MORNEAU SHEPELL

UNAUDITED CONDENSED INTERIM CONSOLIDATED FINANCIAL STATEMENTS

and

MANAGEMENT'S DISCUSSION AND ANALYSIS

For The Quarter Ended March 31, 2012

MORNEAU SHEPELL INC.

Unaudited Condensed Interim Consolidated Statements of Financial Position
(In thousands of Canadian dollars)

	March 31, 2012	December 31, 2011
Assets		
Current assets:		
Trade and other receivables	$ 70,857	$ 62,909
Unbilled fees	26,337	22,732
Prepaid expenses and other	3,996	3,105
Cash and investments held in trust	11,519	12,248
Deferred implementation costs	2,153	2,121
Total current assets	114,862	103,115
Non-current assets:		
Unbilled fees	1,250	1,505
Deferred implementation costs	6,844	7,000
Capital assets	23,405	23,961
Intangible assets	234,835	230,716
Goodwill	301,792	301,792
Total non-current assets	568,126	564,974
Total assets	$ 682,988	$ 668,089

MORNEAU SHEPELL INC.

Unaudited Condensed Interim Consolidated Statements of Financial Position
(In thousands of Canadian dollars)

	March 31, 2012	December 31, 2011
Liabilities and Equity		
Current liabilities:		
Bank indebtedness	$ 6,933	$ 807
Trade and other payables	49,766	47,092
Income taxes payable	1,244	213
Deferred revenue	3,130	2,250
Insurance premium liabilities	11,519	12,248
Future consideration related to acquisition (note 4)	955	500
Dividends payable	3,116	3,116
Total current liabilities	76,663	66,226
Non-current liabilities:		
Long-term debt (note 5)	142,442	207,121
Debenture payable (note 6)	70,416	–
Interest rate swaps (note 5)	3,863	5,389
Future consideration related to acquisition (note 4)	2,153	1,653
Other liabilities	7,736	7,670
Provisions	1,615	1,887
Deferred tax liability	22,642	20,560
Total non-current liabilities	250,867	244,280
Equity:		
Share capital	473,838	473,838
Contributed surplus	9,481	8,721
Deficit	(125,374)	(120,328)
Accumulated other comprehensive loss	(3,244)	(4,648)
Equity component of convertible debenture (note 6)	757	–
Total equity	355,458	357,583
Total liabilities and equity	$ 682,988	$ 668,089

See accompanying notes to unaudited condensed interim consolidated financial statements.

MORNEAU SHEPELL INC.

Unaudited Condensed Interim Consolidated Statements of Income and Comprehensive Income
(In thousands of Canadian dollars, except per share amounts)

	Three months ended March 31	
	2012	2011
Revenue:		
Fees	$ 99,908	$ 81,599
Commissions and other income	4,058	3,803
Total operating revenue	103,966	85,402
Expenses:		
Salary, benefit and contractor	72,475	55,747
Depreciation and amortization	5,916	5,014
Rent and occupancy	4,477	4,248
Office and administration	10,841	9,798
Total operating expenses	93,709	74,807
Finance costs (note 5)	3,511	3,881
Profit from operations before income taxes	6,746	6,714
Income taxes:		
Current	1,068	166
Deferred	1,257	90
	2,325	256
Profit for the period	4,421	6,458
Other comprehensive income:		
Effective portion of change in interest rate cash flow hedge	1,526	(289)
Ineffective portion of changes in fair value of previous interest rate cash flow hedges transferred to profit	–	69
Net change in previous interest rate cash flow hedges prior to termination	–	274
Transfer to profit due to termination of interest rate cash flow hedges	583	1361
Foreign currency translation differences for foreign operations	(150)	29
Income tax on other comprehensive income	(555)	(1,117)
Other comprehensive income, net of tax effect	1,404	327
Comprehensive income for the period	$ 5,825	$ 6,785

Earnings per share

Basic (note 8)	$ 0.09	$ 0.13
Diluted (note 8)	$ 0.09	$ 0.13

See accompanying notes to unaudited condensed interim consolidated financial statements.

MORNEAU SHEPELL INC.

Unaudited Condensed Interim Consolidated Statements of Changes in Equity
(In thousands of Canadian dollars)

Three months ended March 31, 2012	Share capital	Contributed surplus	Deficit	Accumulated other comprehensive income	Equity component of debenture	Total equity
Balance, January 1, 2012	$ 473,838	$ 8,721	$ (120,328)	$ (4,648)	$ –	$ 357,583
Long-term incentive plan - non-cash expense	–	641	–	–	–	641
Long-term incentive plan - DRIP	–	119	(119)	–	–	–
Profit for the period	–	–	4,421	–	–	4,421
Dividends	–	–	(9,348)	–	–	(9,348)
Other comprehensive income	–	–	–	1,404	–	1,404
Convertible debenture (note 6)	–	–	–	–	757	757
Balance, March 31, 2012	$ 473,838	$ 9,481	$ (125,374)	$ (3,244)	$ 757	$ 355,458

Three months ended March 31, 2011	Share capital	Contributed surplus	Deficit	Accumulated other comprehensive income	Total equity
Balance, January 1, 2011	$ 420,109	$ –	$ (107,429)	$ (2,355)	$ 310,325
Exchange of LP Units on reorganization	53,729	–	–	–	53,729
Long-term incentive plan - reclassification as equity-based awards	–	5,449	–	–	5,449
Long-term incentive plan - non-cash expense	–	519	–	–	519
Long-term incentive plan - DRIP	–	63	(63)	–	–
Profit for the period	–	–	6,458	–	6,458
Dividends	–	–	(9,348)	–	(9,348)
Other comprehensive income	–	–	–	327	327
Balance, March 31, 2011	$ 473,838	$ 6,031	$ (110,382)	$ (2,028)	$ 367,459

See accompanying notes to unaudited condensed interim consolidated financial statements.

MORNEAU SHEPELL INC.

Unaudited Condensed Interim Consolidated Statements of Cash Flows
(In thousands of Canadian dollars)

	Three months ended March 31, 2012	Three months ended March 31, 2011
Operating activities:		
Profit for the period	$ 4,421	$ 6,458
Items not involving cash:		
Depreciation of capital assets	2,063	1,636
Amortization of intangible assets	3,853	3,378
Finance costs (note 5)	3,511	3,881
Long-term incentive plan	641	519
Current income taxes	1,068	166
Deferred income taxes	1,257	90
Change in provisions	(272)	70
Other	77	–
	16,619	16,198
Change in non-cash operating working capital (note 10)	(8,966)	(4,626)
Cash generated from operating activities	7,653	11,572
Finance costs paid	(2,652)	(2,335)
Income taxes paid	(38)	(76)
Cash provided by operating activities	4,963	9,161
Financing activities:		
Payment of credit agreement renewal fees	–	(1,200)
Change in revolving loan	(64,795)	2,500
Proceeds from debenture offering (note 6)	75,000	–
Expenses related to issuance of debenture (note 6)	(3,568)	–
Settlement of interest rate swaps	–	(4,150)
Dividends paid	(9,348)	(6,233)
Cash used in financing activities	(2,711)	(9,083)
Investing activities:		
Business acquisition, net of cash acquired (note 4)	(4,740)	–
Additions to intangible assets	(2,382)	(1,126)
Additions to capital assets	(1,256)	(2,083)
Cash used in investing activities	(8,378)	(3,209)
Net decrease in cash for the period	(6,126)	(3,131)
(Bank indebtedness) Cash, beginning of period	(807)	360
Bank indebtedness, end of period	$ (6,933)	$ (2,771)

See accompanying notes to unaudited condensed interim consolidated financial statements.

1. Organization and nature of the business:

Morneau Shepell Inc. (the "Company") provides human resource consulting and outsourcing services, delivering 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.

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.

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

These unaudited condensed interim consolidated financial statements were approved by the Company's Board of Directors on May 15, 2012.

2. Basis of preparation:

These unaudited condensed interim consolidated financial statements for the three months ended March 31, 2012 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, 2011 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 interim consolidated financial statements are consistent with those applied by the Company in its consolidated financial statements as at and for the year ended December 31, 2011.

3. Significant accounting policies (continued):

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 at the 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, dividends, losses and gains relating to the financial liability are recognized in profit or loss. Distributions to the equity holders are recognized in equity, net of any tax benefit.

4. Business acquisitions:

SBC Systems Company Inc. ("SBC Systems Company"):

On January 31, 2012, the Company completed the acquisition of the SBC Systems Company business, a company specializing in providing employee benefits administration systems in the United States. This acquisition will provide the Company with a suite of flexible administration products and a technology platform that will allow it to further build its outsourcing business, broadening its distribution channel to reach more U.S. clients. The purchase price is contingent on future business results and is expected to approximate US$6,000 payable in three instalments. The first instalment of approximately $5,014 (US $5,000) was satisfied on closing through cash consideration. The second and final instalments of US$500 each, are subject to adjustments, dependent on achieving certain revenue targets, and will be settled in March 2013 and 2014, respectively. The Company expects that the revenue targets will be achieved, therefore the full amount of the future consideration has been recognized. At March 31, 2012, $868 has been recognised as an acquisition liability on the statement of financial position, representing the US$1,000 final instalments discounted.

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

4. Business acquisitions (continued):

This acquisition has been accounted for using the purchase method of accounting. The purchase price allocation presented below is preliminary pending finalization of the valuation of the net identifiable assets acquired and liabilities assumed.

Cash	$	274
Trade receivable		180
Prepaid expenses and other		129
Capital assets		250
Intangible assets		5,601
Deferred revenue		(552)
	$	5,882

As at March 31, 2012, the valuation of the net assets acquired had not been completed. Upon finalization of the valuation of the net assets acquired during the measurement period, any excess of the purchase price over net assets acquired will result in an addition to goodwill.

These consolidated financial statements include the results of SBC Systems Company from the date of acquisition January 31, 2012. For the three months ended March 31, 2012, SBC Systems Company contributed revenue of $1,130 and a loss of $157 due to timing of contracts.

Had this acquisition occurred on January 1, 2012, management estimates that revenue and profit would have increased by approximately $565 and ($78) for the three months ended March 31, 2012, respectively. In determining these amounts, management has assumed that the fair values determined provisionally that arose on the date of acquisition would have been the same if the acquisition had occurred on January 1, 2012.

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

5. Long- term debt:

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

	March 31, 2012	December 31, 2011
Non-revolving loans	$ 130,000	$ 130,000
Revolving loans	13,705	78,500
	143,705	208,500
Less:		
Debt issue costs, net of accumulated amortization	1,263	1,379
	$ 142,442	$ 207,121

The Company has a credit facility agreement for a term of four years, maturing on January 5, 2015. The credit facility provides for a term loan of $130,000 and a revolving facility of $100,000 (which includes a swing line of $7,000).

The interest rate for the credit facilities are floating, based on a margin over certain reference rates of interest. The applicable margin may vary up and down depending on the ratio of the Company's consolidated Debt to Adjusted EBITDA as calculated in the credit facility agreement.

The Company is required to maintain Debt to Adjusted EBITDA financial covenant of 3.25:1.00 up to March 30, 2013, and 3.00:1.00 on March 31, 2013, and thereafter.

The credit facilities are secured by a general assignment of all the assets of the Company, and require the Company to maintain, on a consolidated basis, the Debt to Adjusted EBITDA ratio as described above, and an EBITDA to interest expense ratio of not less than 3.00:1.00.

EBITDA in the amended and restated credit agreement is defined as profit before finance costs, income taxes, depreciation, amortization, non-controlling interest, and non-recurring expenditures. Adjusted EBITDA is defined as EBITDA plus the pro-forma EBITDA from Permitted Acquisitions' entities.

At March 31, 2012 the Company had utilized the following credit facilities:

- $130,000 of term loans. The term loan is repayable in full on January 5, 2015 and bears interest at the one-month BA rate plus an applicable margin of 2.625%.

5. Long-term debt (continued):

- $9,500 of BA loans under the revolving loan. The BA loan is renewed on a monthly basis, bearing interest at the one-month BA rate plus an applicable margin of 2.625%.

- $4,200 USD 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 1.625%.

- $5,911 of the swing line available. The swing line carries interest at prime plus an applicable margin of 1.625%.

The Company complied with all the required financial covenants. At March 31, 2012 the Debt to Adjusted EBITDA ratio was 2.0 and the EBITDA to interest expense ratio was 5.4.

(a) Interest rate swaps:

The Company entered into interest-rate swap agreements to hedge against the variable interest rate component of the term loans 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 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 the interest rate swap at March 31, 2012 was a liability of $3,863 (December 31, 2011- 5,389).

In the first quarter of 2011, the Company terminated its previous interest-rate swap agreements for $4,150. $778 of the settlement amount was recognized immediately as a loss while the remaining amount will be amortized into profit and loss concurrently with the variable interest payments on the term loan remaining, until June 1, 2012, the maturity date of the previous credit facility.

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

5. Long-term debt (continued):

(b) Finance costs:

The Company's finance costs comprise the following:

	2012	2011
Interest on term loan	$ 1,736	$ 1,694
Interest on revolving loan, bank indebtedness and other charges	771	565
Interest on convertible debenture (note 6)	59	–
Amortization of debt issuance costs	126	117
Immediate recognition and amortization of terminated interest rate swap	583	1,361
Other	236	144
	$ 3,511	$ 3,881

6. Convertible Debenture:

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 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 the Company 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.

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

6. Convertible Debenture (continued):

The discount on the debentures is being accreted such that the liability at maturity will equal the face value of $75,000. 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 period:

	Debt component	Equity component
Balance at March 27, 2012	$ 70,404	$ 757
Accretion and Amortization on convertible debentures	12	–
	$ 70,416	$ 757

7. Dividends:

Dividends are declared in Canadian dollars. The monthly dividend rate was $0.065 for the three months ended March 31, 2012 (2011 - $0.065). The Company continued to declare the same monthly dividend amount in April 2012.

8. 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.

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

8. Earnings per share (continued):

The following details the earnings per share, basic and diluted, calculations for each of the three months ended March 31, 2012 and 2011:

	2012	2011
Profit attributable to common shares (basic and diluted)	$ 4,421	$ 6,458
Weighted average number of common shares (in actual number of shares):		
January 1, 2012	47,940,409	47,940,409
Vested LTIP awards	519,920	185,764
Basic	48,460,329	48,126,173
Dilutive effect of unvested LTIP awards	316,618	356,418
Diluted	48,776,947	48,482,591
Earnings per share:		
Basic	$ 0.09	$ 0.13
Diluted	$ 0.09	$ 0.13

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

9. Segmented information:

The Company offers human resource consulting, outsourcing, employee assistance, and health management services, delivering solutions to assist employers in managing the financial security, health and productivity of their employees. As at March 31, 2012, on the basis of the type of services provided and in accordance with IFRS 8, Operating Segments, the Company was represented by and had one reportable segment.

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

9. Segmented information (continued):

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:

	2012	2011
Revenue:		
Canada	$ 99,055	$ 81,642
United States	4,911	3,760
Consolidated total	$ 103,966	$ 85,402

	March 31, 2012	December 31, 2011
Total assets:		
Canada	$ 672,568	$ 660,581
United States	10,420	7,508
Consolidated total	$ 682,988	$ 668,089

10. Supplementary cash flow information:

Change in non-cash operating working capital was as follows:

	2012	2011
Trade and other receivables	$ (7,770)	$ (2,436)
Unbilled fees, current and non-current	(3,350)	(1,047)
Prepaid expenses and other	(763)	(1,778)
Deferred implementation costs, current and non-current	124	(1,356)
Trade and other payables	2,464	1,280
Deferred revenue	329	711
	$ (8,966)	$ (4,626)

11. Contingencies:

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. In the acquisition of Jacques Lamarre & Associates, contingent consideration based upon financial performance was agreed at the time of purchase with payment expected to be finalized in October 2013.

In the acquisition of SBC Systems Company (note 4), contingent consideration based on financial performance was agreed at the time of purchase with payment expected to be finalized in March 2013 and 2014. As at March 31, 2012, the contingent consideration has been recognized as an acquisition liability on the consolidated statements of financial position at the estimated discounted value plus accretion.

MORNEAU SHEPELL INC.

Management's Discussion & Analysis

Morneau Shepell Inc. ("Morneau Shepell") was incorporated pursuant to the laws of the Province of Ontario on October 21, 2010, and as of January 1, 2011, is the successor to Morneau Sobeco Income Fund (the "Fund").

This Management's Discussion and Analysis ("MD&A") covers the three months ended March 31, 2012 and should be read in conjunction with the accompanying unaudited condensed interim consolidated financial statements of Morneau Shepell and notes thereto for the three months ended March 31, 2012 as well as the MD&A, and the audited consolidated financial statements and notes thereto for the year ended December 31, 2011.

All financial information is presented in Canadian dollars and in accordance with International Financial Reporting Standards, unless otherwise noted. Certain totals, subtotals and percentages may not reconcile due to rounding.

This MD&A contains "forward-looking statements" within the meaning of applicable securities laws, such as statements concerning anticipated future events, results, circumstances, performance or expectations that are not historical facts. Use of words such as "may", "will", "expect", "believe", or other words of similar effect may indicate a "forward-looking" statement. These statements are not guarantees of future performance and are subject to numerous risks and uncertainties, including those described in our publicly filed documents (available on SEDAR at www.sedar.com) and in this MD&A under the heading "Risks and Uncertainties". Those risks and uncertainties include the ability to maintain profitability and manage growth, ability to pay dividends, reliance on information systems and technology, reputational risk, dependence on key clients, reliance on key professionals and general economic conditions. Many of these risks and uncertainties can affect our actual results and could cause our actual results to differ materially from those expressed or implied in any forward-looking statement made by us or on our behalf. Given these risks and uncertainties, investors should not place undue reliance on forward-looking statements as a prediction of actual results. All forward-looking statements in this MD&A are qualified by these cautionary statements. These statements are made as of the date of this MD&A and, except as required by applicable law, we undertake no obligation to publicly update or revise any forward-looking statement, whether as a result of new information, future events or otherwise. Additionally, we undertake no obligation to comment on analyses, expectations or statements made by third parties in respect of us, our financial or operating results or our securities.

To assist investors in assessing our financial performance, this discussion also makes reference to certain non-IFRS measures such as EBITDA, Adjusted EBITDA, Free Cash Flow, Normalized Free Cash Flow, Payout Ratio and Normalized Payout Ratio. EBITDA is not a calculation based on IFRS and does not have a standardized meaning. It is intended to represent an indication of Morneau Shepell's capacity to generate profit from operations before taking into account management's financing decisions and costs of consuming tangible and intangible capital assets, which vary according to their vintage, technological currency, and management's estimate of their useful life. Accordingly, EBITDA comprises revenues less operating costs before finance costs, depreciation, amortization and impairment losses, and income taxes, while Adjusted EBITDA represents EBITDA before taking into account certain non-recurring expenditures. We believe both EBITDA and Adjusted EBITDA are useful measures in evaluating our performance. We utilize them to monitor compliance with debt covenants and to make decisions related to dividends to shareholders rather than profit due to the significant amount of amortization expense related to our intangible assets. We also believe that Free Cash Flow, Normalized Free Cash Flow, Payout Ratio, and Normalized Payout Ratio are useful supplemental measures of performance as they are generally used as indicators of financial performance. These ratios, however, are non-IFRS measures and therefore, should not be seen as a substitute for cash flow from operating activities. Free Cash Flow is defined as cash provided by operating activities adjusted for capital expenditures. Normalized Free Cash Flow is Free Cash Flow, adjusted for changes in non-cash operating working capital, current income taxes (net of income taxes paid) and certain non-recurring expenditures.

Non-IFRS measures do not have any standard meaning prescribed by IFRS and therefore may not be comparable to similar measures presented by other issuers.

OUTSTANDING SHARE DATA

The Company is authorized to issue an unlimited number of common shares. Each common share entitles the holder to one vote at all meetings of shareholders and represents an interest in dividends declared by the Company and an undivided interest in the net assets of the Company. As at May 15, 2012, Morneau Shepell had 47,940,409 common shares issued and outstanding.

BUSINESS OVERVIEW

Morneau Shepell is the largest Canadian firm providing human resource consulting and outsourcing services. We deliver solutions to assist employers in managing the financial security, health and productivity of their employees. With approximately 2,800 employees in offices across North America, we offer services to over 8,000 organizations in Canada, the United States and around the globe directly and through our distribution channel partners.

We derive our revenue primarily from fees charged to clients for consulting engagements, outsourcing engagements, employee assistance program services and health management services.

Fees from consulting engagements are charged based on billable hours or on a fee-for-service basis. In some cases, consulting engagements may be billed on a fixed-fee basis, although these engagements are typically much smaller and the services are delivered over a shorter period of time. For some benefits consulting assignments which involve the purchase of an insurance policy underwritten by an insurance company, we may be paid commissions (in lieu of fees) by the client's insurance company, which is a common practice in the industry. These commissions are based on a percentage of the premiums paid by the client to the insurance company and our policy is to disclose them to our client. We assume no underwriting risk as the insurance policy is underwritten by the insurance company. In addition, we earn interest income from our cash balances which is included in other revenue.

Our outsourcing business is characterized by fixed contracts, which typically have three-year to five-year terms. Most outsourcing contracts contain an upfront implementation fee and an ongoing monthly service fee. Implementations usually take three to twelve months and involve transferring the administration of a client's pension and/or benefits plans onto our systems, tailoring our systems and training our employees. Additional services provided that are outside the scope of the outsourcing contract are usually paid on a fee-for-service basis.

In the billing for Employee Assistance Program ("EAP") services, a portion of the EAP client agreements require payment of a minimum retainer and incremental usage-based fees. The remainder of the EAP agreements are billed based on an actual usage or fixed fees. Most EAP agreements may be terminated by the client upon 30 to 60 days' notice to us, however, it is typical for EAP agreements to continue for multiple years and many automatically renew on an annual basis.

Fees from health management services, such as attendance support and disability management are generally based on negotiated fees or a formula tied to the nature of the service being provided. Like most EAP agreements, most workplace health and productivity agreements may be terminated by the client upon 30 to 60 days' notice to us; however, it is typical for these agreements to continue for multiple years and many automatically renew on an annual basis.

Our largest operating expense is compensation and related costs. This includes salaries, annual performance-based bonuses, benefits, payroll taxes, independent service providers and temporary staffing services.

The remaining operating expenses include rent and occupancy costs, technology costs (including equipment leases, telecommunications, and software licenses and maintenance), non-recoverable client service costs (such as printing and travel), training, marketing, office costs, professional services and insurance.

SUMMARY AND OUTLOOK

For the three months ended March 31, 2012, revenue was $104.0 million, compared to $85.4 million for the same period in 2011. Adjusted EBITDA for the three months ended March 31, 2012 was $19.3 million, compared to $15.6 million for the same period in 2011. EBITDA for the three months ended March 31, 2012 was $16.2 million, compared to $15.6 million for the same period in 2011. Adjusted EBITDA margin for the three months ended March 31, 2012 was 18.5%, compared to 18.3% for the same period in 2011. EBITDA margin for the three months ended March 31, 2012 was 15.6%, compared to 18.3% for the same period in 2011. Adjusted EBITDA per Share (basic) for the three months ended March 31, 2012 was $0.40, compared to $0.32 for the same period in 2011. EBITDA per Share (basic) for the three months ended March 31, 2012 was $0.33, compared to $0.32 for the same period in 2011.

We had a solid start to 2012 and experienced exceptional revenue growth in all parts of our business during the first quarter. The consulting and outsourcing practices continued to grow as a result of significant new client wins and increased mandates from current clients, while increased utilization and incremental revenues from existing clients drove growth in the EAP practice, and the commencement of service for a large client secured during the fourth quarter of 2011 resulted in increased revenue in the health management practice.

During the quarter, we also completed the acquisition of SBC Systems Company Inc. ("SBC Systems"), a company specializing in providing employee benefits administration systems in the United States. This acquisition will provide us with a suite of flexible administration products and a technology platform that will allow us to further build our outsourcing business, and broaden our distribution channel to reach more U.S. clients.

We completed the issuance of a $75.0 million convertible debenture during the first quarter of 2012. Using the proceeds of the convertible debenture we made a payment against the balance outstanding on the revolving loans. The reduction of the long term debt will provide us additional flexibility to pursue accretive strategic acquisitions.

Q1, 2012 was a strong quarter for Morneau Shepell. We are confident that our recent acquisitions, revised capital structure, established business relationships and prospective client base will continue to yield positive results for the Company.

ANALYSIS OF 2012 FIRST QUARTER OPERATING RESULTS

Results of Operations	**Three Months Ended March 31**	
Selected Unaudited Consolidated Financial Information	**2012**	**2011**
(In thousands of dollars except per share amounts)		
Revenue	**$ 103,966**	$ 85,402
Deduct:		
Salary, benefit and contractor expenses	**72,475**	55,747
Other operating expenses	**15,318**	14,046
Finance costs	**3,511**	3,881
Depreciation and amortization	**5,916**	5,014
Income taxes expenses	**2,325**	256
Profit for the period	**4,421**	6,458
Add:		
Finance costs	**3,511**	3,881
Depreciation and amortization	**5,916**	5,014
Income taxes expense	**2,325**	256
EBITDA (1)	**$ 16,173**	$ 15,609
Adjustments:		
Enterprise software replacement - expenses	**217**	-
Operational effectiveness initiatives	**706**	-
Provision for E-commerce refundable tax credit	**2,155**	-
Adjusted EBITDA	**$ 19,251**	$ 15,609
EBITDA margin	**15.6%**	18.3%
Adjusted EBITDA margin	**18.5%**	18.3%
Cash provided by operating activities	**$ 4,963**	$ 9,161
Deduct: Capital expenditures (2)	**3,638**	3,209
Free Cash Flow (3)	**1,325**	5,952
Add (deduct):		
Changes in non-cash operating working capital	**8,966**	4,626
Enterprise software replacement - capital	**880**	-
Current income taxes (net of income taxes paid) (4)	**(1,030)**	(90)
Adjustments to EBITDA (per above)	**3,078**	-
Normalized Free Cash Flow (4)	**$ 13,219**	$ 10,488
Earnings per Share (basic)	**$ 0.09**	$ 0.13
Earnings per Share (diluted)	**$ 0.09**	$ 0.13
EBITDA per Share (basic)	**$ 0.33**	$ 0.32
Adjusted EBITDA per Share (basic)	**$ 0.40**	$ 0.32
Payout Ratio (5)	**704.9%**	157.1%
Normalized Payout Ratio (6)	**70.7%**	89.1%
Twelve-month rolling Payout Ratio	**124.9%**	133.8%
Twelve-month rolling Normalized Payout Ratio	**86.3%**	96.5%

Footnotes:

(1) "EBITDA" is defined as profit before finance costs, income taxes expenses, depreciation and amortization.

(2) "Capital Expenditures" excludes additions to intangible assets acquired through business acquisition, and is presented net of disposals.

(3) "Free Cash Flow" is defined as cash provided by operating activities adjusted for capital expenditures.

(4) "Normalized Free Cash Flow" is defined as cash provided by operating activities, adjusted for changes in non-cash operating working capital, capital expenditures, current income taxes (net of income taxes paid) and non-recurring expenditures. The calculation has been revised to include current income tax expenses instead of income tax paid to remove the timing effect of annual tax payments as the Company moved into its second year of post income fund structure. The comparative amounts and ratios have been restated to reflect this revision.

(5) "Payout Ratio" is defined as dividends declared divided by Free Cash Flow.

(6) "Normalized Payout Ratio" is defined as dividends declared divided by Normalized Free Cash Flow.

ANALYSIS OF FIRST QUARTER 2012 AND 2011 RESULTS

Revenue

Revenue for the three months ended March 31, 2012 increased by $18.6 million, or 21.8%, to $104.0 million compared to $85.4 million for the same period in 2011. The SBC Systems and the Jacques Lamarre & Associates and Parcours d'enfant ("JLA") acquisitions contributed to an increase in revenue of 4.3% over the comparative quarter in 2011. The other incremental revenue of 17.5% represents year over year organic growth, with all four lines of the business contributing to the increase. Our outsourcing practice accounted for approximately half of the incremental revenue growth as a result of new business agreements and the commencement of service for contracts secured in prior quarters. Our consulting, EAP and health management practices each contributed evenly to the remaining growth as a result of increased mandates from the existing client base and new client wins.

Salary, Benefit and Contractor Expenses

Salary, benefit and contractor expenses for the three months ended March 31, 2012 increased by $16.8 million, or 30.2%, to $72.5 million compared to $55.7 million for the same period in 2011. This increase was primarily attributable to the JLA and SBC Systems acquisitions resulting in an incremental expense of $3.1 million, increased salaries and contractor costs of $10.9 million to support business growth and the provision related to the e-commerce refundable tax credit of $2.2 million.

During the quarter, we received communication from Investissement Quebec that they are unable to conclude on the eligibility of the Company's e-commerce refundable tax credit for the year 2010. Given the uncertainty surrounding this claim we have provided for the amounts accrued for the years 2010 and 2011.

Other Operating Expenses

Other operating expenses for the three months ended March 31, 2012 increased by $1.3 million, or 9.3%, to $15.3 million, compared to $14.0 million for the same period in 2011. The increase is primarily due to additional expenses resulting from the JLA and SBC acquisitions of $0.4 million, enterprise software replacement expenses and operational effectiveness initiatives costs of $0.3 million, and additional operating expenses to support business growth.

Finance Costs

Finance costs for the three months ended March 31, 2012 decreased by $0.4 million or 10.3%, to $3.5 million compared to $3.9 million for the same period in 2011. The decrease is primarily attributable to the immediate recognition of $0.8 million expense on the settlement of the interest rate swap that was terminated in January 2011 which increased the prior period expense. This is offset by an increase in interest on the revolving loan of $0.2 million from increased utilization of the credit facility, accrued interest on the convertible debenture of $0.1 million, and increased accretion interest of $0.1 million related to contingent consideration on business acquisitions.

Depreciation and Amortization

Depreciation and amortization for the three months ended March 31, 2012 increased by $0.9 million, or 18.0%, to $5.9 million compared to $5.0 million for the same period in 2011. This increase is primarily attributable to increased amortization and depreciation expense of $0.7 million on hardware and software (purchased and internally-developed) capital expenditures required for business growth.

Income Tax Expenses

Income tax expenses for the three months ended March 31, 2012 were $2.3 million compared to $0.3 million for the same period in 2011.

The 2011 expense was lower than 2012 due to the Company's re-measurement of certain deferred tax balances as a result of the Company's conversion from an income trust to a corporation and adoption of IFRS.

Profit for the Period

As a result of the changes noted above, profit for the three months ended March 31, 2012 was $4.4 million compared to $6.5 million for the same period in 2011.

Key Financial Measures: EBITDA, Adjusted EBITDA, Free Cash Flow and Normalized Free Cash Flow

Adjusted EBITDA and EBITDA

Adjusted EBITDA grew significantly, increasing by $3.7 million, or 23.7%, to $19.3 million, compared to $15.6 million for the same period in 2011. The increase was primarily due to increased revenue of $18.6 million offset by an increase in salaries and other operating expenses of $14.9 million after adjusting for expenses related to enterprise software replacement, operational effectiveness initiatives and the provision related to the e-commerce refundable tax credit.

EBITDA increased by $0.6 million, or 3.8%, to $16.2 million compared to $15.6 million for the same period in 2011.

Free Cash Flow

Free Cash Flow for the three months ended March 31, 2012 decreased by $4.6 million to $1.3 million compared to $6.0 million for the same period in 2011. This decrease was primarily due to the negative change in non-cash operating working capital of $4.3 million and an increase in capital expenditures of $0.4 million offset by an increase in cash provided by operating activities, before non-cash operating working capital, of $0.1 million.

Normalized Free Cash Flow

Normalized Free Cash Flow for the three months ended March 31, 2012 increased by $2.7 million to $13.2 million compared to $10.5 million for the same period in 2011. The increase is primarily the result of an increase in cash provided by operating activities, before non- cash operating working capital, adjusted for non- recurring expenses of $3.2 million, offset by an increase in capital expenditures of $0.4 million.

LIQUIDITY AND CAPITAL RESOURCES

Cash Flows

The following table provides an overview of the Company's cash flows for the periods indicated:

Cash Flow Information Selected Unaudited Consolidated Financial Information *(In thousands of dollars)*	**Three Months Ended March 31** **2012**	**2011**
Cash provided by (used in):		
Operating activities	**$ 4,963**	$ 9,161
Investing activities	**(8,378)**	(3,209)
Financing activities	**(2,711)**	(9,083)
Decrease in cash	**$ (6,126)**	$ (3,131)

Cash provided by operating activities for three months ended March 31, 2012 decreased by $4.2 million to $5.0 million compared to $9.2 million for the same period in 2011. The decrease is primarily due to the change in non-cash operating working capital of $4.2 million.

Cash used in investing activities for the three months ended March 31, 2012 increased by $5.2 million to $8.4 million compared to $3.2 million for the same period in 2011. This increase is primarily attributable to increased business acquisition-related payments of $4.7 million on the SBC Systems acquisition.

Cash used in financing activities for the three months ended March 31, 2012 decreased by $6.4 million to $2.7 million compared to $9.1 million for the same period in 2011. This decrease is primarily attributable to the net proceeds of the convertible debenture offering of $71.4 million exceeding the pay down of the revolving loan of $64.8 million. Additionally during 2011, there were payments of $4.2 million on settlement of the previous interest-rate swap agreements and $1.2 million in renewal fees related to the new and amended credit agreement that did not recur in 2012. This was offset by increased dividends paid of $3.1 million as there were three monthly payments compared to two in 2011, and lowered utilization of the revolving loan of $2.5 million in Q1, 2011.

Dividends to Shareholders

Monthly dividends were declared for shareholders of record on the last business day of each month and were paid on about the 15th day of the following month. Monthly dividends were $0.065 per share for the quarter.

We consider the amount of cash generated by the business in determining the amount of dividends payable to shareholders. In general, we do not take into account quarterly working capital fluctuations as these tend to be temporary in nature. We do not generally consider profit or loss in setting the level of dividends as this is a non-cash metric and is not reflective of the level of cash flow that we generate.

The twelve month rolling Normalized Payout Ratio for March 31, 2012 was 86.3% compared to 96.5% for the same period in 2011. The improved Normalized Payout Ratio is due to the increase in cash provided by operating activities before non-cash operating working capital and the change in the amount of dividends declared.

Capital Expenditures

Our capital expenditures typically include information technology hardware and software (external and internally developed), facility expansion and improvements, and office furniture. Additional capital expenditure requirements may result from significant business expansion. Such amounts are expected to be funded from our operating cash flow. The increase in capital expenditures for the three months ended March 31, 2012 is primarily due to $0.8 million of capital expenditures related to enterprise software replacement.

Contractual Obligations

Commitments

We lease office space and selected equipment under operating lease agreements with terms ranging from one to fifteen years. We also have a term loan, revolving loan and convertible debenture described under "Capital Resources".

Expected future payments are as follows:

Summary of Contractual Obligations

(In thousands of dollars)

	Total	2012 to 2013	2014 to 2015	Beyond 2016
Term loan	$ 130,000	$ -	$ 130,000	$ -
Revolving loans	13,700	-	13,700	-
Convertible debenture	75,000	-	-	75,000
Operating leases, net	74,831	14,183	14,788	45,860
Total	$293,531	$14,183	$158,488	$ 120,860

We are party to various subleases to which we 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. We consider the risk of default by the subtenants to be low therefore no accrual has been set up.

Contingent Consideration

The purchase price for Jacques Lamarre & Associates is contingent on business results and is payable in two instalments. The first instalment of $4.8 million, of which $0.5 million is currently being held for release pending finalization of the purchase price in first half of 2012, was satisfied on closing through cash considerations. The second and final instalment of $2.0 million is subject to certain revenue adjustments, and will be settled in October 2013. As at March 31, 2012, $1.7 million, representing the discounted value and accretion interest of the $2.0 million remaining to be settled, has been recognized as acquisition liability in the statement of financial position.

The purchase price for SBC Systems is contingent on future business results and is payable in three instalments. The first instalment of approximately $5.0 million was satisfied on closing through cash consideration. The second and final instalments of $0.5 million each, are subject to revenue adjustments, and will be settled in March 2013 and 2014, respectively. At March 31, 2012, $0.9 million has been recognized as an acquisition liability on the statement of financial position, representing the $1.0 million of the future instalments discounted.

We have no material contractual obligations other than those described in this MD&A and have no off-balance sheet financing arrangements.

Capital Resources

The following table provides an overview of our capital resources:

Capital Resources *(In thousands of dollars)*	**As at March 31, 2012**	**As at December 31, 2011**
Bank indebtedness	$ 6,933	$ 807
Long- term debt, net of debt issuance costs	142,442	207,121
Convertible debenture, net of issuance costs	70,416	-
Shareholders' equity	355,458	357,583

As at March 31, 2012, our working capital (current assets minus current liabilities, excluding future consideration related to acquisition), was approximately $39.2 million compared to $37.4 million as at December 31, 2011.

The Company has a credit facility agreement for a term of four years, maturing on January 5, 2015. The credit facility provides for a term loan of $130,000 and a revolving facility of $100,000.

Under the agreement, the following credit facilities are available:

- $130 million senior secured term loan ("term loan").
- $93 million senior secured revolving term facility ("revolving loan").
- $7 million swing line.

The interest rates for the facilities are floating, based on a margin over certain referenced rates of interest. The applicable margin may vary up and down depending on the ratio of our consolidated debt to Adjusted EBITDA as calculated in the credit agreement. EBITDA is defined as net income before interest expense, income taxes expenses (recovery), depreciation, amortization, non-controlling interest and non-recurring expenditures. Adjusted EBITDA is defined as EBITDA plus the pro-forma EBITDA from Permitted Acquisitions' entities.

The credit facilities are secured by a general assignment of all our assets. The credit agreement also requires us to maintain the following financial covenants on a consolidated basis:

(i) Ratio of debt to Adjusted EBITDA not greater than 3.25:1.0 up to March 30, 2013, and 3.0:1.0 on March 31, 2013, and thereafter
(ii) Ratio of EBITDA to interest expense of not less than 3.0:1.0

We are in compliance with all the required financial covenants, and the ratios as at March 31, 2012 were 2.0 and 5.4 respectively.

On March 27, 2012, the Company issued $75.0 million principal amount of 5.75% Convertible Unsecured Subordinated Debentures ("Debentures") for net proceeds of $71.4 allocated between debt and equity. 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 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 the Company common shares.

SELECTED STATEMENT OF FINANCIAL POSITION DATA

The following table provides an overview of our selected statement of financial position data:

Selected Statement of Financial Position Data *(in thousands of dollars)*	**As at March 31, 2012**	**As at December 31, 2011**
Current assets	$ 114,862	$ 103,115
Non-Current assets	568,126	564,974
Current liabilities	76,663	66,226
Non-Current liabilities	250,867	244,280

Current Assets

Current assets as at March 31, 2012 increased by $11.8 million to $114.9 million from $103.1 million as at December 31, 2011. The increase was primarily due to an increase in trade receivables and unbilled fees of $13.7 million as a result of growth in revenue and the timing of billings, offset by the $2.2 million provision for the e-commerce tax credit and an increase in prepaid expenses of $0.9 million due to the timing of employee benefits payments. This was offset by decreased cash and investments held for insurance premiums of $0.7 million.

Non-Current Assets

Non-current assets as at March 31, 2012 increased by $3.1 million to $568.1 million from $565.0 million as at December 31, 2011. The increase was primarily due to capital expenditures of $3.6 million and $5.9 million in acquired capital and intangible assets related to the SBC Systems acquisition. This was partially offset by the amortization of capital and intangible assets of $5.9 million.

Current Liabilities

Current liabilities as at March 31, 2012 increased by $10.5 million to $76.7 million from $66.2 million as at December 31, 2011. The increase was primarily the result of an increase in bank indebtedness of $6.1 million, an increase in trade and other payables of $2.7 million, an increase in income taxes payable of $1.0 million, an increase in deferred revenue of $0.9 million and an increase in future consideration related to acquisition of $0.5 million. This was offset by a reduction in insurance premium liabilities of $0.7 million.

Non-Current Liabilities

Non-current liabilities as at March 31, 2012 increased by $6.6 million to $250.9 million from $244.3 million as at December 31, 2011. The increase in the non-current liabilities is primarily the result of an increase in convertible debenture of $70.4 million issued during the quarter, an increase in future consideration related to acquisition of $0.5 million as a result of the acquisition of SBC Systems during the quarter and an increase in deferred tax liability of $2.1 million. This was offset by a decrease in long-term debt of $64.7 million as a result of a pay down using the proceeds from the convertible debenture issuance, a decrease in the fair value of the interest rate swap of $1.5 million and a $0.2 million decrease in deferred tax liability.

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

The preparation of financial statements, in accordance with IFRS, requires us to make estimates and assumptions that affect the reported values of assets and liabilities as well as disclosures of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting period. These estimates are reviewed periodically and, as adjustments become necessary, they are reported in profit or loss in the periods in which they become known. Accordingly, actual results could differ from these estimates. The Company's significant accounting policies are presented in Note 3 of the unaudited condensed interim consolidated financial statements for the three months ended March 31, 2012. The accounting policies and estimates that are critical to our business relate to the following items:

Revenue Recognition

Revenues include fees generated from administrative, actuarial, and consulting services, EAP, health management, and outsourcing contracts.

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

- The amount of revenue can be reliably measured;
- The stage of completion can be reliably measured;
- The receipt of economic benefits is probable; and
- Costs incurred and to be incurred can be reliably measured.

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

Fees for administrative, actuarial and consulting services are billed either on a time-and-material basis or on a fixed-fee basis. On time-and-material engagements, revenue is recognized as services are rendered and expenditures are incurred. On fixed-fee engagements, revenue is recognized in the period in which the services are rendered.

EAP 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 EAP services. Incremental usage is recognized when the minimum usage threshold is exceeded.

Health management 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 singular contract requires the delivery of multiple components, revenue recognition criteria are applied to 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 all of the following criteria are met:

- The delivered item has value to the customer on a stand-alone basis; and
- 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 are recorded at the lower of unbilled hours worked at normal billing rates and the amount which is estimated to be recoverable upon invoicing. Morneau Shepell maintains a provision for amounts expected to be unrecoverable based on the terms of the agreement.

Commissions 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. Other income includes investment income earned in the course of normal business operations, and are recorded on the accrual basis.

Intangible Assets and Goodwill

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

Intangible assets acquired through acquisitions or business combinations are initially recognized at fair value based on an allocation of the purchase price.

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

- It is technically feasible to complete the software so that it will be available for use;
- Management intends to complete the software and use or sell it;
- Morneau Shepell is able to use or sell the software;
- Future benefits associated with the software can be demonstrated;
- Adequate technical, financial, and other resources to complete the development and to use or sell the software are available; and
- The expenditures attributable to the software during its development can be reliably measured.

Eligible expenditures capitalized as part of internally-developed software developed use 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 internal-use computer software project (to the extent that their time was spent directly on the project). All costs incurred in the preliminary research stage of the projects are expensed as incurred.

Intangible assets with a finite life are amortized on a straight-line basis over their estimated useful lives. Intangible assets with an indefinite life are not amortized, but are tested for impairment. Intangible assets are measured at cost less accumulated amortization and accumulated impairment losses.

Goodwill represents the excess of the cost of business acquisitions over the fair value of our share of the net identifiable assets of the acquired subsidiary or equity method investee at the date of acquisition. Goodwill is not amortized and is subject to an annual impairment test, and is carried at cost less accumulated impairment charges.

Income Taxes

Income tax expense comprises current and deferred tax. Current tax and deferred tax 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 tax is 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 tax is 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 tax is 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 and trademark.

Deferred tax is 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, or on different tax entities, but they intend to settle current tax liabilities and assets on a net basis or their tax assets and liabilities will be realized simultaneously.

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.

Allowance for Doubtful Accounts

We are 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, taking into consideration customer creditworthiness, current economic trends, and past experience. If future collections differ from estimates, future earnings could be adversely affected

Litigation and Claims

We are involved in litigation and other claims arising in the normal course of business. We must use judgment to determine whether or not a claim has any merit, the amount of the claim and whether to record a provision, which is dependent upon the potential success of the claim. We believe that none of the current claims will have a material adverse impact on our financial position.

New Accounting Policies

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 at the 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, dividends, losses and gains relating to the financial liability are recognized in profit or loss. Distributions to the equity holders are recognized in equity, net of any tax benefit.

RISKS AND UNCERTAINTIES

The results of operations, business prospects and financial considerations of Morneau Shepell remains subject to a number of risks and uncertainties and are affected by a number of factors outside our control.

Risks Related to the Business of Morneau Shepell

Ability to Maintain Profitability and Manage Growth

There can be no assurance that Morneau Shepell will be able to sustain profitability in future periods. Morneau Shepell's future operating results will depend on a number of factors, including its ability to continue to successfully execute its strategic initiatives.

There can be no assurance that Morneau Shepell will be successful in achieving its strategic plan or that its strategic plan will enable the firm to maintain its historical revenue growth rates or to sustain profitability. Failure to successfully execute any material part of Morneau Shepell's strategic plan could have a material adverse effect on its business, financial condition and operating results, and the ability of Morneau Shepell to pay dividends.

There can be no assurance that Morneau Shepell will be able to effectively manage its growth, and any failure to do so could have a material adverse effect on the firm's business, financial condition and operating results, and on the ability of Morneau Shepell to pay dividends.

Cash Dividends Are Not Guaranteed and Will Fluctuate With the Business Performance

As a corporation, Morneau Shepell's dividend policy is at the discretion of its Board of Directors. The ability of Morneau Shepell to make dividend payments, and the actual amount paid is entirely dependent on the operations and assets of its subsidiaries and is subject to various factors applicable to Morneau Shepell and its subsidiaries including financial performance, obligations under credit facilities, fluctuations in working capital, the sustainability of margin and capital expenditure requirements and applicable laws and regulations.

Reliance on Information Systems and Technology

Information systems are an integral part of Morneau Shepell's business and the products and services offered to its clients. Morneau Shepell relies on systems to maintain accurate records and to carry out required administrative functions in accordance with the terms of its contractual obligations to its clients. In order to maintain the level of security, service and reliability that clients require, Morneau Shepell may be required to make significant investments in the online means of delivering services. The adoption of additional laws or regulations with respect to the internet may impede the efficiency of the internet as a medium of exchange of information and decrease the demand for Morneau Shepell's services.

Any disruptions in Morneau Shepell's systems, the failure of the systems to operate as expected, or the firm's ability to use the internet effectively to deliver services could, depending on the magnitude of the problem, result in a loss of current or future business and/or potential claims against Morneau Shepell, all of which could have a material adverse effect on Morneau Shepell's business, financial condition and operating results, and on the ability of Morneau Shepell to pay dividends.

Reliance on Key Professionals

Morneau Shepell's operations are dependent upon the abilities, experience and efforts of its professionals, many of whom have excellent reputations and a significant number of contacts in the industry in which Morneau Shepell operates. Morneau Shepell's business depends, in part, on its professionals' abilities to develop and maintain client relationships and alliances with businesses such as financial services companies, healthcare organizations, insurance companies, business process outsourcing organizations and other companies, in order to develop, market and deliver its services. Profitability could be negatively impacted if Morneau Shepell's client relationships or business alliances are discontinued due to the loss of professional staff or if the firm has difficulty developing new alliances.

Should any member of its professional staff be unable or unwilling to continue his or her relationship with Morneau Shepell, this change could have a material adverse effect on Morneau Shepell's business, financial condition and operating results, and on the ability of Morneau Shepell to pay dividends.

Reputational Risk

Morneau Shepell depends to a large extent upon its relationships with its clients and its reputation for high-quality services. As a result, the impact of client dissatisfaction with Morneau Shepell's services or products may be more damaging in Morneau Shepell's business than in other businesses. Moreover, if the firm fails to meet its contractual or regulatory obligations, Morneau Shepell could be subject to legal liability and a loss of client relationships.

Economic conditions

An economic slowdown could cause a decline in demand for Morneau Shepell's services. Growth in its clients' businesses may be affected by economic slowdowns and could therefore potentially have an impact on Morneau Shepell's operating results. During an economic downturn, Morneau Shepell clients and potential clients may reduce or delay services or projects, or defer contracts currently underway. This situation could also lead to greater delays and defaults in payments or debt collection, resulting in lower operating results. Because of lower revenue during an economic slowdown, competition may increase and prices may be reduced by certain competitors to maintain or expand their market share. Pricing and profitability could be adversely affected as a result.

Dependence on Key Clients

As clients may terminate engagements with minimum notice, there can be no assurance that Morneau Shepell will be able to retain relationships with its largest clients. Moreover, there can be no assurance that such clients will continue to use Morneau Shepell's services in the future. Any negative change involving any of Morneau Shepell's largest clients, including but not limited to a client's financial condition or desire to continue using the firm's services, could result in a significant reduction in revenue which could have a material adverse effect on Morneau Shepell's business, financial condition and operating results, and on the ability of Morneau Shepell to pay dividends. No one Morneau Shepell client makes up more than 10% of Morneau Shepell's total revenue for three months ended March 31, 2012 and 2011.

Risk of Future Legal Proceedings

Morneau Shepell may be threatened with, or may be named as a defendant in, or may become subject to, various legal proceedings in the ordinary course of conducting its business, including lawsuits based upon professional errors and omissions.

The pension and benefits consulting and outsourcing service involves assumptions and estimates concerning future events, the actual outcome of which cannot be known with certainty in advance. In addition, computational, software programming or data management errors could occur. For example, possible legal proceedings could result from a client's assertion that actuarial assumptions used in a pension plan were unreasonable, leading to plan underfunding; a claim that inaccurate data was used, which could lead to an underestimation of plan liabilities; or a claim that employee benefits plan documents were misinterpreted or plan amendments were misstated in plan documents, which could lead to overpayments to beneficiaries. The employee health and productivity services involve confidential counseling, occupational health activities and disability case management. Each of these activities could potentially put Morneau Shepell in conflict with its customers, their employees, or both. Possible legal proceedings could also result from matters such as an employee claiming for breach of confidence, failure to provide adequate counsel, or denial of benefits or employment as a result of Morneau Shepell's actions.

Defending lawsuits of this nature could require much management attention, which could divert its focus from operations. Such claims could produce negative publicity that could harm Morneau Shepell's reputation and business. A significant judgment against Morneau Shepell, or the imposition of a significant fine or penalty as a result of a finding that Morneau Shepell failed to comply with laws or regulations, could have a material adverse effect on Morneau Shepell's business, financial condition and operating results, and on the ability of Morneau Shepell to pay dividends.

Insurance

Morneau Shepell believes that its professional errors and omissions insurance, director and officer liability insurance, and commercial general liability insurance coverage address all material insurable risks, provides coverage that is similar to that which would be maintained by a prudent operator of a similar business and is subject to deductibles, limits and exclusions which are customary or reasonable given the cost of procuring insurance and current operating conditions. However, there can be no assurance that such insurance will continue to be offered on economically feasible terms, that all events that could give rise to a loss or liability are insurable, or that the amounts of insurance will at all times be sufficient to cover each and every loss or claim that may occur involving Morneau Shepell's assets or operations.

Competition

Morneau Shepell operates in a highly competitive North American market. As a result, Morneau Shepell competes with many domestic and international firms. Some of its competitors have achieved substantially more market penetration in certain of the areas in which Morneau Shepell competes. In addition, some of Morneau Shepell's competitors have substantially more financial resources and/or financial flexibility than Morneau Shepell. Further, Morneau Shepell's business relies, in part, upon its ability to develop and implement technology solutions, in a cost effective manner that anticipate and keep pace with rapid and continuing changes in technology, industry standards and client preferences.
Morneau Shepell's competitors may offer new technologies more efficiently or cost effectively than Morneau Shepell. Competitive forces could result in reduced market share and thus have a material adverse effect on Morneau Shepell's business, financial condition and operating results, and on the ability of Morneau Shepell to pay dividends.

Relationship with Channel Partners

Morneau Shepell markets its services directly to end-user employers as well as through certain channel partners, primarily insurance companies (many of which compete amongst themselves directly). There can be no assurance that Morneau Shepell will be able to maintain its existing relationships with all these channel partners, which could have a material adverse effect on Morneau Shepell's business, financial condition and operating results, and on the ability of Morneau Shepell to pay dividends.

Satisfactory Performance of Obligations

In its contracts with clients, Morneau Shepell is sometimes committed to meeting identified service levels and/or timelines. If the service levels/timelines are not met, Morneau Shepell may experience reduced revenues, incur significant additional costs or be held responsible for the costs incurred by the client for failure to meet the service level/timeline. Morneau Shepell's success depends in large part upon whether it fulfills these and other contractual obligations with clients and maintains client satisfaction. If Morneau Shepell fails to satisfactorily perform its contractual obligations, its clients could terminate contracts and/or take legal action against Morneau Shepell. Such occurrences could result in a loss of its professional reputation and in extra costs needed to defend or rectify the situation and thus have a material adverse effect on Morneau Shepell's business, financial condition and operating results, and on the ability of Morneau Shepell to pay dividends.

Implications of Fixed-Price Contracts

A portion of Morneau Shepell's revenue comes from fixed-price contracts. A fixed-price contract requires Morneau Shepell to perform either all or a specified portion of work under the contract for a fixed price. Fixed-price contracts expose Morneau Shepell to a number of risks, including underestimation of costs, ambiguities in specifications, unforeseen costs or difficulties, problems with new technologies, delays beyond the control of Morneau Shepell, failures of subcontractors to perform, and economic or other changes that may occur during the contract period. Losses under fixed-price contracts could have a material adverse effect on Morneau Shepell's business, financial condition and operating results, and on the ability of Morneau Shepell to pay dividends.

Confidentiality of Client Information

Morneau Shepell depends to a large extent on its relationships with its customers and its ability to properly maintain confidential client information. Morneau Shepell maintains rigorous controls to protect confidential information from unauthorized use or disclosure, however the failure of Morneau Shepell to maintain client confidentiality could, depending on the magnitude of the problem, result in a loss of future business and/or potential claims against Morneau Shepell. This could have a material adverse effect on Morneau Shepell's business, financial condition and operating results, and on the ability of Morneau Shepell to pay dividends.

Protection of Intellectual Property

Morneau Shepell continually develops and improves its proprietary technology solutions for the delivery of its services. No assurance can be given that Morneau Shepell's competitors will not develop substantially similar technology.

Morneau Shepell relies on one or more of the following to protect its proprietary rights: trademarks, copyrights, trade secrets, confidentiality procedures and contractual provisions. Despite Morneau Shepell's efforts to protect its proprietary rights, unauthorized parties may attempt to obtain and use information that Morneau Shepell regards as proprietary.

Stopping unauthorized use of Morneau Shepell's intellectual property may be difficult, time-consuming and costly. There can be no assurance that Morneau Shepell will be successful in protecting its proprietary rights and, if it is not, this could have a material adverse effect on Morneau Shepell's business, financial condition and operating results, and on the ability of Morneau Shepell to pay dividends.

Potential Undisclosed Liabilities Associated with Acquisition/Limited Indemnification

In connection with acquisitions completed by Morneau Shepell, there may be liabilities and contingencies that Morneau Shepell failed to discover or was unable to quantify in its due diligence which it conducted prior to the execution of an acquisition, and Morneau Shepell may not be indemnified for some or all of these liabilities and contingencies. The existence of any material liabilities or contingencies could have a material adverse effect on Morneau Shepell's business, financial condition, liquidity and results of operations.

Indebtedness and Interest Rates

The ability of Morneau Shepell to pay dividends or make other payments or advances will be subject to applicable laws and contractual restrictions contained in the instruments governing any indebtedness of those entities.

The degree to which Morneau Shepell is leveraged could have important consequences including: Morneau Shepell's ability to obtain additional financing for working capital, capital expenditures or acquisitions in the future may be limited; a significant portion of Morneau Shepell's cash flow from operations may be dedicated to the payment of the principal of and interest on its indebtedness, thereby reducing funds available for future operations; certain borrowings will be at variable rates of interest, which exposes Morneau Shepell to the risk of increased interest rates; and Morneau Shepell may be more vulnerable to economic downturns and be limited in its ability to withstand competitive pressures.

These factors may increase the sensitivity of free cash flow to interest rate variations. Interest rate swap agreements are used as part of Morneau Shepell's program to manage the fixed and floating interest rate of Morneau Shepell's credit facilities related overall cost of borrowing.

The advance of the Credit Facilities and the issuance of the convertible debenture has significantly increased the amount of Morneau Shepell's debt compared to historical levels. The Credit Facilities contain numerous restrictive covenants that limit the discretion of management with respect to certain business matters. These covenants place significant restrictions on, among other things, the ability of Morneau Shepell to create liens or other encumbrances, to pay dividends or make certain other payments, investments, loans and guarantees and to sell or otherwise dispose of assets and merge or consolidate with another entity.

In addition, the Credit Facilities contain a number of financial covenants that require Morneau Shepell to meet certain financial ratios and financial condition tests. A failure to comply with the obligations in the Credit Facilities could result in a default which, if not cured or waived, could result in a reduction or termination of dividends by Morneau Shepell and permit acceleration of the relevant indebtedness. If the indebtedness under the Credit Facilities was to be accelerated, there can be no assurance that the assets of Morneau Shepell would be sufficient to repay in full that indebtedness. In addition, the Credit Facilities mature on January 5, 2015. There can be no assurance that future borrowings or equity financing will be available to Morneau Shepell or available on acceptable terms, in an amount sufficient to fund Morneau Shepell's needs.

The convertible debentures are convertible into the Company's common shares at the option of the holder of the debenture. If the debenture converts this may have a dilutive impact on the Company's earnings per share. Additionally, a conversion will increase the cash required to maintain dividend payments at current levels.

Foreign Exchange Risk

A portion of Morneau Shepell's sales are in U.S. dollars and thus Morneau Shepell is exposed to fluctuations in the value of the U.S. dollar relative to the Canadian dollar. The net revenue exposure denominated in U.S. dollars was $3.9 million for the three months ended March 31, 2012. An increase in foreign revenues would expose Morneau Shepell to fluctuations in exchange rates which may have a material adverse effect on Morneau Shepell's business, financial condition, and operating results, and on the ability of Morneau Shepell to pay dividends.

Risk Related to the Structure of Morneau Shepell

Market Price of Common Shares

The market price of the Common Shares may be subject to wide fluctuations in response to many factors, including variations in operating results of Morneau Shepell, divergence in financial results from expectations, changes in business prospects for Morneau Shepell, general economic conditions, legislative changes, and other events and factors outside Morneau Shepell's control.

Sales of a substantial number of Common Shares by a significant shareholder in the public market or otherwise could adversely affect the prevailing market prices of the Common Shares and could impair the Corporation's ability to raise additional capital through an offering of Common Shares.
The possible perception among the public that these sales will occur could also produce the same effect.

Dilution of Common Shares

Pursuant to its articles of incorporation, Morneau Shepell is authorized to issue an unlimited number of Common Shares and 10 million preferred shares for the consideration and on such terms as are established by the Board of Directors without the approval of any shareholders. Any further issuance of Common shares may dilute the interests of existing shareholders. Furthermore, Morneau Shepell may make future acquisitions or enter into financings or other transactions involving the issuance of securities of Morneau Shepell which may be dilutive.

SUPPLEMENTARY SUMMARY OF QUARTERLY RESULTS

Operating results and condensed statement of financial position history are as follows:

Operating Results, Dividend and Condensed Statement of Financial Positions
Selected Unaudited Consolidated Financial Information (In thousands of dollars except per share amounts)

Quarter ended	March 31 2012	December 31 2011	September 30 2011	June 30 2011	March 31 2011	December 31 2010	September 30 2010	June 30 2010
Revenue	$103,966	$97,447	$91,574	$90,565	$85,402	$87,017	$83,083	$83,669
Profit (loss)	4,421	5,925	6,387	6,133	6,458	(7,238)	8,671	12,345
EBITDA	16,173	17,440	18,491	17,801	15,609	8,119	17,317	15,848
Adjusted EBITDA	19,251	17,995	18,491	17,993	15,609	16,494	17,857	15,848
EBITDA margin	15.6%	17.9%	20.2%	19.7%	18.3%	9.3%	20.8%	18.9%
Adjusted EBITDA margin	18.5%	18.5%	20.2%	19.9%	18.3%	19.0%	21.5%	18.9%
Earnings per Share (basic) (1)	0.09	0.12	0.13	0.13	0.13	NA	NA	NA
Earnings per Share (diluted) (1)	0.09	0.12	0.13	0.13	0.13	NA	NA	NA
Twelve-month rolling Normalized Payout Ratio (2)	86.3%	92.1%	91.7%	94.4%	96.5%	101.8%	97.6%	98.2%
Total assets	$682,998	$668,089	$668,030	$659,721	$656,059	$649,855	$651,339	$660,673
Total long-term debt (3)	$212,858	$207,121	$198,505	$193,388	$184,772	$183,355	$159,238	$159,121

(1) This calculation has not been presented for the comparative 2010 period given the classification of Fund and LP Units as financial liabilities in accordance with IFRS.

(2) Twelve- month Normalized Free Cash Flow has been revised to include current income tax expenses instead of income tax paid to remove the timing effect of annual tax payments as the Company moved into its second year of post income fund structure. The comparative amounts and ratios have been restated to reflect the revision.

(3) Includes convertible debentures issued on March 27, 2012.

Disclosure Controls and Procedures

Our disclosure controls and procedures have been designed to provide reasonable assurance that all relevant information is identified to its Disclosure Committee to ensure appropriate and timely decisions are made regarding public disclosure. The Chief Executive Officer and the Chief Financial Officer have concluded that the disclosure controls and procedures are appropriately designed and operating effectively as at March 31, 2012.

Internal control over financial reporting

Management is responsible for designing internal controls over financial reporting, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with IFRS.

The Chief Executive Officer and the Chief Financial Officer have concluded that the internal controls over financial reporting are appropriately designed as at March 31, 2012.

No changes were made in our internal controls over financial reporting during the first quarter ended March 31, 2012, that have materially affected, or are reasonably likely to materially affect, our internal controls over financial reporting.

Additional Information

Morneau Shepell's shares currently trade on the Toronto Stock Exchange under the symbol MSI. Additional information relating to us, including all public filings, is available on the SEDAR Web site (www.sedar.com) and on our own Web site at www.morneaushepell.com.

The content of this MD&A reflects information known as of May 15, 2012.

MORNEAU SHEPELL

Morneau Shepell Inc. is the largest Canadian-based firm offering benefits and pension consulting, outsourcing, as well as health management services. The company works with clients to develop end-to-end insights and solutions that integrate with their business strategies to achieve results. Through Benefits and Health Solutions Consulting, Pension Consulting, Health Management, Administration Solutions and Shepell·fgi's Employee and Family Assistance Program, Morneau Shepell helps clients reduce costs, increase employee productivity, and improve their competitive positions by supporting their employees' financial security, health and well-being.

Established in 1966, Morneau Shepell serves over 8,000 clients, ranging from small businesses to some of the largest corporations and associations in North America. With approximately 2,600 employees in offices across North America, we provide services to organizations across Canada, in the United States and around the globe.

INFO@MORNEAUSHEPELL.COM