



Management's Discussion and Analysis

For the Fiscal Year Ended February 28, 2011

June 27, 2011

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Management's Discussion and Analysis

The following information should be read in conjunction with the Company's audited consolidated financial statements for the fiscal year ended February 28, 2011 and notes thereto that are prepared in accordance with Canadian generally accepted accounting principles. All financial information is stated in Canadian dollars, unless otherwise stated. Additional information regarding ESI Entertainment Systems Inc ("ESI") is on the System for Electronic Document Analysis and Retrieval (SEDAR) at www.sedar.com.

Forward Looking Information

This Management's discussion and analysis contains forward-looking statements concerning ESI which statements can be identified by the use of forward-looking terminology such as "expect", "proposed", "may", "plan", "intend", "will", "would" or the negative thereof or any other variations thereon or comparable terminology referring to future events or results. Forward-looking statements are statements about the future and are inherently uncertain, and the actual events or results could be materially different than those anticipated in those forward-looking statements as a result of numerous factors discussed more fully in this document. These risks include risks related to revenue growth, operating results, industry growth, changes in regulation and legislation, products, technology, financing, competition, personnel and other factors affecting the Company and its business, any of which could cause actual events or results to vary materially from ESI's anticipated future results. Forward-looking statements are based on beliefs, opinions and expectations of ESI's management at the time they are made, and ESI does not assume any obligation to update its forward-looking statements if those beliefs, opinions or expectations, or other circumstances should change. Investors are referred to the Company's Annual Information Form dated May 28, 2009 for a discussion of risk factors that could affect the Company's performance.

Overview

Core Business, Vision and Strategy

Vision and Strategy

ESI is an idea generation and software development company. We develop concepts, create prototypes, establish partnerships and validate potential markets. When we have proven a product and its opportunities we create subsidiaries with a dedicated team, infrastructure, and resources to allow it to focus on building and selling the product to its market niche. Our team of experienced and dedicated people have led us to be revolutionary market leaders in many industries, including e-commerce payment technologies, hardware based input devices, real time auditing systems, transaction processing systems, graphical 3D displays, e-commerce web services, and payment fraud and risk mitigation. Since formation in 1999 ESI has created three independently operated and controlled subsidiaries based on validated and proven products: Citadel Commerce Corp., ESI Integrity Inc., and PlayLine Inc. PlayLine Inc. is presently dormant.

ESI has 21 employees located in Burnaby, British Columbia, Canada, and markets its products and services globally from this location.

ESI Integrity and Citadel each have a strategic objective to become a leader in the development and sale of products and services to the international gaming and e-commerce industries operating within jurisdictions where such activities are lawful. They are focused on expanding their market reach into new geographic regions and on delivering new products and services that offer compelling value to our customers. The strategy to achieve this objective includes the following key elements:

- Expanding the adoption of our monitoring and payment services into new geographic regions;
- Establishing relationships with new customers in new geographic regions;
- Delivering new products and services to meet customer requirements; and
- Broadening the network of sales agents and strategic relationships.

ESI Integrity Inc. (“ESI Integrity”)

ESI Integrity provides real time auditing, fraud control and risk management systems to government lotteries and pari-mutuel (horse tracks) organizations. Integrity enters into long term customer license and support contracts where it charges a fixed license fee for the use of its audit and risk management software, as well as an annual support fee. The license contracts can be perpetual or renewable. The support contracts are renewable. Revenue is typically earned over a two to five year period, depending on a contract’s respective term. The growth in revenue is dependent on the number of contracts executed in a given year, which may vary substantially from year to year. The cost of licensing revenue primarily consists of the cost of customizing the software and the cost of installing and testing the software. The cost of support revenues primarily relates to personnel support costs.

Citadel Commerce Corp. (“Citadel”)

Citadel’s primary product is its Instant Bank Transfer service. It earns a fee on each payment processed to and from end-users and e-commerce merchants. Citadel provides on-line payment processing services including electronic cheques and paper cheques but its main focus is its instant online banking services. Transactions are processed with concurrent transactional fraud detection services including full identity pre-authorization via in-house and third party databases and validation of previous transaction history. All of Citadel’s services are based on a fee per transaction charged to its merchants. Its existing infrastructure and personnel have the capability to process substantially larger volumes.

The Instant Bank Transfer service uses a software product that assists the consumer to complete the details of an online bank transfer which simplifies the process and eliminates data entry errors. The software also detects when the customer initiated the transfer and the merchant is notified that the funds have been sent. Citadel uses proprietary back-office software to electronically scan Citadel bank accounts for received deposits and to notify merchants of changes in transaction states. Knowing that the funds have been sent by the customer allows the merchant to have a high level of confidence that the funds will soon be received by Citadel. This allows the merchant to provide the customer with instant access to their funds.

Corporate Overhead

ESI provides infrastructure and other support services to the two principal subsidiary companies. These services include facilities, legal, investor relations, insurance and other services.

Fiscal 2011 Financial Highlights

The highlights for ESI, on a consolidated basis, are:

- Consolidated revenue decreased by 5% to \$3.408 million in 2011 compared to \$3.581 million in 2010;
- Consolidated gross profit increased by 75% to \$1.798 million for fiscal 2011 from \$1.023 million for fiscal 2010;
- Consolidated operating expenses decreased by 11% to \$2.938 million for fiscal 2011 from \$3.294 million for fiscal 2010.
- Consolidated net loss before income taxes decreased by 69% to \$0.734 million for fiscal 2011 compared to a loss of \$2.34 million for fiscal 2010.

Selected Financial Information

	February 28, 2011	Year ended February 28, 2010	February 28, 2009
<i>(\$ 000) except for EPS</i>			
Revenue	3,408	3,581	3,954
Gross Profit	1,798	1,023	971
Total operating expenses	2,938	3,294	5,560
Net Loss	(734)	(2,340)	(5,068)
(Loss) earnings per share			
Basic and Diluted	(0.05)	(0.16)	(0.36)
Total Assets	5,238	6,222	6,052
Total long-term liabilities	519	913	1,324
Cash generated from operations	(194)	(984)	(4,467)

Revenues from ESI Integrity decreased by 33% to \$1.642 million in fiscal 2011 from \$2.453 million in fiscal 2010 while Integrity Cost of Sales decreased by 37% resulting in an improvement in Gross Margin from 45% in fiscal 2010 to 48% in fiscal 2011. The decrease in revenues was predominantly due to a 68% decrease in consulting and work plan revenue as lotteries cut back on new games and promotions over the year. The strengthening Canadian dollar relative to the US dollar and Euro over fiscal 2011 also impacted revenues as over 76% of Integrity revenues are contracted for in either USD or EUR.

Citadel's revenues have increased by 57% to \$1.766 million in fiscal 2011 from \$1.128 million in fiscal 2010. Citadel's growth has come from obtaining new merchants and has significantly increased its payment processing volume.

Consolidated gross profit increased from \$1.023 million in fiscal 2010 to \$1.798 million for fiscal 2011, a 76% increase. The profit margin for Citadel improved from (7%) in fiscal 2010 to 57% in fiscal 2011. The profit margin for ESI Integrity increased during fiscal 2011 to 48% from 45% in fiscal 2010.

Total consolidated operating expenses decreased by 11% during fiscal 2011 from \$3.294 million in 2010 to \$2.938 million in fiscal 2011. The company has restructured to account for the reduction in consolidated revenues.

ESI Integrity continues to provide reliable, profitable revenue and has a contracted backlog of \$1.07 million revenue extending forward over many years, as well as new customers and projects forecasted. Citadel has managed its operational costs in order to implement its strategy to maintain a sufficiently comprehensive base of personnel and facilities to enable it to develop new products, access new markets and support the growing business.

Results of Operations

Consolidated Revenues

The following table provides a breakdown of the Company's revenues from its two subsidiaries for the reported periods:

(\$ 000)	Year ended		% change
	February 28, 2011	February 28, 2010	
Integrity	1,642	2,453	(33.1%)
Citadel	1,766	1,128	56.6%
Total revenue	3,408	3,581	(4.8%)

Total revenue decreased by 4.8% to \$3.408 million in fiscal 2011 from \$3.581 million in fiscal 2010. The decrease was due to the reduction in revenue earned by ESI Integrity.

Consolidated Gross Profit

The following table provides a summary of the Company's gross profit for the reported periods:

(\$ 000)	Year ended	
	February 28, 2011	February 28, 2010
Revenues	3,408	3,581
Direct costs	1,610	2,558
Gross profit	1,798	1,023
Gross profit margin	53%	29%

The increase in consolidated gross profit margin in fiscal 2011 was due to the additional revenue earned within the Citadel subsidiary and the reduction of direct costs for Citadel.

The gross profit margin by dollar and as a percentage of revenues for each subsidiary is listed below:

(\$ 000)	February 28, 2011		Year ended February 28, 2010		February 28, 2009	
		<u>GP%</u>		<u>GP%</u>		<u>GP%</u>
Integrity	787	48%	1,099	45%	1,129	35%
Citadel	1,011	57%	(76)	(7%)	(158)	(22%)
Total gross profit	1,798	53%	1,023	29%	971	25%

Integrity's gross profit margin increased to 48% from 45% in the prior fiscal period. This was due to improved operating efficiencies implemented by Integrity in fiscal 2011. Integrity typically has a 40% to 43% gross profit margin. Citadel's gross profit margin during fiscal 2011 was 57%, compared to (7%) for the prior fiscal year, reflecting the significant increase in revenue earned from its payment processing over the prior years and a reduction in direct costs.

Product Development

Product development expenses were \$0.171 million in fiscal 2011, a decrease of 2% compared to \$0.175 million for the prior period. These expenditures are principally related to software development of the Citadel products. Integrity commenced the development of its next-generation software for Monitoring Systems in fiscal 2010, with completion expected in the second quarter of fiscal 2012. Note that Integrity capitalizes product development costs.

Sales, Marketing and Customer Service

Sales, marketing and customer service expenses were \$0.142 million for fiscal 2011, an increase of 5% compared to \$0.135 million for the prior period. The increase primarily related to the expansion of Integrity's sales and marketing activities.

General and Administrative

General and administrative expenses were \$2.57 million for fiscal 2011, a decrease of 8% compared to \$2.79 million for the prior period. This decrease resulted from reductions in the financial, human resources and information systems departments to manage the decreased activity within the Integrity division in particular.

Included in general and administrative expenses was non-cash stock compensation expense of \$92,992 for fiscal 2011, compared to approximately \$138,655 for fiscal 2010. Stock compensation expense decreased during fiscal 2011 as a result of minimum stock grants to the Company's employee base.

Amortization of Property and Equipment

Amortization expenses were \$53,281 for fiscal 2011, a decrease of 72% compared to \$187,298 for the prior period. The decrease is accounted for by the cut back in purchases of computer hardware and software, furniture and fixtures and leasehold improvements, consequent on the contraction of the Company's employee base.

Net Loss

Net loss for fiscal 2011 was \$0.734 million (\$0.05 loss per share - basic and diluted) compared to net loss of \$2.34 million (\$0.16 loss per share; basic and diluted) for fiscal 2010. This decrease was largely driven by the restructuring of the Citadel business unit with the reductions in costs and the increased revenue. The overall loss is due to the slower than planned growth of additional revenue expected from the Citadel business unit.

Citadel Processing Accounts and Liabilities

Citadel processing as at February 28, 2011 totaled \$5.321 million compared to \$5.649 million as at February 28, 2010. The amounts are segregated bank funds arising from the processing of deposits and payments for Citadel merchants and consumers. The processing account balances are also recorded as a liability because these funds represent amounts due to consumers and merchants. The decrease in Citadel processing accounts and Citadel processing liabilities is due to the timing for disbursing to our merchants.

Summary of Quarterly Results

(\$000) except for per share data	28-Feb 2011	30-Nov 2010	31-Aug 2010	31-May 2010	28-Feb 2010	30-Nov 2009	31-Aug 2009	31-May 2009
Consolidated Revenue	907	936	822	743	963	832	952	834
Consolidated Gross Profit	914	488	339	57	253	198	355	160
% of revenues	101%	52%	41%	8%	26%	24%	37%	19%
Total Operating Expenses	841	664	729	704	682	825	752	851
% of revenues	93%	71%	87%	95%	71%	99%	78%	102%
Consolidated Net Income (loss)	(286)	250	(283)	(415)	(199)	(525)	(535)	(522)
% of revenues	-31%	26%	-34%	-56%	-21%	-63%	-56%	-63%
Earnings per share								
Basic	(\$0.02)	\$0.02	(\$0.02)	(\$0.04)	(\$0.02)	(\$0.04)	(\$0.04)	(\$0.04)
Diluted	(\$0.02)	\$0.02	(\$0.02)	(\$0.04)	(\$0.02)	(\$0.04)	(\$0.04)	(\$0.04)

Consolidated revenues have remained consistent despite the reduction in Integrity revenue. Citadel's increased contribution to the consolidated revenues have helped maintain a stable quarterly revenue position.

Total operating expenses have decreased during fiscal 2011 compared to fiscal 2010, mainly due to the decreased level of amortization from fixed asset additions; general and administrative costs also decreased as the Company's personnel and support activities were reduced during fiscal 2011. Certain expenses, specifically stock-based compensation costs and foreign exchange costs, also decreased during fiscal 2011 over fiscal 2010. The amounts of operating expenses are expected to remain fairly level going forward as the Company has made significant restructuring initiatives that allow ongoing improved operating efficiency. The Company will consider adjusting its costs going forward based on sales activity.

Net loss has also been significantly reduced due to the cut-backs on direct and operating expenses. The Company is continuing its efforts to achieve a net income and its success is reliant on the achievement of sales targets both in the Citadel and the Integrity divisions.

Liquidity and Capital Resources

ESI has historically financed its operations through the sale of equity and through cash generated by its operations.

During fiscal 2011, cash used in operating activities was (\$0.194) million compared to (\$0.984) million during fiscal 2010. Non-cash operating items in fiscal 2011 were lower than in fiscal 2010, principally as a result of less provision being taken for assets being amortized and the collection of outstanding accounts receivables.

Cash provided by financing activities totaled \$0.239 million during fiscal 2011 compared to cash provided by financing activities of \$0.291 million in fiscal 2010. The financing activities in fiscal 2011 include the Company's US\$2 million loan obtained in June 2008.

Overall, the net cash used in fiscal 2011 was \$0.071 million compared to net cash used of \$0.821 million in fiscal 2010.

Integrity's Deferred Revenue

ESI Integrity's deferred revenue represents license agreements invoiced for which the non-refundable payment is received or due to be paid in full, but for which the revenue is not yet recognizable under GAAP. Deferred revenue dropped to \$1.004 million at February 28, 2011 compared to \$1.496 million at February 28, 2010. Future sales contracts will increase this balance and will have a corresponding effect on revenue in future periods. Deferred revenue provides a high degree of visibility for future period revenues, with the current portion showing the amount that will be included in revenue over the next twelve months.

ESI Integrity contract costs incurred for the installation of software pursuant to license agreements are included in deferred contract costs. These expenditures, generally related to materials and direct labour costs, are charged to direct cost of revenues earned by ESI Integrity over the term of the related revenue contract.

<u>(\$ 000)</u>	<u>Year ended February 28, 2011</u>	<u>Year ended February 28, 2010</u>
Deferred revenue - current	485	582
Deferred revenue – long term	519	914
Deferred cost	383	550

Loan Payable

In June 2008, the Company secured a US \$2 million dollar loan bearing interest at the rate of 6% per annum. The loan is secured by first ranking fixed charges on the entire issued share capital of the Company's principal subsidiaries, ESI Integrity Inc., Citadel Commerce Corp and Citadel Commerce UK Limited. On January 28, 2010, the Company renegotiated the terms of the loan facility so that the loan is no longer repayable on a fixed date; all other terms of the loan are unchanged.

Contractual Obligations

The Company leases certain office premises and equipment under operating leases. The future minimum payments under these leases are as follows:

2012	\$	228,322
2013	\$	13,106

The Company expects to fund these obligations out of its future revenue and cash reserves.

Contingent Off-Balance Sheet Arrangements

The Company did not have any contingent off-balance sheet arrangements during fiscal 2011.

Outstanding Share Data

ESI's outstanding share data is listed in the table below.

Authorized:

Unlimited voting common shares without par value

	<u>Number of Common Shares</u>	<u>Amount</u>
Issued and outstanding - common shares		
Balance, February 29, 2008	# <u>14,234,727</u>	\$ <u>9,957,959</u>
Balance February 28, 2009	# <u>14,234,727</u>	\$ <u>9,957,959</u>
Balance February 28, 2010	# <u>14,234,727</u>	\$ <u>9,957,959</u>
Balance February 28, 2011	# <u>14,234,727</u>	\$ <u>9,957,959</u>

As at February 28, 2011 and the date of this Report, there were 14,234,727 shares issued and outstanding. As at February 28, 2011, there were 1,559,000 Incentive Stock Options outstanding, which was reduced (by expiry) to 1,392,000 as at the date of this Report.

Please refer to Notes 8 and 9 to the audited financial statements for the years ended February 28, 2011 and February 28, 2010 for particulars of the issued shares and incentive stock options.

Related Party Transactions

During the year ended February 28, 2011, the Company had no related party transactions.

Critical Accounting Policies and Estimates

The Company's accounting policies are outlined in Note 2 to the audited consolidated financial statements.

Additionally, the preparation of the consolidated financial statements in conformity with Canadian generally accepted accounting principles requires management to make estimates and assumptions, which affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amount of revenues and expenses for the period. Actual results could differ from these estimates. Areas where critical accounting estimates are used include revenue recognition and stock compensation expense.

Revenue Recognition

ESI Integrity earns revenue from long term contracts with government lotteries and pari-mutuel organizations. These contracts contain multiple deliverables such as software licenses and support agreements. Since very few contracts have been renewed due to the long term nature of the contracts that have yet to reach the end of their initial term, specific components of the contracts, such as the software licenses, cannot be accounted for as separate units because there is no way to objectively determine their separate values for accounting purposes. Thus, software license revenues are recognized over the term of the related support service contract, subject to the delivery and installation of the software and acceptance by the customer. Revenues earned from support contracts are recognized ratably over the contract term. Any additional services performed for customers on a fee for services basis are recognized when the services have been rendered.

Citadel revenues are earned by processing payment transactions to and from consumers and on-line merchants. Revenues from these transactions are recognized on the execution of the underlying transactions.

Stock Compensation Expense

The Company has adopted the recommendations of the CICA Handbook Section 3870, "*Stock-Based Compensation and Other Stock-Based Payments*", which requires the fair value based method of accounting for all stock based compensation earning during a year. Under the fair value method, compensation cost is measured at fair value at the date of grant and is expensed over the vesting period of the options with a corresponding credit to contributed surplus. The Company uses the Black-Scholes option pricing model to calculate the fair value of stock options granted, which requires that certain assumptions be made, including the expected life of the option, dividend yield and expected volatility of the stock at the time the stock options are granted.

Changes in Accounting Policies and Recent Pronouncements

The Company did not change any accounting policies during the year ended February 28, 2011 relative to the prior fiscal year. A number of new Policies, as set out in the Canadian Institute of Chartered Accountants Handbook were applied. The new policies include:

Financial Instruments Disclosures, Section 3862 / Financial Instruments Presentation, Section 3863

In June 2009, the CICA issued amendments to CICA Section 3862, "Financial Instruments-Disclosures" and Section 3863 "Financial Instruments – Presentation". The amendments include disclosures around the liquidity risk associated with financial instruments and additional disclosures related to the fair value of the same. The amendments are effective for annual financial statements for fiscal years ending after September 30, 2009. Disclosures required by this standard are included in Note 15. The adoption of these sections had no effect on the Company's financial statements.

Goodwill and intangible assets, Section 3064

Effective January 1, 2009 the Company adopted Section 3064 "Goodwill and intangible assets" replacing Section 3062 "Goodwill and intangible assets" and Section 3450 "Research and development costs". Section 3064 establishes revised standards for the recognition, measurement, presentation and disclosure of goodwill subsequent to its initial recognition and of intangible assets by profit-oriented enterprises. Standards concerning goodwill are unchanged from the standards included in the previous Section 3062. The adoption of this section had no effect on the Corporation's financial statements.

Credit risk and the fair value of the financial assets and liabilities, EIC – 173

Effective January 20, 2009, the Company adopted the Emerging Issues Committee ("EIC") Abstract 173, "Credit Risk and the Fair Value of Financial Assets and Liabilities" which provides additional information on the fair value of financial assets and liabilities under Section 3855, "Financial Instruments- Recognition and Measurement". The adoption of this Abstract resulted in no change to the Company's financial statements.

The application of these new policies did not result in any material change to or impact on the Company's financial results for fiscal 2011, but they do result in certain changes in presentation. Readers should note that over the next few years, and in particular commencing in 2012, new financial standards will be applied, namely the International Financial Reporting Standards ("IFRS"). The implementation of IFRS will be regulated for all public companies in Canada in order to bring a single and uniform set of accounting standards to public companies within all the countries that subscribe to IFRS – which includes the countries within the European Union, Canada and the United States.

Convergence with International Financial Reporting Standards (IFRS) as Issued by the International Accounting Standards Board

In February 2008, the Canadian Accounting Standards Board confirmed that publicly listed companies will be required to adopt IFRS for fiscal years beginning on or after January 1, 2011. The Company has adopted March 1, 2011 as the date that it will adopt IFRS; accordingly, the Company will report under these new standards in its first quarter of fiscal 2012, with restatement of comparative information presented. The conversion to IFRS will impact the Company's accounting policies, information technology and data systems, internal control over financial reporting, and disclosure controls and procedures. The transition may also impact business activities, such as foreign currency activities, certain contractual arrangements, capital requirements and compensation arrangements. The Company commenced its IFRS Implementation project in fiscal 2010. The project consists of three phases:

- **Initial impact assessment and scoping phase**

This phase includes the identification of significant differences between existing Canadian GAAP and IFRS, as relevant to the Company. Based upon the current state of IFRS, this phase identified a modest number of topics possibly impacting either the Company's financial results and/or the Company's effort necessary to change to IFRS. This phase is still in process.

- **Focused analysis and review phase**

Upon completion of the Initial Impact and scoping phase, the Company will perform a detailed analysis of the differences between Canadian GAAP and IFRS in order to select the accounting policies that are necessary for the Company to change over to IFRS. The detailed analysis of the accounting policies impacted by the IFRS convergence is expected to be completed in fiscal 2012. The elements that may be affected by the implementation of IFRS are income taxes, capital assets, stock-based compensation and foreign exchange. As well, this phase includes other operational elements such as information technology, internal control over financial reporting and training.

Further analysis and research is required before the Company can elaborate on the pre- and post-IFRS conversion accounting policy differences.

- **Integration phase**

During this phase the Company will integrate the solutions into the Company's underlying financial system and processes that are necessary for the changeover to IFRS.

The Company will present its results through fiscal 2011 using contemporary Canadian GAAP. In fiscal 2012, the Company will present its comparative results for fiscal 2011 using contemporary IFRS. To accomplish this, in fiscal 2011 the Company will effectively maintain two parallel sets of financial statements.

The Company will report on the effect of its IFRS implementation plan in future MD&A's.

Recent pronouncements in accounting standards

International Financial Reporting Standards ("IFRS")

In February 2008, the Canadian Accounting Standards Board ("AcSB") announced that 2011 is the changeover date for publicly-listed companies to use International Financial Reporting Standards ("IFRS"), replacing Canada's own GAAP. The date is for interim and annual financial statements relating to fiscal years beginning on or after January 1, 2011. The transition date of March 1, 2011 will require the restatement for comparative purposes of amounts reported by the Company for the year ended February 28, 2011.

Business combinations, Section 1582 / Consolidated financial statements, Section 1601 / Non-controlling interest, Section 1602

In January 2009, the CICA issued Handbook Sections 1582 "Business Combinations"; 1601 "Consolidated Financial Statements"; and 1602 "Non-controlling Interests", which replace CICA Handbook Sections 1581 "Business Combinations" and 1600 "Consolidated Financial Statements". Section 1582 establishes standards for the accounting for business combinations that is equivalent to the business combination accounting standard under IFRS. Section 1582 is applicable for the Company's business combinations with acquisition dates on or after January 1, 2011. Section 1601 together with Section 1602 establishes standards for the preparation of

consolidated financial statements. Section 1601 is applicable for the Company's interim and annual consolidated financial statements for its fiscal year beginning on or after January 1, 2011. Early adoption of these sections is permitted and all three sections must be adopted concurrently. The adoption of these standards is not expected to have an impact on the Company's financial statements.

Disclosure Controls and Procedures

The Company maintains a set of disclosure controls and procedures ("DC&P") designed to ensure that information required to be disclosed is gathered, recorded, processed, summarized and reported on a timely basis so that appropriate decisions can be made regarding public disclosure within the time periods specified in provincial securities legislation and regulations. The Company evaluated its disclosure controls and procedures as defined under Multilateral Instrument 52-109 for the year ended February 28, 2011. This evaluation was performed by the Chief Executive Officer and the Chief Financial Officer with the assistance of other Company employees to the extent necessary and appropriate. Based on this evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the design and operation of the Company's DC&P were effective to provide reasonable assurance that information required to be disclosed in the Company's annual filings, interim filings and other public disclosures is gathered, recorded, processed, summarized and reported on a timely basis to ensure compliance with applicable securities legislation and regulations and to allow timely decisions regarding required disclosure.

Internal Controls and Procedures

Management is responsible for establishing and maintaining effective internal control over financial reporting ("ICFR"). The Company maintains a set of internal controls over financial reporting which have been designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements in accordance with Canadian GAAP and in compliance with requirements of Canadian Securities Administrators. The Company evaluated the design of its internal controls and procedures as defined under Multilateral Instrument 52-109 for the year ended February 28, 2011. The framework used to design the Company's ICFR is based on the framework established by *Internal Control over Financial Reporting – Guidance for Smaller Public Companies*, published by the Committee of Sponsoring Organizations of the Treadway Committee. The Company's internal control over financial reporting includes:

- Maintaining records that in reasonable detail accurately and fairly reflect transactions and dispositions of assets of the Company;
- Providing reasonable assurance that transactions are recorded as necessary for the preparation of the Company's financial statements in accordance with generally accepted accounting principles;
- Providing reasonable assurance that receipts and expenditures are made in accordance with authorizations of management and the directors of the Company;
- Providing reasonable assurance that unauthorized acquisition, use or disposition of the company assets that could have a material effect on the Company's financial statements would be prevented or detected on a timely basis;

The evaluation was performed by the Chief Executive Officer and the Chief Financial Officer with the assistance of other Company employees to the extent necessary and appropriate. The evaluation identified certain duties within the accounting and finance department that could not be properly segregated, given the Company's limited staff level. None of the segregation of duty deficiencies are believed to have resulted in a misstatement in the financial statements as the Company relies on certain compensating controls, including a substantive periodic review of the financial statements and other financial information by the CEO and the Audit Committee. This weakness is considered to be a common deficiency for many smaller listed companies in Canada. Based on this evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the design of these internal controls and procedures was effective, and no material weaknesses were identified. There were no changes in the Company's internal control over financial reporting that occurred during the fiscal year ended February 28, 2011, that have materially affected, or are reasonably likely to materially affect the Company's internal control over financial reporting.

Risks & Uncertainties

Although not exhaustive, the following list summarizes some of the key risks the Company faces, as well as, strategies the Company employs to manage these risks:

Legislative and Regulatory Risk

Although ESI does not operate a gaming business, anti-gaming legislation or gaming regulation affects many of ESI Integrity and Citadel's customers. Both companies benefit from clear legislation and regulation pertaining to gaming and are challenged in jurisdictions where the situation is ambiguous.

ESI Integrity provides a monitoring service that is not a part of either the gaming system or its support services. Its purpose is to ensure that the gaming system is operating correctly; without error or fraud.

Citadel's service is not a gaming system but is a support service to the gaming industry. It can therefore be more directly affected by the legislative environment and the associated regulations in a particular jurisdiction in which consumers, directly or indirectly, utilize its services.

To manage this risk, the company is accelerating its efforts in the regulated gaming market through its ESI Integrity business initiatives. As well, Citadel processes only for other payment processors in Canada, has ceased all financial processing in the USA, and is actively seeking merchants in the non-gaming industry as well as expanding into the European market where it now derives most of its revenue.

Market, Operating and Competitive Risks

The market opportunity for ESI's products is dependent upon external factors such as the growth of consumers' disposable income, consumer interest in gaming and regulatory and legislative matters. As well, the Company has larger competitors who have larger customer bases and more significant financial and operating resources, which may make it more difficult for ESI to compete in the marketplace. If Citadel and Integrity are not able to continue to renew and grow their customer base, their business would be materially negatively impacted with a commensurate impact upon the Company. To manage this risk, both subsidiaries are investing significant resources in product development, sales, marketing and customer service to ensure

that they deliver products and services that are competitive and valuable to their customers and are attractive to potential new customers. Both subsidiaries are also mitigating some of the market risk by aiming at a diversified customer base in different markets.

Technology Risks

ESI has invested significant resources in its products to ensure that they provide customers with a competitive offering relative to other suppliers. If ESI has not protected its intellectual property adequately or if it infringes third party intellectual property rights, it may lose its competitive advantage and incur significant costs and loss of reputation that could materially negatively impact its business. To manage this risk, ESI has invested significant resources in product development and professional assistance to protect its intellectual property and avoid to the extent possible infringement of third party intellectual property rights.

Financial Risk

Citadel is undertaking an expansion strategy to new markets and new geography. This strategy required significant capital to achieve its long term strategic plan. If the Company is unable fund its strategic plan through operating cash flow, debt and equity financing, its future prospects would be materially negatively impacted. In order to mitigate this risk, Citadel has employed a disciplined budgeting approach to manage its expenditures relative to the achievement of its strategic plan so that appropriate measures can be put in place to reduce the Company's exposure to financial risk.

Citadel is subject to anti-money laundering ("AML") legislation in jurisdictions in which it operates or has operated in. Management has implemented controls and procedures that it believes makes the Company compliant with all applicable AML rules and regulations. It is possible that regulatory authorities may audit Citadel's systems and processes and assess monetary penalties for non-compliance which could be material.

Foreign currency risk

A significant component of the Company's transactions, particularly revenues, may be undertaken in currencies other than the Canadian dollar, and the Company maintains significant deposits in Euro and other currency bank accounts. Fluctuations in exchange rates between the Canadian dollar and other foreign currencies could have a material effect on the business, results of operations and financial condition of the Company. The Company does not use hedging instruments to manage its exposure to foreign currency exchange risk.

Key Personnel Risk

The future success of ESI is heavily dependent upon the Company's ability to retain, recruit and train senior management, technical, sales and managerial personnel. Competition for qualified employees is intense and it may be possible that the Company is unable to retain and recruit qualified personnel in the future. If this were to occur, this would have a material negative impact on the Company. To manage this risk, the Company has implemented employee training programs, recognition programs and competitive compensation.

Management's Responsibility for Financial Reporting

The accompanying consolidated financial statements of ESI Entertainment Systems Inc. and the information in the Annual Report are the responsibility of management and have been approved by the Board of Directors.

The consolidated financial statements have been prepared by management in accordance with accounting principles generally accepted in Canada. When alternative methods exist, management has chosen those it deems most appropriate in the circumstances. Financial statements are not completely precise since they include certain amounts based on estimates and judgment. Management has determined such amounts on a reasonable basis in order to ensure that the consolidated financial statements are presented fairly in all material respects. Management has prepared the financial information presented elsewhere in this Annual Report and has ensured that it is consistent with that in the consolidated financial statements. ESI endeavors to maintain systems of internal accounting and administrative controls of good quality, consistent with reasonable cost. Such systems are necessary to provide reasonable assurance that financial information is relevant, reliable and accurate and that the Company's assets are appropriately accounted for and adequately safeguarded.

The Board of Directors is responsible to ensure that management fulfills its responsibilities for financial reporting and is ultimately responsible for reviewing and approving the financial statements. The Board carries out this responsibility principally through its Audit Committee. The Audit Committee periodically meets with management, as well as the Company's external auditors, to discuss internal controls over the financial reporting process, auditing matters and financial reporting issues, to satisfy itself that each party is properly discharging its responsibilities, and to review the Annual Report, the consolidated and subsidiary level financial statements and the external auditors' report. The Committee reports its findings to the Board for consideration when approving the financial statements for issuance to shareholders. The Committee also considers, for review by the Board and by the shareholders, the engagement or re-appointment of the external auditors.

The Company's consolidated financial statements have been audited by MNP LLP, the external auditors, in accordance with generally accepted auditing standards in Canada on behalf of the shareholders. MNP LLP has the ability to meet with the Audit Committee independent of the Company's management.

Dated: June 27, 2011

"Anthony Greening"
Anthony Greening
Chairman & Chief Executive Officer

"Michael Meeks"
Michael Meeks
President