



**First Quarter Report
and Management's Discussion and Analysis**

For the Fiscal Year 2012

For the Three and Six Months Ending August 31, 2011

October 31, 2011

ESI Entertainment Systems Inc.

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TO OUR SHAREHOLDERS
For the Quarter Ended August 31, 2011

Dear Shareholders:

We are pleased to present our results for the second quarter ended August 31, 2011.

Gross Revenues for the quarter increased by 9% to \$896,000 from \$822,000 during the same period last year. Gross profit increased by 169% to \$914,000 from \$339,000 during the same period last year. Operating expenses decreased by 91% to \$67,000 from \$724,000 during the same period last year. Net comprehensive income was \$889,000 compared to net loss of \$279,000 in the same period last year.

During the period ending August 31, 2011, the Company was pleased to receive approval from certain Executives, Directors and Officers to forgive the majority of amounts owed to them by the Company for their deferred salaries along with the interest accrued on the unpaid amounts for a total of \$1.1 million. The reversal of the Salary Expense significantly reduced the Direct Costs and General and Administration Expense for the quarter, and increased the Gross Profit and Net Income.

Each of the two operating subsidiaries is closely governing expenditures while building its business. ESI Integrity has continued to provide the group with a solid business foundation and Citadel's customers, revenues and transaction volumes have continued to grow.

"Anthony Greening"
Chairman & CEO

"Michael Meeks"
President

MANAGEMENT'S DISCUSSION AND ANALYSIS

The following management discussion and analysis ("MD&A") relates to our unaudited condensed consolidated interim unaudited financial statements for the three and six months ending August 31, 2011 based upon International Financial Reporting Standards ("IFRS"). The MD&A should be read in conjunction with the condensed consolidated interim financial statements for the three and six months ending August 31, 2011, as well as the notes thereto.

On March 1, 2010, the Company transitioned from reporting under Canadian Generally Accepted Accounting Principles ("GAAP") to IFRS for periods commencing on and after that date. Prior to the transition, the Company reported its interim and annual financial statements in accordance with GAAP. An explanation of how the transition from GAAP to IFRS has affected the previously reported financial position, financial performance and cash flows of the Company is provided in note 20 of the unaudited condensed consolidated interim financial statements for the three and six months ending August 31, 2011.

All financial information is stated in Canadian dollars, unless otherwise stated. Additional information regarding ESI Entertainment Systems Inc ("ESI" or "the Company"), including our MD&A and audited consolidated financial statements for the financial year ended February 28, 2011 can be found on the System for Electronic Document Analysis and Retrieval (SEDAR) at www.sedar.com.

Forward Looking Information

This MD&A contains forward-looking statements concerning ESI Entertainment Systems Inc. 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 expected to refer to the “Risks & Uncertainties” section of this MD&A for a discussion of risk factors that could affect the Company’s performance.

Business Overview

ESI Entertainment Systems Inc. is a software development company with two main independently operated and controlled subsidiaries: ESI Integrity Inc. and Citadel Commerce Corp. The two active subsidiaries are located in separate physical locations and operate autonomously with completely separate management, personnel and infrastructure. ESI has 14 Citadel employees and 7 Integrity employees located in Burnaby, British Columbia, Canada from where each company markets its products and services globally.

ESI Integrity provides software solutions for real-time auditing of transaction processing systems, fraud control and risk management systems to businesses requiring high levels of security, integrity, and trust, including government lotteries and pari-mutuel (horse tracks) organizations.

Integrity enters into long term customer license and support contracts and 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 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 provides on-line payment processing services to and from end-users and e-commerce merchants. The payment processing services include Bank Transfers, Instant Bank Transfers, electronic cheques and paper cheques. 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 and end-users.

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

Critical Accounting Policies and Estimates

The 2011 annual consolidated financial statements, as well as the 2011 annual MD&A, outlined the accounting policies and estimates that are critical to the understanding of the Company's business operations and the results of operations. On March 1, 2010, with the adoption of IFRS, the critical accounting policies and estimates have been updated. Refer to notes 2 & 3 of the condensed consolidated interim financial statements for the three and six months ending August 31, 2011 for a detailed discussion regarding the Company's significant accounting policies and the application of critical accounting estimates and judgements. Actual results could differ from these estimates.

Basis of consolidation and financial statement preparation

The unaudited condensed consolidated interim financial statements for the three and six months ending August 31, 2011, have been prepared in accordance with IFRS 34 *Interim Financial Reporting*. The unaudited condensed consolidated interim financial statements do not include all note disclosures required by IFRS for annual consolidated financial statements. Accordingly, these statements should be read in conjunction with the Company's annual audited financial statements for the year ending February 28, 2011.

Transition to IFRS

In February, 2008, the Canadian Accounting Standards Board announced the adoption of IFRS for publicly accountable enterprises in Canada effective January 1, 2011. The accompanying unaudited condensed consolidated interim financial statements for the three and six months ending August 31, 2011 have been prepared under IFRS. The significant accounting policies adopted under IFRS are included in note 3 to the unaudited condensed consolidated interim financial statements and the reconciliations and descriptions of the effect of transitioning from GAAP to IFRS are included in note 20. In accordance with IFRS 1, the Company has retroactively applied IFRS to its comparative data, except for specific instances where IFRS 1 allows for exemptions to the retroactive restatements.

The transition from GAAP to IFRS had no material impact on the consolidated net cash flows of the Company, and as such, no reconciliation has been provided.

Financial Highlights for the Second Fiscal Quarter ending August 31, 2011

The highlights for ESI, on a consolidated basis, compared to the same period last year, are:

- Revenues increased by 9% to \$896,000 from \$822,000
- Gross profit increased by 169%, to \$914,000 from \$339,000
- Operating Expenses decreased by 91% to \$67,000 from \$724,000
- Net comprehensive income was \$889,000 compared to a net loss of 279,000.

During the period ending August 31, 2011, the Company was pleased to receive approval from certain Executives, Directors and Officers to forgive the majority of amounts owed to them by the Company for their deferred salaries along with the interest accrued on the unpaid amounts for a total of \$1.1 million. The reversal of the Salary Expense significantly reduced the Direct Costs and General and Administration Expense for the quarter, which increased the Gross Profit and Net Income

Results of Operations

The Company's three and six months ending August 31, 2011 statements have been prepared using IFRS. Figures for the three and six months ended August 31, 2010 have been restated from those previously reported under GAAP to IFRS. Details regarding the transition to IFRS can be found in the accompanying condensed consolidated interim financial statements (note 20) and in the section above entitled "Transition to IFRS"

Consolidated Revenues

The following table provides a breakdown of the Company's total revenues from its subsidiaries for the three and six months ending August 31, 2011 and 2010.

(\$ 000)	Three months ending August 31			Six months ending August 31		
	2011	2010	% change	2011	2010	% change
Integrity	346	440	(21%)	762	874	(13%)
Citadel	550	382	44%	1,076	691	56%
	896	822	9%	1,838	1,565	17%

Total revenue increased by 9% to \$896,000 for the three months ended August 31, 2011 from \$822,000 for the same period in the prior year. Total revenue increased by 17% to \$1,838,000 for the six months ending August 31, 2011 from \$1,565,000 for the six months ending August 31, 2010.

Integrity Revenues

ESI Integrity provides software solutions for real-time auditing of transaction processing systems to businesses requiring high levels of security, integrity, and trust, including government regulated lotteries and pari-mutuel (horse tracks) organizations.

Integrity Revenues are generated from 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. Revenue is typically earned over a two to five year period, depending on a contract's respective term.

Approximately 38% of ESI's revenues were generated by ESI Integrity during the three months ending August 31, 2011 compared to 54% for the same period in the prior year. Approximately 41% of ESI's revenues were generated by ESI Integrity during the six months ending August 31, 2011 compared to 56% for the same period in the prior year.

The decrease in revenue is due to a reduction in work plan and consulting revenues combined with the adverse effect of the weakened US dollar and Euro currencies relative to the Canadian dollar. The majority of Integrity's revenues are contracted in US dollars or Euros.

Citadel Revenues

Citadel revenues are generated from its on-line payment processing which include electronic cheques and paper cheques but its main focus is its Instant Bank Transfer service. All of Citadel's services are charged on a fee per transaction charged to its merchants.

Approximately 62% of ESI's revenues were generated by Citadel during the three months ended August 31, 2011 compared to 46% for the same period in the prior year. Approximately 59% of ESI's revenues were generated by Citadel during the three months ended August 31, 2011 compared to 44% for the same period in the prior year.

The increase in revenue is due to new merchants implementing Citadel's Instant Bank Transfer service as well as additional volume from existing customers.

Consolidated Gross Profit

The following table provides a summary of the Company's gross profit as prepared in accordance with IFRS for the three and six months ending August 31, 2011 and 2010:

	Three months ending Aug 31		Six months ending Aug 31	
(\$ 000)	2011	2010	2011	2010
Revenues	896	822	1,838	1,565
Direct Costs	(18)	483	790	980
Gross profit	914	339	1,048	585
Gross profit margin (%)	102%	41%	57%	37%

The increase of gross profit in the second quarter ending August 31, 2011, compared to August 31, 2010, is primarily attributable to the reversal of the salary expenses relating to the forgiveness of the majority of deferred salaries and accrued interest by certain Executives, Directors and Officers.

Product Development

All Product Development expenses for ESI Integrity are being capitalized.

Sales, Marketing and Customer Service

Sales, marketing and customer service expenses were \$27,440 and \$59,664 during the three and six months ended August 31, 2011 respectively, a decrease of 5% and 1% respectively compared to \$29,035 and \$60,419 for the three and six months ended August 31, 2010. The decrease in cost is primarily related to the reduction of travel expenses associated with the activity in sales, marketing and customer service

General and Administrative

General and administrative expenses were (\$37,396) and \$257,200 during the three and six months ended August 31, 2011 respectively, compared to \$682,700 and \$1,341,118 for the three months and six months ended August 31, 2010. This reduction is due to the reversal of the salary expenses relating to the forgiveness of the majority of deferred salaries and accrued interest by certain Executives, Directors and Officers for a total of \$ 1.1 million.

Depreciation of Property and Equipment and Capitalized Development Costs

Depreciation expenses were \$19,491 and \$41,578 during the three month and six month periods ended August 31, 2011, respectively, an increase of 57% and 58% compared to \$12,370 and \$26,345 for the corresponding periods ended August 31, 2010. The depreciation being reduced on older equipment is offset by depreciation being recorded on newly incurred capitalized development costs.

Net Loss

Net income for the three and six month periods ended August 31, 2011 was \$889,159 (\$0.06 earning per share) and \$521,192 (\$0.04 earning per share), respectively, compared to net loss of \$278,727 (\$0.02 loss per share) and \$692,906 (\$0.05 loss per share) for the prior comparative periods. This change is due to the reversal of the salary expenses relating to the forgiveness of the majority of deferred salaries and accrued interest by certain Executives, Directors and Officers for a total of \$ 1.1 million.

Citadel Processing Accounts and Liabilities

Citadel processing accounts as at August 31, 2011 totaled \$4.67 million compared to \$4.28 million as at February 28, 2011. The accounts are comprised of cash and accounts receivables arising from the processing of deposits and payments for Citadel merchants and consumers.

Summary of Quarterly Results

The following Table sets out comparative information in respect of the past eight Quarters to August 31, 2011 derived from unaudited statements prepared by Management. As the Table below indicates, results vary from Quarter to Quarter depending on levels of business and operating expenses; for more detail the Reader is referred to other sections of this Report where variations in levels of business and operating expenses are discussed.

(\$000) <i>except for per share data</i>	IFRS						CDN GAAP	
	31-Aug 2011	31-May 2011	28-Feb 2011	30-Nov 2010	31-Aug 2010	31-May 2010	28-Feb 2010	30-Nov 2009
Consolidated Revenue	895	943	907	936	822	743	963	832
Consolidated Gross Profit	914	134	914	488	339	57	253	198
% of revenues	102%	14%	101%	52%	41%	8%	26%	24%
Total Operating Expenses	67	352	841	664	729	704	682	825
% of revenues	8%	37%	93%	71%	87%	95%	71%	99%
Consolidated Net Income (loss)	889	(391)	(315)	250	(283)	(425)	(199)	(525)
% of revenues	99%	-41%	-31%	26%	-34%	-57%	-21%	-63%
Earnings per share								
Basic	\$0.06	(\$0.03)	(\$0.02)	\$0.02	(\$0.02)	(\$0.04)	(\$0.02)	(\$0.04)

Liquidity and Capital Resources

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

During the three month period ended August 31, 2011, cash used in operating activities was \$81,925 and during the six months ended August 31, 2011, cash used in operating activities was \$86,208. During the three month period ended August 31, 2010, cash used in operating activities was \$78,210 and during the six months ended August 31, 2010, cash provided in operating activities was \$7,390

Cash used in financing activities totaled \$9,975 and cash provided totaled \$371,756 during the three months and six months ended August 31, 2011 respectively. These activities relate mainly to the changes in Citadels processing assets. Cash provided by financing activities for the comparative periods for the three and six months ending August 31, 2010, were \$72,247 and \$73,215 respectively. These activities related mainly to the loan payable.

Certain employees have voluntarily deferred part of their compensation. The unpaid deferred amounts are being accrued without interest and are recorded in the Company's financial statements. The salary deferrals are payable upon termination or when the Company's economic conditions have strengthened to accommodate for the repayment. As at August 31, 2011, the total amount of the deferred salaries is \$560,661 (2010 - \$1,158,502).

As at August 31, 2011, the Company had cash and cash equivalents of \$318,794 compared to \$94,794 on August 31, 2010.

During the three months ending August 31, 2011, the decrease in cash totaled \$87,897 compared to \$80,982 for the quarter ended August 31, 2010. During the six months ending August 31, 2011, the increase in cash totaled \$301,000 compared to \$6,000 for the six months ending August 31, 2010

The Company has incurred significant operating losses and net utilization of cash in operations in prior periods. Accordingly, the Company will require continued financial support from its shareholders and creditors and/or new debt or equity financing until it is able to generate sufficient cash flow from operations on a sustained basis.

Outstanding Share Data

ESI's outstanding share data is listed in the table below as at August 31, 2011 and the date of this report.

	Feb 28, 2010	August 31, 2010	Feb 28, 2011	August 31, 2011
Weighted average shares used in computation of basic earnings per share	14,324,727	14,324,727	14,324,727	14,324,727
Fully diluted weighted average common shares	14,324,727	14,324,727	14,324,727	14,324,727

During the three and six months ending August 31, 2011, no options were granted, cancelled or expired, 167,000 were forfeited (2010 – 30,750). 311,750 options became exercisable during the 3 month period ended August 31, 2011. As at August 31, 2011 and the date of this report, there were 1,392,000 options outstanding (August 31, 2010 – 145,000), exercisable at a Weighted Average Price of \$0.05. (August 31, 2010 - \$0.05).

Disclosures, Controls and Procedures

The Company maintains a set of disclosure controls and procedures designed to ensure that information required to be disclosed in filings made pursuant to Multilateral Instrument 52-109 is recorded, processed, summarized and reported within the time periods specified in the Canadian Securities Administrators rules and forms. During the three and six months ending August 31, 2011, the Company did not make any changes to its internal controls over financial reporting that would have materially affected, or would likely materially affect, such controls. The Chief Executive Officer and Chief Financial Officer have evaluated the Company's disclosure controls and procedures as of August 31, 2011 and concluded that the Company's current disclosure controls and procedures are effective.

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:

Market, Operating and Competitive Risks

The market opportunity for ESI's products is dependent upon external factors such as the continued growth in the use of the Internet, 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. Additionally, ESI also has few customers for Citadel business since cessation

of the financial processing business for non-domestic internet gaming merchants. If ESI were not able to grow its customer base, ESI's business would be materially negatively impacted. To manage this risk, ESI has invested significant resources in product development, sales, marketing and customer service to ensure that it delivers products and services that are competitive and valuable to its customers and that are attractive to potential new customers. It also mitigates 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 in its industry. 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

ESI is undertaking an expansion strategy to new markets and new geography. This strategy requires 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, the Company 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.

Regulatory Risk

The Company 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 the Company 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, is undertaken in US dollars, Euros, and other foreign currencies. The Company maintains significant deposits in foreign currencies denominated accounts. Fluctuations in exchange rates between those 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.

For further information please refer to the unaudited condensed consolidated interim financial statements for the three and six months ending August 31, 2011, the audited year end financial statements as at February 28, 2011 and February 28, 2010 and the Management's Discussion and Analysis as at February 28, 2011. All information presented here is filed by the company on SEDAR, (System for Electronic Document Analysis and Retrieval) and can be viewed at www.sedar.com.

Dated : October 31, 2011