ALTERNET SYSTEMS INC
Form 10QSB/A
May 01, 2006

# UNITED STATES
# SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

# FORM 10-QSB/A

**Amendment No. 1**

(Mark One)
[ x ] QUARTERLY REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
FOR THE QUARTERLY PERIOD ENDED **JUNE 30, 2005**

[ ] 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** | **88-0473897** |
| (State or other jurisdiction of incorporation or organization) | (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 [ x ] No [ ]

As of June 30, 2005, the Registrant had 28,249,428 shares of common stock issued and outstanding.

Transitional Small Business Disclosure Format (check one) Yes [ ] No [ x ]

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).
[ ] No [ x ]

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**ADVISEMENT**

This Amendment No.1 (this “Amendment) to Form 10-Q of Alternet Systems Inc. (the Company) for the period ending June 30 2005 is soley for the purpose of filing a corrected Part 1 Item 3 Controls and Procedures.

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**ALTERNET SYSTEMS INC.**

**(A Development Stage Company)**

**INTERIM CONSOLIDATED FINANCIAL STATEMENTS**

**JUNE 30, 2005**

(Unaudited)

**ALTERNET SYSTEMS INC.**
**(A Development Stage Company)**
**CONSOLIDATED BALANCE SHEETS**
**As at June 30, 2005**

| | | June 30 2005 (unaudited) | | December 31, 2004 |
|---|---|---|---|---|
| **ASSETS** | | | | |
| **Current Assets** | | | | |
| Cash | $ | - | $ | 30 |
| Prepaid expenses | | 4,783 | | 3,981 |
| **Total Current Assets** | | 4,783 | | 4,011 |
| **Fixed Assets -** net of depreciation | | 11,427 | | 13,340 |
| **TOTAL ASSETS** | **$** | **16,210** | **$** | **17,351** |
| **LIABILITIES** | | | | |
| **Current Liabilities** | | | | |
| Bank indebtedness | $ | 27 | $ | - |
| Accounts payable & accrued liabilities (Note 3) | | 528,700 | | 537,719 |
| Deferred license revenue | | 6,112 | | 10,394 |
| Due to related parties (Note 5) | | 9,287 | | 22,153 |
| **TOTAL LIABILITIES** | | 544,126 | | 570,266 |
| **Commitments and contingencies (Notes 1, 3 and 6)** | | | | |
| **STOCKHOLDERS' EQUITY (CAPITAL DEFICIENCY)** | | | | |
| Capital Stock (Note 4) | | | | |
| Common stock, $0.00001 par value, 100,000,000 shares authorized 28,249,428 (2004 – 25,779,428) issued and outstanding | | 284 | | 259 |
| Additional paid-in capital | | 2,745,452 | | 2,469,320 |
| Private placement subscriptions | | 125,195 | | 50,250 |
| Obligation to issue shares | | 26,000 | | 37,150 |
| Accumulated other comprehensive income (loss) | | (1,486) | | (557) |
| Deficit accumulated during development stage | | (3,423,361) | | (3,109,337) |
| **TOTAL STOCKHOLDERS' EQUITY (CAPITAL DEFICENCY)** | | (527,916) | | (552,915) |
| **TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY** | **$** | **16,210** | **$** | **17,351** |

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**ALTERNET SYSTEMS INC.**
**(A Development Stage Company)**
**INTERIM CONSOLIDATED STATEMENT OF LOSS AND DEFICIT**
**(Unaudited)**

| | Three months ended June 30, 2005 | Three months ended June 30, 2004 | Six months ended June 30, 2005 | Six months ended June 30, 2004 | October 13, 2000 (inception) to June 30, 2005 |
|---|---|---|---|---|---|
| **REVENUE** | | | | | |
| License fees and hardware sales | $ 3,796 | $ 7,206 | $ 7,707 | $ 14,629 | $ 215,049 |
| | | | | | |
| **COST OF SALES** | | | | | |
| Purchases | - | - | - | - | 16,393 |
| Royalties | 1,340 | 4,583 | 2,697 | 9,303 | 29,233 |
| Installation costs and other | - | 2,355 | - | 4,781 | 58,127 |
| | 1,340 | 6,938 | 2,697 | 14,084 | 103,753 |
| | | | | | |
| **GROSS PROFIT** | 2,456 | 268 | 5,010 | 545 | 111,296 |
| | | | | | |
| **OPERATING EXPENSES** | | | | | |
| Advertising and promotion | - | - | - | 8,030 | 110,753 |
| Bad debt | - | - | - | - | 15,344 |
| Commissions | - | - | - | - | 13,439 |
| Depreciation and amortization | 956 | 925 | 1912 | 1,571 | 37,764 |
| License fees | - | - | - | - | 696,000 |
| Management and consulting | 236,172 | 190,443 | 242,586 | 290,904 | 1,177,532 |
| Marketing | (3,444) | 14,179 | 2,648 | 142,140 | 767,550 |
| Office and general | 1,626 | 4,403 | 7,061 | 16,693 | 176,385 |
| Professional fees | 18,019 | 19,138 | 43,012 | 30,277 | 211,444 |
| Rent | 8,049 | 7,885 | 16,136 | 16,887 | 96,690 |
| Telephone and utilities | 2,034 | 1,759 | 3,296 | 2,695 | 28,704 |
| Training and documentation | - | 12,040 | - | 29,888 | 153,154 |
| Travel | 1,912 | 4,762 | 2,383 | 15,020 | 49,898 |
| | 265,324 | 255,534 | 319,034 | 554,105 | 3,534,657 |
| | | | | | |
| **NET LOSS FOR THE PERIOD** | $ (262,868) | $ (255,266) | $ (314,024) | $ (553,560) | $ (3,423,361) |

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| **BASIC NET LOSS PER SHARE** | **$** | (0.01) | **$** | (0.01) | **$** | (0.02) | **$** | (0.03) |
| | | | | | | | | |
| **WEIGHTED COMMON SHARES OUTSTANDING** | | 26,928,549 | | 21,529,726 | | 26,390,036 | | 20,308,339 |

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**ALTERNET SYSTEMS INC.**
**(A Development Stage Company)**
**INTERIM CONSOLIDATED STATEMENT OF CASH FLOWS**
**(Unaudited)**

| | Six months ended June 30, 2005 | Six months ended June 30, 2004 | October 13, 2000 (inception) to June 30, 2005 |
|---|---|---|---|
| **OPERATING ACTIVITIES** | | | |
| Net Income (Loss) From Operations | $ (314,024) | $ (553,560) | $ (3,423,361) |
| Add: Items Not Affecting Cash | | | |
| Depreciation | 1,912 | 1,571 | 37,764 |
| Gain on disposal of assets | - | - | (215) |
| Issuance of shares for services rendered | 244,000 | 165,000 | 861,997 |
| Obligation to issue shares for services rendered | (11,150) | 49,580 | 492,320 |
| Changes In Non-Cash Working Capital: | | | |
| Changes in prepaids | (802) | 2,306 | (4,783) |
| Changes in deferred license revenue | (4,282) | (6,028) | 6,112 |
| Accounts payable and accrued liabilities | 23,139 | (29,339) | 604,560 |
| Net cash flows used in operations | (61,207) | (370,470) | (1,425,606) |
| | | | |
| **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** | | | |
| Advances (to) from related parties | (12,866) | (21,661) | 5,449 |
| Net proceeds on sale of common stock and subscriptions | 74,945 | 293,266 | 1,440,516 |
| Net cash flows from financing activities | 62,079 | 271,605 | 1,445,965 |
| | | | |
| **EFFECT OF EXCHANGE RATE CHANGES ON CASH** | (929) | (2,228) | (1,486) |
| | | | |
| **NET CHANGE IN CASH DURING THE PERIOD** | (57) | (112,454) | (30) |
| | | | |
| **CASH, BEGINNING OF PERIOD** | 30 | 113,161 | 3 |
| | | | |
| **CASH, END OF PERIOD** | $ (27) | $ 707 | $ (27) |

**OTHER SIGNIFICANT NON-CASH TRANSACTIONS**

During the period the Company issued 2,070,000 shares for services valued at $244,000 and 400,000 shares for settlement of debt
valued at $32,158.

| | | | |
|---|---|---|---|
| SUPPLEMENTARY DISCLOSURE: | | | |
| Interest paid | $ - | $ - | $ - |
| Income taxes paid | $ - | $ - | $ - |

**ALTERNET SYSTEMS INC.**
**(A Development Stage Company)**
**NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS**
**June 30, 2005**
(Unaudited)

**NOTE 1 – NATURE OF OPERATIONS AND BASIS OF PRESENTATION**

Alternet Systems Inc. ("Alternet" or the "Company") designs, markets and sells proprietary software and hardware systems known as "SchoolWeb" and "CommunityWeb". The Company's products provide high speed Internet access to schools and rural communities, in North America and internationally (refer to Note 3).

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 June 30, 2005 the Company had a working capital deficiency of $539,343 (2004 - $586,486). During July, 2005 the Company entered into a settlement agreement with Advanced Interactive Inc. which if completed will result in a significant reduction of accrued liabilities. Refer to Note 9. 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 the USA 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, 2004 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 six months ended June 30, 2005 are not necessarily indicative of the results that may be expected for the year ending December 31, 2005.

**ALTERNET SYSTEMS INC.**
**(A Development Stage Company)**
**NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS**
**June 30, 2005**
(Unaudited)

**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.

**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.

**Fixed Assets**
Fixed assets is recorded at cost and depreciated at the following rates:

Computer equipment and software - 30% declining balance basis
Equipment - 20% declining balance basis.

**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

**ALTERNET SYSTEMS INC.**
**(A Development Stage Company)**
**NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS**
**June 30, 2005**
(Unaudited)

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.

**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 in 2002, 2003, 2004 or to June 30, 2005, 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 June 30, 2005 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.

**ALTERNET SYSTEMS INC.**
**(A Development Stage Company)**
**NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS**
**June 30, 2005**
(Unaudited)
**NOTE 2 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)**

**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.

**Recent Accounting Pronouncements**

In December 2004, the FASB issued SFAS No. 153, *Exchanges of Non-monetary Assets, an amendment of APB Opinion No. 29, Accounting for Non-monetary Transactions* ("SFAS 153") SFAS 153 requires that exchanges of non-monetary assets are to be measured based on fair value and eliminates the exception for exchanges of non-monetary, similar productive assets, and adds an exemption for non-monetary exchanges that do not have commercial substance. SFAS 153 will be effective for fiscal periods beginning after June 15, 2005. Management does not believe that the adoption of this standard will have a material impact on the Company's financial condition or results of operations.

In December 2004, the FASB issued SFAS No. 123R, "Share Based Payment". SFAS 123R is a revision of SFAS No. 123 "Accounting for Stock-Based Compensation", and supersedes APB Opinion No. 25, "Accounting for Stock Issued to Employees" and its related implementation guidance. SFAS 123R establishes standards for the accounting for transactions in which an entity exchanges its equity instruments for goods or services. It also addresses transactions in which an entity incurs liabilities in exchange for goods or services that are based on the fair value of the entity's equity instruments or that may be settled by the issuance of those equity instruments. SFAS 123R focuses primarily on accounting for transactions in which an entity obtains employee services in share-based payment transactions. SFAS 123R does not change the accounting guidance for share-based payment transactions with parties other than employees provided in SFAS 123 as originally issued and Emerging Issues Task Force Issue No. 96-18, "Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services". SFAS 123R does not address the accounting for employee share ownership plans, which are subject to AICPA Statement of Position 93-6, "Employers' Accounting for Employee Stock Ownership Plans". SFAS 123R requires a public entity to measure the cost of employee services received in exchange for an award of equity instruments based on the grant-date fair value of the award (with limited exceptions). That cost will be recognized over the period during which an employee is required to provide service in exchange for the award – the requisite service period (usually the vesting period). SFAS 123R requires that the compensation cost relating to share-based payment transactions be recognized in financial statements. That cost will be measured based on the fair value of the equity or liability instruments issued. The scope of SFAS 123R includes a wide range of share-based compensation arrangements including share options, restricted share plans, performance-based awards, share appreciation rights, and employee share purchase plans. Public entities (other than those filing as small business issuers) will be required to apply SFAS 123R as of the first interim or annual reporting period that begins after June 15, 2005. Public entities that file as small business issuers will be required to apply SFAS 123R in the first interim or annual reporting period that begins after December 15, 2005. For nonpublic entities, SFAS 123R must be applied as of the beginning of the first annual reporting period beginning after December 15, 2005. Management is currently evaluating the impact, which the adoption of this standard will have on the Company's results of operations or financial position.

**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.

**ALTERNET SYSTEMS INC.**
**(A Development Stage Company)**
**NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS**
**June 30, 2005**
(Unaudited)
**NOTE 3 - LICENSE RIGHTS (continued)**

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 June 26, 2002, SW Holdings changed its name to AI Systems Group Inc. ("AI Systems")

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.

AI Systems advised AII that it does not intend to pay the accrued amounts totalling $386,162 in unpaid monthly license fees and other costs under the License Agreement. 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 the Company and to its liquidity and capital resources. The Company has developed its own proprietary software and continues to market SchoolWeb and CommunityWeb in North America and internationally.

On March 13 2004, the Company filed a Writ of Summons and Statement of Claim in the Supreme Court of BC, Vancouver, BC. against AII The writ alleges that the defendants have breached the License Agreement and damages are being sought in the amount of $1,804,709. The Company alleges that 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 Company has received a counterclaim in the lawsuit in the amount of C$1,379,150, representing the amount of license fees that would be payable if the License Agreement was still in effect plus interest of 2% and costs and unspecified damages.

Subsequent to June 30, 2005 this lawsuit was settled, subject to certain closing documents (Refer to Note 9 - Subsequent Events).

**NOTE 4 – CAPITAL STOCK**

To June 30, 2005, 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. Option 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 six months ended June 30, 2005, the company issued 2,070,000 shares for services valued at $244,000 and 400,000 shares for settlement of debt valued at $32,158.

The Company is obligated to issue 100,000 common shares in settlement of debt of $26,000 outstanding from 2003.

The Company has received $125,195 towards a private placement of common stock at a price of $0.10 per share.

**ALTERNET SYSTEMS INC.**
**(A Development Stage Company)**
**NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS**
**June 30, 2005**
(Unaudited)

**NOTE 4 – CAPITAL STOCK (Continued)**

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 4,876,000 shares valued at $1,066,160 relating to services provided in 2003, 2004 and for the period ended June 30, 2005 have been awarded.

Effective January 21, 2005 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 January 21, 2010. The Company filed a Registration Statement on Form S-8 to cover the Plan. To date 2,070,000 shares valued at $244,000 relating to services provided for the period ended June 30, 2005 have been awarded

A summary of the Company's warrants at June 30, 2005 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 | 1,182,514 | | - | |
| Balance, December 31, 2004 | 165,944 | | 0.50 | 0.20 years |
| Granted | - | | - | |
| Exercised | - | | - | |
| Cancelled | - | | - | |
| Expired | 165,944 | | - | |
| Balance, June 30, 2005 | - | $ | - | - |

**NOTE 5 – RELATED PARTY TRANSACTIONS**

At June 30, 2005 a total of $9,287 (December 2004 - $22,153) is owing to directors. During the six months ended June 30, 2005 $12,866 was repaid to these directors. Amounts due to related parties are non-interest bearing and have no specific terms of repayment.

During the six months ended June 30, 2005, 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.

| | Six months ended June 30, 2005 | Six months ended June 30, 2004 |
|---|---|---|
| Consulting | $ - | $ 71,200 |
| Marketing | 13,647 | 54,057 |
| | $ 13,647 | $ 125,257 |

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**ALTERNET SYSTEMS INC.**
**(A Development Stage Company)**
**NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS**
**June 30, 2005**
(Unaudited)

**NOTE 6 – COMMITMENTS**

During the period, the company has reversed obligations to issue shares and accounts payable, resulting in a recovery of prior year accrued marketing expenses of $11,150.

**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 –LEGAL PROCEEDINGS**

On March 14 2005, Native Investment and Trade Association filed a Writ of Summons and Statement of Claim requesting an order that the Company pay the plaintiff $53,500 and for specific performance of the obligation to transfer 100,000 free trading shares to the plaintiff. The Company has disputed any liability and the likelihood of any loss resulting from the above lawsuit is not determinable at this time.

Refer to Note 3 and 9.

**NOTE 9 – SUBSEQUENT EVENT**

The Company has executed a settlement agreement dated July 15, 2005, with AII and all other parties to the License Agreement, whereby the parties have agreed to settle all outstanding issues related to court proceedings brought by the Company against AII, The settlement agreement is subject to final closing documents being executed and the filing and receipt of British Columbia Court approval for the adjournment of all legal proceedings. The terms of settlement include the mutual full and final release of all outstanding debts, liabilities and obligations outstanding, a three year option by AII to the Company or its designees to acquire a total of 3,228,571 shares of the Company's stock held by AII for $10,000, and the retention by the Company of the software, code, trademarks and intellectual property relating to SchoolWeb and CommunityWeb.

## 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. Although no new sales have occurred during this period, the Company has reduced operating expenses significantly and has selected sales agents and is actively marketing the Company's software products internationally.

### Net Sales

For the three month period ending June 30, 2005 the Company had sales of \$3,796, which was a decrease of 46% from the corresponding period to June 30, 2004 which had sales of \$7,206.

The 46% decrease in sales is attributable to the fact that the Company has undertaken a re-organization of its sales and marketing staff over the past 12 months. The objective of the re-organization of the sales and marketing functions was to reduce overhead by utilizing independent sales agents to market SchoolWeb and CommunityWeb. Sales agents have been selected and have been actively pursuing sales for CommunityWeb, HealthWeb and SchoolWeb systems in Europe and Central America. The Company is in final negotiations with a London, England-based company to supply CommunityWeb, HealthWeb and SchoolWeb software for installation in broadband wireless networks in two Eastern European countries.

**Net Loss**

For the three month period ending June 30, 2005, the Company had a net loss of $262,868 or $(0.01) per share, which was a 3% increase when compared to the net loss for the corresponding period to June 30, 2004 was $255,266 or $(0.01) per share.

**Gross Profit**

Gross Profit was $2,456 for the period ending June 30, 2005 compared to $268 for the three month period ended June 30, 2004. Although the gross profit increased compared to the prior period, management has deemed the dollar increase of $2,188 to be not material to comment on.

**Selling, General and Administrative Expenses**

For the three month period ended June 30, 2005 the Company incurred office and general expenses of $1,626; marketing expenses of $(3,444); management and consulting fees of $236,172; and $18,019 in professional fees. Training and documentation fees were $0.

For the corresponding three month period to June 30, 2004, the Company had office and general expenses of $4,403 marketing expenses of $14,179, management and consulting fees of $190,443 and professional fees of $19,138. Training and documentation fees were $12,040 in the period ending June 30, 2004.

Accounts payable decreased 7% to $528,700 at June 30, 2005 of which $407,131 are license and royalty fees owing to Advanced Interactive Inc., which, subsequent to the period ending June 30, 2005, have been settled and cancelled. This compares to accounts payable of $567,266 at June 30, 2004.

Office and general expenses decreased 63 % compared to the corresponding period to June 30, 2004 as the Company has reduced all expenses over the past twelve months. Marketing expense decreased 130 % this period, compared to the corresponding period to June 30, 2004, as a result of reduced staffing and compensation payable to corporate marketing personnel.

Management and consulting expense increased 20 % for the period ending June 30, 2005, compared to the period ending June 30, 2004. The increase was due to an increase in management consultant personnel. Training and documentation expense decreased 100% to as the Company had completed development of all training manuals, compared to the corresponding period ending June 30, 2004.

**Solflex Agreement**

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 Company terminated the Solflex agreement on March 28 2005, due to an inability by Solflex to provide complete due diligence documentation on this acquisition.

**Advanced Interactive Inc.**

The Company has completed negotiations with its former software developer/licensor, Advanced Interactive Inc., and on July 15 2005 entered into a formal Settlement Agreement to cancel all debts and liabilities between the two companies.

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**Interest and other expenses**

The Company had no material interest expenses.

**Liquidity and Capital Resources**

The Company had current assets of $4,783 and cash on hand of $0 as at June 30, 2005. The Company also had a net loss of $262,868 during the period ending June 30, 2005

Although the net loss of $262,868 was an increase of 3% when compared a loss of $255,266 in the corresponding period ending June 30, 2004, the majority of this loss was non-cash expense due to $244,000 in stock issued for services and $32,158 in stock-based debt settlement. Management of the Company has determined that the Company's ability to continue as a going concern is dependent on maintaining low expense levels 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 the assets and wind up and dissolve the Company.

**ITEM 3. CONTROLS AND PROCEDURES**

We maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed in our Exchange Act reports is recorded, processed, summarized and reported within the time periods specified in the U.S. Securities and Exchange Commission rules and forms, and that such information is accumulated and communicated to our management, including our Chief Executive Officer (principal executive officer) and our VP Finance (principal financial officer) as appropriate, to allow timely decisions regarding required disclosure.

As of June 30, 2005, we carried out an evaluation, under the supervision and with the participation of our management, including our Chief Executive Officer (principal executive officer) and our VP Finance (principal financial officer), of the effectiveness of the design and operation of our disclosure controls and procedures pursuant to Exchange Act Rule 13a-14. Based upon the foregoing, our Chief Executive (principal executive officer) and our VP Finance (principal financial officer) concluded that our disclosure controls and procedures are effective in the timely alerting of management to material information relating to us which is required to be included in our periodic SEC filings.

Disclosure controls and procedures are controls and other procedures that are designed to ensure that information required to be disclosed in our reports filed or submitted under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the Securities and Exchange Commission's rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed in our reports filed under the Exchange Act is accumulated and communicated to management, including our Chief Executive Officer (principal executive officer) and our VP Finance (principal financial officer), to allow timely decisions regarding required disclosure. During our most recently completed fiscal quarter ended June 30, 2005, there were no changes in our internal control over financial reporting identified in connection with the evaluation referred to above that occurred during our last fiscal quarter which have materially affected, or are reasonably likely to affect, our internal control over financial reporting.

## 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 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.

On July 15, 2005, the Company and the Defendants signed a settlement agreement whereby the parties have agreed to settle all outstanding issues related to court proceedings brought by the Company against AII, The settlement agreement is subject to final closing documents being executed and the filing and receipt of British Columbia Court approval for the adjournment of all legal proceedings. The terms of settlement include the mutual full and final release of all outstanding debts, liabilities and obligations outstanding, a three year option by AII to the Company or its designees to acquire a total of 3,228,571 shares of the Company's stock held by AII for $10,000, and the retention by the Company of the software, code, trademarks and intellectual property relating to SchoolWeb and CommunityWeb.

On March 14 2005, Native Investment and Trade Association (NITA) filed a Writ of Summons and Statement of Claim requesting an order that the Company pay the plaintiff $53,500 and for specific performance of the obligation to transfer 100,000 free trading shares to the plaintiff. The fees and shares claimed are for trade shows attended by the Company and these amounts are being disputed by the Company.

The likelihood of any gain or loss resulting from the above lawsuit is not determinable at this time.

**ITEM 2. CHANGES IN SECURITIES AND USE OF PROCEEDS**

During the six month period ending June 30, 2005, the Registrant issued 400,000 common shares as a debt settlement to settle debt of $32,158 and issued 2,070,000 for services valued at $244,000.

There are no management contracts currently in force for the Company.

**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 no reports on Form 8K during the period ending June 30, 2005.

(b) Exhibits. Exhibits included or incorporated by reference herein: See Exhibit Index below.

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**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) |
| 31.1 | Section 302 Certification - CEO |
| 31.2 | Section 302 Certification - CFO |
| 32.1 | Section 906 Certification - CEO |
| 32.2 | Section 906 Certification - CFO |

**SIGNATURE**

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

ALTERNET SYSTEMS, INC.

Dated: April 25, 2006

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