

Microforum Inc.

CONSOLIDATED FINANCIAL STATEMENTS August 31, 1998

MICROFORUM INC.**CONSOLIDATED BALANCE SHEETS**

	August 31	
	1998	1997
Assets		
Current assets		
Accounts receivable	\$5,047,416	\$696,788
Inventories	1,398,979	299,242
Non-recourse loans to officers (Note 6)	1,580,668	-
Assets of discontinued software and hardware operations (Note 5)	-	1,799,630
Current portion of note receivable on sale of Microforum Italia s.r.l. (Note 4)	100,000	-
Prepaid expenses and other assets	368,619	152,426
	8,495,682	2,948,086
Capital assets (Note 7)	3,596,058	3,725,147
Note receivable on sale of Microforum Italia s.r.l. (Note 4)	100,000	200,000
Goodwill (Note 2)(Note 2)	6,427,530	-
Due from related parties (Note 13)	519,124	-
	\$19,138,394	\$6,873,233
Liabilities		
Current liabilities		
Bank indebtedness (Note 8)	\$624,597	\$2,076,789
Accounts payable and accrued liabilities	4,255,941	1,726,943
Note payable (Note 2)	502,500	-
Due to officer (Note 13)	110,951	-
Liabilities of discontinued software and hardware operations (Note 5)	588,285	821,108
Deferred revenue	1,163,614	-
Current portion of long-term debt (Note 9)	641,213	1,334,705
	7,887,101	5,959,545
Long-term debt (Note 9)	859,919	2,903,279
Due to officer (Note 13)	519,124	-
Deferred income taxes	13,700	-
	9,279,844	8,862,824
Shareholders' Equity		
Capital stock (Note 10)	27,301,737	10,725,013
Deficit	(17,443,187)	(12,714,604)
	9,858,550	(1,989,591)

MICROFORUM INC.

\$19,138,394 **\$6,873,233**

CONSOLIDATED STATEMENTS OF OPERATIONS AND DEFICIT

	Six months ended August 31,	
	1998	1997
Sales (Note 3)	\$13,315,237	\$2,664,417
Cost of sales	8,510,208	1,574,502
Gross profit (Note 3)	4,805,029	1,089,915
Operating expenses		
General and administration	3,178,332	1,617,660
Sales and marketing	1,959,059	565,737
Research and development	334,839	311,199
Interest on long-term debt	158,488	221,730
	5,630,718	2,716,626
Loss, before loss from discontinued operations and subsidiary	(825,689)	(1,626,411)
Recovery (loss) from discontinued software and hardware operations (Note 5)	518,000	(1,825,544)
Loss from discontinued subsidiary - Microforum Italia s.r.l. (Note 4)	-	(138,432)
Income (loss) before income taxes	(307,689)	(3,590,387)
Income taxes	-	-
Net income (loss) for the period	(307,689)	(3,590,387)
Deficit, beginning of year	(17,135,498)	(9,124,217)
Deficit, end of period	\$(17,443,187)	\$(12,714,604)
Basic earnings (loss) per share (Note 10)		
From continuing operations	\$(0.05)	\$(0.29)
From discontinued operations and subsidiary	0.03	(0.34)
	\$(0.02)	\$(0.63)

**CONSOLIDATED STATEMENTS OF CHANGES
IN FINANCIAL POSITION**

	Six months ended August 31,	
	1998	1997
Cash provided by (used in)		
<i>Operating activities</i>		
Net loss for the period from continuing operations	\$(825,689)	\$(1,626,411)
Items not affecting cash		
Amortization of capital assets	551,994	457,856
Amortization of goodwill	135,765	-
Changes in non-cash working capital		
Accounts receivable	(3,808,533)	425,037
Inventories	(1,269,757)	200,982
Prepaid expenses and other assets	(330,885)	(78,762)
Accounts payable and accrued liabilities	2,903,823	279,701
Deferred revenue	1,163,614	-
	(1,479,668)	(341,597)
<i>Financing activities</i>		
Proceeds on issue of common shares, net	6,755,924	-
Note payable	502,500	-
Due to officer	110,951	-
Due from officers	(1,050,002)	-
Long-term debt, net of repayments	(228,887)	(427,998)
Deferred income taxes	13,700	-
	6,104,186	(427,998)
<i>Investment activity</i>		
Acquisition of shares of subsidiary companies	(7,015,000)	-
Net assets of subsidiaries at acquisition	451,705	-
Acquisition of capital assets, net	(930,490)	(19,320)
	(7,493,785)	(19,320)
Decrease in cash attributable to continuing operations	(2,869,268)	(788,915)
Increase in cash attributable to discontinued software and hardware operations	22,285	439,068
Decrease in cash attributable to discontinued subsidiary	-	(367,774)
	(2,846,983)	(717,621)
Cash (bank indebtedness) from continuing operations, beginning of year	2,222,386	(1,359,168)

MICROFORUM INC.

**Bank indebtedness from continuing operations,
end of period**

\$(624,597)

\$(2,076,789)

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
August 31, 1998

Nature of operations

Microforum Inc. (the "Company" or the "Corporation") is an integrated Internet applications and content, marketing communications company. The Company and its subsidiaries provide contract advertising, public relations, direct marketing and multimedia services to major corporations in North America. Additionally, the Company is an Internet online magazine ("ezine") publisher, engaged in OnLine Electronic Commerce while selling interactive consumer software over the Internet.

1 Significant accounting policies

Significant accounting policies

Consolidation

These consolidated financial statements include the accounts of the Company and its subsidiary, Internet Frontier Inc., a wholly-owned subsidiary of the Company which was incorporated and started business on June 6, 1996. Also included are the accounts of PPL Marketing Services Inc., Marshall Fenn Communications Inc. and Poste Haste Systems Inc., each of which are wholly-owned subsidiaries acquired April 6, 1998.

Inventories

Inventories are valued at the lower of cost and net realizable value. Cost is determined generally on a first-in, first-out basis.

Work-in-progress inventory is recorded at cost, which comprises billable labour production and creative material costs for ongoing projects.

Capital assets

Capital assets are recorded at cost. Amortization is provided on computer equipment and software, production, duplication and packaging equipment, and furniture and office equipment primarily using the diminishing-balance basis at rates of 20% - 30% per annum. Leasehold improvements are amortized using the straight-line basis over the terms of the respective leases.

Revenue recognition

Revenue from product sales is recognized upon shipment of the product to the customer and is net of discounts and allowances for estimated future returns. Revenue from sale of services is recognized as the services are performed under the terms of the contract and, accordingly, customer deposits received in advance are treated as deferred revenue.

Use of estimates

Financial statements prepared in conformity with generally accepted accounting principles require management to make estimates and assumptions about reported assets and liabilities, disclosure of contingent assets and liabilities and reported amounts of revenues and expenses. Management also makes estimates and judgements about future results of operations related to specific elements of the business and operating units in assessing recoverability of assets and recorded values of liabilities. Actual results could differ from

MICROFORUM INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
August 31, 1998

those estimates.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS ...continued August
31, 1998****Financial instruments**

The carrying amounts reported in the balance sheets for accounts receivable, accounts payable and accrued liabilities approximate fair values due to the short-term maturity of those instruments. The carrying value for capital leases and term loans approximate fair value because the rates available for similar types of borrowing arrangements have not changed significantly since the company executed those financing agreements. The carrying amounts for bank loans approximate fair value because they bear interest at variable rates.

Goodwill

The excess of the purchase price over the fair market value of net assets acquired is recorded as goodwill and is amortized on a straight-line basis over 20 years. The company evaluates the carrying value of goodwill for potential permanent impairment on an on-going basis. In order to determine if such permanent impairment exists, the company's management considers each subsidiary's financial condition and estimated fair value. A permanent impairment in the value of goodwill is written off against earnings in the year such impairment is recognized.

2 Acquisition of PPL Group

On April 6, 1998, the Company acquired directly and indirectly all the issued and outstanding common shares of PPL Marketing Services Inc., Marshall Fenn Communications Inc. and Poste Haste Systems Inc. (the "PPL Group"). The purchase price for the transaction was \$6,700,000, of which \$5,695,000 was paid by way of issue of 1,627,143 common shares of the Company, \$502,500 was paid by way of cash, and \$502,500 was paid by way of a non-interest bearing promissory note maturing six months after the closing of the transaction. The Company is currently negotiating an extension of the maturity date applicable to this promissory note. In addition, certain amounts are due from related parties and due to a former controlling shareholder of the PPL Group who is an officer of the Company (Note 13).

Purchase price	\$6,700,000
Fees and estimated expenses attributable to the acquisition	315,000
	<hr/>
Total costs of acquisition	\$7,015,000
	<hr/>
Net assets acquired	
Current assets	\$5,345,974
Capital and other assets	1,456,690
	<hr/>
	6,802,664
Current liabilities	(5,716,076)

MICROFORUM INC.**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS ...continued August 31, 1998**

Long-term and other liabilities	(634,883)
Net assets acquired	451,705
Goodwill arising on acquisition	\$6,563,295
Less: Amortization to August 31, 1998	135,765
Goodwill as at August 31, 1998	\$6,427,530

3 Segmented Information Segmented Information

	August 31, 1998	August 31, 1997
Revenue		
Marketing, programs and distribution	\$7,756,806	\$-
Advertising and public relations	3,211,245	-
Multimedia services	2,077,611	2,566,722
Internet content and services	269,575	97,695
	13,315,237	2,664,417
Gross margin (loss)		
Marketing, programs and distribution	\$2,699,117	\$-
Advertising and public relations	831,638	-
Multimedia services	1,219,155	1,217,046
Internet content and services	55,119	(127,131)
	4,805,029	1,089,915

4 Sale of Microforum Italia s.r.l.

In accordance with its restructuring strategy, on August 18, 1997 the Company concluded an agreement to sell its interest in its subsidiary, Microforum Italia s.r.l. to the Company's founding shareholders for \$200,000. Under the terms of the agreement, the purchasers shall tender to the company 200,000 common shares presently held in Microforum Inc. over a two year period expiring in September 1999. Price adjustment provisions apply in the event the purchasers elect to substitute cash in lieu of common shares otherwise due at the prescribed instalment dates. The purchasers acquired effective control of Microforum Italia s.r.l. and its subsidiary, Dreamware s.r.l., on July 1, 1997.

Discontinued software development / publishing and hardware distribution operations

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS ...continued August 31, 1998

In accordance with its restructuring strategy, the Company discontinued wholesale distribution of hardware equipment during the year ended February 28, 1998. The Company ceased its internal development of software products June 30, 1997 and announced May 14, 1998 (the "measurement date") that it would discontinue all software publishing activities. At February 28, 1998, the company recorded losses of approximately \$4.2 million from discontinued operations which included estimated losses of approximately \$830,000 for the period March 1, 1998 to the disposal date.

Discontinued software development / publishing and hardware distribution operations (continued)

Selected financial information:

	August 31, 1998	August 31, 1997
Revenue		
Software	\$833,968	\$2,133,482
Hardware distribution	-	158,793
	833,968	2,292,275
Cost of sales and operating expenses	499,450	4,323,995
Recovery (loss) from discontinued software development/ publishing and hardware distributions, before other items	334,518	(2,031,720)
Royalty income	183,482	206,176
Recovery (loss) from discontinued software development/ publishing and hardware distributions for the period	\$518,000	\$(1,825,544)

MICROFORUM INC.**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS ...continued August 31, 1998**

Summary of assets and liabilities:

Assets

Accounts and sundry receivable, net of allowances	\$-	\$703,000
Inventories	-	1,096,630
Current assets	-	1,799,630
Total assets attributed to discontinued operations	\$-	\$1,799,630

Liabilities

Accounts payable - trade	\$113,285	\$522,500
Accrued liabilities	475,000	298,608
Total liabilities attributed to discontinued operations	\$588,285	\$821,108

6 Non-Recourse Loans to officers

	August 31, 1998	August 31, 1997
Non-interest bearing	\$1,580,668	\$-

In accordance with the terms of arrangements approved by the Company's shareholders March 24, 1998, the Company may provide financial assistance to allow certain senior officers to exercise options and acquire common shares of the Company up to an aggregate limit of \$2,000,000. Such loans are non-recourse, secured against by the common shares acquired or issued upon exercise of granted options and are repayable on the earlier of such date that the officer disposes of its shareholdings or ceases to act as an officer of the Company. As at August 31, 1998 the fair market value of shares held as security for these loans was approximately \$694,167.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS ...continued August 31, 1998

7 Capital assets

	August 31, 1998	August 31, 1997
Cost		
Computer equipment and software	\$5,681,138	\$4,537,613
Production, duplication and packaging equipment	1,203,100	1,014,121
Furniture, automotive and office equipment	1,240,262	684,740
Leasehold improvements	1,080,052	809,753
	9,204,552	7,046,227
Accumulated amortization		
Computer equipment and software	3,287,928	1,975,288
Duplication and packaging equipment	867,209	662,684
Furniture, automotive and office equipment	697,947	284,082
Leasehold improvements	755,410	399,026
	5,608,494	3,321,080
	\$3,596,058	\$3,725,147

Included in the above capital assets are assets under capital lease with a cost of \$3,477,010 (1997 - \$3,528,010) and accumulated depreciation of \$2,163,608 (1997 - \$1,834,239).

8 Bank lines of credit

The Company and its subsidiaries have aggregate revolving lines of credit for borrowings up to \$2,700,000 and aggregate non-revolving loan facilities of \$388,264 at August 31, 1998 (\$640,831 at August 31, 1997). Advances under the non-revolving loans are repayable over periods of two to three years. Bank indebtedness arising from the revolving lines of credit and the non-revolving loans bear interest at prime plus ¾% to 1.5% and prime plus 1%, respectively. Included in the security for bank indebtedness under the revolving lines of credit and the bank debt described in Note 9 are registered general assignments of book debts and first fixed charges over the assets of the Company and its subsidiaries. The Company and its subsidiaries are subject to certain financial covenants

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS ...continued August 31, 1998

under loan arrangements with its bankers. The Company is currently negotiating with one of its operating lenders with respect to \$1,000,000 of its aggregate revolving lines of credit.

9 Long-term debt

Future minimum payments under capital lease obligations and bank loans and the present value of the minimum lease payments are as follows:

	Term loans	Capital leases	Bank loans	Total
1999	\$-	\$412,500	\$287,053	\$699,553
2000	-	450,000	204,711	654,711
2001	-	186,823	55,000	241,823
Total payments due	-	1,049,323	546,764	1,596,087
Less: Imputed interest	-	94,955	-	94,955
	-	954,368	546,764	1,501,132
Less: Current portion	-	354,160	287,053	641,213
August 31, 1998	\$-	\$600,208	\$259,711	\$859,919
August 31, 1997	\$728,702	\$1,523,419	\$651,158	\$2,903,279

- (a) The term loan amount as at August 31, 1997 originated on the conversion of trade accounts payable owing to a major supplier. On September 18, 1997, \$700,000 of the term loan was converted into 350,000 common shares of the Company (Note 10).
- (b) Capital lease obligations bear interest at rates varying from 8% to 20%. Security under capital lease obligations is provided by a first fixed charge over the related capital asset. On September 18, 1997, \$750,000 of capital lease obligations was converted into 375,000 common shares of the Company (Note 10).
- (c) In addition to the non-revolving loans (Note 8), included in bank loans is \$158,500 (August 31, 1997 - \$342,800) which bears interest at 7.25%. On September 18, 1997, \$359,800 of bank loan obligations were converted into 179,900 common shares of the Company (Note 10).

10 Capital stock

August 31, August 31,

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS ...continued August 31, 1998

	1998	1997
Authorized		
Unlimited number of common shares		
Unlimited number of preference shares		
Issued capital		
17,580,466 (1997 - 5,705,000) common shares	\$27,301,737	\$10,725,013

(a) During the year ended February 28, 1997, the following capital transactions occurred:**(a) During the year ended February 28, 1997, the following capital transactions occurred:**

- (i) On September 11, 1996, the Company reduced its authorized capital by cancelling its non-cumulative redeemable nonvoting Class A, B, C, D and E special shares, non-cumulative redeemable retractable nonvoting Class F special shares and redeemable Class A common shares, and authorized an unlimited number of preference shares which may, from time to time, be issued in series by the board of directors of the Company who, upon issue, may specify the number, designation, preferences, rights, restrictions, conditions, limitations and priorities as to payment of dividends and/or distribution attaching to each such series.
- (ii) On September 12, 1996, the Company completed its initial public offering ("IPO"), pursuant to which it distributed 1,000,000 common shares at a price of \$6.50 per share. The IPO was made under the terms of a prospectus that was filed with the Ontario Securities Commission on August 28, 1996. The IPO prospectus also qualified the distribution of 1,100,000 common shares that were issued upon the exercise of special warrants and the distribution of common shares pursuant to option agreements. The Company has granted the underwriters options to purchase up to an aggregate of 100,000 additional common shares for a period of two years from closing of this offering at a price of \$6.50 per common share.

(b) During the year ended February 28, 1998, the following capital transactions occurred:

- (i) On September 18, 1997, the Company completed a private placement of 8,000,000 Special Warrants for gross proceeds of \$8,000,000 before deducting fees and expenses incurred of \$887,879. Under the terms of the offering, the Special Warrant holders acquired, without additional payment, an aggregate of 8,000,000 common shares of the Company upon issue of a receipt for the final prospectus from the Ontario Securities Commission on December 16, 1997. The Company granted the Agents' non-assignable

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS ...continued August
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Compensation Warrants, representing the right to acquire, for no additional consideration, Compensation Options. The Compensation Options entitle the Agents to subscribe for up to 800,000 Common Shares at an exercise price of \$1.05 per share at any time up to September 18, 1999.

- (ii) On September 18, 1997, the Company concluded arrangements with various creditors under which an aggregate of \$1,809,800 of long-term debt was converted into 904,900 common shares at a conversion price of \$2.00 per share.
- (iii) On October 14, 1997, the Company issued 450,000 common shares to the President and Chief Executive Officer of the Corporation for consideration of \$351,000. The consideration was a non-interest bearing loan (Note 6).
- (iv) On December 12, 1997, the Company issued 20,000 common shares to the General Manger of the Corporation for consideration of \$25,000. The consideration was a non-interest bearing loan (Note 6).
- (v) On December 30, 1997, the Company issued 150,000 common shares to the President and Chief Executive Officer of the Corporation for consideration of \$117,000. The consideration was a non-interest bearing loan (Note 6).
- (vi) On January 5, 1998, the Company issued 33,333 common shares to the Chief Financial Officer of the Corporation for consideration of \$37,666. The consideration was a non-interest bearing loan (Note 6).
- (vii) On January 14, 1998 and February 26, 1998, the Company issued 300,000 shares upon exercise of Compensation Options to the Agents for cash consideration of \$315,000.

During the third quarter of the fiscal year, the Company issued 47,091 common shares to employees and service providers under the provisions of its Stock Option Plan for cash consideration of \$53,213.

During the six months ended August 31, 1998, the following capital transactions occurred:

On April 6, 1998, the Company issued 1,627,143 common shares as partial consideration for the acquisition of PPL Marketing Services Inc., Marshall Fenn Communications Inc. and Poste Haste Systems Inc., such shares having a value of \$5,695,000 (Note 2).

On April 16, 1998 the Company issued 333,334 common shares to the

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS ...continued August 31, 1998

President and Chief Executive Officer of the Corporation for consideration of \$1,050,002. The consideration was a non-interest bearing loan (Note 6).

- (iii) During April, 1998, the Company issued 9,665 common shares to employees under the provisions of its Stock Option Plan for cash consideration of \$10,921.

Basic earnings (loss) per share

Basic earnings (loss) per share is calculated using a weighted average number of outstanding shares of approximately 17,163,100 (August 31, 1997 – 5,705,000). Fully diluted earnings per share data are not presented as they are anti-dilutive.

Stock options

Pursuant to a plan authorized by the directors on April 1, 1996, as amended by shareholder approval March 24, 1998 (the “ Stock Option Plan”), options were granted to directors, officers, employees and other service providers, entitling the holders to purchase an aggregate of 2,007,907 Common Shares from treasury, exercisable at a price equal to or greater than the market price on the day preceding the date of grant. These options vest over a three year period, commencing on the first anniversary of the date of grant and expire on or before the tenth anniversary of the date of grant.

In addition, the Company has also granted the following options: up to 500,000 Common Shares from treasury upon exercise of Compensation Options granted to the Agents under the terms of the Special Warrants financing described above, exercisable at \$1.05 per share, until September 19, 1999; and up to 300,000 common shares from treasury to a service provider, exercisable at \$3.60 per share, until September 18, 1999.

11 Income taxes

The Company’s effective income tax rate varies from the combined Canadian federal and provincial tax rates as follows:

	1998	1997
Basic combined federal and provincial rate	44.62%	44.62%
Losses not recognized for accounting	(44.62)	(44.62)
Total	- %	- %

As of August 31, 1998, the Company had losses available to offset future taxable income of approximately \$15.8 million. If unutilized, these losses will expire in 2003 (\$1.0 million), 2004 (\$8.3 million) and 2005 (\$6.5 million). In addition, the Company has non-refundable

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS ...continued August
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tax credits of approximately \$200,000 that can be applied to reduce future income taxes payable. The benefit of these tax losses has not been recognized in these financial statements.

12 Commitments

The Company and its subsidiaries have entered into operating leases for premises, vehicles and equipment with annual rentals as follows:

1999	\$706,000
2000	643,000
2001	244,000
2002	142,000
2003	220,000

13 Related Party Transactions

Amounts due from / (to) related parties are detailed as follows as at August 31, 1998:

a. Due from Elliot & Andrews Studios Inc.	\$350,000
b. Due from Clubhouse Communications Group Inc.	<u>169,124</u>
Due from related parties	<u>519,124</u>
c. Due to officer	\$630,075
Less: current portion of amount due to officer	<u>110,951</u>
Due to officer	<u>519,124</u>

The companies in (a) and (b) are ultimately controlled by a former controlling shareholder of the PPL Group who is an officer of the Company. All amounts are non-interest bearing and due on demand. The Company does not expect to demand payment within the next twelve months and, accordingly, the amounts have been recorded as long-term assets.

The officer (c) is a former controlling shareholder of the PPL Group and has indicated that

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS ...continued August
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he will not demand repayment of \$519,124 within the next twelve months. Accordingly, only \$110,951 of the \$630,075 has been recorded as a short-term liability.

14 *Economic Dependence*

The Company earns a significant portion of its marketing, program and distribution revenue from three customers who are ultimately controlled by the same group of shareholders. The Company separately negotiates annual renewals of its contracts with each of the three customers. As at August 31, 1998, approximately 25% of the accounts receivable balance was with these three customers.