MDC PARTNERS INC
Form 10-Q
November 09, 2006

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

(Mark One)

x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the quarterly period ended September 30, 2006

Or

o **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the transition period from ______________ to ______________

Commission file number: 001-13178

MDC Partners Inc.
(Exact name of registrant as specified in its charter)

Canada	**98-0364441**
(State or other jurisdiction of incorporation or organization)	(IRS Employer Identification No.)

45 Hazelton Avenue Toronto, Ontario, Canada	**M5R 2E3**
(Address of principal executive offices)	(Zip Code)

(416) 960-9000
Registrant’s telephone number, including area code:

950 Third Avenue, New York, New York 10022
(646) 429-1809

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was

required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer or a non-accelerated filer. See definition of “accelerated filer” and “large accelerated filer” in Rule 12(b)-2 of the Exchange Act (check one)

Large Accelerated Filer o Accelerated Filer x Non-Accelerated Filer o

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes o No x

APPLICABLE ONLY TO REGISTRANTS INVOLVED IN BANKRUPTCY PROCEEDINGS DURING THE PRECEDING FIVE YEARS:

Indicate by check mark whether the registrant has filed all documents and reports required to be filed by Section 12, 13 or 15(d) of the Act subsequent to the distributions of securities under a plan confirmed by a court. Yes o No o

The numbers of shares outstanding as of November 1, 2006 were: 24,191,113 Class A subordinate voting shares and 2,502 Class B multiple voting shares.

Website Access to Company Reports

MDC Partners Inc.'s Internet website address is www.mdc-partners.com. The Company's annual reports on Form 10-K, quarterly reports on Form 10-Q and current reports on Form 8-K, and any amendments to those reports filed or furnished pursuant to section 13(a) or 15(d) of the Exchange Act, will be made available free of charge through the Company's website as soon as reasonably practical after those reports are electronically filed with, or furnished to, the Securities and Exchange Commission.

MDC PARTNERS INC.

QUARTERLY REPORT ON FORM 10-Q

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Item 1. Financial Statements

MDC PARTNERS INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS (unaudited)
(thousands of United States dollars, except share and per share amounts)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	**2005**	**2006**	**2005**
Revenue:				
Services	$ 101,122	$ 96,977	$ 299,333	$ 261,042
Operating Expenses:				
Cost of services sold (1)	57,150	55,509	177,790	155,180
Office and general expenses (2)	36,666	28,853	97,672	77,826
Depreciation and amortization	6,696	6,905	18,595	16,675
	100,512	91,267	294,057	249,681
Operating profit	610	5,710	5,276	11,361
Other Income (Expenses):				
Other income (expense)	625	(395)	1,697	616
Interest expense	(3,704)	(2,302)	(8,134)	(4,926)
Interest income	171	—	429	230
	(2,908)	(2,697)	(6,008)	(4,080)
Income (loss) from continuing operations before income taxes, equity in affiliates and minority interests	(2,298)	3,013	(732)	7,281
Income tax recovery	812	397	1,711	1,676
Income/(loss) from continuing operations before equity in affiliates and minority interests	(1,486)	3,410	979	8,957
Equity in earnings of non-consolidated affiliates	129	348	630	624
Minority interests in income of consolidated subsidiaries	(1,780)	(6,073)	(9,965)	(14,374)
Loss from continuing operations	(3,137)	(2,315)	(8,356)	(4,793)
Income/(loss) from discontinued operations	(9,772)	660	(20,190)	(1,609)
Net Loss	$ (12,909)	$ (1,655)	$ (28,546)	$ (6,402)
Income/(Loss) Per Common Share:				
Basic:				
Continuing operations	$ (0.13)	$ (0.10)	$ (0.35)	$ (0.21)

Discontinued operations		(0.41)		0.03		(0.84)		(0.07)
Net Loss	$	(0.54)	$	(0.07)	$	(1.19)	$	(0.28)
Diluted:								
Continuing operations	$	(0.13)	$	(0.10)	$	(0.35)	$	(0.21)
Discontinued operations		(0.41)		0.03		(0.84)		(0.07)
Net loss	$	(0.54)	$	(0.07)	$	(1.19)	$	(0.28)
Weighted Average Number of Common Shares Outstanding:								
Basic		23,911,327		23,710,572		23,849,571		23,151,825
Diluted		23,911,327		23,710,572		23,849,571		23,151,825

(1) Includes non cash stock-based compensation of $134 and $18 in each of the three month periods ended September 30, 2006 and 2005, respectively, and $2,975 and $89 in each of the nine month periods ended September 30, 2006 and 2005, respectively.

(2) Includes non cash stock-based compensation of $1,515 and $548, respectively, in each of the three month periods ended September 30, 2006 and 2005, respectively, and $4,006 and $2,273 in each of the nine month periods ended September 20, 2006 and 2005 respectively.

The accompanying notes to the unaudited condensed consolidated financial statements are an integral part of these statements.

MDC PARTNERS INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS
(thousands of United States dollars)

	September 30, 2006 (Unaudited)	December 31, 2005
ASSETS		
Current Assets:		
Cash and cash equivalents	$ 4,592	$ 12,923
Accounts receivable, less allowance for doubtful accounts of $1,780 and $1,250	120,414	117,319
Expenditures billable to clients	31,152	7,838
Inventories	—	10,359
Prepaid expenses	4,682	4,401
Other current assets	630	356
Assets held for sale	28,849	—
Total Current Assets	190,319	153,196
Fixed assets, at cost, less accumulated depreciation of $52,196 and $71,220	43,403	63,528
Investment in affiliates	10,068	10,929
Goodwill	199,340	195,026
Other intangibles assets, net	50,130	57,139
Deferred tax asset	17,825	16,057
Other assets	10,173	11,440
Assets held for sale	12,249	—
Total Assets	$ 533,507	$ 507,315
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current Liabilities:		
Short-term debt	$ 4,218	$ 3,739
Revolving credit facility	85,300	73,500
Accounts payable	69,686	63,452
Accruals and other liabilities	69,549	69,891
Advance billings	50,996	38,237
Current portion of long-term debt	1,532	2,571
Deferred acquisition consideration	—	1,741
Liabilities related to assets held for sale	16,221	—
Total Current Liabilities	297,502	253,131
Long-term debt	4,991	8,475
Convertible notes	40,261	38,694
Other liabilities	8,871	7,937
Deferred tax liabilities	2,346	2,446
Liabilities related to assets held for sale	3,352	—
Total Liabilities	357,323	310,683
Minority interests	46,335	44,484
Commitments, contingencies and guarantees (Note 12)		
Shareholders' Equity:		
Preferred shares, unlimited authorized, none issued	—	—
	183,851	178,589

Class A Shares, no par value, unlimited authorized, 24,191,113 and 23,437,615 shares issued in 2006 and 2005				
Class B Shares, no par value, unlimited authorized, 2,502 shares issued in 2006 and 2005, each convertible into one Class A share		1		1
Share capital to be issued, 266,856 Class A shares in 2005		—		4,209
Additional paid-in capital		25,600		20,028
Accumulated deficit		(81,621)		(53,075)
Accumulated other comprehensive income		2,018		2,396
Total Shareholders' Equity		129,849		152,148
Total Liabilities and Shareholders' Equity	$	533,507	$	507,315

The accompanying notes to the unaudited condensed consolidated financial statements are an integral part of these statements.

MDC PARTNERS INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (unaudited)
(thousands of United States dollars)

	Nine Months Ended September 30,	
	2006	2005 Revised Note 1
Cash flows from operating activities:		
Net loss	$ (28,546)	$ (6,402)
Loss from discontinued operations	(20,190)	(1,609)
Loss from continuing operations	(8,356)	(4,793)
Adjustments to reconcile net loss to cash provided by (used in) operating activities		
Depreciation and amortization	18,595	16,675
Non-cash stock-based compensation	6,363	2,362
Amortization of deferred finance charges	1,598	911
Deferred income taxes	(3,342)	(3,270)
Earnings of non-consolidated affiliates	(630)	(624)
Minority interest and other	(194)	(228)
Changes in non-cash working capital:		
Accounts receivable	(17,355)	141
Expenditures billable to clients.	(23,334)	703
Prepaid expenses and other current assets	(1,166)	(1,483)
Accounts payable, accruals and other liabilities	14,353	(14,674)
Advance billings	17,059	(3,389)
Cash flows from continuing operating activities	3,591	(7,669)
Discontinued operations	2,073	2,335
Net cash provided by (used in) operating activities	5,664	(5,334)
Cash flows from investing activities:		
Capital expenditures	(18,791)	(6,572)
Acquisitions, net of cash acquired	(5,176)	(56,446)
Proceeds of dispositions	604	250
Distributions from non-consolidated affiliates	499	1,381
Discontinued operations	(1,641)	(2,052)
Net cash used in investing activities	(24,505)	(63,439)
Cash flows from financing activities:		
Increase (decrease) in bank indebtedness	479	(4,526)
Proceeds from issuance of long term debt	—	36,723
Proceeds from revolving credit facility	11,800	34,000
Repayment of long-term debt	(1,228)	(3,900)
Issuance of share capital	150	16
Subsidiary issuance of share capital	385	—
Deferred financing costs	—	(3,316)
Discontinued operations	(702)	(1,664)
Net cash provided by financing activities	10,884	57,333
Effect of exchange rate changes on cash and cash equivalents	(374)	186
Net decrease in cash and cash equivalents	(8,331)	(11,254)
Cash and cash equivalents at beginning of period	12,923	22,673
Cash and cash equivalents at end of period	$ 4,592	$ 11,419

Supplemental disclosures:				
Cash income taxes paid	$	940	$	1,154
Cash interest paid	$	6,345	$	4,236
Non-cash transactions:				
Share capital issued on acquisitions	$	4,459	$	14,493
Capital leases	$	915	$	998
Note receivable exchanged for shares in subsidiary	$	1,155	$	122

The accompanying notes to the unaudited condensed consolidated financial statements are an integral part of these statements.

MDC PARTNERS INC. AND SUBSIDIARIES
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(thousands of United States dollars, unless otherwise stated)

1. Basis of Presentation

MDC Partners Inc. (the “Company”) has prepared the unaudited condensed consolidated interim financial statements included herein pursuant to the rules and regulations of the United States Securities and Exchange Commission (the “SEC”). Certain information and footnote disclosures normally included in annual financial statements prepared in accordance with generally accepted accounting principles (“GAAP”) of the United States of America (“US GAAP”) have been condensed or omitted pursuant to these rules.

The accompanying financial statements reflect all adjustments, consisting of normally recurring accruals, which in the opinion of management are necessary for a fair presentation, in all material respects, of the information contained therein. Results of operations for interim periods are not necessarily indicative of annual results.

These statements should be read in conjunction with the consolidated financial statements and related notes included in the annual report on Form 10-K for the year ended December 31, 2005.

As of the quarter ended December 31, 2005, the Company revised the 2005 statement of cash flows to separately disclose the operating, investing and financing portions of the cash flows attributable to its discontinued operations. Accordingly, the nine months ended September 30, 2005 statement of cash flows has been revised to conform to such presentation.

Effective June 30, 2006, the Company has classified the assets and liabilities of the Company’s Secure Paper Business and Secure Cards Business as held for sale and accordingly has classified the results of their operations as discontinued operations.

2. Significant Accounting Policies

The Company’s significant accounting policies are summarized as follows:

Principles of Consolidation. The accompanying condensed consolidated financial statements include the accounts of MDC Partners Inc. and its domestic and international controlled subsidiaries that are not considered variable interest entities, and variable interest entities for which the Company is the primary beneficiary. Intercompany balances and transactions have been eliminated in consolidation.

Use of Estimates. The preparation of financial statements in conformity with US GAAP requires management to make estimates and assumptions. These estimates and assumptions affect the reported amounts of assets and liabilities including goodwill, intangible assets, valuation allowances for receivables and deferred tax assets, and the reporting of variable interest entities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting period. The estimates are evaluated on an ongoing basis and estimates are based on historical experience, current conditions and various other assumptions believed to be reasonable under the circumstances. Actual results could differ from those estimates.

Concentration of Credit Risk. The Company provides marketing communications services to clients who operate in most industry sectors. Credit is granted to qualified clients in the ordinary course of business. Due to the diversified nature of the Company's client base, the Company does not believe that it is exposed to a concentration of credit risk as no client accounted for more than 10% of the Company's consolidated accounts receivable at September 30, 2006; however, one client accounted for 14% of revenue for the nine months ended September 30, 2006. For the nine months ended September 30, 2005, no client accounted for more than 10% of revenue. As of December 31, 2005, no client accounted for more than 10% of accounts receivable.

Cash and Cash Equivalents. The Company's cash equivalents are primarily comprised of investments in overnight interest-bearing deposits, commercial paper and money market instruments and other short-term investments with original maturity dates of six months or less at the time of purchase. Included in cash and cash equivalents at September 30, 2006 and December 31, 2005, is approximately $100 and $1,300, respectively, of cash restricted to withdrawal.

Stock-Based Compensation. Effective January 1, 2003, the Company prospectively adopted fair value accounting for stock-based awards as prescribed by SFAS No. 123 "Accounting for Stock-Based Compensation" ("SFAS No. 123"). Prior to January 1, 2003, the Company elected not to apply fair value accounting to stock-based awards to employees, other than for direct awards of stock and awards settleable in cash, which required fair value accounting. Prior to January 1, 2003, for awards not elected to be accounted for under the fair value method, the Company accounted for stock-based awards in accordance with Accounting Principles Board Opinion 25, "Accounting for Stock Issued to Employees" ("APB 25"). APB 25 is based upon an intrinsic value method of accounting for stock-based awards. Under this method, compensation cost is measured as the excess, if any, of the quoted market price of the stock issuance at the measurement date over the amount to be paid by the employee.

The Company adopted fair value accounting for stock-based awards using the prospective application transitional alternative available in SFAS 148 "Accounting for Stock-Based Compensation—Transition and Disclosure". Accordingly, the fair value method is applied to all awards granted, modified or settled on or after January 1, 2003. Under the fair value method, compensation cost is measured at fair value at the date of grant and is expensed over the service period, that is the award's vesting period. When awards are exercised, share capital is credited by the sum of the consideration paid together with the related portion previously credited to additional paid-in capital when compensation costs were charged against income or acquisition consideration.

Stock-based awards that are settled in cash or may be settled in cash at the option of employees are recorded as liabilities. The measurement of the liability and compensation cost for these awards is based on the intrinsic value of the award, and is recorded as a charge to operating income over the service period, that is the vesting period of the award in accordance with FASB Interpretation Number 28- "Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans—an interpretation of APB Opinions No. 15 and 25" ("FIN 28"). Changes in the Company's payment obligation subsequent to vesting of the award and prior to the settlement date are recorded as compensation cost in operating income in the period of the change. The final payment amount for such awards is established on the date of the exercise of the award by the employee.

Stock-based awards that are settled in cash or equity at the option of the Company are recorded at fair value on the date of grant and recorded as additional paid-in capital. The fair value measurement of the compensation cost for these awards is based on the Black-Scholes option pricing model and is recorded as a charge to operating income over the service period, that is the vesting period of the award.

Effective January 1, 2006, the Company adopted FAS 123(R) and has opted to use the modified prospective application transition method. Under this method the Company will not restate its prior financial statements. Instead, the Company will apply FAS 123(R) for new awards granted after the adoption of FAS 123(R), any portion of awards that were granted after December 15, 1994 and have not vested as of January 1, 2006, and any outstanding liability awards.

Measurement of compensation cost for awards that are outstanding and classified as equity, at January 1, 2006, will be based on the original grant-date fair value calculations of those awards. The Company had previously adopted FAS 123 and as such has been expensing the fair value of all awards issued after January 1, 2003. For all previously issued awards, the Company has been providing pro-forma disclosure for such awards. Upon the adoption of FAS 123(R), the Company expenses the fair value of the awards granted prior to January 1, 2003. The Company has adopted the straight-line attribution method for determining the compensation cost to be recorded during each accounting period. The adoption of FAS 123(R) did not have a material effect on the Company's financial position or results of operations.

The table below summarizes what the quarterly pro forma effect for the three and nine months ended September 30, 2005, would have been had the Company adopted the fair value method of accounting for stock options and similar instruments for awards issued prior to 2003 and prior to the adoption of FAS 123(R):

	Three Months Ended September 30, 2005	Nine Months Ended September 30, 2005
Net loss as reported	$ (1,655)	$ (6,402)
Fair value costs, net of income tax, of stock-based employee compensation for options issued prior to 2003	161	522
Net loss pro forma	$ (1,816)	$ (6,924)
Basic net loss per share, as reported	$ (0.07)	$ (0.28)
Basic net loss per share, pro forma	$ (0.08)	$ (0.30)
Diluted net loss per share, as reported	$ (0.07)	$ (0.28)
Diluted net loss per share, pro forma	$ (0.08)	$ (0.30)

The fair value of the stock options and similar awards at the grant date were estimated using the Black-Scholes option-pricing model with the following weighted average assumptions for the following period:

	Nine Months Ended September 30, 2006	Three Months Ended September 30, 2005	Nine Months Ended September 30, 2005
Expected dividend	0.00%	0.00%	0.00%
Expected volatility	40%	40%	40%
Risk-free interest rate	4.95%	2.9%	2.9%
Expected option life in years	5-7	3	3
Weighted average stock option fair value per option granted	$ 4.74	$3.09	$3.67

On February 28, 2006, the Company issued 247,500 Class A shares of financial performance-based restricted stock, and 475,000 financial performance-based restricted stock units to its employees under the 2005 Stock Incentive Plan. The Class A shares underlying each grant of restricted stock or restricted stock units will vest upon achievement by the Company of specified financial performance criteria in 2006, 2007 and 2008. Based on the Company's expected financial performance in 2006, the Company currently believes that 50% of the financial performance-based awards to employees will vest on March 15, 2007. Accordingly, the Company is recording a non-cash stock based compensation charge of $3,089 from the date of grant through March 15, 2007.

On March 6, 2006, the Company issued 16,000 Class A shares of restricted stock and 8,000 restricted stock units to its non-employee Directors under the 2005 Stock Incentive Plan. These awards to non-employee Directors vest on the third anniversary of the grant date. Accordingly, the Company is recording a $205 non-cash compensation charge over the three year vesting period.

On April 28, 2006, the Company issued 50,000 restricted stock units to an employee; 15,000 of these units will vest based upon the achievement by the Company of specified financial criteria in 2006, 2007 and 2008. The remaining 35,000 of these units will vest on the third anniversary of the grant date. Accordingly, the Company is recording a $380 non-cash compensation charge over the three-year vesting period. In addition, the Company issued 10,000 Stock Appreciation Rights to the same employee. The Company also issued 125,000 options to certain non-employee Directors.

For the three and nine months ended September 30, 2006, the Company has recorded a charge of $804 and $1,845, respectively relating to the first quarter of 2006 restricted stock and restricted stock unit grants. The value of the awards was determined based on the fair market value of the underlying stock on the date of grant. The first quarter of 2006 restricted stock granted to employees and non-employee Directors totaling 263,500 Class A shares are included in the Company's calculation of Class A shares outstanding as of September 30, 2006.

Derivative Financial Instruments. The Company follows SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities". SFAS No.133 establishes accounting and reporting standards requiring that every derivative instrument (including certain derivative instruments embedded in other contracts and debt instruments) be recorded in the balance sheet as either an asset or liability measured at its fair value. The accounting for the change in fair value of the derivative depends on whether the instrument qualifies for and has been designated as a hedging relationship and on the type of hedging relationship. There are three types of hedging relationships: a cash flow hedge, a fair value hedge and a hedge of foreign currency exposure of a net investment in a foreign operation. The designation is based upon the exposure being hedged. Derivatives that are not hedges, or become ineffective hedges, must be adjusted to fair value through earnings.

Effective June 28, 2005, the Company entered into a cross currency swap contract ("Swap"), a form of derivative. The Swap contract provides for a notional amount of debt fixed at $45,000 Canadian dollars ("C$") and at $36,452, with the interest rates fixed at 8% per annum for the Canadian dollar amount and fixed at 8.25% per annum for the US dollar amount. Consequently, under the terms of this Swap, semi-annually, the Company will receive interest of C$1,800 and will pay interest of $1,503 per annum. At December 31, 2005, the Swap fair value was estimated to be a receivable of $165 and is reflected in other assets on the Company's balance sheet with the change in the value of the swap reflected in interest expense. On June 22, 2006, the Company settled this swap for its fair value of $357, which resulted in a gain of $192 for the nine months ended September 30, 2006 and is included in other income.

3. Loss Per Common Share

The following table sets forth the computation of basic and diluted loss per common share from continuing operations.

	Three Months Ended September 30,		Nine Months Ended September 30	
	2006	2005	2006	2005
Numerator				
Numerator for basic loss per common share - loss from continuing operations	$ (3,137)	$ (2,315)	$ (8,356)	$ ($4,793)
Effect of dilutive securities:				
Interest expense on convertible debentures, net of taxes of nil	—	—	—	—
Numerator for diluted loss per common share - loss from continuing operations plus assumed conversion	$ (3,137)	$ (2,315)	$ (8,356)	$ (4,793)
Denominator				
Denominator for basic loss per common share - weighted average common shares	23,911,327	23,710,572	23,849,571	23,151,825
Effect of dilutive securities:				
8% convertible debentures	—	—	—	—
Employee stock options, warrants, and stock appreciation rights	—		—	—
Dilutive potential common shares				
Denominator for diluted loss per common share - adjusted weighted shares and assumed conversions	23,911,327	23,710,572	23,849,571	23,151,825
Basic loss per common share from continuing operations	$ (0.13)	$ (0.10)	$ (0.35)	$ (0.21)
Diluted loss per common share from continuing operations	$ (0.13)	$ (0.10)	$ (0.35)	$ (0.21)

The 8% convertible debentures, options and other rights to purchase 8,492,018 shares of common stock, which includes 263,500 shares of non-vested restricted stock, were outstanding during the three and nine months ended September 30, 2006, but were not included in the computation of diluted loss per common share because their effect would be antidilutive. Similarly, during the three and nine months ended September 30, 2005, the 8% convertible debentures, options and other rights to purchase 8,102,679 and 5,983,369 shares, respectively of common stock were outstanding but were not included in the computation of diluted loss per common share because either the exercise prices were greater than the average market price of the common shares and/or their effect would be antidilutive.

4. Acquisitions

2006 Acquisitions

The Company is negotiating with the minority holders of Northstar Research Partners Inc. ("Northstar"), to purchase an additional 20% interest in Northstar for C$4 million ($3.6 million at September 30, 2006). This transaction is expected

to close during the fourth quarter of 2006.

On July 27, 2006, the Company settled a put option obligation for a fixed amount equal to $1,492, relating to the purchase of 4.3% of additional equity interests of Accent Marketing, LLC. The settlement of this put was satisfied by a cash payment of $424, plus the cancellation of an outstanding promissory note to the Company in a principal amount equal to $1,068. The purchase price was allocated as follows: $403 to identified intangibles, amortized over eight years and the balance of $1,089 as additional goodwill. The goodwill and intangibles are not deductible for tax purposes. Including this transaction, the Company now owns 93.7% of Accent Marketing, LLC.

On February 7, 2006, the Company purchased the remaining outstanding membership interests of 12.33% of Source Marketing LLC (“Source”) pursuant to an exercise of a put option notice delivered in October 2005. The purchase price of $2,287 consisted of cash of $1,830 and the delivery of 1,063,516 shares of LifeMed Media Inc. (“LifeMed”) valued at $457. The Company’s carrying value of these LifeMed shares was $27, thus the Company recorded a gain on the disposition of these shares of $430, which has been included in other income.

On February 15, 2006, Source issued 15% of its membership interests to certain members of management. The purchase price for these membership interests was $1,540, which consisted of $385 cash and recourse notes in an aggregate principal amount equal to $1,155. In addition, the purchaser also received a fully vested option to purchase an additional 5% of Source at an exercise price equal to the price paid above. The option is exercisable any time prior to December 31, 2010. An amended and restated LLC agreement was entered into with these new members. The agreement also provides these members with an option to put to the Company these membership interests from December 2008-2012. As a result of the above transactions, the Company now owns 85% of Source. During the quarter ended March 31, 2006, the Company recorded a non-cash stock based compensation charge of $2,338 relating to the price paid for the membership interests which was less than the fair value of such membership interests and the fair value of the option granted.

2005 Acquisitions

Zyman Group

On April 1, 2005, the Company, through a wholly owned subsidiary, purchased approximately 61.6% of the total outstanding membership units of Zyman Group, LLC (“Zyman Group”) for purchase price consideration of $52,389 in cash and 1,139,975 Class A shares of the Company, valued at $11,257 based on the share price on or about the announcement date. Related transaction costs of approximately $976 were also incurred. In addition, the Company may be required to pay up to an additional $12,000 to the sellers if Zyman Group achieves specified financial targets for the twelve month periods ending June 30, 2006 and/or June 30, 2007. For the period ending September 30, 2006, such financial targets were not achieved.

In connection with the Zyman Group acquisition, the Company, Zyman Group and the other unitholders of Zyman Group entered into a new Limited Liability Company Agreement (the “LLC Agreement”). The LLC Agreement sets forth certain economic, governance and liquidity rights with respect to Zyman Group. Zyman Group has seven managers, four of whom were appointed by the Company. Pursuant to the LLC Agreement, the Company will have the right to purchase, and may have an obligation to purchase, for a combination of cash and shares, additional membership units of Zyman Group from the other members of Zyman Group, in each case, upon the occurrence of certain events or during certain specified time periods.

The Zyman Group name is well recognized for strategic marketing consulting and as such was acquired by the Company for its assembled workforce to enhance the creative talent within the Company’s Strategic Marketing Service segment of businesses.

The Zyman Group acquisition was accounted for as a purchase business combination. The purchase price of the net assets acquired in this transaction is $64,622. The final allocation of the cost of the acquisition to the fair value of net assets acquired and minority interests is as follows:

Cash and cash equivalents	$	5,653
Accounts receivable and other current assets		6,734
Fixed assets and other assets		7,785
Goodwill (tax deductible)		45,349
Intangible assets		20,143
Accounts payable, accrued expenses and other liabilities		(7,475)
Total debt		(8,524)
Minority interest at carrying value		(5,043)
Total cost of the acquisition	$	64,622

Identifiable intangible assets of $20,143 are comprised primarily of customer relationships and related backlog and trademarks. The allocation of the purchase price to assets acquired and liabilities assumed is based upon estimates of fair values and certain assumptions that the Company believes are reasonable under the circumstances. The Company's consolidated financial statements include Zyman Group's results of operations subsequent to its acquisition on April 1, 2005.

During the first five years following MDC's acquisition of the Zyman Group, MDC's allocation of profits of the Zyman Group may differ from its proportionate share of ownership. On an annual basis, the Company receives a 20% priority return calculated based on its total investment in Zyman Group. Thereafter, based on calculations set forth in the operating agreement of Zyman Group (the "LLC Agreement"), the Company's share of remaining Zyman Group profits in excess of the annual "threshold" amount of $20,600 may be disproportionately less than its equity ownership in Zyman Group. Specifically, on an annual basis, if Zyman operating results exceed a defined operating margin, the Company would be entitled to 25% of the excess margins in the first two years of the LLC Agreement and 30% of the excess margins in the following three years of the LLC Agreement, rather than the Company's equity portion of 61.6%. After the first five years, the earnings of the Zyman Group will be allocated in a proportion equal to the respective equity interests of the members.

Based on the Company’s investment in the Zyman Group, at September 30, 2006, the annual priority return is expected to be equal to approximately $12,700, with the minority owners receiving the next $7,900 up to the threshold amount. If profits are insufficient to meet the Company’s priority return during any of the first five years, the Company will receive a catch-up payment through year five equal to any shortfall from the prior year(s). Furthermore, if profits do not reach the threshold amount during the first five years, the minority owners will be entitled to receive a catch-up payment through year five equal to any shortfall from the prior year(s). Based on Zyman Group’s expected results for 2006, the Company expects to receive less than the full amount of its priority return from Zyman Group in 2006.

Neuwirth

On December 1, 2005, the Company, through its subsidiary Northstar Research Partners (USA) LLC (“NS LLC”), purchased the business of Neuwirth Research, Inc. (“Neuwirth”) for purchase price consideration of $450 in cash, a 20% equity interest in NS LLC valued at $225 based on the estimated market value of NS LLC on or about the announcement date, and 48,391 MDC Class A shares valued at $300. Related transaction costs of approximately $100 were also incurred. In addition, the Company was required to pay up to an additional $625 in cash to the seller if the acquired Neuwirth business achieves specified financial targets for the year ended December 31, 2005 and/or December 31, 2006. As of March 31, 2006, the Company determined that these targets were achieved and, accordingly, the $625 payment obligation was settled by the Company’s issuance of 30,058 Class A shares MDC stock valued at $250 and cash of $375.

In connection with the Neuwirth acquisition, the Company and seller entered into agreements related to governance and certain put option rights with respect to the seller’s 20% equity interest in NS LLC which becomes 50% exercisable in 2010 and 100% exercisable in 2015.

Neuwirth is a recognized market research firm and was acquired by the Company for its list of blue chip clients and synergies with NS LLC existing business. This acquisition is part of the Specialized Communications Services segment of businesses.

The Neuwirth acquisition was accounted for as a purchase business combination. The allocation of the cost of the acquisition to the fair value of net assets acquired is as follows:

Accounts receivable and other current assets	$	492
Fixed assets and other assets		50
Intangible assets		1,680
Accounts payable, accrued expenses and other liabilities		(522)
Total cost of the acquisition	$	1,700

Identifiable intangible assets, consisting of an employment agreement, estimated to be $1,680, is being amortized on a straight-line basis over ten years. The allocation of the purchase price to assets acquired and liabilities assumed is based upon estimates of fair values and certain assumptions that the Company believes are reasonable under the circumstances. The Company’s consolidated financial statements include Neuwirth’s results of operations subsequent to its acquisition on December 1, 2005.

Powell

On July 25, 2005, the Company, through its subsidiary Margeotes Fertitta Powell, LLC, (“MFP”) purchased the business of Powell, LLC (“Powell”) for purchase price consideration of $332 in cash and a 5% equity interest in MFP valued at $400 based on the estimated market value of MFP on or about the announcement date. The issuance of equity interests by MFP resulted in a loss of $103 on the dilution of the Company’s equity interest in its subsidiary. Related transaction costs of approximately $20 were also incurred. In addition, in August 2006, the Company paid an additional $300 in

cash to the seller.

In connection with the Powell acquisition, the Company and seller entered into agreements related to governance and certain put option rights with respect to seller's 5% equity interest in MFP, which become exercisable in 2010.

Powell is a well recognized, highly creative advertising agency and as such was acquired by the Company for its creative talent to supplement existing creative agencies within the Company's Strategic Marketing Services segment of businesses.

The Powell acquisition was accounted for as a purchase business combination. The allocation of the cost of the acquisition to the fair value of net assets acquired is as follows:

Accounts receivable and other current assets	$	32
Fixed assets and other assets		31
Intangible assets		1,130
Accounts payable, accrued expenses and other liabilities		(141)
Total cost of the acquisition	$	1,052

Identifiable intangible assets, consisting of an employment agreement, estimated to be $1,130, is being amortized on a straight-line basis over five years. The allocation of the purchase price to assets acquired and liabilities assumed is based upon estimates of fair values and certain assumptions that the Company believes are reasonable under the circumstances. The Company's consolidated financial statements include Powell's results of operations subsequent to its acquisition on July 25, 2005.

Other Acquisitions and Transactions

On July 31, 2005, the Company acquired a further 20% equity interest in its existing subsidiary MFP pursuant to the exercise of a put obligation under the existing purchase agreement with a minority interest holder. The purchase price of $1,740 which includes $15 of acquisition costs was paid in cash. Of the purchase price, $500 was allocated to customer relationship intangible assets and $1,240 was allocated to goodwill. The allocation of the purchase price to assets acquired and liabilities assumed is based upon certain assumptions that the Company believes are reasonable under the circumstances. As a result of this acquisition, and the Powell transaction discussed above, the Company retains a 95% equity interest in MFP.

On September 1, 2005, the Company, through a consolidated variable interest entity, Crispin Porter + Bogusky, LLC ("CPB"), purchased 20% of the total outstanding membership units of Fuseproject, LLC ("Fuseproject") for purchase price consideration of $750 in cash and an additional $400, which was paid during the quarter ended March 31, 2006. Fuseproject is a design firm acquired by CPB to complement its creative offerings. The Fuseproject acquisition was accounted for using the equity method as CPB has significant influence over the operations of Fuseproject. The purchase price of the net assets acquired in this transaction is $1,150. The allocation of the cost of the acquisition to the fair value of the net assets acquired resulted in a portion being attributed to intangible assets valued at $40 and $1,090 consisting of goodwill. The allocation of the purchase price to assets acquired and liabilities assumed is based upon estimates of fair values and certain assumptions that the Company believes are reasonable under the circumstances. The Company's consolidated financial statements include Fuseproject's results of operations in equity in earnings of non-consolidated affiliates subsequent to its acquisition on September 1, 2005.

During August 2005, Bryan Mills Group Ltd., ("BMG") a subsidiary whose operations are consolidated by the Company, completed the acquisition of 450 shares from a minority shareholder at a price of $515.00 per share, for a total purchase price of $232. This resulted in the Company's ownership interest in BMG increasing to 71.2% from 68.0%. Also as a result of the equity transaction by BMG, the Company recorded goodwill of $146.

During the quarter ended March 31, 2005, the Company contributed $125 of cash as additional paid in capital to its existing consolidated subsidiary, Banjo Strategies Entertainment LLC. There was no change in the Company's ownership interest. This resulted in a loss on dilution of $61 and is reflected in the Company's consolidated statement of operations. During the quarter ended June 30, 2005, the Company acquired further equity interests in the existing consolidated subsidiaries of Allard Johnson Communications Inc. (0.3%) and Banjo Strategies Entertainment LLC (7.2%). In aggregate, the Company paid $143 in cash for these incremental ownership interests. During the quarter ended September 30, 2005, the Company acquired a further 0.7% equity interest in the existing consolidated subsidiary, Allard Johnson Communications Inc., for $148.

Pro forma Information

The following unaudited pro forma results of operations of the Company for the nine months ended September 30, 2005 assume that the acquisition of the operating assets of the significant businesses acquired during 2005 had occurred on January 1 of the respective year in which the business was acquired. These unaudited pro forma results are not necessarily indicative of either the actual results of operations that would have been achieved had the companies been combined during this period, or are they necessarily indicative of future results of operations.

		Nine Months Ended September 30, 2005
Revenues	$	275,428
Net loss	$	(3,253)
Loss per common share:		
Basic - net loss	$	(0.14)
Diluted - net loss	$	(0.14)

5. Inventory

The components of inventory are listed below:

		December 31, 2005
Raw materials and supplies	$	4,860
Work-in-process		5,499
Total	$	10,359

6. Discontinued Operations

In June 2006, the Company's Board of Directors made the decision to sell or otherwise divest the Company's Secure Paper Business and Secure Card Business (collectively, "SPI"). Since that date, the Company has engaged in active negotiations for the sale of the SPI Group. (See Note 14.)

Based on these events, management has concluded that the criteria for the assets/liabilities of SPI to be accounted for as assets/liabilities held for sale and the results of operations to be accounted for as discontinued operations have been met. Discontinued operations relating to SPI for the three months ended September 30, 2006 and 2005 amounted to net losses of $9,772 and $210, respectively. For the nine months ended September 30, 2006 and 2005, discontinued operations relating to SPI amounted to net losses of $20,190 and $2,177, respectively. Based on the current estimated proceeds from a sale, the Company recorded an impairment charge totaling approximately $19,498 during the nine months ended September 30, 2006. Based on the estimated net proceeds and average borrowing rate for each period, the Company has allocated interest expense to discontinued operations of $1,139 and $886 for the nine months ended September 30, 2006 and 2005.

During July 2005, LifeMed, a variable interest entity whose operations had been consolidated by the Company, completed a private placement issuing approximately 12.5 million shares at a price of $0.4973 per share. LifeMed received net proceeds of approximately $6,200. Consequently, the Company's ownership interest in LifeMed was reduced to 18.3%, and of LifeMed, the Company recorded a gain of $1,300. This gain represents the Company's reversal of a liability related to funding obligations that the Company is no longer obligated to fund. The Company no longer has any significant continuing involvement in the management or operations of LifeMed, and has not participated in the purchase of significant new equity offerings of LifeMed. Consequently, as of July 2005, the Company no longer consolidated the operations of LifeMed, commenced accounting for its remaining investment in LifeMed on a cost basis, and has reported the results of operations of LifeMed as discontinued operations for all periods presented. In February 2006, the Company sold 27% of its remaining ownership in LifeMed as partial settlement of a put option (see Note 4). As of September 30, 2006, the Company holds a 13.4% interest in LifeMed. As of September 30, 2006 and December 31, 2005, other assets include $73 and $100, respectively of the Company's net investment in LifeMed.

In November 2004, the Company's management reached a decision to discontinue the operations of a component of its business. This component is comprised of the Company's UK based marketing communications business, a wholly owned subsidiary named Mr. Smith Agency, Ltd. ("Mr. Smith", formerly known as Interfocus Networks Limited). The Company decided to dispose of the operations of this business due to its unfavorable economics. Substantially all of the net assets of the discontinued business were sold during the fourth quarter of 2004 with the disposition of all activities of Mr. Smith and remaining sale of assets was substantially complete by the end of the first quarter of 2005. No significant one-time termination benefits were incurred or are expected to be incurred. No further significant other charges are expected to be incurred.

For the three and nine months ended September 30, 2005, discontinued operations relating to LifeMed and Mr. Smith amounted to net income of $870 and $568, respectively.

Included in discontinued operations in the Company's consolidated statement of operations for the three and nine months ended September 30, 2006 and 2005 were the following:

	Three Months Ended September 30,		**Nine Months Ended September 30,**	
	2006	**2005**	**2006**	**2005**
Revenue	$ 20,860	$ 21,920	$ 56,799	$ 58,178
Depreciation, amortization and impairment charge	$ 11,607	$ 1,063	$ 21,799	$ 3,199
Operating income (loss)	$ (9,268)	$ 1,163	$ (18,008)	$ (1,906)
Other expense	$ (138)	$ 459	$ (2,068)	$ (320)
Income tax (expense) recovery	$ (366)	$ (962)	$ (114)	$ 357
Minority interest recovery	$ —	$ —	$ —	$ 260
Net income (loss) from discontinued operations	$ (9,772)	$ 660	$ (20,190)	$ (1,609)

As of September 30, 2006, the carrying value on the Company's balance sheet of the assets and liabilities to be disposed were as follows:

	September 30, 2006
Assets held for sale:	
Accounts receivable	$ 15,791
Inventories	11,502
Other current assets	1,556
Fixed assets	10,281
Other long-term assets	1,968
Total assets	$ 41,098
Liabilities related to assets held for sale:	
Accounts payable and other current liabilities	$ 9,861
Advance billings	5,444
Other	4,268
Total liabilities	$ 19,573

7. Comprehensive Loss

Total comprehensive loss and its components were:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
Net loss for the period	$ (12,909)	$ (1,655)	$ (28,546)	$ (6,402)
Foreign currency cumulative translation adjustment	$ (2,241)	$ 1,399	$ (159)	$ (607)
Comprehensive loss for the period	$ (15,150)	$ (256)	$ (28,705)	$