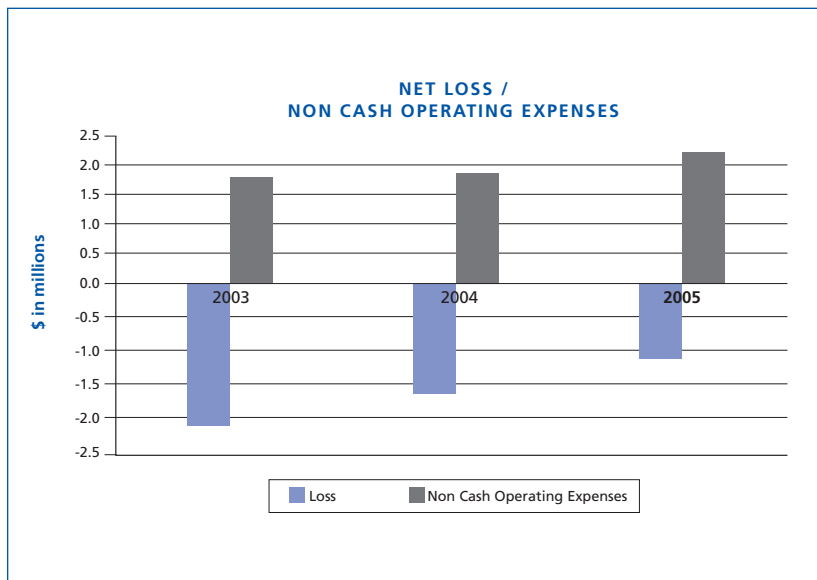
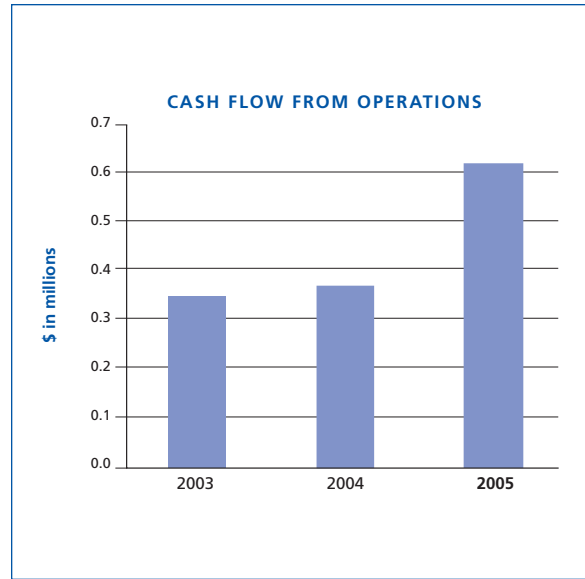
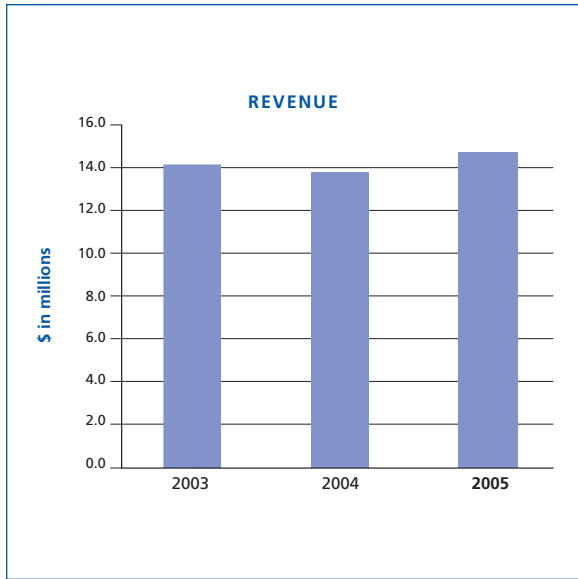


NATIONAL CHALLENGE SYSTEMS INC.



ANNUAL REPORT  
2005

COMPARATIVE FINANCIAL INFORMATION



## CEO's MESSAGE

### Laying the Foundation for Growth

The Company continues to retain its status as Canada's largest provider of vacuum truck services for the collection, treatment and disposal of organic and other non-hazardous liquid waste. Both of our wholly owned subsidiaries are generating significant margins as independent operating companies and maintaining market dominance in their core service. At the same time, National Challenge itself continued to aggressively move through its development phase in pursuit of finalizing infrastructure systems capable of operating multiple subsidiary operations throughout North America and generating significant shareholder value for the long term. The Company now has these systems in place and is capable of supporting an operations base that can extend well beyond its current two operating companies.

This latest fiscal year has presented its fair share of challenges and disappointments. Specifically, less than favorable government legislation and regulations – largely in response to the Walkerton water fiasco – played havoc with our business plan by reducing disposal options that in turn forced us to drive further and pay more for disposal in Ontario. Compounding this was the substantial increase in fuel costs; a big impact to the bottom line when you consider the fact that we provide fleet based services to approximately 8,000 customers. In response to these issues, we undertook a proactive course of action that ultimately made National Challenge stronger by controlling expenses, improving efficiencies and sharpening our competitive advantage. Every single facet of our current operations was reviewed to ensure efficiency and assess its contribution to the Company's overall goals.

As a result of these actions there was a significant improvement in the 2005 financial results as cash flows from operating activities improved during the year by 95% from \$360,000 in 2004 to \$701,000 in 2005. The loss was reduced by 33% from \$1,691,000 in 2004 to \$1,130,000 in 2005. The net loss continues to be negatively impacted by non-cash operating expenses of \$1,894,000 in 2004 and \$2,231,000 in 2005. We see continuation of financial improvements into 2006.

The outlook for the Company's core service of removing organic material from the wastewater infrastructure remains strong as governments continue to tighten regulations in order to protect the wastewater conveyance and treatment facilities. More than ever, governments and people across North America are committed to protecting the environment through recycling organics, and generating clean energy, including energy from organic waste. As the leading collector of liquid organic waste in Canada, National Challenge is well positioned to accommodate what we believe will be a continuously increasing demand for its services.

We have been working diligently to prepare our organization for growth. We are ready. We are confident we have the team, the systems and the ability to consolidate this fragmented industry and expand operations throughout North America.



Charles H. Buehler  
Chief Executive Officer

## MANAGEMENT DISCUSSION & ANALYSIS

The following Management's Discussion and Analysis ("MD&A") should be read in conjunction with National Challenge Systems Inc.'s ("NCS" or the "Company") fiscal 2005 consolidated financial statements and notes thereto.

The Audit Committee of the Board of Directors, consisting entirely of independent Directors, has reviewed this document and all other publicly reported financial information, for integrity, usefulness, reliability and consistency.

Generally, all disclosure is made as of September 21, 2005, unless otherwise indicated. Financial information is presented as at June 30, 2005 in conformity with Canadian generally accepted accounting principles.

## FORWARD-LOOKING STATEMENTS

Certain statements made or incorporated by reference in this MD&A are forward-looking and relate to, among other things, anticipated financial performance, business projects, strategies, regulatory developments, new services, market forces, commitments and technological developments. By its nature, such forward-looking information is subject to various risks and uncertainties, including those discussed in this MD&A or in documents incorporated by reference in this MD&A, which could cause the Company's actual results and experience to differ materially from the anticipated results or expectations expressed. Readers are cautioned not to place undue reliance on this forward-looking information, and the Company undertakes no obligation to update publicly or revise any forward-looking information, whether as a result of new information, future events or otherwise, except in accordance with applicable securities laws.

## CORPORATE OVERVIEW

Through its two wholly owned subsidiaries, Organic Resource Management Inc. ("ORMI") and A&A Anderson Tank Services (Vancouver) Ltd. ("A&A"), NCS is Canada's largest provider of vacuum truck services for the collection, treatment and disposal of organic and other non-hazardous liquid waste. NCS services more than 8,000 commercial, industrial, institutional and residential customers in Ontario, Quebec, and British Columbia.

The Company is unique in the industry, having exclusive access to four proprietary technologies that provide it with low cost competitive advantages plus superior operational efficiencies and controls. These technologies are:

### **Sophisticated Enterprise Management and Route Optimization System ("Software")**

The Software was designed and created specifically for the Company to manage all aspects of providing organic and other non-hazardous liquid waste and related services. It consists of four modules:

- Comprehensive customer relationship management
- Map-based routing, scheduling and dispatch
- Global positioning of vehicles and map-based tracking
- Wireless hand-held work order and data collection

The wireless handheld module, the most recent addition to the software, has been successfully tested and in use at the Company's Ottawa operation and is planned for full roll out in the fall of 2005.

All modules are fully integrated and allow remote access via the Company's secure, virtual private network, over the internet. The efficiency and planning capabilities of the Software allows NCS to accurately plan, optimize and measure personnel productivity performance in real-time. The Company has an exclusive License for the use of the Software in the organic and other non-hazardous liquid waste related services industry ("Industry") anywhere in the World.

#### **Patented Organic Resource Recovery System ("ORRS")**

The ORRS is a unique, patent protected approach to on-site management of organic waste, consisting of a mill, a holding tank and vacuum truck collection. Produce and other food related wastes are ground into slurry by a mill, reducing waste volume by an average of 5:1. The waste slurry is discharged into the holding tank where it is stored until collected by vacuum operated transport.

Organic waste recycling and diversion from landfill continues to be a major issue for most municipalities. ORRS was developed to be a competitive alternative to containerized on-site storage and collection of food waste. ORRS provides a number of benefits over container-based alternatives including reduced transportation, reduced physical space requirements, reduced odour generation and vermin attraction, reduced waste handling and improved waste quality suitable for many recycling options. NCS has an exclusive license to ORRS in Canada until the patent expires in 2017.

#### **Patented Direct Land Application Process ("DLAP")**

The DLAP is a patent protected solution for recycling high-fat content organic waste that uses the natural digestion ability of microbes found in soil to convert organic waste into stable soil organic matter. NCS has an exclusive license to DLAP in Canada until the patent expires in 2017.

DLAP is performed on agricultural farms in conjunction with normal agricultural practices. It is a cost-effective method of recycling organic waste. In addition, access to DLAP eliminates a non-hazardous liquid waste vacuum truck operators' reliance on third parties for waste recycling/disposal.

#### **Liquid Waste Decant Capabilities ("Decant")**

The Decant process removes excess water and discharges it to the municipal sewage system. ORMI has many years of experience developing and operating grease interceptor waste Decant facilities. Grease interceptor waste contains various concentrations of fats, oils and greases ("FOG"), food solids and significant amounts of water. Removing the water prior to disposal reduces the amount of waste for disposal and therefore the cost of disposal.

## CORE BUSINESS

NCS' key focus is on regularly scheduled, repetitive, organic and non-hazardous liquid waste removal and disposal services, primarily to the foodservice and food production industries. These services are essential to the operational maintenance of its customers, and vital to the maintenance, efficiency and longevity of wastewater collection and treatment infrastructures. They are complex from a logistics and administrative standpoint, yet operationally simple to deliver, and therefore do not require a specialized workforce. The services the Company provides are also relatively resilient to economic downturns.

The core services the Company provides are:

### Grease Interceptor Pumping

Grease interception devices are mandatory in all commercial and industrial facilities wherever FOG could be discharged into the sewer system, including restaurants, cafeterias, grocery stores, institutional kitchens and food processors. Most municipalities have strict sewer discharge limit bylaws that govern the amount of FOG and solids that can be discharged. Interceptors are designed to prevent excessive amounts of FOG and solids from entering the sewer system. Interceptors must be periodically emptied in order to meet sewer discharge bylaws, prevent serious drain problems and protect the sewer and wastewater treatment systems. The Company's trained service crews use vacuum trucks to pump out grease interceptors and transport the waste for processing and final recycling/disposal.

### Industrial Food Processing Wastewater Residuals

Industrial food and beverage processors must meet sewer-use bylaws that govern the quality of the wastewater they discharge to the sewer system. To achieve this, they employ a myriad of technologies to remove excess FOG and organic solids from their wastewater. The removed residuals must ultimately be disposed. The Company provides collection and transportation services of these residuals for processing and final recycling/disposal.

### Sewer, Drain, Tank & Site Cleaning

The Company provides vacuum truck services relating to sewer, drain, tank and site cleaning for industrial, commercial, institutional and municipal facilities.

### Other Vacuum Truck Related Services

The Company provides other services related to non-hazardous vacuum truck services including: septic and holding tank pumping; catch basin cleaning; sump and lift-station cleaning and interceptor replacements.

### Compliance Management Services

In addition to the above services, the Company intends to provide compliance management services to regulators. The major factor that prevents regulators from implementing mandatory service requirements is the high cost of compliance management. NCS' proprietary Software contains the foundation for a comprehensive electronic compliance management system that would utilize: (a) radio frequency

identification, (b) mobile hand-held computing for service data collection, (c) automatic wireless database updating, and (d) a visual map-based user interface accessible via the internet. The Company intends to develop and market its compliance management software to municipalities.

## **ORGANIC RESOURCE MANAGEMENT INC.**

ORMI, NCS' Ontario based operating subsidiary, has been servicing the entire Ontario market and parts of Quebec for over 20 years.

ORMI provides primarily repeat, scheduled liquid organic waste removal services to the restaurant, foodservices and food retail industries.

During the past couple of years, ORMI has faced permitting challenges with its DLAP program. Although some progress has been made towards re-opening existing facilities and expanding the DLAP program, ORMI continues to be plagued by the closure of most of its DLAP sites. In the interim there is an increased reliance on third party disposal sites.

ORMI has over 5,000 customer locations. In December 2004 the Company began increasing rates to the Ontario customers in order to offset the erosion to the gross margin that had occurred from the increase in disposal costs. By March 31st over 95% of all Ontario based customers had received rate increases with the balance in place by June 30th.

ORMI's annual revenue for the year end June 30, 2005 was \$8,898,000 up 6% from the previous year's \$8,414,000.

## **A&A Anderson Tank Service (Vancouver) Ltd.**

A&A, NCS' British Columbia based operating subsidiary, has been providing vacuum truck services in Vancouver and the Lower Mainland for over 30 years.

A&A's vacuum truck services vary from ORMI's in that a much smaller portion of its business is repeat scheduled service and with the larger portion being more responsive in nature. Over the last several years, A&A implemented a number of software enhancements designed specifically to manage the business requirements associated with a more responsive business model.

At present the only disposal option available in the Lower Mainland for non-hazardous liquid wastes, including FOG and food processing residuals, is delivery to municipal sewage treatment operated by the Greater Vancouver Regional District (the "GVRD"). There are no Decant facilities in the Lower Mainland. The GVRD has continued increasing prices at its liquid waste receiving facilities. The Company believes there is a significant opportunity to establish a Decant facility in the GVRD and is actively pursuing a site.

A&A has over 3,000 customer locations. Annual revenue for the year end June 30, 2005 was \$4,992,000 up 6% from the previous year's \$4,689,000 reflecting an increase in non-repetitive project work for the year.

## VISION AND STRATEGY

### Wastewater Industry

The Company's core services indirectly support the operational maintenance of wastewater collection and treatment infrastructures.

Wastewater treatment facilities are generally owned by local municipalities and are designed to process and treat wastewater prior to discharge into the environment. The replacement cost of both public and private wastewater treatment and sewer infrastructure in North America has been estimated at between \$1 and \$2 trillion. Wastewater treatment operators are under environmental pressures to continuously improve the quality of treated wastewater being discharged into the environment. Sewer systems convey wastewater from generators to the treatment facility. Treatment facilities are designed to specific waste receiving criteria. The cost of operating the treatment process is directly related to the quality or "strength" of wastewater to be processed. High-strength wastewater is more difficult and, therefore, more expensive to process than regular, lower-strength wastewater. High-strength wastewaters, specifically those that contain excessive quantities of FOG, can cause blockages and sewer overflows that are costly and detrimental to public health. Longevity of sewer pipes can also be adversely affected by wastewater quality. FOG is comprised of fatty acids that have low pH, which causes accelerated corrosion and deterioration of concrete sewer pipes. In addition, overloaded wastewater treatment facilities limit a municipality's capacity to expand its economic base.

Municipalities throughout Canada and the United States are actively pursuing solutions that reduce the negative effects associated with the discharge of excessive amounts of high-strength wastewaters. The Company's core services remove organic materials and FOG from the wastewater stream thereby reducing operating and maintenance costs and prolonging infrastructure life. The Company believes that as regulatory authorities address these issues they will begin mandating some of the services that the Company provides. Government mandated servicing would greatly expand the Company's markets.

### Organic Waste Diversion

In addition to its core business in the wastewater services industry, the Company also believes it is uniquely positioned to participate in the collection, transportation and recycling/disposal of solid organic waste.

The collection, transportation and disposal of organic waste is a large, growing and under-serviced market. Sixty-seven percent<sup>1</sup> of North America's annually discarded waste is comprised of organic materials. At industrial, commercial and institutional waste generators, such as supermarkets, institutions, food processors and restaurants, organic materials can represent 55% to 90%<sup>2</sup> of the total discarded waste stream. As of March 2001, only 2.6% of the 22 million tons of food scraps generated were recovered<sup>3</sup> largely because collection is typically highly inefficient. Inefficient handling results in smelly waste that attracts vermin and flies. Further, organic waste is heavy and bulky requiring excess floor space and smaller more frequent collections due to the many small tote bins on site to hold this waste.

<sup>1</sup> US Environmental Protection Agency, 1998 Waste Generation Report.

<sup>2</sup> Cynthia Greene, US Environmental Protection Agency, unpublished report, March 14, 2001.

<sup>3</sup> Cynthia Greene, US Environmental Protection Agency, unpublished report, March 14, 2001.

The US government is targeting to divert 35%<sup>4</sup> of all waste from landfill. This is estimated to result in an increase in food waste recycling from the 2.6%<sup>5</sup> to 14%, or 5.4 times the recycled mass. The Company brings substantial proprietary efficiencies to this market.

### Organic Waste Recycling/Disposal

The Company continues to face difficulties re-permitting and expanding its DLAP facilities. Despite this, the Company still believes that DLAP is currently the cheapest and best alternative for disposal of organic waste in jurisdictions that have substantive agricultural activities such as Ontario and is therefore continuing its efforts to develop new sites and re-permit its existing ones. Managing DLAP has been and continues to be challenging, primarily because of concerns related to managing unprocessed waste, such as odour.

The Company's strategy is to control a significant portion of its recycling/disposal options, either through equity participation or by obtaining preferential supply agreements in the markets it services. In addition to its DLAP, the Company has always used many third-party processing/recycling alternatives for the disposal of the waste it collects. Beginning with technology reviews in the mid 1980s that identified DLAP as the lowest-cost technology, Company management has kept diligently educated on all organic waste recycling, diversion and disposal technologies in both North America and Europe.

Technologies for processing organic waste generally fall into two categories; aerobic, which includes composting, and anaerobic which includes digestion for methane production (known as "bio-gas"). The methane produced in anaerobic digestion can be used to create electricity and/or heat. Although there are examples of both technologies operating in Ontario, there is still an "extreme shortage" of organic waste disposal capacity.<sup>6</sup> In addition, there is a significant shortage of solid waste disposal options such as landfill. This is resulting in many municipalities implementing or planning to implement organic waste diversion programs, which in turn will create an even greater demand for recycling/disposal alternatives. The Company believes this is consistent throughout North America. Governments are taking steps to promote the development of additional organic recycling capacity such as the recent announcement in Ontario that it would soon begin allowing small generators of energy (such as bio-gas plants) to sell the electricity they produce into the power grid.

Anaerobic digestion of organic waste for bio-gas production is a widely proven technology that has been in constant commercial use in Europe for many years. Bio-gas digesters are situated on farms or centrally in urban centers where they typically process manure or sewage sludge in combination with off-farm organic waste. Bio-gas digesters provide a beneficial service to the agricultural community by alleviating many of the negative environmental impacts of the land application of unprocessed manure. Bio-gas digesters require a clean, continuous and consistent supply of the liquid organic waste they process. Organic waste that contains a high percentage of FOG material, such as that collected by NCS, produces substantially higher methane yields than other organic wastes such as food waste and manure.

<sup>4</sup> US Environmental Protection Agency, 1998 Waste Generation Report.

<sup>5</sup> US Environmental Protection Agency, 1998 Waste Generation Report.

<sup>6</sup> January 2005, Private Sector IC&I Waste Management System In Ontario report prepared for the Ontario Waste Management Association.

The growth of new organic waste recycling facilities in Ontario would supply the Company with access to additional competitively priced disposal capacity, giving the Company an opportunity to substantially increase its business. In addition, the Company has the potential of supplying logistics management and transportation services to bio-gas digester operations moving both the manure feedstock from, and digested waste to, farms. Also the Company's ORRS technology is ideally suited to supply organic waste to bio-gas digesters. The ORRS liquefies solid organics which facilitates the most efficient transportation of waste to the digester facility. Liquefied organic waste is also much easier to process at the digester than solid organic waste.

The same progressive systems that have enabled the Company to provide consistent excellent service and grow into the largest collector and disposer of high-fat content liquid organic waste in Ontario, would also provide significant operational benefits to new organic waste recycling facilities, particularly bio-gas digesters. As a result, NCS is routinely contacted by potential developers of organic waste recycling facilities wishing to secure the Company's substantial organic waste stream and gain access to its operating systems. The Company believes that its combination of logistics expertise, extensive farm and residuals management experience (DLAP), combined with its overall knowledge of organic recycling technologies, positions it well to evaluate and participate in bio-gas digester opportunities as they arise throughout North America.

#### **Vacuum Truck Services Industry Consolidation**

The organic and other non-hazardous liquid vacuum truck services industry is highly fragmented. It is estimated that approximately 52,000 companies operate in this industry in North America.<sup>7</sup> Management estimates that few of these companies have annual revenues in excess of \$1.5 million. Most are family owned, logistically unsophisticated, and inefficiently operated and managed. However, they tend to operate well-maintained and well-equipped vacuum trucks and associated equipment. As well, they have limited exit strategy options as there are no national vacuum truck operators and therefore, limited markets to sell their businesses. The Company believes that its expertise, management software systems and technologies position it well to build a major national vacuum truck services provider in both Canada and the United States.

The Company plans to launch a consolidation effort that includes acquiring, licensing technology and/or providing operational management services to vacuum truck operators in both Canada and the United States.

The Company has been working since June 2002 on development of proprietary infrastructure and management systems that it believes are required to successfully manage vacuum truck services companies throughout North America from its centralized dispatch and customer service center located in Woodbridge, Ontario. During the year the Company substantially completed this development effort and has now begun implementation of the final elements of its systems to its service fleet. As a result, the Company is now able to begin working on its consolidation strategy.

<sup>7</sup> Tom Rulseh, Cole Publishing Inc., Three Lakes WI.

## RISKS & UNCERTAINTIES

### Technology and Competition

The Company's success depends on remaining competitive in the development of systems, technologies and services in its area of expertise. Environmental technology is an evolving field in which new developments are expected to continue at a rapid pace. Competition in the non-hazardous liquid waste services industry is intense and expected to increase, both from within the industry and from those diversifying into the field. Some of NCS' competitors and potential competitors may have greater development, financial or personnel resources.

NCS is subject to the risks generally associated with new systems development and deployment, including lack of acceptance, delays in development and failure of systems to function properly. The market growth potential is subject to certain risks, including costs to develop and deploy such systems, the cost and feasibility of development, introduction of competing technologies and regulatory forces.

The Company believes there are two major constraints to the advancement of the ORRS program. First the capital cost of installed ORRS equipment as compared to containerized collection alternatives, and second the lack of readily available, low-cost organic recycling alternatives in Canada and the United States.

Over the past few years ORMI has been impacted by a number of government regulatory changes that directly affect the way liquid organic waste is handled and processed in Ontario. As a result of these changes, most of the third party disposal facilities in Ontario that receive and process liquid organic waste have significantly reduced their capacity, or have closed down altogether. This has had a major impact on the cost of recycling/disposal.

As part of the regulatory changes, the Ministry of Environment required that ORMI commence a complete re-permitting of all of its DLAP facilities. This is an extensive undertaking that the Company has been working on for over two years. A number of the Company's smaller disposal sites have been closed during this re-application process; however, the Company's main DLAP facility remained open until late November 2004 when the MOE required ORMI to stop hauling into this main disposal facility until the final requirements of the re-permitting were completed. In the interim, the majority of the waste is being trucked to alternative third-party disposal sites located outside of the Province. This 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 facilities.

The Company has been successful in renewing the permits for one of its smaller Ontario DLAP sites. The Company does not control the timeline for completion of the final requirements on the main facility, and continues to work towards obtaining permits to re-open the facility. Failure to obtain permitting would result in the continued need for alternative, more expensive disposal. The Company cannot be assured of the availability of such alternative options for all of its collected waste.

The Company is actively working on a number of new disposal sites that, if successfully permitted, would result in more than doubling the Company's prior Ontario capacity. This additional capacity would allow ORMI to

pursue a number of contracts that it is unable to acquire today because of a lack of competitively priced disposal options. In most cases, the waste generated by these potential customers is being transported outside the Province at much higher costs. ORMI seeks to establish an in-province solution on a long-term contractual basis with these large generators. There are currently no new alternative organic recycling options being made available in Ontario.

#### **Risk Associated With Acquisitions**

NCS is seeking acquisitions that are a good fit for the strategic direction of the Company. The Company does not have control over the market conditions prevailing or likely to prevail in the future, which may impact the ability to finance and execute this strategy. These variables include market valuations of potential targets and stock price volatility of NCS. There can be no assurances that the Company will be able to identify suitable acquisition candidates available for sale at reasonable valuations, consummate any acquisition or successfully integrate any acquired business into its operations. However, the Company continues to believe that with its technologies, systems and experienced management team, it is uniquely positioned to capitalize on a substantial opportunity.

#### **Compactors**

Prior to March 31, 2002, the Company's primary business was the ownership, rental and distribution of waste compactor equipment for disposing of waste. In March 2002, the Company sold to Canadian Waste Services Inc. ("CSW") the vast majority of its compactor fleet located in Western Canada, Ontario and Quebec.

As part of the sale agreement the Company retained 195 compactors located in Western Canada. These remaining compactors are all rented directly to Canada Safeway Limited ("Safeway") under a contract, expiring on September 30, 2006. The Company has a contractual agreement to sell all of its remaining compactors to CWS at fair market value upon the expiration of the Safeway contract.

The annual rental revenue from the Safeway compactors was \$518,000 for 2005 (\$469,000 for 2004). During 2005 the Company took a write-down of \$322,000 reflecting a quoted value for the fleet of compactors.

#### **Dependence on Key Personnel**

NCS' success will depend to a significant extent upon its management group. The loss of the services of key executive personnel could have a material adverse effect on NCS.

## **RESULTS OF OPERATIONS**

#### **Annual Information**

The following table sets out certain selected financial information prepared in conformity with Canadian generally accepted accounting principles for the fiscal years ended June 30 2005, 2004 and 2003:

<i>Three-Year Comparative Financial Information</i>	<b>2005</b>	2004	2003
Revenue	<b>\$ 14,494,091</b>	\$ 13,677,228	\$ 14,053,175
Contribution	<b>3,619,296</b>	3,351,773	3,682,907
Operating Expenses	<b>4,891,170</b>	4,938,979	5,005,143
Non-cash operating expenses	<b>2,231,930</b>	1,894,295	1,842,774
Gain on disposal property, plant and equipment	-	66,929	101,043
Write-down Goodwill	-	-	1,261,971
Future income tax (recovery) expense	<b>(142,000)</b>	197,000	(252,500)
Loss	<b>(1,129,874)</b>	(1,691,352)	(2,140,194)
Loss per share basic and diluted	<b>\$ (0.03)</b>	\$ (0.05)	\$ (0.06)
Cash flows from operating activities	<b>701,422</b>	359,562	345,442
Working capital deficiency	<b>(1,291,947)</b>	(960,088)	(1,682,267)
Total assets	<b>13,278,384</b>	13,534,106	14,506,492
Total liabilities	<b>8,539,291</b>	7,756,333	7,787,530
Shareholders' equity	<b>4,739,093</b>	5,777,773	6,718,962

### Revenue

Revenue for the year was up 6% or \$817,000 from \$13,677,000 for fiscal 2004 to \$14,494,000 for 2005. Most of the increase in revenue occurred during the last six months of the year. In December 2004, the Company began increasing rates to most of the Ontario customers in order to offset the erosion to the gross margin that had occurred from the increase in disposal costs. By March 31st over 95% of all Ontario based customers had received rate increases with the balance in place by June 30th.

### Contribution & Operating Expenses

The primary effort of the Company continues to be systems development and the integration required to effectively manage its two operating companies and embark upon its growth strategy. Operational systems integration and the modifications required to facilitate a broad range of vacuum truck services were extensive and took more time than expected. In August of 2005 the Company launched a successful pilot implementation of its proprietary software on wireless handheld devices at its Ottawa facility. The Company plans to have all of the service technicians at its major Toronto facility fully using its handheld devices by the end of October 2005. Management expects that improved operational efficiencies as a result of these efforts, combined with the anticipated revenue increase, will result in improved financial results for 2006.

These system enhancements and modifications will position the Company well for the integration of future vacuum truck acquisitions, and are essential for the execution of the Company's growth strategy.

The total contribution margin improved by \$268,000 or 8% from \$3,351,000 in 2004 to \$3,619,000 in 2005. The increased waste disposal costs for the year were offset by the increase in customer rates in the last six months of the year.

Selling, general and administrative expenses were down \$377,000 from \$2,851,000 in 2004 to \$2,474,000 in 2005. The reduction was the result of a number of cost cutting measures in various overhead categories.

The Company continues to have large non-cash operating expenses including amortization of intangible assets related to the acquisition of ORMI and A&A. The amortization of these intangible assets was \$969,000 in both 2005 and 2004. Other than \$100,000 per year until 2017 related to patent licence agreements, these intangibles will be written down to zero by May 31, 2007.

Included in non-cash items for 2005 is a \$322,000 write down of property plant and equipment related to compactors. The Company expects to dispose of the machines prior to October 2006 and does not anticipate recovering their stated value. Accordingly the write down was recognized based on a quoted market price.

<i>Non-cash Operating Expenses</i>	<b>2005</b>	2004	2003
Amortization of Property, Plant & Equipment	<b>\$ 606,531</b>	\$ 591,743	\$ 585,218
Amortization of Intangibles	<b>969,064</b>	969,064	1,170,334
Compactor Impairment	<b>322,460</b>	-	-
Accrued Preferred Shares	<b>283,298</b>	189,192	240,000
Share compensation	<b>110,431</b>	152,384	-
Foreign Exchange gain	<b>(59,854)</b>	(8,088)	(152,778)
	<b>\$ 2,231,930</b>	\$ 1,894,295	\$ 1,842,774

#### Income Taxes & Net Loss

The net loss for the year was \$1,130,000 down \$561,000 from \$1,691,000 in 2004. Improvement in the income tax expense accounted for \$329,000 of the reduction in the net loss. There was a future income tax expense of \$197,000 in 2004 compared to a future income tax recovery of \$142,000 in 2005. The difference was the result of changes in timing differences plus the recognition of future tax assets in ORMI and A&A. NCS continues to have significant future income assets (\$2,522,000 in 2005 and \$2,644,000 in 2004) that have not been recognized and if sufficient improvement occurs they may be recorded if they are more likely than not to be realized.

#### Quarterly Review

##### Financial Information - Eight quarter Summary

(in 000's except earnings per share)

	First Quarter		Second Quarter		Third Quarter		Fourth Quarter	
	<b>2005</b>	2004	<b>2005</b>	2004	<b>2005</b>	2004	<b>2005</b>	2004
Revenues	<b>\$3,329</b>	\$3,484	<b>\$3,446</b>	\$3,690	<b>\$3,751</b>	\$3,325	<b>\$3,968</b>	\$3,178
Cashflow From								
Operating Activities	<b>233</b>	238	<b>30</b>	41	<b>55</b>	206	<b>383</b>	(125)
Net Loss	<b>(297)</b>	(237)	<b>(299)</b>	(93)	<b>(179)</b>	(428)	<b>(355)</b>	(933)
Loss per share, basic and fully diluted	<b>\$(0.01)</b>	\$(0.01)	<b>\$(0.01)</b>	\$(0.00)	<b>\$(0.00)</b>	\$(0.01)	<b>\$(0.01)</b>	\$(0.03)

In December 2004 the Company began increasing rates to most of the Ontario customers in order to offset the erosion to the gross margin that had occurred from the increase in disposal costs. By March 31st over 95% of all Ontario based customers had received rate increases with the balance in place by June 30th. As a result, the

revenue for the six months ended June 30, 2005 was up \$944,000 or 14% over the first six months of the year and up \$1,216,000 or 19% over the same period in 2004.

The \$355,000 net loss for the fourth quarter of 2005 was impacted by the \$322,000 write down of property plant and equipment related to compactors. This is a non-cash item.

In the fourth quarter of 2004 the \$933,000 net loss was larger particularly due to recording of three non-cash operating expenses:

- Accrued dividends on the class A preferred shares of \$209,000 in the fourth quarter of 2004 compared to \$74,000 in the fourth quarter of 2005.
- Future tax expense of \$197,000 in the fourth quarter of 2004 compared to a future tax recovery of \$142,000 in the fourth quarter of 2005.
- \$134,000 of stock based compensation was recorded in the fourth quarter of 2004 due to option grants at that time, compared to none in 2005.

#### Fourth Quarter 2005

Revenue for the fourth quarter of 2005 was \$3,968,000 up 25% from \$3,178,000 for the same quarter in 2004. The increase reflects the price increase for the Ontario customers.

The increase in revenue resulted in a \$164,000 improvement in the contribution margin for the fourth quarter of 2005 to \$959,000 from \$795,000 for the same period in 2004. The contribution margin as a percentage of the revenue was impacted when the trucking costs for hauling waste out of province increased seasonally because of half-load road restrictions for the spring months. As a result, the contribution margin as a percentage of revenue decreased marginally by 0.8% from 25.0% the fourth quarter of 2004 to 24.2% for the same period in 2005.

The net loss for the fourth quarter of 2005 was \$355,000 compared to a net loss of \$933,000 in the fourth quarter of 2004. During the fourth quarter of 2005 the Company recorded a \$322,000 write down of property plant and equipment related to compactors with no similar write down in 2004. There was a future tax recovery of \$142,000 recorded in the fourth quarter of 2005 compared to a future tax expense of \$197,000 recorded in the fourth quarter of 2004.

#### Balance Sheet & Cash Flow

At June 30, 2005 accounts receivable increased \$681,000 to \$2,297,000 from \$1,616,000 at June 30, 2004. The increase reflects the 25% increase in revenue from the fourth quarter of 2005 compared to 2004. The increase in accounts payable of \$482,000 from \$2,357,000 at June 30, 2005 compared to \$1,875,000 in 2004 reflects the increased costs of disposal plus \$195,000 for software development.

In 2004, as per shareholder approval, the Company reduced its capital stock and deficit by \$13,000,000 in order to absorb its prior years' losses, which relate primarily to its former activities in the compactor sector and credited the same amount to its stated unconsolidated deficit amount. These deficits were incurred by the operations and

subsequent sale of the majority of the parent company's compactor activities and are not reflective of the operations of the Company's current core business lines in its other subsidiaries.

Cash flows from operating activities increased \$341,000 from \$360,000 in 2004 to \$701,000 in 2005. The increase was primarily the result of the \$561,000 reduction in the net loss for the year.

## **CRITICAL ACCOUNTING POLICIES AND ESTIMATES**

The Company's consolidated financial statements are prepared in conformity with Canadian generally accepted accounting principles. The preparation of these consolidated financial statements requires the Company to make estimates and assumptions that affect the reported amount of assets and liabilities that are inherently uncertain. These estimates and assumptions can affect the reported amounts of assets and liabilities, revenues and expenses. NCS bases its estimates on historical experience and other assumptions which the Company believes to be reasonable in the circumstances. The significant accounting policies are described in Note 2 to the consolidated financial statements. The following items in the consolidated financial statements involve significant estimation or judgement:

### **Goodwill and intangible assets**

The Company accounts for all business combinations using the purchase method, under which it allocates the excess of the purchase price of business acquisitions over the fair value of identifiable net assets acquired to intangibles and goodwill. Purchase price allocations are derived from a formal valuation by an independent third party valuation expert. Any goodwill or intangible assets with indefinite useful lives acquired in a business combination are not amortized to income over their useful lives but are assessed annually for any potential impairment in value. All other intangibles assets are amortized over their estimated useful life.

Intangible assets are identified and recorded at estimated values based on the valuations of customer relationships, software license agreements and patent license agreements relating to the Company's business acquisitions in 2002. The Company must make assumptions regarding estimated future cash flows, market conditions and other factors to determine the fair value of the assets. If these estimates or related assumptions change in the future, the Company may be required to record impairment charges for these assets. In fiscal years 2005 and 2004, the Company did not record an impairment charge related to intangibles assets.

The Company has goodwill arising from business acquisitions, which are comprised of the excess of amounts paid over the fair value of net identifiable assets acquired. The Company performs an annual assessment of the fair value of the businesses to which this goodwill relates. In assessing the fair value of the businesses, the Company must make assumptions regarding estimated future cash flows, market conditions and other factors to determine the fair value of the business. If the estimates or their related assumptions change in the future, the Company could be required to record impairment charges for these assets. In fiscal years 2005 and 2004, the Company did not record an impairment charge related to goodwill.

### Impairment of Long-lived Assets

Long-lived assets held and used by the Company are reviewed for possible impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. If changes in circumstances indicate that the carrying amount of an asset that the Company expects to hold and use may not be recoverable, future cash flows expected to result from the use of the asset and its disposition must be estimated. If the undiscounted value of the future cash flows is less than the carrying amount of the asset, impairment is recognized. During 2005 the Company recorded an impairment loss of \$322,460 in the carrying value of its rental compactors based on quoted market prices.

### Income Taxes

The Company follows the liability method of accounting for income taxes. Under this method, current income taxes are recognized for the estimated income taxes payable or recoverable for the current year. Future income tax assets and liabilities are recognized for temporary differences between the tax and accounting bases of assets and liabilities as well as for the benefit of losses available to be carried forward to future years for tax purposes that are more likely than not to be realized.

The Company has future income tax assets, which are subject to periodic recoverability assessments. Realization of the Company's future income tax assets is largely dependent upon its achievement of projected future taxable income and the continued applicability of ongoing tax planning strategies. The Company's judgements regarding future earnings or losses may change due to future market conditions, changes in tax legislation and any other factors that could adversely affect the ongoing value of future income tax assets. These changes, if any, may require the material adjustment of these future income tax asset balances. This adjustment would reduce the future income tax asset to the amount that is considered to be more likely than not, to be realized and would be recorded in the period such a determination were to be made. Conversely, in the event that the Company's assessments were to determine that it is more likely than not to be able to realize future income tax assets in excess of the recorded amount, an adjustment to the income tax asset that would increase income would be made in the period such a determination was made.

## LIQUIDITY & CAPITAL RESOURCES

NCS' main sources of capital are cash flow generated from operations, a revolving loan and long-term debt. Cash flow from operating activities improved during the year by \$341,000 from \$360,000 in 2004 to \$701,000 in 2005.

On June 14, 2005 the Company entered into a \$2 million revolving credit facility for a 3-year term with Textron Financial. With the proceeds of the financing the Company paid off an outstanding credit line with the Scotiabank. As at June 30, 2005, \$1,125,495 was drawn against the facility.

In July 2004, the Company closed a negotiated, non-brokered private placement which resulted in gross proceeds to the Company of \$613,000. The private placement consisted of an aggregate of 5,040,000 Units at a price of \$0.125 each. Each Unit consists of one Common Share in the capital of the Company and one-half of one Common Share purchase warrant. Each whole Warrant entitles the holder to acquire one Common Share in the

capital of the Company for a period of one year for a purchase price of \$0.20 per Common Share. On July 11, 2005 all of the warrants expired without exercise.

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 funded by the private placement completed in July 2004. 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 \$5,136 and matures in November 2009.

With the purchase of the Toronto facility, the Company's capital expenditures increased for 2005 to \$1,222,534 compared to \$301,339 for 2004. The financing of trucks and equipment is primarily through capital and operating leases. The funding of the software, \$225,408 in 2005 and \$134,519 in 2004 is through cash generated from the operations. The Company's contractual obligations due over the next five years are summarized below:

<i>Contractual Obligations</i>	Less than 1 Year	1 - 3 Years	4 - 5 Years	After 5 Years	Total
Long-term debt	\$ 532,620	\$ 253,054	\$ 37,425	\$ 525,356	\$ 1,348,455
Capital lease obligations	124,489	167,567	4,923	-	296,979
Operating leases	228,706	277,901	187,606	90,168	784,381
	\$ 885,815	\$ 698,522	\$ 229,954	\$ 615,524	\$ 2,429,815

Based on current operating levels, management expects cash flow generated from operations along with the available borrowing capacity under the Company's credit facility to be sufficient to meet its working capital needs and debt service requirements for the next fiscal year. NCS has the ability to reduce capital spending to fund debt requirements if necessary; however, a long-term decline in capital expenditures may negatively impact the Company's growth strategy.

There can be no assurance that operating levels will not deteriorate over the ensuing fiscal year, which could result in the Company being unable to meet its current working capital and debt service requirements. In addition, other factors, not presently known to management, could materially and adversely affect NCS' future cash flow. In such events, the Company would be required to obtain additional capital as is necessary to satisfy working capital and debt service requirements from other sources. Alternative sources of capital could result in increased dilution to shareholders and may be on terms that are not favourable to the Company.

## OUTSTANDING SHARE DATA

As of September 21, 2005 the following is the outstanding share data:

<i>Shares</i>	Issued	Amount
Preferred - Class A	2,048,000	\$2,048,000
Preferred - Class B	900,000	900,000
	2,948,000	2,948,000
Preferred - Class A accrued dividends	555,413	-
	3,503,413	\$2,948,000
Common	39,775,323	\$11,701,123

Both Class A and class B preferred shares are redeemable at any time and convertible on or after June 1, 2007 into common shares at the option of either the Company or the preferred shareholder. The conversion into common shares is to be calculated by dividing the redemption value of the preferred shares at \$1.00 per share by an amount per common share, which would be equal to the lesser of:

- (i) \$0.40; or
- (ii) the average weighted market price over the 15-day period immediately prior to the date upon which conversion notice is given.

## **DIVIDENDS**

The Class A preferred shares provide for the payment of the 12% dividend at the Company's discretion to be either (i) in cash or (ii) in additional Class A preferred shares. The Class A preferred shares paid no dividends in 2004 or 2005. The cumulative dividends in arrears on the Class A preferred shares as at June 30, 2005 is \$492,490 compared to \$209,192 at June 30, 2004. No dividends may be paid on any other class of shares until these shares have been redeemed.

The Company has never paid cash dividends on its common share and does not anticipate paying any cash dividends in the foreseeable future. Subject to approval from Textron Financial, there are no other restrictions that prevent the Company from paying dividends.

## **RELATED PARTY TRANSACTIONS**

### **Software**

The Company has a perpetual license for use of a proprietary route optimization and management information software ("Software") in Canada from Path Information Systems Inc. ("Path") a company partially owned by a director of the Company. The Company has exclusive use of the Software in its industry.

The Company, through its Bermuda subsidiary, NCS ESL, has a perpetual licence from Path, exclusive to its industry for the worldwide (excluding Canada) use of the Software. In addition, NCS ESL has a marketing agreement with Path ("Marketing Agreement") for the Software which: (1) gives NCS ESL the right to market Software licenses to third parties for use in its industry worldwide (excluding Canada); and (2) makes the Software exclusive to NCS ESL for its industry. Licenses marketed by NCS ESL under the Marketing Agreement are at no charge from Path and do not restrict NCS ESL in any way with respect to the fees it can charge to third party licensees. The Software and Marketing Agreement will be applicable to the Company as it pursues its expansion plan outside of Canada.

### **DLAP in Canada**

The Company has an arm's-length exclusive licensing agreement (the "License") until 2017 with Organic Resource Technologies Inc. ("ORTI"), a company partially owned by two Directors of the Company, for exclusive use of DLAP in Canada. The agreement includes a fixed price option until 2017 to purchase all of the outstanding

shares of ORTI (the “Option”). The Option was granted at no cost to the Company. The license requires the payment of \$25,000 per year plus royalties on waste processed using DLAP outside of the Province of Ontario. ORMI has perpetual rights to the DLAP in the Province of Ontario at no cost or royalty; the Company has inherited these rights through its purchase of ORMI. To date no royalties have been paid, and ORTI has waived the requirement to pay the annual license fee.

#### US Patent Rights

The Company owns 70% of NCS ESL, its corporate vehicle for expansion outside of Canada. In March 2000, NCS ESL entered into an intangible asset purchase and sale agreement (“APSA”) whereby it purchased the Organic Resource Recovery System (“ORRS”) and Direct Land Application Process (“DLAP”) United States patents and certain other assets from Organic Resource Technologies International Inc. (“OII”), a company partially owned by two of the directors of NCS. In consideration for these assets, OII received 30% of the common shares of NCS ESL, which is currently inactive.

#### Related party transactions and balances

During the year, the Company incurred charges from directors or companies and/or individuals related to them. These amounts have been recorded at their exchange amount, being the amount agreed to by all parties, for amounts approximately as follows:

<i>Related Party Charge</i>	<b>2005</b>	2004
Consulting fees	\$ -	\$ 83,000
Software development cost	223,000	204,000
Interest expense	9,000	13,000
Dividends on preferred shares	283,298	189,192
Rent expense	-	48,000

Accounts payable as at June 30, 2005 includes amounts payable to certain directors and/or companies controlled by them totalling \$195,172 (2004 - \$58,738). Long-term debt includes a note payable to a related party for \$188,391 (2004 - \$251,188). The note is repayable in 36 equal monthly instalments of \$6,977, the last of which is due September 1, 2007. Long-term debt also includes a loan payable to a company owned by certain directors for \$87,977 (2004 - \$82,660).

#### ADDITIONAL INFORMATION

Additional information relating to the Company including the Annual Information Form, has been filed and is available on SEDAR at [www.sedar.com](http://www.sedar.com).

## AUDITORS' REPORT

To the Shareholders of

NATIONAL CHALLENGE SYSTEMS INC.

We have audited the consolidated balance sheets of NATIONAL CHALLENGE SYSTEMS INC. as at June 30, 2005 and 2004 and the consolidated statements of operations and deficit and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these financial statements present fairly, in all material respects, the financial position of the Company as at June 30, 2005 and 2004 and the results of its operations and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

*Grant Thornton LLP*

Grant Thornton LLP

Chartered Accountants

Toronto, Ontario

August 19, 2005

# NATIONAL CHALLENGE SYSTEMS INC.

## CONSOLIDATED BALANCE SHEETS JUNE 30, 2005 AND 2004

	2005	2004
<b>ASSETS</b>		
CURRENT		
Cash	\$ 147,082	\$ 596,086
Accounts receivable, note 3	2,296,919	1,616,152
Inventory	179,245	204,838
Prepaid expenses	206,786	218,202
	<b>2,830,032</b>	<b>2,635,278</b>
PROPERTY PLANT AND EQUIPMENT, note 4	3,178,743	2,876,925
INTANGIBLE ASSETS, note 5	2,857,372	3,826,436
GOODWILL, note 6	3,817,849	3,817,849
FUTURE INCOME TAXES, note 7	501,000	359,000
DEFERRED FINANCING COSTS, net of accumulated amortization	93,388	18,618
	<b>\$ 13,278,384</b>	<b>\$ 13,534,106</b>
<b>LIABILITIES</b>		
CURRENT		
Revolving loan, note 8	\$ 1,125,495	\$ 1,174,041
Accounts payable and accrued liabilities, note 15 (b)	2,357,494	1,874,680
Income taxes payable	-	78,452
Current portion long-term debt, note 9	532,620	372,002
Current portion of obligations under capital lease, note 10	106,370	96,191
	<b>4,121,979</b>	<b>3,595,366</b>
LONG-TERM DEBT, note 9	815,835	734,268
OBLIGATIONS UNDER CAPITAL LEASE, note 10	160,987	269,507
REDEEMABLE PREFERRED SHARES, note 11	3,440,490	3,157,192
	<b>8,539,291</b>	<b>7,756,333</b>
<b>SHAREHOLDERS' EQUITY</b>		
COMMON SHARES, note 12	11,681,173	11,003,150
OBLIGATION TO ISSUE COMMON SHARES, note 12 (b)	-	613,000
CONTRIBUTED SURPLUS, note 13	160,032	133,861
DEFICIT	(7,102,112)	(5,972,238)
	<b>4,739,093</b>	<b>5,777,773</b>
	<b>\$ 13,278,384</b>	<b>\$ 13,534,106</b>

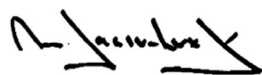
Commitments, note 14

See accompanying notes to consolidated financial statements.

On behalf of the Board of Directors:



Charles H. Buehler, Director



Matthew Gaasenbeek, Director

CONSOLIDATED STATEMENTS OF OPERATIONS AND DEFICIT  
YEARS ENDED JUNE 30, 2005 AND 2004

	2005	2004
REVENUES		
Non hazardous vacuum services	\$ 13,890,558	\$ 13,103,094
Compactor rental income	518,005	469,157
Compactor sales, service & other	85,528	104,977
	<b>14,494,091</b>	13,677,228
DIRECT COSTS	<b>10,874,795</b>	10,325,455
CONTRIBUTION	<b>3,619,296</b>	3,351,773
OPERATING EXPENSE (INCOME)		
Cash operating expenses (income)		
Selling, general and administrative	2,473,667	2,851,304
Interest on long-term debt and obligations under capital lease	137,800	40,666
Other interest	47,773	152,714
	<b>2,659,240</b>	3,044,684
Non-cash operating expenses (income)		
Amortization of property, plant and equipment	606,531	591,743
Write-down of property, plant and equipment, note 4	322,460	-
Amortization of intangible assets	969,064	969,064
Settlement of liabilities through share issuance	84,260	18,523
Stock based compensation	26,171	133,861
Dividends on preferred shares	283,298	189,192
Foreign exchange gain	(59,854)	(8,088)
	<b>2,231,930</b>	1,894,295
TOTAL OPERATING EXPENSES	<b>4,891,170</b>	4,938,979
LOSS BEFORE OTHER INCOME (EXPENSE) AND INCOME TAXES	<b>(1,271,874)</b>	(1,587,206)
OTHER INCOME		
Gain on disposal property, plant and equipment	-	66,929
Recovery of investment	-	16,391
	-	83,320
LOSS BEFORE INCOME TAXES	<b>(1,271,874)</b>	(1,503,886)
INCOME TAXES (RECOVERY)		
Current	-	(9,534)
Future	(142,000)	197,000
	<b>(142,000)</b>	187,466
NET LOSS	<b>(1,129,874)</b>	(1,691,352)
DEFICIT, BEGINNING OF YEAR	<b>(5,972,238)</b>	(17,280,886)
	<b>(7,102,112)</b>	(18,972,238)
REDUCTION OF CAPITAL STOCK AND DEFICIT, note 12(a)	-	13,000,000
DEFICIT, END OF YEAR	<b>\$ (7,102,112)</b>	\$ (5,972,238)
LOSS PER SHARE, BASIC AND DILUTED, note 16	<b>\$(0.03)</b>	\$(0.05)

See accompanying notes to consolidated financial statements.

# NATIONAL CHALLENGE SYSTEMS INC.

## CONSOLIDATED STATEMENTS OF CASH FLOWS YEARS ENDED JUNE 30, 2005 AND 2004

	2005	2004
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>		
Net loss for the year	\$ (1,129,874)	\$ (1,691,352)
Add (deduct) items not involving cash		
Amortization of property, plant and equipment	606,531	591,743
Write down of property, plant and equipment	322,460	-
Amortization of intangible assets	969,064	969,064
Gain on disposal of property plant and equipment	-	(66,929)
Dividends accrued on preferred shares	283,298	189,192
Settlement of liabilities through share issuance	84,260	18,523
Stock-based compensation	26,171	133,861
Foreign exchange gain	(59,854)	(8,088)
Future income taxes	(142,000)	197,000
	<b>960,056</b>	<b>333,014</b>
Changes in operating assets and liabilities:		
(Increase) decrease in accounts receivable, net	(680,767)	307,835
Decrease (increase) in inventory	25,593	(22,309)
Decrease (increase) in prepaid expenses	11,416	(90,737)
Increase (decrease) in accounts payable and accrued liabilities	463,576	(121,021)
Decrease in income taxes payable	(78,452)	(47,220)
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>	<b>701,422</b>	<b>359,562</b>
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>		
Acquisition of property, plant and equipment	(1,222,534)	(301,339)
Proceeds on disposal of property, plant and equipment	-	195,420
	<b>(1,222,534)</b>	<b>(105,919)</b>
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>		
(Repayment) advances of revolving loan	(48,546)	144,463
Proceeds of long-term debt	639,469	(331,735)
Repayment of long-term debt	(337,430)	-
Repayment of capital lease obligation	(98,341)	(83,285)
Payment of deferred financing costs	(83,044)	-
Proceeds from obligation to issue common shares	-	613,000
	<b>72,108</b>	<b>342,443</b>
<b>(DECREASE) INCREASE IN CASH DURING THE YEAR</b>	<b>(449,004)</b>	<b>596,086</b>
<b>CASH BEGINNING OF YEAR</b>	<b>596,086</b>	<b>-</b>
<b>CASH END OF YEAR</b>	<b>\$ 147,082</b>	<b>\$ 596,086</b>
<b>Supplemental cash flow information</b>		
Interest paid	\$ 185,573	\$ 193,380
Income taxes paid	78,452	47,220
<b>Non-cash transactions</b>		
Capital assets acquired through capital leases	\$ -	\$ 211,277
Conversion of notes payable to preferred shares	-	48,000

See accompanying notes to consolidated financial statements.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
JUNE 30, 2005

## 1. NATURE OF OPERATIONS

National Challenge Systems Inc. (the “Company” or “NCS”) is incorporated under the Canada Business Corporations Act. 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

### (a) Consolidation

These consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries as follows:

#### (i) Active

- Organic Resource Management Inc. (“ORMI”) and
- A&A Anderson Tank Service (Vancouver) Ltd. (“A&A”)

#### (ii) Inactive

- National Organic Resources Inc.
- NCS Holdings Limited, which in turn controls 70% of NCS Environmental Services Limited (“NCS ESL”). NCS ESL holds certain patents, software licenses and marketing agreements applicable to planned expansion outside of Canada (see note 5).

### (b) Cash and cash equivalents

Cash and cash equivalents include cash on hand and balances with banks and highly liquid temporary money market instruments with original maturities of three months or less. Bank borrowings are considered to be financing activities.

### (c) Inventory

Inventory, which includes supplies and repair parts, is valued at the lower of cost and replacement cost.

### (d) Property, plant and equipment

Property, plant and equipment are recorded at cost. Amortization of property, plant and equipment is provided at rates designed to write-off the assets as follows:

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
 JUNE 30, 2005

**2. SIGNIFICANT ACCOUNTING POLICIES (cont'd)**

Building	- 5% declining balance
Compactor rental machines	- straight-line over 15 years
Vehicles	- 30% declining balance
Vehicles under capital lease	- 30% declining balance
Office furniture, equipment and computers	- 20% declining balance
Office equipment under capital lease	- 20% declining balance
Software	- straight-line over 5 years
Machinery and equipment	- 20% declining balance
Leasehold improvements	- straight-line over the term of the lease
Farm storage units	- straight-line over 10 years

In the year of addition, half of the normal amortization rate is applied. If property, plant and equipment are subject to permanent impairment, additional amortization or a write-down will be provided.

(e) Goodwill and long-lived intangible assets

The Company does not amortize goodwill, and recognized intangible assets are amortized over their useful life to the Company unless the life is determined to be indefinite. When an intangible asset is determined to have an indefinite life, it is not amortized until its life is considered to be no longer indefinite. Goodwill is subject to an annual impairment test. If intangible assets or goodwill are subject to permanent impairment, additional amortization or a write-down will be provided.

Intangible assets are identified and recorded at estimated values as determined by management. Management's estimate is based on valuations of certain assets relating to the Company's business acquisitions in 2002. Amortization of intangible assets is provided at rates to write-off the assets over their estimated useful life as follows:

(i) Customer relationships	- straight-line over 5 years
(ii) Software license agreement	- straight-line over 5 years
(iii) Patent license agreements	- straight-line over 15 years

## 2. SIGNIFICANT ACCOUNTING POLICIES (cont'd)

### (f) Impairment of long-lived assets and intangibles

Long-lived assets and intangibles held and used by the Company are reviewed for possible impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. If changes in circumstances indicate that the carrying amount of an asset that an entity expects to hold and use may not be recoverable, future cash flows expected to result from the use of the asset and its disposition must be estimated. If the undiscounted value of the future cash flows is less than the carrying amount of the asset, impairment is recognized. During 2005 the Company recorded an impairment loss of \$322,460 in the carrying value of its compactor rental machines based on quoted market prices. Management believes that there has been no impairment of any of the other Company's long-lived assets as at June 30, 2005.

### (g) Income taxes

The Company follows the liability method of accounting for income taxes. Under this method, current income taxes are recognized for the estimated income taxes payable or recoverable for the current year. Future income tax assets and liabilities are recognized for temporary differences between the tax and accounting bases of assets and liabilities as well as for the benefit of losses available to be carried forward to future years for tax purposes that are more likely than not to be realized.

### (h) Deferred financing costs

Deferred financing costs are amortized on a straight-line basis over the repayment period of a term loan which matures on October 1, 2006 and a revolving loan agreement which expires on June 14, 2008.

### (i) Revenue recognition

- (i) Revenue from non-hazardous vacuum services is recognized when the service is performed.
- (ii) Compactor rental income, which is derived from one contract to 2006, is recognized over the term of the lease as it comes due on a straight-line basis.
- (iii) Compactor sales and service revenue is recognized when goods are delivered and services are performed.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
JUNE 30, 2005

**2. SIGNIFICANT ACCOUNTING POLICIES (cont'd)**

(j) Loss per share

Basic loss per share is calculated based on the weighted average number of shares outstanding during the year. Diluted per share amounts are calculated using the treasury stock method whereby loss per share is calculated as if common share equivalents such as convertible preferred shares, stock options and warrants are converted or exercised at the beginning of the year and funds received were used to purchase the Company's own stock. The effect of potential issuances of common shares under preferred share conversions, options and warrants would be anti-dilutive, and accordingly basic and diluted loss per share are the same.

(k) Stock-based compensation plan

The Company has a stock option plan, as described in Note 12, which allows for the issuance of stock options to employees and directors. All stock-based awards made by the Company are recognized using the fair value method whereby the fair value of options granted is recorded as compensation expense in the financial statements in the period the options are vested or expected to vest.

(l) Use of estimates

The preparation of financial statements in conformity with Canadian generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amount of assets and liabilities and disclosures of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

**3. ACCOUNTS RECEIVABLE**

	2005	2004
Trade	\$ 2,233,458	\$ 1,587,993
Other	81,237	55,387
	<b>2,314,695</b>	1,643,380
Less allowances for doubtful accounts	<b>(17,776)</b>	(27,228)
	<b>\$ 2,296,919</b>	\$ 1,616,152

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
JUNE 30, 2005

#### 4. PROPERTY, PLANT AND EQUIPMENT

	2005			2004		
	Cost	Accumulated Amortization	Net	Cost	Accumulated Amortization	Net
Land	\$ 263,500	\$ -	\$ 263,500	\$ -	\$ -	\$ -
Building	639,025	15,976	623,049	-	-	-
Compactor rental machines	2,514,904	1,599,054	915,850	2,514,904	1,108,933	1,405,971
Vehicles	2,905,483	2,659,649	245,834	2,889,345	2,557,750	331,595
Vehicles under capital lease	429,970	241,485	188,485	429,970	160,706	269,264
Office furniture, equipment and computers	948,869	735,537	213,332	957,785	734,435	223,350
Office equipment under capital lease	79,914	22,376	57,538	79,913	7,991	71,922
Software	684,442	240,451	443,991	374,522	83,139	291,383
Machinery and equipment	633,300	476,456	156,844	630,433	437,603	192,830
Leasehold improvements	52,811	46,234	6,577	52,811	41,658	11,153
Farm storage units	157,145	93,402	63,743	157,145	77,688	79,457
	<b>\$ 9,309,363</b>	<b>\$ 6,130,620</b>	<b>\$ 3,178,743</b>	<b>\$ 8,086,828</b>	<b>\$ 5,209,903</b>	<b>\$ 2,876,925</b>

Amortization of property, plant and equipment includes \$95,164 (2004 - \$95,241) relating to assets under capital lease. Due to the expectation that the Company will dispose of the compactor rental machines prior to October 2006 and does not anticipate recovering their stated value, the net loss for the year includes an impairment charge of \$322,460 relating to compactor rental machines based on a quoted market price.

#### 5. INTANGIBLE ASSETS

	2005			2004		
	Cost	Accumulated Amortization	Net	Cost	Accumulated Amortization	Net
Software license agreement	\$ 3,000,000	\$ 1,850,000	\$ 1,150,000	\$ 3,000,000	\$ 1,250,000	\$ 1,750,000
Customer relationships	1,550,000	1,034,294	515,706	1,550,000	765,231	784,769
Patent license agreements	1,500,000	308,333	1,191,667	1,500,000	208,333	1,291,667
	<b>\$ 6,050,000</b>	<b>\$ 3,192,627</b>	<b>\$ 2,857,373</b>	<b>\$ 6,050,000</b>	<b>\$ 2,223,564</b>	<b>\$ 3,826,436</b>

(a) Software license agreement

The software license agreement represents the value attributed to the Company's perpetual license for use of a proprietary route optimization and management information software ("Software") in Canada from Path Information Systems Inc. ("Path") a company partially owned by a director of the Company. The Company has exclusive use of the Software in its industry.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
JUNE 30, 2005

**5. INTANGIBLE ASSETS (cont'd)**

In addition to this agreement, on February 14, 2002, NCS ESL obtained a perpetual non-exclusive license, for the worldwide (excluding Canada) use of the Software from Path (“Worldwide License”). On November 11, 2003, NCS ESL entered into a marketing agreement (“Marketing Agreement”) for the Software which: (1) gives NCS ESL the right to market Software licenses to third parties for use in its industry worldwide (excluding Canada); and (2) makes the Software exclusive to NCS ESL for its industry. Licenses marketed by NCS ESL under the Marketing Agreement are at no charge from Path and do not restrict NCS ESL in any way with respect to the fees it can charge to third party licensees. This Marketing Agreement was provided by Path at no cost to NCS ESL. The Software and Marketing Agreement will be applicable to the Company as it pursues its expansion plan outside of Canada. The value attributed to the Software License Agreement includes only the value of the license in Canada and no value has been attributed to either the Marketing Agreement or the Worldwide License.

(b) Customer relationships

Customer relationships acquired as a result of the acquisition of ORMI and A&A are net of an impairment charge of \$160,334 recorded in 2003.

(c) Patent license agreements

On February 20, 2002, the Company signed an exclusive licensing agreement (“the License”) with Organic Resource Technology Inc. (“ORTI”), a company partially owned by two directors of the Company, for ORTI’s Canadian patented Direct Land Application/Organic Soil Conditioning Process (the “Process”), with a 15-year, fixed price option to purchase all of the outstanding shares of ORTI (the “Option”). The Option was granted at no cost to the Company. The License is for a 15-year period and is exclusive to the Company for use of the Process throughout Canada. The Company has perpetual rights to the Process in the province of Ontario at no cost or royalty.

**6. GOODWILL**

	2005	2004
ORMI, cost	\$ 2,434,793	\$ 2,434,793
A&A, cost net of cumulative provision for impairment of \$1,261,971, recorded in 2003.	<b>1,383,056</b>	1,383,056
	<b>\$ 3,817,849</b>	\$ 3,817,849

The annual goodwill impairment test confirmed no impairment loss for either 2005 or 2004.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
JUNE 30, 2005

## 7. INCOME TAXES

	2005	2004
(a) The income tax expense (recovery) included in the consolidated statements of operations differs from the statutory income tax rate as follows:		
Statutory income tax rate	36.1%	36.1%
Income tax recovery based on the statutory income tax rate	\$ (459,000)	\$ (543,000)
Tax effect of non-deductible and other items	461,000	504,466
Tax effect of losses and temporary differences utilized and not previously recorded	(22,000)	(223,000)
Effect of change in income tax rate	-	79,000
Valuation allowance	(122,000)	370,000
Provision for income taxes	<b>\$ (142,000)</b>	<b>\$ 187,466</b>

(b) Future income tax assets consist of the following temporary differences:

Excess of tax cost over net book value of capital assets at statutory tax rate	<b>\$ 1,262,000</b>	\$ 592,000
Loss carryforwards at statutory tax rate	<b>1,761,000</b>	2,411,000
	<b>3,023,000</b>	3,003,000
Deduct valuation allowance	<b>(2,522,000)</b>	(2,644,000)
Future income tax asset	<b>\$ 501,000</b>	\$ 359,000

(c) Management believes that the realization of a portion of net future income tax assets is more likely than not. The ultimate realization of future income tax assets is dependent upon the generation of future taxable income during the periods in which temporary tax and accounting differences become deductible. Management considered projected future taxable income and tax planning strategies in making their assessment.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
JUNE 30, 2005

**7. INCOME TAXES (cont'd)**

The right to apply non-capital losses of approximately \$4,875,000 included in the disclosure of future income tax assets above, against taxable income of future years generally expires as follows:

2006	<b>\$ 89,000</b>
2007	<b>36,000</b>
2008	<b>473,000</b>
2009	<b>1,561,000</b>
2010	<b>2,497,000</b>
2014	<b>125,000</b>
2015	<b>94,000</b>
	<b>\$ 4,875,000</b>

**8. REVOLVING LOAN**

The Company has access to a revolving credit facility with Textron Financial Canada Ltd. to a limit of \$2,000,000, bearing interest at the Royal Bank of Canada's prime commercial lending rate plus 2.00%. In addition there is an annual fee of 1% of the \$2,000,000 credit line limit. The term of the agreement is for three years commencing June 14, 2005. Security is provided by:

- a continuing security interest against the accounts receivables of ORMI and A&A; and
- unlimited guarantees of the parent and subsidiary companies.

The Company has provided covenants whereby:

- it maintain at all times, adjusted tangible net worth of not less than \$500,000
- it shall not have accounts receivable turnover of more than sixty days; and
- it shall not purchase, make or enter into any commitment to make, non-financed capital expenditures in an amount not to exceed an aggregate of \$350,000 for the 2006 fiscal year and \$250,000 for each fiscal year thereafter during the term of the Agreement.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
JUNE 30, 2005

**9. LONG-TERM DEBT**

	2005	2004
(a) 10% U.S. dollar promissory note payable to Marathon Equipment Company Inc. in blended monthly installments of principal and interest of \$23,160 U.S. maturing in October 2006; compactor rental equipment with a net book value of \$915,850 and the assignment of certain rental revenue receipts, have been provided as security.	\$ 448,194	\$ 772,422
(b) Unsecured 6 <sup>1</sup> / <sub>4</sub> % loan payable to a company owned by certain directors of the Company not due before December 31, 2005.	87,977	82,660
(c) 48-month note payable with interest paid monthly on the outstanding principal at the current bank prime lending rate. Repayment of principal is due in 36 equal monthly installments of \$6,977, maturing September 2007. Certain vehicles with a net book value of \$77,669 have been provided as security.	188,391	251,188
(d) 8% per annum calculated half-yearly mortgage payable in blended monthly installments of principal and interest of \$5,136, maturing in November 2009.	608,981	-
(e) 8.63% notes payable in blended monthly installments of principle and interest of \$886, maturing in January 2007.	14,912	-
	<b>1,348,455</b>	1,106,270
Less current portion	<b>(532,620)</b>	(372,002)
	<b>\$ 815,835</b>	\$ 734,268

Repayment of long-term debt, in aggregate and for each of the next five years is as follows:

2006	\$ 532,620
2007	215,498
2008	37,556
2009	17,979
2010	544,802
	<u>\$ 1,348,455</u>

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
 JUNE 30, 2005

**10. OBLIGATIONS UNDER CAPITAL LEASE**

Future minimum payments, in aggregate and for each of the next five years, together with the balance of the obligation under capital leases are approximately as follows:

2006	\$ 124,489
2007	126,828
2008	40,739
2009	4,923
<hr/>	
Total minimum lease payments	296,979
Less amount representing interest	
at rates from 5% to 9.5% per annum	(29,622)
<hr/>	
Balance of obligation	267,357
Less current portion	(106,370)
<hr/>	
	\$ 160,987
<hr/>	

**11. REDEEMABLE PREFERRED SHARES**

**Preferred Share Attributes**

Authorized

An unlimited number of Class A and Class B preferred shares.

An unlimited number of preferred shares issuable in series.

Class A preferred shares:

Non-voting, non-participating, entitled to a 12% cumulative dividend per annum to be paid quarterly, redeemable at any time and convertible on or after June 1, 2007 into common shares at the option of either the Company or the preferred shareholder. The conversion into common shares is to be calculated by dividing the redemption value of the preferred shares at \$1.00 per share by an amount per common share, which would be equal to the lesser of:

- (i) \$0.40; or
- (ii) the average weighted market price over the 15-day period immediately prior to the date upon which conversion notice is given.

The provision for a 12% dividend on the new Class A preferred shares is cumulative and can be paid in cash or in additional Class A preferred shares at the Company's discretion. The cumulative dividends in arrears on the Class A preferred shares as at June 30, 2005 is \$492,490 (2004 - \$209,192). No dividends may be paid on any other class of shares until these shares have been redeemed.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
JUNE 30, 2005

## 11. REDEEMABLE PREFERRED SHARES (cont'd)

### Class B preferred shares:

Non-voting, non-participating, with no entitlement to dividends, redeemable at any time and convertible on or after June 1, 2007 into common shares at the option of either the Company or the preferred shareholder. The conversion into common shares is to be calculated by dividing the redemption value of the preferred shares at \$1.00 per share by an amount per common share, which would be equal to the lesser of:

- (i) \$0.40; or
- (ii) the average weighted market price over the 15-day period immediately prior to the date upon which conversion notice is given.

	2005		2004	
	Issued	Amount	Issued	Amount
Class A	2,048,000	\$ 2,048,000	2,048,000	\$ 2,048,000
Class B	900,000	900,000	900,000	900,000
	<b>2,948,000</b>	<b>2,948,000</b>	2,948,000	2,948,000
Class A accrued dividends	-	492,490	-	209,192
	<b>2,948,000</b>	<b>\$ 3,440,490</b>	2,948,000	\$ 3,157,192

## 12. COMMON SHARES

### (a) Common shares

Authorized 100,000,000; issued as follows:

	Number of Shares		Book Value	
	2005	2004	2005	2004
Opening balance	34,147,323	34,134,198	\$ 11,003,150	\$ 23,999,848
Private Placement	5,040,000	-	613,000	-
Employee Share Compensation	310,000	-	46,500	-
Directors' compensation	145,000	13,125	18,523	3,302
Reduction of capital	-	-	-	(13,000,000)
Closing balance	<b>39,642,323</b>	34,147,323	<b>\$ 11,681,173</b>	\$ 11,003,150

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

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
JUNE 30, 2005

**12. COMMON SHARES** (cont'd)

(b) Private Placement

During 2004 the Company received net proceeds of \$613,000 related to a private placement of 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. The common shares and warrants that were related to the above private placement were issued from treasury during 2005.

(c) Employee Share Compensation

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. In addition the employee is eligible for a performance bonus of up to 500,000 shares based on the trading price of the shares. At June 30, 2005, unpaid compensation totaling \$20,000 is included in accounts payable and accrued liabilities. The Company may issue up to 133,333 common shares to settle this obligation.

(d) Directors' Compensation Plan

Non-management directors are compensated for Board and Committee meetings through the issuance of common shares. The number of shares to be issued is based on a weekly average closing price of the shares each quarter with a minimum price of \$0.20 per share. At June 30, 2005, the share value of the unpaid compensation amounted to \$17,760 and is included in accounts payable and accrued liabilities. The Company is obligated to issue 191,250 common shares to retire this liability.

(e) Warrants outstanding

Expiry Date	Exercise Price	Number of Shares	
		2005	2004
March 15, 2005	\$1.76	-	1,278,580
May 31, 2005	\$0.40	-	1,000,000
May 31, 2005	\$0.45	-	825,000
May 31, 2005	\$0.50	-	650,000
July 11, 2005	\$0.20	<b>2,520,000</b>	-
June 29, 2007	\$0.20	<b>100,000</b>	100,000
		<b>2,620,000</b>	<b>3,853,580</b>

On July 11, 2005, 2,520,000 warrants expired without exercise.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
JUNE 30, 2005

**12. COMMON SHARES** (cont'd)

(f) Stock option plan

The Company has an incentive stock option plan for certain employees and directors as determined by the Board of Directors. The maximum number of options that can be granted under the plan is 5,200,000 and no one person can be issued options which, when exercised, exceed 5% of the issued and outstanding common shares. The Board of Directors determines the number of options granted and their exercise price. However, the minimum exercise price of a stock option is the weighted average trading price of the Company's shares for the 5 days preceding the award date. As of June 30, 2005 there were 4,265,000 options outstanding with exercise prices ranging from \$0.15 to \$0.63, and average remaining life of 1.3 years. 3,525,000 of the options have vested.

Option activity for each of the years ending June 30 2005 and 2004 is as follows:

	Weighted Average Exercise Price		Number of Options	
	2005	2004	2005	2004
Opening balance	\$ 0.23	\$ 0.45	3,630,000	1,200,000
Granted	0.19	0.15	760,000	2,555,000
Expired	0.68	0.54	(125,000)	(125,000)
Closing balance	\$ 0.21	\$ 0.23	4,265,000	3,630,000

Weighted average characteristics of options outstanding are as follows:

Range of Exercise Prices	Outstanding Options		Exercisable Options		Weighted Average Remaining Life Years
	Number at June 30, 2005	Weighted Average Exercise Price	Number at June 30, 2005	Weighted Average Exercise Price	
\$0.15 - \$0.20	3,315,000	\$0.16	2,575,000	\$0.16	2.0
\$0.30 - \$0.43	675,000	0.34	675,000	0.34	2.3
\$0.55 - \$0.63	275,000	0.57	275,000	0.57	0.9
	<b>4,265,000</b>	<b>\$0.21</b>	<b>3,525,000</b>	<b>\$0.23</b>	<b>1.3</b>

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
JUNE 30, 2005

**12. COMMON SHARES** (cont'd)

(g) Fair value of stock options granted to an employee, director and a non-employee  
The fair value of each option granted during the year is estimated on the date of the grant using the Black-Scholes option pricing model based on the following weighted average assumptions:

	2005	2004
Number of Options Granted	760,000	2,555,000
Fair value	\$ 0.03	\$ 0.05
<u>Assumptions</u>		
Risk free interest rate	3.6%	3.3%
Average expected life in years	4.1	2.1
Expected dividend yield	0%	0%
Volatility	60%	60%

**13. CONTRIBUTED SURPLUS**

	2005	2004
Balance beginning of year	\$ 133,861	\$ -
Value of stock-based compensation	26,171	133,861
Balance end of year	\$ 160,032	\$ 133,861

**14. COMMITMENTS**

(a) Operating leases

Future minimum payments under operating leases for the next five years and in aggregate for premises, automotive and office equipment are approximately as follows:

2006	\$ 228,706
2007	153,797
2008	124,104
2009	104,369
2010	83,237
Thereafter	90,168
	\$ 784,381

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
JUNE 30, 2005

**14. COMMITMENTS (cont'd)**

In addition, the Company is required to pay its share of maintenance, taxes and other costs of the premises leased.

(b) Patent license agreement

Pursuant to a patent license agreement for a Direct Land Application Process with a company related to two directors, the Company is committed to a minimum annual license fee of \$25,000 to 2017.

**15. RELATED PARTY TRANSACTIONS**

(a) Related party charges

During the year, the Company incurred charges from directors or companies and/or individuals related to them. These amounts have been recorded at their exchange amount, being the amount agreed to by all parties, for amounts approximately as follows:

	2005	2004
Consulting fees	\$ -	\$ 83,000
Software development cost	<b>223,000</b>	204,000
Interest expense	<b>9,000</b>	13,000
Dividends on preferred shares	<b>283,298</b>	189,192
Rent expense	-	48,000

(b) Accounts payable and accrued liabilities

Includes amounts payable as at June 30, 2005 to certain directors and/or companies controlled by them totaling \$195,172 (2004 - \$58,738).

(c) Long-term debt

Includes a note payable to a related party for \$188,391 (2004 - \$251,188). The note is repayable in 36 equal monthly installments of \$6,977, the last of which is due September 1, 2007. Long-term debt also includes a loan payable to a company owned by certain directors for \$87,977 (2004 - \$82,660).

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
JUNE 30, 2005

**15. RELATED PARTY TRANSACTIONS (cont'd)**

(d) Patent license agreement

Pursuant to patent license agreements with companies related to directors of the Company as described in note 5, the Company has use of patent products at a minimum annual patent license fee of \$25,000. The charges for 2005 and 2004 were waived by the licensor.

**16. LOSS PER SHARE**

Basic loss per share is based on the weighted average common shares outstanding during the year. Weighted average common shares used in computation of basic loss per share were 39,256,748 and 34,147,323 for the years ended June 30, 2005 and 2004, respectively.

**17. FINANCIAL INSTRUMENTS**

(a) Interest rate risk

The Company's exposure to interest rate risk is as follows:

Accounts receivable	Non-interest bearing
Revolving loan	Floating rate
Accounts payable and accrued liabilities	Non-interest bearing
Income taxes	Floating rate
Long-term debt	Fixed and floating rates

(b) Credit risk

The Company's exposure to credit risk is indicated by the carrying value of its financial assets. The Company does not have a significant exposure to any individual customer. An allowance for doubtful accounts is established based upon factors surrounding the credit risk of specific customers, historical trends and other information.

(c) Currency risk

The Company's exposure to market risks associated with changes in foreign currency exchange rates is substantially limited to its long-term debt with one party which totaled \$365,693 U.S. and \$576,262 U.S. at June 30, 2005 and 2004 respectively.

(d) Fair value

The following summarizes the major methods and assumptions used in estimating fair values of financial instruments.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
JUNE 30, 2005

**17. FINANCIAL INSTRUMENTS (cont'd)**

Short-term financial instruments are valued at their carrying amounts, which are reasonable estimates of fair value due to the relatively short period to maturity. This approach applies to accounts receivable, revolving loan, accounts payable and accrued liabilities and income taxes payable.

The carrying value of long-term debt and obligations under capital lease approximates fair value since the terms and interest rates are consistent with current market terms and rates for such borrowings. The fair value of redeemable preferred shares is not readily determinable because instruments with similar characteristics are not readily available for comparison.

**18. COMPARATIVE FIGURES**

Certain of the comparative figures have been reclassified to conform to the financial statement presentation adopted in the current year.

## CORPORATE DIRECTORY

### Board of Directors

**Dr. Robert A. Bandeen**

Chairman of the Board  
Former Chairman, President and CEO of Crown Life Insurance Company and Former President and CEO of Canadian National Railways

**Charles H. Buehler**

Vice-Chairman and CEO, National Challenge Systems Inc.

**Donald R. Carse, Jr.**

Former CFO, National Challenge Systems Inc.

**Douglas M. Carruthers**

President, National Challenge Systems Inc.

**Frank Facto**

Senior Human Resources Consultant, City of Toronto  
Former President, Toronto Municipal Credit Union

**Martin Fallick**

Former President, Fairway Canadian Express

**Matthew Gaasenbeek**

Chairman of Northern Crown Capital  
Former Chairman, Ontario Development Corporation  
Former Senior Vice President and Director of Midland Doherty

### Executive Officers

**Charles H. Buehler**

Vice-Chairman and CEO

**Douglas M. Carruthers**

President

**Ian R. Kelland**

Vice President Operations and CFO

**Frank K. C. Chen**

Vice President Corporate Development

## CORPORATE INFORMATION

### Independent Auditors

**Grant Thornton LLP**

Royal Bank Plaza  
19th Floor, South Tower  
200 Bay Street  
Toronto, Ontario M5J 2P9

### Legal Counsel

**McMillan Binch Mendelsohn LLP**

BCE Place, Suite 4400  
Bay Wellington Tower  
181 Bay Street  
Toronto, Ontario M5J 2T3

### Transfer Agent

**Pacific Corporate Trust Company**

10th fl - 625 Howe St.  
Vancouver, B.C. V6C 3B8

### Stock Information

Shares of National Challenge Systems Inc. are traded on the Toronto Stock Exchange under the symbol NLC

### Investor Inquiries

Investors are asked to visit the National Challenge IR HUB at [http://www.nationalchallenge.com/NCS\\_Investor.asp](http://www.nationalchallenge.com/NCS_Investor.asp) where they can post questions and receive answers within the same day, or simply review questions and answers posted by other investors. Alternatively, investors are able to e-mail all questions and correspondence to [info@nationalchallenge.com](mailto:info@nationalchallenge.com) where they can also request addition to the investor e-mail list to receive all future press releases and updates in real time.

### Annual Meeting of Shareholders

The Annual Meeting of the Shareholders will be held on October 24, 2005 at 4:00 p.m. at:

The Ontario Club  
30 Wellington Street West, Commerce Court  
5th Floor South, Engineers' Room  
Toronto, Ontario

## PRINCIPAL OFFICES

### Corporate Headquarters

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3700 Steeles Avenue West, Suite 601  
Woodbridge, Ontario L4L 8K8  
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### Organic Resource Management Inc.

290 Garyray Drive  
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Internet: [www.organicresource.com](http://www.organicresource.com)  
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### A&A Anderson Tank Services (Vancouver) Ltd.

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