



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

**For the Fiscal Year 2011**

**March 1 to May 31, 2010**

**August 19, 2010**

**ESI Entertainment Systems Inc.**

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**TO OUR SHAREHOLDERS**  
**For the Quarter Ended May 31, 2010**

**Dear Shareholder:**

We are pleased to present our results for the first quarter ended May 31, 2010.

Gross Revenues for the quarter decreased by 11% to \$743,000 from \$834,000 during the same period last year. Gross profit increased 54% to \$246,000 from \$160,000 during the same period last year. Operating expenses decreased by 17% to \$704,000 from \$851,000 during the same period last year. Net loss after tax was \$415,000 compared to net loss after tax of \$522,000 in the same period last year, a decrease of 21%.

The first quarter of fiscal 2011 has continued to present us challenges but our experienced Management team and Board have worked well together to allow us to weather these difficult conditions. Each of the two operating subsidiaries has closely governed expenditures while building its business. ESI Integrity has continued to provide the group with a solid business foundation while Citadel builds on the relationships it has developed for use of its products and services to re-build its revenues.

"Anthony Greening"  
Chairman & CEO

"Michael Meeks"  
President

**MANAGEMENT'S DISCUSSION AND ANALYSIS**

The following management discussion and analysis ("MD&A") relates to our interim unaudited financial statements for the three months ended May 31, 2010. The MD&A should be read in conjunction with the Company's February 28, 2010 year-end audited consolidated financial statements and related notes therein 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" or "the Company"), including our MD&A and audited consolidated financial statements for the financial year ended February 28, 2010 can be found on the System for Electronic Document Analysis and Retrieval (SEDAR) at [www.sedar.com](http://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 12 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 Company's accounting policies are outlined in Note 2 of the audited consolidated financial statements for the year ended February 28, 2010.

Additionally, the preparation of the consolidated financial statements in conformity with Canadian Generally Accepted Accounting Principles (GAAP) 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.

## Basis of consolidation and financial statement preparation

The unaudited interim Consolidated Financial Statements dated May 31, 2010, have been prepared in accordance with GAAP on a basis consistent with those followed in the most recent audited annual financial statements for the year ended February 28, 2010. The unaudited interim Consolidated Financial Statements do not include all note disclosures required by GAAP for annual consolidated financial statements. Accordingly, these statements should be read in conjunction with the Company's annual audited financial statements for the year ended February 28, 2010.

## Financial Highlights for the First Fiscal Quarter ended May 31, 2010

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

- Revenues decreased by 11% to \$743,000 from \$834,000
- Gross profit increase by 54%, to \$246,000 from \$160,000
- Operating Expenses decreased by 17% to \$704,000 from \$851,000
- Net loss before income taxes decreased by 21% to \$415,000 from \$522,000.

## Results of Operations

### *Consolidated Revenues*

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

(\$ 000)	Three months ended		% change
	May 31/10	May 31/09	
Integrity	434	581	-25%
Citadel	309	253	22%
<b>Total revenue</b>	<b>743</b>	<b>834</b>	<b>-11%</b>

Total revenue decreased by 11% to \$743,000 for the three months ended May 31, 2010 from \$834,000 for the three months ended May 31, 2009.

### *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 58% of ESI's revenues were generated by ESI Integrity during the three months ended May 31, 2010 compared to 70% 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 42% of ESI's revenues were generated by Citadel during the three months ended May 31, 2010 compared to 30% 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 for the three months ended:

(\$ 000)	May 31/10	May 31/09
Revenues	743	834
Direct Costs	497	674
Gross profit	246	160
Gross profit margin (%)	33%	19%

### *Product Development*

All Product Development expenses are now being capitalized.

### *Sales, Marketing and Customer Service*

Sales, marketing and customer service expenses were \$31,000 during the three months ended May 31, 2010, a decrease of 23% compared to \$40,000 for the three months ended May 31, 2009. The decrease is primarily related to the reduction of staff in sales, marketing and customer service.

### *General and Administrative*

General and administrative expenses were \$659,000 during the three months ended May 31, 2010, a decrease of 2% compared to \$676,000 for the three months ended May 31, 2009. This reduction is due to the Company's ongoing efforts to minimize its operating expenses.

### *Amortization of Property and Equipment*

Amortization expenses were \$14,000 during the three months ended May 31, 2010, a decrease of 80% compared to \$72,000 for the three months ended May 31, 2009. The decrease in amortization expense results from very few new assets being purchased and amortization being reduced on older equipment.

### *Net (loss) Earnings*

Net loss for the quarter ended May 31, 2010 was \$415,000 (\$0.03 loss per share) compared to a loss of \$522,000 (\$0.04 loss per share) for the quarter ended May 31, 2009, a decrease of 21%.

### *Citadel Processing Accounts and Liabilities*

Citadel processing accounts as at May 31, 2010 totaled \$4.6 million compared to \$5.6 million as at February 28, 2010. 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 May 31, 2010 derived from unaudited statements prepared by Management.

<i>(\$000)</i> <i>except for per share data</i>	<b>31-May</b> <b>2010</b>	<b>28-Feb</b> <b>2010</b>	<b>30-Nov</b> <b>2009</b>	<b>31-Aug</b> <b>2009</b>	<b>31-May</b> <b>2009</b>	<b>28-Feb</b> <b>2009</b>	<b>30-Nov</b> <b>2008</b>	<b>31-Aug</b> <b>2008</b>
Consolidated Revenue	743	963	832	952	834	1,147	1,196	742
Consolidated Gross Profit	246	253	198	355	160	251	619	(60)
% of revenues	33%	26%	24%	37%	19%	22%	52%	-8%
Total Operating Expenses	704	682	825	752	851	1,297	1,313	1,474
% of revenues	95%	71%	99%	78%	102%	113%	110%	198%
Consolidated Net Income (loss)	(415)	(199)	(525)	(535)	(522)	(1,103)	(1,106)	(1,547)
% of revenues	-56%	-21%	-63%	-56%	-63%	-96%	-92%	-208%
Earnings per share								
Basic	(\$0.03)	(\$0.02)	(\$0.04)	(\$0.04)	(\$0.04)	(\$0.09)	(\$0.07)	(\$0.08)
Diluted	(\$0.03)	(\$0.02)	(\$0.04)	(\$0.04)	(\$0.04)	(\$0.09)	(\$0.07)	(\$0.08)

## Liquidity and Capital Resources

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

During the quarter ended May 31, 2010, cash obtained in operating activities was \$85,000 compared to \$465,000 used during the quarter ended May 31, 2009.

Cash used in financing activities totaled \$1,000 during the quarter ended May 31, 2010 compared to \$344,000 during the quarter ended May 31, 2009. This change relates to the change in the exchange rate for the US \$ 2 million loan payable.

Overall, the increase in cash totaled \$87,000 for the quarter ended May 31, 2010 compared to \$816,000 for the quarter ended May 31, 2009.

For the three month period ending May 31, 2010 the Company incurred a loss from operations of \$415,000 and an increase in operating cash flow of \$87,000. In addition, 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.

## Contingent Off-Balance Sheet Arrangements

The Company did not have any contingent off-balance sheet arrangements during the three month period ending May 31, 2010. (May 31, 2009 – nil)

## Outstanding Share Data

ESI's outstanding share data is listed in the table below as at May 31, 2010 and the date of this report.

	Three months ended	
	May 31/10	May 31/09
Weighted average shares used in computation of basic earnings per share	14,324,726	14,324,726
Fully diluted weighted average common shares	14,324,726	14,324,726

During the period ended May 31, 2010, and at the date of this report, no stock options were granted and a total of 30,750 were forfeited or expired unexercised. (May 31, 2009, nil, nil and 34,250 respectively).

As at May 31, 2010, there were 1,896,000 options outstanding (May 31, 2009 – 1,916,000), exercisable at a Weighted Average Price of \$0.61. (May 31, 2009 - \$0.64). As at the date of this report, there were 145,000 options outstanding, consequence upon the voluntary cancellation by employees and directors, 1,751,000 options without compensation after May 31, 2010.

## **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 months ended May 31, 2010, 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 May 31, 2010 and concluded that the Company's current disclosure controls and procedures are effective.

## **Convergence with International Financial Reporting Standards ("IFRS")**

As described in the MD&A for the year ended February 28, 2010, the Company has designated March 1, 2011, as the date upon which it will adopt IFRS, and is presently engaged on a three-phase project during the current fiscal year to assess the impact that the transition to IFRS will have on the Company's systems, financial reporting controls and procedures and business activities. The Company is still engaged in the First Phase of this project (Initial impact assessment and scoping phase). Management is not yet able to assess with any precision which currently applicable Canadian GAAP Policies will be changed so as to comply with IFRS policies other than in general terms. Management will continue the IFRS Project throughout fiscal 2011 in order to effect the adoption of IFRS at the designated date.

## **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 financial statements for the three months ending May 31, 2010, the audited year end financial statements as at February 28, 2010 and February 28, 2009 and the Management's Discussion and Analysis as at February 28, 2010. 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](http://www.sedar.com). Dated : August 19, 2010**