

NATIONAL CHALLENGE SYSTEMS INC.
Management Discussion and Analysis
Six Months Ending December 31, 2005

MANAGEMENT DISCUSSION & ANALYSIS

The following is a discussion of the consolidated financial condition and results of operations of National Challenge Systems Inc. for the six-month period ended December 31, 2005. This discussion should be read in conjunction with: the Unaudited Interim Consolidated Financial Statements of the Company and notes thereto for the six months ended December 31, 2005, "Management's Discussion and Analysis" for the year ended June 30, 2005 and the Audited Consolidated Financial Statements and notes thereto for the year ended June 30, 2005.

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.

RESULTS OF OPERATIONS

Revenue

Revenue for the three months ended December 31, 2005 was up 16% or \$562,000 from \$3,446,000 in second quarter of 2005 to \$4,008,000 in second quarter of 2006. Year to date revenue was up 18% or \$1,199,000 from \$6,775,000 in 2005 to \$7,974,000 in 2006. The increase reflects the price increase to its Ontario customers that the Company put into effect at the beginning December 2004 in order to offset the increase in disposal costs.

Operating Results

The contribution margin improved by 11% or \$97,000 from \$850,000 for the second quarter 2005 to \$947,000 for the second quarter 2006. The contribution margin for year to date is up 15% or \$246,000 from \$1,699,000 in 2005 to \$1,945,000 in 2006. Year to date the contribution margin as a percentage of the revenue remained steady at 24.4% in 2006 compared to 25.1% in 2005.

The Company continues to face difficulties re-permitting and expanding Direct Land Application Process ("DLAP") facilities in Ontario. As a result the Company is using higher cost disposal alternatives including transporting material out of province to third party disposal sites. Consequently, waste disposal costs year to date are up 52% over the last year. The Company is continuing to investigate other in-province disposal options to reduce this cost.

Year to date vehicle maintenance costs are up \$110,000 over last year reflecting the aging of the fleet. The Company is embarking on a program that will see approximately \$1 million of new trucks added to the fleet over the next six months. This should improve the efficiency of the truck fleet and lower the maintenance costs.

Cash operating expenses were \$661,000 and \$774,000 respectively for the second quarters of 2005 and

2006, and remained at 19% of revenue. Year to date cash operating expenses are \$1,357,000 and \$1,536,000 respectively for 2005 and 2006 and as a percentage of revenue decreased from 20% to 19%. Non-cash operating expenses were down \$9,000 from \$487,000 for the second quarter of 2005 compared to \$478,000 for the same quarter in 2006. Year to date non-cash operating expenses were up \$2,000 from \$937,000 in 2005 to \$939,000 in 2006.

Year to date the net loss was down \$65,000 or 11% from \$596,000 in 2005 to \$530,000 in 2006. The net loss for the second quarter of 2006 was \$305,000 almost unchanged from the net loss of \$299,000 in the first quarter of 2005. The Company continues to have large non-cash operating expenses including amortization of intangible assets related to the acquisition of its two operating subsidiaries, and the amortization of these intangible assets was \$242,000 in the second quarters of both 2006 and 2005 and year to date of \$485,000 in both 2006 and 2005.

Quarterly Review

Financial Information - Eight Quarter Summary

(in 000's except earnings per share)

	<u>Second Quarter</u>		<u>First Quarter</u>		<u>Fourth Quarter</u>		<u>Third Quarter</u>	
	<u>Ending Dec 31st</u>	<u>2005</u>	<u>Ending Sept 30th</u>	<u>2005</u>	<u>Ending July 31st</u>	<u>2004</u>	<u>Ending March 31</u>	<u>2004</u>
Revenues	\$ 4,008	\$ 3,446	\$ 3,966	\$ 3,329	\$ 3,968	\$ 3,178	\$ 3,751	\$ 3,325
Net Loss	(305)	(299)	(225)	(297)	(355)	(933)	(179)	(428)
Net loss including items not involving cash	173	188	242	153	307	30	313	(68)
Cash flows from operating activities	(237)	30	389	207	383	(125)	55	206
Loss per share, basic and fully diluted	\$(0.01)	\$(0.01)	\$(0.01)	\$(0.01)	\$(0.01)	\$(0.03)	\$(0.00)	\$(0.01)

In December 2004 the Company began increasing rates to most of the Ontario customers in order to offset the erosion to the gross margin that had occurred from the increase in disposal costs. By March 31, 2005 over 95% of all Ontario based customers had received rate increases with the balance in place by June 30, 2005. As a result, the revenues for the second half of fiscal 2005 and the first half of fiscal 2006 are on average 18% ahead of the revenues from the comparable periods of the prior years.

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

The net loss of \$933,000 in the fourth quarter of 2004 was particularly larger than the fourth quarter of 2005 due to three non-cash operating expenses recorded during that quarter:

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

Balance Sheet & Cash Flow

For the first six months, the net loss including items not involving cash, improved by 20% or \$67,000 from \$342,000 in 2005 to \$409,000 in 2006.

Accounts receivable increased marginally by \$37,000 from \$2,297,000 at June 30, 2005 to \$2,334,000 at December 31, 2005. For the second quarter of fiscal 2006, accounts receivable increased by \$213,000 reflecting the normal slowdown of payments during the holiday season.

Accounts payable and accrued liabilities decreased by \$259,000 from \$2,357,000 at June 30, 2005 to \$2,098,000 at December 31, 2005 reflecting an improved payment cycle to the Company's vendors. \$195,000 of the decrease in accounts payable occurred in the second quarter of 2006.

For the first six month of 2006 the Company acquired \$107,626 of property plant and equipment. In the same period last year \$1,003,000 was acquired; however, this included the acquisition of land and building related to the Toronto plant for \$901,000.

Cash flows from operating activities was \$153,000 for the first half of 2006. Cash flows from operating activities for the second quarter of 2006 was a negative \$237,000 reflecting the combined impact of the increasing receivables and decreasing payables for the quarter.

Long-term debt and capital leases were reduced by \$275,000 for the first half of 2006 compared to a reduction of \$125,000 in the first half of 2005.

STRATEGY

NCS growth strategy is to use state-of-the-art technologies, both proprietary and otherwise, together with its substantial operational management expertise to capitalize on the emerging opportunity presented by a large, and fragmented organic and other non-hazardous liquid waste vacuum truck services industry in North America.

Its centralized customer service, dispatch infrastructure and service delivery optimization systems can be deployed to deliver a broad range of services to existing Vacuum Truck Operators (VTOs) and the authorities that regulate this industry throughout North America.

NCS' growth plans include acquiring existing VTOs and establishing new VTOs in select new markets. NCS can also provide operational management services to existing VTOs in markets that it does not wish to directly participate in.

During the second quarter the Company successfully completed the pilot testing of its proprietary handheld software at its Ottawa facility and proceeded with a plan to equip all its field service technicians with wireless handheld units at the Toronto facility in January 2006.

One of the most significant benefits of this new handheld technology for NCS will be 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.

Recycling options for the wastes that the Company collects vary from region to region and market to market. The Company's strategy with respect to waste recycling includes controlling a significant portion of the lowest cost, most beneficial recycling options in the markets it services either by obtaining preferential supply agreements, through equity participation or through outright ownership. NCS is continually exploring and monitoring the progress of every potential recycling option that could use the organic wastes that it collects.

One of these recycling options is anaerobic digestion (AD). AD converts organic waste into methane gas that can be used to generate steam or electrical energy thereby providing a continuous source of renewable energy. Anaerobic digestion of organic waste for biogas production is a widely proven technology that has been in constant use in Europe for 20 years.

The Ontario Government unveiled a program in September 2005 that, when implemented, could encourage the development of small generators of "clean" power by allowing them to sell into the Ontario power grid at a fixed premium. This initiative could provide the stimulus to make anaerobic biogas

digesters economically feasible in Ontario. Biogas digesters would provide National Challenge with an opportunity to leverage its position as a leading collector of liquid organic waste by supplying these digesters with energy rich, high fat, oil and grease (FOG) waste that produces substantially higher methane yields than other organic wastes, such as food waste and manure.

The development of anaerobic digesters in Ontario could be a long-term renewable energy solution that could make a significant contribution to Ontario's clean energy requirements. At the same time, it would provide an alternative for managing farm manures that would facilitate the objectives of the Nutrient Management Act as set out by the Ministries of Agriculture and Environment and provide the Company with a virtually unlimited low-cost recycling option for the organic waste it collects in this its largest market.

On October 6th the Company announced it had entered into a Letter of Intent with Canadian Agra Inc. to conduct a feasibility study for the purpose of providing a biogas operation capable of producing steam energy for the Bruce Energy Centre ECO-Industrial Park located near Kincardine Ontario. The study should be completed in early 2006,

ADDITIONAL INFORMATION

Further information about NCS may be obtained at the Company's web site at www.nationalchallenge.com.

Financial Statements of
NATIONAL CHALLENGE SYSTEMS INC.

(Unaudited)

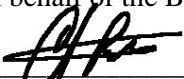
December 31, 2005

NATIONAL CHALLENGE SYSTEMS INC.
CONSOLIDATED BALANCE SHEETS

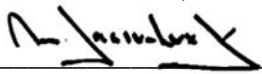
	December 31	June 30
	2005	2005
ASSETS		
CURRENT		
Cash	\$ 81,916	\$ 147,082
Accounts receivable	2,334,228	2,296,919
Inventory	175,555	179,245
Prepaid expenses	164,816	206,786
	<u>2,756,515</u>	<u>2,830,032</u>
PROPERTY PLANT AND EQUIPMENT	3,015,549	3,178,743
INTANGIBLE ASSETS	2,372,841	2,857,372
GOODWILL	3,817,849	3,817,849
FUTURE INCOME TAXES	501,000	501,000
DEFERRED FINANCING COSTS, net of accumulated amortization	79,171	93,388
	<u>\$ 12,542,925</u>	<u>\$ 13,278,384</u>
LIABILITIES		
CURRENT		
Revolving loan	\$ 1,295,182	\$ 1,125,495
Accounts payable and accrued liabilities	2,097,879	2,357,494
Current portion long-term debt	456,906	532,620
Current portion of obligations under capital lease	106,370	106,370
	<u>3,956,337</u>	<u>4,121,979</u>
LONG-TERM DEBT	650,604	815,835
OBLIGATIONS UNDER CAPITAL LEASE	108,847	160,987
	<u>759,451</u>	<u>976,822</u>
REDEEMABLE PREFERRED SHARES	3,595,206	3,440,490
	<u>4,354,657</u>	<u>4,417,312</u>
SHAREHOLDERS' EQUITY		
COMMON SHARES	11,701,123	11,681,173
CONTRIBUTED SURPLUS	163,121	160,032
DEFICIT	(7,632,313)	(7,102,112)
	<u>4,231,931</u>	<u>4,739,093</u>
	<u>\$ 12,542,925</u>	<u>\$ 13,278,384</u>

See accompanying notes to consolidated financial statements. These interim financial statements should be read in conjunction with the 2005 annual consolidated financial statements.

On behalf of the Board of Directors:



 Charles H. Buehler, Director



 Matthew Gaasenbeek, Director

NATIONAL CHALLENGE SYSTEMS INC.
CONSOLIDATED STATEMENTS OF OPERATIONS AND DEFICIT
MONTH ENDED DECEMBER 31, 2005 AND 2004

	6 months ended December 31		3 months ended December 31	
	2005	2004	2005	2004
REVENUES				
Non hazardous vacuum services	\$ 7,683,644	\$ 6,482,543	\$ 3,858,093	\$ 3,304,757
Compactor rental income	259,003	259,003	129,501	129,501
Compactor sales, service & other	31,157	33,119	19,910	11,870
	<u>7,973,804</u>	<u>6,774,665</u>	<u>4,007,504</u>	<u>3,446,128</u>
DIRECT COSTS	<u>6,028,447</u>	<u>5,075,686</u>	<u>3,060,322</u>	<u>2,596,324</u>
CONTRIBUTION	<u>1,945,357</u>	<u>1,698,979</u>	<u>947,182</u>	<u>849,804</u>
OPERATING EXPENSE (INCOME)				
Cash operating expenses (income)				
Selling, general and administrative	1,438,357	1,261,664	725,854	610,480
Interest on long-term debt and obligations under capital lease	57,059	71,908	27,234	38,440
Other interest	41,011	23,809	20,818	12,406
	<u>1,536,427</u>	<u>1,357,381</u>	<u>773,906</u>	<u>661,326</u>
Non-cash operating expenses (income)				
Amortization of property, plant and equipment	289,551	291,050	145,688	147,700
Amortization of intangible assets	484,532	484,532	242,266	242,266
Settlement of liabilities through share issuance	25,000	68,500	10,000	31,000
Stock based compensation	3,089	26,171	333	26,171
Dividends on preferred shares	154,716	137,463	78,501	69,747
Foreign exchange (gain) loss	(17,757)	(70,554)	1,624	(29,509)
	<u>939,131</u>	<u>937,162</u>	<u>478,412</u>	<u>487,375</u>
TOTAL OPERATING EXPENSE	<u>2,475,558</u>	<u>2,294,543</u>	<u>1,252,318</u>	<u>1,148,701</u>
LOSS BEFORE OTHER INCOME (EXPENSE) AND INCOME TAXES	<u>(530,201)</u>	<u>(595,564)</u>	<u>(305,136)</u>	<u>(298,897)</u>
OTHER INCOME				
Gain on disposal property, plant and equipment	-	-	-	-
Recovery of investment	-	-	-	-
	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>
LOSS BEFORE INCOME TAXES	<u>(530,201)</u>	<u>(595,564)</u>	<u>(305,136)</u>	<u>(298,897)</u>
INCOME TAXES (RECOVERY)				
Current	-	-	-	-
Future	-	-	-	-
	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>
LOSS	<u>(530,201)</u>	<u>(595,564)</u>	<u>(305,136)</u>	<u>(298,897)</u>
DEFICIT, BEGINNING OF YEAR/PERIOD	<u>(7,102,112)</u>	<u>(5,972,238)</u>	<u>(7,327,177)</u>	<u>(6,268,905)</u>
DEFICIT, END OF YEAR/PERIOD	<u>\$ (7,632,313)</u>	<u>\$ (6,567,802)</u>	<u>\$ (7,632,313)</u>	<u>\$ (6,567,802)</u>
LOSS PER SHARE, BASIC AND DILUTED	<u>\$ (0.01)</u>	<u>\$ (0.02)</u>	<u>\$ (0.01)</u>	<u>\$ (0.01)</u>

See accompanying notes to consolidated financial statements. These interim financial statements should be read in conjunction with the 2005 annual consolidated financial statements.

NATIONAL CHALLENGE SYSTEMS INC.
CONSOLIDATED STATEMENTS OF CASHFLOWS
MONTH ENDED DECEMBER 31, 2005 AND 2004

	6 months ended December 31		3 months ended December 31	
	2005	2004	2005	2004
CASH FLOWS FROM OPERATING ACTIVITIES:				
Net loss for the year	\$ (530,201)	\$ (595,564)	\$ (305,136)	\$ (298,897)
Add (deduct) items not involving cash				
Amortization of property, plant and equipment	289,551	291,050	145,688	147,700
Amortization of intangible assets	484,532	484,532	242,266	242,266
Dividends accrued on preferred shares	154,716	137,463	78,501	69,747
Settlement of liabilities through share issuance	25,000	68,500	10,000	31,000
Stock-based compensation	3,089	26,171	333	26,171
Foreign exchange (gain) loss	(17,757)	(70,554)	1,624	(29,509)
Net loss including items not involving cash	<u>408,930</u>	<u>341,598</u>	<u>173,276</u>	<u>188,478</u>
Changes in operating assets and liabilities:				
Decrease (increase) in accounts receivable, net	(37,309)	(190,453)	(213,114)	(258,586)
Decrease (increase) in inventory	3,690	(9,330)	5,395	(5,458)
Decrease (increase) in prepaid expenses	41,971	81,769	(7,672)	67,673
(Decrease) increase in accounts payable and accrued liabilities	(264,668)	50,279	(194,544)	55,786
Decrease in income taxes payable	-	(37,020)	-	(17,904)
CASH FLOWS FROM OPERATING ACTIVITIES	<u>152,614</u>	<u>236,843</u>	<u>(236,659)</u>	<u>29,989</u>
CASH FLOWS FROM INVESTING ACTIVITIES:				
Acquisition of property, plant and equipment	(107,626)	(1,002,855)	(68,852)	(47,069)
Proceeds on disposal of property, plant and equipment	-	-	-	183
	<u>(107,626)</u>	<u>(1,002,855)</u>	<u>(68,852)</u>	<u>(46,886)</u>
CASH FLOWS FROM FINANCING ACTIVITIES:				
Advance (repayment) of revolving loan	169,687	(274,256)	444,183	128,228
(Repayment) advance of long-term debt	(223,187)	453,716	(99,041)	(86,305)
(Repayment) advance of capital lease obligation	(52,140)	81	(26,326)	(25,923)
Payment of deferred financing costs	(4,514)	-	-	-
	<u>(110,154)</u>	<u>179,541</u>	<u>318,816</u>	<u>16,000</u>
DECREASE IN CASH DURING THE YEAR	(65,166)	(586,471)	13,305	(897)
CASH BEGINNING OF YEAR / QUARTER	147,082	596,086	68,611	10,512
CASH END OF YEAR / PERIOD	<u>\$ 81,916</u>	<u>\$ 9,615</u>	<u>\$ 81,916</u>	<u>\$ 9,615</u>
Supplemental cash flow information				
Interest paid	\$ 98,070	\$ 95,716	\$ 48,052	\$ 50,846
Income taxes paid	-	37,020	-	17,904

See accompanying notes to consolidated financial statements. These interim financial statements should be read in conjunction with the 2005 annual consolidated financial statements.

NATIONAL CHALLENGE SYSTEMS INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 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

These interim consolidated financial statements have been prepared in Canadian accordance with generally accepted accounting principles and follow the same accounting policies and method of application as the June 30, 2005 annual audited statements except that the interim consolidated financial statements do not conform in all respects with disclosure required for annual financial statements and should be read in conjunction with the annual consolidated financial statements for the year ended June 30, 2005.

3. CAPITAL STOCK

As per the employment contract of one of the executives, the Company at its option may elect to pay the employee in common shares. The number of shares is calculated by dividing the salary payable by \$0.15. The salary is based on an annual amount of \$120,000 pro-rated for the amount of time devoted to the Company. On July 27, 2005 the Company issued 133,000 common shares to the executive related to this contract.

	<u>Number of Shares</u>		<u>Book Value</u>	
	<u>6 Months Ended</u>	<u>Year Ended</u>	<u>3 Months Ended</u>	<u>Year Ended</u>
	<u>December 31, 2005</u>	<u>June 30, 2005</u>	<u>December 31, 2005</u>	<u>June 30, 2005</u>
Opening balance	39,642,323	34,147,323	\$ 11,681,173	\$ 11,003,150
Directors' Compensation		145,000		18,523
Private Placement		5,040,000		613,000
Executive Compensation	133,000	310,000	19,950	46,500
Closing balance	39,775,323	39,642,323	\$ 11,701,123	\$ 11,681,173

4. COMPARATIVE FIGURES

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