

ALTERNET SYSTEMS INC
Form 10QSB
November 15, 2004

**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

FORM 10-QSB

(Mark One)

☒ QUARTERLY REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
FOR THE QUARTERLY PERIOD ENDED **September 30, 2004**

☐ TRANSITION REPORT UNDER SECTION 13 OR 15(d) OF THE EXCHANGE ACT OF 1934
FOR THE TRANSITION PERIOD FROM _____ TO _____

COMMISSION FILE NUMBER: **000-31909**

ALTERNET SYSTEMS, INC.

(Exact name of small business issuer as specified in its charter)

NEVADA

(State or other jurisdiction of incorporation or
organization)

88-0473897

(IRS Employer Identification No.)

#610 815 West Hastings Street

Vancouver, British Columbia
V6C 1B4

(604) 608-2540

(Registrant's telephone number)

N/A

(Former name, former address and former fiscal year, if changed since last report)

Securities registered pursuant to Section 12(b) of the Act: None

Securities registered pursuant to Section 12(g) of the Act: Common Stock, \$0.001 Par Value

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes ☒ No ☐

As of September 30, 2004, the Registrant had 25,157,528 shares of common stock issued and outstanding.

Transitional Small Business Disclosure Format (check one) Yes ☐ No ☒

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PART I. - FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

ALTERNET SYSTEMS INC.

(A Development Stage Company)

INTERIM CONSOLIDATED FINANCIAL STATEMENTS

SEPTEMBER 30, 2004

(Unaudited)

CONSOLIDATED BALANCE SHEETS

INTERIM CONSOLIDATED STATEMENTS OF OPERATIONS

INTERIM CONSOLIDATED STATEMENTS OF CASH FLOWS

NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS

ALTERNET SYSTEMS INC.
(A Development Stage Company)
CONSOLIDATED BALANCE SHEETS

	September 30, 2004 (unaudited)	December 31, 2003
ASSETS		
Current Assets		
Cash	\$ 1,111	\$ 113,161
Prepaid expenses	3,981	8,633
Total Current Assets	5,092	121,794
Fixed Assets - net of depreciation	14,125	5,121
TOTAL ASSETS	\$ 19,217	\$ 126,915
LIABILITIES		
Current Liabilities		
Accounts payable & accrued liabilities (Note 5)	\$ 524,847	\$ 596,605
Deferred license revenue	11,847	19,874
Due to related parties (Note 5)	59,253	34,069
TOTAL LIABILITIES	595,947	650,548
Commitments and contingencies (Notes 1, 3 and 6)		
STOCKHOLDERS' EQUITY (CAPITAL DEFICIENCY)		
Capital Stock (Note 4)		
Common stock, \$0.00001 par value, 100,000,000 shares authorized	252	175
25,157,528 (2003 17,400,029) issued and outstanding		
Additional paid-in capital	2,376,040	1,044,293
Private placement subscriptions	52,962	365,921
Obligation to issue shares	37,150	553,720
Accumulated other comprehensive income (loss)	(4,508)	(6,469)
Deficit accumulated during development stage	(3,038,626)	(2,481,273)
TOTAL STOCKHOLDERS' EQUITY (CAPITAL DEFICIENCY)	(576,730)	(523,633)
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	\$ 19,217	\$ 126,915

ALTERNET SYSTEMS INC.
(A Development Stage Company)
INTERIM CONSOLIDATED STATEMENTS OF OPERATIONS
(Unaudited)

	Three months ended	Three months ended	Nine months ended	Nine months ended	October 13, 2000 (inception) to September 30, 2004
	September 30, 2004	September 30, 2003	September 30, 2004	September 30, 2003	September 30, 2004
REVENUE					
License fees, hardware and software sales	\$ 39,177	\$ 50,970	\$ 53,806	\$ 73,842	\$ 203,928
COST OF SALES					
Purchases	16,393	-	16,393	-	16,393
Royalties	4,775	1,236	14,078	6,316	25,171
Installation costs and other	12	649	4,793	2,050	58,127
	21,180	1,885	35,264	8,366	99,691
GROSS PROFIT	17,997	49,085	18,542	65,476	104,237
OPERATING EXPENSES					
Advertising and promotion	-	-	8,030	-	110,753
Bad debt	-	-	-	17,125	15,344
Commissions	-	-	-	-	13,439
Depreciation and amortization	785	15,055	2,356	18,165	35,066
License fees	-	84,000	-	252,000	696,000
Management and consulting	36,329	61,913	327,233	263,187	913,962
Marketing (Note 6)	(58,821)	128,874	83,319	486,791	757,323
Office and general	17,037	31,255	35,189	77,048	149,759
Professional fees	8,193	8,029	38,470	38,625	160,595
Rent	7,566	-	24,453	-	74,293
Telephone and utilities	1,255	-	3,544	-	19,842
Training and documentation	7,328	13,440	37,216	93,317	151,697
Travel	2,118	-	16,085	-	44,790
	21,790	342,566	575,895	1,246,258	3,142,863
NET LOSS FOR THE PERIOD	\$ (3,793)	\$ (293,481)	\$ (557,353)	\$ (1,180,782)	\$ (3,038,626)
BASIC NET LOSS PER SHARE	\$ (0.00)	\$ (0.02)	\$ (0.03)	\$ (0.07)	
WEIGHTED COMMON SHARES					

OUTSTANDING	24,876,441	16,950,029	21,842,154	16,529,335
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ALTERNET SYSTEMS INC.
(A Development Stage Company)
INTERIM CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)

	Nine months ended September 30, 2004	Nine months Ended September 30, 2003	October 13, 2000 (inception) to September 30, 2004
OPERATING ACTIVITIES			
Net Income (Loss) From Operations	\$ (557,353)	\$ (1,180,782)	\$ (3,038,626)
Add: Items Not Affecting Cash			
Depreciation	2,356	18,165	35,066
Gain on disposal of assets	-	-	(215)
Bad debts	-	17,125	-
non-cash services rendered	209,030	640,750	1,089,309
Changes In Non-Cash Working Capital:			
Changes in prepaids	4,652	-	(3,981)
Changes in deferred license revenue	(8,027)	16,665	11,847
Accounts payable and accrued charges	(71,758)	343,116	600,707
Net cash flows used in operations	(421,100)	(144,961)	(1,305,893)
INVESTING ACTIVITIES			
Net disposition (acquisition) of fixed assets	(11,361)	-	(18,977)
Cash acquired on reverse acquisition of SchoolWeb	-	-	74
Net cash flows used in investing activities	(11,361)	-	(18,903)
FINANCING ACTIVITIES			
Loan payable	-	3,000	-
Advances (to) from related parties	25,184	7,668	55,415
Net proceeds on sale of common stock and subscriptions	293,266	143,326	1,274,997
Net cash flows from financing activities	318,450	153,994	1,330,412
EFFECT OF EXCHANGE RATE CHANGES ON CASH	1,961	(5,918)	(4,508)
NET CHANGE IN CASH DURING THE PERIOD	(112,050)	3,115	1,108
CASH, BEGINNING OF PERIOD	113,161	203	3
CASH, END OF PERIOD	\$ 1,111	\$ 3,318	\$ 1,111
OTHER SIGNIFICANT NON-CASH TRANSACTIONS			

During the current period the Company issued 3,716,000 shares for services valued at \$725,600 (2003: 640,000 shares for services valued at \$153,600).

ALTERNET SYSTEMS INC.**(A Development Stage Company)****NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS****September 30, 2004****(unaudited)****NOTE 1 NATURE OF OPERATIONS AND BASIS OF PRESENTATION**

By agreement dated July 2, 2001 and completed September 10, 2001, Alternet issued 12,343,000 shares of restricted common stock to the shareholders of Schoolweb Holdings Inc. ("SW Holdings"), a development stage company incorporated October 13, 2000 in the State of Nevada, in exchange for all of the issued and outstanding shares of SW Holdings. On June 26, 2002 SW Holdings changed its name to AI Systems Group, Inc. ("AI Systems").

The acquisition resulted in the former shareholders of SW Holdings acquiring 90.1% of the then outstanding shares of the Company and has been accounted for as a reverse merger with SW Holdings being treated as the accounting parent and Alternet, the legal parent, being treated as the accounting subsidiary. Accordingly, the consolidated results of operations of the Company include those of SW Holdings for all periods shown and those of the Alternet since the date of the reverse acquisition. The results of operations of SW Holdings are from its inception, October 13, 2000 and include the results of its wholly-owned subsidiary, AI Systems Group (Canada) Ltd. (formerly SchoolWeb Systems (Canada) Ltd.), a company incorporated April 17, 2001 in the Province of British Columbia.

SW Holdings, distributes, markets, sells and licenses in the United States and Canada, certain proprietary software and hardware systems technology known as "SchoolWeb" used for caching Internet and multimedia files on special servers (refer to Note 3).

The Company is currently finalizing the terms of an acquisition of an equity interest and license for North and South America in the alternative energy sector. Please see Note 6 Subsequent Events for further explanation.

The consolidated financial statements have been prepared on the basis of a going concern, which contemplates the realization of assets and satisfaction of liabilities in the normal course of business. At September 30, 2004 the Company had a working capital deficiency of \$590,855 (2003 - \$528,754). The Company has incurred losses since inception and further losses are anticipated in the development of its products raising substantial doubt as to the Company's ability to continue as a going concern. The Company's continued operations are dependent on the successful implementation of its business plan, its ability to obtain additional financing as needed, continued support from creditors, settling its outstanding debts and ultimately attaining profitable operations. It is management's intention to continue to pursue market acceptance for its proprietary software and hardware systems technology, to settle its outstanding debts and to identify funding sources until such time that there is sufficient operating cash flow to fund operating requirements. Funding for continuing operations will be pursued on a private placement basis with qualified investors in applicable US states and Canada.

Unaudited Interim Financial Statements

The accompanying unaudited interim consolidated financial statements have been prepared in accordance with generally accepted accounting principles for interim financial information and with the instructions to Form 10-QSB of Regulation S-B. They may not include all information and footnotes required by generally accepted accounting principles for complete financial statements. However, except as disclosed herein, there has been no material changes in the information disclosed in the notes to the financial statements for the year ended December 31, 2003 included in the Company's Annual Report on Form 10-KSB filed with the Securities and Exchange Commission. The interim unaudited financial statements should be read in conjunction with those financial statements included in the Form

10-KSB. In the opinion of Management, all adjustments considered necessary for a fair presentation, consisting solely of normal recurring adjustments, have been made. Operating results for the nine months ended September 30, 2004 are not necessarily indicative of the results that may be expected for the year ending December 31, 2004.

NOTE 2 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America.

Principles of Consolidation

The consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries, AI Systems Group, Inc. and AI Systems Group (Canada) Ltd. All significant intercompany transactions and account balances have been eliminated.

NOTE 2 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)**Use of Estimates and Assumptions**

Preparation of the Company's financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect certain reported amounts and disclosures. Accordingly, actual results could differ from those estimates.

Cash and Cash Equivalents

The Company considers all liquid investments, with an original maturity of three months or less when purchased, to be cash equivalents.

License Rights

The Company amortizes the cost of acquiring license rights on a straight-line basis over the term of the license. The Company evaluates the carrying amount of its unamortized license rights against the undiscounted future anticipated cash flows associated with them. If the evaluation indicates that the future undiscounted cash flows are not sufficient to recover the carrying value, an impairment provision is recorded to adjust the carrying value of the license rights to their fair value. During 2003 management determined that based on evaluation there was no reliable basis for estimating new cash flows from the license and the Company wrote off the carrying balance of the AII license.

Furniture and Equipment

Furniture and equipment are recorded at cost and depreciated on a declining balance basis at a rate of 30% per annum.

Impairment of long lived assets

Management monitors the recoverability of long-lived assets based on estimates using factors such as current market value, future asset utilization, and future undiscounted cash flows expected to result from its investment or use of the related assets. The Company's policy is to record any impairment loss in the period when it is determined that the carrying amount of the asset may not be recoverable. Any impairment loss is calculated as the excess of the carrying value over estimated realizable value.

Revenue recognition

The Company licenses its SchoolWeb system on a prepaid basis for terms ranging from one to three years. The Company recognizes license revenues on a straight-line basis over the license term upon completion of the required hardware and software installations and upon acceptance by the purchasers, subject to collection being reasonably assured. License fees paid in advance are recorded as deferred revenue.

The Company has generated revenues from hardware sales in connection with the testing of the SchoolWeb system. Hardware sales are recognized upon completion and acceptance of installation by the purchasers and collection is reasonably assured.

Foreign Currency Translation

The financial statements are presented in United States dollars. In accordance with Statement of Financial Accounting Standards No. 52, "Foreign Currency Translation", foreign denominated monetary assets and liabilities are translated to their United States dollar equivalents using foreign exchange rates which prevailed at the balance sheet date. Revenue and expenses are translated at average rates of exchange during the year. Related translation adjustments are reported as a separate component of stockholders' equity, whereas gains or losses resulting from foreign currency transactions are included in results of operations.

Fair Value of Financial Instruments

In accordance with the requirements of SFAS No. 107, the Company has determined the estimated fair value of

financial instruments using available market information and appropriate valuation methodologies. The fair value of financial instruments classified as current assets or liabilities approximate carrying value due to the short-term maturity of the instruments.

NOTE 2 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)**Stock-Based Compensation**

In December 2002, the Financial Accounting Standards Board issued Financial Accounting Standard No. 148, "Accounting for Stock-Based Compensation Transition and Disclosure" ("SFAS No. 148"), an amendment of Financial Accounting Standard No. 123 "Accounting for Stock-Based Compensation" ("SFAS No. 123"). The purpose of SFAS No. 148 is to: (1) provide alternative methods of transition for an entity that voluntarily changes to the fair value based method of accounting for stock-based employee compensation, (2) amend the disclosure provisions to require prominent disclosure about the effects on reported net income of an entity's accounting policy decisions with respect to stock-based employee compensation, and (3) to require disclosure of those effects in interim financial information. The disclosure provisions of SFAS No. 148 were effective for the Company commencing for the year ended December 31, 2003. As no options were granted during the periods ended September 30, 2004 and 2003, no pro-forma disclosures are required.

The Company has elected to continue to account for stock options granted to employees and officers using the intrinsic value based method in accordance with the provisions of Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees", ("APB No. 25") and comply with the disclosure provisions of SFAS No. 123 as amended by SFAS No. 148 as described above. Under APB No. 25, compensation expense is recognized based on the difference, if any, on the date of grant between the estimated fair value of the Company's stock and the amount an employee must pay to acquire the stock. Compensation expense is recognized immediately for past services and pro-rata for future services over the option-vesting period. In addition, with respect to stock options granted to employees, the Company provides pro-forma information as required by SFAS No. 123 showing the results of applying the fair value method using the Black-Scholes option pricing model. In accordance with SFAS No. 123, the Company applies the fair value method using the Black-Scholes option-pricing model in accounting for options granted to consultants.

The Company accounts for equity instruments issued in exchange for the receipt of goods or services from other than employees in accordance with SFAS No. 123 and the conclusions reached by the Emerging Issues Task Force in Issue No. 96-18. Costs are measured at the estimated fair market value of the consideration received or the estimated fair value of the equity instruments issued, whichever is more reliably measurable. The value of equity instruments issued for consideration other than employee services is determined on the earliest of a performance commitment or completion of performance by the provider of goods or services as defined by EITF 96-18.

The Company has also adopted the provisions of the Financial Accounting Standards Board Interpretation No. 44, Accounting for Certain Transactions Involving Stock Compensation An Interpretation of APB Opinion No. 25 ("FIN 44"), which provides guidance as to certain applications of APB 25. FIN 44 is generally effective July 1, 2000 with the exception of certain events occurring after December 15, 1998.

The Company accounts for direct awards of share for services at the fair value of the shares awarded. The Company records the obligation to issue the shares at such time as performance of the service is complete.

Income taxes

The Company follows the liability method of accounting for income taxes. Under this method, deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax balances. Deferred tax assets and liabilities are measured using enacted or substantially enacted tax rates expected to apply to the taxable income in the years in which those differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the date of enactment or substantive enactment. As at September 30, 2004 the Company had net operating loss carryforwards; however, due to the uncertainty of

realization the Company has provided a full valuation allowance for the deferred tax assets resulting from these loss carryforwards.

Loss per share

Basic earnings (loss) per share includes no dilution and is computed by dividing income available to common stockholders by the weighted average number of common shares outstanding for the period. Dilutive loss per share reflects the potential dilution of securities that could share in the earnings of the Company. Fully diluted loss per share has not been presented as the effects of warrants have been excluded as they are anti-dilutive.

NOTE 3 - LICENSE RIGHTS

By agreement dated January 1, 2001, SW Holdings entered into an agreement with Advanced Interactive Inc. ("AII") and Advanced Interactive (Canada) Inc. ("AIC") whereby SW Holdings acquired exclusive and non-exclusive rights and licenses to commercialise, distribute and market AII and AIC technology, products and services in the United States and Canada for a period of five years renewable for a further five years at SW Holdings' option. SW Holdings issued 2,500,000 shares on June 29, 2001 valued at \$.01 per share or \$25,000 to acquire the license. SW Holdings must pay royalties equal to 40% of net revenue received plus a fixed amount of \$10,000 per month in the first year, \$20,000 per month in year two, and increasing by \$8,000 per month in each of the subsequent years to a maximum of \$84,000 per month in year ten. After year three, the fixed monthly payment is reduced by the amount of royalties otherwise payable.

Effective September 10, 2001 SW Holdings, AII and AIC amended the original agreement such that AI and AIC received an additional 500,000 shares valued at \$5,000 which Alternet issued on September 10, 2001. Also effective September 10, 2001 the President and director of AII and AIC became a director of the Company until May 16, 2003 when this director resigned.

On October 14, 2003, AI Systems terminated its software license agreement (the "License Agreement") with AII. The License Agreement was terminated for a number of reasons including the failure by AII to grant to AI Systems North American exclusivity for technologies and software licensed under the License Agreement.

A total of \$386,162 in unpaid monthly license fees accrued to December 31, 2003 and related costs owing to AII is included in accounts payable. AI Systems has advised AII that it does not intend to pay the \$386,162 in unpaid monthly license fees and other costs. AI Systems has also advised AII that it intends to cancel the 3,000,000 common shares issued to AII under the terms of the License Agreement.

AII has advised AI Systems, in writing, that it considers the agreement now to be a non-exclusive license that is still in effect and that unpaid monthly license fees and related costs are still due to AII. The software licensed under the License Agreement is no longer used in any products sold by the Company.

The terms of the License Agreement state that if either party has a dispute with the other party the dispute should be submitted to arbitration for settlement. If this were to occur, or if other proceedings including court proceedings were to be commenced, such arbitration or other proceedings could involve claims for monetary or other damages, recovery of the unpaid monthly license payments, royalty payments or other claims and would likely be significant and material to the business of Alternet Systems and to its liquidity and capital resources.

On March 13 2004, the Company filed a Writ of Summons and Statement of Claim in the Supreme Court of BC, Vancouver, BC. The writ alleges that the defendants, Advanced Interactive Inc., have breached the License Agreement as follows and damages are being sought in the amount of \$1,804,709. The defendants have breached the Agreement as follows: failed to grant exclusivity to the Plaintiff as required by the License Agreement; failed to provide technical support and/or provide technical support at a reasonable price; and failed to provide usable and working software as is required by the License Agreement. The likelihood of any gain or loss resulting from the above lawsuit is not determinable at this time. The Company is currently in negotiations to achieve a full settlement of all debt and liabilities with the Defendant in this action.

NOTE 4 CAPITAL STOCK

To September 30, 2004, the Company has not granted any stock options although shareholders approved a stock option plan (the "Option Plan") for 3,000,000 incentive stock options at its annual meeting of shareholders held on

May 31, 2004. Options under the Option Plan, when granted, can be for a term of up to five (5) years at an exercise price to be determined by the Directors.

During the nine months ended September 30, 2004 the Company issued 3,716,000 shares for payment of services valued at \$725,600 of which \$466,320 related to services provided during fiscal 2003. Also, during the nine months ended September 30, 2004 the Company completed a private placement of 4,041,499 shares at a price of \$0.15 per share for total proceeds of \$606,225.

NOTE 4 CAPITAL STOCK (continued)

The Company is obligated to issue 45,000 common shares with a fair market value of \$11,150 for final settlement with two consultants under marketing contacts (Note 6).

The Company is obligated to issue 100,000 common shares in settlement of debt of \$26,000.

The Company has received \$52,962 towards a planned private placement at \$0.15 per share.

A summary of the Company's warrants at September 30, 2004 and the changes for the period is as follows:

	Warrants Outstanding	Weighted Average Exercise Price	Weighted Average Remaining Life
Balance, December 31, 2003	1,348,458	\$0.50	0.52 years
Granted	-	-	-
Exercised	-	-	-
Cancelled	-	-	-
Expired	896,514	-	-

Balance September 30, 2004	451,944	\$0.50	0.21 years
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Effective March 1, 2003 the Company adopted a Retainer Stock Plan for Employees, Directors and Consultants (the "Plan") for the purpose of providing the Company with the means to compensate employees, directors and consultants for their efforts in furthering the future success of the Company. The Plan allows for direct awards of common stock as a reward or incentive to employees or as consideration to directors or consultants for their services. A total of 5,000,000 shares may be awarded under this Plan. The Plan will terminate February 29, 2008. The Company filed a Registration Statement on Form S-8 to cover the Plan. To date 4,851,000 shares valued at \$1,063,310 relating to services provided in 2003 and 2004 have been awarded, of which 45,000 shares for final settlement valued at \$11,150 have not yet been issued.

NOTE 5 RELATED PARTY TRANSACTIONS

At September 30, 2004 a total of \$59,253 (2003 - \$20,450) is owing to directors. Amounts due to related parties are non-interest bearing and have no specific terms of repayment.

During the nine months ended September 30, 2004, the following amounts were incurred to directors of the Company or its subsidiary, a company with a director in common and a company controlled by a shareholder of the Company.

	Nine months ended September 30, 2004	Nine months ended September 30, 2003
Consulting	\$ 92,200	\$ 110,583
License fees	-	252,000
Marketing	63,225	152,910
Royalties	-	6,316

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\$	155,425	\$	521,809
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Of the amounts incurred above, the license fees were incurred to AII and AIC. AII and AIC became related to the Company effective September 10, 2001 when the President and director of AII and AIC became a director of the Company and ceased to be related parties on May 16, 2003 when this director resigned. Included in accounts payable are license fees totalling \$386,162 owing to AII which are currently under dispute (refer to Note 3).

NOTE 6 COMMITMENTS

Effective February 1, 2003, March 1, 2003 and December 1, 2003, the Company entered into twenty-four month consulting, management and marketing agreements, which require payment in cash and shares of the Company's common stock on a monthly basis. These contracts may be terminated with seven days notice at any time and with no further cost to the Company. The Company also signed three other marketing agreements covering shorter time periods which require payment in shares of the Company's common stock on a monthly basis. All of these contracts have been terminated in the period and no future commitments remain.

During the nine month period the Company expensed \$228,030 representing cash of \$125,000 and 452,000 shares valued at \$103,030 in connection with these agreements.

During the current period the company negotiated settlements with three marketing consultants and agreed to issue 45,000 common shares with a fair market value of \$11,150 for final settlement of outstanding amounts accrued under the agreements. As a result of these settlements the company has reversed certain obligations to issue shares and accounts payable, resulting in a recovery of previously accrued marketing expenses of \$83,925.

NOTE 7 INCOME TAXES

The Company and its subsidiaries have tax losses which may be available to reduce future year's taxable income, that result in deferred tax assets. Management believes that the realization of the benefits from these deferred tax assets appears uncertain due to the Company's limited operating history and losses to date. Accordingly a full, deferred tax asset valuation allowance has been provided and no deferred tax asset benefit has been recorded.

NOTE 8 SUBSEQUENT EVENT

On October 20 2004, the Company entered into a letter agreement with Solflex Energy Development Corp. to acquire a 25% equity interest in Solflex and an exclusive license for North America and South America, for Solflex's proprietary non-silicone solar panel technology. The letter agreement called for \$170,000 to be paid to Solflex within 14 days of signing and payment of \$330,000 by November 15, 2004.

To date, no payments have been made and the Company is currently negotiating an extension to this agreement and is finalizing the definitive license agreement and equity purchase agreement. The Company expects to conclude these agreements by November 30 2004.

ITEM 2: MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL OPERATIONS AND FINANCIAL RESULTS

The following discussion should be read in conjunction with the Company's consolidated financial statements and the notes thereto. The discussion of results, causes and trends should not be construed to imply any conclusion that such results or trends will necessarily continue in the future.

The statements contained herein, other than historical information, are or may be forward-looking statements, and may involve factors, risks and uncertainties that may cause the Company's actual results to differ materially from such statements. These factors, risks and uncertainties, include the relatively short operating history of the Company; market acceptance and availability of products and services; the impact of competitive products, services and pricing; possible delays in the shipment or development of new products; and the availability of sufficient financial resources to enable the Company to expand or even continue its operations.

Critical Accounting Policies

We believe that the estimates, assumptions and judgments involved in the accounting policies described below have the greatest impact on our financial statements, so we consider these to be our critical accounting policies. Because of the uncertainty inherent in these matters, actual results could differ from the estimates we used in applying the critical accounting policies. Within the context of these critical accounting policies, we are not currently aware of any reasonably likely event that would result in materially different amounts being reported.

RESULTS OF OPERATIONS:

With the closing of the SchoolWeb Agreement in September of 2001, the Company's results, on a consolidated basis, reflected its own results consolidated with its subsidiary, AI Systems Group Inc. (formerly known as SchoolWeb Holdings Inc). For the remainder of this part, the term "Company" refers to both the Company and its wholly owned subsidiary, AI Systems Group Inc.

Software development of the Company's SchoolWeb product, including its innovative Internet content management system (CMS), has been completed. Software programming for the CMS component of SchoolWeb, was delayed 60 days due to an unforeseen delay in completion of the database engine by the Company's contractor. This has now been completed.

The SchoolWeb CMS was successfully installed in Burnaby School District in May 2004. Burnaby School District (BSD) has approximately 25,000 students and is located near Vancouver, BC, Canada.

Net Sales

For the three month period ending September 30, 2004, the Company had sales of \$39,177, which was a decrease of 13% from the corresponding period to September 30, 2003, which had sales of \$50,970. Sales for the nine month period were \$53,806 as compared to \$73,842 for the period ending September 30 2003.

Net Loss

For the three month period ending September 30, 2004, the Company had a net loss of \$3,793 or \$(0.00) per share. The net loss for the corresponding period to September 30, 2003 was \$293,481 or \$(0.02) per

share. The decreased loss was due primarily to: a decrease in marketing expenses and marketing overhead and software license fees and software development costs. The net loss for the nine month period ending September 30 2004, was \$557,353 as compared to \$1,180,782 for the period ending September 30 2003. The reduced net loss is primarily due to the down-sizing of its marketing and software development consultants.

Gross Profit

Gross Profit was \$17,997 compared to \$49,085 for the three month period ended September 30, 2003. Gross profit decreased due to decreased sales activity of SchoolWeb. Gross profit for the nine month period ending September 30 2004 was \$18,542 as compared to \$65,476 in the period ending September 30 2003, due to decreased sales activity during the period.

Selling, General and Administrative Expenses

For the period ended September 30, 2004, the Company incurred office and general expenses of \$17,037; marketing expenses of \$(58,821); management and consulting fees of \$36,329; no fees payable under the License Agreement, and \$8,193 in professional fees. Training and documentation fees were \$7,328.

For the corresponding period to September 30, 2003, the Company had office and general expenses of \$31,255 marketing expenses of \$128,874, management and consulting fees of \$61,913, fees payable under the License Agreement of \$84,000 and professional fees of \$8,029. Training and documentation fees were \$13,440 in the period ending September 30, 2003.

Accounts payable increased 10% to \$524,847 at September 30, 2004, of which \$386,162 are license fees owing to Advanced Interactive Inc., which are currently in dispute. This compares to accounts payable of \$475,343 at September 30, 2003.

Office and general expenses decreased 36% compared to the corresponding period to September 30 2003 as the Company was expanding its office in the previous period and experienced increased expenses in the setting-up phase.

Marketing expense decreased 155% this period, compared to the corresponding period to September 30, 2003, and is a result of decreased activity in marketing the SchoolWeb and cessation of marketing CommunityWeb products. During the period, the Company negotiated settlements with three marketing consultants. As part of the settlements, the Company has reversed certain obligations to issue shares and accounts payable, resulting in a recovery of previously accrued marketing expenses of \$83,925.

Management and consulting expense decreased 42% to \$36,329 for the period ending September 30 2004. The decrease was due to the Company down-sizing its marketing consultant personnel.

Software license fees decreased to \$0.00 this period compared to \$168,000 in the previous period ending September 30 2003, due to the fact that the Company terminated its software license with Advanced Interactive Inc. and does not accrue software license fees in the period ending September 30 2004.

Training and documentation expense decreased 46% to \$7,328 as the Company had completed development of all training manuals and decreased sales activity and training expense in this period, compared to the corresponding period ending September 30 2003.

During the period, a total of \$103,030 was expensed by the Company in connection with management and sales and marketing agreements entered into by the Company during the period ended September 30, 2004. This amount represented the fair value of share consideration where 452,000 shares were issued as compensation for services rendered. Readers should consult Note 6 to the financial statements for an explanation of this expense.

Solflex Agreement

In a significant new development, Alternet entered into a letter agreement on October 20, 2004, with Solflex Energy Development Corp., ("Solflex") to acquire a 25% equity interest in Solflex and an exclusive license for the Solflex non-silicone solar PV panel, for North and South America. The terms of the agreement call for payment of \$170,000 by October 30, 2004, and \$320,000 by November 15th 2004. The Company is currently negotiating an extension to this agreement and expects to have final documentation on the equity purchase agreement and license agreement completed by November 30 2004.

The Solflex agreement signals a significant new product addition for Alternet Systems Inc. This acquisition positions the Company to enter the high-growth, alternative-energy sector, with an innovative solar panel technology, that has the potential to be the low-cost leader in the market.

The Company is in final negotiations with its former software developer/licensor, Advanced Interactive Inc., to achieve a full settlement of all debts and liabilities between the two companies, although no assurance can be given to any outcome of these negotiations.

Interest and other expenses

The Company had no material interest expenses.

Liquidity and Capital Resources

The Company had current assets of \$5,092 and cash on hand of \$1,111 as at September 30, 2004. The Company also had a net loss of \$3,793 during the period ending September 30 2004.

Although the net loss of \$3,793 was a decrease of 99% when compared a loss of \$293,481 in the corresponding period ending September 30 2003, management of the Company has determined that the Company's ability to continue as a going concern is dependent on decreasing expenses and raising additional capital.

Management can give no assurance that any sales will occur in the future and if they do occur, may not be enough to cover the Company's operating expenses or any other costs. Should this be the case, we would be forced, unless sufficient working capital can be raised, to suspend operations and possibly liquidate our assets and wind up and dissolve the Company.

Audit Fees

During the period ended September 30, 2004, the Company incurred approximately \$2,400 in fees to its principal independent accountant.

The Company's revenues to date and for the foreseeable future are received in Canadian dollars. The Canadian dollar has, in the quarter ending September 30, 2004, appreciated against the US dollar in which the Company's financial statements are prepared. If this trend continues, and given that some major expenses of the Company are fixed in US dollars, the Company's results could be affected by currency fluctuations.

PART II. - OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS.

Other than as described below, the Registrant is not a party to any material pending legal proceedings and, to the best of its knowledge, no such action by or against the Registrant has been threatened.

In August of 2003, Karim Lakhani resigned as a director of the Registrant. Karim Lakhani remained President, Director and largest shareholder of Advanced Interactive Inc.

The Company had an agreement with Advanced Interactive Inc. (the "License Agreement") under which it licensed certain of its software products from Advanced Interactive Inc. ("AII")

The Company subsequently terminated the License Agreement.

The Company has commenced legal proceedings against AII and its subsidiary by way of filing of a Writ of Summons and Statement of Claim in the Supreme Court of British Columbia, Canada, Vancouver Registry. The Writ states that the Defendants have breached the License Agreement and damages are being sought in the amount of Cdn \$1,804,709.00.

The Writ alleges that the Defendants have breached the License Agreement primarily as follows: they have failed to grant exclusivity to the Company as required, failed to provide technical support and/or provide technical support at a reasonable price, failed to provide usable and workable software as is required under the terms of the License Agreement.

The Defendants have, subsequent to the filing of a Report on Form 8-K on April 22, 2004, counterclaimed against the Company. The Company and the Defendants are attempting to negotiate a full and final settlement of the subject matter of the proceedings and of any outstanding debts, liabilities and obligations relating to the License Agreement.

ITEM 2. CHANGES IN SECURITIES AND USE OF PROCEEDS

During the three month period ending September 30, 2004, the Registrant issued no common share or other securities.

Effective February 1, 2003 and March 1, 2003 the Company signed twenty-four month consulting, management and marketing agreements which require payment in cash and shares of the Company's common stock on a monthly basis. During the period, all of the contracts were terminated. The Company is obligated to issue a total of 45,000 common shares with a market value of \$11,150 for final settlement with two consultants under marketing contracts.

During the nine months ended September 30, 2004 the Company issued 3,716,000 shares for services valued at \$725,600.

Also, during the nine months ended September 30, 2004 the Company completed a private placement of 4,041,499 shares at a price of \$0.15 per share for total proceeds of \$606,225.

All of the shares for services and private placement shares described above were issued without registration under the Securities Act of 1933. A total of 46 US resident and 16 Canadian resident persons received a total of 4,041,499 common shares of the Company in the private placement above. The Company relied on exemptions available for unregistered sales to accredited investors in Regulation D for those sales made to US resident persons. The Company relied on exemptions available for unregistered sales in Regulation S for those sales made to Canadian resident

persons.

Where the Company relied on Regulation D, purchasers were asked to represent, in writing, that they qualified as accredited investors as that term is defined.

Where the Company relied on Regulation S, these persons was asked to confirm in writing their residential address and each of these persons was a close personal friend, business associate or family member of one or more of the directors and officers of the Company at the time of the shares' issuance.

The offering to these 15 persons was undertaken under Regulation S they were made under Rule 903 (Category 3, equity securities) and:

- - the sale was made in an offshore transaction;
- - no directed selling efforts were made in the United States by the Company;
- - the purchaser confirmed that it is not a US person and is not acquiring the securities for the account or benefit of any US person;
- - the purchaser agreed to resell such securities only in accordance with the provisions of the Securities Act of 1933 or regulations applicable to their securities;
- - the securities contained a legend to the effect that transfer was prohibited unless the securities were first registered under the Securities Act of 1933 or resale was made pursuant to an exemption therefrom.

The offers and sales were not made to any US person or for the account or benefit of a US person. The Company believes that Regulation D Rule 506 would have been available to it had Regulation S not been available to exempt these purchases from registration under the Securities Act of 1933.

No commission or professional fees were paid in connection with the Company's sales of unregistered securities under either Regulation S or Regulation D.

Neither we nor any person acting on our behalf offered or sold the foregoing securities by means of any form of general solicitation or general advertising. All purchasers represented in writing that they acquired the securities for their own accounts. A resale legend has been provided for the stock certificates stating that the securities have not been registered under the Securities Act of 1933 and cannot be resold or otherwise transferred without registration or an exemption (such as that provided by Regulation S or Rule 144).

At a minimum, shares which are resold pursuant to Rule 144 have a resale restriction (often referred to as a hold period or seasoning period) of one year followed by volume resale restrictions for "affiliates" of the Company (persons connected to the Company as directors, officers, employees, consultants or large shareholders, for example).

ITEM 3. DEFAULTS UPON SENIOR SECURITIES.

Not Applicable

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

None.

ITEM 5. OTHER INFORMATION

None

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

- (a) Reports on Form 8-K. The Registrant filed one report on Form 8K during the period ending September 30, 2004. This report was filed on EDGAR on October 12, 2004.
- (b) Exhibits. Exhibits included or incorporated by reference herein: See Exhibit Index below.

EXHIBIT INDEX

Number Exhibit Description

3.1	Articles of Incorporation (incorporated by reference to Exhibit 3 of the Registration Statement on Form 10-SB filed on September 28, 2000).
3.2	Certificate of Amendment to Articles of Incorporation (incorporated by reference to Exhibit 2 of the Form 10-SB filed on September 28, 2000).
3.3	Certificate of Amendment to Articles of Incorporation dated October 13, 2000. (incorporated by reference to Exhibit 3.3 of the Form 10-QSB filed on November 7, 2000)
3.4.1	ByLaws (incorporated by reference to Exhibit 3.3 of the Form 10-QSB filed on November 7, 2001)
<u>31.1</u>	<u>Section 302 Certifications - CEO</u>
<u>31.2</u>	<u>Section 302 Certifications - CFO</u>
<u>32.1</u>	<u>Section 906 Certifications - CEO</u>
<u>32.2</u>	<u>Section 906 Certifications - CFO</u>

SIGNATURES

Pursuant to the requirements of the Exchange Act, the Registrant has caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

ALTERNET SYSTEMS, INC.

Dated: November 12, 2004

By: /s/ Michael Dearden
Michael Dearden, President, CEO
and Director

By: /s/ Griffin Jones
Griffin Jones, Treasurer, Director,
Chief Financial Officer and Chief
Accounting Officer
