

**FIRSTSERVICE CORPORATION**  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(in thousands of US dollars, except share and per share amounts)

**1. Description of the business**

FirstService Corporation (the “Company”) is a North American provider of residential property management and other essential property services to residential and commercial customers. The Company’s operations are conducted in two segments: FirstService Residential and FirstService Brands. The segments are grouped with reference to the nature of services provided and the types of clients that use those services.

FirstService Residential is a full-service property manager and in many markets provides a full range of ancillary services primarily in the following areas: (i) on-site staffing, including building engineering and maintenance, full-service amenity management, security, concierge and front desk personnel, and landscaping; (ii) proprietary banking and insurance products; and (iii) energy conservation and management solutions.

FirstService Brands provides a range of essential property services to residential and commercial customers in North America through franchise networks and company-owned locations. The principal brands in this division include Paul Davis Restoration, California Closets, Certa Pro Painters, Pillar to Post Home Inspectors, Floor Coverings International, College Pro Painters, Century Fire Protection, and Service America.

**2. Summary of significant accounting policies**

The preparation of consolidated financial statements in accordance with accounting principles generally accepted in the United States of America (“GAAP”) requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. The most significant estimates are related to the determination of fair values of assets acquired and liabilities assumed in business combinations, recoverability of goodwill and intangible assets, estimated fair value of contingent consideration related to acquisitions, and the collectability of accounts receivable. Actual results could be materially different from these estimates.

Significant accounting policies are summarized as follows:

**Basis of consolidation**

The consolidated financial statements include the accounts of the Company, its majority-owned subsidiaries and those variable interest entities where the Company is the primary beneficiary. Where the Company does not have a controlling interest but has the ability to exert significant influence, the equity method is used. Inter-company transactions and accounts are eliminated on consolidation.

**Cash and cash equivalents**

Cash equivalents consist of short-term interest-bearing securities, which are readily convertible into cash and have original maturities at the date of purchase of three months or less.

**Restricted cash**

Restricted cash consists of cash over which the Company has legal ownership but is restricted as to its availability or intended use, including funds held on behalf of clients and franchisees.

**Inventories**

Inventories are carried at the lower of cost and market. Cost is determined using the weighted average method. Work-in-progress inventory relates to construction contracts and real estate project management projects in process and are accounted for using the percentage of completion method.

**Fixed assets**

Fixed assets are carried at cost less accumulated depreciation. The costs of additions and improvements are capitalized, while maintenance and repairs are expensed as incurred. Fixed assets are reviewed for impairment whenever events or circumstances indicate that the carrying value of an asset group may not be recoverable. An impairment loss is recorded to the extent the carrying amount exceeds the estimated fair value of an asset group. Fixed assets are depreciated over their estimated useful lives as follows:

Buildings	20 to 40 years straight-line
Vehicles	3 to 5 years straight-line
Furniture and equipment	3 to 10 years straight-line
Computer equipment and software	3 to 5 years straight-line
Leasehold improvements	term of the lease to a maximum of 10 years

**Fair value**

The Company uses the fair value measurements framework for financial assets and liabilities and for non-financial assets and liabilities that are recognized or disclosed at fair value on a non-recurring basis. The framework defines fair value, gives guidance for measurement and disclosure, and establishes a three-level hierarchy for observable and unobservable inputs used to measure fair value. An asset or liability's classification within the hierarchy is determined based on the lowest level input that is significant to the fair value measurement. The three levels are as follows:

Level 1 – Quoted prices (unadjusted) in active markets for identical assets or liabilities

Level 2 – Observable market-based inputs other than quoted prices in active markets for identical assets or liabilities

Level 3 – Unobservable inputs for which there is little or no market data, which requires the Company to develop its own assumptions

**Financing fees**

Financing fees related to the revolving credit facility and Senior Notes are deferred and amortized to interest expense using the effective interest method.

**Goodwill and intangible assets**

Goodwill represents the excess of purchase price over the fair value of assets acquired and liabilities assumed in a business combination and is not subject to amortization.

Intangible assets are recorded at fair value on the date they are acquired. Indefinite life intangible assets are not subject to amortization. Where lives are finite, they are amortized over their estimated useful lives as follows:

Customer lists and relationships	straight-line over 4 to 20 years
Franchise rights	by pattern of use, currently estimated at 2.5% to 15% per year
Trademarks and trade names	straight-line over 5 to 35 years
Management contracts and other	straight-line over life of contract ranging from 2 to 15 years
Backlog	straight-line over 6 to 12 months

The Company reviews the carrying value of finite life intangible assets for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset group may not be recoverable from the estimated future cash flows expected to result from their use and eventual disposition. If the sum of the undiscounted expected future cash flows is less than the carrying amount of the asset group, an impairment loss is recognized. Measurement of the impairment loss is based on the excess of the carrying amount of the asset group over the fair value calculated using an income approach.

Goodwill and indefinite life intangible assets are tested for impairment annually, on August 1, or more frequently if events or changes in circumstances indicate the asset might be impaired, in which case the carrying amount of the asset is written down to fair value.

Impairment of goodwill is tested at the reporting unit level. The Company has six reporting units determined with reference to business segment, customer type, service delivery model and geography. Impairment is tested by first assessing qualitative factors to determine whether it is more likely than not that the fair value of a reporting unit is less than its carrying amount. Where it is determined to be more likely than not that its fair value is greater than its carrying amount, then no further testing is required. Where the qualitative analysis is not sufficient to support that the fair value exceeds the carrying amount then a two-step goodwill impairment test is performed. In the first step, the reporting unit's carrying amount, including goodwill, is compared to the estimated fair value of the reporting unit. The fair values of the reporting units are estimated using an income approach. The fair value measurement is classified within Level 3 of the fair value hierarchy. If the carrying amount of the reporting unit exceeds its fair value, then a second step is performed to measure the amount of impairment loss, if any. Certain assumptions are used to determine the fair value of the reporting units, the most sensitive of which are estimated future cash flows and the discount rate applied to future cash flows. Changes in these assumptions could result in a materially different fair value.

Impairment of indefinite life intangible assets is tested by comparing the carrying amount to the estimated fair value on an individual intangible asset basis.

#### **Redeemable non-controlling interests**

Redeemable non-controlling interests ("RNCI") are recorded at the greater of (i) the redemption amount or (ii) the amount initially recorded as RNCI at the date of inception of the minority equity position. This amount is recorded in the "mezzanine" section of the balance sheet, outside of shareholders' equity. Changes in the RNCI amount are recognized immediately as they occur.

#### **Revenue recognition and unearned revenues**

##### *(a) Franchisor operations*

The Company operates several franchise systems within its FirstService Brands segment. Initial franchise fees are recognized when all material services or conditions related to the sale of the franchise have been performed or satisfied. Royalty revenues are recognized based on a contracted percentage of franchisee revenues, as reported by the franchisees. Revenues from administrative and other support services, as applicable, are recognized as the services are provided.

##### *(b) Revenues from construction contracts and service operations other than franchisor operations*

Revenues are recognized at the time the service is rendered. Certain services including but not limited to construction contracts and real estate project management projects in process, are recognized on the percentage of completion method, in the ratio of actual costs to total estimated contract costs. In cases where anticipated costs to complete a project exceed the revenue to be recognized, a provision for the additional estimated losses is recorded in the period when the loss becomes apparent. Amounts received from customers in advance of services being provided are recorded as unearned revenues when received.

#### **Stock-based compensation**

For equity classified awards, compensation cost is measured at the grant date based on the estimated fair value of the award. The related stock option compensation expense is allocated using the graded attribution method.

#### **Notional value appreciation plans**

Under these plans, subsidiary employees are compensated if the notional value of the subsidiary increases. Awards under these plans generally have a term of up to fifteen years and a vesting period of five years. The increase in notional value is calculated with reference to growth in earnings relative to a fixed threshold amount plus or minus changes in indebtedness relative to a fixed opening amount. If an award is subject to a vesting condition, then graded attribution is applied to the intrinsic value. The related compensation expense is recorded in selling, general and administrative expenses and the liability is recorded in accrued liabilities.

### **Foreign currency translation**

Assets, liabilities and operations of foreign subsidiaries are recorded based on the functional currency of each entity. For certain foreign operations, the functional currency is the local currency, in which case the assets, liabilities and operations are translated at current exchange rates from the local currency to the reporting currency, the US dollar. The resulting unrealized gains or losses are reported as a component of accumulated other comprehensive earnings. Realized and unrealized foreign currency gains or losses related to any foreign dollar denominated monetary assets and liabilities are included in net earnings.

### **Income tax**

Income tax has been provided using the asset and liability method whereby deferred income tax assets and liabilities are recognized for the expected future income tax consequences of events that have been recognized in the consolidated financial statements or income tax returns. Deferred income tax assets and liabilities are measured using enacted income tax rates expected to apply to taxable income in the years in which temporary differences are expected to reverse, be recovered or settled. The effect on deferred income tax assets and liabilities of a change in income tax rates is recognized in earnings in the period in which the change occurs. A valuation allowance is recorded unless it is more likely than not that realization of a deferred income tax asset will occur based on available evidence.

The Company recognizes uncertainty in tax positions taken or expected to be taken in a tax return by recording a liability for unrecognized tax benefits on its balance sheet. Uncertainties are quantified by applying a prescribed recognition threshold and measurement attribute.

The Company classifies interest and penalties associated with income tax positions in income tax expense.

### **Business combinations**

All business combinations are accounted for using the purchase method of accounting. Transaction costs are expensed as incurred.

The fair value of the contingent consideration is classified as a financial liability and is recorded on the balance sheet at the acquisition date and is re-measured at fair value at the end of each period until the end of the contingency period, with fair value adjustments recognized in earnings.

## **3. Acquisitions**

### *2016 acquisitions:*

The Company acquired controlling interests in thirteen businesses, five in the FirstService Residential segment and eight in the FirstService Brands segment. In the FirstService Residential segment, the Company acquired regional firms operating in California, South Carolina, Maryland and Massachusetts. In the FirstService Brands segment, the Company acquired three California Closets franchises operating in California, Washington DC, and Ontario, and three Paul Davis Restoration franchises operating in Florida, Connecticut, and Wisconsin, all six of which will be operated as company-owned locations. In the FirstService Brands segment, the Company also acquired Century Fire Protection and Advanced Fire, full-service fire protection firms, headquartered in Atlanta, Georgia, and Fort Lauderdale, Florida, respectively.

Details of these acquisitions are as follows:

	<u>Aggregate Acquisitions</u>
Current assets	\$ 40,022
Long-term assets	10,282
Current liabilities	(19,299)
Long-term liabilities	(556)
Deferred Tax Liabilities	(14,646)
Redeemable non-controlling interest	(10,612)
	<u>\$ 5,191</u>
Note consideration	\$ (3,434)
Cash consideration, net of cash acquired of \$5,002	(90,852)
Acquisition date fair value of contingent consideration	(9,998)
Total purchase consideration	<u>\$ (104,284)</u>
Acquired intangible assets	<u>\$ 54,438</u>
Goodwill	<u>\$ 44,655</u>

*2015 acquisitions:*

The Company acquired controlling interests in nine businesses, seven in the FirstService Residential segment and two in the FirstService Brands segment. In the FirstService Residential segment, the Company acquired controlling interests in firms operating in Texas, California, New York, Florida, Nevada and British Columbia. In the FirstService Brands segment, the Company acquired a Paul Davis Restoration franchise in Pennsylvania, as well as a California Closets franchise in Colorado, both of which will be operated as Company-owned locations.

Details of these acquisitions are as follows:

	<u>Aggregate Acquisitions</u>
Current assets	\$ 2,502
Non-current assets	2,000
Current liabilities	(1,689)
Long-term liabilities	(64)
Redeemable non-controlling interest	(1,696)
	<u>\$ 1,053</u>
Cash consideration, net of cash acquired of \$175	\$ (12,340)
Acquisition date fair value of contingent consideration	(4,544)
Total purchase consideration	<u>\$ (16,884)</u>
Acquired intangible assets	<u>\$ 8,891</u>
Goodwill	<u>\$ 6,940</u>

“Acquisition-related items” included both transaction costs and contingent acquisition consideration fair value adjustments. Acquisition-related transaction costs for the year ended December 31, 2016 totaled \$682 (2015 - \$354), offset by a recovery of \$621 related to contingent acquisition consideration fair value adjustments (2015 – expense of \$54).

In all years presented, the fair values of non-controlling interests were determined using an income approach with reference to a discounted cash flow model using the same assumptions implied in determining the purchase consideration.

The purchase price allocations of acquisitions resulted in the recognition of goodwill. The primary factors contributing to goodwill are assembled workforces, synergies with existing operations and future growth prospects. For acquisitions completed during the year ended December 31, 2016, goodwill in the amount of \$7,511 is deductible for income tax purposes (2015 - \$6,753).

The Company typically structures its business acquisitions to include contingent consideration. Vendors, at the time of acquisition, are entitled to receive a contingent consideration payment if the acquired businesses achieve specified earnings levels during the one- to two-year periods following the dates of acquisition. The ultimate amount of payment is determined based on a formula, the key inputs to which are (i) a contractually agreed maximum payment; (ii) a contractually specified earnings level and (iii) the actual earnings for the contingency period. If the acquired business does not achieve the specified earnings level, the maximum payment is reduced for any shortfall, potentially to nil.

The fair value of the contingent consideration liability recorded on the consolidated balance sheet as at December 31, 2016 was \$10,442 (see note 15). The estimated range of outcomes (undiscounted) for these contingent consideration arrangements is determined based on the formula price and the likelihood of achieving specified earnings levels over the contingency period, and ranges from \$10,207 to a maximum of \$12,008. These contingencies will expire during the period extending to December 2018. During the year ended December 31, 2016, \$2,490 was paid with reference to such contingent consideration (2015 - \$7,172).

The acquisitions referred to above were accounted for by the purchase method of accounting for business combinations. Accordingly, the accompanying consolidated statements of earnings do not include any revenues or expenses related to these acquisitions prior to their respective closing dates. The consideration for the acquisitions during the year ended December 31, 2016 was financed from borrowings on the Company's revolving credit facility and cash on hand.

The amounts of revenues and earnings contributed from the date of acquisition and included in the Company's consolidated results for the year ended December 31, 2016, and the supplemental pro forma revenues and earnings of the combined entity had the acquisition date been January 1, 2015, are as follows:

	<u>Revenues</u>	<u>Net earnings</u>
Actual from acquired entities for 2016	\$ 128,244	\$ 2,375
Supplemental pro forma for 2016 (unaudited)	1,568,434	57,053
Supplemental pro forma for 2015 (unaudited)	1,475,739	44,047

Supplemental pro forma results were adjusted for non-recurring items.

#### 4. Components of working capital accounts

	<u>December 31, 2016</u>	<u>December 31, 2015</u>
Inventories		
Work-in-progress	\$ 15,529	\$ 6,465
Finished goods	6,071	5,489
Supplies and other	8,112	4,201
	<u>\$ 29,712</u>	<u>\$ 16,155</u>
Accrued liabilities		
Accrued payroll and benefits	\$ 60,546	\$ 45,690
Value appreciation plans	12,467	7,110
Customer advances	501	243
Other	37,094	24,857
	<u>\$ 110,608</u>	<u>\$ 77,900</u>

**5. Fixed assets****December 31, 2016**

	Cost	Accumulated depreciation	Net
Land	\$ 2,520	\$ -	\$ 2,520
Buildings	10,366	4,529	5,837
Vehicles	52,497	33,739	18,758
Furniture and equipment	54,194	37,807	16,387
Computer equipment and software	81,516	59,896	21,620
Leasehold improvements	23,550	15,589	7,961
	<u>\$ 224,643</u>	<u>\$ 151,560</u>	<u>\$ 73,083</u>

## December 31, 2015

	Cost	Accumulated depreciation	Net
Land	\$ 2,519	\$ -	\$ 2,519
Buildings	10,231	4,028	6,203
Vehicles	35,983	26,031	9,952
Furniture and equipment	43,399	29,435	13,964
Computer equipment and software	69,405	48,628	20,777
Leasehold improvements	20,737	16,577	4,160
	<u>\$ 182,274</u>	<u>\$ 124,699</u>	<u>\$ 57,575</u>

Included in fixed assets are vehicles, office and computer equipment under capital lease at a cost of \$6,548 (2015 - \$4,462) and net book value of \$2,826 (2015 - \$2,877).

**6. Intangible assets****December 31, 2016**

	Gross carrying amount	Accumulated amortization	Net
Customer lists and relationships	\$ 104,258	\$ 34,161	\$ 70,097
Franchise rights	39,137	17,230	21,907
Trademarks and trade names	26,069	11,825	14,244
Management contracts and other	36,515	21,648	14,867
	<u>\$ 205,979</u>	<u>\$ 84,864</u>	<u>\$ 121,115</u>

## December 31, 2015

	Gross carrying amount	Accumulated amortization	Net
Customer lists and relationships	\$ 75,279	\$ 28,816	\$ 46,463
Franchise rights	36,539	15,195	21,344
Trademarks and trade names	22,002	11,147	10,855
Management contracts and other	16,648	15,832	816
	<u>\$ 150,468</u>	<u>\$ 70,990</u>	<u>\$ 79,478</u>

During the year ended December 31, 2016, the Company acquired the following intangible assets:

	Amount	Estimated weighted average amortization period (years)
Customer lists and relationships	\$ 32,322	17.8
Franchise rights	2,449	5.2
Trademarks and trade names	4,615	5.5
Management Contracts and other	15,052	14.8
	<u>\$ 54,438</u>	15.3

The following is the estimated annual amortization expense for recorded intangible assets for each of the next five years ending December 31:

2017	\$ 12,974
2018	12,179
2019	11,887
2020	11,337
2021	9,422

## 7. Goodwill

	FirstService Residential	FirstService Brands	Consolidated
Balance, December 31, 2014	\$ 165,390	\$ 52,043	\$ 217,433
Goodwill acquired during the year	4,794	2,146	6,940
Other items	157	-	157
Foreign exchange	(2,892)	(992)	(3,884)
Balance, December 31, 2015	167,449	53,197	220,646
Goodwill acquired during the year	5,696	38,959	44,655
Other items	18	169	187
Foreign exchange	510	168	678
<b>Balance, December 31, 2016</b>	<b>\$ 173,673</b>	<b>\$ 92,493</b>	<b>\$ 266,166</b>

A test for goodwill impairment is required to be completed annually, in the Company's case as of August 1, or more frequently if events or changes in circumstances indicate the asset might be impaired. No goodwill impairments were identified in 2016 or 2015.

## 8. Long-term debt

	December 31, 2016
Revolving credit facility	\$ 96,688
3.84% Notes	150,000
Capital leases maturing at various dates through 2021	1,188
Other long-term debt maturing at various dates up to 2023	3,033
	<u>250,909</u>
Less: current portion	1,043
Long-term debt - non-current	<u>\$ 249,866</u>



The Company has \$150 million of senior secured notes (the “Senior Notes”) bearing interest at a rate of 3.84%. The Senior Notes are due on January 16, 2025, with five annual equal repayments beginning on January 16, 2021.

The Company has a credit agreement with a syndicate of banks to provide a committed multi-currency revolving credit facility (the “Facility”) of \$200 million. The Facility has a 5-year term ending June 1, 2020 and bears interest at 1.25% to 2.50% over floating reference rates, depending on certain leverage ratios. The weighted average interest rate for 2016 was 2.2%. The revolving credit facility had \$97,114 of available un-drawn credit as at December 31, 2016. As of December 31, 2016, letters of credit in the amount of \$6,198 were outstanding (\$5,918 as at December 31, 2015). The Facility requires a commitment fee of 0.25% to 0.50% of the unused portion, depending on certain leverage ratios. At any time during the term, the Company has the right to increase the Facility by up to \$50 million, on the same terms and conditions as the original Facility. The Facility is available to fund working capital requirements and other general corporate purposes.

The Facility and the Senior Notes rank equally in terms of seniority. The Company has granted the lenders under the Facility and holders of the Senior Notes various collateral, including an interest in all of the assets of the Company. The covenants under the Facility and the Senior Notes require the Company to maintain certain ratios, including financial leverage, interest coverage and net worth. The Company is limited from undertaking certain mergers, acquisitions and dispositions without prior approval.

The effective interest rate on the Company’s long-term debt for the year ended December 31, 2016 was 3.9%. The estimated aggregate amount of principal repayments on long-term debt required in each of the next five years ending December 31 and thereafter to meet the retirement provisions are as follows:

2017	\$	1,043
2018		795
2019		547
2020		97,237
2021 and thereafter		151,287

## 9. Redeemable non-controlling interests

The minority equity positions in the Company’s subsidiaries are referred to as redeemable non-controlling interests (“RNCI”). The RNCI are considered to be redeemable securities. Accordingly, the RNCI is recorded at the greater of (i) the redemption amount or (ii) the amount initially recorded as RNCI at the date of inception of the minority equity position. This amount is recorded in the “mezzanine” section of the balance sheet, outside of shareholders’ equity. Changes in the RNCI amount are recognized immediately as they occur. The following table provides a reconciliation of the beginning and ending RNCI amounts:

	<u>2016</u>	<u>2015</u>
Balance, January 1	\$ 77,559	\$ 80,926
RNCI share of earnings	5,238	4,560
RNCI redemption increment	15,408	12,243
Distributions paid to RNCI	(4,985)	(3,602)
Purchases of interests from RNCI, net	(1,057)	(17,817)
RNCI recognized on business acquisitions	10,612	1,696
Other	(423)	(447)
Balance, December 31	<u>\$ 102,352</u>	<u>\$ 77,559</u>

The Company has shareholders' agreements in place at each of its non-wholly owned subsidiaries. These agreements allow the Company to "call" the non-controlling interest at a price determined with the use of a formula price, which is usually equal to a fixed multiple of average annual net earnings before extraordinary items, income taxes, interest, depreciation, and amortization. The agreements also have redemption features which allow the owners of the RNCI to "put" their equity to the Company at the same price subject to certain limitations. The formula price is referred to as the redemption amount and may be paid in cash or in Subordinate Voting Shares. The redemption amount as of December 31, 2016 was \$100,569 (2015 - \$76,332). The redemption amount is lower than that recorded on the balance sheet as the formula price of certain RNCI are lower than the amount initially recorded at the inception of the minority equity position. If all put or call options were settled with Subordinate Voting Shares as at December 31, 2016, approximately 2,200,000 such shares would be issued, and would have resulted in an increase of \$0.48 to diluted earnings per share for the year ended December 31, 2016.

## 10. Capital stock

The authorized capital stock of the Company is as follows:

- An unlimited number of Preferred Shares;
- An unlimited number of Subordinate Voting Shares having one vote per share; and
- An unlimited number of Multiple Voting Shares having 20 votes per share, convertible at any time into Subordinate Voting Shares at a rate of one Subordinate Voting Share for each Multiple Voting Share outstanding.

The following table provides a summary of total capital stock issued and outstanding:

	<i>Subordinate Voting Shares</i>		<i>Multiple Voting Shares</i>		<i>Total Common Shares</i>	
	Number	Amount	Number	Amount	Number	Amount
Balance, December 31, 2016	34,516,917	\$ 138,041	1,325,694	\$ 148	35,842,611	\$ 138,189

Pursuant to the amended management services agreement with the Company dated and effective as of the 1st day of June, 2015, the Company agreed to make payments to a company ("FC Co") indirectly owned by its Founder and Chairman that are contingent upon an arm's length sale of control of the Company or upon a distribution of the Company's assets to its shareholders. The payment amounts will be determined with reference to the consideration per Subordinate Voting Share received or deemed received by shareholders upon an arm's length sale or upon a distribution of assets. The right to receive the payments may be transferred to person(s) who are not at arm's length to FC Co. The agreement provides for FC Co to receive the following two payments. The first payment is an amount equal to 5% of the product of: (i) the total number of Subordinate and Multiple Voting Shares outstanding on a fully diluted basis at the time of the sale or distribution; and (ii) the per share consideration received or deemed received by holders of Subordinate Voting Shares minus a base price of C\$2.351. The second payment is an amount equal to 5% of the product of: (i) the total number of Subordinate and Multiple Voting Shares outstanding on a fully diluted basis at the time of the sale or distribution; and (ii) the per share consideration received or deemed received by holders of Subordinate Voting Shares minus a base price of C\$4.578. Assuming an arm's length sale of control of the Company had occurred on December 31, 2016, the aggregate amount required to be paid to FC Co, based on a market price of C\$63.74 (being the closing price per Subordinate Voting Share on the Toronto Stock Exchange on December 31, 2016), would have been US\$166,976.

**11. Stock-based compensation**

The Company has a stock option plan for certain officers and key full-time employees of the Company and its subsidiaries. Options are granted at the market price for the underlying shares on the date of grant. Each option vests over a four-year term, expires five years from the date granted and allows for the purchase of one Subordinate Voting Share. All Subordinate Voting Shares issued are new shares. As at December 31, 2016, there were 1,148,500 options available for future grants.

Grants under the Company's stock option plan are equity-classified awards. Stock option activity for the year ended December 31, 2016 is follows:

	<u>Number of options</u>	<u>Weighted average exercise price</u>	<u>Weighted average remaining contractual life (years)</u>	<u>Aggregate intrinsic value</u>
Shares issuable under options -				
Beginning of period	1,211,250	\$ 18.51		
Granted	328,500	36.08		
Exercised	(133,600)	14.12		
Forfeited	<u>(54,750)</u>	22.58		
Shares issuable under options -				
December 31, 2016	<u>1,351,400</u>	<u>\$ 23.05</u>	<u>2.5</u>	<u>\$ 33,011</u>
Options exercisable - End of period	<u>505,000</u>	<u>\$ 17.49</u>	<u>1.6</u>	<u>\$ 15,143</u>

The Company incurred stock-based compensation expense related to these awards of \$2,744 during the year ended December 31, 2016 (2015 - \$2,159).

As at December 31, 2016, the range of option exercise prices was \$11.02 to \$44.01 per share. Also as at December 31, 2016, the aggregate intrinsic value and weighted average remaining contractual life for in-the-money options vested and expected to vest were \$33,011 and 2.5 years, respectively.

The following table summarizes information about option exercises during year ended December 31, 2016:

	<u><b>2016</b></u>
Number of options exercised	<b>133,600</b>
Aggregate fair value	<b>\$ 5,516</b>
Intrinsic value	<u><b>3,630</b></u>
Amount of cash received	<u><b>1,886</b></u>
Tax benefit recognized	<u><u><b>\$ 1,270</b></u></u>

As at December 31, 2016, there was \$2,574 of unrecognized compensation cost related to non-vested awards which is expected to be recognized over the next 4 years. During the year ended December 31, 2016, the fair value of options vested was \$7,908 (2015 - \$1,576).

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

	<u>2016</u>
Risk free rate	1.1%
Expected life in years	4.75
Expected volatility	32.2%
Dividend yield	1.0%
Weighted average fair value per option granted	<b>\$9.68</b>

The risk-free interest rate is based on the implied yield of a zero-coupon US Treasury bond with a term equal to the option's expected term. The expected life in years represents the estimated period of time until exercise and is based on historical experience. The expected volatility is based on the historical prices of the Company's shares over the previous four years.

## 12. Income tax

Income tax differs from the amounts that would be obtained by applying the statutory rate to the respective year's earnings before tax. Differences result from the following items:

	<u>2016</u>	<u>2015</u>
Income tax expense using combined statutory rate of 26.5% (2015 - 26.5%, 2014 - 26.5%)	\$ 21,632	\$ 16,326
Permanent differences	434	488
Tax effect of flow through entities	(243)	(230)
Impact of changes in foreign exchange rates	-	(10)
Adjustments to tax liabilities for prior periods	(456)	1,393
Effects of changes in enacted tax rates	-	(42)
Changes in liability for unrecognized tax benefits	(156)	(130)
Foreign, state and provincial tax rate differential	5,699	3,750
Gain on disposition of preferred shares	-	1,246
Other taxes	477	(161)
Change in valuation allowances	-	782
Provision for income taxes as reported	<u>\$ 27,387</u>	<u>\$ 23,412</u>

Earnings before income tax by jurisdiction comprise the following:

	<u>2016</u>	<u>2015</u>
Canada	\$ 16,989	\$ 8,590
United States	<u>64,641</u>	<u>53,020</u>
Total	<u>\$ 81,630</u>	<u>\$ 61,610</u>

Income tax expense (recovery) comprises the following:

	<u>2016</u>	<u>2015</u>
Current		
Canada	\$ 3,689	\$ 829
United States	<u>21,945</u>	<u>10,757</u>
	<u>25,634</u>	<u>11,586</u>
Deferred		
Canada	(317)	1,352
United States	<u>2,070</u>	<u>10,474</u>
	<u>1,753</u>	<u>11,826</u>
Total	<u>\$ 27,387</u>	<u>\$ 23,412</u>

The significant components of deferred income tax are as follows:

	<u>2016</u>	<u>2015</u>
Deferred income tax assets		
Loss carry-forwards	\$ 1,066	\$ 6,071
Expenses not currently deductible	18,120	13,245
Stock-based compensation	2,956	2,420
Basis differences of partnerships and other entities	1,047	925
Allowance for doubtful accounts	3,457	2,967
Inventory and other reserves	542	548
	<u>27,188</u>	<u>26,176</u>
Deferred income tax liabilities		
Depreciation and amortization	31,168	13,971
Prepaid and other expenses deducted for tax purposes	1,942	1,782
	<u>33,110</u>	<u>15,753</u>
Net deferred income tax asset (liability) before valuation allowance	(5,922)	10,423
Valuation allowance	756	783
Net deferred income tax asset (liability)	<u>\$ (6,678)</u>	<u>\$ 9,640</u>

The recoverability of deferred income tax assets is dependent on generating sufficient taxable income before the 20 year loss carry-forward limitation. Although realization is not assured, the Company believes it is more likely than not that the deferred tax asset will be realized. The amount of the deferred tax asset considered realizable, however, could be reduced in the near term if estimates of future taxable income during the carry-forward period are reduced.

The Company has gross operating loss carry-forwards as follows:

	<u>Loss carry forward</u>		<u>Gross losses not recognized</u>		<u>Net</u>	
	<u>2016</u>	<u>2015</u>	<u>2016</u>	<u>2015</u>	<u>2016</u>	<u>2015</u>
Canada	\$ 2,082	\$ 3,234	\$ -	\$ -	\$ 2,082	\$ 3,234
United States	7,902	21,472	6,470	6,470	1,432	15,002

These amounts above are available to reduce future federal and provincial income taxes in their respective jurisdictions. Net operating loss carry-forward balances attributable to the United States and Canada expire over the next 6 to 20 years.

Cumulative unremitted earnings of US and foreign subsidiaries approximated \$297,631 as at December 31, 2016 (2015 - \$267,899). Income tax is not provided on the unremitted earnings of US and foreign subsidiaries because it has been the practice and is the intention of the Company to reinvest these earnings indefinitely in these subsidiaries.

A reconciliation of the beginning and ending amounts of the liability for unrecognized tax benefits is as follows:

Balance, December 31, 2014	\$ 494
Reduction for lapses in applicable statutes of limitations	<u>(202)</u>
Balance, December 31, 2015	292
Increases based on tax positions related to 2016	<u>(144)</u>
Balance, December 31, 2016	<u>\$ 148</u>

Of the \$148 (2015 - \$292) in gross unrecognized tax benefits, \$148, (2015 - \$292) would affect the Company's effective tax rate if recognized. For the year ended December 31, 2016, a recovery of \$12 in interest and penalties related to provisions for income tax was recorded in income tax expense (2015 - recovery of \$34). As at December 31, 2016, the Company had accrued \$38 (2015 - \$50) for potential income tax related interest and penalties.

The Company's significant tax jurisdictions include the United States and Canada. The number of years with open tax audits varies depending on the tax jurisdictions. Generally, income tax returns filed with the Canada Revenue Agency and related provinces are open for three to four years and income tax returns filed with the U.S. Internal Revenue Service and related states are open for three to five years.

The Company does not currently expect any other material impact on earnings to result from the resolution of matters related to open taxation years, other than noted above. Actual settlements may differ from the amounts accrued. The Company has, as part of its analysis, made its current estimates based on facts and circumstances known to date and cannot predict changes in facts and circumstances that may affect its current estimates.

### 13. Net earnings per common share

The following table reconciles the denominator used to calculate earnings per common share:

	<u>2016</u>	<u>2015</u>
Shares issued and outstanding at beginning of period	35,939,011	35,970,605
Weighted average number of shares:		
Issued during the period	72,023	129,867
Repurchased during the period	<u>(45,247)</u>	<u>(87,214)</u>
Weighted average number of shares used in computing basic earnings per share	35,965,787	36,013,258
Assumed exercise of stock options, net of shares assumed acquired under the Treasury Stock Method	<u>399,997</u>	<u>411,769</u>
Number of shares used in computing diluted earnings per share	<u><u>36,365,784</u></u>	<u><u>36,425,027</u></u>

### 14. Other supplemental information

	<u>2016</u>	<u>2015</u>
<b>Franchisor operations</b>		
Revenues	\$ 105,077	\$ 98,376
Operating earnings	31,807	27,707
Initial franchise fee revenues	6,054	5,474
Depreciation and amortization	3,923	3,533
Total assets	98,816	86,982
<b>Cash payments made during the period</b>		
Income taxes	\$ 9,968	\$ 3,358
Interest	8,648	4,366
<b>Non-cash financing activities</b>		
Increases in capital lease obligations	\$ 1,785	\$ 1,217
<b>Other expenses</b>		
Rent expense	\$ 25,422	\$ 20,229

## 15. Financial instruments

### *Concentration of credit risk*

The Company is subject to credit risk with respect to its cash and cash equivalents, accounts receivable and other receivables. Concentrations of credit risk with respect to cash and cash equivalents are limited by the use of multiple large and reputable banks. Concentrations of credit risk with respect to the receivables are limited due to the large number of entities comprising the Company's customer base and their dispersion across many different service lines.

### *Interest rate risk*

The Company maintains an interest rate risk management strategy that uses interest rate hedging contracts from time to time. The Company's specific goals are to: (i) manage interest rate sensitivity by modifying the characteristics of its debt and (ii) lower the long-term cost of its borrowed funds. Fluctuations in interest rates affect the fair value of the hedging contracts as their value depends on the prevailing market interest rate. Hedging contracts are monitored on a monthly basis.

### *Foreign currency risk*

Foreign currency risk is related to the portion of the Company's business transactions denominated in currencies other than U.S. dollars. A portion of revenue is generated by the Company's Canadian operations. The Company's head office expenses are incurred in Canadian dollars which is hedged by Canadian dollar denominated revenue.

### *Fair values of financial instruments*

The following table provides the financial assets and liabilities carried at fair value measured on a recurring basis as of December 31, 2016:

	Carrying value at December 31, 2016	Fair value measurements		
		Level 1	Level 2	Level 3
Contingent consideration liability	\$ 10,442	\$ -	\$ -	\$ 10,442

The inputs to the measurement of the fair value of contingent consideration related to acquisitions are Level 3 inputs. The fair value measurements were made using a discounted cash flow model; significant model inputs were expected future operating cash flows (determined with reference to each specific acquired business) and discount rates (which range from 8% to 10%). The range of discount rates is attributable to level of risk related to economic growth factors combined with the length of the contingent payment periods; and the dispersion was driven by unique characteristics of the businesses acquired and the respective terms for these contingent payments. Within the range of discount rates, there is a data point concentration at 9%. A 2% increase in the weighted average discount rate would reduce the fair value of contingent consideration by \$219.

Balance, December 31, 2015	\$ 3,316
Amounts recognized on acquisitions	9,998
Fair value adjustments	(621)
Resolved and settled in cash	(2,490)
Other	239
Balance, December 31, 2016	<u>\$ 10,442</u>
Less: current portion	<u>\$ 2,882</u>
Non-current portion	<u>\$ 7,560</u>

The carrying amounts for cash and cash equivalents, restricted cash, accounts receivable, accounts payable and accrued liabilities approximate fair values due to the short maturity of these instruments, unless otherwise indicated. The inputs to the measurement of the fair value of long term debt are Level 3 inputs. The fair value measurements were made using a net present value approach; significant model inputs were expected future cash outflows and discount rates (which range from 2.0% to 2.5%). The following are estimates of the fair values for other financial instruments:

	2016		2015	
	Carrying amount	Fair value	Carrying amount	Fair value
Other receivables	\$ 3,796	\$ 3,796	\$ 3,833	\$ 3,833
Long-term debt	250,909	263,660	201,199	216,788

Other receivables include notes receivable from non-controlling shareholders and other non-current receivables.

## 16. Commitments and contingencies

### (a) Lease commitments

Minimum operating lease payments are as follows:

Year ended December 31	
2017	\$ 21,783
2018	17,463
2019	14,395
2020	12,046
2021	8,849
Thereafter	10,620

### (b) Contingencies

In the normal course of operations, the Company is subject to routine claims and litigation incidental to its business. Litigation currently pending or threatened against the Company includes disputes with former employees and commercial liability claims related to services provided by the Company. The Company believes resolution of such proceedings, combined with amounts set aside, will not have a material impact on the Company's financial condition or the results of operations.

## 17. Related party transactions

The Company has entered into office space rental arrangements and property management contracts with senior managers of certain subsidiaries. These senior managers are usually also minority shareholders of the subsidiaries. The business purpose of the transactions is to rent office space for the Company and to generate property management revenues for the Company. The recorded amount of the rent expense for the year ended December 31, 2016 was \$0.6 million (2015 - \$0.4 million). These amounts are settled monthly in cash, and are priced at market rates. The rental arrangements have fixed terms of up to 10 years.

As at December 31, 2016, the Company had \$2.5 million of loans receivable from minority shareholders (December 31, 2015 - \$2.3 million). The business purpose of the loans receivable was to finance the sale of non-controlling interests in subsidiaries to senior managers. The loan amounts are measured based on the formula price of the underlying non-controlling interests, and interest rates are determined based on the Company's cost of borrowing plus a spread. The loans generally have terms of 5 to 10 years, but are open for repayment without penalty at any time.



In conjunction with the spin-off transaction on June 1, 2015, the Company entered into transition services agreement with Colliers which set out the terms under which certain administrative services, rent and other expenses would be allocated. The Company paid \$0.3 million in rent to Colliers for the year ended December 31, 2016. During the period from the spin-off date to December 31, 2015, the amount was \$0.2 million.

## 18. Segmented information

### *Operating segments*

The Company has two reportable operating segments. The segments are grouped with reference to the nature of services provided and the types of clients that use those services. The Company assesses each segment's performance based on operating earnings or operating earnings before depreciation and amortization. FirstService Residential provides property management and related property services to residential communities in North America. FirstService Brands provides franchised and Company-owned property services to customers in North America. Corporate includes the costs of operating the Company's corporate head office. The reportable segment information excludes intersegment transactions.

2016	FirstService Residential	FirstService Brands	Corporate	Consolidated
Revenues	\$ 1,112,820	\$ 370,069	\$ -	\$ 1,482,889
Depreciation and amortization	20,924	15,982	63	36,969
Operating earnings (loss)	62,539	41,173	(13,162)	90,550
Other income, net				232
Interest expense, net				(9,152)
Income taxes				(27,387)
Net earnings				<u>\$ 54,243</u>
Total assets	<u>\$ 371,780</u>	<u>\$ 393,321</u>	<u>\$ 5,863</u>	<u>\$ 770,964</u>
Total additions to long lived assets	<u>25,039</u>	<u>114,178</u>	<u>-</u>	<u>139,217</u>
2015	FirstService Residential	FirstService Brands	Corporate	Consolidated
Revenues	\$ 1,017,506	\$ 246,571	\$ -	\$ 1,264,077
Depreciation and amortization	21,041	7,840	103	28,984
Operating earnings (loss)	47,550	35,079	(11,882)	70,747
Other expense, net				(60)
Interest expense, net				(9,077)
Income taxes				(23,412)
Net earnings				<u>\$ 38,198</u>
Total assets	<u>\$ 349,507</u>	<u>\$ 239,394</u>	<u>\$ 11,582</u>	<u>\$ 600,483</u>
Total additions to long lived assets	<u>22,006</u>	<u>8,541</u>	<u>53</u>	<u>30,600</u>

*Geographic information*

Revenues in each geographic region are reported by customer locations.

	<u>2016</u>	<u>2015</u>
<b>United States</b>		
Revenues	\$ 1,393,950	\$ 1,181,435
Total long-lived assets	420,087	321,279
<b>Canada</b>		
Revenues	\$ 88,939	\$ 82,642
Total long-lived assets	40,277	36,420
<b>Consolidated</b>		
Revenues	\$ 1,482,889	\$ 1,264,077
Total long-lived assets	460,364	357,699

**19. Impact of recently issued accounting standards**

In May 2014, FASB issued ASU No. 2014-09, *Revenue from Contracts with Customers*. This ASU clarifies the principles for recognizing revenue and develops a common revenue standard for U.S. GAAP and is effective for the Company on January 1, 2018. The Company is still evaluating but does not expect the adoption to have a material impact on overall revenue recognition practices and policies.

In February 2016, FASB issued ASU No. 2016-02, *Leases*. This ASU affects all aspects of lease accounting and has a significant impact to lessees as it requires the recognition of a right-of use asset and a lease liability for virtually all leases including operating leases. In addition to balance sheet recognition, additional quantitative and qualitative disclosures will be required. The standard will be effective on January 1, 2019, at which time it must be adopted using a modified retrospective transition. The Company is currently assessing the impact of this ASU on its financial position and results of operations.

In November 2016, FASB issued ASU No. 2016-18, *Restricted Cash*. This ASU should reduce the diversity in practice in financial reporting for the classification of restricted cash, the classification of changes in restricted cash, and the presentation of cash payments and cash receipts that directly affect restricted cash. This ASU will require the statement of cash flows to explain the change during the period in the total of cash, cash equivalents, and amounts generally described as restricted cash and restricted cash equivalents. The guidance will be effective January 1, 2018 with retrospective transition. The Company is currently assessing the impact of this ASU on its financial position and results of operations.

In January 2017, FASB issued ASU No. 2017-05, *Simplifying the Accounting for Goodwill Impairment*. The guidance removes Step 2 of the goodwill impairment test, which requires a hypothetical purchase price allocation. A goodwill impairment will now be the amount by which a reporting unit's carrying value exceeds its fair value, not to exceed the carrying amount of goodwill. All other goodwill impairment guidance will remain largely unchanged. Entities will continue to have the option to perform a qualitative assessment to determine if a quantitative impairment test is necessary. The same one-step impairment test will be applied to goodwill at all reporting units, even those with zero or negative carrying amounts. Entities will be required to disclose the amount of goodwill at reporting units with zero or negative carrying amounts. The revised guidance will be applied prospectively and early adoption is permitted for any impairment tests performed after January 1, 2017. The Company is currently assessing the impact of this ASU on its financial position and results of operations.