

*Interim Consolidated Financial Statements of*

**STERLING SHOES INC.**

*September 30, 2011*

(Unaudited - Expressed in thousands of Canadian dollars)

STERLING SHOES INC.

Consolidated Statement of Financial Position

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

	As at September 30, 2011	As at December 31, 2010
<b>ASSETS</b>		
<b>CURRENT</b>		
Cash	\$ -	7,444
Accounts receivable	289	359
Inventory [note 4]	40,227	28,614
Prepaid expenses and deposits	400	336
	<b>40,916</b>	<b>36,753</b>
<b>NON-CURRENT</b>		
Leaseholds & Equipment [note 5]	17,350	17,969
Deferred Income Taxes [note 14]	-	-
Intangible Assets [note 6]	-	16,623
	<b>17,350</b>	<b>34,592</b>
	<b>\$ 58,266</b>	<b>\$ 71,345</b>

**LIABILITIES AND SHAREHOLDERS' EQUITY**

<b>CURRENT</b>		
Operating loan [note 7]	\$ 10,227	\$ -
Accounts payable and accrued liabilities	17,043	16,225
Convertible Debentures [note 8]	25,000	-
Term loan [note 7]	4,000	1,000
	<b>56,270</b>	<b>17,225</b>
<b>NON-CURRENT</b>		
Deferred Income Taxes [note 14]	-	793
Term Loan [note 7]	-	3,500
Convertible Debentures [note 8]	-	23,264
Deferred Lease Inducements	1,474	1,653
	<b>1,474</b>	<b>29,210</b>
<b>SHAREHOLDERS' EQUITY</b>		
Shareholders' capital	59,809	59,809
Equity component of Debentures [note 8]	2,657	2,657
Accumulated Deficit	(61,944)	(37,556)
	<b>522</b>	<b>24,910</b>
	<b>\$ 58,266</b>	<b>\$ 71,345</b>

GOING CONCERN AND SUBSEQUENT EVENTS [note 1]

COMMITMENTS [note 9]

On behalf of the Board of Directors

\_\_\_\_\_  
(signed) Rick Mahler  
Director

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(signed) Dave Alves  
Director

See accompanying notes to the interim consolidated financial statements

STERLING SHOES INC.

Consolidated Statements of Loss and Comprehensive Loss

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

	Three-month period ended		Nine-month period ended	
	September 30, 2011	September 30, 2010	September 30, 2011	September 30, 2010
SALES	\$ 26,960	\$ 32,218	\$ 73,284	\$ 87,679
COST OF SALES	14,953	21,537	38,210	50,108
GROSS MARGIN	12,007	10,681	35,074	37,572
EXPENSES				
Store and selling	10,817	11,215	31,565	33,418
General and administrative	2,290	1,909	6,758	5,607
Conversion costs	-	90	-	398
Amortization of leaseholds and equipment	939	867	2,675	2,745
	14,046	14,082	40,998	42,168
Loss before interest, financing expense and disposal	(2,039)	(3,401)	(5,924)	(4,596)
Impairment of intangible assets [note 6]	16,623	-	16,623	-
Interest and financing expense	798	653	2,212	1,955
Accelerated interest accretion on convertible debentures [note 8]	1,120	-	1,120	-
Unrealized (gain) / loss on foreign exchange	(1,057)	-	(974)	-
Loss on disposal of leaseholds and equipment	124	2	276	220
NET LOSS BEFORE TAXES	(19,647)	(4,056)	(25,181)	(6,771)
Deferred income taxes (expense) / recovery [note 14]	(577)	-	793	-
NET LOSS AND TOTAL COMPREHENSIVE LOSS	(20,224)	(4,056)	(24,388)	(6,771)
Basic and Diluted net loss per share	\$ (3.04)	\$ (0.61)	\$ (3.67)	\$ (1.02)
Basic weighted average number of shares outstanding	6,641,860	6,641,860	6,641,860	6,641,860
Diluted weighted average number of shares outstanding	7,823,885	7,823,885	7,823,885	7,823,885

See accompanying notes to the interim consolidated financial statements

STERLING SHOES INC.

Consolidated Statement of Changes in Equity

For the nine-month period ended September 30, 2011

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

	Number of shares	Par value of shares	Shareholders' capital	Equity component of Debentures [note 9]	Accumulated deficit	Shareholders' equity
BALANCE, January 1, 2010	6,641,860	\$ 9.00	59,809	2,657	(32,248)	\$ 30,218
Net loss for the period	-	-	-	-	(6,771)	(6,771)
BALANCE, September 30, 2010	6,641,860	\$ 9.00	59,809	2,657	(39,019)	\$ 23,447
Net loss for the period	-	-	-	-	1,463	1,463
BALANCE, December 31, 2010	6,641,860	\$ 9.00	59,809	2,657	(37,556)	\$ 24,910
Net loss for the period	-	-	-	-	(24,388)	(24,388)
BALANCE, September 30, 2011	6,641,860	\$ 9.00	59,809	2,657	(61,944)	\$ 522

See accompanying notes to the interim consolidated financial statements

STERLING SHOES INC.

Consolidated Statements of Cash Flows

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

	Three-month period ended		Nine-month period ended	
	September 30, 2011	September 30, 2010	September 30, 2011	September 30, 2010
<b>OPERATING ACTIVITIES</b>				
Net Loss	\$ (20,224)	\$ (4,056)	\$ (24,388)	\$ (6,771)
Items not involving cash				
Impairment of intangible assets	16,623	-	16,623	-
Deferred income taxes expense / (recovery)	577	-	(793)	-
Amortization of leaseholds and equipment	939	867	2,675	2,745
Loss on disposal of leaseholds and equipment	124	2	276	220
Amortization of deferred lease inducements	(78)	(92)	(250)	(318)
Accreted interest expense	1,329	188	1,733	552
	(710)	(3,091)	(4,124)	(3,572)
Change in non-cash working capital balances related to operations				
Accounts receivable	142	(1,171)	71	(1,096)
Inventory	(4,730)	(354)	(11,613)	(814)
Prepaid expenses and deposits	(0)	(78)	(64)	(147)
Accounts payable and accrued liabilities	4,180	5,453	820	3,231
	(408)	3,850	(10,786)	1,174
Cash (used in) / provided by operating activities	(1,118)	759	(14,910)	(2,398)
<b>INVESTING ACTIVITIES</b>				
Acquisition of leaseholds and equipment	(395)	(950)	(2,398)	(1,710)
Proceeds from disposal of assets	66	-	66	-
Lease inducements received	-	-	71	-
Cash used in investing activities	(329)	(950)	(2,261)	(1,710)
<b>FINANCING ACTIVITIES</b>				
Term loan	-	(250)	(500)	(250)
Cash used in financing activities	-	(250)	(500)	(250)
<b>CASH OUTFLOW DURING THE PERIOD</b>	(1,447)	(441)	(17,671)	(4,358)
<b>CASH, BEGINNING OF PERIOD</b>	(8,780)	202	7,444	4,119
<b>CASH, END OF PERIOD</b>	\$ (10,227)	\$ (239)	\$ (10,227)	\$ (239)
<b>Supplemental cash flow information</b>				
Interest paid	\$ 182	\$ 74	\$ 1,186	\$ 1,013

See accompanying notes to the interim consolidated financial statements

**NOTICE OF NO AUDITOR REVIEW OF INTERIM CONSOLIDATED FINANCIAL STATEMENTS**

Under National Instrument 51-102, Part 4, subsection 4.3(3)(a), if an auditor has not performed a review of the interim consolidated financial statements, they must be accompanied by a notice indicating that the financial statements have not been reviewed by an auditor.

The accompanying unaudited interim consolidated financial statements of Sterling Shoes Inc. for the three and nine month periods ending September 30, 2011 and 2010 have been prepared by management and approved by the Board of Directors of the Company.

The Company's independent auditor has not performed a review of these interim consolidated financial statements.

DATED this 10th day of November, 2011

STERLING SHOES INC.

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(signed) Rick Mahler  
Director

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(signed) Dave Alves  
Director

# STERLING SHOES INC.

## Notes to Interim Consolidated Financial Statements

September 30, 2011

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

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### 1. BASIS OF PRESENTATION AND GOING CONCERN

#### *Nature of operations*

Sterling Shoes Inc. (the “Company”) is an incorporated entity headquartered in Richmond, B.C., Canada. The head office, principal address and registered and records office of the Company are located at 2580 Viscount Way, Richmond, British Columbia, V6V 1N1.

The Company operates retail stores in five provinces in shopping malls, high-streets and strip malls, principally in Western Canada. The Company is a footwear retailer offering a broad selection of private label and national brand name shoes and accessories through five separate retail banners: Sterling, Joneve, Shoe Warehouse, Freedman Shoes, and Gia.

#### *Creditor Protection Proceedings*

On October 21, 2011, the Company obtained an Initial Order (the “Order”) from the Supreme Court of British Columbia (the “Court”) under the Companies’ Creditors Arrangement Act (Canada), R.S.C. 1985, c. C-36, as amended (the “CCAA”). The Company will continue to operate during this period of restructuring.

The Court granted protection under the CCAA for an initial period expiring on November 18, 2011 to be extended as required and approved by the Court. The Company expects to seek an extension on or before November 18, 2011. While the Company is under CCAA protection, all proceedings on the part of its creditors are stayed.

The Order permits the Company to pay all expenses incurred in carrying on the business after the date of the Order, including goods and services delivered by suppliers. The terms and conditions of the restructuring plan have not yet been determined by the Company.

Alvarez and Marsal Canada Inc. has been appointed Monitor pursuant to the Initial Order.

#### *Basis of presentation and going concern*

These unaudited interim consolidated financial statements have been prepared on a going concern basis, which assumes that the Company will continue to realize certain assets and discharge certain liabilities while operations are ongoing during this restructuring period. The CCAA filing provides the Company with temporary relief and financial support to enable it to continue to operate with minimal disruption while a restructuring plan is developed and implemented.

Certain adjustments have been made in the financial statements as at September 30, 2011:

#### *a. Reclassification of convertible debentures (Note 8)*

On September 27, 2011, the Company announced that its Board of Directors resolved that the Company would not make the interest payment on its Convertible Debentures (Note 8) that was due to be paid on October 31, 2011. The Company has notified the Debenture Trustee that it will default on its interest payment on the Debentures. As at September 30, 2011, the Debentures were reclassified to current liabilities and shown at face value to reflect the fact that the Debentures became a demand loan upon the Company’s default. As a result, the remaining

# STERLING SHOES INC.

## Notes to Interim Consolidated Financial Statements

September 30, 2011

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

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unamortized interest accretion of \$1.1 million was expensed during the three-months ended September 30, 2011.

***b. Write-down of deferred income tax asset (Note 14)***

The Company is experiencing negative cash flow from operations and there is no certainty as to when or if it will return to positive cash generation. In light of these conditions, the value of the deferred income tax asset was written down to \$nil at September 30, 2011 resulting in an income tax expense of \$577 thousand for the three months ended September 30, 2011 and an income tax recovery of \$793 thousand (2010 - \$Nil and \$Nil) for the nine months ended September 30, 2011.

***c. Impairment of intangible assets (Note 6)***

At September 30, 2011, the Company determined that the fair value of the intangible assets was \$nil, resulting in a non-cash impairment charge of \$16.6 million for the three-months ended September 30, 2011. The impairment arose primarily due to future economic uncertainty and the higher cost of capital assumptions in the valuation methodology.

***Amended banking facilities (Note 7)***

On October 20, 2011, the Company concluded negotiations with the Bank of Montreal as to the terms and conditions of the forbearance agreement (the "Forbearance Agreement"). Pursuant to the Forbearance Agreement, the Bank of Montreal will continue to provide the Company with availability under the Amended Facility, including an overadvance limit of up to \$2.5 million, on the terms and conditions set out in the Amended Facility, as amended by the Forbearance Agreement.

The Forbearance Agreement expires on December 31, 2011 (or such earlier time as provided in the Forbearance Agreement on the occurrence of certain events).

***Notice of Delisting***

On October 27, 2011 the Company received notice from the Toronto Stock Exchange (the "TSX") that its common shares and convertible debentures (Symbol: SSI and SSI.DB, respectively) will be delisted at the close of market on November 25, 2011 for failure to meet the continued listing requirements of TSX. The common shares and debentures will remain suspended from trading until that date.

***Significant uncertainties related to Creditor Protection Proceedings***

Should the stay period in the CCAA proceedings and any subsequent extensions thereof not be sufficient in duration or scope to allow the Company to develop and present a restructuring plan under the CCAA or should the restructuring plan not be accepted by affected creditors or confirmed by the Court and, in any such case, should the Company lose the protection of the stay of proceedings, creditors may immediately enforce their rights and remedies against the Company and its assets which would in all likelihood lead to liquidation proceedings. Failure to implement a restructuring plan and obtain sufficient exit financing within the time granted by the Court would in all likelihood also lead to liquidation of the Company's assets.

As the Company is in the process of completing the restructuring plan, the financial statements do not reflect any write-downs of leaseholds and equipment and associated inventory write-downs if

# STERLING SHOES INC.

## Notes to Interim Consolidated Financial Statements

September 30, 2011

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

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a store closure program is determined to be necessary. The financial statements also do not reflect any adjustment to the Company's indebtedness that may result from the restructuring plan.

There can be no assurance that a restructuring plan proposed by the Company will be supported by the Company's creditors or confirmed by the Court or that it will be consummated or successful. The Company's financial statements do not contain any adjustments to the amounts or classification of assets and liabilities that might be necessary should the Company be unable to continue in business.

### *Financial Statements*

These interim consolidated financial statements include the accounts of the Company, and its wholly owned subsidiaries. Wholly owned subsidiaries are entities in which the Company has control, directly or indirectly, where control is defined as the power to govern the financial and operating policies of an enterprise so as to obtain benefits from its activities. All intercompany transactions have been eliminated.

Details of the Company's subsidiaries at September 30, 2011 are as follows:

<u>Name</u>	<u>Place of incorporation</u>	<u>Interest %</u>	<u>Principal activity</u>
Sterling Shoes LP	Manitoba, Canada	100%	Limited partner
Sterling Shoes GP Inc.	British Columbia, Canada	100%	General partner

These interim consolidated financial statements are prepared in accordance with IFRS applicable to the preparation of interim financial statements, including IAS 34, Interim Financial Reporting ("IAS 34") and IFRS 1, First-Time Adoption of International Financial Reporting Standards ("IFRS 1"). Subject to certain transition elections disclosed in Note 4, we have consistently applied the same accounting policies in our opening IFRS balance sheet as at January 1, 2010 and throughout all periods presented, as if these policies had always been in effect. Note 3 discloses the impact of the transition to IFRS on our reported balance sheet, comprehensive income and cash flows, including the nature and effect of significant changes in accounting policies from those used in our consolidated financial statements for the year ended December 31, 2010.

The policies applied in these interim consolidated financial statements are presented in Note 2 and are in accordance with IFRS. Any subsequent changes to IFRS that are given effect in our annual consolidated financial statements for the year ending December 31, 2011 could result in restatement of these interim consolidated financial statements. In previous periods, the Company prepared its interim consolidated financial statements in accordance with Canadian GAAP.

These interim consolidated financial statements were approved and authorized for issue by the Board of Directors on November 10, 2011.

# STERLING SHOES INC.

## Notes to Interim Consolidated Financial Statements

September 30, 2011

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

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### 2. ACCOUNTING POLICIES

#### a) *Presentation currency and foreign currency translation*

Functional currency is the currency of the primary economic environment in which an entity operates and is normally the currency in which the entity primarily generates and expends cash. The majority of the Company's business is transacted in Canadian dollars and, accordingly, these interim consolidated financial statements have been measured and expressed in that currency.

Monetary assets and liabilities denominated in foreign currencies are translated to the Canadian dollar equivalent at the rate of exchange at the balance sheet date. Transactions in foreign currencies are translated to the Canadian dollar equivalent at the rate of exchange in effect at the time of the transaction. Foreign currency gains and losses are included in the statement of loss in the period in which they occur.

#### b) *Inventory*

The Company determines inventory cost based on a weighted average cost formula and values inventory at the lower of cost and net realizable value. Net realizable value represents the estimated selling price for inventories less all estimated costs of completion and costs necessary to make the sale.

Incentives received from suppliers are treated as a reduction in the prices of the suppliers' products and are accounted for as a reduction in the related inventory.

Cost of sales is comprised of inventory and inventory-related costs only.

#### c) *Financial Instruments*

Financial assets and financial liabilities are initially recognized at fair value including transaction costs. Their subsequent measurement is dependent on their classification as described below. Their classification depends on the purpose for which the financial instruments were acquired or issue, their characteristics and the Company's designation of such instruments. The standards require that all financial assets be classified either as FVTPL, available-for-sale ("AFS"), held-to-maturity ("HTM"), or loans and receivables. The standards require that all financial assets, including all derivatives, be measured at fair value with the exception of loans and receivables, debt securities classified as HTM, and AFS financial assets that do not have a reliable measurable fair value.

The following is a summary of the accounting model the Company has elected to apply to each of its significant categories of financial instruments outstanding.

Cash	Fair value through profit and loss ("FVTPL")
Accounts receivable	Loans and receivables
Accounts payable	Other liabilities
Bank indebtedness	Other liabilities
Long-term debt	Other liabilities

# STERLING SHOES INC.

## Notes to Interim Consolidated Financial Statements

September 30, 2011

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

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FVTPL financial assets are financial assets typically acquired for resale prior to maturity. They are measured at fair value at the balance sheet date. Interest earned, interest accrued, gains and losses realized on disposal and unrealized gains and losses from market fluctuations are included in interest and other expenses, net.

Financial liabilities designated at FVTPL accounted for in the same manner as FVTPL financial assets. The Company has not designated any non-derivative financial liabilities as FVTPL.

Held-to-maturity – HTM financial assets are non-derivative financial assets with fixed or determinable payments and a fixed maturity, other than loans and receivables that an entity has the positive intention and ability to hold to maturity. These financial assets are measured at amortized cost. The Company does not have any HTM financial assets as at March 31, 2011.

Available-for-sale – AFS financial assets are those non-derivative financial assets that are designated as AFS, or that are not classified as loans and receivables, HTM investments or FVTPL. AFS financial assets are carried at fair value with unrealized gains and losses included in other comprehensive income until realized when the cumulative gain or loss is transferred to the Statement of Income (Loss). The Company has not designated any financial assets as AFS.

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

Other liabilities – Other liabilities (“OL”), are recorded at amortized cost and include all liabilities, other than derivatives or liabilities to which the FVTPL has been applied.

### *d) Income Taxes*

Deferred income taxes are accounted for using the asset and liability method. The liability method requires that income taxes reflect the expected future tax consequences of temporary differences between the carrying amounts of assets and liabilities and their tax bases. Deferred income tax assets and liabilities are determined based on the difference between the tax basis of the Company’s assets and liabilities and the amounts reported in the financial statements. Deferred tax assets or liabilities are calculated using currently enacted or substantially enacted tax rates that are expected to be in effect in the periods in which the differences are expected to be settled. The effect of a change in tax rates or tax legislation is recognized in the period of substantive enactment. Deferred tax assets are recognized when it is considered probable that there will be sufficient taxable income for them to be realized.

### *e) Use of Estimates*

The preparation of financial statements in accordance with IFRS requires management to make estimates and assumptions that affect the reported amount of assets and liabilities and disclosure of contingencies at the date of the financial statements and the reported amount of revenues and expenses during the period. Areas requiring significant management estimates include the valuation of inventory, the valuation of intangible assets, the valuation of the liability and equity components of the convertible unsecured subordinated debentures, the recorded amounts of

# STERLING SHOES INC.

## Notes to Interim Consolidated Financial Statements

September 30, 2011

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

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accrued liabilities, the estimation of deferred income taxes, and the useful life of leaseholds and equipment. Actual results could differ from these estimates.

*f) Accounting Judgments*

In the process of selecting accounting policies and interpreting and applying guidance under IFRS, management made various judgments that can significantly impact the consolidated financial statements. Areas requiring significant management judgements include the identification of Cash Generating Units, and segments, as well as the determination of fair value as deemed cost for intangible assets on transition to IFRS and the assessment of the probability of realizing future tax assets.

*g) Cash*

Cash consists of cash on hand and bank balances.

*h) Leaseholds and equipment*

Leaseholds and equipment are recorded at cost. Amortization is provided on a straight-line basis over the following estimated useful lives of the assets:

Furniture and equipment .....	10 years
Computer equipment and software.....	5 years
Leasehold improvements .....	shorter of the initial term of the lease or useful life

Amortization is pro-rated in the year of acquisition.

Computer equipment and software acquired for use by the Company comprises its purchase price and any directly attributable costs to prepare the asset for its intended use. These costs are amortized over the asset's expected useful life with amortization to commence when the asset is available for use.

Leaseholds and equipment are reviewed for impairment whenever changes in circumstances indicate that the carrying amount of an asset may not be recoverable from expected undiscounted future cash flows from their expected use and eventual disposition. If such assets are considered impaired, the impairment to be recognized is measured as the amount by which the carrying amount of the assets exceeds their fair value.

*i) Intangible assets*

Identifiable intangible assets, including store banners and private label brand names are carried at deemed cost, being the fair value amount of the assets as at December 31, 2010. 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 the assets may be impaired. In performing a formal impairment assessment, the Company estimates the recoverable amount of the asset by performing a

# STERLING SHOES INC.

## Notes to Interim Consolidated Financial Statements

September 30, 2011

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

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comparison of the asset's carrying value to the higher of fair value less costs to sell and value in use, which is defined as the present value of future cash flows expected to be derived from the asset in its current state. 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 the higher of fair value less costs to sell and value in use.

*j) Deferred lease inducements*

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

*k) Transaction costs*

Transaction costs attributable to financial instruments classified as other than FVTPL are included in the recognized amount of the related financial instrument and recognized over the life of the instrument using the effective interest rate method. The convertible debentures have an effective interest rate of 10.7%.

*l) Revenue recognition*

Revenue is recognized to the extent that it is probable that the economic benefits will flow to the Company and the revenue can be reliably measured.

Revenue is measured at the fair value of the consideration received at the point of sale excluding discounts, sales tax and duty, and a provision for sales returns.

*m) Net income (loss) per share*

Basic net income (loss) per share of the Company is calculated by dividing the net income (loss) by the weighted average number of shares outstanding during the reporting period. Diluted net income (loss) per share is calculated by dividing the net income (loss), adjusted for the interest expense on the Convertible Debentures (Note 8), by the sum of the weighted average number of shares outstanding used in the basic net income (loss) per share calculation and the number of shares that would be issued assuming conversion of all Convertible Debentures. As at September 30, 2011 the Convertible Debentures were not included in the computation of diluted net loss per share for the three and nine month periods ended September 30, 2011 because to do so would have been anti-dilutive.

*n) Long-term incentive plan*

Under the terms of a long-term incentive plan ("LTIP") the Board may grant, at its discretion, LTIP rights to employees or non-employees who are, at the time of such grant, providing service to the Company. The grant of an LTIP right will be based on the performance during the prior year as determined and approved by the Board.

# STERLING SHOES INC.

## Notes to Interim Consolidated Financial Statements

September 30, 2011

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

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LTIP shares will vest on the 3<sup>rd</sup> anniversary of the purchase of shares which in the meantime will be held by the LTIP plan trustee. The cost is expensed evenly over the three year vesting period. As at September 30, 2011, the Company did not accrue any liability in respect of the LTIP (2010 - \$nil). During the three and nine month periods ended September 30, 2011 the Company recorded \$17 thousand and \$50 thousand compensation expense (2010 - \$nil and \$nil).

*o) Provisions*

Provisions are recognized where a legal or constructive obligation has been incurred as a result of past events, it is probable that an outflow of resources embodying economic benefit will be required to settle the obligation, and a reliable estimate of the amount of the obligation can be made. If material, provisions are measured at the present value of the expenditures expected to be required to settle the obligation. The Company has recognized no such provisions in these interim consolidated financial statements.

### 3. ADOPTION OF INTERNATIONAL REPORTING STANDARDS (“IFRS”)

These interim consolidated financial statements comply with IFRS, including the application of IFRS 1 First-Time Adoption of International Financial Reporting Standards.

#### *IFRS 1 First-Time Adoption of International Financial Reporting Standards*

Adoption of IFRS requires the application of IFRS 1, “First-time Adoption of International Financial Reporting Standards”, which provides guidance for an entity’s initial adoption of IFRS. IFRS 1 gives entities adopting IFRS for the first time a number of optional exemptions and mandatory exceptions, in certain areas, to the general requirement for full retrospective application of IFRS.

#### *Elections upon first time adoption of IFRS:*

The following are the optional exemptions available under IFRS 1 that the Company applied in the conversion from Canadian GAAP to IFRS.

#### *Fair value or revaluation as deemed cost*

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

#### *Borrowing Costs*

IAS 23 “Borrowing Costs” requires capitalization of eligible borrowing costs directly attributable to the acquisition or construction of qualifying assets. Under Canadian GAAP, the Company’s accounting policy was to expense interest costs in connection with development activity. A first-

# STERLING SHOES INC.

## Notes to Interim Consolidated Financial Statements

September 30, 2011

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

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time adopter may elect to apply the transitional provisions prescribed by IAS 23, and thereby be exempt from having to apply the standard to past transactions. The Company has elected to utilize this exemption, and will therefore apply IAS 23 on a strictly prospective basis from the date of transition to IFRS (meaning for eligible projects with a commencement date after January 1, 2010).

### *Share-Based Payments*

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

### *Business Combination*

IFRS 1 provides an option to apply IFRS 3, Business Combinations, (“IFRS 3”) on a full retrospective basis or prospectively from the transition date onwards. The full retrospective basis would require restatement of all business combinations that occurred prior to the transition date. The Company has elected not to retrospectively apply IFRS 3 to business combinations that occurred prior to the transition date and such business combinations have not been restated.

### *Mandatory Exceptions under IFRS*

#### *Estimates*

In accordance with IFRS 1, an entity’s estimates under IFRS at the date of transition to IFRS must be consistent with estimates made for the same date under previous GAAP unless those estimates were in error. The Company’s IFRS estimates as at the transition date are consistent with its Canadian GAAP estimates as at that date.

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

There are no adjustments to balances in the Company’s financial statements on transition from Canadian GAAP to IFRS as at January 1, 2010, nor are there any adjustments to financial statement balances and results as at and for the year ended December 31, 2010. There are, however, some financial statement presentation and disclosure changes on adoption of IFRS, particularly regarding note disclosure. While there are no adjustments to financial statement balances on transition to IFRS, management has modified some of its accounting policies to conform with IFRS requirements.

## 4. INVENTORY

	September 30, 2011		December 31, 2010	
Inventory at carrying value	\$	40,514	\$	30,665
Obsolescence provision		(287)		(2,051)
Inventory at lower of cost or net realizable value	\$	40,227	\$	28,614

# STERLING SHOES INC.

## Notes to Interim Consolidated Financial Statements

September 30, 2011

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

### 5. LEASEHOLDS AND EQUIPMENT

	Leasehold Improvements	Furniture and Equipment	Computer Equipment and Software	Total
Balance at December 31, 2010	\$ 15,488	\$ 11,948	\$ 5,423	\$ 32,859
Additions	683	357	1,358	2,398
Disposals	(334)	(248)	-	(582)
Cost at September 30, 2011	15,837	12,057	6,781	34,675
Accumulated depreciation at December 31, 2010	(7,006)	(5,743)	(2,141)	(14,890)
Retirements	143	97	-	240
Depreciation/depletion	(1,116)	(859)	(700)	(2,675)
Accumulated Depreciation at September 30, 2011	\$ (7,979)	\$ (6,505)	\$ (2,841)	\$ (17,325)
Net book value at September 30, 2011	\$ 7,858	\$ 5,552	\$ 3,940	\$ 17,350

### 6. INTANGIBLE ASSETS

	September 30, 2011	December 31, 2010
Store banners	\$ -	\$ 10,005
Private label brand names	-	6,618
	\$ -	\$ 16,623

At September 30, 2011, the Company determined that the fair value of the intangible assets was \$nil, resulting in a non-cash impairment charge of \$16.6 million for the three-months ended September 30, 2011.

### 7. BANK INDEBTEDNESS

	September 30, 2011	December 31, 2010
Operating Loan	\$ 10,227	\$ -
Term Loan	\$ 4,000	\$ 4,500
	\$ 14,227	\$ 4,500

Prior to obtaining the CCAA Order under the CCAA, the Company had a revolving credit facility of up to \$20 million (the "Operating Loan") with the Bank of Montreal, which was available for working capital requirements, capital expenditures and for general corporate purposes. The Company also had utilized \$4 million of a \$5 million credit facility with the Bank of Montreal (the "Term Loan") for funding capital expenditures including new store facilities.

During the third quarter ended September 30, 2011, the Company reached an agreement with the Bank of Montreal to amend its Operating Loan and Term Loan, including provisions for overadvance (the "Amended Facility"). The Amended Facility was made on a demand basis and contained step-down provisions which would have permanently reduced the availability of the overadvance limit by October 20, 2011. The overadvance limit under the Amended Facility was designed (and provided) by the Bank of Montreal to provide the Company with the additional liquidity necessary to address seasonal fluctuations.

# STERLING SHOES INC.

## Notes to Interim Consolidated Financial Statements

September 30, 2011

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

On October 20, 2011, the Company concluded negotiations with the Bank of Montreal as to the terms and conditions of a forbearance agreement (the "Forbearance Agreement") to address its liquidity needs while the Company restructures its affairs under the CCAA. Pursuant to the Forbearance Agreement, the Bank of Montreal will continue to provide an availability under the Amended Facility, including an overadvance limit of up to \$2.5 million, on the terms and conditions set out in the Amended Facility, as amended by the Forbearance Agreement.

As the Forbearance Agreement expires on December 31, 2011 (or such earlier time as provided in the Forbearance Agreement on the occurrence of certain events), the Company has entered into discussions with the Bank on the terms of an overadvance limit and availability after December 31, 2011 in amounts sufficient to allow it to complete its restructuring.

Loans under the Amended Facility, as amended by the Forebearance Agreement, are pre-payable without any penalties and bear interest at a floating rate based on the Canadian dollar prime rate rates plus an applicable margin to those rates. The Amended Facility is secured by a general security agreement covering all assets of Sterling Shoes LP, Sterling Shoes GP Inc. and the Company.

The Amended Facility is 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 Amended Facility also requires the Company to meet certain conditions in order to make interest payments on the Debentures.

The Amended Facility is a demand facility and could be called for payment at any time. In the event that the Amended Facility is called for payment, or if we are unsuccessful in negotiating terms for further financing with the Bank of Montreal or other replacement borrowings, there would be a material negative impact on the Company's business, financial condition and results of operations.

### 8. CONVERTIBLE DEBENTURES

		September 30, 2011	December 31, 2010
Principal amount	\$	25,000	\$ 25,000
Equity component		(2,657)	(2,657)
Accretion		2,657	1,400
Deferred financing fees, net of amortization		-	(479)
Convertible unsecured subordinated debentures (current)	\$	25,000	\$
Convertible unsecured subordinated debentures (non-current)	\$	\$	23,264

The convertible unsecured subordinated debentures (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. The

# STERLING SHOES INC.

## Notes to Interim Consolidated Financial Statements

September 30, 2011

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

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maturity date for the Debentures is October 31, 2012. On September 27, 2011, the Company announced that its Board of Directors resolved that the Company would not make the interest payment on its Debentures that was due to be paid on October 31, 2011. Accrued interest expense on the Debentures was included in accounts payable and accrued liabilities in the consolidated statement of financial position as at September 30, 2011

The Debentures are convertible at any time at the option of the holders into shares ("Shares") of the Company at a conversion rate of approximately 47.281 Shares per \$1 principal amount of Debentures, which is equal to a conversion price of \$21.15 per Share. After October 31, 2010 and on or before October 31, 2011, the Company will have the right to redeem all or a portion of the Debentures equal to the principal amount plus accrued and unpaid interest, provided that the market price on the date on which the notice of redemption is given is not less than 125% of the conversion price. After October 31, 2011, the Company will have the right to redeem all or a portion of the Debentures equal to the principal amount plus accrued and unpaid interest.

The Company 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 for similar debentures having no conversion rights.

The conversion option was valued at \$2,657 at the date of issuance. The liability portion of the Debentures is being accreted to its face value over the term of the debt 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.

### 9. COMMITMENTS

(a) *Minimum rental commitments*

The Company has the following minimum rental commitments for premises, excluding percentage rent adjustments and operating expense assessments, for the remainder of the current fiscal year and over the next four fiscal years:

2011	\$	4,041
2012		15,067
2013		13,809
2014		12,355
2015		11,197
Thereafter		22,834
	\$	79,303

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

# STERLING SHOES INC.

## Notes to Interim Consolidated Financial Statements

September 30, 2011

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

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(b) *Letters of credit*

The Company had letters of credit outstanding on September 30, 2011 securing inventory purchase commitments totaling \$2.6 million (December 31, 2010 - \$3.4 million and January 1, 2010 - \$2.7 million). The last of these letters of credit expires on December 31, 2011 for \$1.5 million.

### 10. FINANCIAL INSTRUMENTS

(a) *Fair value*

Financial instruments consist of cash at fair value, accounts receivable, term loans, accounts payable, foreign exchange contracts, and the debentures. The fair values of all financial instruments, other than cash, the Debentures (Note 8), and the foreign exchange contracts, approximate their carrying values due to their short term or floating rate nature.

Cash is stated at fair value. Prior to the CCAA filing, the fair value of the Debentures is determined by calculating its present value using the estimated market interest rate for loans with similar terms, conditions, and maturities. Given the current uncertainties, there is no reliable information available to practicably determine the fair value of the Convertible Debentures as at September 30, 2011 (December 31, 2010 - \$21.9 million). As at September 30, 2011, the Debentures were reclassified to current liabilities and shown at face value of \$25 million.

(b) *Liquidity risk*

Liquidity risk is the risk that the Company will not be able to meet its obligations associated with financial liabilities and commitments as they become due. Liquidity risk also includes the risk of not being able to liquidate assets in a timely manner at a reasonable price. As described above, on September 27, 2011 the Company announced that it would not make the interest payment on its Debentures that was due to be paid on October 31, 2011.

The Company faces several risks and uncertainties that materially impact the Company's liquidity position, cash flows and future operating results throughout the remainder of 2011 and future years. Refer to Note 1 basis of presentation and going concern.

The following table shows the maturity dates for the Company's liabilities at September 30, 2011:

# STERLING SHOES INC.

## Notes to Interim Consolidated Financial Statements

September 30, 2011

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

<u>in \$000's</u>	<u>2011</u>	<u>2012</u>	<u>2013</u>	<u>2014</u>	<u>2015</u>
Operating loan	10,227				
Accounts payable and accrued liabilities	17,043				
Convertible Debentures	25,000				
Term Loan	4,000				
	<u>56,270</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>

The Company's future obligations under operating leases are discussed in Note 9. Deferred lease inducements will not result in cash outflow for the Company.

The Company's ability to maintain and sustain its future operations will depend upon its ability to emerge from the CCAA proceedings and to (i) restructure, refinance or amend terms of its existing debt obligations; (ii) remain in compliance with its debt covenants to the Amended Facility; (iii) obtain additional equity or debt financing; (iv) achieve revenue growth and improve gross margins; and (v) achieve greater operating efficiencies and reduce expenses.

(c) *Interest rate risk*

Interest rate risk is the risk that the Company's financial instruments or cash flows associated with the instrument will fluctuate due to changes in market interest rates. The Company's interest rate risk arises primarily from the Debentures, the Operating Loan, and the Term Loan, including access to the overadvance amount "Amended Facility" as amended by the Forebearance Agreement (Note 1). The interest rate on the Debentures is at a fixed rate (Note 8). The Amended Facility bear interest at a floating rate based on the Canadian dollar prime rate plus an applicable margin to those rates. Based on the average carrying value of the Amended Facility, a fluctuation in interest rate of 1% would represent a \$35 and \$70 change to the net loss for the three-month and nine-month periods ended September 30, 2011 (2010 - \$13 and \$38), respectively.

(d) *Foreign exchange risk*

Foreign exchange risk is the risk that the value of a financial asset or liability or commitment will fluctuate due to changes in foreign exchange rates. The Company's foreign exchange risk arises primarily from its inventory purchases. Substantially all footwear sold in Canada is manufactured outside of Canada and hence, the cost of substantially all inventory purchases is exposed to currency fluctuations. During the three-month and nine-month periods ended September 30, 2011, approximately 30% and 28% (2010- 41% and 40%) of product purchases were denominated in US dollars.

From time to time, the Company enters into contracts to manage the foreign exchange risk associated with anticipated purchases in US dollars. At September 30, 2011, the Company had forward foreign exchange contracts as follows:

# STERLING SHOES INC.

## Notes to Interim Consolidated Financial Statements

September 30, 2011

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

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Settlement dates	Face Value \$US	Average rate \$Cdn
Oct 2011	1,545	0.995
Nov 2011	2,020	0.995
Dec 2011	1,100	0.996
Jan 2012	1,000	0.977
Feb 2012	2,000	0.971
Mar 2012	1,500	0.968
Apr 2012	500	0.964
May 2012	500	0.964
Jun 2012	500	0.964
Jul 2012	500	0.964

As at September 30, 2011, the cumulative unrealized gain on these contracts was \$762 (2010 – \$57) which is included in accounts payable and accrued liabilities in the consolidated statement of financial position.

(e) *Credit risk*

Credit risk is the risk that customers on account are not able to discharge their obligations in due time. The Company is not exposed to material credit risk because it factors all of its receivables to a third party. The risk of loss is transferred entirely to this third party.

### 11. MANAGEMENT OF CAPITAL

The Company's capital structure consisted of the following components at September 30, 2011: Shareholders' equity of \$522 (December 31, 2010 - \$24,910) and the Debentures of \$25 million (December 31, 2010 - \$23.3 million). The Company was not in compliance with its bank covenants at September 30, 2011.

The Company is experiencing negative cash flow from operations and there is no certainty as to when or if we will return to positive cash generation. This led to its CCAA filing on October 21, 2011. In light of these conditions, there is significant uncertainty regarding the Company's ability to continue as a going concern, which is dependent on achieving on-going cash flow from operating activities and receiving additional support from our creditors and suppliers, as well as obtaining additional sources of financing.

Given the Company's current level of cash flows from operations, the Company will need to rely upon outside sources and third party financings to obtain sufficient capital to implement a restructuring plan and continue as a going concern.

# STERLING SHOES INC.

## Notes to Interim Consolidated Financial Statements

September 30, 2011

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

### 12. RELATED PARTY TRANSACTIONS

- (a) The Company leases its head office from a company in which a director of the Company has an interest. Rent expense recognized on this lease was \$79 and \$237 for the three-month and nine-month periods ended September 30, 2011 (2010 - \$79 and \$227) and is included in general and administrative expenses in the consolidated statement of loss and comprehensive loss.
- (b) The Company purchased equipment from a company in which a director of the Company has an interest for \$7 and \$86 during the three-month and nine-month periods ended September 30, 2011 (2010 - \$47 and \$60).

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

### 13. KEY MANAGEMENT COMPENSATION

Remuneration of directors and key management personnel comprises:

	Three-month period ended		Nine-month period ended	
	Sept 30, 2011	Sept 30, 2010	Sept 30, 2011	Sept 30, 2010
Short-term benefits	\$ (445)	\$ (308)	\$ (1,325)	\$ (915)
	\$ (445)	\$ (308)	\$ (1,325)	\$ (915)

Short-term benefits comprise salaries, bonuses and directors' fees. The Company had seven key management personnel as at September 30, 2011 (2010 – four).

### 14. INCOME TAXES

Prior to the conversion to incorporated status on July 1, 2010, Sterling was a unit trust for income tax purposes and, accordingly, was taxable only on any taxable income not allocated to the unitholders. Any income tax obligations relating to the distributions were the obligations of the unitholders. Commencing July 1, 2010, the Company is subject to tax at statutory rates.

# STERLING SHOES INC.

## Notes to Interim Consolidated Financial Statements

September 30, 2011

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

(a) *Income tax expense:*

	Three-month period ended		Nine-month period ended	
	September 30, 2011		September 30, 2011	
Current tax expense				
Current period	\$	-	\$	-
Adjustment to prior year		-		-
	\$	-	\$	-
Deferred tax expense				
Origination and reversal of temporary differences	\$	577	\$	(793)
Other				
	\$	577	\$	(793)
<b>Total income tax expense (recovery)</b>	<b>\$</b>	<b>577</b>	<b>\$</b>	<b>(793)</b>

The tax rate used in the calculations above is the corporate tax rate of 26.5% payable by corporate entities on taxable profits under tax laws in Canada.

(b) *Reconciliation of the effective tax rate:*

Income tax expense differs from the amounts that would be obtained by applying the Canadian statutory income tax rate to income before income taxes. These differences are as follows:

	Three-month period ended		Nine-month period ended	
	September 30, 2011		September 30, 2011	
Loss before income taxes	\$	(19,647)	\$	(25,181)
Income tax at statutory rates (26.5%)		(5,206)		(6,673)
Non-deductible expenses		2,207		2,216
Change in valuation allowance		3,415		3,415
Change in deferred income tax on application of future enacted rates		170		252
Other		(8)		(3)
<b>Deferred income taxes expense (recovery)</b>	<b>\$</b>	<b>577</b>	<b>\$</b>	<b>(793)</b>

# STERLING SHOES INC.

## Notes to Interim Consolidated Financial Statements

September 30, 2011

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

(c) *Deferred tax assets and liabilities:*

- (i) The tax effect of temporary differences that give rise to deferred income tax liabilities and deferred income tax assets are as follows:

	September 30, 2011	December 31, 2010
Operating losses	\$ (1,759)	\$ (704)
Leasehold & improvements	(1,078)	(814)
Other temporary differences	(577)	-
Deferred income tax asset	(3,414)	(1,518)
Valuation allowance	(3,414)	-
Net deferred income tax asset	-	(1,518)
Intangible Asset - store banners	-	1,251
Intangible asset - private label brand names	-	827
Other temporary differences	-	233
Deferred income tax liability	-	2,311
Net deferred income tax (asset)/liability	\$ -	\$ 793

In addition the Company has a capital loss of \$27 million. The related future tax asset of approximately \$3.4 million has not been recognized as the management is of the view that such asset would unlikely be realized in the future.

### 15. SEGMENTED INFORMATION

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

### 16. SUBSEQUENT EVENTS

Refer to discussion under Note 1 basis of presentation and going concern.