

**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 September 30, 2006

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 November 14, 2006, the number of shares outstanding of the registrant's only class of common stock was 18,207,415.

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 September 30, 2006, and December 31, 2005	3
	Condensed Statements of Operations for the Three and Nine Months ended September 30, 2006, and 2005	4
	Condensed Statements of Cash Flows for the Nine Months ended September 30, 2006, and 2005	5
	Notes to Condensed Financial Statements	6
Item 2	Management's Discussion and Analysis of Financial Condition and Results of Operations	16
Item 3	Controls and Procedures	32

PART II - OTHER INFORMATION

Item 1	Legal Proceedings	32
Item 2	Unregistered Sales of Equity Securities	32
Item 6	Exhibits	33
	Signatures	34
	Certifications	35

**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 13 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.*

NBO Systems, Inc.

**PART I. FINANCIAL INFORMATION**

**ITEM 1. CONDENSED FINANCIAL STATEMENTS**

CONDENSED BALANCE SHEETS  
(UNAUDITED)  
ASSETS

	September 30, 2006	December 31, 2005
<b>CURRENT ASSETS</b>		
Cash	\$ 55,992	\$ 2,038,617
Restricted cash	4,417,253	13,502,850
Accounts receivable, net of allowance for uncollectible accounts of \$6,000 at September 30, 2006, and December 31, 2005	268,086	516,579
Inventory	32,629	10,923
Prepaid expenses	65,549	76,999
Employee advances	425	3,635
Total current assets	<u>4,839,934</u>	<u>16,149,603</u>
<b>PROPERTY AND EQUIPMENT, NET</b>	302,408	373,997
<b>OTHER ASSETS</b>		
Deposits and reserves	28,386	290,312
Other assets	345,731	159,428
	<u>374,117</u>	<u>449,740</u>
	<u>\$ 5,516,459</u>	<u>\$ 16,973,340</u>

LIABILITIES AND STOCKHOLDERS' DEFICIT

<b>CURRENT LIABILITIES</b>		
Gift certificates/cards payable	4,820,544	13,646,020
Accounts payable	3,189,605	4,579,935
Accrued liabilities	1,984,459	1,558,080
Notes to stockholders	7,557,329	6,203,475
Notes to officer	602,000	485,918
Total current liabilities	<u>18,153,937</u>	<u>26,473,428</u>
 Total liabilities	 <u>18,153,937</u>	 <u>26,473,428</u>

COMMITMENTS AND CONTINGENCIES (NOTE I)

STOCKHOLDERS' DEFICIT

Capital stock		
Convertible redeemable preferred stock, par value \$1.00; authorized 1,000,000 shares; 86,724 and 78,838 shares issued and outstanding at September 30, 2006 and December 31, 2005; redemption value \$2.20 per share	86,724	78,838
Common stock, par value \$0.0005; authorized 50,000,000 shares; 18,207,415 and 18,192,026 shares issued and outstanding at September 30, 2006, and December 31, 2005, respectively	9,104	9,096
Deferred financing costs	(74,341)	(495,977)
Additional paid-in capital	32,279,890	31,056,705
Accumulated deficit	(44,938,855)	(40,148,750)
Total stockholders' deficit	<u>(12,637,478)</u>	<u>(9,500,088)</u>
	<u>\$ 5,516,459</u>	<u>\$ 16,973,340</u>

The accompanying notes are an integral part of the financial statements.

NBO SYSTEMS, INC.

CONDENSED STATEMENTS OF OPERATIONS  
(UNAUDITED)

	Three months ended September 30,		Nine months ended September 30,	
	2006	2005	2006	2005
Revenues	\$ 1,873,059	\$ 1,744,008	\$ 5,730,494	\$ 5,559,546
Other Income	34,060	52,139	100,015	495,268
Total revenues and other income	<u>1,907,119</u>	<u>1,796,147</u>	<u>5,830,509</u>	<u>6,054,814</u>
Operating expenses				
Cost of revenues and other income	1,390,207	1,239,073	4,607,239	4,634,102
Selling, general and administrative expenses	1,059,915	1,276,197	3,442,353	4,086,489
Total operating expenses	<u>2,450,122</u>	<u>2,515,270</u>	<u>8,049,592</u>	<u>8,720,591</u>
Operating loss	(543,003)	(719,123)	(2,219,083)	(2,665,777)
Non-operating income (expenses)				
Interest expense	(914,928)	(601,806)	(2,431,967)	(2,104,035)
Other income (expenses)	(26,622)	(40,050)	(18,409)	(56,507)
Loss before income taxes	(1,484,553)	(1,360,979)	(4,669,459)	(4,826,319)
Income tax benefit (provision)	625	(950)	(4,073)	(3,953)
NET LOSS	<u>(1,483,928)</u>	<u>(1,361,929)</u>	<u>(4,673,532)</u>	<u>(4,830,272)</u>
Dividends on preferred stock	(73,932)	(67,200)	(73,932)	(67,200)
Deemed dividends on warrants	(42,641)	-	(42,641)	-
NET LOSS ATTRIBUTABLE TO COMMON SHAREHOLDERS	<u>\$(1,600,501)</u>	<u>\$(1,429,129)</u>	<u>\$(4,790,105)</u>	<u>\$(4,897,472)</u>
Net loss per common share – basic and diluted	<u>\$ (0.09)</u>	<u>\$ (0.08)</u>	<u>\$ (0.26)</u>	<u>\$ (0.28)</u>
Weighted-average number of common shares outstanding – basic and diluted	<u>18,207,000</u>	<u>17,615,000</u>	<u>18,196,000</u>	<u>17,615,000</u>

The accompanying notes are an integral part of the financial statements.

The remainder of this page is intentionally left blank.

NBO SYSTEMS, INC.

CONDENSED STATEMENTS OF CASH FLOWS  
(UNAUDITED)

	Nine months ended September 30,	
	2006	2005
Increase (decrease) in cash and cash equivalents		
Cash flows from operating activities:		
Net loss	\$ (4,673,532)	\$ (4,830,272)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	99,008	175,439
Loss on disposal of other assets and property and equipment	42,015	60,465
Common stock options and warrants issued for services and compensation	337,276	-
Common stock warrants issued for payment of interest	84,342	242,564
Common stock issued for services	28,930	56,268
Amortization of debt discount and deferred financing costs	926,385	856,888
Bad debt expense	11,813	18,493
Changes in assets and liabilities:		
Accounts receivable	236,680	326,003
Employee advances	3,210	270
Inventory	(21,706)	289,471
Prepaid expenses and other assets	45,577	36,104
Accounts payable	(1,390,330)	(1,311,698)
Accrued liabilities	426,379	(78,160)
Total adjustments	829,579	672,107
Net cash used in operating activities	(3,843,953)	(4,158,165)
Cash flows used in investing activities:		
Purchase of property and equipment	(27,937)	(44,676)
Proceeds from sale of property, equipment, and other assets	-	7,816
Net cash used in investing activities	(27,937)	(36,860)
Cash flows provided by (used in) financing activities:		
Increase in checks written in excess of cash in the bank	-	107,620
Decrease in advances on restricted cash	260,121	1,075,707
Proceeds from sale of common stock	-	1,362,209
Proceeds from sale of warrants	163,062	-
Proceeds from notes to officer	132,000	190,000
Principal payments on notes to officer	(15,918)	(50,000)
Proceeds from notes to stockholders	1,635,000	1,925,000
Principal payments on notes to stockholders	(285,000)	(568,421)
Net cash provided by financing activities	1,889,265	4,042,115
Net decrease in cash	(1,982,625)	(152,910)
Cash at beginning of period	2,038,617	152,910
Cash at end of period	<u>\$ 55,992</u>	<u>\$ -</u>
<b>Supplemental disclosures of cash flow information</b>		
Cash paid during the period for interest	\$ 634,411	\$ 867,583
Cash paid during the period for income taxes	4,073	3,953
<b>Non-cash investing and financing activities</b>		
Transfers of fixed assets to other assets	\$ 4,079	\$ 1,397
Transfers of other assets to fixed assets	12,058	107
Preferred stock dividend	73,932	67,200
Proceeds from debt allocated to debt discount	17,000	456,161
Deferred financing costs from refinance of convertible debt	483,896	1,069,296
Deemed dividend on warrants	42,641	-

The accompanying notes are an integral part of the financial statements.

NBO SYSTEMS, INC.  
NOTES TO CONDENSED 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 U.S. generally accepted accounting principles (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, 2005, included in our Form 10-KSB. 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 September 30, 2006, its results of operations for the three and nine months ended September 30, 2006 and 2005, and its cash flows for the nine months ended September 30, 2006 and 2005. The results of operations for the period ended September 30, 2006, may not be indicative of the results that may be expected for the year ending December 31, 2006.

NOTE B – GOING CONCERN

The Company has incurred net losses since inception and negative cash flows from operating activities. During the nine months ended September 30, 2006, the Company had negative cash flows of \$3,843,953 from operating activities. At September 30, 2006, the Company had a deficit in working capital of \$13,314,003 and an accumulated deficit of \$44,938,855. These conditions raise substantial doubt about the Company's ability to continue as a going concern. 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.

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. The Company may sell assets to retire existing debt.

There can be no assurance that the Company will be successful in executing its plans to improve operations or obtain additional debt or 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 2006. 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 obligations associated with 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. The Company had no uninsured balances at September 30, 2006. Withdrawals of the funds are restricted to the payment to merchants in connection with the use of issued and outstanding gift certificates and gift cards and may not be transferred into operating accounts until such time that the unused 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 unused 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 cash equal to all or a portion of estimated breakage from restricted cash to unrestricted cash, meaning our general operating accounts, upon issuance of the gift certificate or gift card. Estimated breakage used is not recorded as income at that time. Any estimated breakage amount transferred to unrestricted cash decreases the restricted cash balance but remains in gift certificates payable, until such estimated breakage becomes actual breakage and is recognized as income. At such time, the amount of the obligation associated with gift certificates and gift cards payable is reduced by a corresponding amount.

NOTE D – INVENTORY

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

## NOTE E – EQUITY

During the nine month period ended September 30, 2006, the Company:

- Issued 189 shares of common stock in the amount of \$377 according to the terms of an employment agreement for one of the Company's former officers.
- Recognized, in accordance with SFAS No. 123(R), \$337,276 in employee compensation expense determined under the fair value based method for all awards, net of related tax effects. The fair value of the stock options issued was recognized as general and administrative expense.
- Issued, in connection with the issuance of convertible notes payable to stockholders, an aggregate of 50,000 warrants to purchase common stock with exercise prices between \$2.00 and \$3.00. The Company allocated \$17,000 of the proceeds from the convertible notes to stockholders to a debt discount based on the fair value of the warrants and the beneficial conversion feature on the convertible notes. The debt discount is being amortized over the life of the notes.
- Refinanced certain notes to stockholders. As part of the refinance, warrants to purchase 30,000 shares of common stock with an exercise price of \$2.00 per share were issued. In addition, 70,000 warrants already held by a note holder were repriced to an exercise price of \$2.50 per share. The fair value of the new warrants plus the incremental fair value of the repriced warrants totaled \$54,421. The combined fair value of the warrants and beneficial conversion features of \$71,421 were recorded as deferred financing costs and are being amortized over the term of the notes.
- Issued warrants to purchase 165,000 shares of common stock at exercise prices between \$2.00 and \$3.00 per common share in accordance with several notes to stockholders resulting in deferred financing costs totaling \$73,442 and interest expense of \$1,393.
- Amortized \$905,532 of deferred financing and beneficial conversion costs. The January 1, 2006 deferred financing and beneficial conversion costs beginning balance was \$495,977. The beginning balance combined with additional deferred financing and beneficial conversion costs during the period of \$483,896 and the amortization of the deferred financing and beneficial conversion costs during the period resulted in a deferred financing and beneficial conversion costs balance of \$74,341 at September 30, 2006.
- Issued 96,249 warrants to purchase common stock with exercise prices between \$2.00 and \$4.00 with a combined fair value of \$42,913 as payment of interest in connection with note agreements. The note agreements call for the quarterly issuance of a specified number of warrants. The fair value of the warrants issued is recorded as interest expense as the warrants are issued.
- Reinstated, to debt holders of the Company, warrants to purchase 232,374 shares of common stock that had previously expired unexercised. The warrants have an exercise price of \$2.00 per share. As part of the agreement, the debt holders paid \$.50 per share for the warrants, which will be applied to the exercise price of the warrants. Total proceeds received from the reinstatement of the warrants were \$163,062. For accounting purposes, the transaction was accounted for as a sale of warrants for cash.
- Reinstated, to certain debt holders and stockholders of the Company, warrants to purchase 155,718 shares of common stock that had previously expired unexercised. The warrants have exercise prices between \$2.00 and \$3.00 per share. No cash was paid in the reinstatement of these warrants. The warrants issued to current debt holders were recorded at fair value as interest expense of \$41,428. The warrants issued to current stockholders were recorded at fair value as a deemed dividend of \$42,641.
- Issued 7,886 preferred stock dividends in the amount of \$73,932.

Remainder of this page intentionally left blank.

NBO SYSTEMS, INC.

NOTE F - NOTES TO STOCKHOLDERS

	September 30, 2006	December 31, 2005
Unsecured notes to stockholders, with interest at 20%, in default, due on demand on the earlier of June 30, 1996 or upon the Company obtaining \$3,000,000 of debt or equity financing. Because the notes are in default, the notes provided for the stockholders to receive an additional 5,208 shares of common stock for each \$25,000 note payable at September 30, 1996.	\$ 147,329	\$ 147,329
Non interest-bearing unsecured note to a stockholder, in default, due on demand.	10,000	10,000
20% unsecured note to stockholder, due April 4, 2007. Interest payments of \$4,500 due every 90 days. Convertible at \$4.00 per share at option of Holder.	100,000	100,000
Unsecured note to stockholder, with interest at 10%, due December 29, 2006. At time of execution of note, 10,000 warrants at an exercise price of \$2.00 were issued. An amendment to the note resulted in an issuance of an additional 100,000 warrants being issued at an exercise price fo \$2.00 per common share. Interest payment of \$2,083 payable on due date of note.	250,000	-
25% unsecured note to stockholder, due May 31, 2006. Convertible at \$2.00 per share at option of Holder.	500,000	500,000
40% unsecured note to stockholder due October 2, 2006. At the time of execution of the note, the interest rate was 22% and 30,000 warrants were issued at an exercise price of \$2.50. The note entered the first default period on June 2, 2006, increasing the interest rate to 30% and an additional 30,000 warrants were issued at an exercise price of \$2.50. The note entered the second default period on August 2, 2006, increasing the interest rate to 40% and an additioanl 30,000 warrants were issued at an exercise price of \$2.50.	1,000,000	-
Unsecured note to stockholder, with interest at 27%, due January 1, 2007. Interest payments of \$5,500 and the issuance of 1,000 warrants at an exercise price of \$2.00 every 3 months.	100,000	-
Unsecured note to stockholder, with interest at 25%, due November 23, 2006. At time of execution of note, 7,500 warrants at an exercise price of \$3.00 were issued. Interest payment of \$6,667 payable on due date of note.	100,000	-
30% unsecured note to stockholder, due August 16, 2007. Interest payments of \$206,250 due every 90 days, and one interest payment of \$142,363 on September 10, 2005. Holder receives 7,083 warrants to purchase Common Stock at an exercise price of \$2.00 per share, every 90 days. Convertible at \$2.00 per share at option of Holder.	3,750,000	3,750,000
Unsecured note to stockholder, with interest at 22%, due January 3, 2007. At time of execution of note, 15,000 warrants at an exercise price of \$2.00 were issued. Interest payment of \$7,009 on January 3, 2007, and interest payments of \$44,000 and the issuance of 12,000 warrants at an exercise price of \$2.00 every 3 months.	800,000	-
Unsecured note to stockholder, with interest at 22%, due January 3, 2007. At time of execution of note, 15,000 warrants at an exercise price of \$2.00 were issued. Interest payment of \$7,009 on January 3, 2007, and interest payments of \$44,000 and the issuance of 12,000 warrants at an exercise price of \$2.00 every 3 months.	800,000	-
Unsecured notes to stockholder, with interest at 30%, due January 3, 2006. Holder received 33,333 warrants to purchase Common Stock at an exercise price of \$4.00 per share. Convertible at \$4.00 per share at option of Holder.	-	100,000

NBO SYSTEMS, INC.

NOTE F - NOTES TO STOCKHOLDERS – CONTINUED

	September 30, 2006	December 31, 2005
Unsecured notes to stockholder, with interest at 30%, due January 3, 2006. Holder received 66,666 warrants to purchase Common Stock at an exercise price of \$4.00 per share. Convertible at \$4.00 per share at option of Holder.	-	200,000
Unsecured notes to stockholder, with interest at 30%, due January 3, 2006. Holder received 66,666 warrants to purchase Common Stock at an exercise price of \$4.00 per share. Convertible at \$4.00 per share at option of Holder.	-	200,000
Unsecured note to stockholder, with interest at 22%, due January 24, 2006. Interest payments of \$27,500 and the issuance of 5,000 warrants at an exercise price of \$5.50 every 90 days.	-	500,000
Unsecured note to stockholder, with interest at 22%, due January 24, 2006. Interest payments of \$27,500 and the issuance of 5,000 warrants at an exercise price of \$5.50 every 90 days.	-	500,000
Unsecured note to stockholder, with interest at 20%, due May 15, 2006. Holder received 5,000 warrants to purchase Common Stock at an exercise price of \$3.00 per share. Convertible at \$2.00 per share at option of Holder.	-	100,000
Unsecured notes to stockholder, with interest at 20%, due May 15, 2006. Holder received 5,000 warrants to purchase Common Stock at an exercise price of \$3.00 per share. Convertible at \$2.00 per share at option of Holder.	-	100,000
Discount on notes payable	-	(3,854)
Total	<u>7,557,329</u>	<u>6,203,475</u>

NOTE G – STOCK BASED COMPENSATION

Prior to January 1, 2006, as permitted under Statement of Financial Accounting Standards (SFAS) No. 123, the Company accounted for its stock option plans following the recognition and measurement principles of Accounting Principles Board (APB) Opinion No. 25, “Accounting for Stock Issued to Employees,” and related interpretations. Accordingly, no stock-based compensation had been reflected in net loss for stock options granted to directors, officers and employees of the Company as all options granted had an exercise price equal to the market value of the underlying common stock on the date of grant and the related number of shares granted was fixed at that time.

In December 2004, the Financial Accounting Standards Board (FASB) issued SFAS No. 123 (R), “Share-Based Payment.” This statement revised SFAS No. 123 by eliminating the option to account for employee stock options under APB Opinion No. 25 and requiring companies to recognize the cost of employee services received in exchange for awards of equity instruments based on the grant-date fair value of those awards (the “fair-value-based” method).

Effective January 1, 2006, the Company adopted the fair value recognition provisions of SFAS No. 123(R) using the modified prospective method. Under this transition method, compensation cost recognized in the nine months ended September 30, 2006, includes amounts of compensation cost for stock-based awards granted prior to the effective date of SFAS 123(R) that vested during the period (based on grant-date fair value estimated in accordance with original provisions of SFAS No. 123, and previously presented in the pro-forma footnote disclosures). In accordance with the modified prospective method, results for the prior periods have not been restated.

The following table summarizes the effect during the three and nine months ended September 30, 2006 of adopting SFAS No. 123(R) as of January 1, 2006:

NBO SYSTEMS, INC.

NOTE G – STOCK BASED COMPENSATION - CONTINUED

	<u>Three Months Ended</u> <u>September 30, 2006</u>	<u>Nine Months Ended</u> <u>September 30, 2006</u>
Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects	\$ 52,551	\$ 337,276
Increase in net loss	<u>\$ 52,551</u>	<u>\$ 337,276</u>
Impact on net loss per common share -- basic and diluted	<u>\$ -</u>	<u>\$ 0.02</u>

Under the modified prospective method, results for prior periods have not been restated to reflect the effects of implementing SFAS No. 123(R). The following pro-forma information, as required by SFAS No. 148, “*Accounting for Stock-Based Compensation – Transaction and Disclosure, an amendment of FASB Statement No. 123*,” is presented for comparative purposes and illustrates the effect on net loss and net loss per common share for the three and nine months ended September 30, 2005 as if the Company had applied the fair value recognition provisions of SFAS No. 123 to stock-based compensation prior to January 1, 2006.

	<u>Three Months Ended</u> <u>September 30, 2005</u>	<u>Nine Months Ended</u> <u>September 30, 2005</u>
Net loss - as reported	\$ (1,429,129)	\$ (4,897,472)
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	\$ (153,486)	\$ (306,973)
Net loss - pro forma	<u>\$ (1,582,615)</u>	<u>\$ (5,204,445)</u>
Loss per share - as reported	<u>\$ (0.08)</u>	<u>\$ (0.28)</u>
Loss per share - pro forma	<u>\$ (0.09)</u>	<u>\$ (0.30)</u>

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:

	<u>September 30,</u>	
	<u>2006</u>	<u>2005</u>
Expected dividend yield	-	-
Expected price volatility	33.44%	35.74%
Risk-free interest rate	4.95%	4.15%
Expected life of options	10	10

The weighted average fair value of options granted during the nine months ended September 30, 2006 and 2005, is \$2.23 and \$3.84, respectively.

The pre-vesting forfeiture rate used for the three and nine months ended September 30, 2006 was based on historical rates and forward-looking factors. As required under SFAS 123(R), we will adjust the estimated forfeiture rates to our actual experience. Prior to adoption of SFAS 123(R) we accounted for forfeitures as they occurred.

A summary of the time-based stock options awards as of September 30, 2006, and changes during the nine months ended, is as follows:

NBO SYSTEMS, INC.

NOTE G – STOCK BASED COMPENSATION – CONTINUED

Stock Option Awards	Shares	Weighted- Average Exercise Price	Weighted- Average Remaining Contractual Term (years)
Outstanding at January 1, 2006	5,709,285	\$ 1.89	
Granted	110,000	2.23	
Exercised	-	-	
Forfeited or expired	514,250	4.11	
Outstanding at September 30, 2006	5,305,035	\$ 1.69	2.42
Exercisable at September 30, 2006	4,555,260	\$ 1.34	1.51

The weighted-average grant-date fair value of stock options granted during the three and nine months ended September 30, 2006 was \$1.06. Stock-based compensation expense related to stock options recognized under SFAS 123(R) for the three and nine months ended September 30, 2006 was \$52,551 and \$337,276, respectively. At September 30, 2006, there was approximately \$1.3 million of unrecognized stock-based compensation expense related to non-vested options, which will be recognized over a weighted-average period of 1.97 years.

NOTE H - LOSS PER COMMON SHARE

Basic earnings (loss) per share (EPS) is calculated using income (loss) attributable to common shareholders 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.

For the periods ended September 30, 2006, and 2005, respectively, the Company had 8,733,029 and 8,508,947 potentially dilutive shares of common stock from the exercise of stock options and warrants, 406,520 and 369,554 potentially dilutive shares of common stock from the conversion of preferred stock and 4,154,635 and 2,407,104 potentially dilutive shares of common stock from the conversion of debt, respectively, not included in the computation of diluted net loss per common share because it would have decreased the net loss per common share. The shares of common stock issuable upon exercise of stock options and warrants and upon conversion of debt and preferred stock to common stock could be dilutive in the future.

NOTE I - COMMITMENTS AND CONTINGENCIES

1. Litigation

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

On October 11, 2005, together with codefendants, the Company entered into a Memorandum of Understanding with the plaintiff's attorney for the settlement of this litigation. Under the terms of the settlement, the Company denied any wrongdoing or liability whatsoever, and, the Company made payments to some cardholders who paid administrative fees and submitted. The Company contributed amounts not claimed by cardholders to charity. The Court approved the settlement and certified a class for settlement purposes. On February 21, 2006, the Court issued a final order and judgment approving the settlement. The Company paid \$72,353 as its share of the settlement. The complaint has now been dismissed with prejudice.

- b. WildCard Systems, Inc., Claim for Indemnification

WildCard Systems, Inc. ("WildCard") is a credit card transaction processor. In connection with the lawsuit filed by Thomas Ripperda, WildCard asserted a claim to indemnification against the Company. The Company denied liability. WildCard and the Company agreed to settle the claim. The settlement was effective upon the final settlement of the litigation in Ripperda. The Company will make no additional payment in connection with the settlement of the claim.

NOTE I - COMMITMENTS AND CONTINGENCIES – CONTINUED

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.

The remainder of this page is intentionally left blank.

## 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 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 September 30, 2006, we have incurred cumulative losses of approximately \$44.9 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 promissory notes providing for interest at annual rates of between 17 and 40 percent. The aggregate amount of such loans was approximately \$7.56 million as of September 30, 2006. 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 in 2006 and 2007. 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/certificate programs at such properties. Our target market for gift card/certificate 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.

We maintain 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 clients or 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, a bill was recently 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 unused 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 or claim as abandoned property the funds associated with the obligation related to gift certificates and gift cards that remain unclaimed or unused 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 or delivery to the states.

However, approximately 14 states have enacted unclaimed property laws that both provide for the escheat or the delivery of funds underlying the obligation related to gift certificates 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 funds associated with the unused 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 might 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.

**We may undertake acquisitions to expand our business that may pose risks to our business and dilute the ownership of our existing stockholders.**

## NBO SYSTEMS, INC.

We may, in the future, evaluate opportunities to acquire other businesses, products or technologies that would complement our current offerings, or enhance our capabilities. We have no experience making acquisitions and we may not realize the anticipated benefits of any acquisitions we do undertake. Acquisitions that we may potentially make in the future may entail a number of risks that could materially and adversely affect our business prospects, liquidity, financial position, and results of operations, including:

- problems integrating the acquired operations, technologies or products with our existing business and products;
- costs associated with acquiring another business;
- diversion of management's time and attention from our core business;
- the need for financial resources above our planned investment levels;
- overestimation of potential synergies or a delay in realizing those synergies;
- difficulties in retaining business relationships with suppliers and customers of the acquired company;
- risks associated with entering markets in which we lack prior experience;
- the potential loss of key employees of the acquired company; and
- potential litigation arising from the acquired company's operations before the acquisition.

We could be required to use a substantial portion of our available cash to consummate any acquisition. Any future acquisitions also could cause us to incur debt or contingent liabilities or cause us to issue equity securities that would reduce the ownership percentages of existing stockholders. Furthermore, acquisitions could result in adverse tax consequences, substantial depreciation, deferred compensation charges, in-process research and development charges, impairment of goodwill or the amortization of amounts related to deferred compensation and to identifiable purchased intangible assets, any of which would negatively affect our operating results.

### **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.**

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 the Company's first fiscal year ending on or after July 15, 2007, which would require our compliance by December 31, 2007. 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 our results of operations for the three and nine month periods ended September 30, 2006, and compares this period with the same period of the previous year. In addition, the discussion describes the significant changes in our financial position at September 30, 2006, as compared to December 31, 2005, our fiscal year end. This discussion should be read in conjunction with our 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 our Form 10-KSB for the period ended December 31, 2005.

**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). 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.

## NBO SYSTEMS, INC.

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. The universal 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 used at any merchant that accepts Visa or MasterCard. Universal Discover cards are issued by NBO on behalf of Discover and, if not restricted, may be used at any participating merchant that accepts Discover. The Discover platform also allows us to restrict the retail establishments in which the universal card may be used. Our ability to offer customers multiple network alternatives relieves us of the costs of maintaining our own infrastructure to support transaction payment 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 used 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 has consistently shifted from gift certificate products to gift card products. 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. If an inclusion table is not used, the Discover card would be considered an open network card.

### *Fulfillment Services*

We provide Internet and call-center fulfillment services for dedicated closed network gift cards for our partners such as ValueLink. We regularly add new ValueLink clients to our dedicated closed network card order fulfillment program, with 37 ValueLink clients representing approximately 53 brand names.

### *Re-Sale of Third Party Gift Certificates and Gift Cards*

We pre-purchase gift certificates and gift cards at a discount from the full face value and resell the gift certificates and gift cards through various distribution channels. We incur the full inventory risk for our purchases. Our largest re-sale customer is Darden.

*Corporate Incentive and Membership Reward Cards*

Over the last two years, we developed a multi-merchant prepaid stored-value card program. During the development process, subsequent to marketing efforts, we entered into agreements with approximately 90 national and regional retail merchants having in excess of 50,000 brick and mortar retail consumer locations, in addition to the merchant's online retail operations. 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.

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 usage 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. Although we have not yet distributed any of these retail incentive cards, 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 tested and sold multi-merchant stored value cards in the fundraising channel as a supplement to traditional scrip products, useable at a variety of participating local and national merchants. We branded cards used in the K-12 schools under the "Children's Heroes" name, and label them as Community Scrip Cards (CSC). We have not fully implemented sales and marketing initiatives for the CSC, nor recognized any revenue in 2006, but plan to in 2007.

We have agreements with merchants that allow us to receive rebates or discounts when our cards are presented for use 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 used at a participating merchant, the merchant receives the full value of the card as is typical in any debit card transaction. We track card usage 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.

## Growth Strategy

Our objective is to become one of the leading providers 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. In March 2006, we filed a provisional patent with the US Patent and Trademark Office for two separate patents relating to the customization, personalization and delivery of gift cards. Specifically, the personalization and customization could include the placement of text, photos and graphics of a customers choosing through our regular delivery channels together with un-manned kiosks. These two patents, among others being contemplated, can be integrated into any of the growth strategies detailed below and may provide enhanced revenue opportunities. We place significant value on the opportunities these patents represent. 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 87 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.

- *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, convenience 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 by other vendors at such locations is well established, and an increasing number of open and closed network gift cards from other vendors 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. Where feasible, we will market our products directly with existing resources and add staff as necessary.

## 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, and we hope to grow our business substantially from a small base with these retailers. 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, and we hope to grow our business substantially in this channel from a small base with these 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](http://nbo.com), [thegiftcardcompany.com](http://thegiftcardcompany.com), [thegiftcertificatecompany.com](http://thegiftcertificatecompany.com), and [childrensheroes.com](http://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](http://www.giftcardbalance.com) and [www.myprepaidcard.info](http://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 entered into rebate agreements with approximately 90 national retail merchants having more than 50,000 retail consumer locations, who pay us a rebate on card redemptions in their stores in exchange for increasing customer traffic. Additionally, we created a virtual mall website that has more than 3,000 brand name merchandise products available for purchase and delivery at prices typically below brick-and-mortar retail prices. 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

### *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 transactions. 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.

## NBO SYSTEMS, INC.

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 obligations. These restricted bank accounts are maintained by the card-issuing bank or network designate and are separate from our operating accounts. The funds are remitted to merchants as consumers use the gift cards. We earn interest income on the deposited funds.

### *Redemption*

The flow of funds from use of the funds 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 transaction 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 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 usage of the cards.

### *Post-Use Activity*

The data processors relay usage information to us on a regular basis. We use the usage information to add value for our clients by supplying them with store-by-store usage 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 usage 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-usage step is the calculation of merchant rebates. We match card usage 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.

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 if one of the key relationships were to fail. 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.

Prior to January 1, 2006, as permitted under Statement of Financial Accounting Standards (SFAS) No. 123, the Company accounted for its stock option plans following the recognition and measurement principles of Accounting Principles Board (APB) Opinion No. 25, "Accounting for Stock Issued to Employees," and related interpretations. Accordingly, no stock-based compensation had been reflected in net loss for stock options granted to directors, officers and employees of the Company as all options granted had an exercise price equal to the market value of the underlying common stock on the date of grant and the related number of shares granted was fixed at that time.

In December 2004, the Financial Accounting Standards Board (FASB) issued SFAS No. 123 (R), "Share-Based Payment." This statement revised SFAS No. 123 by eliminating the option to account for employee stock options under APB Opinion No. 25 and requiring companies to recognize the cost of employee services received in exchange for awards of equity instruments based on the grant-date fair value of those awards (the "fair-value-based" method).

## NBO SYSTEMS, INC.

Effective January 1, 2006, the Company adopted the fair value recognition provisions of SFAS No. 123(R) using the modified prospective method. Under this transition method, compensation cost recognized in the nine months ended September 30, 2006, includes amounts of compensation cost for stock-based awards granted prior to the effective date of SFAS 123(R) that vested during the period (based on grant-date fair value estimated in accordance with original provisions of SFAS No. 123, and previously presented in the pro-forma footnote disclosures). In accordance with the modified prospective method, results for the prior periods have not been restated. Reference Footnote G.

### **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. 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 card transactions.
- Rebates paid by merchants who participate in our card programs.
- Interest on funds held in reserve for the payment of transactions with the prepaid, stored-value cards.
- Monthly administrative fees and renewal fees charged on inactive prepaid, stored-value cards.
- Remaining amount inquiry fees.
- Fees charged to sponsors of employee incentive and customer rewards programs.
- “Breakage” resulting from prepaid, stored-valued cards that expire or are never used.

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, remaining amount 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 transactions by the customer.
- Breakage resulting from unused or unusable 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 through our call center and internet fulfillment website. We record revenue equal to the sales price of the gift cards and gift certificates sold plus shipping and handling charges.

We also provide gift card fulfillment services to clients of ValueLink through our call center and internet fulfillment website. We record revenue equal to the fulfillment fee paid to us by ValueLink and the shipping and handling charges.

### **Revenue Recognition/Cost of Goods**

#### *Gift Card Fees*

We recognize several different types of fees related to our gift card programs. The timing of the revenue recognition varies depending on the type of fee being charged.

#### *Point of Sale Fees*

During 2005, in some cases, we began charging an up-front point of sale convenience fee on the sale of gift cards in retail establishments. This fee is charged to the customer at the time they purchase the gift card. We recognize revenue from the point of sale convenience fee ratably over the life of the gift card or gift certificate. If the gift card or gift certificate is fully used, any remaining balance of deferred point of sale convenience fee is recognized as revenue at that time.

#### *Interchange and Transaction Fees*

We record interchange transaction or processing fees earned in connection with card usage transactions as revenues when received. We begin to recognize material revenues on multi-merchant card sales within the first 90 days from issuance. 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.

## NBO SYSTEMS, INC.

### *Monthly Administrative Fees, Renewal Fees, and Expiration 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 usage from our restricted cash accounts to be held for future multi-merchant card usage. 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 usage and fees owed to us.

The average life of all multi-merchant cards is approximately 3 to 4 months. Consumers use 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 used by a particular date (which may vary from mall to mall), we charge a monthly administrative 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 remaining amount on the multi-merchant card is zero or until the card reaches the expiration date, subject to the requirements of local law which might place restrictions on fees. 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. We record revenue from monthly administrative fees in the month in which they are charged. Cardholders may check the remaining balance on their card or reload amounts on an existing card by calling us at the phone number listed on the back of the card or through our website. We charge a fee to the cardholder to check the remaining card balance or to reload funds on the existing card. Such inquiry fees and renewal fees are recognized at the time balance inquiry is made or an amount is reloaded on the existing card.

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. Upon expiration of the card, the issuing bank holding the funds for our multi-merchant cards remits to us the funds remaining as an expiration fee, 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 up front convenience fees, monthly administrative 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.

### *Rebates Paid by Merchants*

We have developed a multi-merchant prepaid stored value card program in which we have entered into agreements with 85 national and regional retail merchants where the prepaid cards can be used. Each of the participating merchants provides us with rebates, varying from 3% to 30%, whenever the multi-merchant card is presented for redemption at the merchant location. We record rebate income as revenue net of any revenue sharing agreements with third parties in the period received.

### *Incentive and Customer Reward Program Fees*

We contract with third-party providers of incentive, promotion and loyalty programs for a wide variety of entities, including financial institutions, subscription-based services, and membership clubs, to provide the prepaid stored-value cards and associated administration of the cards. Generally, we charge an up front fee per card issued in the incentive programs. Revenue from the up front fees is recognized ratably over the life of the card. If the prepaid stored-value card is fully used, any remaining balance of deferred up front fee is recognized as revenue at that time.

*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 payment. 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 unused or unusable 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 usage 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 statements 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 exited the traditional scrip business entirely in the period ended June 30, 2005.

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 59.0% of our revenues and other income. 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 selling through other business channels in 2006.

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 September 30,		Dollar Change	Percentage Change
	2006	2005		
Mall gift cards	\$ 3,131,000	\$ 3,346,000	\$ (215,000)	-6.4%
NBO fulfillment (excluding ValueLink and Scrip)	944,000	850,000	94,000	11.1%
ValueLink	655,000	350,000	305,000	87.1%
Mall gift certificates	350,000	675,000	(325,000)	-48.1%
B2B Loyalty/Incentive card	122,000	3,000	119,000	3966.7%
Fundraising card	-	2,000	(2,000)	-100.0%
	<u>\$ 5,202,000</u>	<u>\$ 5,226,000</u>	<u>\$ (24,000)</u>	<u>-0.5%</u>

	Nine Months Ended September 30,		Dollar Change	Percentage Change
	2006	2005		
Mall gift cards	\$ 11,226,000	\$ 10,281,000	\$ 945,000	9.2%
NBO fulfillment (excluding ValueLink and Scrip)	3,228,000	2,810,000	418,000	14.9%
ValueLink	1,796,000	1,015,000	781,000	76.9%
Mall gift certificates	1,035,000	2,363,000	(1,328,000)	-56.2%
B2B Loyalty/Incentive card	419,000	27,000	392,000	1451.9%
Scrip	-	484,000	(484,000)	-100.0%
Fundraising card	-	21,000	(21,000)	-100.0%
	<u>\$ 17,704,000</u>	<u>\$ 17,001,000</u>	<u>\$ 703,000</u>	<u>4.1%</u>

Overall transaction volume (decreased) increased (0.5%) and 4.1% in the three and nine-month periods ended September 30, 2006 respectively. We anticipate increases in our overall transaction volume in 2006 compared to 2005 primarily from our mall gift cards, fulfillment operations including ValueLink, B2B loyalty and incentive cards, and a new distribution channel being pilot tested in 4 malls for the 2006 holiday season. This test involves obtaining lease space as a tenant in 4 shopping malls and selling NBO open platform cards as well as re-selling national and local merchant closed-loop gift cards. Further fundraising card sales and marketing efforts have been postponed until 2007.

Starting in 2004, through 2005, and continuing into 2006, we experienced a major shift from mall gift certificate sales (-56.2% in the nine months ended September 30, 2006) to mall gift card sales (+9.2% in the nine months ended September 30, 2006). This was primarily a result of The Rouse Company and JP Realty being purchased by General Growth Properties. We replaced a significant portion of the lost Rouse and JP Realty gift certificate 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 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 experienced an 11.1% and 14.9% increase in the number of third party gift certificates and gift cards fulfilled in the three and nine month period ended September 30, 2006, respectively. The majority of this transaction volume resulted from year-over-year increases in GMRI (Darden) sales (Red Lobster, Olive Garden, Bahama Breeze and Seasons 52). Our contract with GMRI (Darden) was renewed in August 2006.

ValueLink transaction volume increased 87.1% and 76.9% in the three and nine-month periods ended September 30, 2006, respectively. We expect full year 2006 ValueLink transaction volume to substantially exceed 2005 volumes as ValueLink brings us new clients and brands.

NBO SYSTEMS, INC.

The Scrip transaction volume decrease is a result of our decision to exit the traditional scrip business in favor of selling our Fundraising Card marketed as the Community Scrip Card and the Children's Heroes Card. We transitioned all of our participating schools to other traditional scrip providers, sold our traditional scrip inventory and phased out traditional scrip operations as of June 30, 2005. Fundraising Cards were sold through one traditional scrip provider. In the future, we expect to sell Fundraising Cards through our own direct marketing efforts. We have not expended significant resources in 2006 but expect substantial increases in marketing and advertising, which we expect to result in increases in transaction volume of cards sold in 2007.

We began sales and marketing of our B2B Loyalty and Incentive Cards with three new clients representing four programs – two for Cisco Systems, Inc., and one each for US Homes as well as Discount Lifestyles. We partner with Jack Nadel International for marketing opportunities. 2006 B2B Loyalty and Incentive Cards transaction volume represents approximately 2.4% of total year to date transaction volume, however, we anticipate significant increases in sales and revenues from this channel going forward as new contracts with third parties are executed.

**Revenues and Other Income**

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

	Three Months Ended September 30,		Dollar Change	Percentage Change
	2006	2005		
Sale of third party gift certificates/cards	\$ 945,000	\$ 851,000	\$ 94,000	11.0%
Fees earned from customers	640,000	624,000	16,000	2.6%
Merchant fees earned from retailers	133,000	136,000	(3,000)	-2.2%
Miscellaneous Income	114,000	101,000	13,000	12.9%
Interest on restricted cash	41,000	31,000	10,000	32.3%
Gift certificate breakage	34,000	53,000	(19,000)	-35.8%
Total revenues and other income	<u>\$ 1,907,000</u>	<u>\$ 1,796,000</u>	<u>\$ 111,000</u>	<u>6.2%</u>

	Nine Months Ended September 30,		Dollar Change	Percentage Change
	2006	2005		
Sale of third party gift certificates/cards	\$ 3,215,000	\$ 3,282,000	\$ (67,000)	-2.0%
Fees earned from customers	1,491,000	1,371,000	120,000	8.8%
Merchant fees earned from retailers	496,000	437,000	59,000	13.5%
Miscellaneous Income	376,000	366,000	10,000	2.7%
Interest on restricted cash	153,000	104,000	49,000	47.1%
Gift certificate breakage	100,000	495,000	(395,000)	-79.8%
Total revenues and other income	<u>\$ 5,831,000</u>	<u>\$ 6,055,000</u>	<u>\$ (224,000)</u>	<u>-3.7%</u>

Our Company is subject to typical retail seasonality. We sell the majority of our gift certificates and gift cards between Thanksgiving and Christmas every year. We have specific holiday spikes such as Easter, Mother's Day and Father's day, but the first nine calendar months of the year typically represent only 30% of our transaction volume and revenues and other income. We anticipate approximately 70% of our full year revenues and other income will be represented by the three-month period ended December 31, 2006.

Overall revenues and other income increased (decreased) 6.2% and (3.7%) in the three and nine-month periods ended September 30, 2006 respectively. We anticipate increases in our overall revenues and other income in 2006 compared to 2005 primarily from our sale of third party gift certificates and gift cards, fees earned from customers and retailers, and a new distribution channel being pilot tested in 4 malls for the 2006 holiday season. This test involves obtaining lease space as a tenant in 4 shopping malls and selling NBO open platform cards as well as re-selling national and local merchant closed-loop gift cards. We have become less reliant on gift certificate breakage due to the shift to gift cards. Year over year reductions in gift certificate breakage will become less substantial in future quarters as evidenced by the comparisons for the three-month period ended September 30, 2006.

Revenue from the sale of third party gift certificates/cards increased 11.0% in the three month period ended September 30, 2006 due to strong demand during the summer months. However, revenue from the sale of third party gift certificates/cards decreased 2.0% in the nine month period ended September 30, 2006. The main reason for the overall reduction in the sale of third party gift certificates/cards is from our exiting the traditional scrip business as mentioned above. We view this decline as temporary and do not view the decline as being indicative of the full fiscal year results we anticipate for December 31, 2006.

NBO SYSTEMS, INC.

As noted in the transaction volume table above, we achieved a 9.2% increase in the transaction volume represented by the sale of mall gift cards in the nine month period ended September 30, 2006. We earn the majority of our revenue on gift cards from the monthly maintenance fees and expiration fees from unused gift cards sold in prior periods. 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 the gift cards. In contrast, in our past contracts we generally allowed the malls to retain these point-of-sale fees. We expect the trend of increased fees to continue as we complete new mall contracts going forward and as we sell more gift cards than gift certificates. Fees earned from customers increased 2.6% and 8.8% in the three and nine-month period ended September 30, 2006.

Other income is comprised solely of gift certificate breakage. Other income earned from gift certificate breakage was negative in the three and nine-month periods ended September 30, 2006 due to the shift from the sale of gift certificates to gift cards as previously mentioned. We sold less gift certificates in the last several years, correspondingly reducing the amount of breakage we expect to receive. We anticipate gift certificate breakage to continue to decline as we convert more gift certificate programs to gift card programs. Excluding other income, year over year revenues increased approximately 7.7% and 3.1% in the three and nine-month periods ended September 30, 2006, respectively.

As interest rates rise, we benefit from higher interest rates on our deposit accounts.

**Cost of Revenues and Other Income**

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

	Three Months Ended September 30,		Dollar Change	Percentage Change
	2006	2005		
Third party gift certificates/cards	\$ 887,000	\$ 823,000	\$ 64,000	7.8%
Merchant fees and charges	320,000	262,000	58,000	22.1%
Other	183,000	154,000	29,000	18.8%
Total cost of revenues and other income	<u>\$ 1,390,000</u>	<u>\$ 1,239,000</u>	<u>\$ 151,000</u>	<u>12.2%</u>

Page 26 of 37

	Nine Months Ended September 30,		Dollar Change	Percentage Change
	2006	2005		
Third party gift certificates/cards	\$ 2,996,000	\$ 3,076,000	\$ (80,000)	-2.6%
Merchant fees and charges	1,129,000	865,000	264,000	30.5%
Other	482,000	693,000	(211,000)	-30.4%
Total cost of revenues and other income	<u>\$ 4,607,000</u>	<u>\$ 4,634,000</u>	<u>\$ (27,000)</u>	<u>-0.6%</u>

In the three months ended September 30, 2006, cost of revenues and other income increased 12.2% compared to a 6.2% increase in revenues and other income for the same period. In the nine months ended September 30, 2006, cost of revenues and other income decreased 0.6% compared to a 3.7% decrease in revenues and other income for the same period. We feel the comparisons are skewed on a temporary basis due to the reduction in other income as discussed above. We anticipate full year growth in revenue to exceed the growth in full year cost of revenue.

Cost of revenues associated with third party gift certificates and cards represent the costs associated with providing outside gift certificates and gift cards 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 at face value. As noted above, we experienced increases in transaction volume, and consequently experienced an increase in the cost of revenues associated with third party cards and certificates sold. Merchant fees and charges increased as a result of more consumers purchasing mall gift certificates and gift cards with credit and debit cards versus cash or checks. The mall developer reimburses NBO for the majority of these costs.

Other Costs is comprised primarily of commissions to mall owner/operators as an incentive to utilize our card programs, 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 and the embossing and encoding of the gift 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 30.4% in the nine-month period ended September 30, 2006.

NBO SYSTEMS, INC.

**Gross Profit**

Gross Profit for the related periods is as follows:

	Three Months Ended September 30,		Dollar Change	Percentage Change
	2006	2005		
Revenues and other income	\$ 1,907,000	\$ 1,796,000	\$ 111,000	6.2%
Cost of Revenues and other income	(1,390,000)	(1,239,000)	(151,000)	12.2%
Gross Profit	\$ 517,000	\$ 557,000	\$ (40,000)	-7.2%
Gross Margin %	27.1%	31.0%		

	Nine Months Ended September 30,		Dollar Change	Percentage Change
	2006	2005		
Revenues and other income	\$ 5,831,000	\$ 6,055,000	\$ (224,000)	-3.7%
Cost of Revenues and other income	(4,607,000)	(4,634,000)	27,000	-0.6%
Gross Profit	\$ 1,224,000	\$ 1,421,000	\$ (197,000)	-13.9%
Gross Margin %	21.0%	23.5%		

In the three and nine months ended September 30, 2006, revenues and other income increased (decreased) 6.2% and (3.7%) respectively, as detailed above. During the same period, cost of revenues and other income increased (decreased) 12.2% and (0.6%) respectively as detailed above. Collectively, gross profit decreased 7.2% and 13.9% respectively, and our gross margins decreased 12.6% and 10.6% respectively. We believe these decreases are temporary and are not indicative of the full fiscal year results anticipated for December 31, 2006. We anticipate gross margins will be maintained at approximately 20% to 30% throughout 2006. Our shift in revenues away from traditional scrip, which carried a lower gross margin, combined with our transition from the sale of gift certificates to gift cards are expected to be reflected in an increase in gross profit for the full fiscal year.

***Selling, General and Administrative Expenses***

	Three Months Ended September 30,		Dollar Change	Percentage Change
	2006	2005		
Personnel	\$ 685,000	\$ 757,000	\$ (72,000)	-9.5%
Rent and office expense	176,000	165,000	11,000	6.7%
Professional fees	99,000	234,000	(135,000)	-57.7%
Other selling, general and administrative expenses	68,000	67,000	1,000	1.5%
Depreciation and amortization	32,000	53,000	(21,000)	-39.6%
	\$ 1,060,000	\$ 1,276,000	\$ (216,000)	-16.9%

	Nine Months Ended September 30,		Dollar Change	Percentage Change
	2006	2005		
Personnel	\$ 2,277,000	\$ 2,317,000	\$ (40,000)	-1.7%
Rent and office expense	490,000	494,000	(4,000)	-0.8%
Professional fees	395,000	917,000	(522,000)	-56.9%
Other selling, general and administrative expenses	181,000	183,000	(2,000)	-1.1%
Depreciation and amortization	99,000	175,000	(76,000)	-43.4%
	\$ 3,442,000	\$ 4,086,000	\$ (644,000)	-15.8%

Selling, general and administrative expenses decreased 16.9% and 15.8% during the three and nine-month period ended September 30, 2006 respectively, due primarily to a decrease in legal fees incurred in 2005 related to defending the litigation referenced in Note I to the financial statements.

Professional fees may increase in connection with our refinement of our internal controls and the required, associated documentation. 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.

NBO SYSTEMS, INC.

*Interest Expense*

	<u>Three Months Ended September 30,</u> 2006	<u>2005</u>	<u>Dollar</u> <u>Change</u>	<u>Percentage</u> <u>Change</u>
Interest expense	\$ 915,000	\$ 602,000	\$ 313,000	52.0%
	<u>Nine Months Ended September 30,</u> 2006	<u>2005</u>	<u>Dollar</u> <u>Change</u>	<u>Percentage</u> <u>Change</u>
Interest expense	\$ 2,432,000	\$ 2,104,000	\$ 328,000	15.6%

As of September 30, 2006 we had notes to stockholders totaling \$7,557,329 compared to \$6,203,475 as of September 30, 2005. Our interest expense increased 52.0% and 15.6% respectively in the three and nine-month period ended September 30, 2006 due primarily to raising capital through debt to stockholders at unfavorable rates to us. Until such time that we achieve positive cash flow from operations, we will continue to raise working capital from debt and equity offerings. We may sell certain assets to pay down some or all of the debt. All of the working capital needed in excess of operating funds has been provided by loans from existing shareholders or additional equity investments that are discussed below. We sometimes elect to enter into debt agreements with interest rates that are not favorable to us, or loans with dilutive warrants to purchase common stock attached. Notes to stockholders as of September 30, 2006 bear interest at rates between 17 and 40 percent. In addition, the debt agreements have generally provided for the issuance of warrants to purchase our common stock and provisions to convert the debt to our common stock. In some cases, the conversion price has been less than the fair market value of our common stock, resulting in a non-cash beneficial conversion interest expense feature. In addition, the warrants issued in connection with debt financings and re-financings have been recorded as debt discounts or deferred financing costs. The debt discounts and deferred financing costs are recognized as interest expense over the life of the note. A significant portion of the interest expense recorded resulted from the issuance of warrants as payment of interest, the amortization of debt discounts and deferred financing costs, and the beneficial conversion features. The following table details the interest paid during the year.

	<u>Three Months Ended September 30,</u> 2006	<u>2005</u>	<u>Dollar</u> <u>Change</u>	<u>Percentage</u> <u>Change</u>
Interest paid in cash plus change in accrued interest	\$ 580,000	\$ 378,000	\$ 202,000	53.4%
Interest expense recorded due to beneficial conversion features and amortization of debt discounts and deferred finance costs	335,000	224,000	\$ 111,000	49.6%
Total interest expense	<u>\$ 915,000</u>	<u>\$ 602,000</u>	<u>\$ 313,000</u>	52.0%

	<u>Nine Months Ended September 30,</u> 2006	<u>2005</u>	<u>Dollar</u> <u>Change</u>	<u>Percentage</u> <u>Change</u>
Interest paid in cash plus change in accrued interest	\$ 1,421,000	\$ 995,000	\$ 426,000	42.8%
Interest expense recorded due to beneficial conversion features and amortization of debt discounts and deferred finance costs	1,011,000	1,109,000	\$ (98,000)	-8.8%
Total interest expense	<u>\$ 2,432,000</u>	<u>\$ 2,104,000</u>	<u>\$ 328,000</u>	15.6%

NBO SYSTEMS, INC.

**Net Income (Loss) Attributable to Common Shareholders**

Net Income (Loss) attributable to common shareholders for the related periods is as follows:

	Three Months Ended September 30,		Dollar	Percentage
	2006	2005	Change	Change
NET LOSS ATTRIBUTABLE TO COMMON STOCKHOLDERS	\$ (1,601,000)	\$ (1,429,000)	\$ (172,000)	-12.0%

	Nine Months Ended September 30,		Dollar	Percentage
	2006	2005	Change	Change
NET LOSS ATTRIBUTABLE TO COMMON STOCKHOLDERS	\$ (4,790,000)	\$ (4,897,000)	\$ 107,000	2.2%

Our transaction volume increased slightly for the nine months ended September 30, 2006 from the same period in 2005. Our revenues and other income increased/(decreased) 6.2% and (3.7%) respectively. Cost of revenues and other income increased/(decreased) 12.2% and (0.6%) respectively, gross profit decreased 7.2% and 13.9% respectively, and our gross margin percentages decreased to 27.1% and 21.0% respectively. Additionally, we controlled our selling, general and administrative expenses, realizing decreases of 16.9% and 15.8% respectively year-over-year. We currently have a high cost of capital for operating purposes as evidenced by the interest expense above. In order to obtain operating profitability, we must reduce general and administrative expenses and increase the transaction volume of gift cards sold, thereby increasing revenues. We must take steps to minimize or eliminate interest expense by retiring or restructuring our debt. We may sell assets to eliminate some or all of the notes to stockholders. We were able to reduce our operating losses for the three and nine months ended September 30, 2006 by approximately (\$176,000) and (\$447,000) respectively from approximately (\$719,000) and (\$2,666,000) respectively in 2005, even though we had a modest increase in our transaction volume as stated above. Non-operating expenses increased in the three and nine month period ended September 30, 2006 compared to the same period in 2005 primarily due to the interest expense as discussed above. Net loss attributable to common stockholders (increased) decreased (12.0%) and 2.2% respectively for the three and nine-month period ended September 30, 2006. The increase in net loss attributable to common shareholders is significantly attributed to the high interest expense on our debt. Earnings before interest, taxes, depreciation and amortization ("EBITDA") is discussed below.

**EBITDA (Earnings before interest, taxes, depreciation and amortization)**

	Three Months Ended September 30,		Dollar	Percentage
	2006	2005	Change	Change
Net loss	\$ (1,601,000)	\$ (1,429,000)	\$ (172,000)	-12.0%
Deduct interest expense	915,000	602,000	313,000	52.0%
Deduct income taxes (refund)	(1,000)	1,000	(2,000)	-200.0%
Deduct depreciation and amortization	32,000	53,000	(21,000)	-39.6%
EBITDA	<u>\$ (655,000)</u>	<u>\$ (773,000)</u>	<u>\$ 118,000</u>	<u>15.3%</u>

	Nine Months Ended September 30,		Dollar	Percentage
	2006	2005	Change	Change
Net loss	\$ (4,790,000)	\$ (4,897,000)	\$ 107,000	2.2%
Deduct interest expense	2,432,000	2,104,000	328,000	15.6%
Deduct income taxes (refund)	4,000	4,000	-	0.0%
Deduct depreciation and amortization	99,000	175,000	(76,000)	-43.4%
EBITDA	<u>\$ (2,255,000)</u>	<u>\$ (2,614,000)</u>	<u>\$ 359,000</u>	<u>13.7%</u>

EBITDA is a common metric used to normalize financial results to make comparisons of companies easier and is sometimes referred to as an operating margin. It is a measure of controllable costs by a company and is considered by some, a more stable measure of a company's operations than net income, mainly because it removes non-cash expenses from the financial results. EBITDA is commonly used by investment bankers to evaluate the financial strength of a company and to establish a valuation for the company based on comparable companies in similar industries. However, EBITDA is a non-GAAP measurement and should not be used as a replacement for GAAP measurements such as net loss or cash flows from operating activities. Our EBITDA results improved 15.3% in the three months ended September 30, 2006 compared to the same period in 2005 primarily. Our EBITDA results improved 13.7% in the nine months ended September 30, 2006, compared to the same period in 2005, an indicator of operational improvement.

**Liquidity and Capital Resources**

Our total costs and expenses are currently greater than revenues and other income. In addition, our operating activities have used cash rather than provided cash. We have had a history of losses and our accumulated deficit (since inception June 23, 1994) through September 30, 2006 was approximately \$44.9 million. During the nine months ended September 30, 2006, we utilized approximately \$3.8 million in cash from operating activities. At September 30, 2006 we had a deficit in working capital of approximately \$13.3 million. Our ability to meet our obligations as they come due is dependent upon obtaining additional financing, as may be required and ultimately attaining sustained profitability. Our net losses decreased by 2.2% or approximately \$107,000 to \$4.790 million from \$4.897 million for the nine months ended September 30, 2006, when compared to the nine months ended September 30, 2005.

In January 2006, we restructured several promissory notes to stockholders totaling approximately \$1.7 million by reducing the annual interest rate on the notes and extending the maturities. We issued 30,000 warrants to purchase common stock of the Company at an exercise price of \$2.00 in conjunction with the restructuring of these notes.

In March 2006, we entered into a promissory note with an existing stockholder for \$1 million to be used for general operating purposes. In conjunction with this promissory note, we issued 30,000 warrants to purchase common stock of the Company at an exercise price of \$2.50. The note was amended in June 2006 to extend the maturity date to August 2006. An additional 30,000 warrants to purchase common stock of the Company at an exercise price of \$2.50 were issued as a result of this amendment.

In March 2006, we entered into a promissory note with an existing stockholder for \$100,000 to be used for general operating purposes. In connection with this promissory note, we issued 7,500 warrants to purchase common stock of the Company at an exercise price of \$3.00.

In March 2006, we entered into a promissory note with an existing stockholder for \$250,000 to be used for general operating purposes. In connection with this promissory note, we issued 10,000 warrants to purchase common stock of the Company at an exercise price of \$2.00. The note was amended in April 2006 to extend the maturity date to August 2006. An additional 100,000 warrants to purchase common stock of the Company at an exercise price of \$2.00 were issued as a result of this amendment.

In May 2006, we entered into a promissory note with an existing stockholder for \$125,000 to be used for general operating purposes. The note was retired in May 2006.

In July 2006, we entered into a demand note with our chief executive officer for \$90,000 to be used for general operating purposes.

We continue to attempt to raise capital through private equity or debt offerings, as well as institutional investors until our operations provide sufficient cash to meet our needs. We are taking steps to improve profitability and increasing sales efforts. We can give no assurance that we will be successful in executing our plans to improve operations or obtain additional debt and equity financing. We may sell assets to reduce or eliminate some or all of the notes to stockholders. If we are unable to improve operations or obtain additional debt and equity financing, we may be required to restructure operations during 2006. However, we can give no assurance that we will be able to continue operating without additional financing. Our ability to meet our debts as they come due is dependent on our obtaining additional financing as required, and ultimately on our ability to achieve our business plan and attain profitability. We currently operate without a line of credit and occasionally enter into short and long-term promissory notes with accredited investors, typically existing stockholders. These promissory notes often have conversion privileges into our common stock, easing debt service requirements. However, conversion privileges and warrants issued in conjunction with the notes dilute existing stockholders and increase our operating losses.

### ITEM 3. CONTROLS AND PROCEDURES

- a. Evaluation of disclosure controls and procedures.

The Company's management evaluated, with the participation of the Chief Executive Officer and Chief Financial Officer, the effectiveness of our disclosure controls and procedures, as defined in Exchange Act Rules 13a-15(e) and 15d-15(e) as of September 30, 2006, (the "Evaluation Date"). Based on that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that as of the Evaluation Date, the Company's disclosure controls and procedures were effective.

- b. Changes in internal controls.

During the fiscal quarter covered by this report, there was 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 I 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 nine month period ended September 30, 2006, the Company:

- Reinstated, to debt holders of the Company, warrants to purchase 232,374 shares of common stock that had previously expired unexercised. The warrants have an exercise price of \$2.00 per share. As part of the agreement, the debt holders paid \$.50 per share for the warrants, which will be applied to the exercise price of the warrants. Total proceeds received from the reinstatement of the warrants were \$163,062. For accounting purposes, the transaction was accounted for as a sale of warrants for cash.
- Reinstated, to certain debt holders and stockholders of the Company, warrants to purchase 155,718 shares of common stock that had previously expired unexercised. The warrants have exercise prices between \$2.00 and \$3.00 per share. No cash was paid in the reinstatement of these warrants. The warrants issued to current debt holders were recorded at fair value as interest expense of \$41,428. The warrants issued to current stockholders were recorded at fair value as a deemed dividend of \$42,641.

All of the investors are accredited investors. We 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. All investors are also existing shareholders. All shareholders are financially sophisticated. We have had a long relationship with the investors in our securities. We did not engage in any public solicitation or advertising. All of the securities are restricted by legends and stop-transfer instructions.

NBO SYSTEMS, INC.

Item 6. Exhibits

<u>Exhibit Number</u>	<u>Description</u>
3.1	Articles of Incorporation for a Stock Corporation in the State of Maryland (Filed as Exhibit 2(a) to the Registrant's Form 10-SBA filed on April 26, 2002, and incorporated herein by reference.)
3.2	Certificate of Ownership and Merger (Filed as Exhibit 2(b) to the Registrant's Form 10-SBA filed on April 26, 2002, and incorporated herein by reference.)
3.3	Bylaws of NBO Systems, Inc. (Filed as Exhibit 2(c) to the Registrant's Form 10-SBA filed on April 26, 2002, and incorporated herein by reference.)
3.4	Articles of Amendment of Articles of Incorporation (Filed as Exhibit 3.4 to the Registrant's Form 10KSB filed on May 2, 2005 and incorporated herein by reference.)
4.1	See Exhibits 3.1, 3.2, 3.3 and 3.4 for provisions of the Articles of Incorporation, as amended, and Bylaws for NBO Systems, Inc. defining the rights of holders of common stock of NBO Systems, Inc.
4.2	Amended 1997 Stock Option Plan (Filed as Exhibit 4.2 to the Registrant's Form 10KSB filed on May 2, 2005 and incorporated herein by reference.)
4.3	Warrant Agreement. The form of warrant agreement is substantially the same for all outstanding warrants consisting of Class A Warrants; Class B Incentive Warrants; Other Warrants (Filed as Exhibit 6(c) to the Registrant's Form 10-SB filed on August 2, 2005 and incorporated herein by reference.)
10.1	Master Agreement dated October 10, 2002, with Metavante Corporation (Filed as Exhibit 10.3 to the Registrant's Form 10KSB filed on May 2, 2005 and incorporated herein by reference.)
10.2	Stored Value Card Service Agreement Dated As Of April 1, 2003, With First Data Resources Inc. (Filed as Exhibit 10.6 to the Registrant's Form 10KSB filed on May 2, 2005 and incorporated herein by reference.)
10.3	Card Sponsorship Agreement between Registrant and BankFirst dated April 9, 2003 (Filed as Exhibit 10.7 to the Registrant's Form 10KSB filed on May 2, 2005 and incorporated herein by reference.)
10.4	ODFI Originator Agreement dated as of March 19, 2004, with BANKFIRST (Filed as Exhibit 10.11 to the Registrant's Form 10KSB filed on May 2, 2005 and incorporated herein by reference.)
10.5	Marketer Agreement dated September 2, 2004, with First Federal Savings Bank of the Midwest dba Meta Payment Systems (Filed as Exhibit 10.14 to the Registrant's Form 10KSB filed on May 2, 2005 and incorporated herein by reference.)
10.6	Originating Depository Financial Institution Originator Agreement dated September 13, 2004, with First Federal Savings Bank of the Midwest dba Meta Payment Systems (Filed as Exhibit 10.15 to the Registrant's Form 10KSB filed on May 2, 2005 and incorporated herein by reference.)
10.7	First Amendment to Contract Services Agreement with Glimcher Properties Limited Partnership dated September 9, 2004 (Filed as Exhibit 10.16 to the Registrant's Form 10KSB filed on May 2, 2005 and incorporated herein by reference.)
10.8	Merchant Processing Agreement dated October 14, 2004, with NOVA Information Systems, Inc., and U.S. Bank, N.A. (Filed as Exhibit 10.17 to the Registrant's Form 10KSB filed on May 2, 2005 and incorporated herein by reference.)
10.9	Amendment to the Development and Consulting Services Agreement with First Data Corporation dated March 24, 2005 (Filed as Exhibit 10.22 to the Registrant's Form 10KSB filed on March 31, 2006 and incorporated herein by reference.)
10.10	Amendment to Master Services Agreement with IPS Card Solutions, Inc., effective April 22, 2005 (Filed as Exhibit 10.23 to the Registrant's Form 10KSB filed on March 31, 2006 and incorporated herein by reference.)
10.11	Amendment 3 to Internet Gift Card Agreement dated July 22, 2005 (Filed as Exhibit 10.24 to the Registrant's Form 10KSB filed on March 31, 2006 and incorporated herein by reference.)
10.12	Lease Amendment #2 with 5B Bangerter, L.L.C. dated September 22, 2005 (Filed as Exhibit 10.25 to the Registrant's Form 10KSB filed on March 31, 2006 and incorporated herein by reference.)
10.13	Employer Services Agreement with A Plus Benefits dated October 13, 2005 (Filed as Exhibit 10.26 to the Registrant's Form 10KSB filed on March 31, 2006 and incorporated herein by reference.)
10.14	Second Amendment to Cash Card Issuer Agreement with Discover Financial Services LLC dated January 23, 2006 (Filed as Exhibit 10.28 to the Registrant's Form 10KSB filed on March 31, 2006 and incorporated herein by reference.)
10.15	First Amendment to Marketer Agreement with MetaPayment Systems dated May 31, 2006 (Filed as Exhibit 10.15 to the Registrant's Form 10-QSB filed on July 15, 2006 and incorporated herein by reference.)
10.16	Consent to Assignment to MetaPayment Systems of the Cash Card Issuer Agreement with Discover Financial Services LLD dated June 1, 2006 (Filed as Exhibit 10.16 to the Registrant's Form 10-QSB filed on July 15, 2006 and incorporated herein by reference.)
10.17	Contract Services Agreement with Glimcher Properties dated July 24, 2006 (Filed as Exhibit 10.17 to the Registrant's Form 10-QSB filed on July 15, 2006 and incorporated herein by reference.)
31.1	Section 302 Certification of Keith A. Guevara, Chairman, President and CEO
31.2	Section 302 Certification of Christopher Foley, Board Member and 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

November 14, 2006

/s/ Christopher Foley  
Director, Chief Financial Officer

November 14, 2006

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

November 14, 2006

Exhibit 31.1

I, Keith A. Guevara, certify that:

1. I have reviewed this Form 10-QSB report for the quarter ended September 30, 2006 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, particularly during the period in which this report is being prepared;
  - b) [Paragraph omitted pursuant to SEC Release Nos. 33-8545 and 34-51293 and Nos. 33-8618 and 34-52492]
  - c) 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
  - d) 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: November 14, 2006

/s/ Keith A. Guevara

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 for the quarter ended September 30, 2006 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, particularly during the period in which this report is being prepared;
  - b) [Paragraph omitted pursuant to SEC Release Nos. 33-8545 and 34-51293 and Nos. 33-8618 and 34-52492]
  - c) 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
  - d) 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: November 14, 2006

/s/ Christopher Foley

Director, Chief Financial Officer  
(Principal Financial and Accounting 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) our Report of Form 10-QSB for the quarterly period ended September 30, 2006, 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: November 14, 2006

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

Dated: November 14, 2006

/s/ Christopher Foley  
Chief Financial Officer  
(Principal Financial and Accounting Officer)  
Of NBO Systems, Inc.