

**STERLING SHOES INC.**



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**Annual Information Form**

**For the year ended December 31, 2010**

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March 17, 2011

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## **CERTAIN REFERENCES AND GLOSSARY**

Unless the context otherwise requires, references within this AIF to "we", "us", "our" or similar terms refer to the Sterling Shoes Inc. (the "Company") (either alone or together with its subsidiaries, including Sterling Shoes Limited Partnership (the "Partnership")) and includes, for the period prior to July 12, 2005 the Business we acquired on that date. See the "Glossary of Terms" at the end of this AIF for definitions of terms used in the AIF.

## **DATE OF INFORMATION**

The information in this AIF is presented as of December 31, 2010, unless otherwise indicated.

## **FORWARD-LOOKING STATEMENTS**

Certain statements in this annual information form may constitute "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 "believes", "expects", "expected", "will", "intends", "projects", "anticipated", "estimates", "continues" or similar words. The Company believes that expectations reflected in such statements are reasonable, but no assurance is given that such expectations will be correct. All forward-looking statements are based on management'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 annual information form, 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.

A number of factors could cause actual results to differ materially from the results discussed in the forward-looking statements, including, but not limited to, the following factors: general economic conditions and markets and, in particular, the potential impact of the current uncertain economic conditions, the cost and availability of capital, the possibility of deterioration in the Company's working capital position, the impact on the Company's liquidity if it were to go offside of the covenants in its 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, including rising costs, reliance on key personnel, dependence on consumer spending, unseasonable weather conditions, uncertainties arising from world events, reliance on computerized information systems for our business operations, intellectual property risks, foreign exchange fluctuations on imported merchandise, labour relations, seasonality, restrictions on potential growth, changes to accounting policies and standards, including the transition to International Financial Reporting Standards ("IFRS"), income tax matters, and increases in interest rates. See "Risk Factors". These forward-looking statements are made as of the date of this annual information form and the Company assumes no obligation to update or revise them to reflect new events or circumstances, except as explicitly required by securities laws.

## **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. Accordingly, our management believes that EBITDA and Adjusted EBITDA are important supplemental measures in evaluating our performance and in determining whether to invest in Shares. 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.

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.

### **CURRENCY AND EXCHANGE RATES**

Unless otherwise indicated, all dollar amounts are expressed in Canadian dollars and references to "\$" are to Canadian dollars.

The following table reflects the high and low rates of exchange for one US dollar, expressed in Canadian dollars, in effect during the periods noted, the rates of exchange at the end of such periods and the average rate of exchange during such periods, based on the Bank of Canada noon spot rate of exchange.

	<b>Year ended December 31</b>				
	<b>2010</b>	<b>2009</b>	<b>2008</b>	<b>2007</b>	<b>2006</b>
High for the period	1.0778	1.3066	1.3008	1.1853	1.1726
Low for the period	0.9946	1.0251	0.9711	0.9170	1.0983
Rate at the end of the period	0.9946	1.0510	1.2180	1.0748	1.1653
Average rate for the period	1.0299	1.1420	1.0660	0.9881	1.1341

On March 17, 2011, the Bank of Canada noon spot rate of exchange was Cdn\$0.9885 = US\$1.00.

### **THE STRUCTURE OF THE COMPANY**

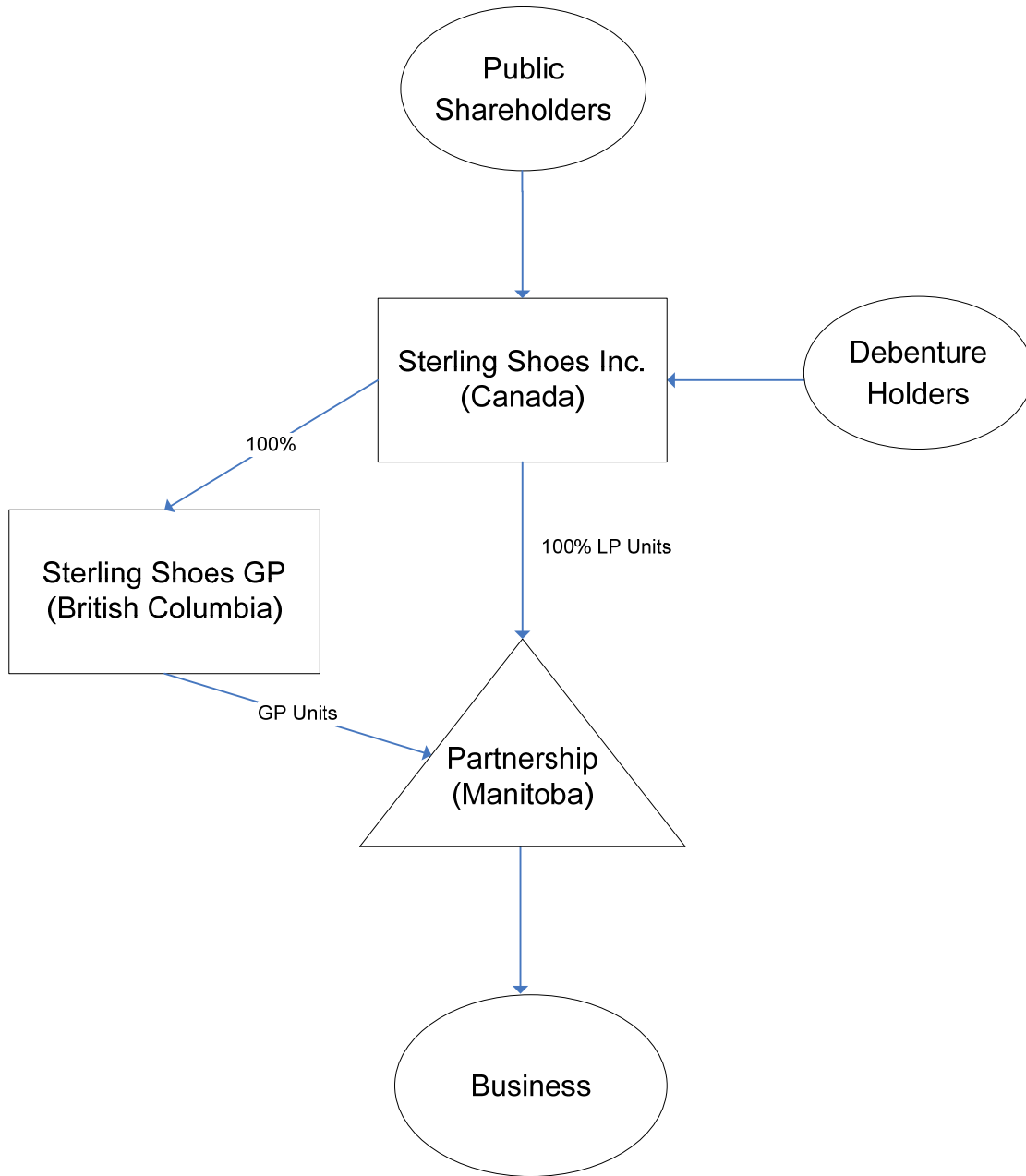
The Company was incorporated under the *Canada Business Corporations Act* on April 23, 2010. The principal and head office of the Company is located at 2580 Viscount Way, Richmond, B.C. The registered office of the Company is located at Suite 2600 - 595 Burrard Street, Vancouver, B.C. The Company was incorporated to effect the conversion of Sterling Shoes Income Fund (the “Fund”) to a corporate structure pursuant to the Arrangement which was completed on July 1, 2010. The Company, through the Partnership, owns and operates the Business.

The Partnership is a limited partnership formed under the laws of the Province of Manitoba with Sterling Shoes GP Inc. (the “GP”) as its general partner. The Partnership was created to acquire and hold substantially all the assets of, and carry on, the Business, and is governed by the Partnership Agreement.

The GP is a company that was incorporated under the laws of the Province of British Columbia on June 16, 2005. The GP is the general partner of the Partnership.

The following chart illustrates, on a simplified basis, the structure of the Company (including jurisdiction of

establishment or incorporation of the various entities):



### **GENERAL DEVELOPMENT OF OUR BUSINESS**

On July 12, 2005, the Fund completed the Offering of 5,313,488 Units at a price of \$10 per Unit, to raise aggregate gross proceeds of \$53,134,880. Prior to the Offering, the Fund did not have a business or any material assets. The proceeds of the Offering, together with proceeds from the Credit Facilities, were used to acquire the Business from SSI Investments Inc. ("Inc.") pursuant to the Acquisition Agreement on July 12, 2005.

#### **The Arrangement**

Effective July 1, 2010 the Fund converted to a corporate structure through the Arrangement.

The conversion to a corporation was undertaken in light of the implementation of the tax to be imposed on the taxable income of income funds effective January 1, 2011. As a corporation, the amount of income taxes payable upon the taxable income of the Company will be less than the amount of income taxes that would be paid on this income if the Fund continued to exist. As a corporation, the Company will be able to retain earnings to provide for anticipated liabilities and finance future growth. In addition, as a corporation, the Company will carry on business in a more common form of business enterprise.

The conversion took place as a “plan of arrangement” and was effective July 1, 2010. Under the Arrangement, unitholders of the Fund received common shares of the Company, on a one-for-one basis. Inc., which previously held a 20% interest in the Partnership, exchanged its exchangeable units for common shares of Company, also on a one-for-one and tax deferred basis and its remaining units in the Partnership for the debt owing to the Trust by Inc. Inc. holds 20% of the Company’s issued and outstanding common shares with public shareholders holding the remaining 80%. The Business continues to be conducted by the Partnership, all of the interests in which are owned, directly or indirectly, by the Company.

### **Offering of Debentures**

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. In connection with the Arrangement, the Company assumed all of the covenants and obligations of the Fund under the Indenture in respect of the outstanding Debentures. (See “*Description of the Company – Debentures*”).

A portion of the net proceeds from the offering was used to repay existing bank indebtedness of approximately \$13 million. The balance of the net proceeds was used for existing expansion and corporate commitments during 2008.

Since our initial public offering, we have opened 75 stores (61 net openings), renovated 28 stores and relocated 14 stores. Previously we used our credit facilities to finance capital expenditure associated with our store openings, renovations and relocations, as well as the growth in inventory required for our new and existing stores. The Company may access the capital markets to assist in its growth, as appropriate. There can be no assurance that the Company will be able to access new capital or new long term debt on acceptable terms.

### **Shareholder Rights Plan**

At the Fund’s annual and special meeting of Unitholders held on June 24, 2010, Unitholders approved effective on completion of the conversion to a corporation, a “shareholder rights plan” (the “Rights Plan”). The Rights Plan is designed to ensure that a person seeking control of the Company gives its shareholders and the directors sufficient time to evaluate the bid, negotiate with the initial bidder and encourage competing bids to emerge. The Rights Plan also seeks to ensure that all shareholders are treated fairly in any transaction involving a change of control of the Company and that all shareholders have an equal opportunity to participate in the benefits of a take-over bid. The Rights Plan encourages potential acquirers to negotiate the terms of any offer for the Company’s common shares with the board of directors or, alternatively, to make a Permitted Bid (as defined in the Rights Plan) without the approval of the board of directors. The Rights Plan may, however, increase the price to be paid by a potential offeror to obtain control of the Company and may discourage certain transactions.

## **RECENT EVENTS AND OUTLOOK**

### **Recent Performance and the Company’s Re-organization**

2010 was the beginning of a transformation for Sterling, which will continue throughout 2011 as we reposition

ourselves to achieve operational efficiencies and growth. Beginning in May 2010 Sterling's board of trustees conducted an international search and hired the Company's new President and CEO, Dave Alves, who joined the Company and the board of directors on November 10, 2010. In late 2010 the Company embarked on a strategic review and has begun re-organizing its operating structure and business processes from top to bottom. At the heart of the re-organization is a company-wide focus on trading, and operational efficiencies. During 2011 we will focus on leveraging the profit potential of our existing store base and operating divisions. Once we have executed the 2011 plan we will be in a position to leverage our more efficient foundation for future growth.

In early 2011, we re-organized our business units to increase focus and accountability throughout the organization. Our operating divisions (banners) have been re-organized as Shoe Warehouse, Sterling Shoes and Freedman / Joneve. Each division has a senior leader responsible for delivering its results. Colin Romain, who has been with the Company for over 12 years, and was previously our VP of Operations, has been appointed as the leader of our largest division, Shoe Warehouse. Colin brings over 30 years experience in all facets of retail management. Melanie Richardson, who has been with the Company for 6 years, has been promoted from General Manager of our Freedman banner, to the VP of Freedman / Joneve. In addition to senior management and buying roles within our organization, prior to joining Sterling, Melanie held a senior operations role at a Canadian apparel retailer.

We have also re-organized our Store Operations group. Scot Sheeler joined Sterling as our Vice-President, Store Operations in January 2011 with a mandate to improve the efficiency and effectiveness of our store network. Scot is a senior executive with over 20 years of diverse and progressive experience in the retail industry. He has expertise in the creation and execution of operational strategies with extensive experience in store operations, in-store marketing, store planning, and loss prevention. Scot's recent experiences include serving as President & CEO of Advanced Electronics, and Vice President, Stores (Zellers Western Region) for the Hudson's Bay Company.

We have created a supply chain and merchandise-planning group and have shifted the management of inventory to this newly created department. We are excited to announce that Sairose Kassam will be joining the Sterling team on March 28, 2011 as the Vice President, Supply Chain. Sairose is a successful retailer with over 20 years of progressive senior management experience. Sairose's recent experiences include Vice President, Merchandising for Roots Canada Limited where she was the senior executive responsible for design, buying, planning and execution of improved sourcing, vendor alliances and supply chain management. In the meantime we are re-organizing the responsibilities of our warehousing and distribution functions to improve efficiencies and reduce costs throughout the supply chain and at the store level. These cost-saving initiatives have already begun to show results, for instance, the removal of non-selling activities at the store level, and moving these activities to the warehouse has allowed us to reduce store costs, improve the appearance of our stores and free up our staff to better serve our customers.

A key part of our strategy is the improvement of our product assortment. One key initiative that we focused on at the end of 2010 was the reduction of aged inventory. This action resulted in lower margins, but has positively impacted our balance sheet; reducing inventory and generating cash flow. We've created a stable foundation upon which our operating divisions can focus on improving performance. This has allowed us improve the freshness of the product mix in our chains and reduce the previously increasing costs of warehousing and logistics related to maintaining unproductive inventory. Management has also established a new markdown strategy, creating a more disciplined approach to the markdown process against in-season inventory which will mitigate the risk in the build-up of aged inventory in the future.

We successfully launched our new enterprise resource planning ("ERP") system in our Freedman banner on January 16, 2011 and have turned on all planned areas of its functionality. The system has significantly increased visibility into our business and the stability of our inventory reporting. Remaining banners will go live with the new system during the second quarter of 2011.

In addition to the ERP implementation, the Company is increasing its organizational intelligence through investments in people and other business intelligence tools. The Company has already implemented a new business

intelligence tool, IBM-Cognos in 2011 and has created a financial planning and analysis group to service the information needs of the organization and allow better organizational decision-making. These additional resources equip the Company with the right tools to efficiently data-mine and analyze its information, which will increase visibility for business leaders and allow them to have a clear indication of the pulse of the business. Executives in turn will be measured against new key performance indicators. In recent months tools have been developed to allow for enhanced divisional reporting which will aid our operating divisions run their businesses and allow management to hold them accountable.

Finally, we have initiated a brand strategy review of all divisions, and now have clearly defined and differentiated customer profile and market segmentation for each division. This clarity will provide the focus and energy for our buying, marketing, recruitment and store operations teams as well as revitalize the image of our respective banners to our customers.

Other highlights for the three and twelve-month periods ended December 31, 2010 include:

- Management reduced inventory by \$7.8 million compared to a year-earlier, a decrease of 21.5%.
- The Company's cash position improved by \$3.3 million, to \$7.4 million December 31, 2010 up from \$4.1 million a year earlier.
- The Company converted from an income trust structure to a corporate structure.
- During the year the Company renewed its bank credit facilities for a 3 year term.

#### Number of Stores

During 2010, we opened three new stores and closed three stores. We opened a Freedman store at Park Royal Mall in West Vancouver, BC, a Joneve store in the new Chinook Centre Mall expansion in Calgary, AB and a Freedman Outlet store on West 4<sup>th</sup> Avenue in Kitsilano, Vancouver, BC. Currently we have one new store commitment for 2011 and may close a few stores in 2011. During 2011 we will focus on improving our performance within our existing stores before adding significantly to our store base, or growing through other methods. 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.

Our 161 stores operate under five retail banners in British Columbia, Alberta, Saskatchewan, Manitoba and Ontario as follows:

Number of Stores Operating												
March 17, 2011							Dec 31, 2009	Dec 31, 2008	Dec 31, 2007	Dec 31, 2006	Dec 31, 2005	July 12, 2005
Province	Shoe						Total	Total	Total	Total	Total	Total
	Warehouse	Sterling	Joneve	Freedman	Gia	Total						
British Columbia	39	20	6	10	2	77	76	75	65	63	60	59
Alberta	13	9	3	-	-	25	27	26	25	25	24	24
Saskatchewan	3	2	-	-	-	5	4	4	3	3	4	4
Manitoba	9	3	-	-	-	12	12	12	12	11	11	11
Ontario	11	23	6	2	-	42	43	43	36	25	5	2
Total	75	57	15	12	2	161	162	160	141	127	104	100

## OUR BUSINESS

We are a Vancouver-based, leading footwear retailer offering a broad selection of private label and brand name shoes and accessories through our five main retail banners: Sterling, Joneve, Shoe Warehouse, Freedman Shoes and Gia. Each of our retail concepts is designed to serve an identified market segment in which we believe we can compete.



Our Business can trace its roots back to 1987, when five Sterling mall locations became the nucleus from which we have grown to 161 stores located in five provinces across Canada.

Our stores are located primarily in western Canada 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.

### Industry Overview

Footwear retailing in Canada enjoys a large and well-established market, encompassing the sale of shoes and boots for leisure, professional and specialty use to all segments of the country's population. Statistics Canada reports that in 2010, the total Canadian retail footwear, market was approximately \$2.0 billion. Based on Statistics Canada information, industry sources and our historical data, women remain the dominant buyers of footwear, spending over 53% of total retail dollars, with men at 37%, and juveniles at 10%. Women prefer to purchase their shoes from specialty shoe stores, buying over 50% of the total through that channel. While men are more balanced in each channel, children's shoes are typically purchased from discount stores or specialty shoe stores

We believe that the market for footwear in Canada broadly tracks general economic trends and conditions and generally reflects the regional distribution of the country's economy. Of the \$5.5 billion total market for footwear, clothing accessories and jewelry in 2010, Statistics Canada reports that Ontario accounted for approximately 40.8%, or \$2.3 billion, Québec accounted for approximately 20.3%, or \$1.1 billion, the Atlantic provinces accounted for approximately 4.9%, or \$273 million and the four western provinces accounted for approximately 34.0%, or \$1.9 billion.

### Competition

Footwear is sold by a wide variety of retailers. Competition occurs principally among traditional retail formats in Canada, the majority of which can be broadly segmented into the following channels:

- *Department Stores.* The principal competitors in this segment are Hudson's Bay Company and Sears Canada;
- *Mass-Market General Merchandisers.* Competitors in this segment include Wal-Mart, Zellers and Winners;
- *Sporting Goods Stores.* Competitors in this segment include Sport Chek, ATMOSPHERE and Sports Experts; and

- *Specialty Shoe Stores.* Competitors in this segment focus almost exclusively on footwear and reflect a wide variety of formats such as Payless ShoeSource, ALDO, Town Shoes and small chains and independent stores.

In addition, as a result of increased customer concentration and variable demand, many national wholesalers (such as Nine West, Ecco and Timberland) have vertically integrated and developed their own retail concepts in order to gain direct access to the consumer. While we believe that this trend may benefit retailers like us who carry multiple brands because it tends to increase the name recognition and therefore the value of those brands in our stores, this trend also increases the competition for our stores.

Sterling, Joneve, Shoe Warehouse and Freedman Shoes compete with other local, regional and national footwear retailers. The fragmented nature of the Canadian retail footwear industry and our four 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/Gia, Shoe Warehouse and Joneve/Freedman Shoes banners are provided below.

<u>Shoe Warehouse</u>	<u>Sterling/Gia</u>	<u>Joneve/Freedman Shoes</u>
<ul style="list-style-type: none"> <li>• Payless Shoe Source</li> <li>• The Shoe Company</li> <li>• Winners</li> <li>• Softmoc</li> <li>• Zellers</li> <li>• Style Sense</li> <li>• Walmart</li> <li>• National and regional comfort-oriented shoe stores</li> </ul>	<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>• The Bay</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>• Browns</li> <li>• Town Shoes</li> <li>• Holt Renfrew</li> <li>• Harry Rosen</li> <li>• Feet First</li> <li>• B2</li> <li>• The Bay</li> </ul>

With the recent announcements by major US retailers of plans for expansion into Canada, we expect to face more competition on product and for retail space in our major markets.

### **Our Strategy**

Our strategy is to have the right shoe, at the right price, at the right place, in the right quantity. We believe that, to be successful, we must quickly identify fashion trends, efficiently source the necessary products and appropriately manage inventory so as to minimize risk while providing consumers with a reason to buy new shoes each season.

Following the appointment of Mr. Alves as President and Chief Executive Officer, we have undertaken an extensive analysis of the fundamentals of our Business, including supply chain and inventory management, efficiency of store operations, pricing strategy, branding strategy, operations and business intelligence, in order to better position our Business.

As a substantial amount of capital was invested in aged inventory, management focused on reducing this aged inventory late 2010. Management undertook a number of initiatives to address this issue with a new approach to inventory management including our product mix, purchasing and planning processes. Aged inventory was marked down during the third and fourth quarters to stimulate sales and to clear out old inventory consistent with our strategy of improving inventory turnover and improving the freshness of inventory mix throughout the Company. As a consequence, management estimates gross margin was eroded by these one-time efforts which resulted in charges of \$1.4 million and \$3.2 million during the three and twelve-month periods ended December 31, 2010 respectively. We believe this will enhance our ability to purchase strategically and result in more current inventory for spring 2011 as well as enable us to lower inventory levels and drive cost savings throughout our supply chain. In addition to our initiatives to enhance product fashionability and assortment, we are refocusing our pricing strategy

to be a value-priced retailer, particularly in our Sterling stores, reducing promotional activity and implementing an in-season markdown strategy based on metrics produced filtered by our management information system.

We believe that the key factors that drive consumer purchasing decisions include brand name recognition, fashion, quality, comfort, price, convenience and overall shopping experience and that to be successful we must have a well-defined customer proposition. We have undertaken a branding project to more clearly define our target customers for each of our core banners; Sterling, Joneve, Shoe Warehouse and Freedman. This has resulted in the repositioning of each of our four banners as discussed below under “Retail Banners and Target Customers”.

In addition, we are strengthening our supply chain management and focusing on initiatives to improve store operations, warehousing and distribution in order to promote greater efficiencies and reduce costs. These initiatives include a restructuring of our planning, purchasing, merchandising and marketing functions to coordinate with our branding strategy, reducing inter-store transfers and improving product planning and flow into stores to provide the required inventory on a timely and efficient basis.

To support the initiatives discussed above, we have restructured our organization with each banner operating as a separate trading division, with separate functions for buying, marketing and merchandising, and full profit and loss accountability. We have reorganized our executive team to reflect the new structure with the appointment of Vice Presidents for each of Shoe Warehouse and Freedmans/Joneve and have hired a new Vice President, Store Operations and Vice President, Supply Chain. We are currently recruiting for a Vice President, Sterling.

We continue to develop our business intelligence tools and culture. One initiative is the implementation of a new enterprise resource planning (“ERP”) system. The ERP is intended to integrate processes and specialized applications, including inventory management, point-of-sale, payroll, distribution and accounting. The ERP has been successfully implemented in our Freedman division and is expected to be implemented in our other banners in the second quarter. The new system will enable us to better manage and sustain our Business, as well as support future growth.

Since our IPO, we have pursued a strategy of expansion, increasing the number of stores from 100 at the time of our initial public offering in July 2005 to 161 today. With the uncertainty of current economic conditions and in light of our recent results we have slowed the pace of our expansion. We will only add stores in strategic locations that meet criteria for expected sales, profitability and return on invested capital. During 2011 we will focus on improving our performance within our existing stores before adding significantly to our store base.

### **Retail Banners and Target Customers**

We own and operate five distinct retail footwear banners: Sterling, Joneve, Shoe Warehouse, Freedman and Gia Shoes. Multiple retail banners with different location strategies provide us with the flexibility to open stores in a wide range of locations under the banner that is best suited to a particular location. If we are limited in our ability to find suitable locations for one particular retail banner, we can focus on opening stores under a different retail banner for which suitable locations are more accessible. With our multiple retail banners, we have also been able to open different stores in the same malls where there is a high concentration of the target consumers. In addition to promoting growth through location flexibility, having multiple retail banners allows us to leverage information from one retail banner for the benefit of the others, including important information relating to purchasing patterns and fashion trends. We believe that this horizontal integration is a critical competitive advantage in our business model. We believe that targeting multiple consumer groups across the full value spectrum also gives us a degree of protection during periods of weaker economic performance.

Through our different retail banners, we strategically target distinct consumer groups. As part of our strategic realignment of our Business we have undertaken a branding strategy analysis to more clearly define our customer proposition for each of the banners. As part of our strategy to focus our initiatives on our four core banners, we have discontinued the Sterling Outlet banner and are in the process reviewing the strategic fit of the Gia banner.

## **Merchandising and Location Strategies**

### ***Sterling***

Until recently our Sterling and Joneve banners were managed jointly. This resulted in a blurring of the differentiation between these banners. During the Company's recent reorganization, management responsibility for Joneve has been moved to the Freedman division to effect a transformation of the brand and force a differentiation of the product mix. Sterling stores are designed and decorated to appeal to the fashion-conscious consumer seeking the latest styles and hottest trends. With aesthetically pleasing merchandising and full-service sales, Sterling stores offer a friendly, inviting and fashion-oriented consumer experience.

Sterling stores are primarily located in major malls and on high streets and average approximately 1,000 square feet in size. The Sterling banner has grown from 23 stores in 2000 to 56 as at March 17, 2011 across British Columbia, Alberta, Saskatchewan, Manitoba and Ontario. We currently do not have plans to substantially expand our Sterling business, rather we intend to focus on improving our existing business.

### ***Shoe Warehouse***

To appeal to value-conscious family customers, Shoe Warehouse stores are organized on a standardized concept to create a spacious, bright, clean, functional and easy shopping experience. Inventory is stored directly under merchandise displays, minimizing the need for a stockroom and significantly increasing retail floor space. Shoe Warehouse focuses on customer service, product mix and location while delivering products at a value price-point. Our experience during difficult economic times is that consumers move from higher price-points to value. We expect this trend to continue to favour our Shoe Warehouse banner.

Shoe Warehouse stores are generally located in strip malls and average 3,000 to 4,000 square feet in size, with some of the newer stores opening in enclosed malls and averaging 2,000 to 3,000 square feet in size. The Shoe Warehouse concept has been successful in high-density urban retail locations as well as suburban and small town retail settings.

Our Shoe Warehouse banner has grown from 35 stores in 2000 to 75 as at March 17, 2011 across the four western provinces and Ontario. Management believes that there is a market for a number of new Shoe Warehouse stores both in Western Canada and in Ontario and expects that Shoe Warehouse will be the future engine to drive the growth of the Company.

### ***Joneve***

Joneve employs a similar location strategy to Sterling and until recently employed a similar merchandising strategy. This resulted in a lack of product differentiation between these banners and deteriorating results. During the Company's recent reorganization, management responsibility for Joneve has been moved to the Freedman division to effect a transformation of the brand and enable a differentiation of the product mix.

Joneve stores are primarily located in major malls and on high streets and average approximately 1,000 square feet in size. The Joneve banner has grown from 5 stores in 2000 to 15 as at March 17, 2011 across British Columbia, Alberta, Saskatchewan, Manitoba and Ontario. We currently do not have plans to substantially expand our Joneve business, rather we intend to focus on improving our existing business.

### ***Freedman Shoes***

Freedman stores are designed and organized to create an easy shopping experience for the high-end footwear consumer. Merchandise is arranged according to gender, style and brand, with separate areas for comfort, orthopedic and branded fashion shoes in a wide variety of sizes and widths. 2011 marks Freedman's 80<sup>th</sup> anniversary in Vancouver. As such, Freedman Shoes has a loyal customer base and an established reputation for providing a

friendly shopping experience with knowledgeable full-service sales staff.

Freedman stores are approximately 2,000 to 2,500 square feet in size and are located primarily on high streets. As at March 17, 2011, there were 10 Freedman Shoes stores in the British Columbia market and 2 in Ontario.

### ***Geographic Diversity***

As at March 17, 2011 we have 161 stores operating under our four retail banners in British Columbia, Alberta, Saskatchewan, Manitoba and Ontario as follows:

<b>Number of Stores Operating</b>												
<b>March 17, 2011</b>							<b>Dec 31, 2009</b>	<b>Dec 31, 2008</b>	<b>Dec 31, 2007</b>	<b>Dec 31, 2006</b>	<b>Dec 31, 2005</b>	<b>July 12, 2005</b>
<b>Province</b>	<b>Shoe</b>					<b>Total</b>	<b>Total</b>	<b>Total</b>	<b>Total</b>	<b>Total</b>	<b>Total</b>	<b>Total</b>
	<b>Warehouse</b>	<b>Sterling</b>	<b>Joneve</b>	<b>Freedman</b>	<b>Gia</b>							
British Columbia	39	20	6	10	2	77	76	75	65	63	60	59
Alberta	13	9	3	-	-	25	27	26	25	25	24	24
Saskatchewan	3	2	-	-	-	5	4	4	3	3	4	4
Manitoba	9	3	-	-	-	12	12	12	12	11	11	11
Ontario	11	23	6	2	-	42	43	43	36	25	5	2
<b>Total</b>	<b>75</b>	<b>57</b>	<b>15</b>	<b>12</b>	<b>2</b>	<b>161</b>	<b>162</b>	<b>160</b>	<b>141</b>	<b>127</b>	<b>104</b>	<b>100</b>

We have committed to opening 1 store in 2011 to date. Until 2009, we pursued a strategy of expansion, increasing the number of stores from 100 at the time of our initial public offering in July 2005 to 161 today. We feel that there is significant growth potential from a sales and profitability perspective within our existing store network. During 2011 we will focus on improving our performance within our existing stores before adding significantly to our store base, or growing through other methods. We will only add stores in strategic locations that meet criteria for expected sales, profitability and return on invested capital.

Our ability to successfully compete and open stores at the rate and schedule we anticipate depends on a number of factors including, but not limited to, consumer preferences and spending patterns, consumer loyalty to established stores and brands, availability of appropriate real estate at reasonable rates, our ability to negotiate acceptable leases with landlords, our ability to renovate and prepare stores for opening, our ability to hire and train sufficient qualified staff and to stock appropriate levels of inventory.

### **Products and Brands**

Each of our retail banners offers private label and national branded footwear products as well as a range of accessories. We believe that in order to be successful we must be able to offer private label and branded products that align with our customers' perception of new and fresh merchandise. We employ a "test and react" strategy to reduce risk associated with developing trends. Cutting-edge footwear styles are initially purchased in small quantities in order to assess consumer appetite for the new trend, and popular styles are quickly replenished in larger quantities.

Although we are constantly introducing new products interpreting the latest trends in footwear fashion, a significant portion of our inventory at any given time is made up of proven styles that our experience tells us will continue to be top sellers. These enduring styles, whether offered under private label or national brands, minimize fashion risk and provide us with a range of merchandise that is appealing to a broad demographic market.

### ***National Branded Footwear***

Our stores carry a wide variety of nationally recognized branded merchandise. Branded merchandise attracts customer traffic, resulting in increased sales and customer loyalty. Some of the key national brands that we offer include Franco Sarto, Stuart Weitzman, Amalfi, Cole Haan, Puma, Skechers and Kenneth Cole. National brands represent a larger percentage of sales at Freedman Shoes stores, where customers are willing to pay a premium for a name brand associated with quality and style.

### ***Private Label Footwear***

In addition to nationally recognized branded merchandise, we carry private label footwear that represent a cost-effective, higher-margin and more streamlined way to offer popular trends to consumers, while building private label brand awareness and loyalty. In addition, as the amount of our private label business has increased, we have been able to further reduce costs by developing relationships that allow us to deal with the manufacturer either directly or through one agent rather than through multiple agents and representatives.

Private label products are generally inspired by fashion trends or shoe designs discovered by us during our regular trips to international shoe and fashion trade shows. Once we have decided upon a concept, we work with third-party manufacturers to develop a prototype shoe. From time to time, the makers of certain national brands may also produce comparable versions of their branded footwear under our private label brands. Private label products are also produced in response to information we receive through our retail outlets regarding trends by item, style, color and/or size. Our buying and design team carefully monitors and supports sales, including re-ordering additional units of certain items, if available.

Our key private label brands include Roberto Vianni, Vianni Collections, Be Wild, Urban XT, Rinaldi, Blizzard, Joy & Peace, Vianni Comfort, EC Collections and Workers. Each of these brands is associated with a particular quality, fashion and design style that our customers have come to expect from it.

### ***Accessories***

We offer a range of accessories in each of our retail chain stores, including handbags, shoe care products and hosiery. Our accessory offerings give our customers the opportunity to complement their footwear with colour-coordinated accessories. Accessories add to our total sales per customer, sales per square foot and overall profitability.

### **Sourcing and Distribution**

#### ***Sourcing***

In our 24 years in the shoe industry, we have developed strong relationships with leading suppliers of branded products, with manufacturers of private label shoes and with key purchasing agents. Strong relationships with our suppliers and agents allow us to obtain a consistent supply of certain high-demand products and to source inventory during periods of high demand. In addition, our growth in recent years has created opportunities for us to source branded and private label shoes directly from manufacturers. Direct sourcing from manufacturers and key agents has resulted in a reduction in our costs, including agents' commissions, and a corresponding increase in our product margins. Management believes that our ability to source products directly will continue to increase as our Business grows.

We source each of our private label product lines separately based on the individual design, style and quality specifications of those products. We do not own or operate any manufacturing facilities and rely primarily on third-party manufacturers in China, Italy, Brazil, India, Vietnam and other countries for the production of our private label merchandise. China's low-cost labour force allows Chinese manufacturers to produce quality goods at a lower cost than those in most other countries. Management estimates that at least 80% of our private label footwear units are currently manufactured in China. Although countries such as Italy, Brazil and others remain important suppliers to the retail footwear industry, we believe most successful retailers require an effective strategy for purchasing product from Asian manufacturers.

The manufacturing of our private label products is closely monitored to ensure a consistent flow of inventory into the stores. Depending upon where the private label shoes are produced and where the materials are sourced, we can have shoes delivered to our stores in 45 to 90 days.

We believe that a sufficient number of alternative sources exist for the manufacture of our products. The principal materials used in the manufacture of our footwear and accessory merchandise are available from any number of domestic or international sources.

Management, or our agents, performs an array of quality control inspection procedures at various stages in the production process, including examination and testing of:

- prototypes of key products prior to manufacture;
- samples and materials prior to production; and
- final products prior to shipment.

### ***Distribution and Supply Chain***

We have created a supply chain and merchandise-planning group, have strengthened this team and consolidated supply chain functions into it. We are excited to announce that Sairose Kassam will be joining the Sterling team on March 28, 2011 as the Vice President, Supply Chain. Sairose is a successful retailer with over 20 years of progressive senior management experience. Sairose's recent experiences include Vice President, Merchandising for Roots Canada where she was the senior executive responsible for design, buying, planning and execution of improved sourcing, vendor alliances and supply chain management. We are also re-organizing our warehousing and distribution functions to reduce work and costs in stores and throughout the organization. A number of these cost-saving initiatives have already begun to show results.

We work with a third-party logistics and distribution business in Ontario, to assist us in receiving, inspecting, processing and distributing our products in eastern Canada. Our distribution centre in Richmond, British Columbia receives, inspects, processes and distributes most of our merchandise. Our allocation teams determine how the product should be distributed among the stores based on current inventory levels, sales trends, specific product characteristics and the buyers' input. Merchandise is typically en route to the stores using third-party carriers within 24 to 48 hours after it is received at our warehouses.

### **Capital Expenditures**

Our disciplined approach to monitoring investments includes subjecting all material capital expenditures to rigorous analysis and ongoing measurement and comparison against budgets to ensure an acceptable return on capital. In addition, we time our store renovations based on the timing and length of our lease agreements and lease renewals to ensure we are able to benefit from the renovations for a substantial period of time.

Capital expenditures could vary based on our ability to negotiate and secure appropriate lease arrangements and control capital expenditure costs, including our relationship with our contractors and our ability to successfully predict consumption patterns in new locations.

## Properties

We lease all of our store locations. A number of our leases provide a lease termination option in specified years of the lease if certain sales levels are not achieved. In addition, our leases typically require payment of property taxes, utilities, repairs, maintenance costs, common area maintenance fees and, in some instances, merchant association fees. Some leases also require percentage rent based on sales.

<u>Number of leases</u>	<u>Years to expiry</u>
65	0 to 5
96	5 +

We lease warehouse and office space in Richmond, British Columbia from a related party at a rate that we believe is in the range of current fair market value. The lease was renegotiated in 2007 for a 10-year period, after which we have an option to extend the lease for an additional two five-year periods.

## Intellectual Property

Our retail brands and private label brands are an important part of our business. We rely on trademark registrations and copyright to protect our products and brands, for example, Roberto Vianni, Urban XT, Blizzard, and EC Collections. To date, we have not experienced any significant infringements of our intellectual property rights. If we experience any significant infringements of our rights in the future, we intend to assert ownership over our intellectual property through available enforcement mechanisms.

The trademarks "Sterling Shoes", "Joneve" and "Gia" are registered trademarks owned by the Partnership. In general, trademarks that are merely descriptive, or are surnames, are not capable of registration. Accordingly, the Partnership has not registered the trademark "Shoe Warehouse" because of its descriptive nature or the trademark "Freedman Shoes" because of its origin as a surname that may not have become sufficiently distinctive at this point.

## Employees

As of December 31, 2010, we employed 1,242 full and part-time employees. Approximately 85 of those 1,242 employees are employed in general administrative functions at our corporate offices and warehouse. The remainder are employed at store locations. The number of part-time employees fluctuates depending on our seasonal needs. None of our employees are represented by a labour union and management believes that its relationship with employees is excellent.

## Seasonality

Our sales are subject to seasonality, primarily related to consumer spending patterns. Historically, sales and net income have been the weakest during the first quarter as a result of the decrease in consumer spending after the Christmas season. April and May are peak months, as consumers are looking for new shoes for the spring and summer, August and September sales are strengthened by back-to-school demand for shoes, and December sales are strong. Our quarterly results may also fluctuate significantly as a result of other factors, including the timing of new store openings, merchandise mix, unseasonable weather and the timing of price markdowns.

## Environmental and Health and Safety Matters

We believe that that the Business is in substantial compliance with all environmental and health and safety laws to which it is subject. As a retail operation, the Business is subject to minimal environmental protection requirements. Accordingly, environmental protection requirements do not have and are not expected to have significant financial and operational effects on our capital expenditures, earnings or competitive position.

## CREDIT FACILITIES

We have implemented a financing strategy that maintains flexibility to appropriately manage our short-term cash needs and the funding of future growth, including the development of new stores.

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 July 31, 2013. As at December 31, 2010, we have not utilized the Operating Loan with the exception of outstanding letters of credit for \$3.4 million.

We have an additional \$5 million credit facility (the "Term Loan"), which has currently been utilized for general funding of capital expenditures, including new store facilities. The Term Loan matures on July 31, 2013. The Term Loan is being amortized, with repayment terms calling for quarterly principal payments of \$250,000, plus interest, to effect a 5 year amortization.

Loans under these facilities are prepayable 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 the 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. Certain covenants have been amended.

## DESCRIPTION OF THE COMPANY

### Common Shares

The authorized capital of the Company consists of an unlimited number of Shares. The following is a summary of the rights, privileges, restrictions and conditions attaching to the Shares.

Holders of Shares are entitled to one vote per share at meetings of shareholders of the Company, to receive dividends if, as and when declared by the board of directors and to receive pro rata the remaining property and assets of the Company upon its dissolution or winding-up, subject to the rights of shares having priority over the Shares. Holders of Shares may make use of the various shareholder remedies available pursuant to the *Canada Business Corporations Act*.

The Company had 6,641,860 Shares issued and outstanding at March 17, 2011.

### Debentures

The Debentures were created and issued pursuant to the Indenture. An unlimited amount of Debentures are authorized. 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. The maturity date for the Debentures is October 31, 2012.

The Debentures are direct obligations of the Company and are not secured by any mortgage, pledge, hypothec or other charge and are subordinated to Senior Indebtedness of the Company. The Indenture does not restrict the Company from incurring additional indebtedness for borrowed money or from mortgaging, pledging or charging its properties to secure any indebtedness. The Indenture provides for customary events of default.

At any time prior to the earlier of the maturity date and, if called for redemption, the last business day before the redemption date, the Debentures are convertible at the option of the holders into Shares at a conversion price of \$21.15 per Share. After October 31, 2010 and on or before October 31, 2011, the Company has the right to redeem all or a portion of the Debentures equal to the principal amount plus accrued and unpaid interest, provided that the

current market price (as defined in the Indenture) on the date on which the notice of redemption is given is not less than 125% of the conversion price. After October 31, 2011, the Company will have the right to redeem all or a portion of the Debentures equal to the principal amount plus accrued and unpaid interest.

Within 30 days following the occurrence of a Change of Control, the Company will be required to make an offer in writing to repurchase all of the Debentures then outstanding (the "Offer") at a price equal to 100% of the principal amount thereof plus accrued and unpaid interest. If 90% or more in aggregate principal amount of the Debentures outstanding on the date of the giving of notice of the Change of Control have been tendered to the Company pursuant to the Offer, the Company will have the right and obligation to redeem all the remaining Debentures at the Offer Price.

### **Book-Entry Only System**

Registration of interests in and transfers of the Shares and the Debentures are made through a book-based system (the "Book-Entry System") administered by CDS. Shares and Debentures may be purchased, transferred and surrendered for redemption through a participant in the CDS depository service (a "CDS Participant"). All rights of Shareholders and Debentureholders must be exercised through, and all payments or other property to which a Shareholder or a Debentureholder is entitled will be made or delivered by, CDS or the CDS Participant through which the Shareholder or Debentureholder holds such Shares or Debentures. Upon a purchase of any Shares or Debentures, the Shareholder or Debentureholder will receive only a customer confirmation from the registered dealer which is a CDS Participant and from or through which the Shares or Debentures are purchased.

The Company has the option to terminate registration of the Shares or the Debentures through the Book-Entry System, in which case certificates for the Shares or the Debentures in fully-registered form will be issued to beneficial owners of such Shares or Debentures or their nominees.

### **Nomination Agreement**

On June 30, 2010 the Company and Inc. entered into a Nomination Agreement which provides that the Company will include two individuals designated by Inc. among management's nominees as directors of the Company at each annual general meeting of shareholders so long as the existing direct and indirect shareholders of Inc. or their associates hold or control directly or indirectly, Shares representing, on a fully diluted basis (before taking into account any dilution in respect of the Shares issuable upon conversion of the Debentures before their conversion or redemption) not less than 15% of the issued and outstanding Shares and one individual when such holdings are not less than 10% (in each case, on a fully-diluted basis as set forth above).

## **DESCRIPTION OF THE PARTNERSHIP**

The following is a summary of the material attributes and characteristics of the Partnership and the Partnership Units issued under the Partnership Agreement. This summary is qualified in its entirety by reference to the provisions of the Partnership Agreement, which contains a complete description of those attributes and characteristics.

The members of the Partnership are the GP, as the general partner holding all of the GP Units and the Company, as the limited partner holding all of the LP Units.

The GP has exclusive authority to manage the business and affairs of the Partnership, to make all decisions regarding the business of the Partnership, and to bind the Partnership.

### **Partnership Units**

The Partnership has issued and outstanding limited partnership interests, consisting of 3,859,678 Class A LP Units, 100 Class B LP Units, 5,313,488 Class C LP Units, 1,328,372 Class D LP Units, 1,182,025 Class E LP Units, and 100 GP Units issued and outstanding, all of which are held by the Company. The rights and entitlements of these

units in the Partnership with respect to voting, distributions of available cash, allocations of Partnership income and distributions of proceeds of liquidation of the Partnership are set out in the Partnership Agreement. Each LP Unit entitles the holder thereof to one vote in respect thereof. The Partnership Agreement provides that, subject to the terms, conditions and restrictions contained therein, the Partnership may issue an unlimited number of Partnership Units to any person.

Limited partners are liable for the liabilities, debts and obligations of the Partnership, but only to the extent of the amount contributed by them or agreed to be contributed by them to the Partnership, provided that they take no part in the management of the Partnership. Subject to applicable law, limited partners will otherwise have no liability in respect of the liabilities, debts and obligations of the Partnership.

### **Distributions and Liquidation Entitlement**

The GP has sole discretion to determine the amount of cash on hand available for distribution to the partners and the timing of any such distribution.

In the event of a dissolution of the Partnership, the net proceeds from the liquidation of the Partnership (after payment of expenses and provision for indebtedness and adequate reserves) will be paid (i) to the limited partners (to the extent of any balance thereof, as a return of capital) in proportion to the total Designated Capital (as defined in the Partnership Agreement) paid in respect of LP Units of each class, and within each class proportionate to the number of LP Units of the relevant class held by them, an amount equal to the amount in cash or kind of all Designated Capital paid in respect of LP Units of the relevant class less any amounts of Designated Capital previously distributed to the limited partners of the relevant class; (ii) as to the remainder, 0.001% to the GP and 99.999% to the limited partners, rateably.

## **DESCRIPTION OF THE GP**

### **Share Capital of the GP**

The authorized share capital of the GP consists of an unlimited number of common shares and an unlimited number of special voting shares. All of the common shares of the GP are owned by the Company. There are no special voting shares outstanding.

Holders of common shares of the GP are entitled to receive dividends as and when declared by the board of directors and are entitled to one vote per share on all matters to be voted on at all meetings of shareholders. Upon the voluntary or involuntary liquidation, dissolution or winding-up of the GP, the holders of common shares are entitled to share rateably in the remaining assets available for distribution, after payment of liabilities and the preferential entitlement to return of capital in favour of the holders of special voting shares.

Holders of special voting shares of the GP are entitled to receive dividends as and when declared by the board of directors and are entitled to two votes per share on all matters to be voted on at all meetings of the shareholders. Upon the voluntary or involuntary liquidation, dissolution or winding-up of the GP, the holders of special voting shares are entitled to a preferential return of capital, after payment of liabilities.

### **Functions and Powers of the GP**

The GP has exclusive authority to manage the business and affairs of the Partnership, to make all decisions regarding the business of the Partnership and to bind the Partnership. The GP is to exercise its powers and discharge its duties honestly, in good faith and in the best interests of the Partnership and to exercise the care, diligence and skill of a reasonably prudent person in comparable circumstances. The authority and power vested in the GP to manage the business and affairs of the Partnership includes all authority necessary or incidental to carry out the objects, purposes and business of the Partnership, including without limitation, the ability to engage agents to assist the GP to carry out its management obligations and administrative functions. The GP cannot dissolve the Partnership or wind up the

Partnership's affairs except in accordance with the provisions of the Partnership Agreement.

### **Withdrawal or Removal of the GP**

The GP may resign on not less than 180 days' written notice to the limited partners of the Partnership, provided that the GP will not resign if the effect would be to dissolve the Partnership.

The GP may not be removed as general partner of the Partnership unless: (i) the GP has committed a material breach of the Partnership Agreement, which breach has continued for 30 days after notice, and that removal is also approved by special resolution of the holders of Partnership Units entitled to vote; or (ii) the shareholders or directors of the GP pass a resolution in connection with the bankruptcy, dissolution, liquidation or winding-up of the GP, or the GP commits certain other acts of bankruptcy or ceases to be a subsisting corporation, provided that certain other conditions are satisfied, including a requirement that a successor general partner with the same ownership and governance structure at the relevant time agrees to act as general partner under the Partnership Agreement.

## **RISK FACTORS**

*The risks related to our business and the retail footwear market in general are summarized below. These risks and uncertainties are not the only ones facing us. Additional risks and uncertainties not presently known to us, or that we currently deem immaterial, may also impair our operations. If any such risks actually occur, our business, financial condition, liquidity and results of operations could be materially adversely affected.*

### **Risks Related to Our Business**

#### ***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, credit availability and interest rates, inflation and taxation. There can be no assurance that consumer spending will not decline in response to economic conditions, thereby adversely affecting our operating results.

The uncertainty of economic conditions and of future developments in the domestic and global economies has continued to depress consumer confidence and negatively impacted our results in 2010. 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 realize increased 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 centre 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 strategy and 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.

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

Our 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 expand will significantly depend upon our ability to locate suitable store sites and negotiate acceptable lease terms. In addition, several other factors could affect our ability successfully negotiate lease renewals and 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 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.

### ***Competition***

The retail footwear market is highly competitive. We compete with department stores, mass-market general retailers, sporting goods stores and specialty shoe stores. Many of these competitors have stores in the markets in which we now operate and in those in which we plan to expand. Many of our competitors have significantly greater financial, marketing and other resources than we do. In addition, there can be no assurance that, in the future, new participants will not enter the retail footwear market; the recent announcements by US retailers of plans for expansion into Canada are an example of this risk. Our stores compete, among other things, on the basis of convenience of location and store layout, product mix and selection, customer service and price. Competitive pressures resulting from competitors' pricing policies could materially adversely affect our gross margins. There can be no assurance that we will not face greater competition from other national, regional or local retailers or from retailers entering the market from outside Canada, or that we will be able to compete successfully with existing and new competitors. Our inability to respond to such competition could have a material adverse effect on our business, financial condition and results of operations.

### ***Inventory and Sourcing Risk***

Our future success will be significantly dependent on our ability to acquire, under favourable terms and conditions, name brand, private label and other merchandise that consumers want to buy. The deterioration of our relationship with any key vendor or vendors could result in delivery delays, merchandise shortages or less favourable terms than we currently enjoy. We deal with our suppliers on an order-by-order basis and, as is common in the industry, we have no long-term purchase contracts or other contractual assurances of continued supply or pricing. As our operations expand, our demand for inventory will continue to increase. Although our relations with key suppliers are currently satisfactory and we have adequate sources of name brand and other merchandise at competitive prices, if, in the future, we are unable to obtain a sufficient supply of readily saleable, high-margin inventory, to negotiate favourable discount and payment agreements with our suppliers, or to sell a significant portion of our inventory purchases without markdowns, our business, financial condition and results of operations could be materially adversely affected.

### ***Ability to Identify and Respond to Changing Consumer Fashion Preferences***

The footwear industry is subject to rapidly changing consumer fashion preferences. Our sales and net income are sensitive to these changing preferences; accordingly, we must identify and interpret fashion trends and respond in a timely manner. We continually market new styles of footwear, but demand for and market acceptance of these new styles are uncertain. Our failure to anticipate, identify or react appropriately to changes in consumer fashion preferences may result in lower sales, higher markdowns to reduce excess inventories, and lower gross profits. Conversely, if we fail to anticipate consumer demand for our products, we may experience inventory shortages, which would result in lost sales and could negatively affect customer goodwill, brand image and profitability.

### ***International Purchasing***

Substantially all of the footwear product we sell, including the merchandise we import directly from overseas manufacturers and agents and the merchandise we purchase from North American vendors, is manufactured overseas. The primary footwear manufacturers are located in China, India, Italy, Brazil and East Asia. A disruption in the flow of imported merchandise or an increase in the cost of those goods could decrease our sales and profits.

If merchandise from our current sources becomes more expensive or unavailable, the transition to alternative sources may not occur in time to meet our demands. Products from alternative sources may be of lesser quality and more expensive than those we currently import. Other risks associated with our use of imported goods include: disruptions in the flow of imported goods because of factors such as electricity or raw material shortages, work stoppages, strikes and political unrest; economic crises and international disputes; increases in the cost of purchasing or shipping foreign merchandise resulting from the failure to maintain normal trade relations with source countries; adverse fluctuations in currency exchange rates; changes in economic conditions in countries in which our manufacturers and suppliers are located; changes in fuel prices or shipping costs; and import duties, import quotas and other trade sanctions.

### ***Promotional Retail Environment***

The pricing in the footwear industry is impacted by many factors including economic conditions, competition and changes in consumer spending. Recent economic conditions have led to a highly promotional retail environment which has caused us to reduce selling prices and has negatively impacted gross margins. In these circumstances, if we are unable to appropriately manage inventory levels or sufficiently reduce product or operating costs, our profitability will decline. This could have a material adverse effect on our results of operations, liquidity and financial condition.

### ***Reliance on Key Personnel***

Our future success will be dependent, to a significant extent, on the efforts and abilities of our executive officers and key personnel. The loss of the services of a key member of our executive team could have a material adverse effect on our operating results. In addition, our continued growth will depend, in part, on our ability to attract, motivate and retain skilled managerial and merchandising personnel. There can be no assurance that we will be able to retain a substantial percentage of our existing personnel or attract additional qualified personnel in the future.

### ***Unseasonable Weather Conditions***

Unseasonable weather conditions generally affect not only customer shopping patterns, but also consumer purchasing decisions. Decreased consumer traffic may lead to decreased sales and slow-moving inventory may lead to lower margins, each of which could have a material impact on our business, financial condition and results of operations.

### ***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 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, 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.

### ***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.

### ***Intellectual Property Risks***

We believe that our trademarks and trade names are generally sufficient to permit us to carry on our Business as presently conducted and planned. We cannot, however, know whether we will be able to secure protection for our intellectual property in the future, or if that protection will be adequate for future operations. Further, we face the risk of ineffective protection of intellectual property rights in jurisdictions where we source our products. We also cannot be certain that our activities do not infringe on the proprietary rights of others. If we are compelled to prosecute infringing parties, defend our intellectual property, or defend ourselves from intellectual property claims made by others, we may face significant expenses and liability.

### ***Foreign Exchange Fluctuations on Imported Merchandise***

Our foreign exchange risk is primarily limited to currency fluctuations between the Canadian and U.S. dollar. Approximately 39% of our inventory purchases are made in United States dollars. Although we take into consideration the Canadian/United States dollar exchange rate at the time of specific purchases and are therefore able to factor the applicable exchange rate into our purchasing decision, we are subject to the risk of exchange rate fluctuations between order and sale of goods. 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.

### ***Labour Relations***

None of our employees are unionized. The maintenance of a productive and efficient labour environment and, in the event of unionization, the successful negotiation of a collective bargaining agreement, cannot be assured. Protracted and extensive work stoppages or labour disruptions such as strikes or lockouts could have an adverse effect on our business, financial condition, liquidity and results of operations.

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

Our Business is seasonal and generally we experience a decline in sales generated in the months of January and February. As the Company's fiscal year is the calendar year, this seasonal decline in sales primarily occurs in one quarter, namely 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 net 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 shareholders, 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, distributions to the Company and dividends to shareholders; (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 pay dividends to shareholders.

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 expire on July 31, 2013, 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 and the Company's financial position. In addition, the terms of any new credit facilities may be less favourable or more restrictive than the terms of the Credit Facilities.

### ***Risk Factors Relating to the Ownership of Sterling Common Shares***

The following is a list of certain risk factors relating to the activities of the Company and the ownership of the Shares:

- the uncertainty of future dividend payments by Company and the level thereof as the Company's dividend policy and the funds available for the payment of dividends from time to time will be dependent upon,

among other things, operating cash flow generated by the Company, financial requirements for operations and the execution of the Company's growth strategy and the satisfaction of solvency tests imposed by the *Canada Business Corporations Act* for the declaration and payment of dividends; and

- the Company may make future acquisitions or may enter into financings or other transactions involving the issuance of securities of Sterling which may be dilutive.

## **Risks Related to the Debentures**

### ***Interest Payments***

Interest payments on the Debentures and redemption or repayment of the Debentures are not guaranteed and are entirely derived from the business operated by related entities of the Company and from the ability of each such entity to make distributions on its securities. There can be no assurance that the Company and the related entities of the Company 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 Company. The Debentures are also effectively subordinate to claims of creditors of the Company's subsidiaries except to the extent the Company is a creditor of such subsidiaries ranking at least *pari passu* with such other creditors.

### ***Inability to Fund Purchase of Debentures***

The Company 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 Company 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 Company 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 Company or any of its subsidiaries.

### ***Redemption Prior to Maturity***

The Debentures may be redeemed, at the option of the Company, after October 31, 2010 and prior to the maturity date at any time and from time to time, at the Redemption Price, together with any accrued and unpaid interest.

Holders of Debentures should assume that this redemption option will be exercised if the Company is able to refinance at a lower interest rate or it is otherwise in the interest of the Company to redeem the Debentures.

### ***Conversion Following Certain Transactions***

In the case of certain transactions, each Debenture will become convertible into securities, cash or property receivable by a holder of Shares in the kind and amount of securities, cash or property into which the Debenture was convertible immediately prior to the transaction. This change could substantially lessen or eliminate the value of the conversion privilege associated with the Debentures in the future.

## **DIVIDENDS**

### ***Dividend Policy***

The dividend policy of the Company is subject to the discretion of its board of directors who will take into account the Company's current and anticipated business needs and financial condition at the time a dividend is being considered. The amounts and time of any future dividends by the Company may vary depending on, among other things, its earnings, financing requirements, the satisfaction of solvency tests imposed by the *Canada Business Corporations Act* for the declaration of dividends and other relevant factors. See: "*Risk Factors*".

### ***Historical Distributions***

The Company has not paid any dividends on the Shares since its incorporation on April 23, 2010.

In light of deteriorating economic conditions in 2009, the Fund's financial performance and the Fund's objective to maintain financial flexibility, the trustees of the Fund suspended monthly distributions effective December 17, 2009. On April 22, 2010, the Fund announced the continued suspension of the distributions for 2010. Prior to the conversion from an income fund, we declared and paid \$38.4 million in cash distributions to Unitholders since the completion of the Offering on July 12, 2005.

## **MARKET FOR SECURITIES**

### **Trading Price and Volume**

The Shares and the Debentures are listed and posted for trading on the Toronto Stock Exchange (the "TSX") under the symbol "SSI" and "SSI.DB" respectively. The Units of the Fund were listed and posted on the TSX under the symbol "SSI.UN") and were delisted following the completion of the Arrangement. The following tables set forth certain trading information on the Toronto Stock Exchange for the most recently completed financial year for the Shares, Units and Debentures:

## Sterling Shoes Income Fund Units / Sterling Shoes Inc. Shares

2010	Share Price (C\$ per share)			Volume
	High	Low	Close	
January	\$1.91	\$1.50	\$1.58	176,519
February	\$1.59	\$1.42	\$1.53	186,471
March	\$2.77	\$1.35	\$2.38	797,021
April	\$2.68	\$2.39	\$2.64	259,130
May	\$2.63	\$2.01	\$2.18	211,247
June	\$2.38	\$1.89	\$2.15	266,839
July	\$2.25	\$2.02	\$2.12	39,320
August	\$2.40	\$1.75	\$1.90	188,490
September	\$2.20	\$1.77	\$1.95	525,798
October	\$2.20	\$1.96	\$2.10	95,901
November	\$2.19	\$1.67	\$1.75	145,169

## Sterling Shoes 6 1/2 Convertible Debenture

2010	Bond Price (C\$ per unit) <sup>1</sup>			Volume <sup>2</sup>
	High	Low	Close	
January	80.00	72.25	80.00	391,170
February	82.00	76.50	80.00	393,000
March	90.00	76.00	85.00	451,000
April	89.00	82.00	87.05	805,000
May	90.00	86.00	87.00	493,000
June	88.50	86.10	87.00	326,000
July	90.00	87.00	90.00	377,000
August	91.00	90.00	90.00	837,000
September	91.75	85.00	90.00	457,000
October	92.00	88.00	90.00	558,000
November	92.99	88.00	88.00	588,000
December	89.99	80.00	81.00	389,000

### Notes

(1) Par value = 100

(2) Total par value of debenture traded

Source: Bloomberg

## Prior Sales

On April 23, 2010, the Company issued one Share to the Trust at a price of \$10 to facilitate its organization.

## DIRECTORS AND OFFICERS

The following table sets out for each of the directors of the Company and our executive officers (collectively, the "Management Group") the person's name, province and country of residence, positions with the Company and the Partnership and principal occupation during the preceding five years, and number of Shares beneficially owned, directly or indirectly, or over which control or direction is exercised.

<b>Name, Province and Country of Residence</b>	<b>Position</b>	<b>Principal Occupation</b>	<b>No. of Voting Shares<sup>(8)</sup></b>
Richard T. Mahler <sup>(1)(2)</sup> British Columbia, Canada	Chairman and Director	Corporate Director	58,400
Allen R. Sello <sup>(2)(4)</sup> British Columbia, Canada	Director	Corporate Director	32,400
Solomon Oshry, Q.C. <sup>(2)(5)</sup> British Columbia, Canada	Director	Barrister & Solicitor	28,850
Steven Richardson <sup>(1)(3)</sup> Ontario, Canada	Director	Corporate Director	22,750
James Bruce <sup>(1)</sup> British Columbia, Canada	Director	Investment Banker	25,000
David Alves British Columbia, Canada	President and Chief Executive Officer, Director	President and Chief Executive Officer	nil
Mannie Druker British Columbia, Canada	Vice President, Finance and Leasing, Director	Vice President, Finance and Leasing	518,140 <sup>(6)</sup>
Daniel Gumprich British Columbia, Canada	Chief Financial Officer	Chief Financial Officer	20,735
Scot Sheeler Ontario, Canada	Vice President, Store Operations	Vice President, Store Operations	nil
Colin Romain British Columbia, Canada	Vice President, Shoe Warehouse	Vice President, Shoe Warehouse	92,400
Melanie Richardson British Columbia, Canada	Vice President, Freedman / Joneve	Vice President, Freedman / Joneve	nil

Notes:

- (1) Member of the Audit Committee.
- (2) Member of the Corporate Governance and Compensation Committee.
- (3) Chair of the Corporate Governance and Compensation Committee.
- (4) Chair of the Audit Committee.
- (5) Mr. Oshry also owns or has control or direction over \$58,000 principal amount of Debentures.
- (6) Includes control or direction over 498,140 Shares held through Inc.
- (7) As of December 31, 2010, the Management Group, as a group, collectively beneficially owned, directly or indirectly, or exercised control or direction over 763,275 Shares, representing approximately 11.5% of the then issued and outstanding Shares.
- (8) The information as to the number of Shares beneficially owned, directly or indirectly, or controlled or directed, not being within the knowledge of the Fund has been based upon reports filed with the British Columbia Securities Commission.

The term of office for each of the directors will expire at the time of the next annual meeting of the Company.

Under the terms of the Nomination Agreement, Inc. has the right to appoint two nominees to the boards of directors of the Company, so long as Inc. owns at least 15% of the Units (on a fully diluted basis).

During the last five years, all of the directors and officers have been employed in various capacities by the Company or by the companies indicated opposite their names except: (i) from 2006 to 2009, Mr. Richardson was the Chief Financial Officer for Hudson's Bay Company; (ii) Mr. Alves; and (iii) Mr. Sheeler was Vice President, Store Operations of Zellers from 1988 to 2006 and President, Advanced Electronics from 2007 to 2008.

The following are brief profiles of the current directors of the Company and the senior officers of the Partnership.

**Richard T. Mahler** — Mr. Mahler was Executive Vice President and Chief Financial Officer of Finning International Inc., the world's largest Caterpillar dealer, from 1990 until his retirement in 2003. From 1981 to 1990, Mr. Mahler served as Vice President Finance of Amdahl Canada, a provider of enterprise-scale computing, networking, and storage systems and services. Prior to that, he held various senior financial management positions with Ford Motor Company of Canada from 1968 to 1980. Mr. Mahler is past Chair and director, Partnerships British Columbia (a provincial crown corporation formed to deliver public services through public/private partnerships), a director and incoming Chair, British Columbia Investment Management Corporation (provides fund management services for public bodies and publically administered trust funds totaling \$85 billion), a director of Ten Peaks Coffee Company Inc. and past Chair and director of the VGH/UBC Hospital Foundation. He was awarded the 2002 Queen's Golden Jubilee Medal for Distinguished Service by the Governor General of Canada and the 2002 Chancellor's Award for Distinguished Service by Simon Fraser University. Mr. Mahler holds a B.Sc. and an MBA.

**James M. I. Bruce** – Mr. Bruce is a partner of Capital West Partners, an independent firm providing investment banking services to mid-market firms in Western Canada. Prior to joining Capital West, he held investment banking positions as Managing Director, TD Securities Inc. and Vice President and Director, RBC Securities Inc. Mr. Bruce has held a number of directorships on both public and private entities. He is currently a director of South Coast British Columbia Transit Authority and is the Chair of the 2010 Games Operating Trust Society and a private company, Genus Capital Management Inc. He holds a Bachelor of Science (Mechanical Engineering) and a Masters of Business Administration. Mr. Bruce was awarded the 2002 Queen's Golden Jubilee Medal for Distinguished Service by the Governor General of Canada. He is a Certified Management Accountant, Chartered Business Valuator and Professional Engineer (retired).

**Solomon Oshry, Q.C.** — Prior to his immigration to Canada in 1978, Mr. Oshry was a Senior Partner in the law firm of Kahn, Oshry and Ellis in Johannesburg, South Africa. Upon his arrival in Canada he joined the Witten LLP law firm in Edmonton, Alberta and until 2002, when he retired from active legal practice and relocated to Vancouver, Mr. Oshry was a Senior Partner and member of the Management Committee of that firm, responsible for finance and administration. Mr. Oshry's legal practice focused primarily in the commercial real estate and corporate commercial areas. Mr. Oshry also taught Business Law at the Northern Alberta Institute of Technology in Edmonton and Commercial Conveyancing at the Vancouver Community College. In 1996 Mr. Oshry was appointed Queen's Counsel and in 2003 he was admitted as a member of the Law Society of British Columbia.

**Steven P. Richardson** – Mr. Richardson retired in 2009 as Chief Financial Officer at Hudson's Bay Company, a national retail group of companies, where he led the financial team from 2006 through to 2009. Over the years 2003 to 2006 he held various senior financial positions with the Hudson's Bay group of companies. Prior to joining the Hudson's Bay Company, he held the position of Chief Financial Officer with financial services companies, including Wells Fargo Financial Canada, Associates Financial Services of Canada and Beneficial Canada. Mr. Richardson began his career at Imperial Oil Limited, with various positions in the corporate finance and controller's departments. Mr. Richardson holds a Certified Management Accountant designation and completed the Senior Executive Leadership Program at Columbia University.

**Allen R. Sello** — Mr. Sello was Senior Vice President and Chief Financial Officer of UMA Group Ltd., a national engineering design and industrial contracting firm, from 1999 until his retirement in 2004. Prior to that, Mr. Sello was Chief Financial Officer of International Forest Products Ltd., a BC-based forest products company. Mr. Sello was employed by Gulf Canada Resources Ltd. from 1979 to 1995 where he was the Chief Financial Officer from 1987 to 1995. Prior to that he held senior financial and marketing management positions at Ford Motor Company of Canada from 1964 to 1979, ultimately as Treasurer. Mr. Sello is a director of North American Energy Partners Inc., a former director of Braintech Inc. and Infowave Software Inc., and past Chairman of the Vancouver Board of Trade – Government, Budget and Finance Committee. Mr. Sello holds a Bachelor of Commerce degree and an MBA.

**David Alves** — Mr. Alves is President and Chief Executive Officer of the Company and the Partnership. Mr. Alves is a global retail executive with over 20 years of experience and has held various senior management and executive positions in buying, operations, e-commerce, and merchandising for Hudson's Bay Company, Winners/HomeSense, and TJX Europe. He spent 3 years in London, England as Managing Director and Group Buying Director where he was responsible for the introduction and growth of the HomeSense brand in Europe.

**Mannie Druker** — Mr. Druker is Vice President, Finance and Leasing of the Company and the Partnership. Mr. Druker has been associated with Mr. Joseph Segal and Kingswood Capital Corporation since 1981, both in Inc and as a partner in other operating businesses. Mr. Druker has been a shareholder and active in management of the Sterling Shoes Inc., primarily in all aspects of finance, leasing and acquisitions, since 1987. Mr. Druker obtained his Bachelor of Commerce degree from the University of Cape Town, South Africa in 1970 and became a Chartered Accountant in 1973. Mr. Druker immigrated to Canada in 1976 and has been a member of the Institute of Chartered Accountants of BC since 1979.

**Daniel Gumprich** — Mr. Gumprich is Chief Financial Officer of the Company and the Partnership. Mr. Gumprich joined Sterling Shoes as Chief Financial Officer in 2005. Mr. Gumprich is a Chartered Accountant, a Chartered Business Valuator and a Certified Public Accountant (Illinois). Mr. Gumprich also holds a Bachelor of Commerce degree from the University of Saskatchewan. Mr. Gumprich gained public accounting and financial advisory experience with PricewaterhouseCoopers from 1992 to 2003. Mr. Gumprich's final role at PwC was of Vice-President in the Corporate Finance group. Prior to joining Sterling Shoes, he was Director of Finance at Inflazyme Pharmaceuticals Ltd.

**Scot Sheeler** – Mr. Sheeler joined Sterling as our Vice-President, Store Operations on January 4, 2011 with a mandate to improve the efficiency and effectiveness of our store network. Scot is a senior executive with over 20 years of diverse and progressive experience in the retail industry. He has expertise in the creation and execution of operational strategies with extensive experience in store operations, in-store marketing, store planning, and loss prevention. Scot's recent experiences include serving as President & CEO of Advanced Electronics, and Vice President, Stores (Zellers Western Region) for the Hudson's Bay Company.

**Sairose Kassam** – Ms. Kassam will join Sterling as our Vice-President, Supply on March 28, 2011 with a mandate to improve the efficiency and effectiveness of our store network. Sairose's recent experiences include 13 years at Roots Canada in progressively senior roles including that of Vice-President Merchandising Roots & Roots 73. At Roots, Sairose was the Senior Executive responsible for design, buying, planning and execution of Roots, Roots 73 and Roots web strategic financial goals. She was also responsible for ensuring marketing and promotional strategies were in line with brand integrity; improving margins by improved sourcing, key vendor alliances and enhanced supply chain management.

**Colin Romain** — Mr. Romain is our Vice President, Shoe Warehouse of the Partnership. Mr. Romain has a broad range of experience in the apparel industry, from manufacturing to retail, holding positions that ranged from head of buying to operations. After completing a year of compulsory military service, Mr. Romain studied Commerce at the University of Cape Town in South Africa from 1970 to 1974. He then joined Woolworths on their retail management program, rising to the position of Merchandising Manager (1975 to 1980). In 1981, he became a partner and General Manager of Polo Manufacturing in South Africa. Mr. Romain immigrated to Canada in 1986, joining Jean Machine of Toronto, Ontario as Operations Manager. Mr. Romain joined Inc in 1999, and is an instrumental member of the senior management team that has grown our Business to its current size.

**Melanie Richardson** – Ms. Richardson is our Vice President, Freedman/Joneve of the Partnership. Ms. Richardson has a broad range of experience in the fashion retail industry, ranging from operations, marketing, human resources, buying, finance and merchandise management. She joined Shoe Warehouse as a buyer in 1995 and was promoted to General Manager – Freedman in 2009. Prior to joining Sterling Shoes in 1995, Melanie spent 20 years with Off The Wall clothing company taking on increasing responsibilities, ending as the Operations Manager and making partner in 1992.

## **Corporate Cease Trade Orders or Bankruptcies**

To the knowledge of the Directors, other than as disclosed herein, none of the Directors and no member of the Management Group or a Shareholder holding a sufficient number of securities of the Company to affect materially the control of the Company, is, or within the ten years prior to the date hereof, has been, a director or executive officer of any company that, while that person was acting in that capacity: (i) was the subject of a cease trade order or similar order, or an order that denied the relevant company access to any exemption under Canadian securities legislation, for a period of more than 30 consecutive days; (ii) was subject to an event that resulted, after the director or executive officer ceased to be a director or executive officer, in the company being the subject of a cease trade or similar order or an order that denied the relevant company access to any exemption under securities legislation, for a period of more than 30 consecutive days; or (iii) or within a year of that person ceasing to act in that capacity, became bankrupt, made a proposal under any legislation relating to bankruptcy or insolvency or was subject to or instituted any proceedings, arrangement or compromise with creditors or had a receiver, receiver manager or trustee appointed to hold its assets.

Mr. Bruce was a director of Vendtek Systems Inc. ("Vendtek") until his resignation in February, 2009. On March 6, 2009 a cease trade order was issued by the British Columbia Securities Commission, and a subsequent cease trade order was issued by the Alberta Securities Commission on June 30, 2009, for failure to file financial statements, Management's Discussion and Analysis and an annual information form for the financial year ended October 31, 2008. The cease trade orders were revoked on March 25, 2010.

## **Penalties or Sanctions**

To the knowledge of the Trustees, none of the Trustees and no member of the Management Group has been subject to any penalties or sanctions imposed by a court relating to Canadian securities legislation or by a Canadian securities regulatory authority or has entered into a settlement agreement with a Canadian securities authority, or any other penalties or sanctions imposed by a court or regulatory body that would likely be considered important to a reasonable investor in making an investment decision.

## **Personal Bankruptcies**

To the knowledge of the Directors, none of the Directors and no member of the Management Group or a Shareholder holding a sufficient number of Shares of the Company to affect materially the control of the Company has, during the ten years prior to the date hereof, become bankrupt, made a proposal under any legislation relating to bankruptcy or insolvency, or became subject to or instituted any proceedings, arrangement or compromise with creditors, or had a receiver, receiver manager or trustee appointed to hold such persons assets.

## **Conflicts of Interest**

Other than as disclosed herein, to the knowledge of the Company, there are no existing or potential material conflicts of interest among us and any director or officer of the Company. Mannie Druker, who is a member of management, is also a director, officer and/or shareholder of Inc. Due to the relationship between us and Inc. Mr. Druker may have conflicting interests. Conflicts, if any, will be subject to the procedures and remedies available under the *Canada Business Corporations Act*. That Act provides that in the event a director or officer of a company is a party to, or is a director or officer of, or has a material interest in any person who is a party to, a material contract or proposed material contract with the Company, such individual shall disclose his interest in such contract and, in the case of directors, shall refrain from voting on any matter in respect of such contract unless otherwise provided by the Act.

## **PROMOTERS AND INTERESTS OF MANAGEMENT AND OTHERS IN MATERIAL TRANSACTIONS**

As at the date hereof, Inc holds a 20% interest in the Company. Certain of Inc.'s shareholders, including certain directors and officers of the Company received (or were or are officers of entities that received) proceeds of the Fund's initial public offering in July, 2005 and LP Units, which were exchangeable into Fund Units. See "Funding,

Acquisition and Related Transactions" and "Principal Agreements — Acquisition Agreement" in the Fund's final prospectus dated July 12, 2005, which is available on [www.sedar.com](http://www.sedar.com).

The Fund and, subsequent to the closing of the Arrangement, the Company paid rent to a company in which Jeremy Horwitz (a trustee of the Fund and President and Chief Executive Officer of Sterling until June 22, 2010) and Mannie Druker, a director and officer of the Company, have an interest, amounting to \$306 thousand for the twelve month period ended December 31, 2010 (\$296 thousand for the year ended December 31, 2009).

The Fund, and subsequent to the closing of the Arrangement the Company, purchased equipment from a company in which Mannie Druker, a director and officer of the Company, has an interest, for \$141 thousand during the twelve month period ended December 31, 2010 (\$170 thousand for the year ended December 31, 2009).

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.

### **Interests of Certain Persons or Companies in the Arrangement**

The trustees of the Fund and the Trust and the executive officers of the GP and their associates, including Inc., as a group, beneficially owned, directly or indirectly, or exercised control or direction over, an aggregate of approximately 236,161 Units and 1,328,372 Exchangeable Units, representing approximately 23.56% of the outstanding Units (assuming exchange of all Exchangeable Units for Units) at the time of the Arrangement.

### **LEGAL PROCEEDINGS AND REGULATORY ACTIONS**

From time to time we are involved in ordinary routine litigation common to companies engaged in our line of business. Currently, we are not involved in any material pending legal proceedings or regulatory actions. To the knowledge of our management, no legal proceedings or regulatory actions of a material nature involving us have been threatened by any third party.

### **TRANSFER AGENT AND REGISTRAR**

The Company's transfer agent and registrar is Computershare Investor Services Inc. at its principal transfer offices in Vancouver, British Columbia and Toronto, Ontario.

### **MATERIAL CONTRACTS**

The only material contracts entered into by us, other than in the ordinary course of business, that are material to us and that were entered into within the most recently completed financial year, or before the most recently completed financial year but are still in effect, are as follows:

1. the Acquisition Agreement, described under "General Development of the Business";
2. the Arrangement Agreement, described under "General Development of the Business";
3. "Shareholder Rights Plan Agreement" means the shareholder rights plan agreement entered into between the Company and Computershare Investor Services Inc. for the purposes of the Rights Plan, described under "General Development of the Business";
4. the Credit Facilities, described under "Credit Facilities";
5. the Nomination Agreement, described under "Description of the Company";
6. the Partnership Agreement, described under "Description of the Partnership";

7. the Indenture referred to under “Description of the Debentures”; and
8. Indemnity agreements among the Company and its subsidiaries and each of the directors and officers.

Copies of the material contracts listed above can be obtained at [www.sedar.com](http://www.sedar.com).

### INTEREST OF EXPERTS

The auditors of the Company are Deloitte & Touche LLP, Chartered Accountants, 2800-1055 Dunsmuir Street, Vancouver, British Columbia, V7X 1P4. To the knowledge of the Fund, neither Deloitte & Touche LLP nor its partners hold any registered or beneficial interest, directly or indirectly, in any securities or other property of the Fund.

### AUDIT COMMITTEE INFORMATION

#### Charter of the Audit Committee

The terms of reference of the audit committee of the Company are attached as Schedule A to this AIF.

#### Composition of the Audit Committee

The audit committee of the Company presently consists of Allen Sello (Chair), Steven Richardson, James Bruce and Richard Mahler.

Each member of the audit committee of the Company is independent and financially literate, as such terms are defined in National Instrument 52-110 – Audit Committees.

#### Relevant Education and Experience

The education and experience of each audit committee member of the Fund that is relevant to the performance of his or her responsibilities as an audit committee member is described below:

**Allen R. Sello.** Mr. Sello was Senior Vice President and Chief Financial Officer of UMA Group Ltd., a national engineering design and industrial contracting firm, from 1999 until his retirement in 2004. Prior to that, Mr. Sello was Chief Financial Officer of International Forest Products Ltd., a large BC-based forest products company. Mr. Sello was employed by Gulf Canada Resources Ltd. from 1979 1995 where he was the Chief Financial Officer from 1987 to 1995. Prior to that he held senior financial and marketing management positions at Ford Motor Company of Canada from 1964 to 1979, ultimately as Treasurer. Mr. Sello is presently the Audit Committee Chairman of North American Energy Partners Inc. and previously served as Audit Committee Chairman of Braintech Inc. and Infowave Software Inc. Each of these positions required Mr. Sello to understand and assess accounting principles, as well as understand internal control and procedures for financial reporting. The positions also required Mr. Sello to supervise others who prepared, analyzed and evaluated financial statements.

**James M. I. Bruce** – Mr. Bruce is a partner of Capital West Partners, an independent firm providing investment banking services to mid-market firms in Western Canada. Prior to joining Capital West, he held investment banking positions as Managing Director, TD Securities Inc. and Vice President and Director, RBC Securities Inc. Mr. Bruce has held a number of directorships on both public and private entities. He is currently a director of South Coast British Columbia Transit Authority and is the Chair of the 2010 Games Operating Trust Society and a private company, Genus Capital Management Inc. He holds a Bachelor of Science (Mechanical Engineering) and a Masters of Business Administration. Mr. Bruce was awarded the 2002 Queen’s Golden Jubilee Medal for Distinguished Service by the Governor General of Canada. He is a Certified Management Accountant, Chartered Business Valuator and Professional Engineer (retired).

**Richard T. Mahler.** Mr. Mahler holds a Master of Business Administration with majors in Finance and Economics.

He was Executive Vice President and Chief Financial Officer of Finning International Inc., the world's largest Caterpillar dealer, from 1990 until his retirement in 2003. From 1981 to 1990, Mr. Mahler served as Vice President Finance of Amdahl Canada, a provider of enterprise-scale computing, networking, and storage systems and services. Prior to that, he held various senior financial management positions with Ford Motor Company of Canada from 1968 to 1980. In these roles he was responsible for understanding and assessing accounting principles, and implementing internal controls and procedures for financial reporting. In such roles, Mr. Mahler was also responsible for, and supervised others engaged in, preparing, analyzing and evaluating financial statements.

**Steven P. Richardson** – Mr. Richardson retired in 2009 as Chief Financial Officer at Hudson’s Bay Company, a national retail group of companies, where he led the financial team from 2006 through to 2009 .Over the years 2003 to 2006 he held various senior financial positions with the Hudson’s Bay group of companies. Prior to joining the Hudson’s Bay Company, he held the position of Chief Financial Officer with financial services companies, including Wells Fargo Financial Canada, Associates Financial Services of Canada and Beneficial Canada. Mr. Richardson began his career at Imperial Oil Limited, with various positions in the corporate finance and controller’s departments. Mr. Richardson holds a Certified Management Accountant designation and completed the Senior Executive Leadership Program at Columbia University.

**Prior Approval Policies and Procedures**

The audit committee of the Company must pre-approve all non-audit services to be provided to the Company or its subsidiaries by the Company’s external auditor, other than non-audit services where:

- (a) the aggregate amount of all such non-audit services that were not pre-approved is reasonably expected to constitute no more than five per cent of the total amount of fees paid by the Company and its subsidiaries to the Company’s external auditor during the fiscal year in which the services are provided;
- (b) the Company or its subsidiary, as the case may be, did not recognize the services as non-audit services at the time of the engagement; and
- (c) the services are promptly brought to the attention of the audit committee of the Company and approved, prior to the completion of the audit, by the audit committee of the Company or by one or more of its members to whom authority to grant such approvals had been delegated by the audit committee of the Company.

Pursuant to National Instrument 52-110, the audit committee has delegated its pre-approval authority to the Chair of the Committee, who is authorized to pre-approve non-audit services performed by the auditors provided that a report is made of such pre-approval at the next meeting of the audit committee.

**External Auditor Service Fees (by category)**

The following table sets forth, by category, the fees billed by Deloitte & Touche LLP, the Fund’s auditors, for the periods ended December 31, 2009 and December 31, 2010:

<b>Fee Category</b>	<b>2009</b>	<b>2010</b>
Audit fees	81,200	94,500
Audit-related fees	60,000	82,500
Tax fees	0	0
	<b>141,200</b>	<b>177,000</b>

“**Audit fees**” include all fees paid to Deloitte & Touche LLP for the audit of the annual consolidated financial statements of the Fund.

“**Audit-related fees**” include all fees paid to Deloitte & Touche LLP for the review of the interim financial statements and other services in connection with regulatory filings, including the conversion of the Fund to a corporate structure.

“**Tax fees**” include all fees paid to Deloitte & Touche LLP for tax compliance, tax advice and tax planning, and advisory services.

### **ADDITIONAL INFORMATION**

Additional information relating to us may be found on SEDAR at [www.sedar.com](http://www.sedar.com). Additional information, including directors’ and officers’ remuneration and indebtedness, principal holders of our securities and securities authorized for issuance under equity compensation plans, as applicable, will be contained in our information circular for our upcoming 2011 annual meeting of Shareholders. Additional financial information is provided in our audited consolidated financial statements and management’s discussion and analysis for our most recently completed financial year.

## GLOSSARY OF TERMS

"**Acquisition Agreement**" means the acquisition agreement dated July 12, 2005 between the Fund, the Trust, the Partnership, the GP and Inc;

"**Adjusted EBITDA**" has the meaning given to it under "Non-GAAP Measures";

"**Arrangement**" means the arrangement pursuant to Section 192 of the *Canada Business Corporations Act* pursuant to which the Fund converted to a corporate structure effective July 1, 2010;

"**Arrangement Agreement**" means the arrangement agreement dated May 18, 2010, among the Fund, the Trust, the Partnership, the GP, the Company and Inc. pursuant to which the parties agreed to the terms and conditions for implementation of the Arrangement;

"**Book-Entry System**" means a book-based system administered by CDS;

"**Business**" means the retail footwear business of the Company;

"**CDS**" means the Canadian Depository for Securities Limited;

"**CDS Participant**" means a participant in the CDS depository system;

"**Change of Control**" means the acquisition of voting control of or direction over 66 2/3% or more of the issued and outstanding Shares (after giving effect to the conversion or exchange of securities convertible into, exchangeable for or otherwise carrying the right to acquire Units);

"**CICA**" means the Canadian Institute of Chartered Accountants;

"**Company**" means Sterling Shoes Inc., a corporation incorporated under the *Canada Business Corporations Act*;

"**Credit Facilities**" means the credit facilities referred to under "Credit Facilities";

"**Debentures**" means the up to \$25,000,000 aggregate principal amount of 6.5% convertible unsecured subordinated debentures of the Fund issued pursuant to the Indenture;

"**Debentureholder**" means a registered holder from time to time of the Debentures;

"**Debenture Trustee**" means Computershare Trust Company of Canada;

"**Debenture Closing Date**" means October 3, 2007;

"**Distributable Cash**" has the meaning given to it under "Non-GAAP Measures";

"**EBITDA**" has the meaning given to it under "Non-GAAP Measures";

"**Exchangeable Units**" means the Class D LP Units of the Partnership all of which, immediately prior to the Arrangement, were held by SSI and were exchangeable for Units on a one for one basis;

"**Fund**" means Sterling Shoes Income Fund, an unincorporated, open-ended, limited-purpose trust established under the laws of the Province of British Columbia;

"**GAAP**" means generally accepted accounting principles in Canada;

"**GP**" means Sterling Shoes GP Inc., a corporation incorporated under the laws of the Province of British Columbia;

"**GP Units**" means ordinary general partner units issued by the Partnership;

"**High street**" means a street well-known for its high concentration of fashion retailers in close proximity;

"**Inc.**" means SSI Investments Inc., formerly named Sterling Shoes Inc., a corporation incorporated under the laws of the Province of British Columbia;

"**Indenture**" means the trust indenture providing for the issuance of Debentures entered into between the Fund and the Debenture Trustee on the Debenture Closing Date;

"**LP Units**" means the Class A, B, C, D and E limited partnership units issued by the Partnership;

"**Management Group**" shall have the meaning ascribed thereto under "Directors and Officers";

"**Offering**" means the offering of 5,313,488 Units issued and sold by the Fund on July 12, 2005 pursuant to a prospectus dated June 30, 2005;

"**Partnership**" means Sterling Shoes Limited Partnership, a limited partnership established under the laws of the Province of Manitoba;

"**Partnership Agreement**" means the amended and restated limited partnership agreement in respect of the Partnership dated as of November 3, 2005, as it may be amended, restated or supplemented from time to time;

"**Partnership Units**" means the GP and LP Units issued by the Partnership;

"**Rights Plan**" means the shareholder rights plan of the Company;

"**same-store sales**" means net delivered sales for stores that were open during the most recently completed fiscal year for the entire year;

"**Senior Indebtedness**" means "Senior Indebtedness" as that term is defined in the Indenture and includes all indebtedness, liability or obligation of or guaranteed by the Company or its subsidiaries which, by the terms of the instrument creating or evidencing the same, will be expressed to rank in right of payment in priority to the indebtedness, liability or obligation evidenced hereby;

"**Shareholder Rights Plan Agreement**" means the shareholder rights plan agreement entered into between the Company and Computershare Investor Services Inc. in respect of the Rights Plan;

"**Shares**" means the common shares in the capital of the Company.

"**Special Voting Units**" means units of the Fund issued to represent voting rights in the Fund that accompany the Exchangeable Units;

"**Tax Act**" means the *Income Tax Act* (Canada) and the regulations thereunder;

"**Trust**" means SS Holdings Trust, an unincorporated, limited-purpose trust established under the laws of the Province of British Columbia;

"**TSX**" means the Toronto Stock Exchange;

"**Unitholders**" means the holders of Units;

**"Units"** means units of the Fund other than Special Voting Units; and

**"Voting Unitholders"** means holders of Units and Special Voting Units.

**SCHEDULE A**  
**STERLING SHOES INC.**

**AUDIT COMMITTEE MANDATE**

**1. PURPOSE OF THE AUDIT COMMITTEE**

The purpose of the Audit Committee (the “Committee”) is to assist the Board in fulfilling its oversight responsibilities by reviewing the financial information which will be provided to the shareholders and others, identifying and monitoring the management of the principal risks that could impact the financial reports of the Corporation and its subsidiaries, reviewing the systems of corporate controls which management and the Board has established, and monitoring auditor independence and the audit process. The Committee is responsible for the engagement of external auditors and for providing an avenue of communication amongst the external auditors, management and the Boards of Directors. More specifically the Audit Committee is to gain reasonable assurance that:

1.1 The Corporation’s annual financial statements fairly present in all material respects the financial condition, results of operations and cash flows of the Corporation and to recommend to the Board whether the annual financial statements should be approved.

1.2 The financial information contained in the Corporation’s quarterly financial statements and report, the Annual Report to Shareholders, the Management’s Discussion and Analysis, the Annual Information Form, and information contained in any other material disclosure document is complete and accurate in all material respects and to recommend to the Board whether these documents should be approved.

1.3 The Corporation has an appropriate system of internal controls, safeguarding of assets and financial reporting to ensure compliance with legal and regulatory requirements. This would include appropriate disclosure controls and procedures that enable financial information to be recorded, processed, summarized, and reported within the time periods required by law.

1.4 The external auditors are independent and qualified, the external audit function has been effectively carried out, and any matter which the external auditors wish to bring to the attention of the Board has been addressed. The Committee will also recommend to the Board the re-appointment or appointment of auditors and their remuneration.

**2. COMPOSITION AND TERMS OF OFFICE**

2.1 Following each annual meeting of Shareholders of the Corporation, the Board shall appoint not less than three Directors to serve on the Committee, each of whom shall be an independent Director who is unrelated and free from any relationship that would interfere with the exercise of his or her independent judgment and who shall otherwise meet all applicable independence and other requirements of law including those set out in National Instrument 52-110 – *Audit Committees* (“**NI 52-110**”).

2.2 All members shall be (except to the extent permitted by NI 52-110) financially literate, defined as being able to read and understand a set of financial statements that present a breadth and level of complexity of accounting issues that are generally comparable to the breadth and complexity of the issues that can reasonably be expected to be raised by the Corporation’s financial statements, and at least one member shall have accounting or related financial management expertise or, if required by applicable legislation, shall be a financial expert.

2.3 The Committee Chair shall be appointed by the Board.

2.4 The Committee Chair shall:

- (a) provide leadership to the Committee by reinforcing and monitoring the achievement of the Committee’s objectives;
- (b) coordinate the agenda, information packages and related events for Committee meetings with the Chief Financial Officer;
- (c) chair Committee meetings

- (d) exercise a second casting vote in the event of an equality of votes; and
- (e) report the activities of the Audit Committee to the Board.

2.5 Any member may be removed or replaced at any time by the Board and shall cease to be a member upon ceasing to be a Director of the Corporation. The Board may fill vacancies on the Audit Committee by election from among the Board. If and whenever a vacancy shall exist on the Audit Committee, the remaining members may exercise all powers of the Audit Committee so long as a quorum remains. Each member shall hold office until the close of the next annual meeting of Shareholders of the Corporation or until the member resigns or is replaced, whichever occurs first.

### **3. AUDIT COMMITTEE MEETINGS**

3.1 The Committee will meet at least four times per year. The meetings will be scheduled to permit timely review of the interim and annual financial statements. Additional meetings may be held as deemed necessary by the Chair of the Committee or as requested by any member or by the external auditors.

3.2 If all members consent, and proper notice has been given or waived, a member or members of the Audit Committee may participate in a meeting of the Committee by means of such telephonic, electronic or other communication facilities as permit all persons participating in the meeting to communicate adequately with each other. A member participating in such a meeting by any such means is deemed to be present at that meeting.

3.3 A quorum for the transaction of business at all meetings of the Committee shall be a majority of the authorized number of members. Questions arising at any meeting shall be determined by a majority of votes by the members present, and in case of an equality of votes the Committee Chair shall have a second casting vote.

3.4 The Committee will meet with management and the external auditors in separate sessions.

3.5 The minutes of all meetings of the Committee will be provided to the Board and will be filed with the corporate records of the Corporation.

3.6 Supporting schedules and information reviewed by the Committee will be available for examination by any Director upon request to the Chair of the Committee.

3.7 The external auditors shall be given notice of, every meeting of the Committee and, unless otherwise advised by the Audit Committee Chair, shall attend such meetings.

3.8 The Secretary of the Corporation will act as Secretary to the Committee.

3.9 A resolution approved in writing by all members shall be as valid and effective as if it had been passed at a meeting duly called and constituted. Such resolution may be in two or more counterparts, which together shall be deemed to constitute one resolution in writing. Such resolution shall be filed with the minutes of the proceedings of the Audit Committee and shall be effective on the date stated thereon or on the latest date stated on any counterpart.

### **4. AUTHORITY AND RESPONSIBILITIES**

#### **4.1 Audit Committee Terms of Reference**

The Committee shall review and assess the adequacy of its terms of reference at least annually and submit its terms of reference to the Board for approval.

#### **4.2 Financial Reporting Control Systems**

The Committee shall:

- (a) Review the quality of reports from senior officers outlining any significant changes in financial risks facing the Corporation;
- (b) review the annual management letter of the external auditors and the Corporation's responses to suggestions made;
- (c) review any new appointments to senior positions with financial reporting responsibilities and pre-approve

the hiring to a financial reporting oversight role of any person who had been employed by the Corporation's external auditor within one year prior to the commencement of procedures for the current audit engagement; and

- (d) annually, as at the end of the Corporation's fiscal year, in consultation with management and the external auditors, evaluate the Corporation's internal controls and procedures for financial reporting, and review significant findings prepared by the external auditors together with management's responses.

#### 4.3 Interim Financial Statements

The Committee shall:

- (a) Review the interim financial statements and the external auditors' report thereon with management and the external auditors prior to their release and recommend approval of the financial statements to the Board; this will include a detailed review of quarterly and year-to-date results, Management's Discussion and Analysis and associated press releases;
- (b) review the report of the Disclosure Committee on the interim financial statements and Management's Discussion and Analysis;
- (c) review the CFO's report on management's financial estimates and judgements for the current quarter.

#### 4.4 Annual Financial Statements and Other Financial Information

The Committee shall:

- (a) review any changes in accounting policies or financial reporting requirements that may affect the current year's financial statements;
- (b) obtain summaries of significant issues regarding accounting principles, practices and significant management estimates and judgments, and other potentially difficult matters whose treatment in the annual financial statements merits advance consideration;
- (c) review the annual financial statements and the auditor's report thereon prior to their release and recommend approval of the financial statements to the Board; this will include a detailed review of year-over-year results, Management's Discussion and Analysis and associated press releases;
- (d) review reports from external auditors on:
  - (i) all critical accounting policies and practices to be used;
  - (ii) all alternative treatments of financial information within generally accepted accounting principles that have been discussed with management, ramifications of the use of such alternative disclosure and treatments, and the treatment preferred by the independent external auditor;
  - (iii) other material written communications between the independent external auditor and management, such as any management letter or schedule of unadjusted differences;
- (e) review disclosures made to the Committee by the President and CEO and the CFO during their certification process for any statutory documents about any significant deficiencies in the design or operation of internal controls or material weakness therein and any fraud involving management or other employees who have a significant role in Corporation internal controls;
- (f) review with management the auditor's internal control report required to be included in any statutory document;
- (g) review a summary of the status of any material pending or threatened litigation, claims and assessments;
- (h) review the Annual Report to Shareholders and other annual public information documents including the Annual Information Form;
- (i) monitor the Corporation's financial risks and management's plans to mitigate such risks including insurance, information technology, hedging, etc.;

- (j) review the report of the Disclosure Committee on its review of the annual financial statements, Management's Discussion and Analysis, the Annual Report and other annual public information including the Annual Information Form; and
- (k) satisfy itself that adequate procedures have been put in place by management for the review of the Corporation's public disclosure of financial information extracted or derived from the Corporation's financial statements and the related Management's Discussion & Analysis.

#### 4.5 External Audit Terms of Reference, Reports, Planning and Appointment

The external auditor shall report directly to the Committee. The Committee shall:

- (a) review the audit plan with the external auditor;
- (b) advise the external auditor that it is required to report to the Committee, and not to Management;
- (c) monitor the relationship between management and the external auditor, including reviewing any management letters or other reports of the external auditor, discussing any material differences of opinion between management and the external auditor and resolving disagreements between the external auditor and management;
- (d) annually review and discuss with the external auditor all significant relationships they have with the Corporation or its affiliates that could impair the external auditors independence;
- (e) discuss with the external auditor, without management present, matters affecting the conduct of their audit and other corporate matters;
- (f) recommend to the Board each year the retention or replacement of the external auditor; if there is a plan to change auditor, review all issues related to the change and the steps planned for an orderly transition;
- (g) annually review and recommend for approval to the Board the terms of engagement and the remuneration of the external auditor;
- (h) pre-approve all non-audit services to be performed by the external auditor that are not prohibited by law (unless not required by applicable law);
- (i) review the performance of the external auditor and recommend any discharge of the external auditor when the Committee determines that circumstances warrant;
- (j) ensure the rotation of the lead or coordinating audit partner having primary responsibility for the audit as required by law; and
- (k) pre-approve the hiring of employees and former employees of current and former auditors.

#### 4.6 Legal Compliance

The Committee shall review quarterly, litigation matters with the Corporation's legal counsel as required.

#### 4.7 Material Disclosure Documents

The Committee shall review the contents of any financial information within any prospectus, information circular or other material disclosure documents prior to their release and recommend their approval to the Board and shall receive a report from the Disclosure Committee concerning its review of such documents, if any.

#### 4.8 Whistleblower, Conduct and Internal Control Complaint Procedure

The Committee shall ensure that the Corporation put in place adequate procedures for:

- (a) the receipt, retention and treatment of complaints received by the Corporation or its Administrator regarding accounting, internal accounting controls or auditing matters;
- (b) the confidential, anonymous submission by employees of the Corporation or its Administrator of concerns regarding questionable accounting or auditing matters; and
- (c) the reporting to the Committee the result of investigations of whistleblower, conduct and internal control

complaints

#### 4.9 Credit worthiness, Treasury and Financial Policy

The Committee shall review with management:

- (a) the Corporation's financial policies and compliance with such policies;
- (b) the credit worthiness of the Corporation;
- (c) the liquidity of the Corporation; and
- (d) important treasury matters including financing plans.

### **5. ACCOUNTABILITY**

5.1 The Committee shall report to the Board at its next regular meeting all such action it has taken since the previous report.

5.2 The Committee is empowered to investigate any activity of the Corporation and all employees are to cooperate as requested by the Committee. The Committee may retain and compensate persons having special expertise to assist it in fulfilling its responsibilities and the Corporation shall provide sufficient funding for this purpose.

5.3 The Committee is authorized to request the presence of, at any meeting, a representative from the external auditor, management, legal counsel, or anyone else who could contribute substantively to the subject of the meeting. The Committee is also authorized to engage the services of independent counsel and such other advisors as it considers necessary for the effective fulfillment of its responsibilities. The expense of such attendance and services shall be borne by the Corporation.

5.4 Nothing in this mandate is intended or may be construed to impose on any member of the Committee a standard of care or diligence that is in any way more onerous or extensive than the standard to which all Board members are subject. While the Committee has the responsibilities set forth in this Mandate, it is not the duty of the Committee to prepare financial statements, plan or conduct audits, manage the Corporation's exposure to risk or to determine that the financial statements and disclosures are complete and accurate and are in accordance with Canadian generally accepted accounting principles and applicable rules and regulations. These are the responsibilities of management and the external auditor, as applicable.

### **6. COMMITTEE TIMETABLE**

The timetable on the following pages outlines the Committee's schedule of activities during the fiscal year.

**AUDIT COMMITTEE CALENDAR**

<i>Agenda Item</i>	<b>March</b>	<b>May</b>	<b>August</b>	<b>November</b>
<b>A Financial Report Control Systems</b>				
Review reports from management outlining changes in financial risks.	X	X	X	X
Review any new appointments to senior positions with financial reporting responsibilities.	X	X	X	X
Obtain assurance from the external auditor regarding the overall control environment and the adequacy of accounting system controls.	X			
Review external auditor's significant audit findings and management's responses to suggestions made		X		
Review procedures for receipt and treatment of complaints regarding accounting controls or auditing matters and confidential, anonymous submission of concerns regarding accounting or auditing matters.(Whistleblower Policy)			X	
Review financial statement certification process and disclosure controls and procedures.				X
Review officers' expenses		X		X
Receive report on results of operations control checklist		X		X

<i>Agenda Item</i>	<b>March</b>	<b>May</b>	<b>August</b>	<b>November</b>
<b>B Interim Financial Statements and MD&amp;A</b>				
Review interim financial statements and MD&A and the auditor's report thereon with management and the external auditor prior to public release and recommend approval of the interim financial statements and MD&A to the Board.		X	X	X
Review associated press releases accompanying interim financial statements.		X	X	X
<b>C. Annual Financial Statements and Other Financial Information</b>				
Review any changes in accounting policies or financial reporting requirements that may affect the current year's financial statements.	X	X	X	X
Review summary of the status of any material pending or threatened litigation, claims and assessments.	X	X	X	X
Review critical accounting policies, alternative treatments of financial information and material communication between management and external auditor.	X	X	X	X
Review risk management plans, as required.	X	X	X	X
Review hedging and credit programs and policies, as required.	X	X	X	X
Receive a report from the Disclosure Committee	X	X	X	X
Review the annual financial statements and the auditor's report thereon and related MD&A and press release with management and the external auditor prior to public release, and recommend approval of such documents to the Board.	X			

<i>Agenda Item</i>	<b>March</b>	<b>May</b>	<b>August</b>	<b>November</b>
Review the annual report and other annual public information documents.	X			
Annual review of insurance programs		X		
Obtain summaries of significant transactions, and other potentially difficult matters whose treatment in the annual financial statements merits advance consideration.				X
<b>D. External Audit Terms of Reference, Reports, Planning and Appointment</b>				
Discuss in private with the external auditor matters affecting the conduct of their audit, interim reviews and other corporate matters.	X	X	X	X
Review and approve engagement of the external auditor for non-audit services	X	X	X	X
Assess independence of external auditor. Ensure rotation of lead or coordinating audit partner having primary responsibility for the audit as required by law.	X			X
Review of external auditor		X		
Recommend to the Board the retention or replacement of the external auditor. If there is a plan to change auditor, review all issues related to the change and the steps planned for an orderly transition.		X		
Review the audit plan with the external auditor.			X	
Review and recommend for approval to the Board the terms of engagement and the remuneration of the external auditor.			X	

<i>Agenda Item</i>	<b>March</b>	<b>May</b>	<b>August</b>	<b>November</b>
<b>E Governance Matters</b>				
Review key finance polices, as required.	X	X	X	X
Review Audit Committee Mandate.			X	
<b>F. Material Disclosure Documents</b>				
Review the contents of any material disclosed documents prior to their release and recommend their approval to the Board.	X	X	X	X

## SCHEDULE TO THE AUDIT COMMITTEE MANDATE

### **I. Auditor independence**

Auditor must be independent in fact and appearance. To achieve it, the external auditors will be prohibited from the following:

- A. Investment in the Corporation or any of its subsidiaries by auditors or their family members.
- B. Employment of the family members of the auditors in the managerial positions with the Corporation or any of its subsidiaries.
- C. Business relationship with the Corporation or any of its subsidiaries other than providing professional services.
- D. Bookkeeping or other services related to the Corporation or any of its subsidiaries accounting records or preparation of financial statements.
- E. Financial systems design and implementation, except services provided in connection with the assessment, design and implementation of internal accounting controls and risk management controls.
- F. Appraisal or valuation services or fairness opinion where the results of any valuation or appraisal would be material to the financial statements, or where the accountant would audit the results.
- G. Actuarial services.
- H. Internal audit services.
- I. Management functions.
- J. Human resources – auditor will not be able to recruit, act as a negotiator for the Corporation or on any of its subsidiaries' behalf, develop employee testing and evaluation programs or recommend or advise that the Corporation or any of its subsidiaries hire a specific candidate for a specific job. It could, however, interview candidates and advise the Corporation or any of its subsidiaries on the candidates' competence for accounting and related positions.
- K. Broker-dealer services. The auditor will not serve as a broker-dealer, promoter or underwriter of the Corporation or any of its subsidiaries' securities.
- L. Legal services.
- M. Employment with the Corporation or any of its subsidiaries for audit managers and partners within 3 years of performing audit or audit-related services.

The external auditors will furnish details of all factors that might have an impact on their independence and objectivity, including all services provided and fees charged by them. The Audit Committee will satisfy itself regarding the independence of external auditors and report its conclusions and the basis therefore to the Board.

### **II. Scope of work**

With the approval of the Audit Committee, external auditor may perform the following services for the Corporation:

- A. External audit.
- B. Quarterly reviews.
- C. Tax advice and reviews.
- D. Due diligence for any M&A transactions that the Corporation or any of its subsidiaries may be associated with.
- E. Other professional services that are not expressly prohibited and will enable the external auditor to maintain factual and perceived independence.

### **III. Lead Partner Rotation**

The incumbent auditors will be expected to institute a policy to rotate the lead partner in charge of the audit every five years.