



## **CHARTWELL TECHNOLOGY INC.**

**Management's Discussion and Analysis of Financial Condition and Results of Operations  
for the years ended October 31, 2006 and 2005.**

**January 29, 2007**

## **MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

The following Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A") should be read in conjunction with Chartwell Technology Inc.'s ("Chartwell" or the "Company") audited consolidated financial statements and the accompanying notes for the year ended October 31, 2006, which have been prepared in accordance with Canadian generally accepted accounting principles ("Canadian GAAP"). Reference to 2006 or fiscal 2006 means the twelve months ended October 31, 2006. Likewise, reference to 2005 or fiscal 2005 refers to the twelve months ended October 31, 2005. Additional information relating to the Company is available on SEDAR at [www.sedar.com](http://www.sedar.com) under Chartwell Technology Inc. and on the Company's website at [www.chartwelltechnology.com](http://www.chartwelltechnology.com).

### **Special Note Regarding Forward-Looking Statements**

This MD&A contains certain forward-looking statements which reflect Management's expectations regarding the Company's growth, results of operations, performance and business prospects and opportunities.

Statements about the Company's future plans and intentions, results, levels of activity, performance or achievements or other future events constitute forward-looking statements. Where possible, words such as "anticipate", "estimate", "may", "will", "should", "could", "expect", "plan", "intend", "believe", "estimate", or "potential" or similar words, have been used to identify these forward-looking statements.

Forward-looking statements involve significant risks, uncertainties and assumptions. Many factors could cause actual results to differ materially from the results discussed or implied in the forward-looking statements. These factors should be considered carefully and readers should not place undue reliance on the forward-looking statements.

Factors which could cause results or events to differ from current expectations include, among other things: the impact of government regulation and laws affecting international operations; the impact of price competition; the ability of the Company to retain and attract qualified professionals; the impact of rapid technological and market change; loss of business or credit risk with current and prospective major customers; general industry and market conditions and growth rates; currency rate fluctuations and the impact of consolidations in the on-line gaming industry. Further information is provided under the heading "Risks and Uncertainties" in this MD&A, which readers are encouraged to review. Chartwell disclaims any intention or obligation to update or revise any forward-looking statements, whether as a result of new information, future events or otherwise, except as required by law. No assurance can be given that actual results, performance or achievement expressed in, or implied by, forward-looking statements within this disclosure will occur, or if they do, that any benefits may be derived from them.

Past performance has been considered in drawing conclusions with respect to forward-looking statements contained in this MD&A.

## **BUSINESS**

Chartwell develops, markets, licenses, implements and supports gaming applications and entertainment content for the internet and wireless platforms. Chartwell's JAVA and Flash based software products and games are designed for deployment in gaming, entertainment and promotional applications. Chartwell does not own or operate a gaming site nor do we operate our clients' gaming sites.

### **Business Plan**

The Company's business plan and objectives through fiscal 2007 are to continue to increase our market share in the traditional internet casino market, with a continued emphasis on the European market, further develop the liquidity of our poker community, establish liquidity in our bingo community, further develop poker variants and establish greater market share in these areas. We will continue to focus on product development and diversification of our products, customers and revenues.

## **Business Model**

The majority of Chartwell's revenue is in the form of software license fees. License fees, including fees from master license agreements, most of which are contingent upon customer usage, are recognized on an accrual basis as earned over the life of the contract. Licensees pay recurring license fees for the licensing and support of the Company's software under a software licensing agreement, which typically has a three to five year term. The license fee is calculated as a percentage of each licensee's level of activity. The Company's contractual agreements with licensees provide for the provision of graphics, web design, software implementation services, licensing of the software and provision of software upgrades over the term of the contract. Additional revenue is derived from software set-up fees and software development fees. Software set-up fees are up front fees for customer related development and installation and are non-recurring. Software set-up fee revenue and related costs are recognized ratably over the term of the contract. Software development fees are fees that the Company charges for software development services. These fees are recognized on a per man hour or per man day basis as determined by the individual contracts and are recorded in other revenue.

Expenses are classified into six categories, namely: software development and support; sales and marketing; general and administrative ("G&A"); depreciation and amortization, stock-based compensation expense and foreign currency gains or losses. Software development and support consists of personnel and related costs associated with the design and development of new products, support of existing products, hosting costs for the poker community paid to a hosting provider, customer implementation and quality assurance. Sales and marketing expenses consist of personnel and related costs associated with the Company's sales, marketing and business development activities. G&A expenses include the costs of all administrative, financial and IT personnel, investor relations and professional fees relating to our public company listing. Stock-based compensation expense consists of the estimated fair value of options granted to employees and consultants. Depreciation and amortization are based on the estimated useful life of our assets and include the amortization of deferred software development costs and the intangible assets. The Company operates internationally with 100% of its revenue derived from non-Canadian licensees. Under the Company's licensing agreements, the majority of the Company's revenue is received in UK pound sterling and Euros. Consequently, the Company is exposed to currency fluctuations, which result in foreign currency gains or losses, which are reported in that expense category.

## **THE YEAR IN REVIEW**

The 2006 fiscal year represented a challenging year for Chartwell and its industry peers. Overall, the Company's traditional product line of internet casino games performed well although external factors contributed to the loss of certain revenue. Following the acquisition of Micropower in mid 2005, the Company continued its development of a European style poker product with recent emphasis on the further development of a community of players to achieve game liquidity. Late in the Company's fiscal year, the United States government enacted legislation to prevent Americans from participating in online gaming. Chartwell has always and will continue to focus its business development in the European Union and accordingly, the effect of this legislation on Chartwell was not significant. The effect, however, has been significant as it relates to the online gaming segment of the capital markets. Many other online gaming operators were nonetheless negatively impacted due to their concentrations of U.S. based business and will now look to the European market, creating more competition there. In addition, during the year Chartwell's contemplated merger with Parlay Entertainment Inc. was terminated, involving significant cost, as a result of, among other things, the impact of the U.S. legislation on capital markets.

The Company's objectives for 2006 and its performance are summarized in the following table:

<b>2006 Objective</b>	<b>Measure</b>	<b>Performance</b>	<b>2007 Action</b>
Continue to increase our market share in the traditional internet casino market, with a continued emphasis on the European market	<ul style="list-style-type: none"> <li>• New customer agreements</li> <li>• Revenue increase</li> </ul>	<ul style="list-style-type: none"> <li>• Four new major European licenses announced</li> <li>• Organic revenue growth in fiscal 2006 was modest while revenue growth from new business more than offset revenue declines and customer losses</li> <li>• Two customers lost in Europe</li> </ul>	<ul style="list-style-type: none"> <li>• Continue to focus on Europe and larger European operators</li> <li>• Manage smaller operators at risk to changing market conditions</li> </ul>
Further develop the liquidity of our poker community	<ul style="list-style-type: none"> <li>• Number of poker community participants</li> <li>• Community size</li> </ul>	<ul style="list-style-type: none"> <li>• Two operators have grown by a factor of 15 times in the community</li> <li>• Community still in the start up phase with a less than ideal number of players</li> <li>• Chartwell net earnings negatively impacted by poker during 2006 due to full year of cost for poker development and support combined with poker revenue that represents approximately 10% of overall Chartwell revenue</li> </ul>	<ul style="list-style-type: none"> <li>• A third large operator joined the community in late 2006</li> <li>• Fine tune the plan to increase the size of the poker community</li> <li>• Pursue new operators</li> <li>• Develop new geographic specific poker games</li> </ul>
Establish liquidity in our bingo community	<ul style="list-style-type: none"> <li>• Number of bingo community participants</li> <li>• Community size</li> </ul>	<ul style="list-style-type: none"> <li>• Chartwell slowed its go to market strategy for bingo pending the outcome of the discussion with Parlay Entertainment to combine their bingo product with the Chartwell product line</li> </ul>	<ul style="list-style-type: none"> <li>• Evaluate latest business case for bingo</li> </ul>
Further develop poker game variants	<ul style="list-style-type: none"> <li>• New European style games released</li> </ul>	<ul style="list-style-type: none"> <li>• Chartwell spent considerable time and effort to create Flash versions of 32 card poker and other games that appeal to the European market</li> </ul>	<ul style="list-style-type: none"> <li>• Release new geographically-specific poker games</li> </ul>
Continue to focus on product development and diversification of our products, customers and revenues.	<ul style="list-style-type: none"> <li>• Add features and new games to casino and poker</li> </ul>	<ul style="list-style-type: none"> <li>• Invested in product features that will coincide with expected requirements of U.K. regulations</li> <li>• European poker game development</li> <li>• New casino games development</li> </ul>	<ul style="list-style-type: none"> <li>• Continue customer and market driven strategy to release product that appeals to European players and operators</li> </ul>

The net consequence of the foregoing was financial performance wherein revenues were relatively unchanged from the previous year, together with significantly higher costs, primarily associated with taking the poker product to market, costs associated with merger initiatives that did not proceed, corporate structuring costs and regulatory compliance costs. Positive developments include new and larger client licenses, progress on poker development and continued success in the casino games product line.

## FINANCIAL REVIEW

Total revenue for the year ended October 31, 2006 increased 4% to \$18.6 million compared to 2005 revenue. Net income for 2006 was \$859,000 (\$0.05 per basic and fully diluted share) compared to \$4.0 million (\$0.22 per share basic and \$0.20 per share fully diluted) in the previous year. The Company's pretax operating margin (defined as net income before income taxes as a percentage of total revenues) declined from 35.7% in fiscal 2005 to 9.2% in fiscal 2006, largely as a result of higher expenses, certain of which were non-recurring and others related to the fixed cost of maintaining full poker product support during the early stages of revenue generation from the Company's poker product.

Organic revenue growth in fiscal 2006 was modest while revenue growth from new business more than offset revenue declines and customer losses. New customers began to contribute to revenue during the year while the loss of two customers negatively impacted revenue. Revenue from poker represented approximately 10% of total revenue during 2006 compared to 3% of total revenue for 2005.

Total reported expenses for software development & support, sales and marketing, and G&A increased to 80% of revenue in fiscal 2006 from 55% of revenue in fiscal 2005. The major factors affecting the growth in expenses from 2005 to 2006 were:

- Increase in professional fees related to a proposed merger and corporate structure and regulatory compliance costs
- Costs associated with a full year of poker support, marketing and community hosting costs
- Provisions for accounts receivable related to one customer in the second quarter and another customer in the fourth quarter; these provisions were unrelated to Chartwell's performance as the software provider.
- Growth of expense base to support an expanded scale of business

In May 2005, the Company acquired Micropower Corporation Limited. This acquisition provided the Company with a significant base in technology to support our poker development and added eighteen technologists to our poker development team. The Company also extended the capabilities and capacity of the development teams in other product areas, product deployment, and customer support through a staged investment program which added technical resources, tools and supporting infrastructure throughout the year. Capital expenditures related to new software development were approximately \$2.6 million in 2006 (\$0.6 million in 2005) and total headcount, including part-time employees and consultants, increased to one hundred and thirty-two from one hundred and twenty-four at the end of fiscal 2005.

Chartwell maintained its strong balance sheet in 2006. Cash and short-term investments totaled \$12,774,000 compared to \$19,122,000 in 2005; the working capital ratio (defined as total current assets divided by total current liabilities) at the end of 2006 was 11 to 1 compared to 7 to 1 a year earlier. The principal investing activity during 2006 was capital expenditures of \$2.6 million and the principal financing activity was the repurchase of common shares for \$3.5 million.

## SELECTED ANNUAL FINANCIAL DATA

### Comparison of the years ended October 31, 2006 and 2005:

#### Consolidated Statement of Operations & Deficit

Year ended October 31, (Amounts in Thousands, Except per Share Data) Revenue	<u>2006</u>	<u>% Revenue</u>	<u>2005</u>	<u>% Revenue</u>	<u>2004</u>	<u>% Revenue</u>
Software license fees	\$ 17,474	94.1	\$ 16,393	91.8	\$ 11,268	92.4
Software set-up fees	296	1.6	657	3.7	798	6.5
Interest and other	793	4.3	799	4.5	135	1.1
	18,563	100.0%	17,849	100.0%	12,201	100.0%
<b>Expenses</b>						
Software development & support	8,071	43.5	6,037	33.8	4,418	36.2
Sales and marketing	2,309	12.4	2,194	12.3	1,320	10.8
General and administrative	4,541	24.5	1,625	9.1	2,179	17.9
Amortization of deferred software development costs	235	1.3	235	1.3	98	0.8
Stock-based compensation	623	3.4	637	3.6	103	0.8
Depreciation & amortization	426	2.3	260	1.5	244	2.0
Amortization of intangible assets	493	2.7	105	0.6	-	-
Foreign currency loss	157	0.8	376	2.1	233	1.9
	16,854	90.8%	11,468	64.3%	8,595	70.4%
<b>Net income before taxes</b>	1,709	9.2%	6,380	35.7%	3,606	29.6%
Income taxes	850	4.6%	2,382	13.3%	(415)	-3.4%
<b>Net Income</b>	859	4.6%	\$ 3,998	22.4%	\$ 4,021	33.0%
Net income per share						
Basic	\$ 0.05		\$ 0.22		\$ 0.28	
Diluted	\$ 0.05		\$ 0.20		\$ 0.24	

October 31, (Amounts in Thousands) Consolidated Balance Sheet Data	<u>2006</u>	<u>2005</u>	<u>2004</u>
Cash & short-term investments	\$ 12,774	\$ 19,122	\$ 9,314
Working capital	17,774	20,933	10,549
Total assets	29,443	32,753	14,962
Deferred revenue	565	473	1,095
Total shareholders equity	27,439	28,847	13,122

## **RESULTS OF OPERATIONS**

### **YEAR ENDED OCTOBER 31, 2006 COMPARED TO YEAR ENDED OCTOBER 31, 2005**

#### ***REVENUE***

Total revenues increased to \$18.6 million for the year ended October 31, 2006 compared to \$17.8 million for the year ended October 31, 2005, an increase of 4%. License fees remain the single largest contributor to revenue and represented 94.1% of total revenue in fiscal 2006 compared to 91.8% of revenue in fiscal 2005. Looking forward, we expect that license fees as a percentage of revenue will continue to represent the major element of our revenue.

Certain customers began to contribute to new business revenue during the year while the loss of two customers (one as a result of a change in corporate ownership and the other who experienced difficulty in the Italian market) negatively impacted revenue. As a result of controversial legislation introduced by the Italian government, access to the Italian market by certain of Chartwell's customers was limited, adversely affecting the Company's license revenue from these customers. Revenue from poker represented approximately 10% of total revenue during 2006 compared to 3% of total revenue for 2005.

Software set-up fees decreased to \$296,000 in the year ended October 31, 2006 compared to \$657,000 for the same period a year earlier. The decrease is attributable to smaller set-up fees from new clients and the completion of amortization of deferred set-up revenues upon completion of initial contract terms. We expect set-up fees to continue to represent a small percentage of the Company's sales revenue as we continue to build our license fee component of revenue.

Interest and other revenue is consistent at \$793,000 in the year ended October 31, 2006 compared to \$799,000 in the year ended October 31, 2005. In fiscal 2006, Chartwell earned approximately \$135,000 in software development fees for custom games development which was recorded to other income. In fiscal 2005, Chartwell entered into a software development services agreement with one customer to provide non recurring software development services, which resulted in \$353,000 of other revenue. In addition, interest income was higher in 2006 due higher levels of interest bearing notes receivables as well as more favorable yields on short-term investments and cash balances.

#### ***OPERATING EXPENSES***

Total expenses increased to \$16.9 million in the year ended October 31, 2006 compared to \$11.5 million in the year ended October 31, 2005. The major factors affecting the growth in expenses from 2005 to 2006 were:

- Increase in professional fees related to a proposed merger and corporate structure and regulatory compliance costs
- Costs associated with a full year of poker support, marketing and community hosting costs
- Provisions for accounts receivable related to one customer in the second quarter and another customer in the fourth quarter; these provisions were unrelated to Chartwell's performance as the software provider.
- Growth of expense base primarily through additional staff to support an expanded scale of business

In addition to higher expenses related to software development and support, sales and marketing and G&A, the Company recorded higher depreciation and amortization resulting from the intangible assets acquired as part of the purchase of Micropower.

As a percentage of total revenue, total operating expenses increased to 90.8 % in the current year compared to 64.3% in the prior year. Operating margins (defined as net income before income taxes as a percentage of revenue) were 9.2% in 2006 versus 35.7% in 2005, reflecting the factors noted above.

#### ***SOFTWARE DEVELOPMENT & SUPPORT***

Software development and support costs continue to represent the Company's single largest expenditure. In 2006, software development and support expense, net of software development costs that were deferred, increased by 33.7% to \$8.1 million compared to \$6.0 million in 2005. Costs relating to the development of software are expensed as incurred unless they meet the criteria for deferral and amortization under generally accepted accounting

principles. In 2006, the Company deferred costs of \$2.6 million compared to \$662,000 in 2005. The majority of the deferred costs relate to the development of the poker software.

The Company's product development focus continues to be reflected in its employee mix with the majority of the employee population dedicated to product planning, design, development, deployment and support. Salaries and benefits accounted for 58.2% of software development costs in 2006 compared to 86.8% in 2005. The fixed cost associated with hosting the poker community on behalf of licensees rose significantly during the year as more bandwidth and customer support was required to support the poker community, together with one time client credits for promotional and client goodwill purposes. In addition, Chartwell incurred higher travel costs in fiscal 2006 for client site visits and trade show attendance by development and management personnel.

As a percentage of revenue, software development and support expenses, net of deferred software development costs, increased to 43.5% in 2006 compared to 33.8% in 2005, reflecting the factors noted above.

#### *SALES AND MARKETING*

Sales and marketing expenses increased by 5.3% to \$2.3 million in 2006 versus \$2.2 million in 2005. The increase is primarily attributable to general increases in costs.

As a percentage of revenue, sales and marketing costs have remained constant at 12.4% in 2006 versus 12.3% in 2005, reflecting Chartwell's continued investment in marketing activities.

#### *GENERAL AND ADMINISTRATIVE*

G&A expense was \$4.5 million for the year ended October 31, 2006 compared to \$1.6 million a year earlier. As a percentage of revenue, G&A expenses increased to 24.5% in 2006 from 9.1% in 2005. Contributing to the increase were additional infrastructure costs required to support growth, including costs for new Malta offices, higher legal and regulatory fees, higher professional fees due to the establishment and expansion of operations in Malta and related corporate structure planning, higher professional fees related to due diligence and legal work for a planned acquisition that was not completed, and increased investor relations activities. The largest year-over-year increase is due to a \$1.0 million expense related to an allowance for a doubtful account recorded in the second quarter of 2006 (versus a bad debt expense recovery of \$132,000 recorded in the second quarter of 2005); followed by professional fees of \$600,000 related to items noted above; and the balance of the year-over-year increase reflecting primarily higher costs to expand senior management of the Company.

#### *AMORTIZATION OF DEFERRED SOFTWARE DEVELOPMENT COSTS*

Amortization of deferred software development costs for 2006 was \$235,000, consistent with \$235,000 for 2005. In fiscal 2003 and fiscal 2004 the Company deferred \$531,000 and \$175,000, respectively, of software development costs relating to the development of the Company's community poker product. Management has estimated the appropriate amortization period to be three years. The Company began amortizing these costs on a straight line basis in the third quarter of fiscal 2004. In fiscal 2005 and fiscal 2006, the Company deferred a combined additional \$3.2 million of software development costs related to the development of version 2.0 of the Company's community poker product, which builds Flash technology and new poker variants on the intellectual property acquired in the purchase of Micropower. In fiscal 2006, the Company deferred \$543,000 of software development costs related to the development of the Company's mobile product. The deferred costs for the community poker and mobile products have not been amortized to date, given that these products are not as yet complete.

#### *STOCK-BASED COMPENSATION*

The Company recorded \$623,000 of stock-based compensation expense for 2006 versus \$637,000 for 2005. Stock-based compensation expense relates to the amortization of the fair value of stock options granted to employees, directors and consultants. Expenses are amortized over the vesting period of three to five years. The year over year decrease in the expense is due to fewer options issued and a higher level of option exercise and expiries, thus decreasing the number of options outstanding.

#### *DEPRECIATION & AMORTIZATION*

Depreciation and amortization increased to \$426,000 in 2006 from \$260,000 in 2005. The increase in depreciation is due to higher net book values of property and equipment at October 31, 2006 versus a year earlier. Significant amounts of hardware were acquired in the fourth quarter of 2005 and the first quarter of 2006 to integrate the Micropower staff into the Chartwell environment and increase the size of their infrastructure. In the last three

quarters of 2006, further investments were made in computer equipment including internal network servers to handle additional volumes as well as computer equipment upgrades to accommodate the Company's growth. It is expected that continued investment in computer hardware and software will be required as the Company increases its presence in Malta.

#### *AMORTIZATION OF INTANGIBLE ASSETS*

Amortization of intangible assets is related to amortization on the customer contracts and intellectual property acquired as part of the acquisition of Micropower. Amortization for 2006 was \$493,000 compared to \$105,000 in 2005. The amount recorded for customer contracts is amortized over the contract period for each contract that was acquired. The amount recorded for intellectual property is amortized straight-line over five years, which is Management's best estimate of the period that the acquired intellectual property will provide future value to Chartwell.

#### *FOREIGN CURRENCY LOSS*

The Company incurred a foreign currency loss of \$157,000 for 2006 compared to a foreign currency loss of \$375,000 for 2005. Lower foreign currency losses experienced in 2006 were due to lower levels of foreign currency denominated accounts receivable balances and more favorable foreign exchange rates during fiscal 2006. The Company does not utilize hedges or forward contracts to mitigate foreign currency risk.

#### *PROVISION FOR INCOME TAXES*

Income tax assets relate to the Company's future tax benefits which arise from loss carry-forwards and future deduction of deferred development costs. The valuation of tax assets is based on the amount of tax benefits available combined with the determination as to when the tax benefits will be realized and the tax rate in effect at that time.

Income taxes for 2006 were \$850,000 versus \$2.4 million in 2005. The Company's reduced tax expense primarily reflects a decrease in income from operations during fiscal 2006.

#### *NET INCOME*

Net income was \$859,000 for the year ended October 31, 2006 versus \$4.0 million for the year ended October 31, 2005. The principal reason for the decline in net income is an increase in expenses consisting of: costs associated with a full year of poker support, marketing and community hosting costs; provisions for accounts receivable taken in the second and fourth quarters of the year; professional fees related to a proposed merger and corporate structure and regulatory compliance costs; and growth of our expense base primarily through additional staff to support an expanded scale of business.

Diluted earnings per share were \$0.05 for the year ended October 31, 2006 compared to \$0.20 in the same period of 2005. The decrease in the diluted earnings per share in the current year reflects, principally, the decrease in net income from the previous year.

#### *CASH FLOW STATEMENT*

##### *OPERATING ACTIVITIES*

Cash flow provided by operating activities for the year ended October 31, 2006 was \$415,000 compared to \$3.5 million for the year ended October 31, 2005. The decrease is due in part to a receivable recorded in 2006 for a tax refund from the Maltese taxation authorities, which was not the case in the previous year, together with income tax payments made in fiscal 2006 that were accrued but not paid in 2005. In addition, cash provided by operations before changes in non-cash working capital was lower in fiscal 2006 compared to fiscal 2005.

##### *FINANCING ACTIVITIES*

Cash used by financing activities was \$3.5 million in 2006 versus cash provided by financing activities of \$10.5 million in 2005. During 2006, the Company's financing activities consisted primarily of the issuance of shares for cash from the exercise of stock options, offset by cash used to repurchase the Company's shares through the Normal Course Issuer Bid, as well as cash used to repay the remainder of the amount due to Honeycomb Holdings Limited

recorded on the acquisition of Micropower. For the year ended October 31, 2006, the Company realized net proceeds of \$616,000 from the exercise of 516,000 stock options at an average exercise price of \$1.19, compared to net proceeds of \$1.4 million from the exercise of stock options in 2005.

The Fiscal 2005 private placement provided gross cash proceeds of \$11.0 million in exchange for 2,365,592 shares issued from treasury at a price of \$4.65 per share, to which there was no similar transaction in fiscal 2006. Cash applied to financing activities decreased by \$3.5 million in 2006 due to the repurchase of 1.1 million shares under the Normal Course Issuer Bid dated September 26, 2005. An additional decrease in cash from financing activities was due to a payment made to Honeycomb Holdings Limited under the purchase agreement for Micropower Corporation, which required Chartwell to make a payment of approximately \$613,000 in U.S. dollar equivalent. There were no other significant financing activities in 2006.

The private placement of shares completed in 2005 was for general corporate purposes and was not subject to commitments for liabilities or capital expenditures. The Company intends to utilize these funds for operating and general corporate purposes as needed.

### INVESTING ACTIVITIES

The Company's investing activities consisted mainly of the redemption of short term investments, an increase in deferred development costs, the purchase of property and equipment which includes computers and software for internal use and furniture and fixtures. Total cash provided by investing activities was \$829,000 compared to cash used in investing activities of \$16.1 million for the fiscal years ended October 31, 2006 and 2005, respectively. The Company redeemed \$4.1 million of short-term investments in 2006 compared to the purchase of \$11.9 million in short term investments during 2005 using cash provided by the private placement financing, which was not repeated in fiscal 2006. The Company purchased \$659,000 of property and equipment in 2006 versus the purchase of \$959,000 in property and equipment during 2005. Deferred software development costs in 2006 were \$2.6 million versus \$662,000 in 2005, representing investment in development of our Flash poker and poker community products, as well as the Company's mobile product. In fiscal 2005, expenditures on investing activities were through the business acquisition of Micropower, which represented a cash outlay of \$2.6 million.

### SELECTED QUARTERLY FINANCIAL DATA

The following table sets out selected unaudited financial information of the Company on a consolidated basis for the last eight quarters.

	<b>Fiscal 2006 Quarters</b>				
	(In Thousands except per share data)				
	(Certain numbers have been re-classified to conform with current period presentation)				
	<b>Q1</b>	<b>Q2</b>	<b>Q3</b>	<b>Q4</b>	<b>Annual</b>
<b>Revenue</b>					
Software license fees	\$ 4,275	\$ 4,449	\$ 4,383	\$ 4,367	\$17,474
Software set-up	51	65	69	111	296
Interest & other	115	243	211	224	793
	<u>4,441</u>	<u>4,757</u>	<u>4,663</u>	<u>4,702</u>	<u>18,563</u>
<b>Expenses</b>					
Software development & support	1,856	1,799	2,201	2,215	8,071
Sales & marketing	541	478	512	778	2,309
General & administrative	526	1,658	835	1,521	4,541
Amortization of deferred software development costs	59	59	59	58	235
Stock-based compensation	224	171	89	139	623
Depreciation & amortization	95	100	114	117	426
Amortization of intangible assets	123	123	123	124	493
Foreign currency loss (gain)	132	45	(68)	48	157
	<u>3,556</u>	<u>4,433</u>	<u>3,865</u>	<u>5,000</u>	<u>16,854</u>

**Fiscal 2006 Quarters**  
(In Thousands except per share data)  
(Certain numbers have been re-classified to conform with current period presentation)

<b>Net Income (loss) before taxes</b>	885	324	798	(298)	1,709
Income taxes (reduction)	382	223	322	(77)	850
<b>Net Income (Loss)</b>	<u>\$ 503</u>	<u>\$ 101</u>	<u>\$ 476</u>	<u>\$ (221)</u>	<u>\$ 859</u>

<b>Basic earnings (loss) per share</b>	\$ 0.03	\$ 0.01	\$ 0.03	\$ (0.01)	\$ 0.05
<b>Diluted earnings (loss) per share</b>	\$ 0.03	\$ 0.01	\$ 0.03	\$ (0.01)	\$ 0.05

**Fiscal 2005 Quarters**  
(In Thousands except per share data)

	Q1	Q2	Q3	Q4	Annual
<b>Revenue</b>					
Software license fees	\$ 4,622	\$ 3,630	\$ 4,028	\$ 4,113	\$ 16,393
Software set-up fees	115	125	348	69	657
Interest & other	78	122	132	467	799
	<u>4,815</u>	<u>3,877</u>	<u>4,508</u>	<u>4,649</u>	<u>17,848</u>
<b>Expenses</b>					
Software development & support	1,325	1,319	1,754	1,639	6,037
Sales & marketing	556	516	449	519	2,040
General & administrative	502	262	457	558	1,779
Amortization of intangible assets	-	-	19	86	105
Amortization of deferred software development costs	59	59	59	58	235
Stock-based compensation	118	91	198	230	637
Depreciation & amortization	36	68	54	102	260
Foreign currency loss (gain)	(20)	(15)	338	72	375
	<u>2,576</u>	<u>2,300</u>	<u>3,328</u>	<u>3,264</u>	<u>11,469</u>
<b>Net income before taxes</b>	2,239	1,577	1,180	1,385	6,381
Income taxes	753	643	452	534	2,382
<b>Net Income</b>	<u>\$ 1,486</u>	<u>\$ 934</u>	<u>\$ 728</u>	<u>\$ 851</u>	<u>\$ 3,999</u>
<b>Basic earnings per share</b>	\$ 0.09	\$ 0.05	\$ 0.04	\$ 0.04	\$ 0.22
<b>Diluted earnings per share</b>	\$ 0.08	\$ 0.05	\$ 0.04	\$ 0.04	\$ 0.20

## QUARTERLY RESULTS

### FOR THE THREE MONTHS ENDED OCTOBER 31, 2006 COMPARED TO THE THREE MONTHS ENDED OCTOBER 31, 2005.

#### REVENUE

In the three months ended October 31, 2006, total revenue was fairly consistent at \$4.7 million compared to \$4.6 million in the same period of 2005. License fees from new customers in 2006 was offset by a decrease in other revenues related to a software development services agreement completed for \$353,000 in the fourth quarter of 2005, to which there is no similar revenue in 2006.

Software license fees increased by 7.3% to \$4.4 million in the fourth quarter of 2006 compared to \$4.1 million in the fourth quarter of 2005. The net increase in license fees reflects the impact and growth of clients that began contributing to revenue in early fiscal 2006 and increased volume in the poker community offset by a decrease in revenues primarily from customers with exposure to the Italian market. Software set-up fees increased to \$111,000 from \$69,000 compared to a year earlier. Although Chartwell is receiving fewer and smaller individual set-up fees from new clients compared to the past, the increase during the period is due to several new clients launching their gaming sites in 2006, thus commencing amortization of the associated previously deferred revenue.

Interest and other income decreased to \$224,000 from \$467,000 for the three months ended October 31, 2006 and 2005, respectively. The decrease was attributable to a software development services agreement completed for

\$353,000 in the fourth quarter of 2005, to which there is no comparative revenue item in the fourth quarter of 2006. This decrease is offset by custom development services performed in the fourth quarter of 2006 for \$68,000 and higher interest revenues resulting from improved yields in the fourth quarter of 2006 versus the same period of 2005.

### ***OPERATING EXPENSES***

Total operating expenses increased by 51.5% to \$5.0 million for the three months ended October 31, 2006 compared to \$3.3 million for the same period of 2005.

During the three months ended October 31, 2006, higher levels of expenses were incurred for continued development of new casino and soft games, new poker game variants, marketing for the poker community, one-time customer credits for promotional and business related purposes, increased professional fees for corporate structure set-up and advice, as well as fees on a potential acquisition that was not concluded. In addition, a provision for a doubtful account receivable of \$276,000 was recorded on which legal action is currently being pursued.

### ***SOFTWARE DEVELOPMENT & SUPPORT***

Software development and support costs, net of deferred software development expenses of \$786,000, increased by 35.1% to \$2.2 million for the three months ended October 31, 2006 compared to \$1.6 million for the same period of 2005. This increase is mostly due to one-time customer credits for promotional and business related issues as well as increased hosting and support costs for the poker community. Salary and consulting expenses increased 8.5% for the three months ended October 31, 2006 compared to the same period of 2005, due to additions of development staff as well as salary increases to existing staff.

### ***SALES AND MARKETING***

Sales and marketing expenses increased by 49.9% to \$778,000 from \$519,000 for the three months ended October 31, 2006 compared the same period of 2005. The increase is attributable to costs incurred in the fourth quarter of 2006 for marketing events and customer related activity.

As a percentage of revenue, sales and marketing expenses increased to 16.5% from 11.2% for the three months ended October 31, 2006 and 2005, respectively.

### ***GENERAL AND ADMINISTRATIVE***

G&A expenses for the three months ended October 31, 2006 increased to \$1.5 million from \$558,000 in the same period of 2005. The main contributors to this increase in the fourth quarter of 2006 are significant professional fees for due diligence, tax advice, and other fees on a potential acquisition that was not concluded. Professional fees were also incurred for legal entity audits in Malta, corporate structure set-up and advice, as well as higher regulatory and compliance costs for the Company. In addition, a provision for a doubtful account receivable of \$276,000 was recorded for an account on which legal action is currently being pursued.

### ***AMORTIZATION OF DEFERRED SOFTWARE DEVELOPMENT COSTS***

Amortization of deferred software development costs for the three months ended October 31, 2006 was \$58,000, consistent with the \$58,000 recorded for the same period of 2005. The Company began amortizing costs related to the Company's poker product deferred costs in fiscal 2003 and 2004 on a straight line basis over their three year estimated life in the third quarter of fiscal 2004. As the amortization is being recorded on a straight-line basis, the amortization expense is consistent for these periods.

### ***STOCK-BASED COMPENSATION***

The Company recorded \$139,000 of stock-based compensation expense for the three months ended October 31, 2006 versus \$230,000 for the three months ended October 31, 2005. Stock-based compensation expense relates to the amortization of the fair value of stock options granted to employees, directors and consultants. Expenses are amortized over the vesting period of three to five years. The year over year decrease in the expense is due to fewer options issued and a higher level of option exercise and expiries, thus decreasing the number of options outstanding.

### ***DEPRECIATION & AMORTIZATION***

Depreciation and amortization increased by 14.7% to \$117,000 for the three months ended October 31, 2006 versus \$102,000 for the similar period of 2005. The increased depreciation expense is due to higher net book values of

property and equipment at October 31, 2006 versus October 31, 2005. It is expected that continued investment in computer hardware and software will be required as the Company continues to expand its operations in Malta.

#### *AMORTIZATION OF INTANGIBLE ASSETS*

Amortization of intangible assets is related to customer contracts and intellectual property acquired as part of the acquisition of Micropower. Amortization for the three months ended October 31, 2006 was \$124,000 compared to \$86,000 for 2005. The amount recorded for customer contracts is being amortized over the contract term for each acquired contract. The amount recorded for intellectual property is being amortized over five years, which is Management's best estimate of the time period that the acquired intellectual property will provide future value to Chartwell.

#### *FOREIGN CURRENCY LOSS*

The Company incurred a foreign currency loss of \$48,000 for the three months ended October 31, 2006 compared to a foreign currency loss of \$72,000 for the comparative period of 2005. The decrease in foreign currency losses during the fourth quarter of 2006 was due to a lower relative change in the value of the Canadian dollar against certain foreign currencies year over year. The Company does not utilize hedges or forward contracts to mitigate foreign currency risk.

#### *PROVISION FOR INCOME TAXES*

Income taxes for the three months ended October 31, 2006 were a tax recovery of \$(77,000) compared to tax expense of \$534,000 for the three months ended October 31, 2005. The decrease in the Company's tax expense reflects decreased income from operations due to significant one-time expenses incurred in the quarter.

#### *NET INCOME*

Net loss was \$221,000 for the three months ended October 31, 2006 versus net income of \$851,000 for the three months ended October 31, 2005. Although revenues showed modest growth in 2006 over 2005, the Company's expenses increased, in part, due to costs associated with poker support, marketing and community hosting costs; professional fees related to a proposed merger and corporate structure and regulatory compliance costs; and growth of expense base through new hires to support an expanded scale of business.

Diluted loss per share was \$0.01 for the three month period ended October 31, 2006 compared to diluted earnings per share of \$0.04 in the same period of 2005. The decrease in the diluted earnings per share in the fourth quarter of 2006 primarily reflects the impact of lower net income.

#### *CASH FLOW STATEMENT*

##### *OPERATING ACTIVITIES*

Cash used by operations for the three months ended October 31, 2006 was \$1.5 million compared to cash provided by operations of \$592,000 for the three months ended October 31, 2005. The decrease is mainly attributable to lower net income and a smaller reduction in the change in working capital due to a receivable from the Malta tax authorities for taxation refund in Malta for fiscal 2006, which was not the case in fiscal 2005.

##### *FINANCING ACTIVITIES*

Cash used in financing activities was \$141,000 for the three months ended October 31, 2006 versus cash used in financing activities for the three months ended October 31, 2005 of \$638,000. The Company's financing activities in the fourth quarter of 2006 consisted primarily of the issuance of shares for cash resulting from the exercise of stock options, offset by cash used to repurchase the Company's shares through the Normal Course Issuer Bid. There were no other significant financing activities in the fourth quarter of 2006.

##### *INVESTING ACTIVITIES*

Cash used in investing activities was \$1.9 million for the three months ended October 31, 2006 versus cash used in investing activities for the three months ended October 31, 2005 of \$77,000. The Company's investing activities in the fourth quarter of 2006 consisted mainly of the purchase of short term investments, deferred development costs

and the purchase of property and equipment which includes computers and software for internal use and furniture and fixtures.

### ***LIQUIDITY AND CAPITAL RESOURCES***

The Company continues to maintain a strong balance sheet. At October 31, 2006 the Company had no debt, \$12.8 million in cash and short term investments and working capital (defined as current assets less current liabilities) of \$17.8 million. The Company has cash and short term investments, as well as cash collected from ongoing license fees, to meet the Company's planned growth and development activities. The Company does not foresee any material fluctuation in its liquidity or working capital position and based on the present level of revenue and expense does not foresee any significant change to its working capital requirements. Contractual commitments are summarized in "Contractual Obligations" section.

The Company does not have commitments for capital expenditures as of October 31, 2006. The Company's capital resources consist of common share issuances.

### ***CONTRACTUAL OBLIGATIONS***

The Company's future minimum annual payments under operating and capital leases are the following:

2007	\$671,359
2008	\$637,078
2009	\$532,760
2010	\$ 69,616
2011	\$ 29,094
Thereafter	\$ 39,773

### ***RELATED PARTY TRANSACTIONS***

For the year ended October 31, 2006, the Company incurred the following related party costs: fees and disbursements of \$311,619 (2005 - \$125,090) pertaining to securities and corporate law billed from a Canadian national law firm, a partner of which is a director of the Company; legal fees of \$35,000 (2005 - \$60,250) pertaining to the Corporation's licensing agreements and commercial contracts billed from a partner of a Canadian law firm who is an officer of the Company; sales and marketing consulting fees of \$165,000 (2005 - \$165,000) as compensation paid to an officer of the Company for business development related activities on behalf of the Company; software development consulting fees of \$168,838 (2005 - \$126,338) paid to an immediate family member of an officer; and \$12,077 (2005 - nil) paid to an officer as a component of compensation in the normal course of business. These transactions were measured at the exchange amount and recorded in general and administrative, sales and marketing, and software development expenses, respectively. As at October 31, 2006, \$231,693 is recorded to accounts payable and accrued liabilities, while all other amounts have been paid. Amount due from related party of \$167,492 (2005 - \$157,997) is an amount due from a Company officer. The balance bears 6% interest, is secured by 189,200 common shares of the Company and has no set terms of repayment.

### ***CRITICAL ACCOUNTING POLICIES***

Critical accounting policies and methods used in the preparation of the Company's financial statements are described in note 1 to the consolidated financial statements of the Company for the year ended October 31, 2006. The Company has not effected any changes to its significant accounting policies during the two years ended October 31, 2006, except as follows:

#### **Stock-based Compensation**

Effective November 1, 2002, the Company adopted the Canadian standards for accounting for stock-based compensation and other stock-based payments. The recommendations require equity instruments awarded to employees and non-employees and the cost of the service received as consideration to be measured and recognized based on the fair value of the equity instruments issued. Compensation expense is recognized over the period of related employee service, usually the vesting period of the equity instrument awarded. In addition, the standards require that equity instruments issued to non-employees be recorded at their fair value at the date they are earned.

## ***CRITICAL ACCOUNTING ESTIMATES***

There are a number of critical estimates underlying the accounting policies the Company applies in preparing its financial statements. The following are those which management has determined to be material.

### ***Allowance for Doubtful Accounts***

The Company charges license fees to licensees based on their level of activity. Chartwell's licensees operate in a number of jurisdictions and currencies and are at various stages of maturity and liquidity in their business. As a result of these factors, collections cycles will vary between licensees. The Company's management exercises judgment in making collectibility assumptions on a customer-by-customer basis in determining whether receivables are collectible and in determining the appropriate allowance for doubtful accounts based on knowledge of the customer's payment history and expectation of collectibility.

### ***Deferred Development Costs***

The Company exercises judgment in the determination of the costs which meet the criteria for deferral and amortization under Canadian generally accepted accounting principles. These costs are estimated based on employee salaries applicable to development activities believed to meet the criteria and have future value to the Company. The amortization period is estimated based on the period of expected benefit to the Company.

### ***Goodwill and Intangible Assets***

The Company estimates future cash flows attributable to recorded goodwill and intangible assets for purposes of the evaluation of potential impairment based on its expectations of future market conditions. These estimates require the use of forward-looking assumptions based on past experience as well as future expectations arising from the Company's strategic and financial planning activities. Changes to these assumptions and future market conditions could result in changes to the impairment and recoverability assumption for these assets.

## ***RISKS AND UNCERTAINTIES***

Important risk factors that could cause actual results, performance or achievements to be materially different than past performance or those implied by forward looking statements include:

- Uncertainty as to the degree of new and continuing market acceptance of our products
- Our products could contain defects that lead to costs, damage of reputation or litigation
- Our dependence on customer performance
- Uncertainty regarding future profitability
- Uncertainty regarding the pricing, reporting and collection of accounts
- Risk associated with sales in foreign countries and government policy and regulation therein
- Our ability to diligently ensure that our customers operate in accordance with the terms of our license agreements that require observation of the laws of Canada and foreign countries
- Our ability to attract and retain key personnel

## ***PROPOSED TRANSACTIONS***

There is no proposed asset or business acquisition or disposition transactions pending as at October 31, 2006, except as noted below.

Subsequent to October 31, 2006 the Company concluded that it wished to acquire the business of poker and bingo community management from Elite Club Management N.V. ("ECM"), who is at present the community manager for the poker community. As part of the acquisition of the community management business of ECM, Chartwell has proposed that it will acquire hardware and software related to the provision of community management services. The Company proposes to enter into an agreement with ECM that, in part, acquires the hardware and software in consideration of satisfaction of approximately US\$577,000 of notes receivable. These arrangements are conditional on ECM's acceptance of proposed terms.

## ***OFF BALANCE SHEET ARRANGEMENTS***

As at October 31, 2006, the Company has not entered into any off balance sheet arrangements.

## ***FINANCIAL INSTRUMENTS AND OTHER INSTRUMENTS***

The Company's financial instruments consist of cash, short term investments, accounts receivable, notes receivable, amounts due from related parties, accounts payable and accrued liabilities, income taxes payable and capital lease obligations. The fair values of these financial instruments approximate their carrying values, except as noted below. It is management's opinion that the Company is not exposed to significant interest risk. The Company's credit risk lies in its accounts receivable and notes receivable where the balances due reflect a concentration among a relatively small number of accounts. The Company's short term investments consist of investments in low risk corporate and government bonds. A substantial portion of the Company's revenue is earned in foreign currencies and is exposed to currency fluctuations.

### **Notes Receivable**

The Company's notes receivable consists of a two promissory notes. The first is a US \$250,000 short term non interest bearing note due on demand from a customer under a Master License Agreement, which is measured at the note value converted to Canadian dollars at the year-end exchange rate which approximates its fair value. The Company expects payment on this note in the first quarter of 2007. In addition, a promissory note in the amount of \$662,313 bearing interest at 12% is due from another arm's length party. The terms of the promissory note require monthly payments of CDN \$20,000 to be made for the period from November 30, 2006 to July 31, 2007 and payment of the remaining outstanding balance, including accrued interest, to be made on August 31, 2007. At October 31, 2006, the fair value of the promissory note approximates its carrying value.

The Company does not use financial derivatives or "other financial instruments".

## ***OTHER MD&A REQUIREMENTS***

The Company evaluated the effectiveness and design of its disclosure controls and procedures for the period ended October 31, 2006, and based on this evaluation (which included testing of the key controls by examining evidence demonstrating their existence on a test basis) have determined these controls to be effective.

The Corporation's financial reporting procedures and practices have enabled the certification of Chartwell Technology Inc.'s annual filings in compliance with Multilateral Instrument 52-109 "Certification of Disclosure in Issuers' Annual and Interim Filings". Management has designed such internal controls over financial reporting to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements and other annual filings in accordance with Canadian Generally Accepted Accounting Principles, except as noted below.

Given the size of the Company, the evaluation of the design of internal controls over financial reporting for the Company resulted in the identification of the following weaknesses:

Management is aware that due to its relatively small scale of operations there is a lack of segregation of duties due to a limited number of employees dealing with accounting and financial matters. However, management has concluded that considering the employees involved and the control procedures in place, including management and Audit Committee oversight, risks associated with such lack of segregation are not significant enough to justify the expense associated with adding employees to clearly segregate duties.

Management is aware that in-house expertise to deal with complex taxation, accounting and reporting issues may not be sufficient. The Company requires outside assistance and advice on new accounting pronouncements and complex accounting and reporting issues, which is common with companies of a similar size.

There have been no significant changes to the Company's internal control over financial reporting that occurred during the most recent period that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

The Company has 18,682,855 common shares outstanding at January 26, 2007. If all of the Company's options were exercised, the Company would have 20,778,923 common shares outstanding.

The Company's 2006 Annual Information Form is available on [www.sedar.com](http://www.sedar.com).