

# **NATIONAL CHALLENGE SYSTEMS INC.**

FORM 51-102F2  
ANNUAL INFORMATION FORM  
FOR FISCAL YEAR ENDED  
JUNE 30, 2006

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*All disclosure is made as of September 20, 2006, unless otherwise indicated.*

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## **ITEM 1 CORPORATE STRUCTURE**

### **1.01 Name and Address of Head Office**

National Challenge Systems Inc.

3700 Steeles Avenue West  
Suite 601  
Woodbridge, Ontario  
L4L 8K8  
Phone: (905) 264-7700  
Facsimile: (905) 264-7273  
Website: [www.nationalchallenge.com](http://www.nationalchallenge.com)

### **1.02 Incorporation**

National Challenge Systems Inc. (“NCS” or the “Company”) was incorporated on January 4, 1990 under the laws of the Province of British Columbia by registration of its Memorandum and Articles pursuant to the Company Act (British Columbia). Effective September 30, 2003, the Company completed its continuance from a corporation under the Business Corporations Act of British Columbia to being a corporation under the Canada Business Corporations Act. The Company’s registered and records offices are located at 3700 Steeles Avenue West, Suite 601, Woodbridge, Ontario L4L 8K8.

The Company’s shares were listed on the Vancouver Stock Exchange on July 12, 1994 (now the Canadian Venture Exchange) and subsequently on the Toronto Stock Exchange (under the trading symbol “NLC”) on January 7, 1998 where it now trades exclusively.

### **1.03 Subsidiaries**

The Company currently has the following wholly owned subsidiaries:

#### **(a) Active**

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

A&A was incorporated under the laws of British Columbia as 352505 BC Ltd. on January 1, 1989 and subsequently changed its name on January 3, 1989 to A&A Anderson Tank Service (Vancouver) Ltd. A&A is a provider of non-hazardous vacuum truck and related services including the collection, transportation and disposal/recycling of non-hazardous and organic wastes. The Company acquired A&A on May 31, 2002.

##### **(ii) Organic Resource Management Inc. (“ORMI”)**

On April 30, 1984, Filtrex Sales & Services Ltd. was incorporated under the laws of Ontario. On September 30, 1992, its name was changed to Organic Resource Management Inc. ORMI is a provider of non-hazardous vacuum truck and related services including the collection, transportation and disposal/recycling of non-hazardous and organic wastes. The Company acquired ORMI on May 31, 2002. ORMI amalgamated with a former subsidiary of the Company, National Challenge Systems (Ontario) Inc., on July 1, 2002.

#### **(b) Inactive:**

##### **(i) NCS Holdings Limited (“Holdings”)**

Holdings was incorporated in Bermuda on March 4, 1999. The Company is currently inactive. Holdings owns 70% of the common shares of NCS Environmental Services Limited (“NCS ESL”), a company incorporated in Bermuda, which although currently inactive, has certain Software and Marketing Agreements for the world, excluding Canada, that will be applicable to the Company as it pursues its expansion plans in the United States.

National Challenge Systems Inc.		
A&A Anderson Tank Services (Vancouver) Ltd. 100%	Organic Resource Management Inc. 100%	NCS Holdings Limited 100%
		NCS Environmental Services Limited 70%

## ITEM 2 GENERAL DEVELOPMENT OF THE BUSINESS

The primary operations of the Company since May 31, 2002 consists of operating vacuum truck fleets that provide collection, treatment and disposal services for non-hazardous liquid waste and other related services. Through its two wholly owned subsidiaries, ORMI and A&A, NCS is Canada's largest provider of vacuum truck services for the collection, treatment and disposal of organic and other non-hazardous liquid waste. NCS services more than 8,000 commercial, industrial, institutional and residential customers in Ontario, Quebec, and British Columbia. Its core focus is on the utilization of leading edge, proprietary, information, and operating technologies to provide regularly scheduled, repetitive, and dispatched services, primarily to the foodservice and food production industries.

### 2.01 Compactor History

Prior to March 31, 2002, the Company's primary business was the ownership, rental and distribution of waste compaction, baling and container equipment for disposing of waste ("Compactors"). Effective March 31, 2002, the Company divested 92% of its Compactor assets and incurred a substantial loss as a result. On May 31, 2002, the Company acquired ORMI and A&A and thereby entered the non-hazardous liquid waste business.

The Company commenced operations in January 1990 as a distributor of waste handling and compaction equipment manufactured by Marathon Equipment Company ("Marathon") of Vernon, Alabama and was appointed as a Marathon distributor on June 22, 1993. Through a series of transactions in 1998, the Company purchased solid waste compactors from Canadian Waste Services Inc ("CWS") for approximately \$12 million and entered into a 10-year subcontracting arrangement with CWS whereby the Company rented its compactor assets to CSW customers. In 2001 CWS informed the Company that it did not intend to renew its subcontracting agreements when they expired and that it intended to resume providing compactor rental services to its customers at that time. In March 2002, the Company sold to CSW the vast majority of its compactor fleet located in Western Canada, Ontario and Quebec for cash consideration of slightly in excess of \$8,000,000 resulting in a loss of \$5,156,861.

The Company retains 195 compactors located in Western Canada. The remaining compactors are all rented directly to Canada Safeway Limited ("Safeway") under a contract expiring on September 30, 2006.

### 2.02 Vacuum Trucks & Non-hazardous Liquid Organic Waste – Canada

On May 31, 2002 the Company acquired 100% of the issued and outstanding shares of ORMI and A&A.

	ORMI	A&A	Total
<b>Net assets acquired</b>			
Current assets	1,073,966	845,456	1,919,422
Capital assets	377,218	699,847	1,077,065
Intangible assets	5,590,000	460,000	6,050,000
Goodwill	2,434,793	2,645,027	5,079,820
Current liabilities	(1,288,941)	(414,165)	(1,703,106)
Long-term debt	-	(449,770)	(449,770)
Future income taxes	-	(11,000)	(11,000)
	<u>8,187,036</u>	<u>3,775,395</u>	<u>11,962,431</u>
<b>Consideration given</b>			
Cash	1,622,000	1,559,500	3,181,500
Short-term promissory notes	200,000	290,000	490,000
Preferred shares series A	1,050,000	950,000	2,000,000
Preferred shares series B	900,000	-	900,000
Common shares	3,550,000	610,000	4,160,000
Paid to vendors	7,322,000	3,409,500	10,731,500
Acquisition costs	865,036	365,895	1,230,931
	<u>8,187,036</u>	<u>3,775,395</u>	<u>11,962,431</u>

Acquisition costs included a finder's fee of 725,000 common shares of the Company issued to Cambridge Capital Limited, a company controlled by a then director of the Company. Also included in the acquisition costs was a fee paid to Global Capital Partners Inc. ("Global") of \$625,000 and 2,475,000 warrants of the Company for the acquisition of ORMI and A&A and the sale of substantially all of the Company's compactor assets to CWS. The Global fee was proportionately allocated between the acquisitions and the sale of assets. The warrants expired unexercised on May 31, 2005.

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. Intangible assets relating to the Company's acquisition of A&A and ORMI were identified by management and recorded at estimated values based on a valuation performed by an independent third party valuation expert:

	<u>ORMI</u>	<u>A&amp;A</u>	<u>TOTAL</u>
Software Licence Agreement	3,000,000	-	3,000,000
Patent Licence Agreements	1,500,000	-	1,500,000
Customer Relationships	1,090,000	460,000	1,550,000
<b>Total Intangibles</b>	<b>5,590,000</b>	<b>460,000</b>	<b>6,050,000</b>
<b>Goodwill</b>	<b>2,434,793</b>	<b>2,645,027</b>	<b>5,079,820</b>
<b>Intangibles and Goodwill</b>	<b>8,024,793</b>	<b>3,105,027</b>	<b>11,129,820</b>

The Company amortizes its intangible assets over their estimated life. The Company's Customer Relationships and the Software License (see 3.01 (a)) are amortized on a straight-line basis over 5 years and the Patent License (see 3.01 (c)) on a straight-line basis over 15 years.

The goodwill is subject to an annual impairment test. The Company must make assumptions regarding estimated future cash flows, market conditions and other factors to determine the fair value of the assets. If these estimates or related assumptions change in the future, the Company may be required to record impairment charges for these assets. In fiscal years 2005 and 2004, the Company did not record an impairment charge related to goodwill or intangibles assets. However, for the year ended June 30, 2003 impairment charges were recorded for A&A Customer Relationships and Goodwill of \$160,334 and \$1,261,971 respectively. Canadian generally accepted accounting principles only provide for downward adjustment in the event of impairment.

At June 30, 2006 intangibles are as below:

	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
	<b>\$ 6,050,000</b>	<b>\$ 4,161,691</b>	<b>\$ 1,888,309</b>	<b>\$ 6,050,000</b>	<b>\$ 3,192,627</b>	<b>\$ 2,857,373</b>

The amortization of intangibles assets, a non-cash operating expense, was \$969,064 for each of 2006 and 2005.

The proprietary Software is owned by Path Information Systems Inc. a company controlled by one of the Directors. On May 31, 2002, the Company signed an arms-length (see Item 5) software licence agreement with Path wherein it obtained an exclusive Canadian License for the use the Software in the Industry anywhere in Canada (“Canadian License”) for a one-time cost of \$100. The Canadian License was exclusive to NCS for a period of three years, after which Path would have had the right to market the Software in geographical areas of Canada that were then not being serviced by the Company. On November 11, 2003, the Company and Path amended the Canadian License to make it perpetually exclusive to the Company for the Industry. This amendment was provided at no cost to NCS.

On May 31, 2002, the Company signed a software maintenance agreement with Path (“Maintenance Agreement”) whereby Path provides ongoing maintenance, support, upgrades and customization of the Software. The Maintenance Agreement requires the Company to pay an annual fee of \$3,000 to Path. Software maintenance, support and customization are provided by Path at market rates at the Company’s direction and sole discretion. Path has provided all maintenance, support, upgrades and customization of the Software to date at cost and has waived the annual fee to date.

### 2.03 Vacuum Trucks & Non-hazardous Liquid Organic Waste – USA & World

The Company is unique in the industry, having exclusive access to four proprietary technologies that provide it with low cost competitive advantages plus superior operational efficiencies and controls. These advantages plus its expert knowledge of vacuum truck services for the collection, treatment and disposal of organic and other non-hazardous liquid waste, positions NCS as a very attractive partner in organic waste and vacuum truck services projects in the United States as well as Canada. The Company is in the process of evaluating various potential business opportunities in the USA and potential ways of entering that market. In November 2003, the Company negotiated amendments to its international technology rights agreements to permanently secure its rights to:

- 1) Organic Resource Recovery System (“ORRS”<sup>1</sup>) and Direct Land Application Process (“DLAP”<sup>2</sup>) patents for the USA and the World excluding Canada.
- 2) The Software for its own use and licensing to third parties anywhere outside of Canada.

#### (a) 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 arm’s-length (see Item 5) intangible asset purchase and sale agreement (“APSA”) whereby it purchased the United States patents covering the ORRS and DLAP technologies 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.

<sup>1</sup> Storage and Disposal of Organic Waste, United States Patent #5,568,996

<sup>2</sup> Process for Disposal of Decomposable Organic Waste, United States Patent #5,645,623

Under the terms of the agreement, NCS was to deliver certain minimum requirements to NCS ESL prior to December 31, 2003. Failure to meet these minimum requirements would have resulted in NCS forfeiting its 70% equity position in NCS ESL to OII and, thereby, its ability to pursue its business strategy outside of Canada. On November 11, 2003, the parties amended the APSA to remove all deadlines and conditions, thus securing NCS' 70% equity stake in NCS ESL. This amendment was provided by OII at no cost to the Company.

#### **(b) The Software**

On February 14, 2002, NCS ESL signed an arm's-length software licence agreement with Path Information Systems Inc. ("Path"), a company controlled by one of the Directors (see Item 5), whereby it obtained a perpetual nonexclusive license for the use of the Software worldwide excluding Canada ("Worldwide License"). For more information on the Software (see 3.01). The Worldwide License was granted to NCS ESL at a one-time cost of \$100 and restricts NCS ESL to use the software in the non-hazardous liquid waste industry ("Industry").

On February 14, 2002, NCS ESL signed a software maintenance agreement with Path ("US Maintenance Agreement") whereby Path provides ongoing maintenance, support, upgrades and customization of the Software. The US Maintenance Agreement requires the Company to pay an annual fee of US\$5,000 to Path. Software maintenance, support and customization are provided by Path at market rates at the Company's direction. Path has not provided any maintenance, support, upgrades and customization of the Software to NCS ESL to date and accordingly has waived the annual fee to date.

In November 2003, Path and NCS ESL entered into a worldwide excluding Canada marketing agreement ("Marketing Agreement") for the Software which: (1) gives NCS ESL the right to market Software licenses to third parties for use in the non-hazardous waste industry (the "Industry") anywhere in the world excluding Canada and (2) makes the Software exclusive to NCS ESL for the 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 Marketing Agreement gives NCS ESL flexibility to exploit the Software to its benefit. This Marketing Agreement was provided by Path at no cost to NCS. No value has been assigned to the Software from Path outside of Canada.

### **ITEM 3 DESCRIPTION OF THE BUSINESS**

#### **3.01 Corporate Overview**

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 on 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.<sup>3</sup> 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 a just-in-time delivery intense customer service.

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-intensive 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. 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.

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<sup>3</sup> Tom Rulseh, Cole Publishing Inc., Three Lakes WI

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 numerous 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.

### **3.02 Core Business**

The core services the Company provides are:

#### **(a) 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.

#### **(b) 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.

#### **(c) 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”) technology 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.

#### **(d) 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.

### **3.03 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 passed 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.

### **3.04 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.

### **3.05 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.

### **3.06 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-served market. Sixty-seven percent<sup>4</sup> of North America's annually discarded waste is comprised of organic materials. At industrial, commercial and institutional waste generators, such as supermarkets, institutions, food processors and restaurants, organic materials can represent 55% to 90%<sup>5</sup> of the total discarded waste stream. As of March 2001, only 2.6% of the 22 million tons of food scraps generated were recovered<sup>6</sup> 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%<sup>7</sup> of all waste from landfill. This is estimated to result in an increase in food waste recycling from the 2.6%<sup>8</sup> to 14%, or 5.4 times the recycled mass. The Company brings substantial proprietary efficiencies to this market.

### **3.07 Organic Waste 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

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

<sup>5</sup> Cynthia Greene, US Environmental Protection Agency, unpublished report, March 14, 2001

<sup>6</sup> Cynthia Greene, US Environmental Protection Agency, unpublished report, March 14, 2001

<sup>7</sup> US Environmental Protection Agency, 1998 Waste Generation Report

<sup>8</sup> US Environmental Protection Agency, 1998 Waste Generation Report

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 1). 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 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 NCS<sup>9</sup>. On-farm ADs will typically be able to utilize most or all of the digested material.

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<sup>9</sup> OMAFRA, On-Farm Mixed Treatment System Design and Operations Manual, October 12, 2005

- **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:
  - **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.

### 3.08 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:

- To provide customers with economic liquid residuals management solutions that are beneficial to society and the environment
- To promote ethical and environmentally responsible business practices
- To recognize the value and respect of employees, customers and neighbours
- To foster innovation and individual commitment among employees
- To continuously research and develop innovative residuals recycling and management technologies

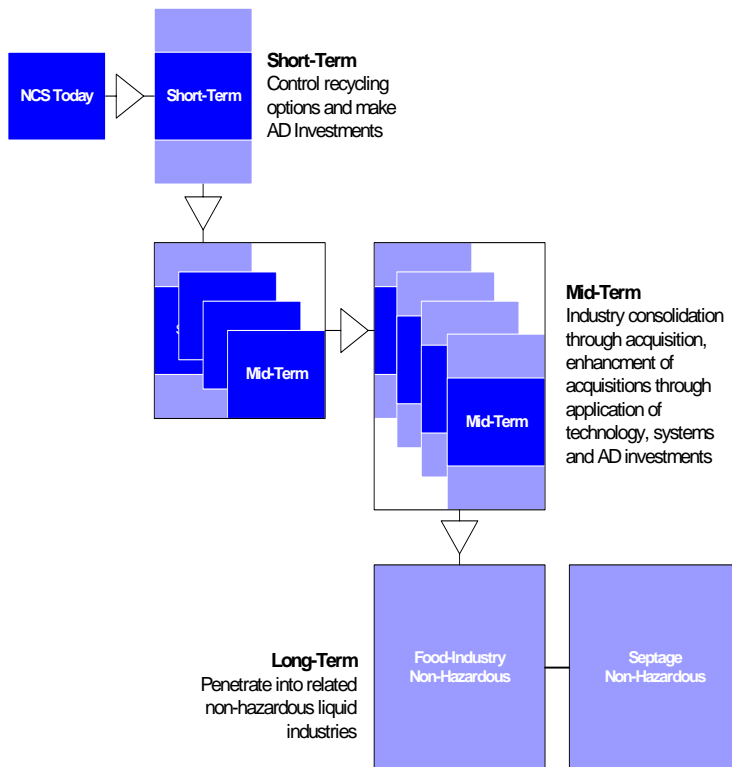
- To be a profitable, secure Company dedicated to continued growth

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:



### **3.09 Risk Factors**

#### **(a) 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.

#### **(b) 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.

**(c) 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.

**(d) 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.

**(e) 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.

**(f) 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.

**ITEM 4 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 2006 or 2005. The cumulative dividends in arrears on the Class A preferred shares as at June 30, 2006 is \$811,343 (\$492,490 at June 30, 2005). No dividends may be paid on any other class of shares until these shares have been redeemed.

The Company has never paid cash dividends on its common share and does not anticipate paying any cash dividends in the foreseeable future. Subject to the terms of the revolving credit facility with Textron Financial Canada Ltd., there are no other restrictions, which prevent the Company from paying dividends.

## ITEM 5 RELATED PARTY TRANSACTIONS

During the year ended June 30, 2006, 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

### (a) Software

The software development costs are for work performed by Path. The terms of the Company's Software licences (see 2.02 and 2.03(b)) with Path were established in February 2000, prior to the Director being appointed to the NCS Board. Subsequent amendments to the licences were negotiated with an independent committee of the Board.

### (b) Interest on 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.

### (c) Patent license agreement

Pursuant to patent license agreements with companies related to directors of the Company as described in Item 3(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.

## ITEM 6 DESCRIPTION OF CAPITAL STRUCTURE

### 6.01 Preferred Shares

Below is a summary of the issued preferred shares at June 30, 2006:

	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

### (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.

**6.02 Common Shares**

Authorized 100,000,000; issued as follows at June 30, 2006:

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

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. The warrants expired on July 11, 2005 without exercise.

## ITEM 7 MARKET FOR SECURITIES

The common shares are listed and posted for trading on the Toronto Stock Exchange (“TSX”) under the symbol “NLC”. As at September 20, 2006 there were 40,133,573 common shares outstanding. The monthly price ranges and total monthly trading volumes for the common shares during the year ended June 30, 2006 are listed below:

<u>Month</u>	<u>Share Price</u>		<u>Total Monthly Volume</u>
	<u>High</u>	<u>Low</u>	
July 2005	0.13	0.07	776,100
August 2005	0.10	0.08	282,950
September 2005	0.19	0.07	790,600
October 2005	0.16	0.11	437,772
November 2005	0.14	0.09	364,282
December 2005	0.13	0.08	542,872
January 2006	0.11	0.08	377,755
February 2006	0.11	0.08	409,600
March 2006	0.11	0.08	638,558
April 2006	0.11	0.08	455,950
May 2006	0.11	0.07	637,200
June 2006	0.12	0.08	636,525
Total			<u>6,350,164</u>

## ITEM 8 DIRECTORS AND OFFICERS

### (a) Name, Occupation and Security Holding

The following table sets forth the name, municipality of residence, principal occupation within the five preceding years and other stated information with respect to each current Director and Officer of the Company as at the date of this Annual Information Form. The term of office of each of the present Directors expires immediately prior to the election of Directors at the Company’s Annual General Meeting scheduled for October 24, 2006. The last Annual General Meeting was held on October 24, 2005.

Name and Municipality Of Residence	Principal Occupation	Office with Corporation	Director Since/ Expire	Issued Common Share	
				No.	%
Dr. Robert A. Bandeen, Toronto, ON	President and Director of Cluny Corporation; former President of Crownex Inc.; former Chairman, President and Chief Executive Officer of Crown Life Insurance Company and President and Chief Executive Officer of Canadian National Railways	Chairman and Director	06/04/98 10/24/05	271,125	0.7
Charles Buehler (a) Tottenham, ON	Founder of Organic Resource Management Inc.	C.E.O and Director	04/28/00 10/24/05	9,213,463	23.0
Douglas M. Carruthers (a) Waterloo, ON	President and Chief Executive Officer of the Company from April 28, 2000 to present; President of Organic Resource Technologies Inc.; Consultant to solid waste industry since 1980	President and Director	04/28/00 10/24/05	262,500	0.7
Donald R. Carse, Jr. London, England	May 1, 2000 to March 25, 2002, Chief Financial Officer of National Challenge Systems Inc.; January 1999 to May 2000, Vice-President, Corporate Development of the Company; worked for 25 years with investment, commercial and development banks in the U.S. and overseas	Director	04/25/02 10/24/05	343,562	0.9
Frank Facto Toronto, ON	Over 20 years experience in the Human Resources and Procurement professions; currently, Senior Human Resources Consultant for The City of Toronto. Former President and director of the Toronto Municipal Credit Union	Director	05/31/02 10/24/05	298,625	0.7

Martin Fallick, Toronto, ON	Director: Canadian Sales Agency Limited (since Feb. 1986), Monterey Transportation Limited (since Aug. 1986), Allied International Marketing, Inc. (since Dec. 1997); former President, Fairway Canadian Express, Vice President Sales, Direct Transport (1983-1986), Canadian General Sales Manager, Canadian Pacific Express; over 45 years of experience in all modes of transportation and storage throughout North America, Asia and Europe	Director	04//25/02 10/24/05	379,775	0.9
Matthew Gaasenbeek, Toronto, ON	Chairman of Northern Crown Capital (Since Nov. 1983); past Chairman, Ontario Development Corporation; former President of Camreco Inc. and former Senior Vice President and Director of Midland Doherty Limited	Director	10/21/04 10/24/05	53,750	0.1
Ian London Toronto, Ontario	Former Chief Executive Officer at Process Products Limited from 2001 to 2006, Hydro One (formerly Ontario Hydro) from 1978 to 2000 where he served as Senior Vice President, Corporate Business Development; Director of Grid Strategies and Plans, and Director of Engineering & Construction Services; President and CEO of Ontario Hydro International.	Director	02/10/06 10/24/05	None	0.0
Ian Kelland Mississauga ON	From 1996 to 2003, Mr. Kelland was the Director of Retail Operations at CN Intermodal where he was responsible for an \$80 million annual expense budget and the consolidation of 9 regional dispatch centers into one central office that included a staff of 85, dispatching and managing a fleet of over 400 trucks. Prior to CN, he was Vice President Operations for Frederick Transport; and, Vice President Finance of Federal Industries Truckload Operations	VP Operations & CFO	N/A	311,000	0.8

In addition to the shares owned by each of Charles Buehler and Douglas Carruthers, 750,747 shares are registered in ORTI (owned as to 1/3<sup>rd</sup>) and 522,958 shares are registered in Organic Resource Technologies International Inc. (owned as to 1/3<sup>rd</sup>).

Charles H. Buehler, who beneficially owns, directly or indirectly, or exercises control or direction over 9,213,463 common shares, representing approximately 23.0% of the issued and outstanding common shares of the Company, is the only person or corporation who beneficially owns, directly or indirectly, or exercises control or direction over common shares carrying more than 10% of the voting rights attached to all outstanding common shares of the Company.

#### (b) Board of Directors and its Committees

The Board's mandate is to protect the interest of the Company and to establish policies and procedures designed to promote and monitor good corporate governance and effective corporate management. The role of the Board is to supervise management and focus on the stewardship rather than the day-to-day operations. To assist the Board in the implementation of key policies, it delegates certain of its responsibilities to committees of the Board. The Board currently has an Audit Committee, Corporate Governance Committee and a Compensation Committee composed entirely of unrelated directors.

- **Audit Committee:** The Audit Committee is composed of three directors none of whom are officers or employees of the Corporation or its affiliates. The members of the Audit Committee currently are: Matthew Gaasenbeek (Chairman), Donald R. Carse, Jr., and Ian London. All members of the Audit Committee are independent and financially literate. A copy of the Audit Committee's Charter is attached in Appendix A.

In addition to carrying out its statutory legal responsibilities (including review of the Corporation's annual financial statements prior to their presentation to the Board), the Audit Committee reviews the Corporation's accounting policies and issues and all financial reporting, including interim financial statements, management's discussion and analysis and the Corporation's annual information form. The Audit Committee meets with the Corporation's external auditor and with members of management at least once a year to assist the external auditor in the effective discharge of its duties. The Audit Committee also makes recommendation to the Board regarding the firm to be appointed as the Corporation's auditors and the terms of its remuneration.

- **Corporate Governance Committee:** The Corporate Governance Committee is composed of Frank Facto (Chairman), Martin Fallick and Ian London.

The Corporate Governance Committee's primary function is to assist the Board in carrying out its responsibilities by reviewing corporate governance and making recommendations to the Board as appropriate. In particular, the Committee is responsible for ensuring that corporate governance guidelines are adopted, disclosed and applied. It is also responsible for providing oversight in the field of human resources and succession planning.

- **Compensation Committee:** The Compensation Committee is composed of Martin Fallick (Chairman), Matthew Gaasenbeek and Frank Facto.

The Compensation Committee reviews the Corporation's overall approach to compensation and the development of compensation plans for executive officers and directors. It has responsibility for the establishment of the Corporation's senior management compensation policy and its implementation through an effective comprehensive compensation program.

## ITEM 9 TRANSFER AGENT AND REGISTRAR

Pacific Corporate Trust Company  
3rd Floor – 510 Burrard Street,  
Vancouver, British Columbia V6C 3B9

## ITEM 10 MATERIAL CONTRACTS

The Company has not entered into any material contracts, other than in the ordinary course of business, during the most recently completed financial year, or before the most recently completed financial year that is still in effect.

## ITEM 11 ADDITIONAL INFORMATION

### (a) Auditor Fee Disclosure

Grant Thornton LLP, Chartered Accountants, have been the auditors of the Company since the fiscal year ended June 30, 2004. At the next annual meeting of the shareholders of the Company, the Company will propose that Grant Thornton LLP be re-appointed as auditors of the Company to hold office until the next meeting of the shareholders.

Grant Thornton LLP provides professional services for audits relating to statutory and regulatory requirements. The Audit Committee negotiates with the auditors of the Company on an arm's-length basis in determining the fees to be paid to the auditors. Such fees have been based on the complexity of the matters in question and the time incurred by the auditors. The Audit Committee believes that the fees negotiated in the past with the auditors of the Company were reasonable and in the circumstances would be comparable to fees charged by other auditors providing similar services.

The following table set forth the various services provided by Grant Thornton LLP to the Company during each of the Company's last two fiscal years, together with the fee billed during the year for such services. The amounts indicated are exclusive of disbursements and GST:

<u>Services</u>	<u>Fees Billed During the Year Ended</u>	
	<u>June 30, 2006</u>	<u>June 30, 2005</u>
Audit services	\$63,500	\$56,000
Audit-related services	Nil	Nil
Tax services	5,000	4,000
Other services	Nil	Nil
Total	<u>\$68,500</u>	<u>\$60,000</u>

The audit services related to the professional services rendered for the audits of the Company's annual financial statements. The tax services is related to the preparation of the annual corporate tax returns of the Company and its subsidiaries.

The Audit Committee has considered whether the provisions of the above-captioned services is compatible with maintaining the auditors' independence and has determined that such services were fully compatible with the maintenance of their independence.

**(b) General**

Additional information, including Directors' and officers' remuneration and indebtedness and the principal holders of National Challenge's securities, options to purchase securities and interests of insiders in material transactions, as applicable, are contained in the management information circular of National Challenge dated September 19, 2006 which was prepared and mailed to shareholders prior to the annual general meeting of shareholders scheduled for October 24, 2006. Additional financial information is provided in National Challenge's comparative Financial Statements and Management Discussion and Analysis for the year ended June 30, 2006.

The comparative financial statements and additional information may be obtained through the Company's website at [www.nationalchallenge.com](http://www.nationalchallenge.com), or on SEDAR at [www.sedar.com](http://www.sedar.com) or upon request in writing to the Chief Financial Officer, National Challenge Systems Inc., 3700 Steeles Avenue West, Suite 601, Woodbridge, Ontario, L4L 8K8.

**APPENDX A**  
**NATIONAL CHALLENGE SYSTEMS INC.**  
**CHARTER OF AUDIT COMMITTEE**

**MANDATE**

The mandate of the audit committee (the “Committee”) is to:

- (a) assist the Board of Directors (the “Board”) of National Challenge Systems Inc. (the “Corporation”) in fulfilling its oversight responsibilities with respect to financial reporting and disclosure requirements
- (b) ensure that an effective risk management and financial control framework has been implemented by management of the Corporation; and
- (c) be responsible for external and internal audit processes.

**RESPONSIBILITIES**

The responsibilities of the Committee are as follows:

**Financial Reporting and Disclosure**

1. Review and recommend to the Board for approval, the quarterly financial statements, management discussion and analysis, financial reports and any public release of financial information through press release or otherwise.
2. Review and recommend to the Board for approval, the audited annual financial statements, including the auditors’ report thereon, management discussion and analysis and financial reports.
3. Review and recommend to the Board for approval, where appropriate, financial information contained in any prospectuses, annual information forms, material change disclosures of a financial nature and similar disclosure documents.
4. Review with management of the Corporation and with external auditors significant accounting principles and disclosure issues and alternative treatments under Canadian

generally accepted accounting principles (“GAAP”) all with a view to gaining reasonable assurance that financial statements are accurate, complete and present fairly the Corporation’s financial position and the results of its operations in accordance with Canadian GAAP.

### **Internal Controls and Audit**

1. Review and assess the adequacy and effectiveness of the Corporation’s system of internal control and management information systems through discussions with management and the external auditor to ensure that the Corporation maintains:
  - a. the necessary books, records and accounts in sufficient detail to accurately and fairly reflect the Corporation’s transactions;
  - b. effective internal control systems; and
  - c. adequate processes for assessing the risk of material misstatement of the financial statement and for detecting control weaknesses or fraud.

From time to time the Committee will assess whether a formal internal audit department is necessary or desirable having regard to the size and stage of development of the Corporation at any particular time.

2. Satisfy itself that adequate procedures are in place for the review of the Corporation’s disclosure of financial information extracted or derived from the Corporation’s financial statements
3. Periodically assess the adequacy of such systems and procedures to ensure compliance with regulatory requirements and recommendations.
4. Review and discuss the Corporation’s major financial risk exposures and the steps taken to monitor and control such exposures, including the use of any financial derivatives and hedging activities.
5. Review annually insurance programs relating to the Corporation and its investments

### **External Audit**

1. Review the performance of the external auditors who are accountable to the Committee and the Board as representatives of the shareholders, including the lead partner of the independent auditors team and recommend to the Board the external auditors to be nominated for the purpose of preparing or issuing an audit report or performing other

audit, review or attest services for the Corporation and the compensation of the external auditors.

2. Oversee the work of the external auditors appointed by the shareholders of the Corporation with respect to preparing and issuing an audit report or performing other audit, review or attest services for the Corporation, including the resolution of issues between management of the Corporation and the external auditors regarding financial disclosure.
3. Review the results of the external audit and the report thereon including, without limitation, a discussion with the external auditors as to the quality of accounting principles used, any alternative treatments of financial information that have been discussed with management of the Corporation, the ramifications of their use as well as any other material changes. Review a report describing all material written communication between management and the auditors such as management letters and schedule of unadjusted differences.
4. Discuss with the external auditors their perception of the Corporation's financial and accounting personnel, records and systems, the cooperation which the external auditors received during their course of their review and availability of records, data and other requested information and any recommendations with respect thereto.
5. Review the reasons for any proposed change in the external auditors which is not initiated by the Committee or Board and any other significant issues related to the change, including the response of the incumbent auditors, and enquire as to the qualifications of the proposed auditors before making its recommendations to the Board
6. Review the independence of the external auditors, including a written report from the external auditors respecting their independence and consideration of applicable auditor independence standards
7. Review annually a report from the external auditors in respect of their internal quality-control procedures, any material issues raised by the most recent internal quality-control review, or peer review of the external auditors, or by any inquiry or investigation by governmental or professional authorities, within the preceding five years, respecting one or more independent audits carried out by the external auditors, and any steps taken to deal with any such issues.

### **Associated Responsibilities**

1. Establish, monitor and periodically review procedures for:

- a. the receipt, retention and treatment of complaints received by the Corporation regarding accounting, internal accounting controls or auditing matters; and
  - b. the confidential, anonymous submission by employees of the Corporation of concerns regarding questionable accounting or auditing matters.
2. Review and approve the Corporation's hiring policies regarding employees and former employees of the present and former external auditor of the Corporation.

### **Non-Audit Services**

1. Pre-approve all non-audit services to be provided to the Corporation or any subsidiary entities by its external auditors or by the external auditors of such subsidiary entities. The Committee may delegate to one or more of its members the authority to pre-approve non-audit services but pre-approval by such member or members so delegated shall be presented to the full audit committee at its first scheduled meeting following such pre-approval (see Audit Committee Pre-approval Policy – August 3, 2004)
2. Review and assess the adequacy of the Corporation's risk management policies and procedures with regard to identification of the Corporation's principal risks and implementation of appropriate systems to manage such risks including an assessment of the adequacy of insurance coverage maintained by the Corporation.

### **MEMBERSHIP AND PROCEDURES**

1. The Committee will be comprised of three directors each of whom will be independent, financially literate and free of any relationship which could, in the view of the Board, reasonably interfere with the exercise of a member's independent judgment. The Board may remove or replace a member of the Committee at any time and from time to time. The Corporation adopts: (a) the meaning of independence described in Multilateral Instrument 52-110 *Audit Committees* (the "Instrument") for the purpose of determining whether a member of the Committee is independent; and (b) the provisions of Sections 3.3 to 3.5, inclusive, of the Instrument relating to certain membership requirements.
2. The Board will appoint the Chairman of the Committee. The Secretary of the Corporation will act as the secretary at meetings of the Committee or, in his absence, the Chairman of the committee may appoint any member or any other person to act as secretary. The secretary will keep minutes of the proceedings at any meeting of the Committee setting out in reasonable detail the business conducted at such meeting. Minutes of the meetings of the Committee will be distributed by the Secretary to the members of the Committee and to the Board.

3. Meetings of the Committee will be held at such times and places as the Chairman may determine, but in any event not less than four times per year. Twenty-four (24) hours notice of each meeting will be given orally, by electronic transmission or by facsimile to all members of the Committee and to the external auditors of the Corporation and such notice will set out in reasonable detail the business proposed to be conducted at the meeting. Notice of a meeting may be waived if all members of the Committee are present at a meeting and waive notice or if a member who is not present waives notice before or after such meeting. A resolution signed by all members of the Committee shall have the same force and effect as a resolution passed at a meeting of the Committee duly called and regularly constituted for the transaction of business.
4. A majority of members of the Committee will constitute a quorum and decisions of the Committee will be by an affirmative vote of the majority with the Chairman having a deciding vote in the event of a tie.
5. At the request of the external auditors of the Corporation, the Chief Executive Officers or the Chief Financial Officer of the Corporation or any member of the Committee, the Chairman will convene a meeting of the Committee. Any such request will set out in reasonable detail the business proposed to be conducted at the meeting so requested.
6. The Committee has the authority to:
  - a. engage independent counsel and other advisors as it determines necessary or desirable to carry out its duties;
  - b. set and pay the compensation for any advisors engaged by the Committee; and
  - c. communicate directly with internal and external auditors.

## **OVERSIGHT FUNCTION**

While the Committee has the responsibilities and powers set forth in this Charter, it is not the duty of the Committee to plan or conduct audits or to determine that the Corporation's financial statements are complete and accurate or are in accordance with GAAP and applicable rules and regulations. These are the responsibilities of Management and the external auditors. The Committee, its Chair and any Committee members identified as having accounting or related financial expertise are members of the Board, appointed to the Committee to provide broad oversight of the financial, risk and control related activities of the Corporation, and are specifically not accountable or responsible for the day to day operation or performance of such activities. Although the designation of a Committee member as having accounting or related financial expertise for disclosure purposes is based on that individual's education and experience, which that individual will bring to bear in carrying out his or her duties on the Committee, such designation does not impose on such person any duties, obligations or liability that are greater than the duties, obligations and liability imposed on such person as a member of the Committee and Board in the absence of

such designation. Rather, the role of a Committee member who is identified as having accounting or related financial expertise, like the role of all Committee members, is to oversee the process, not to certify or guarantee the internal or external audit of the Company's financial information or public disclosure.