

NATIONAL CHALLENGE SYSTEMS INC.

MANAGEMENT DISCUSSION AND ANALYSIS Three Months Ended September 30, 2004

The following is a discussion of the consolidated financial condition and results of operations of National Challenge Systems Inc. for the three-month period ended September 30, 2004. This discussion should be read in conjunction with: the Unaudited Interim Consolidated Financial Statements of the Company and notes thereto for the three months ended September 30, 2004, "Management's Discussion and Analysis" for the year ended June 30, 2004 and the Audited Consolidated Financial Statements and notes thereto for the year ended June 30, 2004.

Certain statements contained in this "Management's Discussion and Analysis" contains forward-looking statements based on the Company's estimates and assumptions, which are subject to risks and uncertainties. This could cause the Company's actual results to differ materially from the forward-looking statements contained in this discussion.

Operating Results

The lack of disposal capacity and uncertainty led two of the Company's largest customers to explore alternative waste disposal solutions during the second half of fiscal 2004. These two customers accounted for a \$312,000 drop in revenue in the first quarter of 2005 compared to same quarter last year. The Company has regained one of these customers in the first quarter of this fiscal year and is optimistic that it will soon be in position to make a new proposal to the other. Approximately 50% of the lost revenue was offset by additional business from other customers in the first quarter, resulting in revenue only being down \$155,504 or 4% over the same quarter last year. Compared to the fourth quarter of 2004 revenue is up \$150,733 or 5% from \$3,177,804 to \$3,328,537.

The cost of waste disposal continues to rise and is the prime reason the contribution margin dropped to 25.5% for the quarter from 28.1% for the same quarter last year. The Company has had some success in securing rate increases from customers in order to offset these cost increases, but some price commitments for larger customers are on an annual basis and, therefore, cannot be adjusted immediately.

As a result of the strengthening Canadian dollar there was a foreign exchange gain on the Marathon loan of \$41,041 during the quarter.

The loss for the period was \$296,666 compared to a loss of \$237,270 for the same period last year. Included in the loss for 2005 are non-cash charges \$242,266 for amortization of intangible assets and \$67,716 for accrued preferred dividends. In the first quarter of 2004 these were \$252,501 and \$60,000 respectively.

Liquidity and Capital Expenditures

On July 12, 2004, the Company closed a private placement and strengthened its balance sheet with net proceeds of \$613,000. 5,040,000 shares were issued, and in conjunction with the private placement, the investors received 2,520,000 warrants at \$0.20, which expire on July 11, 2005. Proceeds from the private placement were received and recorded in June 2004.

On August 31, 2004, ORMI purchased the Toronto facility that it had rented since 1992. The purchase price of the land and building was \$900,857 of which \$280,857 was paid in cash and the remainder was financed through a first mortgage on the property having a principal balance of \$620,000, bearing interest at 8%, repayable in monthly instalments of principal and interest of \$5,186 and matures in November 2009.

Cash generated from Operating Activities was \$232,917 compared to \$238,096 in the same quarter last year.

As reported in the Company's Annual Financial Statements, it is in violation of one of covenants and is currently in discussions with the bank for continuance of the operating line of credit on terms that are favourable to the Company.

Outlook

The primary effort of the Company during the past two years was to complete the extensive systems development and modifications required to manage a broad range of vacuum truck services from a centralized administrative center. These enhancements took significantly longer than expected, and were substantially completed during the first quarter of fiscal 2005. The Company expects that they will improve operational efficiencies on its existing business which, combined with increased revenue will result in improved results for 2005.

The Company required these enhancements to facilitate integration of future vacuum truck acquisitions, and to embark upon its growth strategy. With their completion, the Company is now able to actively pursue financing.

Financial Statements of
NATIONAL CHALLENGE SYSTEMS INC.

(Unaudited)

September 30, 2004

NATIONAL CHALLENGE SYSTEMS INC.

CONSOLIDATED BALANCE SHEETS

(unaudited)

	September 30 2004	June 30 2004
ASSETS		
CURRENT		
Accounts receivable	\$ 1,548,019	\$ 1,616,152
Inventory	208,710	204,838
Prepaid expenses	204,106	218,202
	<u>1,960,835</u>	<u>2,039,192</u>
PROPERTY PLANT AND EQUIPMENT, note 4	3,691,430	2,876,925
INTANGIBLE ASSETS	3,584,170	3,826,436
GOODWILL	3,817,849	3,817,849
FUTURE INCOME TAXES	359,000	359,000
DEFERRED FINANCING COSTS, net of accumulated amortization	16,550	18,618
	<u>\$ 13,429,834</u>	<u>\$ 12,938,020</u>
LIABILITIES		
CURRENT		
Bank indebtedness	\$ 761,045	\$ 577,955
Accounts payable and accrued liabilities	1,891,690	1,874,680
Income taxes payable	59,336	78,452
Current portion long-term debt, note 4	358,396	372,002
Current portion of obligations under capital lease	107,260	96,191
	<u>3,177,727</u>	<u>2,999,280</u>
LONG-TERM DEBT, note 4	1,246,850	734,268
OBLIGATIONS UNDER CAPITAL LEASE	284,442	269,507
REDEEMABLE PREFERRED SHARES	3,224,908	3,157,192
	<u>7,933,927</u>	<u>7,160,247</u>
SHAREHOLDERS' EQUITY		
COMMON SHARES, note 3	11,630,950	11,003,150
OBLIGATION TO ISSUE COMMON SHARES, note 3		613,000
CONTRIBUTED SURPLUS	133,861	133,861
DEFICIT	(6,268,904)	(5,972,238)
	<u>5,495,907</u>	<u>5,777,773</u>
	<u>\$ 13,429,834</u>	<u>\$ 12,938,020</u>

See accompanying notes to consolidated financial statements. These interim financial statements should be read in conjunction with the 2004 annual consolidated financial statements.

Approved

Director "Charles H. Buehler"

Director "Donald R. Carse, Jr."

NATIONAL CHALLENGE SYSTEMS INC.

CONSOLIDATED STATEMENTS OF OPERATIONS AND DEFICIT

(unaudited)

	3 months ended September 30	
	2004	2003
REVENUES		
Non hazardous vacuum services	\$ 3,177,787	\$ 3,342,109
Compactor rental income	129,501	129,370
Compactor sales, service & other	21,249	12,562
	<u>3,328,537</u>	<u>3,484,041</u>
DIRECT COSTS	<u>2,479,362</u>	<u>2,504,320</u>
CONTRIBUTION	849,175	979,721
OPERATING EXPENSE (INCOME)		
Selling, general and administrative	688,680	683,758
Amortization of property, plant and equipment	143,350	162,144
Amortization of intangible assets	242,266	252,501
Dividends on preferred shares	67,716	60,000
Interest on long-term debt and obligations under capital lease	33,468	8,347
Other interest	11,402	42,550
Foreign exchange gain	(41,041)	(992)
	<u>1,145,841</u>	<u>1,208,308</u>
LOSS BEFORE OTHER INCOME (EXPENSE) AND INCOME TAXES	(296,666)	(228,587)
OTHER INCOME (EXPENSE)		
Recovery of investment	-	(8,684)
	<u>-</u>	<u>(8,684)</u>
LOSS BEFORE INCOME TAXES	(296,666)	(237,270)
INCOME TAXES (RECOVERY)		
Current	-	-
Future	-	-
	<u>-</u>	<u>-</u>
LOSS	(296,666)	(237,270)
DEFICIT, BEGINNING OF PERIOD	(5,972,238)	(17,280,886)
DEFICIT, END OF PERIOD	<u>\$ (6,268,904)</u>	<u>\$ (17,518,156)</u>
LOSS PER SHARE, BASIC AND DILUTED	\$(0.01)	\$(0.01)
WEIGHTED AVERAGE NUMBER OF SHARES OUTSTANDING	38,584,714	34,140,761

See accompanying notes to the consolidated financial statements. These interim financial statements should be read in conjunction with 2004 annual consolidated financial statements.

NATIONAL CHALLENGE SYSTEMS INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS

(unaudited)

	3 months ended September 30	
	2004	2003
Increase (decrease) in cash and cash equivalents		
OPERATING ACTIVITIES		
Net loss	\$ (296,666)	\$ (237,270)
Items not involving cash		
Amortization of property, plant and equipment	143,350	162,144
Amortization of intangible assets	242,266	252,501
Dividends accrued on preferred shares	67,716	60,000
	<u>156,666</u>	<u>237,375</u>
Net changes in non-cash working capital items		
Accounts receivable	68,133	233,636
Inventory	(3,872)	(11,407)
Prepaid expenses	14,096	(11,882)
Accounts payable and accrued liabilities	17,010	(199,626)
Income taxes payable	(19,116)	(10,000)
	<u>232,917</u>	<u>238,096</u>
INVESTING ACTIVITIES		
Acquisition of property, plant and equipment	(955,787)	(70,972)
Proceeds on disposal of property, plant and equipment	-	-
	<u>(955,787)</u>	<u>(70,972)</u>
FINANCING ACTIVITIES		
Advances (Repayment) of bank indebtedness	183,090	(68,677)
Proceeds (Repayment) of long-term debt	513,776	(85,285)
Proceeds (Repayment) of capital lease obligation	26,004	(11,475)
	<u>722,870</u>	<u>(165,437)</u>
DECREASE IN CASH AND CASH EQUIVALENTS		
CASH AND CASH EQUIVALENTS, BEGINNING OF YEAR		
CASH AND CASH EQUIVALENTS, END OF 1ST QUARTER	\$ -	\$ -
Supplemental cash flow information		
Interest paid	39,506	50,897
Income taxes paid	19,115	10,000

See accompanying notes to the consolidated financial statements. These interim financial statements should be read in conjunction with 2004 annual consolidated financial statements.

NATIONAL CHALLENGE SYSTEMS INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

SEPTEMBER 30, 2004

1. THE COMPANY

The primary operations of the Company consist of operating vacuum truck fleets that provide collection, treatment and disposal services for non-hazardous liquid waste and other related services.

2. SIGNIFICANT ACCOUNTING POLICIES

These interim consolidated financial statements have been prepared in Canadian accordance with generally accepted accounting principles and follow the same accounting policies and method of application as the June 30, 2004 annual audited statements except that the interim consolidated financial statements do not conform in all respects with disclosure required for annual financial statements and should be read in conjunction with the annual consolidated financial statements for the year ended June 30, 2004.

3. CAPITAL STOCK

On July 12, 2004 the Company closed a private placement with net proceeds of \$613,000 for 5,040,000 shares. In conjunction with the private placement, the investors received 2,520,000 warrants at \$0.20 expiring on July 11, 2005. Proceeds from the private placement were received and recorded in June 2004.

The change in capital stock is reflected below:

	<u>Number of Shares</u>		<u>Book Value</u>	
	<u>Sept 30, 2004</u>	<u>June 30, 2003</u>	<u>Sept 30, 2003</u>	<u>June 30, 2003</u>
Opening balance	34,147,323	34,134,198	\$ 11,003,147	\$ 23,999,848
Directors, Compensation	-	13,125	-	3,299
Reduction of Capital and Deficit	-	-	-	(13,000,000)
Private Placement	5,040,000	-	613,000	-
Closing balance	<u>39,187,323</u>	<u>34,147,323</u>	<u>\$ 11,003,147</u>	<u>\$ 11,003,147</u>

4. ACQUISITION OF LAND AND BUILDING

On August 31, 2004, ORMI purchased the Toronto facility that it had rented since 1992. The purchase price of the land and building was \$900,857 of which \$280,857 was paid in cash and the remainder was financed through a first mortgage on the property having a principal balance of \$620,000, bearing interest at 8%, repayable in monthly instalments of principal and interest of \$5,186 and matures in November 2009.

5. COMPARATIVE FIGURES

Certain comparative figures have been reclassified to conform with the current year's presentation. .