Unaudited Condensed Consolidated Interim Financial Statements
(In Canadian dollars)

MORNEAU SHEPELL INC.

Three and nine months ended September 30, 2012 and 2011
(Unaudited)

MORNEAU SHEPELL INC.

Unaudited Condensed Consolidated Interim Statements of Financial Position
(In thousands of Canadian dollars)
September 30, 2012 and December 31, 2011

	September 30, 2012	December 31, 2011
Assets		
Current assets:		
Trade and other receivables	$ 67,056	$ 62,909
Unbilled fees	31,474	22,732
Prepaid expenses and other	4,436	3,105
Cash and investments held in trust	7,499	12,248
Deferred implementation costs	2,151	2,121
Total current assets	112,616	103,115
Non-current assets:		
Unbilled fees	1,203	1,505
Deferred implementation costs	8,664	7,000
Capital assets	21,357	23,961
Intangible assets	229,015	230,716
Goodwill	305,009	301,792
Total non-current assets	565,248	564,974
Total assets	$ 677,864	$ 668,089

MORNEAU SHEPELL INC.

Unaudited Condensed Consolidated Interim Statements of Financial Position
(In thousands of Canadian dollars)
September 30, 2012 and December 31, 2011

	September 30, 2012	December 31, 2011
Liabilities and Equity		
Current liabilities:		
Bank indebtedness	$ 828	$ 807
Trade and other payables	38,431	47,092
Income taxes payable	3,558	213
Deferred revenue	2,890	2,250
Insurance premium liabilities	7,499	12,248
Future consideration related to acquisition (note 11)	983	500
Dividends payable	3,116	3,116
Total current liabilities	57,305	66,226
Non-current liabilities:		
Long-term debt (note 5)	156,915	207,121
Debenture payable (note 6)	70,875	–
Interest rate swap (note 5)	3,609	5,389
Future consideration related to acquisition (note 11)	2,251	1,653
Other liabilities	7,739	7,670
Provisions	1,464	1,887
Deferred tax liability	26,692	20,560
Total non-current liabilities	269,545	244,280
Equity:		
Share capital	473,838	473,838
Contributed surplus	11,540	8,721
Equity component of convertible debenture (note 6)	757	–
Accumulated other comprehensive loss	(3,090)	(4,648)
Deficit	(132,031)	(120,328)
Total equity	351,014	357,583
Total liabilities and equity	$ 677,864	$ 668,089

Subsequent events (note 7 and 12)

See accompanying notes to unaudited condensed consolidated interim financial statements.

MORNEAU SHEPELL INC.

Unaudited Condensed Consolidated Interim Statements of Income and Comprehensive Income
(In thousands of Canadian dollars, except per share amounts)
For the three and nine months ended September 30, 2012 and 2011

	Three months ended September 30, 2012	Three months ended September 30, 2011	Nine months ended September 30, 2012	Nine months ended September 30, 2011
Revenue:				
Fees	$ 94,632	$ 86,035	$ 296,866	$ 253,914
Commissions and other income	6,699	5,539	15,222	13,627
Total operating revenue	101,331	91,574	312,088	267,541
Operating expenses:				
Salary, benefits and contractor	67,418	58,161	210,865	173,072
Depreciation and amortization	5,908	5,315	18,310	15,595
Rent and occupancy	4,811	4,184	13,864	12,619
Office and administration	10,833	10,738	32,997	29,757
Total operating expenses	88,970	78,398	276,036	231,043
Contingent consideration related to business acquisitions	–	–	–	192
Finance costs (note 5)	3,462	3,847	10,562	11,119
Profit from operations before income taxes	8,899	9,329	25,490	25,187
Income taxes:				
Current	1,369	213	3,799	580
Deferred	1,425	2,729	4,891	5,629
Total income taxes	2,794	2,942	8,690	6,209
Profit for the period	6,105	6,387	16,800	18,978
Other comprehensive income (loss):				
Effective portion of change in interest rate cash flow hedge	528	(3,778)	1,780	(5,927)
Ineffective portion of changes in fair value of interest rate cash flow hedges transferred to profit	–	191	–	380
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	667	2,527
Foreign currency translation differences for foreign operations	(110)	356	(263)	186
Income tax on other comprehensive income (loss)	(59)	761	(626)	(139)
Other comprehensive income (loss), net of tax effect	359	(1,887)	1,558	(2,699)
Comprehensive income for the period	$ 6,464	$ 4,500	$ 18,358	$ 16,279
Earnings per share:				
Basic (note 8)	$ 0.13	$ 0.13	$ 0.35	$ 0.39
Diluted (note 8)	$ 0.12	$ 0.13	$ 0.34	$ 0.39

See accompanying notes to unaudited condensed consolidated interim financial statements.

MORNEAU SHEPELL INC.

Unaudited Condensed Consolidated Interim Statements of Changes in Equity
(In thousands of Canadian dollars)
For the nine months ended September 30, 2012 and 2011

Nine months ended September 30, 2012	Share capital	Contributed surplus	Deficit	Accumulated other comprehensive loss	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	–	2,362	–	–	–	2,362
Long-term incentive plan - DRIP	–	457	(457)	–	–	–
Profit for the period	–	–	16,800	–	–	16,800
Dividends	–	–	(28,046)	–	–	(28,046)
Other comprehensive income	–	–	–	1,558	–	1,558
Convertible debenture (note 6)	–	–	–	–	757	757
Balance, September 30, 2012	$ 473,838	$ 11,540	$ (132,031)	$ (3,090)	$ 757	$ 351,014

Nine months ended September 30, 2011	Share capital	Contributed surplus	Deficit	Accumulated other comprehensive loss	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	–	1,916	–	–	1,916
Long-term incentive plan - DRIP	–	288	(288)	–	–
Profit for the period			18,978	–	18,978
Dividends	–	–	(28,044)	–	(28,044)
Other comprehensive loss	–	–	–	(2,699)	(2,699)
Balance, September 30, 2011	$ 473,838	$ 7,653	$ (116,783)	$ (5,054)	$ 359,654

See accompanying notes to 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, 2012 and 2011

	Nine months ended September 30, 2012	2011
Operating activities:		
Profit for the period	$ 16,800	$ 18,978
Items not involving cash:		
Depreciation of capital assets	6,127	4,971
Amortization of intangible assets	12,183	10,624
Finance costs	10,562	11,119
Long-term incentive plan	2,362	1,916
Current income taxes	3,799	580
Deferred income taxes	4,891	5,629
Change in provisions	(423)	(391)
Other	70	461
	56,371	53,887
Change in non-cash operating working capital (note 10)	(25,298)	(13,397)
Cash generated from operating activities	31,073	40,490
Finance costs paid	(8,850)	(7,866)
Income taxes paid	(310)	(456)
Cash provided by operating activities	21,913	32,168
Financing activities:		
Payment of credit agreement renewal fees	–	(1,200)
Change in revolving loan	(50,551)	16,000
Proceeds from debenture offering (note 6)	75,000	–
Expenses related to issuance of debenture (note 6)	(3,568)	–
Settlement of interest rate swap	–	(4,150)
Dividends paid	(28,046)	(24,928)
Cash used in financing activities	(7,165)	(14,278)
Investing activities:		
Business acquisition, net of cash acquired (note 4)	(4,678)	(9,114)
Additions to intangible assets	(6,938)	(4,912)
Additions to capital assets	(3,153)	(8,166)
Cash used in investing activities	(14,769)	(22,192)
Net decrease in cash for the period	(21)	(4,302)
(Bank indebtedness)/cash, beginning of period	(807)	360
Bank indebtedness, end of period	$ (828)	$ (3,942)

See accompanying notes to unaudited condensed consolidated interim financial statements.

1. Organization and nature of the business:

Morneau Shepell Inc. (the "Company") provides human resource consulting, outsourcing, Employee Assistance Programs ("EAP") and health management 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 consolidated interim financial statements were approved by the Company's Board of Directors on November 14, 2012.

2. Basis of preparation:

These unaudited condensed consolidated interim financial statements for the three and nine months ended September 30, 2012 and 2011 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 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, 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 as 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:

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

On January 31, 2012, the Company completed the acquisition of SBC Systems Company, a company specializing in providing employee benefits administration systems in the United States. This acquisition provides 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 U.S. $6,000 payable in three instalments. The first instalment of approximately $5,014 (U.S. $5,000) was satisfied on closing through cash consideration. The second and final instalments estimated at U.S. $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 September 30, 2012, $908 has been recognized as an acquisition liability on the statement of financial position, representing the U.S. $1,000 final instalments discounted and translated to Canadian dollars.

(In thousands of Canadian dollars)

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 intangible assets. During the second and third quarter of 2012 the Company changed the purchase price allocation as a result of working capital, intangible assets and goodwill adjustments.

	Initial	YTD Adjustments	Revised
Cash	$ 274	$ 60	$ 334
Trade and other receivables	180	–	180
Prepaid expenses and other	129	36	165
Capital assets	250	120	370
Intangible assets	5,601	(2,467)	3,134
Goodwill	–	2,442	2,442
Trade and other payables	–	(104)	(104)
Deferred revenue	(552)	(87)	(639)
	$ 5,882	$ –	$ 5,882

As at September 30, 2012, the valuation of the intangible assets acquired is close to completion. 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 a change to goodwill. The preliminary goodwill is attributable mainly to the workforce and the synergies expected to be achieved from the integration of SBC Systems Company as well as the ability to expand the Company's existing Outsourcing business in the US.

These consolidated financial statements include the results of SBC Systems Company from the date of acquisition, January 31, 2012. For the three and nine months ended September 30, 2012, SBC Systems Company contributed revenue of $1,762 and $4,993, respectively and profit of $6 for the three months ended September 30, 2012 and a loss of $145 for the nine months ended September 30, 2012.

Had this acquisition occurred on January 1, 2012, the revenue would have increased by approximately $565 and profit decreased by ($78) for the nine months ended September 30, 2012. 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)

4. Business acquisitions (continued):

(b) Jacques Lamarre & Associates and Parcours d'enfant ("Jacques Lamarre & Associates"):

On September 30, 2011, the Company completed the acquisition of Jacques Lamarre & Associates, a company specializing in providing EAP services, crisis management, and organizational health and productivity solutions.

This acquisition has been accounted for using the purchase method of accounting. During the third quarter of 2012 the Company finalized the purchase price allocation, making changes to working capital, intangible assets and goodwill. Below is the final purchase price allocation.

	Initial	Adjustment	Revised
Trade and other receivables	$ 1,250	$ (230)	$ 1,020
Unbilled fees	2,210	(910)	1,300
Prepaid expenses and other	20	(20)	–
Capital assets	160	–	160
Intangible assets – customer relationships	2,950	410	3,360
Goodwill	1,000	774	1,774
Trade and other payables	(1,190)	176	(1,014)
Deferred tax liability	–	(200)	(200)
	$ 6,400	$ –	$ 6,400

5. Long- term debt:

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

	September 30, 2012	December 31, 2011
Non-revolving loans	$ 130,000	$ 130,000
Revolving loans	27,944	78,500
	157,944	208,500
Less: debt issuance costs, net of accumulated amortization	1,029	1,379
	$ 156,915	$ 207,121

5. Long- term debt (continued):

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

The Company is required to maintain Debt to Adjusted EBITDA financial covenant of not more than 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 September 30, 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 2.375%.
- $21,500 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 2.375%.
- $3,000 of prime loans under the revolving loan. The prime loan bears interest at the prime rate plus an applicable margin of 1.375%.
- $3,500 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 2.375%.
- $761 of the swing line available. The swing line carries interest at prime plus an applicable margin of 1.375%.

As at September 30, 2012, the Company complied with all the required financial covenants. At September 30, 2012, the Debt to Adjusted EBITDA ratio was 2.0 and the EBITDA to interest expense ratio was 5.7.

(In thousands of Canadian dollars)

5. Long- term debt (continued):

(a) Interest rate swap:

The Company entered into an interest-rate swap agreement 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 September 30, 2012 was a liability of $3,609 (December 31, 2011 - $5,389).

(b) Finance costs:

The Company's finance costs comprise the following:

	Three months ended September 30,		Nine months ended September 30,	
	2012	2011	2012	2011
Interest on term loan	$ 1,515	$ 1,748	$ 4,908	$ 5,158
Interest on revolving loan, bank indebtedness and other charges	435	839	1,672	2,150
Interest on convertible debenture (note 6)	1,141	–	2,332	–
Amortization of debt issuance costs	292	117	710	351
Immediate recognition and amortization of terminated interest rate swap	–	583	667	2,527
Other	79	560	273	933
	$ 3,462	$ 3,847	$ 10,562	$ 11,119

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.

(In thousands of Canadian dollars)

6. Convertible debenture (continued):

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 common shares.

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

The discount on the debentures is being accreted such that the liability at maturity will equal 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 nine months ended September 30, 2012:

	Debt component	Equity component
Balance at March 27, 2012	$ 70,404	$ 757
Accretion and Amortization on convertible debentures	471	–
	$ 70,875	$ 757

(In thousands of Canadian dollars)

7. Dividends:

Dividends are declared in Canadian dollars. The monthly dividend rate, approved by the Board of Directors, was $0.065 for the nine months ended September 30, 2012 (nine months ended September 30, 2011 - $0.065). The Company continued to declare the same monthly dividend amount in October 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.

The following details the earnings per share, basic and diluted, calculations for each of the three months and nine months ended September 30, 2012 and 2011:

	Three months ended September 30, 2012	Three months ended September 30, 2011	Nine months ended September 30, 2012	Nine months ended September 30, 2011
Profit attributable to common shares (basic and diluted)	$ 6,105	$ 6,387	$ 16,800	$ 18,978
Weighted average number of common shares (in actual number of shares):				
January 1	47,940,409	47,940,409	47,940,409	47,940,409
Vested LTIP awards	519,920	243,380	519,920	243,380
Basic	48,460,329	48,183,789	48,460,329	48,183,789
Dilutive effect of unvested LTIP awards	518,421	405,983	495,757	417,365
Diluted	48,978,750	48,589,772	48,956,086	48,601,154
Earnings per share:				
Basic	$ 0.13	$ 0.13	$ 0.35	$ 0.39
Diluted	$ 0.12	$ 0.13	$ 0.34	$ 0.39

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

(In thousands of Canadian dollars)

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 September 30, 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.

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:

	Three months ended September 30, 2012	Three months ended September 30, 2011	Nine months ended September 30, 2012	Nine months ended September 30, 2011
Revenue:				
Canada	$ 95,858	$ 87,779	$ 295,668	$ 256,455
United States	5,473	3,795	16,420	11,086
Consolidated total	$ 101,331	$ 91,574	$ 312,088	$ 267,541

	September 30, 2012	December 31, 2011
Total assets:		
Canada	$ 667,382	$ 660,581
United States	10,482	7,508
Consolidated total	$ 677,864	$ 668,089

(In thousands of Canadian dollars)

10. Supplementary cash flow information:

Change in non-cash operating working capital for the nine months ended September 30, 2012 and 2011 was as follows:

	2012	2011
Trade and other receivables	$ (4,197)	$ (4,261)
Unbilled fees, current and non-current	(9,349)	(5,431)
Prepaid expenses and other	(1,188)	(2,369)
Deferred implementation costs, current and non-current	(1,694)	(5,363)
Trade and other payables	(8,869)	1,901
Deferred revenue	(1)	2,126
	$ (25,298)	$ (13,397)

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 September 30, 2012, the total contingent consideration of $3,234 has been recognized as acquisition liabilities on the consolidated statements of financial position at the estimated discounted value plus accretion.

12. Subsequent events:

On November 1, 2012, the Company completed the acquisition of Mercer Canada's pension and benefits outsourcing ("Mercer Canada Outsourcing") business. This acquisition complements the Company's existing service offering and expands the Company's market presence.

The assets of Mercer Canada Outsourcing were acquired for nil cash consideration. This acquisition will be accounted for using the purchase method of accounting. A preliminary valuation of the assets acquired and liabilities assumed has not been completed as a result of the proximity of the acquisition date to the release date of these Unaudited Condensed Consolidated Interim Financial Statements.

12. Subsequent events (continued):

Through this acquisition, the Company gains approximately 60 clients which represents an estimated $25 million in additional annual revenue to the Company. These Unaudited Condensed Consolidated Interim Financial Statements do not include the results of Mercer Canada Outsourcing given the acquisition date of November 1, 2012.