

IP Applications Corp.

Interim Consolidated Financial Statements
(Unaudited)

June 30, 2006

IP Applications Corp.

Consolidated Balance Sheet

As at June 30, 2006

	2006 June 30 (Unaudited)	2005 December 31 (Audited)
Assets		
Current assets		
Cash (note 3)	\$ (12,006)	\$ 434,690
Restricted cash (note 5)	-	300,000
Accounts receivable	949,497	841,895
Prepaid expenses	128,493	140,423
	<hr/> 1,065,984	<hr/> 1,717,008
Property and equipment (note 6)	1,162,263	1,189,102
Intangible asset (note 7)	966,364	1,323,734
	<hr/> \$ 3,194,611	<hr/> \$ 4,229,844
Liabilities		
Current liabilities		
Accounts payable and accrued liabilities	\$ 1,220,563	\$ 1,475,963
Customer deposits	22,432	33,941
Deferred revenue	-	44,546
Current portion of lease commitment	70,930	83,121
Current portion of leasehold inducement	29,935	29,935
Current portion of obligations under capital lease (note 9)	321,666	336,973
	<hr/> 1,665,526	<hr/> 2,004,479
Leasehold commitment	91,101	126,566
Leasehold inducement	253,200	268,168
Convertible debenture (note 8)	294,367	178,379
Obligations under capital lease (note 9)	124,295	96,224
	<hr/> 2,428,489	<hr/> 2,673,816
Shareholders' Equity		
Capital stock (note 10(b))	8,987,060	8,935,930
Warrants (note 10(c))	851,142	803,526
Contributed surplus (note 11)	1,068,767	906,799
Deficit	(10,140,847)	(9,090,227)
	<hr/> 766,122	<hr/> 1,556,028
	<hr/> \$ 3,194,611	<hr/> \$ 4,229,844
Nature of operations and going concern (note 1)		
Commitments (note 13)		

Approved by the Board of Directors

“David Roberts” Director

“Kelly Edmison” Director

IP Applications Corp.

Consolidated Statement of Operations and Deficit (Unaudited)

	Six months ended June 30		Three months ended June 30	
	2006	2005	2006	2005
Revenue	\$ 4,756,533	\$ 3,280,928	\$ 2,334,013	\$ 1,721,109
Direct costs	3,054,925	2,109,937	1,589,515	1,018,910
	<u>1,701,608</u>	<u>1,170,991</u>	<u>744,498</u>	<u>702,199</u>
Operating expenses				
Amortization of intangible asset	357,371	162,011	178,686	92,271
Amortization of property and equipment	272,516	221,990	138,842	96,572
Foreign exchange loss	56,266	11,510	29,953	3,015
General and administration	989,375	928,275	471,534	508,719
Interest on capital lease obligations	24,716	23,437	11,083	11,193
Accretion of interest on convertible debenture	85,988	-	42,994	-
Marketing and selling	546,996	438,406	278,150	262,803
Stock-based compensation	161,968	101,267	83,043	52,145
Technical and development	257,032	319,250	150,023	136,427
	<u>2,752,228</u>	<u>2,206,146</u>	<u>1,384,308</u>	<u>1,163,145</u>
Loss for the period	(1,050,620)	(1,035,155)	(639,810)	(460,946)
Deficit - Beginning of period	(9,090,227)	(5,638,781)	(9,501,037)	(6,212,990)
Deficit - End of period	<u>\$ (10,140,847)</u>	<u>\$ (6,673,936)</u>	<u>\$ (10,140,487)</u>	<u>\$ (6,673,936)</u>
Loss per share - basic	<u>(0.07)</u>	<u>(0.10)</u>	<u>(0.04)</u>	<u>(0.04)</u>
Weighted average number of common shares used in the calculation of loss per share	<u>14,966,624</u>	<u>10,408,204</u>	<u>15,086,624</u>	<u>11,442,251</u>

IP Applications Corp.

Consolidated Statements of Cash Flows (Unaudited)

	Six months ended June 30		Three months ended June 30	
	2006	2005	2006	2005
Cash flows from operating activities				
Loss for the period	\$ (1,050,620)	\$ (1,035,155)	\$ (639,810)	\$ (460,946)
Items not affecting cash				
Amortization of intangible asset	357,371	162,011	178,686	92,271
Amortization of property and equipment	272,516	221,990	138,842	96,572
Employee share compensation	-	130,336	-	130,336
Tenant inducements amortization	(14,967)	-	(7,484)	-
Accretion on convertible debenture	85,988	-	42,994	-
Accrued loss on lease commitment	(47,655)	-	(17,732)	-
Stock-based compensation	161,968	101,267	83,043	52,145
	(235,399)	(419,551)	(221,461)	(89,622)
Changes in non-cash working capital items				
Accounts Receivable	(107,602)	(89,963)	(58,171)	(123,305)
Prepaid expenses	11,930	(92,426)	14,633	(67,172)
Convertible debenture interest	30,000	-	15,000	-
Accounts payable and accrued liabilities	(255,400)	30,075	(44,819)	(65,408)
Customer deposits	(11,509)	33,941	(11,509)	-
Deferred revenue	(44,546)	(183,988)	(4,839)	-
	(612,526)	(721,912)	(311,166)	(345,507)
Cash flows from investing activities				
Release of restricted cash	300,000	-	-	-
Acquisition intangible asset	-	(220,097)	-	(220,097)
Acquisition PacificNet (note 4)	-	(310,156)	-	(310,156)
Purchase of property and equipment	(73,693)	(58,444)	(19,547)	(25,449)
	226,307	(588,697)	(19,547)	(555,702)
Cash flows from financing activities				
Payments under capital leases	(159,223)	(132,920)	(68,226)	(53,611)
Proceeds from private placements	100,000	1,700,000	-	1,700,000
Capital raising costs	(1,254)	(34,742)	(45)	(28,574)
	(60,477)	1,532,338	(68,271)	1,617,815
Increase / (Decrease) in cash	(446,696)	221,729	(398,984)	716,606
Cash - Beginning of period	434,690	736,295	386,978	241,418
Cash - End of period	\$ (12,006)	\$ 958,024	\$ (12,006)	\$ 958,024
Supplemental disclosure of cash flow information				
Interest earned	10,792	13,696	2,784	4,574

IP Applications Corp.

Notes to Consolidated Financial Statements (Unaudited)

For the six months ended June 30, 2006

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 revenues are not sufficient to solely fund operations. The Company has financed its operations principally through equity financing. External financing will be required by the Company in order to fund its future operations and pursue other potential investments.

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 or generation of profitable operations. There is no assurance that the Company will be successful in achieving any of 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

These consolidated financial statements 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.

It is recommended that these interim financial statements should be read in conjunction with the Annual Report for the nine months ended December 31, 2005. The accounting policies applied to the presentation of the interim financial statements are consistent with those applied to the previous financial year end.

IP Applications Corp.

Notes to Consolidated Financial Statements (Unaudited)

For the six months ended June 30, 2006

3 Significant accounting policies

These interim consolidated financial statements follow the same accounting principles and methods of their application as the December 31, 2005 audited financial statements of the Company except for the following:

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

Office Equipment	5 years
Computer Equipment	3 years
Computer Software	2 years

b) 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.

c) Cash

The negative cash balance at June 30, 2006 does not represent actual bank indebtedness but is a reflection of outstanding cheques at month end.

4 Acquisition

On June 7, 2005, the Company acquired the net assets of Dapac L.L.C., dba PacificNet, for cash consideration of \$268,127 plus costs relating to the acquisition of \$42,029, in aggregate \$310,156 plus the undertaking to pay certain liabilities. 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.

IP Applications Corp.

Notes to Consolidated Financial Statements (Unaudited)

For the six months ended June 30, 2006

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	760,617
Less: Current liabilities assumed	<u>(603,264)</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.

6 Property and equipment

	June 30 2006		
	Cost	Accumulated amortization	Net
Computer equipment	\$ 1,235,618	\$ 585,489	\$ 650,129
Office equipment	64,832	17,680	47,152
Computer software	143,203	76,170	67,033
Leasehold improvements	412,183	14,234	397,949
	<u>\$ 1,855,836</u>	<u>\$ 693,573</u>	<u>\$ 1,162,263</u>

	December 31 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
	<u>\$ 1,610,159</u>	<u>\$ 421,057</u>	<u>\$ 1,189,102</u>

IP Applications Corp.

Notes to Consolidated Financial Statements (Unaudited)

For the six months ended June 30, 2006

Included in property and equipment are assets financed by capital leases with a total cost of \$1,051,031 of which \$171,984 are current additions during the period of January to June 2006, and accumulated amortization of \$505,695 (as at June 30, 2005 total cost was \$879,045 and accumulated amortization \$310,080).

7 Intangible asset

	Amount
Balance – December 31, 2005	\$ 1,323,734
Amortization	<u>(357,371)</u>
Balance – June 30, 2006	<u>\$ 966,364</u>

On June 7, 2005, the Company purchased a customer contract from SourceNet Telecom (“SourceNet”). The aggregate purchase price was \$461,247 and was paid through a combination of cash of \$220,097 and 455,000 common shares of the Company with a value of \$241,150. This intangible asset is amortized over a period of 2 years.

8 Convertible Debenture

On November 17, 2005, the Company completed a convertible debt financing for a total proceeds of \$500,000. The convertible debt has a term of 18 months, due May 17, 2007, and is unsecured and bears interest at an annual rate of 12%, payable quarterly. These debentures are 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 the convertible debenture, the Company also issued 1,250,000 share purchase warrants that have a term of 2 years, expiring 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 has recorded the proceeds of the 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 is being accreted on a straight line basis over the term of the debt.

IP Applications Corp.

Notes to Consolidated Financial Statements (Unaudited)

For the six months ended June 30, 2006

Balance – December 31, 2005	\$ 178,379
Interest expense	30,000
Accretion of interest	<u>85,988</u>
Balance – June 30, 2006	<u>\$ 294,367</u>

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

9 Obligations under capital lease

	June 30 2006	December 31 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	\$ 26,646	\$ 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	121,648	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	143,163	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	29,338	-
Lease payable in monthly instalments of \$3,286 including interest at an imputed rate of 16.2% until December 1, 2008, secured by a charge over equipment	89,461	-
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	<u>35,705</u>	<u>-</u>
	445,961	433,197
Less: Current portion	<u>(321,666)</u>	<u>(336,973)</u>
	<u>\$ 124,295</u>	<u>\$ 96,224</u>

IP Applications Corp.

Notes to Consolidated Financial Statements (Unaudited)

For the six months ended June 30, 2006

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

2006	\$ 239,954
2007	186,593
2008	<u>61,950</u>
	488,497
Less: Imputed interest	<u>42,536</u>
	<u>\$ 445,961</u>

10 Capital stock

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

	Number of shares	Amount
Balance – December 31, 2005	14,786,624	\$ 8,935,930
Private placement for cash (i)	300,000	52,384
Capital raising costs	-	<u>(1,254)</u>
Balance – June 30, 2006	<u>15,086,624</u>	<u>\$ 8,987,060</u>

- i) 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 (Unaudited)

For the six months ended June 30, 2006

10 Capital stock (continued)

c) Warrants

At June 30, 2006, the following share purchase warrants are outstanding:

Number of warrants Outstanding	Exercise price \$	Expiry date	Number of warrants Exercisable
400,000	US\$0.66 - US\$3.30	August 31, 2006	63,819
334,850	1.00	December 23, 2006	334,850
2,205,150	0.35 - 0.40	May 2, 2007	2,205,150
999,999	0.50 - 0.55	June 13, 2007	999,999
100,000	0.53 - 0.70	July 14, 2010	100,000
1,250,000	0.50 - 0.55	November 19, 2007	1,250,000
300,000 (10b)(i)	0.40	February 6, 2008	300,000
<u>5,589,999</u>			<u>5,253,818</u>

Amount

Balance – December 31, 2005

\$ 803,526

Private placement (note 10 (b) (i))

47,616

Balance – June 30, 2006

\$ 851,142

d) Stock options

The Company's Stock Option Plan (the "Plan") was amended at the Company's annual general meeting on August 22, 2005. Significant changes included the change of vesting period to 25% of the Option upon the Grant Date and 12 ½ % every quarter thereafter and the change of percentage reservation of issued share capital for options to 18%. The Company's Plan, a fixed stock option plan, allows for 18% of the issued share capital to be reserved for issuance to executive officers and directors, employees and consultants. At the Company's annual general meeting, the Company's shareholders voted to increase the number of shares reserved for issuance under the Company's Stock Option Plan from 1,483,350 to 2,624,935. 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 any right of any option holder. At June 30, 2006 416,435 options are available for future grant under the Plan.

Stock option transactions for the six month period ended June 30, 2006 and the year ended December 31, 2005, and the number of stock options outstanding are summarized as follows:

IP Applications Corp.

Notes to Consolidated Financial Statements (Unaudited)

For the six months ended June 30, 2006

	June 30 2006	Weighted average exercise price	December 31 2005	Weighted average exercise price
Opening balance	1,002,500	\$ 0.56	1,192,720	\$ 0.69
Granted	1,285,600	0.33	658,112	0.54
Exercised	-	-	-	-
Expired	-	-	-	-
Forfeited	(79,600)	0.53	(848,332)	0.74
Closing balance	<u>2,208,500</u>	<u>\$ 0.42</u>	<u>1,002,500</u>	<u>\$ 0.56</u>

The fair values of the options granted during the six months ended June 30, 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:

	2006
Expected dividend yield	0%
Stock price volatility	93.4 to 94.7%
Risk-free interest rate	4.16 to 4.37%
Expected life of options	3 years
Fair value of the options granted	\$294,355

At June 30, 2006, the following stock options are outstanding:

Number of stock options outstanding	Exercise price	Expiry date	Number of stock options exercisable
2,700	\$ 0.55	August 9, 2006	2,700
1,500	0.55	February 1, 2007	1,500
50,000	0.55	June 16, 2008	50,000
6,000	0.55	September 8, 2008	5,100
20,000	0.55	September 30, 2008	17,000
4,000	0.55	November 15, 2008	3,400
74,000	0.55	February 27, 2009	51,800
164,000	0.55	May 27, 2009	114,800
78,788	0.55	February 24, 2010	78,788
371,612	0.55	May 2, 2010	217,375
74,000	0.55	May 25, 2010	33,597
86,300	0.55	September 22, 2010	43,150
1,175,600	0.33	February 28, 2011	440,850
75,000	0.34	April 20, 2011	18,750
25,000	0.34	April 20, 2011	25,000
<u>2,208,500</u>			<u>1,103,810</u>

IP Applications Corp.

Notes to Consolidated Financial Statements (Unaudited)
For the six months ended June 30, 2006

11 Contributed Surplus

	June 30 2006	December 31 2005
Opening balance	\$ 906,799	\$ 286,759
Stock-based compensation	161,968	383,572
Equity component of convertible debenture	<u>-</u>	<u>236,468</u>
Closing balance	<u>\$ 1,068,767</u>	<u>\$ 906,799</u>

12 Segmented information

During the six months ended June 30, 2006, the Company operated within a single operating segment, being the provision of Internet services and solutions. Information with respect to geographic areas is as follows:

	June 30 2006	June 30 2005
Revenue		
Canada	\$ 987,578	\$ 1,229,902
United States	<u>3,768,955</u>	<u>2,051,026</u>
	<u>\$ 4,756,533</u>	<u>\$ 3,280,928</u>

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

13 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:

2006	\$ 235,320
2007	472,480
2008	470,674
2009	355,388
2010	340,920
Subsequent	<u>1,835,917</u>
	<u>\$ 3,710,699</u>