

## VendTek Systems Inc.

### Management's Discussion and Analysis of Financial Condition and Results of Operations

#### For the Three Month Period Ended January 31, 2007

*The following Management's Discussion & Analysis should be read in conjunction with the financial statements and notes to the consolidated financial statements for the quarter ended January 31, 2007 and the Management's Discussion & Analysis and notes to the consolidated financial statements appearing in the Annual Report for the fiscal year ended October 31, 2006.*

*Except for statements of historical fact contained herein, the following information presented contains "forward-looking statements" within the meaning of the Private Securities Litigation Reform Act of 1995. Such forward looking statements involve known and unknown risks, uncertainties and other factors which may cause the actual results, performance or achievement of VendTek to be materially different from any future results, performance or achievements expressed or implied by such forward-looking statements. Readers are cautioned not to place undue reliance on these forward-looking statements. Actual results may differ materially from those indicated by these forward-looking statements as a result of risks and uncertainties impacting VendTek's business. Although VendTek has attempted to identify important factors that could cause actual results to differ materially, there may be other factors that cause results not to be anticipated, estimated or intended. All amounts presented in this MD&A are in accordance with Canadian generally accepted accounting principles ("GAAP") and presented in Canadian dollars unless otherwise specifically noted. References herein to "VendTek", "the Corporation", "the Company", "we" and "our" mean VendTek Systems Inc.*

*Additional information relating to the Company is available on SEDAR at [www.sedar.com](http://www.sedar.com).*

#### **Overview**

We strive to provide our customers with innovative products, exceptional service and superior technical expertise while endeavouring to enhance value to our shareholders.

We develop, market and sell automated transaction system software and supporting technologies that improve the efficiency of product delivery, reduce costs to clients and offer superior transaction security measures. Our business focuses primarily in the prepaid telecom and financial services industries. We market our products and services directly and through our wholly-owned subsidiaries; Now Prepay Corp. (Canada) ("NPC"), VendTek Systems Technologies (Beijing) Co. Ltd. ("VST") and VendTek Systems Asia Pacific (Singapore) Pte. Ltd. ("VAP").

Our principal product is our proprietary e-Fresh™ software which consists of a suite of server applications and corresponding client modules. The e-Fresh™ software is used to create a distribution system which can be used to sell services on proprietary or non-proprietary hardware thereby creating an e-Fresh™ network.

The e-Fresh™ software utilizes POS terminals and other electronic terminals as clients (located in retail locations) which connect to a central server and provide secure electronic distribution for prepaid goods and services to consumers in real time. Third party kiosks, bank machines, POS terminals, PC computers, and web browsers are all potentially suitable distribution points. Compared to the traditional method of delivering prepaid services using cards or plastic vouchers, distributing these services electronically allows substantial savings through reduced printing and packaging costs, physical distribution costs and shrinkage (theft), as well as the elimination of inventory holding costs at the retail distribution level.

VST is incorporated in China for developing e-Fresh™ licensed customers and providing low cost software development and support. This company's objective is to generate recurring license

revenues from the world's largest prepaid and cellular markets. VendTek's Chinese operations include sales and marketing, customer support and engineering. With five years of operating history, VendTek is continuing to build business with its primary customer in China and evaluating potential opportunities.

VAP, incorporated and located in Singapore, is developing the e-Fresh™ market in South East Asia.

#### *Revenue*

We generate our revenues from the distribution of virtual prepaid products through our NPC network, hardware and equipment sales, license fees from our international customers and related professional service fees.

As part of our strategy to develop recurring sources of revenues, we developed our own electronic distribution business across Canada under the Now Prepay™ brand and our subsidiary NPC. NPC uses e-Fresh to distribute cellular and long distance products, financial products, prepaid gift cards and prepaid internet cards. NPC also sells its own branded long distance products: Now#1 and Connect Now. NPC is currently generating the majority of our revenues.

We also license our e-Fresh™ software to third-parties (service providers, retailers and retail distributors) allowing them to distribute electronic products and services with increased efficiency. By licensing to our customers, we are developing sources of recurring license revenues from a global and growing market. We receive recurring revenues from fees paid to us each time a transaction is completed on one of our customers' terminals.

Going forward, we expect to increase sales through continued deployment of e-Fresh™ software to point-of-sale terminals through the NPC network, increase the product base available to the NPC network and develop new international markets for the e-Fresh™ software. We also expect to see continued growth in the license sales from our United Arab Emirates ("UAE") customer resulting from more transactions.

#### *Cost of Revenues*

Costs of products and services sold consist of payments to carriers who provide cellular and long distance telephone time and various services associated with production and shipping of products, site commissions, transaction processing expenses and personnel. We do not have significant cost of revenues for our license sales.

#### *Research and Development Expenses*

Our research and development expenses consist primarily of salaries, bonuses and benefits for engineering personnel, costs associated with various projects, including testing, developing prototypes and related expenses.

Our engineering personnel are located in our offices in Canada and China. We fund our operations in China because we believe this allows us to continue our development in a cost effective way. As a percentage of revenue, we expect our research and development expense to decrease as revenue increases.

#### *Selling and Marketing Expenses*

Selling and marketing expenses consist primarily of compensation for employees engaged in the sales and marketing functions. Other significant costs include tradeshow participation, journal advertising, and travel. Some of our sales staff is located in China to support our sales initiatives there. We receive minimal revenues from our customers which help offset our costs to maintain our Beijing sales and development office.

### *General and Administrative Expenses*

General and administrative expenses consist primarily of compensation for employees in executive and operational functions, including finance and accounting. Other significant costs include professional fees for accounting and legal services, consulting fees, facilities costs and general corporate overhead.

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

The following discussion and analysis is based upon our consolidated financial statements which have been prepared in conformity with Canadian generally accepted accounting principles. The preparation of these financial statements requires management to make estimates and assumptions that affect the amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent liabilities. We evaluate our estimates including the determination of the fair value of stock-based compensation and financial instruments, the allowance for doubtful accounts, inventory valuation, tax provisions and the useful lives of property, plant and equipment including intangible assets. The discussion below is intended as a brief discussion of some of the judgments and uncertainties that can impact the application of these policies and the specific dollar amounts reported on our financial statements. We base our estimates on historical experience and on various other assumptions that we believe to be reasonable under the circumstances, the results of which form our basis for making judgements about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results could differ from those estimates under different assumptions or conditions, or if management made different judgements or utilized different estimates. Many of our estimates or judgements are based on anticipated future events or performance, and as such are forward-looking in nature, and are subject to many risks and uncertainties, including those discussed below and elsewhere in this annual report. Management does not undertake any obligation to update or revise this discussion to reflect any future events or circumstances.

We have identified some of our accounting policies that we consider critical to our operations and the understanding of our results of operations. This is neither a complete list of all our accounting policies, nor does it include all the details surrounding the accounting policies we have identified. There are other accounting policies that are significant to our company. For a more detailed discussion on the application of these and our other accounting policies, see note 2 to the consolidated financial statements for the three month period ended January 31, 2007.

### *Revenue Recognition*

The Company's revenue is comprised of three sources: resale and distribution of prepaid telecommunication products (principally prepaid cellular and prepaid long distance products); equipment and parts sales; and software license and the related services sales. Revenues are recognized when pervasive evidence of an arrangement exists, delivery has occurred or services have been rendered the price is fixed or determinable, and collectibility is reasonably assured.

The Company's revenues are primarily generated from the distribution of prepaid long distance and cellular telephone time, principally from the sale of prepaid calling cards and point of sale activated PINs. Sales of prepaid calling cards and point of sale activated PINs, in accordance with Emerging Issues Committee ("EIC") No. 123, "Reporting Revenue Gross as Principal versus Net as an Agent," are recognized on a gross basis as the Company is the primary obligor to its customer, being the retail merchant, and incurs inventory risk (including physical inventory risk).

The resale of prepaid telecommunication services where the Company earns commissions on services sold and does not incur inventory risk are recognized at the date of sale as the Company's continued obligations effectively end on that date. These sales are recorded on a net basis and account for \$145,000 of revenue in the first quarter of fiscal 2007. Equipment sales are ancillary to the resale of prepaid products. Equipment sales and parts revenue is recognized when delivered.

Software license revenues are recognized upon the customer's execution of a software license agreement, the receipt of a purchase order and shipment of the software, provided that no significant vendor obligations remain outstanding. Where significant vendor obligations are negotiated, software license revenues are recognized only after these obligations have been satisfied.

Cost of revenues for the prepaid time consists primarily of long distance telephone time, standard telephone cards, net amounts earned on early payments to suppliers plus commissions to Independent Sales Organizations (ISO's) and sales agents. Direct costs include operational salaries, parts and accessories. Cost of revenues for transaction fees and services consist of network communication costs, maintenance and support of terminals and third-party processing costs. Cost of revenues does not include amortization.

#### *Stock-Based Compensation*

Effective January 1, 2002, the Company applied the fair value based method of accounting prescribed by CICA Handbook Section 3870, "Stock-based Compensation and Other Stock-based Payments", only to employee stock appreciation rights, and applied the settlement method of accounting to employee stock options. Under the settlement method, any consideration paid by employees on the exercise of stock options or purchase of stock was credited to share capital and no compensation expense was recognized.

The CICA Accounting Standards Board amended Section 3870 to require entities to account for employee stock options using the fair value based method, beginning January 1, 2004. Under the fair value based method, compensation cost is measured at fair value at the date of grant and expensed over the award's vesting period. During the year ended October 31, 2005, and in accordance with one of the transitional options permitted under amended Section 3870, the Company retroactively applied the fair value based method to all employee stock options granted or repriced on or after January 1, 2002.

#### **Summary of Quarterly Results**

Quarter Ended	Revenue	Earnings (Loss)	Earnings (Loss) per share <sup>1</sup>
January 31, 2007	16,414,540	267,818 <sup>5</sup>	0.01
October 31, 2006	16,826,650	231,367 <sup>(3)(4)</sup>	0.01
July 31, 2006	14,899,228	320,033 <sup>3</sup>	0.01
April 30, 2006	13,468,110	105,688 <sup>3</sup>	0.00
January 31, 2006	12,824,090	93,846 <sup>3</sup>	0.00
October 31, 2005	11,750,060	(65,492) <sup>2</sup>	(0.01)
July 31, 2005	10,718,345	77,265	(0.00)
April 30, 2005	8,315,722	(194,392)	(0.01)

<sup>1</sup> Basic earnings (loss) per share are computed using the weighted average number of common shares outstanding during the periods. The treasury stock method is used for the calculation of diluted net earnings (loss) per share. Stock options and warrants are dilutive when the average market price of the common shares during the period exceeds the exercise price of the options and warrants. Diluted earnings per share assume all outstanding options and warrants have been exercised at the later of the beginning of the fiscal period or the date of issuance.

<sup>2</sup> Includes non-cash year-end adjusting entries, all of which were recorded in the fourth quarter of fiscal 2005: consigned inventory reversal (\$191,000), stock-based compensation expense (\$126,000).

<sup>3</sup> Includes non-cash adjusting entries recorded in each quarter 2006: Stock-based compensation expense for fiscal 2006 totalled (\$291,000).

4. Includes year-end tax expense, all of which was recorded in the fourth quarter of fiscal 2006, of \$135,137 and a future income tax asset of \$170,500.
5. Includes non-cash adjusting entries recorded in each quarter 2007: Stock-based compensation expense for the first quarter of fiscal 2007 totalled (\$143,000).

## Results of Operations

### Comparison of the three month period ended January 31, 2007 compared to the three month period ended January 31, 2006.

Note: The consolidated financial statements include the accounts of the Company and its wholly owned subsidiaries: NPC, VSTB, VSAP, and VendTek Industries Inc., which owns VendTek International Inc. (an inactive U.S. company).

The table below sets forth data from our statements of operations for the three months ended January 31, 2007 and 2006 and the years ended October 31, 2006 and 2005, expressed as a percentage of total revenue.

	Three Months Ended January 31,	
	2007	2006
	(Unaudited)	
Prepaid telecommunication revenue	98.2%	99.2%
Hardware revenue	0.2%	0.5%
Software revenue	1.6%	0.3%
<b>Total revenue</b>	<b>100.0%</b>	<b>100.0%</b>
Cost of products sold	93.0%	94.4%
<b>Gross profit</b>	<b>7.0%</b>	<b>5.6%</b>
General and administrative expense	3.3%	3.5%
Selling and marketing	0.8%	0.5%
Research and development	0.6%	0.6%
Amortization	0.5%	0.3%
<b>Income before income taxes</b>	<b>1.6%</b>	<b>0.7%</b>
Provision for income taxes	-	-
<b>Net income</b>	<b>1.6%</b>	<b>0.7%</b>

### Revenue

Revenues for the quarter ended January 31, 2007, increased \$3.590 million to \$16.415 million, or 28%, from \$12.824 million for the corresponding period in 2006.

Our prepaid telecommunications revenue totalled \$16.117 million for the quarter ended January 31, 2007, compared to \$12.726 million for same quarter in 2006. The 27% increase is primarily due to ongoing installation of POS terminals across Canada for distribution of virtual prepaid telecommunications vouchers (or PINs) through our distribution network.

Our software and related service revenue increased by \$228,000 (or 696%) to \$261,000 for the first quarter of 2007 from \$33,000 for the same period in 2006. Software and services revenue increased because of our licensing customer in the United Arab Emirates.

Our hardware revenue for the first quarter of 2007 was \$36,000 compared to \$66,000 in 2006. The decrease was due to reduced parts orders from our legacy vending machine customers.

#### *Cost of Revenues*

Cost of revenues for the three months ended January 31, 2007, were \$15.264 million, or 93% of revenues, compared to \$12.108 million, or 94% of revenues for the same quarter in 2006. The low margin is indicative of the virtual prepaid telecommunications industry.

#### *General and Administrative*

General and administrative expense increased \$133,000, or 30%, to \$547,000 in the three months ended January 31, 2007 as compared to \$433,000 for the three months ended January 31, 2006. As a percentage of revenue, general and administrative expenses were 3.5% and 3.5% for the three months ended January 31, 2007 and 2006, respectively.

Included in general and administrative expense for the three months in 2007 and 2006 was \$143,000 and \$67,000, respectively, of stock-based compensation expense. An additional reason for the increase was additional professional fees incurred.

#### *Sales and Marketing*

Our sales and marketing expense increased \$61,000, or 96%, to \$123,000 in the quarter ended January 31, 2007 as compared to \$63,000 for same period in 2006. As a percentage of revenue, sales and marketing expense was 0.8% and 0.5% for the three months ended January 31, 2007 and 2006, respectively. The increase is primarily due to additional sales and marketing initiatives for our NPC and international efforts.

#### *Research and Development*

Product development costs for the three months ended January 31, 2007 were \$99,000, or approximately 0.6% of revenues. This compares to \$72,000, or approximately 0.6% of revenues for the quarter ended January 31, 2006.

#### *Amortization*

Amortization expense increased to \$80,000, or 0.5% of revenue, in the quarter ended January 31, 2007 compared to \$40,000, or 0.3% of revenue, for the same period in 2006. The \$40,000, or 100%, increase is due to increased purchases of point-of-sale terminals that are depreciated on a straight-line basis over three years.

#### ***Liquidity and Capital Resources***

As of January 31, 2007, cash totalled approximately \$1.760 million compared to approximately \$1.167 million at January 31, 2006.

### *Cash Flows Used in Operating Activities*

Net cash provided by operating activities totaled \$820,000 and \$1.073 million, during the three month period ended January 31, 2007 and 2006 respectively. Cash was used primarily for payments of accounts payable, accrued expenses, and purchase of inventory.

### *Cash Flows from Investing Activities*

Investing activities used cash of \$150, 000 and \$150,000 during the three months ended January 31, 2007 and 2006, respectively. The funds were used to purchase equipment.

### *Cash Flows from Financing Activities*

Financing activities provided cash of \$320,000, and \$3,000 during the quarters ended January 31, 2007 and 2006, respectively. In first quarter fiscal 2007, cash was provided primarily the exercise of stock options and shares issued. In first quarter fiscal 2006, cash was provided by the exercise of warrants.

### *Financial Condition*

We believe that we have sufficient cash and working capital to meet our obligations as they become due in 2007. We plan capital expenditure for fiscal 2007 in line with prior years.

We expect to continue using funds generated from our existing operations to further finance the expansion prepaid cellular business in Canada. Working capital is managed by rate of inventory turnover, collection terms with customers and terms granted by suppliers. Our cash flow is dependant on our ability to continue to manage the business cycle. Limited credit facilities from vendors may limit our working capital and cash flows to expand the business. As this business expands, we anticipate the need to purchase additional inventory and point-of- sale terminals. A risk to our liquidity is that customers do not pay on time creating a negative cash flow situation. In the first quarter of fiscal 2007, \$150,000 was used in investing activities for the purchase of point-of-sale terminals to be used to distribute prepaid products in Canada.

Our cash flow from operations is impacted by our margin on sales. Increased pricing competition may reduce margins and our ability to negotiate favorable supply contracts will impact our margin, net income and operating cash flow.

Historically, the Company has financed its operations through the sale of equity as well as through long-term debt, lease financing, an operating line of credit with a chartered Canadian bank, term loans from the Business Development Bank of Canada and related party debt. VendTek's operations, development and expansion are financed from the cash flow generated from operating activities, including supplier credit.

There are no legal or practical restrictions on the ability of subsidiaries to transfer funds to the company nor are there defaults or arrears or anticipated defaults or arrears on lease payments, interest or principle payments on debt. We have no minimum purchase or supply agreements in place. The Company's current contractual obligations are as follows:

2007	\$	67,975
2008		67,975
2009		67,975
		<hr/>
	\$	203,925

### Summary of Options Granted

The Company has a stock option plan (the "Plan") whereby it may grant up to 6,843,299 options to its directors, officers and employees. The terms and conditions of options granted under the Plan are determined solely by the Board of Directors. Options are generally granted with a term of five years and vest over eighteen months.

The following table summarizes the continuity of the Company's stock options:

	Number of shares	Weighted average exercise price
Balance, October 31, 2006	3,973,000	\$0.20
Granted	2,800,000	\$0.59
Exercised	(225,000)	\$0.20
Balance, January 31, 2007	6,548,000	\$0.37

The following table summarizes information about share options outstanding at January 31, 2007:

Range of Exercise Prices (\$)	Weighted Average Remaining Contractual Life (Years)	Options Outstanding		Options Exercisable	
		Number Outstanding	Weighted Average Exercise Price	Number Outstanding	Weighted Average Exercise Price
0.20 – 0.40	2.68	3,748,000	\$0.20	3,282,000	\$0.20
0.41 – 0.60	4.79	2,000,000	\$0.53	1,700,000	\$0.51
0.61 – 0.75	4.75	800,000	\$0.75	800,000	\$0.75
	3.23	6,548,000	\$0.37	5,782,000	\$0.49

During the three month period ended January 31, 2007, 2,800,000 options were granted under the Plan. The weighted average remaining contractual life of options outstanding as of January 31, 2007 was 3.23 years (2005 – 2.55 years).

The fair value of each option is estimated as at the date of grant using the Black-Scholes option-pricing model with the following weighted-average assumptions:

	January 31, 2007
Risk free interest rate	3.85%
Expected life	5 years
Expected volatility	117%
Expected dividends	-
Fair value per share option granted	0.35

### Related Party Transactions

During the three month period ended January 31, 2007, we paid rent of \$11,317 (2006 - \$18,468) to a company in which a director has a minority interest. Our premises lease with the related company was renewed for a three year term effective November 1, 2006 expiring on October 31, 2009. This transaction was in the normal course of operations and, our opinion, undertaken with the same terms and conditions as a transaction with an unrelated third party.

### ***Forward-looking Statements***

This Management's Discussion and Analysis contains certain forward-looking statements. All statements, other than statements of historical fact, included herein, including without limitation, statements regarding future plans and objectives of the Company are forward-looking statements that include various risks and uncertainties. There can be no assurance that such statements will prove accurate, and actual results and future events could differ materially from those anticipated in such statements. Important factors that could cause actual results to differ materially from the Company's expectations are disclosed in Company documents filed from time to time with the TSX Venture Exchange and other regulatory authorities.

Management is of the opinion that we have sufficient cash resources and working capital to meet ongoing obligations as they come due during the next fiscal year. We plan capital expenditures in fiscal 2007 to exceed 2006 with potential acquisitions and expansion into the U.S. market.

Management plans to continue using cash flow generated from operations to finance the continued expansion of the Now Prepay network in Canada and the United States. Generally, cash flow terms from suppliers are net 25 days and net 10 days for collections from customers. Credit facilities from our vendors are limited and may restrict our working capital and cash flow to develop the business. An ongoing risk to our liquidity is customer non-payment. However, given the low dollar value generated by each individual customer, this would not create a negative cash flow situation. Substantial growth for the prepaid business is in part dependant on increased credit limits from our suppliers to finance the purchase of inventory, which, historically, has not been a problem.

Cash flow from operations is influenced by our sales margins. Pricing competition among our suppliers of prepaid products may reduce margins. Our ability to negotiate contracts will impact our margins, cash flow and net income.

Required capital for fiscal 2007 will depend on several factors including, but not limited to, the amount of resources we will commit to network development, new product development and prospective strategic alliances and acquisitions of new products and/or other businesses.

Possible future alliances, acquisitions and product initiatives may increase capital requirements. We may seek funding from a combination of sources, including equity and debt financing. No assurances can be given that additional financing will be available to the Company.

### ***Off-Balance Sheet Arrangements***

VendTek does not have any off-balance sheet arrangements.

### ***Controls and Procedures***

As of the end of fiscal year 2006, management has carried out an evaluation of the effectiveness of the operation of the Company's disclosure controls and procedures. This evaluation was carried out under the supervision and with the participation of the Company's management. Based upon that evaluation, management has concluded that the Company's disclosure controls and procedures are effective at October 31, 2006. There have been no changes in internal controls over financial reporting in connection with this evaluation that occurred during the fourth quarter of fiscal 2006 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

We are continuing to evaluate our internal controls and we expect to make necessary improvements and enhance the reliability over financial reporting.

Disclosure controls and procedures are controls and other procedures that are designed to ensure that information required to be disclosed in the Company's reports filed or submitted is recorded, processed, summarized and reported within time periods specified in the Securities and Exchange Commission rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed in the Company's reports filed is accumulated and communicated to management as appropriate, to allow timely decisions regarding required disclosure.

## **VendTek Systems Inc.**

### **North America**

507 – 1952 Kingsway Avenue, Port Coquitlam  
British Columbia, Canada V3C 1S5  
Tel: +1 604 944 9330  
Fax: +1 604 944 0812

### **China & Asia Pacific**

Suite A, 9th Floor, 97 Xuanwumen West Avenue  
Xicheng District, Beijing, China, 100031  
Tel: +86 (10) 6641 8683  
Fax: +86 (10) 6641 5394

**[www.vendteksys.com](http://www.vendteksys.com)**

VendTek Systems Inc. is a publicly traded company listed on the Canadian TSX-Venture Exchange symbol VSI.