

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-QSB

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarter ended March 31, 2005

Commission file number 0-33037

NBO SYSTEMS, INC.

Maryland
(State or other jurisdiction of
incorporation or organization)

55-0795927
(I.R.S. Employer Identification No)

3676 W. California Ave. Bldg. D
Salt Lake City, Utah 84104
(Address of Principal Executive Offices)

(801) 746-8000
(Registrant's telephone number)

Check whether the issuer (1) filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the past 12 months (or for such shorter period that the registrant was required to file such reports) and (2) has been subject to such filing requirements for the past 90 days.

Yes X No

Indicate the number of shares outstanding of each of the issuer's classes of common stock as of the latest practicable date:

As of May 16, 2005, the number of shares outstanding of the registrant's only class of common stock was 17,290,536.

Transitional Small Business Disclosure Format (check one): Yes No X

NBO SYSTEMS, INC.
TABLE OF CONTENTS

PART I - FINANCIAL INFORMATION

Item 1	Condensed Financial Statements	
	Condensed Balance Sheets as of March 31, 2005 (unaudited) and December 31, 2004	3
	Condensed Statements of Operations for the Three Months ended March 31, 2005 (unaudited) and 2004 (unaudited)	4
	Condensed Statements of Cash Flows for the Three Months ended March 31, 2005 (unaudited) and 2004 (unaudited)	5
	Notes to Condensed Financial Statements (unaudited)	6
Item 2	Management's Discussion and Analysis of Financial Condition and Results of Operations	13
Item 3	Controls and Procedures	27

PART II - OTHER INFORMATION

Item 1	Legal Proceedings	27
Item 2	Changes in Securities	27
Item 3	Defaults Upon Senior Securities	28
Item 4	Submission of Matters to a Vote of Security Holders	28
Item 5	Other Information	28
Item 6	Exhibits and Reports on Form 8-K	28
	Signatures	28
	Certifications	29

Forward-looking Statements

This Report on Form 10-QSB, including information incorporated herein by reference, contains "forward-looking statements" within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. These statements relate to expectations concerning matters that are not historical facts. Words such as "projects," "believes," "anticipates," "will," "estimate," "plans," "expects," "intends," and similar words and expressions are intended to identify forward-looking statements. Although we believe that such forward-looking statements are reasonable, we cannot assure you that such expectations will prove to be correct. Important language regarding factors which could cause actual results to differ materially from such expectations are disclosed in this Report, including without limitation under the caption "Risk Factors" beginning on page 10 of this Report. All forward-looking statements attributable to NBO Systems, Inc. are expressly qualified in their entirety by such language. We do not undertake any obligation to update any forward-looking statements.

PART I. FINANCIAL INFORMATION**ITEM 1. CONDENSED FINANCIAL STATEMENTS****CONDENSED BALANCE SHEETS**

	ASSETS	
	March 31, 2005 (unaudited)	December 31, 2004
CURRENT ASSETS		
Cash	\$ 38,222	\$ 152,910
Restricted cash	6,510,681	16,798,638
Accounts receivable, net of allowance for uncollectible accounts of \$6,500 at March 31, 2005 and \$6,000 at December 31, 2004	250,397	598,604
Inventory	96,769	294,471
Prepaid expenses	53,082	136,206
Employee advances	10,333	5,159
Total current assets	6,959,484	17,985,988
PROPERTY AND EQUIPMENT, NET	493,737	548,026
OTHER ASSETS		
Deposits and reserves	334,726	333,478
Other assets	112,740	114,773
	447,466	448,251
	<u>\$ 7,900,687</u>	<u>\$ 18,982,265</u>

LIABILITIES AND STOCKHOLDERS' DEFICIT

CURRENT LIABILITIES		
Gift certificates/cards payable	\$ 8,531,395	\$ 16,884,501
Accounts payable	1,396,189	3,065,340
Accrued liabilities	946,200	1,236,342
Notes to stockholders	5,052,987	1,000,750
Notes to officer	345,918	345,918
Total current liabilities	16,272,689	22,532,851
LONG-TERM LIABILITIES		
Long-term notes to stockholders	500,000	4,100,000
Total long-term liabilities	500,000	4,100,000
Total liabilities	16,772,689	26,632,851
COMMITMENTS AND CONTINGENCIES	-	-
STOCKHOLDERS' DEFICIT		
Capital stock		
Convertible redeemable preferred stock, par value \$1.00; authorized 1,000,000 shares; 71,670 and 71,670 shares issued and outstanding at March 31, 2005 and December 31, 2004; redemption value \$2.20 per share	71,670	71,670
Common stock, par value \$0.0005; authorized 50,000,000 shares; 17,124,944 and 17,058,670 shares issued and outstanding at March 31, 2005 and December 31, 2004, respectively	8,562	8,529
Subscriptions receivable	(17,900)	(17,900)
Deferred financing costs	(559,618)	-
Additional paid-in capital	27,805,117	26,588,832
Accumulated deficit	(36,179,833)	(34,301,717)
Total stockholders' deficit	(8,872,002)	(7,650,586)
	<u>\$ 7,900,687</u>	<u>\$ 18,982,265</u>

NBO SYSTEMS, INC.
CONDENSED STATEMENTS OF OPERATIONS
(UNAUDITED)

	Three months ended March 31,	
	2005	2004
Revenues	\$ 1,971,667	\$ 1,724,007
Other Income	98,240	(25,328)
Total revenues and other income	2,069,907	1,698,679
Operating expenses		
Cost of revenues and other income	1,843,688	1,739,149
Selling, general and administrative expenses	1,542,220	1,294,004
Total operating expenses	3,385,908	3,033,153
Operating loss	(1,316,001)	(1,334,474)
Non-operating income (expense)		
Interest expense	(548,884)	(89,321)
Other expense	(13,231)	(28,868)
Loss before income taxes	(1,878,116)	(1,452,663)
Income tax benefit	-	-
NET LOSS	\$ (1,878,116)	\$ (1,452,663)
Net loss per common share – basic and diluted	\$ (0.11)	\$ (0.09)
Weighted-average number of common shares outstanding – basic and diluted	17,070,000	16,321,000

The remainder of this page is intentionally left blank.

NBO SYSTEMS, INC.

CONDENSED STATEMENTS OF CASH FLOWS
(UNAUDITED)

	Three months ended March 31,	
	2005	2004
Increase (decrease) in cash and cash equivalents		
Cash flows from operating activities:		
Net loss	\$ (1,878,116)	\$ (1,452,663)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:		
Depreciation and amortization	62,383	90,172
Loss on disposal of other assets and property and equipment	14,286	28,944
Common stock warrants issued for interest	25,568	-
Common stock issued for services	50,096	-
Common stock issued as payment of interest	-	3,557
Amortization of debt discount and deferred financing costs	90,290	-
Beneficial conversion feature	157,500	-
Bad debt expense	6,395	2,635
Changes in assets and liabilities:		
Accounts receivable	341,812	464,403
Employee advances	(5,174)	(17,159)
Inventory	197,702	99,552
Prepaid expenses and other assets	76,457	(64,086)
Accounts payable	(1,669,150)	(1,373,549)
Accrued liabilities	(290,142)	(203,572)
Total adjustments	(941,977)	(969,103)
Net cash used in operating activities	(2,820,093)	(2,421,766)
Cash flows provided by (used in) investing activities:		
Purchase of property and equipment	(15,570)	(7,387)
Proceeds from sale of property, equipment, and other assets	641	-
Net cash used in investing activities	(14,929)	(7,387)
Cash flows provided by (used in) financing activities:		
Increase in advances on restricted cash	1,934,851	1,388,923
Proceeds from sale of common stock	215,000	-
Payments on notes to officer	-	(22,082)
Proceeds from notes to stockholders	700,000	1,031,392
Principal payments on notes to stockholders	(129,517)	-
Net cash provided by financing activities	2,720,334	2,398,233
Net decrease in cash	(114,688)	(30,920)
Cash at beginning of period	152,910	58,077
Cash at end of period	<u>\$ 38,222</u>	<u>\$ 27,157</u>
Supplemental disclosures of cash flow information		
Cash paid during the period for interest	\$ 289,905	\$ 143,781
Cash paid during the period for income taxes	3,003	-
Non-cash investing and financing activities		
Transfers of fixed assets to other assets	\$ (1,395)	\$ (27,899)
Transfers of other assets to fixed assets	-	30,355

NBO SYSTEMS, INC.
NOTES TO FINANCIAL STATEMENTS

NOTE A - BASIS OF PRESENTATION

The accompanying unaudited condensed financial statements of NBO Systems, Inc. ("NBO" or "the Company") were prepared in accordance with accounting principles generally accepted in the United States of America (US GAAP) for interim financial information and with the instructions to Form 10-QSB. Accordingly, these financial statements do not include all of the information and footnote disclosures required by US GAAP for complete financial statements. These financial statements and footnote disclosures should be read in conjunction with the audited financial statements and notes thereto for the period ended December 31, 2004 included in the Company's Form 10-KSB/A. In the opinion of management, the accompanying unaudited condensed financial statements contain all adjustments (consisting of only normal recurring adjustments) necessary to fairly present the Company's financial position as of March 31, 2005, its results of operations for the three months ended March 31, 2005 and 2004, and its cash flows for the three months ended March 31, 2005 and 2004. The results of operations for the period ended March 31, 2005 may not be indicative of the results that may be expected for the year ending December 31, 2005.

NOTE B – GOING CONCERN

The Company has incurred net losses since inception and negative cash flows from operating activities. During the three months ended March 31, 2005, the Company had negative cash flows of \$2,820,093 from operating activities. At March 31, 2005, the Company had a deficit in working capital of \$9,313,205 and an accumulated deficit of \$36,179,833. The Company's ability to meet its obligations as they come due is dependent upon its ability to obtain additional financing as required, and ultimately to achieve and sustain profitability. These conditions raise substantial doubt about the Company's ability to continue as a going concern.

The Company will continue to attempt to raise capital through private equity or debt offerings, as well as from institutional investors until internally generated profitability is achieved. The Company may establish a line of credit with a financial institution, or raise bridge financing until a liquidity event can be achieved. The Company is taking steps to improve profitability by restructuring contracts to increase the amount of revenue generated by each contract, and by minimizing costs on existing contracts. The Company is also expanding its available products and services to diversify the risk associated with having limited revenue sources.

There can be no assurance that the Company will be successful in executing its plans to improve operations or obtain additional debt and equity financing. If the Company is unable to improve operations or obtain additional debt and equity financing, it may be required to restructure operations during 2005. Management believes that if the Company were not able to obtain additional financing for the development of its overall business, operations could be restructured in order for the Company to be profitable at the current level of sales. However, there can be no assurance that the Company will be able to achieve its plan or to continue operating without additional financing.

NOTE C – RESTRICTED CASH

Restricted cash consists of funds held for the payment of issued and outstanding gift certificates and gift cards to customers. These funds are maintained at several financial institutions in depository bank accounts and associated sweep accounts held by NBO. The Federal Deposit Insurance Corporation insures balances amounting to \$100,000 cumulatively, per institution. Uninsured balances aggregate to approximately \$1,821,000 at March 31, 2005. Withdrawals of the funds are restricted to the redemption payment of issued and outstanding gift certificates and gift cards and may not be transferred into operating accounts until such time that the unredeemed gift certificates and gift cards are considered breakage or estimated breakage. Breakage is determined based on (1) expiration, (2) legal statute of limitation, or (3) the accumulation of sufficient historical breakage data upon which to make reliable estimates. Breakage by expiration or legal statute of limitation is recorded as income, and a corresponding amount is removed from gift certificates and gift cards payable. The same amount is removed from restricted cash and recorded as unrestricted cash. Estimated unredeemed gift certificates and gift cards ("estimated breakage") is based on Company historical breakage data and is not recorded as income until the expiration date or the legal statute of limitation passes. However, the Company may transfer all or a portion of estimated breakage from restricted cash to unrestricted cash upon issuance of the gift certificate or gift card. Any estimated breakage amount transferred to unrestricted cash decreases the restricted cash balance but remains in gift certificates payable, until such estimated breakage is recognized as income. At such time, gift certificates and gift cards payable is reduced by a corresponding amount.

NOTE D – INVENTORY

Inventory consists only of gift certificates purchased from third party retailers. Gift certificates are recorded at cost (specific identification method).

NOTE E – EQUITY

During the three month period ended March 31, 2005 the Company issued 8,336 shares of common stock for services in the amount of \$33,344 according to the terms of an employment agreement for one of the Company's officers, and issued 4,188 shares of common stock for services in the amount of \$16,752 according to terms of a compensation agreement relating to commissions paid for the private placement of common stock in the Company. The total shares of common stock issued for services was 12,524 in the amount of \$50,096.

During the three month period ended March 31, 2005 the Company issued 999,879 warrants to purchase shares of common stock in the amount of \$839,555 in accordance with the terms of notes payable. The amount of \$839,555 represents a total of \$127,316 in interest expense recorded in the three month period ended March 31, 2005, plus \$559,617 in deferred interest to be accreted over the life of note as a result of debt refinancing, plus \$152,621 in deferred interest expense on the note issued to be accreted over the life of the note. The note holders are also shareholders and accredited investors.

During the three month period ended March 31, 2005, the Company issued 53,750 shares of common stock at \$4.00 cash per share in connection with a private placement generating total proceeds of \$215,000.

NOTE F – STOCK BASED COMPENSATION

The Company accounts for stock-based compensation under the recognition and measurement principles of APB Opinion No. 25, Accounting for Stock Issued to Employees, and related interpretations. The Company has adopted SFAS No. 123, "Accounting for Stock-Based Compensation". In accordance with the provisions of SFAS 123, the Company has elected to continue to apply Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees" ("APB Opinion No. 25"), and related interpretations in accounting for its stock option plans. In accordance with APB Opinion No. 25, no compensation cost has been recognized for these plans. Had compensation cost for these plans been determined based upon the fair value at the grant date consistent with the methodology prescribed under SFAS No. 123, the Company's net loss would have been changed by the following:

The remainder of this page is intentionally left blank.

NBO SYSTEMS, INC.

NOTE F – STOCK BASED COMPENSATION - CONTINUED

	Three Months Ended March 31,	
	2005	2004
Net loss – as reported	\$ (1,878,116)	\$ (1,452,663)
Add: Stock-based employee compensation expense included in reported net income, net of related tax effects	-	-
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects	(178,757)	(20,751)
Net loss – pro forma	\$ (2,056,873)	\$ (1,473,414)
Loss per share – as reported	\$ (0.11)	\$ (0.09)
Loss per share – pro forma	\$ (0.12)	\$ (0.09)

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

	March 31,	
	2005	2004
Expected dividend yield	-	-
Expected price volatility	26.35%	29.44%
Risk-free interest rate	4.29%	2.87%
Expected life of options	10	10

The weighted average fair value of options granted during the three months ended March 31, 2005 and 2004 are \$1.89 and \$ - per share, respectively.

NOTE G - LOSS PER COMMON SHARE

Basic earnings (loss) per share (EPS) is calculated using income (loss) available to common stockholders divided by the weighted-average number of common shares outstanding during the period. Diluted EPS is similar to Basic EPS except that the weighted-average number of common shares outstanding is increased using the treasury stock method to include the number of additional common shares that would have been outstanding if the dilutive potential common shares had been issued. Such potentially dilutive common shares include stock options and warrants granted or sold, convertible preferred stock and convertible debt. Shares having an antidilutive effect on periods presented are not included in the computation of dilutive EPS.

The average number of shares of all stock options and warrants granted, all convertible notes to stockholders, and convertible preferred stock have been omitted from the computation of diluted net loss per common share because their inclusion would have been anti-dilutive for the periods ended March 31, 2005 and 2004.

For the periods ended March 31, 2005 and 2004 respectively, the Company had 8,634,775 and 6,956,543 potentially dilutive shares of common stock, respectively, not included in the computation of diluted net loss per common share because it would have decreased the net loss per common share. These options and warrants could be dilutive in the future.

NOTE H - COMMITMENTS AND CONTINGENCIES

Litigation

- a. Ripperda, et al v. NBO, Inc., et al, Circuit Court Twentieth Judicial Circuit of Illinois, St. Clair County, Case No. 04L91

NOTE H - COMMITMENTS AND CONTINGENCIES - CONTINUED

On February 13, 2004, Thomas Ripperda, et al, filed an action in Illinois State Court in St. Clair County, Illinois, against the Company in connection with gift cards sold at the St. Clair Square Mall in St. Clair County, Illinois. The plaintiff's complaint seeks to establish a class action. However, as of this date, the plaintiff has not moved to certify a class. The complaint alleged that the term "valid thru" appearing on the face of the gift card next to the expiration date of the gift card is misleading in violation of the Illinois unfair business practices laws. The plaintiff seeks a return of all administrative fees charged against his gift card prior to the "valid thru" date. If a class were certified, then the plaintiff would seek to recover similar fees with respect to all gift cards that the Company has sold.

Under the terms and conditions of the gift cards and the gift card program, the Company disclosed that the Company may charge an administrative fee against a gift card if the gift card is not used within 90 days from the date of purchase. The "valid thru" date is typically between 12 months and 18 months after the date the gift card is purchased. In some cases, the administrative fee reduces the amount of the gift card prior to the "valid thru" date on the card. The Company disclosed the charge of an administrative fee on the backside of the gift card and again in the written terms and conditions that are distributed to customers when they purchase the gift cards. The Company also disclosed that a gift card may be renewed after the "valid thru" date with the payment of a renewal fee.

The lawsuit is currently pending in state court in St. Clair County, Illinois. The Company has filed a motion to dismiss, but the plaintiff has not yet filed an opposition. Both the plaintiff and the Company are continuing to conduct discovery. As a result of the continuing discovery, the probability of an adverse outcome cannot be determined, nor can the potential liability be estimated.

b. WildCard Systems, Inc., Claim for Indemnification

WildCard Systems, Inc. ("WildCard") is a credit card transaction processor. The Company entered into an agreement with WildCard for the right to use the MasterCard-branded gift cards sold at the St. Clair Square Mall and for card transaction processing in connection with these gift cards. WildCard in turn contracted with Bank of America and Bank of America issued the gift cards that were sold at St. Clair Square Mall. The term "valid thru" appearing on the face of the card are words required by Bank of America on the face of the card.

Thomas Ripperda, the plaintiff described above, named Bank of America as a defendant together with the Company when he filed his complaint against the Company in connection with the gift cards sold at St. Clair Square Mall. Bank of America has been defending the lawsuit parallel to the Company's defense of the lawsuit. WildCard has not been named as a defendant in the lawsuit.

WildCard has informed the Company that Bank of America has asserted a claim for indemnification against WildCard in connection with Bank of America's expenses and possible liability arising from the lawsuit filed by Thomas Ripperda against Bank of America. WildCard has in turn asserted a claim to indemnification against the Company with respect to Bank of America's claim against WildCard.

Section 9.2 of the Company's agreement with WildCard sets forth the indemnification provisions in clause (a) and (b). The obligation to indemnify only arises out of or relating to the following: "(a) any act or omission by [NBO Systems, Inc.] or its representatives in the performance of [NBO Systems, Inc.'s] obligations under the Agreement, (b) any material breach in a representation, covenant or obligation of [NBO Systems, Inc.] contained in this Agreement". The Company's agreement with WildCard provides a similar reciprocal indemnification requirement by WildCard in the Company's favor.

WildCard asserts that the Company has the responsibility to assure that all aspects of the gift card program at St. Clair Square Mall complied with all laws, and since the plaintiff alleges a breach of the Illinois unfair business practices laws in connection with the sale of the gift cards, the Company should be responsible for indemnifying WildCard for its expenses and liabilities incurred in connection with the gift cards. The Company has denied liability based on several grounds. First, WildCard is not a party to the litigation and the Company claims that it should not be liable for expenses and liabilities incurred by WildCard under a completely independent agreement with Bank of America. Second, WildCard has not identified any specific act or omission by the Company or any breach by it of a specific covenant or obligation. Third, the complaint focuses specifically on the phrase "valid thru" on the front of the card, a phrase required by Bank of America and therefore, the Company claims, indirectly required by WildCard.

The Company has also asserted a right to indemnification from WildCard for its costs and liabilities, if any, incurred in the litigation with Thomas Ripperda. WildCard has rejected the Company's claim for indemnification.

NOTE H - COMMITMENTS AND CONTINGENCIES - CONTINUED

Since the agreement with WildCard contains an arbitration clause, WildCard has invoked the right to arbitrate the dispute. At this point in time, the arbitrators have been appointed and the parties are proceeding in the ordinary course

of the arbitration proceeding. No lawsuit has been filed and no discovery or other proceedings have been initiated in the arbitration proceeding. At this time, the probability of an adverse outcome is uncertain and any potential liability is not estimable.

Except as described above, the Company is not a party to any material threatened or pending legal proceedings, which if adversely determined, would have an adverse material effect on the Company's financial condition or results of operations. From time to time, however, the Company may become subject to legal proceedings, claims, and litigation arising in the ordinary course of business, including, but not limited to, employee, customer and vendor disputes.

RISK FACTORS

Investing in our common stock involves a high degree of risk. Before purchasing our common stock, you should carefully consider the risks described below in addition to the other information in this Report. Our business prospects, results of operations, liquidity or financial position may be materially and adversely affected due to any of the following risks. The risks described below are not the only ones we face. Additional risks we are not presently aware of or that we currently believe are immaterial may also impair our business prospects, results of operations, liquidity or financial position. The value of our common stock could decline due to any of these risks, and you could lose all or part of your investment. In assessing these risks, you should also refer to the other information contained or incorporated by reference in this Report, including our consolidated financial statements and related notes. This Report contains forward-looking statements based on the current expectations, assumptions, estimates and projections about our industry and us. These forward-looking statements involve risks and uncertainties. Our actual results could differ materially from those discussed in these forward-looking statements as a result of certain factors, as more fully described in this section and elsewhere in this Report. We do not undertake to update publicly any forward-looking statements for any reason, even if new information becomes available or other events occur in the future.

Since inception, we have incurred net losses and negative cash flows from operating activities.

Since inception of operations in June 1994, we have incurred net losses and negative cash flows from operating activities. As of March 31, 2005 we have incurred cumulative losses of approximately \$36.2 million. In recent years, we have been financing our operations, in part, through loans extended by existing stockholders, in exchange for which we have issued short-term and long-term promissory notes providing for interest at annual rates of between 17 and 30 percent. The aggregate amount of such loans was approximately \$5.7 million as of March 31, 2005. We may need to raise additional funds to continue to operate our business if we are unable to generate positive cash flows from our operating activities. We may not be able to obtain such financing on terms favorable to us, if at all. Any additional capital raised through the sale of equity or convertible debt securities would dilute the ownership interests of our then-existing stockholders. Any additional capital raised through debt financing would result in increased interest expense and would likely subject us to financial and other covenants that restrict our ability to operate our business. If financing is unavailable when required or is not available upon acceptable terms, we may not be able to develop or enhance our products and services, marketing efforts or operational infrastructure, which may, in turn, prevent us from achieving profitability and/or continuing in business.

If we are not successful in marketing our products and services, our results of operations will suffer.

We have expended few funds on marketing and advertising to date. We anticipate a significant increase in sales and marketing expenditures particularly for our new products and services to be offered later in 2005. We have not developed or tested any targeted, integrated, multi-media marketing program that would include print, radio, television or on-line components to build brand awareness and drive sales. Our future growth and profitability will depend in large part upon our ability to:

- create greater awareness of our products and services and the ways in which consumers and corporations may purchase them;
- identify the most effective and efficient level of spending for each product in each market;
- determine the appropriate creative message and media mix for marketing expenditures;
- effectively manage marketing costs (including creative and media) in order to maintain acceptable operating margins and return on marketing investment;
- select the right markets in which to market; and
- convert consumer awareness into actual store visits, on-line visits and product purchases.

If we are not successful in implementing our marketing program, our results of operations will be adversely affected.

At present, we have a fairly limited number of customers. To continue in business and achieve profitability, we need to expand our customer base.

There are a limited number of shopping mall properties in the United States that would likely have sufficient gift card and gift certificate volume for us to be able to establish profitable gift card programs at such properties. Our target market for gift card programs is further limited as a result of owners/operators of some of the largest malls in the United States developing their own gift card and/or gift certificate programs, as have many large retailers. Further, there has been a significant amount of consolidation in the shopping mall commercial real estate industry. The prospect of further consolidation creates the risk that we may lose some of our existing mall owner/operator customers.

The Company maintains a non-compete agreement with ValueLink, limiting the customer base available for fulfillment contract services. At this time, we are unable to offer fulfillment services to direct ValueLink competitors.

Existing and/or proposed federal and state laws and regulations regarding gift certificates, gift cards and other prepaid stored-value cards have limited (and may further limit) the manner in which we operate our gift, incentive and fund-raising card programs and our revenues.

Existing and/or proposed federal and state laws and regulations have limited and may in the future further limit the manner in which we are able to operate our gift, incentive and fund-raising card programs. For example, in October 2004, a bill was introduced in the U.S. Senate and referred to the Committee on Banking, Housing and Urban Affairs. This proposed legislation, referred to as the Fair Gift Card Act, would, if adopted, preclude us from being able to impose fees, such as the monthly maintenance fees we charge, for non-use or inactivity of gift certificates or gift cards, except in limited circumstances. Further, the proposed legislation would make it unlawful for gift certificates or gift cards to have an expiration date of less than five years from the date of purchase. Some states have already enacted legislation eliminating expiration dates or maintenance fees, and additional states may enact similar legislation in the future. In other states, the statute of limitations before a gift certificate expires is minimally three years from the date of issuance of the gift certificate. We cannot recognize revenue from unused gift certificates until the statute of limitations expires. Accordingly, if the statute of limitations is increased or expiration dates are eliminated then this would extend the time before we would be able to recognize revenue from unused gift certificates and gift cards, which would negatively affect our results of operations.

We currently recognize revenue from the funds underlying unredeemed gift certificates and gift cards, known in our industry as “breakage.” Through their unclaimed property laws (also known as abandoned property or escheat laws), some states seek to escheat gift certificates and gift cards that remain unclaimed or unredeemed for a legally specified amount of time. According to the leading U.S. Supreme Court case, Texas v. New Jersey, 379 U.S. 674 (1965), a state may escheat the unclaimed property held by a company if either (1) that company keeps records indicating that the addresses of the property owners are located in that state, or (2) the company does not keep such records, but is domiciled in that state. As a Maryland corporation, we are subject to Maryland’s unclaimed property laws, which expressly exempt gift certificates from escheat. We have relied on the ruling in Texas v. New Jersey and our Maryland domicile to determine that the breakage we hold is exempt from escheat.

However, approximately 14 states have enacted unclaimed property laws that both provide for the escheat of gift certificate or gift cards and contain so-called “transactional jurisdiction” provisions. Such “transactional jurisdiction” provisions authorize a state to escheat unclaimed property that was initially sold or distributed within such state. The legal validity of “transactional jurisdiction” provisions is in question given the ruling in Texas v. New Jersey. One federal district court has held that transactional jurisdiction is invalid to the extent it conflicts with Texas v. New Jersey. However, the state courts in two states have upheld the validity of transactional jurisdiction. In future years, as the dormancy periods for the years in which the gift cards and gift certificates were issued expire, the potential amount might become material.

We face the risk that some of the states that have enacted “transactional jurisdiction” provisions will attempt to enforce such provisions and escheat the unredeemed gift certificates and gift cards that we hold. If such states are successful in applying such laws, our business prospects, results of operations, liquidity, and financial position would be adversely affected. Furthermore, some of the states which have not enacted “transactional jurisdiction” provisions may enact such provisions in the future. If additional states enact “transactional jurisdiction” provisions and the unclaimed property laws of such states provide for the escheat of gift certificates or gift cards, our business prospects, results of operations, liquidity, and financial position may further be adversely affected. The potential amount subject to escheat to the states that have transactional jurisdiction statutes that do not exempt gift cards and gift certificates at the end of our last fiscal year is not material.

Since we do not have long-term agreements with our vendors and suppliers, we may not be able to secure adequate supplies, which could disrupt our operations and have an adverse affect on our business prospects, liquidity, financial position and results of operations.

We purchase 100% of our materials used for our products and services from outside vendors. These vendors, in turn, contract for our orders with multiple factories for the production of our certificate and card stock. Our relationships with our vendors generally are on a purchase order basis and do not provide a contractual obligation to provide adequate supply, quality or acceptable pricing on a long-term basis. Our vendors could discontinue sourcing products for us at any time. If the vendors were to discontinue their

relationship with us, or if the factories with which they contract were to suffer a disruption in their production, we may be unable to replace the vendors in a timely manner, which could result in short-term disruption to our inventory flow as we transition our orders to new vendors or factories. Disruption in inventory could, in turn, disrupt our operations and have an adverse effect on our business, financial condition and results of operations.

Our success is highly dependent on general economic conditions since consumer gifts are highly discretionary.

Our business is subject to changes in general economic conditions. Since purchases of our products and services are dependent upon discretionary spending by the users of our gift, incentive and fund-raising cards, our financial performance is sensitive to changes in overall economic conditions that affect consumer spending. Consumer spending habits are affected by, among other things, prevailing economic conditions, levels of employment, salaries and wage rates, consumer confidence and consumer perception of economic conditions. A general or perceived slowdown in the United States economy or uncertainty to the economic outlook could reduce discretionary spending or cause a shift in consumer discretionary spending to other products or services. Any of these factors would likely cause us to delay or slow our expansion plans, result in lower transaction volumes and revenues and adversely affect our liquidity and profitability. A nationwide economic downturn could adversely impact our busiest selling season and reduce the expected revenues and other income we expect to receive to fund our operations.

The execution of our growth strategy depends on our ability to retain key personnel, including our executive officers, and to attract qualified personnel.

The successful implementation of our business model and growth strategy depends on the continued contributions of our senior management and other key personnel, including Keith A. Guevara, our President and Chief Executive Officer. We have \$2,000,000 in key man life insurance on Mr. Guevara. We believe future success will also depend, in part, upon the ability to attract, retain and motivate qualified personnel.

If we are unable to protect our intellectual property, which is essential to our business, we may not be able to compete effectively.

We believe our copyrights, service marks, trademarks, trade secrets, and similar intellectual property are critical to our success. In a highly competitive industry with relative ease of entry into the marketplace, we rely on trademark, copyright and other intellectual property laws to protect our proprietary rights and maintain our product differentiation. We also depend on trade secret protection through confidentiality and license agreements with our employees, licensees, licensors and others. We may not have agreements containing adequate protective provisions in every case, and the contractual provisions that are in place may not provide us with adequate protection in all circumstances. The unauthorized reproduction or other misappropriation of our intellectual property could diminish the value of our brands, products and services and competitive advantages and result in decreased revenues. Despite our efforts to protect our intellectual property rights, intellectual property laws afford us only limited protection. A third party could copy or otherwise obtain information from us without authorization. Accordingly, we may not be able to prevent misappropriation of our intellectual property or to deter others from developing similar products and services. Further, monitoring the unauthorized use of our intellectual property rights is difficult. Litigation may be necessary to enforce our intellectual property rights or to determine the validity and scope of the proprietary rights of others. Litigation of this type could result in further substantial costs and diversion of resources, may result in counterclaims or other claims against us and could negatively impact our financial position, liquidity, business prospects, and results of operations. In addition, the laws of some foreign countries do not protect our proprietary rights to the same extent as the laws of the United States.

Damage or long-term disruption to our information systems would substantially harm our business.

We depend heavily on our communications and information systems, which, despite our adoption of industry-standard security measures, are vulnerable to potential systems failures, unauthorized file access, telecommunications provider failures, and power failures. Any damaging failure or long-term interruption of our systems, including those associated with new systems implementations or system upgrades, will significantly harm our business, including our sales, distribution, purchasing, inventory control, merchandising and financial controls.

Consumer-information privacy regulations could subject us to state penalties or litigation, damage our reputation, and deter current and potential users from using our products and services.

NBO SYSTEMS, INC.

Under certain circumstances, we currently obtain and retain personal information about consumers who purchase cards on our websites, phone in orders to our call center, or register cards on our websites for theft-cancellation or loss-replacement services. Federal, state and foreign governments have enacted or may enact laws or regulations regarding the collection and use of personal information, possibly including enforcement and redress provisions. We have implemented programs and procedures designed to protect the privacy of consumers and have established security features to protect our user database and websites. However, our

security measures may not prevent all possible security breaches. If third persons were able to penetrate our network security and gain access to, or otherwise misappropriate, our users' personal information, it could harm our reputation and, therefore, our business, and we could be subject to liability. Such liability could include claims for misuse of personal information. These claims could result in litigation, our involvement in which, regardless of the outcome, could require us to expend financial resources and limit our operational growth.

Increased accounting and financial reporting requirements, as an SEC reporting entity, could stress our internal accounting system and system of internal controls sufficient to potentially impair the accuracy of our financial results or impair our ability to prevent fraud.

The risks associated with financial reporting have come to the forefront in recent years. Any failure to effectively implement adequate controls or meet the growing systems and staffing needs of our accounting and finance functions could result in errors in our published financial reports or in other failures to comply with our obligations as a public company, including the requirements of the Sarbanes-Oxley Act of 2002. Based upon our size and scope of operations, we are not required to comply with Sarbanes-Oxley Section 404 until December 31, 2006. Effective internal controls are necessary for us to provide reliable financial reports and effectively prevent fraud within the company. Our intent is to operate within the confines of the requirement to ensure effective internal controls within the organization. As we have been a non-listed public company, we have had limited accounting personnel and other resources with which to address our internal controls and procedures. Our reporting obligations will increase significantly should we become a listed public company, placing a considerable strain on our management, operational and financial resources and systems for the foreseeable future. We are currently developing and improving our internal accounting systems, particularly our operational, financial, communications and management controls and our reporting systems and procedures. We expect to devote significant resources to ensure that our administrative infrastructure and system of internal controls remain adequate for a listed public company. We cannot be certain that these measures will ensure that we implement and maintain adequate controls over our financial processes and reporting. Non-compliance with Sarbanes-Oxley can result in litigation, public scrutiny, and/or lost revenues, significantly limiting opportunities for future growth.

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

This item discusses the results of operations for the Company for the three month period ended March 31, 2005 and compares this period with the same period of the previous year. In addition, the discussion describes the significant changes in the financial condition of the Company at March 31, 2005 as compared to December 31, 2004, the fiscal year end for the Company. This discussion should be read in conjunction with the unaudited condensed financial statements and accompanying notes presented in Part I, Item 1 of this report, and the audited financial statements and accompanying notes included in the Company's Form 10-KSB/A for the period ended December 31, 2004.

Principal Products and Services

We develop and market prepaid stored-value card programs that operate on the established payment systems operated by Visa and MasterCard (open networks) or on Discover (private dedicated networks). The cards that operate on the Visa and MasterCard payment systems are issued by national banks that are part of a national bank association and may be redeemed at any merchant that accepts Visa or MasterCard. Discover cards are issued by NBO on behalf of Discover and may be redeemed at any merchant that accepts Discover. Our products and services address several different market segments for prepaid stored-value concepts, including universal mall gift cards, corporate incentive and membership reward cards, and cards utilized in fund-raising efforts.

For consumers, prepaid stored-value cards may be better categorized as either "dedicated" or "universal" cards. Dedicated cards are typically "branded" with a retail business's name and are accepted only by that retail business at its specific retail locations. For example, the Blockbuster Entertainment gift card is a dedicated card that permits use only at Blockbuster retail locations. By contrast, multiple retail establishments accept universal cards as in the case of the shopping mall gift card.

The universal cards may operate in an open network environment, such as Visa or MasterCard, or, may be limited to multiple, specific retail establishments through the use of inclusion tables on a private dedicated network environment such as Discover. Our

NBO SYSTEMS, INC.

ability to offer customers multiple network alternatives relieves us of the costs of maintaining our own infrastructure to support card redemption processes. Additionally, our development, marketing, and fulfillment services place us in a central and neutral position among credit card associations, issuing banks and data processors. We intend to leverage this position and offer customers with opportunities to design prepaid stored-value card programs that meet their individual needs.

We continue to offer paper-based gift certificates to legacy customers, but over time, we expect that the paper-based gift certificate business will transition to card-based technology. The growing popularity of gift cards can be attributed, in part, to the convenience

and flexibility provided to both purchasers and recipients. A gift card allows the purchase decision to be made by the card recipient. The card recipient, in turn, may avoid the inconvenience of exchanging or returning unwanted or duplicative merchandise.

Target Markets

Our primary target markets for our card programs consist of:

- owners and operators of shopping malls;
- consumers who prefer to shop on-line via the Internet;
- fulfillment for third-party companies that develop and manage individual retailers' dedicated card programs (i.e., programs in which the gift cards can only be redeemed in the stores of the issuing retailer or its affiliates);
- businesses and organizations that sponsor incentive and loyalty rewards programs;
- high volume retailers such as grocers, convenience stores and pharmacies; and
- the non-profit fund-raising sector, particularly K-12 and university-based educational institutions.

Shopping Mall Universal Gift Cards

Our product delivery to owners/developers and operators of shopping malls shifted from gift certificate products to gift card products in 2001. Our gift card programs may be tailored specifically to the larger owner/operators of multiple shopping malls, as well as individual, independent shopping malls.

A universal mall gift card issued on an open network environment, such as Visa or MasterCard, may be used at a specific shopping mall (or a group of specific shopping malls) and would be valid at any store within the shopping mall, as well as any retail establishment that accepts Visa or MasterCard.

A universal gift card issued on a private dedicated network environment, such as Discover, would be valid only at specific retailers identified in a group, such as retail stores in a specific mall, through the use of inclusion tables, who accept Discover as a payment type for merchandise or services.

Virtual Malls

Our experience indicates that about 25% of open-network mall gift card redemption activity occurs outside of the shopping mall that sold the mall gift card. This phenomenon is commonly referred to in the industry as "leakage." Leakage is applicable to mall gift cards sold on the VISA or MasterCard networks only, as the Visa or MasterCard logos on the face of the card indicates to the retailer that the card may be accepted anywhere VISA or MasterCard are accepted. Leakage is not applicable to mall gift cards sold on the Discover platform because Discover uses inclusion tables to restrict the redemption activity of the card to only those merchants located in the mall property. We believe that leakage percentages will increase as consumers recognize their ability to redeem cards at merchant locations outside the particular shopping mall property where the mall gift card was sold.

Leakage decreases the mall's customer traffic and ultimately the mall's sales volume. Opportunity arises when recipients of mall gift cards are unable to find the merchandise that they seek at that particular brick-and-mortar mall location, or when they prefer to shop on-line via the Internet, versus making a trip to the actual mall location. We anticipate that our Virtual Mall website will provide a solution to these challenges. A customized Virtual Mall website will be established to complement the sales efforts of each brick-and-mortar mall location. Shoppers would access the Virtual Mall either through the mall's website or our own website.

Our Virtual Mall fulfillment partners receive merchandise in bulk, or are able to ship merchandise to shoppers directly from the manufacturer. This greatly reduces the inventory handling costs and enables us to offer the same, high quality merchandise offered at the shopping mall, or elsewhere on the Internet, at discounts to the retail price offered at the physical mall location. In most instances, shipping to the shopper is free of charge, except for very large items. To incentivize the mall to promote the Virtual Mall, we pay a commission to the mall on all virtual mall sales. For mall gift cards issued on the Discover platform, the Virtual Mall is included as one of the participating merchants in the inclusion tables set up.

In February 2005, we established an agreement with i-Carrots, a leading provider of Internet retail services, as the engine behind our Virtual Mall. i-Carrots has direct relationships with the manufacturers of a broad range of consumer merchandise, ranging from consumer electronics to apparel to jewelry. i-Carrots also has a network of distribution centers to handle order fulfillment.

Fulfillment Services

We provide Internet and call-center fulfillment services for dedicated closed network gift cards for our partners such as ValueLink and Darden. Currently, 29 of ValueLink's clients utilize our dedicated closed network card order fulfillment program.

Corporate Incentive and Membership Reward Cards

We developed a multi-merchant prepaid stored-value card program in the fourth quarter of 2004. At December 31, 2004, we entered into agreements with over 80 national and regional retail merchants (i.e., Lowe's Home Improvement Centers, Circuit City and Dillard's) having in excess of 35,000 brick and mortar retail consumer locations, in addition to the merchant's online retail operations. As of this writing, the number of retail merchants has grown to 86, representing a total exceeding 47,400 brick and mortar retail locations. Each of the participating merchants provides us with rebates, varying from 3%-30%, whenever the multi-merchant card is presented for redemption at the merchant locations. The process of adding participating merchants to our cards continued in the three month period ended March 31, 2005.

Sponsors of corporate incentive and membership rewards programs are increasing their use of prepaid stored-value cards. For businesses, prepaid stored-value cards may be in the form of incentive and reward cards given to employees for achieving specific goals or other general purposes. Our target customers for these cards are third-party providers of incentive, promotion and loyalty programs for a wide variety of entities, including financial institutions, subscription-based services and membership clubs.

For example, a membership reward card may be given to a member or customer of a business who satisfies the criteria of a particular program. Once these incentive and membership rewards cards are distributed by the sponsors, they function in the same manner as dedicated or universal gift cards.

We contract with program sponsors and administrators to provide the prepaid stored-value cards and associated administration of the cards as an important component of the overall corporate incentive and membership rewards programs. By using our prepaid stored-value cards, program sponsors are not required to maintain and manage the distribution of any inventory of goods, or the process to track the redemption of incentive or reward systems. Instead, the program sponsor simply distributes the cards to the recipients, thereby relieving the sponsor of much of the logistical time and cost of the traditional incentive and membership rewards programs.

Retail Incentive Cards

The retail incentive card is another use for the multi-merchant prepaid stored-value card designed for mass-market retail distribution. We are negotiating distribution agreements with marketing firms and credit card processors experienced in the retail industry. These third parties will market our retail incentive cards to high volume retail locations such as grocery stores, drug stores or convenience stores with which they already have relationships, or market our products to new retail outlets. Our retail incentive cards will be available in the checkout lines near the cash registers. We do not load value on the cards distributed through this channel until they are purchased. In order to load value on the cards at the time of purchase, we provide a software interface between the merchant's point-of-sale terminal and our distribution partner or our data base system, allowing all parties access to all required transaction data. Our distribution partners for this channel have completed development of the interface software into the point-of-sale terminals for many of the largest retail merchants in the country, making this a viable business channel for our multi-merchant card products. We believe our multi-merchant retail incentive card provides additional convenience and benefits to the consumer over single-retailer incentive cards competing in the same space.

Fund-Raising Cards

Non-profit organizations, including school-based groups such as PTAs, booster groups, support foundations, youth sports organizations and churches use discounted gift certificates and gift cards sold at face value to patrons to generate revenue to supplement tuition and to support extra-curricular activities including trips, music programs, and athletic teams. These discounted certificates and cards are known in the fund-raising industry as "scrip."

There is an inventory and capitalization burden using traditional scrip products. Therefore, the charitable fund-raising industry in the United States is increasingly making use of prepaid stored-value cards. We sell multi-merchant stored value cards in the fundraising channel as a supplement to traditional scrip products, redeemable at a variety of participating local and national merchants. We brand cards used in the K-12 schools under the "Children's Heroes" name, and label them as Community Scrip Cards (CSC). Other applications are under development for universities and specific charitable foundations.

We have agreements with merchants that allow us to receive rebates or discounts when our cards are presented for redemption at participating merchants. Non-profit organizations purchase the fundraising cards from us at face value and then re-sell the cards to parents, members and other supporters at face value. When a card is redeemed at a participating merchant, the merchant receives the full value of the card as is typical in any debit card transaction. We track card redemption activity and invoice the participating merchants for the agreed upon rebate or discount. Revenue sharing does not occur with the fundraising organization or the distributor until we receive the rebates or discounts from the participating merchant. The use of a multi-merchant stored-value card accomplishes the same fundraising objectives as traditional scrip products, but without the capitalization and inventory requirements.

In November 2004, we signed an agreement with Great Lakes Scrip Company ("GLSC") of Grand Rapids, Michigan to operate a pilot program for distributing our fundraising cards in California, Minnesota, and Iowa in the first quarter of 2005. The pilot program is complete and we are currently evaluating the results of the pilot. We intend to enter into a long-term agreement with GLSC to distribute our fundraising cards nationwide. We sell the cards to GLSC, which in turn, sells the cards to its customers - the schools in their traditional scrip programs.

In the three month period ended March 31, 2005, we continued to market the University Fundraising Card Program using a dedicated internal sales team. The target market is large public and private colleges and universities throughout the country. The program includes a university-branded fundraising prepaid card and a university-branded virtual shopping mall. The university receives a percentage of the card purchases and virtual mall purchases.

Growth Strategy

Our objective is to become the leading provider of prepaid stored-value card programs. We intend to build upon our expertise as a developer of prepaid stored-value card systems and services to mall owners/developers, restaurant chains, incentive program providers and fund-raising institutions. Key elements of our strategy include the following:

- *Expand Existing Mall Gift Card Programs*

We intend to continue to provide gift card solutions to large and medium-sized shopping center owner/operators by introducing new programs that are more consumer-friendly, and more attractive revenue-sharing programs through the use of our new virtual mall concept. Of the approximately 3,500 indoor shopping malls located in the United States, we will concentrate our efforts on those malls having a minimum annual gift certificate or gift card sales volume of \$250,000 or greater. We also plan to engage mall owner/operators in the use of our Virtual Mall as a revenue enhancement device to their existing operations.

- *Continue to Establish Merchant Rebate Agreements for use with the Multi-Merchant Card Applications*

As part of our multi-merchant card strategy, we plan to continue to add additional anchor merchants to our current list of 86 participating merchants. These agreements are difficult and time-consuming to craft, and form one barrier to entry in the channel for potential competitors. We believe our existing relationships will facilitate further advancement in the marketplace. We also believe that incremental volumes created for our participating merchants will enable us to receive even larger discounts and rebates than the initial agreements provide. This should increase our margins and provide additional or increased revenue sharing opportunities for our distribution partners, thereby accelerating additional sales and revenues.

- *Expand Corporate Incentive and Membership Reward Card Programs*

We currently supply prepaid stored-value cards to providers of turnkey corporate incentive and membership reward programs. We intend to expand our marketing efforts of prepaid stored-value cards to companies that administer their own incentive and membership reward programs.

- *Establish a Direct Retail Presence for our Multi-Merchant Cards*

We intend to market our prepaid stored-value cards through high-traffic retail locations, such as grocery stores, drug stores, and entertainment venues. These companies market, distribute and manage card activation through the point-of-sale systems for prepaid cards, such as individual merchant cards or phone cards, for sale in grocery store checkout lines or in other retail establishments. The sale of prepaid telephone cards at such locations is well established, and an increasing number of open and closed network gift cards are now being sold through direct retail locations.

- *Expand the Gift Card Fulfillment Program*

As we demonstrate the power, flexibility, and economy of our fulfillment model, we attract additional business from our existing partners such as ValueLink and we entice new customers through word-of-mouth referrals. We plan to expand our gift card order fulfillment business for dedicated prepaid stored-value gift cards primarily through our exclusive arrangement with ValueLink for ValueLink's customers. This increased volume of business has allowed us to leverage economies of scale in our operations. We will also continue to pursue order fulfillment business from outside ValueLink's existing customer base where non-compete agreements allow for such activities.

- *Promote our Fundraising Programs Through Distributorship Relationships*

Fund-raising for schools, youth sports organizations, church and similar organizations is primarily a grass-roots activity, and we are pursuing opportunities to partner with firms who have already established strong distribution networks to market our multi-merchant rebate cards. We are marketing our stored-value multi-merchant cards as complementary or replacement products for traditional scrip products.

- *Credit Card Registration Program to Generate Rebates from Leading Retailers*

We developed a program to supplement the multi-merchant cards with the standard credit/debit cards that most consumers

currently utilize for everyday purchases. Under this program, we contract with leading merchants to provide rebates on purchases made with regular credit/debit cards by those individuals who have registered those credit/debit cards as part of our program. We have already negotiated such agreements with approximately 15 retailers, constituting about 18% of the retailers who participate in the multi-merchant card program. We do not expect material sales or revenues from this new channel until 2006 or 2007. We must demonstrate traction with our multi-merchant stored-value cards and sign up significantly more merchants offering rebates before this becomes a material part of our operations. However, the potential of this opportunity is large and, in our opinion, is worth expending the additional time and resources to expand.

Sales and Marketing

Our approach to sales and marketing varies by product and target market. We maintain an internal sales team supported by senior management, and also use third parties as distribution channels and extensions of our own sales force. We market our gift card programs and services to shopping malls and other retail merchants. Our gift cards are sold at mall customer service desks through mall-staffed dedicated terminals, through Internet websites that we operate and maintain, and through telephone orders to our in-house call center. Our marketing programs may be tailored specifically to one shopping mall, to a number of shopping malls owned by one owner/operator, to one retailer, or to multiple retailers. We market our multi-merchant card to high-volume outlets such as grocery stores and drug stores. We market our incentive cards to businesses that use them for employee incentive rewards programs and for customer loyalty rewards programs. We market our fund-raising cards to primary and secondary schools, colleges and universities and to their affiliated support organizations, as well as single purpose non-profit fundraising organizations. Finally, we market our Internet and call-center gift card fulfillment services to businesses that use proprietary closed system gift cards. We maintain several websites such as nbo.com, thegiftcardcompany.com, thegiftcertificatecompany.com, and childrensheroes.com to accommodate sales in each of the above-mentioned channels. Additionally, purchasers or recipients of a gift card can access our balance inquiry websites, www.giftcardbalance.com and www.myprepaidcard.info, to check the outstanding balance of funds available on their cards.

Our sales in each of the above channels position us in the areas of strongest growth in the prepaid stored-value card industry. Each channel has its strengths, and in addition, we have an underlying program that is common to each sales channel – our merchant rebate program. We have the flexibility to use the multi-merchant card rebates to enhance our own margins, or to create additional or enhanced revenue sharing opportunities with our distribution partners.

Operations and Strategic Relationships

We manage our prepaid stored-value card program operations in four basic categories:

- Program setup
- Sales and distribution
- Redemption
- Post-redemption activity, including analysis, reporting, and billing

In each of these categories, we leverage strategic relationships with industry leaders to ensure smooth and robust operations for our customers.

Program Setup

Our operation steps for program setup vary, depending primarily on the platform or network that the card program will employ. For open-network programs, those that rely on the Visa or MasterCard networks, our first step is to define the new program with an issuing bank, the financial institution that is ultimately responsible for the underwriting of the card. We have relationships with several banks that underwrite our card programs, including Bank First, MetaBank, and Mercantile Bank. For dedicated-network programs, those that rely on the Discover network, we are considered the issuing partner through sponsorship by Discover.

Next, we work with the issuing bank's or network's data processor to establish card number ranges and other details. We have agreements with First Data Corporation and Metavante Corporation, two of the leading data processors in the industry, who handle large volumes of Visa, MasterCard, and Discover traffic. We secure network approval on the card design, including card artwork and terms and conditions. We then order the plastic cards themselves, through the data processors, and the processors prepare the cards for distribution by encoding their magnetic stripes and embossing card numbers.

Our setup steps for a closed-network program, such as a ValueLink gift card program, require us to form a connection to the ValueLink client's data processor, and then establish a shopping cart on the client's website to effect internet and call center sales.

Sales and Distribution

We sell cards through a mall PC desktop counter-top unit ("CTU"), one of our websites, our call center, or in bulk to a business-to-business customer, corporate incentive program provider, or fundraising group. These entities present a credit card, cashier's check, wire transfer, or other form of payment. In exchange, they receive a card or group of cards loaded with value, ready to use. In programs where we are responsible for handling a credit card transaction in support of a prepaid card sale, we route the transaction through our credit card processor, Nova Information Systems ("NOVA"), an industry-leading gateway to the major credit card networks.

We use CTUs located in the malls as our primary mall gift card and gift certificate sales medium. The CTU software gives the consumer the choice of purchasing a gift card or paper gift certificate (where supported) by credit/debit card, check, or cash. When the customer presents a credit/debit card for payment, the most common payment source, the mall employee swipes the consumer's card at the CTU, which then transmits an authorization request to NOVA. Upon receipt of the applicable authorization, the CTU software charges the credit/debit card for the gift card face value, plus any applicable point of sale fees and taxes. We deposit the funds into a local bank account, often on the mall premises. At the end of each business day, we sweep the funds from the depository bank account into a holding account designated specifically for gift card redemptions. These restricted bank accounts are maintained by the card-issuing bank or network designate and are separate from our operating accounts. The funds are dispensed as consumers redeem the gift cards. We earn interest income on the deposited funds.

Redemption

The flow of funds from redemption activity lies solely within the domain of the merchant's credit card processors, the card networks, and the issuing bank's data processors. When a cardholder presents one of our cards at a merchant, that merchant authorizes the redemption using its own credit card processor and the network affiliated with the card. The data processor receives the authorization request, consults its database, and either approves or denies the purchase. The merchant later settles the transaction with the bank, triggering a transfer of funds from our holding accounts to the merchant. The redemption transactions are high volume – we rely on the 'heavy iron' secure and redundant processing systems within the data processors to accommodate this traffic. We earn a portion of the interchange on the redemption of the cards.

Post-Redemption Activity

The data processors relay redemption information to us on a regular basis. We use the redemption information to add value for our clients by supplying them with store-by-store redemption reports, information on the payment sources used by cardholders to load value on the cards, and rebate generation, where appropriate. Our customers use this information to analyze spending trends and to gauge program performance. We rely on redemption data to bill merchants for agreed-upon rebates, and to support our billing to our customers of account initiation and interchange fees.

Another important post-redemption step is the calculation of merchant rebates. We match card redemptions against our list of participating merchants, and determine the rebate that relates to each transaction. The merchant rebates vary in percentage, in general from 3% to 30%. We deduct a technical services fee from each rebate up front, and then, depending on the program and

sales channel, either retain the rest of the rebate, or calculate a split with our distribution partner from the appropriate channels mentioned above.

To support post-redemption processing for the credit/debit card-registration program, we rely on our agreement with Card Commerce International (“CCI”), a leading supplier of transaction filtering and fraud check services. CCI scans all traffic from participating merchants, detects transactions from registered cards, and relays the redemption activity to us for analysis, reporting, and billing. Filtering the large number of transactions is a burdensome task, requiring significant infrastructure and association certification. Our 5-year agreement with CCI, signed in 2002, relieves us of that burden.

In our strategic relationships with issuing banks, data processors, and networks (either open or closed), we have taken care to establish redundant agreements that assure smooth operations in the event that one of the key relationships fails. As mentioned earlier, we offer customers a choice of platforms, and those multiple platforms give us access to multiple issuing banks and data processors that can support similar lines of business.

Critical Accounting Policies and Estimates

The preparation of financial statements in conformity with U.S. generally accepted accounting principles requires the appropriate application of certain accounting policies, many of which require us to make estimates and assumptions about future events and their impact on amounts reported in our financial statements and related notes. Since future events and their impact cannot be determined with certainty, the actual results will inevitably differ from our estimates. Such differences could be material to the financial statements.

We believe the application of accounting policies, and the estimates inherently required in connection with the application of such policies, are reasonable. These accounting policies and estimates are periodically reevaluated, and adjustments are made when facts and circumstances dictate a change. Historically, we have found our application of accounting policies to be appropriate, and actual results have not differed materially from those determined using necessary estimates.

How We Generate Revenues and Other Income

With respect to our various gift card programs, we derive revenue and other income from a number of sources, including:

- enrollment or point of sale fees charged to purchasers of cards issued in connection with one of our card programs, either at the time of purchase or during the life of the card. These fees are an additional expense to the consumer and are deposited with the proceeds from the card sales regularly in accounts swept by us.
- payment system interchange and transaction fees in connection with redemption transactions;
- rebates paid by merchants who participate in our card programs;
- interest on funds held in reserve for the redemption of the prepaid, stored-value cards;
- monthly administrative fees and renewal fees charged on inactive prepaid, stored-value cards;
- balance inquiry fees;
- fees charged to sponsors of employee incentive and customer rewards programs; and
- “breakage” resulting from prepaid, stored-valued cards that expire or are never redeemed.

Historically, we expect to receive approximately 10% of the value loaded on our multi-merchant cards back in the form of maintenance fees, expiration fees, balance inquiry fees and other administrative fees.

With respect to our various gift certificate programs, we derive revenue and other income from a number of sources, including:

- interest income on funds held in reserve until utilized for gift certificate redemption by the customer.
- breakage resulting from unredeemed or unredeemable gift certificates.

We also record revenue from the sale of third-party closed-end gift cards and gift certificates. We purchase these gift cards and gift certificates at a discount as inventory and in turn resell them to customers or provide them to clients of ValueLink, a subsidiary of First Data Corp., through our call center and internet fulfillment website. We record revenue equal to the sales price of the gift cards and gift certificates sold or the fulfillment fee paid to us by ValueLink and the shipping and handling charges.

Revenue Recognition/Cost of Goods*Gift Card Fees*

Our multi-merchant cards are governed by the rules of, and approved by, the member bank associations (Visa and MasterCard) and Discover. The member bank associations and their related issuing financial institutions require us to fund the value of the multi-merchant cards within 24 to 48 hours from the sale of the multi-merchant card. We sweep the depository funds from the mall owner/operator deposit accounts and hold the funds in restricted bank accounts. The issuing bank or financial institution sweeps the funds reserved for gift card redemptions from our restricted cash accounts to be held for future multi-merchant card redemptions. We show the funds on our balance sheet as restricted cash. We record an offsetting liability labeled gift certificates/gift cards payable on our balance sheet. The multi-merchant card-issuing bank makes a perpetual daily reconciliation to net new sales against redemptions and fees owed to us.

We record interchange transaction or processing fees earned in connection with card redemption transactions as revenues when received. We begin to recognize material revenues on multi-merchant card sales approximately 7 months from the date of sale. The issuing bank and card processor calculate the fees owed to us and submit the fee revenue to us from the restricted bank accounts on a regular basis, typically monthly.

The multi-merchant card has a maximum life of 18 months based on the “Valid thru” (or other similar phrase) date imprinted on the face of the multi-merchant card. The issuing banks mandate this expiration date. However, for a period of up to 12 months after the expiration of the multi-merchant card, the consumer may obtain a replacement multi-merchant card with the remaining balance by calling us. All multi-merchant card fees are charged against the value of the multi-merchant card after expiration as described in the terms and conditions document provided to the consumer at the point of sale. The issuing bank holding the funds for our multi-merchant cards remits to us the funds remaining upon expiration of the multi-merchant card, which we record as revenue when received. Our experience shows that approximately 2% of the face value of all multi-merchant cards sold will be returned to us in the form of expiration fees.

The average life of all multi-merchant cards is approximately 3 to 4 months. Consumers redeem most multi-merchant cards (approximately 85% to 90%) before any maintenance fees or expiration fees are imposed. For those multi-merchant cards that are not fully redeemed by a particular date (which may vary from mall to mall), we charge a monthly maintenance fee (typically \$2.50 per month) to the card per the Terms and Conditions (imprinted on the multi-merchant card and in a separate document provided at the point of sale) until the balance on the multi-merchant card is zero. We deactivate the multi-merchant card account 12 months after the multi-merchant card expires. Our experience shows that approximately 8% of the face value of all multi-merchant cards sold will be returned to us in the form of maintenance fees.

The monthly maintenance fees and the expiration fees enable us to provide the multi-merchant card service to consumers and cover our up-front costs. We record gift card maintenance and expiration fees as revenue in the period earned.

We record rebate income as revenue net of any revenue sharing agreements with third parties in the period received. We apply estimates when compiling quarter-end or year-end results due to timing of receipts of receivable invoices or amounts due to us.

Other Income – Gift Certificate Breakage

For gift certificates, we record the gross transaction volume on our balance sheet as restricted cash. We adjust the restricted cash liability as we offset new gift certificate sales against our payment to retailers of gift certificates they present to us for redemption. We earn and retain all of the interest income from the restricted bank accounts. With interest rates at their current levels, revenue from interest income is not material.

We do not record the full amount of the mall gift certificate sale as revenue. We recognize the majority of our other income from unredeemed or unredeemable gift certificates, known in the industry as “breakage”. We classify breakage as “Other Income” in our statement of operations. We recognize income from breakage upon expiration of the gift certificate, or when no expiration date exists, upon the extinguishment of the liability per the applicable state statute of limitations, for which we use an average of three years from the date of issuance. We have tracked redemption and breakage patterns since inception. Our historical analysis indicates that we receive approximately 4% of the gift certificate gross transaction volume in the form of breakage. However, this breakage income is deferred a minimum of 12 months from the sale date to several years from the sale date, based on the existence or non-existence of an expiration date on the gift certificate. As we record breakage income in the statement of operations in the applicable period, we record a corresponding decrease in gift certificate liability.

Gift Certificate Processing Fees

Our sales history shows that typically 70% to 80% of the gift certificates are purchased with a credit or debit card, with the remainder being purchased with either cash or check. Each credit or debit card transaction is assessed a processing fee, which we show as a cost of revenue shown as merchant fees and charges in our statement of operations. We pay the processing fees and subsequently invoice the mall operator for the processing fees in the following month. We record revenue from the credit and debit card processing fees as merchant fees earned from retailers in our statement of operations.

Sale of Third-Party Gift Certificates and Gift Cards and Related Fulfillment Services

Because we pre-purchase third party gift certificate and gift card inventory, we bear all the financial risk associated with that inventory. Therefore, we record the entire transaction volume sold as revenue in our statement of operations. The associated cost of revenue is the discounted price we pay to the seller of the gift certificates and gift cards we purchase for re-sale.

Since we pre-purchase the entire inventory for traditional scrip, we record the face value amount of the scrip as revenue when sold. We offer no terms on traditional scrip products. Non-profit organizations purchasing the scrip products pay for the scrip electronically or by check before we ship out the product. Our cost of revenue is the pre-purchase amount of the scrip, less the agreed upon discount provided by the retailers. We also share the discount provided by the retailers with the non-profit organization.

We record all fulfillment business transaction volume conducted for third parties as revenue. This channel, reflected as sale of third party gift certificates/cards in our statement of operations, currently constitutes approximately 61% of our revenues. We derive the majority of the revenue from this channel from our Darden relationship. We expect the percentage of revenues in future periods to be reduced as we generate other revenue from new products and services that we anticipate to sell through other business channels in 2005.

ValueLink, our leading fulfillment customer, pays us on a per card fulfilled basis, which we record as revenue in the appropriate period. Typically, we ship ValueLink's consumer orders from our facilities in Salt Lake City. Most orders are placed by consumers and corporations via our website or call center operators. We retain any shipping and handling margins from the fulfillment of the ValueLink products.

Results of Operations***Transaction Volume***

The following figures are included for informational purposes only and are not included in the Company's statements of operations. Transaction volume does not represent revenues or other income of the Company. Rather, transaction volume represents the face value amount of the gift certificates and gift cards that we sell through our various business channels. Transaction volume is sometimes referred to as "sales."

	Three Months Ended March 31,		Dollar	Percentage
	2005	2004	Change	Change
Mall gift certificates	\$ 667,000	\$ 4,908,000	\$ (4,241,000)	-86.4%
Mall gift cards	2,772,000	1,586,000	1,186,000	74.8%
NBO fulfillment (excluding ValueLink and Scrip)	869,000	655,000	214,000	32.7%
ValueLink	309,000	44,000	265,000	602.3%
Scrip	418,000	624,000	(206,000)	-33.0%
	<u>\$ 5,035,000</u>	<u>\$ 7,817,000</u>	<u>\$ (2,782,000)</u>	<u>-35.6%</u>

Starting in 2004 and continuing into 2005, we experienced a major shift from mall gift certificate sales to mall gift card sales. This was primarily a result of The Rouse Company being purchased by General Growth Properties. Our gift certificate sales for The Rouse Company ceased in mid-2004. The Rouse Company had been our largest mall customer. We replaced most of the lost Rouse sales with gift card sales by Glimcher Properties, now our largest mall client, as well as other new independent mall owner/operators. We anticipate a further reduction in gift certificate sales as more properties convert to stored-value mall gift cards.

With the decline in gift certificate sales, we have developed new products and services to provide diversification away from the mall

NBO SYSTEMS, INC.

channel. We will continue to grow our mall gift card business, but anticipate less of a reliance on the mall channel for future growth in sales and revenue.

We also experienced a 32.7% increase in the number of third party gift certificates and gift cards fulfilled. The majority of this transaction volume resulted from year-over-year increases in Darden sales (Red Lobster, Olive Garden and Bahama Breeze). This transaction volume could decrease in 2005 if Darden changes its current fulfillment process. Darden has expressed intent from time to time in the year 2004 to change its fulfillment process in a manner that would affect how we record revenue. The contemplated change would be similar to our current processing of our ValueLink transactions, where we invoice ValueLink on a per-card fulfilled basis. Under the contemplated change, we would not record as revenue the full amount of the value of the gift cards sold on behalf of Darden, as we currently do. Accordingly, our recorded revenue would decline significantly, possibly as much as \$4,000,000 in 2005 or more. We would also have a corresponding decrease in our cost of sales in 2005. The change contemplated by Darden would not materially affect our cash available for operations or our profitability.

ValueLink transaction volume increased over six-fold in the three months ended March 31, 2005. We expect 2005 ValueLink transaction volume to continue to substantially exceed 2004 volumes.

The Scrip transaction volume decrease is a result of our decision to exit the traditional scrip business by the end of the second quarter 2005 in favor of selling our Community Scrip Card. We have already transitioned all of our participating schools to other traditional scrip providers, have sold the majority of our inventory and are phasing out traditional scrip operations.

We anticipate increases in our transaction volume in 2005 compared to 2004 arising from our fundraising card, loyalty and incentive cards, retail incentive cards as well as sales from our virtual mall.

Revenues and Other Income

Revenues and other income from the various channels are recorded as follows:

	Three Months Ended March 31,		Dollar	Percentage
	2005	2004	Change	Change
Sale of third party gift certificates/cards	\$ 1,271,000	\$ 1,271,000	\$ -	0.0%
Merchant fees earned from retailers	169,000	225,000	(56,000)	-24.9%
Fees earned from customers	332,000	123,000	209,000	169.9%
Miscellaneous Income	160,000	96,000	64,000	66.7%
Interest on restricted cash	39,000	9,000	30,000	333.3%
Gift certificate breakage	98,000	(25,000)	123,000	492.0%
Total revenues and other income	<u>\$ 2,069,000</u>	<u>\$ 1,699,000</u>	<u>\$ 370,000</u>	21.8%

Revenues and other income increased approximately 21.8% despite a decrease in transaction volume of approximately 35.6%. The main reason for the increase in revenue and other income in the first quarter of 2005 compared to the first quarter of 2004 is the significant increase in fees earned from customers, representing the continuing trend of significant increases in the sale of mall gift cards, and the subsequent collection of maintenance fees and expiration fees. As noted in the transaction volume table above, we have seen a significant increase in the volume represented by the sale of mall gift cards. We have also been able to negotiate with malls to retain all or a portion of the point-of-sale fees assessed by malls upon the sale of gift cards. Our contracts in the past generally allowed malls to retain these point-of-sale fees. Revenues from the sale of third party gift cards and gift certificates were flat, despite an increase in transaction volume of approximately 32.7%. This decrease is due to the renegotiation of our Darden fulfillment contract and the related reduction in the discount provided to us upon the purchase of inventory from Darden. The year over year changes in gift certificate breakage is not indicative of anticipated future results. We experienced no benefit from gift certificate breakage in the three months ended March 31, 2004 as a result of merchants accepting expired gift certificates in excess of the breakage that would have been recognized for the period. We have updated our contracts to invoice the mall developer for expired certificates that are redeemed by merchants in their properties.

Cost of Revenues and Other Income

Cost of revenues for the various revenue channels are as follows:

NBO SYSTEMS, INC.

	Three Months Ended March 31,		Dollar	Percentage
	2005	2004	Change	Change
Third party gift certificates/cards	\$ 1,182,000	\$ 1,167,000	\$ 15,000	1.3%
Merchant fees and charges	322,000	362,000	(40,000)	-11.0%
Commissions paid to mall owner/operators	209,000	65,000	144,000	221.5%
Other	131,000	145,000	(14,000)	-9.7%
Total cost of revenues and other income	<u>\$ 1,844,000</u>	<u>\$ 1,739,000</u>	<u>\$ 105,000</u>	6.0%

Cost of revenues and other income increased 6% compared to a 21.8% increase in revenues and other income.

Cost of Revenues associated with third party gift certificates and cards represent the costs associated with providing outside gift certificates to our fulfillment and scrip customers. Our inventory of outside vendors' cards and certificates are purchased directly from the vendors at a discount and then resold to outside customers. As noted above, we experienced no increase in sales associated with third party cards and certificates. While revenues from the sale of third party gift certificates and gift cards were flat, we incurred a 1.3% increase in costs associated with these sales. We are focused on increasing our margins on these products in future periods.

We incur costs in processing customer transactions, particularly credit/debit card transactions, through our merchant processor, Nova Information Systems, Inc. The shopping mall owner/operator reimburses us for the credit/debit card processing costs. The reimbursement is recognized as revenue. The fees paid by us to Nova Information Systems, Inc. to process the credit card are recorded as Merchant Fees. In 2003 and for the first nine months of 2004, we used the services of First Data Corp. to process our mall gift card transactions. Starting in the fourth quarter of 2004, we began processing mall gift card transactions through Solspark, a subsidiary of First Data Corp. Merchant Fees recorded overall decreased in dollar terms as a result of this vendor change, and as a result of a renegotiation of our credit/debit card processing agreement with Nova Information Systems. However, as a percentage change, merchant fees increased due to higher card-not-present transactions presented for payment due to increased ValueLink sales. We expect to see costs associated with processing customer transactions continue to decrease as we migrate all of our mall clients to Solspark and process more credit/debit transactions at the lower rates provided by Nova. However, increased card-not present transactions may offset the reductions in fees from our processors.

We pay a commission on mall gift cards sold (based on transaction volume and the number of cards sold) to mall owner/operators as an incentive to use our card programs. We accumulate these commissions and pay the commissions to the malls approximately one year following the completion of the card transaction year. Commissions also comprise a portion of the discounts we receive in exchange for re-selling traditional scrip to the various non-profit organizations such as the K-12 schools participating in our Children's Heroes program. We typically pay approximately 60% of the discount we receive to the non-profit organization selling traditional scrip products. Commissions paid to mall owner/operators increased substantially as mall programs selling our gift cards reached their first one-year anniversary, resulting in payouts of contractual commissions due to them. We anticipate further year-over-year increases as more malls migrate from selling paper gift certificates to our mall gift cards. This anticipated increase in cost in the form of rebates paid is more than offset by the revenues we receive in fees earned from customers from our gift cards.

Other Costs is comprised primarily of postage and handling costs associated with providing gift cards and certificates to our mall clients, and the cost of gift card and gift certificate stock. The largest change in these accounts from the prior year is due to the "hard costs" associated with providing our mall gift card products. We incur all of the up-front costs of the raw plastic, the embossing and encoding of the mall and multi-merchant CSC cards. As the number of gift cards issued increases annually, these hard costs increase proportionately. However, we have negotiated volume discounts based on bulk purchases of gift card stock which resulted in the decrease in other costs of revenue of approximately 10.3%.

Gross Profit

Gross Profit for the related periods is as follows:

	Three Months Ended March 31,		Dollar	Percentage
	2005	2004	Change	Change
Revenues and other income	\$ 2,070,000	\$ 1,699,000	\$ 371,000	21.8%
Cost of Revenues and other income	<u>(1,844,000)</u>	<u>(1,739,000)</u>	<u>(105,000)</u>	6.0%
Gross Profit	<u>\$ 226,000</u>	<u>\$ (40,000)</u>	<u>\$ 266,000</u>	665.0%
Gross Profit %	10.9%	-2.4%		

NBO SYSTEMS, INC.

Revenues and other income increased 21.8% as detailed above. Cost of revenues and other income increased 6% as detailed above. Collectively, gross profit increased 665%. We anticipate gross margins will be maintained at approximately 11% throughout 2005.

Selling, General and Administrative Expenses

	Three Months Ended March 31,		Dollar	Percentage
	2005	2004	Change	Change
Personnel	\$ 803,000	\$ 885,000	\$ (82,000)	-9.3%
Depreciation and amortization	62,000	90,000	(28,000)	-31.1%
Professional Fees	463,000	83,000	380,000	457.8%
Other Selling, General and Administrative Expenses	214,000	236,000	(22,000)	-9.3%
	<u>\$ 1,542,000</u>	<u>\$ 1,294,000</u>	<u>\$ 248,000</u>	<u>19.2%</u>

Selling, general and administrative expenses increased 19.2% overall, however, selling, general and administrative expenses decreased for all expenses not related to professional fees, the majority of which are legal fees incurred as a result of defending the litigation referenced in Note G to the financial statements, as well as accounting fees.

Professional fees are expected to continue to grow as we enhance our operating and controls environment. Internal controls are critical to achieve strong performance over time. We will contract, as appropriate, with independent consultants to further strengthen our internal control environment. We cannot predict how federal and state regulatory activity may affect us, especially as state governments address the legal requirements associated with unclaimed property. We expect additional expenditures to protect and further our interests in this area. We also expect additional expenditures to defend ourselves in the matters of litigation we are a party to.

We are committed to keeping selling, general and administrative expenses at a minimum by utilizing cost control measures and implementing process improvements.

Net Income (Loss)

Net Income (Loss) for the related periods is as follows:

	Three Months Ended March 31,		Dollar	Percentage
	2005	2004	Change	Change
NET LOSS	\$ (1,878,000)	\$ (1,453,000)	\$ 425,000	29.2%

Transaction volume decreased 35.6% in the three month period ended March 31, 2005 from the comparable period ended March 31, 2004, primarily due to the shopping mall industry consolidation discussed above. However, revenues and other income increased 21.8% in the comparable periods, while the cost of revenues and other income increased only 6.0%. Gross profit increased 665.0% resulting in gross margins of 10.9%, compared to gross margins of -2.4% for the comparable period. Selling, general and administrative expenses increased 19.2%, however, as noted above, the majority of that increase is due to professional fees that are not a normal part of our everyday operations. Additionally, interest expenses relating to notes issued to stockholders to obtain working capital increased from approximately \$89,000 in the three month period ended March 31, 2004 to approximately \$549,000 in the three month period ended March 31, 2005, an increase of approximately 517%. \$116,000 of the total interest was non-cash interest expense related to warrants issued in connection with debt financing, and \$157,500 was non-cash interest expense related to beneficial conversion features on notes to stockholders. All of these factors combined resulted in an increase in net losses attributable to common stockholders of approximately \$425,000, an increase of 29.2% in the comparable periods. The cost of working capital is exorbitant and stresses the importance of achieving internally generated positive cash flow from operations as quickly as possible.

Our gift card programs are more profitable than our gift certificate programs. Our gift card program costs are “front-loaded”, meaning we bear the cost of providing the card services, but do not receive material revenues until several quarters later. This sometimes has the effect of showing a greater increase in cost of revenues than the growth rate in revenues. We anticipate this trend to continue until new product offerings and programs result in more even revenue recognition throughout the year and minimize the upfront cost of cards to us prior to sale. We are introducing new products that pay us up-front, rather than relying upon deferred revenue products. As we become less dependent upon maintenance fees, expiration fees and breakage, revenues and

NBO SYSTEMS, INC.

costs will be recorded at approximately the same time. We have consistently decreased Selling, General and Administrative expenses through attrition and cost cutting measures. However, our generation of cash flows from operating activities has not been sufficient and therefore, we have raised working capital through equity and debt offerings. The equity offerings dilute existing stockholders and the debt offerings increase our interest expense, which has negatively impacted our net income (loss). We continually strive to increase sales of higher profit margin products and expect this to increase cash flows from operating activities in the future. This will minimize or eliminate the need for raising capital from outside sources. We are currently in discussions with several institutional level financial companies in order to obtain the working capital we need to market and distribute our new products and execute our business plan. We are also in discussions with investment bankers to assist us with the completion of a public offering of our common stock. The timing and success of these events is not certain.

Liquidity and Capital Resources

The Company's total costs and expenses are currently greater than its revenues and other income. In addition, the Company's operating activities have used cash rather than provided cash. The Company to date has had a history of losses and the accumulated deficit (since inception June 23, 1994) as of March 31, 2005 is approximately (\$36,180,000). The Company's net losses increased by 29.2% or \$425,000 to (\$1,878,000) from (\$1,453,000) in the three months ended March 31, 2005, compared to the three months ended March 31, 2004, respectively. The Company's current liabilities exceed its current assets by \$9,313,000 as of March 31, 2005.

The Company's liquidity is dependent on its ability to meet its obligations, to obtain additional financing as may be required and ultimately to attain profitability. In the period ended March 31, 2005, the Company entered into financing agreements that provided the Company with \$700,000 to use for operations. We also raised \$215,000 by selling 53,750 common shares in a private equity offering. The proceeds are for general operating purposes. In March 2005, we renegotiated the terms of certain financing agreements, extending their maturities past March 31, 2006. Subsequent to March 31, 2005, the Company entered into financing agreements that provided the Company with \$200,000 to use for operations. Additionally, the Company's President and Chief Executive Officer entered into short-term demand notes to provide the Company with \$90,000 to use for operations.

The Company will continue to attempt to raise capital through private equity or debt offerings, as well as institutional investors until internally generated profitability is achieved. The Company is taking steps to improve profitability as described above. There can be no assurance that the Company will be successful in executing its plans to improve operations or obtain additional debt and equity financing. If the Company is unable to improve operations or obtain additional debt and equity financing, it may be required to restructure operations during 2005. Management believes that if the Company were not able to obtain additional financing to finance development of its overall business, that operations could be restructured so that the Company may be profitable at the current level of sales.

Liquidity and Financing Arrangements

During the three month period ended March 31, 2005, the Company issued 53,750 shares of common stock at \$4.00 cash per share in connection with a private placement generating total proceeds of \$215,000.

During the three month period ended March 31, 2005 the Company issued 12,524 shares of common stock for services in the amount of \$50,096 according to the terms of an employment agreement for one of the Company's officers, and according to terms of a compensation agreement relating to commissions paid for the private placement of common stock in the Company.

During the three month period ended March 31, 2005 the Company issued 999,879 warrants to purchase shares of common stock in the amount of \$793,722 in accordance with the terms of notes payable. The note holders are also shareholders and accredited investors. Of the \$793,722:

- a. \$157,662 was recorded as a discount to notes to stockholders in connection with the \$700,000 notes issued during the three months ended March 31, 2005. \$39,416 of the discount was recognized as interest expense during the three months ended March 31, 2005, leaving a remaining discount of \$118,246 as of March 31, 2005.
- b. \$610,492 was recorded as deferred financing costs in connection with the refinancing of \$2.1 million of notes to stockholders. \$50,874 of the deferred financing costs was recognized as interest expense during the three months ended March 31, 2005, leaving a balance of \$559,618 in deferred financing costs as of March 31, 2005.
- c. \$25,568 was recorded as interest expense for warrants issued as interest payments during the three months ended March 31, 2005.

On March 8, 2005, the Company executed promissory notes with stockholders in the amount of \$700,000 to fund additional operations. The note holders are accredited investors. The notes bear interest at an annualized rate of 30%, are convertible into shares of common stock of the Company at \$4.00 per share, and are due July 7, 2005. In association with these notes, the Company recorded beneficial conversion features totaling \$157,500 and debt discounts totaling \$157,662. \$39,416 of the debt discount was

NBO SYSTEMS, INC.

recognized as interest expense in the three months ended March 31, 2005 leaving a remaining discount of \$118,246 as of March 31, 2005.

On March 10, 2005, the Company re-structured several promissory notes with a stockholder to extend the maturity of the notes beyond March 31, 2006 in the amount of \$2,100,000 bearing interest at an annualized rate of 22%. The note holder is an accredited investor. In connection with the refinancing, the Company recorded \$610,492 as deferred financing costs, \$50,874 of which was recognized as interest expense in the three months ended March 31, 2005.

On April 5, 2005, the Company executed a promissory note with a stockholder in the amount of \$100,000 to fund additional operations. The note holder is an accredited investor. The note bears interest at an annualized rate of 18%, is convertible into shares of common stock of the Company at \$4.00 per share, and is due April 4, 2006. In connection with the note, the Company issued 2,500 warrants to purchase shares of common stock of the Company at an exercise price of \$4.00 per share.

On April 12, 2005, the Company executed a promissory note with a stockholder in the amount of \$100,000 to fund additional operations. The note holder is an accredited investor. The note bears interest at an annualized rate of 22%, is convertible into shares of common stock of the Company at \$4.00 per share, and is due October 11, 2005. In connection with the note, the Company issued 36,666 warrants to purchase shares of common stock of the Company at an exercise price of \$4.00 per share.

On April 13, 2005, the Company executed a short-term demand note with the President and Chief Executive Officer of the Company in the amount of \$40,000 to fund additional operations. The note bears interest at an annualized rate of 10%.

On April 27, 2005, the Company executed a short-term demand note with the President and Chief Executive Officer of the Company in the amount of \$50,000 to fund additional operations. The note bears interest at an annualized rate of 10%.

The remainder of this page is intentionally left blank.

ITEM 3. CONTROLS AND PROCEDURES

a. Evaluation of disclosure controls and procedures.

Under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, we evaluated the effectiveness of the design and operation of our disclosure controls and procedures as of March 31, 2005 (as defined in Rule 13a-15(e) or 15d-15(e) under the Securities Exchange Act of 1934 (the "Exchange Act")). In connection with this evaluation, management identified a deficiency that existed in the design or operation of our internal control over financial reporting that it considers to be a "material weakness." The Public Company Accounting Oversight Board has defined a material weakness as a "significant deficiency or combination of significant deficiencies that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected."

The deficiency in our internal control related to accounting for the debt discount resulting from the warrants issued in connection with convertible notes and the related beneficial conversion feature. The adjustment to record the debt discount and beneficial conversion feature was detected and has been appropriately recorded and disclosed in this Form 10-QSB. We are in the process of improving our internal control over financial reporting in an effort to remedy this deficiency.

Based upon that evaluation and the deficiency identified above, the Chief Executive Officer and Chief Financial Officer concluded that, as of the end of the period covered by this report, our disclosure controls and procedures were not effective in timely alerting them to the material information relating to us (or our consolidated subsidiaries) required to be included in the reports we file or submit under the Exchange Act or in ensuring that information required to be disclosed in the reports that we file or submit under the Exchange Act is accumulated and communicated to management, including the Chief Executive Officer and Chief Financial Officer, to allow timely decisions regarding required disclosures.

b. Changes in internal controls.

During the fiscal quarter covered by this report, there has been no change in our internal control over financial reporting (as defined in Rule 13a-15(f) or 15d-15(f) under the Exchange Act) that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

Other than described in Note H to the financial statements, the Company is not a party to any material threatened or pending legal proceedings, which if adversely determined, would have an adverse material effect on the financial condition or results of operations of the Company. From time to time, however, the Company may become subject to legal proceedings, claims, and litigation arising in the ordinary course of business, including, but not limited to, employee, customer and vendor disputes.

Item 2. Unregistered Sales of Equity Securities

During the three month period ended March 31, 2005, the Company issued 53,750 shares of common stock at \$4.00 cash per share in connection with a private placement generating total proceeds of \$215,000.

During the three month period ended March 31, 2005 the Company issued 12,524 shares of common stock for services in the amount of \$50,096 according to the terms of an employment agreement for one of the Company's officers, and according to terms of a compensation agreement relating to commissions paid for the private placement of common stock in the Company.

During the three month period ended March 31, 2005 the Company issued 999,879 warrants to purchase shares of common stock in the amount of \$793,792 in accordance with the terms of notes payable. The note holders are also shareholders and accredited investors.

All of the investors are accredited investors. The Company relied upon the exemption from registration set forth in section 4(2) of the Securities Act of 1933, as amended, and Rule 506 of Regulation D thereunder.

NBO SYSTEMS, INC.

Item 3. Defaults Upon Senior Securities

None.

Item 4. Submission of Matters to a Vote of Security Holders

None.

Item 5. Other Information

None.

Item 6. Exhibits

(a) Exhibits:

- | | |
|------|--|
| 31.1 | Certification, Keith A. Guevara, Chairman, President and CEO |
| 31.2 | Certification, Christopher Foley, Board Member, CFO |
| 32 | Certification pursuant to 18 U.S.C. Section 1350 of Keith A. Guevara and Christopher Foley |

SIGNATURES

In accordance with the requirements of the Exchange Act, the registrant caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

NBO SYSTEMS, INC.

By /s/
Keith A. Guevara
Chairman/President/CEO

May 16, 2005

/s/
Christopher Foley
Director, Chief Financial Officer

May 16, 2005

/s/
Kent Jaspersen
Secretary/Treasurer, Chief Accounting Officer

May 16, 2005

NBO Systems, Inc.

Exhibit 31.1

I, Keith A. Guevara, certify that:

1. I have reviewed this Form 10-QSB report of NBO SYSTEMS, INC.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the periods covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the small business issuer as of, and for, the periods presented in this report;
4. The small business issuer's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15e)) for the small business issuer and have:
 - a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the small business issuer, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - b) evaluated the effectiveness of the small business issuer's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - c) disclosed in this report any change in the small business issuer's internal control over financial reporting that occurred during the small business issuer's most recent fiscal quarter that has materially affected or is reasonably likely to materially affect the small business issuer's internal control over financial reporting.
5. The small business issuer's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the small business issuer's auditors and the audit committee of small business issuer's board of directors (or persons performing the equivalent functions):
 - a) all significant deficiencies and material weakness in the design or operation of internal controls which are reasonably likely to adversely affect the small business issuer's ability to record, process, summarize and report financial information; and
 - b) any fraud, whether or not material, that involves management or other employees who have a significant role in the small business issuer's internal control over financial reporting.

Date: May 16, 2004

/s/ Keith A. Guevara
[Signature]

Chairman of the Board of Directors, Chief Executive Officer and President

NBO Systems, Inc.
Exhibit 31.2

I, Christopher Foley, certify that:

1. I have reviewed this Form 10-QSB report of NBO SYSTEMS, INC.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the periods covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the small business issuer as of, and for, the periods presented in this report;
4. The small business issuer's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15e)) for the small business issuer and have:
 - a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the small business issuer, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - b) evaluated the effectiveness of the small business issuer's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - c) disclosed in this report any change in the small business issuer's internal control over financial reporting that occurred during the small business issuer's most recent fiscal quarter that has materially affected or is reasonably likely to materially affect the small business issuer's internal control over financial reporting.
5. The small business issuer's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the small business issuer's auditors and the audit committee of small business issuer's board of directors (or persons performing the equivalent functions):
 - a) all significant deficiencies and material weakness in the design or operation of internal controls which are reasonably likely to adversely affect the small business issuer's ability to record, process, summarize and report financial information; and
 - b) any fraud, whether or not material, that involves management or other employees who have a significant role in the small business issuer's internal control over financial reporting.

Date: May 16, 2004

/s/ Christopher Foley
[Signature]

Director, Chief Financial Officer

NBO Systems, Inc.

**STATEMENT PURSUANT TO
18 U.S.C. SECTION 1350**

Keith A. Guevara, as Chief Executive Officer of NBO Systems, Inc. (the “Company”), and Christopher Foley, as Chief Financial Officer of the Company, hereby certify, pursuant to 18 U.S.C. §1350(b), that

- (1) the Company’s Report of Form 10-QSB for the quarterly period ended March 31, 2005, as filed with the Securities and Exchange Commission on the date hereof (the “Report”) fully complies with the applicable requirements of Section 13(a) or Section 15(d) of the Securities Exchange Act of 1934; and
- (2) the information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Dated: May 16, 2005

/s/Keith A. Guevara
Chief Executive Officer
Of NBO Systems, Inc.

Dated: May 16, 2005

/s/Christopher Foley
Chief Financial Officer
Of NBO Systems, Inc.