

Environmental Management Solutions Inc.

Unaudited Consolidated Financial Statements

For the three and six month periods ended June 30, 2006 and 2005

Environmental Management Solutions Inc.

Unaudited Consolidated Balance Sheets

As at June 30, 2006 and December 31, 2005

	June 30, 2006	December 31, 2005
	\$	\$
ASSETS		
Current Assets		
Cash (Note 2)	2,037,989	861,619
Restricted investments	146,000	1,241,000
Accounts receivable	12,656,403	9,298,438
Inventory	3,315,505	5,202,001
Prepaid expenses and advances	866,281	682,317
Other assets	1,787,279	1,683,029
Current assets held for sale (Note 9)	526,776	742,002
	<u>21,336,233</u>	<u>19,710,407</u>
Property, plant, and equipment	13,106,376	13,791,669
Purchased intangibles	1,920,346	2,986,388
Deferred financing charges (Note 3)	2,530,840	250,000
Goodwill	5,163,880	5,163,878
Other non-current assets	142,125	362,827
Non-current assets held for sale (Note 9)	43,882	25,828
	<u>44,243,682</u>	<u>42,290,997</u>
LIABILITIES AND SHAREHOLDERS EQUITY		
Current liabilities		
Accounts payable and accrued liabilities	14,407,845	15,358,197
Income taxes payable	173,748	170,105
Deferred revenue	1,065,155	1,221,060
Current portion of capital lease obligations	261,656	276,921
Current portion of long-term debt (Note 4)	-	6,299,508
Current liabilities on assets held for sale (Note 9)	772,769	2,076,712
	<u>16,681,173</u>	<u>25,402,502</u>
Capital lease obligations	411,584	542,363
Long-term debt (Note 4)	15,208,551	6,297,127
Future income tax liability	610,136	832,840
Non-controlling interest in subsidiary company	-	1,871,395
Non-current liabilities on assets held for sale (Note 9)	-	37,983
Preferred Shares	823,324	-
	<u>33,734,768</u>	<u>34,984,210</u>
Shareholders' Equity		
Share capital (Note 5)	43,542,252	43,542,252
Contributed surplus (Note 4)	12,603,252	8,378,373
Accumulated deficit	(45,636,590)	(44,613,839)
	<u>10,508,914</u>	<u>7,306,787</u>
	<u>44,243,682</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 and six month periods ended June 30, 2006 and 2005

	Three Months Ended June 30		Six Months Ended June 30	
	2006	2005	2006	2005
	\$	\$	\$	\$
Revenue	17,402,742	17,066,674	26,914,733	25,298,500
Direct costs	12,786,186	12,635,033	19,855,408	18,614,234
	<u>4,616,556</u>	<u>4,431,641</u>	<u>7,059,325</u>	<u>6,684,266</u>
Expenses				
Indirect salaries	1,738,524	1,526,104	3,458,857	3,087,585
Selling and marketing	122,313	140,053	203,978	286,972
General and administrative	1,185,373	1,025,696	2,241,572	2,091,799
Stock -based compensation	128,086	145,636	271,943	403,496
Restructuring and other costs (Note 8)	28,067	1,776,466	95,315	3,011,820
	<u>1,414,193</u>	<u>(182,314)</u>	<u>787,660</u>	<u>(2,197,406)</u>
Operating income (loss)				
Loss (gain) on sale of property, plant and equipment	(3,870)	76,055	(596)	(311,162)
Interest and bank charges	567,764	974,688	1,392,597	1,868,217
Depreciation and amortization	628,503	764,962	1,356,920	1,467,822
	<u>221,796</u>	<u>(1,998,019)</u>	<u>(1,961,261)</u>	<u>(5,222,283)</u>
Income tax expense (recovery)	240,848	220,825	(212,794)	(61,529)
	<u> </u>	<u> </u>	<u> </u>	<u> </u>
Loss before discontinued operations and non-controlling interest in subsidiary company	(19,052)	(2,218,844)	(1,748,467)	(5,160,754)
Non-controlling interest in subsidiary company (Note 7)	-	(124,216)	104,123	(16,603)
Discontinued operations (Note 9)	442,213	(6,450,834)	621,593	(8,520,516)
	<u> </u>	<u> </u>	<u> </u>	<u> </u>
Net income (loss)	423,161	(8,793,894)	(1,022,751)	(13,697,873)
Deficit - Beginning of period	<u>(46,059,751)</u>	<u>(32,193,542)</u>	<u>(44,613,839)</u>	<u>(27,289,563)</u>
Deficit - End of period	<u>(45,636,590)</u>	<u>(40,987,436)</u>	<u>(45,636,590)</u>	<u>(40,987,436)</u>
Basic and diluted income (loss) per share (Note 6)				
From continuing operations	(0.00)	(0.06)	(0.04)	(0.14)
From discontinued operations	0.01	(0.17)	0.02	(0.23)
Weighted average shares				
Basic	38,012,247	37,671,422	38,012,247	37,671,422
Diluted	38,305,993	37,671,422	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 and six month periods ended June 30, 2006 and 2005

	Three Months Ended June 30		Six Months Ended June 30	
	2006	2005	2006	2005
	\$	\$	\$	\$
Cash provided by (used in)				
Operating activities				
Net loss before discontinued operations	(19,052)	(2,343,059)	(1,644,344)	(5,177,357)
Non-cash items:				
Non-controlling interest in subsidiary company	-	124,216	(104,123)	16,603
Non-cash interest charges	176,038	314,001	176,038	628,002
Depreciation and amortization	628,503	764,962	1,356,920	1,467,822
Gain on disposal of fixed assets	(3,870)	76,055	(596)	(311,162)
Stock-based compensation	128,086	145,636	271,943	403,496
Provision for future income tax	289,297	(226,079)	(222,704)	(83,520)
Change in non-cash working capital	(2,937,163)	(374,599)	(2,872,580)	(1,632,446)
	(1,738,161)	(1,518,867)	(3,039,446)	(4,688,562)
Cash used in operating activities of discontinued operations	(454,931)	(4,749,619)	(467,124)	(5,563,459)
	(2,193,092)	(6,268,486)	(3,506,570)	(10,252,021)
Financing activities				
Changes in capital lease obligations	(64,963)	(764,084)	(146,044)	(764,013)
Repayment of long-term debt	-	108,616	(12,596,635)	173,489
Increase in deferred financing charges	(218,954)	92,532	(2,461,786)	(391,689)
Change in other long-term assets	183,152	162,007	220,702	(105,248)
Change in purchased intangibles	-	(43,602)	-	(43,601)
Change in amounts due to non-controlling interest in subsidiary	-	(41,408)	(52,189)	672,378
Proceeds from issuance of preferred shares and other equity	-	-	4,661,663	-
Proceeds from term borrowings	-	(290,286)	15,338,337	970,541
	(100,765)	(776,225)	4,964,048	511,857
Cash provided by (used in) financing activities of discontinued operations	-	(542,682)	(37,983)	(1,021,803)
	(100,765)	(1,318,907)	4,926,065	(509,946)
Investing activities				
Purchase of property, plant and equipment	(703,030)	(323,089)	(1,020,071)	(273,603)
Change in restricted investments	1,100,943	353,775	1,095,000	-
Acquisition of non-controlling interest	-	-	(300,000)	-
	397,913	30,686	(225,071)	(273,603)
Cash provided by (used in) investing activities of discontinued operations	(18,054)	6,990,214	(18,054)	7,999,445
	379,859	7,020,900	(243,125)	7,725,842
Net increase (decrease) in cash for the period	(1,913,998)	(566,493)	1,176,370	(3,036,125)
Cash (Bank indebtedness) – Beginning of period	3,951,987	(1,254,325)	861,619	1,215,307
Cash (Bank indebtedness) – End of period	2,037,989	(1,820,818)	2,037,989	(1,820,818)

See accompanying notes to the consolidated financial statements

Environmental Management Solutions Inc.

Unaudited Notes to the Consolidated Financial Statements

For the three and six months periods ended June 30, 2006 and 2005

1. 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; 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 on a basis consistent with those followed in the most recently audited financial statements. In management's opinion all adjustments necessary for the fair presentation have been reflected in the consolidated financial statements. All adjustments made are normal and recurring in nature. These unaudited consolidated financial statements do not include all the information and disclosures required by generally accepted accounting principles for annual consolidated financial statements and therefore should be read in conjunction with the December 31, 2005 audited consolidated financial statements and the notes thereto.

2. Cash

During the quarter ended June 30, 2006, the Company arranged a \$3,000,000 operating line facility bearing interest at a rate of prime plus ¼% secured by a first charge over the trade accounts receivable of the Company. As at June 30, 2006 this line of credit was used to provide \$1,112,500 in letters of credit granted as security for bonding, certificates of approval and operating or property security.

3. 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. The Company capitalized an additional \$2,355,840 for a total of \$2,605,840 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.

4. 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.

Each debenture has a term of 8 years, annual rate of 5% paid quarterly 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 preferred shares 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

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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. An amount of \$2,268,082 for the costs of issuance has been allocated to the debt component and recorded as a deferred financing charge and \$698,447 has been allocated to contributed surplus.

5. Capital Stock

Stock Option Plan

For both the three and six month periods ended June 30, 2006, there were 1,283,333 options granted under the Employee Stock Option Plan with a fair value of \$548,535 (2005 – 910,000 and 2,040,000 options with a value of \$336,853 and \$778,426 respectively). For the three and six month periods ended June 30, 2006 – 901,079 and 934,769 options were forfeited respectively.

The following table presents the number and weighted exercise price of options outstanding as at June 30, 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	2,843,333	468,000	4.18
1.01 - 1.75	192,000	184,000	1.77
1.76 - 3.00	205,000	123,000	2.80
3.01 - 3.65	227,117	136,270	2.70
	<u>3,467,450</u>	<u>911,270</u>	<u>3.87</u>

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 administer 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

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employee may, at their option require the Company to issue common shares, 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 June 30, 2006.

Exercise Price \$	Number Outstanding	Number Exercisable	Weighted Average Life In Years
0.635	1,600,000	-	9.75
0.750	2,200,000	-	9.75
1.000	2,700,000	-	9.75
1.250	3,200,000	-	9.75
1.500	2,700,000	-	9.75
1.750	2,100,000	-	9.75
	14,500,000	-	9.75

Warrants

The following table presents the number and weighted exercise price of warrants outstanding as at June 30, 2006.

Exercise Price \$	Number Outstanding	Number Exercisable	Weighted Average Life In Years
0.43	500,000	500,000	3.71
0.71	633,800	633,800	3.46
0.90	833,334	833,334	3.71
1.65	250,000	250,000	0.43
1.90	140,000	140,000	3.78
2.00	5,712,896	5,712,896	0.43
	8,070,030	8,070,030	1.25

6. Earnings Per Share

The calculation of basic 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 convertible preferred shares, 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 June 30, 2006 and 2005, the exercise of outstanding stock options and warrants would be anti-dilutive.

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7. Acquisition

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
Property plant and equipment	<u>580,059</u>
Total proceeds	<u>300,000</u>

8. 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 six months ended June 30, 2006, the Company recorded restructuring charges in the amount of \$95,315 related to settling outstanding lawsuits and closing out legal files associated with the restructuring. During the six months ended June 30, 2005, restructuring charges of \$3,011,820 comprised of severance expenses of \$932,753, reorganization of the office of the CEO of \$1,554,935, premises closure costs of \$261,268 and special meeting of shareholders of \$262,864.

9. Discontinued Operations

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

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For the three and six months periods ended June 30, 2006 and 2005

	Three Months Ended June 30		Six Months Ended June 30	
	2006	2005	2006	2005
	\$	\$	\$	\$
Revenues from discontinued operations	77,520	7,559,399	243,352	16,236,903
Income (loss) from discontinued operations (net of income taxes of \$nil)	442,213	(6,450,834)	621,593	(8,520,516)
Assets and liabilities of discontinued operations:				
Current assets held for sale	526,776	10,773,555	526,776	10,773,555
Non-current asset sheld for sale	43,882	5,843,135	43,882	5,843,135
	570,658	16,616,690	570,658	16,616,690
Current liabilities on assets held for sale	772,769	11,141,014	772,769	11,141,014
Non-current liabilities	-	2,818,449	-	2,818,449
Net assets (liabilities) from discontinued operations	(202,111)	2,657,227	(202,111)	2,657,227
Net cash used in operating activities	(454,931)	(4,749,619)	(467,124)	(5,563,459)
Net cash used in financing activities	-	(542,682)	(37,983)	(1,021,803)
Net cash provided by (used in) investing activities	(18,054)	6,990,214	(18,054)	7,999,445
Net cash provided by (used in) discontinued operations	(472,985)	1,697,913	(523,161)	1,414,183

10. 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.

During the quarter ended June 30, 2006, a former shareholder of GSI Environmental Inc., a wholly owned subsidiary of the Company, commenced an action against the Company, its former President and CEO and the Company's current and former directors. The Plaintiff claims: \$5,000,000 from the Company for alleged breach of contract and misrepresentation; \$5,000,000 from the former President and CEO for alleged misrepresentation; and declaratory and compensatory relief for alleged oppressive conduct, together with special damages in amount of \$250,000, from all of the Defendants. The Company has notified its Director and Officer Insurance underwriter and has been advised that this is an insurable claim. The Plaintiff has not taken any steps to move the action along since the service of the Statement of Claim. The action will not proceed to trial, if at all, for many months. Accordingly, at this point in time, the amount of losses, if any, resulting from the claims made in the action is undeterminable.

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11. 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 and six ended June 30, 2006 and 2005 are as follows:

Three months ended June 30, 2006	Integrated Environmental Services	Testing and Calibration	Total
	\$	\$	\$
Revenue	16,545,875	856,867	17,402,742
Depreciation and amortization	598,593	29,910	628,503
Income tax expense	203,563	37,285	240,848
Contribution before the under-noted	323,286	68,022	391,308
Stock-based compensation			128,086
Interest and bank charges			567,764
Corporate expenses			(313,557)
Non-controlling interest in subsidiary company			-
Discontinued operations			(442,213)
Restructuring & other costs			28,067
Net Income			<u>(423,161)</u>
Identifiable assets excluding the under noted	38,020,913	488,231	38,509,144
Goodwill	4,375,602	788,278	5,163,880
Discontinued Operations	-	-	570,658
	<u>42,396,515</u>	<u>1,276,509</u>	<u>44,243,682</u>

Six months ended June 30, 2006	Integrated Environmental Services	Testing and Calibration	Total
	\$	\$	\$
Revenue	25,483,890	1,430,843	26,914,733
Depreciation and amortization	1,308,136	48,784	1,356,920
Income tax expense (recovery)	(237,066)	24,272	(212,794)
Contribution before the under-noted	478,231	44,352	522,583
Stock-based compensation			271,943
Interest and bank charges			1,392,597
Corporate expenses			302,949
Non-controlling interest in subsidiary company			104,123
Discontinued operations			(621,593)
Restructuring & other costs			95,315
Net Loss			<u>1,022,751</u>
Identifiable assets excluding the under noted	38,020,913	488,231	38,509,144
Goodwill	4,375,602	788,278	5,163,880
Discontinued Operations	-	-	570,658
	<u>42,396,515</u>	<u>1,276,509</u>	<u>44,243,682</u>

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Three months ended June 30, 2005	Integrated Environmental Services	Testing and Calibration	Total
	\$	\$	\$
Revenue	16,298,294	768,380	17,066,674
Depreciation and amortization	749,809	15,153	764,962
Income tax expense	180,106	40,719	220,825
Contribution before the under-noted	922,915	63,067	985,982
Stock-based compensation			145,636
Interest and bank charges			974,688
Corporate expenses			556,468
Non-controlling interest in subsidiary company			(124,216)
Discontinued operations			6,450,834
Restructuring & other costs			1,776,466
Net Loss			<u>8,793,894</u>
Identifiable assets excluding the under noted	36,881,082	1,219,913	38,100,995
Goodwill	4,375,601	788,277	5,163,878
Discontinued Operations			16,616,690
	<u>41,256,683</u>	<u>2,008,190</u>	<u>59,881,563</u>
Six months ended June 30, 2005	Integrated Environmental Services	Testing and Calibration	Total
	\$	\$	\$
Revenue	24,044,459	1,254,041	25,298,500
Depreciation and amortization	1,433,914	33,908	1,467,822
Income tax expense	(83,600)	22,071	(61,529)
Contribution before the under-noted	1,312,960	31,019	1,343,979
Stock-based compensation			403,496
Interest and bank charges			1,868,217
Corporate expenses			1,254,406
Non-controlling interest in subsidiary company			(16,603)
Discontinued operations			8,520,516
Restructuring & other costs			3,011,820
Net Loss			<u>13,697,873</u>
Identifiable assets excluding the under noted	36,881,082	1,219,913	38,100,995
Goodwill	4,375,601	788,277	5,163,878
Discontinued Operations			16,616,690
	<u>41,256,683</u>	<u>2,008,190</u>	<u>59,881,563</u>

12. Comparative June 30, 2005 information

Comparative information has been presented to reflect the consolidation of Les Composts du Quebec Inc. (CdQ) which had been classified as a discontinued operation as at June 30, 2005. Subsequent to the June 30, 2005 financial statements CdQ was taken off the market and as a result has been consolidated with other continuing operations in the comparative information.

13. Seasonality of Operations

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