ENVOY COMMUNICATIONS GROUP INC
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envoy communications
group inc.
3rd quarter report 2001
energy
focus
strength

Management Discussion and Analysis
Results of Operations

Nine Months Ended June 30, 2001 compared with Nine Months Ended June 30, 2000.

Net Revenue

Net revenue increased by 60% to $62.9 million for the nine months ended June 30, 2001, from $39.4 million in the nine months ended June 30, 2000. This increase is a result of both growth through acquisition and organic growth. Effective January 1, 2001, we acquired all of the shares of the International Design Group (Canada) Inc. (IDG), a retail planning and design firm. This acquisition was accounted for using purchase accounting, and as a result of this acquisition, there are six months of net revenues included in the nine months ended June 30, 2001. In fiscal 2000, Envoy completed two acquisitions: the acquisition of Sage Information Consultants, effective June 1, 2000, and the acquisition of Gilchrist Brothers Limited, effective July 1, 2000. As a result of the acquisitions of Sage and Gilchrist, there are an additional eight and nine months of net revenues for these companies, respectively, included in the June 30, 2001 results of operations that were not included in our results of operations for the nine months ended June 30, 2000. Organic growth accounted for approximately $7.7 million or 14% of the overall increase in net revenue for the period.

In the nine months ended June 30, 2001, net revenue from our marketing services represented approximately 31% of our net revenue, while design and technology represented 49% and 20% respectively. In the nine months ended June 30, 2000, marketing services represented approximately 57% of net revenue, with design and technology services representing 35% and 8% respectively.

We have continued to geographically diversify our revenue base. The geographical breakdown of our net revenue for the nine months ended June 30, 2001 was 50% from the United States, 23% from the United Kingdom and Continental Europe, and 27% from Canada. Net revenue for the nine months ended June 30, 2000 was 63% from the United States and 37% from Canada.

EBITDA Before and After Unusual Items

For the nine months ended June 30, 2001, we earned $9.2 million in earnings before interest expense, income taxes, depreciation and amortization (EBITDA) before unusual items, and our EBITDA after unusual items was $7.1 million. For the nine months ended June 30, 2000, we earned $7 million in EBITDA.

Operating Expenses

Operating expenses increased by 66% to $53.8 million for the nine months ended June 30, 2001, from $32.4 million for the nine months ended June 30, 2000. The increase in salaries and benefits reflects staff of acquired operations plus the additional management and client support employed to handle the continued growth and expanded operations throughout the Company. As a percentage of net revenue, salaries and benefits remained relatively constant at 63% for the nine months ended June 30, 2001 and 60% for the nine months ended June 30, 2000. The additional general and administrative expenses were largely due to expanded business development activities by our existing business divisions as well as new and expanded business development activity by the acquired businesses. General and administrative expenses decreased slightly at 17% of net revenue for the nine months ended June 30, 2001 compared with 18% of net revenue for the nine months ended June 30, 2000. Occupancy costs increased due to additional space required to support our growth from acquisitions. The additional depreciation charges were due to the depreciation of the costs of our additional leasehold improvements and of newly purchased capital equipment as a result of acquisitions.

The increase in interest charges was due to the additional debt relating to acquisitions.

See Note 1 to the consolidated financial statements. During the quarter, the Company announced that it was terminating its discussions in connection with the proposed acquisition of Leagas Delaney. Generally accepted accounting principles require that all costs in connection with the proposed acquisition and the related equity financing need to be expensed in full as of the date of abandonment. The impact of this was to expense $2.1 million of costs relating to the proposed acquisition. Costs include legal, accounting, consulting and other out-of-pocket expenses incurred in the negotiating and preparation of legal documents and preparation of long-form prospectus materials.

See Note 2 to the consolidated financial statements. Effective October 1, 2000, the Company was required to adopt on a retroactive basis the new accounting standards of the Canadian Institute of Chartered Accountants ("CICA") for income taxes. As a result of the December 2000 announcement by the government to introduce legislation to reduce income tax rates over the next four years, the Company was required to revalue its future tax assets as at December 31, 2000 to reflect the reduction in future expected tax rates. This increased the Company's tax provision for the three months ended December 31, 2000 by $100,000. Under the CICA's new accounting standard the Company is required to record this item as an adjustment to income tax expense, notwithstanding the fact that such amounts were not previously reflected in income tax expense when recorded.

Net Earnings Before and After Unusual Items

For the nine months ended June 30, 2001, we earned $1.3 million in net earnings before unusual items, and our net earnings after unusual items was $135,000. For the nine months ended June 30, 2000, we earned $2.2 million in net earnings.

Per Share Amounts Before and After Unusual Items

Before unusual items: For the nine months ended June 30, 2001, the EBITDA before unusual items per share was $0.43, the earnings before goodwill before unusual items per share was $0.17 and the net earnings before unusual items per share was $0.06. After unusual items: For the nine months ended June 30, 2001, the EBITDA per share was $0.33, the earnings before goodwill per share was $0.11 and the net earnings per share was $0.01. For the nine months ended June 30, 2000, the EBITDA per share was $0.38, the earnings before goodwill per share was $0.17 and the net earnings per share was $0.12.

Cash Flows
Nine months ended June 30, 2001 compared with nine months ended June 30, 2000.

Net cash provided by operating activities before any increase and decrease in non-cash operating working capital was $4.9 million for the nine months ended June 30, 2001 and $4.4 million for the nine months ended June 30, 2000. Increase in net cash provided by operating activities is primarily due to increased earnings of acquisitions, as discussed previously.

Net cash used in financing activities was ($3.6) million for the nine months ended June 30, 2001, and net cash provided by financing activities was $11.8 million for the nine months ended June 30, 2000. The decrease is primarily due to a public offering in the prior year and the repayment of debt in the current year. In June 2000, the Company issued 1,533,571 common shares for net proceeds of $10 million. In addition, in June 2000, we established a new US$8 million revolving credit facility, and borrowed US$3.1 million under the facility. In January 2001, we borrowed an additional US$1 million, which has been used in part to fund the acquisition of IDG. In February 2001, we repaid US$3.1 million of the facility using cash from operations.

Results of Operations
Three months ended June 30, 2001 compared with three months ended June 30, 2000.

Net Revenue

Net revenue increased by 51% to $20.7 million in the three months ended June 30, 2001, from $13.7 million in the three months ended June 30, 2000. This increase occurred as a result of both growth through acquisition and organic growth. As a result of the acquisition of IDG there are three months of net revenues included in the three months ended June 30, 2001 that were not included in our results of operations for the three months ended June 30, 2000. As a result of the acquisitions of Sage and Gilchrist, there are three and two months of net revenues for these companies, respectively, included in the June 30, 2001 results of operations that were not included in our results of operations for the three months ended June 30, 2000. Organic growth was approximately $1.8 million or 10% for the period.

EBITDA Before and After Unusual Items

For the three months ended June 30, 2001, we earned $1.7 million in EBITDA before unusual items, and our EBITDA after unusual items resulted in a loss of ($447,000). For the three months ended June 30, 2000, we earned $2.8 million in EBITDA.

Operating Expenses

Operating expenses increased by 75% to $19.1 million for the three months ended June 30, 2001 from $10.9 million for the three months ended June 30, 2000. The primary reasons for the increase are increases in salaries and benefits of $6.6 million or 82%; an increase in general and administrative expenses of $949,000 or 42%; and an increase in occupancy costs of $619,000 or 104%. There were also increases in depreciation of $233,000 or 53%, and in goodwill amortization net of income taxes of $364,000 or 97%. The explanations for the increases are the same as previously discussed in the nine-month comparison, including the acquisitions of Sage, Gilchrist and IDG.

See Note 1 to the consolidated financial statements and previously discussed explanation on unusual items in the nine-month comparison.

The increase in interest charges was due to the additional debt relating to acquisitions.

Goodwill amortization increased from $374,000 to $738,000, due largely to the increased amount of goodwill derived from the acquisitions discussed above.

Net Earnings (Loss) Before and After Unusual Items

For the three months ended June 30, 2001, we earned ($273,000) in net earnings before unusual items, and our net loss after unusual items was ($1.5) million.

For the three months ended June 30, 2000, we earned $971,000 in net earnings.

Per Share Amounts Before and After Unusual Items

Before unusual items: For the three months ended June 30, 2001, the EBITDA before unusual items per share was $0.08, the earnings before goodwill before unusual items per share was $0.02 and the net earnings before unusual items per share was ($0.01). After unusual items: For the three months ended June 30, 2001, the EBITDA per share was ($0.02), the loss before goodwill per share was ($0.04) and the net loss per share was ($0.07). For the three months ended June 30, 2000, the EBITDA per share was $0.15, the earnings before goodwill per share was $0.07 and the net earnings per share was $0.05.

Cash Flows
Three months ended June 30, 2001 compared with three months ended June 30, 2000.

Net cash used in operating activities before any increase and decrease in non-cash operating working capital was $45,000 for the three months ended June 30, 2001 and $1.8 million for the three months ended June 30, 2000.

Net cash used in financing activities was ($5.0) million for the three months ended June 30, 2001, and net cash provided by financing activities was $3.3 million for the three months ended June 30, 2000. The explanations for the decreases are the same as previously discussed in the nine-month comparison.

Financial Condition
As at June 30, 2001 compared with September 30, 2000.

The working capital balance was $10.5 million and the cash balance was $12.3 million at June 30, 2001. At September 30, 2000, working capital was $11.4 million and the cash balance was $7.1 million. Additional cash balance is primarily due to an increase in outstanding accounts payable and accrued liabilities as a result of timing of payments.

Cash flow from operations as well as the availability of the remaining existing credit facilities and the net proceeds of any future share offerings are expected to provide the liquidity to meet current foreseeable cash needs for at least the next year.

Consolidated Balance Sheets
(In Canadian dollars)
(Unaudited-Prepared by Management)

As at	June 30 2001	September 30 2000
ASSETS		
Current assets:		
Cash	$ 12,304,360	$ 7,105,418
Restricted cash	551,102	-
Accounts receivable	31,695,683	34,234,974
Prepaid expenses	2,524,149	1,732,212
	47,075,294	43,072,604
Restricted cash	-	832,337
Capital assets	10,479,922	10,448,625
Goodwill and other assets	45,529,927	46,987,707

Deferred income taxes	642,151	966,715
	$ 103,727,294	$ 102,307,988

Liabilities and Shareholders' Equity

Current liabilities:

Accounts payable and accrued liabilities	$ 30,425,905	$ 24,247,075
Income taxes payable	289,165	1,190,313
Deferred revenue	413,371	1,044,873
Amounts collected in excess of pass-through costs incurred	2,350,355	2,307,047
Current portion of long-term debt	3,064,718	2,848,430
	36,543,514	31,637,738
Long-term debt	3,691,968	7,983,449

Shareholders' equity:

Share capital	55,509,715	54,597,762
Retained earnings	8,538,756	8,403,367
Cumulative translation adjustment	(556,659)	(314,328)
	63,491,812	62,686,801
	$ 103,727,294	$ 102,307,988

Consolidated Statements of Operations and Retained Earnings
(In Canadian dollars)
(Unaudited-Prepared by Management)

For the nine months ended	June 30 2001	June 30 2000
Net revenue	$ 62,954,227	$ 39,358,968
Operating expenses:		
Salaries and benefits	39,925,588	23,524,816
General and administrative	10,391,596	7,190,469
Occupancy costs	3,475,816	1,640,810
	53,793,000	32,356,095
Earnings before interest expense, income taxes,depreciation, goodwill amortization, and unusual items	9,161,227	7,002,873
Depreciation	2,177,500	1,269,901
Interest expense	529,304	245,966
Earnings before income taxes, goodwill amortization,and unusual items	6,454,423	5,487,006
Impact of unusual items (Note 1)	2,100,000	-
Earnings before income taxes and goodwill amortization	4,354,423	5,487,006
Income tax expense, excluding the undernoted	1,899,911	2,374,993
Impact of tax rate changes (Note 2)	100,000	-
Earnings before goodwill amortization	2,354,512	3,112,013

Goodwill amortization, net of income taxes of $18,000 (2000-$18,000)	2,219,123	909,816
Net earnings	$ 135,389	$ 2,202,197
Retained earnings, beginning of period	8,403,367	5,492,940
Retained earnings, end of period	$ 8,538,756	$ 7,695,137
Net earnings per share-basic	$ 0.01	$ 0.12
Net earnings per share-fully diluted	0.01	0.12
Earnings per share before goodwill amortization-basic	0.11	0.17
Earnings per share before goodwill amortization-fully diluted	0.11	0.17

See accompanying notes to consolidated financial statements.

Consolidated Statements of Cash Flow
(In Canadian dollars)
(Unaudited-Prepared by Management)

For the nine months ended	June 30 2001	June 30 2000
Cash flows from operating activities:		
Net earnings	$ 135,389	$ 2,202,197
Items not involving cash:		
Deferred income taxes	306,508	1,032
Depreciation	2,177,500	1,269,901
Goodwill amortization	2,237,123	927,816
Net changes in non-cash working capital balances:		
Increase in restricted cash	(551,102)	-
Accounts receivable	3,578,587	4,518,384
Prepaid expenses	(781,795)	(626,661)
Accounts payable and accrued liabilities	7,135,141	(5,371,285)
Income taxes payable	(766,977)	(895,264)
Deferred revenue	(633,403)	335,053
Amounts collected in excess of pass-through costs incurred	36,968	1,685,346
Net cash provided by operating activities	12,873,939	4,046,519
Cash flows from financing activities:		
Long-term debt	334,613	3,391,756
Long-term debt repayments	(5,542,692)	(1,779,630)
Issuance of common shares for cash	415,993	10,478,808
Reduction (increase) in restricted cash	834,962	(300,854)
Other	389,171	-
Net cash provided by (used in) financing activities	(3,567,953)	11,790,080
Cash flows from investing activities:		

Acquisition of subsidiaries (net of cash acquired(bank indebtedness assumed) of $214,179; 2000-nil)	(1,905,133)	(2,205,892)
Purchase of capital assets	(2,082,771)	(1,765,020)
Net cash used in investing activities	(3,987,904)	(3,970,912)
Change in cash balance due to foreign exchange	(119,140)	78,440
Increase in cash	5,198,942	11,944,127
Cash, beginning of period	7,105,418	15,300,454
Cash, end of period	$ 12,304,360	$ 27,244,581
Cash flow from operations per share:		
Basic	$ 0.23	$ 0.24
Fully diluted	$ 0.23	$ 0.24
Supplemental cash flow information:		
Interest paid	$ 268,102	$ 218,891
Income taxes paid	2,069,069	2,903,844
Shares issued for non-cash consideration	4,123,821	6,848,173

Consolidated Statements of Operations and Retained Earnings
(In Canadian dollars)
(Unaudited-Prepared by Management)

For the three months ended	June 30 2001	June 30 2000
Net revenue	$ 20,747,839	$ 13,716,105
Operating expenses:		
Salaries and benefits	14,654,133	8,044,640
General and administrative	3,223,366	2,274,531
Occupancy costs	1,217,593	598,192
	19,095,092	10,917,363
Earnings before interest expense, income taxes,depreciation, goodwill amortization, and unusual items	1,652,747	2,798,742
Depreciation	672,738	439,684
Interest expense	159,023	82,956
Earnings before income taxes, goodwill amortization, and unusual items	820,986	2,276,102
Impact of unusual items (Note 1)	2,100,000	-
Earnings (loss) before income taxes and goodwill amortization	(1,279,014)	2,276,102
Income taxes	(536,290)	930,874
Earnings (loss) before goodwill amortization	(742,724)	1,345,228
Goodwill amortization, net of income taxes		

of $6,000 (2000-$6,000)	738,107	374,493
Net earnings (loss)	$ (1,480,831)	$ 970,735
Net earnings per share-basic	$ (0.07)	$ 0.05
Net earnings per share-fully diluted	(0.07)	0.05
Earnings per share before goodwill amortization-basic	(0.04)	0.07
Earnings per share before goodwill amortization-fully diluted	(0.04)	0.07

See accompanying notes to consolidated financial statements.

Consolidated Statements of Cash Flow
(In Canadian dollars)
(Unaudited-Prepared by Management)

For the three months ended	June 30 2001	June 30 2000
Cash flows from operating activities:		
Net earnings (loss)	$ (1,480,831)	$ 970,735
Items not involving cash:		
Deferred income taxes	18,994	26,189
Depreciation	672,738	439,684
Goodwill amortization	744,107	380,493
Net changes in non-cash working capital balances:		
Reduction (increase) in restricted cash	(551,102)	-
Accounts receivable	2,231,471	10,993,980
Prepaid expenses	922,304	(444,966)
Accounts payable and accrued liabilities	(5,780,443)	(8,706,342)
Income taxes payable	(1,050,685)	1,469,988
Deferred revenue	(258,684)	335,053
Amounts collected in excess of pass-through costs incurred	(327,206)	(2,192,413)
Other	(144,904)	-
Net cash provided by (used in) operating activities	(5,004,241)	3,272,401
Cash flows from financing activities:		
Long-term debt	334,613	2,841,756
Long-term debt repayments	(589,114)	(152,764)
Issuance of common shares for cash	18,100	9,915,158
Reduction in restricted cash	1,089,361	293,969
Other	1,002,336	-
Net cash provided by financing activities	1,855,296	12,898,119
Cash flows from investing activities:		
Acquisition of subsidiaries	110,213	(19,687)
Purchase of capital assets	(641,348)	(218,818)

Net cash used in investing activities	(531,135)	(238,505)
Change in cash balance due to foreign exchange	(471,511)	155,163
Increase in cash	(4,151,591)	16,087,178
Cash, beginning of period	16,455,951	11,157,403
Cash, end of period	$ 12,304,360	$ 27,244,581
Cash flow from operations per share:		
Basic	$ 0.00	$ 0.10
Fully diluted	$ 0.00	$ 0.10
Supplemental information:		
Interest paid	$ 51,001	$ 56,503
Income taxes paid	779,248	433,861
Shares issued for non-cash consideration	-	4,417,973

Notes to Consolidated Financial Statements

1. Unusual Items
During the quarter the Company announced that it was terminating its discussions in connection with the proposed acquisition of Leagas Delaney. Generally accepted accounting principles require that all costs in connection with the proposed acquisition and the related equity financing need to be expensed in full as of the date of abandonment. Costs include legal, accounting, consulting and other out-of-pocket expenses incurred in the negotiating and preparation of legal documents and preparation of long-form prospectus materials.

2. Income Taxes
Effective October 1, 2000, the Company was required to adopt on a retroactive basis the new accounting standards of the Canadian Institute of Chartered Accountants ("CICA") for income taxes. Under this accounting standard, the Company is not required to restate its comparative figures for prior years.

Under these new standards, future tax assets and liabilities attributable to all temporary differences are measured using the future tax rates expected to be in effect when the items are recovered or settled. The effect of a change in tax rates must be recognized in income at the enactment date.

Previously, future tax assets and liabilities were recorded at the tax rate in effect in the period in which the temporary difference arose and were not adjusted for subsequent tax rate changes. The Company's temporary differences are principally in respect to deductible share issue costs that were recorded directly in capital stock rather than as a credit to income tax expense. There is no cumulative effect as of October 1, 2000 of this change in accounting policy.

As a result of the December 2000 announcement by the government to introduce legislation to reduce income tax rates over the next four years, the Company was required to revalue its future tax assets as at December 31, 2000 to reflect the reduction in future expected tax rates. The impact of this was to increase the Company's tax provision for the three months ended December 31, 2000 by $100,000. Under the CICA's new accounting standards, the Company is required to record this item as an adjustment to income tax expense, notwithstanding the fact that such amounts were not previously reflected in income tax expense when recorded.

3. Segmented Information

The Company provides integrated marketing communication services to its clients. While the Company has subsidiaries in Canada, the United States, the United Kingdom and Continental Europe, it operates as a global business and has no distinct operating segments. The tables below set out the following information:

	By Customer Location	By Geographic Area	
June 30, 2001	Net Revenue	Capital Assets	Goodwill
Canada	$ 16,955,785	$ 7,873,752	$ 21,783,752
United States	31,404,861	664,109	16,208,576
United Kingdom and Continental Europe	14,593,581	1,942,061	7,437,784
	$ 62,954,227	$ 10,479,922	$ 45,430,112
June 30, 2000			
Canada	$ 14,537,694	$ 7,625,559	$ 23,045,522
United States	24,821,274	885,030	11,256,691
United Kingdom and Continental Europe	-	-	-
	$ 39,358,968	$ 8,510,589	$ 34,302,213

The Company's external net revenue by type of service is as follows:

June 30	2001	2000
Net revenue:		
Marketing	$ 19,789,373	$ 22,543,012
Design	30,632,540	13,562,558
Technology	12,532,314	3,253,398
	$ 62,954,227	$ 39,358,968