

**STERLING SHOES INC.**

*(formerly Sterling Shoes Income Fund)*

**MANAGEMENT'S DISCUSSION AND ANALYSIS****March 17, 2011**

*The following management's discussion and analysis ("MD&A") should be read in conjunction with the audited consolidated financial statements and accompanying notes ("Financial Statements") of Sterling Shoes Inc. ("Sterling" or the "Company") for the year ended December 31, 2010. Results have been prepared in accordance with Canadian generally accepted accounting principles ("GAAP" and reported in Canadian dollars unless otherwise indicated). The fiscal year-end of the Company is December 31.*

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

**OVERVIEW OF THE COMPANY**

Effective July 1, 2010 Sterling Shoes Income Fund (the "Fund") converted to a corporation, "Sterling Shoes Inc." ("Sterling" or the "Company").

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

The conversion took place as a "plan of arrangement" (the "Arrangement") and was effective July 1, 2010. Under the Arrangement, unitholders of the Fund received common shares of Sterling, on a one-for-one basis. SSI Investments Inc., which previously held a 20% interest in Sterling Shoes Limited Partnership, the Fund's operating unit, exchanged its exchangeable units for common shares of Sterling, also on a one-for-one and tax deferred basis and its remaining units in the partnership for the debt owing to SS Holdings Trust by SSI Investments Inc. SSI Investments Inc. holds 20% of Sterling's issued and outstanding common shares with public shareholders holding the remaining 80%. The business of Sterling continues to be conducted by Sterling Shoes Limited Partnership, all of the interests in which are owned, directly or indirectly, by Sterling.

The dividend policy of Sterling replaced the distribution policy of the Fund and is subject to the discretion of the Board of Directors which takes into account the Company's current and anticipated business needs and financial condition at the time a dividend is considered. Currently no dividends are paid on Sterling's common shares.

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

In connection with the Arrangement, Sterling assumed all of the covenants and obligations of the Fund relating to the outstanding Debentures. The Debentures have become convertible unsecured subordinated debentures of Sterling and holders are entitled to receive Sterling common shares, rather than Units, at the same conversion price at which the Units were previously issuable upon conversion thereof (being \$21.15 per Sterling common share representing a conversion ratio of 47.281 Sterling common shares for each \$1,000 principal amount of Debentures converted), subject to adjustment in certain events as provided for in the Debenture Indenture.

The trustees of the Fund have become the directors of Sterling and the officers and management of Sterling Shoes Limited Partnership have become officers and management of Sterling.

There are 6,641,860 shares of Sterling and 25,000 Debentures issued and outstanding as at March 17, 2011. The shares of Sterling trade on the Toronto Stock Exchange under the symbol SSI and the Debentures trade under the symbol SSI.DB.

## **SHAREHOLDER RIGHTS PLAN**

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

## **OVERVIEW OF OUR BUSINESS**

Sterling is a Vancouver-based, leading footwear retailer operating through five separate retail banners: Sterling, Joneve, Shoe Warehouse, Freedman Shoes, and Gia. These retail concepts were designed to effectively and profitably serve identified market segments. Since 1987 the Sterling Shoes business has grown from five locations to 161 stores as at March 17, 2011. Our stores are located in leased premises primarily in high-traffic, high-visibility locations within enclosed shopping malls, on high streets and in strip malls.

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

Each of our banners targets a specific consumer group through different product, merchandising, location, pricing, service and advertising strategies. Sterling, Joneve, Shoe Warehouse, Freedman Shoes, and Gia compete with other local, regional and national footwear retailers. The fragmented nature of the Canadian retail footwear industry and our five distinct retail banners means that we compete against a wide variety of participants at various levels of the value chain. Examples of who we believe to be the principal competitors for our banners are provided below.

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

We now operate 161 stores across Canada, a significant increase from the 100 stores at the time of our initial public offering in July 2005.

## **RECENT EVENTS AND OUTLOOK**

### Recent Performance and the Company's Reorganization

In the fourth quarter, 2010 a number of events occurred directed at transforming the Company:

- Following an international search the Company hired a new President and CEO, Dave Alves, who joined the Company and the board of directors on November 10, 2010.
- The Company embarked on a strategic review and began a comprehensive re-organization of its operating structure and business processes. At the heart of the re-organization is a company-wide focus on trading, and operational efficiencies. During 2011 we will focus on leveraging the profit potential of our existing store base and operating divisions. Once we have executed the 2011 plan we will be in a position to leverage our more efficient foundation for future growth.
- The Company accelerated its strategy of clearing out aged inventory to make room for fresh product and to reduce its investment in inventory thereby decreasing warehousing and logistic costs. While resulting in lower margins in the quarter, our balance sheet has been strengthened. Inventory levels were \$7.8 million less at December 31, 2010, a decrease of 21.5% compared to a year ago
- The Company's cash position rose to \$7.4 at December 31, 2010 up \$3.3 million from a year earlier due to our aggressive approach to clearing out older inventory.

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

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

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

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

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

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

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

revitalize the image of our respective banners to our customers.

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

- The Company converted from an income trust structure to a corporate structure.
- During the year the Company renewed its bank credit facilities for a 3 year term.

#### Number of Stores

During 2010, we opened three new stores and closed three stores. We opened a Freedman store at Park Royal Mall in West Vancouver, BC, a Joneve store in the new Chinook Centre Mall expansion in Calgary, AB and a Freedman Outlet store on West 4<sup>th</sup> Avenue in Kitsilano, Vancouver, BC. Currently we have one new store commitment for 2011 and may close a few stores. We believe that there is significant growth potential from a sales and profitability perspective within our existing store network. During 2011 we will focus on improving our performance within our existing store base before adding significantly to our store base or growing through other methods. The normal course of business includes closing stores due to a number of factors such as the redevelopment of real estate in malls, high streets and strip malls, changes in the economic environment and lease terms.

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

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

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

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

Our conversion project is led by finance management and includes input from various areas of the organization. Using the changeover plan that we developed to map conversion to these new standards, we have identified and documented the areas of significant change as follows:

#### **First time adoption of IFRS**

IFRS 1, “First-Time Adoption of International Financial Reporting Standards”, provides entities adopting IFRS for the first time with a number of optional exemptions and mandatory exceptions, in certain areas, to the general requirement for full retrospective application of IFRS. Sterling Shoes Inc. has decided to apply the following optional exemptions:

#### Fair Value or Revaluation as Deemed Cost:

IFRS 1 provides an option to allow a first-time IFRS adopter to elect to use the amount determined under a previous GAAP revaluation as the deemed cost of intangible assets so long as the revaluation was broadly comparable to fair value under IFRS. Management considers the September 30, 2009 Canadian GAAP impairment of the carrying value of our intangible assets, specifically the store banners and private label brand names, as a “revaluation broadly comparable to fair value”; the Company has elected that amount to be deemed IFRS cost as of that date. The IFRS carrying value of those intangible assets on transition to IFRS is therefore consistent with the Canadian GAAP carrying value on the transition date.

#### Borrowing Costs:

IAS 23 “Borrowing Costs” requires capitalization of eligible borrowing costs directly attributable to the acquisition or construction of qualifying assets. Under Canadian GAAP, the Company’s accounting policy was to expense interest costs in connection with development activity. A first-time adopter may elect to apply the transitional provisions prescribed by IAS 23, and thereby be exempt from having to apply the standard to past transactions. The Company has elected to utilize this exemption, and will therefore apply IAS 23 on a prospective basis from the date of transition to IFRS (meaning for eligible projects with a commencement date after January 1, 2010).

#### Share-Based Payments:

IFRS 1 permits the application of IFRS 2 “Share-Based Payments” only to equity instruments granted after November 7, 2002 that had not vested by the date of transition to IFRS. The Company has applied this exemption and will apply IFRS 2 for equity instruments granted after November 7, 2002 that had not vested by January 1, 2010.

#### **IFRS Changeover Plan – Impact of IFRS on:**

##### 1. ***Information technology and data systems*** –:

- As at January 1, 2010, our accounting software was upgraded to include modules to support our changeover or conversion to IFRS. We have assessed the impact on system requirements and expect there will be no significant impact to applications arising from the transition to IFRS.

##### 2. ***Internal controls over financial reporting*** –

- We have identified the required accounting process changes that result from the application of IFRS accounting policies; these changes are not considered significant.
- As part of the transition project, additional controls have been designed and implemented to ensure that the recorded balance is appropriately recorded in accordance with IFRS.

##### 3. ***Disclosure controls and procedures*** –

- As part of the transition project, additional controls have been designed and implemented to ensure proper disclosure in the areas of leaseholds and equipment and key management compensation.

##### 4. ***Financial reporting expertise*** –

- We engaged financial reporting consultants to assist with changeover to IFRS.
- The finance & accounting professionals of Sterling Shoes Inc. have taken training sessions and attended seminars in order to familiarize themselves with IFRS.
- Members of the Board of directors and Audit Committee have taken training sessions and attended seminars in order to familiarize themselves with IFRS.

- In October 2010, we held an IFRS information session with the audit committee that included an in-depth review of accounting policy changes on transition to IFRS, a discussion of optional exemptions under IFRS 1 that the Company expects to elect on transition to IFRS, and an overview of draft IFRS financial statements.
  - We will continue to provide additional training and updates for key employees, senior management, the audit committee, the Board and other stakeholders throughout the convergence period.
  - Sterling Shoes Inc. has engaged its auditors, Deloitte & Touche LLP, to review IFRS transition documentation.
5. **Business activities** – Sterling Shoes Inc. has not identified any impact on its bank covenants, executive compensation, foreign currency or hedging activities as a result of IFRS implementation; therefore, Sterling does not expect that there will be any impact on business activities due to the implementation of IFRS.
6. **Timing of each phase** –
- Scoping and diagnostic phase — this phase involved performing a detailed diagnostic comparing Canadian GAAP to IFRS and identifying key areas that may be impacted by the transition to IFRS; it was completed in October 2009.
  - Impact analysis and design phase — in this phase, each area identified from the scoping and diagnostic phase was addressed. The results of this phase identified the impact of the conversion on existing accounting policies, information systems, business processes and internal controls over financial reporting and disclosure. This phase included an analysis of policy alternatives allowed under IFRS and development of draft IFRS financial statements. Parallel second quarter 2010 IFRS financial statements were prepared in October 2010 and presented to the audit committee at that time. This phase was completed in October 2010.
  - Implementation and review phase — this phase included execution of changes to business processes, completing formal authorization processes to approve recommended accounting policy changes and conducting training programs. The above activities were completed in October 2010. Sterling plans to present parallel third and fourth quarter 2010 IFRS financial statements and notes to its audit committee in early 2011.

### **Financial Statement Impact on Transition to IFRS**

The Company has not yet prepared the 2010 comparative results for the full year under IFRS. This work will be completed over the next few months, and may result in additional adjustments that have not been anticipated above. In addition, the IASB continues to update the International Financial Reporting Standards. If any standards change prior to December 31, 2011, we are required to apply such changes retrospectively to the date of transition (January 1, 2010), and any such changes may have a material impact on our financial statements. Moreover, our opening consolidated statement of financial position for January 1, 2010, together with our consolidated statements of financial position as at December 31, 2010 and December 31, 2011 will not be audited until the results of operations for 2011 are audited by our external auditors in 2012. Although we have engaged our external auditors to review the preliminary comparative financial results under IFRS, a review does not involve the same level of analysis as an audit, and as such cannot be expected to identify all matters that may need to be addressed in order to fully comply with IFRS as enacted at December 31, 2011. However, management has modified some of its accounting policies to apply prospectively in order to conform to IFRS requirements. Significant changes to accounting policies are discussed below.

### **Significant Changes in Accounting Policies**

Information on those accounting policy changes that management considers most significant to the Company is presented below.

**Impairment of Assets:**

Under both Canadian GAAP and IFRS, intangible assets are reviewed at least annually for impairment or whenever indicators of impairment are present. If such an indicator exists, a formal impairment assessment is performed.

Under IAS 36, "Impairment of Assets" to reverse any previous impairment losses may be reversed where circumstances have changed such that the impairments have been reduced. Canadian GAAP prohibits reversal of impairment losses. The adoption of these new standards does not result in a change to the carrying value of our assets on transition to IFRS.

The discussion above on IFRS 1 elections and significant accounting policy changes on transition to IFRS is provided to allow readers to obtain a better understanding of our IFRS changeover plan and the resulting potential effects on the financial statements of Sterling Shoes Inc. This information provides an indication of the major differences identified to date based on the current IFRS guidance, relative to the Company's current Canadian GAAP accounting policies. This discussion reflects management's most recent assumptions and expectations; circumstances may arise, such as changes in IFRS, regulations or economic conditions, which could change these assumptions or expectations. Any further changes to the election of IFRS 1 exemptions, the selection of IFRS accounting policies and any related adjustments to the financial statements would be subject to approval by the audit committee prior to being finalized. Accordingly, the discussion above is subject to change.

## SUMMARY FINANCIAL INFORMATION

<b>Statement of Income Items (\$000's)</b>	<b>Three months ended December 31</b>		<b>Twelve months ended December 31</b>	
	<b>2010</b>	<b>2009</b>	<b>2010</b>	<b>2009</b>
Sales	\$ 39,348	41,195	127,028	131,170
Cost of Sales <sup>(2)</sup>	(22,065)	(18,011)	(72,173)	(69,127)
Gross Margin	17,283	23,184	54,855	62,043
<i>As a percentage of sales</i>	43.9%	56.3%	43.2%	47.3%
Store and selling expenses	(12,998)	(12,664)	(46,416)	(46,785)
General and administrative expenses	(2,690)	(2,383)	(8,695)	(7,616)
EBITDA <sup>(1)</sup>	1,595	8,137	(256)	7,642
<i>As a percentage of sales</i>	4.1%	19.8%	-0.2%	5.8%
EBITDA excluding impairment of old inventory <sup>(2)</sup>	2,980	8,137	2,994	7,642
<i>As a percentage of sales</i>	7.6%	19.8%	2.4%	5.8%
Adjusted EBITDA <sup>(1)</sup>	1,508	8,126	(660)	7,093
<i>As a percentage of sales</i>	3.8%	19.7%	-0.5%	5.4%
Interest expense	(657)	(669)	(2,612)	(2,637)
(Loss) / Gain on disposal	0	(367)	(220)	(627)
Unrealized (Loss) / Gain on foreign exchange	(256)	-	(256)	-
Impairment of goodwill and intangible assets	-	-	-	(33,246)
Amortization	(79)	(863)	(3,535)	(3,401)
Income / (Loss) before taxes	(108)	6,238	(6,879)	(32,269)
Future income taxes	1,571	-	1,571	4,636
Net income / (loss)	1,463	6,238	(5,308)	(27,633)
Maintenance capital expenditures	375	103	1,746	3,012
	<b>As at December 31</b>			
<b>Balance Sheet Items (\$000's)</b>	<b>2010</b>	<b>2009</b>		
Total assets	71,345	77,165		
Long-term financial liabilities	27,557	25,000		

### Notes:

- (1) See definition of EBITDA, Adjusted EBITDA and Maintenance Capital Expenditures under "Non-GAAP Measures".
- (2) Management estimates charges of \$1.4 million and \$3.2 million were taken in Cost of Sales during the three and twelve-months periods ended December 31, 2010, respectively, see below for additional discussion.

## OPERATING RESULTS

### Sales

Sales were \$39.3 million and \$127 million during the three and twelve-month periods ended December 31, 2010, representing a decrease of 4.5% and 3.2% over the \$41.2 million and \$131.2 million in the same periods in 2009. Same-store sales for the three and twelve-month periods ended December 31, 2010 decreased by 4.0% and 5.0% respectively, compared to the same periods during 2009.

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

### ***Cost of sales and gross margin***

The decline in sales also increased pressure on gross margins due to promotional activity in response to our competitive position. Cost of sales as a percentage of sales for the three and twelve-month periods ended December 31, 2010 was 56.1% and 56.8%, compared to 43.7% and 52.7% respectively for the same period during 2009.

As a substantial amount of capital was invested in aged inventory, management focused on reducing this unproductive inventory late 2010. Management undertook a number of initiatives to address this issue with a new approach to inventory management including our product mix, purchasing and planning processes. Unproductive inventory was marked down during the third and fourth quarters to stimulate sales and to clear out old inventory consistent with our strategy of improving inventory turnover and improving the freshness of inventory mix throughout the Company. As a consequence, management estimates gross margin was eroded by these one-time efforts which resulted in charges of \$1.4 million and \$3.2 million during the three and twelve-month periods ended December 31, 2010 respectively. Excluding these charges, cost of sales as a percentage of sales for the three and twelve-month periods ended December 31, 2010 was 52.6% and 54.3% respectively.

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

Store and selling expenses for the three and twelve-months ended December 31, 2010 were 33.0% and 36.5% of sales, compared to 30.7% and 35.7% for the same periods during 2009, respectively. Store and selling expenses have a fixed underlying core with a large variable component, primarily consisting of expenses relating to occupancy and employee costs. In nominal dollar terms, store and selling expenses increased by \$334 thousand and decreased \$369 thousand for the three and twelve-month periods ending December 31, 2010. However the overall savings were nullified as a percentage of sales by the decrease in sales in 2010.

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

General and administrative (“G&A”) expenses for each of the three and twelve-months ended December 31, 2010 were 6.8% of sales, compared to 5.8% during each of the same periods in 2009, respectively.

G&A expenses have increased in the three and twelve months ended December 31, 2010 primarily due to investments in human resources, severance costs, executive search fees incurred for recruiting a new CEO and other key business executives as well as the costs to convert to a corporation.

The implementation of the Company’s strategic initiatives (see “Recent Events and Outlook”) will result in further investments in executive personnel to improve operational performance and margins, reduce costs and increase profitability.

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

EBITDA for the three and twelve-months ended December 31, 2010 was 4.1% and -0.2% of sales, respectively, compared to 19.8% and 5.8% for the same periods during 2009. The variance in EBITDA is accounted for by the reduction in sales, the estimated one-time margin erosion to clear

older inventory and inventory impairment charges. Excluding these items EBITDA for the three and twelve-months ended December 31, 2010 was 7.6% and 2.4% respectively.

### ***Interest expense***

Net interest expense with respect to funds utilized under the credit facilities for the three-month and twelve-months ended December 31, 2010 was \$56 thousand and \$257 thousand respectively, compared to \$87 thousand and \$339 thousand in 2009.

Interest expense with respect to the convertible debentures for the three and twelve-month periods ended December 31, 2010 was \$601 thousand and \$2.4 million (2009 - \$582 thousand and \$2.3 million), respectively.

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

The conversion option was valued at \$2,657 thousand at the date of issuance. The liability portion of the Debentures is being accreted to its face value over the term of the debt. Included in interest expense for the three and twelve-months ended December 31, 2010 was \$195 thousand and \$747 thousand (2009 - \$176 thousand and \$673 thousand), respectively, relating to this interest accretion.

### ***Inventory***

As noted earlier, in late 2010 management took action to make room for higher margin inventory and improve inventory turnover. The Company discounted specific aged inventory resulting in estimated charges of \$1.4 million and \$3.2 million in cost of sales during the three and twelve-months periods ended December 31, 2010, respectively.

At December 31, 2010 we had \$7.8 million, or 21.5% less inventory than at December 31, 2009. Inventory greater than 12 months old comprised of 8.9% of the Company's inventory on hand at December 31, 2010 compared to 17.0% at December 31, 2009.

On January 16, 2011 we went live in our Freedman division with our new ERP system. One of the key benefits this system gives us compared to our legacy system is greater visibility into and integrity of our inventory. Remaining banners will go live with the new system during the second quarter of 2011.

## SELECTED QUARTERLY FINANCIAL INFORMATION

<u>in (\$000's) except per Share amounts</u>	<u>Q4-2010</u>	<u>Q3-2010</u>	<u>Q2-2010</u>	<u>Q1-2010</u>	<u>Q4-2009</u>	<u>Q3-2009</u>	<u>Q2-2009</u>	<u>Q1-2009</u>
Sales	\$ 39,348	\$ 32,218	\$ 28,606	\$ 26,855	\$ 41,195	\$ 31,685	\$ 30,618	\$ 27,672
(Loss) / Income before non-controlling interest and taxes <sup>(1)</sup>	\$ (108)	\$ (4,056)	\$ (1,754)	\$ (961)	\$ 6,238	\$ (35,432)	\$ (651)	\$ (2,428)
Future income taxes	1,571				-	4,636	-	-
(Loss) / Income before non-controlling interest <sup>(1)</sup>	\$ 1,463	\$ (4,056)	\$ (1,754)	\$ (961)	\$ 6,238	\$ (30,796)	\$ (651)	\$ (2,428)
Net (Loss) / Income	\$ 1,463	\$ (4,056)	\$ (1,754)	\$ (961)	\$ 6,238	\$ (30,796)	\$ (651)	\$ (2,428)
Basic (loss) / income per Share	\$ 0.220	\$ (0.611)	\$ (0.264)	\$ (0.145)	\$ 0.939	\$ (4.637)	\$ (0.098)	\$ (0.366)
Diluted (loss) / income per Share	\$ 0.187	\$ (0.611)	\$ (0.264)	\$ (0.145)	\$ 0.820	\$ (4.637)	\$ (0.098)	\$ (0.366)
Cash distributions per Share	\$ 0.000	\$ 0.000	\$ 0.000	\$ 0.000	\$ 0.037	\$ 0.056	\$ 0.056	\$ 0.085
Number of stores open at end of period	162	162	160	161	162	162	161	159

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

## CASH FLOW AND LIQUIDITY

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

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

### Cash Flow from Operations

The table below reconciles net income to cash flow from operations for the three and twelve-month periods ended December 31, 2010 and 2009.

**Sterling Shoes Income Fund**  
**Reconciliation of Net Income to Cash provided by operations**  
**December 31, 2010**

in (\$000's)	Three-months ended Dec 31		Year ended Dec 31	
	2010	2009	2010	2009
<b>Net loss</b>	\$ 1,463	6,238	(5,308)	(27,633)
Add charges (deduct credits) to operations not requiring a cash payment:				
Impairment of goodwill and intangible assets	-	-	-	33,246
Future income taxes	(1,571)	-	(1,571)	(4,636)
Amortization of leaseholds and equipment	790	863	3,535	3,401
Accreted interest expense	195	175	747	673
Amortization of deferred leasehold inducements	(86)	(11)	(404)	(550)
Loss on disposal of leaseholds and equipment	-	367	220	627
	791	7,632	(2,781)	5,128
Net change in non-cash working capital balances related to operations:				
Accounts receivable	931	456	(165)	690
Inventory	8,646	6,560	7,832	3,445
Prepaid expenses and deposits	(2)	213	(149)	297
Accounts payable and accrued liabilities	(2,010)	(3,340)	1,219	55
<b>Cash provided by operating activities</b>	\$ 8,356	11,521	5,956	9,615

For the three-month period ended December 31, 2010, cash provided by operations was \$8.4 million compared to \$11.5 million in the same period of 2009. For the twelve-month period ended December 31, 2010 cash provided by operations was \$6.0 million as compared to \$9.6 million for the same period in 2009.

Interim period working capital requirements typically reflect the seasonality of the business. In order to ensure that we have adequate inventory in advance of in-season demand, inventory levels increase in the periods immediately preceding peak seasons throughout the year. Accordingly, inventory levels typically increase in the first and third quarters and decline in the second and fourth quarter as sales pick up. Operating results in the three and twelve-month periods ended December 31, 2010 generally reflected these expectations.

### **Capital Expenditures**

We invested in capital expenditures of \$0.4 million and \$2.1 million (net of leasehold inducements) during the three and twelve-month periods ended December 31, 2010 (2009 - \$0.3 million and \$3.3 million) respectively. Of this amount, \$1.1 million was invested in leaseholds and equipment to furnish new stores during the year ended December 31, 2010. We incurred maintenance capital expenditures of \$0.4 million and \$1.7 million during the three and twelve-month periods ended December 31, 2010 (2009 - \$0.1 million and \$3 million) respectively, which were related to upgrades to our information technology system and store renovations. These maintenance capital expenditures were funded by cash from operations and available credit facilities.

### **CAPITAL RESOURCES**

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

A Canadian chartered bank has provided us with a revolving credit facility of up to \$15 million (the

“Operating Loan”), which is available for working capital requirements, capital expenditures and for general corporate purposes and is repayable on July 31, 2013. As at December 31, 2010, we had no utilization of the Operating Loan.

We have utilized \$4.5 million of our \$5 million credit facility (the “Term Loan”) for funding capital expenditures including new store facilities. The Term Loan matures on July 31, 2013. The Term Loan is being amortized, with repayment terms calling for quarterly principal payments of \$250,000, plus interest, to effect a 5 year amortization. The second payment was made on December 31, 2010.

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

The facilities are subject to customary terms and conditions, including limits on incurring additional indebtedness, granting liens or selling assets without the consent of the lender, and to customary financial covenants, including the maintenance of a minimum senior fixed charge coverage ratio. Certain covenants have been amended.

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

We enter into standby letters of credit to facilitate the international purchase of merchandise and to secure certain of our obligations, including insurance programs and duties related to import purchases. As of December 31, 2010, letters of credit totaling \$3.4 million are outstanding. The last of these letters of credit expires on July 31, 2011 for \$1.5 million. There are no other off-balance sheet arrangements.

#### **CONTRACTUAL OBLIGATIONS**

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

<b>in \$000's</b>	<b>2011</b>	<b>2012</b>	<b>2013</b>	<b>2014</b>	<b>2015</b>
Inventory purchase commitments	3,373				
Long-term debt		25,000			
Operating and Term Loans	1,000	1,000	2,500		
Minimum rental commitments <sup>(1)</sup>	15,261	15,281	14,093	12,924	11,037
	<u>19,634</u>	<u>41,281</u>	<u>16,593</u>	<u>12,924</u>	<u>11,037</u>

Note:

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

#### **DIVIDENDS**

The Company did not declare any dividends to the Shareholders for the three and twelve-month periods ended December 31, 2010 (2009 - \$247 thousand and \$1.56 million in distributions).

The Board of Directors reviews the Company’s dividend periodically in the context of the Company’s overall profitability, free cash flow, capital requirements and other business needs.

## **NON-GAAP MEASURES**

References to "EBITDA" are to earnings before interest, income taxes, depreciation and amortization and references to "Adjusted EBITDA" are to EBITDA after adjusting for amortization of leasehold inducements. EBITDA is a measure used by many investors to compare issuers on the basis of ability to generate cash flow from operations. Adjusted EBITDA is a measure our management believes facilitates the comparability and analysis of our financial performance. Accordingly, our management believes that EBITDA and Adjusted EBITDA are important supplemental measures in evaluating our performance and in determining whether to invest in Shares. EBITDA and Adjusted EBITDA are not earnings measures recognized by GAAP and do not have standardized meanings prescribed by GAAP and are therefore unlikely to be comparable to similar measures presented by other issuers.

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

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

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

## **INCOME TAXES**

Upon converting Sterling Shoes to a corporation, income taxes are now calculated differently from that of an income fund. See "Critical Accounting Estimates." For the year ended December 31, 2010 there was an income tax recovery of \$1.6 million, compared to a recovery of \$4.6 million last year.

## **TRANSACTIONS WITH RELATED PARTIES**

- (a) The Company paid rent to a company in which Mannie Druker, director and officer of Sterling, has an interest, amounting to \$79 thousand and \$306 for the three and twelve-month periods ended December 31, 2010 (2009 – \$71 thousand and \$296 thousand) respectively.
- (b) The Company purchased equipment from a company in which Mannie Druker, a director and officer of Sterling, has an interest for \$81 thousand and \$141 thousand during the three and twelve-month periods ended December 31, 2010 (2009 – \$48 thousand and \$170 thousand).

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

## **CRITICAL ACCOUNTING ESTIMATES**

The preparation of our financial statements requires us to estimate the effect of several variables that are inherently uncertain. These estimates and assumptions can affect the reported amounts of assets, liabilities, sales and expenses. Management bases its estimates on historical experience and other assumptions, which it believes to be reasonable under the circumstances. Management also evaluates its estimates on an ongoing basis. Our significant accounting policies are described in Note 2 of the Company's financial statements for the three and twelve-month periods ended December 31, 2010. Management believes that the following items represent the Company's critical accounting estimates.

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

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

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

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

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

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

### ***Convertible Debentures***

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

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

## **FUTURE CHANGES IN ACCOUNTING STANDARDS**

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

The Canadian Accounting Standards Board (AcSB) will require all publicly accountable entities to adopt IFRS for interim and annual financial statements relating to fiscal years beginning on or after January 1, 2011. The Company will be required to prepare both current and comparative financial information using IFRS.

The International Accounting Standards Board (“IASB”) is responsible for the development and publication of IFRS standards and has indicated that IFRS standards will continue to change in the coming years. Upcoming changes which could affect Sterling include:

- Provisions & Contingencies
- Financial Statement Presentation

- Leases
- Income taxes
- Financial Instruments
- Revenue.

While the conceptual framework for IFRS and Canadian GAAP are similar, there are significant differences in recognition, measurement and disclosure requirements. The areas that are expected to significantly impact the Company are described above.

## **RISKS AND UNCERTAINTIES**

A detailed discussion of our significant business risks is provided below for the year ended December 31, 2010 and in our 2010 Annual Information Form, both of which can be found at [www.sedar.com](http://www.sedar.com).

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

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

Management cannot estimate the level of growth or contraction for the economy as a whole or for the economy of any particular region or market that we serve. Adverse changes in our financial condition and results of operations may occur as a result of continuing uncertain economic conditions, employment levels, declines in stock markets, contraction of credit availability or other factors affecting economic conditions generally.

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

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

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

There is no assurance that we will be able to successfully execute our strategy and maintain or increase historical sales, profitability or growth rates as there are many factors outside of management control. The inability to successfully execute any material part of our strategic plan could have an adverse effect on our business, financial condition, liquidity and results of operations.

### ***Competition***

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

### ***Foreign Exchange***

Our foreign exchange risk is primarily limited to currency fluctuations between the Canadian and U.S. dollar. Approximately 39% of our inventory purchases in 2010 are made in United States dollars. Although we take into consideration the Canadian/United States dollar exchange rate at the time of specific purchases and are therefore able to factor the applicable exchange rate into our purchasing decision, we are subject to the risk of exchange rate fluctuations between order and sale of goods. From time to time we enter into foreign exchange forward contracts that oblige us to purchase specific amounts of foreign currencies at set future dates at predetermined exchange rates. The contracts are matched with anticipated foreign currency purchases in U.S. dollars from time to time. We enter into the foreign exchange forward contracts to provide a hedge against the risk of losses should the value of the Canadian dollar decline compared to the foreign currency. We do not enter into foreign exchange contracts for speculative or trading purposes. See further discussion under "Financial Instruments".

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

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

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

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

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

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

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

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

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

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

The Credit Facilities each expire on July 31, 2013, subject to extension provisions. The Partnership may need to refinance the Credit Facilities at the conclusion of their term, and there can be no assurance that the Partnership will be able to do so or able to do so on terms that are as favourable as the Credit Facilities. If the Partnership is unable to refinance the Credit Facilities or is only able to refinance the Credit Facilities on less favourable and / or more restrictive terms, this may have a material adverse effect on the Partnership's financial position. In addition, the terms of any new credit facilities may be less favourable or more restrictive than the terms of the Credit Facilities.

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

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

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

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

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

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

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

#### ***Prior Ranking Indebtedness***

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

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

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

#### ***Absence of Covenant Protection***

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

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

The following is a list of certain risk factors relating to the activities of Sterling and the ownership of Sterling common shares:

- The uncertainty of future dividend payments by Sterling and the level thereof Sterling’s dividend policy and the funds available for the payment of dividends from time to time will be dependent upon, among other things, operating cash flow generated by the Company, financial requirements for operations and the execution of Sterling’s growth strategy and the satisfaction of solvency tests imposed by the *Canada Business Corporations Act* for the declaration and payment of dividends; and
- Sterling may make future acquisitions or may enter into financings or other transactions involving the issuance of securities of Sterling which may be dilutive.

**FINANCIAL INSTRUMENTS**

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

Risk from foreign exchange arises as a result of variations in exchange rates between the Canadian and the U.S. dollar. Historically, approximately 35% to 45% of the Company’s product purchases are denominated in U.S. dollars. The Company does not hold or issue financial instruments for trading or speculative purposes. From time to time, the Company enters into contracts to manage the foreign exchange risk associated with anticipated purchases in US dollars.

At December 31, 2010, the Company had forward foreign exchange contracts as follows:

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

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

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

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

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

Our Chief Executive Officer and Chief Financial Officer certified the appropriateness of the financial disclosures in the MD&A and consolidated financial statements for the year ended December 31, 2010. These executives also certified that they are responsible for the design of disclosure controls and procedures and internal control over financial reporting. There have been no changes in internal control over financial reporting during the quarter ended December 31, 2010 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

The Company’s board of directors and Audit Committee reviewed and approved the December 31, 2010 consolidated financial statements and this management’s discussion and analysis prior to its release.

## **FORWARD-LOOKING STATEMENTS**

This MD&A includes forward-looking statements. Forward-looking statements relate to, among other things, anticipated financial performance, business prospects, strategies, market forces, and commitments. Many of these statements can be identified by words such as “believe”, “expects”, “expected”, “will”, “intends”, “projects”, “anticipates”, “estimates”, “continues” or similar words.

We believe the expectations reflecting in such statements are reasonable but no assurance is given that such expectations will be correct. All forward-looking statements are based on our beliefs and assumptions based on information available at the time the assumption was made and on management’s experience and perception of historical trends, current conditions and expected further developments as well as other factors deemed appropriate in the circumstances. In addition to other assumptions made in this MD&A, assumptions have been made in respect of factors such as, but not limited to, the following:

- industry activity levels;
- competitive conditions;
- consumer demand;
- access to capital;
- capital expenditure estimates, plans, schedules and activities;

- tax laws;
- operating performance and risks;
- exchange rates; and
- cost of labour and services.

By its nature, such forward-looking information is subject to various risks and uncertainties that are known and unknown, including general economic conditions and markets and, in particular, the uncertainty of the current economic recovery, the cost and availability of capital, the possibility of deterioration in our working capital position, the impact on our liquidity and interest costs if we were to go offside of the covenants in our debt facilities, our ability to maintain profitability and manage growth, risks associated with leasing and expansion, competition, inventory and sourcing risk, ability to identify and respond to changing consumer fashion preferences, risks associated with international purchasing, reliance on key personnel, dependence on consumer spending, unseasonable weather conditions, uncertainties arising from world events, intellectual property risks, foreign exchange fluctuations on imported merchandise, labour relations, seasonality and fluctuations in cash distributions, fluctuations in distributable cash based on our performance, restrictions on potential growth, future issuances of shares by Sterling or future disposition of shares held by SSI Investments Inc., income tax matters, changes in accounting standards, including the transition to IFRS, and increases in interest rates. These risks are discussed in our most recent annual information form and in this management's discussion and analysis and could cause actual results and experience to differ materially from the anticipated results or other expectations expressed.

Readers are cautioned not to place undue reliance on this forward-looking information, which is given as of the date it is expressed in this annual information form or otherwise, and Sterling Shoes Inc. undertakes no obligation to update publicly or revise any forward-looking information to reflect new events or circumstances, except as explicitly required by securities laws.

## **ADDITIONAL INFORMATION**

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

## **INVESTOR RELATIONS**

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