

**STERLING SHOES INCOME FUND**  
**MANAGEMENT'S DISCUSSION AND ANALYSIS**  
**May 11, 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-month period ended March 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 Fund 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**

The Fund is an unincorporated, open-ended; limited-purpose trust established under the laws of the Province of British Columbia pursuant to the declaration of trust dated May 31, 2005. The 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., previously named Sterling Shoes Inc. ("Inc"). Inc retained a 20% interest in Sterling Shoes LP.

As at May 11, 2010, there were 5,313,488 units ("Units") of the Fund issued and outstanding. In addition, to provide Inc with voting rights commensurate with Inc's retained interest in Sterling Shoes LP, Inc holds 1,328,372 special voting units of the Fund (equal to the number of Class D LP Units Inc holds in Sterling Shoes LP (the "Class D LP Units")), which entitle the holder to one vote per special voting unit at meetings of unitholders of the Fund ("Unitholders").

Distributions on the Class D LP Units were subordinated and the Class D LP Units themselves were not exchangeable for Units of the Fund until the Subordination End Date. As a result of the Fund achieving a specified EBITDA target for the year ended December 31, 2007 and distribution target for each of the fiscal years ended December 31, 2007 and 2006, the Subordination End Date occurred on March 31, 2008. Consequently, the Class D LP Units became freely exchangeable for Units on a one-for-one basis and were reclassified from non-controlling interest to unitholders' equity in 2008. The distributions on the Class D LP Units are no longer subordinated and are made monthly, instead of quarterly.

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.

The Units trade on the Toronto Stock Exchange under the symbol SSI.UN and the Debentures trade under the symbol SSI.DB.

## OVERVIEW OF OUR BUSINESS

The Fund 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 (formerly carried on by Sterling Shoes Inc.) has grown from five locations to 160 stores as at May 11, 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"> <li>• mid-range women's fashion and comfort footwear</li> <li>• latest fashion trends, current looks</li> <li>• targeted to women between 15 years of age &amp; up</li> </ul>	<ul style="list-style-type: none"> <li>• Roberto Vianni</li> <li>• Joy &amp; Peace</li> <li>• Gianni Collections</li> </ul>	<ul style="list-style-type: none"> <li>• Skechers</li> <li>• Puma</li> <li>• Franco Sarto</li> <li>• Steve Madden</li> <li>• Converse</li> <li>• Blowfish</li> <li>• DC Skate</li> <li>• Roxy</li> <li>• Kenneth Cole</li> <li>• Rocket Dog</li> </ul>
<i>Joneve</i>	\$69 to \$180	<ul style="list-style-type: none"> <li>• mid-high end women's fashion and comfort footwear</li> <li>• fashionable upscale career, comfort and dress shoes</li> <li>• dress, casual and fashion athletic shoes, boots and sandals</li> <li>• targeted to women 20 years of age &amp; up</li> </ul>	<ul style="list-style-type: none"> <li>• Roberto Vianni</li> <li>• Gianni Collections</li> </ul>	<ul style="list-style-type: none"> <li>• Skechers</li> <li>• Puma</li> <li>• Nine West</li> <li>• Franco Sarto</li> <li>• Guess</li> <li>• Bebe Sport</li> <li>• Steve Madden</li> <li>• Kenneth Cole</li> </ul>
<i>Shoe Warehouse</i>	\$19 to \$49 — kids \$39 to \$99 — ladies \$39 to \$99 — mens	<ul style="list-style-type: none"> <li>• value-priced, family footwear products, including fashion, comfort, athletic footwear and work boots</li> <li>• leather and synthetic products representing good value to family-oriented or price-conscious consumers</li> </ul>	<ul style="list-style-type: none"> <li>• Be Wild</li> <li>• Rinaldi</li> <li>• Blizzard</li> <li>• Workers</li> <li>• Urban XT</li> <li>• EC Collections</li> </ul>	<ul style="list-style-type: none"> <li>• Bare Traps</li> <li>• Fila</li> <li>• Rockport</li> <li>• Nike</li> <li>• Kodiak</li> <li>• Sorel</li> <li>• Skechers</li> <li>• New Balance</li> <li>• Saucony</li> <li>• BOC by Børn</li> </ul>
<i>Freedman Shoes</i>	\$90 to \$350	<ul style="list-style-type: none"> <li>• high-end men's and women's fashion and comfort footwear</li> <li>• 95% of products are national brands</li> <li>• wide selection of fittings and sizes</li> <li>• targeted to men and women 25 years of age &amp; up</li> </ul>	<ul style="list-style-type: none"> <li>• Gianni Collections</li> <li>• Roberto Vianni</li> </ul>	<ul style="list-style-type: none"> <li>• Amalfi</li> <li>• Stuart Weitzman</li> <li>• Donald J Pliner</li> <li>• Johnson &amp; Murphy</li> <li>• Cole Haan</li> <li>• Rockport</li> <li>• DKNY</li> <li>• Franco Sarto</li> </ul>
<i>Gia</i>	\$70 to \$360	<ul style="list-style-type: none"> <li>• cutting-edge, funky women's street fashion</li> <li>• fashion-athletic footwear and accessories</li> <li>• 85% of products are national brands</li> </ul>	<ul style="list-style-type: none"> <li>• Gianni Collections</li> </ul>	<ul style="list-style-type: none"> <li>• Guess</li> <li>• Steve Madden</li> <li>• Jessica Simpson</li> <li>• Betsey Johnson</li> <li>• Rocket Dog</li> <li>• Puma</li> <li>• UGG</li> <li>• Blowfish</li> <li>• BCBG</li> </ul>
<i>Sterling Outlet</i>	\$50 to \$140	<ul style="list-style-type: none"> <li>• mid-range women's fashion and comfort footwear</li> <li>• latest fashion trends at clearance prices</li> <li>• dress, casual and fashion athletic shoes, boots and sandals</li> <li>• targeted to women between 15 years of age &amp; up</li> </ul>	<ul style="list-style-type: none"> <li>• Roberto Vianni</li> <li>• Gianni Collections</li> <li>• Joy &amp; Peace</li> </ul>	<ul style="list-style-type: none"> <li>• Skechers</li> <li>• Puma</li> <li>• Franco Sarto</li> <li>• Steve Madden</li> <li>• Kenneth Cole</li> <li>• Converse</li> <li>• Rocket Dog</li> </ul>

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"> <li>● ALDO</li> <li>● Town Shoes</li> <li>● Nine West</li> <li>● Feet First</li> <li>● Little Burgundy</li> <li>● Mall-based specialty shoe stores</li> <li>● Apparel stores selling mid-to-high range fashion and fashion-athletic footwear products</li> </ul>	<ul style="list-style-type: none"> <li>● Payless Shoe Source</li> <li>● The Shoe Company</li> <li>● Winners</li> <li>● Softmoc</li> <li>● The Bay</li> <li>● Zellers</li> <li>● National and regional comfort-oriented shoe stores</li> <li>● Style Sense</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> </ul>

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 current economic environment, we have slowed the pace of our expansion. We are cautious with opening new locations and we will only add to our store base if the locations meet strict criteria for expected sales, profitability and return on invested capital. 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 quarter of 2010 there were some mixed signals of economic recovery in select sectors of the economy. Retail footwear was not one of them. Market conditions in our segment remain soft.

Management undertook several initiatives commencing in the first quarter of 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 quarter of 2010.

One of the most important strategic initiatives we have undertaken recently is the significant investment in our information technology systems. We expect to go live with this system during 2010. We believe improvements in our cost competitiveness and improvement in our financial position will provide us with greater business flexibility to position Sterling Shoes for sustainable long-term earnings and growth.

Highlights for the three-month period ended March 31, 2010 are summarized below:

- Gross margin increased to 50.3% during the three-month period ended March 31, 2010, compared to 43.4% during the same period in 2009. Strengthening of the Canadian dollar coupled with changes in product mix contributed to this performance;
- EBITDA rose by \$1,575 thousand to \$629 thousand (2.3% as a percentage of sales), during the three-month period ended March 31, 2010 compared to a negative EBITDA of \$946 thousand (-3.4% as a percentage of sales) during the same period in 2009;
- Net bank debt at March 31, 2010 of \$4.7 million compares to [\$7.9] million a year earlier;
- Development testing and training for the new information technology system continued with implementation targeted during 2010.

#### Suspension of Distributions and Conversion to a Corporate Structure

On April 22, 2010 we announced that unitholders will be asked to approve the conversion of the Fund to a corporation at its annual and special meeting of unitholders to be held on June 24, 2010. We are undertaking this conversion to a corporation at this time to simplify our business structure. The income fund structure is a less desirable form of business enterprise for Sterling Shoes at the present time as the Fund has suspended distributions and the proposed corporate structure will result in lower income taxes being paid on the taxable income of Sterling Shoes in 2010.

The conversion is to take place as a “plan of arrangement” and is expected to be effective July 1, 2010. Under the arrangement, unitholders of the Fund are to receive common shares of a newly formed corporation, “Sterling Shoes Inc.,” on a one-for-one basis. Unitholders resident in Canada will [generally] receive their shares of Sterling Shoes Inc. on a tax deferred basis. SSI Investments Inc., the current holder of a 20% interest in Sterling Shoes Limited Partnership, the Fund’s operating unit, will also exchange its exchangeable units for common shares of Sterling Shoes Inc., 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. When the conversion is effective, SSI Investments Inc. will hold 20%, and the existing unitholders will hold 80%, of the issued common shares of Sterling Shoes Inc. The business of Sterling Shoes will continue to be conducted by Sterling Shoes Limited Partnership, all of the interests in which will be owned, directly or indirectly, by Sterling Shoes Inc.

The Fund also announced that the Trustees determined to continue the previously announced suspension of distributions by the Fund for the balance of 2010. The future dividend policy of Sterling Shoes Inc. 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.

The Debentures will become debentures of Sterling Shoes Inc. The Debentures will continue to be convertible, but into common shares of Sterling Shoes Inc. at the same price at which the Debentures are now convertible into units of the Fund: namely, \$21.15 per common share, subject to adjustment as provided for in the trust indenture governing the Debentures.

It is expected that, other than Jeremy Horwitz, the current trustees of the Fund will become the directors of Sterling Shoes Inc., and the current officers and management of Sterling Shoes Limited Partnership, other than Jeremy Horwitz, will become officers and management of Sterling Shoes Inc.

The conversion to a corporation is a result of the changes to the taxation of income funds which

become effective January 1, 2011, and which makes the income fund form of business enterprise less advantageous.

The conversion will require the approval of at least 2/3 of the votes by the holders of units and of special voting units, all of which are owned by SSI Investments Ltd., present and in person or by proxy voting as a class at the meeting, and court and regulatory approval. Further details of the proposed conversion will be set out in an information circular of the Fund, expected to be sent to unitholders in mid May, 2010.

#### Resignation of Jeremy Horwitz

On April 22, 2010 the Fund announced that Jeremy Horwitz, the Fund's President and Chief Executive Officer resigned effective June 22, 2010 for personal reasons. He has also resigned as a trustee of the Fund and a director of Sterling Shoes GP Inc. effective on that date.

Mr. Horwitz has held senior positions with Sterling Shoes since 1988 and became President of Sterling Shoes Inc. (the predecessor to the Fund) in 1994. He has been a trustee of the Fund since its initial public offering in 2005

The Board of Trustees and Mr. Horwitz are working closely with the senior management team in continuing to oversee the strategic management of the business. The Board is also conducting a search for a new President and Chief Executive Officer.

#### Number of Stores

During the first quarter of 2010, we closed two underperforming stores. Currently we have two new store commitments for 2010. We are taking a cautious approach to additional store openings and expansion in light of 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													
May 11, 2010								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	Sterling 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. The Fund expects to apply the following optional exemption:

#### **Borrowing Cost:**

The Fund must include borrowing costs in the capitalized costs of a qualifying asset per IAS 23. In accordance with IFRS 1, the Fund 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, the Fund 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 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 Fund’s finance & accounting professionals 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.

- The Fund has engaged its auditors, Deloitte, to review IFRS transition documentation.
- 5. **Business activities** – the Fund 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), 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 currently in progress and is expected to be completed by June 2010. 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 Q2-2010 and Q3-2010.

**Accounting Policy – Impact of IFRS on the Fund’s current accounting policies:**

**The following discussion relates to some key differences identified in some of the significant accounting policies of the Fund:**

1. Impairment of intangible 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.

The Fund is in the process of quantifying the impact on transition

2. Property, Plant and Equipment

The Fund will value property, plant and equipment using the historical cost model.

Under IFRS, where part of an item of property, plant and equipment has a cost that is significant in relation to the cost of the item as a whole, it must be depreciated separately from the remainder of the item. The Fund is in the process of quantifying the impact on transition however does not expect the impact to be significant.

## SUMMARY FINANCIAL INFORMATION

<b>Statement of Income Items (\$000's)</b>	<b>Three months ended</b>	
	<b>March 31</b>	
	<b>2010</b>	<b>2009</b>
Sales	\$ 26,855	27,672
Cost of Sales	(13,337)	(15,675)
Gross Margin	13,518	11,997
<i>As a percentage of sales</i>	50.3%	43.4%
Store and selling expenses	(11,146)	(11,256)
General and administrative expenses	(1,743)	(1,687)
EBITDA <sup>(1)</sup>	629	(946)
Adjusted EBITDA <sup>(1)</sup>	533	(1,134)
<i>As a percentage of sales</i>	2.0%	-4.1%
Interest expense	(644)	(652)
(Loss) / Gain on disposal	-	(66)
Amortization	(946)	(764)
Income / (Loss) before taxes	(961)	(2,428)
Future income taxes	-	-
Net income / (loss)	\$ (961)	(2,428)
Maintenance capital expenditures	218	602
	<b>March 31,</b>	<b>March 31,</b>
<b>Balance Sheet Items (\$000's)</b>	<b>2010</b>	<b>2009</b>
Total assets	77,639	115,580
Long-term financial liabilities (including equity component)	25,000	25,000

Notes:

- (1) See definition of EBITDA, Adjusted EBITDA and Maintenance Capital Expenditures under "Non-GAAP Measures".
- (2) On the Subordination End Date, the 20% non-controlling interest held by Inc, in the business of Sterling Shoes LP, was reclassified to unitholders' equity. As a result, (loss) / income before non-controlling interest and taxes are applicable to the quarters up to December 31, 2007 only.

The table below summarizes the distributions declared during the three-month periods ended March 31, 2010 and 2009 for Units of the Fund and to Inc on the Class D LP Units:

	<b>Three-months ended Mar 31</b>	
	<b>2010</b>	<b>2009</b>
Trust Units and Class D LP Units	\$ -	\$ 566

## **OPERATING RESULTS**

### ***Sales***

Sales were \$26.9 million during the three-month period ended March 31, 2010, representing a decrease of 3% over the \$27.7 million in 2009. The decline in sales was a result of continued economic uncertainty and management's efforts to improve margins at the expense of some sales.

The Fund experienced a same-store sales decline of 6.7% in those stores that were open at least three months leading up to April 1, 2009. The three-month period ended March 31, 2010 was characterized by a conscious effort to improve gross margins, thereby sacrificing some sales. This is in contrast to the same quarter of the prior year when we engaged in significant promotional activity to attract consumers in a negative economic environment.

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 period ended March 31, 2010 was 49.7%, compared to 56.6% for the same period during 2009. The Fund was able to substantially increase its gross margins in the first quarter of 2010 due in part to management initiative taken during 2009 to reduce inventory levels and make room for higher margin inventory. Gross margin as a percentage of sales for the three-month period ended March 31, 2010 was 50.3% compared to 43.4% 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 early 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 three-month period ended March 31, 2010, approximately 43% of product purchases were denominated in U.S. dollars. During the quarter ended March 31, 2010 the Canadian dollar was worth approximately 20% more against the U.S. dollar than during the same period in 2009. This has decreased purchase prices, inventory valuation and cost of sales.

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

Store and selling expenses for the three-months ended March 31, 2010 were 41.5% of sales, compared to 40.7% for the same period during 2009. 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 dollar terms store and selling expenses decreased by \$110 thousand due to a comprehensive review of the business processes undertaken in 2009 to manage the business through the current economic volatility. However the overall effect as a percentage of sales is nullified by the decrease in sales in the first quarter of 2010.

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

General and administrative (“G&A”) expenses for the three-months ended March 31, 2010 were 6.5% of sales, compared to 6.1% during the same period in 2009.

G&A expenses have increased \$56 thousand due primarily to the additional costs required to support the legacy system while the new information technology system is being implemented.

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

Adjusted EBITDA for the three-months ended March 31, 2010 was 2.0% of sales compared to negative 4.1% for the same period during 2009. This increase of \$1.7 million is predominantly due to the reduction in cost of sales discussed above.

### ***Interest expense***

Net interest expense with respect to funds utilized under the Fund’s credit facilities for the three-months ended March 31, 2010 was \$59 thousand (2009 - \$85 thousand).

Interest expense with respect to the Debentures for the three-months ended March 31, 2010 was \$585 thousand (2009 - \$567 thousand).

The Fund has allocated the proceeds of the Debentures between debt and equity based on the relative fair values of the debt and the conversion option, as determined by the residual valuation of the equity component. Under this approach, the liability component was valued first, and the difference between the proceeds of the Debentures and the fair value of the debt was assigned to the conversion option. The present value of the liability component was calculated using a discount rate of 9.2% (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 million 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. Included in interest expense for the three-months ended March 31, 2010 was \$179 thousand (2009 - \$161 thousand) relating to this interest accretion.

### ***Inventory***

During 2009 and into 2010 management reduced inventory levels and adapted product mix in response to market conditions

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

## SELECTED QUARTERLY FINANCIAL INFORMATION

in (\$000's) except per Unit amounts	Q1-2010	Q4-2009	Q3-2009	Q2-2009	Q1-2009	Q4-2008	Q3-2008	Q2-2008
Sales	\$ 26,855	\$ 41,195	\$ 31,685	\$ 30,618	\$ 27,672	\$ 42,520	\$ 33,895	\$ 29,405
(Loss) / Income before non-controlling interest and taxes <sup>(1)</sup>	\$ (961)	\$ 6,238	\$ (35,432)	\$ (651)	\$ (2,428)	\$ 6,453	\$ 1,402	\$ 866
Future income taxes			4,636					
(Loss) / Income before non-controlling interest <sup>(1)</sup>	\$ (961)	\$ 6,238	\$ (30,796)	\$ (651)	\$ (2,428)	\$ 6,453	\$ 1,402	\$ 866
Net (Loss) / Income	\$ (961)	\$ 6,238	\$ (30,796)	\$ (651)	\$ (2,428)	\$ 6,453	\$ 1,402	\$ 866
Basic (loss) / income per Unit	\$ (0.145)	\$ 0.939	\$ (4.637)	\$ (0.098)	\$ (0.366)	\$ 0.972	\$ 0.211	\$ 0.130
Diluted (loss) / income per Unit	\$ (0.145)	\$ 0.820	\$ (4.637)	\$ (0.098)	\$ (0.366)	\$ 0.897	\$ 0.211	\$ 0.130
Cash distributions per Unit	\$ 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	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 the Fund's ability to generate sufficient cash flow to fund its 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-months ended March 31, 2010 and 2009.

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

<u>in (\$000's)</u>	<u>Three-months ended Mar 31</u>	
	<u>2010</u>	<u>2009</u>
<b>Net loss</b>	\$ (961)	(2,428)
Add charges (deduct credits) to operations not requiring a cash payment:		
Amortization of leaseholds and equipment	946	764
Accreted interest expense	179	161
Amortization of deferred leasehold inducements	(96)	(188)
Loss on disposal of leaseholds and equipment	-	66
	<u>68</u>	<u>(1,625)</u>
Net change in non-cash working capital balances related to operations:		
Accounts receivable	(248)	419
Inventory	(4,718)	(4,380)
Prepaid expenses and deposits	(47)	(122)
Accounts payable and accrued liabilities	<u>1,352</u>	<u>5,091</u>
<b>Cash used in operating activities</b>	<b>\$ <u>(3,593)</u></b>	<b><u>(617)</u></b>

For the three-month period ended March 31, 2010, cash used in operations was \$3.6 million (2009 – cash used in operations was \$0.6 million). The increase in cash used by operations during the period is primarily due to the timing of the investments in inventory and the payment of trade payables.

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 period ended March 31, 2010 generally reflected these expectations compared to prior years.

**Capital Expenditures**

The Fund did not open any stores during the three-months ended March 31, 2010. Consequently we did not make any investment in leaseholds and equipment to furnish new stores during the three-months ended March 31, 2010 (2009 - \$1.2 million). We incurred maintenance capital expenditures of \$0.2 million during the three -months ended March 31, 2010 (2009 - \$0.6 million), which were related to upgrades to our information technology system, store renovations and store relocations. These maintenance capital expenditures were funded by cash from operations.

**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 October 31, 2010, subject to extension

provisions. As at March 31, 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 matures on October 31, 2010 with no scheduled repayments of principal required prior to maturity.

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 March 31, 2010, we were in compliance with all covenants of these credit facilities.

#### **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 March 31, 2010, letters of credit totaling \$1.47 million are outstanding. The Fund has 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:

<b>in \$000's</b>	<b>2010</b>	<b>2011</b>	<b>2012</b>	<b>2013</b>	<b>2014</b>
Inventory purchase commitments	1,470				
Long-term debt			25,000		
Operating and Term Loans	5,000				
Minimum rental commitments <sup>(1)</sup>	11,898	14,402	13,801	12,626	10,666
	<u>18,368</u>	<u>14,402</u>	<u>38,801</u>	<u>12,626</u>	<u>10,666</u>

Note:

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

#### **DISTRIBUTABLE CASH AND DISTRIBUTIONS**

In past fiscal years Sterling Shoes LP and the Fund has made distributions of available cash to the maximum extent possible to the Unitholders and the non-controlling interest. This includes 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 has 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 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 Fund for the balance of 2010. If the conversion to a corporation is completed, the future dividend policy of Sterling Shoes Inc. 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 the dividend is being considered.

### 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 Fund has 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 Fund has also retained the Fund's 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 period ended March 31, 2010.

<b>in \$000's except per unit amounts and payout ratios</b>	<b>Three-months ended Mar 31</b>	
	<b>2010</b>	<b>2009</b>
<b>Standardized Distributable Cash</b>		
Cash used in operating activities	\$ (3,593)	\$ (617)
Less: Maintenance Capital Expenditures	(218)	(602)
<b>Standardized distributable cash generated</b>	<b>\$ (3,811)</b>	<b>\$ (1,219)</b>
Less: Changes in non-cash working capital balances related to operations	(3,661)	1,008
<b>Adjusted distributable cash generated</b>	<b>\$ (150)</b>	<b>\$ (2,227)</b>
Adjusted Distributable Cash available for distribution to Unitholders	\$ (150)	\$ (2,227)
Adjusted Distributable Cash generated per Unit	\$ (0.023)	\$ (0.335)
Distributions declared per Unit	\$ -	\$ 0.192
Adjusted Payout Ratio	0.0%	-57.2%
Number of units outstanding:	6,641,860	6,641,860

Management believes that the Standardized Distributable Cash calculation introduces significant volatility to the 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 Fund's policy has been to make distributions to its Unitholders necessary to pay out its taxable income. The adjusted payout ratio for the trailing twelve months ended March 31, 2010 was 19%, as compared to 101.2% for the three months ended March 31, 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:

<b>Distribution History</b>	<b>Distributions</b>	<b>Distribution History</b>	<b>Distributions</b>	<b>Distribution History</b>	<b>Distributions</b>
<b>Year / Month</b>	<b>per Unit</b>	<b>Year / Month</b>	<b>per Unit</b>	<b>Year / Month</b>	<b>per Unit</b>
<b>2005</b>		<b>2006</b>		<b>2007</b>	
		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 <sup>(3)</sup>	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 <sup>(1)</sup>	\$ 0.14737	September	0.10500	September	0.12000
September	0.08958	October	0.10500	October	0.12000
October	0.08958	November <sup>(4)</sup>	0.12000	November	0.12000
November	0.08958	December	0.12000	December	0.12000
December	0.08958	December <sup>(5)</sup>	0.32000	December <sup>(7)</sup>	0.36000
December <sup>(2)</sup>	0.16000	December <sup>(6)</sup>	0.15000	December <sup>(8)</sup>	0.06000
<b>Total 2005</b>	<b>\$ 0.66569</b>	<b>Total 2006</b>	<b>\$ 1.69832</b>	<b>Total 2007</b>	<b>\$ 1.86000</b>
<b>Distribution History</b>	<b>Distributions</b>	<b>Distribution History</b>	<b>Distributions</b>	<b>Distribution History</b>	<b>Distributions</b>
<b>Year / Month</b>	<b>per Unit</b>	<b>Year / Month</b>	<b>per Unit</b>	<b>Year / Month</b>	<b>per Unit</b>
<b>2008</b>		<b>2009</b>		<b>2010</b>	
January <sup>(9)</sup>	\$ 0.12500	January	\$ 0.03333	January	\$ nil
February	0.12500	February	0.03333	February	nil
March	0.12500	March <sup>(11)</sup>	0.01862	March	nil
April	0.12500	April	0.01862	April <sup>(13)</sup>	nil
May	0.12500	May	0.01862	May	nil
June	0.12500	June	0.01862		
July	0.12500	July	0.01862		
August	0.12500	August	0.01862		
September	0.12500	September	0.01862		
October <sup>(10)</sup>	0.12500	October	0.01862		
November	0.03333	November	0.01862		
December	0.03333	December <sup>(12)</sup>	nil		
<b>Total 2008</b>	<b>\$ 1.31667</b>	<b>Total 2009</b>	<b>\$ 0.23424</b>	<b>Total year-to-date 2010</b>	<b>\$ nil</b>

Notes:

- (1) The 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 Fund announced a special distribution of \$0.16 per Unit to Unitholders of record on December 30, 2005, representing the Fund's estimate of the distribution required to ensure the Fund was not liable for income taxes under Part I of the Tax Act for fiscal 2005. \$0.16 per Unit, the Fund's estimate of this amount, was paid on January 16, 2006 to Unitholders of record on December 30, 2005.
- (3) Effective May 1, 2006 the Fund raised its monthly distribution by 17.2% from \$0.08958 per Unit to \$0.105 per Unit.

- (4) Effective November 1, 2006 the Fund raised its monthly distribution by 14.3% from \$0.105 per Unit to \$0.12 per Unit.
- (5) On December 18, 2006 the Fund announced a special distribution of \$0.32 per Unit to Unitholders of record on December 29, 2006, representing the Fund's estimate of the distribution required to ensure the 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 Unitholders of record on December 29, 2006.
- (6) On March 22, 2007 the Fund announced a supplementary special distribution of \$0.15 per Unit to Unitholders of record on December 29, 2006, representing the Fund's remaining distribution required to ensure the 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 Fund announced a special distribution of \$0.36 per Unit to Unitholders of record on December 31, 2007, representing the Fund's estimate of the distribution required to ensure the 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 Fund announced a supplementary special distribution of \$0.06 per Unit to Unitholders of record on December 31, 2007, representing the Fund's remaining distribution required to ensure the 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 Fund raised its monthly distribution by 4.2% from \$0.12 per Unit to \$0.125 per Unit.
- (10) Effective November 1, 2008 the Fund reduced its monthly distribution by 73% from \$0.125 per Unit to \$0.03333 per Unit.
- (11) Effective March 1, 2009 the Fund reduced its monthly distribution by 44% from \$0.03333 per Unit to \$0.01862 per Unit.
- (12) Effective December 1, 2009 the Fund suspended its monthly distributions from \$0.01862 to \$Nil per Unit.
- (13) On April 22, 2010 the Fund suspended distributions for the remainder of 2010 and announced its intention to convert to a corporate entity, subject to Unitholder approval, effective July 1, 2010.

When declared, distributions are paid on the 15<sup>th</sup> of each month, or the next following business day, to Unitholders of record on the last business day of the preceding month. Unitholders who are non-residents of Canada are required to pay all withholding taxes payable on any distributions by the Fund. Effective April 1, 2008, distributions to the non-controlling interest have been made monthly and are no longer subordinated. These distributions were subject to subordination until December 31, 2007 pending the Fund achieving specific EBITDA and distribution targets. For further information see "End of Subordination".

The Fund did not declare any distributions to public Unitholders for the three-months ended March 31, 2010 (2009 - \$453 thousand). Furthermore, Sterling Shoes LP did not declare distributions (excluding special distributions) to Inc, the holder of the Class D LP Units, for the three-months ended March 31, 2010 (2009 - \$113 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.

As a result the Fund has recorded a future tax liability. 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 January 1, 2011.

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 will 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 three-months ended March 31, 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 the Fund's 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 the Fund's 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 Jeremy Horwitz and Mannie Druker, trustees and officers of the Fund, have an interest, amounting to \$74 thousand for the three-month period ended March 31, 2010 (2009 – \$74 thousand).
- (b) The Fund purchased equipment from a company in which Mannie Druker, a trustee and officer of the Fund, has an interest, for \$6 thousand during the three-month period ended March 31, 2010 (2009 – \$58 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 Fund's financial statements for the three-month period ended March 31, 2010. Management believes that the following items represent the 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 the Fund's assets and liabilities and the amounts reported in the financial statements. Future tax assets or liabilities are calculated using the tax rates for the periods in which the differences are expected to be settled. Future tax assets are recognized to the extent that they are considered more likely than not to be realized.

### ***Convertible Debentures***

The Fund has allocated the proceeds of the Debentures between debt and equity based on the relative fair values of the debt and the conversion option, as determined by the residual valuation of the equity component. Under this approach, the liability component was valued first, and the

difference between the proceeds of the Debentures and the fair value of the debt was assigned to the conversion option. The present value of the liability component was calculated using a discount rate of 9.2%, the 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 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 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 Fund has 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 Fund has 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](http://www.sedar.com). There were no changes to our significant business risks during the three months ended March 31, 2010.

The proposed conversion to a corporate entity is subject to risks and uncertainty, including the failure to receive approval of the conversion from the unitholders, the court or other regulatory authorities or to realize the anticipated benefits of the conversion

## **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 Fund's product purchases are denominated in U.S. dollars. During the three-month period ended March 31, 2010 approximately 43% (2009 – 39%) of the Fund's product purchases were denominated in U.S. dollars. The Fund does not hold or issue financial instruments for trading or speculative purposes. From time to time, the Fund enters into contracts to manage the foreign exchange risk associated with anticipated purchases in US dollars. At March 31, 2010, the Fund had forward foreign exchange contracts as follows.

Settlement dates	Face Value \$US	Average rate \$Cdn
April 2010	1,000	1.041
May 2010	950	1.025
June 2010	1,300	1.014
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 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 March 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 March 31, 2010 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

The Fund’s Board of Trustees and Audit Committee reviewed and approved the March 31, 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. The Fund believes 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 the Fund’s 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;
- income tax considerations;
- operating risks; and
- cash distributions

In particular, this MD&A contains forward-looking information and statements relating to the expectations of the Fund regarding the proposed conversion including, but not limited to: timing, completion, receipt of necessary approvals and anticipated benefits of the conversion.

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 Units by the Fund or future disposition of Units held by SSI Investments Inc., income tax matters, changes in accounting standards, including the transition to IFRS, increases in interest rates, the failure to receive approval of the conversion from the unitholders, the court or other regulatory authorities and the failure realize the anticipated benefits of the conversion. These risks are discussed in the Fund's most recent annual information form and in this management's discussion and analysis of the Fund 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 the Fund 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 the Fund, including the Fund's Annual Information Form and other public filings, are available on SEDAR ([www.sedar.com](http://www.sedar.com)) and on the Fund's website at [www.SterlingShoesIncomeFund.com](http://www.SterlingShoesIncomeFund.com).

## **INVESTOR RELATIONS**

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