

**STERLING SHOES INCOME FUND  
MANAGEMENT'S DISCUSSION AND ANALYSIS  
March 18, 2010**

*The following management's discussion and analysis ("MD&A") should be read in conjunction with the consolidated financial statements and accompanying notes ("Financial Statements") of Sterling Shoes Income Fund (the "Fund") for the year ended December 31, 2009. Results have been prepared in accordance with Canadian generally accepted accounting principles ("GAAP" and reported in Canadian dollars unless otherwise indicated). The fiscal year-end of the Fund is December 31.*

*This MD&A contains forward-looking statements. Please see "Forward-Looking Statements" and "Risks and Uncertainties" for a discussion of the risks, uncertainties and assumptions relating to these statements. This MD&A also makes reference to certain non-GAAP measures to assist in assessing our financial performance. Non-GAAP measures do not have any standard meaning prescribed by GAAP and are therefore unlikely to be comparable to similar measures presented by other issuers. See "Non-GAAP Measures" and "Adjusted Distributable Cash".*

**OVERVIEW OF THE FUND**

The Fund is an unincorporated, open-ended; limited-purpose trust established under the laws of the Province of British Columbia pursuant to the declaration of trust dated May 31, 2005. The Fund was established to acquire an 80% interest in Sterling Shoes Limited Partnership ("Sterling Shoes LP"), which had acquired the retail footwear business of SSI Investments Inc., previously named Sterling Shoes Inc. ("Inc"). Inc retained a 20% interest in Sterling Shoes LP.

As at March 18, 2010, there were 5,313,488 units ("Units") of the Fund issued and outstanding. In addition, to provide Inc with voting rights commensurate with Inc's retained interest in Sterling Shoes LP, Inc holds 1,328,372 special voting units of the Fund (equal to the number of Class D LP Units Inc holds in Sterling Shoes LP (the "Class D LP Units")), which entitle the holder to one vote per special voting unit at meetings of unitholders of the Fund ("Unitholders").

Distributions on the Class D LP Units were subordinated and the Class D LP Units themselves were not exchangeable for Units of the Fund until the Subordination End Date. As a result of the Fund achieving a specified EBITDA target for the year ended December 31, 2007 and distribution target for each of the fiscal years ended December 31, 2007 and 2006, the Subordination End Date occurred on March 31, 2008. Consequently, the Class D LP Units became freely exchangeable for Units on a one-for-one basis and were reclassified from non-controlling interest to unitholders' equity in 2008. The distributions on the Class D LP Units are no longer subordinated and are made monthly, instead of quarterly.

On October 3, 2007 the Fund closed an offering of \$25 million of convertible unsecured subordinated debentures (the "Debentures") at a price of \$1,000 per debenture. The Debentures bear interest at an annual rate of 6.5% payable semi-annually in arrears on October 31 and April 30 in each year commencing April 30, 2008. The maturity date for the Debentures is October 31, 2012.

The Units trade on the Toronto Stock Exchange under the symbol SSI.UN and the Debentures trade under the symbol SSI.DB.

## OVERVIEW OF OUR BUSINESS

The Fund is a Vancouver-based, leading footwear retailer operating through six separate retail banners: Sterling, Joneve, Shoe Warehouse, Freedman Shoes, Gia and Sterling Outlet. These retail concepts were designed to effectively and profitably serve identified market segments. Since 1987 the Sterling Shoes business (formerly carried on by Sterling Shoes Inc.) has grown from five locations to 162 stores as at March 18, 2010. Our stores are located in leased premises primarily in high-traffic, high-visibility locations within enclosed shopping malls, on high streets and in strip malls.

Our products include dress and casual footwear ranging from sandals and athletic shoes to career footwear and special occasion shoes. We offer footwear products under both private label and national brands in each of our stores as well as a range of accessories, including handbags, shoe care products and hosiery.

Each of our banners targets a specific consumer group through different product, merchandising, location, pricing, service and advertising strategies.

Retail Banner	General Price Range	Products and Consumers	Key Private Label Brands	Key National Brands
<i>Sterling</i>	\$50 to \$ 140	<ul style="list-style-type: none"> <li>• mid-range women's fashion and comfort footwear</li> <li>• latest fashion trends, current looks</li> <li>• targeted to women 15 years of age &amp; up</li> </ul>	<ul style="list-style-type: none"> <li>• Roberto Vianni</li> <li>• Joy &amp; Peace</li> <li>• Vianni Collections</li> </ul>	<ul style="list-style-type: none"> <li>• Skechers</li> <li>• Puma</li> <li>• Franco Sarto</li> <li>• Steve Madden</li> <li>• Converse</li> <li>• Blowfish</li> <li>• DC Skate</li> <li>• Roxy</li> <li>• Kenneth Cole</li> <li>• Rocket Dog</li> </ul>
<i>Joneve</i>	\$69 to \$180	<ul style="list-style-type: none"> <li>• mid-high end women's fashion and comfort footwear</li> <li>• fashionable upscale career, comfort and dress shoes</li> <li>• dress, casual and fashion athletic shoes, boots and sandals</li> <li>• targeted to women 20 years of age &amp; up</li> </ul>	<ul style="list-style-type: none"> <li>• Roberto Vianni</li> <li>• Vianni Collections</li> </ul>	<ul style="list-style-type: none"> <li>• Skechers</li> <li>• Puma</li> <li>• Nine West</li> <li>• Franco Sarto</li> <li>• Guess</li> <li>• Bebe Sport</li> <li>• Steve Madden</li> <li>• Kenneth Cole</li> </ul>
<i>Shoe Warehouse</i>	\$19 to \$49 — kids \$39 to \$99 — ladies \$39 to \$99 — mens	<ul style="list-style-type: none"> <li>• value-priced, family footwear products, including fashion, comfort, athletic footwear and work boots</li> <li>• leather and synthetic products representing good value to family-oriented or price-conscious consumers</li> </ul>	<ul style="list-style-type: none"> <li>• Be Wild</li> <li>• Rinaldi</li> <li>• Blizzard</li> <li>• Workers</li> <li>• Urban XT</li> <li>• EC Collections</li> </ul>	<ul style="list-style-type: none"> <li>• Bare Traps</li> <li>• Fila</li> <li>• Rockport</li> <li>• Nike</li> <li>• Kodiak</li> <li>• Sorel</li> <li>• Skechers</li> <li>• New Balance</li> <li>• Saucony</li> <li>• BOC by Børn</li> </ul>
<i>Freedman Shoes</i>	\$90 to \$350	<ul style="list-style-type: none"> <li>• high-end men's and women's fashion and comfort footwear</li> <li>• 95% of products are national brands</li> <li>• wide selection of fittings and sizes</li> <li>• targeted to men and women 25 years of age &amp; up</li> </ul>	<ul style="list-style-type: none"> <li>• Vianni Collections</li> <li>• Roberto Vianni</li> </ul>	<ul style="list-style-type: none"> <li>• Amalfi</li> <li>• Stuart Weitzman</li> <li>• Donald J Pliner</li> <li>• Johnson &amp; Murphy</li> <li>• Cole Haan</li> <li>• Rockport</li> <li>• DKNY</li> <li>• Franco Sarto</li> </ul>
<i>Gia</i>	\$70 to \$360	<ul style="list-style-type: none"> <li>• cutting-edge, funky women's street fashion</li> <li>• fashion-athletic footwear and accessories</li> <li>• 85% of products are national brands</li> </ul>	<ul style="list-style-type: none"> <li>• Vianni Collections</li> </ul>	<ul style="list-style-type: none"> <li>• Guess</li> <li>• Steve Madden</li> <li>• Jessica Simpson</li> <li>• Betsey Johnson</li> <li>• Rocket Dog</li> <li>• Puma</li> <li>• UGG</li> <li>• Blowfish</li> <li>• BCBG</li> </ul>
<i>Sterling Outlet</i>	\$50 to \$ 140	<ul style="list-style-type: none"> <li>• mid-range women's fashion and comfort footwear</li> <li>• latest fashion trends at clearance prices</li> <li>• dress, casual and fashion athletic shoes, boots and sandals</li> <li>• targeted to women 15 years of age &amp; up</li> </ul>	<ul style="list-style-type: none"> <li>• Roberto Vianni</li> <li>• Vianni Collections</li> <li>• Joy &amp; Peace</li> </ul>	<ul style="list-style-type: none"> <li>• Skechers</li> <li>• Puma</li> <li>• Franco Sarto</li> <li>• Steve Madden</li> <li>• Kenneth Cole</li> <li>• Converse</li> <li>• Rocket Dog</li> </ul>

Sterling/Joneve, Shoe Warehouse, Freedman Shoes, Gia and Sterling Outlet compete with other local, regional and national footwear retailers. The fragmented nature of the Canadian retail footwear industry and our six distinct retail banners means that we compete against a wide variety of participants at various levels of the value chain. Examples of who we believe to be the principal competitors for our Sterling/Joneve/Gia, Shoe Warehouse and Freedman Shoes banners are provided below.

<u>Sterling/Joneve/Gia</u>	<u>Shoe Warehouse/Sterling Outlet</u>	<u>Freedman Shoes</u>
<ul style="list-style-type: none"> <li>● ALDO</li> <li>● Town Shoes</li> <li>● Nine West</li> <li>● Feet First</li> <li>● Little Burgundy</li> <li>● Mall-based specialty shoe stores</li> <li>● Apparel stores selling mid-to-high range fashion and fashion-athletic footwear products</li> </ul>	<ul style="list-style-type: none"> <li>● Payless Shoe Source</li> <li>● The Shoe Company</li> <li>● Winners</li> <li>● Softmoc</li> <li>● The Bay</li> <li>● Zellers</li> <li>● National and regional comfort-oriented shoe stores</li> <li>● Style Sense</li> </ul>	<ul style="list-style-type: none"> <li>● Browns</li> <li>● Town Shoes</li> <li>● Holt Renfrew</li> <li>● Harry Rosen</li> <li>● Feet First</li> <li>● B2</li> </ul>

We now operate 162 stores across Canada, a significant increase from the 100 stores at the time of our initial public offering in July 2005. In light of the current economic environment, we have slowed the pace of our expansion. We are cautious with opening new locations and we will only add to our store base if the locations meet strict criteria for expected sales, profitability and return on invested capital. We remain focused on our strategic objective: the right shoe, at the right price, at the right place, in the right quantity. We do so by managing the fundamentals that we control, including: managing purchasing, product mix and inventory, offering excellent customer service, tightening control over expenses and continually evaluating our planned capital expenditures. Additionally, we actively seek ways to improve the efficiency and profitability of our existing stores. One of the most important strategic initiatives we have undertaken recently is the investment in a new information technology system to better position our business, expected to be operational during 2010.

## **RECENT EVENTS AND OUTLOOK**

### Economic Conditions and our Recent Performance

Throughout 2009 economic conditions deteriorated in many countries and regions, including Canada. Volatility in financial markets, higher unemployment rates and recessionary conditions resulted in a low level of consumer confidence, increased promotional activity, reductions in consumer spending and weakness in a number of industries in the regions in which we operate.

During the fourth quarter of 2009 there were some mixed signals of economic recovery in select sectors of the economy. Retail footwear was not one of them. Market conditions in our segment remain soft.

While the economic environment remains volatile, management worked to reposition our cost structure throughout 2009. In response to economic conditions, and in order to bring flexibility to our cost structure, we decreased inventory levels, changed our product mix, restricted maintenance and capital expenditures, and reduced operating, overhead, administrative and selling costs.

We started these initiatives in earnest in first quarter 2009; but many of them took a number of months to show a material impact. We have been highlighting these efforts throughout 2009. Our fourth quarter 2009 results reflect the benefit of many of these initiatives, as illustrated by increased profitability despite a soft sales environment.

Our cost control measures will continue to provide savings and improve the flexibility of the business. Management feels that the business is currently in a much better position to weather sustained economic volatility than it was twelve months ago.

Highlights for the three and twelve-month periods ended December 31, 2009 are summarized below:

- Our financial position at December 31, 2009 was stronger than a year ago reflecting :
  - Reduced inventory levels which generated cash flow and shelf space for new, higher-margin product;
  - Stronger operating cash flow, and
  - Lower bank indebtedness
- Overall sales decreased 3.0% to \$41.2 million during the three-month period ended December 31, 2009 and increased 0.3% to \$131.2 million for the full year, compared to the same periods in 2008;
- Same-store sales decreased 5.6% and 5.7% during the three and twelve-month periods ended December 31, 2009, respectively, compared to the same periods in 2008;
- Gross margin increased to 56.3% during the three-month period ended December 31, 2009, compared to 43.2% for the nine-months ended September 30, 2009. Gross margin during the three-month period ended December 31, 2008 was 56.0%;
- Store and selling expenses fell to 30.7% and 35.7%, as a percentage of sales, during the three and twelve-month periods ended December 31, 2009 compared to 31.5% and 35.8% during the same periods in 2008, respectively;
- General and administration expenses fell to 5.8% as a percentage of sales during the three and twelve-month periods ended December 31, 2009 compared to 6.2% and 6.1% during the same periods in 2008, respectively;
- Cost control measures continued to provide savings and improved business flexibility.
- EBITDA rose to \$8.1 million (19.8% as a percentage of sales), during the three-month period ended December 31, 2009 compared to \$7.8 million (18.3% as a percentage of sales) during the same period in 2008;
- EBITDA was \$7.6 million (5.8% as a percentage of sales), during the twelve-month period ended December 31, 2009 compared to \$11.7 million (8.9% as a percentage of sales) during the same period in 2008;
- Continued progress on development testing and training for the new information technology system
- Strengthening of the Canadian dollar coupled with changes in product mix boosted margin in inventory.

We will also continue to assess the costs and benefits of converting to a corporate structure in advance of the new taxation rules taking effect in 2011. Together with the Fund's Trustees and with the assistance of various professional advisors, we have been analyzing the implications of modifying our structure. It is anticipated that the Trustees will make a decision as to whether, and if so how and when, to convert to a corporation prior to the end of 2010. Additional information will be provided once that decision is made.

#### Number of Stores

During 2009, we opened seven new stores and closed five underperforming stores. Currently we have one new store commitment for 2010 and expect to close one underperforming store in the upcoming quarter. We are taking a cautious approach to additional store openings and expansion in light of uncertain economic conditions. The normal course of business includes closing stores due to a number of factors such as the redevelopment of real estate in malls, high streets and strip malls, changes in the economic environment and lease terms. We are taking a cautious approach to additional store openings and expansion in light of uncertain economic conditions.

Our 162 stores operate under six retail banners in British Columbia, Alberta, Saskatchewan, Manitoba and Ontario as follows:

Number of Stores Operating												
March 18, 2010								Dec 31, 2008	Dec 31, 2007	Dec 31, 2006	Dec 31, 2005	July 12, 2005
Province	Shoe Warehouse	Sterling	Joneve	Freedman	Gia	Sterling Outlet	Total	Total	Total	Total	Total	Total
British Columbia	40	20	6	8	2	-	76	75	65	63	60	59
Alberta	15	9	2	-	-	1	27	26	25	25	24	24
Saskatchewan	2	2	-	-	-	-	4	4	3	3	4	4
Manitoba	9	3	-	-	-	-	12	12	12	11	11	11
Ontario	12	23	6	2	-	-	43	43	36	25	5	2
Total	78	57	14	10	2	1	162	160	141	127	104	100

### Suspension of Distributions

In response to negative market conditions, we announced a suspension of distribution payments beginning with the December 2009 distribution. We take a long term view of distributions that considers, among other criteria, current and expected economic and operating conditions. While our operations are sound, in view of the deteriorating economic conditions and the heightened risk in the credit markets, we considered it prudent to suspend the distribution in order to further strengthen our balance sheet and increase our operating flexibility. This allows us to position our business for sustainable long-term earnings and distributions growth once economic conditions stabilize.

### **INTERNATIONAL FINANCIAL REPORTING STANDARDS (“IFRS”)**

On February 13, 2008, the Canadian Accounting Standards Board confirmed that publicly accountable enterprises will be required to adopt IFRS in place of GAAP for interim and annual reporting purposes for fiscal years beginning on or after January 1, 2011.

Our conversion project is led by finance management and includes input from various areas of the organization. Using the changeover plan that we developed to map conversion to these new standards, we have identified and documented the areas of significant differences that apply to the Fund as well as the different options available under IFRS. This plan also assessed the impact of the changes to the Fund’s financial reporting, business processes and information systems.

The conversion project consists of three primary phases, which in certain cases will be in process concurrently as IFRS is applied to specific areas from start to finish:

- Scoping and diagnostic phase — This phase involves performing a detailed diagnostic comparing Canadian GAAP to IFRS and identifying key areas that may be impacted by the transition to IFRS.
- Impact analysis and design phase — In this phase, each area identified from the scoping and diagnostic phase will be addressed. This phase will determine the impact of the conversion on existing accounting policies, information systems, business processes and internal controls over financial reporting and disclosure. This phase will include an analysis of policy alternatives allowed under IFRS and development of draft IFRS financial statement content.
- Implementation and review phase — this phase will include execution of changes to information systems and business processes, completing formal authorization processes to approve recommended accounting policy changes and conducting training programs. The ultimate objective being able to provide IFRS compliant financial information.

During the fourth quarter of 2009, we continued to work with our accounting system consultants and ERP developers to enable the Fund's system to capture the necessary information for IFRS reporting. In many financial statement areas, IFRS requires more extensive disclosures than Canadian standards. Management has made the necessary estimates and draft disclosures for the transition date of January 1, 2010. The impact on our future financial position and results of operations appears to be limited to property, plant & equipment.

IFRS 1, "First-Time Adoption of International Financial Reporting Standards", provides entities adopting IFRS for the first time with a number of optional exemptions and mandatory exceptions, in certain areas, to the general requirement for full retrospective application of IFRS. We are analyzing the various accounting policy choices available and will implement those determined to be most appropriate in the Fund's circumstances.

## SUMMARY FINANCIAL INFORMATION

Statement of Income Items (\$000's)	Twelve months ended December 31			Three months ended December 31	
	2009	2008	2007	2009	2008
Sales	131,170	130,767	118,759	41,195	42,520
Cost of Sales	(69,127)	(64,306)	(51,210)	(18,011)	(18,703)
Gross Margin	62,043	66,461	67,549	23,184	23,817
<i>As a percentage of sales</i>	47.3%	50.8%	56.9%	56.3%	56.0%
Store and selling expenses	(46,785)	(46,784)	(41,273)	(12,664)	(13,384)
General and administrative expenses	(7,616)	(8,016)	(7,923)	(2,383)	(2,646)
EBITDA <sup>(1)</sup>	7,642	11,661	18,353	8,137	7,787
Adjusted EBITDA <sup>(1)</sup>	7,093	11,302	18,024	8,126	7,710
<i>As a percentage of sales</i>	5.4%	8.6%	15.2%	19.7%	18.1%
Interest expense	(2,637)	(2,322)	(984)	(669)	(676)
(Loss) / Gain on disposal	(627)	(333)	5	(367)	-
Impairment of goodwill & intangible assets	(33,246)	-	-	-	-
Amortization	(3,401)	(3,006)	(2,911)	(863)	(658)
(Loss) / Income before non-controlling interest and taxes <sup>(2)</sup>	(32,269)	6,000	14,463	6,238	6,453
Future income taxes / (recovery)	4,636	724	(7,724)	-	-
(Loss) / Income before non-controlling interest <sup>(2)</sup>	(27,633)	6,724	6,739	6,238	6,453
Non-controlling interest <sup>(2)</sup>	-	-	1,393	-	-
Net (Loss) / Income	(27,633)	6,724	5,346	6,238	6,453
Maintenance capital expenditures	3,012	2,913	2,929	103	574
	<b>As at December 31</b>				
<b>Balance Sheet Items (\$000's)</b>	<b>2009</b>	<b>2008</b>			
Total assets	77,165	111,126			
Long-term financial liabilities (including equity component)	25,000	25,000			

Notes:

- (1) See definition of EBITDA, Adjusted EBITDA and Maintenance Capital Expenditures under "Non-GAAP Measures".
- (2) On the Subordination End Date, the 20% non-controlling interest held by Inc. in the business of Sterling Shoes LP, was reclassified to unitholders' equity. As a result, (loss) / income before non-controlling interest and taxes are applicable to the quarters up to December 31, 2007 only.

The table below summarizes the distributions declared during the three and twelve-month periods ended December 31, 2009 and 2008 for Units of the Fund and to Inc on the Class D LP Units:

	<u>Three-months ended Dec 31</u>		<u>Twelve-months ended Dec 31</u>	
	<u>2009</u>	<u>2008</u>	<u>2009</u>	<u>2008</u>
Trust Units and Class D LP Units	\$ <u>247</u>	\$ <u>1,273</u>	\$ <u>1,555</u>	\$ <u>8,745</u>

## OPERATING RESULTS

### *Sales*

Sales for the three and twelve-month periods ended December 31, 2009 were \$41.2 million and \$131.2 million respectively compared to \$42.5 million and \$130.8 million respectively for the same periods in 2008. Same store sales for the three and twelve-month periods ended December 31, 2009 declined by 5.6% and 5.7% respectively, compared to the same periods during 2008.

As noted earlier, the twelve-months ended December 31, 2009 reflected a difficult retail sales environment, characterized by significant promotional activity in response to negative consumer sentiment and a recession-induced slowdown in customer traffic. For most of 2009 the Fund followed this pattern along with its competitors. During the three-months ended December 31, 2009 the Fund successfully protected margins at the expense of some sales. Weather during this period was seasonal; however it was not as advantageous as the conditions experienced in the three-months ended December 31, 2008 when unseasonal weather provided superior selling conditions.

Our ability to grow sales will depend on a number of factors including our ability to successfully identify and respond to changes in trends and customer tastes, our ability to hire, train, motivate, manage and retain qualified buyers, retail store management and personnel, as well as other factors further outlined in “Risks and Uncertainties”.

### *Cost of sales and gross margin*

Consumer confidence and the overall retail market (fashion and apparel in particular) continues to be weak. As noted earlier, the Fund continued its promotional activity to generate sales, clear inventory and respond to competitive forces during the three-months ended December 31, 2009. More promotional activity took place during each quarter of 2009 than the same periods of 2008 and 2007 which contributed to weaker gross margins. Efforts to reduce inventory levels during the first three quarters of 2009 allowed the Fund to make room for higher margin inventory, which contributed to higher margins during the three-month period ended December 31, 2009.

The Fund undertook a comprehensive review of business processes in order to manage the business through the current economic volatility. During 2009 cost of sales was negatively impacted by the deterioration of the Canadian dollar versus the U.S. dollar compared to 2008. Management expects that if the recent recovery of the Canadian dollar is sustained, margins will improve in 2010. Substantially all footwear sold in Canada is manufactured outside of Canada. Consequently, the cost of substantially all of our purchases is exposed to currency fluctuations either directly or indirectly. During the three and twelve-month periods ended December 31, 2009, approximately 57.9% and 49.2% of product purchases were denominated in U.S. dollars, respectively.

Cost of sales as a percentage of sales for the three and twelve-month periods ended December 31, 2009 was 43.7% and 52.7%, compared to 44.0% and 49.2% respectively for the same periods during 2008.

### ***Store and selling expenses***

Store and selling expenses for the three and twelve-month periods ended December 31, 2009 were 30.7% and 35.7% of sales, compared to 31.5% and 35.8% for the same periods during 2008, respectively. Store and selling expenses have a fixed underlying core with a large variable component, primarily consisting of expenses relating to occupancy and employee costs.

The decreases in store and selling expenses are a result of undertaking a comprehensive review of the business processes in order to manage the business through the current economic volatility. Efforts to reduce store and selling expenses, particularly store payroll costs, as a percentage of sales continues to be a key area of focus in this current economic climate. The increased flexibility of our cost structure should allow us to better weather further economic uncertainty.

### ***General and administrative expenses***

General and administrative (“G&A”) expenses for the three and twelve-month periods ended December 31, 2009 were 5.8% of sales, compared to 6.2% and 6.1% during the same periods in 2008, respectively. G&A expenses have been reduced in nearly all cost categories as a result of our comprehensive review of business processes to manage the business through the current economic volatility.

Lower G&A expenses for the three and twelve-month periods ended December 31, 2009 were due to reductions in professional fees, legal fees and information technology (“IT”) costs related to IT services and the evaluation phase of various new inventory management systems. However, until the new systems are implemented, we will continue to support our legacy system to run our business, which offsets some of the cost savings.

### ***Adjusted EBITDA*** (see “Non-GAAP Measures”)

Adjusted EBITDA for the three-months ended December 31, 2009 increased to \$8.1 million from \$7.8 million in 2008. For the twelve-months ended December 31, 2009 adjusted EBITDA fell to \$7.1 million from \$11.3 million in 2008.

### ***Interest expense***

Net interest expense with respect to funds utilized under the Fund’s credit facilities for the three and twelve-month periods ended December 31, 2009 was \$87 thousand and \$339 thousand, respectively (2008 - \$112 thousand and \$93 thousand, respectively).

Interest expense with respect to the Debentures for the three and twelve-month periods ended December 31, 2009 was \$582 thousand and \$2.3 million (2008 - \$564 thousand and \$2.2 million), respectively.

The Fund has allocated the proceeds of the Debentures between debt and equity based on the relative fair values of the debt and the conversion option, as determined by the residual valuation of the equity component. Under this approach, the liability component was valued first, and the difference between the proceeds of the Debentures and the fair value of the debt was assigned to the

conversion option. The present value of the liability component was calculated using a discount rate of 9.2% (at the date of issuance), the estimated market interest rate for similar debentures having no conversion rights.

The conversion option was valued at \$2,657 thousand at the date of issuance. The liability portion of the Debentures is being accreted to its face value over the term of the debt using the effective interest method, at an effective interest rate of 10.7%. Transaction costs consisting of commissions and professional fees related to the issuance of the Debentures amounted to \$1,231.

Included in interest expense for the three and twelve-month periods ended December 31, 2009 was \$176 thousand and \$673 thousand (2008 - \$158 thousand and \$604 thousand), respectively, relating to this interest accretion.

### *Impairment of goodwill and intangible assets*

During 2008 and 2009, the global economic and financial crisis significantly impacted the Canadian economy. This crisis resulted in reduced liquidity in the financial markets, increased unemployment rates, decreased consumer confidence and adversely affected the retail industry. The erosion of the Fund's valuation, primarily as a result of these factors, future economic uncertainty and the higher cost of capital assumptions used in the valuation methodology, contributed to the impairment charges against the Fund's goodwill and intangible asset balances taken during the year ended December 31, 2009.

The Fund undertook a detailed analysis in its determination of the fair value of its intangible assets. As a result of this analysis, the Fund incurred a non-cash impairment charge of \$33.2 million during the three-months ended September 30, 2009.

### *Inventory*

During 2009 management reduced inventory levels and adapted product mix in response to market conditions. At December 31, 2009, on a units per store basis, the Fund had 19% less inventory units, on a per store basis than at December 31, 2008.

We are currently working on major enhancements to our information technology systems which we believe will add to our ability to effectively manage inventory in our business. We have made significant strides in the project and we are working diligently towards project completion in 2010.

## **SELECTED QUARTERLY FINANCIAL INFORMATION**

in (\$000's) except per Unit amounts	Q4-2009	Q3-2009	Q2-2009	Q1-2009	Q4-2008	Q3-2008	Q2-2008	Q1-2008
Sales	\$ 41,195	\$ 31,685	\$ 30,618	\$ 27,672	\$ 42,520	\$ 33,895	\$ 29,405	\$ 24,948
Income / (Loss) taxes	\$ 6,238	\$ (35,432)	\$ (651)	\$ (2,428)	\$ 6,453	\$ 1,402	\$ 866	\$ (2,723)
Future income taxes / (recovery)	-	4,636	-	-	-	-	-	724
Income / (Loss)	\$ 6,238	\$ (30,796)	\$ (651)	\$ (2,428)	\$ 6,453	\$ 1,402	\$ 866	\$ (1,999)
Net income / (loss)	\$ 6,238	\$ (30,796)	\$ (651)	\$ (2,428)	\$ 6,453	\$ 1,402	\$ 866	\$ (1,999)
Basic income / (loss) per Unit	\$ 0.939	\$ (4.637)	\$ (0.098)	\$ (0.366)	\$ 0.972	\$ 0.211	\$ 0.130	\$ (0.371)
Diluted income / (loss) per Unit	\$ 0.820	\$ (4.637)	\$ (0.098)	\$ (0.366)	\$ 0.897	\$ 0.211	\$ 0.130	\$ (0.371)
Cash distributions per Unit	\$ 0.037	\$ 0.056	\$ 0.056	\$ 0.085	\$ 0.192	\$ 0.375	\$ 0.375	\$ 0.375
Number of stores open at end of period	162	162	161	159	160	158	148	143

Our sales are seasonal, primarily related to consumer spending patterns. The footwear and accessories sector of the Canadian retail market has two primary selling seasons during which new merchandise is introduced – spring and fall. Gross margins fluctuate over the course of these two primary selling seasons. Other factors include, and are not limited to, the timing of new store openings, merchandise mix and weather.

In any given period, weather can have a material impact on our business. As we become more geographically diversified, we expect weather-related effects will become less significant.

## CASH FLOW AND LIQUIDITY

We assess liquidity in terms of the Fund's ability to generate sufficient cash flow to fund its operations. Net cash flow is affected by the following items:

- operating activities, including the level of accounts receivable, inventory, prepaid expenses and deposits and accounts payable and accrued liabilities;
- investing activities, including capital expenditures; and
- External financing, including bank credit facilities and other capital market activities, providing both short and long-term financing. See "Capital Resources".

### Cash Flow from Operations

The table below reconciles net income to cash flow from operations for the three and twelve-month periods ended December 31, 2009 and 2008.

<b>Sterling Shoes Income Fund</b>				
<b>Reconciliation of Net Income / (Loss) to Cash provided by / (used in) operations</b>				
<b>December 31, 2009</b>				
<b>in (\$000's)</b>	<b>Three-months ended Dec 31</b>		<b>Twelve-months ended Dec 31</b>	
	<b>2009</b>	<b>2008</b>	<b>2009</b>	<b>2008</b>
<b>Net income / (Loss) and comprehensive income / (Loss)</b>	\$ 6,238	6,453	(27,633)	6,724
Add charges (deduct credits) to operations not requiring a cash payment:				
Impairment of goodwill and intangible assets			33,246	-
Revaluation of inventory per CICA Handbook Section 3031	-	-	-	3,306
Future income taxes / (recovery)	-	-	(4,636)	(724)
Amortization of leaseholds and equipment	863	658	3,401	3,006
Accreted interest expense	175	158	673	604
Amortization of deferred leasehold inducements	(11)	(77)	(550)	(359)
Loss on disposal of leaseholds and equipment	367	-	627	333
	<u>7,632</u>	<u>7,192</u>	<u>5,128</u>	<u>12,890</u>
Net change in non-cash working capital balances related to operations:				
Accounts receivable	456	(373)	690	(112)
Inventory	6,560	5,762	3,445	(10,858)
Prepaid expenses and deposits	213	316	297	524
Accounts payable and accrued liabilities	(3,340)	(8,193)	55	(3,464)
<b>Cash provided by / (used in) operating activities</b>	\$ <u>11,521</u>	<u>4,704</u>	<u>9,615</u>	<u>(1,020)</u>

For the year ended December 31, 2009, cash provided by operations was \$9.6 million compared to cash used in operations of \$1 million in the same period of 2008. The increase in cash provided by operations is due to our ongoing efforts to manage the timing of the investments in inventory and the payment of trade payables. Similarly, cash provided by operations was \$11.5 million for the three-month period ended December 31, 2009 as compared \$4.7 million for the same period in 2008.

Interim period working capital requirements typically reflect the seasonality of the business. In order to ensure that we have adequate inventory in advance of in-season demand, inventory levels increase in the period's immediately preceding peak seasons throughout the year. Accordingly, inventory levels typically increase in the first and third quarters and decline in the second and fourth quarter as sales pick up. Operating results in the three and twelve-month periods ended December 31, 2009 generally reflected these expectations.

### **Capital Expenditures**

We invested in capital expenditures of \$0.25 million and \$3.25 million (net of leasehold inducements) during the three and twelve-month periods ended December 31, 2009 (2008 - \$0.5 million and \$5.9 million) respectively. Of this amount, \$0.25 million and \$1.1 million were invested in leaseholds and equipment to furnish new stores during the three and twelve-month periods ended December 31, 2009 respectively (2008 - \$0.2 million and \$3.3 million). We incurred maintenance capital expenditures of \$0.1 million and \$3 million during the three and twelve-month periods ended December 31, 2009 (2008 - \$0.6 million and \$2.9 million), which were related to upgrades to information IT infrastructure, store renovations and store relocations. New store capital expenditures and maintenance capital expenditures were funded by cash from operations.

### **CAPITAL RESOURCES**

Cash flow from operations, bank borrowings and debentures issued have been the primary funding sources for working capital requirements and capital expenditures over the last several years.

A Canadian chartered bank has provided us with a revolving credit facility of up to \$15 million (the "Operating Loan"), which is available for working capital requirements, capital expenditures and for general corporate purposes and is repayable on October 31, 2010, subject to extension provisions. As at December 31, 2009, we have not utilized the Operating Loan.

We have utilized our \$5 million credit facility (the "Term Loan") for general funding of capital expenditures, including new store facilities. The Term Loan matures on October 31, 2010 with no scheduled repayments of principal required prior to maturity.

Loans under these facilities are pre-payable without any penalties and bear interest at a floating rate based on the Canadian dollar prime rate or on the bankers' acceptance rates plus, in each case, an applicable margin to those rates. The facilities are secured by a general security agreement covering all assets of Sterling Shoes GP.

The facilities are subject to customary terms and conditions, including limits on incurring additional indebtedness, granting liens or selling assets without the consent of the lender, and to customary financial covenants, including the maintenance of a minimum senior fixed charge coverage ratio. The facilities may in certain circumstances restrict our ability to pay distributions, including limiting distributions unless sufficient funds are available for the repayment of indebtedness and the payment of interest expenses. At December 31, 2009, we were in compliance with all covenants of these credit facilities.

### **OFF-BALANCE SHEET FINANCING**

We enter into standby letters of credit to facilitate the international purchase of merchandise and to secure certain of our obligations, including insurance programs and duties related to import

purchases. As of December 31, 2009, letters of credit totaling \$2.7 million are outstanding. The Fund has no other off-balance sheet arrangements.

## CONTRACTUAL OBLIGATIONS

We have the following inventory purchase, long-term debt and minimum rental commitments for premises, for the remainder of the current fiscal year and over the next four fiscal periods, in thousands of dollars:

<u>in \$000's</u>	<u>2010</u>	<u>2011</u>	<u>2012</u>	<u>2013</u>	<u>2014</u>
Inventory purchase commitments	1,740				
Long-term debt			25,000		
Operating and Term Loans	5,000				
Minimum rental commitments <sup>(1)</sup>	15,244	13,974	13,372	12,243	10,341
	<u>21,984</u>	<u>13,974</u>	<u>13,372</u>	<u>12,243</u>	<u>10,341</u>

Note:

- (1) Excludes percentage rent adjustments and operating expense adjustments.

## DISTRIBUTABLE CASH AND DISTRIBUTIONS

In any fiscal year Sterling Shoes LP and the Fund intend to make distributions of available cash to the maximum extent possible to the Unitholders and the non-controlling interest. This includes the distribution of all available cash from operations after cash required for maintenance capital expenditures, and after consideration of changes in non-cash working capital balances and other reserves considered advisable.

The Fund may make additional distributions in excess of monthly distributions. Distributions declared in respect of the month ended December 31 of each year may include such amounts as are necessary to ensure that the Fund will not be liable for income taxes under Part I of the Tax Act.

The Fund reviews its historic and expected results on a regular basis. This review includes consideration of economic conditions, including seasonality, and the competitive environment. Distributions made may not equal Adjusted Distributable Cash generated in any one period. The Fund's policy is to make stable monthly distributions to Unitholders based on estimated Adjusted Distributable Cash for the year.

In response to negative market conditions, we announced a suspension of distribution payments beginning with the December 2009 distribution. We take a long term view of distributions that considers, among other criteria, current and expected economic and operating conditions. While our operations are sound, in view of the deteriorating economic conditions and the heightened risk in the credit markets, we considered it prudent to suspend the distribution in order to maintain our sound balance sheet and increase our flexibility. This allows us to position our business for sustainable long-term earnings and distributions growth once economic conditions stabilize.

## ADJUSTED DISTRIBUTABLE CASH

On July 6, 2007 the Canadian Securities Administrators ("CSA") amended National Policy 41-201 "Income Trusts and Other Indirect Offerings" (the "CSA Guidance"). The Fund has calculated Standardized Distributable Cash based on the CSA Guidance as cash flows from operating activities, including the effects of changes in non-cash working capital, less sustaining

(maintenance) capital expenditures. The Fund has also retained the Fund's historical Non-GAAP measure of Adjusted Distributable Cash (formerly Distributable Cash) by further adjusting Standardized Distributable Cash to exclude the effect of changes in non-cash working capital. The table below is a summary of Standardized Distributable Cash and Adjusted Distributable Cash and per Unit and Ratio disclosures for the three and twelve-month periods ended December 31, 2009.

in \$000's except per unit amounts and payout ratios	Three-months ended Dec 31		Twelve-months ended Dec 31		From inception
	2009	2008	2009	2008	of the Fund to Dec 31, 2009
<b>Standardized Distributable Cash</b>					
Cash provided by / (used in) operating activities	\$ 11,521	\$ 4,704	\$ 9,615	\$ (1,020)	\$ 40,571
Less: Maintenance Capital Expenditures	(103)	(574)	(3,012)	(2,913)	(12,150)
<b>Standardized distributable cash generated</b>	<u>\$ 11,418</u>	<u>\$ 4,130</u>	<u>\$ 6,603</u>	<u>\$ (3,933)</u>	<u>\$ 28,421</u>
Less: Changes in non-cash working capital balances related to operation	3,889	(2,488)	4,487	(13,910)	(14,827)
<b>Adjusted distributable cash generated</b>	<u>\$ 7,529</u>	<u>\$ 6,618</u>	<u>\$ 2,116</u>	<u>\$ 9,977</u>	<u>\$ 43,248</u>
Adjusted Distributable Cash available for distribution to Unitholders	\$ 7,529	\$ 6,618	\$ 2,116	\$ 9,977	\$ 43,248
Adjusted Distributable Cash generated per Unit	\$ 1.133	\$ 0.996	\$ 0.319	\$ 1.502	\$ 6.511
Distributions declared per Unit	\$ 0.037	\$ 0.192	\$ 0.234	\$ 1.317	\$ 7.092
Adjusted Payout Ratio	3.3%	19.2%	73.5%	87.7%	108.92%
Number of units outstanding:	6,641,860	6,641,860	6,641,860	6,641,860	6,641,860

Management believes that the Standardized Distributable Cash calculation introduces significant volatility to the Fund's quarter-to-quarter distributable cash and payout ratios, as our non-cash working capital fluctuates significantly as a result of the seasonality of our business, changes in the timing of the payment of payable transactions and the investment in working capital required to open new stores. As a result, management believes our historical measure of Adjusted Distributable Cash, which excludes the impact of changes in non-cash working capital, is a better measure for determining our operating performance.

The Fund's Board looks beyond quarter-to-quarter fluctuations in working capital when making decisions regarding monthly distributions. As mentioned earlier, the Fund's policy has been to make distributions to its Unitholders necessary to pay out its taxable income. The adjusted payout ratio for the trailing twelve months ended December 31, 2009 was 73.5%, as compared to 87.7% for the twelve months ended December 31, 2008.

Cash distributions have been made as follows:

<b>Distribution History</b>	<b>Distributions</b>	<b>Distribution History</b>	<b>Distributions</b>	<b>Distribution History</b>	<b>Distributions</b>
<b>Year / Month</b>	<b>per Unit</b>	<b>Year / Month</b>	<b>per Unit</b>	<b>Year / Month</b>	<b>per Unit</b>
<b>2005</b>		<b>2006</b>		<b>2007</b>	
		January	\$ 0.08958	January	\$ 0.12000
		February	0.08958	February	0.12000
		March	0.08958	March	0.12000
		April	0.08958	April	0.12000
		May <sup>(3)</sup>	0.10500	May	0.12000
		June	0.10500	June	0.12000
		July	0.10500	July	0.12000
		August	0.10500	August	0.12000
July / August <sup>(1)</sup>	\$ 0.14737	September	0.10500	September	0.12000
September	0.08958	October	0.10500	October	0.12000
October	0.08958	November <sup>(4)</sup>	0.12000	November	0.12000
November	0.08958	December	0.12000	December	0.12000
December	0.08958	December <sup>(5)</sup>	0.32000	December <sup>(7)</sup>	0.36000
December <sup>(2)</sup>	0.16000	December <sup>(6)</sup>	0.15000	December <sup>(8)</sup>	0.06000
<b>Total 2005</b>	<b>\$ 0.66569</b>	<b>Total 2006</b>	<b>\$ 1.69832</b>	<b>Total 2007</b>	<b>\$ 1.86000</b>
<b>2008</b>		<b>2009</b>		<b>2010</b>	
January <sup>(9)</sup>	\$ 0.12500	January	\$ 0.03333	January	\$ nil
February	0.12500	February	0.03333	February	nil
March	0.12500	March <sup>(11)</sup>	0.01862		
April	0.12500	April	0.01862		
May	0.12500	May	0.01862		
June	0.12500	June	0.01862		
July	0.12500	July	0.01862		
August	0.12500	August	0.01862		
September	0.12500	September	0.01862		
October <sup>(10)</sup>	0.12500	October	0.01862		
November	0.03333	November	0.01862		
December	0.03333	December <sup>(12)</sup>	nil		
<b>Total 2008</b>	<b>\$ 1.31667</b>	<b>Total 2009</b>	<b>\$ 0.23424</b>	<b>Total year-to-date 2010</b>	<b>\$ nil</b>

Notes:

- (1) The Fund made its initial distribution of \$0.14737 per Unit for the 51-day period from July 12, 2005 to August 31, 2005.
- (2) On December 13, 2005 the Fund announced a special distribution of \$0.16 per Unit to Unitholders of record on December 30, 2005, representing the Fund's estimate of the distribution required to ensure the Fund was not liable for income taxes under Part I of the Tax Act for fiscal 2005. \$0.16 per Unit, the Fund's estimate of this amount, was paid on January 16, 2006 to Unitholders of record on December 30, 2005.
- (3) Effective May 1, 2006 the Fund raised its monthly distribution by 17.2% from \$0.08958 per Unit to \$0.105 per Unit.
- (4) Effective November 1, 2006 the Fund raised its monthly distribution by 14.3% from \$0.105 per Unit to \$0.12 per Unit.
- (5) On December 18, 2006 the Fund announced a special distribution of \$0.32 per Unit to Unitholders of record on December 29, 2006, representing the Fund's estimate of the distribution required to ensure the Fund was not liable for income taxes under Part I of the Tax Act for fiscal 2006. This amount was paid on January 15, 2007 to Unitholders of record on December 29, 2006.

- (6) On March 22, 2007 the Fund announced a supplementary special distribution of \$0.15 per Unit to Unitholders of record on December 29, 2006, representing the Fund's remaining distribution required to ensure the Fund was not liable for income taxes under Part I of the Tax Act for fiscal 2006. The \$0.15 per Unit supplementary special is in addition to the \$0.32 per Unit that was estimated at December 18, 2006 and paid on January 15, 2007. The \$0.15 per Unit was paid on March 30, 2007 to Unitholders of record on December 29, 2006.
- (7) On December 17, 2007 the Fund announced a special distribution of \$0.36 per Unit to Unitholders of record on December 31, 2007, representing the Fund's estimate of the distribution required to ensure the Fund was not liable for income taxes under Part I of the Tax Act for fiscal 2007. This amount was paid on January 15, 2008 to Unitholders of record on December 31, 2007.
- (8) On March 26, 2008 the Fund announced a supplementary special distribution of \$0.06 per Unit to Unitholders of record on December 31, 2007, representing the Fund's remaining distribution required to ensure the Fund was not liable for income taxes under Part I of the Tax Act for fiscal 2007. The \$0.06 per Unit supplementary special is in addition to the \$0.36 per Unit that was estimated at December 17, 2007 and paid on January 15, 2008. The \$0.06 Unit was paid on March 31, 2008 to Unitholders of record on December 31, 2007.
- (9) Effective January 1, 2008 the Fund raised its monthly distribution by 4.2% from \$0.12 per Unit to \$0.125 per Unit.
- (10) Effective November 1, 2008 the Fund reduced its monthly distribution by 73% from \$0.125 per Unit to \$0.03333 per Unit.
- (11) Effective March 1, 2009 the Fund reduced its monthly distribution by 44% from \$0.03333 per Unit to \$0.01862 per Unit.
- (12) Effective December 1, 2009 the Fund suspended its monthly distributions from \$0.01862 to \$Nil per Unit.

When declared, distributions are paid on the 15<sup>th</sup> of each month, or the next following business day, to Unitholders of record on the last business day of the preceding month. Unitholders who are non-residents of Canada are required to pay all withholding taxes payable on any distributions by the Fund. Effective April 1, 2008, distributions to the non-controlling interest have been made monthly and are no longer subordinated. These distributions were subject to subordination until December 31, 2007 pending the Fund achieving specific EBITDA and distribution targets. For further information see "End of Subordination".

The Fund declared distributions to public Unitholders of \$247 thousand and \$1.56 million for the three and twelve-month periods ended December 31, 2009 (2008 - \$1.3 million and \$8.7 million), respectively.

## **NON-GAAP MEASURES**

References to "EBITDA" are to earnings before interest, income taxes, depreciation and amortization and references to "Adjusted EBITDA" are to EBITDA after adjusting for amortization of leasehold inducements. EBITDA is a measure used by many investors to compare issuers on the basis of ability to generate cash flow from operations. Adjusted EBITDA is a measure our management believes facilitates the comparability and analysis of our financial performance. EBITDA and Adjusted EBITDA are not earnings measures recognized by GAAP and do not have standardized meanings prescribed by GAAP and are therefore unlikely to be comparable to similar measures presented by other issuers. We intend to distribute substantially all of our cash on an on-going basis (after providing for certain amounts described elsewhere in this MD&A) and, accordingly, our management believes that EBITDA and Adjusted EBITDA are important

supplemental measures in evaluating our performance and in determining whether to invest in Units.

You are cautioned that EBITDA and Adjusted EBITDA should not be construed as an alternative to net income or loss determined in accordance with GAAP as indicators of our performance or to cash flows from operating, investing and financing activities as measures of our liquidity and cash flows.

“Maintenance Capital Expenditures” is not a recognized measure under GAAP. Maintenance Capital Expenditures include those required to upgrade existing stores and to maintain information systems and equipment and our warehouse.

“Net Senior Debt” is not a recognized measure under GAAP. Net Senior Debt is equal to net bank indebtedness combining Operating loan balance and Term loan balance.

## **FUTURE INCOME TAXES**

On October 31, 2006, the Minister of Finance announced proposed changes to the income tax treatment of “flow-through entities”, including income trusts. On June 22, 2007 the Government of Canada enacted new legislation imposing a tax on distributions paid by publicly traded income trusts in Canada, commencing in 2011. Unitholders will be treated as if they have received an eligible dividend from a Canadian public corporation equal to the taxable portion of their distributions and will be taxed accordingly.

Prior to June 22, 2007, the Fund calculated its future income tax on temporary differences between amounts recorded on its balance sheet for book and tax purposes at a nil tax rate. Under the newly enacted legislation, the tax rate on the post-2010 reversal of these temporary differences is estimated to be 27.5%. Temporary differences reversing prior to December 31, 2010 will still give rise to nil future income taxes.

As a result the Fund has recorded a future tax liability. The Fund’s identifiable intangible assets, recorded on the balance sheet at \$16.6 million, (but which have nil basis for tax purposes), are treated as a temporary difference that will reverse after January 1, 2011.

The result of this treatment was a future income tax liability of \$7.7 million created during the second quarter of 2007. This future income tax liability was based on the expected tax rate of 31.5% and the assumption that the Fund will be a taxable entity in 2011. Based on the currently enacted tax rate of 27.5%, and the same assumptions, the Fund revised this future income tax liability during the first quarter of 2008 to \$7.0 million. As at December 31, 2009 the impairment of intangible assets further reduced the Fund’s expected future income tax liability. The future income tax recovery for the three-month and twelve-month periods ended December 31, 2009 was \$nil and \$4.6 million, respectively (2008 - \$nil and \$0.7 million, respectively) with the remaining future income tax liability estimated at \$2.4 million based on the temporary differences between the accounting and tax basis of the Fund’s assets and liabilities expected to reverse after January 1, 2011.

In future periods, adjustments to this future tax liability may be required based on changes in the differences between the tax basis and financial statement basis of the Fund’s assets and liabilities. These adjustments could be material. Consistent with the initial recognition, any future adjustments will be non-cash in nature and will be either a charge or an addition to net income of the period.

Since this tax will not be in effect until 2011, any changes to the tax legislation or to the legal structure of the Fund prior to that time could have a material effect on the level of the future income taxes recorded by the Fund.

## **TRANSACTIONS WITH RELATED PARTIES**

- (a) The Fund paid rent to a company in which Jeremy Horwitz and Mannie Druker, trustees and officers of the Fund, have an interest, amounting to \$71 thousand and \$296 thousand for the three and twelve-month periods ended December 31, 2009 ( 2008 – \$71 thousand and \$282 thousand), respectively.
- (b) The Fund purchased equipment from a company in which Mannie Druker, a trustee and officer of the Fund, has an interest, for \$48 thousand and \$170 thousand during the three and twelve-month periods ended December 31, 2009 (2008 – \$17 thousand and \$430 thousand), respectively.

These transactions arose during the normal course of business and have been recorded at the exchange amount, which is the amount agreed upon by the parties.

## **CRITICAL ACCOUNTING ESTIMATES**

The preparation of our financial statements requires us to estimate the effect of several variables that are inherently uncertain. These estimates and assumptions can affect the reported amounts of assets, liabilities, sales and expenses. Management bases its estimates on historical experience and other assumptions, which it believes to be reasonable under the circumstances. Management also evaluates its estimates on an ongoing basis. Our significant accounting policies are described in Note 2 of the Fund's financial statements for the three and twelve-month periods ended December 31, 2009. Management believes that the following items represent the Fund's critical accounting estimates.

### ***Inventory Valuation***

Effective January 1, 2008, the Fund adopted CICA Handbook Section 3031, Inventories ("Section 3031"). Section 3031 requires inventories to be measured at the lower of cost and net realizable value. The Fund determines inventory cost based on a weighted average cost formula and values inventory at the lower of cost and net realizable value.

### ***Intangible assets and Goodwill***

Identifiable intangible assets, including store banners and private label brand names, are carried at cost. These assets have been determined by management to have indefinite lives and are therefore not being amortized. These assets are reviewed at least annually for impairment or whenever events or changes in circumstances indicate that the carrying amount of an asset may be impaired.

If such assets are considered to be impaired, the impairment to be recognized is measured as the amount by which the carrying amount of the assets exceeds fair value.

At September 30, 2009 the Fund determined that the fair value of the intangible assets was less than the book value, resulting in a non-cash impairment charge of \$32.4 million for the three-months ended September 30, 2009. The impairment arose primarily due to future economic uncertainty and the higher cost of capital assumptions in the valuation methodology.

Goodwill is recorded at cost and is not amortized. Goodwill is reviewed for impairment at least annually, or whenever events or changes in circumstances indicate that the carrying amount may be impaired. If goodwill is considered to be impaired, the impairment to be recognized is measured as the estimated amount by which the carrying amount of the goodwill exceeds fair value.

At September 30, 2009 the Fund determined that the fair value of the goodwill was less than the book value primarily due to future economic uncertainty and the higher cost of capital assumptions in the valuation methodology. As a result, the Fund has written off goodwill, recording an impairment charge of \$0.8 million.

### ***Future income taxes***

Future income tax assets and liabilities are determined based on the difference between the tax basis of the Fund's assets and liabilities and the amounts reported in the financial statements. Future tax assets or liabilities are calculated using the tax rates for the periods in which the differences are expected to be settled. Future tax assets are recognized to the extent that they are considered more likely than not to be realized.

### ***Convertible Debentures***

The Fund has allocated the proceeds of the Debentures between debt and equity based on the relative fair values of the debt and the conversion option, as determined by the residual valuation of the equity component. Under this approach, the liability component was valued first, and the difference between the proceeds of the Debentures and the fair value of the debt was assigned to the conversion option. The present value of the liability component was calculated using a discount rate of 9.2%, the estimated market interest rate at the date of issuance for similar debentures having no conversion rights.

The conversion option was valued at \$2,657 thousand at the date of issuance. The liability portion of the Debentures is being accreted to its face value over the term of the debt using the effective interest method, at an effective interest rate of 10.7%. Transaction costs consisting of commissions and professional fees related to the issuance of the Debentures amounted to \$1,231 thousand.

## **NEW ACCOUNTING STANDARDS ADOPTED**

The Canadian Institute of Chartered Accountants ("CICA") issued a new accounting standard that became effective for the Fund on January 1, 2009: Handbook Section 3064, Goodwill and Intangibles ("Section 3064"). Section 3064 replaces Handbook Section 3062 of the same title and Handbook Section 3450, Research and Development Costs. Section 3064, effective for fiscal years beginning on or after October 1, 2008, establishes standards for the recognition, measurement and disclosure of goodwill and intangible assets. While the standards concerning goodwill are unchanged from the standards in the previous Section 3062, the provisions related to the definition and initial recognition of intangible assets are equivalent to the corresponding provisions of IFRS.

## **FUTURE CHANGES IN ACCOUNTING STANDARDS**

(i) International Financial Reporting Standards ["IFRS"], as discussed above.

The Canadian Accounting Standards Board (AcSB) will require all publicly accountable entities to adopt IFRS for interim and annual financial statements relating to fiscal years beginning on or

after January 1, 2011. The Fund will be required to prepare both current and comparative financial information using IFRS.

While the conceptual framework for IFRS and Canadian GAAP are similar, there are significant differences in recognition, measurement and disclosure requirements. The Fund has developed a changeover plan to map its conversion from Canadian GAAP to IFRS by identifying and documenting the areas of significant differences that apply to the Fund, evaluating the different options available under IFRS, assessing the impact of the changes to the Fund's financial reporting, business processes and information systems, and anticipating the steps necessary for successful conversion on the date of transition. The Fund expects training and additional resources will be utilized to ensure timely conversion to IFRS.

The financial impact of the transition to IFRS cannot be reasonably estimated at this time. The Fund will continually review and adjust the changeover plan as necessary to properly address the key elements of the plan.

(ii) Handbook Section 1582, Business Combinations (“Section 1582”)

Section 1582 replaces Handbook Section 1581 of the same title. It provides the Canadian equivalent to corresponding sections of IFRS.

Section 1582 applies prospectively to business combinations for which the acquisition date is on or after January 1, 2011 with early adoption permitted. This section improves the relevance, reliability, and comparability of the information that a reporting entity provides in its financial statements about a business combination. Adoption of this standard is not expected until January 1, 2011. The Fund has not yet determined the impact of the adoption of this new Section on the consolidated financial statements.

(iii) Handbook Section 1601, Consolidated Financial Statements (“Section 1601”) and Handbook Section 1602, Non-controlling Interests (“Section 1602”)

Sections 1601 and 1602 replace Handbook Section 1600, Consolidated Financial Statements and apply to fiscal years beginning on or after January 1, 2011, with early adoption permitted. Section 1601 establishes standards for the preparation of consolidated financial statements. Section 1602 establishes standards for accounting for a non-controlling interest in a subsidiary in consolidated financial statements subsequent to a business combination. An entity which adopts Section 1582, 1601, or 1602 early also adopts the other two sections at the same time. Adoption of this standard is not expected until January 1, 2011. The Fund has not yet determined the impact of the adoption of this new Section on the consolidated financial statements.

## **RISKS AND UNCERTAINTIES**

### **BUSINESS RISK**

#### ***Dependence on Consumer Spending and Economic Environment***

The success of our operations depends upon a number of general economic factors relating to consumer spending, including employment levels, business conditions, consumer confidence, interest rates, inflation and taxation. There can be no assurance that consumer spending will not decline further in response to economic conditions, thereby adversely affecting our operating results.

The recent deterioration in economic conditions and the uncertainty of future developments in the domestic and global economies has significantly reduced consumer confidence negatively impacted our results in 2009. Management cannot estimate the level of growth or contraction for the economy as a whole or for the economy of any particular region or market that we serve. Adverse changes in our financial condition and results of operations may occur as a result of continuing negative economic conditions, unemployment, declines in stock markets, contraction of credit availability or other factors affecting economic conditions generally.

### ***Maintaining Profitability and Managing Growth***

Our future operating results will depend on a number of factors, including:

- our ability to maintain or increase sales and profitability;
- our ability to successfully identify and respond to changes in trends and customer tastes;
- our ability to maintain cost-effective delivery of our merchandise to our distribution centres and our stores;
- our ability to hire, train, motivate, manage and retain qualified buyers, retail store management and personnel;
- the level of competition in the retail footwear industry in the markets in which we operate;
- the efficiency and effectiveness of our marketing programs in building brand awareness and increasing sales; and
- general economic conditions and consumer confidence.

There can be no assurance that we will be able to successfully execute our strategic plan or that such plan will enable us to maintain or increase historical sales, profitability or growth rates. Failure to successfully execute any material part of our strategic plan could have a material adverse effect on our business, financial condition, liquidity and results of operations. There can be no assurance that we will be able to effectively manage our growth, and any failure to do so could have a material adverse effect on our business, financial condition, liquidity and results of operations.

### ***Competition***

Retail footwear is a highly competitive global business that is subject to rapidly changing consumer demands. In addition, several external factors over which we have no influence affect the economic climate and consumer confidence.

In this competitive environment, the importance of the following cannot be over-emphasized: implementing efficient and effective marketing programs to build brand awareness; identifying and responding to changes in trends and customer tastes; providing quality service; and continually exceeding customer expectations so that we deliver a total customer experience.

We believe that our sound financial position, targeted marketing, purchasing expertise, strong sourcing capabilities, cost-effective delivery of merchandise, experienced management, and dedicated personnel will facilitate our continued success; however, there is no guarantee that we will be successful.

### ***Risks Associated with Leasing and Expansion***

Our on-going success will depend to a significant degree on our ability to maintain our existing operations through the successful renewal, on a profitable basis, of our existing store leases as they come due. Our continued growth will depend to a significant degree on our ability to expand our operations through the opening of new stores and to operate these stores on a profitable basis. Our ability to successfully negotiate lease renewals and to expand will be significantly dependent upon our ability to locate suitable store sites and negotiate acceptable lease terms. In addition, several other factors could affect our ability to expand, including the adequacy of our capital resources, the ability to hire, train and integrate employees and the ability to adapt our operational systems.

There can be no assurance that we will successfully renew our existing leases as they come due on a profitable basis or achieve our planned expansion or that any such expansion will be profitable. In addition, there can be no assurance that our expansion within our existing markets will not adversely affect the financial performance of our existing stores or our overall operating results, or that new stores will achieve net sales and profitability levels consistent with existing stores. As part of our expansion planning, we regularly evaluate the adequacy of our existing systems and procedures, including our product distribution facility, store management, financial controls and management information systems. However, there can be no assurance that we will anticipate all of the changing demands that expanded operations may impose on such systems. Failure to adapt our internal systems or procedures as required could have a material adverse effect on our business, financial condition and results of operations.

### ***Foreign Exchange***

Our foreign exchange risk is primarily limited to currency fluctuations between the Canadian and U.S. dollar. From time to time we enter into foreign exchange forward contracts that oblige us to purchase specific amounts of foreign currencies at set future dates at predetermined exchange rates. The contracts are matched with anticipated foreign currency purchases in U.S. dollars from time to time. We enter into the foreign exchange forward contracts to provide a hedge against the risk of losses should the value of the Canadian dollar decline compared to the foreign currency. We do not enter into foreign exchange contracts for speculative or trading purposes. See further discussion under “Financial Instruments”.

### ***Seasonality and Fluctuations in Quarterly Results***

Our business is seasonal and generally we experience lower sales in the months of January and February. As the Fund's fiscal year is the calendar year, this seasonal decline in sales will likely occur in the first quarter of each fiscal year.

The footwear and accessories sector of the Canadian retail market has two primary selling seasons during which new merchandise is introduced – Spring and Fall. Gross margins fluctuate over the course of each of these selling seasons, declining as the season draws to a close as mark-downs are taken on sales and the inventory is discounted.

Our quarterly results of operations may also fluctuate based upon such factors as delays in the flow of merchandise, the number and timing of new store openings and related pre-opening expenses, the amount of sales contributed by new and existing stores, the mix of products sold, competitive factors, changes to shipping costs, general economic conditions, labour market fluctuations, changes in accounting rules and regulations and unseasonable weather conditions.

### ***Credit Facilities and Restrictive Covenants***

The Partnership has third-party debt service obligations under the Credit Facilities. See "Credit Facilities". The degree to which the Partnership is leveraged could have important consequences to the holders of the Units, including: (i) a portion of the Partnership's cash flow from operations will be dedicated to the payment of the principal of and interest on the indebtedness, thereby reducing funds available for future operations and distribution to the Trust and ultimately to the Fund; (ii) certain of the Partnership's borrowings will be at variable rates of interest, which exposes the Partnership to the risk of increased interest rates; and (iii) the Partnership's ability to obtain additional financing for working capital, capital expenditures or acquisitions in the future may be limited. The Partnership's ability to make scheduled payments of principal and interest on, or to refinance, its indebtedness will depend on its future operating performance and cash flow, which are subject to prevailing economic conditions, prevailing interest rate levels, and financial, competitive, business and other factors, many of which are beyond our control. These factors might inhibit the Partnership from refinancing the indebtedness at all or on favourable terms, which could have a negative impact on our ability to make distributions on the Units.

The Credit Facilities contain numerous restrictive covenants that limit the discretion of management with respect to certain business matters. These covenants will place restrictions on, among other things, the ability of the Partnership to incur additional indebtedness, to create liens or other encumbrances, to pay distributions or make certain other payments, investments, loans and guarantees, and to sell or otherwise dispose of assets or merge or consolidate with another entity. A failure to comply with the obligations in the agreements in respect of the Credit Facilities could result in an event of default which, if not cured or waived, could permit acceleration of the relevant indebtedness. If the indebtedness under the Credit Facilities were to be accelerated, there can be no assurance that our assets would be sufficient to repay in full that indebtedness.

The Credit Facilities each expire on October 31, 2010, subject to extension provisions. The Partnership may need to refinance the Credit Facilities at the conclusion of their term, and there can be no assurance that the Partnership will be able to do so or able to do so on terms that are as favourable as the Credit Facilities. If the Partnership is unable to refinance the Credit Facilities or is only able to refinance the Credit Facilities on less favourable and / or more restrictive terms, this may have a material adverse effect on the Partnership's financial position, which may result in a reduction or suspension of cash distributions to Unitholders. In addition, the terms of any new credit facilities may be less favourable or more restrictive than the terms of the Credit Facilities, which may indirectly limit or negatively impact the ability of the Fund to pay cash distributions to Unitholders.

### ***Future Capital Needs***

We cannot assure you that we will be able to generate sufficient cash flow from operations or obtain sufficient borrowings under our credit facilities, on reasonable terms or at all, to finance our growth strategy and meet our other liquidity needs. Our actual costs may be greater than anticipated. We also require working capital to support inventory for our existing stores. Failure to generate or raise sufficient funds may require us to modify, delay or abandon some of our future growth or expenditure plans. Also, our results would be adversely affected if interest rates were to increase materially from present levels.

### ***Management Information Systems***

With the growth in our Business we are increasingly dependent on our computer systems to support our operations. We have used legacy systems to support the majority of our operations in the areas of finance, inventory management and point of sale. Management determined that these legacy systems were not the most effective to support our growth in the number of stores in our Business and has been working toward the implementation of a new enterprise resource planning (“ERP”) system. The ERP system is intended to be a centralized system that is linked to servers supporting localized processes and specialized applications, including payroll and distribution. There can be no assurance that we will not experience operational problems, with our existing legacy systems or with the ERP system, as a result of implementation issues, system failures, viruses, security breaches or other causes. In addition there can be no assurance that we will be able to timely implement, modify or adapt our systems to meet evolving requirements for our Business. Any material disruption or slowdown of our systems could cause operational issues.

### ***Cash Distributions Are Not Guaranteed and May Fluctuate with Sterling Shoes LP’s Performance***

Although the Fund intends to distribute the interest and distributions received by the Fund on the Units and notes of SS Holdings Trust (the “Trust”) less expenses and amounts, if any, paid by the Fund in connection with the redemption of Units, there can be no assurance regarding the amounts of income to be generated by Sterling Shoes LP and paid, indirectly, to the Fund. The actual amount distributed in respect of the Units will depend upon numerous factors associated with Sterling Shoes LP, including its profitability, fluctuations in its working capital, the sustainability of its margins, interest expenses and its requirements for repayment of indebtedness and incurrence of capital expenditures.

### ***Nature of Units***

Unitholders own an equal undivided interest in the Fund. The Units do not and will not represent a direct investment in Sterling Shoes LP. As holders of Units, Unitholders do not have the statutory rights normally associated with ownership of shares of a corporation including, for example, the right to bring oppression or derivative actions. The Units represent a fractional interest in the Fund.

The Fund’s primary assets are its 100% ownership interest in the notes and units of the Trust. The Trust, in turn, is a limited partner in Sterling Shoes LP. The price per Unit is, in part, a function of anticipated distributable income, distributions, as well as the consolidated indebtedness, net of cash and cash equivalents of the Fund including the net indebtedness of Sterling Shoes LP. The price per Unit may also be a function of interest rates or expected returns available, or perceived to be available, on alternative investments.

### ***Risks Associated with Convertible Debentures***

#### ***Interest Payments***

Interest payments on the Debentures and cash distributions on the Units issuable upon conversion, redemption or repayment of the Debentures are not guaranteed and are entirely derived from the business operated by related entities of the Fund and from the ability of each such entity to make distributions on its securities. There can be no assurance that the Fund and the related entities of the Fund will be able to make interest payments as they become due pursuant to the terms of the Debentures.

### *Prior Ranking Indebtedness*

The Debentures are subordinate to all Senior Indebtedness. The payment of the principal premium (if any) and interest on the Debentures is subordinated to Senior Indebtedness of the Fund. The Debentures are also effectively subordinate to claims of creditors of the Fund's subsidiaries except to the extent the Fund is a creditor of such subsidiaries ranking at least *pari passu* with such other creditors.

### *Inability to Fund Purchase of Debentures*

The Fund is required to offer to purchase all outstanding Debentures upon the occurrence of a change of Control. However, it is possible that following a Change of Control, the Fund will not have sufficient funds at that time to make the required purchase of outstanding Debentures or that restrictions contained in other indebtedness will restrict those purchases.

### *Absence of Covenant Protection*

The Indenture does not restrict the Fund or any of its subsidiaries from incurring additional indebtedness or from mortgaging, pledging or charging its assets to secure any indebtedness. The Indenture does not contain any provisions specifically intended to protect holders of the Debentures in the event of a future leveraged transaction involving the Fund or any of its subsidiaries.

### *Update for Tax Legislation*

On June 22, 2007, the Parliament of Canada passed into law Bill C-52, an Act to implement certain provisions of the federal budget tabled in Parliament on March 19, 2007, which included legislation to implement the proposal announced by the Minister of Finance on October 31, 2006 to tax specified investment flow-through trusts ("SIFTs"), including the Fund, on the taxable portion of their distributions. As a result of the enactment of Bill C-52 commencing January 1, 2011 (subject to the qualification below regarding the possible loss of the four year grandfathering period in the case of "undue expansion"), the Fund will not be entitled to deduct certain of its distributed income (referred to as specified income) and the Fund will be subject to a distribution tax on the specified income at a special rate estimated to be 27.5%.

The Fund may be subject to this distribution tax in respect of a taxation year of the Fund commencing earlier than January 1, 2011 if, prior to such date, the Fund engages in "undue expansion" as set out in the guidelines released by the Department of Finance on December 15, 2006 and which was incorporated by reference in Bill C-52. The implementation of the legislation could have an adverse effect on the Fund, its ability to pay distributions and the market value of its units.

The Department of Finance has published proposed amendments to the Tax Act which are intended to facilitate the conversion of a SIFT into corporate form on a tax deferred basis (the "Conversion Rules"). The Conversion Rules address many of the principal substantive and administrative issues that currently arise when structuring the conversion of a SIFT under the Tax Act.

The Fund is considering these legislative changes and their possible impact on the Fund.

## FINANCIAL INSTRUMENTS

Our business is exposed to financial risks that arise from fluctuations in interest rates (in terms of our credit facilities) and foreign exchange rates (in terms of our U.S. dollar-denominated purchases) and the degree of volatility of these rates.

Risk from foreign exchange arises as a result of variations in exchange rates between the Canadian and the U.S. dollar. Historically, approximately 35% to 40% of the Fund's product purchases are denominated in U.S. dollars. During the three and twelve-month periods ended December 31, 2009 approximately 57.9% and 49.2% (2008 – 54.1% and 39.4%) of the Fund's product purchases were denominated in U.S. dollars. The Fund does not hold or issue financial instruments for trading or speculative purposes. From time to time, the Fund enters into contracts to manage the foreign exchange risk associated with anticipated purchases in US dollars. At December 31, 2009, the Fund had forward foreign exchange contracts as follows.

Settlement dates	Face Value \$US	Average rate \$Cdn
January 2010	1,150	1.092
February 2010	850	1.062
March 2010	850	1.062
April 2010	550	1.066
May 2010	300	1.051
June 2010	150	1.036
July 2010	150	1.036

We are subject to risks associated with fluctuating interest rates on our credit facilities, which contain interest terms which float with movements in prevailing interest rates.

## CERTIFICATION OF DISCLOSURE CONTROLS AND PROCEDURES AND INTERNAL CONTROL OVER FINANCIAL REPORTING

Our management is responsible for designing disclosure controls and procedures that: (a) provide reasonable assurance that material information required to be disclosed by us is accumulated and communicated to management to allow timely decisions regarding required disclosure; and (b) ensure that information required to be disclosed by us is recorded, processed, summarized, and reported within the time periods specified in applicable securities legislation. .

Our management is responsible for designing, establishing and maintaining an adequate system of internal control over financial reporting. Our internal control system was designed based on the Internal Control – Integrated Framework (“COSO Framework”) published by The Committee of Sponsoring Organizations of the Treadway Commission to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes, in accordance with Canadian generally accepted accounting principles (“Canadian GAAP”).

Our Chief Executive Officer and Chief Financial Officer certified the appropriateness of the financial disclosures in the MD&A and audited consolidated financial statements for the year ended December 31, 2009. These executives also certified that they are responsible for the design of disclosure controls and procedures and internal control over financial reporting. There

have been no changes in internal control over financial reporting during the quarter ended December 31, 2009 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

The Fund's Board of Trustees and Audit Committee reviewed and approved the December 31, 2009 audited consolidated financial statements and this management's discussion and analysis prior to its release.

## **FORWARD-LOOKING STATEMENTS**

This MD&A includes forward-looking statements. Forward-looking statements relate to, among other things, anticipated financial performance, business prospects, strategies, market forces, and commitments. Many of these statements can be identified by words such as "believe", "expects", "expected", "will", "intends", "projects", "anticipates", "estimates", "continues" or similar words. The Fund believes the expectations reflecting in such statements are reasonable but no assurance is given that such expectations will be correct. All forward-looking statements are based on the Fund's beliefs and assumptions based on information available at the time the assumption was made and on management's experience and perception of historical trends, current conditions and expected further developments as well as other factors deemed appropriate in the circumstances. In addition to other assumptions made in this MD&A, assumptions have been made in respect of factors such as, but not limited to, the following:

- industry activity levels;
- competitive conditions;
- consumer demand;
- access to capital;
- capital expenditure estimates, plans, schedules and activities;
- income tax considerations;
- operating risks; and
- cash distributions

By its nature, such forward-looking information is subject to various risks and uncertainties that are known and unknown, including general economic conditions and markets and, in particular, the potential impact of the current economic downturn, the cost and availability of capital, the possibility of deterioration in our working capital position, the impact on our liquidity if we were to go offside of the covenants in our debt facilities, our ability to maintain profitability and manage growth, risks associated with leasing and expansion, competition, inventory and sourcing risk, ability to identify and respond to changing consumer fashion preferences, risks associated with international purchasing, reliance on key personnel, dependence on consumer spending, unseasonable weather conditions, uncertainties arising from world events, intellectual property risks, foreign exchange fluctuations on imported merchandise, labour relations, seasonality and fluctuations in cash distributions, fluctuations in distributable cash based on our performance, restrictions on potential growth, future issuances of Units by the Fund or future disposition of Units held by SSI Investments Inc., income tax matters, changes in accounting standards, including the transition to IFRS, and increases in interest rates. These risks are discussed in the Fund's most recent annual information form and in this management's discussion and analysis of the Fund and could cause actual results and experience to differ materially from the anticipated results or other expectations expressed. Readers are cautioned not to place undue reliance on this forward-looking information, which is given as of the date it is expressed in this annual information form or otherwise, and the Fund undertakes no obligation to update publicly or revise any forward-looking information to reflect new events or circumstances, except as explicitly required by securities laws.

## **ADDITIONAL INFORMATION**

Additional information relating to the Fund, including the Fund's Annual Information Form and other public filings, are available on SEDAR ([www.sedar.com](http://www.sedar.com)) and on the Fund's website at [www.SterlingShoesIncomeFund.com](http://www.SterlingShoesIncomeFund.com).

## **INVESTOR RELATIONS**

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