Unaudited Condensed Consolidated Interim Financial Statements
(In Canadian dollars)

MORNEAU SHEPELL INC.

Three months ended March 31, 2014 and 2013
(Unaudited)

MORNEAU SHEPELL INC.

Unaudited Condensed Consolidated Interim Statements of Financial Position
(In thousands of Canadian dollars)
March 31, 2014 and December 31, 2013

	March 31, 2014	December 31, 2013
Assets		
Current assets:		
Trade and other receivables	$ 73,824	$ 67,194
Unbilled fees	63,509	57,185
Prepaid expenses and other	5,816	3,761
Cash and investments held in trust	14,974	16,016
Deferred implementation costs	4,726	4,134
Total current assets	162,849	148,290
Unbilled fees	960	1,251
Deferred implementation costs	10,611	10,693
Capital assets	23,639	22,858
Intangible assets	244,157	221,957
Goodwill	309,949	295,067
Total assets	$ 752,165	$ 700,116
Liabilities and Equity		
Current liabilities:		
Bank indebtedness (note 5)	$ 2,840	$ 5,195
Trade and other payables	58,315	50,194
Income taxes payable	1,121	3,675
Deferred revenue	4,503	2,126
Insurance premium liabilities	14,974	16,016
Future consideration related to acquisitions (notes 4 and 10)	1,460	821
Promissory notes (note 4)	2,397	–
Dividends payable	3,116	3,116
Total current liabilities	88,726	81,143
Long-term debt (note 5)	209,862	175,647
Convertible debenture payable	72,250	72,021
Interest rate swaps (note 5)	2,093	1,789
Future consideration related to acquisitions (notes 4 and 10)	1,006	859
Promissory notes (note 4)	2,285	–
Other liabilities	10,292	9,899
Provisions	3,305	3,326
Deferred tax liability	36,872	30,185
Total liabilities	426,691	374,869
Equity:		
Share capital	474,088	474,088
Contributed surplus	17,530	16,514
Equity component of convertible debenture	757	757
Accumulated other comprehensive loss	(1,759)	(1,839)
Deficit	(165,142)	(164,273)
Total liabilities and equity	$ 752,165	$ 700,116

Contingencies (note 10)

See accompanying notes to unaudited condensed consolidated interim financial statements.

MORNEAU SHEPELL INC.

Unaudited Condensed Consolidated Interim Statements of Income and Comprehensive Income
(In thousands of Canadian dollars, except per share amounts)
For the three months ended March 31, 2014 and 2013

	Three months ended March 31, 2014	Three months ended March 31, 2013
Operating revenue	$ 131,091	$ 115,730
Operating expenses:		
Salary, benefits and contractor	88,898	78,405
Depreciation and amortization	6,894	6,607
Rent and occupancy	5,842	5,366
Office and administration	13,904	11,771
Total operating expenses	115,538	102,149
Finance costs (note 5)	3,384	3,430
Profit from operations before income taxes	12,169	10,151
Income taxes expense (recovery):		
Current	3,253	3,493
Deferred	432	(293)
Total income taxes	3,685	3,200
Profit for the period	8,484	6,951
Other comprehensive income:		
Items that may be reclassified subsequently to profit:		
Effective portion of change in interest rate cash flow hedges	(304)	280
Foreign currency translation differences for foreign operations	407	153
Income taxes on the above items	83	(74)
	186	359
Items that will not be reclassified to profit:		
Actuarial gain/ (loss) on post-employment benefit plans	(145)	284
Income taxes on the above item	39	(75)
	(106)	209
Other comprehensive income, net of tax effect	80	568
Comprehensive income for the period	$ 8,564	$ 7,519
Earnings per share (note 7):		
Basic	$ 0.17	$ 0.14
Diluted	$ 0.17	$ 0.14

See accompanying notes to unaudited condensed consolidated interim financial statements.

MORNEAU SHEPELL INC.

Unaudited Condensed Consolidated Interim Statements of Changes in Equity
(In thousands of Canadian dollars)
For the three months ended March 31, 2014 and 2013

Three months ended March 31, 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	–	1,016	–	–	–	1,016
Profit for the period	–	–	8,484	–	–	8,484
Dividends	–	–	(9,353)	–	–	(9,353)
Other comprehensive income	–	–	–	80	–	80
Balance, March 31, 2014	$ 474,088	$ 17,530	$ (165,142)	$ (1,759)	$ 757	$ 325,474

Three months ended March 31, 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	–	857	–	–	–	857
Long-term incentive plan - DRIP	–	158	(158)	–	–	–
Profit for the period	–	–	6,951	–	–	6,951
Dividends	–	–	(9,348)	–	–	(9,348)
Other comprehensive income	–	–	–	568	–	568
Balance, March 31, 2013	$ 473,838	$ 13,689	$ (139,877)	$ (2,761)	$ 757	$ 345,646

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

MORNEAU SHEPELL INC.

Unaudited Condensed Consolidated Interim Statements of Cash Flows
(In thousands of Canadian dollars)
For the three months ended March 31, 2014 and 2013

	Three months ended March 31, 2014	2013
Operating activities:		
Profit for the period	$ 8,484	$ 6,951
Items not involving cash:		
Depreciation and amortization	6,894	6,607
Finance costs (note 5)	3,384	3,430
Long-term incentive plan	1,016	857
Income taxes	3,685	3,200
Change in provisions	(21)	(37)
Other	115	(97)
	23,557	20,911
Change in non-cash operating working capital (note 9)	(5,288)	(11,539)
Cash generated from operating activities	18,269	9,372
Finance costs paid	(4,086)	(4,113)
Income taxes paid	(5,428)	(5,075)
Cash provided by operating activities	8,755	184
Financing activities:		
Change in revolving loan (net)	34,146	9,074
Dividends paid	(9,353)	(9,348)
Cash provided by (used) in financing activities	24,793	(274)
Investing activities:		
Business acquisitions (note 4)	(27,343)	(500)
Additions to intangible assets	(1,773)	(1,742)
Additions to capital assets	(2,077)	(1,725)
Cash used in investing activities	(31,193)	(3,967)
Increase/ (decrease) in cash for the period	2,355	(4,057)
Bank indebtedness, beginning of period	(5,195)	(134)
Bank indebtedness, end of period	$ (2,840)	$ (4,191)

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

1. Organization and nature of the business:

Morneau Shepell Inc. (the "Company") was incorporated pursuant to the laws of the Province of Ontario on October 21, 2010 and is a continuation of Morneau Sobeco Income Fund (the "Fund"), which was converted from an income trust structure into the Company, effective January 1, 2011.

The Company provides 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 unaudited condensed consolidated interim financial statements were approved by the Company's Board of Directors on May 12, 2014.

2. Basis of preparation:

These unaudited condensed consolidated interim financial statements for the three months ended March 31, 2014 and 2013 have been prepared in accordance with International Accounting Standards 34, Interim Financial Reporting, as issued by the International Accounting Standards Board ("IASB").

These interim financial statements do not include all the disclosures required by International Financial Reporting Standards ("IFRS") for annual consolidated financial statements and accordingly should be read in conjunction with the Company's audited consolidated financial statements for the year ended December 31, 2013 prepared in accordance with IFRS as issued by the IASB.

3. Significant accounting policies:

Except as described below, the accounting policies applied by the Company in these unaudited condensed consolidated interim financial statements are consistent with those applied by the Company in its consolidated financial statements as at and for the year ended December 31, 2013.

(a) 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. The Company adopted this amendment to IAS 39 effective January 1, 2014. This amendment did not result in any changes to the Company's hedge accounting for any of its existing hedges.

(b) 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 Company adopted these amendments to IAS 36 effective January 1, 2014. The adoption of these amendments to IAS 36 will not have a significant impact on the Company's existing disclosures for its impairment testing of its non-financial assets.

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 Services sub-service line within the Organizational Health Solutions line of business. Acquiring Groupe AST will expand the Company's client base and market share in Quebec and nationally.

The consideration for this acquisition included an initial payment of $27,000 that was settled on closing, an additional $558 in cash consideration for working capital adjustments which is expected to be settled in the second quarter of 2014, and the issuance of promissory notes that are in the principal amount of $5,000. The promissory notes are unsecured, non-interest bearing and have a fair value of $4,664, with $2,500 due on 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. The cash consideration of $558 unpaid as at March 31, 2014 has been recognized as an acquisition liability on the statement of financial position.

(In thousands of Canadian dollars)

This acquisition has been accounted for using the acquisition method of accounting. The allocation of the $32,222 fair value purchase consideration is preliminary pending the finalization of working capital adjustments and the valuation of the net assets acquired, and is as follows:

Cash	$ 107
Trade and other receivables	1,518
Prepaid expenses and other	65
Income taxes receivable	362
Capital assets	671
Intangible assets	24,612
Goodwill	14,766
Trade and other payables	(1,254)
Deferred revenue	(2,287)
Deferred tax liability	(6,338)
	$ 32,222

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 Services sub-service line within the Organizational Health Solutions line of business.

During the measurement period, any excess of the purchase price over the net assets acquired will result in an addition to goodwill.

From the date of acquisition up to and including March 31, 2014, Groupe AST has contributed revenues of $1,875 and profit of $630. Had this acquisition occurred on January 1, 2014, the Company estimates that the consolidated revenues and consolidated profit of the Company would have been higher by $3,505 and $532, respectively. In determining these amounts, the Company has assumed that the preliminary fair value adjustments that arose on the acquisition date of Groupe AST would have been the same had the acquisition occurred on January 1, 2014.

(b) Pacific Risk Management Corp.:

On March 31, 2014, the Company completed the acquisition of Pacific Risk Management Corp. ("PRM"), a workers' compensation provider in British Columbia. This acquisition further solidifies the Company's position as a leading provider of workers' compensation services and Absence Management within the Organizational Health Solutions line of business.

The consideration for this acquisition included an initial payment of $450 that was settled on closing, an additional $39 of cash consideration which was settled in April 2014, and $100 in future cash consideration due within 60 days of March 31, 2015 which is dependent on achieving certain revenue targets. The future cash consideration of $139 has been recognized as an acquisition liability on the statement of financial position as at March 31, 2014.

(In thousands of Canadian dollars)

This acquisition has been accounted for using the acquisition method of accounting. The allocation of the $589 purchase consideration is preliminary pending the finalization of the valuation of the net assets acquired, and is as follows:

Trade and other receivables	$	79
Intangible assets		510
	$	589

During the measurement period, any excess of the purchase price over the net assets acquired will result in an addition to goodwill.

5. Long- term debt:

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

		March 31, 2014		December 31, 2013
Revolving loans	$	210,873	$	176,720
Less: debt issuance costs, net of accumulated amortization		1,011		1,073
	$	209,862	$	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).

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

- $196,500 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%.
- $10,500 of prime loans under the revolving loan. The prime loans bear interest at the prime rate plus an applicable margin of 0.875%.
- $3,873 (U.S. $3,500) of Libor loans under the revolving loan. The Libor loans are renewed on a monthly basis, bearing interest at the one- month Libor rate plus an applicable margin of 1.875%.
- $2,783 of the swing line available. The swing line carries interest at prime plus an applicable margin of 0.875%.

As at March 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 under the Original Credit Facility Agreement. 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 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 fair value of this interest rate swap at March 31, 2014 was a liability of $1,388 (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 Agreement.

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 this interest rate swap at March 31, 2014 was a liability of $705.

(In thousands of Canadian dollars)

(b) Finance costs:

The Company's finance costs comprise the following:

	Three months ended March 31, 2014	Three months ended March 31, 2013
Interest on term loan, revolving loan, bank indebtedness and other charges	$ 1,931	$ 1,948
Interest on convertible debenture	1,117	1,117
Amortization of debt issuance costs	244	289
Other	92	76
	$ 3,384	$ 3,430

6. Dividends:

The monthly dividend rate, approved by the Board of Directors, was $0.065 for the three months ended March 31, 2014 (2013 - $0.065). The Company continued to declare the same monthly dividend amount in April 2014.

7. 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.

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 three months ended March 31, 2014 and 2013:

(In thousands of Canadian dollars)

	Three months ended March 31, 2014	Three months ended March 31, 2013
Profit attributable to common shares (basic and diluted)	$ 8,484	$ 6,951
Weighted average number of common shares (in actual number of shares):		
January 1	47,962,793	47,940,409
Vested LTIP awards	861,852	572,735
Basic	48,824,645	48,513,144
Dilutive effect of unvested LTIP awards	705,790	605,097
Diluted	49,530,435	49,118,241
Earnings per share:		
Basic	$ 0.17	$ 0.14
Diluted	$ 0.17	$ 0.14

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

8. Segmented information:

The Company provides health and productivity, administrative and retirement solutions to assist employers in managing the financial security, health and productivity of their employees. As at March 31, 2014, aggregation of operating segments was applied to determine that the Company had only one reportable segment.

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

	Three months ended March 31 2014	Three months ended March 31 2013
Revenue:		
Canada	$ 121,060	$ 108,990
United States	10,031	6,740
Consolidated total	$ 131,091	$ 115,730

(In thousands of Canadian dollars)

	March 31, 2014	December 31, 2013
Total assets:		
Canada	$ 728,867	$ 680,360
United States	23,298	19,756
Consolidated total	$ 752,165	$ 700,116

9. Supplementary cash flow information:

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

	2014	2013
Trade and other receivables	$ (5,033)	$ (8,790)
Unbilled fees, current and non-current	(6,033)	(6,103)
Prepaid expenses and other	(1,990)	(2,135)
Deferred implementation costs, current and non-current	(510)	113
Trade and other payables	8,188	4,481
Deferred revenue	90	895
	$ (5,288)	$ (11,539)

Significant non-cash transactions included the issuance of promissory notes with a fair value of $4,664 as partial consideration for the acquisition of Groupe AST (see note 4).

10. Financial instruments:

Financial instruments carried at fair value:

Fair value represents management's estimates of the market value at a given point in time. The fair value of the Company's current financial assets and liabilities approximate their carrying values due to their short-term nature.

(In thousands of Canadian dollars)

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		
	Mar. 31, 2014	Dec. 31, 2013	Level
Assets carried at fair value:			
Cash and investments held in trust	$ 14,974	$ 16,016	2
	$ 14,974	$ 16,016	
Liabilities carried at fair value:			
Interest rate swaps	$ 2,093	$ 1,789	2
Bank indebtedness	2,840	5,195	2
Future consideration related to acquisitions	2,466	1,680	3
	$ 7,399	$ 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 three months ended March 31, 2014, there were no transfers between any levels.

The interest rate swaps are financial instruments carried at fair value. The liability is measured at fair value through other comprehensive income. As at March 31, 2014, the liability was $2,093 (December 31, 2013 - $1,789).

The future consideration related to acquisitions is a financial instrument carried at fair value. The liability is measured at fair value through profit or loss. As at March 31, 2014, the liability was $2,466 (December 31, 2013 - $1,680). Contingent consideration arose on the acquisitions of SBC Systems Company, Dion Durrell Workers' Compensation and PRM.

In the acquisitions of SBC Systems Company, Dion Durrell Workers' Compensation and PRM, there is a clause that entitles the seller to an amount based on exceeding revenue targets.

(In thousands of Canadian dollars)

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:

	March 31, 2014	December 31, 2013
SBC Systems Company	$ 553	$ 532
Dion Durrell Workers' Compensation	2,146	2,146
PRM	100	–
	$ 2,799	$ 2,678

The estimated payment is calculated considering different scenarios of projected revenue and the amount to be paid under each scenario, weighted by the probability of each scenario. The key unobservable inputs included anticipated revenue and the discount rate. The estimated fair value increases the higher the annual revenue and the lower the discount rate, with estimated payments being limited to a contractual maximum for each of SBC Systems Company, Dion Durrell Workers' Compensation and PRM 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 three months ended March 31, 2014:

	Future consideration related to acquisitions
Balance at January 1, 2014	$ 1,680
Fair value of future consideration for Groupe AST	558
Fair value of future consideration for PRM	139
Accretion on future consideration related to acquisitions	68
Foreign exchange on future consideration related to acquisitions	21
	$ 2,466

Financial instruments carried at amortized cost:

The carrying value of trade and other receivables, trade and other payables, insurance premium liabilities, and dividends payable, which are financial instruments carried at amortized cost, 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 $72,250 (December 31, 2013 - $72,021) and a fair value of $81,315 (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 $209,862 (December 31, 2013 - $175,647) and a fair value of $210,873 (December 31, 2013 - $176,720). The fair value is determined based on the current cost of borrowing for a company with a similar risk profile (Level 2).