



## Pareto Corporation 2006 Q3 Results

## **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 November 13, 2006, summarizes the significant factors affecting the consolidated operating results, financial condition, liquidity and cash flows of Pareto for the quarter and the nine month period ended September 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 September 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, gain on acquisition 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, gain on acquisition and non-controlling interest, all of which are clearly identified on the Company's Statement of Operations and Retained Earnings.

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 marketing.
- Retail sales and merchandising.
- Design, production and coordination of consumer promotions.
- Corporate events and incentive travel management.

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- Outsourced sales and marketing program management.
- Customer loyalty programs.
- 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.

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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 September 30, 2006:**

	<b>2006</b>	<b>2005</b>	<b>\$ Change</b>	<b>% Change</b>
Revenue	\$ 10,316,477	\$ 10,645,812	\$ (329,335)	(3%)
Operating and administrative expenses	9,608,427	9,639,618	(31,191)	0%
	<u>708,050</u>	<u>1,006,194</u>	<u>(298,144)</u>	<u>(30%)</u>
Amortization of capital assets	\$ 80,994	\$ 82,907	\$ (1,913)	(2%)
Amortization of intangible and other assets	62,671	57,298	5,373	9%
Interest and finance charges, net	12,463	69,969	(57,506)	(82%)
Share-based compensation	69,956	13,759	56,197	408%
Gain on acquisition	(128,584)	-	(128,584)	-
Non-controlling interest	-	(19,549)	(19,549)	(100%)
	<u>97,500</u>	<u>204,384</u>	<u>(106,884)</u>	<u>(52%)</u>
Earning before income taxes	610,550	801,810	(191,260)	(24%)
Income taxes	146,203	273,680	(127,477)	(47%)
Net earnings	\$ 464,347	\$ 528,130	\$ (63,783)	(12%)
Basic and diluted earning per share	\$ 0.01	\$ 0.01	\$ 0.00	0%

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**Operating Results for the nine months ended September 30, 2006:**

	<b>2006</b>	<b>2005</b>	<b>\$ Change</b>	<b>% Change</b>
Revenue	\$ 32,885,572	\$ 35,066,574	\$ (2,181,002)	(6%)
Operating and administrative expenses	30,176,682	31,860,577	(1,683,895)	(5%)
	<u>\$ 2,708,890</u>	<u>\$ 3,205,997</u>	<u>\$ (497,107)</u>	<u>(16%)</u>
Amortization of capital assets	\$ 228,531	\$ 248,151	\$ (19,620)	(8%)
Amortization of intangible assets and deferred costs	188,280	171,894	16,386	10%
Interest and finance charges, net	14,226	205,051	(190,825)	(93%)
Share-based compensation	207,832	44,195	163,637	370%
Gain on acquisition	(128,584)	-	(128,584)	-
Non-controlling interest	-	(70,633)	70,633	(100%)
	<u>510,285</u>	<u>598,658</u>	<u>(88,373)</u>	<u>(15%)</u>
Earning before income taxes	2,198,605	2,607,339	(408,734)	(16%)
Income taxes	675,059	887,919	(212,860)	(24%)
Net earnings	<u>\$ 1,523,546</u>	<u>\$ 1,719,420</u>	<u>\$ (195,874)</u>	<u>(11%)</u>
Basic earnings per share	\$ 0.04	\$ 0.05	\$ (0.01)	(20%)
Diluted earnings per share	\$ 0.04	\$ 0.05	\$ 0.00	0%

**Revenue**

Revenue in the third quarter of 2006 totaled \$10.3 million, a reduction of \$330,000 or 3% from the third quarter of 2005. Retail revenues increased by 12% or \$0.7 million; driven by the acquisition of SourceLink Canada, completed in mid-August 2006. Channel revenues for the quarter declined by \$1.0 million or 19% with a \$337,000 increase in corporate events offset by reductions in Ford program administration (\$565,000) and non-Elevate incentive programs (\$700,000). For the quarter revenues from Pareto's Elevate activities were consistent with Q3 2005.

On a year-to-date basis for the nine month period ended September 30, 2006, revenues totaled \$32.9 million compared to \$35.1 million in 2005, a reduction of \$2.2 million or 6%. In the first nine months of the year Retail revenues increased by 11% while Channel revenues declined 19%. The growth in Retail revenues resulted from the inclusion of SourceLink Canada as well as growth in print management and fulfillment and distribution activities offset by a reduction in Retail activities with Ford. The decline in Channel revenues on a year to date basis was driven by reduced corporate event and incentive program revenues offset by a \$1.7 million increase in Elevate revenues. As previously disclosed the Company's corporate event revenues in 2006 are being negatively impacted by approximately \$6 million of event revenue which occurred in 2005 related to biannual events which will not reoccur in 2006 with substantially that entire amount occurring in the first nine months of the year. In spite of this impact event revenues declined only \$2.7 million during the period as new client wins offset the majority of the impact. Channel incentive program revenues have declined \$1.2 million to September 30, 2006 due to lower client incentive spending and the conversion of some incentive programs to Elevate programs. On a year-to-date basis, revenues derived from Ford declined by approximately \$2.0 million. Excluding the impact of the biannual events and the decline in Ford revenues, revenue for the quarter would have increased by approximately \$2.2 million.

The Company expects 2006 full year revenues to be similar to the total revenue amount derived in 2005 as growth in print management, fulfillment and distribution and Elevate revenues in 2006 combined with the impact of the inclusion of SourceLink Canada and Secom Plus (acquired in October 2006) will be offset by reduced Ford and customer loyalty program revenues and the biannual event impact described above. As a result of Ford's recently announced restructuring initiatives, the Company expects continued reduced revenues derived from Ford for the balance of the year with total spend for the year to be reduced by approximately \$4.0 million as compared to 2005. In 2005 Channel revenues included a number of significant

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non-Elevate customer gift with purchase incentive programs in the fourth quarter. The Company has recently determined it will not pursue similar programs in 2006 as the programs are often lower margin generating and less consistent compared to the Company's other revenue streams. The Company generated approximately \$3.0 million of revenues from these types of customer loyalty programs in 2005. While the Company expects growth for the full year in Elevate revenues, recent regulatory changes affecting a pharmaceutical industry client program in Ontario will slow growth in the fourth quarter and in 2007.

In the third quarter of 2006 Retail activities represented 58% of revenues compared to 50% in 2005 with Channel activities representing 42% versus 50% in 2005. On a year to date basis 2006 Retail activities represented 51% of revenues compared to 43% in 2005 with Channel activities representing 49% versus 57% in 2005. In 2006 the Company's mix of revenues by business model was as follows:

- Fixed fee basis- 70% for the quarter (61% in 2005) – 55% year to date (70% in 2005)
- Time and materials basis - 16% for the quarter (25% in 2005) – 19% year to date (24% in 2005)
- Resale of reward units - 14% for the quarter (14% in 2005) – 13% year to date (6% in 2005)

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

For the quarter, operating and administrative expenses remained unchanged from 2005 at \$9.6 million. On a year-to-date basis these costs decreased to \$30.2 million from \$31.9 million, a reduction of 5%. Operating and administrative expenses include project, selling, general, administrative and facilities costs. In the third quarter operating and administrative costs did not decline in step with the 3% decline in revenues due to changes in the revenue mix and higher administrative costs. For the nine month period operating and administrative costs declined by 5%, consistent with the 6% decline in revenues. In the fourth quarter of 2006, the Company is integrating its Retail and Channel operations as well as the recently acquired SourceLink Canada and expects to incur approximately \$1.0 million of costs including costs related to facilities and personnel changes in the fourth quarter. The integration will result in the relocation of the Company's Oakville operations into the Company's North York operations and the Company's Mississauga operations into the Company's Markham operations with these moves reducing costs and improving operating efficiencies. The company expects the actions undertaken in 2006 will reduce 2007 operating and administrative costs by approximately \$2.5 million.

#### **EBITDA**

EBITDA (see "Non-GAAP Measures" above) in Q3 2006 was \$0.7 million compared with \$1.0 million in Q3 2005, a decline of 30%. For the nine month period EBITDA decreased by \$500,000 in 2006 or 16% versus 2005. EBITDA as a percentage of revenue represented 6.9% in Q3 2006, down 260 basis points from 9.5% in 2005 while on a year-to-date basis the percentage was 8.2% compared to 9.1% in 2005. As a result of the lower EBITDA margin generated in the first nine months of the year and the above integration costs to be incurred in Q4 2006; the Company expects full year EBITDA as a percentage of revenue to decline from the percentage achieved in 2005. The Company maintains its commitment to a long-term EBITDA margin target of 15% of revenue.

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

Amortization, interest and share-based compensation increased 1% or \$2,000 during the quarter with an increase in share-based compensation expense resulting from restricted stock units issued in the year offset by a reduction in interest costs as a result of interest earned on the Company's cash balances and loan receivables. On a year-to-date basis, amortization, interest and share-based compensation decreased by \$3,000 with a \$190,000 reduction in interest costs offset by a \$163,000 increase in share-based compensation.

#### **Income Taxes**

Income tax expense in Q3 2006 represented 31% of earnings before tax (excluding gain on acquisition, 33% for the nine month period). Pareto recorded income tax expense of \$146,000 (\$675,000) in 2006 compared to \$273,000 (\$887,000) last year. The reduction was driven primarily by the decrease in pre-tax earnings in the periods. As a result of the acquisition of SourceLink Canada in August 2006, Pareto acquired a future tax

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asset of \$3.8 million. This asset reduces the amount of cash income taxes paid though it will not change the Company's effective tax rate for financial statement purposes. The Company expects to save approximately \$1.4 million in cash taxes over the next twelve months.

#### Gain on acquisition

In August 2006, the Company acquired SourceLink Canada. As set out in note 3(b) to the Company's September 30, 2006 interim financial statements, the fair value of the net assets acquired exceeded the consideration paid by \$128, 584, with the excess being reflected as a gain on acquisition in the Company's results for the quarter.

#### 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 third quarter of 2006 decreased by 12% or \$64,000 to \$464,000 compared to 2005, while on a year-to-date basis net earnings declined 11% to \$1.5 million from \$1.7 million. Excluding the effect of income taxes, earnings before income taxes represented declined to 5.9% of revenue in the quarter compared to 7.5% in 2005, while for the nine month period the percentage changed from 7.4% to 6.7%.

#### Earnings per share

Pareto's diluted earnings per share remain unchanged in the quarter and for the nine month period versus 2005 at \$0.01 and \$0.04 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 June 30, 2005 and the 5,000,000 share private placement completed by Pareto in March 2006.

### **Liquidity and Capital Resources**

#### Financial Position

	September 30, 2006	December 31, 2005	\$ Change	% Change
Cash or equivalents	\$ 6,304,309	\$ 5,078,927	\$ 1,225,382	24%
Acquisition notes payable	300,000	335,000	(35,000)	(10%)
Long-term debt	957,993	1,332,996	(375,003)	(28%)
Capital lease obligations	1,326,607	-	1,326,607	-
Total debt	2,584,600	1,667,996	916,604	55%
Total cash (net debt) position	3,719,709	3,410,931	308,778	9%
Shareholders' equity	23,111,910	13,366,917	9,744,993	42%
Working capital position	\$ 7,275,410	\$ 1,559,342	\$ 5,716,068	367%
Net debt: Shareholders' equity	n/a	n/a		
Net debt: EBITDA	n/a	n/a		
Total debt: EBITDA	0.52:1	0.30:1		

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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 \$0.95 million outstanding as at September 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 - \$125,001; 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 considering acquisition opportunities including signing non-disclosure agreements with 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 present 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 its Normal 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 generated \$2.2 million of cash flow in the third quarter of 2006 compared to utilizing \$0.6 million in 2005. Operating activities before changes in non-cash operating accounts generated \$686,000 in the quarter compared to \$952,000 in 2005. Changes in non-cash operating accounts generated \$1.5 million in the quarter as accounts receivable excluding the accounts receivables acquired as part of the SourceLink acquisition decreased by \$3.6 million since June 30, offset by cash utilized to reduce accounts payable and income taxes payable. On a year-to-date basis, at September 30, 2006, excluding the impact of acquisitions completed in the year, the Company's days sales outstanding stood at 83 days compared to 81 days at June 30, 2006 and 105 days at September 30, 2005.

On a nine month basis, Pareto's operating activities utilized \$2.7 million of cash flow compared to utilizing \$73,000 in 2005. Operating activities before changes in non-cash operating accounts generated \$2.2 million in the period compared to \$2.4 million in 2005. Changes in non-cash operating accounts utilized \$4.8 million in the period as accounts receivable excluding the accounts receivables acquired as part of the SourceLink acquisition decreased by \$1.4 million, offset by a \$4.4 reduction in accounts payable and a \$1.1 million reduction in deferred revenue.

#### **Investing activities**

In 2006, investing activities for the third quarter utilized \$1.2 million of cash flow and \$2.5 million for the year-to-date, up significantly from 2005 in both cases. The primary uses of funds were the acquisition of SourceLink in the third quarter and Trajectory in the second quarter; as well as significantly higher capital asset additions led by the purchase of a new information system for the Company's Retail business (approximately \$400,000).

#### **Financing activities**

To September 30, 2006, Pareto's financing activities generated \$6.4 million of cash flow compared to \$262,000 in 2005. The increase resulted from net proceeds from share issuances of \$7.5 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 cash flow was utilized to reduce long term debt by \$375,003 and improve the Company's working capital position. The Company has also utilized \$361,000 of cash flow to repurchase its common shares in 2006.

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**Contractual Obligations**

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

	Total	Payments due by period			
		Less than 1 year	1-3 years	4-5 years	After 5 years
Long-term debt	\$ 957,993	\$ 500,000	\$ 457,993	\$ -	\$ -
Capital lease obligations	1,326,607	395,928	697,416	233,263	-
Acquisition notes payable	300,000	200,000	200,000	-	-
Operating leases	3,463,815	950,379	1,249,724	1,123,299	140,413
<b>Total contractual obligations</b>	<b>\$ 6,048,415</b>	<b>\$ 1,946,307</b>	<b>\$ 2,605,133</b>	<b>\$ 1,356,562</b>	<b>\$ 140,413</b>

In May 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.

In October 2006, the Company acquired the shares of Secom Plus Inc. ("Secom"). As part of the purchase, potential future consideration of up to \$5.0 million may be payable by the Company based on the performance of Secom through 2007.

**Outstanding Share Data**

At September 30, 2006, an unlimited number of common shares were authorized and 44,235,877 common shares were outstanding. The Company has 1,959,168 options currently outstanding to acquire common shares pursuant to its Option Plan of which 1,214,167 were exercisable. The Company also has 474,334 common share purchase warrants and 571,666 restricted stock units 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 September 30, 2006, in October, 2006, the Company acquired all of the outstanding shares of Secom Plus Inc., a Montreal based field marketing company, for initial consideration of \$5.0 million including the issuance of 450,450 common shares. Future cash payments of up to a maximum of \$5.0 million may be payable in 2008 based on future events.

**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

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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 third quarter of 2006 Pareto generated revenues from two clients representing greater than 10% of revenues (24% and 17% respectively – 2005: 25% and 25% respectively) (for the nine month period three clients represented more than 10% of revenues – 23%, 21% and 10% respectively – 2005: 24% and 23% 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.

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 30% of consolidated assets at September 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.

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#### **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 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. 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 September 30, 2006.

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

**SUMMARY OF QUARTERLY AND ANNUAL RESULTS**

**2006**                      **March 31**                      **June 30**    **September 30**

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**Quarterly information:**

Revenue	\$ 9,532,273	\$ 13,036,822	\$ 10,316,477
EBITDA <sup>1</sup>	764,547	1,236,293	708,050
Net earnings	346,152	663,047	464,347
Basic and diluted earnings per share <sup>2</sup>	0.01	0.02	0.01

**2005**                      **March 31**                      **June 30**    **September 30**    **December 31**                      **Total**

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**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

**2004**                      **March 31**                      **June 30**    **September 30**    **December 31**                      **Total**

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**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

**Annual Information:**

Total assets	24,966,769
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## Pareto Corporation

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

Total long-term financial liabilities	1,948,576
Cash dividends declared	0.00

2003	March 31	June 30	September 30	December 31	Total
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#### 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

	September 30 2006 (unaudited)	December 31 2005 (audited)
<b>Assets</b>		
<b>Current assets</b>		
Cash	\$ 6,304,309	\$ 5,078,927
Accounts receivable	12,160,014	10,760,008
Work in progress	1,607,531	1,954,353
Inventory and other current assets	1,350,795	513,955
Current future income tax assets	1,417,962	97,854
	22,840,611	18,405,097
<b>Loans receivable</b>	1,300,000	433,333
<b>Long-term future income tax assets</b>	2,521,003	-
<b>Deferred costs and other assets</b>	566,456	609,791
<b>Capital assets</b>	1,381,622	990,622
<b>Goodwill and intangible assets</b>	12,141,120	11,479,110
	\$ 40,750,812	\$ 31,917,953
<b>Liabilities and Shareholders' Equity</b>		
<b>Current liabilities</b>		
Accounts payable and accrued liabilities	\$ 10,802,149	\$ 10,841,641
Current portion of deferred revenue	3,048,890	4,151,498
Income taxes payable	754,492	927,065
Current future income tax liabilities	93,350	90,551
Current portion of acquisition notes payable	100,000	335,000
Current portion of capital lease obligations	266,320	-
Current portion of long-term debt	500,000	500,000
	15,565,201	16,845,755
<b>Long-term deferred revenue</b>	-	474,144
<b>Long-term future income tax liabilities</b>	355,421	398,141
<b>Long-term debt</b>	457,993	832,996
<b>Long-term capital lease obligations</b>	1,060,287	-
<b>Long-term acquisition notes payable</b>	200,000	-
<b>Total liabilities</b>	17,638,902	18,551,036
<b>Shareholders' equity</b>		
Share capital	15,989,140	7,576,707
Contributed surplus	358,531	254,192
Common share purchase warrants	77,700	126,454
Retained earnings	6,686,539	5,409,564
<b>Total shareholders' equity</b>	23,111,910	13,366,917
	\$ 40,750,812	\$ 31,917,953

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 September 30 (unaudited)

	Three Months		Nine Months	
	2006	2005	2006	2005
<b>Revenue</b>	<b>\$ 10,316,477</b>	\$ 10,645,812	<b>\$ 32,885,572</b>	\$ 35,066,574
<b>Operating and administration expenses</b>	<b>9,608,427</b>	9,639,618	<b>30,176,682</b>	31,860,577
	<b>708,050</b>	1,006,194	<b>2,708,890</b>	3,205,997
Amortization of capital assets	<b>80,994</b>	82,907	<b>228,531</b>	248,151
Amortization of intangible and other assets	<b>62,671</b>	57,298	<b>188,280</b>	171,894
Interest and finance charges, net	<b>12,463</b>	69,969	<b>14,226</b>	205,051
Share-based compensation	<b>69,956</b>	13,759	<b>207,832</b>	44,195
Gain on acquisition	<b>(128,584)</b>	-	<b>(128,584)</b>	-
Non-controlling interest	-	(19,549)	-	(70,633)
	<b>97,500</b>	204,384	<b>510,285</b>	598,658
Earnings before income taxes	<b>610,550</b>	801,810	<b>2,198,605</b>	2,607,339
Income taxes	<b>146,203</b>	273,680	<b>675,059</b>	887,919
<b>Net earnings for the period</b>	<b>464,347</b>	528,130	<b>1,523,546</b>	1,719,420
<b>Retained earnings, beginning of period</b>	<b>6,419,434</b>	3,625,822	<b>5,409,564</b>	2,434,532
<b>Net earnings for the period</b>	<b>464,347</b>	528,130	<b>1,523,546</b>	1,719,420
<b>Loss on repurchase of common shares</b>	<b>(197,242)</b>	-	<b>(246,571)</b>	-
<b>Retained earnings, end of period</b>	<b>\$ 6,686,539</b>	\$ 4,153,952	<b>\$ 6,686,539</b>	\$ 4,153,952
<b>Basic earnings per share</b>	<b>\$ 0.01</b>	\$ 0.01	<b>\$ 0.04</b>	\$ 0.05
<b>Diluted earnings per share</b>	<b>\$ 0.01</b>	\$ 0.01	<b>\$ 0.04</b>	\$ 0.04
<b>Average number of common shares outstanding</b>				
Basic	<b>44,266,346</b>	36,601,115	<b>41,815,879</b>	36,326,643
Diluted	<b>45,872,139</b>	38,863,354	<b>43,512,361</b>	38,498,243

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 September 30 (unaudited)

	Three Months		Nine Months	
	2006	2005	2006	2005
<b>Operating activities</b>				
Net earnings for the period	\$ 464,347	\$ 528,130	\$ 1,523,546	\$ 1,719,420
Items not involving cash:				
Amortization of capital assets	80,994	82,907	228,531	248,151
Amortization of intangible assets and deferred costs	62,671	57,298	188,280	171,894
Non-cash interest and finance charges	3,281	9,463	9,843	28,391
Share-based compensation	69,956	13,759	207,832	44,195
Non-controlling interest	-	(19,549)	-	(70,633)
Gain on acquisition	(128,584)	-	(128,584)	-
Future income tax provision	133,362	280,084	97,932	297,444
	<b>686,027</b>	<b>952,092</b>	<b>2,127,380</b>	<b>2,438,862</b>
Changes in non cash operating accounts	<b>1,535,108</b>	<b>(1,558,463)</b>	<b>(4,849,857)</b>	<b>(2,511,779)</b>
	<b>2,221,135</b>	<b>(606,371)</b>	<b>(2,722,477)</b>	<b>(72,917)</b>
<b>Investing activities</b>				
Capital asset additions	(121,897)	(15,815)	(583,909)	(100,565)
Change in other assets	2,704	(2,444)	(78,822)	(44,232)
Acquisitions, net of cash acquired	(1,117,222)	-	(1,792,917)	(100,000)
	<b>(1,236,415)</b>	<b>(18,259)</b>	<b>(2,455,648)</b>	<b>(244,797)</b>
<b>Financing activities</b>				
Issue of acquisition notes payable	-	-	-	100,000
Repayment of acquisition notes payable	-	(30,000)	(335,000)	(525,000)
Repayment of long-term debt	(125,001)	(125,001)	(375,003)	(375,003)
Repayment of capital lease obligations	(33,438)	-	(33,438)	-
Issuance of shares	85,186	72,500	8,180,322	1,158,246
Share issue costs	-	-	(671,972)	(5,089)
Change in non-controlling interest	-	(91,000)	-	(91,000)
Repurchase of common shares	(289,412)	-	(361,402)	-
	<b>(362,665)</b>	<b>(173,501)</b>	<b>6,403,507</b>	<b>262,154</b>
<b>Increase (decrease) in cash for the period</b>	<b>622,055</b>	<b>(798,131)</b>	<b>1,225,382</b>	<b>(55,560)</b>
<b>Cash and cash equivalents, beginning of period</b>	<b>5,682,254</b>	<b>1,706,627</b>	<b>5,078,927</b>	<b>964,956</b>
<b>Cash and cash equivalents, end of period</b>	<b>\$ 6,304,309</b>	<b>\$ 908,496</b>	<b>\$ 6,304,309</b>	<b>\$ 908,496</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.

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# Pareto Corporation

## Notes to Consolidated Financial Statements

September 30, 2006 (Unaudited)

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### 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 September 30, 2006 and for the three-month and nine-month periods ended September 30, 2006 and September 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

- (a) On August 10, 2006, the Company acquired all of the outstanding shares of SourceLink Canada Corporation (SourceLink Canada) for total cash consideration of \$1.2 million. The acquisition was accounted for as a purchase.

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

Cash	\$	484,861
Current assets		3,099,746
Future income tax asset		3,766,984
Current liabilities		(4,544,282)
Long-term liabilities		(1,093,725)
Net identifiable assets acquired		<u>1,713,584</u>
Purchase consideration		
Cash		1,200,000
Integration costs		250,000
Transaction costs		135,000
		<u>1,585,000</u>
Excess of fair value of assets acquired reflected as gain on acquisition	\$	<u>128,584</u>

- (b) 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.

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

September 30, 2006 (Unaudited)

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**3. Business combinations (continued)**

A summary of the fair value 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>

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 if earned.

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

# Pareto Corporation

## Notes to Consolidated Financial Statements

September 30, 2006 (Unaudited)

### 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 warrants	297,666	346,423
Shares issued on exercise of stock options	1,261,342	486,146
Repurchased for cancellation	(317,900)	(114,831)
Shares issue costs	-	(671,972)
Balance, September 30, 2006	44,235,877	\$ 15,989,140

(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.

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	275,000	1.32
Exercised in 2006	(1,261,342)	0.30
Cancelled in 2006	(100,000)	0.57
Options outstanding, September 30, 2006	1,959,168	\$ 0.65
Options exercisable, September 30, 2006	1,214,167	\$ 0.32
Options exercisable, December 31, 2005	2,214,676	\$ 0.29

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

**September 30, 2006 (Unaudited)**

**4. Share capital (continued)**

As at September 30, 2006, the Company had the following options outstanding pursuant to the plan:

<u>Number of Options</u>	<u>Exercise Price Per Share</u>	<u>Expiry Date</u>
236,429	\$ 0.35	November 30, 2006
158,571	\$ 0.35	February 15, 2007
205,000	\$ 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
35,000	\$ 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
100,000	\$ 1.15	August 8, 2011
35,000	\$ 1.15	August 11, 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. At September 30, 2006, 571,666 restricted stock units were outstanding pursuant to the LTIP (333,333 to December 31, 2005)

(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 September 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 September 30, 2006.

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

September 30, 2006 (Unaudited)

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**4. Share capital (continued)**

(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 October, 2006, the Company acquired all of the outstanding shares of Secom Plus Inc., a Montreal based field marketing company, for initial consideration of \$5.0 million including the issuance of 450,450 common shares. Future cash payments of up to a maximum of \$5.0 million may be payable in 2008 based on future events.

**6. Comparative Figures**

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