

*Consolidated Financial Statements of*

**STERLING SHOES INC.**

*(formerly Sterling Shoes Income Fund)*

*December 31, 2010*

(Expressed in thousands of dollars)

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## **Independent Auditor's Report**

To the Shareholders of Sterling Shoes Inc. (formerly Sterling Shoes Income Fund)

We have audited the accompanying consolidated financial statements of Sterling Shoes Inc. (formerly Sterling Shoes Income Fund) (the "Company"), which comprise the consolidated balance sheet as at December 31, 2010 and 2009 and the consolidated statements of loss and comprehensive loss, changes in shareholders' equity, and cash flows for the years then ended, and a summary of significant accounting policies and other explanatory information.

### *Management's responsibility for the consolidated financial statements*

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with Canadian generally accepted accounting principles, and for such internal control as management determines is necessary to enable the preparation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

### *Auditor's responsibility*

Our responsibility is to express an opinion on these consolidated financial statements based on our audit. We conducted our audit in accordance with Canadian generally accepted auditing standards. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

### *Opinion*

In our opinion, the consolidated financial statements present fairly, in all material respects, the financial position of the Company as at December 31, 2010 and 2009, and its financial performance and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

***(Signed) Deloitte & Touche LLP***

Chartered Accountants  
Vancouver, British Columbia  
March 17, 2011

**STERLING SHOES INC.****Consolidated Balance Sheets**

(Expressed in thousands of dollars, except per share and number of share figures.)

	As at December 31, 2010	As at December 31, 2009
<b>ASSETS</b>		
<b>CURRENT</b>		
Cash	\$ 7,444	4,119
Accounts receivable	359	195
Inventory [note 3]	28,614	36,446
Prepaid expenses and deposits	336	187
	<u>36,753</u>	<u>40,947</u>
LEASEHOLDS AND EQUIPMENT [note 4]	17,969	19,595
INTANGIBLE ASSETS [note 5]	16,623	16,623
	<u>\$ 71,345</u>	<u>\$ 77,165</u>

**LIABILITIES AND UNITHOLDERS' EQUITY****CURRENT**

Accounts payable and accrued liabilities	16,225	15,006
Term loan [notes 6]	1,000	5,000
	<u>17,225</u>	<u>20,006</u>
FUTURE INCOME TAXES [note 12]	793	2,364
TERM LOAN [note 6]	3,500	-
CONVERTIBLE DEBENTURES [note 7]	23,264	22,520
DEFERRED LEASE INDUCEMENTS	1,653	2,057
SHAREHOLDERS' EQUITY	24,910	30,218
	<u>\$ 71,345</u>	<u>\$ 77,165</u>

## COMMITMENTS [note 9]

On behalf of the Board of Directors

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(signed) Rick Mahler  
Director

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(signed) Dave Alves  
Director

See accompanying notes

STERLING SHOES INC.

Consolidated Statements of Loss and Comprehensive Loss

(Expressed in thousands of dollars, except per share and number of share figures.)

	Three-month period ended		Year ended	
	December 31, 2010	December 31, 2009	December 31, 2010	December 31, 2009
	(unaudited)	(unaudited)		
SALES	\$ 39,348	\$ 41,195	\$ 127,028	\$ 131,170
COST OF SALES	22,065	18,011	72,173	69,127
GROSS MARGIN	17,283	23,184	54,855	62,043
EXPENSES				
Store and selling	12,998	12,664	46,416	46,785
General and administrative	2,690	2,383	8,297	7,616
Conversion costs	0	-	398	-
Amortization of leaseholds and equipment	790	863	3,535	3,401
	16,478	15,910	58,646	57,802
Income/(Loss) before interest, impairment and non-controlling interest	805	7,274	(3,791)	4,241
Interest and financing expense	657	669	2,612	2,637
Impairment of goodwill and intangible assets [note 5]	0	0	0	33,246
Unrealized loss on foreign exchange	256	0	256	0
Loss on disposal of leaseholds and equipment	-	367	220	627
INCOME / (LOSS) BEFORE TAXES	(108)	6,238	(6,879)	(32,269)
Future income taxes recovery [note 12]	1,571	-	1,571	4,636
NET INCOME / (LOSS) AND COMPREHENSIVE INCOME / (LOSS)	1,463	6,238	(5,308)	(27,633)
Basic net income/(loss) per share	\$ 0.22	\$ 0.94	\$ (0.80)	\$ (4.16)
Diluted net income/(loss) per share	0.21	0.82	(0.80)	(4.16)
Basic weighted average number of shares outstanding	6,641,860	6,641,860	6,641,860	6,641,860
Diluted weighted average number of shares outstanding	7,823,885	7,823,885	7,823,885	7,823,885

See accompanying notes

STERLING SHOES INC.

Consolidated Statements of Shareholders' Equity

For the year ended December 31, 2010

(Expressed in thousands of dollars, except per share and number of share figures.)

	Shareholders' capital [note 8]	Equity component of Debentures [note 7]	Accumulated earnings	Accumulated distributions	Accumulated deficit	Shareholders' equity
<b>BALANCE, December 31, 2008</b>	\$ 59,809	2,657	33,740	(36,800)	(3,060)	\$ 59,406
Net loss for the period	-	-	(27,633)	-	(27,633)	(27,633)
Distributions declared	-	-	-	(1,555)	(1,555)	(1,555)
<b>BALANCE, December 31, 2009</b>	\$ 59,809	2,657	6,107	(38,355)	(32,248)	\$ 30,218
Net loss for the period	-	-	(5,308)	-	(5,308)	(5,308)
<b>BALANCE, December 31, 2010</b>	\$ 59,809	2,657	799	(38,355)	(37,556)	\$ 24,910

See accompanying notes

STERLING SHOES INC.

Consolidated Statements of Cash Flows

(Expressed in thousands of dollars, except per share and number of share figures.)

	Three-month period ended		Year ended	
	December 31, 2010	December 31, 2009	December 31, 2010	December 31, 2009
	(unaudited)	(unaudited)		
<b>OPERATING ACTIVITIES</b>				
Net Income/ (Loss)	\$ 1,463	\$ 6,238	\$ (5,308)	\$ (27,633)
Items not involving cash				
Impairment of goodwill and intangible assets	-	-	-	33,246
Future income taxes recovery	(1,571)	0	(1,571)	(4,636)
Amortization of leaseholds and equipment	790	863	3,535	3,401
Loss on disposal of leaseholds and equipment	-	367	220	627
Amortization of deferred lease inducements	(86)	(11)	(404)	(550)
Accreted interest expense [note 7]	195	175	747	673
	791	7,632	(2,781)	5,128
Change in non-cash working capital balances related to operations				
Accounts receivable	931	456	(165)	690
Inventory [note 3]	8,646	6,560	7,832	3,445
Prepaid expenses and deposits	(2)	213	(149)	297
Accounts payable and accrued liabilities	(2,010)	(3,340)	1,219	55
	7,565	3,889	8,737	4,487
Cash provided by operating activities	8,356	11,521	5,956	9,615
<b>INVESTING ACTIVITIES</b>				
Acquisition of leaseholds and equipment	(423)	(346)	(2,131)	(3,626)
Lease inducements received	-	96	-	374
Cash used in investing activities	(423)	(250)	(2,131)	(3,252)
<b>FINANCING ACTIVITIES</b>				
Term loan [note 6]	(250)	(6,781)	(500)	(467)
Payment of distributions	-	(371)	-	(1,777)
Cash used in financing activities	(250)	(7,152)	(500)	(2,244)
<b>CASH INFLOW DURING THE PERIOD</b>	<b>7,683</b>	<b>4,119</b>	<b>3,325</b>	<b>4,119</b>
<b>CASH, BEGINNING OF PERIOD</b>	<b>(239)</b>	<b>-</b>	<b>4,119</b>	<b>-</b>
<b>CASH, END OF PERIOD</b>	<b>\$ 7,444</b>	<b>\$ 4,119</b>	<b>\$ 7,444</b>	<b>\$ 4,119</b>
<b>Supplemental cash flow information</b>				
Interest paid	\$ 659	\$ 906	\$ 1,866	\$ 1,963

See accompanying notes

# STERLING SHOES INC.

## Notes to Consolidated Financial Statements

December 31, 2010

(Expressed in thousands of dollars, unless otherwise specified and except for per share amounts.)

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### 1. NATURE OF OPERATIONS AND CONVERSION TO A CORPORATION

Sterling Shoes Inc. (the “Company”), through its wholly owned subsidiary, Sterling Shoes Limited Partnership (“Sterling Shoes LP”), a partnership established under the laws of the Province of Manitoba, operates Canadian retail stores in five provinces in shopping malls, high-streets and strip malls. The Company is a leading retailer offering a broad selection of private label and national brand name shoes and accessories through six separate retail banners: Sterling, Joneve, Shoe Warehouse, Freedman Shoes, Gia and Sterling Outlet.

Prior to July 1, 2010, these operations were owned by Sterling Shoes Income Fund, (the “Fund”). On July 1, 2010, the Fund was converted, on a tax deferred basis, from an open-ended limited purpose trust to an incorporated corporation (the “Conversion”) pursuant to a plan of arrangement under the Business Corporations Act (British Columbia). Pursuant to the Conversion, the Company acquired all of the outstanding units of the Fund (“Units”), in exchange for Common Shares, on the basis of one Common Share for each Unit. Other securities exercisable or exchangeable for Units were either exchanged for Common Shares or for securities exercisable for Common Shares, as applicable. As a result of the Conversion, the Company became the sole holder of the outstanding Units. On July 1, 2010, the Fund was dissolved and all of its assets were transferred to, and all of its liabilities were assumed by, the Company on that date. The exchange of the units of the Fund to the Company was recorded at the carrying values of the Fund’s assets and liabilities on July 1, 2010 in accordance with the continuity of interest method of accounting as the Company is considered to be a continuation of the Fund.

### 2. SIGNIFICANT ACCOUNTING POLICIES

#### (a) *Basis of presentation*

These consolidated financial statements and accompanying notes have been prepared in accordance with Canadian generally accepted accounting principles (“GAAP”). These consolidated financial statements include the accounts of the Company, and its direct 100% interest in Sterling Shoes LP. All material intercompany transactions have been eliminated upon consolidation.

#### (b) *Inventory*

The Company determines inventory cost based on a weighted average cost formula and values inventory at the lower of cost and net realizable value.

Incentives received from suppliers are treated as a reduction in the prices of the suppliers’ products and are accounted for as a reduction in the related inventory.

Cost of sales is comprised of inventory and inventory-related costs only.

#### (c) *Financial Instruments*

Under CICA Handbook Section 3855 - “Financial Instruments – Recognition and Measurement”, financial assets and financial liabilities are initially recognized at fair value and their subsequent measurement is dependent on their classification as described below. Their classification depends on the purpose for which the financial instruments

# STERLING SHOES INC.

## Notes to Consolidated Financial Statements

December 31, 2010

(Expressed in thousands of dollars, unless otherwise specified and except for per share amounts.)

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were acquired or issued, their characteristics and the Company's designation of such instruments. The standards require that all financial assets be classified either as held-for-trading ("HFT"), available-for-sale ("AFS"), held-to-maturity ("HTM"), or loans and receivables. The standards require that all financial assets, including all derivatives, be measured at fair value with the exception of loans and receivables, debt securities classified as HTM, and AFS financial assets that do not have quoted market prices in an active market. Settlement date accounting continues to be used for all financial assets, except changes in fair value between the trade date and settlement date are reflected in interest and other expenses, net for HFT financial assets, while changes in fair value between trade date and settlement date are reflected in other comprehensive income ("OCI") for AFS financial assets.

The following is a summary of the accounting model the Company has elected to apply to each of its significant categories of financial instruments outstanding.

Cash	Designated as held-for-trading
Accounts receivable	Loans and receivables
Accounts payable	Other liabilities
Bank indebtedness	Other liabilities
Long-term debt	Other liabilities

Held-for-trading – HFT financial assets are financial assets typically acquired for resale prior to maturity. They are measured at fair value at the balance sheet date. Interest earned, interest accrued, gains and losses realized on disposal and unrealized gains and losses from market fluctuations are included in interest and other expenses, net.

Financial liabilities designated at fair value ("FVO") are those non-derivative financial liabilities that the Company elects to designate on initial recognition as instruments that it will measure at fair value through interest and other expenses, net. These are accounted for in the same manner as HFT financial assets. The Company has not designated any non-derivative financial liabilities as FVO.

Held-to-maturity – HTM financial assets are non-derivative financial assets with fixed or determinable payments and a fixed maturity, other than loans and receivables that an entity has the positive intention and ability to hold to maturity. These financial assets are measured at amortized cost. The Company does not have any HTM financial assets as at December 31, 2010.

Available-for-sale – AFS financial assets are those non-derivative financial assets that are designated as AFS, or that are not classified as loans and receivables, HTM investments or HFT. AFS financial assets are carried at fair value with unrealized gains and losses included in OCI until realized when the cumulative gain or loss is transferred to the Statement of Income (Loss). The Company has not designated any financial assets as AFS.

Loans and receivables – Loans and receivables are accounted for at amortized cost.

# STERLING SHOES INC.

## Notes to Consolidated Financial Statements

December 31, 2010

(Expressed in thousands of dollars, unless otherwise specified and except for per share amounts.)

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Other liabilities – Other liabilities (“OL”), are recorded at amortized cost and include all liabilities, other than derivatives or liabilities to which the FVO has been applied.

In June 2009, the CICA amended Section 3862 to improve fair value and liquidity risk disclosures. Section 3862 – “Financial Instruments – Disclosures” now requires that all financial instruments measured at fair value be categorized into one of three hierarchy levels, to reflect the significance of the inputs used to measure the fair values of assets and liabilities:

- Level 1 – inputs are unadjusted quoted prices of identical instruments in active markets.
- Level 2 – inputs other than quoted prices included in Level 1 that are observable for the asset or liability, either directly or indirectly.
- Level 3 – inputs used in a valuation technique are not based on observable market data in determining fair values of the instruments.

Section 3862 requires that the classification of a financial instrument in the hierarchy be based on the lowest level of input that is significant to the measurement of fair value.

(d) *Income taxes*

The Company follows the asset and liability method of accounting for income taxes whereby future income tax assets and liabilities are recognized for differences between the bases of assets and liabilities used for financial statement and income tax purposes. Future income tax assets and liabilities are determined based on the difference between the tax basis of the Company’s assets and liabilities and the amounts reported in the financial statements. Future tax assets or liabilities are calculated using the tax rates for the periods in which the differences are expected to be settled. Future tax assets are recognized to the extent that they are considered more likely than not to be realized.

(e) *Changes in accounting standards*

(i) *Adoption of New Accounting Standards*

The Company has not adopted any new accounting standards during the current year.

(ii) *Transition to International Financial Reporting Standards (“IFRS”)*

In 2006, the Canadian Accounting Standards Board (“AcSB”) published a new strategic plan that will significantly affect financial reporting requirements for Canadian companies. The AcSB strategic plan outlines the convergence of Canadian GAAP with International Financial Reporting Standards (“IFRS”) over an expected five year transitional period. In February 2008, the AcSB announced that 2011 is the changeover date for publicly-listed companies to use IFRS, replacing Canadian GAAP. This date is for interim and annual financial statements relating to fiscal years beginning on or after January 1, 2011.

(f) *Measurement uncertainty*

# STERLING SHOES INC.

## Notes to Consolidated Financial Statements

December 31, 2010

(Expressed in thousands of dollars, unless otherwise specified and except for per share amounts.)

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The preparation of financial statements in accordance with GAAP requires management to make estimates and assumptions that affect the reported amount of assets and liabilities and disclosure of contingencies at the date of the financial statements and the reported amount of revenues and expenses during the period. Areas requiring significant management estimates include the valuation of inventory, the valuation of intangible assets, the valuation of the liability and equity components of the convertible debentures, the recorded amounts of accrued liabilities, the estimation of future income taxes, and the useful life of leaseholds and equipment. Actual results could differ from these estimates.

(g) *Cash*

Cash consists of cash on hand and bank balances.

(h) *Leaseholds and equipment*

Leaseholds and equipment are recorded at cost. Amortization is provided on a straight-line basis over the following estimated useful lives of the assets:

Furniture and equipment .....	10 years
Computer equipment and software.....	5 years
Leasehold improvements .....	initial term of the lease or useful life if that is shorter

Amortization is pro-rated in the year of acquisition.

Computer equipment and software acquired for use by the Company comprises its purchase price and any directly attributable costs to prepare the asset for its intended use. These costs are amortized over the asset's expected useful life with amortization to commence when the asset is available for use.

Leaseholds and equipment are reviewed for impairment whenever changes in circumstances indicate that the carrying amount of an asset may not be recoverable from expected undiscounted future cash flows from their expected use and eventual disposition. If such assets are considered impaired, the impairment to be recognized is measured as the amount by which the carrying amount of the assets exceeds their fair value.

(i) *Intangible assets*

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

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

# STERLING SHOES INC.

## Notes to Consolidated Financial Statements

December 31, 2010

(Expressed in thousands of dollars, unless otherwise specified and except for per share amounts.)

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(j) *Deferred lease inducements*

Deferred lease inducements consist of lease incentive amounts received from landlords and rent-free lease periods. These lease inducements are deferred and amortized over the life of the initial lease term as a reduction of store and selling expenses.

(k) *Financing fees*

Transaction costs attributable to financial instruments classified as other than held-for-trading are included in the recognized amount of the related financial instrument and recognized over the life of the instrument using the effective interest method, in the case of convertible debentures at an effective interest rate of 8.3%.

(l) *Revenue recognition*

Revenue is recognized at the point of sale, net of a provision for sales returns.

(m) *Foreign currency translation*

Monetary assets and liabilities denominated in foreign currencies are translated to the Canadian dollar equivalent at the rate of exchange at the balance sheet date. Transactions in foreign currencies are translated to the Canadian dollar equivalent at the rate of exchange in effect at the time of the transaction. Foreign currency gains and losses are included in the results of operations in the period in which they occur.

(n) *Net loss per Share*

Basic net loss per Share of the Company (a "Share") is calculated by dividing the net loss by the weighted average number of Shares outstanding during the reporting period. Diluted net loss per Share is calculated by dividing the net loss, adjusted for the interest expense on the Convertible Debentures (note 7), by the sum of the weighted average number of Shares outstanding used in the basic net loss per Share calculation and the number of Shares that would be issued assuming conversion of all Convertible Debentures. As at December 31, 2010, the Convertible Debentures were not included in the computation of diluted net income per Share for the twelve-month period ended December 31, 2010 because to do so would have been anti-dilutive.

(o) *Long-term incentive plan*

Under the terms of a long-term incentive plan ("LTIP") 10% to 25% of distributable cash in excess of an established threshold is allocated as between: (i) cash awards to participants who already hold significant ownership positions; and (ii) monies to be used by the plan trustee to purchase shares of the Company for other participants. The cost is accrued in the period when distributable cash exceeds the thresholds established by the LTIP and amortized to compensation expense over the vesting period of the applicable employee award.

# STERLING SHOES INC.

## Notes to Consolidated Financial Statements

December 31, 2010

(Expressed in thousands of dollars, unless otherwise specified and except for per share amounts.)

As at December 31, 2010, the Company did not accrue any liability in respect of the LTIP (2009 - \$nil). During the year ended December 31, 2010 the Company recorded \$50 variable compensation expense (2009 - \$313).

(p) *Derivative financial instruments*

Derivative financial instruments are utilized by the Company from time to time in the management of its foreign currency exposures. The Company's policy is to not utilize derivative financial instruments for trading or speculative purposes.

The Company does not use hedge accounting; derivatives are recorded at fair value with gains and losses recorded through the statement of earnings.

### 3. INVENTORY

December 31		2010		2009
Inventory at carrying value	\$	30,665	\$	37,278
Obsolescence provision		(2,051)		(832)
Inventory at net realizable value	\$	28,614	\$	36,446

The Company recorded an obsolescence provision of \$2.1 million (2009-\$0.8 million) when valuing inventory at its net realizable value.

### 4. LEASEHOLDS AND EQUIPMENT

	December 31, 2010			December 31, 2009		
	Cost	Accumulated Amortization	Net Book Value	Cost	Accumulated Amortization	Net Book Value
Leasehold improvements	\$ 15,488	\$ (7,006)	\$ 8,482	\$ 14,981	\$ (5,576)	\$ 9,405
Furniture and equipment	11,949	(5,743)	6,206	11,704	(4,348)	7,356
Computer equipment and software	5,423	(2,141)	3,282	4,470	(1,636)	2,834
	\$ 32,860	\$ (14,890)	\$ 17,970	\$ 31,155	\$ (11,560)	\$ 19,595

As at December 31, 2010, the Company has invested \$2.2 million (2009 - \$1.4 million) in the development of a new enterprise resource planning (ERP) system. Amortization of the ERP system will take place when it is substantially complete and ready for productive use.

# STERLING SHOES INC.

## Notes to Consolidated Financial Statements

December 31, 2010

(Expressed in thousands of dollars, unless otherwise specified and except for per share amounts.)

### 5. INTANGIBLE ASSETS

	December 31, 2010		December 31, 2009	
Store banners	\$	10,005	\$	10,005
Private label brand names		6,618		6,618
	\$	16,623	\$	16,623

At December 31, 2010 the Company determined that no impairment was required. In 2009, the Company determined that the fair value of the intangible assets was less than the book value, resulting in an impairment of \$33.2 million (including Goodwill \$0.8 million).

### 6. BANK INDEBTEDNESS

	December 31, 2010		December 31, 2009	
Term loan	\$	4,500	\$	5,000

The Company has utilized \$4.5 million (2009 - \$5 million) of an available \$5 million term facility (the "Term Loan"). The Term Loan began amortizing upon renewal of the credit facilities, with repayment terms calling for quarterly principal payments of \$250,000, plus interest, to effect a 5 year amortization. The second payment was made on December 31, 2010. Interest, term, covenants and security are the same as for the Operating Loan, noted below. Certain covenants have been amended.

The Company has available a \$15 million, 3-year committed revolving loan (the "Operating Loan") due on July 31, 2013. The Operating Loan is available for working capital requirements, capital expenditures and for general corporate purposes. Advances bear interest at the lender's prime rate plus 1.25% to 2.75% or at the banker's acceptance rate plus 2.75% to 4.25% based on the ratio of debt to earnings before interest, taxes, depreciation and amortization, calculated on a quarterly basis. This loan is secured by a general security agreement covering all assets of Sterling Shoes LP.

### 7. CONVERTIBLE DEBENTURES

	December 31, 2010		December 31, 2009	
Principal amount	\$	25,000	\$	25,000
Equity component		(2,657)		(2,657)
Accretion		1,400		920
Deferred financing fees, net of amortization		(479)		(743)
Convertible unsecured subordinated debentures	\$	23,264	\$	22,520

# STERLING SHOES INC.

## Notes to Consolidated Financial Statements

December 31, 2010

(Expressed in thousands of dollars, unless otherwise specified and except for per share amounts.)

The convertible unsecured subordinated debentures (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 convertible at any time at the option of the holders into shares (“Shares”) of the Company at a conversion rate of approximately 47.281 Shares per \$1 principal amount of Debentures, which is equal to a conversion price of \$21.15 per Share. After October 31, 2010 and on or before 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, provided that the market price 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.

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

The conversion option was valued at \$2,657 at the date of issuance. The liability portion of the Debentures is being accreted to its face value over the term of the debt using the effective interest method, at an effective interest rate of 8.3% (2009 – 10.7%). Transaction costs consisting of commissions and professional fees related to the issuance of the Debentures amounted to \$1,231.

### 8. SHAREHOLDERS’ CAPITAL

	Shares		Fund Units	
	Number	Amount \$	Number	Amount \$
<b>Balance, December 31, 2009</b>			<b>6,641,860</b>	<b>59,809</b>
Balance prior to conversion to corporate entity			6,641,860	59,809
Exchange of fund units for Common shares	6,641,860	59,809	(6,641,860)	(59,809)
<b>Balance, December 31, 2010</b>	<b>6,641,860</b>	<b>59,809</b>	-	-

Pursuant to the Conversion, the company is considered to be a continuation of the Fund and therefore the exchange of Fund Units for common Shares of the Company is recorded at the carrying values of the Fund’s assets and liabilities on July 1, 2010, in accordance with the continuity of interest method of accounting.”

# STERLING SHOES INC.

## Notes to Consolidated Financial Statements

December 31, 2010

(Expressed in thousands of dollars, unless otherwise specified and except for per share amounts.)

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The authorized capital of the Company consists of an unlimited number of common shares.

### 9. COMMITMENTS

#### (a) *Minimum rental commitments*

The Company has the following minimum rental commitments for premises, excluding percentage rent adjustments and operating expense assessments, over the next five fiscal years:

2011	\$	15,261
2012		15,281
2013		14,093
2014		12,924
2015		11,037
Thereafter		20,694
	\$	89,290

Certain of the operating leases provide for additional annual rentals based on store sales.

#### (b) *Letters of credit*

The Company had letters of credit outstanding on December 31, 2010 securing inventory purchase commitments totaling \$3.4 million (2009 - \$2.7 million). The last of these letters of credit expires on July 31, 2011 for \$1.5 million.

### 10. FINANCIAL INSTRUMENTS

#### (a) *Fair value*

Financial instruments consist of cash at fair value (which is a Level 1 input), accounts receivable, term loans, accounts payable, foreign exchange contracts, and the debentures. The fair values of all financial instruments, other than cash, the Debentures (Note 7), and the foreign exchange contracts, approximate their carrying values due to their short term or floating rate nature.

The fair value of the Debentures is determined by calculating its present value using the estimated market interest rate for loans with similar terms, conditions, and maturities. By using this valuation method, the estimated fair value of the Debentures at December 31, 2010 was \$21.9 million (2009 - \$19.9 million) compared to its carrying value of \$23.3 million (2009 - \$22.5 million). As the Debentures are other financial liabilities and are measured at amortized cost, no gain or loss has been recognized in net income relating to the difference between the Debentures' estimated fair value and carrying value.

# STERLING SHOES INC.

## Notes to Consolidated Financial Statements

December 31, 2010

(Expressed in thousands of dollars, unless otherwise specified and except for per share amounts.)

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(b) *Liquidity risk*

Liquidity risk is the risk that the Company will not be able to meet its obligations associated with financial liabilities and commitments as they become due. Liquidity risk also includes the risk of not being able to liquidate assets in a timely manner at a reasonable price. The following table shows the maturity dates for the Company's liabilities:

<u>in \$000's</u>	<u>2011</u>	<u>2012</u>	<u>2013</u>	<u>2014</u>	<u>2015</u>
Accounts payable and accrued liabilities	16,225				
Convertible Debentures		25,000			
Operating and Term Loans	1,000	1,000	2,500		
	<u>17,225</u>	<u>26,000</u>	<u>2,500</u>	<u>0</u>	<u>0</u>

The Company's future income tax obligation is discussed in Note 12, while its future obligations under operating leases are discussed in Note 9. Deferred lease inducements will not result in cash outflow for the Company.

The Company manages liquidity risk by managing its capital and debt structure, its cash flows, and its inventory levels. The Company monitors the cash flows generated from operations and evaluates on a regular basis whether it needs to access the capital and banking markets to meet its financial obligations.

(c) *Interest rate risk*

Interest rate risk is the risk that the Company's financial instruments or cash flows associated with the instrument will fluctuate due to changes in market interest rates. The Company's interest rate risk arises primarily from the Debentures, the Operating Loan, and the Term Loan. The interest rate on the Debentures is at a fixed rate (Note 7). The loans under the Operating Loan and Term Loan 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. Based on the average carrying value of these facilities, a fluctuation in interest rate of 1% would represent a \$45 change to the net loss for the year ended December 31, 2010 (2009 - \$89). The interest rate risk would be mitigated by income received on cash balances.

(d) *Foreign exchange risk*

Foreign exchange risk is the risk that the value of a financial asset or liability or commitment will fluctuate due to changes in foreign exchange rates. The Company's foreign exchange risk arises primarily from its inventory purchases. Substantially all footwear sold in Canada is manufactured outside of Canada. The cost of substantially all inventory purchases is exposed to currency fluctuations. During the year ended December 31, 2010, approximately 39.0% (2009- 49.2%) of product purchases were denominated in US dollars.

# STERLING SHOES INC.

## Notes to Consolidated Financial Statements

December 31, 2010

(Expressed in thousands of dollars, unless otherwise specified and except for per share amounts.)

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From time to time, the Company enters into contracts to manage the foreign exchange risk associated with anticipated purchases in US dollars. At December 31, 2010, the Company had forward foreign exchange contracts as follows:

Settlement dates	Face Value \$US	Average rate \$Cdn
January 2011	1,525	1.019
February 2011	1,525	1.020
March 2011	1,525	1.020
April 2011	1,525	1.023
May 2011	775	1.019
June 2011	475	1.010
July 2011	750	1.007
Aug 2011	750	1.008
Sept 2011	750	1.009
Oct 2011	475	1.014
Nov 2011	950	1.004
Dec 2011	450	1.002

As at December 31, 2010, the aggregate unrealized loss on these contracts was \$238 (2009 – \$70).

(e) *Credit risk*

Credit risk is the risk that customers on account are not able to discharge their obligations in due time. The Company is not exposed to material credit risk because it factors all of its receivables to a third party. The risk of loss is transferred entirely to this third party.

### 11. RELATED PARTY TRANSACTIONS

- (a) The Company leases its head office location from a company in which a director and officer of the Company has an interest. Rent expense recognized on this lease was \$306 for the year ended December 31, 2010 (2009 - \$296) and is included in general and administrative expenses in the statement of income.
- (b) The Company purchased equipment from a company in which a director and officer of the Company has an interest for \$141 during the year ended December 31, 2010 (2009 - \$170).

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 related parties.

### 12. INCOME TAXES

For the months of January to June, (prior to the Conversion) the Fund was a unit trust for income tax purposes and, accordingly, the Fund was taxable only on any taxable income in those months

# STERLING SHOES INC.

## Notes to Consolidated Financial Statements

December 31, 2010

(Expressed in thousands of dollars, unless otherwise specified and except for per share amounts.)

not allocated to the unitholders. Any income tax obligations relating to the distributions are the obligations of the unitholders.

Commencing July 1, 2010, the Company and its subsidiaries are subject to tax at statutory rates. The Fund and the Company's effective income tax rate differs from the statutory income tax rate. The difference arises from the following items:

<b>For the year ended December 31</b>	<b>2010</b>
Earnings (loss) before income taxes	(6,879)
Income tax at statutory rates (29%)	(1,995)
Pre-conversion partnership income allocated to unrelated partners	61
Non-deductible expenses	82
Previously unrecognized future tax liability and other	281
Provision for (recovery of) future income taxes	(1,571)

The tax effected temporary differences comprising the future income tax are estimated as follows:

	<b>Dec 31, 2010</b>	<b>Dec 31, 2009</b>
Operating losses	\$ (704)	\$ -
Leasehold & improvements	(814)	-
Other temporary differences	-	(5)
Future income tax asset	(1,518)	(5)
Intangible Asset - store banners	1,251	1,426
Intangible asset - private label brand names	827	943
Other temporary differences	233	-
Future income tax liability	2,311	2,369
Net future income tax liability	\$ 793	\$ 2,364

In addition the Company has a capital loss of \$27 million. The related future tax asset of approximately \$3.4 million has not been recognized as the management is of the view that such asset would unlikely be realized in the future.

### 13. SEGMENTED INFORMATION

The Company operates in one industry segment; that being the retail footwear business, offering a broad selection of private label and brand name shoes and accessories.

### 14. CAPITAL DISCLOSURES

The Company's capital structure consisted of the following components at December 31, 2010: Shareholders' equity of \$24.9 million (2009 - \$30.2 million) and the Debentures of \$23.3 million (2009 - \$22.5 million). The Company's objectives when managing its capital is to maintain compliance with its bank covenants. The covenants include non-GAAP measures such as adjusted EBITDA. The Company was in compliance with its bank covenants at December 31, 2010.

# **STERLING SHOES INC.**

## **Notes to Consolidated Financial Statements**

**December 31, 2010**

**(Expressed in thousands of dollars, unless otherwise specified and except for per share amounts.)**

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The Company reviews its historical and expected operating results on a regular basis. This review includes consideration of economic conditions, including seasonality, and the competitive environment. In order to maintain or adjust the capital structure, the Company may adjust the amount of dividends paid to its Shareholders, issue new Shares, or issue or reduce debt.