

## MANAGEMENT'S DISCUSSION AND ANALYSIS

*The following Management's Discussion and Analysis ("MD&A") provides discussion and analysis of the years ended December 31, 2006 and 2005, and should be read in conjunction with the audited consolidated financial statements as at and for the year ended December 31, 2006.*

*The annual consolidated financial statements have been prepared in accordance with Canadian generally accepted accounting principles ("GAAP"). The Company reports on certain non-GAAP measures that are used by management to evaluate performance of the business. Because non-GAAP measures do not have a standardized meaning, securities regulators require that non-GAAP measures be clearly defined and qualified, reconciled to their nearest GAAP measure and be given no more prominence than the closest GAAP measure. For the reader's reference, the definition, calculation and reconciliation of non-GAAP measures is provided in section 13: Reconciliation of Non-GAAP Measures.*

*Additional information is available on the Company's website ([www.zedi.ca](http://www.zedi.ca)) and all previous public filings, including the annual information form (AIF), are available through SEDAR ([www.sedar.com](http://www.sedar.com)).*

### **Forward-Looking Statements**

Certain statements contained in this MD&A constitute forward-looking statements. These statements relate to future events or the Company's future performance. All statements other than statements of historical fact may be forward-looking statements. These statements involve known and unknown risks, uncertainties and other factors that may cause actual results or events to differ materially from those anticipated in such forward-looking statements. The Company believes that the expectations reflected in those forward-looking statements are reasonable but no assurance can be given that these expectations will prove to be correct and such forward-looking statements included in this MD&A should not be unduly relied upon.

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## **1 Business Overview**

zed.i solutions inc. (the “Company” or “Zedi”) specializes in production operations management, delivering systems and services that help oil and gas producers to better manage people, assets and information. We help our customers increase earnings and decrease operating costs, through improved utilization of human, physical and fiscal assets. In addition, our solutions and services help our customers mitigate compliance risk.

Established in 1987, Zedi™ has over 240 upstream, midstream and oilfield services customers who are primarily located in Western Canada. Zedi has over 5,600 installed systems and in excess of 115,000 assets managed with our solutions that are delivered through five lines of business:

- a. *Zedi Fixed Asset Management™* – the business of maximizing the utilization and effectiveness of fixed assets used during production operations, plus meeting compliance standards, all delivered through Roughneck™.
- b. *Zedi Health, Safety & Environment™* – the business of tracking, reporting, managing, and communicating HS&E programs to ensure a safe work environment and regulatory compliance, delivered through our Roughneck application.
- c. *Zedi Surveillance™* – the business of monitoring, collecting, and digitizing high quality data at the source, delivered with Smart-Alek®, Zedi SCADA™, Smart-Skid™ and MTRAC®.
- d. *Zedi Production Optimization™* – the business of analyzing the data collected and taking action to impact operations in order to improve hydrocarbon production, and is delivered to our customers through tools available on [www.smart-alek.com](http://www.smart-alek.com), and with our Zedi SCADA and embedded MTRAC offerings.
- e. *Zedi Production Volume Measurement™* – the business of web-based, on demand, production and revenue accounting, delivered through our PetroNet™ application.

## **2 Corporate Vision and Strategy**

The vision of Zedi is to be a global leader in the management of decentralized production operations and we will accomplish that through five strategic imperatives. They are:

- a. *People* – Zedi will partner with its employees to promote their personal development, growth and success and together they achieve and share the benefits of corporate success.
- b. *Customers* – With a primary view toward improving customer earnings, Zedi will structure all of its customer interactions to deliver a personal experience that positively addresses customer needs, enabling them to achieve greater success.
- c. *Data* – Zedi will deliver and further develop products and services that add to the quality and quantity of well and field operation data and increase its value by transforming it to information.
- d. *Open Interface* – Zedi will leverage the high data value through developing the FINE® system, Zedi’s intelligent network, to be vendor neutral, seeking to be an industry standard and enabling broad surveillance inputs and application extractions through an open interface.
- e. *Execution* – Zedi will balance near term returns with long term wealth by focusing on market sectors that it can dominate and by making pragmatic decisions that maximize shareholder return.

### **3 Key Performance Indicators**

Zedi monitors a number of key performance indicators including those set out below (*see selected quarterly information table for past eight quarters in section 5*). In addition, Zedi tracks a number of customer specific indicators:

- a. *RECURRING REVENUE AS A PERCENTAGE OF OPERATIONS AND SG&A*  
Growth of this indicator ensures that our decisions and actions are supporting a strategy of building a significant foundation of recurring revenue in relation to the size of the operations. This also serves to measure our success in structuring our operations on a scalable basis.
- b. *RECURRING REVENUE AS A PERCENTAGE OF TOTAL CASH EXPENDITURES*  
This indicator combines the investment in R&D and capital assets with the operating expenses to monitor the scalability of the business model with operating and investing activities combined.
- c. *TOTAL REVENUE*  
This measure is an overall indication of our success and progress toward achieving a dominant position in the marketplace.
- d. *PERCENT GROSS MARGIN*  
This serves to measure our success in developing and delivering our products and services efficiently and on a scalable basis.
- e. *INCOME PER SHARE*  
As a primary measure of return to shareholders, this measure also ensures the acquisitions we make are accretive to shareholders.

### **4 Overall Performance**

#### **4.1 Materiality for Disclosure**

Management determines whether or not information is “material” based on whether it believes a reasonable investor’s decision to buy, sell or hold securities in the Company would be significantly influenced or changed if the information were omitted or misstated.

#### **4.2 Events or Activities Impacting the Business in 2006**

Zedi achieved several milestones during 2006 while weathering the impact of some challenging market conditions and volatile commodity pricing that faced the oil & gas industry, our primary customer base.

2006 events and activities included:

- Appointing Matthew Heffernan as President and CEO with Keith Smith moving into the role of Chairman on November 1, 2006. Having been a member of the Board of Directors of Zedi for 5 years, Matthew’s strong understanding of the business combined with his background in sales and operations will help drive the Company to the next level of performance through growth.
- U.S. Patent Number 6,985,831 titled “Systems for Acquiring Data from a Facility and Method” which protects the proprietary function of the Company’s Smart-Alek system and FINE System operating network was obtained and announced on January 17, 2006. The FINE System operating network is a key foundational element in the delivery of solutions from Zedi.
- The adoption of the Roughneck Enterprise Asset Management solution incorporating the Asset Management, Preventative Maintenance and Compliance modules, by Penn West

Energy Trust represented a significant milestone as the Company's first entrance in the Tier 1 market with our Roughneck solution.

- Zedi announced the acquisition of PetroNet Systems Inc. on April 11, 2006 with a maximum purchase price of \$2.5 million. The PetroNet Production Accounting Application strengthened the Company's offering in the production operations management arena by addressing a core business need for its customer base.
- The adoption of PetroNet in the marketplace outperformed expectations during the year and the Company successfully penetrated the Tier 2 market, illustrated by the announcement of Compton Petroleum augmenting its production accounting practices with the corporate adoption of the Zedi PetroNet Production Accounting Application.
- As natural gas prices declined and producers shifted their drilling and exploration focus to oil wells, sales of the Company's Smart-Alek solution for new drills declined. This decline was partially offset by the Zedi SCADA solution, introduced early in 2006, which is applicable for use on both oil and gas wells.
- The discontinuance of CDPD communication service in January 2007 by Nortel and TELUS drove the need for a field conversion program on over 2300 Smart-Aleks. This conversion, which was over 96% complete by December 31, 2006, negatively impacted margins as Zedi shared the conversion costs with our customers.
- The announcement by the federal government regarding a change in the status of Income Trust taxation laws created uncertainty in our customer base during Q4 as they evaluated their business model and resulted in delayed purchase decisions.

#### **4.3 Impact of Stock-Based Compensation on Reported Results**

Throughout this MD&A the Company will at times describe or discuss results with Stock-based compensation not included. The following information will provide readers of our financial statements with an opportunity to fully understand the impact of stock-based compensation on results and to provide context for the Company's discussion of results with stock-based compensation excluded.

The Company currently has three forms of stock-based compensation: stock options, deferred share units, and restricted share units.

##### Stock Options

The shareholders of the Company approve the stock option plan each year at the AGM. The current plan authorizes the Board of Directors of the Company to grant options numbering up to 10% of the number of issued and outstanding shares, which structure has remained unchanged since the Company's initial public offering. As an important part of the Company's compensation strategy options are granted annually to all employees to recruit and retain the best talent. All options are granted at market price on the date of grant, vest in thirds on the first three anniversaries from the date of grant and expire in thirds on the second third and fourth anniversaries. This results in a rolling plan with options expiring each year and new ones being granted at market prices at that time.

The following table shows the status of stock options outstanding:

	<u>December 31, 2006</u>		<u>December 31, 2005</u>	
	<u>Options</u>	<u>Weighted Average Exercise Price</u>	<u>Options</u>	<u>Weighted Average Exercise Price</u>
Outstanding, beginning of year	<b>9,143,357</b>	<b>\$ 1.41</b>	4,669,239	\$ 0.36
Granted	<b>4,306,496</b>	<b>1.02</b>	6,341,835	1.76
Exercised	<b>(1,804,147)</b>	<b>0.44</b>	(1,762,051)	0.35
Expired/cancelled	<b>(1,422,943)</b>	<b>1.92</b>	(105,666)	2.09
Outstanding, end of period	<b>10,222,763</b>	<b>\$ 1.33</b>	9,143,357	\$ 1.41
Options exercisable, end of year	<b>2,471,986</b>		2,639,148	

Exercise Prices	<u>Options Outstanding</u>			<u>Options Exercisable</u>		
	<u>Number Outstanding</u>	<u>Weighted Average Remaining Contractual Life</u>	<u>Weighted Average Exercise Price</u>	<u>Number Exercisable</u>	<u>Weighted Average Exercise Price</u>	
\$0.00-\$0.20	3,334	1.4 yrs	\$0.20	3,334	\$0.20	
\$0.21-\$0.49	504,702	1.1 yrs	\$0.42	342,523	\$0.42	
\$0.50-\$1.00	3,457,415	3.9 yrs	\$0.91	3,333	\$0.62	
\$1.01-\$2.00	4,982,083	2.8 yrs	\$1.47	1,492,868	\$1.47	
\$2.01-\$2.88	1,275,229	2.0 yrs	\$2.32	629,928	\$2.32	
<b>\$0.20 - \$2.88</b>	<b>10,222,763</b>	<b>3.0 yrs</b>	<b>\$1.33</b>	<b>2,471,986</b>	<b>\$1.54</b>	

#### Deferred Share Units

A deferred share unit is compensation paid in the form of a right to a share that is not received until the occurrence of a future event. The Company currently offers to directors an option to receive compensation for directors' fees either in cash or deferred share units. Directors' fees are currently \$18,000 per year. In addition, deferred share units were granted to Mr. Heffernan as part of a signing incentive at the time he was hired as the new President and CEO of the Company, which will be received over the following four years or, at the discretion of the board, could be delivered earlier based on performance.

The total outstanding DSUs as at December 31, 2006 is 7,601, all of which relate to Mr. Heffernan.

#### Restricted Share Units

A restricted share unit is compensation paid in the form of a right to a share that is not received until a later date. Restricted share units were granted to Mr. Heffernan as part of a signing incentive at the time he was hired as the new President and CEO of the Company, which will be received over the following four years or, at the discretion of the board, could be delivered earlier based on performance.

## Stock-based Compensation Expense

The total of the stock-based compensation expense for 2006 was \$3,115,000, which is broken down in the table below.

The Company expensed \$754,000 relating to the deferred share units and restricted share units granted to Mr. Heffernan in the third quarter of 2006.

The portion of the expense related to stock options is calculated using the Black-Scholes option pricing model at the time the options are granted. The model incorporates an historical volatility analysis to determine valuation. Historical volatility may or may not be a reliable indication of future volatility. Although the expense is calculated at the time options are granted, it is reported over the vesting period for the options. The Company's standard vesting period is three years in which case the expense will be reported proportionately in each of the next 12 quarters from the date of grant.

The following table shows the breakdown of the stock-based compensation expense reported in 2006.

<b>Annual Option Grant Date</b>	<b>Number of options outstanding as at Dec. 31, 2006</b>	<b>Exercise Price</b>	<b>Expensed in 2006</b>	<b>Remaining to be expensed in future periods.</b>
January 29, 2004	404,702	\$0.42	\$ 41,256	\$ 2,630
January 6, 2005	1,169,562	\$2.30	773,655	226,150
November 1, 2005 <sup>1</sup>	3,825,001	\$1.46	1,091,283	1,706,282
December 13, 2006	3,450,748	\$0.91	23,457	1,404,808
Various dates <sup>2</sup>	1,372,750	\$1.46 <sup>3</sup>	424,152	545,130
Option Totals	10,222,763		\$2,353,803	\$ 3,885,000
<b>DSU Grant Date</b>	<b>Number of DSUs as at Dec. 31, 2006</b>	<b>Price</b>	<b>Expensed in 2006</b>	<b>Remaining to be expensed in future periods.</b>
June 30, 2006	2,143	\$0.95	\$ 2,036	-
September 29, 2006	3,879	\$0.95	3,685	-
December 31, 2006	1,579	\$0.95	1,500	-
September 25, 2006	250,000	\$1.16	290,000	-
DSU Totals	257,601	\$0.95	\$297,221	-
<b>RSU Grant Date</b>	<b>Number of RSUs as at Dec. 31, 2006</b>	<b>Price</b>	<b>Expensed in 2006</b>	<b>Remaining to be expensed in future periods.</b>
September 25, 2006	400,000	\$1.16	\$464,000	-
RSU Totals	400,000	\$1.16	\$464,000	-
All stock-based comp. totals			\$3,115,024	
<sup>1</sup> The timing of the annual grant was shifted from the beginning of the year to the fall board meeting to align with annual compensation program reviews. <sup>2</sup> There are some options granted in between the annual grants related to new hires during the year or staff added through acquisitions. <sup>3</sup> This is the weighted average exercise price.				

## Discussion of Performance Results Excluding the Stock-based Compensation Expense

The amount expensed in the third quarter for the grant of DSUs and RSUs to Mr. Heffernan represents an unusual one time expense that is not specifically related to the Company's performance in the third quarter or in 2006. Therefore, the Company will at times discuss the performance of the Company with this expense excluded (a reconciliation to the nearest GAAP measure is provided in section 13).

Significant historical share price volatility has impacted the valuation of stock options for the purpose of recording of a stock-based compensation expense. A number of options that have already been expensed have in fact expired without being exercised and a large number of options that were expensed in 2006 remain significantly out of the money. The expensed options do not impact cash flow or the operations of the Company. From the table above the reader can assess the specific options that the expense relates to, with approximately 95% of the expense being for options that are significantly out of the money and some of which having already expired. Therefore, the Company will at times discuss the performance of the Company with this expense excluded (a reconciliation to the nearest GAAP measure is provided in section 13).

Stock-based compensation does have a cost to the Company and shareholders, primarily in their dilutive effect to share value and therefore the Company believes that "earnings per share fully diluted" is a reliable method of measuring value with the impact of stock-based compensation taken into account. Where the Company discusses a result with stock-based compensation not included it also discusses the result including stock-based compensation so that the reader can accurately assess the performance of the Company.

### 4.4 Consolidated Highlights

(\$ in thousands except per-share amounts)	Three Months ended December 31				Annual			
	2006	2005	Change	% Change	2006	2005	Change	% Change
Revenue	10,760	9,348	1,412	15%	37,137	26,416	10,721	41%
Gross Profit	5,326	4,514	812	18%	17,096	12,705	4,391	35%
EBITDA <sup>(1)</sup>	3,809	2,009	1,800	90%	6,502	4,313	2,189	51%
Net Income before income taxes	3,132	1,411	1,721	122%	4,238	2,597	1,641	63%
Net income	1,759	1,813	(54)	(3%)	4,019	4,977	(958)	(19%)
Net income per share, basic	0.02	0.02	0.0	0%	0.04	0.05	(0.01)	(20%)
Net Income per share, diluted	0.02	0.02	0.0	0%	0.04	0.05	(0.01)	(20%)
Cash from operations	(220)	(149)	(71)	(48%)	6,234	4,629	1,605	35%
Free cash flow <sup>(2)</sup>	3,631	2,267	1,364	60%	6,649	3,813	2,836	74%

<sup>(1)</sup> Earnings before interest, taxes, depreciation and amortization is a non-GAAP measure. See Section 13.1 Earnings before interest, taxes, depreciation and amortization (EBITDA)

<sup>(2)</sup> Free cash flow is a non-GAAP measure. See Section 13.2 Free cash flow.

The following table reviews some results excluding stock-based compensation (please see section 4.3 above for a full explanation of the stock-based compensation expense).

(\$ in thousands except per-share amounts)	Three Months ended December 31				Annual			
	2006	2005	Change	% Change	2006	2005	Change	% Change
Net Income before income taxes <sup>(1)</sup>	3,827	1,911	1,916	100%	7,353	4,246	3,107	73%
Net Income per share before taxes, basic <sup>(1)</sup>	0.04	0.02	0.02	100%	0.07	0.04	0.03	75%
Net Income per share before taxes, diluted <sup>(1)</sup>	0.04	0.02	0.02	100%	0.07	0.04	0.03	75%
<sup>(1)</sup> This is a non-GAAP measure. See Section 13 for reconciliation to the nearest GAAP measure.								

The Company continues to maintain positive growth trends. For specific comments on trends and financial performance please see sections 5.3 and 6 below.

## **5 Selected Annual and Quarterly Information**

### **5.1 Summary Table**

The following table sets forth selected three-year consolidated financial information and should be read in conjunction with the audited consolidated financial statements for the year ended December 31, 2006:

(expressed in \$000's except per share amounts)	2006	2005	2004
Total Revenues	<b>37,137</b>	26,416	18,284
Income Before Taxes	<b>4,238</b>	2,597	1,107
Income Before Taxes per share - basic	<b>0.04</b>	0.03	0.01
Income Before Taxes per share - diluted	<b>0.04</b>	0.03	0.01
Income After Taxes	<b>4,019</b>	4,977	1,107
Income After Taxes per share - basic	<b>0.04</b>	0.05	0.01
Income After Taxes per share - diluted	<b>0.04</b>	0.05	0.01
Total Assets	<b>47,394</b>	38,493	23,887
Total Long-term Liabilities	<b>59</b>	61	1,383

## 5.2 Quarterly Results Summary

The following table sets forth certain financial information on a consolidated basis for the last eight financial quarters:

(expressed in \$000's except per share and % amounts)	2006				2005			
	Fourth Quarter	Third Quarter	Second Quarter	First Quarter	Fourth Quarter	Third Quarter	Second Quarter	First Quarter
Total Revenues	<b>10,760</b>	<b>6,793</b>	<b>8,276</b>	<b>11,308</b>	9,348	5,986	5,888	5,194
Recurring Revenue <sup>(1)</sup>	<b>2,220</b>	<b>1,764</b>	<b>1,651</b>	<b>1,425</b>	1,303	1,176	1,045	910
Recurring Revenue <sup>(1)</sup> as a % of Operation Expenses <sup>(2)</sup>	<b>90%</b>	<b>93%</b>	<b>73%</b>	<b>57%</b>	65%	70%	60%	70%
Recurring Revenue <sup>(1)</sup> as a % of Total Cash Expenditures <sup>(3)</sup>	<b>65%</b>	<b>68%</b>	<b>54%</b>	<b>44%</b>	56%	58%	41%	45%
Percent Gross Margin	<b>49%</b>	<b>44%</b>	<b>43%</b>	<b>46%</b>	48%	52%	49%	42%
Income (Loss)	<b>1,759</b>	<b>(850)</b>	<b>402</b>	<b>2,708</b>	1,813	2,517	349	298
Income (Loss) (per share) - basic and diluted	<b>0.02</b>	<b>(0.01)</b>	<b>0.00</b>	<b>0.03</b>	0.02	0.03	0.00	0.00
Income before taxes excluding the stock-based compensation expense <sup>(4)</sup>	<b>3,827</b>	<b>504</b>	<b>675</b>	<b>2,347</b>	1,911	921	755	659
Income per share before taxes excluding stock- based compensation expense - basic and diluted <sup>(4)</sup>	<b>0.04</b>	<b>0.01</b>	<b>0.01</b>	<b>0.02</b>	0.02	0.01	0.01	0.01
Note: <sup>(1)</sup> Recurring Revenue includes all fees that are billed to customers on a recurring basis. <sup>(2)</sup> Operational Expenses includes all expenses except for Stock-based compensation. In addition, the \$1,656,000 reduction in R&D expense as described in section 6.5 is not included in Operational Expenses. <sup>(3)</sup> Total Cash Expenditures includes all Operational Expenses plus the amount of R&D deferred in the period and all amounts for the acquisition of capital assets. In addition, the \$1,656,000 reduction in R&D expense as described in section 6.5 is not included in Operational Expenses. <sup>(4)</sup> This is a non-GAAP measure. See Section 13 for reconciliation to the nearest GAAP measure.								

## 5.3 Comments on Corporate Performance Trends

The three-year performance trends affirm our positioning as a high growth company. In 2003 the company was still investing a considerable amount on development and the commercial launch of the Smart-Alek-Intelligent Flow Monitoring System and revenues were just beginning to build. In 2004 we began to build a base of earnings as we expanded our position in the market. In 2005 the results begin to show the scalability of our business model as the base of installations became much more significant. In 2006 the Company gained additional market share and grew revenue from a greater diversity of products, resulting from the recent acquisitions. In 2006 Smart-Alek hardware revenue represents approximately 47% of total revenue compared to 64% in 2004.

Revenue continues to demonstrate strong year over year growth, with 41% in 2006. The Company expects to continue to produce strong year over year growth and maintain the trends established over the past eight quarters. The first quarter was our strongest quarter in 2006, with another record performance. The Company continued strong year over year growth through the second quarter but

experienced the impact of lower natural gas prices in the third quarter. Some of this carried over into the start of the fourth quarter as well.

Recurring revenue as a percentage of operational expenses continues to grow year over year. The Company expects there to be some fluctuation in this number quarter to quarter but tracks the year over year trend to be sure the Company is continuing to take advantage of the scalability of our business model. The amount of recurring revenue for the fourth quarter was \$2,220,000 and was \$7,060,000 for the year, compared to \$1,303,000 for Q4 2005 and \$4,434,000 for 2005. For 2006 the percent of recurring revenue to operating expenses is 77%, growing from 66% in 2005, 51% in 2004 and 27% in 2003. Management expects growth of recurring revenue to continue.

The Company has added a second key performance indicator related to recurring revenue. By combining the investment in R&D and capital assets with the operating expenses the Company is able to monitor the ability of recurring revenue to meet the total cash requirements. The trend tracks relatively close to the prior measure, looking solely at operation expenses. For 2006 the percent of recurring revenue to total cash expenditures is 57%, growing from 49% in 2005, 46% in 2004 and 25% in 2003. Management expects this type of growth trend for the recurring revenue to continue as we have achieved in the past. This trend is very positive, validating the strength of the business model and demonstrating significant financial stability for the future.

Percent gross margin rebounded in the fourth quarter as most of the impact from the 1xRtt transition program was completed. In addition, the Company released a new model of the Smart-Alek in the fourth quarter, which has reduced costs and higher margins than the older model. Fluctuations between quarters reflect the different revenue mix, which have different gross margins.

The net income in 2006 and the fourth quarter is significantly reduced by a stock-based compensation expense of \$3,115,000 for the year and \$695,000 for the fourth quarter, which is a non-cash expense item. The earnings growth is impacted by the stock-based compensation amounts (please see section 4.3 above for a full explanation of the stock-based compensation expense).

## **6 Results of Operations – Annual 2006**

### **6.1 Revenue**

The Company is reporting continued year over year revenue growth in the fourth quarter and for the year.

The Company generated revenues of \$10,760,000 for the three months ended December 31, 2006 compared to \$9,348,000 for the three months ended December 31, 2005 and annual revenues of \$37,137,000 for the year ended December 31, 2006 compared to \$26,416,000 for the year ended December 31, 2005. This represents an increase of 15% for the fourth quarter and 41% growth for the year. While it is mostly attributed to increased sales of the Company's Smart-Alek-Intelligent Flow Monitoring System, the Company's revenue growth is becoming more and more diversified with the increasing recurring revenue and the addition of MTRAC, Roughneck and PetroNet products. The Company's 2006 revenue includes \$1,161,000 related to sales of raw materials to manufacturers, with the resulting impact of increasing revenues but reducing overall percent gross margin.

## **6.2 Cost of Sales**

The cost of sales for the three months ended December 31, 2006 was \$5,434,000 resulting in a 49% margin compared to a 48% margin on cost of sales of \$4,834,000 for the same period in 2005. The increase in margins is attributable to the addition of the higher margin Roughneck-Operations Management System business, the PetroNet production accounting business and growth of the recurring revenue stream for network service fees, which has higher margins. In addition, the Company began to deliver a new model of the Smart-Alek in the fourth quarter, which has reduced costs resulting in higher margins.

The cost of sales for the year ended December 31, 2006 was \$20,041,000 resulting in a 46% margin compared to a 48% margin on cost of sales of \$13,711,000 for 2005. The reduced margins for the year are primarily due to the transition to 1xRtt technology discussed in the second and third quarter MD&As.

## **6.3 Operating Expenses**

Operating expenses include compensation and benefits of the information technology, customer support, purchasing, shipping, quality assurance and operations departments, facility cost for Edmonton, Alberta and all related expenditures for these departments, excluding those costs charged to cost of sales.

Operating expenses for the quarter ended December 31, 2006 were \$524,000, which is higher than the same period for 2005 by \$141,000 or 37%. The operating expenses for the year ended December 31, 2006 were \$1,707,000, which is higher than 2005 by \$202,000 or 13%. The increase is primarily attributed to the addition of the PetroNet operations, which was added in April of 2006, as well as some growth in operations overall. Operating expense, as a percentage of revenue was 4.9% for the fourth quarter ended December 31, 2006, as compared to 4.1% for the same quarter in 2005. Operating expense, as a percentage of revenue was 4.6% for the year ended December 31, 2006, as compared to 5.7% for 2005.

## **6.4 Sales, General and Administrative Expenses**

Sales, general and administrative (SG&A) expenses include compensation and benefits of sales, marketing, executives, financial, legal, human resources and administrative staff, lease obligations, advertising, trade shows, travel, marketing materials and general supplies.

The SG&A expense was \$1,694,000 for the fourth quarter ended December 31, 2006. This expense was \$218,000 more during the quarter ended December 31, 2006, compared to the same quarter last year. SG&A expense as a percentage of revenue was 15.7% for the quarter ended December 31, 2006 as compared to 15.8% for the same quarter in 2005. The SG&A expense for the year ended December 31, 2006 was \$6,406,000, which was \$1,843,000 more than 2005. As a percentage of revenue SG&A was 17% for the year ended December 31, 2006 as compared to 17% for 2005. The increase in the SG&A expense for the year is due to staff and expenses from the acquisition of PetroNet and from new hires and higher sales commissions paid on higher sales numbers. This increase in costs is consistent with managements' expectations following the acquisition of PetroNet. SG&A expenses are expected to decrease over time as a percentage of revenue with anticipated sales growth from the acquisition.

## **6.5 Research & Development**

The Company is engaged in research and development work. Research costs are expensed as incurred. Development costs are expensed in the period incurred, unless they meet the criteria for deferral established by GAAP. Further, in accordance with GAAP, development costs are deferred only to the extent that their recovery can reasonably be regarded as assured. Management reviews the applicable criteria on a regular basis and if the criteria are no longer met, any remaining unamortized balance is written off as a charge to income. Research and development costs are reduced by any scientific research tax credits.

The Company takes a conservative approach in the application of the deferred development policy and in the three years prior to 2005 it expensed all development costs. This was considered appropriate because the Company was developing a new product that it had not sold before and the Company had significant losses and relatively low working capital. With the significant market acceptance and growth in earnings experienced in 2004 as well as the current strong working capital position, the Company effective January 1, 2005 began to defer a portion of development costs, to be amortized over a three-year period. The three-year period was consistent with the historical lifecycle of prior product versions and more appropriately matches the product revenue stream with its development costs.

Research and Development (R&D) expenses include compensation and benefits of all the development teams working on the continuing development of our products as well as the testing activities. These expenses also include the cost to retain independent contractors and consultants, software licensing expenses, and all related administrative expenses and supplies.

In the fourth quarter the Company recognized the benefit of \$2,031,000 related to SRED Investment tax credits for qualifying expenditures of previous years. Of this amount, \$268,000 was recorded as a reduction of deferred development costs, \$107,000 was recorded as a reduction of capital assets and \$1,656,000 was recorded as the reduction of research and development expense.

The total R&D cost was \$743,000 in the fourth quarter 2006 up from \$416,000 in the fourth quarter of the prior year. The Company capitalized \$483,000 of development costs in the fourth quarter and expensed \$260,000 of the costs. For the year ended December 31, 2006, the total R&D cost was \$2,920,000 an increase from \$2,016,000 in the prior year. The Company capitalized \$1,898,000 of development costs in the year and expensed \$1,022,000 of the costs. As a result of the recording of the \$1,656,000 reduction in research and development expense referred to above, there was a recovery of \$634,000 on the year. The total R&D cost as a percentage of revenue was 7.8% for the year ended December 31, 2006 as compared to 7.6% for 2005. The overall increase in R&D activity primarily reflects the additional development activity related to the integration of new technology from the acquisitions of Menex, Roughneck and PetroNet and the development of a new Smart-Alek model. In addition there was ongoing development of a number of new products to continue to fill out a full operations management solution suite.

## **6.6 Stock-based Compensation**

Effective January 1, 2004, Canadian accounting standards require recognition of compensation costs arising out of stock-based compensation plans under the fair-value based method. Under the fair-value based method, compensation cost is measured at fair value at the date of the grant and expensed over the stock option's vesting period.

The Company's non-cash stock-based compensation expense was \$695,000 for the quarter ended December 31, 2006 and \$3,115,000 for 2006, compared with \$500,000 for the quarter ended December 31, 2005 and \$1,649,000 for 2005 (please refer to section 4.3 for a full discussion of the breakdown of the stock-based compensation expense).

## **6.7 Net Income**

The overall net income for the fourth quarter, 2006 was \$1,759,000 or \$0.02 per share compared to \$1,813,000 or \$0.02 per share for the same period in 2005 for an overall decrease of \$54,000 or 3%. A future income tax recovery amount of \$1,373,000 was recognized in the quarter. For the year ended December 31, 2006 the overall net income was \$4,019,000 or \$0.04 per share compared to \$4,977,000 or \$0.05 per share for 2005 for an overall decrease of \$958,000 or 19%. A future income tax provision amount of \$219,000 was recognized in the year.

Net Income before taxes (excluding the impact of recognition of the future tax asset) better represents the performance of the Company. Net Income before taxes in the fourth quarter of 2006 was \$3,132,000 and for the year it was \$4,238,000. With stock-based compensation factored out net income before taxes was \$3,827,000 in the fourth quarter and \$7,353,000 for the year. This represents 100% growth in the fourth quarter over the fourth quarter in 2005 and 73% growth on the year.

The increased market penetration of the Company's Smart-Alek-Intelligent Flow Monitoring System, growth of the recurring revenue and growth in sales of the new Roughneck and PetroNet applications, were the primary reasons for the positive fourth quarter 2006 result.

## **6.8 Amortization of Capital and Intangible Assets**

In the fourth quarter the amortization of capital and intangible assets was \$768,000, of which \$257,000 related to intangible assets acquired in the purchase of Menex, Roughneck and PetroNet, which are non-recurring capital expenditures. Amortization of deferred development costs accounted for \$275,000 and patents accounted for \$2,000. The balance of \$234,000 is for the amortization of other capital assets that are required for the day-to-day operations of the Company.

For the year ended December 31, 2006 the amortization of capital and intangible assets was \$2,500,000, of which \$974,000 related to intangible assets acquired in the purchase of Menex, Roughneck and PetroNet, which are non-recurring capital expenditures. Amortization of deferred development costs accounted for \$821,000 and patents accounted for \$7,000. The balance of \$698,000 is for the amortization of other capital assets that are required for the day-to-day operations of the Company.

## **6.9 Roughneck Earnout**

The purchase price for the Roughneck-Operations Management System included an earnout provision calculated on revenues achieved from September 2004 through to December 31, 2005. The Company completed calculations of the earnout, with the total payable to Roughneck shareholders in the amount of \$2,751,302. The earnout was paid on January 26, 2006 as 20% cash (\$550,260) and 80% in Zedi common shares (1,467,361 based on a deemed share price of \$1.50 based on the average closing market price for the 20 trading days prior to the execution of the letter of intent, discounted by 10%).

### **6.91 PetroNet Acquisition**

During the second quarter of 2006 the Company completed the acquisition of all issued and outstanding shares of PetroNet Systems Inc. ("PetroNet"). PetroNet's core asset is an on-demand production accounting application for junior to intermediate Canadian oil and gas producers. The acquisition is for a maximum purchase price of \$2.5 million. The purchase price is comprised of an upfront payment and an earnout portion. The amount of the upfront payment at closing was approximately \$1.1 million, which was paid 75% in Zedi common shares and 25% in cash. The portion of the payment in Zedi common shares is based on a share price of \$1.25 per share. Based on the achievement of revenue performance targets over the next two years, the shareholders of PetroNet have an opportunity to earn an additional amount up to a maximum of approximately \$1.3 million. The earnout is payable as to 25% in Zedi common shares and 75% in cash, with the portion paid in Zedi common shares valued at \$1.25 per share. The maximum payout is calculated on the basis of a multiple of approximately 3.1 times 2007 projected earnings. The performance of PetroNet has been slightly ahead of projections.

### **6.92 Future Income Tax Assets**

In assessing the realizability of future tax assets, management considers whether it is more likely than not that some portion or all of the future tax assets will not be realized. The ultimate realization of future tax assets is dependent upon the generation of future taxable income during the periods in which those temporary differences become deductible. Management considers the scheduled reversal of future tax liabilities, projected future taxable income, and tax planning strategies in making this assessment. The amount of the future tax asset considered realizable could change materially in the near term based on future taxable income during the carry forward period. During the twelve months ended December 31, 2006, the Company recognized a provision of \$219,000 in previously unrecognized tax losses.

## **7 Financial Condition**

The following are the significant changes in the consolidated balance sheets between December 31, 2006 and December 31, 2005.

(\$ thousands)	December 31, 2006	December 31, 2005	Change	Explanation
<b>Current Assets</b>				
Cash and cash equivalents	9,753	6,368	3,385	The growth in cash is primarily a result of continuing positive earnings.
Accounts receivable	9,757	7,749	2,008	The growth in receivables reflects the increased sales activity in the fourth quarter.
Inventories	7,164	7,115	49	Inventory levels remained stable.
<b>Current Liabilities</b>				
Accounts payable	2,018	1,985	33	In line with expectations
Accrued liabilities	1,169	3,874	(2,705)	The reduction in accrued liabilities primarily relates to the payment of the Roughneck earnout which was accrued at the end of last year.
Deferred revenue	1,680	1,265	415	Invoicing of contracts are yearly, but revenue is deferred and recognized monthly. This amount fluctuates depending upon the timing of contract renewals.
<b>Working Capital<sup>(1)</sup></b>	<b>21,962</b>	<b>14,324</b>	<b>7,638</b>	This reflects the continued strong growth of cash flow.
<b>Capital Assets</b>	<b>1,441</b>	<b>1,194</b>	<b>247</b>	Increase is in line with expectations and growth.
<b>Other Assets</b>				
Intangibles	4,227	4,450	(223)	Reducing as result of depreciation.
Goodwill	8,480	7,932	548	Increase is due to PetroNet Systems Inc. acquisition.
<sup>(1)</sup> Current Assets minus current liabilities is an indicator of the ability to finance current operations and meet obligations as they fall due.				

## **8 Liquidity and Capital Resources**

The Company's cash balance at December 31, 2006 was \$9,753,000, an increase of \$3,385,000 from the December 31, 2005 balance. The Company's cash flows from operating, financing and investing activities, as reflected in the Consolidated Statements of Cash Flow, are summarized below:

	<b>Years ended December 31</b>	
(\$ thousands)	<b>2006</b>	<b>2005</b>
<b>Opening cash</b>	<b>6,368</b>	4,376
Cash provided by operations	<b>6,234</b>	4,629
Cash provided by financing	<b>799</b>	863
Cash used in investing	<b>(3,648)</b>	(3,500)
<b>Closing cash</b>	<b>9,753</b>	6,368

The increase in cash from operations reflects the continued growth in earnings. The cash from financing is from the exercise of options throughout the year. The cash used in investing is related to the normal capital purchases throughout the year, which is more fully described in a later section and the acquisition of Roughneck and PetroNet.

The following table presents summarized working capital information.

	<b>Years ended December 31,</b>	
(\$ thousands)	<b>2006</b>	<b>2005</b>
Current assets	<b>26,831</b>	21,450
Current liabilities	<b>4,869</b>	7,126
Working capital	<b>21,962</b>	14,324
Current ratio	<b>5.51</b>	3.01

The Company has historically experienced two normal trends that impact liquidity throughout the year. Inventory build up and annual fee billing. The Company's inventory typically peaks through the winter months reflecting the buildup for the peak activity period. The Company bills network fees on an annual basis and in the past renewals were all timed on a calendar year this resulted in a growth in cash in the second quarter as these billings are received. This as well resulted in an increase in the deferred revenue as the revenue is recognized on a monthly basis for network fees and the unrecognized revenue appears in the deferred revenue until it is earned. In 2005 the Company changed its contract renewal policy and began to renew contracts on their anniversaries. This will minimize the peaks and gradually level the receipts and deferred revenue throughout the year.

The Company had capital spending of \$3,222,000 during 2006 funded from the cash flow from operations. Spending was as follows:

Computer Hardware	\$ 362,000
Computer Software	\$ 369,000
Vehicles	\$ 36,000
Furniture & Equipment	\$ 140,000
Manufacturing Tools & Equipment	\$ 66,000
Leasehold Improvements	\$ 89,000
Patents and Trademarks	\$ 17,000
Deferred Development Costs	\$ 2,143,000

## Credit Facilities

The Company has credit facilities of \$5,000,000 to cover increased cash needs during peak demand periods. The interest rate is at Royal Bank Prime plus 1.5%. Security consists of a general security agreement creating a security interest in all of the Company's personal property. The credit facility contains customary covenants. Zedi is currently not using any of the credit facility available.

## Financial Instruments

At December 31, 2005, the Company had outstanding foreign currency forward contracts for the purchase of JPY80,000,000 and JPY40,000,000 at fixed rates expiring March 31, 2006 and April 28, 2006 respectively. Subsequent to the expiry of these contracts the Company had no further financial instruments outstanding.

## Cash Requirements

The following aggregated information about our contractual obligations and other commitments is to provide insight into the Company's short and long term liquidity and capital resource requirements. The information does not include obligations that have original maturities of less than one year or planned capital expenditures.

(\$ thousands)	Total	Within 1 year	2 to 3 years	3 to 5 years
Long-term debt	61	2	3	3
Operating leases	3,066	574	1,222	1,270
Total	3,127	576	1,225	1,273

### *Long-term Debt*

The long-term debt is a loan payable to Natural Resources Canada under an Industry Energy Research and Development (IERD) program. The loan is repayable at the rate of 1.5% of gross revenues from the sale of product developed under the program. Payments are due semi-annually, no more than 30 days after the end of June and December. The loans bears no interest except for over due payments, which bear interest at Bank of Canada prime plus 2%. The loan is unsecured.

### *Operating Leases*

The Company has various operating leases for office premises in Edmonton and Calgary and vehicles.

## Capital Expenditures

Capital expenditures are funded from cash flow from operations. The Company may adjust opportunity capital spending throughout the year depending on results. The most significant capital spending will be for deferred development costs.

Based on current projections the Company has sufficient working capital required to meet capital spending requirements and achieve projected sales and production levels, as sales increase.

## Outstanding Share Information

Authorized and issued shares:

The Company is authorized to issue an unlimited number of common voting shares without nominal or par value. The following is a summary of the Company's issued and outstanding common shares:

	Year Ended December 31, 2006		Year Ended December 31, 2005	
	Number	Amount	Number	Amount
Balance outstanding, beginning of year	<b>97,862,341</b>	<b>\$49,960,802</b>	95,564,576	\$47,693,244
Shares issued:				
• Issued pursuant to acquisition of Roughneck, net of share issuance costs	-	-	535,714	1,305,544
• Issued from Treasury pursuant to earnout provision of Roughneck	<b>1,467,361</b>	<b>2,201,042</b>	-	-
• Stock options exercised	<b>1,804,147</b>	<b>1,314,318</b>	1,762,051	962,014
• Issued pursuant to acquisition of PetroNet, net of share issuance costs	<b>720,000</b>	<b>1,030,403</b>	-	-
• Issuance of RSU and DSU	-	<b>754,000</b>	-	-
Balance outstanding, end of year	<b><u>101,853,849</u></b>	<b><u>\$55,260,565</u></b>	<u>97,862,341</u>	<u>\$49,960,802</u>

## 9 Critical Accounting Estimates

### 9.1 Critical Accounting Estimates

#### Use of estimates

The preparation of financial statements in conformity with Canadian Generally Accepted Accounting Principles ("GAAP") requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the period. Actual results could differ from those reported. Scientific research tax credits recoverable, amortization rates and the recoverable amounts for inventories, capital assets, intangible assets, deferred development costs, future income taxes and goodwill are the more significant items subject to estimates in these consolidated financial statements.

#### Cash and cash equivalents

The Company considers all balances with banks and highly liquid investments with original maturities of three months or less to be cash and cash equivalents.

### Inventory

Inventories of raw materials and consumable supplies are valued at the lower of cost and replacement cost. Inventories of work-in-progress and finished goods are valued at the lower of cost and net realizable value.

### Revenue recognition

Revenues from the Company's well-test product-line are recorded when the goods are shipped and services are rendered. Revenue from the sale of the Company's Smart-Alek product-line is recorded for the unit when it is shipped and installation fees are recognized when the installation of the Smart-Alek unit is completed. Revenue from monthly network service fees is recorded in the month in which the services are provided. Software revenue is recognized once a license agreement has been signed.

### Financial Instruments

At December 31, 2005, the Company had outstanding foreign currency forward contracts for the purchase of JPY80,000,000 and JPY40,000,000 at fixed rates expiring March 31, 2006 and April 28, 2006 respectively. Subsequent to the expiry of these contracts the Company had no further financial instruments outstanding.

### Foreign exchange risk

The cost of certain components of cost of sales and the associated accounts payable are denominated in foreign currency. During 2006 the Company significantly reduced this risk by negotiating a contract denominated in Canadian dollars with our largest Japanese supplier.

### Seasonality

The Company sells its products to the Oil and Gas Industry, primarily in Canada, which is subject to seasonal variations in activity. Traditionally, Canadian drilling activities increase during winter months and tend to slow during the spring, which may result in fluctuations in revenue.

### Future income tax assets and income taxes

The Company follows the asset and liability method for accounting for income taxes. Under this method, future income taxes are recognized for the future income tax consequences attributable to differences between the financial statement carrying values of existing assets and liabilities and their respective income tax bases (temporary differences). Changes in the net future tax asset or liability are included in operations.

Future tax assets and liabilities are measured using enacted or substantively enacted tax rates expected to apply to taxable income in the years in which temporary differences are expected to be recovered or settled. The effect on future income tax assets and liabilities of a change in tax rates is included in income in the period that includes the substantive enactment date. Future income tax assets are evaluated and if realization is not considered more likely than not, a valuation allowance is provided for all or a portion of the value.

The investment tax credits receivable are recoverable from the Government of Canada under the Scientific Research and Experimental Development Incentive Program as a reduction in income taxes otherwise payable. The amounts claimed under the program represent management's best estimate based on research and development costs incurred. Realization is subject to government approval. Any adjustment to the amounts claimed will be recognized in the year in which the adjustment occurs.

#### Guarantees

On January 1, 2003, the Company adopted CICA Accounting Guideline 14, "Disclosure of Guarantees" ("AcG-14"), that requires the disclosure of significant guarantees without regard as to whether the Company will have to make any payments under the guarantees and in addition to the accounting and disclosure requirements of CICA Handbook 3290, "Contingencies". There are no material guarantees, which require disclosure.

#### Research & development costs

The Company is engaged in research and development work. Research costs are expensed as incurred. Development costs are expensed in the period incurred, unless they meet the criteria for deferral established by GAAP. Further, in accordance with GAAP, development costs are deferred only to the extent that their recovery can reasonably be regarded as assured. Management reviews the applicable criteria on a regular basis and if the criteria are no longer met, any remaining unamortized balance is written off as a charge to income. Research and development costs are reduced by any scientific research tax credits.

#### Deferred development costs

Deferred development costs incurred on new product development projects, which, in the Company's view, have clearly defined market prospects, are deferred and amortized on a straight-line basis over 3 years, commencing in the year in which the new products begin generating revenue. The ability to recover the carrying value of deferred development costs is based on estimates, which by their nature, are subject to measurement uncertainty and the effect on the financial statements of changes in such estimates in future periods could be significant.

#### Stock-based compensation

The Company has three forms of stock-based compensation outstanding, stock options, deferred share units and restricted share units. The Company accounts for stock options using the fair-value based method beginning January 1, 2004. Under the fair-value based method, compensation expense for stock options is measured at fair value at the date of grant and is amortized over the stock option vesting period. In accordance with Handbook Section 3870, the Company has applied the fair-value based method to all employee stock options granted after January 1, 2002, but has not restated all prior periods.

### Purchased intangible assets

Purchased intangible assets are recorded at cost and amortized on a straight-line basis over a period of up to twelve years. The net carrying amount of purchased intangible assets is reviewed regularly to determine whether there has been impairment in value. The review methodology is comprised of an assessment of the continuing contribution of the applicable product contribution to operations and an assessment of future cash flows. Intangibles acquired on the acquisition of WebTech 2000 Inc., D.G. Wehrhahn Company Ltd., Menex Technologies Inc., Roughneck.ca® Inc., and PetroNet Systems Inc. are being amortized as follows:

- Intangibles – Purchased software (5 years)
- Intangibles – Workforce (2 years)
- Intangibles – Workforce Menex and Roughneck (3 years)
- Intangibles – Intellectual property Menex (12 years)
- Intangibles – Customer relationships Roughneck (3 years)
- Intangibles – Customer relationships PetroNet (1 year)
- Intangibles – Developed software and Patent Roughneck (5 years)
- Intangibles – Developed software PetroNet (3 years)
- Intangibles – Patents and Trademarks (17 years)

### **10 Disclosure Controls and Internal Controls**

The Company has established and maintains disclosure controls and procedures. The CEO and CFO of the Company have evaluated the effectiveness of the Company's disclosure controls and procedures as of December 31, 2006 and have concluded that such disclosure controls and procedures are effective to provide reasonable assurance that material information relating to the Company and its subsidiaries would be made known to them by others within those entities.

During 2006, the Company implemented a new software program to coordinate and manage its internal control system. This replaced a system that was primarily paper-based and prepares the Company to more adequately manage internal controls as it continues to grow. There were no changes to the Company's internal controls over financial reporting that have materially affected, or are reasonably likely to materially affect, the Company's internal controls over financial reporting in the fourth quarter of 2006 other than as described below.

The Company conducts regular reviews and internal audits to identify weaknesses in its internal controls over financial reporting and to ensure that an environment of continuous improvement becomes a part of the culture of the Company. As a result of these internal audits, the Company identified weaknesses in the internal controls related to invoicing procedures for recurring contracts. A system for ensuring the timeliness of invoicing for renewing contracts was not adequate. New interim procedures were implemented and changes to the design of the internal controls and documentation of new procedures will be completed in the first quarter of 2007.

## **11 Outlook**

In 2007, Zedi expects to deliver:

- Growth of revenues and earnings through all lines of business.
- Continued progress toward 100% coverage of operating costs by recurring revenues.
- On-going investment in research & development to enhance existing products and to introduce new solutions that are in line with our strategic imperatives, such as:
  - The introduction of non-proprietary hardware that will interface with a broad base of third party well site controllers. This will facilitate the introduction of Zedi SCADA on wells where (a) customers already have an investment in legacy hardware and (b) tier one customers have established standards for well site controllers. The introduction of this solution, expected by Q4 2007, significantly expands the available market for sales.
- Expansion of Zedi training and education services to include classroom, on-line instructor led and self-paced tutorials. We believe the key to corporate adoption within our customers' organizations is their ability to understand how to effectively integrate our solutions with their business practices. The tight integration of the solutions and business practices drives the value customers receive from their investment in Zedi technology.
- Focus on increasing efficiencies within our business to drive execution improvements that we believe will contribute to the improvement of earnings performance.
- Increased attention to our people through the addition of a Director of Human Resources, recognizing the importance of developing and retaining quality employees in a competitive and shrinking labour market.

## **12 Business Risks and Uncertainty**

The Company is exposed to a number of risks in the normal course of business that have the potential to affect its performance. The Company seeks to avoid unnecessary risk and initiates policies and processes to limit any significant risk as much as practical.

### Fair values

The carrying values of cash, accounts receivable, accounts payable and accrued liabilities approximate their fair value due to the relatively short periods to maturity of the instruments. The carrying value of Sales leases receivable does not differ significantly from its fair value.

### Credit risk

At December 31, 2006, no customer represented a significant percentage of total accounts receivable. The Company does not obtain collateral or other security to support financial instruments subject to credit risk but mitigates this risk by dealing with financially sound counterparties and, accordingly, does not anticipate significant loss for non-performance.

### Foreign exchange risk

The Company earns some revenue and records accounts receivable in foreign currency and translates to Canadian dollars at the time of these transactions. The Company does not use derivative instruments to mitigate the effects of foreign exchange changes between the recording date of the accounts receivable and the receipt of cash. The accounts receivable are short-term in nature. The effect of the foreign exchange changes has not been significant and foreign exchange gains and losses are included in income as they occur. The Company purchases some components priced in US dollars and Japanese Yen. The Company is subject to some risk in the fluctuation of

foreign currencies but accounts payable are short-term in nature reducing the risk. During 2006 the Company significantly reduced this risk by negotiating a contract denominated in Canadian dollars with our largest Japanese supplier. The Company has on occasion purchased some forward contracts for Yen to fix rates on orders that are in process for components from Japan.

### Regulatory Risks

The Company is subject to various laws, regulations, regulatory actions and court decisions that may have negative effects on the Company. The Company may also be subject to regulation in foreign countries in connection with certain of its business activities. Changes in the regulatory environment imposed upon the Company could adversely affect the ability of the Company to attain its corporate objectives. There can be no assurance that foreign countries will not adopt laws or regulatory requirements that could adversely affect the Company.

### Competition

The markets for remote production operations management are expected to remain highly competitive. While the Company believes that it currently has unique products and has patents that protect its technology, there can be no assurance that competitors will not emerge in the near to medium term with comparable products. There are several very large companies involved in remote data management processes. Such companies have more established and larger sales and marketing organizations, larger technical staff and significantly greater financial resources than the Company. It is the Company's intention to establish marketing and distribution alliances with several of these companies but there can be no assurance that such alliances will be formed.

### Dependence on a Market that has Historic Volatility

The Company's products are sold into the oil & gas industry, which historically has had significant shifts in activity and spending due to fluctuations in commodity prices. The Company's revenues are primarily dependant upon spending by oil & gas producers. A reduction in spending by producers could have a material adverse effect on the Company's business, results of operations and financial condition.

### Reliance Upon the Internet

A portion of the Company's revenue is dependent on the continued use and expansion of the Internet. Use of the Internet has grown dramatically, but no assurance can be given of the continued use and expansion of the Internet as a medium of communication and commerce. A decrease in the demand for Internet services or a reduction in the currently anticipated growth for such services could have a material adverse effect on the Company's business, financial condition and results of operations.

### Liability Risks

The Company is subject to a variety of potential liabilities connected with its business operations, including potential liabilities and expenses associated with possible product defects. These risks could expose the Company to substantial liability for personal injury, wrongful death, property damage and other damages.

Although the Company has obtained insurance against certain of these risks, no assurance can be given that such insurance will be adequate to cover the Company's liabilities or will be generally available in the future or, if available, that premiums will be commercially justifiable. If the Company were to incur substantial liability and such damages were not covered by insurance or were in excess of policy limits, or if the Company were to incur such liability at a time when it is not able to obtain liability insurance, its business, results of operations and financial condition could be materially adversely affected.

### Dependence on Key Personnel

The success of the Company is dependent on management and the performance of key personnel in the areas of finance, product development, marketing, and sales. There is intense competition for qualified personnel and there can be no assurance that the Company will be able to attract and retain qualified personnel. The failure to attract or loss of any such personnel could adversely affect the success of the business for the period of time required to recruit a replacement.

### Management of Growth

The Company's rapid growth places a significant strain on its financial, operational and managerial resources. While the Company engages in strategic and operational planning to adequately manage anticipated growth, there can be no assurance that the Company will be able to implement and subsequently improve its operations and financial systems successfully and in a timely manner in order to fully manage its growth. There can be no assurance that the Company will be able to manage its growth successfully. Any inability of the Company to manage its growth successfully could have a material adverse effect on the Company's business, financial condition and results of operations.

## **13 Reconciliation of Non-GAAP Measures**

### **13.1 Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA)**

The Company reports EBITDA because it is a key measure used by management to evaluate the performance of the business. The Company also believes EBITDA is a measure commonly reported and widely used by investors as an indicator of a company's operating performance and ability to incur and service debt, and as a valuation metric. The Company believes EBITDA assists investors in comparing a company's performance on a consistent basis without regard to depreciation and amortization, which are non-cash in nature and can vary significantly depending upon accounting methods or non-operating factors such as historical cost.

EBITDA is not a calculation based on GAAP and should not be considered an alternative to Net Income in measuring the Company's performance or used as an exclusive measure of cash flow because it does not consider the impact of working capital growth, capital expenditures, debt principal reductions and other sources and uses of cash, which are disclosed in the interim consolidated financial statements of cash flows. Investors should carefully consider the specific items included in the Company's calculation of EBITDA. While EBITDA has been disclosed herein to permit a more complete comparative analysis of the Company's operating performance and debt servicing ability relative to other companies, investors should be cautioned that EBITDA as reported by Zedi may not be comparable in all instances to EBITDA reported by other companies.

The following is a reconciliation of EBITDA with Net Income.

	<b>Years ended December 31</b>	
(\$ thousands)	<b>2006</b>	<b>2005</b>
<b>Net Income</b>	<b>4,019</b>	4,977
Amortization of capital assets and intangibles	<b>2,500</b>	1,653
Gain on disposal of assets	-	(1)
Future income taxes	<b>219</b>	(2,380)
Interest	<b>(236)</b>	64
<b>EBITDA</b>	<b>6,502</b>	4,313

	<b>Three Months ended December 31</b>	
(\$ thousands)	<b>2006</b>	<b>2005</b>
<b>Net Income</b>	<b>1,759</b>	1,813
Amortization of capital assets and intangibles	<b>768</b>	498
Future income taxes	<b>1,373</b>	(402)
Interest	<b>(91)</b>	100
<b>EBITDA</b>	<b>3,809</b>	2,009

### 13.2 Free Cash Flow

The Company reports free cash flow because it is a key measure used by management to evaluate the performance of consolidated operations. Free cash flow excludes certain working capital changes and other sources and uses of cash, which are disclosed in the interim consolidated statements of cash flows. Free cash flow is not a calculation based on GAAP and should not be considered an alternative to the interim consolidated statements of cash flows. Free cash flow is a measure that can be used to gauge the Company's performance over time. Investors should be cautioned that free cash flow as reported by Zedi may not be comparable in all instances to free cash flow as reported by other companies. While the closest GAAP measure is Cash provided by operating activities less Cash used for acquisition of capital assets, free cash flow is relevant because it provides an indication of how much cash generated by operations is available after capital expenditures, but before proceeds from divested assets and changes in certain working capital items (such as trade receivables and trade payables).

The following shows management's calculation of free cash flow:

	<b>Years ended December 31</b>	
(\$ thousands)	<b>2006</b>	<b>2005</b>
<b>EBITDA</b>	<b>6,502</b>	4,313
Stock-based compensation	<b>3,115</b>	1,649
Cash interest (paid)	<b>236</b>	64
Cash available for discretionary spending and capital expenditures	<b>9,853</b>	6,026
Proceeds from disposal of capital assets	<b>18</b>	11
Deferred development	<b>(2,143)</b>	(1,087)
Purchase of other capital assets	<b>(1,079)</b>	(1,137)
<b>Free Cash Flow</b>	<b>6,649</b>	3,813

	<b>Three Months ended December 31</b>	
(\$ thousands)	<b>2006</b>	<b>2005</b>
<b>EBITDA</b>	<b>3,809</b>	2,009
Stock-based compensation	<b>695</b>	500
Cash interest (paid)	<b>91</b>	100
Cash available for discretionary spending and capital expenditures	<b>4,595</b>	2,609
Capital expenditures		
Proceeds from disposal of capital assets	<b>1</b>	-
Deferred development	<b>(564)</b>	(167)
Purchase of other capital assets	<b>(401)</b>	(175)
<b>Free Cash Flow</b>	<b>3,631</b>	2,267

### **13.3 Net Income before Taxes with Stock-based Compensation Excluded**

The Company reports net income before taxes with stock-based compensation excluded because it is a key measure used by management to evaluate the performance of the business. The Company believes this measure assists investors in comparing a company's performance on a consistent basis without regard to stock-based compensation, which is non-cash in nature and can vary significantly depending upon non-operating factors such as historical share price volatility. Please reference section 4.3 for further information on the stock-based compensation expense.

Net income before taxes with stock-based compensation excluded is not a calculation based on GAAP and should not be considered an alternative to net income before taxes.

The following shows management's calculation of net income before taxes with stock-based compensation excluded:

	<b>Years ended December 31</b>	
(\$ thousands)	<b>2006</b>	<b>2005</b>
<b>Net Income before Taxes</b>	<b>4,238</b>	2,597
Stock-based compensation	<b>3,115</b>	1,649
<b>Net Income before Taxes Excluding Stock-based Compensation</b>	<b>7,353</b>	4,246

	<b>Three Months ended December 31</b>	
(\$ thousands)	<b>2006</b>	<b>2005</b>
<b>Net Income before Taxes</b>	<b>3,132</b>	1,411
Stock-based compensation	<b>695</b>	500
<b>Net Income before Taxes Excluding Stock-based Compensation</b>	<b>3,827</b>	1,911

### **13.4 Income per Share before Taxes with Stock-based Compensation Excluded, basic and diluted**

The Company reports income per share before taxes with stock-based compensation excluded because it is a key measure used by management to evaluate the performance of the business. The Company believes this measure assists investors in comparing a company's performance on a consistent basis without regard to stock-based compensation, which is non-cash in nature and can vary significantly depending upon non-operating factors such as historical share price volatility. Please reference section 4.3 for further information on the stock-based compensation expense.

Income per share before taxes with stock-based compensation excluded, basic and diluted is not a calculation based on GAAP and should not be considered an alternative to income per share before taxes, basic and diluted.

The following shows management's calculation of income per share before taxes with stock-based compensation excluded, basic and diluted:

	<b>Years ended December 31</b>	
(\$)	<b>2006</b>	<b>2005</b>
<b>Income per Share, basic and diluted</b>	<b>0.04</b>	0.05
Future Income Tax per Share	<b>0.00</b>	0.02
<b>Income per Share before Taxes, basic and diluted</b>	<b>0.04</b>	0.03
Stock-based compensation per share	<b>0.03</b>	0.02
<b>Income per Share Before Taxes Excluding Stock-based Compensation, Basic and Diluted</b>	<b>0.07</b>	0.04

  

	<b>Three Months ended December 31</b>	
(\$)	<b>2006</b>	<b>2005</b>
<b>Income per Share, basic and diluted</b>	<b>0.02</b>	0.02
Future Income Tax per Share	<b>(0.01)</b>	0.00
<b>Income per Share before Taxes, basic and diluted</b>	<b>0.03</b>	0.02
Stock-based compensation per share	<b>0.01</b>	0.01
<b>Income per Share Before Taxes Excluding Stock-based Compensation, Basic and Diluted</b>	<b>0.04</b>	0.02