



## Pareto Corporation 2006 Q2 Report

## **Pareto Corporation**

### **Management's Discussion and Analysis of Results of Operations and Financial Position**

Management's Discussion and Analysis of Results of Operations and Financial Position ("MD&A") of Pareto Corporation ("the Company" or "Pareto"), dated August 11, 2006, summarizes the significant factors affecting the consolidated operating results, financial condition, liquidity and cash flows of Pareto for the quarter and the six month period ended June 30, 2006. All amounts are in Canadian dollars. This MD&A should be read in conjunction with consolidated financial statements for the year ended December 31, 2005, which are prepared in accordance with Canadian GAAP. Additional information relating to Pareto, including the Annual Information Form dated March 30, 2006, can be found at the Company's website at [www.pareto.ca](http://www.pareto.ca) and on SEDAR at [www.sedar.com](http://www.sedar.com).

#### **Forward-looking Statements**

The Company and its representatives periodically make written and spoken forward-looking statements, including those contained in this report. By their nature, forward-looking statements are subject to risks and uncertainties that could result in actual performance being materially different from anticipated results. The Company cautions readers, when making decisions, to consider the risks and uncertainties of forward-looking statements. The Company relies upon litigation protection for forward-looking statements.

#### **Disclosure Controls**

The Company's Chief Executive Officer and Chief Financial Officer are responsible for establishing and maintaining the Company's disclosure controls and procedures. They are assisted in this responsibility by other senior managers of the Company and the Company's Disclosure Committee. Based on an evaluation of the Company's disclosure controls and procedures, the Company's Chief Executive Officer and Chief Financial Officer have concluded that these controls and procedures operated effectively as of June 30, 2006.

#### **Non-GAAP Measures**

In this discussion and analysis, management uses "EBITDA" (earnings before amortization, net interest and finance charges, share-based compensation, income taxes and non-controlling interest); a measure not defined under Canadian generally accepted accounting principles ("GAAP"), to discuss Pareto's operating performance. The Company cautions readers that measures adjusted to a basis other than GAAP do not have standardized meaning and are unlikely to be comparable to similar measures used by other companies. EBITDA is presented as a supplemental figure for discussion because management believes it provides useful information regarding operating performance. The items required to reconcile between EBITDA and net earnings are amortization of capital assets, amortization of intangible and other assets, net interest and finance charges, share-based compensation, income taxes, and non-controlling interest, all of which are clearly identified on the Company's Statement of Operations and Retained Earnings (Deficit).

Management uses other non-GAAP financial measures, including net debt (long-term debt plus acquisition notes payable, less cash), EBITDA margin and cash interest expense.

The Company's non-GAAP financial measures, particularly EBITDA, are measures used by investors, financial analysts and lenders, who may use EBITDA and other non-GAAP financial measures to value the Company and assess the Company's ability to service its debt.

#### **Business Overview**

Pareto is a marketing services company that provides marketing execution services to its clients for both retail and channel (business-to-business) applications. Pareto provides measurable, quantifiable services that complement its clients' marketing and sales departments. The specific products and services which Pareto offers to its clients include:

- Print management and fulfillment and distribution of in-store point of sale/point of purchase materials.
- Direct mail.
- Design, production and coordination of consumer promotions.
- Corporate events and incentive travel management.
- Outsourced sales and marketing program management.
- Customer loyalty programs.

## **Pareto Corporation**

### **Management's Discussion and Analysis of Results of Operations and Financial Position**

- Channel sales and employee training and incentive programs.

Pareto will typically provide its clients a combination of the foregoing products and services, and seeks over time to use the knowledge and experience acquired in working with each client to design and develop a broader range of services that will meet their marketing objectives in a more cost efficient manner. Pareto seeks to build long-term relationships with its clients which result in the clients outsourcing, to Pareto, the execution of all of aspects of their marketing program within Pareto's operational expertise.

Pareto's clients are, predominately, Canadian companies in the financial services, automotive, retail, communications, pharmaceutical, services and technology sectors. Pareto sells products and services to these clients for both retail and business-to-business applications.

Pareto sells its products and services, other than channel sales and employee incentive programs which are based on reward unit resale (described in more detail below), either on a project or deliverable fixed fee basis or on a time and materials basis. Pareto services typically sold on a fixed fee basis include print management, direct mail, consumer promotions, corporate events and customer loyalty programs. For example, in a retail application the Company sells finished goods (such as in-store signage and direct mail) bundled with a management system (which may include web or data management and distribution) for a fixed price per unit. The value proposition to the client in these circumstances is reduced cost and the benefits of Pareto's management system in terms of reduced cycle times, program effectiveness, and data availability. Profitability in the project or deliverable fixed fee business model is driven by Pareto's success in accurately projecting its costs in pricing products and services and by effective project management.

Outsourced sales and marketing program management are typically sold on a time and materials basis. In this application Pareto often acts as the client's representative. The Company's personnel are positioned as an extension of, and support for, the client's sales or marketing department. In addition to offering support, Pareto adds value in these situations through program management where it administers and manages an ongoing sales and marketing program to specified objectives. These services may also be sold on a fixed fee basis. In the time and materials based business model profitability is driven by establishing appropriate billing rates for services rendered, and by ensuring that each billable employee is engaged in an appropriate level of billable activity.

Certain channel sales and employee incentive programs, and in particular the Elevate business, are based upon the resale of reward units at prices in excess of the cost of the unit to Pareto. Profitability in this business model is dependent on the successful achievement by Pareto's clients of the sales and other business objectives for which the reward units are used as an incentive as well as the number of participants registered in the program. This drives the volume of reward units resold by the Company. These programs are also characterized by significant start-up costs incurred to put the program into place and to sign up participants. As Elevate revenues directly reflect our clients' sales volume, the timing of those revenues trends toward the end of the year, as client companies are working to ensure they meet their annual sales targets and accordingly offer attractive incentives to their sales channel during this time. The attractiveness of the reward units resold is also a factor in the overall performance and growth potential of the Company's loyalty and incentive business. In that regard, the acceptance and use of Aeroplan Miles in the Canadian marketplace is anticipated to be a significant contributor to the success of the Company's Elevate business.

Pareto businesses are grouped in two revenue units; Retail Solutions and Channel Solutions. Retail revenues are derived from numerous activities, which include print management, direct mail, fulfillment and distribution, consumer promotions and certain customer loyalty programs while Channel revenue activities include corporate events, channel sales and employee incentive programs and certain outsourced sales and marketing management programs. When a marketing activity is aimed at influencing a consumer – whether delivered at a retail location, in their home or elsewhere – we consider it Retail Marketing. When the activity is intended to educate or incent a business or its employees – even if those employees happen to work in a retail location – it is Channel Marketing.

**Pareto Corporation**  
**Management's Discussion and Analysis of Results of Operations and Financial Position**

In all of Pareto's businesses it is critical that the Company have and retain the highest quality of personnel having the capabilities and expertise required to deliver the services and products required by Pareto's clients. Personnel development and retention is a key focus of Pareto management and the Company believes that its personnel systems and processes are a key component of its achievements in terms of growth and profitability to date.

Pareto is managed and operated as a single business. The Company endeavors to sell, to each client, as many of its operational services and products as possible and while the Company markets a number of distinct "solutions", in reality a particular project typically involves contributions from several service offerings. Senior management also participates directly in the sales and delivery of products and services to the Company's clients. Accordingly, the Company has determined that it is not practical to prepare and provide meaningful profitability information for individual components of Pareto's business, nor is it meaningful to present a measure of profitability for the business, which includes all direct costs incurred in respect of sales and operational execution other than EBITDA.

Pareto endeavors to enter into long-term contracts with its clients in order to deliver the most cost effective outsourcing of the client's marketing execution as possible. Customer contracts are often annual with certain contracts being 2 to 3 years in length. Long-term contracts allow Pareto to develop and execute longer-term performance improvement and cost reduction programs. The contracts also allow Pareto to achieve a seamless interaction with the client personnel and have been shifting our focus towards more strategic relationships, and away from opportunistic or reactive business. We are striving to build enterprise-wide relationships. Our business model favours the cultivation of a smaller number of large relationships, where we can become fully ingrained in our customers' marketing operations, rather than a large number of smaller projects.

**Operating Results for the quarter ended June 30:**

	2006	2005	\$ Change	% Change
Revenue	\$ 13,036,822	\$ 15,278,951	\$ (2,242,129)	(15%)
Operating and administrative expenses	11,800,529	13,758,036	(1,957,507)	(14%)
	\$ 1,236,293	\$ 1,520,915	\$ (284,622)	(19%)
Amortization of capital assets	\$ 76,107	\$ 81,188	\$ (5,081)	(6%)
Amortization of intangible assets and deferred costs	62,671	57,298	5,373	9%
Interest and finance charges, net	(31,632)	72,378	(104,010)	(144%)
Share-based compensation	71,407	13,972	57,435	411%
	178,553	224,836	(46,283)	(21%)
Earnings before income taxes and non-controlling interest	1,057,740	1,296,079	(238,339)	(18%)
Income taxes	344,693	450,001	(105,308)	(23%)
Non-controlling interest	-	(22,782)	(22,782)	(100%)
Net earnings	\$ 713,047	\$ 868,860	\$ (155,813)	(18%)
Basic and Diluted earnings per share	\$ 0.02	\$ 0.02	\$ 0.00	0%

**Pareto Corporation**  
**Management's Discussion and Analysis of Results of Operations and Financial Position**

**Operating Results for the six months ended June 30:**

	2006	2005	\$ Change	% Change
Revenue	\$ 22,569,095	\$ 24,420,762	\$ 1,851,667	(8%)
Operating and administrative expenses	20,568,255	22,220,959	(1,652,704)	(7%)
	\$ 2,008,840	\$ 2,199,803	\$ (198,963)	(9%)
Amortization of capital assets	\$ 147,537	\$ 165,244	\$ (17,707)	(11%)
Amortization of intangible assets and deferred costs	125,609	114,596	11,013	10%
Interest and finance charges, net	1,763	135,082	(133,319)	(99%)
Share-based compensation	137,876	30,436	107,440	353%
	412,785	445,358	(32,573)	(7%)
Earnings before income taxes and non-controlling interest	1,588,055	1,754,445	(166,390)	(9%)
Income taxes	528,856	614,239	(85,383)	(14%)
Non-controlling interest	-	(51,084)	51,084	(100%)
Net earnings	\$ 1,059,199	\$ 1,191,290	\$ (132,091)	(11%)
Basic and Diluted earnings per share	\$ 0.03	\$ 0.03	\$ 0.00	0%

**Revenue**

Revenue for the second quarter of 2006 declined to \$13.0 million from \$15.3 million, a reduction of 15%. The decline resulted from a significant decline in revenues from Channel activities. Channel revenues decreased by \$3.6 million or 34% to \$7.0 million from the second quarter 2005. The decline in Channel revenues of \$3.6 million was driven by a \$4.1 million decrease in Event and non Elevate incentive revenues caused mainly by biannual events. As disclosed previously, approximately \$6M of Event revenue which occurred in 2005 and will reoccur in 2007 will not take place in 2006 with approximately \$4.9 million of that amount occurring in the second quarter of 2005. This decline was offset by a \$585,000 increase in Elevate revenues in the second quarter compared to 2005, a 149% improvement. Revenue from Retail activities increased by \$1.3 million or 28% in the quarter compared to last year driven primarily by new client spending.

On a year to date basis for the six month period ended June 30, 2006, the Company generated \$22.6 million of revenue compared to \$24.4 million in the same period of 2005, a reduction of \$1.8 million or 8%. For the period Retail revenues increased 10% or \$1.0 million while Channel revenues declined \$2.8 million or 20% compared to last year. For the period Elevate revenues increased by \$1.8 million or 373% to reach a total of \$2.3 million while non Elevate Channel revenues declined \$4.6 million driven by the \$4.1 million decline in the second quarter of 2006.

In addition to the timing of Event revenues in Q2, revenue growth in 2006 for both Retail and Channel activities has been slowed by a reduction in spending by two of the Company's major customers offset somewhat by new client spending. As previously announced Pareto was not awarded approximately \$2.0 million of anticipated US Ford based work related to trade show management and sponsorship resulting from the strengthened Canadian dollar, combined with a Ford US strategy to use US based suppliers for their US based marketing initiatives. The Company's Retail sales growth has been reduced by a client's decision to reduce promotional spending in light of their exceptional strong sales results. The Company expects these factors will restrict revenue growth for 2006. The Company expects revenue growth in the second half of 2006, although organic revenue growth for the year will likely not reach the Company's long term objective of 20% average annual revenue growth,

## **Pareto Corporation**

### **Management's Discussion and Analysis of Results of Operations and Financial Position**

In the second quarter of 2006 Retail activities represented 46% of revenues compared to 31% in 2005 with Channel activities representing 54% versus 69% in 2005. On a year to date basis 2006 Retail activities represented 48% of revenues compared to 41% in 2005 with Channel activities representing 52% versus 59% in 2005. In 2006 the Company's mix of revenues by business model was as follows:

- Fixed fee basis- 71% for the quarter (74% in 2005) – 66% year to date (74% in 2005)
- Time and materials basis - 19% for the quarter (22% in 2005) – 22% year to date (24% in 2005)
- Resale of reward units - 10% for the quarter (4% in 2005) – 12% year to date (4% in 2005)

#### **Operating and Administrative Expenses**

For the quarter, operating and administrative expenses decreased by \$2.0 million from 2005 to \$11.8 million representing a 14% decrease. On a year to date basis these costs also reduced to \$20.6 million from \$24.4 million or 7%. Operating and administrative expenses include project, selling, general, administrative and facilities costs. In both cases the reduction in costs was primarily driven by the reduction in revenues, with improved project efficiencies being offset by increased infrastructure to support future growth.

#### **EBITDA**

EBITDA (see "Non-GAAP Measures" above) in Q2 2006 decreased by 19% to \$1.2 million from \$1.5 million in the same period last year. For the six month period EBITDA decreased by \$200,000 in 2006 or 9% versus 2005. EBITDA as a percentage of revenue represented 9.5% in Q2 2006, down 50 basis points from 10.0% in 2005 while on a year to date basis the percentage was 8.9% compared to 9.0% in 2005. The reduction in EBITDA margins in the second quarter of 2006 resulted primarily from lower absorption of fixed costs. The Company has established a long-term EBITDA margin target of 15% of revenue.

#### **Amortization, Interest and Share-based Compensation**

Amortization, interest and share-based compensation declined 21% or \$46,000 during the quarter. This resulted primarily from a \$103,000 improvement in interest and finance charges generated by the Company on cash balances from the equity offering completed at the end of March 2006 and loan receivable balances in the quarter compared to last year. The improvement was offset by a \$58,000 increase in share based compensation costs resulting from options and restricted stock units issued by the Company since June 30, 2005. On a year to date basis, amortization, interest and share-based compensation decreased by only \$33,000 with a \$133,000 reduction in interest costs offset by a \$107,000 increase in share based compensation.

#### **Income Taxes**

Income tax expense in Q2 2006 represented 33% of earnings before tax (33% for the six month period). Pareto recorded income tax expense of \$345,000 (\$528,000) in 2006 compared to \$450,000 (\$615,000) last year. The reduction was driven primarily by the decrease in pre tax earnings in the periods. The Company expects to incur an effective tax rate of approximately 36% on an on-going basis. As a result of the acquisition of SourceLink Canada in August 2006, Pareto acquired a significant tax asset which will reduce the amount of cash income taxes paid in future periods though this will not change the Companies' effective tax rate for financial statement purposes.

#### **Non-controlling interest**

Effective September 30, 2005, the Company acquired the remaining minority ownership interest in Pareto Dialogue and accordingly no non-controlling interest was recorded in the Company's 2006 financial statements.

#### **Net earnings**

Net earnings for the second quarter of 2006 decreased by 18% or \$155,000 to \$713,000 compared to 2005 while on a year to date basis net earnings declined 11% to \$1.1 million from \$1.2 million. Excluding the effect of income taxes, earnings before income taxes and non-controlling interest declined to 8.1% of revenue in the year compared to 8.5% in 2005 while for the six month period the percentage remained consistent at approximately 7.1%.

**Pareto Corporation**  
**Management's Discussion and Analysis of Results of Operations and Financial Position**

Earnings per share

Pareto's basic and diluted earnings per share remain unchanged in the quarter and for the six month period versus 2005 at \$0.02 and \$0.03 respectively. The weighted average number of diluted shares outstanding increased by 18% in the quarter versus 2005 as a result of options and restricted stock units issued since March 31, 2005, the 5,000,000 share private placement completed by Pareto in March 2006 and the effect of the increase in the Company's share price over the last year.

**Liquidity and Capital Resources**

Financial Position

	June 30, 2006	December 31, 2005	\$ Change	% Change
Cash or equivalents	\$ 5,682,254	\$ 5,078,927	\$ 603,327	12%
Acquisition notes payable	300,000	335,000	(35,000)	(10%)
Long-term debt	1,082,994	1,332,996	(250,002)	(19%)
Total debt	1,382,994	1,667,996	(285,002)	(17%)
Total cash (net debt) position	4,299,260	3,410,931	888,329	26%
Shareholders' equity	22,731,833	13,366,917	9,364,916	70%
Working capital position	\$ 8,543,018	\$ 1,559,342	\$ 6,983,676	447%
Net debt:Shareholders' equity	n/a	n/a		
Net debt:EBITDA	n/a	n/a		
Total debt:EBITDA	0.26:1	0.30:1		

Pareto's sources of short-term liquidity include cash provided by operating activities and a \$5.5 million operating line of credit secured by a general security agreement over the assets of Pareto and its subsidiaries, and which is repayable on demand.

The Company has long-term subordinated debt with a principal amount of \$1.1 million outstanding as at June 30, 2006. The debt bears variable interest payable monthly at bankers' acceptance rates plus 3.5%. In addition, the Company pays monthly fees of \$6,000 in respect of the subordinated debt. Scheduled principal repayments on the subordinated debt are due in the following years: 2006 - \$250,002; 2007 - \$500,000; and 2008 - \$332,996. The Company may make discretionary prepayments of \$167,000 in November of 2006, and 2007.

Management considers the Company's capital resources adequate to meet the Company's operating, capital expenditure, and financing requirements though the Company is actively considering acquisition opportunities in both the Retail and Channel areas including signing non-disclosure agreements with a number of candidates we are evaluating. Depending on the size of an acquisition, the Company may need to secure external capital, in the form of debt or share equity, to finance the acquisition.

The Company's balance sheet and financial flexibility presents a number of options. One is the ability to realize greater efficiencies with our suppliers, for example seeking more favourable pricing in exchange for faster payment. The Company may also utilize the available cash for share repurchases under a Normal

**Pareto Corporation**  
**Management's Discussion and Analysis of Results of Operations and Financial Position**

Course Issuer Bid should the Board determine it to be in the best interests of the Company. Alternatively the Company may also fund internal start-up ventures, as has been done in the past with Pareto Dialogue and Elevate. The Company may also use its current resources to finance acquisitions. In the long term we do not intend to maintain unnecessarily high cash balances.

**Operating activities**

Pareto's operating activities utilized \$1.3 million of cashflow in the second quarter of 2006 compared to generating \$1.7 million in 2005. Operating activities before changes in non-cash operating accounts generated \$850,000 in the quarter compared to \$968,000 in 2005 with the change driven by the decrease in net earnings. Changes in non-cash operating accounts utilized \$2.2 million in the quarter as accounts receivable increased and deferred revenue decreased partially offset by increases in accounts payable and accrued liabilities. In addition, during the quarter the Company acquired approximately \$300,000 of inventory as part of the transfer of a new client to Pareto.. At June 30, 2006, the Company's days sales outstanding stood at 90 days compared to 90 days at March 31, 2006

On a six month basis, Pareto's operating activities utilized \$4.9 million of cashflow compared to generating \$500,000 in 2005. Operating activities before changes in non-cash operating accounts generated \$1.4 million in the quarter compared to \$1.5 million in 2005.. Changes in non-cash operating accounts utilized \$6.4 million in the period as accounts receivable increased and deferred revenue and accounts payable and accrued liabilities decreased.

**Investing activities**

In 2006, Investing activities for the second quarter utilized \$1.1 million of cashflow and \$1.2 million for the year to date up significantly from 2005 in both cases. The primary uses of funds (\$675,000) was the acquisition of Trajectory as well as significantly higher capital asset additions led by the purchase of a new information system for the Company's Retail business (approximately \$300,000).

**Financing activities**

So far in 2006, Pareto's financing activities generated \$6.7 million of cashflow compared to only \$435,000 in 2005. The increase resulted from net proceeds from share issuances of \$7.4 million, including a 5 million share placement at \$1.50 per share completed by the Company in March 2006, compared to \$1.0 million in private placements in the first half of 2005. This cashflow was utilized to reduce long term debt by \$250,002 and improve the Company's working capital position.

**Contractual Obligations**

The following table provides a summary of Pareto's contractual obligations under various debt and lease agreements as at June 30, 2006:

	Payments due by period				
	Total	Less than 1 year	1-3 years	4-5 years	After 5 years
Long-term debt	\$ 1,082,994	\$ 500,000	\$ 582,994	\$ -	\$ -
Acquisition notes payable	300,000	100,000	200,000	-	-
Operating leases	4,082,762	794,033	1,803,417	1,204,487	280,825
<b>Total contractual obligations</b>	<b>\$ 5,465,756</b>	<b>\$ 1,394,033</b>	<b>\$ 2,586,411</b>	<b>\$ 1,204,487</b>	<b>\$ 280,825</b>

In the quarter the Company renewed the lease for its main office location through to the end of 2011, which future obligation is included in the above amounts. The renewal includes expanding the space in that facility by approximately 6,000 square feet to provide for future growth,

## **Pareto Corporation**

### **Management's Discussion and Analysis of Results of Operations and Financial Position**

On May 2, 2006, the Company acquired the assets of Trajectory Business Performance Inc. ("TBPI"). As part of the purchase, potential future consideration of up to \$1.2 million may be payable by the Company based on the performance of TBPI through 2008.

#### **Outstanding Share Data**

At June 30, 2006, an unlimited number of common shares were authorized and 44,336,773 common shares were outstanding. The Company has 2,011,606 options currently outstanding to acquire common shares pursuant to its Option Plan of which 1,323,272 were exercisable. The Company also has 474,334 common share purchase warrants and 491,666 restricted stock units currently outstanding, all convertible to common shares on a one to one basis. See note 4 to the consolidated financial statements for further information on the Company's share capital.

#### **Subsequent Events**

Subsequent to June 30, 2006, the acquired Sourcelink Canada, a Toronto based direct marketing company for total consideration of approximately \$1.2 million in cash, paid from the Company's existing cash balances. The acquisition is expected to add approximately \$10 million to the Company's revenue in 2007.

#### **Risks and Uncertainties**

##### **Economic Uncertainty**

The marketing services industry is subject to the effects of economic downturns. The Company is also exposed to the risk of clients changing their business plans or reducing their budgets for the Company's services. As a result, the Company's business, financial condition, and operating results may be affected in a material adverse manner.

##### **Access to Capital Resources**

While the Company expects to generate positive cash flow from operations, the Company may raise capital to fund its future growth, either from the incurrence of short-term or long-term indebtedness or the issuance of equity securities. Although the Company has been able to obtain such financing in the past, there is no assurance that required capital will continue to be available or that the Company will be able to refinance current or future indebtedness on terms that are acceptable to the Company. The incurrence of additional indebtedness may result in increased interest expense or decreased net income and the issuance of additional equity securities could result in dilution of existing equity positions.

##### **Competition**

The marketing services industry is highly competitive. The Company has competition in all major markets in which it does business from competitors that range from large multinational agencies to smaller, regional agencies. The Company must compete with these companies, firms and agencies in order to maintain existing client relationships and to obtain new clients and assignments. Competitive factors include account management and creative capabilities and reputation, management, personal relationships, quality and reliability of service, and expertise in particular niche areas of the marketplace. As the Company continues to expand through strategic acquisitions or organic growth, this may reduce the number of competitors in the market, however the success achieved may be a springboard for other companies to enter the market, therefore the competitive landscape is ever fluctuating and difficult to predict.

##### **Dependence Upon a Limited Number of Clients**

Although the Company has a significant number of clients, a relatively small number of them contribute the majority of the Company's revenue and gross profit. During the second quarter of 2006 Pareto generated revenues from two clients representing greater than 10% of revenues (20% and 19% respectively – 2005: 20% and 19% respectively) (for the six month period three clients represented more than 10% of revenues – 22%, 22% and 12% respectively – 2005: 23%, 22% and 11% respectively). The Company's dependence on a limited number of clients may increase in the future, should the Company continue to achieve improved relationships with key clients and succeed in providing new services to them.

## **Pareto Corporation**

### **Management's Discussion and Analysis of Results of Operations and Financial Position**

The Company endeavors to reduce the risk of key client dependence by entering into multi-year contractual arrangements with its key clients and by developing multiple relationships within the client organization. The Company also reduces the risk of key client dependence by winning new clients through strategic acquisitions and internal growth.

#### **Credit Risk**

Accounts receivable represented 36% of consolidated assets at June 30, 2006 (December 31, 2005 – 33%). The Company mitigates its credit risk with respect to accounts receivable by dealing with large, creditworthy clients and also by billing whenever possible in advance of the provision of services.

#### **Dependence on Key Personnel**

The Company's success is dependent on the leadership of a number of key executive and management personnel. If any of these key individuals leave the Company, the relationships they have with certain of the Company's clients could be lost. In addition, the Company's ability to generate revenue is dependent upon the number and expertise of individuals who perform project work. The competition for the most experienced and able employees is intense, even during cyclical downturns in the industry. As a result, if the Company fails to retain existing employees or hire new employees when necessary, the Company's business, financial condition, and operating results could be materially and adversely affected.

Although certain members of Pareto's senior management team have entered into employment contracts that include non-competition and non-solicitation agreements, those agreements may not be effective in retaining key personnel. All key employees are shareholders of the Company.

#### **Consolidation of Accounts**

Large business organizations have shown a tendency towards consolidating their marketing services providers so that one firm provides these services to all national and international locations. While the Company could benefit from this trend, it is also possible that the Company could lose client relationships if certain clients elected to consolidate their marketing services relationship with another supplier. To the extent that Pareto loses revenue as a result of this trend, the Company's business, financial condition and operating results may be affected in a material adverse manner.

#### **Transactions with Related Parties**

The Company did not have any new related party transactions in the first half of 2006 other than the employee common share private placement described in Note 4 of the interim financial statements. The Company's related party transactions in 2005 and 2004 are outlined in note 12 of the Company's 2005 annual financial statements.

#### **Critical Accounting Estimates**

##### **Overview**

The preparation of consolidated financial statements in conformity with GAAP requires management to make estimates that affect the amounts reported and disclosed in the consolidated financial statements. Management bases estimates on historical experience and various other assumptions that are believed to be reasonable in the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities. On an ongoing basis, management evaluates its estimates. However, actual results could differ from estimated results. The Company's significant accounting policies are included in note 1 to the 2005 consolidated financial statements. Management believes the following critical accounting policy involves the most significant judgments and estimates used in the preparation of the Company's consolidated financial statements.

##### **Goodwill and Intangible Assets**

Goodwill and intangible assets represent the Company's most significant assets. Goodwill represents the consideration paid for acquisitions in excess of the fair market value of the net identifiable assets acquired.

## **Pareto Corporation**

### **Management's Discussion and Analysis of Results of Operations and Financial Position**

The carrying value of the goodwill is assessed at least annually by comparing it to its fair value. For the fourth quarter of 2005, the Company completed the annual assessment and found no impairment of goodwill. Intangible assets consist of the value of the Company's acquired customer relationships. In the marketing services industry, these are typically long-term in nature, and therefore customer relationship assets are amortized on a straight-line basis over an estimated useful life of 10 years. If impairment losses related to goodwill and intangible assets were to be recognized in future periods, the losses could have a material adverse impact on the Company's results of operations and financial position.

#### **Financial Instruments and Other Instruments**

Pareto engages in transactions in foreign currencies, most commonly involving the U.S. dollar and the euro. From time to time, Pareto will use currency forward contracts to fix the exchange rate for known future transactions. No such contracts were outstanding at June 30, 2006.

**Pareto Corporation**  
**Management's Discussion and Analysis of Results of Operations and Financial Position**

**SUMMARY OF QUARTERLY AND ANNUAL RESULTS**

**Year Ended**  
**December 31, 2006**    **March 31**                      **June 30**

---

**Quarterly information:**

Revenue	\$ 9,532,273	\$ 13,036,822
EBITDA <sup>1</sup>	764,547	1,236,293
Net earnings	346,152	663,047
Basic and diluted earnings per share <sup>2</sup>	0.01	0.02

**Year Ended**  
**December 31, 2005**    **March 31**                      **June 30**    **September 30**    **December 31**                      **Total**

---

**Quarterly information:**

Revenue	\$ 9,141,811	\$15,278,951	\$10,645,812	\$17,884,195	\$52,950,769
EBITDA <sup>1</sup>	678,888	1,520,915	1,006,194	2,300,590	5,506,587
Net earnings	322,430	868,860	528,130	1,255,612	2,975,032
Basic and diluted earnings per share <sup>2</sup>	0.01	0.02	0.01	0.03	0.08

**Annual Information:**

Total assets	31,917,953
Total long-term financial liabilities	1,667,996
Cash dividends declared	0.00

**Year Ended**  
**December 31, 2004**    **March 31**                      **June 30**    **September 30**    **December 31**                      **Total**

---

**Quarterly information:**

Revenue	\$ 6,811,555	\$ 7,389,411	\$ 7,588,106	\$16,956,135	\$38,745,207
EBITDA <sup>1</sup>	498,256	564,206	684,888	1,655,428	3,402,778
Net earnings	431,446	424,206	436,662	1,193,753	2,486,067
Basic and diluted earnings per share <sup>2</sup>	0.01	0.01	0.01	0.03	0.07

**Pareto Corporation**  
**Management's Discussion and Analysis of Results of Operations and Financial Position**

**Annual Information:**

Total assets	24,966,769
Total long-term financial liabilities	1,948,576
Cash dividends declared	0.00

**Year Ended**

<b>December 31, 2003</b>	<b>March 31</b>	<b>June 30</b>	<b>September 30</b>	<b>December 31</b>	<b>Total</b>
--------------------------	-----------------	----------------	---------------------	--------------------	--------------

**Quarterly information:**

Revenue	\$ 3,249,140	\$ 4,515,375	\$ 4,889,182	\$ 6,474,964	\$19,128,661
EBITDA <sup>1</sup>	167,310	191,876	304,161	444,624	1,107,971
Net earnings <sup>3</sup>	37,406	4,736	185,335	234,386	461,863
Basic and diluted earnings per share <sup>2</sup>	0.00	0.00	0.01	0.01	0.01

**Annual Information:**

Total assets	14,766,281
Total long-term financial liabilities	925,865
Cash dividends declared	0.00

<sup>1</sup> EBITDA is a non-GAAP financial measure. See above under "Non-GAAP Measures".

<sup>2</sup> The quarterly figures do not add to the annual figure due to rounding and differences in weighted average diluted shares outstanding during the periods.

<sup>3</sup> Net earnings have been retroactively restated to give effect to the adoption of CICA Handbook Section 3870, "Stock-based Compensation and Other Stock-based Payments". See above under "Changes in Accounting Policies".

**Seasonality**

Because of the project-based nature of certain of the Company's business units which recognize revenue using the completed contract method, the Company's results can be significantly impacted in a quarterly period depending on the timing of the completion of significant projects. This impact, which is particularly pronounced in the Event business, does not follow a predetermined seasonal pattern though the fourth quarter is traditionally the largest period of client spending in the marketing services industry and can cause material fluctuations in quarterly revenues, EBITDA, and net earnings.

**ADDITIONAL INFORMATION**

Other information relating to Pareto, including the Company's Annual Information Form, is available on SEDAR at [www.sedar.com](http://www.sedar.com).

## Pareto Corporation Consolidated Balance Sheets

	June 30 2006 (unaudited)	December 31 2005 (audited)
<b>Assets</b>		
<b>Current assets</b>		
Cash	\$5,682,254	5,078,927
Accounts receivable	13,125,548	10,760,008
Work in progress	1,106,875	1,954,353
Inventory and other current assets	874,450	513,955
Current future income tax assets	327,981	97,854
	21,117,108	18,405,097
<b>Loans receivable</b>	<b>1,300,000</b>	<b>433,333</b>
<b>Deferred costs and other assets</b>	<b>609,879</b>	<b>609,791</b>
<b>Capital assets</b>	<b>1,340,719</b>	<b>990,622</b>
<b>Goodwill and intangible assets</b>	<b>12,149,270</b>	<b>11,479,110</b>
	<b>\$36,516,976</b>	<b>\$31,917,953</b>
<b>Liabilities and Shareholders' Equity</b>		
<b>Current liabilities</b>		
Accounts payable and accrued liabilities	7,891,469	\$10,841,641
Current portion of deferred revenue	2,276,169	4,151,498
Income taxes payable	1,713,102	927,065
Current future income tax liabilities	93,350	90,551
Current portion of acquisition notes payable	100,000	335,000
Current portion of long-term debt	500,000	500,000
	12,574,090	16,845,755
<b>Long-term deferred revenue</b>	<b>-</b>	<b>474,144</b>
<b>Long-term future income tax liabilities</b>	<b>378,059</b>	<b>398,141</b>
<b>Long-term debt</b>	<b>582,994</b>	<b>832,996</b>
<b>Long-term acquisition notes payable</b>	<b>200,000</b>	<b>-</b>
<b>Total liabilities</b>	<b>13,785,143</b>	<b>18,551,036</b>
<b>Shareholders' equity</b>		
Share capital	15,972,924	7,576,707
Contributed surplus	311,775	254,192
Common share purchase warrants	77,700	126,454
Retained earnings	6,419,434	5,409,564
	22,781,833	13,366,917
<b>Total shareholders' equity</b>	<b>\$36,516,976</b>	<b>\$31,917,953</b>

These financial statements have not been reviewed by the Company's external auditors.  
The accompanying significant accounting policies and notes are an integral part of these statements.

# Pareto Corporation

## Consolidated Statements of Operations and Retained Earnings

for the period ended June 30 (unaudited)

	Three Months		Six Months	
	2006	2005	2006	2005
<b>Revenue</b>	<b>\$13,036,822</b>	\$15,278,951	<b>\$22,569,095</b>	\$24,420,762
<b>Operating and administration expenses</b>	<b>11,800,529</b>	13,758,036	<b>20,568,255</b>	22,220,959
	<b>1,236,293</b>	1,520,915	<b>2,000,840</b>	2,199,803
Amortization of capital assets	<b>76,107</b>	81,188	<b>147,537</b>	165,244
Amortization of intangible and other assets	<b>62,671</b>	57,298	<b>125,609</b>	114,596
Interest and finance charges, net	<b>(31,632)</b>	72,378	<b>1,763</b>	135,082
Share-based compensation	<b>71,407</b>	13,972	<b>137,876</b>	30,436
	<b>178,553</b>	224,836	<b>412,785</b>	445,358
Earnings before income taxes and non-controlling interest	<b>1,057,740</b>	1,296,079	<b>1,588,055</b>	1,754,445
Non-controlling interest	-	(22,782)	-	(51,084)
Income taxes	<b>344,693</b>	450,001	<b>528,856</b>	614,239
<b>Net earnings for the period</b>	<b>713,047</b>	868,860	<b>1,059,199</b>	1,191,290
<b>Retained earnings, beginning of period</b>	<b>5,755,716</b>	2,756,962	<b>5,409,564</b>	2,434,532
<b>Loss on repurchase of common shares</b>	<b>(49,329)</b>	-	<b>(49,329)</b>	-
<b>Retained earnings, end of period</b>	<b>6,419,434</b>	3,625,822	<b>6,419,434</b>	3,625,822
<b>Basic earnings per share</b>	<b>\$0.02</b>	\$0.02	<b>\$0.03</b>	\$0.03
<b>Diluted earnings per share</b>	<b>\$0.02</b>	\$0.02	<b>\$0.03</b>	\$0.03
<b>Average number of common shares outstanding</b>				
Basic	<b>43,716,300</b>	36,333,865	<b>40,537,939</b>	36,183,491
Diluted	<b>45,409,834</b>	38,387,740	<b>42,310,443</b>	38,362,300

These financial statements have not been reviewed by the Company's external auditors.  
The accompanying significant accounting policies and notes are an integral part of these statements.

# Pareto Corporation

## Consolidated Statements of Cash Flows

for the period ended June 30 (unaudited)

	Three Months		Six Months	
	2006	2005	2006	2005
<b>Operating activities</b>				
Net earnings for the period	\$713,047	\$868,860	\$1,059,199	\$1,191,290
Items not involving cash:				
Amortization of capital assets	76,107	81,188	147,537	165,244
Amortization of intangible assets and deferred costs	59,390	57,298	125,609	114,596
Non-cash interest and finance charges	3,281	9,464	6,562	18,928
Share-based compensation	71,407	13,972	137,876	30,436
Non-controlling interest	-	(22,782)	-	(51,084)
Future income tax provision	(22,267)	(39,969)	(35,430)	17,360
	<b>850,965</b>	<b>968,031</b>	<b>1,391,353</b>	<b>1,486,770</b>
Changes in non cash operating accounts	<b>(2,211,897)</b>	<b>738,333</b>	<b>(6,384,965)</b>	<b>(953,316)</b>
	<b>(1,310,932)</b>	<b>1,706,364</b>	<b>(4,943,612)</b>	<b>533,454</b>
<b>Investing activities</b>				
Capital asset additions	(359,850)	(37,473)	(462,012)	(84,750)
Other asset additions	(27,845)	(19,338)	(81,526)	(41,788)
Acquisitions, net of cash acquired	(675,695)	-	(675,695)	(100,000)
	<b>(1,063,390)</b>	<b>(56,811)</b>	<b>(1,219,233)</b>	<b>226,538</b>
<b>Financing activities</b>				
Issue of acquisition notes payable	-	-	-	100,000
Repayment of acquisition notes payable	(335,000)	(130,000)	(335,000)	(495,000)
Repayment of long-term debt	(125,001)	(125,001)	(250,002)	(250,002)
Issuance of shares	85,770	80,333	8,095,136	1,085,746
Share issue costs	(1,000)	-	(671,972)	(5,089)
Repurchase of common shares	(71,990)	-	(71,990)	-
	<b>(447,221)</b>	<b>(174,668)</b>	<b>6,766,172</b>	<b>435,655</b>
<b>Increase (decrease) in cash for the period</b>	<b>(2,821,543)</b>	<b>1,474,885</b>	<b>603,327</b>	<b>742,571</b>
<b>Cash and cash equivalents, beginning of period</b>	<b>8,503,797</b>	<b>231,742</b>	<b>5,078,927</b>	<b>964,956</b>
<b>Cash and cash equivalents, end of period</b>	<b>\$5,682,254</b>	<b>\$1,706,627</b>	<b>\$5,682,254</b>	<b>\$1,706,627</b>

**These financial statements have not been reviewed by the Company's external auditors.**

The accompanying significant accounting policies and notes are an integral part of these statements.

---

# Pareto Corporation

## Notes to Consolidated Financial Statements

June 30, 2006 (Unaudited)

---

### 1. Interim financial information

These interim consolidated financial statements have been prepared in accordance with Canadian generally accepted accounting principles and use the same accounting policies and methods used in the preparation of the Company's most recent annual consolidated financial statements. However, not all disclosures required for annual financial statements have been included in these financial statements. These interim consolidated financial statements should therefore be read in conjunction with the company's most recent annual consolidated financial statements. The financial information as at June 30, 2006 and for the three-month and six-month periods ended June 30, 2006 and June 30, 2005 are unaudited.

### 2. Accounting Estimates

The preparation of interim financial statements in conformity with Canadian generally accepted accounting principles requires management to make estimates and assumptions that affect the amounts reported in the financial statements. Actual results could differ from those estimated.

### 3. Business combinations

On April 30, 2006, the Company acquired certain operating assets and liabilities of Trajectory Business Performance Inc. ("Trajectory") for initial consideration of \$700,000, comprised of \$400,000 in cash and \$300,000 of acquisition notes payable. The acquisition was accounted for as a purchase.

A summary of the net assets acquired and consideration given is as follows:

Current assets	\$	153,232
Capital assets		35,622
Future income tax asset		239,973
Intangible assets		77,500
Bank overdraft		(50,695)
Other current liabilities		(296,032)
Future income tax liability		(27,993)
Net identifiable assets acquired		<u>131,607</u>
Purchase consideration		
Cash		400,000
Acquisition notes payable		300,000
Transaction costs		75,000
		<u>775,000</u>
Excess of purchase price consideration allocated to goodwill	\$	<u>643,393</u>

---

**Pareto Corporation**  
**Notes to Consolidated Financial Statements**

June 30, 2006 (Unaudited)

---

**3. Business Combination (continued)**

Additional cash consideration is payable based on future operating results as follows and if paid would be accounted for as an increase in goodwill:

2006	\$325,000
2007	\$387,500
2008	\$187,500

In addition, the Company issued to the vendor 258,065 warrants to acquire 258,065 common shares of the Company at \$1.55 per share. The warrants expire on May 20, 2008. The exercise of the warrants is conditional upon the earning of the above additional consideration and the fair value of the warrants of \$101,678 will be added to goodwill upon the exercise of the warrants.

The acquisition notes payable are non-interest bearing and are repayable in six equal quarterly installments beginning January 1, 2007.

**4. Share capital**

- (a) Authorized  
Unlimited common shares  
Unlimited special shares issuable in series

(b) Issued common shares

	Number of Shares	Amount
Balance, December 31, 2005	37,328,102	\$ 7,576,707
Shares issued pursuant to private placements (i)	5,666,667	8,366,667
Shares issued upon conversion of common share purchase	297,666	346,423
Shares issued on exercise of stock options	1,107,238	377,760
Repurchased for cancellation	(62,900)	(22,661)
Shares issue costs	-	(671,972)
Balance, June 30, 2006	44,336,773	\$ 15,972,924

(i) On March 30, 2006, Pareto issued 5,000,000 common shares pursuant to a private placement at an issue price of \$1.50 per common share for net proceeds of \$6,829,028. On May 16, 2006, the company issued 666,667 common shares pursuant to an employee private placement at an issue price of \$1.30 per common share for net proceeds of \$866,667.

(c) Stock options

The Company has a stock option plan (the "Plan") for employees, consultants, directors and officers of the Company. Pursuant to the Plan, a total of 3,500,000 of the Company's common shares have been reserved for issue. One-third of granted options vest on each of the anniversary dates of the grant.

**Pareto Corporation**  
**Notes to Consolidated Financial Statements**

**June 30, 2006 (Unaudited)**

**4. Share capital (continued)**

Stock option transactions under the Plan during the period are as follows:

	Number of Options	Weighted Average Exercise Price
Options outstanding, December 31, 2005	3,045,510	\$0.45
Granted in 2006	140,000	1.49
Exercised in 2006	(1,107,238)	0.27
Cancelled in 2006	(66,666)	0.43
Options outstanding, June 30, 2006	2,011,606	\$0.62
Options exercisable, June 30, 2006	1,323,272	\$0.33
Options exercisable, December 31, 2005	2,214,676	\$0.29

As at June 30, 2006, the Company had the following options outstanding pursuant to the Plan:

Number of Options	Exercise Price Per Share	Expiry Date
305,534	\$0.35	November 30, 2006
158,571	\$0.35	February 15, 2007
223,333	\$0.20	August 1, 2007
45,000	\$0.20	November 4, 2007
400,000	\$0.25	June 23, 2008
166,667	\$0.43	February 10, 2009
135,000	\$0.86	July 19, 2009
30,000	\$0.88	December 13, 2009
34,167	\$0.90	March 7, 2010
40,000	\$0.90	April 26, 2010
333,334	\$1.30	October 11, 2010
50,000	\$1.53	March 30, 2011
90,000	\$1.47	May 15, 2011

(d) Restricted stock units:

During 2005, the Company implemented a long-term incentive plan (LTIP) for employees, consultant, directors and officers of the Company. Pursuant to the LTIP, a total of 1,000,000 of the Company's common shares have been reserved for issue through the redemption of restricted stock units into common shares on a one to one basis. Restricted stock units are redeemable upon the third anniversary of the date of grant. To June 30, 2006, 491,666 restricted stock units have been granted pursuant to the LTIP (333,333 to December 31, 2005)

---

**Pareto Corporation**  
**Notes to Consolidated Financial Statements**

June 30, 2006 (Unaudited)

---

**4. Share capital (continued)**

(e) Common share purchase warrants:

(i) In 2004, the Company issued 800,000 common share purchase warrants (the "warrants"), each of which provide the holder with the right to purchase one common share of the Company for \$1.00. The warrants expire on October 13, 2006, and 474,334 of the warrants were outstanding at June 30, 2006 (772,000 at December 31, 2005). The fair value of the warrants at the date of issuance was \$131,040, which has been included in shareholder's equity as common share purchase warrants.

(ii) In 2006, pursuant to the acquisition of Trajectory, the Company issued 258,065 common share purchase warrants, each of which provide the holder with the right to purchase one common share of the Company for \$1.55. The warrants expire on May 20, 2008. The exercise of the warrants is conditional upon the future operating results of Trajectory. All of the warrants are outstanding at June 30, 2006.

(f) Share-based compensation:

The fair value of share options granted in 2006 was estimated using the Black-Scholes option-pricing model with the following assumptions:

Dividend yield	0%
Expected volatility	40%
Risk-free interest rate	4.0% to 4.25%
Expected option life	2 to 4 years

The fair value of share options granted in 2005 was estimated using the Black-Scholes option-pricing model with the following assumptions:

Dividend yield	0%
Expected volatility	40%
Risk-free interest rate	3.0% to 3.6%
Expected option life	2 to 4 years

**5. Subsequent Event**

In August, 2006, the Company acquired all of the outstanding shares of SourceLink Canada, a Toronto based direct marketing company, for total cash consideration of \$1.2 million.

**6. Comparative Figures**

Certain comparative figures have been reclassified to correspond to the current periods presentation.