Pareto Corporation 2007 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, 2007, summarizes the significant factors affecting the consolidated operating results, financial condition, liquidity and cash flows of Pareto for the quarter and nine month period ended September 30, 2007. All amounts are in Canadian dollars. This MD&A should be read in conjunction with consolidated annual financial statements for the year ended December 31, 2006, which are prepared in accordance with Canadian GAAP. Additional information relating to Pareto, including the Annual Information Form dated March 29, 2007, can be found at the Company's website at www.pareto.ca and on SEDAR at 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.

Non-GAAP Measures

In this discussion and analysis, management uses "EBITDA" (earnings before amortization, net interest and finance charges, share-based compensation, gain on acquisition and income taxes) and pro forma revenue; measures 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, gain on acquisition and income taxes all of which are clearly identified on the Company's Statement of Operations and Retained Earnings.

Pro forma revenue is calculated by including the revenue of businesses acquired since the end of the prior year comparative period in the Company's revenue for the corresponding period as if the acquired business was acquired at the beginning of the comparative period.

Management uses other non-GAAP financial measures, including net debt (long-term debt and capital lease obligations 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 clients in a wide range of industries. All of Pareto's operations are located in Canada. 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.
- Outsourced sales and marketing program management.
- Customer loyalty programs.
- Channel sales and employee training and incentive programs.

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.

Retail sales and merchandising as well as 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.

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.

Operating Results for the quarter ended September 30:

	2007	2006	$ Change	% Change
Revenue	$ 14,345,259	$ 10,316,477	$ 4,028,782	39%
Operating and administrative expenses	13,744,123	9,608,427	4,135,696	43%
	601,136	708,050	(106,914)	(15%)
Amortization of capital assets	$ 135,555	$ 80,994	$ 54,561	67%
Amortization of intangible assets and deferred costs	90,217	62,671	27,546	44%
Interest and finance charges, net	135,096	12,463	122,633	984%
Share-based compensation	125,764	69,956	55,808	80%
	486,632	226,084	260,548	115%
Earnings before income taxes and gain on acquisition	114,504	481,966	(367,462)	(76%)
Gain on acquisition	-	(128,584)	128,584	100%
Income taxes	38,290	146,203	(107,913)	(74%)
Net earnings	$ 76,214	$ 464,347	$ (388,133)	(84%)
Basic and Diluted earnings per share	$ 0.00	$ 0.01	$ (0.00)	(100%)

Operating Results for the nine months ended September 30:

	2007	2006	$ Change	% Change
Revenue	$ 53,408,608	$ 32,885,572	$ 20,523,036	62%
Operating and administrative expenses	49,638,232	30,176,682	19,461,550	64%
	$ 3,770,376	$ 2,708,890	$ 1,061,486	39%
Amortization of capital assets	$ 352,625	$ 228,531	$ 124,094	54%
Amortization of intangible assets and deferred costs	270,650	188,280	82,370	44%
Interest and finance charges, net	320,642	14,226	306,416	2,154%
Share-based compensation	310,121	207,832	102,289	49%
	1,254,038	638,869	615,169	96%
Earnings before income taxes and gain on acquisition	2,516,338	2,070,021	446,317	22%
Gain on acquisition	-	(128,584)	128,584	100%
Income taxes	822,326	675,059	147,267	22%
Net earnings	$ 1,694,012	$ 1,523,546	$ 170,466	11%
Basic and Diluted earnings per share	$ 0.04	$ 0.04	$ 0.00	0%

Revenue

In the third quarter of 2007, revenues increased by 39% or $4.0 million to $14.3 million from $10.3 million in 2006. The increase was driven primarily by the inclusion of the operations of the SourceLink Canada business acquired in August 2006 and the Secom Plus business acquired in October 2006. On a pro forma basis, assuming the above acquisitions completed in 2006 had occurred on January 1, 2006, overall organic revenue growth of 2% was achieved, driven by growth in print management, retail sales and merchandising as well as corporate events, and offset by declines in direct mail, incentive and service revenues.

On a year to date basis to September 30, 2007, revenues increased by 62% or $20.5 million to $53.4 million from $32.9 million in the same period last year. Revenues on a pro forma basis increased 15% led by significant growth in retail sales and merchandising, corporate events and print management. Excluding corporate events pro forma revenues increased by 11% on a year to date basis.

The Company expects to generate a double digit full year organic revenue growth rate in 2007.

Operating and Administrative Expenses
In the third quarter, operating and administrative expenses increased 43% or $4.1 million to $13.7 million from $9.6 million in the prior year. Operating and administrative expenses include project, selling, general, administrative and facilities costs. The increase in operating and administrative expenses resulted from the inclusion of the expenses of the businesses acquired after June 30, 2006 and was higher then the 39% increase in revenues for the quarter due to changes in service mix of revenues in 2007 as compared to 2006.

On a year to date basis, operating and administrative expenses increased by 64% to $49.6 million compared to $30.2 million last year. This percentage increase exceeded the corresponding revenue increase of 62% as a result of higher than average operating cost percentage incurred in the first and third quarters of 2007 compared to last year.

EBITDA
EBITDA (see "Non-GAAP Measures" above) totaled $0.6 million in the third quarter of 2007 compared to $0.7 million in Q3 2006 representing a decline of 15%. EBITDA as a percentage of revenue represented 4.2% in 2007 down from 6.9% in 2006. The volume of business has traditionally been slower in Q3, so the Company expects to achieve below-average margins due to lower absorption of fixed costs. In comparison to the previous year, the Q3/07 business mix was slightly less favourable for our margins as margins derived from corporate events and the businesses acquired in 2006 reduced the Company's overall average.

In addition, Q3 was also affected as was Q1 2007 by work begun on a number of large projects to be completed in the next quarter with revenue recognized on a completed project basis while corresponding employee and infrastructure costs are expensed as they are incurred.

For the nine month period ended September 30, 2007 EBITDA totaled $3.8 million, up 39% from 2006. EBITDA as a percentage of revenue of 7.1% was lower then the 8.2% recorded in the first nine months of 2006 due to the lower EBITDA margin rate achieved in the first and third quarters of 2007 resulting from lower revenue volume in those quarters as well as unfavourable changes in margin as a result of changes in business mix between quarters.

To some extent 2007 margins have been constrained this year by the impact of investments related to several initiatives undertaken to improve the company's long-term profitability. The Company is implementing a new business management system across the business to ensure processes and methodologies are scalable to facilitate continued growth. In the third quarter, Pareto opened a state-of-the-art production facility in Richmond Hill to handle all of its' integrated retail operations. The costs of that relocation are primarily capital however operating results were diluted somewhat as a result of the four week relocation of this business. In addition significant capital investment was made in new machinery and technology in the direct marketing area to enhance capability and productivity. Each of these projects required management to devote meaningful amounts of time and energy this year, with the vast majority of the expected cost savings and productivity gains being realized in future years.

Amortization, Interest and Share-based Compensation
For the quarter, amortization, interest and share-based compensation increased by 115% or $260,548 over the same period in 2006. Each of the components of the total increased with the primary driver being increased interest and finance charges. Net interest and finance charges increased by $122,633 as a result of the inclusion of interest costs on capital lease obligations taken on by the Company as part of the acquisition of SourceLink Canada in August 2006, increased use of the Company's overdraft facility and the

loss of interest income derived in the first six months of 2006 subsequent to the Company's March 2006 private placement. Amortization of capital assets increased by 67% as a result of capital assets acquired by the Company since June 30, 2006. The acquisition of Secom Plus by the Company in October 2006 also led to increased amortization of both capital assets and intangible assets. The Company expects both capital asset and intangible asset amortization to increase in 2007 due the full year effect of the acquisitions and capital assets acquired. Share-based compensation expense increased by 80% resulting from stock options and restricted stock units issued by the Company since June 30, 2006. Similar factors affected these costs for the nine month period ended September 30, 2007, with total amortization, interest and share-based compensation expenses increasing 96% during the period compared to last year.

Gain on acquisition
In August 2006, the Company acquired Sourcelink Canada. As set out in the Company's 2006 annual 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 third quarter of 2006.

Income Taxes
Income tax expense in the third quarter of 2007 represented 33% of earnings before tax compared to 24% in Q3 2006. The overall tax rate increased as a result of higher amounts of non-deductible items for tax purposes such as share-based compensation. For the nine month period, the overall tax rate increased from 30% to 33%. At September 30, 2007 the Company had approximately $2.8 million of future income tax assets still to be utilized. Going forward, the Company expects to incur a long term effective tax rate of approximately 36%.

Net Earnings
In the third quarter net earnings reduced from $464,347 in 2006 to $76,214 in 2007 or 84%. The $388,133 decline resulted from lower EBITDA, increased interest and finance charges and share based compensation and due to the inclusion of the $128,584 gain on acquisition in 2006 offset by a corresponding lowering of income taxes.

Year to date in 2007, the Company has generated a total of $1.7 million of total net earnings including $0.1 million in the third quarter of 2007. This represents an 11% increase over 2006 as significant revenue and EBITDA increases were offset by higher amortization, interest and share-based compensation as well as higher income taxes. Net earnings as a percentage of revenue were 3.2% in the first nine months of 2007, compared to 4.6% in the comparable period of 2006. Excluding the effect of income taxes, year-to-date earnings before income taxes were 4.7% of revenue in 2007 compared to 6.7% the previous year.

Earnings per Share
For the third quarter both basic and diluted earnings per share decreased by $0.01 to $0.00 from Q3 2006 due to lower net earnings. The weighted average number of diluted shares outstanding remained similar for the quarter as dilution resulting from common shares, options and restricted stock units issued was offset by common shares repurchased for cancellation. On a nine month basis basic and diluted earnings per share remained constant at $0.04 as the 11% increase in net earnings was offset by a 5% increase in the weighted average number of diluted shares outstanding. This increase resulted from two private placements completed in 2006 and the shares issued pursuant to the acquisition of Secom Plus in October 2006, offset by shares repurchased for cancellation during the year and the effect of the change in the Company's share price compared to the same period last year.

Financial Outlook
The Company expects, as has been the case in the last three years, that fourth quarter revenues will be considerably larger than third quarter revenues.

The Company expects to achieve EBITDA margins approaching 10% for the year and has established a long-term EBITDA margin target of 15% of revenue.

Liquidity and Capital Resources

Financial Position

	September 30, 2007	December 31, 2006	$ Change	% Change
Cash	$ (4,196,626)	$ 5,020,127	$ (9,216,753)	(184%)
Acquisition notes payable	5,066,667	1,450,000	3,616,667	250%
Long-term debt	-	665,992	(665,992)	(100%)
Long-term capital leases	1,060,042	1,256,355	(196,313)	(16%)
Total debt	6,126,709	3,372,347	2,754,362	82%
Total net cash (debt) position	(10,323,335)	1,647,780	(11,971,115)	(726%)
Shareholders' equity	24,690,730	23,736,606	954,124	4%
Total capitalization	$ 35,014,065	$ 22,088,826	$ 12,925,239	59%
Working capital position	$ (1,474,423)	$ 4,134,294	$ 5,608,717	(135%)
Net debt: Shareholders' equity	0.42:1	n/a		
Net debt: Total Capitalization	0.29:1	n/a		
Net debt: EBITDA	2.71:1	n/a		
Total debt: EBITDA	1.61:1	1.23:1		

At September 30, 2007, the Company had drawn $4.2 million on its operating line of credit. Pareto draws on its operating line of credit from time to time to meet normal business obligations. In the third quarter of 2007, the Company's utilization of its operating line of credit was impacted by $2.4 million of significant expenditures including $1.0 million of capital asset additions, a $0.7 million account payable related to the Secom acquisition, a $0.4 million early repayment of long-term debt, and $0.3 million expended under the Company's normal course issuer bid. Subsequent to September 30, 2007, cash flow from operations has improved the Company's cash position by over $2 million. Pareto's sources of short-term liquidity include cash provided by operating activities and a $9.0 million operating line of credit (increased from $5.5 million in July 2007) secured by a general security agreement over the assets of Pareto and its subsidiaries, and which is repayable on demand. As at November 13, 2007, the Company's capacity on it's line of credit was approximately $7 million.

Operating activities
For the quarter operating activities before changes in non-cash working capital accounts generated $0.9 million of cash flow compared to $0.7 million of cash flow in Q3 2006, an improvement of $0.2 million. The increase was achieved in spite of the reduction in net earnings as a result of the increase in non-cash expenses deducted from net earnings. Most notably future income tax expense increased by approximately $265,000 as a result of utilization of the Company's future tax asset acquired in the acquisition of SourceLink Canada. Changes in non-cash working capital accounts utilized $2.7 million of cash flow in the quarter, representing a decline of $5.1 million from the same period in 2006. The cash utilization in Q3 2007 resulted equally from an increase in accounts receivable and a decrease in account payable. The Company's days sales outstanding measured on a quarterly basis stood at 99 days at September 30, 2007 and 80 days measured on a year to date basis. This compares to 106 days and 100 days respectively at September 30, 2006.

On a year to date basis operating activities utilized $4.0 million of cash flow compared to a utilization of $2.7 million in 2006 cash flow, a decline of $1.3 million. The decline resulted from a $1.5 million improvement in cash from operating activities before changes in non-cash working capital accounts offset by a $2.8 decline in changes in non-cash working capital accounts. The increase in cash from operating activities before changes in non-cash working capital accounts was driven by increased net earnings and increased future income tax expense. The cash utilization in changes in non-cash working capital accounts in 2007 primarily resulted from increases in accounts receivable driven by the significant increase in revenues and a reduction in accounts payable. The Company has targeted to achieve improved cash flow from changes in non-cash working capital accounts over the remainder of 2007.

Investing activities

In the third quarter of 2007, Pareto's investing activities utilized $0.9 million of cash flow, down from $1.2 million in the same period of 2006, with almost all of the total 2007 cash flow utilization resulting from capital asset expenditures. On a year to date basis, cash utilized for investing activities decreased to $1.7 million from $2.5 million utilized in 2006, with capital asset expenditures representing the majority of the activities in 2007. The capital expenditures undertaken in 2007 primarily related to leasehold improvements and machinery and equipment. To September 30, 2007, the Company has expended $1.3 million to acquire new production equipment and to relocate its print management, direct mail and fulfillment and distribution centre to create a new state of the art facility located in Richmond Hill, Ontario which became fully operational in July 2007. The Company does not expect significant capital expenditures in the remainder of 2007 or in 2008 with expenditure levels returning to a more normal rate.

Financing activities

Pareto's financing activities utilized approximately $731,000 of cash flow in Q3 2007. The Corporation reduced debt by $481,000 and utilized $322,000 to repurchase common shares of the Company pursuant to its normal course issuer bid. This compares to debt reduction of $158,000 and share repurchases of $289,000 in Q3 2006. On a year to date basis, financing activities utilized $3.5 million of cash flow compared to generating $6.4 million in the same period of 2006. In 2007, the Company reduced debt by $2.2 million and expended $1.4 million on common share repurchases. This compares to $7.2 million of cash flow generated in Q1 2006 resulting from the net proceeds from share issuances. The Company may expend further funds to repurchase common shares in 2007.

Management considers the Company's capital resources adequate to meet the Company's operating, capital expenditure, and financing requirements. The Company is continuing to explore acquisition opportunities. 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.

Contractual Obligations

The following table provides a summary of Pareto's contractual obligations under various debt and lease agreements:

	Payments due by period				
	Total	Less than 1 year	1-3 years	4-5 years	After 5 years
Long-term debt	$ -	$ -	$ -	$ -	$ -
Capital leases	1,060,042	262,537	797,505	-	-
Acquisition notes payable	5,066,667	5,066,667	-	-	-
Operating leases	5,112,014	889,130	1,330,310	990,489	1,902,085
Total contractual obligations	$ 11,238,723	$ 6,218,334	$ 2,127,815	$ 990,489	$ 1,902,085

In May 2006, the Company acquired the assets of Trajectory Business Performance Inc. ("TBPI"). As part of the purchase, future consideration of up to $450,000 was potentially payable by the Company based on the performance of TBPI through 2008. In June 2007, the Company amended the purchase agreement pursuant to which the potential future consideration has been cancelled.

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 became payable by the Company based on the performance of Secom during 2007 and is due in January 2007.

There are no other amounts of future consideration potentially payable for acquisitions completed by the Company up to September 30, 2007.

Outstanding Share Data

At September 30, 2007, an unlimited number of common shares were authorized and 44,569,248 (44,434,448 at November 13, 2007) common shares were outstanding. The Company had 1,659,168 options (1,614,168 at November 13, 2007) outstanding to acquire common shares of which 456,112 (419,445 at November 13, 2007) were exercisable. The Company also has 1,219,285 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.

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 quarter Pareto generated revenues from two clients that represented greater than 10% of revenues (26% and 10% respectively). In the third quarter of 2006 two clients represented greater than 10% of revenues (24% and 17% respectively). For the nine month period one client represented greater then 10% of revenues (30%) (2006: three clients – 23%, 21%, 10% 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 32% of consolidated assets at September 30, 2007. 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.

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 2006 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 2006, 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, 2007.

Recent Accounting Developments

The Canadian Institute of Chartered Accountants (CICA) has published three new accounting standards: Section 3855 "Financial Instruments – Recognition and Measurement", Section 3865 "Hedges" and Section 1530 "Comprehensive Income" that are effective for fiscal periods beginning on or after October 1, 2006. These accounting standards introduce new requirements for the recognition and measurement of financial instruments, the application of hedge accounting and the reporting of comprehensive income that are designed to harmonize Canadian accounting standards with US and International Financial Reporting Standards. The new standards will require the presentation of a separate statement of comprehensive income. Derivative financial instruments will be recorded in the balance sheet at fair value and the changes in fair value of derivatives designated as cash flow hedges will be reported in comprehensive income.

The Corporation does not expect these new accounting pronouncements to have a significant impact on its financial statements.

Internal Control over Financial Reporting

Internal control over financial reporting is designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with Canadian GAAP. Management has not assessed the design of internal controls over financial reporting for operating units acquired during 2006. While management is not aware of any material deficiency in the design of such internal controls in these acquired units, such a material deficiency may exist.

There have been no changes in the Corporation's internal control over financial reporting that occurred during the third quarter of 2007, the most recently completed interim period, that have materially affected or are reasonably likely to materially affect, the Corporation's internal control over financial reporting.

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 with respect to corporate event revenues, 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.

Summary of Quarterly and Annual Results

Year Ended December 31, 2007	**March 31**	**June 30**	**September 30**	**December 31**	**Total**
Quarterly information:					
Revenue	$14,716,308	$24,347,041	$14,345,259		
EBITDA[1]	816,693	2,352,547	601,136		
Net earnings	347,544	1,270,254	76,214		
Basic and diluted earnings per share[2]	0.01	0.03	0.00		

Year Ended December 31, 2006	**March 31**	**June 30**	**September 30**	**December 31**	**Total**
Quarterly information:					
Revenue	$ 9,532,273	$ 13,036,822	$ 10,316,477	$18,194,436	$51,080,008
EBITDA[1]	764,547	1,236,293	708,050	40,846	2,749,736
Net earnings	346,152	713,047	464,347	26,249	1,549,795
Basic and diluted earnings per share[2]	0.01	0.02	0.01	0.00	0.04
Annual Information:					
Total assets					44,807,361
Total long-term financial liabilities					3,372,347
Cash dividends declared					0.00

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[1]	458,366	1,520,915	1,006,194	2,521,112	5,506,587
Net earnings	322,430	868,860	528,130	1,255,612	2,975,032
Basic and diluted earnings per share[2]	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[1]	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[2]	0.01	0.01	0.01	0.03	0.07
Annual Information:					
Total assets					24,966,769
Total long-term financial liabilities					1,948,576
Cash dividends declared					0.00

[1] EBITDA is a non-GAAP financial measure. See above under "Non-GAAP Measures".

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

Pareto Corporation
Consolidated Balance Sheets

	September 30, 2007 (unaudited)	December 31,2006
Assets		
Current assets		
Cash	$ -	$ 5,020,127
Accounts receivable	**15,808,187**	12,399,746
Inventory and work in progress	**3,109,267**	2,457,361
Other current assets	**569,020**	540,698
Current portion of loans receivable	**301,667**	-
Current future income tax assets	**1,808,157**	2,903,293
	21,596,298	23,321,225
Loans receivable	**486,250**	616,667
Long-term future income tax assets	**952,962**	850,590
Deferred costs	**365,842**	513,708
Capital assets	**3,044,997**	1,722,298
Goodwill and intangible assets	**22,658,463**	17,782,873
	$ 49,104,812	$ 44,807,361
Liabilities and Shareholders' Equity		
Current liabilities		
Bank Indebtedness	**$ 4,196,626**	$ -
Accounts payable and accrued liabilities	**10,687,822**	14,059,056
Current portion of deferred revenue	**2,635,932**	2,607,264
Income taxes payable	**106,640**	275,091
Current future income tax liabilities	**114,497**	131,225
Current portion of acquisition notes payable	**5,066,667**	1,350,000
Current portion of long-term debt	-	500,000
Current portion of capital lease obligations	**262,537**	264,295
	23,070,721	19,186,931
Long-term future income tax liabilities	**545,856**	625,772
Long-term debt	-	165,992
Long-term capital lease obligations	**797,505**	992,060
Long-term acquisition notes payable	-	100,000
Total liabilities	**24,414,082**	21,070,755
Shareholders' equity		
Share capital	**17,247,676**	17,176,172
Contributed surplus	**537,257**	268,895
Retained earnings	**6,905,797**	6,291,539
Total shareholders' equity	**24,690,730**	23,736,606
	$ 49,104,812	$ 44,807,361

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	
	2007	2006	**2007**	2006
Revenue	**$ 14,345,259**	$ 10,316,477	$ **53,408,608**	$32,885,572
Operating and administrative expenses	**13,744,123**	9,608,427	**49,638,232**	30,176,682
	601,136	708,050	**3,770,376**	2,708,890
Amortization of capital assets	**135,555**	80,994	**352,625**	228,531
Amortization of intangible assets and deferred costs	**90,217**	62,671	**270,650**	188,280
Interest and finance charges, net	**135,096**	12,463	**320,642**	14,226
Share-based compensation	**125,764**	69,956	**310,121**	207,832
Gain on acquisition	**-**	(128,584)	**-**	(128,584)
	486,632	97,500	**1,254,038**	510,285
Earnings before income taxes	**114,504**	610,550	**2,516,338**	2,198,605
Income taxes	**38,290**	146,203	**822,326**	675,059
Net earnings for the period	**76,214**	464,347	**1,694,012**	1,523,546
Retained earnings, beginning of period	**7,037,627**	6,419,434	**6,291,539**	5,409,564
Excess price paid over carrying value on repurchase of common shares	**(208,044)**	(197,242)	**(1,079,754)**	(246,571)
Retained earnings, end of period	**$ 6 905 797**	$ 6,686,539	**$ 6,905,797**	$ 6,686,539
Basic and diluted earnings per share	**$ 0.00**	$ 0.01	**$ 0.04**	$ 0.04
Average number of common shares outstanding:				
Basic	**44,737,190**	44,266,346	**44,649,180**	41,815,879
Diluted	**45,775,867**	45,872,139	**45,638,911**	43,512,361

Pareto Corporation
Consolidated Statements of Cash Flows

For the period ended September 30 (unaudited)

	Three Months		Nine Months	
	2007	2006	**2007**	2006
Operating activities				
Net earnings for the period	**$ 76,214**	$ 464,347	**$ 1,694,012**	$ 1,523,546
Items not involving cash**:**				
Amortization of capital assets	**135,555**	80,994	**352,625**	228,531
Amortization of intangible assets and deferred costs	**90,217**	62,671	**270,650**	188,280
Non-cash interest and finance charges	**31,813**	3,281	**38,375**	9,843
Share-based compensation	**125,764**	69,956	**310,121**	207,832
Gain on acquisition	**-**	(128,584)	**-**	(128,584)
Future income tax provision	**398,014**	133,362	**896,120**	97,932
	857,577	686,027	**3,561,903**	2,127,380
Changes in non cash operating accounts	**(3,545,130)**	1,535,108	**(7,599,686)**	(4,849,857)
	(2,687,553)	2,221,135	**(4,037,783)**	(2,722,477)
Investing activities				
Capital asset additions	**(953,554)**	(121,897)	**(1,675,324)**	(583,909)
Other asset additions	**56,479**	2,704	**(2,825)**	(78,822)
Acquisitions, net of cash acquired	**(10,589)**	(1,117,222)	**(33,923)**	(1,792,917)
	(907,664)	(1,236,415)	**(1,712,072)**	(2,455,648)
Financing activities				
Repayment of acquisition notes payable	**-**	-	**(1,383,333)**	(335,000)
Repayment of long-term debt	**(415,990)**	(125,001)	**(665,992)**	(375,003)
Repayment of capital lease obligations	**(66,152)**	(33,438)	**(196,313)**	(33,438)
Issuance of shares	**29,000**	85,186	**139,500**	8,180,322
Share issue costs	**(20,535)**	-	**(20,535)**	(671,972)
Repayment of loans receivable	**65,000**	-	**65,000**	-
Repurchase of common shares	**(322,399)**	(289,412)	**(1,405,225)**	(361,402)
	(731,076)	(362,665)	**(3,466,898)**	6,403,507
Increase (decrease) in cash for the period	**(4,326,293)**	622,055	**(9,216,753)**	1,225,382
Cash and cash equivalents, beginning of period	**129,667**	5,682,254	**5,020,127**	5,078,927
Cash and cash equivalents, end of period	**$ (4,196,626)**	$ 6,304,309	**$ (4,196,626)**	$ 6,304,309

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, all disclosures required for annual financial statements have not 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, 2007 and for the three and nine-month periods ended September 30, 2007 is 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) In 2006, the company acquired certain operating assets and liabilities of Trajectory Business Performance Inc. The consideration included cash, acquisition notes payable, common share purchase warrants and contingent consideration based on future operating results. The acquisition was accounted for as a purchase. In 2007, the company paid additional cash consideration and amended the purchase agreement under which the contingent future consideration and the common share purchase warrants were cancelled.

b) In 2006, the Company acquired Secom Plus Inc. with additional cash consideration of up to $5.0 million payable in January 2008 based on the operating results of Secom for the period ended September 30, 2007. At September 30, 2007, as the operating results criteria have been met, an acquisition note payable of $5.0 million has been recorded which has been accounted for as an addition to goodwill.

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, 2006	45,058,204	$	17,176,172
Shares issued pursuant to private placements (i)	225,000		236,250
Shares issued on exercise of stock options	553,571		181,259
Share issue costs	-		(20,535)
Shares repurchased for cancellation	(1,267,527)		(325,470)
Balance, September 30, 2007	44,569,248	$	17,247,676

(i) In April 2007, Pareto issued 225,000 common shares pursuant to a private placement at an issue price of $1.05 per common share for gross proceeds of $236,250. The company issued a loan in the amount of $236,250 in connection with the hiring of a new executive of the company to facilitate the placement.

4. Share capital (continued)

c) Stock options

The Company has a stock option plan (the "Plan") for employees, consultants 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. In addition, subject to regulatory approval, the company grants options to new employees as an incentive of employment. One-third of granted options vest on each of the anniversary dates of the grant.

Stock option transactions during the period are as follows:

	Number of Options	Weighted Average Exercise Price
Options outstanding, December 31, 2006	1,385,516	$ 0.67
Granted in 2007	963,334	1.09
Exercised in 2007	(553,571)	0.25
Cancelled in 2007	(136,111)	1.27
Options outstanding, September 30, 2007	1,659,168	$ 0.37
Options exercisable, September 30, 2007	456,112	$ 0.67
Options exercisable, December 31, 2006	864,775	$ 0.37

4. Share capital (continued)

As at September 30, 2007, the Company had the following options outstanding:

Number of Options	Exercise Price Per Share	Expiry Date
45,000	$ 0.20	November 4, 2007
50,000	$ 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
50,000	$ 1.53	March 30, 2011
90,000	$ 1.47	May 15, 2011
100,000	$ 1.21	August 8, 2011
30,000	$ 1.15	August 11, 2011
25,000	$ 1.15	October 3, 2011
333,334	$ 1.05	March 7, 2012
130,000	$ 1.05	May 14, 2012
500,000	$ 1.12	June 8, 2012

d) Restricted stock units:

The Company has a long-term incentive plan (LTIP) for employees, consultants, directors and officers of the Company. Pursuant to the LTIP, a total of 2,000,000 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. In addition, subject to regulatory approval, the company grants restricted stock units to new employees as an incentive of employment. Restricted stock units are redeemable upon the third anniversary of the date of grant. At September 30, 2007, 1,196,618 restricted stock units were outstanding (238,333 at December 31, 2006)

4. Share capital (continued)

e) Share-based compensation:

The fair value of stock options granted in 2007 was estimated using the Black-Scholes option-pricing model with the following assumptions:

Dividend yield 0%
Expected volatility 40 %
Risk-free interest rate 3.9% to 4.7%
Expected option life 2 to 4 years

The fair value of stock 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 3.9% to 4.2%
Expected option life 2 to 4 years

The fair value of restricted stock units granted in 2007 and 2006 were estimated to equal the market price of a Pareto common share on the date of grant.

The weighted average grant date fair value of the options granted in 2007 was $0.35 (2006: $0.41).

In 2007, $310,121 (2006: $207,832) of share based compensation has been added to contributed surplus with $41,759 (2006: $103,493) of contributed surplus reallocated to share capital as a result of options exercised in the period.