

NATIONAL CHALLENGE SYSTEMS INC.

Management Discussion and Analysis

Nine Months Ended March 31, 2007

MANAGEMENT DISCUSSION & ANALYSIS

The following Management Discussion and Analysis (“MD&A”) is a discussion of the consolidated financial condition and results of operations of National Challenge Systems Inc. for the nine-month period ended March 31, 2007. This discussion should be read in conjunction with the Unaudited Interim Consolidated Financial Statements of the Company and notes thereto for the nine-months ended March 31, 2007, the MD&A for the year ended June 30, 2006 and the Audited Consolidated Financial Statements and notes thereto for the year ended June 30, 2006. This MD&A is prepared as at May 8, 2007.

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

Appointment

During the third quarter the Company appointed Mr. Gary Kain to its Board of Directors. Mr. Kain is a successful entrepreneur with extensive financial and funding experience in the Canadian public markets. Mr. Kain founded Regional Cablesystems Inc. in 1988 and was its CEO and Chairman of the Board. A cable television, high speed internet and telecom company with operations in Canada and the Bahamas, Regional Cablesystems (later renamed Persona Inc), was listed on the TSE and sold in 2004 for gross proceeds of \$406 million.

From 1984 until 1988, Mr. Kain was with Canadian Satellite Communications Inc. (Cancom), a T.S.E. listed satellite communications and broadcasting company, where he held the positions of VP Finance, CFO and then COO. Mr. Kain obtained a BA and a MBA from McMaster University and is a Chartered Accountant. He also obtained a CBV designation from The Canadian Institute of Chartered Business Valuators.

Mr. Kain is (or has been) a member of the board of directors of McMaster University, Sheridan College, Oakville Hydro Ltd., Cable Bahamas Ltd., and The Community Foundation of Oakville. He was a member of the Canadian government appointed Local Network Convergence Committee; the author of a number of articles on business valuations; and, a lecturer for the Law Society of Upper Canada and the Ontario Institute of Chartered Accountants.

Revenue

The Company’s core greasetrap business recorded an increase in revenue of 10% during the first nine months of fiscal 2007 compared to the same period last year as a result of both volume and price increases. However, the Company’s two largest industrial accounts, both food processing facilities, significantly reduced their service levels after making capital improvements to their wastewater handling system to reduce the amount of residuals they produce. The vast majority of the Company’s customers do not have sufficient volumes of liquid organic waste to justify capital investments of this type. The lost revenue from these two industrial customers was very competitively priced and did not have a significant impact on the gross margin of the

Company. The net result for the three months ended March 31, 2007 was a decrease in revenue of 4.3% or \$175,000 from \$4,103,000 in the third quarter of fiscal 2006 to \$3,928,000 in the third quarter of fiscal 2007. Year to date, revenue was down 4.0% or \$492,000 from \$12,076,000 in fiscal 2006 to \$11,584,000 in fiscal 2007.

Operating Results

The net loss of \$264,000 for the third quarter of fiscal 2007 was reduced by 34% or \$134,000 as compared to the net loss of \$398,000 for the same period last year. Year to date, the net loss was \$408,000, a reduction of 56% or \$521,000 from \$929,000 in fiscal 2006. The gross margin grew 35% or \$314,000 to \$1,206,000 for the third quarter of fiscal 2007 from \$892,000 for the same period last year. Year to date, gross margin was \$3,770,000, up 33% or \$935,000 from \$2,835,000 in fiscal 2006. As a percentage of revenues, gross margin increased to 31% in the third quarter of 2007 and to 33% year to date compared to 22% and 23% for the same periods last year, respectively.

The Company's single largest operating expense, residuals management, was reduced significantly beginning in May 2006 as the Company was able to take more residuals to third-party recycling sites in Ontario instead of transporting them out of province. In the second and third quarter of fiscal 2007 the Ontario sites reduced the volume of residuals they received as a result of colder weather. The Company expects the volume to increase to third-party recycling sites in Ontario during the fourth quarter of fiscal 2007. However, the Company has no long-term contracts with these third-party recycling sites and therefore cannot predict with certainty the volume of material they will receive. The Company's profitability can be materially impacted by the volume of residuals these Ontario sites receive.

Selling, general and administrative expenses were up \$102,000 or 13% from \$766,000 in the third quarter of fiscal 2006 to \$868,000 in the third quarter of fiscal 2007. Year to date, these expenses were \$2,511,000, 14% or \$309,000 higher than the \$2,202,000 recorded in fiscal 2006. This increase was the result of higher banking, audit and legal fees as well as expenses related to the exploration and development of the Company's involvement in anaerobic digestion ("AD").

The Company continues to have large non-cash operating expenses including amortization of intangible assets related to the acquisition of its two operating subsidiaries. The amortization of the intangible assets was \$242,000 in each of the first three quarters of 2006 and 2007. The Company has been amortizing intangible assets since 2003 and effective May 31, 2007, \$4,550,000 of these intangibles assets related to customers and software will be fully amortized. At that time only \$1,000,000 related to patent license agreements will remain. As a result, the quarterly amortization charge will be reduced from \$242,000 to \$25,000 beginning in June 2007 through to 2017.

Non-Cash Expenses (in 000's)

	Third Quarter		Second Quarter		First Quarter		Fourth Quarter	
	Ending March 31	2006	Ending Dec 31	2005	Ending Sept 30	2005	Ending June 30	2005
Amortization of property, plant & equip	\$ 178	\$ 149	\$ 163	\$ 146	\$ 142	\$ 144	\$ 169	\$ 171
Write down of property, plant & equip	-	-	-	-	-	-	190	322
Loss (gain) on disposal property, plant & equipment	15	-	-	-	(6)	-	-	-
Amortization of intangibles	242	242	242	242	242	242	242	242
Dividends accrued on preferred shares	91	81	88	78	86	76	83	74
Share based compensation	21	-	-	10	-	18	27	1
Foreign exchange (gain) loss	-	1	-	2	-	(19)	(6)	(6)
Future income taxes	-	-	-	-	-	-	(4)	(142)
	\$ 547	\$ 473	\$ 493	\$ 478	\$ 464	\$ 461	\$ 701	\$ 662

Quarterly Review

Financial Information - Eight Quarter Summary (in 000's except earnings per share)

	<u>Third Quarter</u> Ending Mar. 31		<u>Second Quarter</u> Ending Dec. 31		<u>First Quarter</u> Ending Sep. 30		<u>Fourth Quarter</u> Ending Jun. 30	
	<u>2007</u>	<u>2006</u>	<u>2006</u>	<u>2005</u>	<u>2006</u>	<u>2005</u>	<u>2006</u>	<u>2005</u>
Revenues	\$3,928	\$4,103	\$3,810	\$4,008	\$3,846	\$3,966	\$3,955	\$3,968
Net profit (loss)	(264)	(398)	(155)	(305)	11	(225)	(268)	(355)
Cash flows from operating activities	297	395	96	(237)	473	389	192	383
Profit (loss) per share, basic and fully diluted	0.00	(0.01)	0.00	(0.01)	0.00	(0.00)	(0.01)	(0.01)

The net losses of \$264,000 in the most recent quarter and \$155,000 in the second quarter reflect an erosion of gross margin due to increased residuals disposal cost as more waste volume was trucked to out of province recycling sites. The fourth quarters of fiscal 2006 and 2005 include a \$190,000 and \$322,000 write down of property, plant and equipment, respectively, both of which related to compactors. These write downs are non-cash items.

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

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

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

	<u>Third Quarter</u> Ending March 31		<u>Second Quarter</u> Ending Dec 31		<u>First Quarter</u> Ending Sept 30		<u>Fourth Quarter</u> Ending June 30	
	<u>2007</u>	<u>2006</u>	<u>2006</u>	<u>2005</u>	<u>2006</u>	<u>2005</u>	<u>2006</u>	<u>2005</u>
Net profit (loss)	(264)	(398)	\$ (155)	(305)	\$ 11	(225)	(268)	(355)
Non-cash expenses	547	473	493	478	464	461	701	662
Adjusted net earnings excluding non-cash expenses	283	75	338	173	475	236	433	307
Changes in operating assets and liabilities	14	320	(242)	(410)	(2)	153	(241)	76
Cash flows from operating activities	\$ 297	\$ 395	\$ 96	\$ (237)	\$ 473	\$ 389	\$ 192	\$ 383

Balance Sheet & Cash Flow

Cash flows from operating activities were \$297,000 for the three months ended March 31, 2007. For the year, cash flows from operating activities were \$866,000 in fiscal 2007, an increase of \$318,000 or 58% compared to the same period last year.

The Company's compactor rental contract with Canada Safeway Limited ("Safeway") expired on September 30, 2006. The compactors are now on a month to month rental agreement with Safeway, and in due course will be sold or retired as the Company exists from this business. During the quarter there were disposals proceeds of \$143,099 primarily related to the sale of the compactors. Approximately 25% of the fleet of 195 compactors was sold or retired during the quarter.

One new vacuum truck was added to the fleet in the quarter. Year to date, a total of six vacuum trucks have been acquired under capital leases at a cost of \$811,000. No trucks were added under a capital lease in the first nine months of fiscal 2006.

The Company's revolving loan decreased during the third quarter by \$424,000 or 37% from \$1,157,000 at December 31, 2006 to \$733,000 at March 31, 2007. For the year, the revolving loan decreased by \$485,000 or 40%.

Share Re-structuring

On April 16, 2007, subsequent to the quarter end, the Company announced that subject to regulatory approval, it intends to convert all of the outstanding Class A and Class B Preferred shares into common shares on June 1, 2007, and subsequently, subject to regulatory and shareholder approvals consolidate the issued and outstanding common shares of the Company on the basis of one new common share for every ten issued and outstanding common shares.

The disinterested directors approved a resolution to cause all class A and B preferred shares to convert into common shares on June 1, 2007; the earliest date allowed by the terms of the preferred shares. As at June 1, 2007 there will be a total of 4,086,971 class A and B shares outstanding. Under the terms of these shares, 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:

- \$0.40; or
- the average weighted market price over the 15-day period immediately prior to the date upon which conversion notice is given, which in this case will be June 1, 2007.

Based on the current market price of the Company's common shares, the conversion will result in the issuance of approximately 40 million additional common shares.

National Challenge will be seeking shareholder approval for the proposed common share consolidation. Pending approval of the consolidation, each shareholder would receive one new share of common stock for every ten shares of common stock previously held. Immediately after the reverse stock split, the aggregate value of the shareholder's stock would be unchanged.

The purpose of the share conversion and consolidation is to present the investment community with a more appropriate and simplified capital structure as the Company prepares for its anaerobic digester / renewable energy initiatives. The conversion of the preferred shares to common shares will also eliminate the Company's dividend expense which was \$319,000 in fiscal 2006 and \$174,000 for the first six months of fiscal 2007.

STRATEGY

As previously reported NCS is exploring anaerobic digestion ("AD") as a potential recycling solution. AD converts raw organic materials such as agricultural and other food-related residuals into reliable streams of biogas for electricity generation, thus creating a sustainable renewable energy supply.

The Ontario Government unveiled a proposed Standard Offer Program ("SOP") in September 2005 that, when implemented, 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. A key goal of the SOP is to make anaerobic digestion for biogas energy production financially viable in Ontario and includes a long-term (20 year) fixed price contract. In November 2006 the Ontario Power Authority issued the final rules for the SOP and began accepting applications.

NCS has initiated contractual discussions with selected developers of AD projects in Ontario. These projects would produce biogas energy that qualifies under the SOP. ADs could offer NCS a secure and long-term recycling solution for large volumes of organic residuals, thereby providing the Company with much needed additional and cost-effective organics recycling capacity in Ontario.

RISKS & UNCERTAINTIES

The first three quarters of 2007 include the impact of a price increase to all the Ontario based customers. 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 increase should continue to have a positive impact on the Company's operating contribution, subject to the amount of lost business.

The Company is actively working on a number of potential AD sites that, if successfully funded, permitted and developed, would result in an Ontario in-province solution for the residuals the Company collects. This additional capacity would allow the Company 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. 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.

The Company has been forced to transport a large part of its Ontario residuals out-of-province in the last two years at increased 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. In the second quarter of fiscal 2007 this situation again changed as the Ontario sites reduced the volume of residuals they received. The Company has no long-term contracts with these third-party recycling sites and therefore cannot predict with certainty the volume of material they will continue to receive.

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)

For the nine months ended March 31, 2007

NATIONAL CHALLENGE SYSTEMS INC.
CONSOLIDATED BALANCE SHEETS
(UNAUDITED)

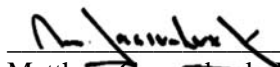
	MARCH 31	JUNE 30
	2007	2006
ASSETS		
CURRENT		
Cash	\$ 226,513	\$ 227,302
Accounts receivable	2,254,541	2,226,910
Inventory	159,878	151,667
Prepaid expenses	220,234	145,734
	<u>2,861,166</u>	2,751,613
PROPERTY PLANT AND EQUIPMENT	3,197,283	2,724,391
INTANGIBLE ASSETS	1,161,511	1,888,309
GOODWILL	3,817,849	3,817,849
FUTURE INCOME TAXES	505,000	505,000
DEFERRED FINANCING COSTS, net of accumulated amortization	36,482	60,441
	<u>\$ 11,579,291</u>	<u>\$ 11,747,603</u>
LIABILITIES		
CURRENT		
Revolving loan	\$ 733,345	\$ 1,217,865
Accounts payable and accrued liabilities	1,861,677	1,983,102
Current portion long-term debt	73,108	228,495
Current portion of obligations under capital lease	227,886	132,275
	<u>2,896,016</u>	3,561,737
LONG-TERM DEBT	722,293	670,940
OBLIGATIONS UNDER CAPITAL LEASE	687,273	119,220
	<u>1,409,566</u>	790,160
REDEEMABLE PREFERRED SHARES	4,024,608	3,759,343
	<u>5,434,174</u>	4,549,503
SHAREHOLDERS' EQUITY		
COMMON SHARES	11,743,933	11,743,933
CONTRIBUTED SURPLUS	211,338	190,380
DEFICIT	(8,706,169)	(8,297,950)
	<u>3,249,102</u>	3,636,363
	<u>\$ 11,579,291</u>	<u>\$ 11,747,603</u>

See accompanying notes to consolidated financial statements. These interim financial statements should be read in conjunction with the 2006 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)

	9 Months Ended March 31		3 Months Ended March 31	
	2007	2006	2007	2006
REVENUES				
Non hazardous vacuum services	\$ 11,039,555	\$ 11,592,808	\$ 3,756,938	\$ 3,909,163
Compactor rental income	491,168	388,504	152,473	129,501
Compactor sales, service & other	52,898	95,055	18,572	63,899
	<u>11,583,621</u>	<u>12,076,367</u>	<u>3,927,983</u>	<u>4,102,563</u>
COST OF SALES	7,813,295	9,241,334	2,722,408	3,210,451
GROSS MARGIN	3,770,326	2,835,033	1,205,575	892,112
OPERATING EXPENSE (INCOME)				
Selling, general and administrative	2,511,359	2,201,500	867,674	765,579
Amortization of property, plant and equipment	482,490	438,272	177,729	148,721
Amortization of intangible assets	726,798	726,798	242,266	242,266
Share based compensation	20,958	28,089	20,825	-
Foreign exchange loss (gain)	453	(17,026)	-	731
	<u>3,742,058</u>	<u>3,377,633</u>	<u>1,308,494</u>	<u>1,157,297</u>
PROFIT (LOSS) BEFORE THE UNDERNOTED AND INCOME TAXES	28,268	(542,600)	(102,919)	(265,185)
OTHER INCOME AND EXPENSES				
Interest on long-term debt and obligations under capital lease	83,648	81,726	31,547	24,668
Other interest	77,835	68,607	23,269	27,595
Dividends on preferred shares	265,265	235,572	91,133	80,856
Loss on disposal of property, plant and equipment	9,739	-	15,325	-
	<u>436,487</u>	<u>385,905</u>	<u>161,274</u>	<u>133,119</u>
LOSS BEFORE INCOME TAXES	(408,219)	(928,505)	(264,193)	(398,304)
INCOME TAXES	-	-	-	-
NET LOSS	(408,219)	(928,505)	(264,193)	(398,304)
DEFICIT, BEGINNING OF QUARTER / YEAR	(8,297,950)	(7,102,112)	(8,441,976)	(7,632,313)
DEFICIT, END OF QUARTER	\$ (8,706,169)	\$ (8,030,617)	\$ (8,706,169)	\$ (8,030,617)
LOSS PER SHARE, BASIC AND DILUTED	\$(0.01)	\$(0.02)	\$(0.00)	\$(0.00)

See accompanying notes to consolidated financial statements. These interim financial statements should be read in conjunction with the 2006 annual consolidated financial statements.

NATIONAL CHALLENGE SYSTEMS INC.
CONSOLIDATED STATEMENTS OF CASHFLOWS
(UNAUDITED)

	9 Months Ended March 31		3 Months Ended March 31	
	2007	2006	2007	2006
CASH FLOWS FROM OPERATING ACTIVITIES:				
Net loss	\$ (408,219)	\$ (928,505)	\$ (264,193)	\$ (398,304)
Add (deduct) items not involving cash:				
Amortization of property, plant and equipment	482,490	438,272	177,729	148,721
Amortization of intangible assets	726,798	726,798	242,266	242,266
Loss on disposal of property plant and equipment	9,739	-	15,325	-
Dividends accrued on preferred shares	265,265	235,572	91,133	80,856
Share based compensation	20,958	28,089	20,825	-
Foreign exchange loss (gain)	453	(17,026)	-	731
	1,097,484	483,200	283,085	74,270
Changes in operating assets and liabilities:				
Decrease (increase) in accounts receivable, net	(27,631)	82,327	(54,061)	119,637
Decrease (increase) in inventory	(8,210)	6,825	(6,508)	3,134
Decrease (increase) in prepaid expenses	(74,500)	17,675	(98,714)	(24,296)
Increase (decrease) in accounts payable and accrued liabilities	(121,425)	(42,402)	172,736	222,266
CASH FLOWS FROM OPERATING ACTIVITIES	865,718	547,625	296,538	395,011
CASH FLOWS FROM INVESTING ACTIVITIES:				
Acquisition of property, plant and equipment	(281,190)	(166,255)	(120,480)	(58,629)
Proceeds on disposal of property, plant and equipment	151,099	-	143,099	-
	(130,091)	(166,255)	22,619	(58,629)
CASH FLOWS FROM FINANCING ACTIVITIES:				
Advance (repayment) of revolving loan	(484,520)	1,439	(424,268)	(168,248)
Advance (repayment) of long-term debt	(104,488)	(324,319)	20,587	(101,132)
Repayment of capital lease obligation	(147,408)	(78,988)	(62,458)	(26,848)
Payment of deferred financing costs	-	(4,514)	-	-
	(736,416)	(406,382)	(466,139)	(296,228)
INCREASE (DECREASE) IN CASH DURING THE QUARTER/YEAR	(789)	(25,012)	(146,982)	40,154
CASH BEGINNING OF THE QUARTER / YEAR	227,302	147,082	373,495	81,916
CASH END OF QUARTER	\$ 226,513	\$ 122,070	\$ 226,513	\$ 122,070
Supplemental cash flow information				
Interest paid	\$ 161,482	\$ 150,333	\$ 54,815	\$ 52,263
Non-cash transactions				
Capital assets acquired through capital leases	\$ 811,073	\$ -	141,500	\$ -

See accompanying notes to consolidated financial statements. These interim financial statements should be read in conjunction with the 2006 annual consolidated financial statements.

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 accordance with Canadian generally accepted accounting principles and follow the same accounting policies and method of application as the June 30, 2006 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, 2006.

3. COMPARATIVE FIGURES

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

4. SUBSEQUENT EVENT

On April 16, 2007, subsequent to the quarter end, the Company announced that subject to regulatory approval, it intends to convert all of the outstanding Class A and Class B preferred shares into common shares on June 1, 2007, and subsequently, subject to regulatory and shareholder approvals, consolidate the issued and outstanding common shares of the Company on the basis of one new common share for every ten issued and outstanding common shares.

The disinterested directors approved a resolution to cause all class A and B preferred shares to convert into common shares on June 1, 2007; the earliest date allowed by the terms of the preferred shares. As at June 1, 2007 there will be a total of 4,086,971 class A and B shares outstanding. Under the terms of these shares, 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:

- \$0.40; or
- the average weighted market price over the 15-day period immediately prior to the date upon which conversion notice is given, which in this case will be June 1, 2007.

Based on the current market price of the Company's common shares, the conversion will result in the issuance of approximately 40 million additional common shares.

National Challenge will be seeking shareholder approval for the proposed common share consolidation. Pending approval of the consolidation, each shareholder would receive one new share of common stock for every ten shares of common stock previously held. Immediately after the reverse stock split, the aggregate value of the shareholder's stock would be unchanged.