

Consolidated Financial Statements of

TELEHOP COMMUNICATIONS INC.

December 31, 2002 and 2001

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**Deloitte
& Touche**

Auditors' Report

To the Shareholders of
Telehop Communications Inc.

We have audited the consolidated balance sheets of Telehop Communications Inc. as at December 31, 2002 and 2001 and the consolidated statements of income and retained earnings and of cash flows for the years then ended. 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, 2002 and 2001 and the results of its operations and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

Deloitte & Touche LLP

Chartered Accountants

Toronto, Ontario
March 7, 2003

**Deloitte
Touche
Tohmatsu**

TELEHOP COMMUNICATIONS INC.

Consolidated Balance Sheets

December 31, 2002 and 2001

	<u>2002</u>	<u>2001</u>
ASSETS		
CURRENT		
Cash	\$1,464,079	\$ 450,205
Accounts receivable	1,675,372	2,785,969
Income taxes recoverable	38,719	87,478
Prepaid expenses	37,170	30,643
Advance to shareholder (Note 2)	26,101	31,067
	<u>3,241,441</u>	<u>3,385,362</u>
FUTURE INCOME TAXES (Note 3)	25,271	22,741
CAPITAL ASSETS (Note 4)	838,773	767,930
	<u>\$4,105,485</u>	<u>\$4,176,033</u>
LIABILITIES		
CURRENT		
Accounts payable and accrued charges	\$2,820,328	\$2,918,862
Obligations under capital lease - current portion (Note 5)	17,247	93,351
	<u>2,837,575</u>	<u>3,012,213</u>
OBLIGATIONS UNDER CAPITAL LEASE (Note 5)	21,757	13,459
	<u>2,859,332</u>	<u>3,025,672</u>
SHAREHOLDERS' EQUITY		
CAPITAL STOCK (Note 6)	1,094,164	1,094,164
RETAINED EARNINGS	151,989	56,197
	<u>1,246,153</u>	<u>1,150,361</u>
	<u>\$4,105,485</u>	<u>\$4,176,033</u>

APPROVED BY THE BOARD

..... HERSH SPIEGELMAN Director

..... RUTH BARTHOLOMEUSZ Director

TELEHOP COMMUNICATIONS INC.
Consolidated Statements of Income and Retained Earnings
Years ended December 31, 2002 and 2001

	<u>2002</u>	<u>2001</u>
REVENUE	\$12,334,438	\$10,877,445
EXPENSES		
Telecom costs	7,236,666	7,263,709
General and administration	2,270,307	1,704,449
Marketing and selling	1,462,397	1,105,470
Development and technical support	915,778	416,397
Depreciation and amortization	254,613	308,488
Interest	16,023	57,055
	<u>12,155,784</u>	<u>10,855,568</u>
INCOME BEFORE INCOME TAXES	178,654	21,877
INCOME TAXES (Note 3)	82,862	11,867
NET INCOME FOR THE YEAR	95,792	10,010
RETAINED EARNINGS, BEGINNING OF YEAR	56,197	46,187
RETAINED EARNINGS, END OF YEAR	\$ 151,989	\$ 56,197
BASIC AND DILUTED EARNINGS PER SHARE (Note 6)	\$ 0.01	\$ 0.00

TELEHOP COMMUNICATIONS INC.
Consolidated Statements of Cash Flows
Years ended December 31, 2002 and 2001

	<u>2002</u>	<u>2001</u>
CASH FLOW PROVIDED BY (USED FOR)		
OPERATING ACTIVITIES		
Net income for the year	\$ 95,792	\$ 10,010
Items not affecting cash		
Depreciation and amortization	254,613	308,488
Future income taxes	(2,530)	(18,383)
Loss on disposal of capital assets	-	149,026
Deferred charges	-	1,657
	<u>347,875</u>	<u>450,798</u>
Changes in operating working capital items		
Accounts receivable	1,110,597	(948,834)
Prepaid expenses	(6,527)	29,084
Accounts payable and accrued charges	(98,534)	406,856
Income taxes recoverable	48,759	30,247
	<u>1,402,170</u>	<u>(31,849)</u>
INVESTING ACTIVITIES		
Repayments of advance to shareholder	4,966	20,447
Additions to capital assets	(253,067)	(212,389)
	<u>(248,101)</u>	<u>(191,942)</u>
FINANCING ACTIVITY		
Repayment of obligations under capital lease	(140,195)	(97,994)
	<u>(140,195)</u>	<u>(97,994)</u>
INCREASE (DECREASE) IN CASH DURING THE YEAR	1,013,874	(321,785)
CASH, BEGINNING OF YEAR	450,205	771,990
CASH, END OF YEAR	\$ 1,464,079	\$ 450,205
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION		
Interest paid	\$ 22,942	\$ 60,383
Interest earned	\$ (6,919)	\$ (3,328)
Assets acquired and financed under capital lease	\$ 72,389	\$ 19,030

TELEHOP COMMUNICATIONS INC.

Notes to Consolidated Financial Statements

December 31, 2002 and 2001

1. SIGNIFICANT ACCOUNTING POLICIES

The consolidated financial statements have been prepared in accordance with Canadian generally accepted accounting principles and reflect the following policies:

Basis of consolidation

The consolidated financial statements include the accounts of the Company and its subsidiaries, all of which are wholly owned. All intercompany transactions and accounts have been eliminated on consolidation.

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 reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Cash and cash equivalents

For purposes of the consolidated financial statements, cash is defined as cash and short-term deposits having a maturity of three months or less.

Capital assets and amortization

Capital assets are stated at cost. Amortization is based on the estimated useful lives of the assets and is provided as follows:

Telecom equipment	20% straight-line
Furniture and equipment	20% straight-line
Leasehold improvements	Lesser of estimated useful life and period of lease agreement
Telecom switch	14% straight-line
Computer software	20% straight-line
Telecom equipment under capital lease	10% - 20% on a straight-line basis

Income taxes

The Company uses the asset and liability method for accounting for income taxes which requires the establishment of future tax assets and liabilities, as measured by substantively enacted tax rates, for all temporary differences caused when tax bases of assets and liabilities differ from those reported in the financial statements. Future income tax assets are evaluated and if realization is not considered more likely than not, a valuation allowance is provided.

Revenue recognition

The Company records revenue from the sale of telecom services at the time of customer usage primarily based upon minutes of use. The Company recognizes revenues on the accrual basis and includes an estimate of revenues earned but not billed.

TELEHOP COMMUNICATIONS INC.

Notes to Consolidated Financial Statements

December 31, 2002 and 2001

1. SIGNIFICANT ACCOUNTING POLICIES (continued)

Stock option plan

The Company has an employee stock option plan, which is described in Note 6.

Effective January 1, 2002, the Company adopted the Canadian Institute of Chartered Accountants recommendations ("CICA") in Handbook Section 3870 "Stock-based Compensation and Other Stock-based Payments" ("HB 3870"). These guidelines establish standards for the recognition, measurement and disclosure of stock-based compensation and other stock-based payments made in exchange for goods and services. HB 3870 sets out a fair value based method of accounting that is required for certain, but not all, stock-based transactions.

The new standard permits the Company to continue its existing policy that no compensation cost is recorded on the grant of stock options to employees. Consideration paid by employees on the exercise of stock options is recorded as share capital.

HB 3870, however, does require additional disclosures for options granted to employees, including disclosure of pro forma earnings and pro forma earnings per share as if the fair value based accounting method had been used to account for employee stock options. The adoption of HB 3870 did not have an effect on the Company's results of operations or financial condition.

Earnings per share

The Company uses the treasury stock method of calculating the dilutive effect of options on earnings per share.

Recent Canadian Accounting Pronouncements

Impairment or Disposal of Long-Lived Assets

In December 2002, the CICA issued Handbook Section 3063, "Impairment of Long-Lived Assets". This Section supersedes the write-down and disposal provisions of Section 3061, "Property, Plant and Equipment". Section 3063 amends existing guidance on long-lived asset impairment measurement and establishes standards for the recognition, measurement and disclosure of the impairment of long-lived assets held for use by the Company. It requires that an impairment loss be recognized and measured as the amount by which the carrying amount of the asset exceeds its fair value. The new standards contained in Section 3063 are applicable for years beginning on or after April 1, 2003; however, early application is permitted. The Company plans to adopt this standard as of January 1, 2003. The Company expects the adoption of this standard will have no material impact on its current financial position, results of operations or cash flows.

Disclosure of Guarantees

In February 2003, the CICA issued Accounting Guideline 14, "Disclosure of Guarantees" ("AcG 14"). AcG 14 requires certain disclosures to be made by a guarantor in its interim and annual financial statements for periods beginning after January 1, 2003. The Company is currently determining the impact this new requirement will have on its consolidated financial statements.

TELEHOP COMMUNICATIONS INC.
Notes to Consolidated Financial Statements
December 31, 2002 and 2001

2. ADVANCE TO SHAREHOLDER

The Board of Directors agreed during the year to amend the terms of an advance to a shareholder. The maturity date was extended to August 31, 2003. The advance bears no interest.

3. INCOME TAXES

Future income tax assets and liabilities result primarily from the difference between depreciation recorded for accounting purposes and that claimed for income tax purposes.

As at December 31, 2002 and 2001, the Company's future income tax assets and liabilities were as follows:

	<u>2002</u>	<u>2001</u>
Future income tax assets		
Tax value of capital assets in excess of accounting base	\$ 21,634	\$ 22,001
Losses available for carry forward	3,124	-
Other	513	740
Net future income tax asset	\$ 25,271	\$ 22,741

The reconciliation of the provision for income taxes reflected in the financial statements with the amount of tax that would result from the application of Canadian statutory tax rates to reported income, is as follows:

	<u>2002</u>	<u>2001</u>
Income before income taxes	\$ 178,654	\$ 21,877
Approximate applicable statutory tax rate	39%	42%
Income taxes at statutory tax rates	68,996	9,133
Add (deduct) the tax effect of		
Adjustment to prior year's provision	12,896	-
Non-deductible amounts	2,094	3,623
Rate adjustment	(712)	(3,239)
Other	(412)	2,350
	\$ 82,862	\$ 11,867

TELEHOP COMMUNICATIONS INC.
Notes to Consolidated Financial Statements
December 31, 2002 and 2001

4. CAPITAL ASSETS

	2002			2001		
	Cost	Accumulated Amortization	Net Book Value	Cost	Accumulated Amortization	Net Book Value
Telecom equipment	\$ 446,687	\$ 157,312	\$ 289,375	\$ 290,209	\$ 87,529	\$ 202,680
Furniture and equipment	48,001	30,820	17,181	38,478	22,159	16,319
Leasehold improvements	131,809	30,565	101,244	73,701	8,449	65,252
Telecom Switch	455,752	327,811	127,941	455,752	262,704	193,048
Computer software	72,835	30,765	42,070	43,877	19,521	24,356
	<u>1,155,084</u>	<u>577,273</u>	<u>577,811</u>	<u>902,017</u>	<u>400,362</u>	<u>501,655</u>
Telecom equipment under capital lease	554,776	293,814	260,962	482,387	216,112	266,275
	<u>\$ 1,709,860</u>	<u>\$ 871,087</u>	<u>\$ 838,773</u>	<u>\$ 1,384,404</u>	<u>\$ 616,474</u>	<u>\$ 767,930</u>

Depreciation and amortization of assets under capital lease was \$77,702 in the year ended December 31, 2002 (for year ended December 31, 2001 - \$64,059).

In 2001, the Company consolidated its premises into one new location and wrote down the net book value of its capital assets by \$149,026.

5. COMMITMENTS

Details of obligations under capital lease as at December 31, 2002 are as follows:

2003	\$ 21,269
2004	17,310
2005	4,090
Total minimum lease payments	42,669
Less amount representing imputed interest of approximately 6%	3,665
Present value of obligations under capital lease	39,004
Current portion - due within one year	17,247
Long-term obligations under capital lease	<u>\$ 21,757</u>

TELEHOP COMMUNICATIONS INC.
Notes to Consolidated Financial Statements
December 31, 2002 and 2001

5. COMMITMENTS (continued)

The future minimum payments under operating leases as at December 31, 2002 are as follows:

2003	\$ 145,652
2004	145,652
2005	145,652
2006	147,457
2007	177,984
Thereafter	690,276
	<u>\$ 1,452,673</u>

6. CAPITAL STOCK

Authorized

An unlimited number of common shares

	<u>2002</u>	<u>2001</u>
Issued and outstanding		
12,067,500 common shares	\$1,094,164	\$1,094,164

Earnings per share is the amount of earnings for the period available to each common share outstanding during the reporting period. Earnings per share was calculated using earnings of \$95,792 (2001 – \$10,010) and weighted average number of common shares of 12,067,500 (2001 – 12,067,500). There was no adjustment arising from the effect of dilutive securities on the adjusted weighted average number of shares outstanding.

Stock option plan

The Company's employee stock option plan ("ESOP") authorized the Company to reserve 1,500,000 common shares of the Company for issuance in accordance with the terms of the ESOP. Options granted vest over a period not exceeding five years and the purchase price is payable in full at the time the options are exercised.

TELEHOP COMMUNICATIONS INC.
Notes to Consolidated Financial Statements
December 31, 2002 and 2001

6. CAPITAL STOCK (continued)

Summarized information relative to the Company's stock option plan is as follows:

	2002	Weighted Average Exercise Price	2001	Weighted Average Exercise Price
Options outstanding, beginning of year	1,355,500	\$ 0.40	1,058,500	\$ 0.40
Options granted	400,000	0.40	523,000	0.40
Options exercised	-	0.40	-	0.40
Options cancelled	(602,500)	0.40	(226,000)	0.40
Options outstanding, end of year	1,153,000	\$ 0.40	1,355,500	\$ 0.40
Options exercisable, end of year	648,400	\$ 0.40	528,000	\$ 0.40

The following table summarizes information about stock options outstanding at December 31, 2002:

Range of Exercise Price	Outstanding		Exercisable	
	Number Outstanding	Weighted Average Remaining Life	Number Exercisable	Weighted Average Exercise Price
\$ 0.40	1,153,000	3.36	648,400	\$ 0.40

The Company's board of directors has resolved to reprice all options outstanding as at December 31, 2002. The repricing of the options at an exercise price of \$0.20 is subject to final shareholder approval.

The Company accounts for its stock-based employee compensation other than all stock-based payments to non-employees, as capital transactions. Section 3870 requires the disclosure of pro forma net income as if the Company had accounted for its stock options issued subsequent to December 31, 2001 under the fair value method. The Company has evaluated the fair value of the options granted during the year using the Black-Scholes option pricing model to estimate the fair value of the options at the date of grant. The Company determined that the fair values are insignificant and do not have an effect on its results of operations, or earnings per share. The financial statements, therefore, do not include the pro forma disclosure.

TELEHOP COMMUNICATIONS INC.
Notes to Consolidated Financial Statements
December 31, 2002 and 2001

7. RELATED PARTY TRANSACTIONS

A company owned by a significant shareholder provided managerial and consulting services in the amount of \$151,150 (2001 - \$69,360) and an additional \$30,500 with respect to prior year managerial services. At the year end no amounts were owing in connection with these services (2001 - \$8,560).

A director of the Company is also a partner in the firm providing legal services to the Company. Fees paid to the firm were \$32,253 (2001 - \$15,712) of which \$2,254 (2001 - \$4,224) remained payable at year end.

8. FINANCIAL INSTRUMENTS AND FINANCIAL RISK MANAGEMENT

Fair value of financial instruments

The carrying amounts of financial assets and financial liabilities approximate their fair value.

Credit risk

The Company is subject to credit risk through accounts receivables, which is limited by the large number of customers and their geographic dispersion across Ontario. The Company also mitigated the majority of its credit risk through an arrangement with the BCE group of companies.

9. SEGMENTED INFORMATION

The Company operates in one industry and one operating segment, being the telecom industry. All of the Company's assets are located in Canada and substantially all of the Company's revenues are derived in Canada.

10. COMPARATIVE FIGURES

Certain of the comparative figures have been reclassified to conform with the current presentation.