



**Management's Discussion and Analysis**

**For the Fiscal Year Ended February 28, 2009**

**May 28, 2009**

**ESI Entertainment Systems Inc.**  
15<sup>th</sup> Floor, 4710 Kingsway Ave  
Burnaby, BC V5H 4M2

Telephone 604.299.6922  
Facsimile 604.299.3984

## **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, 2009 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](http://www.sedar.com).

### **Forward Looking Information**

This Management's discussion and analysis 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 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 Entertainment Systems Inc 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 Entertainment Systems Inc 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 approximately 40 employees located in Burnaby, British Columbia, Canada, and markets its products and services globally from this location.

In fiscal 2008 and 2009, the Company's financial results were significantly negatively impacted by the cessation of Citadel's financial processing business for US customers. This segment had

represented approximately 90% of the Company's revenues during fiscal 2007. As a result, it was the ESI Integrity division that generated the majority of the gross profits during fiscal 2009.

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***

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***

During fiscal 2007, until its withdrawal from that marketplace, Citadel had generated the majority of ESI's revenues and profits in the financial processing business for non-domestic internet gaming merchants for US consumers; during fiscal 2008 and 2009, no business was conducted in that marketplace. The Company launched a sales force in the UK to attract European internet gaming merchants and other e-commerce based non-gaming businesses in Europe, North America and other regions.

Citadel provides two services that are transaction-based: Citadel Direct service for merchants and the myCitadel wallet service for consumers. It earns a fee on each payment processed to and from end-users and e-commerce merchants.

Citadel Direct is a software product that electronically scans Citadel bank accounts and notifies merchants when consumer funds are received. For transactions processed by Citadel Direct, a transaction fee is charged to an e-commerce merchant. The transaction fee is typically fixed if the merchant uses the services via an API or a hosted page or the fee is charged as a percentage if used via the myCitadel wallet.

For transactions using myCitadel wallet, a transaction fee is charged either to the e-commerce merchant or the end-user who has created the wallet. Fund transfers to an e-commerce merchant are paid by the merchant, while transactions involving transfers from an e-commerce merchant to an end-user are paid by the end-user.

### **Corporate Overhead**

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

### **Critical Accounting Policies and Estimates**

The Company's accounting policies are outlined in Notes 2 and 3 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

The Company did not change any accounting policies during the year ended February 28, 2009 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 application of these new policies did not result in any material change to or impact on the Company's financial results for fiscal 2009, but they do result in certain changes in presentation. Reference is made to Note 3 to the Audited Financial Statements of the Company for the years ended February 28, 2009 and February 29, 2008, where the full extent of these changes is described. Readers should note that over the next few years, and in particular commencing in 2011, 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.

### Fiscal 2009 Financial Highlights

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

- 22% increase in consolidated revenues to \$3.95 million for fiscal 2009 from \$3.25 million for fiscal 2008;
- 87% increase in consolidated gross profit to \$0.971 million for fiscal 2009 from \$0.518 million for fiscal 2008;
- 29% decrease in consolidated net loss before income taxes and non-controlling interest to a loss of \$5.1 million for fiscal 2009 from a loss of \$7.2 million for fiscal 2008.

### Selected Financial Information

	February 28, 2009	Years ended February 29, 2008	February 28, 2007
<i>(\$ 000) except for EPS</i>			
Revenue	3,954	3,248	22,023
Gross Profit	971	518	13,544
Total operating expenses	5,560	7,045	12,943
Net Loss	(5,068)	(7,200)	(4,991)
(Loss) earnings per share			
Basic and Diluted	(0.36)	(0.42)	(0.27)
Total Assets	6,052	7,653	29,556
Total long-term liabilities	4,282	3,485	18,209
Cash generated from operations	(4,467)	(7,047)	2,582

Revenues from ESI Integrity have grown over the past three years. This is due to increased sales and marketing efforts and the stronger recognition of the ESI Integrity brand as the number of installations with government lotteries and pari-mutuel organizations has grown on a worldwide basis.

Citadel's revenues were reduced significantly during fiscal 2008 and 2009 consequent upon the cessation by Citadel of financial processing to the non-domestic internet gaming merchants for US based consumers on January 17, 2007. This has had a significant material impact on the revenues for Citadel in fiscal 2008 and 2009, since 97% of the revenues generated by Citadel in fiscal 2007 had been generated from that market place.

Consolidated gross profit was reduced from \$13.5 million for fiscal 2007 to \$518,000 for fiscal 2008 but increased to \$971,022 for fiscal 2009. The decrease in prior years was a direct result of Citadel's withdrawal from the USA market. The increase in fiscal 2009 is due to the increase in ESI Integrity revenue and the reduction of direct costs for Citadel. Gross profit for ESI Integrity during fiscal 2009 increased from \$1.027 million in fiscal 2008 to \$1.129 million in fiscal 2009, reflecting continued growth in that division.

Total operating expenses decreased during fiscal 2008 and 2009 from prior years as the company has been significantly restructured to account for the reduction in Citadel revenues.

The widely fluctuating trend of the past three years is not likely to continue. ESI Integrity continues to provide reliable, profitable revenue and has a large contracted backlog of revenue extending forward over many years. Citadel has reduced 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 rebuild its 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, 2009	February 29, 2008	
Integrity	3,253	2,373	37%
Citadel	701	875	(20%)
Total revenue	3,954	3,248	22%

Total revenue increased by 22% to \$3.954 million in fiscal 2009 from \$3.248 million in fiscal 2008. The increase was entirely due to the 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 29, 2008	February 29, 2008
Revenues	3,954	3,248
Direct costs	2,983	2,730
Gross profit	971	518
Gross profit margin	25%	16%

The increase in consolidated gross profit margin in fiscal 2009 was due to the additional revenue earned within the ESI Integrity subsidiary and the reduction of direct cost for Citadel.

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

(\$ 000)	Year ended			
	February 28, 2009	GP%	February 29, 2008	GP%
Integrity	1,129	35%	1,027	43%
Citadel	(158)	(22%)	(509)	(58%)
Total gross profit	971	25%	518	16%

Integrity's gross profit decreased to 35% from 43% the prior fiscal period. This was due to recognizing deferred contract costs on discontinued contracts. Citadel's gross profit margin during fiscal 2009 was (22%), compared to (58%) for the prior fiscal year, reflecting the significant change to its business consequent upon the cessation of financial processing in the USA.

### *Product Development*

Product development expenses were \$0.604 million in fiscal 2009, a decrease of 51% compared to \$1.24 million for the prior period. These expenditures are principally related to software development since the Company no longer capitalizes those costs.

### *Sales, Marketing and Customer Service*

Sales, marketing and customer service expenses were \$0.741 million for fiscal 2009, a decrease of 56% compared to \$1.67 million for the prior period. The decrease primarily related

to the contraction of Citadel's sales and marketing forces, reduced travel, and reduction of marketing activities relating to trade shows and promotional activities.

#### *General and Administrative*

General and administrative expenses were \$3.76 million for fiscal 2009, a decrease of 30% compared to \$5.41 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 Citadel division in particular.

Included in general and administrative expenses was non-cash stock compensation expense of approximately \$230,712 for fiscal 2009, compared to approximately \$423,588 for fiscal 2008. Stock compensation expense decreased during fiscal 2009 as a result of minimum stock grants to the Company's employee base.

#### *Amortization of Property and Equipment*

Amortization expenses were \$453,205 for fiscal 2009, a decrease of 42% compared to \$776,706 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 2009 was \$5.068 million (\$0.36 loss per share - basic and diluted) compared to net loss of \$7.2 million (\$0.42 earnings per share; basic and diluted) for fiscal 2008. This decrease was largely driven by the restructuring of the Citadel business unit with the reductions in staffing and rented premises as well as the legal and auditing costs associated with the significant reduction of that portion of the Company's business. The over all loss is due to the lack of additional revenue expected from the Citadel business unit.

#### *Capital Expenditures*

Capital expenditures for fiscal 2009 were \$15,061 compared to \$103,811 for fiscal 2008. The decrease in capital expenditures was primarily the result of reductions in acquisitions and consolidation of operations by Citadel.

#### *Citadel Processing Accounts and Liabilities*

Citadel processing accounts as at February 28, 2009 totaled \$2.958 million compared to \$1.53 million as at February 29, 2008. 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 increase in Citadel processing accounts and Citadel processing liabilities is due to the additional processing business in the European market as well as the timing for disbursing to our merchants.

During fiscal 2008 approximately US\$9.1 million of funds which had been on deposit in the USA, principally Merchant funds, were seized by the United States Department of Justice (DoJ). Throughout fiscal 2008 the Company was engaged in negotiations with the DoJ and the US

District Attorney's Office for the Southern District of New York ("USDA"); subsequent to the end of fiscal 2008 a resolution was reached with the USDA.

## Summary of Quarterly Results

<i>(\$000)</i>	<b>28-Feb</b>	<b>30-Nov</b>	<b>31-Aug</b>	<b>31-May</b>	<b>29-Feb</b>	<b>30-Nov</b>	<b>31-Aug</b>	<b>31-May</b>
<i>except for per share data</i>	<b>2009</b>	<b>2008</b>	<b>2008</b>	<b>2008</b>	<b>2008</b>	<b>2007</b>	<b>2007</b>	<b>2007</b>
Consolidated Revenue	1,147	1,196	742	869	1,029	762	682	776
Consolidated Gross Profit	251	619	-60	161	145	64	29	280
% of revenues	22%	52%	-8%	19%	14%	8%	4%	36%
Total Operating Expenses	1,297	1,313	1,474	1,476	2,042	2,513	2,343	2,202
% of revenues	113%	110%	198%	170%	198%	330%	344%	284%
Consolidated Net Income (loss)	(1,103)	(1,106)	(1,547)	(1,312)	225	(2,251)	(2,642)	(2,532)
% of revenues	-96%	-92%	-208%	-151%	22%	-295%	-387%	-326%
Earnings per share								
Basic	(\$0.09)	(\$0.07)	(\$0.08)	(\$0.07)	(\$0.02)	(\$0.13)	(\$0.14)	(\$0.13)
Diluted	(\$0.09)	(\$0.07)	(\$0.08)	(\$0.07)	(\$0.02)	(\$0.13)	(\$0.14)	(\$0.13)

Consolidated revenues have steadily grown since the first two Quarters of fiscal 2009, mainly as a result of increased revenues from Integrity. Since the beginning of fiscal 2008 Citadel's contribution to revenues declined to very minimal numbers, and Integrity has provided the bulk of the operational cash flow to the Company.

Total operating expenses have decreased during fiscal 2009 compared to fiscal 2008, mainly due to the decreased levels of sales and marketing activities, and a lower level of amortization from fixed asset additions; general and administration costs also decreased as the Company's personnel and support activities were reduced during fiscal 2009. Certain expenses, specifically stock-based compensation costs and foreign exchange costs, also decreased during fiscal 2009 over fiscal 2008. The amounts of operating expenses are expected to remain fairly level going forward as the Company has made significant restructuring initiatives and is operating at a bare minimum. 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 operating expenses. The Company is continuing its efforts to record a net income and its success is reliant on the achievement of sales targets both in the Citadel and the Integrity divisions.

### *Review of the Fourth Quarter Ended February 28, 2009*

Consolidated revenues for Q4 of fiscal 2009 were \$1.147 million compared to \$1,029 million for the same period in fiscal 2008, an increase of 11%. This increase was due to additional revenue earned in the ESI Integrity business unit.

Consolidated gross profit for Q4 of fiscal 2009 was \$0.251 million compared to \$0.145 million for the same period in fiscal 2008, an increase of 73%. This increase was primarily due to additional revenue earned in the ESI Integrity business unit.

The gross profit margin was 22% during Q4 of fiscal 2009 compared to 14% during the same period in fiscal 2008. This increase was primarily due to additional revenue earned in the ESI Integrity business unit.

Total operating expenses for Q4 of fiscal 2009 were \$1.297 million compared to \$2.042 million for the same period in fiscal 2008, a decrease of 36%. This decrease resulted from the reduction of operating costs and other expenses in fiscal 2009 compared to the same period in fiscal 2008.

Net loss for Q4 of fiscal 2009 was \$1.103 million compared to net income of \$0.205 million for the same period in fiscal 2008, when the year end adjusting entries were booked.

### **Liquidity and Capital Resources**

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

During fiscal 2009, cash used in operating activities was (\$4.467) million compared (\$7.046) million during fiscal 2008, a decrease of \$2.579 million from the prior period. Non-cash operating items in fiscal 2009 were lower than in fiscal 2008, principally as a result of less provision being taken for assets being amortized.

Cash provided by financing activities totaled \$2.349 million during fiscal 2009 compared to cash used by financing activities of \$0.361 million in fiscal 2008. The financing activities in fiscal 2009 include the Company's US\$2 million loan obtained in June 2008.

Overall, the net cash used in fiscal 2009 was \$2.133 million compared to net cash used of \$6.411 million in fiscal 2008.

#### *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 \$1.860 million at February 28, 2009 compared to \$2.630 million at February 29, 2008. 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.

<i>(\$ 000)</i>	<b>Year ended February 28, 2009</b>	<b>Year ended February 29, 2008</b>
Deferred revenue - current	535	707
Deferred revenue – long term	1,324	1,923
Deferred cost	696	1,117

### *Integrity's Profitability*

ESI Integrity had strong revenue growth of 37%, driven by revenues from its international lottery customers.

While operating profitability has improved considerably, management has determined it appropriate and favorable to recognize one-time deferred cost adjustments for its Greek, Oregon and Virginia projects which impacted the Gross Profit margins in FY09. These adjustments improve the outstanding deferred revenue and costs balances remaining on the Balance Sheet, ensuring gross margins to improve on the recognition of those deferred amounts in the future.

Integrity took a one-time recognition of \$274,316 in Research and Development costs for the development of its new Monitoring System for Sports Betting. Management views the opportunity for this new product to be very favorable given the growth of this area of wagering activity internationally, and the recent liberalization of this form of wagering in Canada and the USA.

### *Loan Payable*

In June 2008, the company secured a US\$2 million dollar loan bearing interest at the rate of 6% per annum. In April 2009, the agreement was amended to reflect new repayment terms, which are; US\$1,500,000 repayable on June 11, 2009 and the balance plus accrued interest due on December 11, 2009. 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.

### *Contractual Obligations*

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

2010     \$    560,384

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 2009.

## 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 28, 2007	<u>19,008,333</u>	\$ <u>13,220,776</u>
Expiry of Warrants		78,708
Cancellation of Common Shares	(4,773,606)	(3,341,525)
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>

On August 30, 2007, the Company entered into an agreement with Royal Bank of Canada ("RBC") whereby RBC agreed to surrender up to a total of 4,773,606 common shares to the treasury of the Company for cancellation without compensation. That transaction was completed on October 24, 2007. The average per share amount on the date of the transaction was \$0.70. Upon cancellation of the common shares, \$3,341,525 was removed from Capital Stock and credited to Contributed Surplus on the company's Balance Sheet.

As at February 28, 2009 and the date of this Report, there were 14,234,727 shares issued and outstanding. As at February 28, 2009 and the date of this Report there were 1,950,250 Incentive Stock Options outstanding, which was reduced (by cancellation) to 1,934,000 as at the date of this Report.

Please refer to Notes 8, 9, 10 and 11 to the audited financial statements for the years ended February 28, 2009 and February 29, 2008 for particulars of the issued shares, warrants and incentive stock options.

## Related Party Transactions

During the year ended February 28, 2009, the Company had no related party transactions. During the prior year, the Company paid consulting fees for advisory services to a company controlled by a former director totaling \$25,242.

## 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, 2009. 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, 2009. 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, 2009, that have materially affected, or are reasonably likely to materially affect the Company's internal control over financial reporting.

## **Risks & Uncertainties**

A detailed explanation of risk factors which ESI faces is provided in its Annual Information Form listed on [www.sedar.com](http://www.sedar.com). 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 company's 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. By example, in the United States, President Bush signed the *Unlawful Internet Gambling Enforcement Act of 2006* (the "UIGEA") into force on October 13, 2006. The UIGEA represents an attempt by the U.S. government to stop non-domestic online gaming in the United States by cutting off the cash flow between U.S. online gamblers and non-domestic online gaming websites. Subsequently, Citadel became the subject of legal proceedings and has entered into a deferred Prosecution Agreement with the United States District Attorney for the Southern District of New York. Additionally, gaming, subject to certain exemptions, is a prohibited activity in Canada and it may be found that Citadel's payment processing activities aid or assist in a prohibited activity. Judicial interpretation and enforcement provisions in an on-line gaming context have to date been very limited and Canada has become a global leader in providing services and support to this industry.

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.

### *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. Additionally, ESI also has very few customers for Citadel business since its withdrawal from the USA market. If Citadel is not able to grow its customer base, its business would be materially negatively impacted with a commensurate impact upon the Company. To manage this risk, Citadel is investing 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. 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 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, 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 for 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 Meyers Norris Penny LLP, the external auditors, in accordance with generally accepted auditing standards in Canada on behalf of the shareholders. Meyers Norris Penny LLP has the ability to meet with the Audit Committee independent of the Company's management.

Dated: May 28, 2009

"Anthony Greening"

Anthony Greening

Chairman & Chief Executive Officer

"Mike Meeks"

Michael Meeks

President