

STERLING SHOES INC.
(formerly Sterling Shoes Income Fund)
MANAGEMENT'S DISCUSSION AND ANALYSIS
August 10, 2010

The following management's discussion and analysis ("MD&A") should be read in conjunction with the unaudited interim consolidated financial statements and accompanying notes ("Interim Financial Statements") of Sterling Shoes Income Fund (the "Fund") for the three and six month periods ended June 30, 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 former Fund, now Sterling Shoes Inc., 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" and "Adjusted Distributable Cash".

OVERVIEW OF THE FUND

Up to June 30, 2010 the Fund was 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 Fund was established to acquire an 80% interest in Sterling Shoes Limited Partnership ("Sterling Shoes LP"), which had acquired the retail footwear business of SSI Investments Inc. SSI Investments Inc. retained a 20% interest in Sterling Shoes LP.

As at June 30, 2010, there were 5,313,488 units ("Units") of the Fund issued and outstanding. In addition, to provide SSI Investments Inc. with voting rights commensurate with SSI Investments Inc.'s retained interest in Sterling Shoes LP, SSI Investments Inc. held 1,328,372 special voting units of the Fund (equal to the number of Class D LP Units SSI Investments Inc. held in Sterling Shoes LP (the "Class D LP Units")), which entitled the holder to one vote per special voting unit at meetings of unitholders of the Fund ("Unitholders").

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.

CONVERSION TO STERLING SHOES INC.

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

The conversion to a corporation was undertaken in light of the implementation of the tax to be imposed on the taxable income of income funds effective January 1, 2011. As a corporation, the amount of income taxes payable upon the taxable income of 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 Shoes continues to be conducted by Sterling Shoes Limited Partnership, all of the interests in which is owned, directly or indirectly, by Sterling.

The dividend policy of Sterling replaced the distribution policy of the Fund and will be subject to the discretion of the Board of Directors who will take into account the corporation’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.

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 issued and outstanding as at August 10, 2010. 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.

RESIGNATION OF JEREMY HORWITZ AS CEO

Jeremy Horwitz resigned as President and Chief Executive Officer of Sterling Shoes effective June 22, 2010 for personal reasons. Mr. Horwitz also stepped down as a trustee of the Fund and as a director of Sterling Shoes GP Inc.,

Effective June 24, 2010 Rick Mahler, Chair of the board of directors, was appointed as interim CEO of the Company. The board of directors is actively engaged in the recruitment of a new President and CEO for the Company.

OVERVIEW OF OUR BUSINESS

Sterling is a Vancouver-based, leading footwear retailer operating through six separate retail banners: Sterling, Joneve, Shoe Warehouse, Freedman Shoes, Gia and Sterling Outlet. 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 160 stores as at August 10, 2010. 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.

Retail Banner	General Price Range	Products and Consumers	Key Private Label Brands	Key National Brands	
<i>Sterling</i>	\$50 to \$ 140	<ul style="list-style-type: none"> • mid-range women's fashion and comfort footwear • latest fashion trends, current looks • targeted to women between 15 years of age & up 	<ul style="list-style-type: none"> • Roberto Vianni • Joy & Peace • Vianni Collections 	<ul style="list-style-type: none"> • Skechers • Puma • Franco Sarto • Steve Madden • Converse 	<ul style="list-style-type: none"> • Blowfish • DC Skate • Roxy • Kenneth Cole • Rocket Dog
<i>Joneve</i>	\$69 to \$180	<ul style="list-style-type: none"> • mid-high end women's fashion and comfort footwear • fashionable upscale career, comfort and dress shoes • dress, casual and fashion athletic shoes, boots and sandals • targeted to women 20 years of age & up 	<ul style="list-style-type: none"> • Roberto Vianni • Vianni Collections 	<ul style="list-style-type: none"> • Skechers • Puma • Nine West • Franco Sarto 	<ul style="list-style-type: none"> • Guess • Bebe Sport • Steve Madden • Kenneth Cole
<i>Shoe Warehouse</i>	\$19 to \$49 — kids \$39 to \$99 — ladies \$39 to \$99 — mens	<ul style="list-style-type: none"> • value-priced, family footwear products, including fashion, comfort, athletic footwear and work boots • leather and synthetic products representing good value to family-oriented or price-conscious consumers 	<ul style="list-style-type: none"> • Be Wild • Rinaldi • Blizzard • Workers • Urban XT • EC Collections 	<ul style="list-style-type: none"> • Bare Traps • Fila • Rockport • Nike • Kodiak • Sorel 	<ul style="list-style-type: none"> • Skechers • New Balance • Saucony • BOC by Børn
<i>Freedman Shoes</i>	\$90 to \$350	<ul style="list-style-type: none"> • high-end men's and women's fashion and comfort footwear • 95% of products are national brands • wide selection of fittings and sizes • targeted to men and women 25 years of age & up 	<ul style="list-style-type: none"> • Vianni Collections • Roberto Vianni 	<ul style="list-style-type: none"> • Amalfi • Stuart Weitzman • Donald J Pliner • Johnson & Murphy 	<ul style="list-style-type: none"> • Cole Haan • Rockport • DKNY • Franco Sarto
<i>Gia</i>	\$70 to \$360	<ul style="list-style-type: none"> • cutting-edge, funky women's street fashion • fashion-athletic footwear and accessories • 85% of products are national brands 	<ul style="list-style-type: none"> • Vianni Collections 	<ul style="list-style-type: none"> • Guess • Steve Madden • Jessica Simpson • Betsy Johnson • Rocket Dog 	<ul style="list-style-type: none"> • Puma • UGG • Blowfish • BCBG
<i>Sterling Outlet</i>	\$50 to \$ 140	<ul style="list-style-type: none"> • mid-range women's fashion and comfort footwear • latest fashion trends at clearance prices • dress, casual and fashion athletic shoes, boots and sandals • targeted to women between 15 years of age & up 	<ul style="list-style-type: none"> • Roberto Vianni • Vianni Collections • Joy & Peace 	<ul style="list-style-type: none"> • Skechers • Puma • Franco Sarto • Steve Madden 	<ul style="list-style-type: none"> • Kenneth Cole • Converse • Rocket Dog

Sterling, Joneve, Shoe Warehouse, Freedman Shoes, Gia and Sterling Outlet compete with other local, regional and national footwear retailers. The fragmented nature of the Canadian retail footwear industry and our six distinct retail banners means that we compete against a wide variety of participants at various levels of the value chain. Examples of who we believe to be the principal competitors for our Sterling/Joneve/Gia, Shoe Warehouse and Freedman Shoes banners are provided below.

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

We now operate 160 stores across Canada, a significant increase from the 100 stores at the time of our initial public offering in July 2005. In light of the ongoing uncertain economic environment, we have slowed the pace of our expansion. We remain focused on our strategic objective: the right shoe, at the right price, at the right place, in the right quantity. We do so by managing the fundamentals that we control, including: managing purchasing, product mix and inventory, offering excellent customer service, tightening control over expenses and continually evaluating our planned capital expenditures. Additionally, we actively seek ways to improve the efficiency and profitability of our existing stores.

RECENT EVENTS AND OUTLOOK

Economic Conditions and our Recent Performance

Throughout 2009 economic conditions deteriorated in many countries and regions, including Canada. Volatility in financial markets, higher unemployment rates and recessionary conditions resulted in a low level of consumer confidence, increased promotional activity, reductions in consumer spending and weakness in a number of industries in the regions in which we operate. During the first half of 2010 there were some mixed signals of economic recovery. We cannot predict with certainty the strength or timing for full recovery.

Management undertook several initiatives commencing in 2009 in order to bring flexibility to our cost structure including: decreasing inventory levels, changing our product mix, restricting maintenance and capital expenditures, and reducing operating, overhead, administrative and selling costs. Our fourth quarter 2009 results started to reflect the benefit of many of these strategies and we continued to focus on these projects in the first half of 2010. Given the decline in sales, and the pressure on gross margins due to promotional activity in response to our competitive position, we are evaluating how we manage our inventory, including reviewing our product mix and purchasing and planning processes, to strengthen our operational results.

One of the most important strategic initiatives we have undertaken is the significant investment in our information technology systems. We are planning to go live with this system in 2010.

Highlights for the three-month and six-month periods ended June 30, 2010 are summarized below:

- Gross margin as a percentage of sales increased to 46.7% during the three-month period ended June 30, 2010, compared to 45.6% during the same period in 2009. Changes in product mix and the strengthening of the Canadian dollar contributed to this performance;
- Gross margin for the six-month period ended June 30, 2010 increased to 48.5% as a percentage of sales compared to 44.5% in 2009;
- EBITDA decreased by \$878 thousand to \$55 thousand (0.2% as a percentage of sales), during the three-month period ended June 30, 2010 compared to an EBITDA of \$933 thousand (2.2% as a percentage of sales) during the same period in 2009;

- EBITDA rose by \$696 thousand to \$683 thousand (1.2% as a percentage of sales), during the six-month period ended June 30, 2010 compared to a negative EBITDA of \$13 thousand (-0.02% as a percentage of sales) during the same period in 2009;
- On June 24, 2010 the Fund's unitholders unanimously approved the conversion to a corporate entity, which was completed July 1, 2010;
- In early July 2010, the Company renewed its credit facilities with Bank of Montreal for a 3 year term;
- Development testing and training for the new information technology system continued with implementation targeted late 2010.

Number of Stores

During the second quarter of 2010, we closed one underperforming store. Currently we have two new store commitments for 2010. We have slowed store expansion in light of the uncertain economic conditions. 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 160 stores operate under six retail banners in British Columbia, Alberta, Saskatchewan, Manitoba and Ontario as follows:

Number of Stores Operating														
August 10, 2010								Dec 31, 2009	Dec 31, 2008	Dec 31, 2007	Dec 31, 2006	Dec 31, 2005	July 12, 2005	
Province	Shoe					Sterling		Total	Total	Total	Total	Total	Total	Total
	Warehouse	Sterling	Joneve	Freedman	Gia	Outlet								
British Columbia	39	20	6	8	2	-	75	76	75	65	63	60	59	
Alberta	15	9	2	-	-	1	26	27	26	25	25	24	24	
Saskatchewan	2	2	-	-	-	-	4	4	4	3	3	4	4	
Manitoba	9	3	-	-	-	-	12	12	12	12	11	11	11	
Ontario	12	23	6	2	-	-	43	43	43	36	25	5	2	
Total	77	57	14	10	2	1	160	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. expects to apply the following optional exemption:

Borrowing Cost:

Sterling Shoes Inc. must include borrowing costs in the capitalized costs of a qualifying asset per IAS 23. In accordance with IRFS 1, Sterling Shoes Inc. has elected to prospectively apply IAS 23 effective 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.

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

- Due to the implementation of IFRS, Sterling Shoes Inc. is required, among other things, to
 - Calculate the value-in-use of the cash generating units to which the intangible assets belong.
 - Track depreciation of fixed assets on a component basis.
 - Include borrowing costs in the cost of assets under construction, in the future.
- These new policies differ from the existing policies, and additional controls have been designed and implemented to ensure that the recorded balance appropriately recorded in accordance with IFRS. Such controls include the use of senior management oversight on the development of key assumptions, additional accounting system changes and valuation methodologies.

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

- We are in the process of identifying key disclosures under IFRS and additional controls are currently being designed and implemented to ensure proper disclosures in the areas of accounting policies, critical accounting judgments and key sources of estimation uncertainty, leasehold & equipment, intangible assets, bank indebtedness, commitments, related party transactions, taxation, inventories, trade receivables, trade and other payable, subsidiaries and earnings per share.

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

- We engaged additional 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 addition they receive briefings from auditors & management.
- Sterling Shoes Inc. has engaged its auditors, Deloitte, 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 involves 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. Areas of key differences identified include: property, plant and equipment (PP&E) and intangible assets.
- Impact analysis and design phase — in this phase, each area identified from the scoping and diagnostic phase will be addressed. This phase will determine the impact of the conversion on existing accounting policies, information systems, business processes and internal controls over financial reporting and disclosure. This phase will include an analysis of policy alternatives allowed under IFRS and development of draft IFRS financial statement content. This phase is nearing completion. Parallel second quarter 2010 IFRS

financial statements are expected to be completed in September 2010 and will be presented to the Board at that time. Some aspects of this phase were addressed prior to the end of fiscal 2009.

- Implementation and review phase — this phase will include execution of changes to information systems and business processes, completing formal authorization processes to approve recommended accounting policy changes and conducting training programs. The ultimate objective being able to provide IFRS compliant financial information. Sterling has completed the first draft of its IFRS financial statements and notes and plans to present parallel statements and notes to its audit committee for the third and fourth quarters 2010.

Accounting Policy – Impact of IFRS on the current accounting policies:

The following discussion relates to key differences identified in the significant accounting policies:

1. Impairment of assets

Under Canadian GAAP generally a two-step approach to impairment testing is performed: firstly, the asset carrying value is compared with its undiscounted future cash flow to determine whether an impairment exists. The impairment is then measured by comparing asset carrying value with its fair value. IAS 36 - *Impairment of Assets*, requires the application of a one-step approach for both testing for and measuring impairment, with asset carrying values compared directly with the higher of fair value less costs to sell and value in use and includes the use of discounted cash flows, when a cash flow model is used. Management will be responsible to determine its best estimates on assumptions applicable to such discounted cash flows, which may give rise to different results under different circumstances. Applying IAS 36 can result in more write-downs in cases where the carrying values of assets may have previously been supported under Canadian GAAP on an undiscounted cash flow basis but could not be supported on a discounted cash flow basis. IFRS also requires the reversal of impairments for property, plant and equipment if conditions that gave rise to those impairments no longer exist. It is expected that there may be increased volatility in impairment recognition due to the possibility of more frequent impairments and the reversal of impairments.

We are in the process of quantifying the impact on transition.

SUMMARY FINANCIAL INFORMATION

Statement of Income Items (\$000's)	Three months ended June 30		Six months ended June 30	
	2010	2009	2010	2009
Sales	\$ 28,606	30,618	55,461	58,290
Cost of Sales	(15,234)	(16,667)	(28,571)	(32,341)
Gross Margin	13,372	13,951	26,890	25,949
<i>As a percentage of sales</i>	46.7%	45.6%	48.5%	44.5%
Store and selling expenses	(11,057)	(11,364)	(22,203)	(22,620)
General and administrative expenses	(2,261)	(1,654)	(4,004)	(3,342)
EBITDA ⁽¹⁾	55	933	683	(13)
Adjusted EBITDA ⁽¹⁾	55	683	683	(451)
<i>As a percentage of sales</i>	0.2%	2.2%	1.2%	-0.8%
Interest expense	(659)	(644)	(1,302)	(1,296)
(Loss) / Gain on disposal	(218)	(168)	(218)	(232)
Amortization	(932)	(772)	(1,878)	(1,535)
Income / (Loss) before taxes	(1,754)	(651)	(2,715)	(3,076)
Future income taxes	-	-	-	-
Net income / (loss)	(1,754)	(651)	(2,715)	(3,076)
Maintenance capital expenditures	541	527	759	1,129

Balance Sheet Items (\$000's)	June 30 2010	December 31, 2009
Total assets	72,364	77,165
Long-term financial liabilities	27,077	26,941

Notes:

- (1) See definition of EBITDA, Adjusted EBITDA and Maintenance Capital Expenditures under "Non-GAAP Measures".

OPERATING RESULTS

Sales

Sales were \$28.6 million during the three-month period ended June 30, 2010, representing a decrease of 6.6% over the \$30.6 million in 2009. We experienced same-store sales decline of 6.2% for the three-months period ended June 30, 2010. For the six-month period ended June 30, 2010, sales were \$55.4 million compared to \$58.3 million in 2009 representing a 4.9% decline. During the six-month period ended June 30, 2010 same store sales declined by 7.0%. Given the decline in sales, and the pressure on gross margins due to promotional activity in response to our competitive position, we are evaluating how we manage our inventory, including reviewing our product mix and purchasing and planning processes, to strengthen our operational results.

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 buyers, retail store management and personnel, as well as other factors further outlined in "Risks and Uncertainties".

Cost of sales and gross margin

Cost of sales as a percentage of sales for the three-month and six-month periods ended June 30, 2010 was 53.3% and 51.5%, compared to 54.4% and 55.5% respectively for the same period during 2009.

Cost of sales was also positively impacted by the appreciation of the Canadian dollar versus the US dollar compared to the first half of 2009. Substantially all footwear sold in Canada is manufactured outside of Canada. Consequently, the cost of substantially all of our purchases is exposed to currency fluctuations either directly or indirectly. During the six-month period ended June 30, 2010, approximately 43% of product purchases were denominated in U.S. dollars. During the quarter ended June 30, 2010 the Canadian dollar was worth approximately 10% more against the U.S. dollar than during the same period in 2009. This has decreased purchase prices, inventory valuation and cost of sales.

For the three-month period ended June 30, 2010 gross margin as a percentage of sales increased to 46.7% compared to 45.6% during the same period in 2009. For the six-month period ended June 30, 2010 gross margin as a percentage of sales increased to 48.5% compared to 44.5% during the same period in 2009. We were able to increase gross margins during the three and six-month periods ended June 30, 2010 due in part to management initiatives taken to improve inventory turnover and make room for higher margin inventory.

During the second quarter we continued a high level of promotional activity to generate sales, clear inventory and respond to competitive forces. This promotional activity reduced the positive impact from other improvements in gross margins in the quarter.

Store and selling expenses

Store and selling expenses for the three and six-months ended June 30, 2010 were 38.7% and 40.0% of sales, compared to 37.1% and 38.8% 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 decreased by \$307 thousand and \$417 thousand for the three-month and six-month periods ending June 30, 2010 as a result of management's actions to reduce costs in managing the business through the current economic volatility. However the overall effect as a percentage of sales was nullified by the decrease in sales in the first half of 2010.

General and administrative expenses

General and administrative ("G&A") expenses for the three and six-months ended June 30, 2010 were 7.9% and 7.2% of sales, compared to 5.4% and 5.7% during the same periods in 2009, respectively.

G&A expenses have increased \$607 thousand in the three months ended June 30, 2010 due to non-recurring items such as the costs of conversion to a corporate entity, executive search fees incurred for recruiting a new CEO, and additional costs required to support the legacy system while the new information technology system is being implemented. These costs added approximately \$500 thousand to G&A costs during the second quarter.

EBITDA (see "Non-GAAP Measures")

EBITDA for the three and six-months ended June 30, 2010 was 0.2% and 1.2% of sales, respectively, compared to 3.0% and nil% for the same periods during 2009.

Without the aforementioned non-recurring G&A expenses noted above, EBITDA for the three and six-month periods ended June 30, 2010 would be 1.9% and 2.1% of sales.

Interest expense

Net interest expense with respect to funds utilized under the credit facilities for the three-month and six-months ended June 30, 2010 was \$62 thousand and \$121 thousand respectively, compared to \$71 thousand and \$156 thousand in 2009.

Interest expense with respect to the convertible debentures for the three-month and six-month periods ended June 30, 2010 was \$597 thousand and \$1.2 million (2009 - \$573 thousand and \$1.1 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-month and six-months ended June 30, 2010 was \$185 thousand and \$364 thousand (2009 - \$167 thousand and \$327 thousand), respectively, relating to this interest accretion.

Inventory

During 2009 and into 2010 management reduced inventory levels and adapted product mix in response to market conditions. At June 30, 2010, on a valuation basis, we had \$2.3 million, or 5.8% less inventory than at June 30, 2009.

We are currently working on major enhancements to our information technology systems which we believe will add to our ability to more effectively manage inventory in our business. We have made significant strides in the project and we are working diligently towards project completion in late 2010.

SELECTED QUARTERLY FINANCIAL INFORMATION

in (\$000's) except per Unit amounts	Q2-2010	Q1-2010	Q4-2009	Q3-2009	Q2-2009	Q1-2009	Q4-2008	Q3-2008	Q2-2008
Sales	\$ 28,606	\$ 26,855	\$ 41,195	\$ 31,685	\$ 30,618	\$ 27,672	\$ 42,520	\$ 33,895	\$ 29,405
(Loss) / Income before non-controlling interest and taxes ⁽¹⁾	\$ (1,754)	\$ (961)	\$ 6,238	\$ (35,432)	\$ (651)	\$ (2,428)	\$ 6,453	\$ 1,402	\$ 866
Future income taxes				4,636					
(Loss) / Income before non-controlling interest ⁽¹⁾	\$ (1,754)	\$ (961)	\$ 6,238	\$ (30,796)	\$ (651)	\$ (2,428)	\$ 6,453	\$ 1,402	\$ 866
Net (Loss) / Income	\$ (1,754)	\$ (961)	\$ 6,238	\$ (30,796)	\$ (651)	\$ (2,428)	\$ 6,453	\$ 1,402	\$ 866
Basic (loss) / income per Unit	\$ (0.264)	\$ (0.145)	\$ 0.939	\$ (4.637)	\$ (0.098)	\$ (0.366)	\$ 0.972	\$ 0.211	\$ 0.130
Diluted (loss) / income per Unit	\$ (0.264)	\$ (0.145)	\$ 0.820	\$ (4.637)	\$ (0.098)	\$ (0.366)	\$ 0.897	\$ 0.211	\$ 0.130
Cash distributions per Unit	\$ 0.000	\$ 0.000	\$ 0.037	\$ 0.056	\$ 0.056	\$ 0.085	\$ 0.192	\$ 0.375	\$ 0.375
Number of stores open at end of period	160	161	162	162	161	159	160	158	148

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.

In any given period, weather can have a material impact on our business. As we become more geographically diversified, we expect weather-related effects will become less significant.

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-month and six-month periods ended June 30, 2010 and 2009.

Sterling Shoes Income Fund
Reconciliation of Net Income to Cash provided by operations
June 30, 2010

in (\$000's)	Three-months ended Jun 30		Six-months ended Jun 30	
	2010	2009	2010	2009
Net loss	\$ (1,754)	(651)	(2,715)	(3,076)
Add charges (deduct credits) to operations not requiring a cash payment:				
Future income taxes	-	-	-	-
Amortization of leaseholds and equipment	932	772	1,878	1,535
Accreted interest expense	185	167	363	327
Amortization of deferred leasehold inducements	(131)	(250)	(226)	(438)
Loss on disposal of leaseholds and equipment	218	168	218	232
	(549)	206	(482)	(1,420)
Net change in non-cash working capital balances related to operations:				
Accounts receivable	323	151	76	572
Inventory	4,259	5,087	(459)	707
Revaluation of inventory per CICA Handbook Section 3031	-	-	-	-
Prepaid expenses and deposits	(22)	170	(70)	48
Accounts payable and accrued liabilities	(3,574)	(5,046)	(2,222)	42
Cash provided by / (used in) operating activities	\$ 436	568	(3,157)	(51)

For the three-month period ended June 30, 2010, cash provided by operations was \$0.4 million as compared to \$0.6 million in the same period of 2009. Similarly, cash used in operations was \$3.2 million for the six-month period ended June 30, 2010 as compared to \$51 thousand for the same period in 2009. Cash used in operations was impacted by the shift in product mix and different payment terms associated with private label product versus branded product.

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-month and six-month periods ended June 30, 2010 generally reflected these expectations.

Capital Expenditures

We have not opened any stores during 2010. Consequently we did not make any investment in leaseholds and equipment to furnish new stores during the three-month and six-month periods ended June 30, 2010 (2009 - \$0.5 million and \$1.0 million respectively). We incurred maintenance capital expenditures of \$0.5 million and \$ 0.8 million during the three-month and six-month periods ended June 30, 2010 (2009 - \$0.5 million and \$1.1 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 was repayable on October 31, 2010. This facility has been renewed and will expire on July 31, 2013 as described below. As at June 30, 2010, we had no utilization of the Operating Loan.

We have utilized our \$5 million credit facility (the "Term Loan") for general funding of capital expenditures, including new store facilities. The Term Loan was to mature on October 31, 2010, which term has been renewed to July 31, 2013 as described below.

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. The facilities may in certain circumstances restrict our ability to pay distributions, including limiting distributions unless sufficient funds are available for the repayment of indebtedness and the payment of interest expenses. At June 30, 2010, we were in compliance with all covenants of these credit facilities.

On July 6, 2010 we extended our credit facilities described above for a 3 year term. The terms providing for the amount, purpose, availability and margin of the Operating Loan and Term Loan remain the same. Interest rates and fees have been changed to reflect market conditions precedent at the time. The changes to the interest rate and fee pricing grid represent improvements over the previous pricing grid.

The Term Loan begins amortizing upon renewal of the credit facilities, with repayment terms

calling for quarterly principal payments of \$250,000, plus interest, to effect a 5 year amortization. The first payment will be made on September 30, 2010.

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 June 30, 2010, letters of credit totaling \$2.46 million are outstanding. The last of these letters of credit expires on November 20, 2010 for \$133 thousand. 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 remainder of the current fiscal year and over the next four fiscal periods, in thousands of dollars:

in \$000's	2010	2011	2012	2013	2014
Inventory purchase commitments	2,464				
Long-term debt			25,000		
Operating and Term Loans	5,000				
Minimum rental commitments ⁽¹⁾	7,763	14,892	14,202	12,974	11,014
	15,227	14,892	39,202	12,974	11,014

Note:

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

DISTRIBUTABLE CASH AND DISTRIBUTIONS

In past fiscal years Sterling Shoes LP and the Fund made distributions of available cash to the maximum extent possible to the Unitholders and the non-controlling interest. This included the distribution of all available cash from operations after cash required for maintenance capital expenditures, and after consideration of changes in non-cash working capital balances and other reserves considered advisable.

The Fund also made additional distributions in excess of monthly distributions. Distributions declared in respect of the month ended December 31 of each year included such amounts as were necessary to ensure that the former Fund would not be liable for income taxes under Part I of the Tax Act.

In response to negative market conditions, we announced a suspension of distribution payments beginning with the December 2009 distribution. On April 22, 2010, we announced that the Trustees determined to continue the previously announced suspension of distributions by the former Fund for the balance of 2010.

With the conversion to a corporation completed, the dividend policy of Sterling is subject to the discretion of the Board of directors who will take into account the corporation's current and anticipated business needs and financial condition at the time the dividend is being considered. Currently no dividends are paid on the Company's common shares.

ADJUSTED DISTRIBUTABLE CASH

On July 6, 2007 the Canadian Securities Administrators (“CSA”) amended National Policy 41-201 “Income Trusts and Other Indirect Offerings” (the “CSA Guidance”). The former Fund had calculated Standardized Distributable Cash based on the CSA Guidance as cash flows from operating activities, including the effects of changes in non-cash working capital, less sustaining (maintenance) capital expenditures. The former Fund has also retained the historical Non-GAAP measure of Adjusted Distributable Cash (formerly Distributable Cash) by further adjusting Standardized Distributable Cash to exclude the effect of changes in non-cash working capital. The table below is a summary of Standardized Distributable Cash and Adjusted Distributable Cash and per Unit and Ratio disclosures for the three-month and six-month periods ended June 30, 2010.

in \$000's except per unit amounts and payout ratios	Three-months ended Jun 30		Six-months ended Jun 30	
	2010	2009	2010	2009
Standardized Distributable Cash				
Cash used in operating activities	\$ 436	\$ 568	\$ (3,157)	\$ (51)
Less: Maintenance Capital Expenditures	(541)	(527)	(759)	(1,129)
Standardized distributable cash generated	\$ (105)	\$ 41	\$ (3,916)	\$ (1,180)
Less: Changes in non-cash working capital balances related to operations	985	362	(2,675)	1,369
Adjusted distributable cash generated	\$ (1,090)	\$ (321)	\$ (1,241)	\$ (2,549)
Adjusted Distributable Cash available for distribution to Unitholders	\$ (1,090)	\$ (321)	\$ (1,241)	\$ (2,549)
Adjusted Distributable Cash generated per Unit	\$ (0.164)	\$ (0.048)	\$ (0.187)	\$ (0.384)
Distributions declared per Unit	\$ -	\$ 0.056	\$ -	\$ 0.141
Adjusted Payout Ratio	0.0%	-115.6%	0.0%	-36.8%
Number of units outstanding:	6,641,860	6,641,860	6,641,860	6,641,860

Management believes that the Standardized Distributable Cash calculation introduces significant volatility to the former Fund’s quarter-to-quarter distributable cash and payout ratios, as our non-cash working capital fluctuates significantly as a result of the seasonality of our business, changes in the timing of the payment of payable transactions and the investment in working capital required to open new stores. As a result, management believes our historical measure of Adjusted Distributable Cash, which excludes the impact of changes in non-cash working capital, is a better measure for determining our operating performance.

The Fund’s Board looks beyond quarter-to-quarter fluctuations in working capital when making decisions regarding monthly distributions. As mentioned earlier, the policy has been to make distributions to its former Unitholders necessary to pay out the former Fund’s taxable income. The adjusted payout ratio for the trailing twelve months ended June 30, 2010 was 18.9%, as compared to 80% for the twelve months ended June 30, 2009.

As noted under “Recent Events and Outlook”, we announced a suspension of distribution payments, for the remainder of 2010, in order to further strengthen our balance sheet and increase our operating flexibility.

Cash distributions have been made as follows:

Distribution History Year / Month	Distributions per Unit	Distribution History Year / Month	Distributions per Unit	Distribution History Year / Month	Distributions per Unit
2005		2006		2007	
		January	\$ 0.08958	January	\$ 0.12000
		February	0.08958	February	0.12000
		March	0.08958	March	0.12000
		April	0.08958	April	0.12000
		May ⁽³⁾	0.10500	May	0.12000
		June	0.10500	June	0.12000
		July	0.10500	July	0.12000
		August	0.10500	August	0.12000
July / August ⁽¹⁾	\$ 0.14737	September	0.10500	September	0.12000
September	0.08958	October	0.10500	October	0.12000
October	0.08958	November ⁽⁴⁾	0.12000	November	0.12000
November	0.08958	December	0.12000	December	0.12000
December	0.08958	December ⁽⁵⁾	0.32000	December ⁽⁷⁾	0.36000
December ⁽²⁾	0.16000	December ⁽⁶⁾	0.15000	December ⁽⁸⁾	0.06000
Total 2005	\$ 0.66569	Total 2006	\$ 1.69832	Total 2007	\$ 1.86000

Distribution History Year / Month	Distributions per Unit	Distribution History Year / Month	Distributions per Unit	Distribution History Year / Month	Distributions per Unit
2008		2009		2010	
January ⁽⁹⁾	\$ 0.12500	January	\$ 0.03333	January	\$ nil
February	0.12500	February	0.03333	February	nil
March	0.12500	March ⁽¹¹⁾	0.01862	March	nil
April	0.12500	April	0.01862	April ⁽¹³⁾	nil
May	0.12500	May	0.01862	May	nil
June	0.12500	June	0.01862	June ⁽¹⁴⁾	nil
July	0.12500	July	0.01862		
August	0.12500	August	0.01862		
September	0.12500	September	0.01862		
October ⁽¹⁰⁾	0.12500	October	0.01862		
November	0.03333	November	0.01862		
December	0.03333	December ⁽¹²⁾	nil		
Total 2008	\$ 1.31667	Total 2009	\$ 0.23424	Total year-to-date 2010	\$ nil

Notes:

- (1) The former Fund made its initial distribution of \$0.14737 per Unit for the 51-day period from July 12, 2005 to August 31, 2005.
- (2) On December 13, 2005 the former Fund announced a special distribution of \$0.16 per Unit to Unitholders of record on December 30, 2005, representing the former Fund's estimate of the distribution required to ensure the former Fund was not liable for income taxes under Part I of the Tax Act for fiscal 2005. \$0.16 per Unit, the former Fund's estimate of this amount, was paid on January 16, 2006 to former Unitholders of record on December 30, 2005.
- (3) Effective May 1, 2006 the former Fund raised its monthly distribution by 17.2% from \$0.08958 per Unit to \$0.105 per Unit.
- (4) Effective November 1, 2006 the former Fund raised its monthly distribution by 14.3% from \$0.105 per Unit to \$0.12 per Unit.

- (5) On December 18, 2006 the former Fund announced a special distribution of \$0.32 per Unit to Unitholders of record on December 29, 2006, representing the former Fund's estimate of the distribution required to ensure the former Fund was not liable for income taxes under Part I of the Tax Act for fiscal 2006. This amount was paid on January 15, 2007 to former Unitholders of record on December 29, 2006.
- (6) On March 22, 2007 the former Fund announced a supplementary special distribution of \$0.15 per Unit to Unitholders of record on December 29, 2006, representing the former Fund's remaining distribution required to ensure the former Fund was not liable for income taxes under Part I of the Tax Act for fiscal 2006. The \$0.15 per Unit supplementary special is in addition to the \$0.32 per Unit that was estimated at December 18, 2006 and paid on January 15, 2007. The \$0.15 per Unit was paid on March 30, 2007 to Unitholders of record on December 29, 2006.
- (7) On December 17, 2007 the former Fund announced a special distribution of \$0.36 per Unit to Unitholders of record on December 31, 2007, representing the former Fund's estimate of the distribution required to ensure the former Fund was not liable for income taxes under Part I of the Tax Act for fiscal 2007. This amount was paid on January 15, 2008 to Unitholders of record on December 31, 2007.
- (8) On March 26, 2008 the former Fund announced a supplementary special distribution of \$0.06 per Unit to Unitholders of record on December 31, 2007, representing the former Fund's remaining distribution required to ensure the former Fund was not liable for income taxes under Part I of the Tax Act for fiscal 2007. The \$0.06 per Unit supplementary special is in addition to the \$0.36 per Unit that was estimated at December 17, 2007 and paid on January 15, 2008. The \$0.06 Unit was paid on March 31, 2008 to Unitholders of record on December 31, 2007.
- (9) Effective January 1, 2008 the former Fund raised its monthly distribution by 4.2% from \$0.12 per Unit to \$0.125 per Unit.
- (10) Effective November 1, 2008 the former Fund reduced its monthly distribution by 73% from \$0.125 per Unit to \$0.03333 per Unit.
- (11) Effective March 1, 2009 the former Fund reduced its monthly distribution by 44% from \$0.03333 per Unit to \$0.01862 per Unit.
- (12) Effective December 1, 2009 the former Fund suspended its monthly distributions from \$0.01862 to \$Nil per Unit.
- (13) On April 22, 2010 the former Fund suspended distributions for the remainder of 2010.
- (14) On June 24, 2010 the former Fund's unitholders voted in favor of a plan of arrangement to convert the former Fund into a corporate entity. The conversion was effective July 1, 2010

When declared, distributions were paid on the 15th of each month, or the next following business day, to former Unitholders of record on the last business day of the preceding month.

The Fund did not declare any distributions to the Unitholders for the three-month and six-month periods ended June 30, 2010 (2009 - \$371 thousand and \$937 thousand).

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 Units. 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.

FUTURE INCOME TAXES

On October 31, 2006, the Minister of Finance announced proposed changes to the income tax treatment of “flow-through entities”, including income trusts. On June 22, 2007 the Government of Canada enacted new legislation imposing a tax on distributions paid by publicly traded income trusts in Canada, commencing in 2011. Unitholders will be treated as if they have received an eligible dividend from a Canadian public corporation equal to the taxable portion of their distributions and will be taxed accordingly.

Prior to June 22, 2007, the Fund calculated its future income tax on certain temporary differences between amounts recorded on its balance sheet for book and tax purposes at a nil tax rate. Under the newly enacted legislation, the tax rate on the post-2010 reversal of these temporary differences is estimated to be 27.5%. Temporary differences reversing prior to December 31, 2010 will still give rise to nil future income taxes.

However, the Fund’s identifiable intangible assets, recorded on the balance sheet at \$16.6 million, (but which have nil basis for tax purposes), are treated as a temporary difference that will reverse after July 1, 2010.

The result of this treatment was a future income tax liability of \$7.7 million created during the second quarter of 2007. This future income tax liability was based on the expected tax rate of 31.5% and the assumption that the Fund would be a taxable entity in 2011. Based on the currently enacted tax rate of 27.5%, and the same assumptions, the Fund revised this future income tax liability during the first quarter of 2008 to \$7.0 million. As at December 31, 2009 the impairment of intangible assets further reduced the Fund’s expected future income tax liability with a future income tax recovery of \$4.6 million. For the six-months ended June 30, 2010 there were no further income tax recoveries, and there is a remaining future income tax liability estimated at \$2.4 million based on the temporary differences between the accounting and tax basis of assets and liabilities expected to reverse after January 1, 2011.

In future periods, adjustments to this future tax liability may be required based on changes in the differences between the tax basis and financial statement basis of assets and liabilities. These adjustments could be material. Consistent with the initial recognition, any future adjustments will be non-cash in nature and will be either a charge or an addition to net income of the period.

TRANSACTIONS WITH RELATED PARTIES

- (a) The Fund paid rent to a company in which Mannie Druker, trustee and officer of the Fund, has an interest, amounting to \$74 thousand and \$148 for the three-month and six-month periods ended June 30, 2010 (2009 – \$71 thousand and \$142 thousand) respectively.
- (b) The Fund purchased equipment from a company in which Mannie Druker, a trustee and officer of the Fund, has an interest, for \$7 thousand and \$13 thousand during the three-month and six-month periods ended June 30, 2010 (2009 – \$57 thousand and \$115 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 former Fund's financial statements for the three-month and six-month periods ended June 30, 2010. Management believes that the following items represent the former Fund'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 10.7%. 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 former Fund will be required to prepare both current and comparative financial information using IFRS.

In January 2010, the AcSB added IFRS to Part I of the Handbook. Part I includes:

- an introduction
- the “Framework for the Preparation and Presentation of Financial Statements”
- the IFRSs in effect at December 31, 2009; and
- amendments, reviews and new IFRSs issued at December 31, 2009 but not yet effective, except for IFRS 9 Financial Instruments.

In April 2010, the introduction to Part I was amended to clarify that it should be read in conjunction with the “Preface to the CICA Handbook – Accounting”, which defines the various categories of reporting entity and specifies which Part of the Handbook applies to each category.

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 former Fund are described above.

The financial impact of the transition to IFRS cannot be reasonably estimated at this time.

(ii) Handbook Section 1582, Business Combinations (“Section 1582”)

Section 1582 replaces Handbook Section 1581 of the same title. It provides the Canadian equivalent to corresponding sections of IFRS.

Section 1582 applies prospectively to business combinations for which the acquisition date is on or after January 1, 2011 with early adoption permitted. This section improves the relevance, reliability, and comparability of the information that a reporting entity provides in its financial statements about a business combination. Adoption of this standard is not expected until January 1, 2011. The former Fund had not yet determined the impact of the adoption of this new Section on the consolidated financial statements.

(iii) Handbook Section 1601, Consolidated Financial Statements (“Section 1601”) and Handbook Section 1602, Non-controlling Interests (“Section 1602”)

Sections 1601 and 1602 replace Handbook Section 1600, Consolidated Financial Statements and apply to fiscal years beginning on or after January 1, 2011, with early adoption permitted. Section 1601 establishes standards for the preparation of consolidated financial statements. Section 1602 establishes standards for accounting for a non-controlling interest in a subsidiary in consolidated financial statements subsequent to a business combination. An entity which adopts Section 1582, 1601, or 1602 early also adopts the other two sections at the same time. Adoption of this standard is not expected until January 1, 2011. The former Fund had not yet determined the impact of the adoption of this new Section on the consolidated financial statements.

RISKS AND UNCERTAINTIES

A detailed discussion of our significant business risks is provided in the MD&A for the year ended December 31, 2009 and in our 2010 Annual Information Form, both of which can be found at www.sedar.com. There were no changes to our significant business risks during the six months ended June 30, 2010 other than as set out below:

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 as 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 former Fund's product purchases are denominated in U.S. dollars. The former Fund does not hold or issue financial instruments for trading or speculative purposes. From time to time, the former Fund enters into contracts to manage the foreign exchange risk associated with anticipated purchases in US dollars.

At June 30, 2010, the former Fund had forward foreign exchange contracts as follows.

Settlement dates	Face Value \$US	Average rate \$Cdn
July 2010	2,150	1.012
August 2010	2,350	1.010
September 2010	2,625	1.010
October 2010	2,250	1.013

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 interim Chief Executive Officer and Chief Financial Officer certified the appropriateness of the financial disclosures in the interim MD&A and unaudited interim consolidated financial statements for the period ended June 30, 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 June 30, 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 June 30, 2010 unaudited interim 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 potential impact of the current economic downturn, the cost and availability of capital, the possibility of deterioration in our working capital position, the impact on our liquidity 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 Fund's Annual Information Form and other public filings, are available on SEDAR (www.sedar.com) and on our website at www.SterlingShoesInc.com.

INVESTOR RELATIONS

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