

**Environmental Management  
Solutions Inc.**

Consolidated Financial Statements  
**December 31, 2006 and 2005**

February 28, 2007

## Auditors' Report

### To the Shareholders of Environmental Management Solutions Inc.

We have audited the consolidated balance sheets of **Environmental Management Solutions Inc.** as at December 31, 2006 and 2005 and the consolidated statements of operations and deficit and cash flows for the years then ended. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the Company as at December 31, 2006 and 2005 and the results of its operations and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

*PricewaterhouseCoopers LLP*

**Chartered Accountants**

Hamilton, Ontario

# Environmental Management Solutions Inc.

## Consolidated Balance Sheets

As at December 31, 2006 and 2005

	2006 \$	2005 \$
<b>Assets</b>		
<b>Current assets</b>		
Cash	5,603,877	861,619
Restricted investments (note 5)	-	1,241,000
Accounts receivable	32,918,508	9,298,439
Work in progress and other inventory (note 6)	16,972,406	5,202,001
Prepaid expenses and advances	1,708,964	682,317
Other assets	170,262	1,683,029
Future income taxes (note 14)	394,200	-
Current assets held for sale (note 4)	309,223	742,002
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	58,077,440	19,710,407
<b>Property, plant and equipment</b> (note 7)	32,816,673	13,791,669
<b>Intangible assets</b> (note 8)	28,432,496	2,986,388
<b>Deferred financing charges</b> (note 9)	3,560,864	250,000
<b>Goodwill</b>	14,386,757	5,163,878
<b>Other non-current assets</b>	140,735	362,827
<b>Non-current assets held for sale</b> (note 4)	2,376	25,828
	<hr/>	<hr/>
	137,417,341	42,290,997
<b>Liabilities</b>		
<b>Current liabilities</b>		
Accounts payable and accrued liabilities	30,249,424	15,358,197
Income taxes payable	3,082,947	170,105
Deferred revenue	10,727,543	1,221,060
Current portion of capital lease obligations (note 10)	352,030	276,921
Current portion of long-term debt (note 11)	4,204,196	6,299,508
Current portion of other long-term obligation (note 3)	619,718	-
Current liabilities of assets held for sale (note 4)	10,673	2,076,712
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	49,246,531	25,402,503
<b>Capital lease obligations</b> (note 10)	190,333	542,363
<b>Long-term debt</b> (note 11)	53,167,368	6,297,127
<b>Other long-term obligation</b> (note 3)	775,860	-
<b>Future income taxes</b> (note 14)	2,542,339	832,840
<b>Non-controlling interest in subsidiary company</b>	-	1,871,395
<b>Non-current liabilities of assets held for sale</b> (note 4)	-	37,983
<b>Preferred shares</b> (note 11)	878,707	-
	<hr/>	<hr/>
	106,801,138	34,984,211
<b>Shareholders' Equity</b>		
<b>Share capital</b> (note 12)	61,619,577	43,542,252
<b>Contributed surplus</b> (note 13)	12,879,912	8,378,373
<b>Deficit</b>	(43,883,286)	(44,613,839)
	<hr/>	<hr/>
	30,616,203	7,306,786
	<hr/>	<hr/>
	137,417,341	42,290,997
<b>Commitments and contingencies</b> (note 18)		

The accompanying notes are an integral part of these consolidated financial statements

Approved by the Board of Directors

*(signed)* "Michael Harris", Chairman

*(signed)* "Allen Clarke", Director

# Environmental Management Solutions Inc.

## Consolidated Statements of Operations and Deficit For the years ended December 31, 2006 and 2005

	2006 \$	2005 \$
<b>Revenue</b>	69,920,754	52,686,614
<b>Direct costs</b>	50,731,513	37,680,735
<b>Gross profit</b>	19,189,241	15,005,879
<b>Expenses</b>		
Selling, general and administrative	12,611,705	11,245,488
Amortization of property, plant and equipment	2,606,217	2,202,900
Amortization of intangible assets	643,463	569,569
Stock-based compensation	547,996	696,324
Restructuring and other costs (note 17)	476,390	5,303,185
<b>Operating income (loss)</b>	2,303,470	(5,011,587)
Interest on long-term debt	992,864	-
Other interest and bank charges	1,595,992	4,406,257
Gain on disposal of property, plant and equipment	(4,141)	(330,013)
	(281,245)	(9,087,831)
<b>Income tax recovery</b> (note 14)	(60,738)	(81,485)
<b>Loss before discontinued operations and non-controlling interest in subsidiary company</b>	(220,507)	(9,006,346)
<b>Non-controlling interest in subsidiary company</b>	104,123	(31,481)
<b>Net loss before discontinued operations</b>	(116,384)	(9,037,827)
<b>Net earnings (loss) from discontinued operations</b> (note 4)	846,937	(8,286,450)
<b>Net earnings (loss) for the year</b>	730,553	(17,324,277)
<b>Deficit – Beginning of year</b>	(44,613,839)	(27,289,562)
<b>Deficit – End of year</b>	(43,883,286)	(44,613,839)
<b>Basic earnings (loss) per share</b> (note 15)		
From continuing operations	0.00	(0.24)
From discontinued operations	0.02	(0.22)
	0.02	(0.46)
<b>Diluted earnings (loss) per share</b>		
From continuing operations	0.00	(0.24)
From discontinued operations	0.02	(0.22)
	0.02	(0.46)

The accompanying notes are an integral part of these consolidated financial statements

# Environmental Management Solutions Inc.

## Consolidated Statements of Cash Flows

For the years ended December 31, 2006 and 2005

	2006 \$	2005 \$
<b>Cash provided by (used in)</b>		
<b>Operating activities</b>		
Net earnings (loss) for the year	730,553	(17,324,277)
Net earnings (loss) from discontinued operations	(846,937)	8,286,450
Net loss from continuing operations	(116,384)	(9,037,827)
Items not affecting cash		
Depreciation and amortization	3,249,680	2,772,469
Deferred financing charges	569,709	1,204,099
Stock-based compensation	547,996	696,324
Gain on disposal of property, plant and equipment	(4,141)	(330,013)
Provision for future income tax	(101,462)	(596,210)
Non-controlling interest in subsidiary company	(104,123)	(31,481)
Change in non-cash working capital (note 21)	4,041,275	(5,322,639)
	(8,168,688)	3,181,156
Cash used in operating activities of continuing operations	(4,127,413)	(2,141,483)
Cash used in operating activities of discontinued operations	(786,322)	(4,264,836)
	(4,913,735)	(6,406,319)
<b>Investing activities</b>		
Change in restricted investments	1,241,000	104,000
Purchase of property, plant and equipment	(7,130,042)	(673,330)
Proceeds from disposal of property, plant and equipment	168,046	-
Purchase of intangible assets	(124,590)	-
Acquisition of company, net of cash acquired (note 3)	(39,209,347)	-
Acquisition of non-controlling interest in subsidiary (note 3)	(375,000)	-
Cash used in investing activities of continuing operations	(45,429,933)	(569,330)
Cash provided by investing activities of discontinued operations	23,452	13,719,884
	(45,406,481)	13,150,554
<b>Financing activities</b>		
Increase in deferred financing charges	(3,667,086)	(574,168)
Change in other long-term assets	229,807	154,769
Repayment of capital lease obligations	(276,921)	(307,949)
Proceeds from long-term debt	57,338,337	1,500,000
Repayment of long-term debt	(14,087,980)	(4,074,019)
Change in amounts due to non-controlling interest in subsidiary	(52,188)	5,712
Proceeds from issuance of preferred shares and other equity	4,661,663	-
Proceeds from issuance of common shares	10,954,825	-
Cash provided by (used in) financing activities of continuing operations	55,100,457	(3,295,655)
Cash used in financing activities of discontinued operations	(37,983)	(3,802,269)
	55,062,474	(7,097,924)
<b>Change in cash for the year</b>	4,742,258	(353,689)
<b>Cash – Beginning of year</b>	861,619	1,215,308
<b>Cash – End of year</b>	5,603,877	861,619
<b>Supplemental disclosure of cash flow information</b>		
Interest paid	1,261,561	2,087,268
Income taxes paid	238,033	71,082

The accompanying notes are an integral part of these consolidated financial statements

# **Environmental Management Solutions Inc.**

Notes to Consolidated Financial Statements

**December 31, 2006 and 2005**

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## **1 Nature of operations**

Environmental Management Solutions Inc. (“EMS” or the “Company”) was incorporated on August 31, 2000 under the Business Corporations Act (Alberta) and registered under the Canada Business Corporations Act on September 27, 2004. Prior to June 13, 2002, EMS was a Capital Pool Company on the TSX Venture Exchange.

EMS is an environmental services company specializing in the management of organic-based waste streams and contaminated soils, with an emphasis on beneficial re-use. EMS provides solutions to municipal, commercial and industrial clients in Canada, the northern United States, England and France through its subsidiaries, Biogénie S.R.D.C. Inc. (“Biogénie”) (note 3), GSI Environment Inc. (“GSI”) and Tanknology Canada Inc. (“Tanknology”). The Company operates in three principal business segments: Site Assessment and Remediation (“SAR”), Organic Waste Management and Tank Testing and Calibration. SAR, provided by Biogénie, encompasses environmental contracting, off-site treatment and recycling of contaminated soil and remediation of contaminated or degraded sites in North America, the United Kingdom and France. Organic Waste Management, provided by GSI, encompasses environmental services including the land application, composting or disposal of organic wastes and eco-product sales in Quebec and Ontario. Tank Testing and Calibration, provided by Tanknology, encompasses storage tank precision leak testing and statistical inventory reconciliation, compliance testing, and facility compliance and tank system audits across Canada.

## **2 Basis of presentation and significant accounting policies**

The consolidated financial statements include the accounts of EMS and its subsidiaries, including companies controlled by EMS. All material inter-company transactions and balances have been eliminated.

### **Use of estimates**

The preparation of financial statements in conformity with Canadian generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting periods. Actual results could differ from such estimates.

# Environmental Management Solutions Inc.

Notes to Consolidated Financial Statements

December 31, 2006 and 2005

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## Foreign currency translation

The Company's operations conducted in foreign countries are considered to be integrated foreign operations and are translated into Canadian dollars using the temporal method. Monetary assets and liabilities are translated at exchange rates in effect at the year-end and non-monetary assets and liabilities are translated at historical exchange rates. Revenue and expenses, other than depreciation and amortization which are translated at the same exchange rate as the assets to which they relate, are translated at the average exchange rate for the period. Gains and losses resulting from foreign currency translations are included in the consolidated statements of operations.

## Cash

Cash consists of cash on hand, deposits with banks and investments in liquid instruments with original maturities of three months or less.

## Joint ventures

Joint ventures, which are not variable interest entities, are accounted for using the proportional consolidation method.

## Inventory

Inventory is valued at the lower of average cost and net realizable value. Cost has been determined by the first-in, first-out method.

## Property, plant and equipment

Property, plant and equipment are recorded at cost and amortized over their estimated useful lives using the following annual rates and methods:

Buildings	5% declining balance 10 years straight-line
Heavy equipment	2 – 10 years straight-line
Automotive and trailers	3 – 5 years straight-line
Vehicles	30% declining balance
Testing vehicles	1 – 5 years straight-line
Furniture and equipment	20% declining balance or 3 – 10 years straight-line
Computer equipment and software	30% declining balance or 1 – 3 years straight-line
Leasehold improvements	Over the term of the lease on a straight-line basis
Composting and soil recycling facilities	5 – 20 years straight-line

# Environmental Management Solutions Inc.

Notes to Consolidated Financial Statements

December 31, 2006 and 2005

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## Assets under capital leases

Leases that transfer substantially all of the benefits and risks of ownership of the asset to the Company are accounted for as capital leases. At the time a capital lease is entered into, an asset is recorded together with the related obligation. Assets under capital leases are amortized over their estimated useful lives at the same rates for other similar assets.

## Intangible assets

Intangible assets, with a finite life are recorded at cost and amortized over their estimated life on a straight-line basis as follows:

Back-log	2.5 years
Non-compete agreements	5 years
Managed soil treatment facilities	10 years
Customer relationships	7 years
Licences	5 years

The Company acquired certain permits in conjunction with the acquisition of Biogénie. These are intangible assets with indefinite lives, and accordingly, are not subject to amortization. Intangible assets with indefinite lives are tested for impairment annually or whenever events or circumstances indicate that the asset might be impaired. When the carrying amount of the asset exceeds its fair value an impairment loss is recognized.

## Impairment of long-lived assets

An impairment charge is recognized on long-lived assets, including intangible assets with definite lives, when events or changes in circumstances causes the assets' carrying value to exceed the total undiscounted cash flows for its use and eventual disposition. The impairment loss is calculated as the difference between the fair value of the asset and its carrying value.

## Goodwill

Goodwill represents the excess of the purchase price of an acquired business over the estimated fair value of the identifiable tangible and intangible assets acquired. The Company assesses the carrying value of its goodwill for impairment annually or whenever events or circumstances indicate that the carrying amount may not be recoverable. In evaluating whether there is an impairment of goodwill, management compares the carrying amount of the reporting unit with its fair value. In the event impairment exists, an impairment charge would be determined by comparing the fair value of goodwill to its carrying amount.

## Deferred financing charges

Deferred financing charges represent professional fees incurred to obtain financing and are amortized over the term of the original debt.

# **Environmental Management Solutions Inc.**

Notes to Consolidated Financial Statements

**December 31, 2006 and 2005**

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## **Research and development**

Development expenses are charged to earnings as incurred unless a development project meets the criteria for deferral and amortization. The Company has not deferred any development expenses to date. Research expenses are charged to earnings as incurred. During 2006, \$502,858 (2005 - \$425,473) in research and development costs were expensed.

## **Revenue recognition**

The Company provides professional services under fee for service, cost based and fixed price contracts. Under level of effort contracts, revenue is recognized as services are provided. For cost based contracts, revenue is recorded as reimbursable costs are incurred. Revenue from fixed price contracts is recorded using the percentage-of-completion method whereby revenue and profit are based on a ratio of costs incurred to total estimated costs of the projects. Losses, if any, on fixed price contracts are recognized during the period they are identified.

The Company recognizes revenue on product sales when persuasive evidence of an agreement exists, the terms are fixed or determinable, services are performed and collection is probable.

## **Income taxes**

The Company follows the asset and liability method for determining income taxes. Under this method, future income tax assets and liabilities are recognized for future tax consequences attributable to the differences between the carrying amount of assets and liabilities and their respective tax bases. Future income tax assets and liabilities are measured using substantively enacted tax rates expected to apply to taxable income in the years in which temporary differences are expected to recover or settle. Changes to these balances are recognized in income in the period in which they occur. The Company records a valuation allowance when it is more likely than not that all of the future tax assets will not be realized prior to their expiration.

## **Investment tax credits**

Investment tax credits, which arise as a result of qualifying research and development expenditures, are recognized and applied to reduce research and development expense in the period in which their realization is reasonably assured.

# **Environmental Management Solutions Inc.**

Notes to Consolidated Financial Statements

**December 31, 2006 and 2005**

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## **Stock-based compensation**

The Company has two types of stock-based compensation plans. The first is the Company's employee and consultant stock option plan. Awards made to employees and non-employees are measured and recognized using a fair value based model whereby the fair value of stock-based awards is measured at the date of grant and is charged to expense on a straight-line basis over the award's vesting period with an offsetting amount recorded to contributed surplus. When the options are exercised, the proceeds received on exercise plus the amount previously credited to contributed surplus are credited to capital stock.

The second plan is the Company's tandem option and stock appreciation rights plan. Under this plan, the employee may, at their discretion, require the Company to issue common shares or require the Company to pay the incremental market value of the stock appreciation right over the exercise price of the option. The Company has recorded a liability for the potential future settlement of vested options at the balance sheet date by reference to the value of the Company's shares and the strike price of the option. Compensation expense is recognized for increases or decreases between the strike price of these options and the quoted market value of the Company's shares between the grant date and the reporting date, subject to the cumulative expense recognized not being less than zero.

## **Warrants**

Warrants are recorded at fair value as a credit to contributed surplus and expensed over the associated service period or, if related to equity financing, as a reduction of capital stock. When warrants are exercised, the proceeds received on exercise plus the amount previously credited to contributed surplus are credited to share capital.

## **Recently issued accounting pronouncements**

### **Financial Instruments – Recognition and Measurement, Handbook Section 3855**

Section 3855 prescribes when a financial asset, financial liability, or non-financial derivative is to be recognized on the balance sheet and at what amount – in certain instances using fair value and in others using cost-based measures. It also specifies how financial instrument gains and losses are to be presented.

Section 3855 applies to interim and annual financial statements relating to fiscal years beginning on or after October 1, 2006. The Company will adopt this standard effective January 1, 2007. Transitional provisions for this Section are complex and vary based on the type of financial instrument under consideration. Management does not expect the adoption of this standard to have a significant impact on the Company's consolidated financial statements.

# **Environmental Management Solutions Inc.**

Notes to Consolidated Financial Statements

**December 31, 2006 and 2005**

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## **Comprehensive Income, Handbook Section 1530**

Section 1530 introduces a new requirement to temporarily present certain gains and losses outside net income.

Section 1530 applies to interim and annual financial statements relating to fiscal years beginning on or after October 1, 2006. The Company will adopt this standard effective January 1, 2007. Financial statements of prior periods are required to be restated for certain comprehensive income items. In addition, an enterprise is encouraged, but not required, to present reclassification adjustments in comparative financial statements provided for earlier periods. Management does not expect the adoption of this standard to have a significant impact on the Company's consolidated financial statements.

## **Hedges – Handbook Section 3865**

Section 3865 establishes standards for when and how hedge accounting may be applied. Hedge accounting is optional. This Section applies for interim and annual financial statements relating to fiscal years beginning on or after October 1, 2006. Retroactive application is not permitted.

The Company will adopt this standard effective January 1, 2007. The Company had no arrangements for hedging at December 31, 2006. At this time, management does not expect the adoption of this standard to have a significant impact on the Company's consolidated financial statements.

# Environmental Management Solutions Inc.

Notes to Consolidated Financial Statements

December 31, 2006 and 2005

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## 3 Acquisitions

Assets acquired and liabilities assumed in business combinations are recorded on the Company's consolidated balance sheet based at their estimated fair value. The results of operations of the businesses acquired are included in the Company's consolidated statements of operations from their respective dates of acquisition. The excess of the purchase price over the fair value of the underlying assets and liabilities assumed is allocated to goodwill. In certain circumstances, the original allocation of the purchase price is based upon preliminary estimates and assumptions. Accordingly, these allocations are subject to revision when the Company receives final information, including appraisals and other analyses.

### (a) Acquisition of Biogénie

On November 24, 2006, the Company purchased all of the issued and outstanding shares of Biogénie. Biogénie specializes in on-site and off-site soil treatment and reclamation for public and private sector companies across Canada, as well as in the United States, United Kingdom and France. The price paid for the equity of Biogénie was \$51,438,120 and is comprised of the following:

	\$
Cash	42,465,620
Common shares	7,122,500
Accrued acquisition costs	<u>1,850,000</u>
	<u>51,438,120</u>

The preliminary purchase price was allocated to identifiable tangible and intangible assets acquired and liabilities assumed based on their estimated fair values as follows:

	\$
Cash	3,256,273
Working capital	246,130
Property, plant and equipment	15,170,147
Other assets	7,715
Other long-term obligation	(1,395,578)
Future income taxes	<u>(1,869,446)</u>
	15,415,241
Intangible assets	26,800,000
Goodwill	<u>9,222,879</u>
Total consideration	<u>51,438,120</u>

# Environmental Management Solutions Inc.

## Notes to Consolidated Financial Statements

December 31, 2006 and 2005

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As a result of the acquisition of Biogénie, the Company has recognized the benefit of \$4,143,961 in tax losses not previously recognized.

The goodwill was assigned to the Company's Site Assessment and Remediation operating segment and is not deductible for tax purposes.

The results of Biogénie were consolidated with those of the Company effective November 25, 2006.

### (b) Acquisition of non-controlling interest

On March 31, 2006, the Company acquired the remaining 29.1% interest in Les Composts du Quebec for cash of \$275,000 and transaction costs of \$100,000. The purchase price was applied to non-controlling interest in subsidiary company, a reduction in the portion of intangible assets attributable to Les Composts du Québec Inc. and a reduction in property, plant and equipment as follows:

	\$
Non-controlling interest in subsidiary company	1,715,082
Reduction in:	
Intangible assets	(835,023)
Property, plant and equipment	<u>(505,059)</u>
	<u>375,000</u>

## 4 Discontinued operations

On April 22, 2005, the Company finalized the agreement to sell certain property, plant and equipment and working capital of its Cannington subsidiary. Total consideration of \$1,063,178 was in the form of cash of \$244,137 and debt assumed of \$819,041.

On May 30, 2005, the Company finalized the agreement to sell certain property, plant and equipment of its Rom-Neg subsidiary. The total consideration of \$242,000 was in the form of cash of \$117,368 and assumed debt and liabilities of \$124,632.

During 2005, the Company ceased operations of Greenbank Environmental Inc. and ongoing contracts have been wound down or reassigned to other parties.

In March 2005, the Company decided to exit the civil contracting business and dispose of all associated assets of its K-Lor Contractor Services Inc. subsidiaries. In June 2005, the Company decided to exit the remaining operations of environmental contracting. Many of the ongoing contracts have been sold, assigned or exited. The remaining contracts have been completed or are nearing completion.

In August 2005, the Company sold substantially all of the assets of its WasteCo Environmental Services Ltd. for \$7.6 million. The proceeds from the sale of the assets were used to reduce secured debt by approximately \$6.5 million, including early cancellation costs and outstanding interest.

# Environmental Management Solutions Inc.

## Notes to Consolidated Financial Statements

December 31, 2006 and 2005

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Summarized below is selected financial information for the discontinued operations for 2006 and 2005.

	2006 \$	2005 \$
Revenue from discontinued operations	365,543	19,783,315
Earning (loss) from discontinued operations (net of income taxes of \$nil)	846,937	(8,286,450)
Assets and liabilities of discontinued operations		
Current assets	309,223	742,002
Non-current assets	2,376	25,828
	311,599	767,830
Current liabilities	10,673	2,076,712
Non-current liabilities	-	37,983
Net assets from discontinued operations	300,926	(1,346,865)
Net cash used in operating activities	(786,322)	(4,264,836)
Net cash provided by investing activities	23,452	13,719,884
Net cash used in financing activities	(37,983)	(3,802,269)
Net cash (used in) provided from discontinued operations	(800,853)	5,652,779

## 5 Restricted investments

At December 31, 2005, the Company was required to restrict \$1,241,000 of cash and short-term investments. Of this amount, \$1,000,000 was pledged as collateral on a bonding facility, \$95,000 was pledged as collateral on letters of credit (see note 18, "Commitments and contingencies") and \$146,000 was held in trust pending release by secured creditors. At December 31, 2006, the Company is not subject to any restrictions on its cash or short-term investments.

## 6 Work in progress and other inventory

	2006 \$	2005 \$
Finished goods	2,812,662	1,495,000
Work in progress	11,924,323	606,618
Raw materials	2,235,421	3,100,383
	16,972,406	5,202,001

# Environmental Management Solutions Inc.

Notes to Consolidated Financial Statements

December 31, 2006 and 2005

## 7 Property, plant and equipment

	<b>2006</b>		
	<b>Cost</b>	<b>Accumulated</b>	<b>Net</b>
	<b>\$</b>	<b>amortization</b>	<b>\$</b>
		<b>\$</b>	<b>\$</b>
Land and buildings	7,608,049	702,380	6,905,669
Heavy equipment	18,151,853	6,255,667	11,896,186
Automotive and trailers	4,123,831	2,160,967	1,962,864
Vehicles	275,916	53,365	222,551
Testing vehicles	191,994	94,460	97,534
Furniture and equipment	622,290	61,088	561,202
Computer equipment and software	2,899,698	1,789,863	1,109,835
Leasehold improvements	571,471	217,257	354,214
Composting and soil recycling facilities	16,074,810	6,368,192	9,706,618
	<b>50,519,912</b>	<b>17,703,239</b>	<b>32,816,673</b>
	<b>2005</b>		
	<b>Cost</b>	<b>Accumulated</b>	<b>Net</b>
	<b>\$</b>	<b>amortization</b>	<b>\$</b>
		<b>\$</b>	<b>\$</b>
Land and buildings	3,568,221	206,534	3,361,687
Heavy equipment	6,481,182	1,611,200	4,869,982
Automotive and trailers	1,610,186	236,098	1,374,088
Vehicles	48,105	19,554	28,551
Testing vehicles	184,683	87,297	97,386
Furniture and equipment	508,525	125,737	382,788
Computer equipment and software	653,400	242,228	411,172
Leasehold improvements	294,199	79,117	215,082
Composting and soil recycling facilities	3,900,665	849,732	3,050,933
	<b>17,249,166</b>	<b>3,457,497</b>	<b>13,791,669</b>

# Environmental Management Solutions Inc.

Notes to Consolidated Financial Statements

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The costs of assets held under capital lease and the related amortization included in property, plant and equipment are as follows:

	<b>2006</b>		
	<b>Cost</b>	<b>Accumulated</b>	<b>Net</b>
	\$	amortization	\$
	\$	\$	\$
Heavy equipment	1,470,014	559,352	910,662
	<b>2005</b>		
	<b>Cost</b>	<b>Accumulated</b>	<b>Net</b>
	\$	amortization	\$
	\$	\$	\$
Heavy equipment	1,470,014	339,118	1,130,896

## 8 Intangible assets

	<b>2006</b>		
	<b>Cost</b>	<b>Accumulated</b>	<b>Net</b>
	\$	amortization	\$
	\$	\$	\$
Permits	18,300,000	-	18,300,000
Back-log	3,400,000	141,666	3,258,334
Non-compete agreements	2,700,000	25,000	2,675,000
Managed soil treatment facilities	2,400,000	56,250	2,343,750
Customer relationships	2,735,476	988,042	1,747,434
Licences	124,590	16,612	107,978
	29,660,066	1,227,570	28,432,496
	<b>2005</b>		
	<b>Cost</b>	<b>Accumulated</b>	<b>Net</b>
	\$	amortization	\$
	\$	\$	\$
Customer relationships	4,030,600	1,044,212	2,986,388

# Environmental Management Solutions Inc.

Notes to Consolidated Financial Statements

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## 9 Deferred financing charges

	2006 \$	2005 \$
Current		
Costs of issuance of various debt covenants	-	1,336,099
Accumulated amortization	-	1,336,099
	<hr/>	<hr/>
	-	-
Non-current		
Costs of issuing convertible debenture	3,811,139	250,000
Accumulated amortization	250,275	-
	<hr/>	<hr/>
	3,560,864	250,000
	<hr/>	<hr/>

## 10 Capital lease obligations

Future minimum annual lease payments under capital leases for the rental of heavy equipment are as follows:

	\$
Year ending December 31, 2007	376,199
2008	136,394
2009	51,643
2010	8,607
	<hr/>
	572,843
Less: Interest	30,480
	<hr/>
	542,363
Less: Current portion of long-term lease obligation	352,030
	<hr/>
	190,333
	<hr/>

Capital leases bear interest at rates varying between 5.50% and 17.90%.

# Environmental Management Solutions Inc.

Notes to Consolidated Financial Statements

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## 11 Long-term debt

	2006 \$	2005 \$
Term loan (a)	42,000,000	-
Convertible debenture (b)	15,371,564	-
Other debt (c)	-	12,596,635
	<hr/>	<hr/>
	57,371,564	12,596,635
Less: Current portion of long-term debt	4,204,196	6,299,508
	<hr/>	<hr/>
	53,167,368	6,297,127

### (a) Term loan and revolver facility

On November 24, 2006, the Company arranged a 5 year term loan for the acquisition of Biogénie (note 3) bearing interest at the Banker's Acceptance rate plus 2%. The loan is collateralized by all assets of the operating companies. The interest rate is adjustable based on achieving certain financial measures and the base rate can be changed from prime rate to Banker's Acceptance or LIBOR at the discretion of the Company. Repayment of the principal is made quarterly and excess cash flow, as defined in the agreement, is to be used to repay the term loan.

At December 31, 2006, the Company also has an available \$13,000,000 revolver facility bearing interest at a rate of prime or Banker's Acceptance plus 2%. The facility is collateralized by the operating assets of the Company.

### (b) Convertible debenture and preferred shares

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 with net proceeds to the Company of \$20,000,000 cash after 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 share at the discretion of the holders of the Company if certain minimum earnings levels 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 each debenture. The preferred shares can be redeemed at the option of the holder after the debentures become due and payable or at the option of the holders and Company if the debentures have been repaid.

# Environmental Management Solutions Inc.

## Notes to Consolidated Financial Statements

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Certain events, such as litigation or damages arising after March 31, 2006 and before March 31, 2010 that have a financial impact on the Company, will result in an adjustment to the price the debentures or preferred shares are converted. The adjustment will reduce the price by \$0.0263 for every \$1 million in excess of \$250,000.

Because the units have 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 on March 31, 2006, 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 Inc. 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 is recorded as a deferred financing charge and \$698,447 has been allocated to contributed surplus.

The long-term debt detailed above requires minimum payments as follows:

	\$
2007	4,204,196
2008	4,195,802
2009	6,300,000
2010	6,300,000
2011	21,000,000
Thereafter	<u>15,371,566</u>
	<u>57,371,564</u>

# Environmental Management Solutions Inc.

## Notes to Consolidated Financial Statements

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- (c) As at December 31, 2005, the Company had a variety of facilities across its subsidiary companies as follows.

	\$
Various loans from a Canadian chartered bank bearing fixed interest (at 8% per annum) or variable interest (ranging from prime plus 0.25% to prime plus 1.25%) at an average rate of 4.72% per annum, and maturing at various dates from March 2006 to September 2009, which a general security interest on all the assets of certain subsidiaries of the Company.	5,009,410
Term loan of \$2,650,000 maturing July 23, 2007, bearing interest at 11.00% (with an effective interest rate of 13.8%) with interest payable monthly and principal repayable in 36 monthly instalments of \$25,000 beginning in July 2004, and upon maturity, a final principal instalment of \$1,900,000. The loan was collateralized by a general security arrangement providing a subordinated security interest in all of the assets of the Company.	1,450,985
Loan from non-controlling shareholder maturing December 2006, bearing interest at 6.0%, repayable by annual instalment of \$200,000. The loan was collateralized by a general security agreement in the amount of \$650,000 covering all the assets of the Company's majority owned subsidiary, Les Composts du Québec Inc.	400,000
Term loan of \$1,050,000 maturing January 16, 2006, bearing interest at 10.45% (with an effective interest rate of 15.63%) with interest payable monthly and principal repayable in 24 monthly instalments of \$29,200 beginning in January 2004, and a final principal instalment of \$699,200 upon maturity. The loan was collateralized by a general security arrangement providing a subordinated security interest in all of the assets of the Company.	731,468
Term debenture of \$4,000,000 maturing December 15, 2005 bearing interest at 12% (with an effective interest rate of 29%) with interest payable monthly and principal due upon maturity. The debenture was collateralized by a general security arrangement providing a subordinated security interest in all the assets of the Company and its wholly-owned subsidiaries, except for the assets of a less than wholly-owned subsidiary.	3,907,441
Other	1,097,331
	<u>12,596,635</u>

# Environmental Management Solutions Inc.

Notes to Consolidated Financial Statements

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## 12 Share capital

Authorized

Unlimited number of common shares with no par value

Issued

	Number of shares	Amount \$
<b>Common shares</b>		
Balance at December 31, 2004	37,671,422	43,348,252
Cancellation of shares	(75,000)	-
Release of WasteCo's security	120,370	64,000
Issuance of Wellington Financial Special Warrants	295,455	130,000
	<hr/>	<hr/>
Balance at December 31, 2005	38,012,247	43,542,252
Private placement, net of issuance costs (\$33,163)	1,975,976	954,825
Private placement	24,336,937	10,000,000
Acquisition of Biogénie	14,245,000	7,122,500
	<hr/>	<hr/>
Balance at December 31, 2006	78,570,160	61,619,577
	<hr/>	<hr/>

### Share issuances and cancellations

On November 24, 2006, the Company completed a private placement of 1,975,976 common shares for total proceeds of \$987,988 less costs of issuance of \$33,163 issued to management and directors.

On November 24, 2006, the Company completed a private placement of 24,336,937 common shares for total proceeds of \$10,000,000 issued to the majority holder of the convertible debentures and preferred shares.

On November 24, 2006, the Company issued 14,245,000 common shares with a value of \$7,122,500 for the acquisition of Biogénie S.R.D.C. Inc. (see note 3, Acquisitions).

In September 2005, the Company issued 120,370 common shares with a value of \$64,000 or \$0.53 per share to a secured debenture holder for the lease of their security over the assets of WasteCo Environmental Services Limited.

In November 2005, the Company issued 295,455 common shares with a value of \$130,000 or \$0.44 per share to a secured debenture holder as compensation for waiving certain terms and conditions associated with the release of their security interest in WasteCo Environmental Services Ltd.

# Environmental Management Solutions Inc.

## Notes to Consolidated Financial Statements

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On February 12, 2004, the Company issued 75,000 common shares to a former employee upon the exercise of stock options. The exercise price of the options of \$131,250 was not paid upon exercise and remained outstanding as at December 31, 2004. In August 2005, the Company cancelled the 75,000 shares issued and forgave the amount owed.

### Stock option plans

The Company has an employee and consultant stock option plan (the "ESOP"). On August 24, 2004, the Company's shareholders approved an increase in the maximum number of shares that may be reserved and set aside under options to eligible persons pursuant to the ESOP to 7,243,768 common shares from 5,000,000. In addition, the Board of Directors adopted a policy to limit the number of shares outstanding under the ESOP to a maximum of 15% of the number of common shares outstanding at the time. The maximum number of common shares at any time available for issuance under the ESOP, or pursuant to other outstanding options, to any one person may not exceed 2% of the common shares then issued and outstanding. Under the terms of the ESOP, the option exercise price for all options issued under the ESOP must be based on the market value of the common shares on the date of grant and have a 5 year term and generally vest annually in portions of 30%, 30% and 40% over a three-year period. A committee appointed by the Board of Directors administers the ESOP.

The following tables present the option activity during 2006 and 2005 and the number and weighted average exercise price of options outstanding at December 31, 2006.

	<b>Number of options</b>	<b>Weighted average exercise price \$</b>
Outstanding at December 31, 2004	4,112,995	2.06
Granted	2,090,000	1.02
Forfeited	(3,084,109)	1.96
	<hr/>	
Outstanding at December 31, 2005	3,118,886	1.45
Granted	1,666,665	0.44
Forfeited	(1,158,313)	1.39
	<hr/>	
Outstanding at December 31, 2006	3,627,238	1.00

# Environmental Management Solutions Inc.

Notes to Consolidated Financial Statements

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Range of exercise prices \$	Number of options outstanding	Number of options exercisable	Weighted average remaining life in years
0.40 – 0.60	1,516,665	-	4.42
0.61 – 1.54	1,525,000	457,500	3.20
1.55 – 2.19	192,000	184,000	1.27
2.20 – 3.24	205,000	125,000	2.29
3.25 – 3.65	188,573	113,144	2.19
	<u>3,627,238</u>	<u>879,644</u>	<u>3.50</u>

## Stock-based compensation

The fair value of each option is estimated on the date of the grant using the Black-Scholes model with the following weighted average assumptions:

	2006	2005
Expected option life in years	3	3
Volatility	81 – 84%	84%
Risk free interest rate	4%	3.63%
Dividend yield	-	-

## Tandem option and stock appreciation rights

In 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 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 exceeds the exercise price of the OSAR on a grading vesting basis.

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

# Environmental Management Solutions Inc.

## Notes to Consolidated Financial Statements

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

Exercise price \$	Number outstanding	Number exercisable	Weighted average remaining life in years
0.635	1,600,000	-	9.25
0.750	2,200,000	-	9.25
1.000	2,700,000	-	9.25
1.250	3,200,000	-	9.25
1.500	2,700,000	-	9.25
1.750	2,100,000	-	9.25
	<hr/>		
	14,500,000	-	9.25
	<hr/>		

### Warrants

In addition to the warrants issued in conjunction with various private placements, the Company has also issued warrants in conjunction with debt issuances as follows:

On March 15, 2005, the Company issued 633,800 warrants with an exercise price of \$0.71 and a five-year term in conjunction with a term debenture maturing December 15, 2005. The value of \$307,411 assigned to these warrants using the Black-Scholes method has been credited to contributed surplus and applied to reduce the original value of the long-term debt increasing the effective interest rate from 12.00% to 29.00%. The Black-Scholes model used to calculate the fair value of these warrants assumed a warrant life of 5 years, volatility of 84%, a risk free rate of 3.63% and no dividend yield.

On December 15, 2005, the Company agreed to the cancellation of 500,000 warrants previously issued with an exercise price of \$0.90 and the issuance of 500,000 warrants ("special warrants") at an exercise price of \$0.43 in return for the extension until March 31, 2006 of a debenture originally due on December 15, 2005. The incremental value of \$72,955 assigned to the re-issuance of the warrants was estimated using the Black-Scholes method and has been credited to contributed surplus and applied to the associated outstanding debenture. The effective interest rate increased from 12% to 19% during the first quarter of 2006. The Black-Scholes model used to calculate the fair value of these warrants assumed a warrant life of 5 years, volatility of 32%, a risk free rate of 4.15% and no dividend yield.

On December 15, 2005, the Company extended by one year the term of 140,000 warrants with an exercise price of \$1.90 and original term of 4 years. There was no incremental value assigned to the re-issuance of the warrants using the Black-Scholes method. The Black-Scholes model used to calculate the fair value of these warrants assumed a warrant life of 3.3 years, volatility of 13%, a risk free rate of 4.15% and no dividend yield.

# Environmental Management Solutions Inc.

## Notes to Consolidated Financial Statements

December 31, 2006 and 2005

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On December 1, 2006, 5,962,896 warrants issued in conjunction with a private placement expired.

The following table presents the warrant activity during 2006 and 2005 and the number of warrants outstanding and the weighted average exercise price of warrants outstanding at December 31, 2006:

	<b>Number of options</b>	<b>Exercise price \$</b>
Outstanding at December 31, 2004	7,436,230	1.79
Granted	1,133,800	0.59
Forfeited	(500,000)	0.90
	<hr/>	
Outstanding at December 31, 2005	8,070,030	1.65
Expired	(5,962,896)	1.99
	<hr/>	
Outstanding at December 31, 2006	2,107,134	0.75
	<hr/>	

Information in respect of the outstanding warrants at December 31, 2006 is as follows:

<b>Exercise price \$</b>	<b>Number outstanding</b>	<b>Number exercisable</b>	<b>Weighted average life in years</b>
0.43	500,000	500,000	2.95
0.71	633,800	633,800	3.21
0.90	833,334	833,334	2.95
1.90	140,000	140,000	3.27
	<hr/>		
	2,107,134	2,107,134	3.05
	<hr/>		

# Environmental Management Solutions Inc.

Notes to Consolidated Financial Statements

December 31, 2006 and 2005

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## 13 Contributed surplus

The movement in contributed surplus is as follows:

	\$
Balance – December 31, 2004	7,204,376
Stock-based compensation expense	696,324
Warrants	477,673
	<hr/>
Balance – December 31, 2005	8,378,373
Stock-based compensation expense	547,996
Equity component of convertible units	3,953,543
	<hr/>
Outstanding – December 31, 2006	12,879,912
	<hr/>

## 14 Income taxes

The components of the provision for income taxes are as follows:

	2006	2005
	\$	\$
Current	40,724	514,725
Future	(101,462)	(596,210)
	<hr/>	<hr/>
	(60,738)	(81,485)
	<hr/>	<hr/>

A reconciliation of the combined Canadian federal and provincial income tax rates with the Company's effective income tax rate is as follows:

	2006	2005
	\$	\$
Expected income tax recovery based on statutory income tax rate of 33.0% (2005 – 33.5%)	(92,810)	(3,044,423)
Decreased by the effect of non-deductible expenses	232,392	236,283
Unrecognized tax losses	-	2,726,655
Other	(200,320)	-
	<hr/>	<hr/>
	(60,738)	(81,485)
	<hr/>	<hr/>

The Company's expenses which are not deductible for income tax purposes, are principally its stock-based compensation expense and amortization of purchased intangible assets.

# Environmental Management Solutions Inc.

## Notes to Consolidated Financial Statements

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Differences between the financial statement carrying amounts and underlying tax bases giving rise to future tax assets and liabilities are as follows:

	2006	2005
	\$	\$
Future income tax assets		
Non-capital loss carryforwards	4,143,961	-
Carrying value of property, plant and equipment	(838,854)	-
Carrying value of intangible assets	(5,807,562)	(832,840)
Deferred financing charges	(200,939)	-
Tax credits	(194,172)	-
Deferred revenues	305,000	-
Deferred payments	435,500	-
Other	8,927	-
	<u>(2,148,139)</u>	<u>(832,840)</u>
Reported as		
Future income tax asset	<u>394,200</u>	-
Future income tax liability	<u>(2,542,339)</u>	<u>(832,840)</u>

As at December 31, 2006, the Company and its subsidiaries have available non-capital losses of \$12,407,313 (2005 - \$10,618,150) for income tax purposes which expire as follows:

	\$
2009	665,148
2010	282,138
2013	394
2014	1,976,882
2015	7,693,588
2026	<u>1,789,163</u>
	<u>12,407,313</u>

# Environmental Management Solutions Inc.

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## 15 Earnings (loss) 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.

The following table reconciles the net earnings (loss) and the number of shares for the basic and diluted earnings (loss) per share calculations:

	<b>2006</b>		
	<b>Net earnings (loss) attributable to common shareholders \$</b>	<b>Weighted average number of shares</b>	<b>Per share amount \$</b>
Basic earnings (loss) per share			
Continuing operations	(116,384)	42,234,715	(0.00)
Discontinued operations	846,937	42,234,715	0.02
	730,553	42,234,715	0.02
Dilutive effect of warrants	-	60,237	0.00
Dilutive effect of stock options	-	154,702	0.00
Diluted earnings (loss) per share	730,553	42,449,654	0.02
			<b>2005</b>
	<b>Net loss attributable to common shareholders \$</b>	<b>Weighted average number of shares</b>	<b>Per share amount \$</b>
Loss per share			
Continuing operations	(9,037,828)	37,847,823	(0.24)
Discontinued operations	(8,286,450)	37,847,823	(0.22)
Basic and diluted loss per share	(17,324,278)	37,847,823	(0.46)

For 2005, the exercise of outstanding stock options and warrants would be anti-dilutive. The number of options and warrants outstanding at December 31, 2005 are 11,188,916.

# Environmental Management Solutions Inc.

Notes to Consolidated Financial Statements

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## 16 Joint venture

A subsidiary of the Company, Biogénie, has a 50% joint venture interest with Biffa Waste Services Ltd. Biogénie has joint control over this joint venture and its share of the assets and liabilities and items on the statements of operations and cash flows included in the consolidated financial statements are summarized as follows:

	\$
Assets	
Cash	503,688
Accounts receivable	<u>182,014</u>
	<u>685,702</u>
Liabilities	
Accounts payable and accrued liabilities	116,976
Deferred revenues	<u>299,350</u>
	<u>416,326</u>
Net assets	<u>269,376</u>
Revenue	26,493
Costs	<u>21,224</u>
	5,269
Opening net assets	<u>264,107</u>
Closing net assets	<u>269,376</u>

# Environmental Management Solutions Inc.

Notes to Consolidated Financial Statements

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## 17 Restructuring and other costs

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 2005 the Company incurred \$5,303,185 in restructuring charges as a result of a forensic audit and significant litigation including settlement and other costs associated with the termination of the former President and CEO. These charges include \$1,069,754 in severance costs, \$3,687,723 in legal and professional costs, \$282,844 of premises and closure costs and \$262,864 of special shareholder meeting costs.

During 2006, the Company incurred an additional \$476,390 in restructuring charges, including \$279,494 in severance costs, \$46,396 in legal and professional fees and \$150,500 in other costs.

## 18 Commitments and contingencies

- (a) The Company leases office premises and vehicles and equipment from unrelated parties with minimum annual payments as follows:

	<b>Vehicles and equipment</b>	<b>Premises</b>
	\$	\$
Year ending December 31, 2007	576,233	1,263,567
2008	493,738	1,130,565
2009	414,749	1,046,118
2010	249,910	373,648
2011 and thereafter	13,173	238,324
	<hr/>	<hr/>
	1,747,803	4,052,222

The Company is obligated to remediate soil at a discount for 7 years in order to maintain rights to operate a licensed bio-treatment facility in Sudbury, Ontario.

- (b) The Company has renewable letters of credit outstanding in the aggregate of \$4,433,389, which are used, in part, as security for bonding, in place of bonding or in place of cash security.

# Environmental Management Solutions Inc.

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(c) Litigation

- i) A statement of claim has been filed against Wasteco Environmental Services Ltd, a subsidiary of EMS, currently discontinued and other parties alleging damages of \$23.8 million. WasteCo and the other co-defendants deny any liability. Other defendants' insurance proceeds have paid for a significant amount of the damages claimed, however, there continues to be ongoing investigation into this matter. WasteCo is named as an additional insured under a co-defendant's policy. The amount of any settlement in excess of insurance coverage cannot be determined at this time and no amount has been recorded. Management believes that any potential loss not covered in the co-defendants policy will be adequately covered by the Company's insurance.
- ii) 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 million from the Company for alleged breach of contract and misrepresentation, \$5 million from the former President and CEO for alleged misrepresentation and declaratory and compensatory relief for alleged oppressive conduct, together with special damages in the 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 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.

- iii) A statement of claim has been filed against the Company by the former President and CEO, a company and a trust controlled by the former President and CEO, alleging a conspiracy by the Company with a third party to the suit with the intention of fraudulently obtaining ownership of the shares owned or controlled by the plaintiff. The amount of the claim is for \$17 million. Management believes this claim is without merit and the final determination will not materially affect the financial position or results of the Company.
- iv) In the normal course of business the Company is threatened from time to time with, or named as a defendant in, legal proceedings, including those relating to wrongful dismissal. Many claims are covered by the Company's insurance policies and none of the current claims are expected to have a material adverse effect on the Company.

# Environmental Management Solutions Inc.

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## 19 Segment information

The Company's operations consist of three operating segments: Site Assessment and Remediation, Organic Waste Management and Tank Testing & Calibration services. Services are provided to customers in Canada, the United States, United Kingdom and France. These segments differ from the reportable segments disclosed in prior years, as a result of the acquisition of Biogénie on November 24, 2006 which operates exclusively in the Site Assessment and Remediation group. Segmented results for the years ended December 31, 2006 and 2005 are as follows:

	<b>2006</b>			
	<b>Site Assessment and Remediation \$</b>	<b>Organic Waste Management \$</b>	<b>Tank Testing and Calibration \$</b>	<b>Total \$</b>
Revenue				
Canada	13,889,323	47,502,992	3,759,403	65,151,718
France	3,074,130	-	-	3,074,130
United States	1,474,494	-	-	1,474,494
United Kingdom	220,412	-	-	220,412
	<u>18,658,359</u>	<u>47,502,992</u>	<u>3,759,403</u>	<u>69,920,754</u>
Amortization and depreciation	<u>657,324</u>	<u>2,467,474</u>	<u>124,882</u>	<u>3,249,680</u>
Segment earnings before the under-noted	2,299,549	261,268	771,180	3,331,997
Income tax recovery				(60,738)
Stock-based compensation				547,996
Interest on long-term debt				992,864
Other interest and bank charges				1,595,992
Non-controlling interest in subsidiary company				(104,123)
Net loss from discontinued operations				(846,937)
Restructuring and other costs				<u>476,390</u>
Net earnings				<u>730,553</u>
Goodwill as at December 31, 2006	<u>9,222,879</u>	<u>4,375,601</u>	<u>788,277</u>	<u>14,386,757</u>
Discontinued operations	<u>-</u>	<u>-</u>	<u>-</u>	<u>311,599</u>
Acquired goodwill	<u>9,222,879</u>	<u>-</u>	<u>-</u>	<u>9,222,879</u>

Identifiable assets, excluding goodwill and discontinued operations, are not separated into specific segments. Total expenditures for property, plant and equipment for the year were \$7,130,042 (2005 - \$673,330).

# Environmental Management Solutions Inc.

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	<b>2005</b>			
	<b>Site Assessment and Remediation \$</b>	<b>Organic Waste Management \$</b>	<b>Tank Testing and Calibration \$</b>	<b>Total \$</b>
Revenue – Canada	13,785,298	36,094,704	2,806,612	52,686,614
Amortization and depreciation	386,000	2,326,072	60,397	2,772,469
Segment earnings before the under-noted	654,828	524,615	138,492	1,317,935
Income tax recovery				(81,485)
Stock-based compensation				696,324
Other interest and bank charges				4,406,257
Non-controlling interest in subsidiary company				31,481
Net loss from discontinued operations				8,286,450
Restructuring and other costs				5,303,185
Net loss				<u>(17,324,277)</u>
Goodwill as at December 31, 2005	-	4,375,601	788,277	5,163,878
Discontinued operations	-	-	-	767,830

There were no acquisitions in 2005 and as a result there was no acquired goodwill.

External revenue by market is attributed to countries based on the location of the Company's subsidiary responsible for the revenue.

# Environmental Management Solutions Inc.

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## Geographic segments

The Company's assets, operations and employees are located in Canada, France, the United Kingdom and the United States.

	Canada \$	France \$	United Kingdom \$	United States \$	Total \$
Property, plant and equipment	26,678,590	3,453,469	2,369,214	225,400	32,726,673
Goodwill and intangible assets	32,238,943	7,887,710	2,608,309	84,291	42,819,253
Other assets	43,642,923	11,825,848	5,454,339	948,305	61,871,415
Total assets	<u>102,560,456</u>	<u>23,167,027</u>	<u>10,431,862</u>	<u>1,257,996</u>	<u>137,417,341</u>

In 2005, all assets and operations were located in Canada.

## 20 Financial instruments

### Fair values

The carrying values of cash, accounts receivable, accounts payable and accrued liabilities and income taxes payable approximate fair values due to their short-terms to maturity of these assets and liabilities. The carrying value of the Company's capital lease obligations, long-term debt and other long-term obligation approximates fair value.

### Credit risk

The Company's financial instruments that are exposed to credit risk include cash and accounts receivable. The Company places its cash with institutions of high credit worthiness. The Company's accounts receivable are not subject to a high concentration of credit risk.

The Company provides a wide variety of environmental services for a broad public and private sector customers and which spans numerous industries. Long-term contracts are with large well-established customers. The Company monitors its credit exposure to its customers on a regular basis.

# Environmental Management Solutions Inc.

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## Interest rate risk

The Company's principal exposure to interest rate fluctuations is limited to long-term debt (as described in note 11) which bears interest at both fixed and floating interest rates.

## Foreign exchange risk

The Company operates internationally, which gives rise to the risk that results of operations and cash flows may be adversely impacted by exchange rate fluctuations. The Company does not use derivative instruments to manage this risk.

## 21 Change in non-cash working capital and significant non-cash transaction

	2006 \$	2005 \$
Accounts receivable	(4,453,561)	(2,228,506)
Work in progress and other inventory	(3,973,619)	927,051
Prepaid expenses and advances	(607,670)	198,280
Other assets	1,511,765	1,092,186
Accounts payable and accrued liabilities	(3,084,283)	4,273,888
Deferred revenue	2,833,856	(1,762,602)
Income taxes payable	(395,176)	680,859
	<u>(8,168,688)</u>	<u>3,181,156</u>

During 2005, the Company issued 415,826 common shares to extinguish debt in the amount of \$194,000 (note 12).

## 22 Comparative figures

Certain of the prior year's comparative figures have been reclassified to conform to the current year's financial statement presentation.