

# ***Management Discussion and Analysis***

**Third Quarter Ending September 30, 2007**

Prepared as of November 26, 2007

[www.MunicipalSoftware.com](http://www.MunicipalSoftware.com)



# Municipal Solutions Group Inc.

Third Quarter Ending September 30, 2007

## MANAGEMENT DISCUSSION AND ANALYSIS

The following information should be read in conjunction with the Company's unaudited consolidated interim financial statements and the notes thereto for the nine months ended September 30, 2007 and 2006. All financial information is presented in Canadian dollars unless otherwise noted.

## OVERVIEW OF THE COMPANY

Municipal Solutions Group, Inc. (TSX-V:MSZ) is the parent company of Municipal Software Corporation. Municipal Software provides trusted solutions that help local governments grow and improve their communities. Our powerful, flexible and easy-to-use software solutions manage everyday business processes to improve efficiencies, reduce costs and enhance customer service.

With over 25 years of experience in standardizing and automating business processes, developing and implementing solutions, and providing ongoing support to local governments, we provide our clients with a valuable pool of information and best practices to build their solutions on.

Today, Municipal Software has over 140 clients who use our flagship product suite CityView, to issue building permits, track planning for communities, generate licenses and ensure that codes are followed and enforced. The CityView Application Builder provides them with the tools and flexibility they need to create their own custom applications and ensures that as their business processes change their solution changes.

Recently, the Company released a web-based solution, Local Government Manager, to meet the needs of local governments who cannot afford the cost or complexity of an On Premises solution. Local Government Manager offers new levels of security, flexibility and efficiency for the permitting and inspections, code enforcement and planning needs of local governments with restricted resources.

Municipal Software invests in our client's success by building meaningful, long-term relationships that empower them to grow and improve their communities. With clients that range in size from Medina, WA to Charlotte, NC and Miami, FL and 2,500 installed concurrent licenses and more than 8,000 users, we are a trusted partner for local governments

The Company generates revenue in three ways: developing and licensing its software products, providing services such as custom applications, implementation and training, and through annual maintenance and support.

## OVERALL PERFORMANCE

During the third quarter Municipal Software continued to focus its efforts on implementing, in an efficient and cost-effective way, those customers it has secured over the past year. The Company enjoys a backlog of license and service revenue in excess of \$4.5M that will be recognized as revenue as implementation projects are completed.

New sales of the Company's CityView PreBuilts solution remained strong as the Company signed Yucaipa, CA, Greenwich, CT and Paramount, CA in the quarter. Subsequent to quarter end, Lawndale, CA was secured as a customer. Revenue increased year over year for both the three month and nine month periods ending September 30, 2007.

The Company continued with success to market and sell its new SaaS solution called Local Government Manager as new clients continued to adopt and implement the solution. New clients included the cities of Mammoth Lakes, Fairfax and Adelanto in California. Local Government Manager was developed by Municipal Software for municipalities that require a low-maintenance, configurable, ready-to-use solution. There are three fully integrated modules available with Local Government Manager including Permits and Inspections, Planning and Code Enforcement.

During the quarter, the Company completed an equity financing and raised gross proceeds of approximately \$863,200. Under this financing, the Company issued a total of 2,538,823 units at a price of \$0.34 per unit. Each unit consisted of one common share and one common share purchase warrant. Each warrant entitles the holder to acquire an additional common share of Municipal at the price of \$0.50 for a period of two years. The proceeds will be used for working capital and other general corporate purposes.

Operating costs increased in the quarter over the same quarter in 2006. These increases were largely related to the increased efforts related to the implementation of new customers and the benefit of this investment was seen in the Company's services revenue for the quarter. The Company, however, continues to focus on improving the cost efficiency of the operations and as a result a second restructuring and rationalization of costs occurred in October, subsequent to the quarter end. As part of the restructuring the Company's CEO and President, Iain McLean, resigned and his duties were assumed by the VP Sales of the Company, Dennis J. Asbury. In addition to this 6 other positions were eliminated in the Company. The Company believes these changes are necessary in order to achieve its goal of profitable growth.

## SELECTED ANNUAL INFORMATION

Presented below is the Company's calendar-based Selected Annual Information for the year ended December 31, 2006 and the previous three fiscal years:

	2006	2005 Restated (1)	2004	2003
Total Revenues	\$4,204,812	\$3,545,253	\$3,576,029	\$5,011,970
Net Income (Loss)	\$(2,229,824)	\$(2,802,179)	\$(832,220)	\$(587,344)
Net Income (Loss) Per share*	\$(0.18)	\$(0.66)	\$(0.23)	\$(0.18)

\*Net Income (Loss) per share has been restated for prior years for comparison purposes. Consolidation of 8 old shares for 1 new share took place on April 6, 2005.

(1) See "Restatement of 2005 Financial Statements" in note 12 to the 2006 annual financial statements.

## RESULTS OF OPERATIONS

The discussion and analysis that follows relates to the results of operations of the Company and should be read in conjunction with the consolidated interim financial statements and accompanying notes for the nine months ended September 30, 2007 and 2006. All financial results are stated in Canadian dollars and were prepared in accordance with Generally Accepted Accounting Principles (GAAP).

### Revenue

The components of revenue for the three and nine months ended September 30, 2007 and 2006 are as follows:

	Three months ended September 30, 2007		Three months ended September 30, 2006	
	\$	% of total	\$	% of total
Software licenses	270,903	25%	317,818	30%
Software maintenance fees	360,098	32%	378,759	35%
Services	443,210	40%	343,792	32%
Other	34,440	3%	27,948	3%
Total	1,108,651	100%	1,068,317	100%

	Nine months ended September 30, 2007		Nine months ended September 30, 2006	
	\$	% of total	\$	% of total
Software licenses	704,261	20%	748,849	25%
Software maintenance fees	1,097,729	31%	1,109,843	37%
Services	1,661,944	48%	1,126,085	37%
Other	42,449	1%	53,674	1%
Total	3,506,383	100%	3,038,451	100%

Total revenue for the third quarter in 2007 was \$1,108,651 as compared to \$1,068,317 in the third quarter of 2006, an increase of 4%. Total revenue for the nine months ended September 30, 2007 was \$3,506,383 as compared to \$3,038,451 in the nine months ended September 30, 2006, an increase of 15%. The increase in the third quarter and the nine month period was predominantly related to Services revenue offset by slight decreases in Software License revenue and Software Maintenance Fee revenue.

Software license revenue was \$270,903 in the third quarter of 2007, a decrease of 15% over 2006. Software license revenue decreased by \$44,588 in the nine months ended September 30, 2007 compared to the nine months ended September 30, 2006. These decreases were mainly the result of fully recognizing revenue on some of the license sales in the third quarter of 2006 due to the nature of those license sales. All license sales made in the third quarter of 2007 were deferred and will be recognized in revenue as the projects are implemented. Deferred License Revenue (i.e. the amount of License Revenue billed to customers but not yet recognized as revenue) was \$705,756 as at September 30, 2007.

Revenue from software maintenance fees, which are fees charged annually to existing customers for customer support, was \$360,098 in the third quarter and \$1,097,729 for the nine months ended September 30, 2007, slightly lower from the corresponding periods in 2006 due to the attrition of a few customers.

Client services revenue for implementation, data conversion, customization and training services increased in the third quarter to \$443,210 as compared to \$343,792 in the third quarter of 2006, an increase of 29%. Client services revenue for the nine months ended September 30, 2007 was \$1,661,944 compared to \$1,126,085 in the nine months ended September 30, 2006 an increase of \$535,859 or 48%. These increases were the result of the Company focusing on the implementation of the CityView PreBuilt solution for new customers signed in the last year.

### **Operating Costs**

The Company's operating expenses for the three months ended September 30, 2007 were \$1,574,159, an increase of \$106,256 or 7% over the three months ended September 30, 2006. Operating expenses for the nine months ended September 30, 2007 were \$5,170,540 as compared to \$3,975,125 for the nine months ended September 30, 2006, an increase of 30%.

The increase in operating costs for the third quarter and the nine month period was largely the result of i) additional costs for staff and travel related to the implementation of customer projects and ii) various general and administrative expenses. In addition, for the nine month period, costs were higher due to i) labour and marketing costs related to the Company's SaaS product offering ii) one-time severance costs associated with the rationalization of a number of staff in June as part of an on-going effort to keep operating costs at an efficient level and iii) stock compensation expense related to options issued to officers and directors of the Company in June 2007.

The details of the changes in operating costs for the third quarter of 2007 over 2006 are as follows:

i) Customer Service

Customer service costs increased by \$119,687 in the third quarter of 2007 compared to the third quarter of 2006 due to an increase in staff costs for salary and travel that were required in order to provide adequate resources for the implementation of new customer contracts signed by the Company in the last year.

ii) Sales and Marketing

Sales and marketing costs increased by \$31,148 in the third quarter of 2007 compared with the same quarter in 2006. This increase was largely due to costs related to the Company's annual user conference.

iii) Research and Development

Research and Development costs were \$463,096 for the quarter ending September 30, 2007 compared to \$509,343 in the third quarter of 2006, a decrease of \$46,247. This decrease was due largely to labour restructuring costs incurred in the third quarter of 2006 for which there was no corresponding charge in the third quarter of 2007 and decreased costs related to hosting of the Company's new SaaS solution.

iv) General and Administrative

General and Administrative costs were \$414,087 in the third quarter of 2007, an increase of \$1,668 from the third quarter in 2006. This increase relates mainly to an increase in bad debts expense and legal fees for the quarter offset by other various reductions in administrative expenses.

Other Costs

In the third quarter of 2007, Other Costs totaled \$212,104, an increase of \$152,606 over the third quarter in 2006. The increase related largely to an increase in the foreign exchange loss which changed from a foreign exchange gain of \$15,845 in the third quarter of 2006 to a foreign exchange loss of \$119,209 in the third quarter of 2007.

For the nine months ended September 30, 2007, Other Costs totaled \$501,330, a decrease of \$35,892 over the nine months ended September 30, 2006. The decrease related largely to a reduction in accreted interest of \$295,277 which the Company had no expense for in 2007 as a result of the conversion of its convertible debentures in April 2006. This decrease was offset by an increase in the loss on foreign exchange which

increased by \$215,472 in the nine months ended September 30, 2007 compared to the nine months ended September 30, 2006.

## SUMMARY OF QUARTERLY RESULTS

The following table provides summary quarterly results (unaudited) for the eight quarters prior to and including the quarter ended September 30, 2007:

	Q3 2007	Q2 2007	Q1 2007	Q4 2006
Total Revenues *	\$1,108,651	\$1,258,758	\$1,138,977	\$1,166,361
Net Income (Loss) **	\$(677,612)	\$(862,295)	\$(625,580)	\$(755,926)
Net Income (Loss) per share *	\$(0.04)	\$(0.05)	\$(0.04)	\$(0.05)

	Q3 2006	Q2 2006	Q1 2006	Q4 2005
Total Revenues *	\$1,068,317	\$817,009	\$1,153,125	\$951,429
Net Income (Loss) **	\$(459,084)	\$(755,078)	\$(259,736)	\$(1,771,219)
Net Income (Loss) per share *	\$(0.03)	\$(0.06)	\$(0.06)	\$(0.42)

\* Certain of the figures presented for comparative purposes have been reclassified to conform to the presentation adopted in the current period.

\*\* Net Income (Loss) includes Write-off of Deferred Software Development Costs of \$1,020,518 in Q4 2005.

## LIQUIDITY AND CAPITAL RESOURCES

### Working Capital

As at September 30, 2007 the Company's working capital position was a deficiency of \$2,147,541 compared to a deficiency of \$921,192 as at December 31, 2006. \$1,993,069 of the deficiency at September 30, 2007 related to deferred revenue items (Non-refundable Advances On Maintenance Contracts (\$1,041,406), Deferred Customer Service Revenue (\$245,907) and Deferred license revenue (\$705,756)), which are deferred credits for which no cash will be distributed but for which services will be provided for in regular operations.

### Accounts Receivable and Work In Progress

Accounts receivable were \$604,075 at September 30, 2007, a decrease of \$602,972 or 50% from the accounts receivable balance at December 31, 2006. This decrease was due to the collection of a number of large receivables related to contracts that were executed late in the fourth quarter of 2006 and due to a decrease in the average days sales outstanding of the existing receivables.

Work in progress was \$568,125 at September 30, 2007 an increase of \$302,777 or 114% over the balance at December 31, 2006. This increase is due to implementation services which have been performed by the Company and recognized as revenue but are not yet billable to certain customers until specific milestones or customer acceptance criteria are achieved. The Company's services backlog (revenue contracted for but yet to be performed and recorded as revenue) exceeded \$4.0M at September 30, 2007.

### **Deferred Revenue and Non-refundable Advances On Maintenance Contracts**

The total amount of deferred revenue was \$1,993,069 at September 30, 2007. Of this balance, the Deferred Customer Service Revenue balance of \$245,907 represents implementation, configuration, training and public portal services that have been invoiced but not yet delivered. The Deferred License Revenue balance of \$705,756 represents software license fees that have been invoiced but not recognized as revenue. These license fees will be recognized as revenue as the projects to which they relate are completed. Non-refundable Advances On Maintenance Contracts of \$1,041,406 is related to Annual Software Maintenance agreements, which automatically renew each year and once renewed provide no opportunity for cancellation or refund.

### **Capital Resources**

As at September 30, 2007, the Company's principal sources of liquidity included working capital and borrowing availability under the Company's bank credit facilities and under a loan facility with Pender Growth Fund (VCC) Inc. ("Pender"), the Company's controlling shareholder. The Company's working capital position at September 30, 2007 was a deficiency of \$2,147,541. \$1,993,069 of this deficiency related to deferred revenue items which are deferred credits for which no cash will be distributed but for which services will be provided for in regular operations.

On July 6, 2007, the Company completed a non-brokered private placement and raised gross proceeds of approximately \$863,200. Under this financing, the Company issued a total of 2,538,823 units, each unit consisting of one common share and one common share purchase warrant. Each warrant entitles the holder to acquire an additional common share of the Company at the price of \$0.50 for a period of two years. The Company intends to use the net proceeds from the financing for working capital and other general corporate purposes.

Pender and other insiders of Municipal Software participated in this financing and Pender's participation included the conversion of approximately \$300,000 in debt previously provided by Pender to Municipal Software.

On September 18, 2007 the Company entered into a loan facility agreement with Pender. Under the terms of the Loan Agreement, the Company may borrow up to \$300,000 from Pender in one or more draw downs. All amounts outstanding under the Loan Agreement from time to time bear interest at a rate of 18% per annum and are repayable in full on February 28, 2008. In addition, to secure repayment of all amounts owing under the Loan Agreement, the Company has entered into a general security agreement with Pender

pursuant to which it has granted to Pender a security interest over all of its present and after acquired property.

Subsequent to the end of the quarter, the Company received advances from Pender and other insiders of the Company.

The Company is currently in the process of negotiating a convertible debenture financing with Pender and other Company insiders.

Management believes these sources of liquidity will be sufficient to meet the Company's requirements and to finance its projected growth in the near term.

### **OFF-BALANCE SHEET ARRANGEMENTS**

The Company does not have any off-balance sheet arrangements.

### **TRANSACTIONS WITH RELATED PARTIES**

During the quarter, the Company received advances of \$200,000 from its largest shareholder, Pender Growth Fund (VCC) Inc. ("Pender") as part of its loan facility agreement. As at September 30, 2007, \$200,000 plus accrued interest of \$2,121 was owing to Pender under this facility.

In July 2007, a loan in the amount of \$25,000 was advanced to the Company by an officer of the Company at an interest rate of 10.5%, calculated and paid monthly. As at September 30, 2007, \$75,000 of advances were owed to this officer.

In July 2007, a \$127,500 loan from a director of the Company was converted to common shares as part of the equity financing.

### **CONTROL CERTIFICATIONS**

Management has designed disclosure controls and procedures to provide reasonable assurance that material information relating to the Company, including its consolidated subsidiaries, is known to the Chief Executive Officer and the CFO or made known to them by others within those entities, particularly during the period in which the annual and quarterly filings of the Company are being prepared, in an accurate and timely manner in order for the Company to comply with its continuous disclosure and financial reporting obligations and in order to safeguard assets. Management has concluded that the Company's disclosure controls and procedures, as of the end of the period covered by the interim filings, are effective in providing reasonable assurance that material information is accumulated and disclosed accurately. Consistent with the concept of reasonable assurance, the Company recognizes that the relative cost of maintaining these controls and procedures should not exceed their expected benefits. As such, the Company's disclosure controls and procedures can only provide reasonable assurance, and not absolute assurance, that the objectives of such controls and procedures are met.

The Corporation's financial reporting procedures and practices have enabled the certification of the Company's interim filings in compliance with Multilateral Instrument 52-109 "Certification of Disclosure in Issuers' Annual and Interim Filings". Management

has designed such internal controls over financial reporting to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements and other interim filings in accordance with Canadian Generally Accepted Accounting Principles, except as noted below.

Given the size of the Company, the evaluation of the design of internal controls over financial reporting for the Company resulted in the identification of the following weaknesses:

Management is aware that due to its relatively small scale of operations there is a lack of segregation of duties due to a limited number of employees dealing with accounting and financial matters. However, management has concluded that considering the employees involved and the control procedures in place, including management and Audit Committee oversight, risks associated with such lack of segregation are not significant enough to justify the expense associated with adding employees to clearly segregate duties.

Management is aware that in-house expertise to deal with complex taxation, accounting and reporting issues may not be sufficient. The Company requires outside assistance and advice on new accounting pronouncements and complex accounting and reporting issues, which is common with companies of a similar size.

There have been no significant changes to the Company's internal control over financial reporting that occurred during the most recent interim period that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

## **CHANGES IN ACCOUNTING POLICIES**

Effective January 1, 2007, the Company adopted the Canadian Institute of Chartered Accountants (CICA) Handbook Section 1530, Comprehensive Income, CICA Handbook Section 3251, Equity, CICA Handbook Section 3855, Financial Instruments – Recognition and Measurement, CICA Handbook Section 3861, Financial Instruments – Disclosure and Presentation, and CICA Handbook Section 3865, Hedges. These new Handbook Sections provide comprehensive requirements for the recognition and measurement of financial instruments, as well as standards on when and how hedge accounting may be applied. Handbook Section 1530 also establishes standards for reporting and displaying comprehensive income. Comprehensive income is defined as the change in equity from transactions and other events from non-owner sources. Other comprehensive income refers to items recognized in comprehensive income but that are excluded from net income calculated in accordance with generally accepted accounting principles.

Under these new standards, all financial instruments are classified (with certain exceptions) into one of the following four categories: held for trading, held-to-maturity investments, loans and receivables or available-for-sale financial assets. All financial instruments, including derivatives, are included on the consolidated balance sheet and are initially measured at fair market value. Subsequent measurement and recognition of changes in fair value of financial instruments depends on their initial classification. Held for trading financial investments are measured at fair value and all gains and losses are included in net income in the period in which they arise. Available-for-sale financial instruments are measured at fair value with revaluation gains and losses included in other comprehensive income until the asset is removed from the balance sheet. Loans and

receivables, investments held-to-maturity and other financial liabilities are measured at amortized cost.

The standards require derivative instruments to be recorded as either assets or liabilities measured at their fair value unless exempted from derivative treatment as a normal purchase and sale. Certain derivatives embedded in other contracts must also be measured at fair value. All changes in the fair value of derivatives are recognized in earnings unless specific hedge criteria are met, which requires that a company must formally document, designate and assess the effectiveness of transactions that receive hedge accounting.

The adoption of these standards did not result in any material impact on the Company's financial statements.

## **FORWARD-LOOKING STATEMENTS**

Certain statements in the consolidated financial statements and notes, and this Management Discussion and Analysis may constitute forward-looking statements reflecting Municipal Solutions Group Inc.'s current expectation in the local government sector. Investors are cautioned that all forward-looking statements involve certain risks and uncertainties, including, without limitation, changes in market and competition, technological and competitive developments, cooperation and performance of strategic partners, and potential downturns in economic conditions generally. Forward-looking statements are based upon management's estimates, beliefs, and opinions on the date the statements are made. Additional information on these and other potential factors that could affect the Company's financial results are detailed in documents filed from time to time on SEDAR.

## **RISKS AND UNCERTAINTIES**

The Company operates in a highly competitive market and is focused on expanding its existing business to achieve continued growth and profitability. The Company faces a number of risks and uncertainties, which are detailed below.

### Potential Fluctuations in Quarterly Results:

The Company's quarterly operating results fluctuate depending on the timing and size of orders, the number, timing and significance of new product announcement by the Company and its competitors. Price competition and general economic factors may also influence the Company's quarterly results.

### Product Development and Technological Change:

The software industry is characterized by rapid technological change and frequent new product introductions. The Company currently has a limited number of product offerings. The ability of Municipal to compete successfully will depend in large measure on the Company's ability to retain technically skilled research and development staff and to adapt to technological changes and advances in the industry, including the ability of current or future products to conform with evolving computer hardware and software platforms and operating environments.

### Proprietary Technology:

The Company has relied, and expects to continue to rely on a combination of trademark and trade secret laws, confidentiality procedures, and contractual provisions to establish,

maintain and protect the Company's proprietary rights. Unauthorized parties may attempt to copy aspects of Municipal's products or to obtain information regarded as proprietary. With increased competition come companies attempting to emulate Municipal's technologies and products. Policing unauthorized use of the Company's technology is difficult, time-consuming, and costly.

Executive Officers and Key Personnel:

The Company's future success largely depends on the continued efforts and performance of its executive officers and key employees. Failure to retain key employees and to attract and retain additional key employees with necessary skills could have a material adverse impact upon the Company's future business, operating results, and financial condition.

Foreign Exchange Exposure:

Currently 90% of the Company's revenues are realized in U.S. dollars and are anticipated in the future to be in U.S. dollars, while the majority of expenses are incurred principally in Canadian dollars. As a result, fluctuations in the exchange rate between the Canadian and U.S. dollar may have a material adverse effect on the Company. The Company does not currently utilize derivative instruments and does not hedge its exposure to exchange rate fluctuations.

**OTHER**

Information on the Company's share capital including the number of shares authorized and outstanding and the number of shares issuable on conversion of stock options and warrants are detailed in the Company's financial statements. The number of common shares and share purchase options outstanding as of the date of this report are 18,584,646 and 2,240,462 respectively.

Additional disclosures pertaining to the Company including material change reports, press releases and other information are available at [www.sedar.com](http://www.sedar.com).