

NATIONAL CHALLENGE SYSTEMS INC.

MANAGEMENT DISCUSSION AND ANALYSIS Nine Months Ended March 31, 2005

The following 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, 2005. 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, 2005, "Management's Discussion and Analysis" for the year ended June 30, 2004 and the Audited Consolidated Financial Statements and notes thereto for the year ended June 30, 2004.

Certain statements contained in this "Management's Discussion and Analysis" contains forward-looking statements based on the Company's estimates and assumptions, which are subject to risks and uncertainties. This could cause the Company's actual results to differ materially from the forward-looking statements contained in this discussion.

Operating Results

In December 2004 the Company decided to increase the rates to Ontario customers in order to offset the erosion to the gross margin that had occurred from the increase in Ontario disposal costs. During the quarter over 95% of all Ontario based customers received rate increases. As a result, the revenues for the three months ended March 31, 2005 were up \$426,000 or 12.8% over the same period last year. Year to date revenues were up marginally at 0.2% or \$27,000 from \$10,499,000 to \$10,526,000.

The Company continued to be plagued by the closure of most of its Direct Land Application Process ("DLAP") sites (see Summary of Quarterly Results below). During the quarter the Company sourced alternatives including disposal sites located out of province which resulted in a dramatic increase in the Company's transportation expense. The Company is working with the Ontario Ministry of Environment to complete the re-permitting of the Company's facilities.

Transportation costs to take waste material to disposal sites outside of Ontario resulted in direct costs increasing \$186,000 from \$2,604,000 in the third quarter of 2004 to \$2,790,000 for the third quarter of 2005. These additional transportation costs were partially offset by improved driver productivity and lower truck maintenance expense. Year to date direct costs were down \$77,000 from \$7,943,000 in 2004 to \$7,866,000 in 2005 with the nine month impact of improved driver productivity and the lower maintenance costs more than offsetting three months of out-of-province trucking costs.

Productivity gains and the price increase improved the contribution margin by \$240,000 or 33% from \$721,000 for the third quarter 2004 to \$961,000 for the third quarter of 2005. Year to date the contribution margin is up 4% from \$2,557,000 to \$2,660,000.

Cash operating expenses are down \$120,000 for the third quarter from \$785,000 in 2004 to \$665,000 in 2005 mainly due to lower legal, accounting and advertising expenses in SG&A. For the same reasons cash operating expense for the year to date are down \$146,000 from \$2,263,000 in 2004 to \$2,117,000 in 2005.

Non-cash operating expenses were up \$101,000 for the third quarter from \$374,000 for 2004 to \$475,000 for 2005. \$72,000 of the increase relates to preferred dividend expense expensed in the third quarter of 2005 with no preferred dividend expense recorded for the same quarter in 2004. Year to date non-cash operating expenses are up \$196,000 from \$1,121,000 in 2004 to \$1,317,000 in 2005. \$229,000 of the increase relates to preferred dividend expense.

As a result of a weakening of the Canadian dollar there was a foreign exchange loss on the Marathon

compactor note payable of \$16,000 during the quarter compared to a loss of \$13,000 for the same period last year. Year to date there is a foreign exchange gain of \$54,000 in 2005 compared to \$29,000 in 2004.

The loss for the third quarter was \$179,000 compared to a loss of \$438,000 for the same period last year. Included in the third quarter loss this year is amortization of intangible assets of \$242,000 compared to \$253,000 for the same quarter in 2004. Year to date the loss is \$775,000 compared to \$828,000 for last year. Amortization of intangible assets was \$727,000 for 2005 compared to \$758,000 for year to date 2004.

Summary of Quarterly Results

Financial Information - Eight Quarter Summary

(in 000's except earnings per share)

	<u>First Quarter</u>		<u>Second Quarter</u>		<u>Third Quarter</u>		<u>Fourth Quarter</u>	
	<u>2005</u>	<u>2004</u>	<u>2005</u>	<u>2004</u>	<u>2005</u>	<u>2004</u>	<u>2004</u>	<u>2003</u>
Revenues	3,329	3,484	3,446	3,690	3,751	3,325	3,178	3,686
Cashflow From								
Operating Activities	233	238	30	41	55	206	(126)	336
Loss	(297)	(237)	(299)	(93)	(179)	(428)	(933)	(1,703)
Loss per share, basic and fully diluted	\$(0.01)	\$(0.01)	\$(0.01)	\$(0.00)	\$(0.00)	\$(0.01)	\$(0.00)	\$(0.00)

During 2004 two of the Company's largest customers decided to explore alternative waste disposal solutions because of uncertainty in the marketplace. These two customers averaged \$336,000 in revenue for the first and second quarters of 2004, but during the third and fourth quarters of 2004 they generated only average quarterly revenues of \$13,000. During the first quarter of 2005 the Company regained one of these customers.

The Company has been restricted by disposal capacity since December 2004. Over the last several years, 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. In addition, the Company's own DLAP disposal sites were required to be re-permitted under the new Ontario Nutrient Management Act (a direct result of the Walkerton municipal water crisis). In November, the Company received permits for a new disposal facility north of Toronto, but it is not able to use the facility until the final requirements of the re-permitting have been completed. In the interim, NCS has sourced the most economical alternative disposal solutions. These alternatives include disposal sites located out of province which has resulted in a substantial increase in the Company's transportation expense during the second and third quarters of 2005. In addition, the actual disposal costs at these new sites are much more expensive than using the Company's own Ontario facilities.

The fourth quarter 2003 loss of \$1,703,000 includes intangible asset amortization of \$969,000 for all of 2003. In the fourth quarter of 2004 the loss of \$933,000 reflects the preferred share expense of \$209,000 for all of 2004.

Liquidity and Capital Expenditures

The Company is in violation of one of its banking covenants; however at present the bank continues to support the Company with access to the demand operating line of credit. Notwithstanding such support, the Company is in the process of negotiating a new credit facility with another lender.

The Company is also actively pursuing additional financing, and while it has been successful in the past, there can be no assurance it will be successful in raising additional funds in the future. The Company is also negotiating the sale of certain non-core rental assets.

On July 12, 2004, the Company closed a private placement and strengthened its balance sheet with net proceeds of \$613,000. 5,040,000 shares were issued, and in conjunction with the private placement, the investors received 2,520,000 warrants at \$0.20, which expire on July 11, 2005. Proceeds from the private placement were received and recorded in June 2004.

Bank indebtedness has increased since June 30, 2004 by \$371,000 from \$578,000 to \$949,000. This primarily related to the purchase on August 31, 2004 of the Company's Toronto facility that it had rented since 1992. The purchase price of the land and building was \$900,857 of which \$280,857 was paid in cash and the remainder was financed through a first mortgage on the property having a principal balance of \$620,000, bearing interest at 8%, repayable in monthly instalments of principal and interest of \$5,186 and matures in November 2009.

Cash generated from Operating Activities Before Changes to Non-cash Working Capital improved during the quarter and year to date mainly because of improved revenues. For the third quarter of 2005 it was a positive \$313,000 compared to a negative of \$68,000 for 2004. Year to date 2005 cash generated from Operating Activities Before Changes to Non-cash Working Capital was \$657,000 compared to \$378,000 in 2004, an increase of almost 75%.

During the quarter, accounts receivable increased by \$305,000 reflecting the impact of the higher revenues from the customers compared to a reduction of accounts receivable of \$310,000 for the same quarter last year because of reduced volumes. For the same reasons the year to date accounts receivable increased by \$495,000 compared to a reduction of accounts receivable of \$285,000 in 2004. Collection of accounts receivable has remained consistent over the same time frame.

Financial Statements of
NATIONAL CHALLENGE SYSTEMS INC.

(Unaudited)

March 31, 2005

NATIONAL CHALLENGE SYSTEMS INC.

CONSOLIDATED BALANCE SHEETS

(unaudited)

	March 31 2005	June 30 2004
ASSETS		
CURRENT		
Accounts receivable	\$ 2,111,309	\$ 1,616,152
Inventory	206,425	204,838
Prepaid expenses	104,106	218,202
	<u>2,421,840</u>	<u>2,039,192</u>
PROPERTY PLANT AND EQUIPMENT, note 4	3,436,743	2,876,925
INTANGIBLE ASSETS	3,099,638	3,826,436
GOODWILL	3,817,849	3,817,849
FUTURE INCOME TAXES	359,000	359,000
DEFERRED FINANCING COSTS, net of accumulated amortization	12,412	18,618
	<u>\$ 13,147,482</u>	<u>\$ 12,938,020</u>
LIABILITIES		
CURRENT		
Bank indebtedness	\$ 948,656	\$ 577,955
Accounts payable and accrued liabilities	1,970,045	1,874,680
Income taxes payable	22,521	78,452
Current portion long-term debt, note 4	390,248	372,002
Current portion of obligations under capital lease	96,191	96,191
	<u>3,427,661</u>	<u>2,999,280</u>
LONG-TERM DEBT, note 4	1,062,575	734,268
OBLIGATIONS UNDER CAPITAL LEASE	196,478	269,507
	<u>1,259,053</u>	<u>1,003,775</u>
REDEEMABLE PREFERRED SHARES	3,366,675	3,157,192
	<u>4,625,728</u>	<u>4,160,967</u>
SHAREHOLDERS' EQUITY		
COMMON SHARES, note 3	11,681,173	11,003,150
OBLIGATION TO ISSUE COMMON SHARES, note 3		613,000
CONTRIBUTED SURPLUS	160,032	133,861
DEFICIT	(6,747,112)	(5,972,238)
	<u>5,094,093</u>	<u>5,777,773</u>
	<u>\$ 13,147,482</u>	<u>\$ 12,938,020</u>

See accompanying notes to consolidated financial statements. These interim financial statements should be read in conjunction with the 2004 annual consolidated financial statements.

Approved

Director “Charles H. Buehler”

Director “Frank Facto”

NATIONAL CHALLENGE SYSTEMS INC.

CONSOLIDATED STATEMENTS OF OPERATIONS AND DEFICIT

(unaudited)

	9 months ended March 31		3 months ended March 31	
	2005	2004	2005	2004
REVENUES				
Non hazardous vacuum services	\$ 10,079,027	\$ 10,043,977	\$ 3,596,484	\$ 3,144,730
Compactor rental income	388,504	387,531	129,501	129,342
Compactor sales, service & other	58,384	67,917	25,265	51,357
	10,525,915	10,499,425	3,751,250	3,325,429
DIRECT COSTS	7,866,055	7,942,822	2,790,369	2,604,135
CONTRIBUTION	2,659,860	2,556,602	960,881	721,294
OPERATING EXPENSE (INCOME)				
Cash operating expenses (income)				
Selling, general and administrative	1,976,435	2,120,584	620,100	724,581
Interest on long-term debt and obligations under capital lease	105,056	23,987	33,148	24,212
Other interest	35,754	118,619	11,945	36,520
	2,117,245	2,263,190	665,193	785,313
Non-cash operating expenses (income)				
Amortization of property, plant and equipment	435,475	412,649	144,425	108,555
Amortization of intangible assets	726,798	757,500	242,266	252,500
Dividends on preferred shares	209,483	(20,000)	71,840	
Foreign exchange (gain) loss	(54,267)	(28,961)	16,287	13,223
	1,317,489	1,121,188	474,818	374,278
Total operating expense (income)	3,434,734	3,384,378	1,140,011	1,159,591
LOSS BEFORE OTHER INCOME (EXPENSE) AND INCOME TAXES	(774,873)	(827,776)	(179,130)	(438,297)
OTHER INCOME (EXPENSE)				
Gain on disposal property, plant and equipment	-	41,928	-	350
Recovery of investment	-	18,086	-	(24)
	-	60,014	-	326
LOSS BEFORE INCOME TAXES	(774,873)	(767,763)	(179,130)	(437,970)
INCOME TAXES (RECOVERY)				
Current	-	(9,534)	-	(9,534)
Future	-	-	-	-
	-	(9,534)	-	(9,534)
LOSS	(774,873)	(758,229)	(179,130)	(428,436)
DEFICIT, BEGINNING OF PERIOD	(5,972,238)	(17,280,886)	(6,567,981)	(4,610,679)
REDUCTION OF CAPITAL STOCK & DEFICIT		13,000,000		
DEFICIT, END OF PERIOD	\$ (6,747,111)	\$ (5,039,115)	\$ (6,747,111)	\$ (5,039,115)
LOSS PER SHARE, BASIC AND DILUTED	\$(0.02)	\$(0.02)	\$(0.00)	\$(0.01)
WEIGHTED AVERAGE NUMBER OF SHARES OUTSTANDING				
	39,256,748	34,145,128	39,632,763	34,147,323

See accompanying notes to the consolidated financial statements. These interim financial statements should be read in conjunction with 2004 annual consolidated financial statements.

NATIONAL CHALLENGE SYSTEMS INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS

(unaudited)

	9 months ended March 31		3 months ended March 31	
	2005	2004	2005	2004
Increase (decrease) in cash and cash equivalents				
OPERATING ACTIVITIES				
Net loss for the period	\$ (774,873)	\$ (758,229)	\$ (179,130)	\$ (428,436)
Add (deduct) items not involving cash				
Amortization of property, plant and equipment	429,269	412,649	142,357	108,555
Amortization of intangible assets	726,798	757,500	242,266	252,500
Deferred/Accrued expenses	10,163		3,408	
Gain on disposal of property plant and equipment	-	(41,928)	0	(350)
Dividends accrued on preferred shares	209,483		71,840	
Stock-based compensation, note 3(a)	84,500		16,000	
Stock option compensation, note 3(b)	26,171	8,000	0	
Foreign Exchange gain/loss	(54,267)		16,287	
Cashflows before changes in non-cash working capital	657,244	377,992	313,028	(67,731)
Net changes in non-cash working capital items				
Accounts receivable	(495,157)	284,725	(304,703)	309,581
Inventory	(1,587)	2,990	7,743	42,319
Prepaid expenses	114,096	(6,739)	32,326	(11,971)
Accounts payable and accrued liabilities	75,885	(144,413)	25,606	(52,756)
Income taxes payable	(55,930)	(29,308)	(18,910)	(13,308)
Cashflows from operating activities	294,551	485,247	55,090	206,133
INVESTING ACTIVITIES				
Acquisition of property, plant and equipment	(989,087)	(239,078)	13,768	(132,192)
Proceeds on disposal of property, plant and equipment	-	126,577		-
	(989,087)	(112,501)	13,768	(132,192)
Cashflows from operating and investing activities	\$ (694,536)	\$ 372,746	\$ 68,858	\$ 73,941
FINANCING ACTIVITIES				
Advances (Repayment) of bank indebtedness	370,702	(247,881)	58,487	22,189
Proceeds (Repayment) of long-term debt	396,863	(69,902)	(54,235)	(91,847)
Proceeds (Repayment) of capital lease obligation	(73,029)	(35,982)	(73,110)	(11,084)
Cashflows from financing activities	\$ 694,536	\$ (353,765)	\$ (68,858)	\$ (80,742)
Cash and cash equivalents, beginning and end of year	\$ -	\$ -	\$ -	\$ -
Supplemental cash flow information				
Interest paid	112,496	120,002	33,001	44,989
Income taxes paid	55,930	33,588	18,910	17,588

See accompanying notes to the consolidated financial statements. These interim financial statements should be read in conjunction with 2004 annual consolidated financial statements.

NATIONAL CHALLENGE SYSTEMS INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

March 31, 2005

1. NATURE OF OPERATIONS AND GOING CONCERN

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.

These financial statements have been prepared on the basis of accounting principles applicable to a going concern, which assume that the Company will continue in operation for the foreseeable future and will be able to realize its assets and discharge its liabilities in the normal course of operations.

The Company has incurred significant operating losses in the current period and prior years and at March 31, 2005 the Company's current liabilities exceeded its current assets. In addition, as described in note 8 of the annual financial statements, the Company is in violation of one of its banking covenants; however at present the bank continues to support the Company with access to the demand operating line of credit. Notwithstanding such support, the Company is in the process of negotiating a new credit facility with another lender.

The Company is also actively pursuing additional financing, and while it has been successful in the past, there can be no assurance it will be successful in raising additional funds in the future. The Company is also negotiating the sale of certain non-core rental assets.

These financial statements do not reflect adjustments that would be necessary in the carrying values of assets and liabilities, the reported revenues and expenses, and the balance sheet classifications used if the going concern assumption were not appropriate. The recovery of the carrying value of the Company's assets and the Company's continued existence is dependent upon continued support of its bank, the obtaining of alternate financing and/or the achievement of profitable operations.

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, 2004 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, 2004.

3. CAPITAL STOCK

(a) Common Share

On July 12, 2004 the Company closed a private placement with net proceeds of \$613,000 for 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. Proceeds from the private placement were received and recorded in June 2004.

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 December 31, 2004 the Company issued 310,000 common shares to the executive related to this contract.

As approved by the shareholders at the Company's annual general meeting on November 17, 2003, the Company reduced capital stock and deficit in the unconsolidated financial statements of the parent

NATIONAL CHALLENGE SYSTEMS INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

March 31, 2005

3. CAPITAL STOCK (cont'd)

company by \$13,000,000 during 2004. The reduction in capital stock and deficit absorbs prior years' losses, which related primarily to its former activities in the compactor sector.

The change in capital stock is reflected below:

	<u>Number of Shares</u>		<u>Book Value</u>	
	<u>March 31, 2005</u>	<u>June 30, 2004</u>	<u>March 31, 2005</u>	<u>June 30, 2004</u>
Opening balance	34,147,323	34,134,198	\$ 11,003,150	\$ 23,999,848
Directors, Compensation	145,000	13,125	18,523	3,302
Reduction of Capital and Deficit	-	-	-	(13,000,000)
Private Placement	5,040,000	-	613,000	-
Executive Compensation	310,000	-	46,500	-
Closing balance	<u>39,642,323</u>	<u>34,147,323</u>	<u>\$ 11,681,173</u>	<u>\$ 11,003,150</u>

(b) Stock options

At the Corporation's annual general meeting held on November 18, 2004, the shareholders of the Corporation approved an amendment to its Stock Option Plan (the "Plan") to provide for the increase in the maximum number of common shares reserved for issuance under the Plan from 4,218,137 shares to 5,200,000 shares.

On November 18, 2004 a total 500,000 options were granted to a director at an exercise price of \$0.20/share. Using the Black-Scholes option pricing model the fair value of these options was recorded as a compensation cost at \$0.04/each based on the following assumptions:

- | | |
|-------------------------------|-----------|
| (i) Risk free interest rate | 3.9% |
| (ii) Expected life | 5.0 years |
| (iii) Expected dividend yield | 0% |
| (iv) Volatility | 60% |

4. ACQUISITION OF LAND AND BUILDING

On August 31, 2004, Organic Resource Management Inc., a wholly owned subsidiary, purchased the Toronto facility that it had rented since 1992. The purchase price of the land and building was \$900,857 of which \$280,857 was paid in cash and the remainder was financed through a first mortgage on the property having a principal balance of \$620,000, bearing interest at 8%, repayable in monthly instalments of principal and interest of \$5,186 and matures in November 2009.

5. COMPARATIVE FIGURES

Certain comparative figures have been reclassified to conform with the current year's presentation.