Unaudited Condensed Consolidated Interim Financial Statements
(In Canadian dollars)

MORNEAU SHEPELL INC.

Three and nine months ended September 30, 2017 and 2016
(Unaudited)

MORNEAU SHEPELL INC.

Unaudited Condensed Consolidated Interim Statements of Financial Position
(In thousands of Canadian dollars)
September 30, 2017 and December 31, 2016

	September 30, 2017	December 31, 2016
Assets		
Current assets:		
Trade and other receivables	$ 78,203	$ 67,291
Unbilled fees	72,110	61,131
Prepaid expenses and other	11,685	8,159
Cash and investments held in trust	12,834	17,211
Deferred implementation costs	7,973	7,146
Total current assets	182,805	160,938
Non-current assets:		
Unbilled fees	3,830	5,128
Deferred implementation costs	22,004	19,406
Capital assets	36,398	34,499
Intangible assets	219,256	230,572
Goodwill	320,108	320,757
Interest rate swaps (note 4)	294	–
Deferred tax asset	1,017	2,326
Total non-current assets	602,907	612,688
Total assets	$ 785,712	$ 773,626

MORNEAU SHEPELL INC.

Unaudited Condensed Consolidated Interim Statements of Financial Position
(In thousands of Canadian dollars)
September 30, 2017 and December 31, 2016

	September 30, 2017	December 31, 2016
Liabilities and Equity		
Current liabilities:		
Bank indebtedness (note 4)	$ 7,717	$ 3,056
Trade and other payables	49,400	59,157
Income taxes payable	5,955	2,200
Deferred revenue	6,520	5,121
Insurance premium liabilities	12,834	17,211
Future consideration related to acquisitions (note 9)	2,633	5,252
Dividends payable	3,497	3,460
Interest rate swaps (note 4)	242	1,625
Total current liabilities	88,798	97,082
Non-current liabilities:		
Long-term debt (note 4)	184,254	166,299
Convertible debentures payable	81,828	81,096
Future consideration related to acquisitions (note 9)	427	2,258
Other liabilities	12,516	12,838
Provisions	3,282	3,764
Deferred tax liability	48,991	48,582
Total non-current liabilities	331,298	314,837
Equity:		
Share capital	558,250	552,038
Contributed surplus	26,819	27,369
Equity component of convertible debentures	1,045	1,045
Accumulated other comprehensive loss	(3,175)	(2,451)
Deficit	(217,323)	(216,294)
Total equity	365,616	361,707
Total liabilities and equity	$ 785,712	$ 773,626

Commitments and contingencies (note 9)

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

MORNEAU SHEPELL INC.

Unaudited Condensed Consolidated Interim Statements of Income and Comprehensive Income
(In thousands of Canadian dollars, except per share amounts)
For the three and nine months ended September 30, 2017 and 2016

	Three months ended September 30, 2017	Three months ended September 30, 2016	Nine months ended September 30, 2017	Nine months ended September 30, 2016
Operating revenue	$ 153,782	$ 144,594	$ 472,433	$ 442,967
Operating expenses:				
Salaries, benefits and contractors	102,716	100,903	317,619	302,439
Rent and occupancy	6,859	7,481	20,805	21,377
Office and administration	17,247	16,177	52,162	51,090
Depreciation and amortization	9,603	8,778	28,392	26,126
Write-down of deferred implementation costs	–	935	–	935
Total operating expenses	136,425	134,274	418,978	401,967
Finance costs (note 4)	3,450	3,250	9,888	11,749
Profit from operations before income taxes	13,907	7,070	43,567	29,251
Income taxes expense (recovery):				
Current	3,774	2,290	13,327	8,541
Deferred	479	(430)	(53)	370
Total income taxes	4,253	1,860	13,274	8,911
Profit for the period	9,654	5,210	30,293	20,340
Other comprehensive income (loss):				
Items that may be reclassified subsequently to profit:				
Effective portion of change in interest rate cash flow hedges	772	459	1,677	1,504
Foreign currency translation differences for foreign operations	(1,106)	366	(2,049)	(1,731)
Income taxes on the above items	(208)	(123)	(450)	(404)
	(542)	702	(822)	(631)
Items that will not be reclassified to profit:				
Actuarial gain/(loss) on post-employment benefit plans	78	(27)	132	(259)
Income taxes on the above item	(20)	7	(34)	75
	58	(20)	98	(184)
Other comprehensive income (loss), net of tax effect	(484)	682	(724)	(815)
Comprehensive income for the period	$ 9,170	$ 5,892	$ 29,569	$ 19,525
Earnings per share (note 6):				
Basic	$ 0.17	$ 0.09	$ 0.55	$ 0.39
Diluted	$ 0.17	$ 0.09	$ 0.54	$ 0.39

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

MORNEAU SHEPELL INC.

Unaudited Condensed Consolidated Interim Statements of Changes in Equity
(In thousands of Canadian dollars)
For the nine months ended September 30, 2017 and 2016

2017	Share capital	Contributed surplus	Deficit	Accumulated other comprehensive loss	Equity component of convertible debentures	Total equity
Balance, January 1, 2017	$ 552,038	$ 27,369	$ (216,294)	$ (2,451)	$ 1,045	$ 361,707
Long-term incentive plan – expense and issuance	–	5,662	–	–	–	5,662
Long-term incentive plan – redemption	6,212	(6,212)	–	–	–	–
Profit for the period	–	–	30,293	–	–	30,293
Dividends	–	–	(31,322)	–	–	(31,322)
Other comprehensive loss	–	–	–	(724)	–	(724)
Balance, September 30, 2017	$ 558,250	$ 26,819	$ (217,323)	$ (3,175)	$ 1,045	$ 365,616

2016	Share capital	Contributed surplus	Deficit	Accumulated other comprehensive loss	Equity component of convertible debentures	Total equity
Balance, January 1, 2016	$ 477,500	$ 23,312	$ (197,605)	$ (2,850)	$ 757	$ 301,114
Long-term incentive plan – expense and issuance	–	3,955	–	–	–	3,955
Long-term incentive plan – redemption	64	(64)	–	–	–	–
Equity component of convertible debentures issuance	–	–	–	–	1,045	1,045
Shares issued upon conversion of convertible debentures	73,121	–	–	–	(731)	72,390
Redemption of convertible debentures	–	26	–	–	(26)	–
Profit for the period	–	–	20,340	–	–	20,340
Dividends	–	–	(29,625)	–	–	(29,625)
Other comprehensive loss	–	–	–	(815)	–	(815)
Balance, September 30, 2016	$ 550,685	$ 27,229	$ (206,890)	$ (3,665)	$ 1,045	$ 368,404

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 nine months ended September 30, 2017 and 2016

	Nine months ended September 30, 2017	Nine months ended September 30, 2016
Operating activities:		
Profit for the period	$ 30,293	$ 20,340
Items not involving cash:		
Depreciation and amortization	28,392	26,126
Finance costs (note 4)	9,888	11,749
Long-term incentive plan expense	5,662	3,646
Income taxes	13,274	8,911
Change in provisions	(482)	(314)
Other	(397)	(329)
	86,630	70,129
Change in non-cash operating working capital (note 8)	(34,965)	(17,201)
Cash generated from operating activities	51,665	52,928
Finance costs paid	(9,642)	(9,170)
Income taxes paid	(8,440)	(4,666)
Cash provided by operating activities	33,583	39,092
Financing activities:		
Change in revolving loan (net)	17,719	(69,652)
Redemption of convertible debentures	–	(2,512)
Dividends paid	(31,284)	(29,293)
Proceeds from convertible debentures (net of issuance costs)	–	81,982
Repayment of promissory note	–	(2,500)
Cash used in financing activities	(13,565)	(21,975)
Investing activities:		
Business acquisitions	(4,941)	(1,033)
Additions to intangible assets	(8,445)	(10,065)
Additions to capital assets	(11,293)	(7,935)
Cash used in investing activities	(24,679)	(19,033)
Decrease in cash for the period	(4,661)	(1,916)
Cash/(Bank indebtedness), beginning of period	(3,056)	1,900
Bank indebtedness, end of period	$ (7,717)	$ (16)

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

1. Organization and nature of the business:

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

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

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

These unaudited condensed consolidated interim financial statements were approved by the Company's Board of Directors on November 7, 2017.

2. Basis of preparation:

These unaudited condensed consolidated interim financial statements for the three and nine months ended September 30, 2017 and 2016 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, 2016 prepared in accordance with IFRS as issued by the IASB.

3. Significant accounting policies:

(i) Changes in accounting policies:

The accounting policies applied by the Company in these unaudited condensed consolidated interim financial statements are consistent with those applied by the Company in its consolidated financial statements as at and for the year ended December 31, 2016.

(ii) Future accounting changes:

IFRS 15, Revenue from Contracts with Customers ("IFRS 15")

On May 28, 2014, the IASB issued IFRS 15. The new standard is effective for fiscal years beginning on or after January 1, 2018 and is available for early adoption. The standard contains a single model that applies to contracts with customers and two approaches to recognizing revenue: at a point in time or over time. The model features a contract-based five-step analysis of transactions to determine whether, how much and when revenue is recognized. New estimates and judgmental thresholds have been introduced, which may affect the amount and/or timing of revenue recognized. The Company intends to adopt IFRS 15 in its financial statements for the annual period beginning on January 1, 2018.

We expect the application of IFRS 15 will impact our financial statements in respect of timing of revenue recognition and the accounting for deferred implementation costs related to certain groups of clients within our Administrative Solutions line of business. We are working through our project plan and have made progress in our implementation of IFRS 15, but it is not yet possible to make a final determination of the impact of the new standard on our financial statements. We expect to report more detailed information, including estimated quantitative financial effects, in our 2017 annual consolidated financial statements.

IFRS 9, Financial Instruments ("IFRS 9")

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

IFRS 16, Leases ("IFRS 16")

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

(In thousands of Canadian dollars)

4. Long-term debt:

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

	September 30, 2017	December 31, 2016
Revolving loans	$ 185,104	$ 167,385
Less: debt issuance costs, net of accumulated amortization	(850)	(1,086)
	$ 184,254	$ 166,299

The Company has a credit facility agreement (the "Credit Facility Agreement") that matures on December 20, 2020 and provides for a revolving facility of $300,000 (including a swing line of $14,000).

At September 30, 2017, the Company had utilized the following amounts under the Credit Facility Agreement:

- $170,000 of BA loans under the revolving loan. The BA loans are renewed on a monthly basis, bearing interest at the one-month BA rate plus an applicable margin of 1.45%.
- $2,000 of Prime loans under the revolving loan. The Prime loans are renewed on a monthly basis, bearing interest at the one-month Prime rate plus an applicable margin of 0.45%.
- $4,992 (US $4,000) of US Libor loans under the revolving loan. The US Libor loans are renewed on a monthly basis, bearing interest at the one-month US Libor rate plus an applicable margin of 1.45%.
- $8,112 (US $6,500) of US Base Rate loans under the revolving loan. The US Base Rate loans are renewed on a monthly basis, bearing interest at the one-month US Base Rate plus an applicable margin of 0.45%.
- $6,930 of the swing line available. The swing line carries interest at prime plus an applicable margin of 0.45%.

As at September 30, 2017, the Company complied with all the required financial covenants.

Interest rate swaps:

The Company entered into a forward-starting interest rate swap agreement in February 2014 to hedge against the variable interest rate component on $160,000 notional amount borrowed under the 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 September 30, 2017 was a liability of $242 (December 31, 2016 - $1,625).

In July 2017, the Company entered into a forward-starting interest rate swap agreement to hedge against the variable interest rate component on $50,000 notional amount borrowed under the Credit Facility Agreement for the period from November 29, 2017 up to and ending December 20, 2020. The notional amount of this swap is $50,000 and is used to fix the variable component of the interest rate at 1.79%, 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 September 30, 2017 was an asset of $294.

5. Dividends:

The monthly dividend rate, approved by the Board of Directors, was $0.065 for the three and nine months ended September 30, 2017 (2016 - $0.065). Dividends declared for the three and nine months ended September 30, 2017 were $10,525 and $31,322, respectively. The Company continued to declare the same monthly dividend amount in October 2017.

6. Earnings per share:

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

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

(In thousands of Canadian dollars)

The following details the earnings per share, basic and diluted, calculations for the three and nine months ended September 30, 2017 and 2016:

	Three months ended September 30, 2017	Three months ended September 30, 2016	Nine months ended September 30, 2017	Nine months ended September 30, 2016
Profit attributable to common shareholders (basic and diluted)	$ 9,654	$ 5,210	$ 30,293	$ 20,340
Weighted average number of common shares (in number of shares):				
January 1	–	–	53,228,470	48,272,449
July 1	53,792,312	53,104,152	–	–
Issued on redemption of LTIP[1]	5,159	–	270,219	2,563
Issued upon conversion of convertible debentures[1]	–	–	–	2,064,186
Vested LTIP awards	1,670,954	1,902,727	1,757,988	1,703,966
Basic	55,468,425	55,006,879	55,256,677	52,043,164
Dilutive effect of unvested LTIP awards	573,258	532,901	570,909	591,748
Diluted	56,041,683	55,539,780	55,827,586	52,634,912
Earnings per share:				
Basic	$ 0.17	$ 0.09	$ 0.55	$ 0.39
Diluted	$ 0.17	$ 0.09	$ 0.54	$ 0.39

[1] During the three months ended September 30, 2017, 12,559 shares (2016- nil shares) were issued on redemption of LTIP units. During the nine months ended September 30, 2017, 576,401 shares (2016- 5,576 shares) were issued on redemption of LTIP units, and nil shares (2016- 4,826,127 shares) were issued upon conversion of convertible debentures.

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

7. Segmented information:

The Company provides health and productivity, administrative and retirement solutions to assist employers in managing the financial security, health and productivity of their employees. As at September 30, 2017, aggregation of operating segments was applied to determine that the Company had only one reportable segment.

(In thousands of Canadian dollars)

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 September 30,		Nine months ended September 30,	
	2017	2016	2017	2016
Revenue:				
Canada	$ 131,897	$ 124,934	$ 408,989	$ 386,522
United States	21,885	19,660	63,444	56,445
Consolidated total	$ 153,782	$ 144,594	$ 472,433	$ 442,967

	September 30, 2017	December 31, 2016
Total assets:		
Canada	$ 713,728	$ 712,779
United States	71,984	60,847
Consolidated total	$ 785,712	$ 773,626

8. Supplementary cash flow information:

Change in non-cash operating working capital for the nine months ended September 30, 2017 and 2016 was as follows:

	2017	2016
Trade and other receivables	$ (10,912)	$ (627)
Unbilled fees, current and non-current	(9,681)	(2,562)
Prepaid expenses and other	(3,526)	(2,978)
Deferred implementation costs, current and non-current	(4,648)	(6,142)
Trade and other payables	(7,597)	(7,837)
Deferred revenue	1,399	2,945
	$ (34,965)	$ (17,201)

(In thousands of Canadian dollars)

9. Financial instruments:

Financial instruments carried at fair value:

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

	Carrying Value and Fair Value September 30, 2017	Carrying Value and Fair Value December 31, 2016	Level
Assets carried at fair value:			
Cash and investments held in trust	$ 12,834	$ 17,211	2
Interest rate swaps	294	–	2
	$ 13,128	$ 17,211	
Liabilities carried at fair value:			
Bank indebtedness	$ 7,717	$ 3,056	1
Interest rate swaps	242	1,625	2
Future consideration related to acquisitions	3,060	7,510	3
	$ 11,019	$ 12,191	

During the nine months ended September 30, 2017, there were no transfers between any levels.

The future consideration related to acquisitions is a financial instrument carried at fair value through profit or loss. The fair value of the future consideration related to these acquisitions is determined considering the estimated payment, discounted to present value. The total aggregate contingent consideration remaining to be paid for these acquisitions ranges from a contractual amount of $nil to maximum of $3,175.

(In thousands of Canadian dollars)

The following table indicates the changes in the future consideration related to acquisitions during the nine months ended September 30, 2017:

	Future consideration related to acquisitions
Balance at January 1, 2017	$ 7,510
Settlements of contingent consideration	(4,941)
Foreign exchange	59
Re-measurement	(207)
Accretion	639
	$ 3,060

Financial instruments carried at amortized cost:

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

The convertible debentures payable and long-term debt are financial instruments carried at amortized cost whose carrying values do not equal their fair market values. The convertible debentures payable have a carrying value of $81,828 (December 31, 2016 - $81,096) and a fair value of $91,160 (December 31, 2016 - $90,300). 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 $184,254 (December 31, 2016 - $166,299) and a fair value of $185,104 (December 31, 2016 - $167,385). The fair value is determined based on the cost of borrowing for a company with a similar risk profile (Level 2).

Credit Risk:

As at September 30, 2017, one U.S. public sector customer comprised $13,342 (December 31, 2016- $4,083) of the trade and other receivables balance, of which $10,008 (December 31, 2016- $504) is greater than ninety days past due.