

*Interim Consolidated Financial Statements of*

**STERLING SHOES INCOME FUND**

*June 30, 2008*

(Unaudited – expressed in thousands of dollars)

**STERLING SHOES INCOME FUND****Consolidated Balance Sheets**

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

	As at June 30, 2008	As at December 31, 2007
<b>ASSETS</b>		
<b>CURRENT</b>		
Cash	\$ -	13,860
Accounts receivable	217	773
Inventory	36,764	29,034
Prepaid expenses and deposits	1,031	1,008
	<u>38,012</u>	<u>44,675</u>
LEASEHOLDS AND EQUIPMENT [note 3]	18,474	16,648
GOODWILL	828	828
INTANGIBLE ASSETS [note 4]	49,041	49,041
	<u>\$ 106,355</u>	<u>\$ 111,192</u>

**LIABILITIES AND UNITHOLDERS' EQUITY**

<b>CURRENT</b>		
Bank indebtedness [note 5]	\$ 1,985	\$ -
Accounts payable and accrued liabilities	17,821	18,415
Distributions payable	830	3,905
	<u>20,636</u>	<u>22,320</u>
FUTURE INCOME TAXES [note 12]	7,000	7,724
CONVERTIBLE DEBENTURES [note 6]	21,672	21,243
DEFERRED LEASE INDUCEMENTS	1,733	1,785
NON-CONTROLLING INTEREST [note 7]	-	11,152
UNITHOLDERS' EQUITY	55,314	46,968
	<u>\$ 106,355</u>	<u>\$ 111,192</u>

COMMITMENTS [note 9]

SUBSEQUENT EVENTS [note 15]

On behalf of the Board of Trustees

\_\_\_\_\_  
(signed) Rick Mahler  
Trustee

\_\_\_\_\_  
(signed) Jeremy Horwitz  
Trustee

*See accompanying notes*

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

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

	Three-month period ended		Six-month period ended	
	June 30, 2008	June 30, 2007	June 30, 2008	June 30, 2007
SALES	\$ 29,405	\$ 28,242	\$ 54,353	\$ 52,193
COST OF SALES	14,395	12,706	28,270	22,557
GROSS MARGIN	15,010	15,536	26,083	29,636
EXPENSES				
Store and selling	10,768	9,933	21,289	19,208
General and administrative [note 11]	1,574	1,887	3,634	3,551
	12,342	11,820	24,923	22,759
Income before interest, amortization and non-controlling interest	2,668	3,716	1,160	6,877
Interest and financing expense	690	185	1,152	294
Loss (Gain) on disposal of leaseholds and equipment	333	-	333	(5)
Amortization of leaseholds and equipment	779	616	1,530	1,404
INCOME (LOSS) BEFORE NON-CONTROLLING INTEREST AND TAXES	866	2,915	(1,855)	5,184
Future income taxes [note 12]	-	7,724	(724)	7,724
INCOME (LOSS) BEFORE NON-CONTROLLING INTEREST	866	(4,809)	(1,131)	(2,540)
NON-CONTROLLING INTEREST [note 7]	-	(960)	-	(498)
NET INCOME (LOSS) AND COMPREHENSIVE INCOME (LOSS)	\$ 866	\$ (3,849)	\$ (1,131)	\$ (2,042)
Basic and diluted net income (loss) per unit	\$ 0.13	\$ (0.72)	\$ (0.19)	\$ (0.38)
Basic weighted average number of units outstanding [note 7]	6,641,860	5,313,488	6,007,193	5,313,488
Diluted weighted average number of units outstanding [note 6]	7,823,885	6,641,860	7,189,218	6,641,860

See accompanying notes

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

For the six month period ended June 30, 2008

(Unaudited - expressed in thousands of dollars, except per unit and number of unit figures.)

	Equity				Total
	Unitholders' capital [note 8]	component of Debentures [note 6]	Cumulative earnings	Cumulative distributions	
BALANCE, June 30, 2007	\$ 47,847	-	11,520	(16,386)	\$ 42,981
Option on convertible debentures	-	2,657	-	-	2,657
Net income for the period	-	-	7,389	-	7,389
Distributions declared	-	-	-	(6,058)	(6,058)
BALANCE, December 31, 2007	\$ 47,847	2,657	18,909	(22,444)	\$ 46,968
Reclassification of Class D LP units from non-controlling interest [note 7]	11,962	-	4,801	(5,611)	11,152
Re-valuation of inventory per CICA Handbook s.3031 [note 2]	-	-	3,306	-	3,306
Net loss for the period	-	-	(1,131)	-	(1,131)
Distributions declared	-	-	-	(4,981)	(4,981)
BALANCE, June 30, 2008	\$ 59,809	2,657	25,885	(33,037)	\$ 55,314

See accompanying notes

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

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

	Three-month period ended		Six-month period ended	
	June 30, 2008	June 30, 2007	June 30, 2008	June 30, 2007
<b>OPERATING ACTIVITIES</b>				
Net Income (loss)	\$ 866	\$ (3,849)	\$ (1,131)	\$ (2,044)
Items not involving cash				
Future income taxes	-	7,724	(724)	7,724
Amortization of leaseholds and equipment	779	616	1,530	1,404
Loss on disposal of leaseholds and equipment	333	-	333	-
Amortization of deferred lease inducements	(95)	(78)	(184)	(153)
Accreted interest expense [note 6]	295	-	429	-
Non-controlling interest	-	(960)	-	(498)
Revaluation of inventory per CICA HB S3031 [note 2]	-	-	3,306	-
	2,178	3,453	3,559	6,434
Change in non-cash working capital balances related to operations				
Accounts receivable	75	304	556	(422)
Inventory	(14)	1,131	(7,730)	(7,663)
Prepaid expenses and deposits	(76)	(146)	(23)	(252)
Accounts payable and accrued liabilities	(4,763)	(3,867)	(594)	1,965
	(4,778)	(2,578)	(7,791)	(6,372)
Cash (used in) / provided by operating activities	(2,600)	875	(4,232)	61
<b>INVESTING ACTIVITIES</b>				
Acquisition of leaseholds and equipment	(2,095)	(1,995)	(3,689)	(3,598)
Proceeds from disposal of assets	-	-	-	5
Lease inducements received	58	168	132	168
Cash used in investing activities	(2,037)	(1,827)	(3,557)	(3,426)
<b>FINANCING ACTIVITIES</b>				
Capital expenditure loan [note 10]	-	2,932	-	2,932
Operating loan [note 5]	1,985	411	1,985	5,471
Payment of distributions	(2,823)	(2,391)	(8,056)	(7,884)
Cash (used in) / provided by financing activities	(838)	952	(6,071)	519
<b>CASH OUTFLOW DURING THE PERIOD</b>	(5,475)	-	(13,860)	(2,845)
<b>CASH, BEGINNING OF PERIOD</b>	5,475	-	13,860	2,845
<b>CASH, END OF PERIOD</b>	\$ -	\$ -	\$ -	\$ -
<b>Supplemental cash flow information</b>				
Interest paid	\$ 932	\$ 185	\$ 932	\$ 294

See accompanying notes

# STERLING SHOES INCOME FUND

## Notes to Interim Consolidated Financial Statements

June 30, 2008

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

### 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 unaudited interim consolidated financial statements and accompanying notes have been prepared in accordance with Canadian generally accepted accounting principles (“GAAP”). These unaudited interim consolidated financial statements do not include all of the disclosures required by Canadian generally accepted accounting principles for annual financial statements and, accordingly, should be read in conjunction with the audited annual consolidated financial statements and notes for the year-ended December 31, 2007. These unaudited interim consolidated financial statements follow the same accounting policies and methods of computation as used in the annual audited consolidated financial statements for the period ended December 31, 2007, except as noted below.

These unaudited interim 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*

The Canadian Institute of Chartered Accountants (“CICA”) issued four new accounting standards that became effective for the Fund on January 1, 2008: Handbook Section 3031, Inventories (“Section 3031”), Handbook Section 3862, Financial Instruments – Disclosures (“Section 3862”), Handbook Section 3863, Financial Instruments – Presentation (“Section 3863”) and Handbook Section 1535, Capital Disclosures (“Section 1535”).

# STERLING SHOES INCOME FUND

## Notes to Interim Consolidated Financial Statements

June 30, 2008

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

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(i) *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 was 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.

Section 3031 requires inventories to be measured at the lower of cost and net realizable value. The Fund determines inventory cost based on a weighted average cost formula and values inventory at the lower of cost and net realizable value. The Fund previously valued its inventory at the lower of average cost and net realizable value less a normal profit margin, using the retail method. Under the previous method, net realizable value included a reduction for a normal profit margin, taking into consideration current and expected selling prices, historic sales patterns for the inventory, recent product introductions and the level of inventory on hand. Section 3031 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.

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.

Upon adoption of the new standard, inventory was increased by a one-time adjustment of \$3,306 on January 1, 2008, which was credited to opening retained earnings.

(ii) *Financial Instruments*

CICA Handbook Section 3862 and 3863 applies to interim and annual financial statements relating to fiscal years beginning on or after October 1, 2007. These sections replace Handbook Section 3861, Financial Instruments – “Disclosure and Presentation” to revise and enhance the disclosure requirements, and to carry forward its presentation requirements. These new sections place increased emphasis on disclosures about the nature and extent of risks arising from financial instruments and how the entity manages those risks. The new disclosures are included in Note 10.

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 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

# STERLING SHOES INCOME FUND

## Notes to Interim Consolidated Financial Statements

June 30, 2008

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

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 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.

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(iii) *Capital disclosures*

CICA Handbook Section 1535 – “Capital Disclosures” applies to interim and annual financial statements relating to fiscal years beginning on or after October 1, 2007. Section 1535 specifies the disclosure of: (i) an entity’s objectives, policies and processes for managing capital; (ii) quantitative data about what the entity regards as capital; (iii) whether the entity has complied with any capital requirements; and, (iv) if it has not complied, the consequences of such non-compliance. The new disclosure is included in Note 14.

(iv) *Income taxes and future income taxes*

As the Fund intends to 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.

(v) *International Financial Reporting Standards [“IFRS”]*

The Canadian Accounting Standards Board (AcSB) will require all public companies to adopt IFRS for interim and annual financial statements relating to fiscal years beginning on or after January 1, 2011. The Fund will be required to prepare both current and comparative financial information using IFRS. The Fund expects the transition to IFRS to impact financial reporting, business processes, and information systems. The Fund will begin to assess the impact of the adoption of IFRS in 2008. The financial impact of the transition to IFRS cannot be reasonably estimated at this time.

(c) *Measurement uncertainty*

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 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.

# STERLING SHOES INCOME FUND

## Notes to Interim Consolidated Financial Statements

June 30, 2008

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

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(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 pro-rated 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.

(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.

# STERLING SHOES INCOME FUND

## Notes to Interim Consolidated Financial Statements

June 30, 2008

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

(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.

(j) *Revenue recognition*

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

(k) *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.

(l) *Net income (loss) per Unit*

Basic net income (loss) per Unit of the Fund (a "Unit") is calculated by dividing net income (loss) by the weighted average number of Units outstanding during the reporting period. Diluted net income (loss) per Unit is calculated by dividing the income (loss) 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 (loss) per Unit calculation and the number of Units that would be issued assuming conversion of all Class D LP units ("Class D LP units") (note 7) and all Convertible Debentures. On the Subordination End Date as described in note 7, distributions on the Class D LP units were no longer subordinated and the Class D LP units became freely exchangeable for Units. As a result, the Class D LP units are no longer classified as non-controlling interest and are not dilutive factors. As at June 30, 2008, the Convertible Debentures were not included in the computation of diluted net income (loss) per Unit because to do so would have been anti-dilutive for the three-month and six-month periods ended June 30, 2008.

(m) *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 compensation expense over the vesting period of the applicable employee award.

As at June 30, 2008, the Fund did not record any additional liability in respect of the LTIP (June 30, 2007 - \$675). During the three-month and six-month periods ended June

# STERLING SHOES INCOME FUND

## Notes to Interim Consolidated Financial Statements

June 30, 2008

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

30, 2008 the Fund recorded compensation expense of \$139 and \$279 (2007 - \$293 and \$586), respectively.

(n) *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.

(o) *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 is 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 three-month and six-month periods ended June 30, 2008, \$2.5 million and \$5.0 million (2007 - \$1.9 million and \$3.8 million) in cash distributions were declared payable by the Board of Trustees of the Fund and paid to unitholders, respectively.

# STERLING SHOES INCOME FUND

## Notes to Interim Consolidated Financial Statements

June 30, 2008

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

### 3. LEASEHOLDS AND EQUIPMENT

	June 30, 2008			December 31, 2007		
	Cost	Accumulated Depreciation	Net Book Value	Cost	Accumulated Depreciation	Net Book Value
Leasehold improvements	\$ 12,771	\$ (3,953)	\$ 8,818	\$ 10,785	\$ (3,268)	\$ 7,517
Furniture and equipment	10,567	(2,759)	7,808	9,439	(2,185)	7,254
Computer equipment and software	2,923	(1,075)	1,848	2,681	(804)	1,877
	\$ 26,261	\$ (7,787)	\$ 18,474	\$ 22,905	\$ (6,257)	\$ 16,648

### 4. INTANGIBLE ASSETS

	June 30, 2008	December 31, 2007
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. BANK INDEBTEDNESS

	June 30, 2008	December 31, 2007
Operating loan	\$ 1,985	\$ -

The Fund has utilized \$1,985 of an available \$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 1.5% to 2.00%, 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.

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

### 6. CONVERTIBLE DEBENTURES

	June 30, 2008	December 31, 2007
Principal amount	\$ 25,000	\$ 25,000
Equity component	(2,657)	(2,657)
Accreted interest expense	560	131
Deferred financing fees	(1,231)	(1,231)
Convertible unsecured subordinated debentures	\$ 21,672	\$ 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.

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

### 7. NON-CONTROLLING INTEREST ("NCI")

	Cumulative Cumulative			
	NCI	Income	Distribution	Total
<b>Balance, June 30, 2007</b>	\$ 11,962	\$ 2,910	\$ (4,097)	\$ 10,775
NCI in income of Sterling Shoes LP for the period		1,891	-	1,891
Distributions declared in respect of the NCI		-	(1,514)	(1,514)
<b>Balance, December 31, 2007</b>	\$ 11,962	\$ 4,801	\$ (5,611)	\$ 11,152
Reclassification of Class D LP units to unitholder's equity	(11,962)	(4,801)	5,611	(11,152)
<b>Balance, June 30, 2008</b>	\$ -	\$ -	\$ -	\$ -

The shareholders of Inc 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 were equivalent in all material respects, except that distributions on the Class D LP units were subordinated to distributions on the Class A LP units and 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 the Distribution Target for each of the fiscal years ended December 31, 2007 and 2006, the Subordination End Date has occurred.

On the Subordination End Date, the Class D LP units became freely exchangeable for Units on a one-for-one basis. As a result, the Class D LP units have been reclassified from non-controlling interest to unitholders' equity.

### 8. UNITHOLDERS' CAPITAL

	Unitholders'		
<i>(in thousands of dollars)</i>	Fund Units	Class D LP Units	Capital
<b>Balance, December 31, 2007</b>	47,847	-	47,847
Reclassification of Class D LP units from non-controlling interest to unitholders' equity [note 7]		11,962	11,962
<b>Balance, June 30, 2008</b>	47,847	11,962	59,809

	Unitholders'		
<i>(in number of units)</i>	Fund Units	Class D LP Units	Capital
<b>Balance, December 31, 2007</b>	5,313,488		5,313,488
Reclassification of Class D LP units from non-controlling interest to unitholders' equity [note 7]		1,328,372	1,328,372
<b>Balance, June 30, 2008</b>	5,313,488	1,328,372	6,641,860

# STERLING SHOES INCOME FUND

## Notes to Interim Consolidated Financial Statements

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

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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.

### 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:

2008	\$	7,570
2009		14,804
2010		13,715
2011		12,459
2012		11,848
	\$	<u>60,396</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 June 30, 2008 securing inventory purchase commitments totaling \$2,702. The last of these letters of credit expires November 16, 2008.

# STERLING SHOES INCOME FUND

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### 10. FINANCIAL INSTRUMENTS

(a) *Fair value*

Financial instruments consist of cash, accounts receivable, operating and term facilities, accounts payable, foreign exchange contracts, distributions payable, and the Debentures. The fair values of all financial instruments, other than the Debentures (Note 6), are considered to approximate their carrying values due to their short term 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 June 30, 2008 was \$21,326 compared to its carrying value of \$21,672. As the Debentures are other financial liabilities and are measured at amortized cost, no gain or loss has been recognized in net income (loss) relating to the difference between the Debentures' fair value and carrying value.

(b) *Liquidity risk*

Liquidity risk is the risk that the Fund 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 Fund manages liquidity risk by managing its capital and debt structure, its cash flows, its inventory flow. The Fund believes the future cash flows generated from operations and access to capital and banking markets will adequately meet its financial obligations in the foreseeable future.

In addition to the \$12.5 million operating facility (note 5), the Fund has a \$10 million term facility, which is available for general funding of new store facilities. As at June 30, 2008, the Fund has not utilized the term facility.

(c) *Interest rate risk*

Interest rate risk is the risk that the Fund's financial instruments or cash flows associated with the instrument will fluctuate due to changes in market interest rates. The Fund's interest rate risk arises primarily from the Debentures, the operating facility, and the term facility. The interest rate on the Debentures is at a fixed rate (Note 6) and the Fund has not utilized any of the term facility as at June 30, 2008.

(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 Fund's foreign exchange risk arises primarily from its inventory purchases. During the quarter ended June 30, 2008, approximately 34% (three months ended June 30, 2007- 32%) of product purchases was denominated in US dollars. From time to time, the Fund enters into

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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 June 30, 2008, the Fund had outstanding forward foreign exchange contracts as follows:

Settlement dates	Face Value \$US	Average rate \$Cdn
July 2008	2,000,000	1.0045
August 2008	2,500,000	1.0049
September 2008	1,000,000	1.0051
October 2008	1,000,000	1.0056
November 2008	1,000,000	1.0058

As at June 30, 2008, the unrealized gain on these contracts is \$110.

(e) *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 in which two trustees and officers of the Fund have an interest. Rent expense recognized on this lease was \$71 and \$142 for the three-month and six-months ended June 30, 2008 (2007 - \$50 and 100), respectively and is included in general and administrative expenses in the statement of income.
- (b) The Fund purchased equipment from a company in which a trustee and officer of the Fund has an interest, for \$131 and \$223 during the three-month and six-months ended June 30, 2008 (2007 - \$187 and \$327), respectively.

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

# STERLING SHOES INCOME FUND

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### 12. FUTURE INCOME TAXES

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

	June 30, 2008	December 31, 2007
Future income tax liability:		
Intangible Asset - store banners	\$ 4,058	\$ 4,649
Intangible asset - private label brand names	2,685	3,075
Other temporary differences	257	
Expected reversal of temporary differences prior to 2011	-	-
	\$ 7,000	\$ 7,724

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.

For the three months and six months ended June 30, 2008, the estimated future income tax liability was reduced by \$nil and \$0.7 million based on the temporary differences between the accounting and tax basis of the Fund's assets and liabilities as at June 30, 2008 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.

### 14. CAPITAL DISCLOSURES

The Fund's objective in managing capital remains unchanged from December 31, 2007. The capital structure consisted of the following components at June 30, 2008: unitholders' equity and the Debentures. At December 31, 2007, the Fund's capital also included non-controlling interest (Note 7). The Fund's objectives when managing its capital are to make stable monthly distributions to Unitholders and being in compliance with its bank covenants. The covenants include non-GAAP measures such as adjusted EBITDA,

The Fund reviews its historic 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 Fund may adjust the amount of distributions paid to its Unitholders, return capital to its unitholders, issue new Units, or issue or reduce debt.

# **STERLING SHOES INCOME FUND**

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### **15. SUBSEQUENT EVENT**

Subsequent to June 30, 2008, the Fund increased its operating facility (note 5) from \$12.5 million to \$15.0 million.