

NATIONAL CHALLENGE SYSTEMS INC.

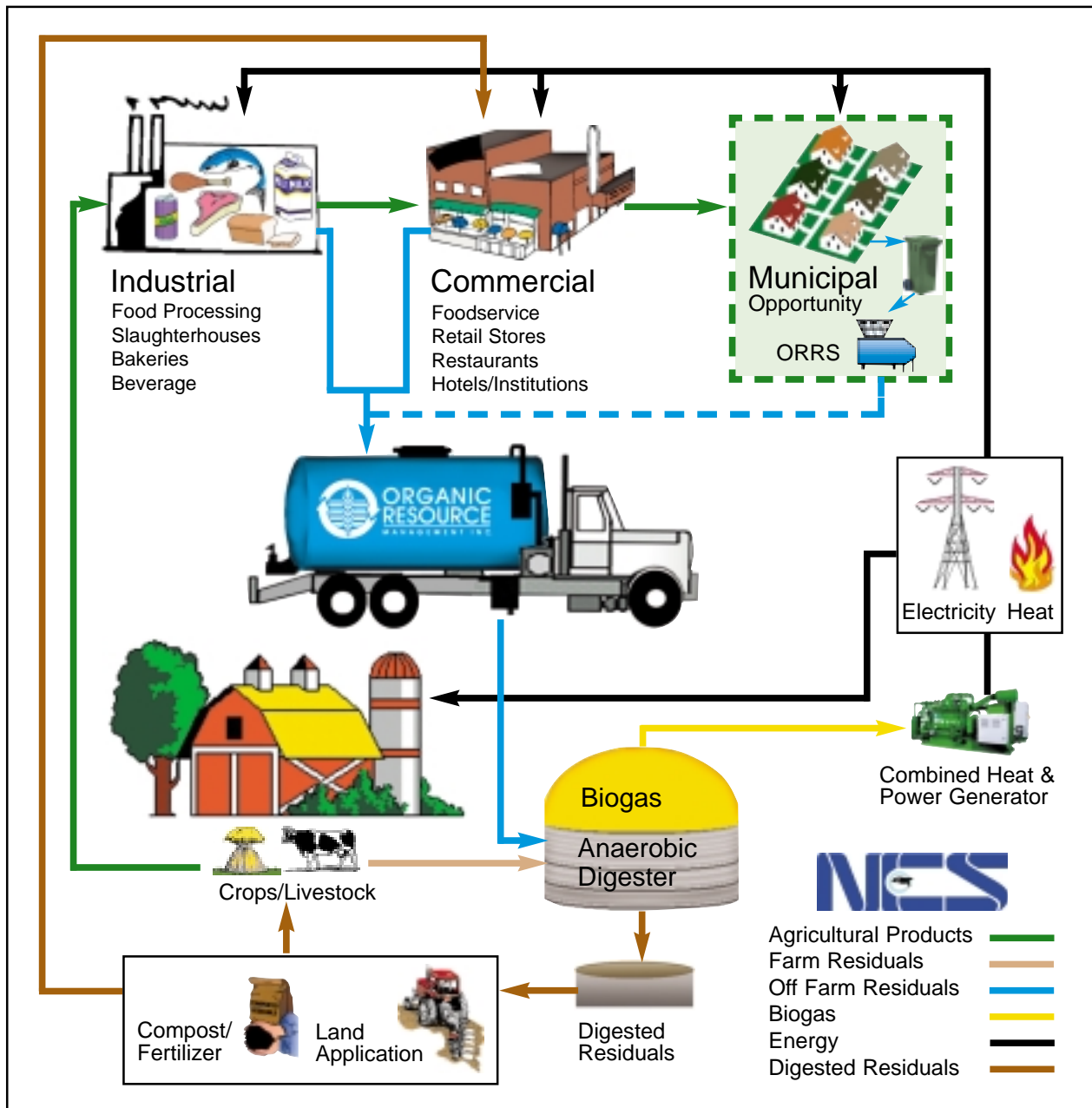


ANNUAL REPORT
2006

NATIONAL CHALLENGE SYSTEMS INC.

ORGANIC RESIDUALS TO RENEWABLE ENERGY

(A Closed Loop Solution)



BENEFITS

- Renewable heat and energy generation through improved carbon cycle utilization
- 90+% Pathogen reduction in manure & urban organic waste
- 90+% Odour reduction in manure & urban organic waste
- Significant greenhouse gas reduction
- Reduced chemical fertilizer use through improved nutrient management
- Reduced herbicide use through weed-seed destruction
- Additional source of farm revenues through renewable energy sales
- Expanded organic recycling capacity facilitates urban waste diversion goals
- Improved wastewater treatment and groundwater protection
- Reduced reliance on landfill disposal
- NCS' high-energy organic residuals produce ~400% greater energy yields than manures alone

CEO's MESSAGE

The Company continues to strive towards its mission to be the recognized leader in providing optimum solutions for the collection, transportation and recycling of organic and other non-hazardous liquid residuals through a team dedicated to service excellence and environmental responsibility.

The combination of a weak balance sheet and an extremely challenging organic residuals recycling environment has made this a difficult task over the last several years. It is a tribute to our employees, our systems, technology and customer loyalty that we have been able to persevere.

I am pleased to be able to report that our financial position continues to improve. Revenues increased by 11% and Cash Flow from Operating Activities by 5%. At the same time the balance sheet improved as a result of paying down \$449,000 of total long-term debt. The good news is that most of the intangibles will be completely written off by May 31, 2007 and the annual amortization charge of \$969,000 will be reduced to only \$100,000.

The Company's single largest expense, residuals management, has increased by over 100% during the last two years as a result of reduced recycling capacity in Ontario. Beginning in May 2006 this changed somewhat with an increase in third-party capacity. As a result, the Company is realizing significantly reduced residuals management costs. The Company has no long-term contracts with these third party facilities and therefore cannot predict with certainty how long or to what extent this situation will continue. However, it will have a material positive impact on the Company's profitability for as long as it continues.

I am also happy to report that we are continuing to position the Company to participate in the emerging biogas renewable energy industry in North America. We believe that anaerobic digestion ("AD") of organic residuals to produce biogas and generate clean renewable energy will ultimately be the most cost effective and environmentally beneficial recycling technology; a technology capable of managing the largest variety and quantities of organic residuals. We also believe that the numerous benefits of managing organic residuals through AD renewable energy production create a unique win-win-win opportunity for all parties affected.

Participation in AD projects will allow the Company to convert what is today a significant cost of operations into a new revenue center. And, the combination of a sustainable low-cost residuals recycling solution with the Company's established customer service, logistics and collection base and infrastructure will allow the Company to achieve superior profitability and growth for years to come.

Although much is still to be done before AD becomes an industry in North America and a reality for NCS, we certainly welcome the challenges and look forward to the next twelve months.

On behalf of your executive team and the Board, I take this opportunity to thank our employees, our customers and our shareholders for their exemplary efforts, continued commitment and support.



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 2006 consolidated financial statements and notes thereto.

Generally, all disclosure is made as of September 20, 2006, unless otherwise indicated. Financial information is presented as at June 30, 2006 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.

TABLE OF ACRONYMS

CORPORATE OVERVIEW

Acronym	Description	Acronym	Description
A&A	A&A Anderson Tank Services (Vancouver) Ltd.	MD&A	Management Discussion & Analysis
AD	Anaerobic Digestion	NCS	National Challenge Systems Inc.
Company	National Challenge Systems Inc.	OII	Organic Resource Technologies International Inc.
CWS	Canadian Waste Services Inc	ORMI	Organic Resource Management
DAF	Dissolved Air Flotation	Inc.	
DLAP	Direct Land Application Process	ORRS	Organic Resource Recovery System
FOG	Fats, Oils & Grease	ORTI	Organic Resource Technologies Inc.
GIS	Geographic Information System	Path	Path Information Systems Inc.
GPS	Global Positioning System	Safeway	Canada Safeway Limited
GVRD	Greater Vancouver Regional District	SOP	Standard Offer Program
IC&I	Industrial, Commercial & Institutional		

NCS is Canada's largest provider of vacuum truck services for the collection, treatment and recycling of organic and other non-hazardous liquid residuals. The vast majority of the residuals the Company collects are from customers in the food service, processing, production or retail business and include industrial, commercial and institutional ("IC&I") operations.

NCS services more than 8,000 customers in Canada through its two wholly-owned subsidiaries, Organic Resource Management Inc. ("ORMI") operating in Ontario and Quebec, and A&A Anderson Tank Services (Vancouver) Ltd. ("A&A") operating in the lower mainland of British Columbia.

NCS' core business is comprised of two distinct elements. The first is the regularly scheduled collection and

transportation of organic and other non-hazardous liquid residuals. The primary source of these residuals is the food industry sectors. Within the food sectors the primary source is from the separation of excess organic residuals from wastewater discharges to prevent the adverse effect of discharging excessive organic materials to the drainage and sewer systems. These residuals accumulate on a predictable basis and require regular scheduled collection and removal. The second element of the Company's business is comprised of managing the disposal or recycling of the residuals it collects in the most cost effective and environmentally responsible manner. The Company does this through owned technologies and facilities, as well as through third party relationships.

There are three major market drivers for the Company's services:

- **Protection of the customer's physical drainage infrastructure.** The Company's services help prevent drain blockages that can result in costly backups, floods and business interruption.
- **Protection of the municipal sewer infrastructure (regulation driven).** The Company's services also help to prevent blockages and floods in the sewer system. In this case floods and blockages can result in extremely expensive fines and remediation charges as well as adverse environmental impact. Also, organic fats, oil and greases that are discharged into and deposit in concrete sewer pipes accelerate corrosion of those pipes, thereby reducing infrastructure longevity. Municipalities regulate the amounts of organic residuals that can be discharged, hence requiring the capture, removal and proper disposal of these residuals by the generator. The Company provides the collection, transportation and recycling of these residuals.
- **Organic residuals diversion.** Municipalities are continuously looking for recycling and diversion from landfill options. The Company specializes in recycling organic residuals.

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.¹ Management estimates that few of these companies have annual revenues in excess of \$1.5 million. There are no National operators, and therefore very few exit strategy options for the companies in this industry. The prime reason for this is the extremely complex logistics involved in delivering an intense customer service on a just-in-time basis.

At the heart of the Company are sophisticated, proprietary logistics and operational management software and systems, specifically designed for the Company's business, vision and growth plans. These systems allow it to deliver complex and intense customer services from its centralized call and logistics/dispatch center located in Woodbridge, Ontario. Although the Company currently operates only in Canada, its systems are ready for use in the US, a target market for future growth of the Company. Map-based GIS routing and dispatch software, coupled with GPS tracking and live, real-time handheld work order and data collection capabilities allow the Company to deliver superior customer service at extremely high productivity levels. The systems are easily scalable and have substantial inherent capacity. They were designed specifically to computerize otherwise labour-intense logistics decisions and administrative functions, and provide the Company with unique competitive advantages and a serious barrier to entry for potential competitors.

The Company's demonstrated success in obtaining, servicing and retaining customers has resulted in its ability to collect and be responsible for the management of large quantities of liquid organic residuals on an ongoing basis. A key corporate strategy is to control access to the lowest cost, most beneficial recycling alternatives in the markets the Company services. To date, the Company has achieved that through the development and deployment of proprietary processes as well as contractual arrangements with third party organic recyclers such as composting facilities.

The Company believes that anaerobic digestion ("AD") of organic residuals to produce biogas and generating clean renewable energy will ultimately be the most cost effective and most environmentally beneficial organic waste recycling technology; capable of managing the largest variety of organic residuals. The Company also believes that it has a significant opportunity to participate in an emerging renewable energy industry in North America, and that the positive elements of combining organic recycling with energy production is a unique win-win opportunity.

The reason AD has not immersed previously in North America is the abundant supply of relatively low cost energy.

¹Tom Rulseh, Cole Publishing Inc., Three Lakes WI

It has been widely demonstrated in Europe and parts of Asia (where appropriately priced energy markets exist to purchase the electricity generated by the AD) that AD becomes the lowest cost organic residuals recycling solution. Energy markets in North America, particularly Ontario, the Company's current largest market, are beginning to adopt pricing regimes and operational policies that are favourable to AD renewable energy development. NCS is extremely well positioned to take advantage of this trend.

The residuals the Company collects are ideal feedstock for ADs. Their high volatile organics content (particularly fat, oils and greases) results in their ability to provide 4 to 10 times the gas production of other typical agricultural anaerobic digester feedstocks. As a result, the addition of even a relatively small quantity of the Company's residuals stream will result in at least a doubling of the energy production.

The Company's call center and communications infrastructure, its logistics and fleet management expertise, combined with the significant productivity gains to be achieved by co-digesting the Company's residuals with typical agricultural feedstock, makes NCS an ideal energy side partner for AD facilities.

The Company intends to partner with AD facilities through contractual relationships and through equity participation. Equity participation would be through the contribution of its high energy feedstock as well as energy generation assets (generator sets), remote monitoring and benchmarking of day-to-day AD operations. In cases where the Company has an equity stake it will receive a return on investment through renewable energy sales, and in all cases it will benefit by securing the lowest-cost recycling solution for the organic residuals it collects.

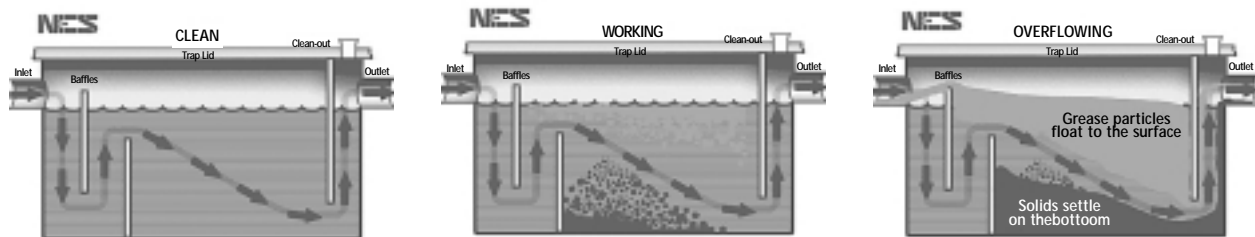
The Company believes the combination of increased low-cost residuals recycling capacity and the Company's sophisticated logistics and fleet management systems will allow it to aggressively expand its business across Canada and into the United States as it begins consolidating the highly fragmented non-hazardous liquid waste services industry.

CORE BUSINESS

The core services the Company provides are:

Grease Interceptor Pumping

Grease interception devices are mandatory in all commercial, industrial and institutional facilities wherever fats, oils and grease ("FOG") could be discharged into the sewer system. These facilities include restaurants, cafeterias, grocery stores, institutional kitchens, food processors, etc.



The grease interceptor captures and retains excess FOG and solids allowing only the cleaner wastewater to pass through to the sewer. As grease interceptors fill with captured FOG and solids, they progressively become less effective.

Grease 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 liquid organics for processing and final recycling.

Provision of these services involves significant customer communications and care, which must be integrated with trucking logistics and residuals transportation.



Industrial Food Processing Wastewater Residuals

Industrial food and beverage processors typically generate large quantities of residuals that must be removed from their wastewater prior to discharge to the municipal sewer system. This process is referred to as “pre-treatment”. In most cases, grease interceptors are not efficient enough and other pre-treatment technologies are required.

The most common technology deployed is dissolved air flotation (“DAF”). DAF is a clarification process for the separation of residuals from wastewater. It works by producing a stream of micro-fine air bubbles that attach to solids and float them to the surface, where they can be removed and stored in a holding tank for periodic collection.

The Company’s trained service crews use vacuum trucks to collect and transport the pre-treatment residuals for processing and final recycling or disposal.

Liquification and Diversion of Food Residuals

NCS provides organics diversion services to the IC&I food industries sectors where the materials to be collected are liquid or semi-liquid and can therefore be collected using the Company’s vacuum truck fleet and can be managed through the Company’s organics recycling programs.

The Organic Resource Recovery System (“ORRS”) is a reliable and cost-effective system that converts solid organics into a liquid, stores them on site and facilitates vacuum truck collection. Liquification of food organics provides an approximate five-fold volume reduction and makes these residuals ideally suited for use as a feedstock for renewable energy production in ADs.



Current efforts by the Company to deploy its ORRS have been focussed on a few large IC&I organics generators and have been limited by the lack of viable low-cost recycling alternatives. The Company believes that the establishment of ADs will make the ORRS a more financially viable residuals handling technology.

Other Related Vacuum Truck Offerings

In addition to its two core services, Wastewater Residuals Management and Organic Residuals Diversion, the Company also provides related vacuum truck services such as: off-spec product removal, sewer and drain cleaning, site cleaning, septic and holding tank pumping; catch basin cleaning; sump and lift-station cleaning and grease interceptor replacements. These services help to insure a fully integrated menu of offerings to customers, but they represent a secondary source of revenue and profitability to the Company.

ORGANIC RESOURCE MANAGEMENT INC.

Organic Resource Management Inc. (“ORMI”), NCS’ Ontario based operating subsidiary, has been servicing the Ontario market and parts of Quebec for over 25 years.

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

ORMI operates three transfer facilities in Ontario, and is permitted to de-water residuals it collects (“Decant”). The Decant process removes excess water from the residuals the Company collects prior to delivery for final recycling/disposal.

During the past couple of years, ORMI has faced challenges with its Direct Land Application Process (“DLAP”). In light of the recent developments in Ontario, and the Company’s knowledge of organic recycling options in general, NCS believes that an anaerobic digestion industry is emerging in Ontario, and that it will ultimately provide a low-cost, long-term recycling solution for all of the organic residuals the Company does and can collect. As a result, the Company has decided to suspend efforts to re-permit and expand its DLAP facilities in Ontario. In the interim, the

Company continues to use higher cost recycling alternatives including transporting material out of province to third party recycling sites.

ORMI services 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. Further increases in disposal costs during 2006 were past along to customers with a rate increase in May 2006.

ORMI's annual revenue for the year end June 30, 2006 was \$10,320,000 up 16% from the previous year's \$8,898,000.

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, 2006 was \$5,090,000 up 2% from the previous year's \$4,992,000 reflecting an increase in rates for the year.

VISION AND STRATEGY

Wastewater Residuals Management

NCS' key focus is to collect, remove, transport and recycle residuals that are generated by its IC&I customers. Customers are often legally obliged to capture or prevent residuals from entering sewage collection and wastewater treatment networks. The provision of this service is vital to maintaining the physical infrastructure and business operations of customers, and ensures their compliance with municipal bylaws. It also strengthens the efficiency and longevity of municipal wastewater infrastructures.

The need for wastewater residuals collection/removal is driven by two factors:

- **Maintenance of Customer Drainage Infrastructure** – Food industry companies typically generate wastewaters that are high in FOG and other organic streams. These materials must be intercepted and prevented from entering the drainage system. If wastewaters containing FOG and other food solids are allowed to enter the drainage system, they accumulate on the walls of the drainpipes over time. These deposits eventually cause blockages and backups that can, in turn, cause serious floods – all of which are extremely costly to repair and may result in operational closures.
- **Municipal Regulations Protecting Wastewater Treatment Infrastructure** – Municipalities throughout Canada and the United States are actively mandating grease interceptor requirements, designed to reduce the discharge of excessive amounts of high-strength wastewaters into municipal sewer systems.

In the absence of proper grease interception, high-strength wastewaters pose a material risk to customer and community infrastructure. Without effective abatement, collection and removal of residuals, high-strength wastewaters emptying directly into drainage systems can cause significant damage/impact, including the following:

- **Sewer Blockages and Floods** – Accumulation of residuals on the interior walls of sewer piping systems is akin to sclerotic deposits in blood vessels: over time, fluid pressures increase as blockages occur, causing

inevitable failure of pipes and channels. The risk posed to municipal infrastructure has resulted in a well developed compliance function in most North American cities. Foodservice businesses face various monitoring, reporting, insurance and litigating risks given heightened bylaw enforcement. Increasingly, state and provincial jurisdictions are legislating compliance, given the regional and environmental protection impacts. For example, the State of California mandated (Chapter 533 of Statutes 2005) a process last year for documenting and tracking the transportation of kitchen grease to ensure proper disposal or recycling.

- **Capacity of Sewage Treatment** – Even in situations where the negative impact on sewer systems is slow to develop, the presence of residuals in wastewater treatment facilities is a costly and complex threat. Moreover, these challenges affect opportunities for municipal growth, since they impose a limit on sewer plant capacity and the effectiveness of wastewater infrastructure.
- **Increased Sewer System Operating and Maintenance Costs** – The impact on plant capital is high, given the difficulty in removing residual deposits from plant collection, pumping and treatment systems. To cope with operating and maintenance issues associated with removing residuals accumulation, municipal plant managers are increasingly forced to invest in customized equipment and handling processes. Lift station scum removal and pooling systems are some of the additional investments made by municipalities to contain the problem of residuals accumulation.
- **Reduced Life Expectancy of Sewer Infrastructure** – The low PH levels of FOG material causes accelerated deterioration of concrete sewer pipes. With underground and facility infrastructure failing at an accelerated rate, municipalities are facing significant cost pressures on replacement and repair.

As a result of the above consequences, municipalities seek to reduce the quantity of residuals that may be discharged into the sewer system. The focus of current municipal policy is to expand regulatory intervention, which includes increased fines and/or penalties for non-compliance to ensure excessive amounts of FOG and other organics are not discharged to the sewer systems. As a result, residual generators are increasingly required to improve their ability to capture these materials through the installation of additional or more efficient interception equipment and implement stringent maintenance (residual removal) programs in order to ensure compliance.

In the commercial and institutional sectors, grease interceptors are recognized as the best available technology to capture and prevent excess residuals from entering the sewer systems. Grease interceptors have been mandated by building codes throughout North America for decades. They must be installed wherever there is the potential for discharge of residuals to the drainage system. The standard for grease trap design, PDI-G101, has been in effect for more than 50 years. Design specifications were intended to ensure capture of FOG materials prior to discharge of commercial wastewaters to sewer systems.

In the industrial sector, numerous technologies and devices exist to facilitate the removal and capture of excess residuals from processed wastewater. Given the significantly larger wastewater volumes, and in many cases higher residuals concentrations in those wastewaters, technologies and devices tend to be more complex and capable of delivering significantly better residuals removal efficiencies, which in turn creates substantial residual volumes that must be managed.

Once captured, residuals must be periodically collected and removed from customers' premises. The core business of NCS is the deployment of a skilled workforce and a fleet of vacuum trucks and related equipment to collect captured residuals from customer locations and ensure they are recycled and/or disposed in an approved manner. Once removed, residuals are transported to owned and/or third-party facilities for either recycling or disposal.

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 percent² 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%³ of the total discarded waste stream. As of March 2001, only 2.6% of the 22 million tons of food scraps generated were recovered⁴ largely because collection is typically highly inefficient. Inefficient handling results in smelly waste that attracts vermin and flies. Further, organic residuals are heavy and bulky requiring excess floor space and smaller more frequent collections due to the many small tote bins on site to hold this material.

The US government is targeting to divert 35%⁵ of all waste from landfill. This is estimated to result in an increase in food waste recycling from the 2.6%⁶ to 14%, or 5.4 times the recycled mass. The Company brings substantial proprietary efficiencies to this market.

Organic Residuals Recycling and Disposal

The Company has invested significant resources in the past 15 years to develop a comprehensive knowledge base of all types of organic recycling and disposal alternatives. The geography of each NCS service territory has different drivers which dictate the practical recycling and/or disposal options that are available for collected residuals. The Company's over-riding strategy is to control the lowest cost recycling (or disposal) option in the markets that it does business. It has and will continue to do that by obtaining long-term contractual relationships and/or through direct equity participation.

NCS' market leadership in the collection, transportation and recycling of residuals has resulted in it being responsible for managing large volumes of organic residual streams. Historically, in Ontario NCS has recycled these organic residuals using aerobic methods such as composting and its own patented DLAP technology. In British Columbia the only option has, and continues to be, delivery to the municipally operated sewage treatment plant for de-watering and use in a mine-tailings reclamation project.

In Ontario, as in most markets, the composting industry has matured to the extent that markets for end product are saturated. In addition, odour management and truck traffic issues around both DLAP and composting facilities are making them increasingly difficult to site as the urbanization of rural areas continues to foster strong community opposition. As a result, costs for composting large quantities of residuals are at an all-time high.

A particularly attractive recycling option for NCS is the AD process, a widely proven technology that has been in constant commercial use in Europe for many years. In the simplest terms, AD is a biological process that breaks down organic materials in the absence of oxygen. The primary by-products of AD are: stable organic matter, water, carbon dioxide/methane gas. The carbon dioxide/methane gas combination is what is commonly referred to as biogas. Biogas is combusted to create energy (see page two). The energy content of NCS residuals significantly improves the biogas output of AD systems, which makes the Company's residual streams a highly desirable material to combine and co-digest with other AD organic inputs such as livestock manure and source separated organics from urban residential collection programs.

During the past decade, NCS has amassed a significant AD knowledge base, and has been a strong proponent of its introduction and development in Canada. Recent Ontario Government policy announcements have confirmed NCS' efforts. The province has announced that it will make long-term purchases of electricity from Ontario generators of biogas. These generators will be capable of producing energy at a rate that makes AD systems economically viable. As a result, the Company has delayed development of additional DLAP sites in favour of a more focused effort to implement AD projects.

Policy changes in Ontario have made the province a leader in the promotion and development of the AD renewable

² US Environmental Protection Agency, 1998 Waste Generation Report

³ Cynthia Greene, US Environmental Protection Agency, unpublished report, March 14, 2001

⁴ Cynthia Greene, US Environmental Protection Agency, unpublished report, March 14, 2001

⁵ US Environmental Protection Agency, 1998 Waste Generation Report

⁶ US Environmental Protection Agency, 1998 Waste Generation Report

energy industry in North America. Other jurisdictions will be watching closely as the Ontario experience unfolds over the next few years and NCS stands to benefit from its position at the forefront of this emerging industry.

The Company believes that co-digestion of the organic residuals it collects in AD systems with agricultural residuals will eventually be adopted by multiple North American jurisdictions, including British Columbia. The major policy driver in British Columbia is the high density of livestock in the Fraser Valley, and the urgent need for better environmental stewardship; primarily odour and manure management practices. Implementation of co-digested AD systems will address these factors.

AD recycling eliminates the challenges that both composting and DLAP face. In strategic terms, it offers a more environmentally sustainable approach in managing the recycling of residual streams. AD extracts the inherent energy from the residuals and at the same time reduces pathogens and odours, and improves nutrient availability. AD processes create a more efficient and environmentally responsible approach.

AD facilities can be divided into two primary categories; both are ideal partners for NCS:

- **On-farm ADs** are located on the farms that have large numbers of livestock generating significant quantities of manure feedstock. Proposed Ontario regulations would allow On-farm ADs to receive prescribed quantities of industrial, commercial and institutionally generated clean organics such as those collected by NCS⁷. On-farm ADs will typically be able to utilize most or all of the digested material.
- **Centralized ADs** are typically large facilities strategically located to receive most or all of their feedstock from off-site generators like source separated organics from an urban residential collection program, large industrial generators and livestock manure from multiple farms. Centralized facilities are typically larger than On-farm ADs and require significantly more transportation logistics as most if not all of the material to be digested must be transported in, and all of the digested material must be transported out from the digester for final use. This additional transportation requirement could be a positive opportunity for the Company to provide additional transportation services. The Company believes there is a significant hurdle to siting Centralized ADs as they are designated as waste processing facilities and must be permitted and regulated by the Ministry of Environment.

The implications of AD recycling are dramatic to NCS:

- **Lower Operating Cost Base** – AD recycling represents a significantly lower cost alternative to third party disposal options in and especially out of province. AD recycling will attach a commercial value to the reliable delivery of NCS’ high-energy characteristics of its residual streams.
- **Increased Volumes** – Increased business volumes can come in three areas:
 - IC&I Customers** - AD recycling offers NCS a secure and long-term solution for larger volumes of organic residuals. This new capacity will enable the Company to increase its market by providing reliable collection services in Ontario to customers with large residual streams that the Company has not been able to service previously due to a lack of cost affective recycling capacity.
 - ORRS** - Once Centralized AD operations appear, NCS believes it will have substantially more opportunities for utilizing its ORRS system, including the management of source separated organics on behalf of municipalities.
 - AD’s** - NCS will have new opportunities to utilize its fleet to transport farm manures to AD facilities and the digestate that results from AD processes back to neighbouring farms, where it will be used as a feedstock for land application and composting operations.
- **Renewable Energy Partnerships** – Direct participation in AD projects would convert a cost center into a revenue generating opportunity. AD’s will desire NCS as a partner because of the Company’s:

⁷ OMAFRA, On-Farm Mixed Treatment System Design and Operations Manual, October 12, 2005

Residuals - Reliable volumes and high-energy characteristics of NCS residuals.

Knowledge - Significant technical, operational and industry contact knowledge and on-going practical knowledge the Company will develop by participating in multiple AD's.

Direct Land Application - NCS believes it will have the opportunity to utilize its existing DLAP know-how, infrastructure and composting relationships for the management of digested organics coming from AD's.

NCS' strategy is to participate in AD projects through both contractual feedstock supply agreements and energy-side equity participation. NCS has a unique opportunity to directly participate in the development, ownership and operations of multiple ADs.

Integrated Strategy

The Company's mission is:

“To be the recognized leader in providing optimum solutions for the collection, transportation and recycling of organic and other non-hazardous liquid residuals through a team dedicated to service excellence and environmental responsibility”

Six core values reflect the Company's quest for excellence:

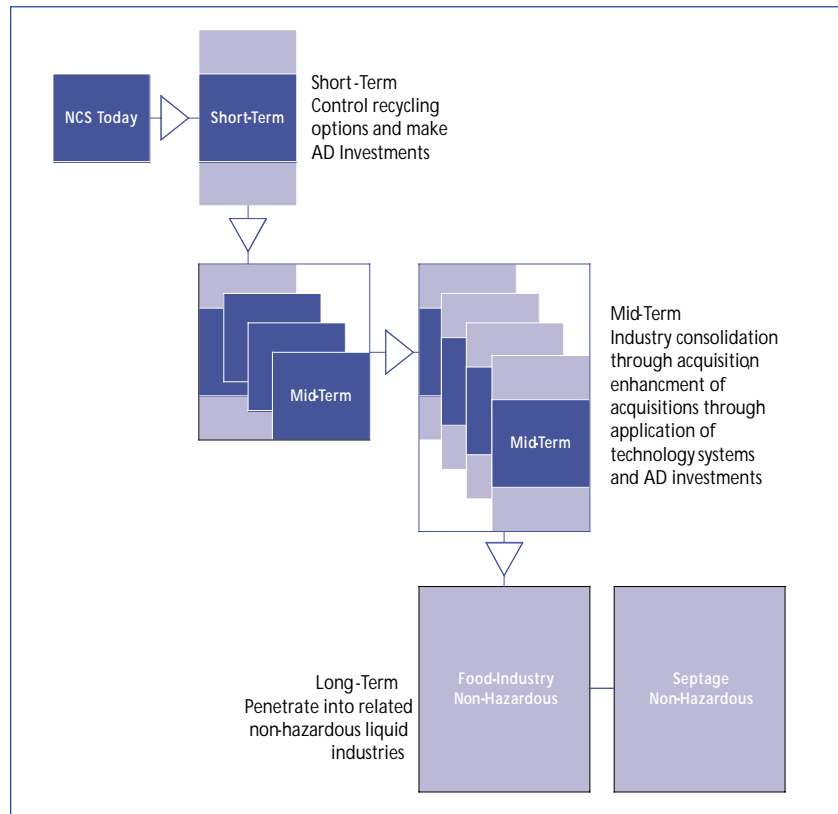
1. To provide customers with economic liquid residuals management solutions that are beneficial to society and the environment
2. To promote ethical and environmentally responsible business practices
3. To recognize the value and respect of employees, customers and neighbours
4. To foster innovation and individual commitment among employees
5. To continuously research and develop innovative residuals recycling and management technologies
6. To be a profitable, secure Company dedicated to continued growth

Three integrated strategies flow from the mission and values of the Company. These strategies represent a prudent and consistent approach to growing the business of NCS based on its current operations and future opportunities:

- **Short-Term – Renewable Energy and Organic Growth**
 - Control and expand recycling and disposal options in existing markets, including development of AD projects.
 - Generate additional financial returns from its increased residual streams by making commercial investments in AD projects.
 - Expand collection business in existing markets through customer growth opportunities resulting from expanded residuals recycling capacity, as well as several small acquisition opportunities.
 - Continue to focus on efficiency improvements that build on the technologies, expertise and systems developed by NCS.
- **Mid-Term – Geographic Market Expansion** - Expand into new markets through a targeted program of industry consolidation and acquisition companies.
- **Long-Term – Expand Into Related Industries** - Launch vacuum truck collection services to related non-hazardous liquid organic markets by leveraging operational logistics and management capabilities.

The three strategies are connected. The short-term goals will provide greater control over recycling and disposal options and lower costs of recycling, which will allow the Company to accelerate growth in existing markets. The resulting increased operations will increase overall efficiency in the Company's existing business, particularly in the area of infrastructure utilization. This will have a compounding positive affect on the Company's financial position. Improved financial performance will position the Company to secure additional financing for its mid-term strategy of industry consolidation through acquisitions. NCS may then apply its systems and expertise to its long-term goals

of penetrating related industries for non-hazardous liquid organic services, such as municipal source separated organics and septage. This sequential approach is illustrated below:



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.

The Company offset the erosion to the gross margin that occurred from the increase in Ontario recycling costs by increasing rates several times to Ontario based customers in the last 18 months. The Company has successfully increased customer rates in the past, but with any price increase there is a risk that the Company may lose accounts. The price increases should have a long-term positive impact on the Company's gross margin, subject to the amount of lost business.

Government Regulation

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 Company had to close most of its DLAP sites during 2005 and commence a re-permitting process. This was an extensive undertaking and the Company had limited success, with only one of the smaller Ontario DLAP sites being re-permitted. In the interim, the majority of the waste has been trucked to alternative third party disposal sites located in Quebec. 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.

In light of the recent developments in Ontario, and the Company's knowledge of organic recycling options in general, NCS believes that an AD industry is emerging in Ontario, and that it will ultimately provide a low-cost, long-term recycling solution for all of the organic residuals the Company does and can collect. As a result, the Company has decided to suspend efforts to re-permit and expand its DLAP facilities in Ontario.

The Company is actively working on a number of potential AD sites that, if successfully funded and permitted, would result in an Ontario in-province solution. This additional capacity would allow ORMI to pursue a number of long-term contracts that it is unable to acquire today because of a lack of secure and competitively priced disposal options. In most cases, the waste generated by these potential customers is being transported outside the Province at much higher costs.

The development of AD is subject to pending changes in government regulations for bringing off-farm waste (NCS' residuals) onto a farm for co-digestion. In addition, the growth of AD's in Ontario will be positively impacted by a successful implementation of the Ontario Government proposed Standard Offer Program ("SOP"). When implemented, it could encourage the development of small generators of "clean", renewable electricity by allowing them to sell into the Ontario power grid at a fixed premium. On March 21, 2006, the Government confirmed the SOP and announced the general terms under which it would proceed, which includes a long-term fixed price (20 year) contract. A key goal of the SOP is to make AD for biogas energy production financially viable in Ontario.

The Company has been forced to transport a large part of its Ontario residuals out-of-province in the last 2 years at great cost. Beginning in May 2006 this changed, and the Company began delivering the majority of its Ontario residuals to third party sites in Ontario, thereby saving significant transportation costs. However, the Company has no long-term contracts with these third party Ontario disposal sites and therefore cannot predict with certainty how long this situation will continue.

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 ("CWS") 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 had a contractual obligation to sell all of its remaining compactors to CWS at fair market value upon the expiration of the Safeway contract. Due to difficulties encountered in negotiations between CWS, Safeway and potential third party purchasers for the compactors, the Company obtained a release of the contractual

obligation from CWS during 2006. The Company is currently negotiating directly with Safeway to continue to lease or sell them the remaining compactors.

The annual rental revenue from the Safeway compactors for 2006 was \$518,000 (2005 - \$518,000). During 2006 the Company took a write-down of \$190,000 (2005 - \$322,000) reflecting the price quoted by the Company to Safeway to sell the entire fleet of compactors.

Labour

A union certification vote was held at the Toronto facility of ORMI on March 29, 2006. The majority of the approximately 25 employees at that facility voted in favour of certifying the Universal Workers Union as their representative.

At this point in time, it is not known what the outcome or impact will be with respect to labour costs as a result of the union certification at the Toronto facility. The Company is currently in collective bargaining process. NCS' operations in British Columbia have operated successfully with a unionized hourly labour force for over 30 years.

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

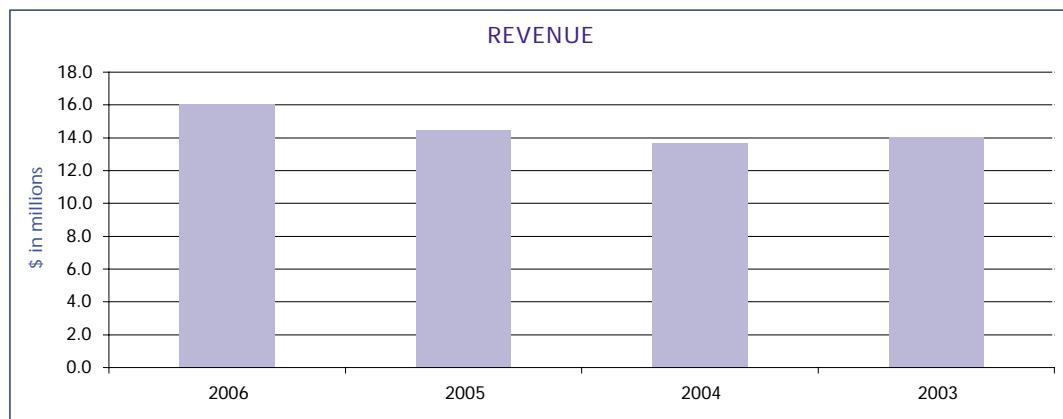
Annual Information

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 from 2003 to 2006:

<i>Four-Year Comparative Financial Information</i>	<u>2006</u>	<u>2005</u>	<u>2004</u>	<u>2003</u>
Revenue	\$ 16,031,828	\$ 14,494,091	\$ 13,677,228	\$ 14,053,175
Gross margin	4,049,693	3,614,654	3,351,773	3,682,907
Operating expenses	4,541,352	4,095,197	4,555,413	4,527,338
Non-cash expenses	2,112,891	2,089,930	2,091,295	2,852,245
Gain on disposal property, plant and equipment	-	-	66,929	101,043
Write-down goodwill	-	-	-	1,261,971
Future income tax (recovery) expense	(4,000)	(142,000)	197,000	(252,500)
Loss	(1,195,838)	(1,129,874)	(1,691,352)	(2,140,194)
Cash flows from operating activities	739,061	701,422	359,562	345,442
Working capital deficiency	(810,124)	(1,291,947)	(960,088)	(1,682,267)
Total assets	11,747,603	13,278,384	13,534,106	14,506,492
Total liabilities	8,111,240	8,539,291	7,756,333	7,787,530
Long-term debt	899,435	1,348,455	1,106,270	1,486,005
Shareholders' equity	3,636,363	4,739,093	5,777,773	6,718,962

Revenue

Revenue for the year was up 11% or \$1,538,000 from \$14,494,000 for fiscal 2005 to \$16,032,000 for 2006. Most of the increase in revenue was a result of the Company increasing rates to Ontario customers in order to offset the erosion to the gross margin that had occurred from the increase in disposal costs.



Gross Margin & Operating Expenses

The Company continues with systems development and the integration required to effectively manage its operations and embark upon its growth strategy. During the third quarter, the Company successfully equipped all its field service technicians with wireless handheld units at the Toronto facility using NCS' proprietary handheld software. The most significant benefits of this new handheld technology for NCS are the elimination of the more than 75,000 paper work orders annually and the ability to deliver electronic work orders anywhere, anytime via wireless technology. NCS should realize a direct cost saving associated with the elimination of paper and the handling that goes with it, but more importantly, this will allow NCS to deploy its workforce throughout North America from its existing Woodbridge logistics call center location.

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 Company was forced to continue using higher cost third party recycling alternatives including transporting material out of province to recycling sites. Consequently, waste recycling costs have increased significantly for two years in a row and were up 22% in 2006 over 2005 (2005 compared to 2004 – 88%).

The total gross margin improved by \$435,000 or 12%, from \$3,615,000 in 2005 to \$4,050,000 in 2006. The increased waste disposal costs for the year were offset by the increase in customer rates.

Selling, general and administrative expenses were up \$464,000 or 19%, from \$2,469,000 in 2005 to \$2,933,000 in 2006. The increase was the result of increased banking and audit fees related to the Company's new asset based lending facility, expenses related to the investigation of AD and a one-time provincial sales tax credits that occurred in 2005.

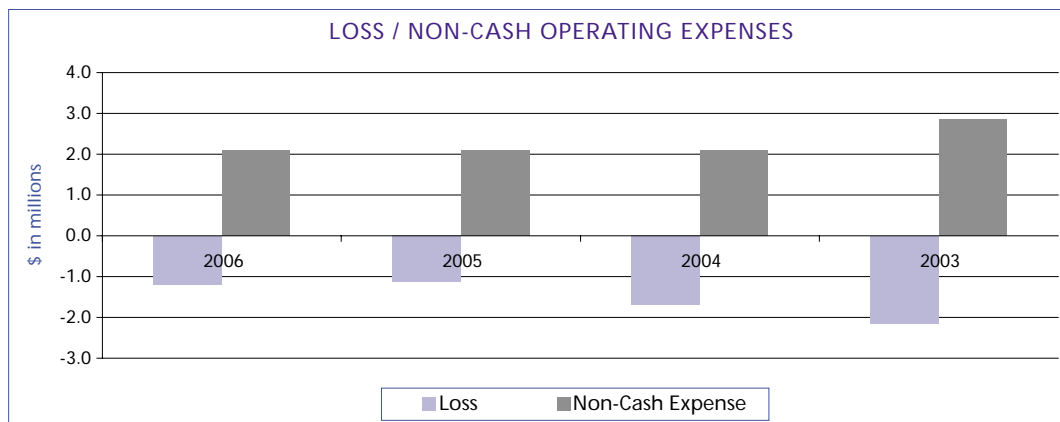
The Company continues to have large non-cash expenses including amortization of intangible assets related to the acquisition of ORMI and A&A. The amortization of these intangible assets was \$969,000 in both 2006 and 2005. Other than \$100,000 per year until 2017 related to patent license agreements, these intangibles will be written down to zero by May 31, 2007.

Included in non-cash expenses for 2006 is the \$190,000 (2005 - \$322,000) write down of property, plant and equipment related to compactors.

<i>Non-Cash Expenses</i>	<u>2006</u>	<u>2005</u>	<u>2004</u>	<u>2003</u>
Amortization of property, plant & equipment	\$ 606,859	\$ 606,531	\$ 591,743	\$ 585,218
Write down of property, plant & equipment	189,514	322,460	-	-
Amortization of intangibles	969,064	969,064	969,064	1,170,334
Write-down of goodwill	-	-	-	1,261,971
Dividends accrued on preferred shares	318,853	283,298	189,192	240,000
Share based compensation	55,348	110,431	152,384	-
Foreign exchange gain	(22,747)	(59,854)	(8,088)	(152,778)
Future income taxes	(4,000)	(142,000)	197,000	(252,500)
	\$ 2,112,891	\$ 2,089,930	\$ 2,091,295	\$ 2,852,245

Income Taxes & Net Loss

The net loss for the year was \$1,196,000 up \$66,000 from \$1,130,000 in 2005. The future income tax recovery decreased by \$138,000, from \$142,000 in 2005 to \$4,000 in 2006. The future income tax recovery is 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 of \$2,020,000 (2005 - \$1,997,000) that have not been recognized and if sufficient improvement in income occurs, they may be recorded if they are more likely than not to be realized.



Quarterly Review

In the third quarter of 2005, the Company increased rates to most of the Ontario customers in order to offset the erosion to the gross margin that had occurred from the increase in recycling costs. As a result, the revenue for the first three quarters of fiscal 2006 is 15% more than the revenue for the comparable three quarters in 2005.

Financial Information - Eight Quarter Summary

(in 000's except earnings per share)

	Fourth Quarter Ending June 30th		Third Quarter Ending March 31		Second Quarter Ending Dec 31st		First Quarter Ending Sept 30th	
	<u>2006</u>	<u>2005</u>	<u>2006</u>	<u>2005</u>	<u>2006</u>	<u>2005</u>	<u>2006</u>	<u>2005</u>
Revenues	\$ 3,955	\$ 3,968	\$ 4,103	\$ 3,751	\$ 4,008	\$ 3,446	\$ 3,966	\$ 3,329
Net loss	(268)	(355)	(398)	(179)	(305)	(299)	(225)	(297)
Cash flows from operating activities	192	383	395	55	(237)	30	389	233
Loss per share, basic and fully diluted	(0.01)	(0.01)	(0.01)	(0.00)	(0.01)	(0.01)	(0.00)	(0.01)

The increasing loss through the first three quarters of 2006 reflects the ongoing increasing costs of recycling organic residuals. In the fourth quarter of 2006 this trend reversed as the revenue quality improved with additional rate increases and disposal costs dropped with the Company's ability to take some of its waste to third-party facilities in Ontario.

The \$268,000 net loss for the fourth quarter of 2006 was impacted by the \$190,000 (2005 - \$322,000) write down of property, plant and equipment related to compactors. This is a non-cash item.

Adjusted net earnings excluding non-cash expenses as displayed in the table below is a non-GAAP measure and does not have any standardized meaning prescribed by GAAP and is therefore unlikely to be comparable to similar measures presented by other issuers. It should not be construed as an alternative to net earnings or cash flow from operating activities determined in accordance with GAAP.

Adjusted net loss excluding non-cash expenses is a measure of NCS' ability to earn cash and is intended to be a measure that is representative of NCS' operating performance. Adjusted net loss excluding non-cash expenses appears on the Consolidated Statement of Cash Flows as a subtotal and is the sum of the net loss and items not involving cash.

Fourth Quarter 2006

Adjusted net earnings excluding non-cash expenses (in 000's)

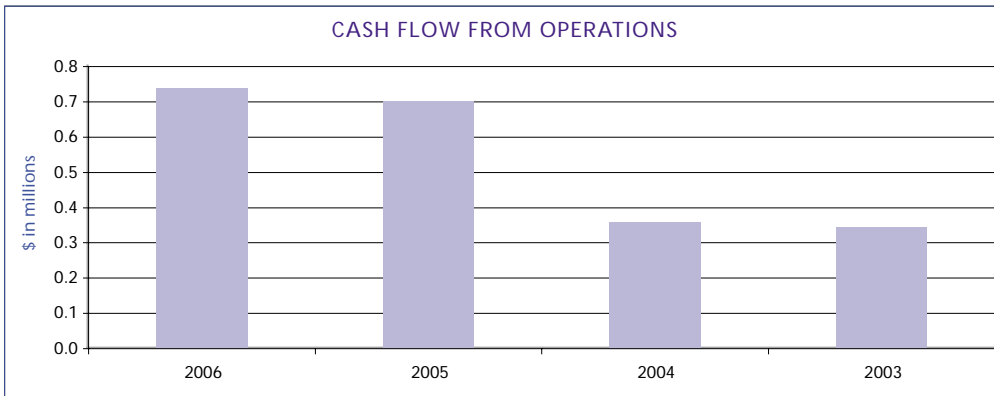
	Fourth Quarter		Third Quarter		Second Quarter		First Quarter	
	Ending June 30th	2005	Ending March 31	2005	Ending Dec 31st	2005	Ending Sept 30th	2005
Net loss	(268)	(355)	(398)	(179)	(305)	(299)	(225)	(297)
Non-cash expenses	696	662	472	491	478	487	467	450
Adjusted net earnings excluding non-cash expenses	428	307	74	312	173	188	242	153
Changes in operating assets and liabilities	(236)	76	321	(257)	(410)	(158)	147	80
Cash flows from operating activities	192	383	395	55	(237)	30	389	233

Revenue for the fourth quarter of 2006 was \$3,955,000 almost unchanged from the same quarter in 2005. During the quarter prices were increased to Ontario customers to reverse the deteriorating gross margin caused by the increasing costs of recycling. During the fourth quarter of 2006, the Company's largest industrial account significantly reduced their service after having made a major capital investment to their waste handling process. The majority of ORMI's residuals are collected from small volume generators that cannot make an economic argument to invest in capital to reduce the limited volumes of residuals they produce. The lost revenue was offset by the higher customer rates and new business.

The gross margin was improved by 26% or \$252,000 for the fourth quarter, from \$959,000 in 2005 to \$1,211,000 in 2006. As a percentage of revenue the gross margin in the fourth quarter was 30.6% for 2006 compared to 24.1% for 2005. The significant improvement in gross margin over last year reflects the impact of reduced transportation costs in the fourth quarter because of the Company's ability to take some of its residuals to third-party facilities in Ontario, as well as increased customer rates in Ontario.

The net loss for the fourth quarter of 2006 was \$268,000 compared to a net loss of \$355,000 in the fourth quarter of 2005. During the fourth quarter of 2006 the Company recorded a \$190,000 (2005 - \$322,000) write down of property, plant and equipment related to compactors. There was also a future tax recovery of \$4,000 recorded in the fourth quarter of 2006 compared to \$142,000 recorded in the fourth quarter of 2005.

Balance Sheet & Cash Flow



Accounts receivable had a small decrease of \$70,000 from \$2,297,000 at June 30, 2005 to \$2,227,000 at June 30, 2006. Accounts payable decreased \$374,000 from \$2,357,000 at June 30, 2005 to \$1,983,000 at June 30, 2006. The decrease reflects an improvement in the payment cycle to the Company's vendors.

During the year long-term debt was reduced by \$426,000 (2005 - \$337,000) being primarily the repayment of the note secured by the compactors. The note will be fully paid by October 2006.

Cash flows from operating activities increased \$38,000 from \$701,000 for 2005 compared to \$739,000 for 2006.

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 of 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 intangible 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 2006 and 2005, the Company did not record an impairment charge related to intangible 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 2006 and 2005, 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 2006 the Company recorded an impairment loss of \$190,000 (2005 - \$322,000) 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 to be realized and would be recorded in the period such a determination was 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 flows from operating activities increased \$38,000 from \$701,000 for 2005 compared to \$739,000 for 2006.

On June 14, 2005 the Company entered into a \$2 million revolving credit facility for a 3-year term with Textron Financial. The Textron loan increased by \$93,000 from \$1,125,000 at June 30, 2005 to \$1,218,000 at June 30, 2006. However the Company's cash position also increased by \$80,000 from \$147,000 at June 30, 2005 to \$227,000 at June 30, 2006.

On August 31, 2004, ORMI purchased the Toronto facility that it had rented since 1992. The purchase price of the land and building was \$901,000 of which \$281,000 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 last year the Company's capital expenditures decreased by \$918,000 from \$1,223,000 in 2005 to \$305,000 in 2006. The financing of trucks and equipment is primarily through capital and operating leases. Subsequent to year end the Company entered into capital leases with terms ranging from 4 to 5 years in the amount of \$249,000 to purchase trucks assets. The funding of the software, \$77,000 in 2006 and

\$225,000 in 2005 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	\$ 228,495	\$ 126,139	\$ 544,801	\$ -	\$ 899,435
Capital lease obligations	150,420	92,846	45,219	-	288,485
Operating leases	260,392	255,996	90,173	-	606,561
	\$ 639,307	\$ 474,981	\$ 680,193	\$ -	\$ 1,794,481

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 20, 2006 the following is the outstanding share data:

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

<i>Shares</i>	<u>Issued</u>	<u>Amount</u>
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	-	887,799
	2,948,000	\$ 3,835,799
Common	40,133,573	\$ 11,743,933

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 2005 or 2006. The cumulative dividends in arrears on the Class A preferred shares as at June 30, 2006 is \$811,343 compared to \$492,490 at June 30, 2005. The financial liability for the preferred shares reflected in the June 30, 2006 consolidated financial statements includes these dividends, though they have not been declared as payable by the Board of Directors. No dividends may be paid on any other class of shares until these shares have been redeemed.

The Class B preferred shares are not entitled to dividends and 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 license 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: (i) gives NCS ESL the right to market Software licenses to third parties for use in its industry worldwide (excluding Canada); and (ii) 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 ORRS and 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>	<u>2006</u>	<u>2005</u>
Consulting fees	\$ -	\$ -
Software development cost	9,234	223,000
Interest expense	12,776	14,581
Dividends on preferred shares	318,853	283,298
Rent expense	-	-

Accounts payable as at June 30, 2006 includes amounts payable to certain directors and/or companies controlled by them totalling \$52,251 (2005 - \$195,172). Long-term debt includes a note payable to a related party for \$104,662 (2005 - \$188,391). 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 note payable to a company owned by certain directors for \$93,636 (2005 - \$87,977) repayable in 24 blended monthly instalments of principal and interest of \$4,292 commencing January 2007 and maturing 2008.

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.

MANAGEMENT'S RESPONSIBILITY FOR FINANCIAL REPORTING

The consolidated financial statements and other financial information for this annual report were prepared by the management of National Challenge Systems Inc., reviewed by the Audit Committee and approved by the Board of Directors.

Management is responsible for the preparation of the consolidated financial statements and believes that they fairly present the Company's financial position, the results of its operation and its cash flows in accordance with Canadian generally accepted accounting principles. Management has included amounts in the Company's consolidated financial statements based on estimates, judgements and policies that it believes reasonable in the circumstances.

In fulfilling its responsibilities for financial reporting and the safeguarding of assets, management has designed such internal controls over financial reporting to provide reasonable assurance regarding the reliability of financial reporting and the preparation of these financial statements. There are no changes in the Company's internal control over financial reporting that occurred during the Company's most recent interim period that has materially affected, or is reasonably likely to materially affect, the Company's control over financial reporting.

National Challenge Systems Inc. has a formal policy on Corporate Disclosure approved by the Board on September 1, 2005. The Chief Executive Officer and the Chief Financial Officer have evaluated the effectiveness of the Company's disclosure controls and procedures as at June 30, 2006. They have concluded that the Company's disclosure controls and procedures were effective, at a reasonable assurance level, to ensure that material information relating to the Company would be made known to them by others within the Company, particularly during the period in which the management discussion and analysis and the consolidated financial statements contained in this report were prepared.



Charles H. Buehler
Chief Executive Officer



Ian R. Kelland, C.A.
VP Operations & CFO

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, 2006 and 2005 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 consolidated financial statements present fairly, in all material respects, the financial position of the Company as at June 30, 2006 and 2005 and the results of its operations and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

A handwritten signature in cursive script that reads "Grant Thornton LLP".

Grant Thornton LLP
Chartered Accountants
Toronto, Ontario
August 25, 2006

NATIONAL CHALLENGE SYSTEMS INC.

CONSOLIDATED BALANCE SHEETS		
JUNE 30, 2006 AND 2005		
	2006	2005
ASSETS		
CURRENT		
Cash	\$ 227,302	\$ 147,082
Accounts receivable, note 3	2,226,910	2,296,919
Inventory	151,667	179,245
Prepaid expenses	145,734	206,786
	2,751,613	2,830,032
PROPERTY PLANT AND EQUIPMENT, note 4	2,724,391	3,178,743
INTANGIBLE ASSETS, note 5	1,888,309	2,857,372
GOODWILL, note 6	3,817,849	3,817,849
FUTURE INCOME TAXES, note 7	505,000	501,000
DEFERRED FINANCING COSTS, net of accumulated amortization	60,441	93,388
	\$ 11,747,603	\$ 13,278,384
LIABILITIES		
CURRENT		
Revolving loan, note 8	\$ 1,217,865	\$ 1,125,495
Accounts payable and accrued liabilities, note 15 (b)	1,983,102	2,357,494
Current portion long-term debt, note 9	228,495	532,620
Current portion of obligations under capital lease, note 10	132,275	106,370
	3,561,737	4,121,979
LONG-TERM DEBT, note 9	670,940	815,835
OBLIGATIONS UNDER CAPITAL LEASE, note 10	119,220	160,987
	790,160	976,822
REDEEMABLE PREFERRED SHARES, note 11	3,759,343	3,440,490
	4,549,503	4,417,312
SHAREHOLDERS' EQUITY		
COMMON SHARES, note 12	11,743,933	11,681,173
CONTRIBUTED SURPLUS, note 13	190,380	160,032
DEFICIT	(8,297,950)	(7,102,112)
	3,636,363	4,739,093
	\$ 11,747,603	\$ 13,278,384

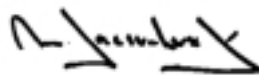
Commitments, note 14

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, 2006 AND 2005**

	2006	2005
REVENUES		
Non hazardous vacuum services	\$ 15,409,763	\$ 13,890,558
Compactor rental income	518,005	518,005
Compactor sales, service & other	104,060	85,528
	16,031,828	14,494,091
COST OF SALES	11,982,135	10,879,437
GROSS MARGIN	4,049,693	3,614,654
OPERATING EXPENSE (INCOME)		
Selling, general and administrative	2,932,828	2,469,025
Amortization of property, plant and equipment	606,859	606,531
Amortization of intangible assets	969,064	969,064
Share based compensation	55,348	110,431
Foreign exchange gain	(22,747)	(59,854)
	4,541,352	4,095,197
LOSS BEFORE THE UNDERNOTED AND INCOME TAXES	(491,659)	(480,543)
OTHER EXPENSES		
Write-down of property, plant and equipment, note 4	189,514	322,460
Interest on long-term debt and obligations under capital lease	103,617	137,800
Other interest	96,195	47,773
Dividends on preferred shares	318,853	283,298
	708,179	791,331
LOSS BEFORE INCOME TAXES	(1,199,838)	(1,271,874)
FUTURE INCOME TAXES, note 7	(4,000)	(142,000)
NET LOSS	(1,195,838)	(1,129,874)
DEFICIT, BEGINNING OF YEAR	(7,102,112)	(5,972,238)
DEFICIT, END OF YEAR	\$ (8,297,950)	\$ (7,102,112)
LOSS PER SHARE, BASIC AND DILUTED, note 16	\$(0.03)	\$(0.03)

See accompanying notes to consolidated financial statements.

NATIONAL CHALLENGE SYSTEMS INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS YEARS ENDED JUNE 30, 2006 AND 2005		
	2006	2005
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net loss for the year	\$ (1,195,838)	\$ (1,129,874)
Add (deduct) items not involving cash		
Amortization of property, plant and equipment	606,859	606,531
Write down of property, plant and equipment	189,514	322,460
Amortization of intangible assets	969,064	969,064
Dividends accrued on preferred shares	318,853	283,298
Share based compensation	55,348	110,431
Foreign exchange gain	(22,747)	(59,854)
Future income taxes	(4,000)	(142,000)
	917,053	960,056
Changes in operating assets and liabilities:		
Decrease (increase) in accounts receivable, net	70,009	(680,767)
Decrease in inventory	27,578	25,593
Decrease in prepaid expenses	61,052	11,416
(Decrease) increase in accounts payable and accrued liabilities	(336,631)	463,576
Decrease in income taxes payable	-	(78,452)
CASH FLOWS FROM OPERATING ACTIVITIES	739,061	701,422
CASH FLOWS FROM INVESTING ACTIVITIES:		
Acquisition of property, plant and equipment	(203,997)	(1,222,534)
	(203,997)	(1,222,534)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Advances (repayment) of revolving loan	92,370	(48,546)
Proceeds of long-term debt	-	639,469
Repayment of long-term debt	(426,273)	(337,430)
Repayment of capital lease obligation	(116,427)	(98,341)
Payment of deferred financing costs	(4,514)	(83,044)
	(454,844)	72,108
INCREASE (DECREASE) IN CASH DURING THE YEAR	80,220	(449,004)
CASH BEGINNING OF YEAR	147,082	596,086
CASH END OF YEAR	\$ 227,302	\$ 147,082
Supplemental cash flow information		
Interest paid	\$ 199,812	\$ 185,573
Income taxes paid	-	78,452
Non-cash transactions		
Capital assets acquired through capital leases	\$ 90,508	\$ -

See accompanying notes to consolidated financial statements.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
JUNE 30, 2006 AND 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 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 writeoff the assets as follows:

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.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
 JUNE 30, 2006 AND 2005

2. SIGNIFICANT ACCOUNTING POLICIES (cont'd)

(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 cost. Cost 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

(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 2006 the Company recorded an impairment loss of \$189,514 (2005 - \$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, 2006.

(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 September 30, 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.

(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.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
JUNE 30, 2006 AND 2005

2. SIGNIFICANT ACCOUNTING POLICIES (cont'd)

(k) Stock-based compensation plan

The Company has a stock option plan, as described in note 12 (f), 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

	2006	2005
Trade	\$ 2,193,633	\$ 2,233,458
Other	49,954	81,237
	2,243,587	2,314,695
Less allowances for doubtful accounts	(16,677)	(17,776)
	\$ 2,226,910	\$ 2,296,919

4. PROPERTY, PLANT AND EQUIPMENT

	2006			2005		
	Cost	Accumulated Amortization	Net	Cost	Accumulated Amortization	Net
Land	\$ 263,500	-	\$ 263,500	\$ 263,500	-	\$ 263,500
Building	656,623	47,568	609,055	639,025	15,976	623,049
Rental machines	2,514,904	1,919,404	595,500	2,514,904	1,599,054	915,850
Vehicles	2,905,484	2,733,739	171,745	2,905,483	2,659,649	245,834
Vehicles under capital lease	530,535	313,115	217,420	429,970	241,485	188,485
Office furniture, equipment and computers	998,374	783,154	215,220	948,869	735,537	213,332
Office equipment under capital lease	79,913	33,883	46,030	79,914	22,376	57,538
Software	760,962	384,884	376,078	684,442	240,451	443,991
Machinery and equipment	693,673	513,862	179,811	633,300	476,456	156,844
Leasehold improvements	22,866	20,862	2,004	52,811	46,234	6,577
Farm storage units	157,145	109,117	48,028	157,145	93,402	63,743
	\$ 9,583,979	\$ 6,859,588	\$ 2,724,391	\$ 9,309,363	\$ 6,130,620	\$ 3,178,743

Amortization of property, plant and equipment includes \$83,137 (2005 - \$95,164) 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 \$189,514 (2005 - \$322,460) relating to compactor rental machines based on a quoted market price.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
JUNE 30, 2006 AND 2005

5. INTANGIBLE ASSETS

	2006			2005		
	Cost	Accumulated Amortization	Net	Cost	Accumulated Amortization	Net
Software license agreement	\$ 3,000,000	\$ 2,450,000	\$ 550,000	\$ 3,000,000	\$ 1,850,000	\$ 1,150,000
Customer relationships	1,550,000	1,303,358	246,642	1,550,000	1,034,294	515,706
Patent license agreements	1,500,000	408,333	1,091,667	1,500,000	308,333	1,191,667
	\$ 6,050,000	\$ 4,161,691	\$ 1,888,309	\$ 6,050,000	\$ 3,192,627	\$ 2,857,373

(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. 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.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
JUNE 30, 2006 AND 2005

6. GOODWILL

	2006	2005
ORMI, cost	\$ 2,434,793	\$ 2,434,793
A&A, cost net of cumulative provision for impairment of \$1,261,971, recorded in 2003	1,383,056	1,383,056
	3,817,849	3,817,849

The annual goodwill impairment test confirmed no impairment loss for either 2006 or 2005.

7. INCOME TAXES

(a) Provision for taxes

The income tax expense (recovery) included in the consolidated statements of operations differs from the statutory income tax rate as follows:

	2006	2005
Statutory income tax rate	36.12%	36.12%
Income tax recovery based on the statutory income tax rate	\$ (433,000)	\$ (459,000)
Tax effect of non-deductible and other items	210,000	233,000
Tax effect of losses and temporary differences utilized and not previously recorded	53,000	31,000
Effect of tax rate changes	143,000	-
Valuation allowance	23,000	53,000
Provision for income taxes	\$ (4,000)	\$ (142,000)

(b) Future tax asset

Future income tax assets consist of the following temporary differences:

	2006	2005
Excess of capital cost for tax purposes over net book value of capital assets at statutory tax rate	\$ 1,130,000	\$ 737,000
Loss carryforwards at statutory tax rate	1,395,000	1,761,000
	2,525,000	2,498,000
Deduct valuation allowance	(2,020,000)	(1,997,000)
Future income tax asset	\$ 505,000	\$ 501,000

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
 JUNE 30, 2006 AND 2005

7. INCOME TAXES (cont'd)

(c) Non-capital losses

Management believes that 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.

The right to apply non-capital losses of approximately \$4,100,000 included in the disclosure of future income tax assets above, against taxable income of future years generally expires as follows:

2006	\$	89,000	
2007		36,000	
2008		26,000	
2009		1,444,000	
2010		2,389,000	
2014		22,000	
2015		94,000	
		4,100,000	
\$		4,100,000	

8. REVOLVING LOAN

The Company has access to a revolving credit facility with Textron Financial Canada Ltd. to a limit of \$2,000,000; advances bearing interest at the Royal Bank of Canada's prime commercial lending rate plus 2%. 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, equal to the sum of shareholders' equity and redeemable preferred shares less prepaid expenses, intangible assets, goodwill, future income taxes and deferred financing costs, 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, 2006 AND 2005

9. LONG-TERM DEBT

	2006	2005
(a) 10% U.S. dollar promissory note payable in blended monthly instalments of principal and interest of \$23,160 U.S. maturing in 2006; compactor rental equipment with a net book value of \$595,000 and the assignment of certain rental revenue receipts, have been provided as security.	\$ 101,179	\$ 448,194
(b) 6.25% note payable in 24 blended monthly instalments of principal and interest of \$4,292 commencing January 2007 and maturing in December 2008.	93,636	87,977
(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 monthly instalments of \$6,977, maturing September 2007. Certain vehicles with a net book value of \$56,491 have been provided as security.	104,662	188,391
(d) 8% per annum calculated half-yearly for mortgage payable in blended monthly instalments of principal and interest of \$5,136, maturing in November 2009.	594,772	608,981
(e) 8.63% notes payable in blended monthly instalments of principal and interest of \$886, maturing in January 2007.	5,186	14,911
	899,435	1,348,455
Less current portion	(228,495)	(532,620)
	\$ 670,940	\$ 815,835

Long-term debt due in each of the next four years is as follows:

2007	\$ 228,495
2008	85,833
2009	40,306
2010	544,801
	\$ 899,435

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
 JUNE 30, 2006 AND 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:

2007	\$	150,420
2008		64,331
2009		28,515
2010		23,592
2011		21,627
Total minimum lease payments		288,485
Less amount representing interest at rates from 5% to 10.4%		(36,990)
Balance of obligation		251,495
Less current portion		(132,275)
		\$ 119,220

11. REDEEMABLE PREFERRED SHARES

(a) Authorized

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

An unlimited number of preferred shares issuable in series.

(b) 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, 2006 is \$811,343 (2005 - \$492,490). No dividends may be paid on any other class of shares until these shares have been redeemed.

(c) 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.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
JUNE 30, 2006 AND 2005

11. REDEEMABLE PREFERRED SHARES (cont'd)

	2006		2005	
	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
	2,948,000	2,948,000	2,948,000	2,948,000
Class A accrued dividends	-	811,343	-	492,490
	2,948,000	\$ 3,759,343	2,948,000	\$ 3,440,490

The specific conversion provisions of the Class A and B preferred shares, which allow the holder to receive a number of common shares which varies based on the redemption value and accrued dividends of the preferred shares, result in classification of the preferred shares as a financial liability. The financial liability includes accrued dividends, notwithstanding that the Board of Directors has not declared these dividends.

12. COMMON SHARES

(a) Common shares

Authorized 100,000,000; issued as follows:

	Number of Shares		Book Value	
	2006	2005	2006	2005
Opening balance	39,642,323	34,147,323	\$ 11,681,173	\$ 11,003,150
Private placement	-	5,040,000	-	613,000
Employee share compensation	300,000	310,000	45,000	46,500
Directors' compensation	191,250	145,000	17,760	18,523
Closing balance	40,133,573	39,642,323	\$ 11,743,933	\$ 11,681,173

(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.

(d) Directors' compensation plan

Non-management directors are compensated for Board and Committee meetings in cash or through the issuance of common shares at the Company's discretion. 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.

NATIONAL CHALLENGE SYSTEMS INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
JUNE 30, 2006 AND 2005

12. COMMON SHARES (cont'd)

(e) Warrants outstanding

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

Expiry Date	Exercise Price	Number of Shares	
		2006	2005
July 11, 2005	\$0.20	-	2,520,000
June 29, 2007	\$0.20	100,000	100,000
		100,000	2,620,000

(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 and vesting period. 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, 2006 there were 4,023,000 options outstanding with exercise prices ranging from \$0.13 to \$0.63, and average remaining life of 1.5 years. 3,378,000 of the options have vested.

Option activity for each of the years ending June 30, 2006 and 2005 is as follows:

	Weighted Average Exercise Price		Number of Options	
	2006	2005	2006	2005
Opening balance	\$0.21	\$0.23	4,265,000	3,630,000
Granted	0.14	0.19	475,000	760,000
Expired	0.27	0.68	(717,000)	(125,000)
Closing Balance	\$0.19	\$0.21	4,023,000	4,265,000

Weighted average characteristics of options outstanding at June 30, 2006 are as follows:

Range of Exercise Prices	Outstanding Options		Exercisable Options		Weighted Average Remaining Life Years
	Number at July 1, 2010	Weighted Average Exercise Price	Number at July 1, 2010	Weighted Average Exercise Price	
\$0.13 - \$0.20	3,290,000	\$0.16	2,645,000	\$0.16	1.6
\$0.30 - \$0.43	675,000	0.34	675,000	0.34	1.3
\$0.55 - \$0.63	58,000	0.63	58,000	0.63	0.1
	4,023,000	\$0.19	3,378,000	\$0.20	1.5

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
JUNE 30, 2006 AND 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 grant using the Black-Scholes option pricing model based on the following weighted average assumptions:

	2006	2005
Number of options granted	475,000	760,000
Fair value	\$ 0.07	\$ 0.03
Assumptions		
Risk free interest rate	3.6%	3.6%
Average expected life in years	3.6	4.1
Expected dividend yield	0%	0%
Volatility	70%	60%

13. CONTRIBUTED SURPLUS

	2006	2005
Balance beginning of year	\$ 160,032	\$ 133,861
Value of stock-based compensation	30,348	26,171
Balance end of year	\$ 190,380	\$ 160,032

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:

2007	\$ 260,392
2008	141,741
2009	114,255
2010	83,237
2011	6,936
	\$ 606,561

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

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
JUNE 30, 2006 AND 2005

14. COMMITMENTS (cont'd)

(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:

	2006	2005
Software development cost	\$ 9,234	\$ 223,000
Interest expense	12,776	14,581
Dividends on preferred shares	318,853	283,298

(b) Accounts payable and accrued liabilities

Includes amounts payable as at June 30, 2006 to certain directors and/or companies controlled by them totaling \$52,251 (2005 - \$195,172).

(c) Long-term debt

Includes a note payable to a related party for \$104,662 (2005 - \$188,391). 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 note payable to a company owned by certain directors for \$93,636 (2005 - \$87,977), repayable in 24 blended monthly installments of principal and interest of \$4,292 commencing January 2007 and maturing in December 2008.

(d) Patent license agreement

Pursuant to patent license agreements with companies related to directors of the Company as described in note 5 (c), the Company has use of patent products at a minimum annual patent license fee of \$25,000. The charges for 2006 and 2005 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 39,789,250 and 39,256,748 for the years ended June 30, 2006 and 2005, respectively.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
 JUNE 30, 2006 AND 2005

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
Long-term debt	Fixed and floating rates
Obligations under capital lease	Fixed 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 \$90,743 U.S. and \$365,693 U.S. at June 30, 2006 and 2005, respectively.

(d) Fair value

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

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 and accounts payable and accrued liabilities.

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.

19. SUBSEQUENT EVENT

Subsequent to year end, the Company entered into capital leases in the amount of \$249,000 to purchase truck assets, with terms ranging from 4 to 5 years.

CORPORATE DIRECTORY

Board of Directors

Dr. Robert A. Bandeen

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

Charles H. Buehler

Vice-Chairman and CEO,
National Challenge Systems Inc.

Donald R. Carse, Jr.¹

Former CFO, National Challenge Systems Inc.

Douglas M. Carruthers

President, National Challenge Systems Inc.

Frank Facto^{2,3}

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

Martin Fallick^{2,3}

Former President, Fairway Canadian Express

Matthew Gaasenbeek^{1,2}

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

Ian London^{1,3}

Former CEO, Process Products Limited
Former Senior Vice President, Corporate Business
Development Ontario Hydro
Former President & CEO, Ontario Hydro International

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

¹Member Audit Committee

²Member Compensation Committee

³Member Corporate Governance Committee

CORPORATE INFORMATION

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Toronto, Ontario M5J 2T3

Transfer Agent

Pacific Corporate Trust Company

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Vancouver, B.C. V6C 3B9

Stock Information

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

Investor Inquiries

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Investor Relations

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Also visit National Challenge's IR HUB at <http://www.agoracom.com/IR/NationalChallenge>.

Annual Meeting of Shareholders

The Annual Meeting of the Shareholders will be held on October 24, 2006 at 4:00 p.m. at:

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

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