance sheet, and unutilized losses carried forward are used to calculate future income tax assets or liabilities. Future income tax assets or liabilities are calculated using tax rates anticipated to apply in the year that the temporary differences are expected to reverse. The carrying value of the future income tax asset is limited to the amount that is more likely than not to be realized. A valuation allowance is provided. See Note 14.

j) Financing Costs -

Costs directly identifiable with the raising of capital are charged against the related capital stock. Costs incurred to obtain debt financing are deferred and amortized by a charge to interest expense over the term of the related debt. Debt financing fees are amortized and included as part of interest expense. Financing costs expensed for 2005 are \$769,982 (2004 - \$38,421).

k) Deferred Start-up Costs -

Start-up costs incurred by Symmetric were deferred and amortized by Symmetric on a straight-line basis over three years. If it were to appear that the deferred costs could not be recovered, the unamortized balance would be immediately written-off. The comparative statements include the Company's share of the deferred startup costs, recorded on a proportionate consolidated basis.

l) Organizational Costs -

Organizational costs, direct or incremental costs directly related to acquisitions, are deferred and added to the cost of purchase. Only costs that are directly related to proposed transactions, where completion is considered more likely than not, are deferred. Once the Company ceases to be engaged on a regular ongoing basis and it is not likely that activities will resume, the costs are expensed.

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**2. Significant Accounting Policies: (Continued)**

m) Foreign Currency Transactions -

Monetary assets and liabilities denominated in currencies other than the Canadian dollar are translated at the rate of exchange in effect at the end of the year. Revenue and expense items are translated at the rate of exchange in effect on the dates they occur. Exchange gains or losses are recognized immediately in the consolidated statement of operations.

The Company's US subsidiaries are managed as integrated operations and accordingly are accounted for under the temporal method. Under this method, monetary assets and liabilities are translated at the exchange rate in effect at the balance sheet date. Non-monetary assets and liabilities are translated at historical rates. Revenues and expenses are translated at average rates for the year. Exchange gains or losses arising from the translation are included in operations.

n) Revenue Recognition -

The four sources of revenue are co-location, internet traffic, rental of dedicated servers and general services. General services include installation, IP monitoring, tape back-up, technical support, additional access cards, and DNS services. Co-location, internet traffic, rental of dedicated servers and general services revenue is recognized once an agreement is in place, the price is fixed or determinable, the service is provided and there is reasonable assurance of cash collection.

o) Stock-based Compensation -

The Company has a stock-based compensation plan for executives and other key employees. The stock-based compensation expense is recognized in accordance with CICA Handbook Section 3870 "Stock-Based Compensation and Other Stock-Based Payments". Beginning January 1, 2004, the Company changed its accounting policy related to employee stock options, and began to recognize compensation expense for stock or stock option grants to employees, based on the fair value of the stock or stock options issued. Consideration paid by employees on the purchase of shares under the employee share purchase plan and exercise of stock options is recorded as share capital. Also see Note 3.

p) Earnings Per Share –

The diluted earnings per share is calculated based on the weighted-average number of common shares outstanding during the year, plus the effects of dilutive common share equivalents. This method requires that the dilutive effect of outstanding options issued should be calculated using the treasury stock method. This method assumes that all common share equivalents have been exercised at the beginning of the period (or a time of issuance, if later), and that the funds obtained thereby were used to purchase common shares of the Company at the average trading price of common shares during the period.

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**2. Significant Accounting Policies: (Continued)**

q) Use of Estimates -

The preparation of financial statements in conformity with Canadian generally accepted accounting principles requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying disclosures. Although these estimates are based on management's best knowledge of current events and actions the Company may undertake in the future, actual results may differ from these estimates.

**3. Changes in Accounting Policies:**

Stock-based Compensation –

The recommendations of CICA Handbook Section 3870 "Stock-based Compensation and Other Stock-based Payments" are followed. These recommendations establish standards for the recognition, measurement and disclosure of stock-based compensation and other stock-based payments made in exchange for goods and services. Effective January 1, 2004, these recommendations require that compensation for all awards made, including stock appreciation rights, direct awards of stock and awards that call for settlement in cash or other assets, be measured and recorded in the financial statements at fair value. For the purpose of this Section, employees include directors who receive stock compensation for services provided as a director since all directors are elected by the shareholders. This Section also sets out a fair value based method of accounting for stock options issued to employees and applies to awards granted on or after January 1, 2002.

Prior to the adoption of the new standard, no compensation expense was recognized when stock options were issued to employees as options were issued at the market value of the shares at the date of the grant. Consideration paid by employees on the purchase of shares under the employee share purchase plan and exercise of stock options was recorded as share capital. The Company had previously disclosed the pro forma effect of accounting for these awards under the fair value based method.

In accordance with the requirements of Section 3870, this change in accounting policy is applied retroactively without restatement of prior periods. Opening deficit for 2005 was increased by \$329,723 reflecting the cumulative effect of the change in the accounting policy.

**PEER 1 NETWORK ENTERPRISES INC.**  
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**4. Restricted Cash:**

The Company has issued letters of credit totaling US\$500,000 (2004 - \$Nil) to landlords and other vendors in the normal course of business in lieu of deposit requirements. The letters of credit have a term of one year, with annual renewal provisions. Certificates of deposit in the amount of US\$500,000 have been pledged as security for the letters of credit, and are disclosed on the balance sheet as restricted cash. Restricted cash in 2004 was related to the provisions of the line of credit agreement with Polygon Financial, Inc. (See Note 12(c)).

**5. Investments in Symmetric:**

Symmetric provides voice services over the internet. This is a more technically demanding service than those currently offered by the Company, it entered into an agreement with a joint venturer who would provide the required expertise.

At June 30, 2004 the Company recorded its proportionate interest (50%) in Symmetric's assets and liabilities as set out below:

Cash	\$158
Lease deposits	18
Computer equipment	1
Deferred start-up costs	42
<hr/>	
Total Assets	\$219
<hr/>	
Accounts payable	\$ 12
Shareholders' equity	207
<hr/>	
Total Liabilities and Shareholders' Equity	\$219
<hr/>	

In January 2005 the Company amended the agreement with the joint venturer. Under the terms of the revised agreement, the Company is no longer responsible for continuing to fund Symmetric's operations, with all current funding being made available by the other party to the agreement. As a result, the Company's ownership interest has declined from 50% at December 31, 2004 to 28% at June 30, 2005, and the basis of accounting has been changed from proportionate consolidation to equity accounting.

At year-end, after reflecting the Company's share of the losses incurred by Symmetric during the year on both the proportionate consolidation basis and the equity basis, the net investment in Symmetric is \$14,111. The investment is included as a component of Other Assets on the balance sheet

The Company has retained the right to increase its interest in Symmetric back to the 50% level by providing funding equivalent to twice the amount that would otherwise be required to match the contributions made by the other party to the agreement.



**PEER 1 NETWORK ENTERPRISES INC.**  
**Notes to Consolidated Financial Statements**  
**June 30, 2005**

(tabular dollar amounts are presented in thousands of  
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**6. Other Assets:**

	2005	2004
Financing costs	\$ 86	\$ 124
Deferred start-up costs - Joint Venture (Note 5)	-	42
Investment in Symmetric Broadband Inc. (Note 5)	14	-
Network installation fees	5	14
Organizational costs	352	163
Security deposits	817	452
	<b>\$1,274</b>	<b>\$795</b>

**7. Property and Equipment:**

**2005**

	Cost	Accumulated Amortization	Net
Co-location equipment	\$ 2,779	\$ 957	<b>\$ 1,822</b>
Computer equipment	483	217	<b>266</b>
Computer software	180	149	<b>31</b>
Dedicated servers	3,847	863	<b>2,984</b>
Furniture and fixtures	144	49	<b>95</b>
Leasehold improvements	4,742	704	<b>4,038</b>
Network equipment	4,980	1,727	<b>3,253</b>
	<b>\$17,155</b>	<b>\$4,666</b>	<b>\$12,489</b>

**2004**

	Cost	Accumulated Amortization	Net
Co-location equipment	\$2,153	\$ 604	\$1,549
Computer equipment	308	138	170
Computer software	124	97	27
Furniture and fixtures	93	34	59
Leasehold improvements	2,081	378	1,703
Network equipment	2,971	1,178	1,793
	<b>\$7,730</b>	<b>\$2,429</b>	<b>\$5,301</b>

Software totaling \$124,323 (2004 - \$90,100) has been fully amortized and remains in service.

There are no assets under capital lease in the current year (2004 - \$54,423).

**PEER 1 NETWORK ENTERPRISES INC.**  
**Notes to Consolidated Financial Statements**  
**June 30, 2005**  
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**8. Acquisition of ServerBeach, Ltd.:**

On October 20, 2004, the Company, through its 100% owned subsidiary, P1 Acquisition, Ltd. ("P1") acquired all of the operating assets of San Antonio, Texas-based ServerBeach, Ltd. ("ServerBeach").

Included in the operating assets were existing customer contracts, an exclusive use licence for technology that is essential to the ServerBeach business and over 4,200 dedicated servers. As part of the purchase of assets, the Company obtained rights to the Company name, was granted the authority to rename P1 Acquisition, Ltd. to ServerBeach, Ltd. on October 22, 2004, and now operates under that name. The asset purchase price was US\$7,500,000 and a secured promissory note agreement. (See Note 12(d)).

The purchase price and related organizational costs were allocated to the assets acquired based on their fair market value, with the excess recorded as goodwill, as follows:

	US	CDN
Inventory	\$ 46	\$ 57
Tangible capital assets	2,357	2,955
Licences	4,727	5,924
Goodwill	590	731
	\$7,720	\$9,667

**9. Licences:**

	2005	2004
Cost	\$5,924	\$ -
Less: Accumulated amortization	790	-
	\$5,134	\$ -

See also Note 8.

**10. Shareholder Notes Payable:**

The shareholder notes payable are unsecured, payable on demand and bear interest at prime plus 7%. At June 30, 2005, accrued interest payable is \$227,054 (2004 - \$130,821).

**PEER 1 NETWORK ENTERPRISES INC.**  
**Notes to Consolidated Financial Statements**  
**June 30, 2005**  
**(tabular dollar amounts are presented in thousands of**  
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**11. Deferred Lease Inducements:**

	<b>2005</b>	2004
Deferred lease inducements	<b>\$445</b>	\$163
Less: Current portion	0	12
	<b>\$385</b>	\$151

**12. Notes Payable:**

	Principal and Interest	Unamortized Accretion	<b>2005 Total</b>	2004 Total
Secured Loans –				
a) Sutton Group Financial Services Limited	\$ 978	\$ 52	<b>\$ 926</b>	\$ 780
b) Sutton Group Financial Services Limited	1,242	103	<b>1,139</b>	906
c) Polygon Financial, Inc.	823	334	<b>489</b>	702
d) Polygon Financial Investments Inc.	9,805	-	<b>9,805</b>	-
d) Code Capital Limited	353	28	<b>325</b>	408
	13,201	517	<b>12,684</b>	2,796
Unsecured Loans –				
f) ACACIA Management Services Inc.	110	3	<b>107</b>	399
g) Cyber Pacific Holdings Limited	734	61	<b>673</b>	536
h) Code Marketing Limited	134	11	<b>123</b>	98
	978	75	<b>903</b>	1,033
	\$14,179	\$592	<b>13,587</b>	3,829
Less: Current portion			<b>13,468</b>	510
			<b>\$ 119</b>	<b>\$3,319</b>

a) Sutton Group Financial Services Limited -

On July 1, 2003, the Company amended the terms of a convertible, secured 10% note dated May 10, 2002 held by a significant shareholder, Sutton Group Financial Services Limited. The amended note accelerated the maturity date from January 2008 to July 2006. It also reduced the share price at which the outstanding principal and interest may be converted to common shares of the Company, from a range of \$0.45 to \$0.65 during the term of the note to \$0.32 until September 30, 2005, and \$0.352 thereafter.

**PEER 1 NETWORK ENTERPRISES INC.**  
**Notes to Consolidated Financial Statements**  
**June 30, 2005**  
**(tabular dollar amounts are presented in thousands of**  
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**12. Notes Payable: (continued)**

As consideration for the acceptance of the amended terms, the Company issued warrants to purchase 2,502,900 common shares at \$0.32 per share until October 22, 2005. The warrants were exercised in March 2004. The fair value of the warrants (2005 - \$Nil; 2004 - \$226,977) and of the conversion feature (2005 - \$Nil; 2004 - \$32,965) have been credited to shareholders' equity.

The shares of Peer 1 Network Inc., the Canadian operating subsidiary, have been registered under a pledge agreement to secure the note.

b) Sutton Group Financial Services Limited -

An unsecured, demand promissory note bearing interest at prime plus 7% was issued to a significant shareholder of the Company, Sutton Group Financial Services Limited, in September 2002 and amended the terms of the note effective July 1, 2003. The amended terms provide that the principal and interest accrued at prime plus 7% are due June 30, 2006. The note may be converted to common shares of the Company at \$0.32 per share until June 30, 2005, and thereafter at \$0.352 per share.

The Company has also agreed that the holders may exchange the amended note to the Company for shares in the capital of Peer 1 Network Enterprises Inc. Prior to September 30, 2005, the number of shares issued will be based on \$0.32 per share, thereafter, \$0.352 per share.

As partial consideration for agreeing to renegotiate the terms of the existing debt, the creditors were granted warrants to purchase 3,013,821 common shares at \$0.32 per share expiring on October 22, 2005. The warrants were exercised in March 2004. The fair value of the warrants (2005 - \$Nil; 2004 - \$267,123) and the conversion feature (2005 - \$Nil; 2004 - \$41,549) have been credited to shareholders' equity.

The Company has pledged the assets of Peer 1 Network Enterprises Inc. as security for the loan, subject to the security interest of the Code Capital Limited loan (Note 12(e)), and a postponement agreement. Code Capital Limited is a Company owned by a shareholder and director of the Company.

c) Polygon Financial, Inc. -

Under an April 4, 2003 line of credit agreement with Polygon Financial, Inc., a lender controlled by a director of the Company, the lender advanced US \$900,000, the full amount of the agreement, in four draws. Until the funds are spent on purposes specified in the agreement, expanding operations of and providing working capital for one of the US subsidiaries, they were reported as "Restricted Cash" on the balance sheet (2005 - \$Nil; 2004 - \$121,370). (See Note 4.)

**PEER 1 NETWORK ENTERPRISES INC.**  
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**12. Notes Payable: (continued)**

Interest is charged at 10% per annum compounded monthly (increasing to 15% in the event of default). Principal and interest are payable in quarterly installments commencing October 31, 2003 and ending on January 31, 2008. The unused portion of the facility bore a standby fee of 7.5%.

The aggregate principal amount under the line of credit may be converted into common shares at the option of the lender. During the first two years of the line of credit, the conversion price is \$0.32 per share. The conversion price increases by 10% per year thereafter. The conversion price at June 30, 2005 was \$0.352. If the conversion results in the lender holding more than 20% of the issued common shares, shareholder approval must be obtained.

In connection with the agreement, the Company issued to the lender, a non-transferable share purchase warrant entitling it to purchase up to 4,145,906 common shares at a price of \$0.32 per share, for two years. The warrants, issued in lieu of additional interest and fees, have expired. The fair value of warrants issued (2005 - \$Nil; 2004 - \$156,506) and of the conversion feature associated with advances (2005 - \$Nil; 2004 - \$332,755) have been credited to shareholders' equity.

The assets of Peer 1 Network (USA) Inc. have been pledged as security for the facility.

d) Polygon Financial Investments Inc. -

On October 18, 2004 a senior secured promissory note agreement was entered into with Polygon Financial Investments Inc., a Company owned by a shareholder and a director of the Company, in the amount of US\$7,500,000. Under the terms of the note, interest accrued at a rate of 6% per annum, compounded monthly, from the date of issue to December 31, 2004 at which time the accrued interest was payable. The interest rate then increased to 15% per annum, compounded monthly, with accrued interest payable monthly commencing January 31, 2005.

A US\$500,000 transaction fee was charged as additional compensation for the making of the loan. On April 1, 2005 the agreement was amended to add the \$500,000 fee to the principal amount of the note. The transaction fee has been charged to income over the term of the note.

The maturity date of the note was June 30, 2005, with provisions for extension at the discretion of the borrower. The note extension periods varied from three to six months, with renewal fees equivalent to 2.5% of the outstanding principal for each three month period. The Company exercised a six month renewal option, and extended the maturity date of the note to December 31, 2005. The transaction fee associated with the renewal is US\$400,000, which was satisfied subsequent to year end by issuing 1,538,625 shares at \$0.32 per share.

The shares of ServerBeach GP Inc., ServerBeach LP Inc., ServerBeach Ltd., and Data Centre Technologies IP Inc. have been pledged as security for the note.



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**12. Notes Payable: (continued)**

e) Code Capital Limited -

In October 2003, a promissory note agreement was entered into with Code Capital Limited, a company owned by a shareholder and a director of the Company, in the amount of \$500,000. Under the terms of the note, interest accrues at a rate of prime plus 4%. Principal and interest are payable in 60 equal installments of \$10,359 commencing October 15, 2003.

Under the agreement, the Company issued 500,000 warrants to purchase 500,000 common shares at \$0.28 per share if exercised before November 6, 2005. The fair value of the warrants issued (2005 - \$Nil; 2004 - \$42,481) has been credited to shareholders' equity.

The loan has first security over the assets of the Company, except for the security interest in the shares of Peer 1 Network (USA) Inc., a wholly-owned subsidiary of the Company.

f) ACACIA Management Services Inc. -

An unsecured, convertible note agreement was entered into with ACACIA Management Services Inc., and amended the terms of the agreement effective July 1, 2003. The loan bears interest at 10%. As amended, \$500,000 may be converted to common shares of the Company at \$0.38 per share. Upon conversion, the balance of the loan is repayable without interest in quarterly payments of \$75,000.

The lender exercised its right to convert debt of \$500,000 and received 1,315,789 common shares of the Company on November 6, 2003. (See also Note 13)

g) Cyber Pacific Holdings Limited -

An unsecured, demand promissory note bearing interest at prime plus 7% was issued to a lender, Cyber Pacific Holdings Limited, whose director is also a shareholder of the Company, in November 2002 and amended the terms of the note effective July 1, 2003. The amendments provide that the note may be converted to common shares of the Company at \$0.32 per share until June 30, 2005 and at \$0.352 until June 30, 2006, when the note is to be repaid.

In consideration of the amendment, the Company issued 1,834,215 warrants to purchase common shares of the Company at \$0.32 per share if exercised before October 23, 2005. The fair value of the warrants (2005 - \$Nil; 2004 - \$157,857) and the conversion feature (2005 - \$Nil; 2004 - \$24,130) have been credited to shareholders' equity.

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**12. Notes Payable: (continued)**

h) Code Marketing Limited -

An unsecured, demand promissory note without interest was issued to a lender, Code Marketing Limited, controlled by a shareholder and director of the Company in May 2002 and amended the note effective July 1, 2003. Under the amended terms, the note may be converted to common shares at \$0.32 per share until June 30, 2005 and \$0.352 per share thereafter. If the note is not converted by June 30, 2006, the principal plus all accrued and unpaid interest, calculated at prime plus 7%, is payable immediately.

In consideration for the lender's acceptance of the amendments, the Company issued 334,375 share purchase warrants. The warrants entitle the lender to purchase common shares at \$0.32 per share if exercised before October 22, 2005. The warrants were exercised in March 2004. The fair value of the warrants (2005 - \$Nil; 2004 - \$28,777) and the conversion feature (2005 - \$Nil; 2004 - \$4,239) have been credited to shareholders' equity.

**13. Capital Stock:**

Authorized -  
100,000,000 Common shares without par value

Issued and Fully Paid -

	Number of Shares	Amount
Balance, June 30, 2003	36,934,482	\$ 6,780
Conversion option exercised	1,315,789	276
Warrants exercised	6,115,096	2,878
Share issuance costs	-	(20)
Balance, June 30, 2004	44,365,367	9,914
Private placement	4,750,000	1,330
Warrants exercised	4,000	2
Balance, June 30, 2005	49,119,367	\$11,246

**Private Placement -**

The Company completed a private placement on March 16, 2005 for 4,750,000 common shares at a price of \$0.28 per share. Gross proceeds received were \$1,330,000.

**Shares Held in Escrow -**

Shares in the amount of 13,082,925 (2004 - 16,231,275) are subject to an escrow agreement and may not be transferred, assigned or otherwise dealt with without regulatory approval.

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**13. Capital Stock: (Continued)**

**Warrants Outstanding -**

The following non-transferable share purchase warrants are outstanding:

<u>Exercise Price</u>	<u>2004</u>	<u>Issued</u>	<u>Expired/ Exercised</u>	<u>2005</u>	<u>Expiry Date</u>
0.72	4,305,416	-	<b>4,305,416</b>	-	July 24 2004
0.45	400,000	-	<b>400,000</b>	-	July 24 2004
0.39	5,312,343	-	<b>5,138,343</b>	-	February 18 2005
0.32	4,145,906	-	<b>4,145,906</b>	-	April 4 2005
0.32	1,834,215	-	-	<b>1,834,215</b>	October 22 2005
0.28	500,000	-	-	<b>500,000</b>	November 6 2005
	16,323,880	-	13,989,665	<b>2,334,215</b>	

**Stock Options -**

	<u>2005</u>		<u>2004</u>	
	<u>Shares</u>	<u>Weighted Average Exercise Price</u>	<u>Shares</u>	<u>Weighted Average Exercise Price</u>
Outstanding, beginning	3,428,250	\$0.43	2,644,250	\$0.45
Granted	452,000	0.35	858,000	0.38
Exercised	-	-	-	-
Expired	-	-	(74,000)	0.40
Forfeited	(233,000)	0.39	-	-
Outstanding, ending	3,647,250	0.42	3,428,250	0.45
Options exercisable, ending	3,647,250		3,028,250	

The following table summarizes stock options outstanding and exercisable:

<u>Range of Exercise Prices</u>	<u>Number Outstanding 2005</u>	<u>Weighted Average Remaining Contractual Life</u>	<u>Weighted Exercise Price</u>
\$0.24 - \$0.47	3,647,250	2.6 Years	\$0.42

Under the stock option plan, the Company may grant options to its directors, consultants, and employees for up to 4,911,937 (2004 – 4,436,537) shares of common stock. The exercise price of each option equals the market price of the stock on the date of the grant. These options vest when granted.

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**13. Capital Stock: (Continued)**

The fair value of each option is estimated as at the date of grant using the Black-Scholes Option Pricing Model with the following weighted average assumptions:

	2005	2004
Dividend yield	-	-
Expected volatility	75%	75%
Risk-free interest rate	3.0%	3.0%
Expected average option term	5 years	5 years

The weighted average fair value of the options granted to employees during the year was \$0.21 (2004 - \$0.29) per option. Accordingly, the 2005 compensation expense is \$85,978.

**Loss Per Share**

Loss per share is based on the weighted average number of common shares outstanding during the year. The exercise of outstanding stock options and warrants as at June 30, 2005 and June 30, 2004 would have had an anti-dilutive effect on the loss per share.

**14. Income Taxes:**

Accumulated non-capital losses of approximately \$11,884,407 (2004 - \$7,037,355) are available to be carried forward to apply against future years' income for tax purposes. These losses expire as follows:

	\$ 977
2010	635
2011	730
2012	1,010
2023	1,915
2024	6,617
2025	

For Canadian Tax purposes losses can be carried forward for seven years, whereas, for US tax purposes losses can generally be carried forward for twenty years.

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**14. Income Taxes: (Continued)**

Significant components of the future tax assets are shown below:

	<b>2005</b>	2004
Future Tax Assets -		
Non-capital loss carried forward	<b>\$ 4,159</b>	\$ 2,090
Property and equipment	<b>(1,346)</b>	163
Financing costs	<b>101</b>	123
Other	<b>175</b>	(179)
Total future tax assets	<b>3,089</b>	2,197
Valuation allowance	<b>(3,089)</b>	(2,197)
	<b>\$ -</b>	<b>\$ -</b>

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

Income taxes vary from the amount that would be computed by applying the combined statutory income tax rate for the following reasons:

	<b>2005</b>	2004
Basic blended federal and provincial tax at statutory income tax rates	<b>\$(880)</b>	\$ 62
Change in valuation allowance	<b>893</b>	(224)
Non-deductible interest	<b>130</b>	108
Amortization of goodwill	<b>(187)</b>	-
Other permanent differences	<b>44</b>	53
	<b>\$ -</b>	<b>\$ -</b>

**15. Supplemental Disclosure of Cash Flow Information:**

a) Supplemental Disclosure -

	<b>2005</b>	2004
Interest	<b>\$127</b>	\$271

b) Non-cash Transactions -

- i) Issuance of Nil (2004 - 8,275,311) bonus warrants with a fair value of \$Nil (2004 - \$723,575) as additional consideration for promissory note.
- ii) In 2004, there was a conversion of \$500,000 of debt into 1,315,789 shares.

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**16. Related Party Balances and Transactions:**

The Company has entered into a number of related party transactions with companies either owned or subject to significant influence by management, directors, and principal shareholder.

The significant transactions with related parties are as follows:

	<b>2005</b>	2004
<hr/>		
Transactions During the Year -		
Revenue earned	<b>\$ 109</b>	\$361
Interest expensed	<b>1,506</b>	877
Other expenses	<b>75</b>	-

These transactions are in the normal course of operations and are measured at their exchange amounts, which is the amount of consideration established and agreed to by the related parties. Included in other expenses is \$69,643 in accounts receivable that has been written off.

	<b>2005</b>	2004
<hr/>		
Balances at Year-End -		
Accounts receivable from related companies	<b>\$61</b>	\$265
Accounts payable to a related party	<b>(5)</b>	(3)

The balances are payable on demand and have arisen from the sales of products and provision of services referred to above.

Also see Notes 5, 10, 12 and 13 for details of additional related party transactions and balances.

**17. Financial Instruments:**

a) Fair Values -

Cash and cash equivalents, restricted cash, accounts receivable, accounts payable and accrued liabilities, deferred revenue, and shareholder notes payable are stated at amounts approximating fair value due to their short-term nature. The fair value of notes payable are stated at amounts that approximate their fair value.

b) Foreign Currency Risk -

The Company has accounts receivable and accounts payable denominated in US dollars. The carrying value of these items may change due to fluctuations in foreign exchange rates. The Company currently does not enter into hedging transactions.

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**17. Financial Instruments: (Continued)**

c) Credit Risk -

The accounts receivable are subject to credit risk as several customers operate in a volatile segment of the economy. The Company mitigates this risk through receipt and review of credit applications, diligent collection procedures and encouraging customers to pay via credit cards or pre-authorized payment. A deposit at the onset for installation charges is also required.

d) Interest Rate Risk -

The Company is exposed to interest rate risk as the shareholder notes payable and other notes payable bear interest based on the prime lending rate plus 4% to 7%.

e) Liquidity Risk -

The Company is subject to significant liability risk on its accounts payable, shareholder notes payable and notes payable. All shareholder notes payable may be demanded at any time. The Company must rely on their shareholders not to demand these amounts at a time or times when the Company reasonably could not meet such demands.

**18. Commitments:**

a) Premises Leases -

The Company has entered into agreements to lease premises which expire between 2010 and 2014. The future minimum lease payments for the next five years are as follows:

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2006	\$3,482
2007	3,586
2008	3,618
2009	3,545
2010	2,751

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b) Services Agreements -

The Company has entered into a series of agreements to obtain bandwidth, backbone, peering, local loop/cross connect and points of presence services. These arrangements expire between 2006 and 2008. Minimum lease payments for the next three years under the contracts are as follows:

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**18. Commitments: (Continued)**

	2006	2007	2008
Bandwidth	\$1,270	\$ 375	\$ -
Backbone	1,367	469	224
Peering	27	-	-
Local loop/cross connect	509	208	128
Points of presence	175	43	-
	<b>\$3,348</b>	<b>\$1,095</b>	<b>\$352</b>

**19. Segmented Information:**

Prior to the second quarter of the fiscal year, the Company operated one reporting segment and two geographic segments. Following the acquisition of ServerBeach assets on October 20, 2004, two reporting segments are now in operation with two geographic segments.

The reporting segments are as follows:

	Co-location & Bandwidth	Dedicated Servers	<b>2005 Total</b>	2004 Total
Revenue	\$16,992	\$7,121	<b>\$24,113</b>	\$13,588
Income (Loss)	(1,605)	(909)	<b>(2,514)</b>	(992)
Amortization	13,935	10,219	<b>24,154</b>	9,517
Total Assets				

The geographic segments in operation are as follows:

<b>2005</b>	Canada	US	<b>Total</b>
Revenue	\$13,834	\$10,279	<b>\$24,113</b>
Property and equipment	5,211	7,278	<b>12,489</b>
Goodwill	-	731	<b>731</b>
Licences	-	5,134	<b>5,134</b>
Amortization of property and equipment	1,007	1,230	<b>2,237</b>
Amortization of licences	-	790	<b>790</b>

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**19. Segmented Information: (Continued)**

<b>2004</b>	Canada	US	<b>Total</b>
Revenue	\$11,894	\$1,694	<b>\$13,588</b>
Property and equipment	3,723	1,578	<b>5,301</b>
Amortization of property and equipment	635	233	<b>868</b>

**20. Differences Between Canadian and United States  
Generally Accepted Accounting Principles:**

These financial statements are expressed in Canadian dollars and are prepared in accordance with Canadian GAAP which conform, in all material respects with US GAAP except as described below:

Statement of Operations -	<b>2005</b>	2004
Net Loss - Canadian GAAP	<b>\$2,514</b>	\$ 992
Add: Deferred charges	<b>55</b>	42
Debt conversion charges	<b>117</b>	62
Stock based compensation	<b>-</b>	116
Unrealized foreign exchange	<b>(253)</b>	(71)
Accretion interest charge on convertible debt	<b>(116)</b>	(326)
Net Loss - US GAAP	<b>2,317</b>	815
Unrealized foreign exchange	<b>253</b>	71
Comprehensive Loss - US GAAP	<b>\$2,570</b>	\$ 886

The Company has deferred certain costs associated with developing a new business venture. These costs have been expensed for US reporting.

During the year, the company negotiated various debt instruments. The costs associated with this restructuring have been expensed for US reporting purposes.

In accordance with APB 16, internal and indirect costs associated with merger and acquisition activities have been expensed as incurred. Incremental fees such as finders' fees and consulting fees have been capitalized.

Unrealized foreign exchange gains have been added back to the Net Loss and become a component of the Company's comprehensive income.

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**20. Differences Between Canadian and United States**  
**Generally Accepted Accounting Principles: (Continued)**

The interest on convertible debt includes an accretion charge to reflect the increase in the equity component of the convertible debt. Under US GAAP APB No. 14 "Accounting for Convertible Debt and Debt Issued with Stock Purchase Warrants", no portion of the security should be attributable to the conversion feature, so the accretion charge should be added back to Net Loss.

**Employee Stock Options -**

The Company accounts for all its employee stock options with the fair value method "FAS 123". Under this method, compensation cost is measured at the grant date based on the fair value of the options granted. FAS 123 requires that the option be valued using a fair value option pricing model. The Company adopted the fair value method for Canadian purposes effective January 1, 2004. As a result there is no adjustment to net income for 2005, but there is an adjustment to share capital and deficit to reflect the different dates of adoption.

**Non-employee Stock Option -**

The Company accounts for its non-employee stock options with the fair value method "FAS 123". Under this method, compensation cost is measured at the grant date based on the fair value of the options granted. FAS 123 requires that the option be valued using the Black-Scholes Option Pricing Model.

The Company has granted employee and non-employee stock options at various times during the year ended June 30, 2005. At the dates of grant the options were valued using the Black-Scholes Option Pricing Model with the following assumptions:

Volatility factor of market	75%
Price of Company shares	\$0.45
Risk-free interest rate	3%
Weighted average exercise price	\$0.45
Term	5 years

**Share Purchase Warrants -**

Under FAS 133 as amended by FAS 149 and 150, beneficial detachable warrants issued as a component of debt have been reclassified as equity. As Canadian GAAP conforms to US GAAP, this has no material impact on the Company.

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**20. Differences Between Canadian and United States  
Generally Accepted Accounting Principles: (Continued)**

**Net Loss Per Share -**

On February 1997, SFAS No. 128 "Earnings per Share" was issued. SFAS 128 redefines earnings per share under US GAAP and replaces primary earnings per share with basic earnings per share. The net loss per share, as reported, is different from basic loss per share prescribed by SFAS 128 as follows:

	2005	2004
Weighted Average Number of Shares Outstanding -		
Canadian	45,722,660	39,365,775
Less: Escrow shares	13,082,925	16,231,275
US GAAP	32,639,735	23,134,500
Basic loss per share under US GAAP	\$(0.08)	\$(0.04)

**Application of US GAAP -**

In June 1997, FASB issued SFAS No. 130 "Reporting Comprehensive Income", which was effective for fiscal years beginning after December 15, 1997. The Company has determined that comprehensive income consists of its net loss and foreign currency translation adjustments, and is shown net of tax in the statement of changes in shareholders' equity.

The application of US GAAP would have the following effects on the balance sheet items as reported under Canadian GAAP:

**Balance Sheet**

**Assets**

	2005	2004
Canadian GAAP	\$24,154	\$9,517
Effect of deferred charges and debt conversion costs	(173)	(147)
US GAAP	\$23,981	\$9,370

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**Liabilities**

Canadian GAAP	\$23,813	\$8,080
Effect of equity portion of convertible debentures	185	6
US GAAP	\$23,998	\$8,086



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**20. Differences Between Canadian and United States**  
**Generally Accepted Accounting Principles: (Continued)**

**Shareholders' Deficiency**

Deficit - Canadian GAAP	<b>\$11,977</b>	\$ 9,133
Add: Effect of deferred charges and debt conversion costs	<b>172</b>	104
Stock based compensation	-	116
Accretion interest charge on convertible debt	<b>(116)</b>	(326)
Cumulative effect of prior years' adjustments:		
Deferred charges and debt conversion costs	-	43
Stock based compensation	527	740
Accretion interest charge on convertible debt	<b>(134)</b>	(103)
Deficit - US GAAP	12,426	9,707
Capital - Canadian GAAP	<b>12,318</b>	10,571
Add: Stock based compensation	<b>527</b>	856
Equity component of convertible debt	<b>(436)</b>	(436)
Capital - US GAAP	<b>12,409</b>	10,991
Shareholders' Equity (Deficiency) - US GAAP	<b>\$ (17)</b>	\$ 1,284

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**Convertible Promissory Debentures -**

Under US GAAP, in accordance with APB No. 14 "Accounting for Convertible Debt and Debt Issued with Stock Purchase Warrants", no portion of the proceeds from the issuance of convertible debt securities should be accounted for as attributable to the conversion feature. Canadian GAAP requires the separate presentation of the liability and equity component of the convertible debentures (Note 12).

**Recent Accounting Pronouncements:**

a) Revenue Recognition -

In 1999, SAB No. 101 "Revenue Recognition in Financial Statements" was issued. SAB 101 provides guidance on recognition, presentation and disclosure of revenue in financial statements filed with the SEC. Although SAB 101 does not change any of the accounting profession's existing rules on revenue recognition, it draws upon existing rules and explains how the SEC staff applies those rules, by analogy, to other transactions that existing rules do not address.

SAB 101 as amended by SAB 101B becomes effective for the fourth fiscal quarter of fiscal years commencing after December 15, 1999. The Company has determined that SAB 101 does

not have a material effect on its consolidated financial statements.

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**20. Differences Between Canadian and United States**  
**Generally Accepted Accounting Principles: (Continued)**

**Recent Accounting Pronouncements: (Continued)**

b) Derivative Instruments and Hedging Activities -

On April 30, 2003 the FASB issued Statement No. 149, Amendment of Statement No. 133 on "Derivative Instruments and Hedging Activities". Statement 149 is intended to result in more consistent reporting of contracts as either freestanding derivative instruments subject to Statement 133 in its entirety, or as hybrid instruments with debt host contracts and embedded derivative features. In addition, Statement 149 clarifies the definition of a derivative by providing guidance on the meaning of initial net investments related to derivatives. Statement 149 is effective for contracts entered into or modified after June 30, 2003. The adoption of Statement 149 did not have any effect on the Company's consolidated financial position, results of operations or cash flows.

c) Certain Financial Instruments with Characteristics of both Liabilities and Equity -

On May 15, 2003 the FASB issued Statement No. 150, "Accounting For Certain Financial Instruments with Characteristics of both Liabilities and Equity". Statement 150 establishes standards for classifying and measuring as liabilities certain financial instruments that embody obligations of the issuer and have characteristics of both liabilities and equity. Statement 150 represents a significant change in practice in the accounting for a number of financial instruments, including mandatory redeemable equity instruments and certain equity derivatives that frequently are used in connection with share repurchase programs. Statement 150 is effective for all financial instruments created or modified after May 31, 2003 and to other instruments as of September 1, 2003. The adoption of Statement 150 on July 1, 2003 did not have any impact on its consolidated financial position, results of operations or cash flows.

d) Accounting for Stock-Based Compensation -

In 2004, FASB issued a revision of FASB Statement No. 123, "Accounting for Stock-Based Compensation". This Statement supersedes APB Opinion No. 25, Accounting for Stock Issued to Employees, and its related implementation guidance. This revised pronouncement requires that all stock options and warrants be accounted for using the Fair Value Method. This pronouncement will impact on the Company as a charge of \$526,620 increasing the deficit, offset by an equal credit to capital.

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**20. Differences Between Canadian and United States**  
**Generally Accepted Accounting Principles: (Continued)**

**Recent Accounting Pronouncements: (Continued)**

e) Consolidation of Variable Interest Entities -

FIN 46(R), "Consolidation of Variable Interest Entities", applies at different dates to different types of enterprises and entities, and special provisions apply to enterprises that have fully or partially applied Interpretation 46 prior to issuance of Interpretation 46(R). Application of Interpretation 46 or Interpretation 46(R) is required in financial statements of public entities that have interests in variable interest entities or potential variable interest entities commonly referred to as special-purpose entities for periods ending after December 15, 2003. Application by public entities (other than small business issuers) for all other types of entities is required in financial statements for periods ending after March 15, 2004. Application by small business issuers to entities other than special-purpose entities and by non-public entities is required at various dates in 2004 and 2005. There is no impact on the Company's consolidated financial statements.

f) Exchange of Non-Monetary Assets -

In December 2004, the FASB issued SFAS Statement No. 153, "Exchanges of Non-monetary Assets". The statement is an amendment of APB Opinion No. 29 to eliminate the exception for non-monetary exchanges of similar productive assets and replaces it with a general exception for exchanges of non-monetary assets that do not have commercial substance. The Company believes that the adoption of this standard will have no material impact on its consolidated financial statements.

g) Accounting Changes and Error Corrections -

In May 2005, FASB issued SFAS Statement No. 154 "Accounting Changes and Error Corrections" requiring retrospective application to prior periods' financial statements of a change in an accounting policy. The Company believes that the adoption of this standard will have no material impact on its consolidated financial statements.

**21. Subsequent Events:**

a) Extension of Promissory Note Agreement -

As noted in Note 12(d), the Company exercised a six month renewal option with Polygon Financial Investments Inc., and extended the maturity of the US\$7,500,000 note to December 31, 2005. The transaction fee associated with the renewal is US\$400,000, which was satisfied subsequent to year end by issuing 1,538,625 shares at \$0.32 per share. This note was subsequently converted to equity. (See Note 211(f))

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**21. Subsequent Events: (Continued)**

b) US\$2,000,000 Financing -

On July 18, 2005 the Company closed a US\$2,000,000 loan, the proceeds of which are to be used to build or acquire a data centre in Los Angeles and to complete the build out of the new facility in Toronto. The lenders are companies which are controlled by directors of the Company.

The loan bears interest at 10% per annum, compounded monthly, plus contingent interest in certain circumstances equal to 50% of the aggregate operating profit generated from the new locations during the period ending June 30, 2010. Interest only is payable monthly effective July 31, 2005 and blended payments of principal and interest are payable effective July 31, 2006. The loan matures on June 30, 2008.

At the option of the lender, the loan is convertible into common shares at \$0.40 per share if exercised by July 18, 2007 and \$0.46 per share if exercised thereafter. The loan is convertible only until 90 days after the lender receives any payment of contingent interest. As further consideration for the loan, the Company issued 3,100,000 warrants to the lenders, pro rata to their respective percentage of the loan. Each warrant entitles the holder to purchase one common share of the Company at \$0.40 per share until July 18, 2007.

The loan is secured by the assets of the new Los Angeles and Toronto facilities. This loan was subsequently converted to equity on September 2, 2005. (See Note 211(f))

c) Interland, Inc. Asset Acquisition -

The Company, through a wholly owned subsidiary, entered into an asset purchase agreement dated August 31, 2005 with Interland, Inc. ("Interland"). Pursuant to the agreement, Interland has agreed to sell, and the Company has agreed to purchase, all of the assets of Interland that are necessary for the daily operation of Interland's dedicated server business. The Company has also agreed to assume certain liabilities of Interland. In addition, Interland has granted to the Company a royalty-free non-exclusive licence to the intellectual property owned by Interland and access to property licenced by Interland from third parties.

The purchase price for the assets and the obligations of Interland is US\$14,000,000, subject to adjustment in accordance with the asset purchase agreement. 20% of the purchase price prior to adjustment was placed in escrow as security for the obligations of Interland under the agreement.

The Company and Interland have also entered into an administrative services agreement dated August 31, 2005. As a result of the transaction, Interland becomes a significant co-location, bandwidth and managed services customer of the Company.



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**21. Subsequent Events: (Continued)**

d) Loan and Security Agreement -

In connection with the Interland acquisition, the Company has entered into a Loan and Security Agreement (the "LSA") dated September 2, 2005 by and among Peer 1 (USA), Inc. and each of its subsidiaries that are signatories thereto as borrowers (the "Borrowers"), the Company and each of its subsidiaries that are signatories thereto as guarantors (the "Guarantors"), and Fortress Credit Corp. ("Fortress") as the lender, arranger and administrative agent.

Pursuant to the LSA, Fortress agreed to make three loan facilities available to the Borrowers after they have met the terms of the contract: a term loan which was advanced on September 2, 2005 in the amount of US\$24,000,000; a term loan (the "Incremental Term Loan") of up to US\$4,000,000 (less if certain cash flow criteria specified in the LSA are not satisfied) and a revolving loan (the "Revolving Facility") of up to US\$7,000,000 until September 2, 2008 and US\$10,000,000 thereafter until September 2, 2010 if the maturity date is extended by the Company for two years in accordance with the terms of the LSA.

The interest rate on borrowings under the LSA is LIBOR plus 6.5% per annum, subject to adjustment in certain specified circumstances. The amounts borrowed must be repaid in instalments, commencing on October 1, 2005. A portion of the net proceeds received by any of the Borrowers from the sale of assets or the issuance of equity securities must be used to prepay the loan. The maturity date of the loan is September 1, 2008, though the Company may extend the maturity date for two years by giving notice of such extension at least 90 days before September 1, 2008.

In connection with the LSA, the Company issued warrants entitling the holders to acquire 2,306,571 common shares at US\$0.23 per share for a period of five years.

e) Preferred Stock Financing -

The Company and its subsidiary, Peer 1 Network (USA Inc.) ("Peer 1 USA"), have entered into a Series A preferred stock Purchase Agreement (the "SPA") dated September 2, 2005 with several investors (the "Investors") pursuant to which Peer 1 USA has issued 7,000 shares of Series A preferred stock in its capital at US\$1,000 per share, for aggregate proceeds of US\$7,000,000.

The Series A preferred stock carries one vote per share and a cumulative annual dividend of 8%. In the event of any liquidation, dissolution or winding up of Peer 1 USA, the holders of the Series A preferred stock are entitled to receive, in preference to any distribution of the assets of Peer 1 USA, an amount per share equal to the liquidation value for each share of Series A preferred stock. The liquidation value of a share of Series A preferred stock is:

- (i) for the period beginning on September 2, 2005 (the "Closing Date") through but excluding the second anniversary of the Closing Date, US\$1,000 per share;

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**21. Subsequent Events: (Continued)**

- (ii) for the period beginning on such second anniversary through but excluding the third anniversary of the Closing Date, US\$1,500 per share; and
- (iii) for the period beginning on the third anniversary of the Closing Date and thereafter, US\$2,000 per share, subject in each case to adjustments in certain circumstances.

At any time after the fourth anniversary of the Closing Date and provided that the amounts borrowed under the LSA have been repaid and the LSA has been terminated, any holder of shares of Series A preferred stock may cause Peer 1 USA to redeem any or all of its outstanding shares of Series A preferred stock at US\$2,000 per share.

In connection with the SPA, the Company and Peer 1 USA entered into an Investors' Rights Agreement (the "IRA") dated September 2, 2005 with the Investors. In addition to providing the Investors with rights to register their shares of Series A preferred stock in the United States in certain circumstances, the IRA contains rights of put and call as follows:

- (iv) any Investor may require the Company to purchase for US\$2,000 per share any or all of its shares of Series A preferred stock at any time after the fourth anniversary of the Closing Date, upon a liquidation, dissolution or winding up of the Company or upon a change of control.
- (v) at any time after the fourth anniversary of the Closing Date, the Company may require the Investors to sell all of their shares of Series A preferred stock to the Company at US\$2,000 per share.
- (vi) any investor may at any time require the Company to purchase any or all of its shares of Series A preferred stock in exchange for the number of common shares in the capital of the Company determined by dividing \$1,000 per share of Series A preferred stock being exchanged by US\$0.2291, subject to adjustment in certain specified circumstances.

Pursuant to the IRA, the Company has granted to each Investor a right of first offer with respect to future sales by the Company of any of its shares or securities convertible into or exchangeable or exercisable for any shares in the capital of the Company.

The Company, Peer 1 USA, the Investors and certain shareholders of the Company have entered into a Shareholder Agreement dated September 2, 2005 (the "Shareholder Agreement"). Pursuant to the Shareholder Agreement, the Company has agreed to seek shareholder approval to increase its authorized share capital and cause its management to take all necessary actions so that a nominee of Celerity Partners SBIC, L.P. is a member of the Board of Directors of the Company.

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**21. Subsequent Events: (Continued)**

Celerity Partners SBIC, L.P., of Menlo Park, California, acquired US\$4,090,000 and insiders of the Company acquired US\$2,660,000 of the Series A preferred stock.

f) Debt for Equity Conversion -

On September 2, 2005, the Company converted approximately \$7,013,698 of its aggregate indebtedness into 25,274,588 common shares of the Company, at \$0.2775 per share.