

*Consolidated Financial Statements of*

**STERLING SHOES INCOME FUND**

*December 31, 2007*

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## **Auditors' report**

To the Unitholders of  
Sterling Shoes Income Fund

We have audited the consolidated balance sheets of Sterling Shoes Income Fund as at December 31, 2007 and 2006 and the consolidated statements of income and comprehensive income, unitholders' equity and cash flows for the years then ended. These financial statements are the responsibility of the Fund's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the Fund as at December 31, 2007 and 2006 and the results of its operations and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

*(Signed) Deloitte & Touche LLP*

Chartered Accountants  
March 14, 2008

**STERLING SHOES INCOME FUND**

**Consolidated Balance Sheets**

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

|                                   | As at<br>December<br>31, 2007 | As at<br>December<br>31, 2006 |
|-----------------------------------|-------------------------------|-------------------------------|
| <b>ASSETS</b>                     |                               |                               |
| <b>CURRENT</b>                    |                               |                               |
| Cash                              | \$ 13,860                     | \$ 2,845                      |
| Accounts receivable               | 773                           | 465                           |
| Inventory                         | 29,034                        | 18,640                        |
| Prepaid expenses and deposits     | 1,008                         | 625                           |
|                                   | 44,675                        | 22,575                        |
| LEASEHOLDS AND EQUIPMENT [note 3] | 16,648                        | 13,283                        |
| GOODWILL                          | 828                           | 828                           |
| INTANGIBLE ASSETS [note 4]        | 49,041                        | 49,041                        |
|                                   | \$ 111,192                    | \$ 85,727                     |

**LIABILITIES AND UNITHOLDERS' EQUITY**

|  |            |           |
|--|------------|-----------|
| <b>CURRENT</b>                           |            |           |
| Accounts payable and accrued liabilities | \$ 18,415  | \$ 13,895 |
| Distributions payable                    | 3,905      | 4,218     |
|  | 22,320     | 18,113    |
| FUTURE INCOME TAXES [note 12]            | 7,724      | -         |
| CONVERTIBLE DEBENTURES [note 6]          | 21,243     | -         |
| TERM LOAN [note 5]                       | -          | 5,000     |
| DEFERRED LEASE INDUCEMENTS               | 1,785      | 1,535     |
| NON-CONTROLLING INTEREST [note 7]        | 11,152     | 12,231    |
| UNITHOLDERS' EQUITY                      | 46,968     | 48,848    |
|  | \$ 111,192 | \$ 85,727 |

COMMITMENTS [note 9]

SUBSEQUENT EVENTS [note 14]

On behalf of the Board of Trustees

"Rick Mahler"  
(signed) Rick Mahler  
Trustee

"Jeremy Horwitz"  
(signed) Jeremy Horwitz  
Trustee

See accompanying notes

**STERLING SHOES INCOME FUND**
**Consolidated Statements of Income and Comprehensive Income**

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

|   | Three-month period ended |              | Twelve-month period ended |              |
|---|--------------------------|--------------|---------------------------|--------------|
|   | Dec 31, 2007             | Dec 31, 2006 | Dec 31, 2007              | Dec 31, 2006 |
|   | (unaudited)              | (unaudited)  |                           |              |
| SALES   | \$ 36,083                | \$ 31,415    | \$ 118,759                | \$ 102,588   |
| COST OF SALES   | 15,340                   | 15,306       | 51,210                    | 46,846       |
| GROSS MARGIN  | 20,743                   | 16,109       | 67,549                    | 55,742       |
| EXPENSES  |                          |              |                           |              |
| Store and selling   | 11,499                   | 10,001       | 41,273                    | 34,292       |
| General and administrative [note 11]                              | 2,729                    | 1,767        | 7,923                     | 5,913        |
|   | 14,228                   | 11,768       | 49,196                    | 40,205       |
| Income before interest, amortization and non-controlling interest | 6,515                    | 4,341        | 18,353                    | 15,537       |
| Interest and financing expense                                    | 496                      | 94           | 984                       | 326          |
| (Gain) Loss on disposal of leaseholds and equipment               | -                        | 75           | (5)                       | 118          |
| Amortization of leaseholds and equipment                          | 791                      | 579          | 2,911                     | 2,467        |
| Amortization of deferred financing costs                          | -                        | 64           | -                         | 91           |
| INCOME BEFORE NON-CONTROLLING INTEREST AND TAXES                  | 5,228                    | 3,529        | 14,463                    | 12,535       |
| Future income taxes [note 12]                                     | -                        | -            | 7,724                     | -            |
| INCOME BEFORE NON-CONTROLLING INTEREST                            | 5,228                    | 3,529        | 6,739                     | 12,535       |
| NON-CONTROLLING INTEREST [note 7]                                 | 1,075                    | 707          | 1,393                     | 2,521        |
| NET INCOME AND COMPREHENSIVE INCOME                               | \$ 4,152                 | \$ 2,822     | \$ 5,346                  | \$ 10,014    |
| Basic and diluted net income per unit                             | \$ 0.79                  | \$ 0.53      | \$ 1.01                   | \$ 1.88      |
| Basic weighted average number of units outstanding                | 5,313,488                | 5,313,488    | 5,313,488                 | 5,313,488    |
| Diluted weighted average number of units outstanding              | 6,641,860                | 6,641,860    | 6,641,860                 | 6,641,860    |

See accompanying notes

**STERLING SHOES INCOME FUND**
**Consolidated Statements of Unitholders' Equity**

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

|  | Fund Units | Equity component | Cumulative | Cumulative    | Total     |
|--|------------|------------------|------------|---------------|-----------|
|  | [note 8]   | of Debentures    | earnings   | distributions |           |
|  |            | [note 6]         |            |               |           |
| Balance, July 12, 2005                           | \$ -       | -                | -          | -             | \$ -      |
| Issuance of units on initial public offering     | 53,135     | -                | -          | -             | 53,135    |
| Issuance costs                                   | (5,288)    | -                | -          | -             | (5,288)   |
| Net income for the 173-day period                | -          | -                | 3,549      | -             | 3,549     |
| Distributions declared during the 173-day period | -          | -                | -          | (3,537)       | (3,537)   |
| <b>BALANCE, December 31, 2005</b>                | \$ 47,847  | -                | 3,549      | (3,537)       | \$ 47,859 |
| Net income                                       | -          | -                | 10,014     | -             | 10,014    |
| Distributions declared                           | -          | -                | -          | (9,024)       | (9,024)   |
| <b>BALANCE, December 31, 2006</b>                | \$ 47,847  | -                | 13,563     | (12,561)      | \$ 48,849 |
| Option on convertible debentures                 | -          | 2,657            | -          | -             | 2,657     |
| Net income                                       | -          | -                | 5,346      | -             | 5,346     |
| Distributions declared                           | -          | -                | -          | (9,883)       | (9,883)   |
| <b>BALANCE, December 31, 2007</b>                | \$ 47,847  | 2,657            | 18,909     | (22,444)      | \$ 46,968 |

See accompanying notes

**STERLING SHOES INCOME FUND**
**Consolidated Statement of Cash Flows**

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

|   | Three-month period ended |                 | Twelve-month period ended |                 |
|---|--------------------------|-----------------|---------------------------|-----------------|
|   | Dec 31, 2007             | Dec 31, 2006    | Dec 31, 2007              | Dec 31, 2006    |
|   | (unaudited)              | (unaudited)     |                           |                 |
| <b>OPERATING ACTIVITIES</b>                                       |                          |                 |                           |                 |
| Net Income  | \$ 4,152                 | \$ 2,822        | \$ 5,346                  | \$ 10,014       |
| Items not involving cash  |                          |                 |                           |                 |
| Future income taxes   | -                        | -               | 7,724                     | -               |
| Amortization of leaseholds and equipment                          | 791                      | 579             | 2,911                     | 2,467           |
| Amortization of deferred financing costs                          | -                        | 64              | -                         | 91              |
| Accreted interest expense [note 6]                                | 131                      | -               | 131                       | -               |
| Amortization of deferred lease inducements                        | (92)                     | (55)            | (330)                     | (320)           |
| Loss on disposal of leaseholds and equipment                      | -                        | 75              | -                         | 118             |
| Non-controlling interest  | 1,075                    | 707             | 1,393                     | 2,521           |
|   | 6,058                    | 4,192           | 17,175                    | 14,891          |
| Change in non-cash working capital balances related to operations |                          |                 |                           |                 |
| Accounts receivable   | 53                       | 30              | (308)                     | (368)           |
| Inventory   | 3,529                    | 5,189           | (10,394)                  | (3,302)         |
| Prepaid expenses and deposits                                     | (46)                     | 152             | (383)                     | (382)           |
| Accounts payable and accrued liabilities                          | (3,404)                  | (2,291)         | 4,520                     | 2,921           |
|   | 132                      | 3,080           | (6,565)                   | (1,131)         |
| Cash provided by operating activities                             | 6,190                    | 7,272           | 10,610                    | 13,760          |
| <b>INVESTING ACTIVITIES</b>                                       |                          |                 |                           |                 |
| Acquisition of leaseholds and equipment                           | (1,205)                  | (1,088)         | (6,283)                   | (6,262)         |
| Proceeds from disposal of assets                                  | -                        | -               | 5                         | -               |
| Lease inducements received  | 301                      | 358             | 579                       | 595             |
| Cash used in investing activities                                 | (904)                    | (730)           | (5,699)                   | (5,667)         |
| <b>FINANCING ACTIVITIES</b>                                       |                          |                 |                           |                 |
| Issuance of convertible debentures [note 6]                       | 25,000                   | -               | 25,000                    | -               |
| Transaction costs related to convertible debentures [note 6]      | (1,230)                  | -               | (1,230)                   | -               |
| Capital expenditure loan [note 5]                                 | (7,932)                  | -               | (5,000)                   | -               |
| Operating loan [note 5]   | (4,873)                  | (1,525)         | -                         | -               |
| Payment of distributions  | (2,391)                  | (2,172)         | (12,666)                  | (8,958)         |
| Cash provided by / (used in) financing activities                 | 8,574                    | (3,697)         | 6,104                     | (8,958)         |
| <b>CASH INFLOW (OUTFLOW) DURING THE PERIOD</b>                    | <b>13,860</b>            | <b>2,845</b>    | <b>11,015</b>             | <b>(865)</b>    |
| CASH, BEGINNING OF PERIOD   | -                        | -               | 2,845                     | 3,710           |
| <b>CASH, END OF PERIOD</b>  | <b>\$ 13,860</b>         | <b>\$ 2,845</b> | <b>\$ 13,860</b>          | <b>\$ 2,845</b> |
| <b>Supplemental cash flow information</b>                         |                          |                 |                           |                 |
| Interest paid   | \$ -                     | \$ 94           | \$ 357                    | \$ 326          |

See accompanying notes

# STERLING SHOES INCOME FUND

## Notes to Consolidated Financial Statements

December 31, 2007

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

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### 1. ORGANIZATION AND NATURE OF OPERATIONS

Sterling Shoes Income Fund (the “Fund”) is an unincorporated, open-ended, limited-purpose trust established under the laws of the Province of British Columbia pursuant to the declaration of trust dated May 31, 2005 (the “Declaration of Trust”). The Fund commenced operations on July 12, 2005 when it acquired an 80% interest in the retail footwear business of Sterling Shoes Inc (“Inc”).

The Fund operates retail stores in five provinces in shopping malls, high-streets and strip malls, principally in Western Canada. The Fund 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. The Fund holds, indirectly, an 80% interest in Sterling Shoes Limited Partnership (“Sterling Shoes LP”), a partnership established under the laws of the Province of Manitoba.

### 2. SIGNIFICANT ACCOUNTING POLICIES

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

These consolidated financial statements and accompanying notes (“Financial Statements”) have been prepared in accordance with Canadian generally accepted accounting principles (“GAAP”). These Financial Statements include the accounts of the Fund, and its 80% interest in Sterling Shoes LP. All material intercompany transactions have been eliminated upon consolidation.

#### (b) *New accounting development and changes*

##### (i) *Inventory*

Inventory, all of which is finished goods, is valued using the retail method at the lower of estimated average cost and net realizable value. The net realizable value is derived from the anticipated selling price after adjustments for markdowns and obsolescence, less a normal profit margin. Inventory write-downs are included in cost of sales.

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.

In June 2007, the Canadian Institute of Chartered Accountants (“CICA”) issued CICA Handbook Section 3031 – “Inventories”, which replaces Section 3030 of the same title. The new standard has been developed based on International Financial Reporting Standards (“IFRS”). The standard was revised to provide more extensive guidance than Section 3030, to facilitate the CICA’s move towards IFRS, and to reduce the number of alternatives for the measurement of inventories.

This Section applies to interim and annual financial statements for fiscal years beginning on or after January 1, 2008. The Fund will apply this section to opening inventory for fiscal 2008. Opening retained earnings as at January 1, 2008 will be adjusted for the difference on adoption of the new standard (prior periods will not be restated).

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As noted above, the Fund currently values its inventory at the lower of average cost and net realizable value less a normal profit margin, using the retail method. Management estimates the net realizable value less a normal profit margin, taking into consideration current and expected selling prices, sales patterns for the inventory, recent product introductions and the level of inventory on hand.

Section 3031 allows for the measurement of inventories at the lower of cost and net realizable value, however, it excludes from the definition of net realizable value the ability to maintain a normal profit margin and notes that the retail method is only an acceptable technique for measuring the cost of inventories, if the results approximate cost.

The Fund believes that the adoption of the new standard will have a material impact on the Fund's valuation of its inventory, which will increase by a one-time adjustment to January 1, 2008 inventory and retained earnings. Based on our analysis of the December 31, 2007 inventory, the impact of the change in valuation method is projected to be an increase of approximately 12% to the consolidated inventory value as at January 1, 2008.

### (ii) *Income taxes and Future income taxes*

As the Fund will allocate all of its taxable income and taxable capital gains to unitholders (the "Unitholders"), the Fund itself will not be subject to income taxes.

In June 2007 the Government of Canada substantially enacted new legislation to tax distributions of publicly traded income trusts, commencing in 2011. As a result, the Fund is now required to recognize the future income tax assets and liabilities expected to arise when the tax on distributions becomes applicable.

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

### (iii) *Financial Instruments*

Under CICA Handbook Section 3855 - "Financial Instruments - Recognition and Measurement" and Section 3861 - "Financial Instruments - Disclosure and Presentation", 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 were acquired or issued, their characteristics and the Fund'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,

# STERLING SHOES INCOME FUND

## Notes to Consolidated Financial Statements

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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 Fund has elected to apply to each of its significant categories of financial instruments outstanding.

|  |                                |
|--|--------------------------------|
| Cash and cash equivalents                | Designated as held-for-trading |
| Accounts receivable                      | Loans and receivables          |
| Accounts payable and accrued liabilities | 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 Fund 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 Fund 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.

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 interest and other expenses, net. The Company has not designated any financial assets as AFS.

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

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.

(iv) *Deferred financing fees*

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

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## Notes to Consolidated Financial Statements

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(c) *Measurement uncertainty*

The preparation of the 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 goodwill and intangible assets, the valuation of the liability and equity components of the convertible unsecured subordinated 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.

(d) *Cash*

Cash consists of cash on hand and bank balances.

(e) *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 |

Amortization is reduced to one-half the normal rate in the year of acquisition.

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.

# STERLING SHOES INCOME FUND

## Notes to Consolidated Financial Statements

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(f) *Goodwill*

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

(g) *Intangible assets*

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

(h) *Deferred lease inducements*

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

(i) *Revenue recognition*

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

(j) *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. Purchases transacted 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.

(k) *Net income per Unit*

Basic net income per Unit of the Fund (a "Unit") is calculated by dividing net income by the weighted average number of Units outstanding during the reporting period. Diluted net income per Unit is calculated by dividing the income before non-controlling interest, adjusted for the interest expense on the Convertible Debentures (note 6), by the sum of the weighted average number of Units outstanding used in the basic net income per Unit calculation and the number of Units that would be issued assuming conversion of all Subordinated Exchangeable Class D LP units ("Class D LP units") (note 7) and all Convertible Debentures. As at December 31, 2007, the Convertible Debentures were not included in the computation of diluted net income per Unit because to do so would have been anti-dilutive for the year ended December 31, 2007.

# STERLING SHOES INCOME FUND

## Notes to Consolidated Financial Statements

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(l) *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 units of the Fund for other participants. The cost is accrued in the period when distributable cash exceeds the thresholds established by the LTIP and amortized to general and administrative expenses over the vesting period of the applicable employee award.

As at December 31, 2007, the Fund has recorded a liability of \$825 (2006 - \$341) in respect of the LTIP. During the year-ended December 31, 2007 the Fund recorded compensation expense of \$1,598 (2006 - \$948).

(m) *Derivative financial instruments*

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

The Fund formally documents all relationships between hedging instruments and hedged items, as well as its risk management objectives and strategies for undertaking various hedge transactions. This process includes linking all derivatives to forecasted transactions. The Fund also formally assesses, both at the hedge's inception and on an ongoing basis, whether the derivatives that are used in hedging transactions are highly effective in offsetting changes in cash flows of hedged items.

When the Fund discontinues its designation of a hedging relationship, or when a hedging relationship is no longer effective, hedge accounting is discontinued. When the Fund discontinues hedge accounting, the derivative financial instrument is recorded on the consolidated balance sheet at fair value. Gains and losses that had previously been deferred are carried forward for recognition in the statement of income and statement of other comprehensive income in the same period that the hedged items are recognized. The Fund has decided not to use hedge accounting.

(n) *Cash Flow Statements*

Amendments to CICA 1540, Cash Flow Statements, require entities to disclose total cash distributions on financial instruments classified as equity in accordance with a contractual agreement and the extent to which total cash distributions are non-discretionary. This disclosure requirement is effective for interim and annual financial statements for fiscal periods ending on or after March 31, 2007. The determination to declare and make payable distributions from the Fund are at the discretion of the board of Trustees of the Fund and, until declared payable by the Board of Trustees of the Fund, the Fund has no contractual requirement to pay cash distributions to unitholders' of the Fund. During the year-ended December 31, 2007, \$9.9 million (2006 - \$9.0 million) in cash distributions

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were declared payable by the Board of Trustees of the Fund and paid to unitholders, respectively.

### 3. LEASEHOLDS AND EQUIPMENT

|                                 | December 31, 2007 |                             |                   | December 31, 2006 |                             |                   |
|---------------------------------|-------------------|-----------------------------|-------------------|-------------------|-----------------------------|-------------------|
|                                 | Cost              | Accumulated<br>Depreciation | Net Book<br>Value | Cost              | Accumulated<br>Depreciation | Net Book<br>Value |
| Leasehold improvements          | \$ 10,785         | \$ (3,268)                  | \$ 7,517          | \$ 7,810          | \$ (1,763)                  | \$ 6,047          |
| Furniture and equipment         | 9,439             | (2,185)                     | 7,254             | 7,317             | (1,154)                     | 6,163             |
| Computer equipment and software | 2,681             | (804)                       | 1,877             | 1,502             | (429)                       | 1,073             |
|                                 | \$ 22,905         | \$ (6,257)                  | \$ 16,648         | \$ 16,629         | \$ (3,346)                  | \$ 13,283         |

### 4. INTANGIBLE ASSETS

|                           | December 31, 2007 | December 31, 2006 |
|---------------------------|-------------------|-------------------|
| Store banners             | \$ 29,516         | \$ 29,516         |
| Private label brand names | 19,525            | 19,525            |
|                           | \$ 49,041         | \$ 49,041         |

These intangible assets have no basis for tax purposes.

### 5. OPERATING LOAN AND TERM LOAN

During the year ended December 31, 2007, the Fund repaid and extinguished a \$5,000, 3-year committed non-revolving loan (the "Term Loan #1") with the proceeds from the offering of the convertible unsecured subordinated debentures (Note 6).

The Fund has available a \$12,500, 3-year committed revolving loan (the "Operating Loan"). 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 0.25% to 0.75% or at the banker's acceptance rate plus 1.50% to 2.00%, based on the ratio of debt to earnings before interest, taxes, depreciation and amortization, calculated on a quarterly basis. The Operating Loan is secured by a general security agreement covering all assets of Sterling Shoes LP. As at December 31, 2007, the Fund did not utilize the Operating Loan.

The Fund has available a \$10,000, 3-year committed revolving loan ("Term Loan #2"). Term Loan #2 is available for future funding of new store facilities. Interest, terms and security are the same as the Operating Loan. As at December 31, 2007, the Fund did not utilize Term Loan #2.

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

### 6. CONVERTIBLE UNSECURED SUBORDINATED DEBENTURES

|   | December 31, 2007 | December 31, 2006 |
|---|-------------------|-------------------|
| Principal amount                              | \$ 25,000         | \$ -              |
| Equity component                              | (2,657)           | -                 |
| Accreted interest expense                     | 131               | -                 |
| Deferred financing fees                       | (1,231)           | -                 |
| Convertible unsecured subordinated debentures | \$ 21,243         | \$ -              |

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

The Debentures are convertible at any time at the option of the holders into trust units ("Trust Units") of the Fund at a conversion rate of approximately 47.281 Trust Units per \$1 thousand principal amount of Debentures, which is equal to a conversion price of \$21.15 per Trust Unit. After October 31, 2010 and on or before October 31, 2011, the Fund 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 Fund will have the right to redeem all or a portion of the Debentures equal to the principal amount plus accrued and unpaid interest.

The Fund has allocated the proceeds of the Debentures between debt and equity based on the relative fair values of the debt and the conversion option, as determined by the residual valuation of the equity component. Under this approach, the liability component was valued first, and the difference between the proceeds of the Debentures and the fair value of the debt was assigned to the conversion option. The present value of the liability component was calculated using a discount rate of 9.2%, the 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. Transaction costs consisting of commissions and professional fees related to the issuance of the Debentures amounted to \$1,231.

# STERLING SHOES INCOME FUND

## Notes to Consolidated Financial Statements

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

### 7. NON-CONTROLLING INTEREST (“NCI”)

|  | NCI       | Cumulative<br>Income | Cumulative<br>Distribution | Total     |
|--|-----------|----------------------|----------------------------|-----------|
| <b>Balance, December 31, 2005</b>            | \$ 11,962 | \$ 887               | \$ (884)                   | \$ 11,965 |
| NCI in income of Sterling Shoes LP           |           | 2,521                | -                          | 2,521     |
| Distributions declared in respect of the NCI |           | -                    | (2,255)                    | (2,255)   |
| <b>Balance, December 31, 2006</b>            | \$ 11,962 | \$ 3,408             | \$ (3,139)                 | \$ 12,231 |
| NCI in income of Sterling Shoes LP           |           | 1,393                | -                          | 1,393     |
| Distributions declared in respect of the NCI |           | -                    | (2,472)                    | (2,472)   |
| <b>Balance, December 31, 2007</b>            | \$ 11,962 | \$ 4,801             | \$ (5,611)                 | \$ 11,152 |

The shareholders of Inc have retained a 20% interest in Sterling Shoes LP through ownership of 100% of the issued and outstanding Class D LP units and Class B LP units.

The Class C LP units (all of which are owned indirectly by the Fund) and the Class D LP units (collectively, the “LP Units”) have economic and voting rights that are equivalent in all material respects, except that distributions on the Class D LP units are subordinated to distributions on the Class A LP units and Class C LP units, such that distributions will only be paid on the Class D LP units at the end of a fiscal quarter to the extent that Sterling Shoes LP has paid average monthly distributions on the Class C LP units to enable the Fund to make distributions of at least \$0.0896 per Unit to holders of Units during that quarter, along with priority Class A LP unit distributions, and any deficiency in such distributions during the preceding 12 months has been satisfied.

Subject to subordination, distributions are to be made monthly on the outstanding LP Units of Sterling Shoes LP. Generally, distributions on the Class D LP units will be made quarterly on a prorated basis to the amount distributed on the outstanding LP Units during such fiscal quarter, only after the distributions have been made on the other outstanding LP Units and to the extent that cash is available to make such distributions.

Class D LP units will automatically become freely exchangeable for Units on a one-for-one basis on (and the distribution subordination provisions will only apply until) the date (the “Subordination End Date”) that is the earlier of:

1. December 31, 2007, if the Fund’s consolidated earnings before interest, depreciation and amortization (“EBITDA”) for the fiscal year then ended is at least \$9.545 million (the “EBITDA Target”) (based on the audited consolidated financial statements of the Fund) and cash distributions of at least \$5.712 million (\$1.075 per Unit) have been paid on the Units, and cash advances or distributions of at least \$1.428 million (effectively \$1.075 per Unit) have been paid to Inc, as the holder of the Class B LP Units and Class D LP Units (the “Distribution Target”) for each of the fiscal years ended December 31, 2007 and 2006, and

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2. the last day of any fiscal year of the Fund following December 31, 2007 in respect of which the Fund's consolidated EBITDA (based on the audited consolidated financial statements of the Fund) is at least the EBITDA Target and cash distributions at least equal to the Distribution Target have been made for such fiscal year.

As noted above, the distributions on the Class D LP units are not economically equivalent to those on the Class C LP units owned by the Fund, as a result of the subordination of distributions on Class D LP units. As a result, the Class D LP units have been classified as non-controlling interests.

On the Subordination End Date the Class D LP units will become freely exchangeable for Class C LP, as described above. Thereafter, the Class D LP units will be reclassified from non-controlling interest, to unitholders' equity.

### 8. FUND UNITS

An unlimited number of Units may be created and issued pursuant to the Declaration of Trust. Each Unit is transferable and represents an equal undivided beneficial interest in any distributions from the Fund, whether of net income, net realized capital gains or other amounts and in the net assets of the Fund in the event of a termination or winding up of the Fund. Each Unit entitles the holder thereof to one vote at all meetings of voting Unitholders.

On July 12, 2005, the Fund issued 5,313,488 Units at a price of \$10 per Unit pursuant to the Offering. Net proceeds from the Offering were \$47,847 after deducting expenses of the Offering of \$5,288. The holders of the Class D LP units were issued 1,328,372 special voting units ("Special Voting Units") of the Fund, representing the number of Units such Class D LP units are in certain circumstances exchangeable for. The Special Voting Units are not entitled to any beneficial interest in any distribution from the Fund or in the net assets of the Fund in the event of a termination or winding up of the Fund. Such Special Voting Units are to be cancelled on the exchange of the Class D LP units for Units of the Fund.

The Units are redeemable at any time on demand by the holders thereof, subject to the terms and conditions as outlined in the prospectus of the Fund dated June 30, 2005. The total amount payable by the Fund in respect of those Units and all other Units tendered for redemption in the same calendar month shall not exceed \$50, provided that the Trustees of the Fund may, in their sole discretion, waive this limitation in respect of all Units tendered for redemption in any calendar month.

# STERLING SHOES INCOME FUND

## Notes to Consolidated Financial Statements

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

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### 9. COMMITMENTS

(a) *Minimum rental commitments*

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

|      |    |               |
|------|----|---------------|
| 2007 | \$ | 12,969        |
| 2008 |    | 12,621        |
| 2009 |    | 11,056        |
| 2010 |    | 9,498         |
| 2011 |    | 8,858         |
|      | \$ | <u>55,002</u> |

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

(b) *Letters of credit*

The Fund had letters of credit outstanding on December 31, 2007 securing inventory purchase commitments totaling \$1,319. The last of these letters of credit expires March 15, 2008.

### 10. FINANCIAL INSTRUMENTS

(a) *Fair value*

Financial instruments consist of cash, accounts receivable, operating loan, accounts payable, foreign exchange contracts, distributions payable, the Debentures, the Term Loans and the Operating Loan. The fair values of all financial instruments, other than the Debentures are considered to approximate their carrying values due to their short term nature.

(b) *Interest rate risk*

The Fund is subject to the risks associated with fluctuating interest rates on its credit facilities.

(c) *Foreign exchange risk*

During the year ended December 31, 2007, approximately 39% (2006: 41%) of product purchases were denominated in US dollars. From time to time, the Fund enters into contracts to manage the foreign exchange risk associated with anticipated purchases in US dollars. The Fund does not hold or issue financial instruments for trading or speculative purposes. At December 31, 2007 there were no foreign exchange contracts outstanding.

# STERLING SHOES INCOME FUND

## Notes to Consolidated Financial Statements

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

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(d) *Secured loan*

A loan of \$38,597 has been made to Inc by SS Holdings Trust (the "Trust") (all the trust units of which are owned by the Fund), secured, in turn, by Class A LP units (with a par value of \$38,597) issued by Sterling Shoes LP to Inc.

The secured loan and the Class A LP units, which have the attributes of a liability, are presented net in the consolidated balance sheet of the Fund as this reflects the entities' cash flows and the intention for settlement of the financial instruments, as well as the associated risks related to the cash flows.

### 11. RELATED PARTY TRANSACTIONS

(a) The Fund leases its head office location from a company controlled by the shareholders of Inc, who have a non-controlling interest in the Fund (see Note 7). Rent expense recognized on this lease was \$250 for the year-ended December 31, 2007 (2006 - \$198) and is included in general and administrative expenses in the statement of income.

(b) The Fund purchased equipment from a company in which a Board member has an interest, for \$519 during the year-ended December 31, 2007 (2006 - \$612).

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. FUTURE INCOME TAXES

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

|  | <b>December 31, 2007</b> |              |
|--|--------------------------|--------------|
| Future income tax liability:                             |                          |              |
| Intangible Asset - store banners                         | \$                       | 4,649        |
| Intangible asset - private label brand names             |                          | 3,075        |
| Expected reversal of temporary differences prior to 2011 |                          | -            |
|  | \$                       | <u>7,724</u> |

Based on a current estimate of the income tax liability at the beginning of 2011, the Fund recognized a future income tax liability and corresponding non-cash future tax charge to net income in 2007. This non-cash charge relates to the Fund's intangible assets and is based on temporary differences between the accounting and tax basis of the Fund's assets and liabilities expected to reverse after January 1, 2011.

### 13. SEGMENTED INFORMATION

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

# STERLING SHOES INCOME FUND

## Notes to Consolidated Financial Statements

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### 14. SUBSEQUENT EVENTS

- (a) As indicated in Note 7, distributions on the Class D LP Units are subordinated to the distributions on the Class A LP Units and the Class C LP Units until the Subordination End Date. As a result of the Fund achieving the EBITDA Target for the year ended December 31, 2007 and Distribution Target for each of the fiscal years ended December 31, 2007 and 2006, the Subordination End Date occurred on March 26, 2008.

The Class D LP Units are now freely exchangeable for Units on a one-for-one basis. In future periods the Class D LP Units will be reclassified from non-controlling interest to unitholders' equity. Also, in future periods distributions on the Class D LP Units will no longer be subordinated, and will be made monthly.

- (b) Subsequent to December 31, 2007, the Fund declared a supplemental special distribution of \$0.06 per Unit to all Unitholders of record on December 31, 2007. This amount has been included in accrued distributions at December 31, 2007.