

NATIONAL CHALLENGE SYSTEMS INC.
Management Discussion and Analysis
Three Months Ending September 30, 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 three-month period ended September 30, 2005. This discussion should be read in conjunction with: the Unaudited Interim Consolidated Financial Statements of the Company and notes thereto for the three months ended September 30, 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 first quarter of 2006 was \$3,966,000, up 19% or \$637,000 from \$3,329,000 in the first quarter of 2005. 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 was \$998,000 for the first quarter of 2006, up 18% or \$149,000 from \$849,000 in the first quarter of 2005. With most of the Company's Ontario Direct Land Application Process ("DLAP") facilities still not operating, the Company continues to use higher cost disposal alternatives including transporting material out of province. As a result, waste disposal costs for the first quarter were up \$372,000 or 60% over the first quarter of 2005. Despite this higher cost, the contribution margin as a percentage of the revenue remained steady at 25.2% in 2006 compared to 25.5% in 2005.

During the quarter, customer fuel surcharges were increased to offset the rising price of fuel consumed in the Company's truck fleet.

Cash operating expenses are up \$61,000 from \$696,000 in the first quarter of 2005 to \$757,000 in the first quarter of 2006. \$32,000 of the increase relates to temporary salary reductions during fiscal 2005 that ended at the beginning of fiscal 2006.

Non-cash operating expenses were up \$17,000 at \$467,000 for the first quarter of 2006 compared to \$450,000 for the same quarter last year. As the Canadian dollar strengthens against the US dollar, the Company continues to enjoy foreign exchange gains on its US currency note payable to Marathon Equipment. The gain for the first quarter of 2006 was \$19,000 compared to a gain of \$41,000 in the first quarter of 2005 accounting for a \$22,000 year over year increase in non-cash operating expenses.

The net loss for the first quarter of 2006 was down \$72,000 or 24% at \$225,000 compared to a net loss of \$297,000 in the first quarter of 2005, even though the Company continues to have large non-cash operating expenses including amortization of intangible assets related to the acquisition of it two

operating subsidiaries. The amortization of these intangible assets was \$242,000 in the first quarters of both 2006 and 2005.

Quarterly Review

Financial Information - Eight Quarter Summary

(in 000's except earnings per share)

	First Quarter		Fourth Quarter		Third Quarter		Second Quarter	
	2006	2005	2005	2004	2005	2004	2005	2004
Revenues	\$ 3,966	\$ 3,329	\$ 3,968	\$ 3,178	\$ 3,751	\$ 3,325	\$ 3,446	\$ 3,690
Cash flows from operating activities	389	207	383	(125)	55	206	30	41
Net Loss	(225)	(297)	(355)	(933)	(179)	(428)	(299)	(93)
Loss per share, basic and fully diluted	\$(0.01)	\$(0.01)	\$(0.01)	\$(0.03)	\$(0.00)	\$(0.01)	\$(0.01)	\$(0.00)

In December 2004 the Company began increasing rates to most of the Ontario customers in order to offset the erosion to the gross margin that had occurred from the increase in disposal costs. By March 31st over 95% of all Ontario based customers had received rate increases with the balance in place by June 30, 2005. As a result, the revenues for the third and fourth quarter of fiscal 2005 and the first quarter of fiscal 2006 are on average 19% ahead of the revenues from the comparable quarters 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

The balance outstanding on the Company's \$2 million revolving credit facility decreased by \$274,000 from \$1,125,000 at June 30, 2005 to \$851,000 at September 30, 2005.

Accounts receivable decreased by \$176,000 from \$2,297,000 at June 30, 2005 to \$2,121,000 at September 30 2005 reflecting improved collections. Cash flows from operating activities were \$389,000 for the first quarter of 2006, up 88% or \$182,000 compared to \$207,000,000 for the same quarter last year.

Long-term debt and capital leases were reduced by \$150,000 for the first quarter of 2006 compared to an increase of \$566,000 in the first quarter of 2006.

STRATEGY

The Company's strategy is to control a significant portion of its recycling options in the markets it services either by obtaining preferential supply agreements or through equity participation. The Company continues to face difficulties re-permitting and expanding its DLAP facilities primarily because of concerns related to managing unprocessed odorous waste. With a lack of low cost disposal options in Ontario, the Company has been restricted in its growth and has been unable to aggressively pursue a number of large volume industrial customer opportunities. The Company continues in its efforts to develop new DLAP sites and re-permit its existing ones. At the same time NCS is exploring other recycling options including anaerobic digestion which converts organic waste into methane gas that can be used to generate steam or electricity.

During the quarter the Ontario Government unveiled a program that 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.

Anaerobic digestion of organic waste for biogas production is a widely proven technology that has been in constant commercial use in Europe for 20 years. 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

Subject to the Ontario Government providing a workable structure for the purchase of renewable energy from biogas production, the Company believes it will be offered significant opportunities. Anaerobic digesters could provide:

- The primary Ontario solution for a large amount of NCS' clean, high energy, organic waste that is today being transported long distances out of province.
- Competitively priced disposal capacity in Ontario that would give the Company an opportunity to aggressively seek additional large industrial organic customers.
- Digesters provide additional transportation service opportunities for the Company to move agricultural wastes to and from these digesters, which NCS is ideally suited to provide employing its sophisticated logistics management capability.
- Digesters provide increased opportunities for the use of the Company's ORRS technology. The ORRS liquefies solid organics, which facilitates the most efficient transportation of waste to a digester facility. Liquefied organic waste is ready for the digester whereas solid organic waste must be ground after delivery before entering the digester.

On October 6th the Company announced it had entered into a Letter of Intent with Canadian Agra Inc. to conduct a feasibility study, which should be completed by early next year, 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 Company will continue to explore other opportunities to participate in these types of renewable and sustainable energy projects as they arise, where it can leverage its operating expertise and technologies.

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)

September 30, 2005

NATIONAL CHALLENGE SYSTEMS INC.

CONSOLIDATED BALANCE SHEETS

(Unaudited)

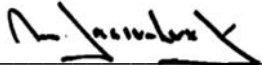
	September 30	June 30
	2005	2005
ASSETS		
CURRENT		
Cash	\$ 68,611	\$ 147,082
Accounts receivable	2,121,116	2,296,919
Inventory	180,950	179,245
Prepaid expenses	157,144	206,786
	<u>2,527,821</u>	<u>2,830,032</u>
PROPERTY PLANT AND EQUIPMENT	3,083,020	3,178,743
INTANGIBLE ASSETS	2,615,106	2,857,372
GOODWILL	3,817,849	3,817,849
FUTURE INCOME TAXES	501,000	501,000
DEFERRED FINANCING COSTS, net of accumulated amortization	88,536	93,388
	<u>\$ 12,633,332</u>	<u>\$ 13,278,384</u>
LIABILITIES		
CURRENT		
Revolving loan	\$ 850,999	\$ 1,125,495
Accounts payable and accrued liabilities	2,282,422	2,357,494
Current portion long-term debt	500,374	532,620
Current portion of obligations under capital lease	106,370	106,370
	<u>3,740,165</u>	<u>4,121,979</u>
LONG-TERM DEBT	704,555	815,835
OBLIGATIONS UNDER CAPITAL LEASE	135,173	160,987
	<u>839,728</u>	<u>976,822</u>
REDEEMABLE PREFERRED SHARES	3,516,705	3,440,490
	<u>8,096,598</u>	<u>8,539,291</u>
SHAREHOLDERS' EQUITY		
COMMON SHARES, note 3	11,701,123	11,681,173
CONTRIBUTED SURPLUS	162,788	160,032
DEFICIT	(7,327,177)	(7,102,112)
	<u>4,536,734</u>	<u>4,739,093</u>
	<u>\$ 12,633,332</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
(Unaudited)

	3 months ended September 30	
	2005	2004
REVENUES		
Non hazardous vacuum services	\$ 3,825,552	\$ 3,177,787
Compactor rental income	129,501	129,501
Compactor sales, service & other	11,247	21,249
	<u>3,966,300</u>	<u>3,328,537</u>
DIRECT COSTS	<u>2,968,125</u>	<u>2,479,362</u>
CONTRIBUTION	<u>998,175</u>	<u>849,175</u>
OPERATING EXPENSE (INCOME)		
Cash operating expenses (income)		
Selling, general and administrative	706,503	651,184
Interest on long-term debt and obligations under capital lease	29,825	33,468
Other interest	20,193	11,402
	<u>756,521</u>	<u>696,054</u>
Non-cash operating expenses (income)		
Amortization of property, plant and equipment	143,862	143,350
Amortization of intangible assets	242,266	242,266
Settlement of liabilities through share issuance	21,000	37,500
Stock based compensation	2,756	-
Dividends on preferred shares	76,215	67,716
Foreign exchange gain	(19,380)	(41,045)
	<u>466,719</u>	<u>449,787</u>
TOTAL OPERATING EXPENSE	<u>1,223,240</u>	<u>1,145,841</u>
LOSS BEFORE OTHER INCOME (EXPENSE) AND INCOME TAXES	(225,065)	(296,666)
OTHER INCOME		
Gain on disposal property, plant and equipment	-	-
Recovery of investment	-	-
	<u>-</u>	<u>-</u>
LOSS BEFORE INCOME TAXES	(225,065)	(296,666)
INCOME TAXES (RECOVERY)		
Current	-	-
Future	-	-
	<u>-</u>	<u>-</u>
LOSS	(225,065)	(296,666)
DEFICIT, BEGINNING OF QUARTER	(7,102,112)	(5,972,238)
DEFICIT, END OF QUARTER	\$ (7,327,177)	\$ (6,268,904)
LOSS PER SHARE, BASIC AND DILUTED	\$(0.01)	\$(0.01)

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
(Unaudited)

	3 months ended September 30	
	2005	2004
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net loss for the year	\$ (225,065)	\$ (296,666)
Add (deduct) items not involving cash		
Amortization of property, plant and equipment	143,862	143,350
Amortization of intangible assets	242,266	242,266
Dividends accrued on preferred shares	76,215	67,716
Settlement of liabilities through share issuance	21,000	37,500
Stock-based compensation	2,756	-
Foreign exchange gain	(19,380)	(41,045)
	<u>241,654</u>	<u>153,121</u>
Changes in operating assets and liabilities:		
Decrease in accounts receivable, net	175,804	68,133
Increase in inventory	(1,705)	(3,871)
Decrease in prepaid expenses	49,643	14,096
Decrease in accounts payable and accrued liabilities	(76,123)	(5,692)
Decrease in income taxes payable	-	(19,115)
CASH FLOWS FROM OPERATING ACTIVITIES	<u>389,273</u>	<u>206,672</u>
CASH FLOWS FROM INVESTING ACTIVITIES:		
Acquisition of property, plant and equipment	(38,774)	(955,787)
	<u>(38,774)</u>	<u>(955,787)</u>
CASH FLOWS FROM FINANCING ACTIVITIES:		
(Repayment) of revolving loan	(274,496)	(402,484)
(Repayment) advance of long-term debt	(124,146)	540,021
(Repayment) advance of capital lease obligation	(25,814)	26,004
Payment of deferred financing costs	(4,514)	-
	<u>(428,970)</u>	<u>163,541</u>
DECREASE IN CASH DURING THE YEAR	(78,471)	(585,574)
CASH BEGINNING OF QUARTER	147,082	596,086
CASH END OF QUARTER	<u>\$ 68,611</u>	<u>\$ 10,512</u>
Supplemental cash flow information		
Interest paid	\$ 50,018	\$ 44,870
Income taxes paid	-	19,115

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
September 30, 2005

1. NATURE OF OPERATIONS

National Challenge Systems Inc. (the “Company” or “NCS”) is incorporated under the Canada Business Corporations Act. The primary operations of the Company consist of operating vacuum truck fleets that provide collection, treatment and disposal services for non-hazardous liquid waste and other related services.

2. SIGNIFICANT ACCOUNTING POLICIES

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 June30, 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>3 Months Ended</u>	<u>Year Ended</u>	<u>3 Months Ended</u>	<u>Year Ended</u>
	<u>September 30, 2005</u>	<u>June 30, 2005</u>	<u>September 30, 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.