

Environmental Management Solutions Inc.

Unaudited Consolidated Financial Statements
For the three months ended March 31, 2006 and 2005

Environmental Management Solutions Inc.

Unaudited Consolidated Balance Sheets

As at March 31, 2006 and December 31, 2005

	March 31, 2006	December 31, 2005
	\$	\$
ASSETS		
Current Assets		
Cash (Note 3)	3,951,987	861,619
Restricted investments	1,246,943	1,241,000
Accounts receivable	8,499,738	9,298,438
Inventory	5,144,290	5,202,001
Prepaid expenses and advances	1,114,260	682,317
Other assets	1,742,184	1,683,029
Current assets held for sale (Note 10)	692,429	742,002
	<u>22,391,831</u>	<u>19,710,407</u>
Property, plant, and equipment	12,939,352	13,791,669
Purchased intangibles	2,008,973	2,986,388
Deferred financing charges (Note 4)	2,386,886	250,000
Goodwill	5,163,878	5,163,878
Other non-current assets	325,277	362,827
Non-current assets held for sale (Note 10)	25,828	25,828
	<u>45,242,025</u>	<u>42,290,997</u>
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities		
Accounts payable and accrued liabilities	15,032,315	15,358,197
Income taxes payable	139,895	170,105
Deferred revenue	1,277,424	1,221,060
Current portion of capital lease obligations	102,203	276,921
Current portion of long-term debt (Note 5)	-	6,299,508
Current liabilities on assets held for sale (Note 10)	1,835,566	2,076,712
	<u>18,387,403</u>	<u>25,402,502</u>
Capital lease obligations	636,000	542,363
Long-term debt (Note 5)	15,134,295	6,297,127
Future income tax liability	320,839	832,840
Non-controlling interest in subsidiary company	-	1,871,395
Non-current liabilities on assets held for sale (Note 10)	-	37,983
Preferred Shares	796,542	-
	<u>35,275,079</u>	<u>34,984,210</u>
Shareholders' Equity		
Share capital (Note 6)	43,542,252	43,542,252
Contributed surplus (Note 5)	12,484,445	8,378,373
Accumulated deficit	(46,059,751)	(44,613,839)
	<u>9,966,946</u>	<u>7,306,787</u>
	<u>45,242,025</u>	<u>42,290,997</u>

See accompanying notes to the consolidated financial statements

Environmental Management Solutions Inc.

Unaudited Consolidated Statement of Operations & Deficit
For the three months ended March 31, 2006 and 2005

	March 2006 \$	March 2005 \$
Revenue	9,511,991	8,231,826
Direct costs	7,069,222	5,979,201
	<u>2,442,769</u>	<u>2,252,625</u>
Expenses		
Indirect salaries	1,720,333	1,561,481
Selling and marketing	81,665	140,226
General and administrative	1,056,199	1,072,796
Stock -based compensation	143,857	257,860
Restructuring and other costs (Note 9)	67,248	1,235,354
	<u>626,533</u>	<u>(2,015,092)</u>
Operating loss	(626,533)	(2,015,092)
Loss (gain) on sale of fixed assets	3,274	(387,217)
Interest and bank charges	824,833	893,529
Depreciation and amortization	728,417	702,860
	<u>(2,183,057)</u>	<u>(3,224,264)</u>
Income tax recovery	(453,642)	(282,354)
	<u>(1,729,415)</u>	<u>(2,941,910)</u>
Loss before discontinued operations and non-controlling interest in subsidiary company	(1,729,415)	(2,941,910)
Non-controlling interest in subsidiary company	104,123	107,613
Discontinued operations (Note 10)	179,380	(2,069,682)
	<u>(1,445,912)</u>	<u>(4,903,979)</u>
Net loss	(1,445,912)	(4,903,979)
Deficit - Beginning of period	(44,613,839)	(27,289,562)
	<u>(46,059,751)</u>	<u>(32,193,541)</u>
Basic and diluted loss per share (Note 7)		
From continuing operations	(0.04)	(0.08)
From discontinued operations	0.00	(0.05)
Weighted average shares		
Basic and diluted	38,012,247	37,671,422

See accompany notes to the consolidated financial statements

Environmental Management Solutions Inc.

Unaudited Consolidated Statement of Cashflows

For the three months ended March 31, 2006 and 2005

	March 2006 \$	March 2005 \$
Cash provided by (used in)		
Operating activities		
Net loss before discontinued operations	(1,625,292)	(2,834,297)
Non-cash items:		
Minority interest in income of subsidiary	(104,123)	(107,613)
Amortization of deferred charges	-	(170,220)
Depreciation and amortization	728,417	702,860
Gain on disposal of fixed assets	3,274	(387,217)
Stock-based compensation	143,857	257,860
Provision for future income tax	(782,181)	142,559
Change in non-cash working capital	334,762	(1,257,848)
	(1,301,287)	(3,653,916)
Cash used in operating activities of discontinued operations	(12,192)	(813,840)
	(1,313,479)	(4,467,756)
Financing activities		
Changes in capital lease obligations	(81,081)	-
Repayment of long-term debt	(12,596,635)	-
Increase in deferred financing charges	(2,242,833)	-
Change in other long-term assets	37,550	(267,255)
Change in amounts due to non-controlling interest in subsidiary	(52,189)	713,786
Proceeds from issuance of preferred shares and other equity	4,661,663	-
Proceeds from term borrowings	15,338,337	1,325,771
	5,064,812	1,772,302
Cash used in financing activities of discontinued operations	(37,983)	(479,121)
	5,026,829	1,293,181
Investing activities		
Purchase of property, plant and equipment	(317,041)	49,487
Change in restricted investments	(5,943)	(353,775)
Acquisitions	(300,000)	-
	(622,984)	(304,288)
Cash provided by investing activities of discontinued operations	-	1,009,231
	(622,984)	704,943
Net decrease in cash for the period	3,090,366	(2,469,632)
Cash – Beginning of period	861,619	1,215,307
Cash – End of period	3,951,985	(1,254,325)

See accompanying notes to the consolidated financial statements

Environmental Management Solutions Inc.

Unaudited Notes to the Consolidated Financial Statements

For the three months ended March 31, 2006 and 2005

1. Ontario Securities Commission Enquiries

Prior to year end, the OSC informed the Company that it was investigating certain trading activities of the Company's shares that were made prior to the release of a letter of agreement for a \$20.0 million recapitalization and litigation settlement agreements with the former President and CEO and other related parties. The Company provided the OSC its full cooperation and the investigation was completed during the quarter ended March 31, 2006 with no action taken against the Company, its officers or directors.

2. Summary of Significant Accounting Policies

Nature of Operations

EMS is an environmental services company specializing in the management, treatment, re-use and disposal of organic wastes and contaminated soils, with an emphasis on beneficial re-use. Facilities and knowledge based, the Company provides solutions to industries across Canada and in strategic markets in the northern United States. Services include: Facilities; including soil treatment, composting, industrial waste landfills and transfer stations; Waste Management; Environmental Contracting; Eco-Products Sales; and, Tank Testing and Calibration. The Company operates through two principal business segments: Integrated Environmental Services and Tank Testing and Calibration.

The unaudited consolidated financial statements have been prepared in accordance with the accounting principles generally acceptable in Canada. In management's opinion all adjustments necessary for the fair presentation have been reflected in the financial statements. All adjustments made are normal and recurring in nature. The Company has followed the same accounting policies and methods of application as the most recent audited financial statements. These statements should be read in conjunction with the December 31, 2005 audited statements.

3. Cash

During the quarter, the Company, through GSI's less than wholly owned subsidiary Les Composts du Québec Inc. ("CDQ"), had a \$2,000,000 credit line bearing interest at prime plus 0.50% collateralized by all the assets of CDQ and guaranteed by GSI. On March 31, 2006, the Company re-financed its existing debt-facilities and currently does not have an available credit line.

4. Deferred Financing Charges

On December 19, 2005, the Company paid a \$250,000 fee in connection with the convertible debenture financing that closed March 31, 2006. On March 31, 2006, the Company capitalized an additional \$2,136,886 for a total of \$2,386,886 in costs associated with the debt component of the convertible units issuance. The deferred financing charge will be amortized over the 8 year term of the convertible debenture.

5. Long-Term Debt

On March 31, 2006, the Company issued convertible units with each unit consisting of a \$950 convertible debenture and 500 convertible preferred shares at \$0.10. The total value of the convertible units issued was \$20,592,500 and raised \$20,000,000 cash net of financing fees paid to the holders.

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Each debenture has a term of 8 years, pays quarterly cash interest of 5% and is convertible at \$0.323 per common shares at the discretion of the holders or the Company if certain minimum earnings level are achieved.

A total of 10,296,250 convertible were issued concurrently with the debentures. The convertible preferred shares are voting and pay a cumulative 5% dividend and are convertible and redeemable at \$0.323 per common share. The preferred shares have been issued contemporaneously with the debenture and may only be assigned or transferred on the basis of 500 preferred shares with each debenture. The preferred shares can be redeemed at the option of the holder after the debentures become due and payable or the option of the holders and Company if the debentures have been repaid.

Certain events, such as litigation or damages arising after March 31, 2006 that have financial impact on the Company, will result in an adjustment to the price the debentures or preferred shares at which the common shares are converted. The adjustment will reduce the price by \$0.0263 for every \$1 million in excess of \$250,000.

Because the units bear the elements of both debt and equity, they necessitate the recording of separate equity and debt components. Management used the residual method to fair value the components. Using 9%, which is management's estimate of the effective interest rate, the debt component, representing the redemption feature of the units, was valued at \$15,930,837 and the equity component, representing the conversion feature of the units, was valued at \$4,661,663. The equity component has been allocated to contributed surplus.

The proceeds of the issuance were used to pay all outstanding third party debt of the Company as at March 31, 2006, except capital leases, to settle outstanding litigation with the former President and CEO, to acquire the remaining 29.1% interest in Les Composts du Québec, and pay associated financing fees of \$3,085,333. \$2,386,886 of the costs of issuance have been allocated to the debt component and recorded as a deferred financing charge and \$698,447 has been allocated to contributed surplus.

6. Capital Stock

Stock Option Plan

During the three months ended March 31, 2006, there were no options granted under the Employee Stock Option Plan (2005 – 1,130,000 options were granted with a fair value \$441,574) and 33,690 options were forfeited.

The following table presents the number and weighted exercise price of options outstanding as at March 31, 2006:

<u>Exercise Price</u> <u>\$</u>	<u>Number</u> <u>Outstanding</u>	<u>Number</u> <u>Exercisable</u>	<u>Weighted Average</u> <u>Life In Years</u>
0.40 - 1.00	2,010,000	318,750	4.00
1.55 - 1.75	457,000	292,200	2.35
2.00 - 3.00	385,000	117,000	3.16
3.27 - 3.65	233,196	139,918	2.95
	<u>3,085,196</u>	<u>867,868</u>	<u>3.57</u>

Environmental Management Solutions Inc.

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Tandem Option and Stock Appreciation Rights

During the three months ended March 31, 2006, the Company adopted an Option and Stock Appreciation Rights (OSAR) plan which is intended to align the interests of key employees and directors with that of the Company. The Corporate Governance and Compensation Committee of the Board of Directors administers the OSAR Plan. The OSARs have a term of 10 years and vest on a straight-line basis over five years or fully in the event of a change in control. Upon exercise the employee may, at their option require the Company to issue common shares, to the extent that common shares are available, or require the Company to pay the incremental market value of the common shares compared with the exercise price. The Company will expense the compensation based on the amount by which the market value of the Company's common shares exceed the exercise price of the OSAR on a graded vesting basis.

On March 31, 2006, the Company issued 14,500,000 OSARs with various exercise prices.

The following table presents the number and weighted exercise price of OSAR outstanding as at March 31, 2006.

<u>Exercise Price</u> <u>\$</u>	<u>Number</u> <u>Outstanding</u>	<u>Number</u> <u>Exercisable</u>	<u>Weighted Average</u> <u>Life In Years</u>
0.635	1,600,000	-	10.00
0.750	2,200,000	-	10.00
1.000	2,700,000	-	10.00
1.250	3,200,000	-	10.00
1.500	2,700,000	-	10.00
1.750	2,100,000	-	10.00
	<u>14,500,000</u>	<u>-</u>	<u>10.00</u>

Warrants

The following table presents the number and weighted exercise price of OSAR outstanding as at March 31, 2006.

<u>Exercise Price</u> <u>\$</u>	<u>Number</u> <u>Outstanding</u>	<u>Number</u> <u>Exercisable</u>	<u>Weighted Average</u> <u>Life In Years</u>
0.43	500,000	500,000	3.96
0.71	633,800	633,800	3.71
0.90	833,334	833,334	3.96
1.65	250,000	250,000	0.68
1.90	140,000	140,000	4.03
2.00	5,712,896	5,712,896	0.68
	<u>8,070,030</u>	<u>8,070,030</u>	<u>1.50</u>

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7. Earnings Per Share

The calculation of earnings per share is based on the daily weighted average number of common shares outstanding during the year. The calculation of diluted earnings per share assumes that all outstanding options and warrants have been exercised at the later of the beginning of the fiscal period or the option issuance date, if they have a dilutive effect.

For the quarter ended March 31, 2006 and 2005, the exercise of outstanding stock options and warrants would be anti-dilutive.

8. Acquisitions

On March 31, 2006, the Company acquired the remaining 29.1% of interest in Les Composts du Québec for cash proceeds of \$200,000 and transaction costs estimated at \$100,000. The purchase price was applied to non-controlling interest in subsidiary, a reduction in the portion of purchased intangibles attributable to Les Composts du Quebec and a reduction in fixed assets as follows:

	\$
Non-controlling interest in subsidiary	1,715,082
Less: Purchased intangibles	835,023
Fixed Assets	<u>580,059</u>
Total proceeds	<u>300,000</u>

9. Restructuring

In September 2004, the Board of Directors decided to reorganize the Company's management as well as close down an Alberta transfer station and a facility in Manitoba. In the fourth quarter of 2004, management continued the rationalization of costs with further downsizing of staff and the relocation of the Company's corporate office to Burlington, Ontario.

As a result, during the first quarter 2006, the Company recorded restructuring charges in the amount of \$67,248 related to settling outstanding lawsuits associated with the restructuring. During the first quarter of 2005, restructuring charges of \$1,235,354 comprised of severance expenses of \$148,984, reorganization of the office of the CEO of \$826,396, premises closure costs of \$50,871, and special meeting of shareholders of \$209,103.

10. Discontinued Operations

Summarized below is selected financial information for the discontinued operations for the quarters:

Environmental Management Solutions Inc.

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For the three months ended March 31, 2006 and 2005

	March 2006 \$	March 2005 \$
Revenues from discontinued operations	165,832	8,677,504
Earnings (loss) from discontinued operations (net of income taxes of \$nil)	179,380	(2,069,682)
Assets and liabilities of discontinued operations:		
Current assets	692,429	9,792,914
Non-current assets	25,828	12,792,729
	<u>718,257</u>	<u>22,585,643</u>
Current liabilities	1,835,566	8,459,158
Non-current liabilities	-	3,361,131
Net assets (liabilities) from discontinued operations	<u>(1,117,309)</u>	<u>10,765,354</u>
Net cash used in operating activities	(12,192)	(813,840)
Net cash used in financing activities	(37,983)	(479,121)
Net cash provided by investing activities	-	1,009,231
Net cash used in discontinued operations	<u>(50,175)</u>	<u>(283,730)</u>

11. Litigation

On March 31, 2006, concurrent with the closing of the re-financing of the Company, litigation with the former CEO, associated company and other associated parties was settled with the payment of \$1,700,000 to the former President & CEO.

There have been no changes to the status of other litigation disclosed in the December 31, 2005 financial statements.

12. Segment Information

The Company's operations consist of two operating segments: Integrated Environmental Services providing environmental services, to customers primarily in Québec and Ontario; and the Testing & Calibration segment performs precision testing and evaluation of storage tank systems. Segmented results for the three months ended March 31, 2006 and 2005 are as follows:

Environmental Management Solutions Inc.

Unaudited Notes to the Consolidated Financial Statements

For the three months ended March 31, 2006 and 2005

Three months ended March 31, 2005	Integrated Environmental Services	Testing and Calibration	Total
	\$	\$	\$
Revenue	7,746,165	485,661	8,231,826
Amortization	684,105	18,755	702,860
Income Taxes	(263,706)	(18,648)	(282,354)
Contribution before the under-noted	390,045	(32,048)	357,997
Stock-based compensation			257,860
Interest			893,529
Corporate expenses			697,938
Non-controlling interest and equity investment			107,613
Discontinued operations			2,069,682
Restructuring & other costs			1,235,354
Net Loss			<u>4,903,979</u>
Identifiable assets excluding the under noted	36,730,954	1,121,399	37,852,353
Goodwill	4,375,601	788,277	5,163,878
Discontinued Operations			22,585,643
	<u>41,106,555</u>	<u>1,909,676</u>	<u>65,601,874</u>

Three months ended March 31, 2006	Integrated Environmental Services	Testing and Calibration	Total
	\$	\$	\$
Revenue	8,938,015	573,976	9,511,991
Amortization	709,543	18,874	728,417
Income Taxes	(440,629)	(13,013)	(453,642)
Contribution before the under-noted	154,945	(23,670)	131,275
Stock-based compensation			143,857
Interest			824,833
Corporate expenses			616,506
Non-controlling interest and equity investment			104,123
Discontinued operations			(179,380)
Restructuring & other costs			67,248
Net Loss			<u>1,445,912</u>
Identifiable assets excluding the under noted	39,213,399	146,491	39,359,890
Goodwill	4,375,601	788,277	5,163,878
Discontinued Operations	-	-	718,257
	<u>43,589,000</u>	<u>934,768</u>	<u>45,242,025</u>

13. Seasonality of Operations

Historically demand for services of the Company is lower in the first quarter of the year.