

# NATIONAL CHALLENGE SYSTEMS INC.

## MANAGEMENT DISCUSSION AND ANALYSIS Six Months Ended December 31, 2004

*The following is a discussion of the consolidated financial condition and results of operations of National Challenge Systems Inc. for the six-month period ended December 31, 2004. This discussion should be read in conjunction with: the Unaudited Interim Consolidated Financial Statements of the Company and notes thereto for the six months ended December 31, 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 continued to plague the Company's capacity to serve customers and although revenue was up \$118,000 or 3.5% over the first quarter this year, it is still off \$399,000 or 9.6% over year to date 2004. Uncertainty in the marketplace 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 \$619,000 drop in revenue for the first half of 2005 compared to same period last year. The Company 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.

The Company's Direct Land Application Process ("DLAP") is an extremely cost-effective method of recycling organic waste. This patent protected process provides positive impact to the soil and environment by enhancing the organic matter content in agricultural soils. DLAP is performed on farms in conjunction with normal agricultural practices. During the past year the Ontario Ministry of Environment, the regulating agency of the Company's DLAP sites, and the Ministry of Agriculture and Food have been struggling with the implementation of a new Nutrient Management Act (the "Act"). The Act was a direct result of the Walkerton municipal water crisis and was created to manage the application of organic wastes to agricultural land. As a result of these changes, most of the third party disposal facilities in Ontario that receive and process this waste have significantly reduced their capacity, or have closed down altogether. This has had a major negative impact on NCS' cost of disposal/recycling.

As part of the regulatory changes, the Ministry of Environment required that Organic Resource Management (ORMI), NCS' wholly owned subsidiary, commence a complete re-permitting of all of its waste processing and direct land application facilities. This is an extensive undertaking that the Company has been working on for over a year. In November the Company received permits for a new facility north of Toronto, but was not able to use the disposal facility until the final requirements of the re-permitting were completed. The Company does not completely control the timeline for completion of the final requirements; however it is optimistic this new disposal facility will be opened by end of February 2005. In the interim, the Company sourced the most economical alternative disposal solutions. These alternatives include disposal sites located out of province which has resulted in a dramatic increase in the Company's transportation expense. In addition, the actual cost of disposal is significantly more expensive than using ORMI's own Ontario facilities.

The Company needed to offset the erosion to the gross margin that has occurred from the increase in Ontario disposal costs. Therefore after careful assessment and review, a decision was taken to begin an aggressive program of increasing rates to the Ontario customers. By February 1, 2005 over 95% of all Ontario based customers will receive significant rate increases.

As with any price increase there is a risk that the Company may lose business. Subject to the loss of business resulting from the price increase, there will be a positive impact on the company's operating contribution.

The cost of waste disposal continues to rise and is the prime reason the contribution as a percentage of revenue dropped to 25.1% year to date from 26.1% for last year. For the second quarter contribution as a percentage of revenue was slightly better at 24.6% for 2005 compared to 24.4% for 2004.

As a result of the strengthening Canadian dollar there was a foreign exchange gain on the Marathon loan of \$30,306 during the quarter for a total year to date foreign exchange gain of \$71,346.

The loss for the second quarter was \$298,898 compared to a loss of \$92,519 for the same period last year. Included in the second quarter loss last year was an \$80,000 credit in preferred dividends compared to an expense this year of \$69,747. In addition, last year's loss included other income of \$59,688 related to gains on disposal of assets and recovery of investments. This year there was no other income.

Year to date the loss is \$595,565 compared to \$329,793 for last year. Included in the year to date loss for 2004 was a \$20,000 credit in preferred dividends compared to an expense this year of \$137,463. In addition, year to date last year included other income of \$59,688 compared to no other income for year to date 2005.

Also included in the second quarter loss for 2005 is a non-cash charge for amortization of intangible assets of \$242,266 compared to \$252,499 in 2004. Year to date the amortization of intangibles assets is \$484,532 compared to \$505,000 for 2004.

### **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 for the second quarter was \$29,908 compared to \$41,022 for the same quarter last year. Year to date \$238,324 compared to \$279,113 in 2004.

The Company is in the process of negotiating with the bank to maintain its existing line of credit on terms that are favourable to the Company. The Company is actively pursuing additional financing, and while it has been successful in the past, there can be no assurance it will be successful in raising additional funds in the future. The Company is also negotiating the sale of certain non-core rental assets.

### **Board of Directors**

In October the Board of Directors was strengthened by the addition of Mr. Matthew Gaasenbeek. Mr. Gaasenbeek is the former chairman of the Ontario Development Corporation and was a senior partner with Midland Doherty. Mr. Gaasenbeek is also chairing NCS' audit committee.

Financial Statements of  
**NATIONAL CHALLENGE SYSTEMS INC.**

(Unaudited)

December 31, 2004

# NATIONAL CHALLENGE SYSTEMS INC.

## CONSOLIDATED BALANCE SHEETS

(unaudited)

	December 31 2004	June 30 2004
<b>ASSETS</b>		
<b>CURRENT</b>		
Accounts receivable	\$ 1,806,605	\$ 1,616,152
Inventory	214,168	204,838
Prepaid expenses	136,433	218,202
	<u>2,157,206</u>	<u>2,039,192</u>
PROPERTY PLANT AND EQUIPMENT, note 4	3,592,868	2,876,925
INTANGIBLE ASSETS	3,341,904	3,826,436
GOODWILL	3,817,849	3,817,849
FUTURE INCOME TAXES	359,000	359,000
DEFERRED FINANCING COSTS, net of accumulated amortization	14,481	18,618
	<u>\$ 13,283,308</u>	<u>\$ 12,938,020</u>
<b>LIABILITIES</b>		
<b>CURRENT</b>		
Bank indebtedness	\$ 890,170	\$ 577,955
Accounts payable and accrued liabilities	1,946,961	1,874,680
Income taxes payable	41,432	78,452
Current portion long-term debt, note 4	372,396	372,002
Current portion of obligations under capital lease	107,260	96,191
	<u>3,358,219</u>	<u>2,999,280</u>
LONG-TERM DEBT, note 4	1,117,036	734,268
OBLIGATIONS UNDER CAPITAL LEASE	258,519	269,507
	<u>1,375,555</u>	<u>1,003,775</u>
REDEEMABLE PREFERRED SHARES	3,294,655	3,157,192
	<u>4,670,210</u>	<u>4,160,967</u>
<b>SHAREHOLDERS' EQUITY</b>		
COMMON SHARES, note 3	11,662,650	11,003,150
OBLIGATION TO ISSUE COMMON SHARES, note 3		613,000
CONTRIBUTED SURPLUS	160,032	133,861
DEFICIT	(6,567,803)	(5,972,238)
	<u>5,254,879</u>	<u>5,777,773</u>
	<u>\$ 13,283,308</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*                "Frank Facto"

**NATIONAL CHALLENGE SYSTEMS INC.**  
**CONSOLIDATED STATEMENTS OF OPERATIONS AND DEFICIT**  
(unaudited)

	6 months ended December 31		3 months ended December 31	
	2004	2003	2004	2003
<b>REVENUES</b>				
Non hazardous vacuum services	\$ 6,482,543	\$ 6,899,247	\$ 3,304,757	\$ 3,557,138
Compactor rental income	259,003	258,189	129,501	128,819
Compactor sales, service & other	33,119	16,559	11,870	3,997
	<u>6,774,665</u>	<u>7,173,995</u>	<u>3,446,128</u>	<u>3,689,954</u>
<b>DIRECT COSTS</b>	<u>5,076,197</u>	<u>5,295,267</u>	<u>2,596,835</u>	<u>2,790,947</u>
<b>CONTRIBUTION</b>	<u>1,698,468</u>	<u>1,878,728</u>	<u>849,293</u>	<u>899,006</u>
<b>OPERATING EXPENSE (INCOME)</b>				
Cash operating expenses (income)				
Selling, general and administrative	1,356,617	1,426,285	667,938	733,839
Interest on long-term debt and obligations under capital lease	71,908	57,580	38,440	26,214
Other interest	23,809	37,433	12,406	17,903
	<u>1,452,334</u>	<u>1,521,298</u>	<u>718,784</u>	<u>777,956</u>
Non-cash operating expenses (income)				
Amortization of property, plant and equipment	291,050	304,094	147,700	141,951
Amortization of intangible assets	484,532	505,000	242,266	252,499
Dividends on preferred shares	137,463	(20,000)	69,747	(80,000)
Foreign exchange gain	(71,346)	(42,184)	(30,306)	(41,192)
	<u>841,699</u>	<u>746,910</u>	<u>429,407</u>	<u>273,258</u>
Total operating expense (income)	<u>2,294,033</u>	<u>2,268,208</u>	<u>1,148,191</u>	<u>1,051,214</u>
<b>LOSS BEFORE OTHER INCOME (EXPENSE) AND INCOME TAXES</b>	<u>(595,565)</u>	<u>(389,480)</u>	<u>(298,898)</u>	<u>(152,208)</u>
<b>OTHER INCOME (EXPENSE)</b>				
Gain on disposal property, plant and equipment	-	41,578	-	41,578
Recovery of investment	-	18,110	-	18,110
	<u>-</u>	<u>59,688</u>	<u>-</u>	<u>59,688</u>
<b>LOSS BEFORE INCOME TAXES</b>	<u>(595,565)</u>	<u>(329,793)</u>	<u>(298,898)</u>	<u>(92,519)</u>
<b>INCOME TAXES (RECOVERY)</b>				
Current	-	-	-	-
Future	-	-	-	-
	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>
<b>LOSS</b>	<u>(595,565)</u>	<u>(329,793)</u>	<u>(298,898)</u>	<u>(92,519)</u>
<b>DEFICIT, BEGINNING OF PERIOD</b>	<u>(5,972,238)</u>	<u>(17,280,886)</u>	<u>(6,268,905)</u>	<u>(17,518,160)</u>
<b>DEFICIT, END OF PERIOD</b>	<u>\$ (6,567,803)</u>	<u>\$ (17,610,679)</u>	<u>\$ (6,567,803)</u>	<u>\$ (17,610,679)</u>
<b>LOSS PER SHARE, BASIC AND DILUTED</b>	<u>\$(0.02)</u>	<u>\$(0.01)</u>	<u>\$(0.01)</u>	<u>\$(0.00)</u>
<b>WEIGHTED AVERAGE NUMBER OF SHARES OUTSTANDING</b>				
	<u>38,886,019</u>	<u>34,144,042</u>	<u>39,190,693</u>	<u>34,147,323</u>

*See accompanying notes to the consolidated financial statements. These interim financial*

# NATIONAL CHALLENGE SYSTEMS INC.

## CONSOLIDATED STATEMENTS OF CASH FLOWS

(unaudited)

	6 months ended December 31		3 months ended December 31	
	2004	2003	2004	2003
Increase (decrease) in cash and cash equivalents				
<b>OPERATING ACTIVITIES</b>				
Net loss for the period	\$ (595,565)	\$ (329,793)	\$ (298,898)	\$ (92,519)
Add (deduct) items not involving cash				
Amortization of property, plant and equipment	286,913	304,094	145,631	141,951
Amortization of intangible assets	484,532	505,000	242,266	252,499
Deferred/Accrued expenses	5,170		1,803	
Gain on disposal of property plant and equipment	-	(41,578)		(41,578)
Dividends accrued on preferred shares	137,463		69,747	
Stock-based compensation, note 3(a)	46,500		46,500	
Stock option compensation, note 3(b)	26,171	8,000	26,171	8,000
Foreign Exchange gain/loss	(70,107)		(29,508)	
Cashflows before changes in non-cash working capital	321,077	445,723	203,712	268,353
Net changes in non-cash working capital items				
Accounts receivable	(190,453)	(24,856)	(258,586)	(258,492)
Inventory	(9,330)	(39,328)	(5,458)	(27,921)
Prepaid expenses	81,769	5,232	67,673	17,114
Accounts payable and accrued liabilities	72,281	(91,658)	40,471	47,968
Income taxes payable	(37,020)	(16,000)	(17,904)	(6,000)
Cashflows from operating activities	238,324	279,113	29,908	41,022
<b>INVESTING ACTIVITIES</b>				
Acquisition of property, plant and equipment	(1,002,856)	(106,885)	(47,069)	(35,913)
Proceeds on disposal of property, plant and equipment	-	126,577		126,577
	(1,002,856)	19,692	(47,069)	90,664
<b>Cashflows from operating and investing activities</b>	<b>\$ (764,532)</b>	<b>\$ 298,805</b>	<b>\$ (17,161)</b>	<b>\$ 131,686</b>
<b>FINANCING ACTIVITIES</b>				
Advances (Repayment) of bank indebtedness	312,215	(25,782)	129,125	(24,100)
Proceeds (Repayment) of long-term debt	450,652	(248,125)	(87,624)	(94,163)
Proceeds (Repayment) of capital lease obligation	1,665	(24,898)	(24,340)	(13,423)
Cashflows from financing activities	\$ 764,532	\$ (298,805)	\$ 17,161	\$ (131,686)
<b>Cash and cash equivalents, beginning and end of year</b>	<b>\$ -</b>	<b>\$ -</b>	<b>\$ -</b>	<b>\$ -</b>
Supplemental cash flow information				
Interest paid	95,717	95,013	50,846	50,897
Income taxes paid	37,020	16,000	17,905	10,000

*See accompanying notes to the consolidated financial statements. These interim financial*

# NATIONAL CHALLENGE SYSTEMS INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2004

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### 1. NATURE OF OPERATIONS AND GOING CONCERN

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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.

These financial statements have been prepared on the basis of accounting principles applicable to a going concern, which assume that the Company will continue in operation for the foreseeable future and will be able to realize its assets and discharge its liabilities in the normal course of operations.

The Company has incurred significant operating losses in the current period and prior years and at December 31, 2004 the Company's current liabilities exceeded its current assets. In addition, as described in note 8 of the annual financial statements, the Company is in violation of one of its banking covenants; however the bank continues to support the company with access to the demand operating line of credit.

The Company is in the process of negotiating a new credit facility with another lender. The Company is also actively pursuing additional financing, and while it has been successful in the past, there can be no assurance it will be successful in raising additional funds in the future. The Company is also negotiating the sale of certain non-core rental assets.

These financial statements do not reflect adjustments that would be necessary in the carrying values of assets and liabilities, the reported revenues and expenses, and the balance sheet classifications used if the going concern assumption were not appropriate. The recovery of the carrying value of the Company's assets and the Company's continued existence is dependent upon continued support of its bank, the obtaining of alternate financing and/or the achievement of profitable operations.

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### 2. SIGNIFICANT ACCOUNTING POLICIES

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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.

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### 3. CAPITAL STOCK

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(a) Common Share

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.

As per the employment contract of one of the executives, the Company at its option may elect to pay the employee in common shares. The number of shares is calculated by dividing the salary payable by \$0.15. The salary is based on an annual amount of \$120,000 pro-rated for the amount of time devoted to the Company. On December 31, 2004 the Company issued 310,000 common shares to the executive related to this contract.

As approved by the shareholders at the Company's annual general meeting on November 17, 2003, the Company reduced capital stock and deficit in the unconsolidated financial statements of the parent

# NATIONAL CHALLENGE SYSTEMS INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2004

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### 3. CAPITAL STOCK (cont'd)

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company by \$13,000,000 during 2004. The reduction in capital stock and deficit absorbs prior years' losses, which related primarily to its former activities in the compactor sector.

The change in capital stock is reflected below:

	<u>Number of Shares</u>		<u>Book Value</u>	
	<u>Dec 31, 2004</u>	<u>June 30, 2004</u>	<u>Dec 31, 2004</u>	<u>June 30, 2004</u>
Opening balance	34,147,323	34,134,198	\$ 11,003,150	\$ 23,999,848
Directors, Compensation	-	13,125	-	3,302
Reduction of Capital and Deficit	-	-	-	(13,000,000)
Private Placement	5,040,000	-	613,000	-
Executive Compensation	310,000	-	46,500	-
Closing balance	<u>39,497,323</u>	<u>34,147,323</u>	<u>\$ 11,662,650</u>	<u>\$ 11,003,150</u>

#### (b) Stock options

At the Corporation's annual general meeting held on November 18, 2004, the shareholders of the Corporation approved an amendment to its Stock Option Plan (the "Plan") to provide for the increase in the maximum number of common shares reserved for issuance under the Plan from 4,218,137 shares to 5,200,000 shares.

On November 18, 2004 a total 500,000 options were granted to a director at an exercise price of \$0.20/share. Using the Black-Scholes option pricing model the fair value of these options was recorded as a compensation cost at \$0.04/each based on the following assumptions:

- |                               |           |
|-------------------------------|-----------|
| (i) Risk free interest rate   | 3.9%      |
| (ii) Expected life            | 5.0 years |
| (iii) Expected dividend yield | 0%        |
| (iv) Volatility               | 60%       |

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### 4. ACQUISITION OF LAND AND BUILDING

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On August 31, 2004, Organic Resource Management Inc., a wholly owned subsidiary, 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.

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### 5. COMPARATIVE FIGURES

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