

Consolidated Financial Statements
(In Canadian dollars)

MORNEAU SHEPELL INC.

Years ended December 31, 2014 and 2013



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INDEPENDENT AUDITORS' REPORT

To the Shareholders of Morneau Shepell Inc.

We have audited the accompanying consolidated financial statements of Morneau Shepell Inc., which comprise the consolidated statements of financial position as at December 31, 2014 and 2013, the consolidated statements of income and comprehensive income, changes in equity and cash flows for the years then ended, and notes, comprising a summary of significant accounting policies and other explanatory information.

Management's Responsibility for the Consolidated Financial Statements

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with International Financial Reporting Standards, and for such internal control as management determines is necessary to enable the preparation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

Auditors' Responsibility

Our responsibility is to express an opinion on these consolidated financial statements based on our audits. We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on our judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, we consider internal control relevant to the entity's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence we have obtained in our audits is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the consolidated financial statements present fairly, in all material respects, the consolidated financial position of Morneau Shepell Inc. as at December 31, 2014 and 2013, and its consolidated financial performance and its consolidated cash flows for the years then ended in accordance with International Financial Reporting Standards.

Chartered Professional Accountants, Licensed Public Accountants
March 2, 2015
Toronto, Canada

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MORNEAU SHEPELL INC.

Consolidated Statements of Financial Position

(In thousands of Canadian dollars)

December 31, 2014 and December 31, 2013

	December 31, 2014	December 31, 2013
Assets		
Current assets:		
Trade and other receivables (note 6)	\$ 74,372	\$ 67,194
Unbilled fees (note 7)	60,271	57,185
Income taxes receivable	1,677	–
Prepaid expenses and other (note 8)	4,451	3,761
Cash and investments held in trust	13,121	16,016
Deferred implementation costs (note 9)	6,388	4,134
Total current assets	160,280	148,290
Non-current assets:		
Unbilled fees (note 7)	400	1,251
Deferred implementation costs (note 9)	14,232	10,693
Capital assets (note 10)	34,459	22,858
Intangible assets (note 11)	235,625	221,957
Goodwill (note 12)	311,659	295,067
Total non-current assets	596,375	551,826
Total assets	\$756,655	\$700,116

MORNEAU SHEPELL INC.

Consolidated Statements of Financial Position

(In thousands of Canadian dollars)

December 31, 2014 and December 31, 2013

	December 31, 2014	December 31, 2013
Liabilities and Equity		
Current liabilities:		
Bank indebtedness (note 16)	\$ 5,171	\$ 5,195
Trade and other payables (note 13)	56,935	50,194
Income taxes payable	–	3,675
Deferred revenue	2,597	2,126
Insurance premium liabilities	13,121	16,016
Future consideration related to acquisitions (note 29)	810	821
Promissory notes (note 4)	2,481	–
Dividends payable	3,120	3,116
Interest rate swaps (note 16)	145	–
Total current liabilities	84,380	81,143
Non-current liabilities:		
Long-term debt (note 16)	222,435	175,647
Convertible debenture payable (note 17)	72,875	72,021
Interest rate swaps (note 16)	1,968	1,789
Future consideration related to acquisitions (note 29)	537	859
Promissory notes (note 4)	2,369	–
Other liabilities (note 14)	13,483	9,899
Provisions (note 15)	2,029	3,326
Deferred tax liability (note 19)	38,559	30,185
Total non-current liabilities	354,255	293,726
Equity:		
Share capital (note 22)	474,490	474,088
Contributed surplus (note 22)	20,812	16,514
Equity component of convertible debenture (note 17)	757	757
Accumulated other comprehensive loss (note 22)	(1,484)	(1,839)
Deficit	(176,555)	(164,273)
Total equity	318,020	325,247
Total liabilities and equity	\$756,655	\$700,116

Commitments and contingencies (notes 4, 28 and 29)

See accompanying notes to the consolidated financial statements.

On behalf of the Board:

"Robert Chisholm"
Audit Committee Chair

"Alan Torrie"
President & CEO

MORNEAU SHEPELL INC.

Consolidated Statements of Income and Comprehensive Income
(In thousands of Canadian dollars, except per share amounts)
Years ended December 31, 2014 and 2013

	2014	2013
Operating revenue	\$535,866	\$471,154
Operating expenses:		
Salary, benefits and contractors (note 27)	368,727	320,525
Depreciation, amortization and impairment losses (notes 10, 11 and 12)	33,947	44,385
Rent and occupancy	24,901	23,786
Office and administration	58,388	50,560
Total operating expenses	485,963	439,256
Finance costs (note 16)	14,582	14,098
Gain on business divestitures (note 5)	(1,763)	–
Profit from operations before income taxes	37,084	17,800
Income taxes (note 19):		
Current	9,611	5,548
Deferred	2,333	1,807
Total income taxes	11,944	7,355
Profit for the year	25,140	10,445
Other comprehensive income (loss):		
Items that may be reclassified subsequently to profit:		
Effective portion of change in interest rate cash flow hedges	(324)	1,312
Foreign currency translation differences for foreign operations	3	587
Reclassification of foreign currency translation differences on divestiture of foreign operations (note 5)	289	–
Income taxes on the above items	87	(345)
	55	1,554
Items that will not be reclassified to profit:		
Actuarial loss on post-employment benefit plans	405	(88)
Income taxes on the above item	(105)	24
	300	(64)
Other comprehensive income, net of tax effect	355	1,490
Comprehensive income for the year	\$ 25,495	\$ 11,935
Earnings per share (note 23):		
Basic	\$ 0.51	\$ 0.21
Diluted	\$ 0.51	\$ 0.21

See accompanying notes to the consolidated financial statements.

MORNEAU SHEPELL INC.

Consolidated Statements of Changes in Equity

(In thousands of Canadian dollars)

Years ended December 31, 2014 and 2013

2014	Share capital	Contributed surplus	Deficit	Accumulated other comprehensive loss	Equity component of convertible debenture	Total equity
Balance, January 1, 2014	\$ 474,088	\$ 16,514	\$ (164,273)	\$ (1,839)	\$ 757	\$ 325,247
Long-term incentive plan – issuance (notes 21 and 22)	–	4,630	–	–	–	4,630
Long-term incentive plan – redemption	332	(332)	–	–	–	–
Shares issued upon conversion of convertible debentures	70	–	–	–	–	70
Profit for the year	–	–	25,140	–	–	25,140
Dividends	–	–	(37,422)	–	–	(37,422)
Other comprehensive income (note 22)	–	–	–	355	–	355
Balance, December 31, 2014	\$ 474,490	\$ 20,812	\$ (176,555)	\$ (1,484)	\$ 757	\$ 318,020

2013	Share capital	Contributed surplus	Deficit	Accumulated other comprehensive loss	Equity component of convertible debenture	Total equity
Balance, January 1, 2013	\$ 473,838	\$ 12,674	\$ (137,322)	\$ (3,329)	\$ 757	\$ 346,618
Long-term incentive plan – issuance (notes 21 and 22)	–	4,090	–	–	–	4,090
Long-term incentive plan – redemption	250	(250)	–	–	–	–
Profit for the year	–	–	10,445	–	–	10,445
Dividends	–	–	(37,396)	–	–	(37,396)
Other comprehensive income (note 22)	–	–	–	1,490	–	1,490
Balance, December 31, 2013	\$ 474,088	\$ 16,514	\$ (164,273)	\$ (1,839)	\$ 757	\$ 325,247

See accompanying notes to the consolidated financial statements.

MORNEAU SHEPELL INC.

Consolidated Statements of Cash Flows

(In thousands of Canadian dollars)

Years ended December 31, 2014 and 2013

	2014	2013
Operating activities:		
Profit for the year	\$ 25,140	\$ 10,445
Items not involving cash:		
Depreciation, amortization and impairment losses (notes 10, 11 and 12)	33,947	44,385
Finance costs (note 16)	14,582	14,098
Long-term incentive plan expense (note 21)	4,515	3,653
Income taxes (note 19)	11,944	7,355
Change in provisions	(1,297)	1,907
Gain on business divestitures (note 5)	(1,763)	–
Other	3,805	(199)
	90,873	81,644
Change in non-cash operating working capital (note 25)	(14,598)	(23,920)
Cash generated from operating activities	76,275	57,724
Finance costs paid	(12,982)	(12,441)
Income taxes paid	(14,377)	(5,805)
Cash provided by operating activities	48,916	39,478
Financing activities:		
Credit facility agreement amendment fees (note 16)	–	(609)
Change in revolving loan (net)	46,513	22,740
Dividends paid	(37,422)	(37,396)
Cash provided by (used in) financing activities	9,091	(15,265)
Investing activities:		
Business acquisitions (note 4)	(29,757)	(7,495)
Business divestitures (note 5)	5,324	–
Additions to intangible assets	(13,879)	(12,125)
Additions to capital assets	(19,671)	(9,654)
Cash used in investing activities	(57,983)	(29,274)
Increase/ (decrease) in cash for the year	24	(5,061)
Bank indebtedness, beginning of year	(5,195)	(134)
Bank indebtedness, end of year	\$ (5,171)	\$ (5,195)

See accompanying notes to the consolidated financial statements.

MORNEAU SHEPELL INC.

Notes to Consolidated Financial Statements

(In thousands of Canadian dollars, except per share amounts)

Years ended December 31, 2014 and 2013

1. Organization and nature of the business:

Morneau Shepell Inc. was incorporated pursuant to the laws of the Province of Ontario on October 21, 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, whose 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 consolidated financial statements were approved by the Company's Board of Directors on March 2, 2015.

2. Basis of preparation:

(a) Statement of compliance:

The consolidated financial statements have been prepared in accordance with International Financial Reporting Standards ("IFRS").

(b) Basis of measurement:

The consolidated financial statements have been prepared on the historical cost basis except for the following material items in the consolidated statements of financial position:

- (i) interest rate swap is measured at fair value;
- (ii) future consideration related to acquisitions is measured at fair value; and
- (iii) net pension benefit liability measured in accordance with employee benefit policy

MORNEAU SHEPELL INC.

Notes to Consolidated Financial Statements (continued)

(In thousands of Canadian dollars, except per share amounts)

Years ended December 31, 2014 and 2013

(c) Functional currency:

These consolidated financial statements are presented in Canadian dollars, which is the Company's presentation currency and functional currency of Morneau Shepell Inc. Items included in the financial statements of each of Morneau Shepell Inc.'s subsidiaries are measured using their functional currency, which is the currency of the primary economic environment in which they operate in. Unless otherwise noted, all financial information presented herein is in thousands of Canadian dollars.

(d) Use of estimates and judgments:

The preparation of the consolidated financial statements requires management to make judgments, estimates and assumptions that affect the application of accounting policies and reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenue and expenses during the reporting year.

Estimated values of the reported amounts of assets and liabilities on the consolidated financial statements usually depend upon estimates of the profitability of the related business which, in turn, depend upon assumptions regarding future conditions in the general or specific industry, including the effects of economic cycles, and other factors that affect the operating revenue. These assumptions are limited by the availability of reliable comparable data, economic uncertainty and the uncertainty of predictions concerning future events. Accordingly, by their nature, estimates of fair value are subjective and do not necessarily result in precise determinations. Should the underlying assumptions change, the estimated value could change by a material amount, and actual results may differ from these estimates.

Estimates and underlying assumptions are reviewed by management on an ongoing basis, and revisions to accounting estimates are recognized in the period giving rise to the change.

Information about the most significant estimates and judgments that the Company is required to make is included in the following notes:

(i) Revenue recognition (outsourcing contracts) (note 3(c)):

Where a singular outsourcing contract requires the delivery of multiple components, the Company is required to assess the criteria for the recognition of revenue related to each component. These assessments require judgment by management to determine whether separately identifiable components exist, and where applicable, the appropriate fair value allocations to each. Amongst other factors, management considers whether implementation services are sold separately in the normal course of business, have stand-alone value to the customer, and look to budgeted salary costs associated with each phase of the service contract to derive fair value estimates.

MORNEAU SHEPELL INC.

Notes to Consolidated Financial Statements (continued)

(In thousands of Canadian dollars, except per share amounts)

Years ended December 31, 2014 and 2013

Additional discussion on the Company's revenue recognition policies can be found in note 3(c). Changes in management's estimates could affect the timing of recognizing the revenues and expenses associated with these contracts.

(ii) Unbilled fees (note 7):

The Company is required to assess the recoverability of fees on services provided but not yet billed. This assessment requires judgment by management to determine whether fees will be less than fully recoverable through invoicing. Amongst other factors, management considers the solvency of the client, the age of the outstanding unbilled fees balance, fee arrangement and historic client experience. If future billings differ from estimates, future profits could be materially affected.

(iii) Intangible assets (note 11):

(a) Internally-developed software:

The Company is required to estimate the expected period of benefit over which costs should be amortized. Management considers the anticipated rate and timing of technological obsolescence and competitive pressures, historical usage patterns, and internal business plans for the projected use of the software in deriving its useful life. Due to the rapidly changing technological environment and the uncertainty of the development processes themselves, future results could be affected if management's current assessment of future benefits materially differs from actual performance.

(b) Other intangible assets:

Other intangible assets consist of those acquired through business acquisitions. Purchase price allocations involve significant estimates and assumptions regarding cash flow projections, growth projections, economic risk, and cost of capital. If future events or results differ adversely from these estimates and assumptions, the Company could incur increased amortization or impairment charges in future periods.

(iv) Goodwill (note 12):

Goodwill impairment review involves significant estimates and assumptions regarding cash flow projections, growth projections, economic risk, and cost of capital. If future events or results differ adversely from these estimates and assumptions, the Company could incur impairment charges in future periods. Additional discussion on impairment of long-lived assets can be found in notes 11 and 12.

MORNEAU SHEPELL INC.

Notes to Consolidated Financial Statements (continued)

(In thousands of Canadian dollars, except per share amounts)

Years ended December 31, 2014 and 2013

(v) Trade receivables (allowance for doubtful accounts) (note 6):

The Company is required to assess whether accounts receivables are collectible from customers. Accordingly, management establishes an allowance for estimated losses arising from non-payment and delinquent accounts, current economic trends, and past experience. If future collections differ from estimates, future profits could be adversely affected.

(vi) Deferred income tax assets and liabilities (utilization of tax losses) (note 19):

Deferred tax assets are recognized for all unused tax losses and deductible temporary differences to the extent that it is probable that taxable profit will be available against which the losses and deductible temporary differences can be utilized. Significant management judgment is required to determine the amount of deferred tax assets that can be recognized, based upon the likely timing and the level of future taxable profits together with future tax planning strategies.

(vii) Provisions (note 15):

In identifying required provisions, the Company has to assess the probability of the future outflows of resources. Estimates must subsequently be made by management to approximate the timing and amount of these liabilities. If future events or results differ adversely from these estimates, future profits could be adversely affected.

(viii) Future consideration related to acquisitions (note 29):

The Company may pay future consideration related to acquisitions based upon performance measures contractually agreed at the time of purchase. Management estimates the future consideration payable based on underlying contract terms, and best estimates of the future performance of the acquiree. Depending on the future performance of the acquiree, management estimates of the amounts payable for future consideration related to acquisitions may materially differ from the consideration ultimately paid.

3. Significant accounting policies:

The accounting policies set out below have been applied consistently to all periods presented in these consolidated financial statements.

(a) Basis of consolidation:

(i) Business combinations:

Acquisitions of businesses are accounted for using the acquisition method. The acquisition cost is measured at the acquisition date at the fair value of the consideration transferred, including all contingent consideration.

MORNEAU SHEPELL INC.

Notes to Consolidated Financial Statements (continued)

(In thousands of Canadian dollars, except per share amounts)

Years ended December 31, 2014 and 2013

Subsequent changes in contingent consideration are accounted for through the statement of income and comprehensive income in accordance with the applicable standards.

Goodwill arising on acquisition is initially measured at cost, being the difference between the fair value of the consideration transferred including the recognized amount of any non-controlling interest in the acquiree and the net recognized amount (generally fair value) of the identifiable assets and liabilities assumed at the acquisition date. If the net of the amounts of the identifiable assets acquired and liabilities assumed exceeds the sum of the consideration transferred, the amount of any non-controlling interests in the acquiree and the fair value of the acquirer's previously held interest in the acquiree (if any), the excess is recognized immediately in profit or loss as a bargain purchase gain.

Acquisition-related costs, other than those that are associated with the issue of debt or equity securities that the Company incurs in connection with a business combination, are expensed as incurred.

(ii) Subsidiaries:

These consolidated financial statements include the assets, liabilities, revenue and expenses of all the Company's subsidiaries. Subsidiaries are entities that the Company controls either when it is exposed, or has rights, to variable returns from its involvement with the entity and has the ability to affect those returns through its power over the entity. Subsidiaries are consolidated from the date control is transferred to the Company, and de-consolidated from the date control ceases.

These consolidated financial statements include the assets, liabilities, revenue and expenses of all the Company's subsidiaries including the following operating entities:

	% Ownership
Morneau Shepell Ltd.	100.0
Morneau Shepell Limited	100.0
Morneau Shepell SBC Limited	100.0
Morneau Sobeco IT Solutions Inc.	100.0
1137273 Ontario Limited	100.0
Morneau Shepell Asset & Risk Management Ltd.	100.0
Morneau Shepell (Bahamas) Ltd.	100.0
Groupe AST (1993) Inc.	100.0

All intercompany transactions and balances between subsidiaries have been eliminated upon consolidation.

(b) Foreign currency translation:

Transactions denominated in currencies other than the functional currency are recorded at the exchange rates prevailing at the date of the transaction. At each reporting date, monetary assets and liabilities denominated

MORNEAU SHEPELL INC.

Notes to Consolidated Financial Statements (continued)

(In thousands of Canadian dollars, except per share amounts)

Years ended December 31, 2014 and 2013

in foreign currencies are translated at the rates prevailing as at that date. Non-monetary items that are measured in terms of historical cost in a foreign currency are not re-translated.

Assets and liabilities of subsidiaries with functional currencies other than the Canadian dollar are translated at period-end rates of exchange, and operating results are translated at average rates of exchange for the period. The resulting translation adjustments are included in accumulated other comprehensive income in shareholders' equity.

(c) Revenue recognition and unbilled fees:

Revenues include fees generated from outsourcing, consulting services, Employee Support Solutions ("ESS"), and absence management solutions contracts.

Generally, revenue from the rendering of services is recognized when the following criteria are met:

- (i) the amount of revenue can be reliably measured;
- (ii) the stage of completion can be reliably measured;
- (iii) the receipt of economic benefits is probable; and
- (iv) costs incurred and to be incurred can be reliably measured.

Concurrently with the above general principles, the Company applies the following specific revenue recognition policies:

Fees for outsourcing, actuarial and consulting services are billed either on a time-and-material basis or on a fixed-fee basis. Revenue is recognized as services are rendered and expenditures are incurred.

ESS revenue is recognized through a combination of the minimum contracted amount and incremental usage above the minimum thresholds. The minimum contracted amount is recognized on a basis consistent with provision of ESS services. Incremental usage is recognized when the minimum usage threshold is exceeded.

Absence management solutions revenue is recognized on a fixed-fee or time-and-material basis. On fixed-fee basis arrangements, where the provision of service is characterized by an indeterminate number of acts, revenue is recognized on a straight-line basis over the term of the contract. On time-and material basis arrangements, revenue is recognized as services are rendered and expenditures are incurred.

Outsourcing engagements typically involve both an implementation and administration component. Where a single contract requires the delivery of multiple components, revenue recognition criteria are applied to

MORNEAU SHEPELL INC.

Notes to Consolidated Financial Statements (continued)

(In thousands of Canadian dollars, except per share amounts)

Years ended December 31, 2014 and 2013

determine whether each component of the outsourcing contract qualifies for treatment as a separate unit of account. Multiple deliverable arrangements are determined to exist if both of the following criteria are met:

- (i) the delivered item has value to the customer on a stand-alone basis; and
- (ii) the fair value of the undelivered item can be reliably measured.

If these criteria are not met, deliverables (components) included in an arrangement are accounted for as a single unit of accounting and revenue is deferred and recognized on a basis consistent with elements of the service contract.

Unbilled fees represent fees earned for services rendered but not yet invoiced as at the reporting date; upon billing, this balance will be transferred to trade receivables. Unbilled fees on time and material basis arrangements are recorded at the lower of unbilled hours worked at normal billing rates and at the amount which is estimated to be recoverable upon invoicing. The Company maintains a provision for amounts expected to be unrecoverable.

Other sources of operating revenue include the following:

- (i) Investment income earned in the course of normal business operations, and is recorded on the accrual basis.
- (ii) Commissions income are recognized when earned, which is at the later of the billing or the effective date of the policy, net of a provision for return commissions due to policy cancellations or change of brokers.

(d) Deferred implementation costs and deferred outsourcing revenues:

Implementation costs incurred in connection with outsourcing service contracts, relate to those costs necessary to set up clients and their human resource or benefit programs onto the Company's systems and operating processes. Such costs may include internal and external costs for coding and customizing systems, client data conversion costs, and contract negotiation costs. For outsourcing contracts that are accounted for as a combined unit of accounting, specific, incremental, and direct costs, net of any revenue received from the implementation component, are deferred and amortized over the term of the service contract. For outsourcing contracts where each component is considered a separate unit of accounting, those costs are deferred and amortized over the remaining term of each component.

If a client terminates an outsourcing contract prior to its end, a loss on the contract may be recorded (if necessary), and any remaining deferred implementation revenues and costs would be recognized into income over the remaining implementation period through to the date of termination.

MORNEAU SHEPELL INC.

Notes to Consolidated Financial Statements (continued)

(In thousands of Canadian dollars, except per share amounts)

Years ended December 31, 2014 and 2013

(e) Cash and bank indebtedness:

Cash is comprised of bank balances and banker's deposit notes with an original maturity of three months or less, and are primarily held in Canadian and U.S. dollars. Where the cash is in a net overdraft position, it has been presented as bank indebtedness.

(f) Trade and other receivables:

Trade receivables are fees due from customers from the rendering of services in the ordinary course of business. Trade receivables are classified as current if payment is due within one year of the reporting period date, and are initially recognized at fair value and subsequently measured at amortized cost.

The Company maintains an allowance for doubtful accounts to provide for impairment of trade receivables. An impairment loss is recognized when there is evidence that the Company will not be able to collect the amount due under the original terms of the invoice. Expenses related to doubtful accounts are reported as office and administration expenses.

Other receivables are those amounts incidental to the Company's normal business operations and are classified as current when they are expected to be settled within one year of the reporting period date. Other receivables are initially recognized at fair value, and are subsequently measured at amortized cost, less impairment.

(g) Capital assets:

Capital assets are recognized at initial cost less accumulated depreciation and impairment losses.

Cost includes expenditures that are directly attributable to the acquisition of the asset, including those attributable to bringing the asset to its intended working condition. Where significant parts of a capital asset have different useful lives, they are accounted for and depreciated as separate components. Software, to the extent that it is integral to the operation of the related computer equipment, has been included as part of the cost of computer equipment.

Gains and losses on disposals of a capital asset item are determined by comparing the proceeds from disposal with its carrying amount, and is recognized as a gain (loss) on disposal in the consolidated statement of income and comprehensive income.

Depreciation is calculated over the depreciable amount, which is the cost of the asset less its residual value. Depreciation is recognized on a straight-line basis, over the assets' estimated useful lives, since this most closely reflects the expected pattern of consumption of the future economic benefits embodied in the asset. The estimated useful lives of the Company's capital assets are as follows:

MORNEAU SHEPELL INC.

Notes to Consolidated Financial Statements (continued)

(In thousands of Canadian dollars, except per share amounts)

Years ended December 31, 2014 and 2013

Computer hardware	3 - 5 years
Furniture and fixtures	5 years
Leasehold improvements	Over the term of the lease

Residual values, useful lives, and depreciation methods are reviewed at the end of each reporting period and adjusted prospectively as required.

(h) Intangible assets:

Intangible assets consist of customer relationships, customer contracts, proprietary software, clawback agreements and trade names acquired through acquisitions or business combinations, internally-developed software and purchased software.

Internally-developed software is recognized at the aggregate cost of all eligible development costs, when all the following criteria are met:

- (i) it is technically feasible to complete the software so that it will be available for use;
- (ii) management intends to complete the software and use or sell it;
- (iii) the Company is able to use or sell the software;
- (iv) future benefits associated with the software can be demonstrated;
- (v) adequate technical, financial, and other resources to complete the development and to use or sell the software are available; and
- (vi) the expenditures attributable to the software during its development can be reliably measured.

Eligible expenditures capitalized as part of internally-developed software include external direct costs of materials and services consumed in development, and payroll and payroll-related costs for employees who are directly associated with and who devote time to the development of the software. All costs incurred in the preliminary research stage of the projects are expensed as incurred.

Purchased software is recognized at initial cost.

Other intangible assets acquired as part of business acquisitions are measured initially at fair value.

MORNEAU SHEPELL INC.

Notes to Consolidated Financial Statements (continued)

(In thousands of Canadian dollars, except per share amounts)

Years ended December 31, 2014 and 2013

Intangible assets with a finite life are amortized on a straight-line basis over their estimated useful lives. Amortization is recognized over the assets' estimated useful lives as follows:

Customer relationships	15 - 20 years
Customer contracts	1 - 2 years
Proprietary software	5 - 10 years
Clawback agreements	10 years
Trade names	Indefinite
Internally-developed software	3 -10 years
Purchased software	3 years

Intangible assets with an indefinite life are not amortized, but are subject to impairment tests annually or whenever impairment indicators are identified. Trade names have been determined to have an indefinite life based on their strength, history, and expected future use.

Amortization expense has been presented in profit or loss as depreciation, amortization, and impairment losses. Assets are removed from asset and accumulated amortization balances once they become fully depreciated. Proceeds from disposals are netted against the related assets and accumulated amortization, and resulting gains and losses are included in profit or loss.

Amortization on internally-developed software does not commence until the asset is ready for use as management intended.

(i) Goodwill:

Goodwill represents the excess of the cost of the Company's business acquisitions over the fair value of the Company's share of the net identifiable assets of the acquired subsidiary at the date of acquisition. Goodwill is carried at cost less accumulated impairment charges, and is not amortized but is subject to an impairment test annually or whenever impairment indicators are identified.

(j) Impairment of non-financial assets:

The Company's identifiable tangible and intangible assets with finite useful lives are reviewed for indications of impairment at each statement of financial position date and when events or changes in circumstances indicate that they may be impaired. Impairments are recorded when the recoverable amount of assets are less than their carrying amounts. The recoverable amount is the higher of an asset's fair value less cost of disposal or its value in use.

Similarly, intangible assets with indefinite useful lives and goodwill are tested annually or whenever impairment indicators are identified, by estimating their recoverable amounts and comparing it to their

MORNEAU SHEPELL INC.

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carrying amounts. Where individual assets cannot be tested individually, they are grouped together into cash-generating units ("CGUs"), which represent the smallest group of assets that are capable of generating cash inflows from continuing use largely independent of other groups of assets, and tested on this basis. Goodwill acquired through a business combination is allocated to each CGU, or groups of CGUs but not larger than an operating segment, that are expected to benefit from the synergies of the combination.

An impairment loss is recognized if the carrying amount of the CGU exceeds its estimated recoverable amount. Impairment losses are recognized in profit or loss, and those impairment losses recognized in respect of CGUs are allocated first to reduce the carrying amount of any goodwill allocated to the CGU, and then to reduce the carrying amount of the other non-financial assets in the CGU on a pro rata basis.

Impairment losses in respect of goodwill are not reversed. In respect of other assets, impairment losses recognized in prior periods are assessed at each reporting date for any indications that the loss has decreased or no longer exists. An impairment loss is reversed if there has been a change in the estimates used to determine the recoverable amount, and only to the extent that the asset's carrying amount does not exceed the carrying amount that would have been determined, net of depreciation or amortization, had no impairment charge been recorded.

(k) Provisions:

Provisions are recognized when the Company has a present obligation to a third-party and it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation. The obligation may be legal, regulatory or contractual or it may represent a constructive obligation deriving from the Company's actions where, by an established pattern of past practice or published policies, the Company creates a valid expectation on the part of other parties that the Company will discharge certain responsibilities.

(l) Deferred revenue:

Deferred revenue represents the excess of retainer amounts billed over revenue earned on service contracts. The amount is amortized in profit or loss as services are rendered, in accordance with the revenue recognition policies described above.

(m) Convertible debentures:

Compound financial instruments issued by the Company comprise convertible debentures that can be converted to share capital at the option of the holder, and the number of shares to be issued does not vary with changes in their fair value.

The liability component of a compound financial instrument is recognized initially at the fair value of a similar liability that does not have an equity conversion option. The equity component is recognized initially as the

MORNEAU SHEPELL INC.

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difference between the fair value of the compound financial instrument as a whole and the fair value of the liability component. Any directly attributable transaction costs are allocated to the liability and equity components in proportion to their initial carrying amounts.

Subsequent to initial recognition, the liability component of a compound financial instrument is measured at amortized cost using the effective interest rate method. The equity component of a compound financial instrument is not remeasured subsequent to initial recognition.

Interest, losses and gains relating to the financial liability are recognized in profit or loss.

(n) Share capital:

Common shares are classified as an equity instrument. Incremental costs directly attributable to the issuance of common shares are recognized as a reduction of equity, net of the related tax effect.

(o) Insurance premium liabilities and related cash and investments:

In its capacity as consultants, the Company collects premiums from insurers and remits premiums, net of agreed deductions, such as taxes, administrative fees and commissions, to insurance underwriters. The cash and investment balances and the related liabilities have been presented separately in the Company's consolidated statements of financial position.

(p) Employee benefits:

Short-term employee benefit obligations are measured on an undiscounted basis and are expensed as the related service is provided.

The Company also offers a pension benefit plan for its eligible employees, which includes a defined benefit option and a defined contribution option.

A defined contribution plan is a post-employment benefit plan under which an entity pays fixed contributions into a separate entity and will have no legal or constructive obligation to pay further amounts. A defined benefit plan is a post-employment benefit plan other than a defined contribution plan.

(i) Defined benefit plan:

The liability recognized in the consolidated statements of financial position in respect of the defined benefit option is the present value of the defined benefit obligation at the end of the reporting period less the fair value of plan assets. The defined benefit obligation is calculated using the projected benefit method pro-rated on service. The present value of the defined benefit obligation is determined by discounting the estimated future cash outflows using interest rates of high-quality corporate bonds that are denominated in the currency

MORNEAU SHEPELL INC.

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in which the benefits will be paid, and that have terms to maturity approximating the terms of the related pension obligation. Past service costs are recognized immediately in profit or loss. Interest is recognized on the net defined benefit liability using market yields on high quality bonds.

(ii) Defined contribution plan:

Under the defined contribution option, each member is required to contribute a percentage of earnings. The Company matches this required contribution. Each member may elect to make an optional contribution in addition to the required contribution. The Company contributes 50% of the optional contributions.

For other members who had completed at least 10 years of service on December 31, 2010, their contributions follow the grandfathered provisions. Each member is required to contribute a specific dollar amount based on the member's job level classification. Each member may elect to make an optional contribution up to 300% of the member's required contribution. The Company matches required contributions and contributes 75% of optional contributions for grandfathered members and 50% for all other members.

The Company has no further payment obligations once the contributions have been paid. The contributions are recognized as employee benefit expense when they are due.

(q) Share-based compensation plan:

The Company offers an equity-settled compensation plan under which it receives services from employees as consideration for equity instruments of the Company. Under the long-term incentive plan ("LTIP"), the Company may grant participants restricted share units ("RSUs"), retirement deferred share units ("Retirement DSUs"), or post-retirement deferred share units ("Post-Retirement DSUs"), collectively referred to as "LTIP Units".

Expense related to LTIP Units is measured based on the fair value of the awards at grant date. The expense is recognized as salary, benefit and contractor expense over the vesting period, which is the period over which all of the specified vesting conditions are satisfied. As LTIP Units vest, they are issued to the participant and are recorded as share capital. At the option of the Company holders of LTIP Units are entitled to either additional LTIP Units as determined based on the fair market value of those LTIP Units on the date credited or cash bonuses equivalent to the dividends payable had those Units been common shares. LTIP Units credited under the dividend reinvestment policy ("DRIP") vest at the same rate as the LTIP Units to which they are determined. Cash bonuses are recorded as salary, benefit, and contractor expense.

At the end of each reporting period, the Company reassesses its estimates of the number of awards that are expected to vest and be forfeited, and recognizes the impact of any revisions into profit or loss.

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(r) Income taxes:

Income tax expense comprises current and deferred taxes. Current taxes and deferred taxes are recognized in profit or loss except to the extent that it relates to a business combination, or items recognized directly in equity or in other comprehensive income.

Current taxes are the expected tax payable or receivable on the taxable income or loss for the year, using tax rates enacted or substantively enacted at the reporting date, and any adjustment to tax payable in respect of previous years.

Deferred taxes are recognized in respect of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for taxation purposes.

Deferred taxes are not recognized for the following temporary differences: the initial recognition of assets or liabilities in a transaction that is not a business combination and that affects neither accounting nor taxable profit or loss, and differences relating to investments in subsidiaries and jointly controlled entities to the extent that it is probable that they will not reverse in the foreseeable future. In addition, deferred tax is not recognized for taxable temporary differences arising on the initial recognition of goodwill.

In determining the amount of current and deferred taxes, the Company takes into account the impact of uncertain tax positions and whether additional taxes and interest may be due. The Company believes that its accruals for tax liabilities are adequate for all open tax years based on its assessment of many factors, including interpretations of tax laws and prior experience. This assessment relies on estimates and assumptions and may involve a series of judgments about future events. New information may become available that causes the Company to change its judgment regarding the adequacy of existing tax liabilities; such changes to tax liabilities will impact tax expense in the period that such a determination is made.

Deferred taxes are measured at the tax rates that are expected to be applied to temporary differences when they reverse, based on the laws that have been enacted or substantively enacted by the reporting date. Deferred tax assets and liabilities are offset if there is a legally enforceable right to offset current tax liabilities and assets, and they relate to income taxes levied by the same tax authority on the same taxable entity.

A deferred tax asset is recognized for unused tax losses, tax credits and deductible temporary differences, to the extent that it is probable that future taxable profits will be available against which they can be utilized. Deferred tax assets are reviewed at each reporting date and are reduced to the extent that it is no longer probable that the related tax benefit will be realized.

(s) Financial instruments:

Financial assets and liabilities are recognized initially at fair value, defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the

MORNEAU SHEPELL INC.

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measurement date. In certain circumstances, however, the initial fair value may be based on other observable current market transactions in the same instrument, without modification or on a valuation technique using market based inputs. Subsequent measurement of the Company's financial assets and liabilities is dependent on their classification as held for trading, loans and receivables, other financial liabilities or derivative instruments.

The Company initially recognizes loans and receivables on the date that they originated. All other financial assets (including assets designated at fair value through profit or loss) are recognized initially on the trade date or when the Company becomes a party to the contractual provisions of the instrument.

The Company derecognizes a financial asset when the contractual rights to the cash flows from the asset expire, or it transfers the rights to receive the contractual cash flows on the financial asset in a transaction in which substantially all the risks and rewards of ownership of the financial asset are transferred. Any interest in transferred financial assets that is created or retained by the Company is recognized as a separate asset or liability.

Financial assets and liabilities are offset and the net amount presented in the consolidated statements of financial position, when and only when, the Company has a legal right to offset the amounts and intends either to settle on a net basis or to realize the asset and settle the liability simultaneously.

The Company assesses as at each reporting period whether there is objective evidence that a financial asset or group of financial assets is impaired. When an impairment has occurred, the cumulative loss is recognized into profit or loss. The cumulative loss is measured as the difference between the amortized cost and the current fair value, less any impairment loss previously recognized in profit or loss.

(i) Non-derivative financial assets:

(a) Financial assets at fair value through profit and loss:

Financial assets at fair value through profit and loss are comprised of cash and investments held in trust. A financial asset is classified at fair value through profit or loss if it is classified as held for trading or is designated as such upon initial recognition. Financial assets are designated at fair value through profit or loss if it is a part of an identified portfolio of financial instruments that the Company manages and has an actual pattern of short-term profit-taking. Upon initial recognition attributable transaction costs are recognized in profit or loss as incurred. Financial assets at fair value through profit or loss are measured at fair value at each reporting date, and any unrealized gains or losses from market fluctuations are recognized in profit or loss.

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(b) Loans and receivables:

Loans and receivables comprise trade and other receivables. Loans and receivables are financial assets with fixed or determinable payments that are not quoted in an active market. Such assets are recognized initially at fair value and subsequently measured at amortized cost using the effective interest method, less any impairment losses.

(ii) Non-derivative financial liabilities:

The Company initially recognizes debt securities issued and subordinated liabilities on the date that they originated. All other financial liabilities are recognized initially on the trade date at which time the Company becomes a party to the contractual provisions of the instrument.

Financial liabilities are recognized initially at fair value less any directly attributable transaction costs. Subsequent to initial recognition these financial liabilities are measured at amortized cost using the effective interest method. Financial liabilities are derecognized when the contractual obligations are discharged, cancelled or expire.

Non-derivative financial liabilities of the Company include long-term debt, convertible debenture payable, bank indebtedness, trade and other payables, promissory notes and insurance premium liabilities.

(iii) Derivative financial instruments:

Derivative financial instruments are used by the Company in the management of its interest rate risk exposure on debt financing. Derivatives that have been designated and function effectively as hedges are accounted for using hedge accounting principles (see note 3(t) below). Derivative financial instruments that are not accounted for as a hedging instrument are measured at fair value through profit or loss.

(iv) Fair value of financial instruments:

Fair values of financial instruments are classified into one of three levels in the fair value hierarchy according to the relative reliability of the inputs used to estimate the fair values. The three levels of the fair value hierarchy are:

- Level 1 - quoted prices (unadjusted) in active markets for identical assets or liabilities;
- Level 2 - inputs other than quoted prices included in Level 1 that are observable for the asset or liability, either directly or indirectly; and
- Level 3 - inputs for the asset or liability that are not based on observable market data.

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Each type of fair value is categorized based on the lowest level input that is significant to the fair value measurement.

(t) Cash flow hedge - derivative instruments:

Derivative instruments are initially recognized at fair value on the date the contract is entered into and are subsequently re-measured to fair value at each reporting date. The Company holds derivative instruments for hedging purposes only, and does not enter into derivative contracts for speculative purposes.

The Company prepares formal documentation at the inception of the transaction to detail the relationship between derivative hedging instruments and hedged items, as well as its risk management objectives and strategy in partaking in the hedging transaction. The Company also documents its assessment, both at hedge inception and on an ongoing basis, of whether the derivative used in hedging transactions is highly effective in offsetting the changes in cash flows of the hedged items.

Non-performance risk, inclusive of the Company's credit risk, is considered in determining the fair value of the financial instruments.

The Company has designated its derivative instruments as cash flow hedges. Cash flow hedges are hedges against highly probable forecasted transactions. The effective portion of changes in the fair value of derivatives that are designated as a cash flow hedge is recognized as a component of other comprehensive income. The gain or loss relating to the ineffective portion is recognized immediately into profit or loss. Amounts accumulated in other comprehensive income are recycled into profit or loss in the period in which the hedged item will affect profit or loss. When a hedge no longer meets the criteria for hedge accounting, any cumulative gain or loss in other comprehensive income remains in other comprehensive income and is recognized when the original forecasted transaction is ultimately recognized into profit or loss. If a forecasted transaction is no longer expected to occur, the cumulative gain or loss in other comprehensive income is immediately recognized into profit or loss.

(u) Changes in accounting policies:

The Company has adopted the following revised standards, along with any consequential amendments, effective January 1, 2014. These changes were made in accordance with the applicable transitional provisions.

(i) IAS 39, Financial Instruments ("IAS 39"):

An amendment to IAS 39 made it clear that there is no need to discontinue hedge accounting where a derivative hedging instrument has been novated to effect clearing with a central counterparty as a result of laws or regulation, provided specific conditions are met. Novation refers to where parties to a contract agree to replace their original counterparty with a new one. This amendment did not result in any changes to the Company's hedge accounting for any of its existing hedges.

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(ii) IAS 36, Impairment of Assets ("IAS 36"):

Amendments to IAS 36 cover recoverable amount disclosures for non-financial assets, including circumstances in which the recoverable amount of assets or cash-generating units ("CGUs") are required to be disclosed, clarification of the disclosures required, and the introduction of an explicit requirement to disclose the discount rate used in determining impairment or impairment reversals where the recoverable amount is determined using a present value technique. The adoption of these amendments to IAS 36 did not have a significant impact on the Company's existing disclosures for its impairment testing of its non-financial assets.

(v) Future accounting changes:

(i) 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 ending on or after December 31, 2017 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, 2017. The extent of the impact of adoption of the standard has not yet been determined.

(ii) 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.

4. Business acquisitions:

(a) Groupe AST (1993) Inc.:

On March 3, 2014, the Company completed the acquisition of 100% of the outstanding shares of Groupe AST (1993) Inc. ("Groupe AST") from ADP Canada Co. This acquisition complements the Company's existing workers' compensation practice in the Absence Management Solutions line of business. Acquiring Groupe AST will expand the Company's client base and market share in Quebec and nationally.

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The consideration for this acquisition included an initial payment of \$27,000 that was settled on closing, an additional \$686 in cash consideration for working capital adjustments, of which \$553 was settled in the second quarter of 2014 and the remainder is expected to be settled in the first quarter of 2015, and the issuance of promissory notes in the principal amount of \$5,000. The promissory notes are unsecured, non-interest bearing and had a fair value of \$4,664 upon issuance, with \$2,500 due on each of February 28, 2015 and 2016. The fair value of the promissory notes due on February 28, 2015 and 2016 on initial recognition was determined using market rates of interest of 4.70% and 4.80%, respectively, that would be charged on similar promissory notes issued by a company with a similar risk profile (Level 2 inputs on the fair value hierarchy). The promissory notes will be accreted to their principal amount due on maturity as finance costs through profit or loss. At December 31, 2014, \$4,850 has been recognized on the statement of financial position, representing the amortized cost of the promissory notes.

This acquisition has been accounted for using the acquisition method of accounting. During the third quarter of 2014 the Company finalized the purchase price allocation resulting from adjustments to working capital, intangible assets, goodwill, and the deferred tax liability. The final valuation increased the purchase consideration assigned to customer contract intangible assets which have a shorter amortization period than the intangible assets initially identified.

	Initial	Adjustments	Final
Cash	\$ 107	\$ –	\$ 107
Trade and other receivables	1,518	–	1,518
Prepaid expenses and other	65	–	65
Income taxes receivable	362	134	496
Capital assets	671	–	671
Intangible assets	24,612	(1,092)	23,520
Goodwill	14,766	937	15,703
Trade and other payables	(1,254)	–	(1,254)
Deferred revenue	(2,287)	–	(2,287)
Deferred tax liability	(6,338)	150	(6,188)
	\$ 32,222	\$ 129	\$ 32,351

The goodwill acquired is attributable primarily to the synergies expected to be achieved from integrating Groupe AST's workers' compensation practice into the Company's existing Absence Management Solutions line of business. The goodwill recognized is not expected to be deductible for tax purposes.

From the date of acquisition up to and including December 31, 2014, Groupe AST has contributed revenues of \$18,908 and profit of \$4,434. Had this acquisition occurred on January 1, 2014, the Company estimates that the consolidated revenues of the Company would have been higher by \$3,505 and consolidated profit would have remained unchanged. In determining these amounts, the Company has assumed that the fair value

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adjustments that arose on the acquisition date of Groupe AST would have been the same had the acquisition occurred on January 1, 2014.

(b) Other Acquisitions during year ended December 31, 2014

During the year the Company completed three other smaller strategic acquisitions. On March 31, 2014, the Company completed the acquisition of Pacific Risk Management Corp. ("PRM"), a workers' compensation provider in British Columbia. On July 4, 2014, the Company completed the acquisition of Blue Balloon Health Services ("Blue Balloon"), a privately-held group of professionals providing pediatric health-centered care in the Greater Toronto Area. Finally, on December 31, 2014 the Company completed the acquisition of D.A. Krieger Insurance Agency Ltd. ("Krieger"), a Health and Benefits consulting provider in Ontario. These acquisitions complement our Absence Management Solutions, Employee Support Solutions and Consulting lines of business. The total consideration for the above acquisitions was as follows:

PRM – amount paid on closing and settlement of working capital adjustments	\$ 489
Blue Balloon – amount paid on closing	500
Krieger – amount paid on closing	450
Future consideration, discounted	359
	<hr/> \$ 1,798

The future consideration is dependent on achieving certain revenue and/or earnings before interest, taxes, depreciation and amortization ("EBITDA") targets. At December 31, 2014, \$376 has been recognized as an acquisition liability on the statement of financial position, representing the fair value of future cash consideration discounted.

These acquisitions have been accounted for using the acquisition method of accounting. The allocation of the \$1,798 purchase consideration for these acquisitions is final, and is as follows:

Working capital	\$ 56
Intangible assets	1,131
Capital assets	60
Goodwill	622
Deferred tax liability	(71)
	<hr/> \$ 1,798

Goodwill arose on the Blue Balloon acquisition and is attributable primarily to the workforce and the synergies expected to be achieved from the ability to expand the Company's existing Children's Support Solutions

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portfolio. For the purpose of impairment testing, the goodwill amount has been included under the Employee Support Solutions CGU.

(c) Dion, Durrell + Associates Inc. workers' compensation practice:

On July 5, 2013, the Company acquired Dion, Durrell + Associates Inc. workers' compensation practice ("Dion Durrell Workers' Compensation"). This acquisition complements the Company's existing Organizational Health Solutions line of business, and expands the Company's market presence.

The consideration for this acquisition included an initial payment of \$3,754 that was settled on closing, and estimated future payments of cash and LTIP units totaling \$1,589 and \$250, respectively, due within 45 days of June 30 over three years commencing in 2014. The first instalment was satisfied through the payment of cash and issuance of LTIP units of \$320 and \$83, respectively, in the third quarter of 2014.

The remaining future payments of LTIP units will be settled in equal instalments of \$83. The remaining future instalments to be settled in cash have been revised and are dependent on achieving certain revenue targets. The Company expects to pay cash consideration of \$528 in year two, and \$559 in year three, based on revenues for Dion Durrell that are projected to grow in the range of 3.0% to 5.0% over the next two years. At December 31, 2014, \$906 has been recognized as an acquisition liability on the statement of financial position, representing the two expected cash instalments discounted. Future payments of \$167 to be settled through the issuance of LTIP units of the Company have been recognized in contributed surplus on the statement of financial position.

This acquisition has been accounted for using the acquisition method of accounting. The allocation of the \$5,041 purchase consideration is final and is as follows:

Customer relationships	\$ 4,587
Clawback agreements	155
Goodwill	668
Trade and other payables	(72)
Deferred tax liability	(297)
	<hr/> \$ 5,041

The goodwill acquired is attributable primarily to the Dion Durrell workforce, and the synergies expected to be achieved from integrating the workers' compensation practice into the Company's Absence Management Solutions business. For the purpose of impairment testing, the goodwill amount has been included under the Absence Management Solutions CGU.

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(d) Collage Pediatric Therapy Centre Inc.:

On August 30, 2013, the Company completed the acquisition of Collage Pediatric Therapy Centre Inc. ("Collage Pediatric Therapy") which specializes in providing multidisciplinary health services to children. This acquisition complements the Company's existing Children's Support Solutions portfolio, and will expand the Company's market presence. The consideration for this acquisition consisted of a cash payment of \$948 that was settled on closing.

This acquisition has been accounted for using the purchase method of accounting. The final purchase price allocation is as follows:

Prepaid expenses and other	\$ 31
Capital assets and intangibles	311
Goodwill	632
Deferred tax asset	128
Trade and other payables	(154)
	<hr/> \$ 948

The goodwill is attributable primarily to the workforce and the synergies expected to be achieved from the ability to expand the Company's existing ESS Children's Support Solutions portfolio services across Canada. For the purpose of impairment testing the goodwill amount has been included under the ESS CGU.

5. Business divestitures:

During 2014, the Company completed a strategic review of its clinic-based occupational health operations and made the decision to exit the business. The Company closed some locations and sold the remainder of the business and health clinic locations, including its 48% and 70% interest held in Innu-Med Inc. and FGI World New Caledonia, respectively. The assets and liabilities disposed of were comprised of the following:

Cash	\$ 376
Trade and other receivables	5,774
Unbilled fees	356
Prepaid expenses and other	40
Capital assets	78
Intangible assets	176
Trade and other payables	(900)
Income taxes payable	(15)
	<hr/> \$ 5,885

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The consideration for the sale is preliminary, pending finalization of contractual adjustments including for working capital and customer contracts sold. The sales price includes cash consideration of \$5,700 that was received during the third quarter, future cash consideration including adjustments for working capital and customer contracts of \$568 that is expected to be settled in the first quarter of 2015, and a \$2,000 holdback receivable. The holdback receivable is included in Trade and other receivables on the statements of financial position and is expected to be received within 10 days of August 29, 2015. Its fair value on initial recognition of \$1,860 was determined using a market rate of interest of 7.5% that would be received on a similar holdback receivable due from a company with a similar risk profile as the purchaser (Level 2 inputs on the fair value hierarchy). The holdback receivable will be accreted to its gross amount receivable on maturity as a reduction of finance costs through profit or loss.

Total selling costs for the divestiture of the Health Clinics sub-service line were \$191. The gain recognized through profit or loss for the divestiture, including reclassification of foreign currency translation differences on the divestiture of FGI World New Caledonia from accumulated other comprehensive income, was \$1,763.

6. Trade and other receivables:

The Company's trade and other receivables are as follows:

	December 31, 2014	December 31, 2013
Trade receivables	\$ 71,847	\$ 66,671
Less allowance for doubtful accounts	(803)	(728)
Net trade receivables	71,044	65,943
Other receivables	3,328	1,251
	<u>\$ 74,372</u>	<u>\$ 67,194</u>

The aging of trade receivables at each reporting date was as follows:

	December 31, 2014	December 31, 2013
Current	\$ 24,693	\$ 30,601
Past due 1 - 30 days	19,049	16,241
Past due 31 - 90 days	11,883	8,308
Past due > 90 days	16,222	11,521
	<u>\$ 71,847</u>	<u>\$ 66,671</u>

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The change in allowance for doubtful accounts was as follows:

Balance, January 1, 2013	\$	418
Additions		415
Amounts written off as uncollectible		(105)
Balance, December 31, 2013		728
Additions		482
Amounts written off as uncollectible		(407)
Balance, December 31, 2014	\$	803

7. Unbilled fees:

The Company's unbilled fees are as follows:

	December 31, 2014	December 31, 2013
Total unbilled fees	\$ 60,671	\$ 58,436
Less non-current portion	400	1,251
Current portion	\$ 60,271	\$ 57,185

8. Prepaid expenses and other:

The Company's prepaid expenses and other comprise the following:

	December 31, 2014	December 31, 2013
Vendor prepayments and prepaid insurance	\$ 3,367	\$ 2,744
Prepaid deposits	771	690
Prepaid supplies	313	327
	\$ 4,451	\$ 3,761

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9. Deferred implementation costs:

The Company's deferred implementation costs comprise the following:

	Cost	Accumulated amortization	Net book value
Balance, January 1, 2013	\$ 16,737	\$ (3,709)	\$ 13,028
Deferred implementation costs for the year, net of revenue	5,427	–	5,427
Amortization for the year	–	(3,628)	(3,628)
Balance, December 31, 2013	22,164	(7,337)	14,827
Deferred implementation costs for the year, net of revenue	10,877	–	10,877
Amortization for the year	–	(5,084)	(5,084)
Balance, December 31, 2014	\$ 33,041	\$ (12,421)	\$ 20,620
Less current portion			6,388
Non-current portion			\$ 14,232

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10. Capital assets:

The Company's capital assets comprise the following:

	Computer hardware	Furniture and fixtures	Leasehold improvements	Total
Cost				
Balance, January 1, 2013	\$ 19,832	\$ 10,091	\$ 21,633	\$ 51,556
Additions	6,706	976	3,324	11,006
Acquired through business acquisitions (note 4)	21	81	201	303
Disposals	(3,594)	(3,096)	(2,607)	(9,297)
Balance, December 31, 2013	22,965	8,052	22,551	53,568
Additions	6,632	2,473	10,566	19,671
Acquired through business acquisitions (note 4)	38	632	61	731
Disposals	(347)	(21)	(618)	(986)
Effect of movements in exchange rates	195	152	223	570
Balance, December 31, 2014	\$ 29,483	\$ 11,288	\$ 32,783	\$ 73,554
Accumulated depreciation				
Balance, January 1, 2013	\$ 12,273	\$ 6,402	\$ 11,608	\$ 30,283
Depreciation	4,879	1,488	2,869	9,236
Impairment charges (note 12)	–	100	388	488
Disposals	(3,594)	(3,096)	(2,607)	(9,297)
Balance, December 31, 2013	13,558	4,894	12,258	30,710
Depreciation	5,134	1,303	2,756	9,193
Disposals	(289)	(21)	(618)	(928)
Effect of movements in exchange rates	63	21	36	120
Balance, December 31, 2014	\$ 18,466	\$ 6,197	\$ 14,432	\$ 39,095
Carrying amount				
December 31, 2013	\$ 9,407	\$ 3,158	\$ 10,293	\$ 22,858
December 31, 2014	\$ 11,017	\$ 5,091	\$ 18,351	\$ 34,459

MORNEAU SHEPELL INC.

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11. Intangible assets:

The Company's intangible assets comprise the following:

	Indefinite useful life		Finite useful life					Total
	Trade names	Customer relationships	Customer contracts	Proprietary software	Internally-developed software	Purchased software	Other	
Cost								
Balance, January 1, 2013	\$ 70,000	\$ 203,539	\$ 27,900	\$ 43,497	\$ 18,935	\$ 10,186	\$ –	\$ 374,057
Internally Developed	–	–	–	–	8,747	–	–	8,747
Purchased	–	–	–	–	–	3,378	–	3,378
Acquired through business acquisitions	–	4,587	–	–	–	–	155	4,742
Disposals	–	–	(27,900)	(41,000)	(865)	(2,966)	–	(72,731)
Balance, December 31, 2013	70,000	208,126	–	2,497	26,817	10,598	155	318,193
Internally Developed	–	–	–	–	9,336	–	–	9,336
Purchased	–	–	–	1,500	–	3,043	–	4,543
Acquired through business acquisitions	–	19,931	4,720	–	–	–	–	24,651
Disposals	–	(1,992)	–	–	(516)	–	–	(2,508)
Effects of movements in exchange rates	–	–	–	95	–	17	–	112
Balance, December 31, 2014	\$ 70,000	\$ 226,065	\$ 4,720	\$ 4,092	\$ 35,637	\$ 13,658	\$ 155	\$ 354,327

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	Indefinite useful life		Finite useful life					Other	Total
	Trade names	Customer relationships	Customer contracts	Proprietary software	Internally-developed software	Purchased software			
Accumulated amortization									
Balance, January 1, 2013	\$ –	\$ 67,786	\$ 27,900	\$ 41,147	\$ 2,820	\$ 6,079	–	\$ 145,732	
Amortization	–	12,220	–	333	3,271	2,617	8	18,449	
Impairment charges (note 12)	–	4,794	–	–	–	–	–	4,794	
Disposals	–	–	(27,900)	(41,000)	(865)	(2,974)	–	(72,739)	
Balance, December 31, 2013	–	84,800	–	480	5,226	5,722	8	96,236	
Amortization	–	12,992	4,259	250	4,214	3,024	15	24,754	
Disposals	–	(1,816)	–	–	(516)	–	–	(2,332)	
Effects of movements in exchange rates	–	–	–	19	–	25	–	44	
Balance, December 31, 2014	\$ –	\$ 95,976	\$ 4,259	\$ 749	\$ 8,924	\$ 8,771	\$ 23	\$ 118,702	
Carrying amount									
Balance, December 31, 2013	\$ 70,000	\$ 123,326	\$ –	\$ 2,017	\$ 21,591	\$ 4,876	\$ 147	\$ 221,957	
Balance, December 31, 2014	\$ 70,000	\$ 130,089	\$ 461	\$ 3,343	\$ 26,713	\$ 4,887	\$ 132	\$ 235,625	

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As at December 31, 2014, \$5,281 (2013 - \$8,659) of internally-developed software remained under development and had not been put into use.

Impairment test of indefinite-lived intangible assets:

The Company has determined, in accordance with IAS 36, that it has the following seven CGUs: Retirement Solutions and Health and Benefits Consulting ("Consulting") - East, Consulting - Ontario, Consulting - West, Consulting - Québec, Administrative Solutions, ESS, and Absence Management Solutions (formerly named Organizational Health Solutions).

The fair value of the trade names, which are included in the ESS CGU, was based on the relief-from-royalty method. This method recognizes that the Company does not have to pay a royalty fee as a result of owning the trade names. The fair value of the trade names is then calculated as the present value of the after-tax savings from not having to pay a royalty.

Based on this method, the recoverable amount of the trade names was calculated as \$86,570 (2013- \$86,470). As the recoverable amount of the trade names exceeded their carrying amount for the years ended December 31, 2014 and December 31, 2013 no impairment charges were recorded. Significant assumptions used in the trade names impairment test include the projected revenues, the royalty rate, the projected royalty revenue growth rates and the discount rate, which are all Level 3 inputs in the fair value hierarchy.

The details of the significant assumptions used were as follows:

	December 31, 2014	December 31, 2013
Royalty revenue rate	3.5%	3.9%
Discount rate	9.6%	10.1%
Perpetuity growth rate	3.0%	3.0%

The projected revenues to which to apply the royalty rate were based on internal revenue forecasts for the Company's CGUs that used the trade names. The royalty revenue rate was then derived based on the internal projected pre-tax profitability rate of the CGUs that use the trade names, adjusted for an estimate of the percentage that an assumed licensor and licensee of the trade names would be willing to share.

The Company has also performed a sensitivity analysis on the perpetuity growth rate and discount rate in assessing the recoverable amounts of the trade names as at December 31, 2014 and 2013. Sensitivity analysis indicates reasonable changes to key assumptions will not result in an impairment loss for the trade names.

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Notes to Consolidated Financial Statements (continued)

(In thousands of Canadian dollars)

Years ended December 31, 2014 and 2013

12. Goodwill:

(i) The change in goodwill was as follows:

Balance, January 1, 2013	\$ 304,988
Acquired through business combination – Dion, Durrell Workers' Compensation	668
Acquired through business combination – Collage Pediatric Therapy	632
Impairment loss – Organizational Health Solutions	(11,418)
Effect of movement in exchange rates	197
Balance, December 31, 2013	295,067
Acquired through business combination – Groupe AST	15,703
Acquired through business combination – Blue Balloon	622
Effect of movement in exchange rates	267
Balance, December 31, 2014	\$ 311,659

(ii) Impairment test of goodwill

For the purposes of impairment testing, goodwill has been allocated to the Company's lines of business, which represent the Company's operating segments and the lowest level within the Company at which goodwill is monitored for internal management purposes, as defined in IAS 36. The aggregate carrying amount of goodwill allocated to each prior to the recognition of any impairment charges was as follows:

	December 31, 2014	December 31, 2013
Consulting	\$ 113,536	\$ 113,536
Administrative Solutions	64,514	64,247
Employee Support Solutions	117,906	117,284
Absence Management Solutions	15,703	11,418
	\$ 311,659	\$ 306,485

Goodwill impairment is assessed on an annual basis or whenever there is an indication that the asset may be impaired. The valuation techniques, significant assumptions and sensitivities applied in the goodwill impairment test as at December 31, 2014 and December 31, 2013 are described below.

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(a) Valuation technique:

The recoverable amount of each CGU was calculated based on its fair value less costs of disposal, using an income approach to estimate its fair value. The recoverable amount of each CGU was as follows:

	December 31, 2014	December 31, 2013
Consulting	\$ 395,400	\$ 322,000
Administrative Solutions	310,500	238,600
Employee Support Solutions	372,900	378,000
Absence Management Solutions	72,500	18,500
	<u>\$1,151,300</u>	<u>\$ 957,100</u>

The income approach is predicated upon the value of the future cash flows that the business is expected to generate going forward. The discounted cash flow ("DCF") method was used which involved projecting cash flows and converting them into a present value equivalent through discounting. The discounting process uses a rate of return that will commensurate with the risks associated with the business and the time value of money. This approach requires assumptions about revenue growth rates, operating margins, prevailing tax rates, and discount rates, which are Level 3 inputs based on the fair value hierarchy.

The significant assumptions and sensitivities of this methodology considered are described below.

(b) Growth and EBITDA margins

The assumptions used were based on the Company's internal forecasts. The Company projected revenue, EBITDA margins, working capital, and capital expenditures for a period of five years, and applied a perpetual long-term growth rate thereafter. Customer retention rates, past experience, economic trends (i.e. GDP, CPI, interest rate, and unemployment rate projections), and human resource industry and market trends were also considered in deriving these forecasts. A perpetuity growth rate of 3.0% (2013: 3.0%) was applied in determining the recoverable amount of the CGUs.

(c) Discount rate:

A discount rate was required in order to calculate the present value of projected cash flows. The discount rate represented a weighted average cost of capital ("WACC") applicable to each CGU. The WACC is an estimate of the overall required after-tax rate of return on investment required by all investors of capital and serves as the basis for developing the appropriate discount rate. Determination of the discount rate requires separate analysis of the cost of equity and debt, and considers a market risk premium based on an assessment of specific risks related to the projected cash flows of each CGU. Discount rates represent the volatility

MORNEAU SHEPELL INC.

Notes to Consolidated Financial Statements (continued)

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assessment of expected cash flows based on past performance, competition, market conditions, and other factors.

The following discount rates were applied in determining the recoverable amount of the CGU:

	December 31, 2014	December 31, 2013
Consulting	9.9%	9.8%
Administrative Solutions	11.0%	9.8%
Employee Support Solutions	9.6%	10.1%
Absence Management Solutions	11.4%	12.1%

The recoverable amounts of the Consulting, Administrative Solutions, and ESS CGUs assessed as at December 31, 2014 and 2013, were in excess of their respective carrying amounts, and the recoverable amount of the Absence Management Solutions CGU assessed as at December 31, 2014 was in excess of its carrying amount.

As at December 31, 2013, the carrying amount of the Organizational Health Solutions CGU was higher than its recoverable amount of \$18,500 and an impairment loss of \$16,700 was recognized.

The impairment loss was first allocated to reduce the goodwill of this CGU by \$11,418 to \$nil, and then to the non-current assets of this CGU as follows:

	December 31, 2014	December 31, 2013
Capital assets (note 10)	\$ –	\$ 488
Intangible assets (note 11)	–	4,794
	\$ –	\$ 5,282

The impairment loss is included in depreciation, amortization and impairment losses on the consolidated statement of income and comprehensive income.

The impairment loss was primarily related to the Health Clinics sub-service line within the formerly named Organizational Health Solutions CGU and was due to the reduced expectations for increasing the operating profit. After recognition of the impairment loss in 2013, the carrying amount of the formerly named Organizational Health Solutions CGU was equal to its recoverable amount.

The Company has also performed a sensitivity analysis on the perpetuity growth rate and discount rate in assessing the recoverable amounts of each of the CGUs. Sensitivity analysis indicates reasonable changes to key assumptions will not result in an impairment loss for these other CGUs.

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13. Trade and other payables:

The Company's trade and other payables comprise the following:

	December 31, 2014	December 31, 2013
Trade payables and accrued liabilities	\$ 25,133	\$ 23,181
Accrued salaries and compensation	28,996	24,577
Other current liabilities	2,806	2,436
	<u>\$ 56,935</u>	<u>\$ 50,194</u>

14. Other liabilities:

The Company's other liabilities were as follows:

	December 31, 2014	December 31, 2013
Acquired above-market leases	\$ 2,304	\$ 2,887
Deferred lease obligations	10,821	6,130
Net pension benefit liability (note 20)	358	882
	<u>\$ 13,483</u>	<u>\$ 9,899</u>

15. Provisions:

The Company has recognized sublease loss provisions associated with the lease of excess office space, and for expenditures related to contingency reserves on legal matters that the Company may become aware of in the normal course of operations. The sublease loss provision has been initially measured at the discounted present value of the minimum rental payments liable on the subleased properties and related commissions, net of sublease income related to these premises, and subsequently measured at best estimate. The estimate of the contingency reserve corresponds to the expenditure likely to be incurred by the Company to settle its obligation.

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Years ended December 31, 2014 and 2013

	December 31, 2014	December 31, 2013
Contingency reserve	\$ 561	\$ 449
Sublease loss provisions	1,468	2,877
	\$ 2,029	\$ 3,326

The following tables present the movement in provisions for the years ended December 31, 2014 and 2013:

	Sublease loss provisions	Contingency reserve	Total provisions
Balance, January 1, 2013	\$ 1,028	\$ 391	\$ 1,419
Accrual	2,000	189	2,189
Utilization and amortization	(151)	(131)	(282)
Balance, December 31, 2013	\$ 2,877	\$ 449	\$ 3,326
Accrual	–	202	202
Utilization and amortization	(1,409)	(90)	(1,499)
Balance, December 31, 2014	\$ 1,468	\$ 561	\$ 2,029

16. Long-term debt:

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

	December 31, 2014	December 31, 2013
Revolving loans	\$ 223,240	\$ 176,720
Less: debt issuance costs, net of accumulated amortization	(805)	(1,073)
	\$ 222,435	\$ 175,647

The Company had a credit facility agreement (the "Original Credit Facility Agreement") with a term of four years, maturing on January 5, 2015 which was amended on November 29, 2013. The second amended and restated credit facility agreement (the "Amended Credit Facility Agreement") matures on November 29, 2017 and provides for a revolving facility of \$250,000 (including a swing line of \$7,000).

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Under IAS 39, the amendments to the Original Credit Facility Arrangement were not substantive and therefore, amounts owing under the Original Credit Facility at the date of amendment were not deemed to be extinguished.

The interest rates for the Amended Credit Facility are floating, based on a margin over certain referenced rates of interest. The applicable margin may vary up or down depending on the ratio of the Company's consolidated Debt to Adjusted EBITDA as calculated in the Amended Credit Facility Agreement.

The Amended Credit Facility is secured by a general assignment of all the assets of the Company and requires the Company to maintain, on a consolidated basis, a Debt to Adjusted EBITDA financial covenant of not more than 3.0:1.0 and an EBITDA to interest expense ratio of not less than 3.0:1.0.

In the calculation of the consolidated Debt to Adjusted EBITDA financial covenant under the Amended Credit Facility Agreement, Debt excludes the Convertible Debenture Payable.

EBITDA in the Amended Credit Facility Agreement is defined as profit before finance costs, income taxes, depreciation, amortization, non-controlling interest, and non-recurring gains or losses. Adjusted EBITDA is defined as EBITDA plus the pro-forma EBITDA from permitted acquisitions' entities.

At December 31, 2014, the Company had utilized the following amounts under the Amended Credit Facility:

- \$216,500 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 1.875%.
- \$5,000 of prime loans under the revolving loan. The prime loan bears interest at the prime rate plus an applicable margin of 0.875%.
- \$1,160 (U.S. \$1,000) of Libor loans under the revolving loan. The Libor loan is renewed on a monthly basis, bearing interest at the one-month Libor rate plus an applicable margin of 1.875%.
- \$580 (U.S. \$500) of US Base Rate loans under the revolving loan. The US Base Rate loan is renewed on a monthly basis, bearing interest at the one-month US Base Rate plus an applicable margin of 0.875%.
- \$600 of the swing line available. The swing line carries interest at prime plus an applicable margin of 0.875%.

As at December 31, 2014, the Company complied with all the required financial covenants.

(a) Interest rate swaps:

The Company had entered into an interest-rate swap agreement to hedge against the variable interest rate component of the term loan outstanding. The notional amount of the swap is \$130,000, for the period from February 1, 2011 up to and ending January 5, 2015. This swap is used to fix the variable component of the

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interest rate at 2.48%, before the applicable margin, for the duration of the term and has been designated as a cash flow hedge.

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 swaps at December 31, 2014 was a liability of \$2,113 (December 31, 2013 - \$1,789).

On November 29, 2013 the term loan was converted into a revolving loan under the Amended Credit Facility. As detailed above, the amendments to the Original Credit Facility were not considered substantive and therefore the variable interest payments on the term loan, the hedged item under the designated cash flow hedge, were not deemed to be extinguished under IAS 39. Therefore, the designated cash flow hedge was not required to be discontinued on the date of amendment of the Original Credit Facility Arrangement.

(b) Finance costs:

The Company's finance costs comprise the following:

	2014	2013
Interest on term loan, revolving loan, bank indebtedness and other charges	\$ 8,696	\$ 8,065
Interest on convertible debenture	4,529	4,528
Amortization of debt issuance costs	986	1,143
Other	371	362
	\$ 14,582	\$ 14,098

17. Convertible debentures:

On March 27, 2012, the Company issued \$75,000 principal amount of 5.75% Convertible Unsecured Subordinated Debentures for net proceeds of \$71,432. The debentures pay interest semi-annually on March 31 and September 30, commencing with the initial interest payment on September 30, 2012 and have a maturity date of March 31, 2017. The debentures are convertible at the option of the holder to common shares at a conversion price of \$15.00 per common share.

The Company has the option to redeem the debentures on and after March 31, 2015 and at any time prior to March 31, 2016 at a redemption price equal to 100% of their principal amount plus accrued and unpaid interest

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provided that the weighted average trading price for the 20 consecutive trading days ending five days preceding the date on which the notice of redemption is given is at least 125% of the conversion price of \$15.00. On and after March 31, 2016, but prior to the maturity date, the debentures will be redeemable at a redemption price equal to 100% of their principal amount plus accrued and unpaid interest. On redemption or maturity the Company may elect to repay the principal and satisfy its interest obligations by issuing common shares.

Upon issuance of the debentures, the liability component of the convertible debentures was recognized initially at the fair value of a similar liability that does not have an equity conversion option, using an effective interest rate of 6.1%. The difference between these two amounts of \$1,079 has been recorded as equity with the remaining \$73,921 allocated to long-term debt.

The discount on the debentures is being accreted such that the liability at maturity will equal to its face value. The transaction costs of \$3,568 were proportionally allocated to the liability and equity components.

The convertible debenture has been allocated as follows:

	March 27, 2012
Long-term liability, net of transaction costs	\$ 70,404
Equity component, net of transaction costs and deferred tax	757
Deferred tax on equity component of convertible debentures	271
Transaction costs	3,568
Face value	\$ 75,000

The following table indicates the changes in the convertible debentures during the years ended December 31, 2014 and 2013:

	Debt component	Equity component
Balance January 1, 2013	\$ 71,104	\$ 757
Accretion and amortization on convertible debentures	917	-
Balance, December 31, 2013	72,021	757
Accretion and amortization on convertible debentures	924	-
Conversion of convertible debentures	(70)	-
Balance, December 31, 2014	\$ 72,875	\$ 757

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18. Financial instruments:

(a) Financial risk management:

The Company's financial instruments are exposed to certain financial risks, including interest rate risk, credit risk, currency risk and liquidity risk. The Company's exposure to these risks and its methods of managing the risks remain consistent.

(i) Interest rate risk:

The Company's exposure to the risk of changes in market interest rates relates primarily to the Company's long-term debt obligations with floating interest rates. Specifically, the Company is subject to interest rate risk as its long-term debt bears interest at market rates. Interest rate swap agreements are used as part of the Company's program to manage the floating interest rate mix of the Company's total debt outstanding and related overall cost of borrowing.

The interest-rate swap agreements involve the periodic exchange of payments without the exchange of the notional principal amount upon which the payments are based.

Interest rate sensitivity analysis:

A sensitivity analysis that assumes interest rates increased or decreased by 50 basis points with all other variables held constant would result in an increase or decrease of the Company's interest expense, excluding the interest subjected to interest rate swap agreements, by \$448 (2013 - \$214).

(ii) Credit risk:

The Company's exposure to credit risk is limited to the carrying amount of cash and accounts receivable recognized at the reporting date.

No allowance for credit losses on financial assets was required as of December 31, 2014, other than the allowance for doubtful accounts (note 6). The Company determines its allowance for doubtful accounts based on its best estimate of the net recoverable amount by customer account. Accounts that are considered uncollectible are written off. The Company's bad debt expense for the year ended December 31, 2014 was \$482 (2013 - \$415).

The Company believes that the credit risk of accounts receivable is limited for the following reasons:

- (a) Risk associated with concentration of credit risk with respect to accounts receivable is limited due to the credit rating of the Company's top 10 clients.

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(In thousands of Canadian dollars)

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(b) Management regularly reviews and assesses customer accounts and credit risk. Historically, bad debt as a percentage of revenue has been minimal.

The credit risk on cash and investments held in trust is limited because the counterparties are banks with high credit ratings assigned by international credit-rating agencies.

(iii) Currency risk:

The Company realizes a portion of sales in U.S. dollars and has operations in the United States and thus is exposed to fluctuations in the value of the U.S. dollar relative to the Canadian dollar. Morneau Shepell Inc.'s U.S. operation's functional currency is the U.S. dollar. Any fluctuations in the value of the U.S. dollar relative to the Canadian dollar on the Company's U.S. operation's net assets will result in a change in other comprehensive income for the year. The net revenue exposure after accounting for related expenses denominated in U.S. dollars for the year ended December 31, 2014 was \$13,073 (2013 - \$16,669).

Foreign exchange sensitivity analysis:

As at December 31, 2014, the Company's net exposure to currency risk through its current assets and liabilities denominated in U.S. dollars was U.S. \$10,081. An appreciation (depreciation) of the Canadian dollar against the U.S. dollar would have resulted in an increase (decrease) of \$585 in the Company's profit and other comprehensive income as a result of the Company's net exposure to currency risk through its current assets and liabilities denominated in U.S. dollars. This analysis is based on a foreign currency exchange rate variance of 5% which the Company considered to be reasonably possible at the end of the reporting period. The analysis assumes that all other variables, in particular interest rates, remain constant.

(iv) Liquidity risk:

Liquidity risk is the risk that the Company is not able to meet its financial obligations as they fall due. The Company manages liquidity risk through regular monitoring of financial results and actual cash flows, and also the management of its capital structure and financial leverage as outlined in note 30.

The Company's principal liquidity needs arise from working capital requirements, debt servicing and repayment obligations, capital expenditures, dividends to shareholders and acquisition funding requirements. The Company has historically utilized cash from operations to satisfy the above needs, with the exception of acquisition funding requirements.

The tables below set forth non-derivative and derivative financial liabilities by maturity based on the remaining period from December 31 to the contractual maturity date. The amounts disclosed are the contractual undiscounted cash flows.

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2014	<1 year	1 - 2 years	3 -5 years
Non-derivative financial liabilities:			
Bank indebtedness	\$ 5,171	\$ -	\$ -
Trade and other payables	56,935	-	-
Dividends payable	3,120	-	-
Insurance premium liabilities	13,120	-	-
Future consideration related to acquisitions	810	537	-
Long-term debt	-	-	223,240
Convertible debentures	-	-	74,929
Promissory notes	2,481	2,369	-
Derivative financial liabilities:			
Cash flow hedges - interest rate swaps	145	1,968	-
	\$ 81,782	\$ 4,874	\$ 298,169

2013	<1 year	1 - 2 years	3 -5 years
Non-derivative financial liabilities:			
Bank indebtedness	\$ 5,195	\$ -	\$ -
Trade and other payables	50,194	-	-
Dividends payable	3,116	-	-
Insurance premium liabilities	16,016	-	-
Future consideration related to acquisitions	821	457	402
Long-term debt	-	-	176,720
Convertible debentures	-	-	75,000
Derivative financial liabilities:			
Cash flow hedges - interest rate swaps	-	1,789	-
	\$ 75,342	\$ 2,246	\$ 252,122

It is not expected that the cash flows included in the maturity analysis could occur significantly earlier, or at significantly different amounts.

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(b) Fair values:

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		
	December 31, 2014	December 31, 2013	Level
Assets carried at fair value:			
Cash and investments held in trust	\$ 13,121	\$ 16,016	2
	\$ 13,121	\$ 16,016	
Liabilities carried at fair value:			
Bank indebtedness	5,171	5,195	1
Interest rate swaps	\$ 2,113	\$ 1,789	2
Future consideration related to acquisitions	1,347	1,680	3
	\$ 8,631	\$ 8,664	

Fair value hierarchy:

Below is a discussion of the Company's determination of fair value for financial instruments carried at fair value. The three levels of fair value hierarchy are defined as follows:

- Level 1: quoted prices (unadjusted) in active markets for identical assets or liabilities;
- Level 2: inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly; and
- Level 3: inputs for the asset or liability that are not based on observable market data

During the year ended December 31, 2014, there were no transfers between any levels.

The interest rate swaps are financial instruments carried at fair value through other comprehensive income.

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(In thousands of Canadian dollars)

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The future consideration related to acquisitions is a financial instrument carried at fair value through profit or loss. Contingent consideration arose on the acquisitions of SBC Systems Company, Dion Durrell Workers' Compensation, Blue Balloon, PRM and Krieger.

In the acquisitions of Dion Durrell Workers' Compensation, PRM and Krieger, there is a clause that entitles the seller to an amount based on exceeding revenue targets. In the acquisition of Blue Balloon there are clauses that entitle the seller to an amount based on exceeding certain EBITDA and revenue targets.

The fair value of the future consideration related to these acquisitions is determined considering the estimated payment, discounted to present value. The contingent consideration remaining to be paid for these acquisitions ranges from a contractual amount of \$nil to a contractual maximum as follows:

	December 31, 2014	December 31, 2013
SBC Systems Company	\$ –	\$ 532
Dion Durrell Workers' Compensation	1,636	2,146
Blue Balloon	200	–
Krieger	300	–
PRM	100	–
	<u>\$ 2,236</u>	<u>\$ 2,678</u>

The estimated payment is calculated considering different scenarios of projected revenue and EBITDA, and the amount to be paid under each scenario, weighted by the probability of each scenario. The key unobservable inputs include anticipated revenue and EBITDA, and the discount rate. The estimated fair value increases the higher the annual revenue and EBITDA, and the lower the discount rate, with estimated payments being limited to a contractual maximum for each of the Dion Durrell Workers' Compensation, PRM, Blue Balloon and Krieger acquisitions.

Management considers that changing the above mentioned unobservable inputs to reflect other reasonably possible alternative assumptions would not result in a significant change in the estimated fair value.

The following table indicates the changes in the future consideration related to acquisitions during the year ended December 31, 2014:

MORNEAU SHEPELL INC.

Notes to Consolidated Financial Statements (continued)

(In thousands of Canadian dollars)

Years ended December 31, 2014 and 2013

	Future consideration related to acquisitions
Balance at January 1, 2014	\$ 1,680
Fair value of future consideration for acquisitions	492
Settlement of final contingent consideration for SBC Systems Company	(552)
First instalment contingent consideration for Dion Durrell Workers' Compensation	(320)
Accretion on future consideration related to acquisitions	209
Foreign exchange on future consideration related to acquisitions	22
Re-measurement of future consideration related to acquisitions	(184)
	<u>\$ 1,347</u>

Financial instruments carried at amortized cost:

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

The promissory notes are financial instruments carried at amortized cost whose carrying value approximates their fair value. The fair value is determined based on the market rate of interest that would be charged on similar promissory notes issued by a company with a similar risk profile (Level 2).

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 \$72,875 (December 31, 2013 - \$72,021) and a fair value of \$88,416 (December 31, 2013 - \$81,930). 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 \$222,435 (December 31, 2013 - \$175,647) and a fair value of \$223,240 (December 31, 2013 - \$176,720). The fair value is determined based on the cost of borrowing for a company with a similar risk profile (Level 2).

MORNEAU SHEPELL INC.

Notes to Consolidated Financial Statements (continued)

(In thousands of Canadian dollars)

Years ended December 31, 2014 and 2013

19. Income taxes:

The income taxes recognized in profit or loss comprise the following:

	2014	2013
Current tax expense:	\$ 9,611	\$ 5,548
Deferred tax expense:		
Origination and reversal of temporary differences	2,329	1,648
Effect of changes in tax rates	4	159
	2,333	1,807
Total income tax expense	\$ 11,944	\$ 7,355

The difference between income taxes calculated using the Company's effective income tax rates and the amounts that would result from the application of the statutory income tax rates arises from the following:

	2014	2013
Income taxes at statutory rates:		
Federal	15.00%	15.00%
Provincial	11.65%	11.66%

	2014	2013
Income tax provision applied to profit before income taxes:		
Combined basic federal and provincial income taxes at statutory rates	\$ 9,883	\$ 4,745
Non-deductible expenses	1,767	1,342
Adjustment to deferred income taxes and liabilities for change in income tax rate	4	159
Non-deductible portion of goodwill impairment	–	760
Other	290	349
	\$ 11,944	\$ 7,355

MORNEAU SHEPELL INC.

Notes to Consolidated Financial Statements (continued)

(In thousands of Canadian dollars)

Years ended December 31, 2014 and 2013

The income taxes recognized on components of other comprehensive income are as follows:

	Before taxes	Tax expense (benefits)	2014 Net of taxes
Change in fair value of interest rates swaps	\$ (324)	\$ 87	\$ (237)
Actuarial gain on post-employment benefit plans	405	(105)	300
	\$ 81	\$ (18)	\$ 63

	Before taxes	Tax expense (benefits)	2013 Net of taxes
Change in fair value of interest rates swaps	\$ 1,312	\$ (345)	\$ 967
Actuarial gain on post-employment benefit plans	(88)	24	(64)
	\$ 1,224	\$ (321)	\$ 903

The approximate tax effect of each item that gives rise to the Company's deferred tax assets and liabilities are as follows:

	December 31, 2014	December 31, 2013
Deferred tax assets:		
Capital assets	\$ –	\$ 386
Loss carry forwards	3,889	315
Interest rate swaps	563	476
Post-employment benefit plans	164	279
Other assets	1,820	1,198
	6,436	2,654

MORNEAU SHEPELL INC.

Notes to Consolidated Financial Statements (continued)

(In thousands of Canadian dollars)

Years ended December 31, 2014 and 2013

	December 31, 2014	December 31, 2013
Deferred tax liabilities:		
Deferred implementation costs	5,229	1,926
Capital assets	1,140	–
Intangible assets	37,606	29,725
Other liabilities	1,020	1,188
	44,995	32,839
	\$ (38,559)	\$ (30,185)

Movement in temporary differences during the year 2014:

	Balance at January 1, 2014	Recognized in profit or loss	Recognized in other comprehensive income	Acquisition & other	Balance at December 31, 2014
Capital assets	\$ 386	\$ (1,526)	\$ -	\$ -	\$ (1,140)
Intangible assets	(29,725)	(1,723)	-	(6,158)	(37,606)
Tax value – losses carried forward	315	3,574	-	-	3,889
Interest rate swaps	476	-	87	-	563
Post-employment benefit plans	279	-	(105)	-	174
Deferred implementation	(1,926)	(3,303)	-	-	(5,229)
Other	10	645	-	135	790
	\$ (30,185)	\$ (2,333)	\$ (18)	\$ (6,023)	\$ (38,559)

20. Employee future benefits:

The Company offers a pension benefit plan for its employees, which includes a defined benefit option and a defined contribution option. The defined benefit option was closed to new members effective January 1, 1998. Under the defined contribution option, each member is required to contribute a percentage of earnings. The Company matches this required contribution. Each member may elect to make an optional contribution in addition to the required contribution. The Company contributes 50% of the optional contributions. For members who had completed at least 10 years of service on December 31, 2010, their contributions follow the grandfathered provisions.

MORNEAU SHEPELL INC.

Notes to Consolidated Financial Statements (continued)

(In thousands of Canadian dollars)

Years ended December 31, 2014 and 2013

The defined benefit option was closed effective January 1, 1998 and included 57 members as at December 31, 2014, comprising active employees, retirees, and deferred vested members. All other employees are covered by the defined contribution option of the plan.

The pension benefit plan is administered by Morneau Shepell Ltd. and is registered under the Pension Benefits Act (Ontario).

(a) Funding

The defined benefit option is funded by the Company based on the pension plan's actuaries' calculation. The members are not required to contribute to the defined benefit option.

The Company expects to contribute \$240 to the defined benefit option during the upcoming fiscal year.

(b) Amounts recognized in the consolidated financial statements

The amounts recognized in the consolidated statements of financial position in respect of the defined benefit option are determined as follows:

	December 31, 2014	December 31, 2013
Present value of funded obligations	\$ 4,641	\$ 3,980
Fair value of plan assets	(4,294)	(3,998)
Impact of minimum funding requirement/asset ceiling	11	900
Liability in the consolidated statements of financial position	\$ 358	\$ 882

MORNEAU SHEPELL INC.

Notes to Consolidated Financial Statements (continued)
(In thousands of Canadian dollars)
Years ended December 31, 2014 and 2013

The movement in the defined benefit obligation over the year is as follows:

	2014	2013
Defined benefit obligations at January 1	\$ 3,980	\$ 4,631
Included in profit or loss:		
Current service cost	21	40
Interest cost	185	167
	206	207
Included in other comprehensive income:		
Actuarial losses (gains) arising from experience adjustments	44	(98)
Actuarial losses arising from changes in demographic assumptions	216	–
Changes in financial assumptions	512	(534)
	772	(632)
Other:		
Benefits paid by the plan	(317)	(226)
Defined benefit obligations at December 31	\$ 4,641	\$ 3,980

The movement in the fair value of plan assets during the year is as follows:

	2014	2013
Fair value of plan assets at January 1	\$ 3,998	\$ 3,761
Included in profit or loss:		
Estimated interest income on plan assets	187	140
Included in other comprehensive income:		
Return on plan assets in excess of estimated interest income	245	180
Other:		
Employer contributions	181	143
Benefits paid	(317)	(226)
	(136)	(83)
Fair value of plans assets at December 31	\$ 4,294	\$ 3,998

MORNEAU SHEPELL INC.

Notes to Consolidated Financial Statements (continued)

(In thousands of Canadian dollars)

Years ended December 31, 2014 and 2013

The movement in the impact of the minimum funding requirement/asset ceiling is as follows:

	2014	2013
Minimum funding requirement/ asset ceiling at January 1	\$ 900	\$ –
Included in profit or loss:		
Interest on asset ceiling	43	–
Included in other comprehensive income:		
Change in asset ceiling, excluding amounts recognized in interest expense	(932)	900
Minimum funding requirement/ asset ceiling at December 31	\$ 11	\$ 900

(c) Plan Assets

The allocation of fair value of plan assets as a percentage of total plan assets was as follows:

	December 31, 2014	December 31, 2013
Pooled Equities Fund	42%	48%
Pooled Bond Fund	44%	42%
Pooled Low Volatility Fund	14%	10%
	100%	100%

Pooled funds are valued at the unit values supplied by the pooled fund administrator, which represent the pension plan's proportionate share of the fair value of the underlying net assets.

The strategic investment policy of the defined benefit option of the pension plan, implemented in 2013, can be summarized as follows:

A strategic asset mix comprising 29% to 73% equity securities (return and yield funds), 30% to 45% fixed income investments, and 0% to 23% low volatility investments (mortgages, real estate and infrastructure), with a target asset mix of 44% equity securities, 43% fixed income investments and 13% low volatility investments.

MORNEAU SHEPELL INC.

Notes to Consolidated Financial Statements (continued)

(In thousands of Canadian dollars)

Years ended December 31, 2014 and 2013

(d) Actuarial assumptions:

The principal actuarial assumptions were as follows:

	2014	2013
Discount rate at the end of the current fiscal period used to determine the accrued benefit obligation	3.75%	4.75%
Discount rate at the end of preceding period used to determine the benefit cost	4.75%	3.75%
Rate of compensation increase used to determine the accrued benefit obligation	3.50%	3.50%
Rate of compensation increase used to determine the benefit cost	3.50%	3.50%

(e) Mortality assumptions:

Assumptions regarding future mortality experience are based on published statistics and mortality tables.

The calculation of the defined benefit obligation is sensitive to mortality assumptions. For the Company, an increase in life expectancy of one year across all age groups would result in a \$102 increase in the defined benefit obligation as of December 31, 2014.

21. Long-term incentive plan:

Under the LTIP, the Company may grant participants restricted share units, retirement deferred share units, or post-retirement deferred share units, collectively referred to as LTIP Units. The characteristics of each are as follows:

(a) Retirement DSU:

Retirement DSUs generally vest three years after the date of grant and become redeemable only on the participant's termination of employment. Retirement DSUs are redeemable either for one common share or for an amount in cash equal to the fair market value of one common share (at the option of the Company). The value of the award is determined at grant date, and the related salary expense is recognized over the vesting period, which is the period over which all of the specified vesting conditions are satisfied. Participants are entitled to receive cash bonuses or additional Units equivalent to the dividends payable had those Units been common shares. The number of DSUs awarded as bonus is determined based on the fair market value of those DSUs on the date credited.

MORNEAU SHEPELL INC.

Notes to Consolidated Financial Statements (continued)
(In thousands of Canadian dollars)
Years ended December 31, 2014 and 2013

(b) Post-Retirement DSU:

Post-Retirement DSUs vest at such times as determined by the Company, with each being redeemable for one Common Share issued from treasury of the Company. Except in certain circumstances or in the retirement of a participant, any unvested LTIP Units will terminate on their termination date.

The value of the award is determined as at grant date, and related salary expense is recognized over the vesting period, which is the period over which all of the specified vesting conditions are satisfied.

(c) RSU:

RSUs generally vest three years after the date of grant. RSUs are redeemable either for one common share or for an amount in cash equal to the fair market value of one common share (at the option of the Company). The value of the award is determined at grant date, and the related salary expense is recognized over the vesting period, which is the period over which all of the specified vesting conditions are satisfied. Participants are entitled to receive cash bonuses or additional Units equivalent to the dividends payable had those Units been common shares. The number of RSUs awarded as bonus is determined based on the fair market value of those RSUs on the date credited.

The fair value at grant date is calculated with reference to the closing price of the Company's common shares on the Toronto Stock Exchange ("TSX") for the five business days preceding grant date.

The change in the number of awards outstanding, and their related weighted average grant prices for the years ended December 31, 2014 and 2013 were as follows:

MORNEAU SHEPELL INC.

Notes to Consolidated Financial Statements (continued)

(In thousands of Canadian dollars)

Years ended December 31, 2014 and 2013

	RSU	Retirement DSU	Post- retirement DSU	Total
Awards outstanding, January 1, 2013	–	1,422,087	48,890	1,470,977
Granted (at \$13.61 per unit)	30,442	521,536	23,417	575,395
Exercised	–	(63,033)	–	(63,033)
Forfeited	–	(37,633)	–	(37,633)
Awards outstanding, December 31, 2013	30,442	1,842,957	72,307	1,945,706
Granted (at \$15.51 per unit)	23,586	396,788	20,787	441,161
Exercised	–	(32,249)	–	(32,249)
Forfeited	–	(3,067)	–	(3,067)
Awards outstanding, December 31, 2014	54,028	2,204,429	93,094	2,351,551
Total vested awards, December 31, 2013	–	789,545	72,307	861,852
Total vested awards, December 31, 2014	–	1,184,175	93,094	1,277,269
Share-based compensation expense, year ended December 31, 2013				\$ 3,653
Share-based compensation expense, year ended December 31, 2014				\$ 4,515

22. Equity:

(a) Share capital

(i) Common shares:

The Company is authorized to issue an unlimited number of common shares, with no par value.

(ii) Preferred shares:

The Company is authorized to issue 10 million preferred shares, with no limit on their value. As of December 31, 2014 and 2013, no preferred shares were issued or outstanding.

(iii) Dividends:

Dividends are declared in Canadian dollars. The monthly dividend rate was \$0.065 for the year ended December 31, 2014 (2013 - \$0.065). The Company continued to declare the same monthly dividend amount in January and February of 2015.

The change in share capital, including contributed surplus was as follows:

MORNEAU SHEPELL INC.

Notes to Consolidated Financial Statements (continued)

(In thousands of Canadian dollars)

Years ended December 31, 2014 and 2013

	Number of common shares	Share capital	Contributed surplus
Balance, January 1, 2013	47,940,409	\$ 473,838	\$ 12,674
LTIP issuance	–	–	4,090
Shares issued on redemption of LTIP	22,384	250	(250)
Balance, December 31, 2013	47,962,793	474,088	16,514
LTIP issuance	–	–	4,630
Shares issued on redemption of LTIP	32,187	332	(332)
Shares issued on conversion of convertible debentures	4,732	70	–
Balance, December 31, 2014	47,999,712	\$ 474,490	\$ 20,812

(b) Accumulated other comprehensive income

The changes in the components of accumulated other comprehensive income, net of tax, are as follows:

	Cash flow hedge reserve	Post-employment benefit plans	Foreign exchange translation reserve	Total
Balance, January 1, 2013	\$ (2,262)	\$ (706)	\$ (361)	\$ (3,329)
Actuarial loss on post-employment benefit plans	–	(64)	–	(64)
Effective portion of change in interest rate cash flow hedges	967	–	–	967
Foreign currency translation differences for foreign operations	–	–	587	587
Balance, December 31, 2013	(1,295)	(770)	226	(1,839)
Actuarial gain on post-employment benefit plans	–	300	–	300
Effective portion of change in interest rate cash flow hedges	(237)	–	–	(237)
Foreign currency translation differences for foreign operations	–	–	3	3
Reclassification of foreign currency translation differences on divestiture of foreign operations	–	–	289	289
Balance, December 31, 2014	\$ (1,532)	\$ (470)	\$ 518	\$ (1,484)

23. Earnings per share:

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

MORNEAU SHEPELL INC.

Notes to Consolidated Financial Statements (continued)

(In thousands of Canadian dollars)

Years ended December 31, 2014 and 2013

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 redemption of the convertible debenture.

The following details the earnings per share, basic and diluted, calculations for the years ended December 31, 2014 and 2013:

	2014	2013
Profit attributable to common shares (basic and diluted)	\$ 25,140	\$ 10,445
Weighted average number of common shares (in actual number of shares):		
January 1	47,962,793	47,940,409
Shares issued on redemption of LTIP ¹	13,989	7,059
Shares issued upon redemption of convertible debentures ¹	1,588	–
Vested LTIP awards	1,165,110	796,546
Basic	49,143,480	48,744,014
Dilutive effect of unvested LTIP awards	602,473	573,039
Diluted	49,745,953	49,317,053
Earnings per share:		
Basic	\$ 0.51	\$ 0.21
Diluted	\$ 0.51	\$ 0.21

¹ During the year ended December 31, 2014, 32,187 shares (2013- 22,384 shares) were issued on redemption of LTIP units and 4,732 shares (2013- nil shares) were issued upon redemption 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.

24. 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 December 31, 2014, aggregation of operating segments was applied to determine that the Company had only one reportable segment.

MORNEAU SHEPELL INC.

Notes to Consolidated Financial Statements (continued)

(In thousands of Canadian dollars)

Years ended December 31, 2014 and 2013

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 consolidated financial statements:

	2014	2013
Revenue:		
Canada	\$ 490,783	\$ 436,346
United States	45,083	34,808
Consolidated total	\$ 535,866	\$ 471,154

	2014	2013
Total assets:		
Canada	\$ 726,871	\$ 680,360
United States	29,794	19,756
Consolidated total	\$ 756,665	\$ 700,116

25. Supplementary cash flow information:

Change in non-cash operating working capital for the years ended December 31, 2014 and 2013 was as follows:

	2014	2013
Trade and other receivables	\$ (8,896)	\$ (11,618)
Unbilled fees, current and non-current	(2,591)	(11,975)
Prepaid expenses and other	(614)	(1,198)
Deferred implementation costs, current and non-current	(5,793)	(1,799)
Trade and other payables	5,108	3,330
Dividends payable	4	–
Deferred revenue	(1,816)	(660)
	\$ (14,598)	\$ (23,920)

MORNEAU SHEPELL INC.

Notes to Consolidated Financial Statements (continued)

(In thousands of Canadian dollars)

Years ended December 31, 2014 and 2013

26. Related parties:

These consolidated financial statements include the assets, liabilities, revenue and expenses of the Company's subsidiaries; all intercompany balances and transactions have been eliminated upon consolidation and therefore are not disclosed in this note.

(a) Compensation of key management personnel:

Key management personnel include the Company's executive officers and directors; remuneration related to this group was as follows:

	2014	2013
Salaries and other benefits	\$ 8,031	\$ 7,494
Share-based payments	3,060	2,683
	\$ 11,091	\$ 10,177

(b) Unconsolidated structured entities:

The Company's wholly owned subsidiary, Morneau Shepell Asset & Risk Management Ltd. is the sponsor and manages the financial and operating activities of the Company's funds. In exchange, each fund pays an administrative fee of 0.08% of the fund's net asset value to cover regulatory filing fees and other day-to-day operating expenses. The Company does not hold any units of the funds.

The Company is considered to sponsor the funds as it was significantly involved in their design and formation, and has continuing involvement as described above. The Company does not control the funds and therefore, does not consolidate them. The Company has no interests in the funds apart from the agreements outlined above. The Company did not transfer any assets to the funds during the reporting periods.

27. Salary, benefit and contractor:

The Company's salary, benefit and contractor expenses are comprised of the following:

	2014	2013
Salaries and other benefits	\$ 309,347	\$ 268,516
Contractors	59,380	52,009
	\$ 368,727	\$ 320,525

MORNEAU SHEPELL INC.

Notes to Consolidated Financial Statements (continued)

(In thousands of Canadian dollars)

Years ended December 31, 2014 and 2013

28. Commitments:

The Company has lease commitments for office premises and equipment with options for renewal. As at December 31, 2014 the minimum payments not including operating expenses, due in each of the next five years and thereafter, are expected to be as follows for each year ending December 31:

	Gross commitment	Sublease income	Net commitment
2015	\$ 14,712	\$ (776)	\$ 13,936
2016	13,756	(731)	13,025
2017	12,838	(648)	12,190
2018	11,836	(464)	11,372
2019	11,575	(464)	11,111
Thereafter	48,366	(1,197)	47,169
Total	\$ 113,083	\$ (4,280)	\$ 108,803

The Company is party to various subleases to which the Company would be liable for the rental payment in the case of a default by the subtenants. The minimal payments and the aggregate sublease income related to these premises have been included above. The Company considers the risk of default by the subtenants to be low therefore no accrual has been setup.

29. Contingencies:

(a) Lawsuits and legal claims:

From time to time, the Company is involved in routine litigation incidental to the Company's business. Management believes that adequate provisions have been made where required and the ultimate resolution with respect to any claim will not have a material adverse effect on the financial position or results of operations of the Company.

(b) Business combinations:

The Company has obligations to pay additional consideration for prior acquisitions, typically based upon performance measures contractually agreed at the time of purchase.

For the acquisition of Dion Durrell Workers' Compensation (see note 4(c)), contingent consideration based on financial performance was agreed at the time of purchase and is expected to be settled through remaining future payments of cash and LTIP units due within 45 days of June 30 over the next two years.

MORNEAU SHEPELL INC.

Notes to Consolidated Financial Statements (continued)

(In thousands of Canadian dollars)

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For the acquisitions of PRM, Krieger and Blue Balloon (see note 4(b)), contingent consideration based on financial performance also arose at the time of purchase and is expected to be settled through future payments of cash due within 60 days of March 31, 2015, October 31, 2015 and December 31, 2015 respectively.

As at December 31, 2014, the total contingent consideration of \$1,347 has been recognized as future consideration related to acquisitions on the consolidated statements of financial position at the estimated discounted value plus accretion.

30. Management of capital:

The Company views its capital as the combination of its cash (bank indebtedness), long-term debt, convertible debentures and shareholders' equity. As at December 31, 2014 the Company's capital is \$618,501 (2013 - \$578,110), comprised of \$300,481 (2013- \$252,863) debt and \$318,020 (2013- \$325,247) equity. The Company's objectives when managing capital are to safeguard the entity's ability to continue as a going concern while maintaining dividends to its shareholders and the growth of the Company's business through organic growth and new acquisitions.

The Company manages the capital structure and makes adjustments to it in accordance with the aforementioned objectives, as well as taking into consideration changes in economic conditions and the risk characteristics of the underlying assets. To maintain or adjust the capital structure, the Company may adjust the amount of dividends paid to shareholders, issue new or repurchase existing shares and assume new or repay existing debt.

No changes were made in the objectives, policies or processes for managing capital during the year.

The credit facilities require the Company to maintain certain financial covenants. Management also uses these ratios as key indicators in managing the Company's capital. Dividends are made to shareholders monthly. Ratios of dividends to free cash flow, cash from operating activities, and EBITDA are used by management to assist with the determination of dividends.

The Company is subject to externally imposed capital requirements to maintain certain financial covenants as mentioned above. The Company complied with all the required financial covenants at December 31, 2014.