Unaudited Condensed Consolidated Interim Financial Statements
(In Canadian dollars)

MORNEAU SHEPELL INC.

Three months ended March 31, 2016 and 2015
(Unaudited)

MORNEAU SHEPELL INC.

Unaudited Condensed Consolidated Interim Statements of Financial Position
(In thousands of Canadian dollars)
March 31, 2016 and December 31, 2015

	March 31, 2016	December 31, 2015
Assets		
Current assets:		
Cash	$ –	$ 1,900
Trade and other receivables	64,965	65,579
Unbilled fees	68,434	64,229
Income taxes receivable	–	721
Prepaid expenses and other	8,919	6,092
Cash and investments held in trust	12,919	12,449
Deferred implementation costs	6,003	5,440
Total current assets	161,240	156,410
Non-current assets:		
Unbilled fees	20	20
Deferred implementation costs	10,339	10,831
Capital assets	35,375	35,658
Intangible assets	230,649	233,305
Goodwill	316,642	316,834
Deferred tax asset	3,092	2,590
Total non-current assets	596,117	599,238
Total assets	$ 757,357	$ 755,648

MORNEAU SHEPELL INC.

Unaudited Condensed Consolidated Interim Statements of Financial Position
(In thousands of Canadian dollars)
March 31, 2016 and December 31, 2015

	March 31, 2016	December 31, 2015
Liabilities and Equity		
Current liabilities:		
Bank indebtedness (note 4)	$ 729	$ –
Trade and other payables	55,602	54,241
Income taxes payable	915	–
Deferred revenue	5,847	2,521
Insurance premium liabilities	12,919	12,449
Future consideration related to acquisitions (note 9)	2,479	1,043
Promissory notes	–	2,481
Dividends payable	3,120	3,120
Interest rate swaps (note 4)	1,782	1,906
Convertible debenture payable	73,985	–
Total current liabilities	157,378	77,761
Non-current liabilities:		
Long-term debt (note 4)	242,307	241,846
Convertible debenture payable	–	73,760
Interest rate swaps (note 4)	1,320	1,769
Future consideration related to acquisitions (note 9)	2,277	3,538
Other liabilities	13,504	13,552
Provisions	2,269	2,367
Deferred tax liability	40,298	39,941
Total non-current liabilities	301,975	376,773
Equity:		
Share capital	477,500	477,500
Contributed surplus	24,351	23,312
Equity component of convertible debenture	757	757
Accumulated other comprehensive loss	(4,635)	(2,850)
Deficit	(199,969)	(197,605)
Total equity	298,004	301,114
Total liabilities and equity	$ 757,357	$ 755,648

Commitments and contingencies (note 9)

See accompanying notes to the unaudited condensed consolidated interim financial statements.

MORNEAU SHEPELL INC.

Unaudited Condensed Consolidated Interim Statements of Income and Comprehensive Income
(In thousands of Canadian dollars, except per share amounts)
For the three months ended March 31, 2016 and 2015

	Three months ended March 31, 2016	2015
Operating revenue	$ 149,123	$ 138,392
Operating expenses:		
Salaries, benefits and contractors	102,966	94,629
Rent and occupancy	6,931	7,078
Office and administration	16,647	13,439
Depreciation and amortization	8,697	7,958
Total operating expenses	135,241	123,104
Finance costs (note 4)	3,949	3,525
Profit from operations before income taxes	9,933	11,763
Income taxes expense (recovery):		
Current	3,585	4,012
Deferred	(701)	(460)
Total income taxes	2,884	3,552
Profit for the period	7,049	8,211
Other comprehensive income (loss):		
Items that may be reclassified subsequently to profit:		
Effective portion of change in interest rate cash flow hedges	573	(2,564)
Foreign currency translation differences for foreign operations	(1,950)	114
Income taxes on the above items	(153)	683
	(1,530)	(1,767)
Items that will not be reclassified to profit:		
Actuarial gain/(loss) on post-employment benefit plans	(348)	54
Income taxes on the above item	93	(14)
	(255)	40
Other comprehensive loss, net of tax effect	(1,785)	(1,727)
Comprehensive income for the period	$ 5,264	$ 6,484
Earnings per share (note 6):		
Basic	$ 0.14	$ 0.17
Diluted	$ 0.14	$ 0.16

See accompanying notes to the unaudited condensed consolidated interim financial statements.

MORNEAU SHEPELL INC.

Unaudited Condensed Consolidated Interim Statements of Changes in Equity
(In thousands of Canadian dollars)
For the three months ended March 31, 2016 and 2015

2016	Share capital	Contributed surplus	Deficit	Accumulated other comprehensive loss	Equity component of convertible debenture	Total equity
Balance, January 1, 2016	$ 477,500	$ 23,312	$ (197,605)	$ (2,850)	$ 757	$ 301,114
Long-term incentive plan – expense and issuance	–	1,039	–	–	–	1,039
Profit for the period	–	–	7,049	–	–	7,049
Dividends	–	–	(9,413)	–	–	(9,413)
Other comprehensive loss	–	–	–	(1,785)	–	(1,785)
Balance, March 31, 2016	$ 477,500	$ 24,351	$ (199,969)	$ (4,635)	$ 757	$ 298,004

2015	Share capital	Contributed surplus	Deficit	Accumulated other comprehensive loss	Equity component of convertible debenture	Total equity
Balance, January 1, 2015	$ 474,490	$ 20,812	$ (176,555)	$ (1,484)	$ 757	$ 318,020
Long-term incentive plan – expense and issuance	–	1,156	–	–	–	1,156
Long-term incentive plan – redemption	131	(131)	–	–	–	–
Shares issued upon conversion of convertible debentures	24	–	–	–	–	24
Profit for the period	–	–	8,211	–	–	8,211
Dividends	–	–	(9,360)	–	–	(9,360)
Other comprehensive loss	–	–	–	(1,727)	–	(1,727)
Balance, March 31, 2015	$ 474,645	$ 21,837	$ (177,704)	$ (3,211)	$ 757	$ 316,324

See accompanying notes to the unaudited condensed consolidated interim financial statements.

MORNEAU SHEPELL INC.

Unaudited Condensed Consolidated Interim Statements of Cash Flows
(In thousands of Canadian dollars)
For the three months ended March 31, 2016 and 2015

	Three months ended March 31, 2016	Three months ended March 31, 2015
Operating activities:		
Profit for the period	$ 7,049	$ 8,211
Items not involving cash:		
Depreciation and amortization	8,697	7,958
Finance costs (note 4)	3,949	3,525
Long-term incentive plan expense	993	1,071
Income taxes	2,884	3,552
Change in provisions	(98)	527
Other	(395)	655
	23,079	25,499
Change in non-cash operating working capital (note 8)	(1,594)	(8,766)
Cash generated from operating activities	21,485	16,733
Finance costs paid	(4,462)	(4,225)
Income taxes paid	(1,701)	(2,083)
Cash provided by operating activities	15,322	10,425
Financing activities:		
Change in revolving loan (net)	382	8,326
Dividends paid	(9,413)	(9,360)
Repayment of promissory note	(2,500)	(2,500)
Cash provided by (used in) financing activities	(11,531)	(3,534)
Investing activities:		
Business acquisitions	(447)	(216)
Additions to intangible assets	(3,322)	(2,615)
Additions to capital assets	(2,651)	(3,277)
Cash used in investing activities	(6,420)	(6,108)
Increase/(decrease) in cash for the period	(2,629)	783
Cash/(Bank indebtedness), beginning of period	1,900	(5,171)
Bank indebtedness, end of period	$ (729)	$ (4,388)

See accompanying notes to the unaudited condensed consolidated interim financial statements.

1. Organization and nature of the business:

Morneau Shepell Inc. was incorporated pursuant to the laws of the Province of Ontario on October 19, 2010 and is a continuation of Morneau Sobeco Income Fund, which was converted from an income trust structure into Morneau Shepell Inc., effective January 1, 2011.

Morneau Shepell Inc. and its subsidiaries (the “Company”) provide health and productivity, administrative and retirement solutions to assist employers in managing the financial security, health and productivity of their employees. The Company’s principal and head office is located at One Morneau Shepell Centre, 895 Don Mills Road, Suite 700, Toronto, Ontario, M3C 1W3. The Company offers its services to organizations that are situated in Canada, in the United States and internationally.

References herein to the Company represent the financial position, results of operations, cash flows and disclosures of Morneau Shepell Inc. and its subsidiaries on a consolidated basis.

These unaudited condensed consolidated interim financial statements were approved by the Company's Board of Directors on May 9, 2016.

2. Basis of preparation:

These unaudited condensed consolidated interim financial statements for the three months ended March 31, 2016 and 2015 have been prepared in accordance with International Accounting Standards 34, Interim Financial Reporting, as issued by the International Accounting Standards Board ("IASB").

These interim financial statements do not include all the disclosures required by International Financial Reporting Standards ("IFRS") for annual consolidated financial statements and accordingly should be read in conjunction with the Company's audited consolidated financial statements for the year ended December 31, 2015 prepared in accordance with IFRS as issued by the IASB.

3. Significant accounting policies:

(i) Changes in accounting policies:

The accounting policies applied by the Company in these unaudited condensed consolidated interim financial statements are consistent with those applied by the Company in its consolidated financial statements as at and for the year ended December 31, 2015.

(ii) Future accounting changes:

IFRS 15, Revenue from Contracts with Customers (“IFRS 15”)

On May 28, 2014 the IASB issued IFRS 15. The new standard is effective for fiscal years beginning on or after January 1, 2018 and is available for early adoption. The standard contains a single model that applies to contracts with customers and two approaches to recognizing revenue: at a point in time or over time. The model features a contract-based five-step analysis of transactions to determine whether, how much and when revenue is recognized. New estimates and judgmental thresholds have been introduced, which may affect the amount and/or timing of revenue recognized. The Company intends to adopt IFRS 15 in its financial statements for the annual period beginning on January 1, 2018. The extent of the impact of adoption of the standard has not yet been determined.

IFRS 9, Financial Instruments (“IFRS 9”)

In July 2014 the IASB finalized IFRS 9. The standard is effective for fiscal years beginning on or after January 1, 2018 and is available for early adoption. The new standard includes revised guidance on the classification and measurement of financial assets, a new ‘expected loss’ impairment model and introduces a substantially-reformed approach to hedge accounting. The Company intends to adopt IFRS 9 in its financial statements for the annual period beginning on January 1, 2018. The extent of the impact of adoption of the standard has not yet been determined.

IFRS 16, Leases (“IFRS 16”)

In January 2016, the IASB issued IFRS 16. The standard is effective for annual periods beginning on or after January 1, 2019, with earlier adoption permitted for those entities that have also adopted IFRS 15. The new standard provides a comprehensive model for the identification of lease arrangements and their treatment in the financial statements. IFRS 16 supersedes IAS 17, Leases, and its associated interpretative guidance. IFRS 16 applies a control model to the identification of leases, differentiating between leases and service contracts on the basis of whether there is an identified asset controlled by the customer. Among other significant changes, the distinction between operating and finance leases is removed and assets and liabilities are recognized in respect of all leases. Furthermore, IFRS 16 requires a front-loaded pattern for the recognition of lease expense over the life of the lease. The Company intends to adopt IFRS 16 in its financial statements for the annual period beginning on January 1, 2019. The extent of the impact of adoption of the standard has not yet been determined.

(In thousands of Canadian dollars)

4. Long-term debt:

The Company's long-term debt obligations can be broken down as follows:

	March 31, 2016	December 31, 2015
Revolving loans	$ 242,838	$ 242,456
Less: debt issuance costs, net of accumulated amortization	(531)	(610)
	$ 242,307	$ 241,846

The Company has an amended credit facility agreement (the "Amended Credit Facility Agreement") maturing on November 29, 2017 which provides for a revolving facility of $300,000 (including a swing line of $7,000). At March 31, 2016, the Company had utilized the following amounts under the Amended Credit Facility Agreement:

- $228,000 of BA loans under the revolving loan. The BA loans are renewed on a monthly basis, bearing interest at the one-month BA rate plus an applicable margin of 1.70%.
- $2,500 of Prime loans under the revolving loan. The Prime loans are renewed on a monthly basis, bearing interest at the one-month Prime rate plus an applicable margin of 0.70%.
- $9,090 (U.S. $7,000) of US Libor loans under the revolving loan. The US Libor loans are renewed on a monthly basis, bearing interest at the one- month US Libor rate plus an applicable margin of 1.70%.
- $3,248 (U.S. $2,500) of US Base Rate loans under the revolving loan. The US Base Rate loans are renewed on a monthly basis, bearing interest at the one- month US Base Rate plus an applicable margin of 0.70%.
- $946 of the swing line available. The swing line carries interest at prime plus an applicable margin of 0.70%.

As at March 31, 2016, the Company complied with all the required financial covenants.

(a) Interest rate swaps:

The Company entered into a forward starting interest-rate swap agreement in February 2014 to hedge against the variable interest rate component on $160,000 notional amount borrowed under the Amended Credit Facility Agreement for the period from January 5, 2015 up to and ending November 29, 2017. The notional amount of this swap is $160,000 and is used to fix the variable component of the interest rate at 1.98%, before the applicable margin, for the duration of this period and has been designated as a cash flow hedge. The fair value of the interest rate swap at March 31, 2016 was a liability of $3,102 (December 31, 2015 - $3,675).

(In thousands of Canadian dollars)

5. Dividends:

The monthly dividend rate, approved by the Board of Directors, was $0.065 for the three months ended March 31, 2016 (2015 - $0.065). Dividends declared for the three months ended March 31, 2016 were $9,413. The Company continued to declare the same monthly dividend amount in April 2016.

6. Earnings per share:

Basic earnings per share was calculated by dividing profit attributable to common shareholders by the sum of the weighted average number of common shares outstanding during the period, plus vested LTIP awards.

Diluted earnings per share was calculated using the basic calculation described above, and adjusting for the potentially dilutive effect of total number of additional common shares that would have been issued by the Company on unvested LTIP awards and the conversion of the convertible debenture.

The following details the earnings per share, basic and diluted, calculations for the three months ended March 31, 2016 and 2015:

	Three months ended March 31 2016	2015
Profit attributable to common shareholders (basic and diluted)	$ 7,049	$ 8,211
Weighted average number of common shares (in number of shares):		
January 1	48,272,449	47,999,712
Shares issued on redemption of LTIP[1]	–	1,948
Shares issued upon conversion of convertible debentures[1]	–	1,388
Vested LTIP awards	1,498,384	1,262,729
Basic	49,770,833	49,265,777
Dilutive effect of unvested LTIP awards	645,891	752,385
Diluted	50,416,724	50,018,162
Earnings per share:		
Basic	$ 0.14	$ 0.17
Diluted	$ 0.14	$ 0.16

[1] During the three months ended March 31, 2016, nil (2015- 13,488 shares) were issued on redemption of LTIP units and nil (2015- 1,666 shares) were issued upon conversion of convertible debentures.

Due to its anti-dilutive effect, the potential issuance related to the convertible debenture has been excluded from the earnings per share calculation.

(In thousands of Canadian dollars)

7. Segmented information:

The Company provides health and productivity, administrative and retirement solutions to assist employers in managing the financial security, health and productivity of their employees. As at March 31, 2016, aggregation of operating segments was applied to determine that the Company had only one reportable segment.

The Company operates primarily within two geographical areas: Canada and the United States. The following details the revenues and total assets by geographical area, reconciled to the Company's unaudited condensed consolidated interim financial statements:

	Three months ended March 31, 2016	Three months ended March 31, 2015
Revenue:		
Canada	$ 129,880	$ 123,506
United States	19,243	14,886
Consolidated total	$ 149,123	$ 138,392

	March 31, 2016	December 31, 2015
Total assets:		
Canada	$ 705,675	$ 704,684
United States	51,682	50,964
Consolidated total	$ 757,357	$ 755,648

(In thousands of Canadian dollars)

8. Supplementary cash flow information:

Change in non-cash operating working capital for the three months ended March 31, 2016 and 2015 was as follows:

	2016	2015
Trade and other receivables	$ 613	$ (2,522)
Unbilled fees, current and non-current	(4,205)	(7,456)
Prepaid expenses and other	(2,827)	(2,802)
Deferred implementation costs, current and non-current	(493)	(2,844)
Trade and other payables	1,992	4,897
Deferred revenue	3,326	1,961
	$ (1,594)	$ (8,766)

9. Financial instruments:

Financial instruments carried at fair value:

Fair value represents management's estimates at a given point in time. The fair value of the Company's financial assets and liabilities, with the exception of convertible debentures and long-term debt, approximate their carrying values due to their short-term nature. The following table summarizes information regarding the carrying value, fair value and level used to determine the fair value measurement of the Company's financial assets and liabilities carried at fair value:

	Carrying Value and Fair Value		
	March 31, 2016	December 31, 2015	Level
Assets carried at fair value:			
Cash and investments held in trust	$ 12,919	$ 12,449	2
	$ 12,919	$ 12,449	
Liabilities carried at fair value:			
Bank indebtedness	$ 729	$ –	1
Interest rate swaps	3,102	3,675	2
Future consideration related to acquisitions	4,756	4,581	3
	$ 8,587	$ 8,256	

(In thousands of Canadian dollars)

During the three months ended March 31, 2016, there were no transfers between any levels.

The future consideration related to acquisitions is a financial instrument carried at fair value through profit or loss. The fair value of the future consideration related to these acquisitions is determined considering the estimated payment, discounted to present value. The total aggregate contingent consideration remaining to be paid for these acquisitions ranges from a contractual amount of $nil to maximum of $6,500.

The following table indicates the changes in the future consideration related to acquisitions during the three months ended March 31, 2016:

	Future consideration related to acquisitions
Balance at January 1, 2016	$ 4,581
Settlement of working capital adjustments for Bensigner Du Pont & Associates, Inc.	(231)
First instalment of contingent consideration for PAE Consultants Inc.	(216)
Foreign exchange on future consideration related to acquisitions	(210)
Fair value of future consideration for in-period acquisition and accretion	832
	$ 4,756

Financial instruments carried at amortized cost:

The carrying values of trade and other receivables, trade and other payables, insurance premium liabilities, and dividends payable are amortized cost and approximate their fair value because of their short-term nature.

The convertible debenture payable and long-term debt are financial instruments carried at amortized cost whose carrying values do not equal their fair market values. The convertible debenture payable has a carrying value of $73,985 (December 31, 2015 - $73,760) and a fair value of $86,117 (December 31, 2015 - $77,900). The fair value is determined using quoted market values (Level 1) for the convertible debentures at the end of the period. The long-term debt has a carrying value of $242,307 (December 31, 2015 - $241,846) and a fair value of $242,838 (December 31, 2015 - $242,456).). The fair value is determined based on the cost of borrowing for a company with a similar risk profile (Level 2).