

Interim Consolidated Financial Statements of

STERLING SHOES INC.

March 31, 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 March 31, 2011	As at December 31, 2010	As at January 1, 2010
ASSETS			
CURRENT			
Cash	\$ -	7,444	4,119
Accounts receivable	924	359	195
Inventory [note 5]	33,822	28,614	36,446
Prepaid expenses and deposits	500	336	187
	<u>35,246</u>	<u>36,753</u>	<u>40,947</u>
NON-CURRENT			
Leaseholds & Equipment [note 6]	17,632	17,969	19,595
Deferred Income Taxes [note 15]	313	-	-
Intangible Assets [note 7]	16,623	16,623	16,623
	<u>34,568</u>	<u>34,592</u>	<u>36,218</u>
	<u>\$ 69,814</u>	<u>\$ 71,345</u>	<u>\$ 77,165</u>
LIABILITIES AND SHAREHOLDERS' EQUITY			
CURRENT			
Bank indebtedness	\$ 1,150	\$ -	\$ -
Accounts payable and accrued liabilities	17,828	16,225	15,006
Term loan [note 8]	1,000	1,000	5,000
	<u>19,978</u>	<u>17,225</u>	<u>20,006</u>
NON-CURRENT			
Deferred Income Taxes [note 15]	-	793	2,364
Term Loan [note 8]	3,250	3,500	-
Convertible Debentures [note 9]	23,463	23,264	22,520
Deferred Lease Inducements	1,570	1,653	2,057
	<u>28,282</u>	<u>29,210</u>	<u>26,941</u>
SHAREHOLDERS' EQUITY			
Shareholders' capital	59,809	59,809	59,809
Equity component of Debentures [note 9]	2,657	2,657	2,657
Accumulated Deficit	(40,913)	(37,556)	(32,248)
	<u>21,553</u>	<u>24,910</u>	<u>30,218</u>
	<u>\$ 69,814</u>	<u>\$ 71,345</u>	<u>\$ 77,165</u>

COMMITMENTS [note 10]

On behalf of the Board of Directors

(signed) Rick Mahler
Director

(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	
	March 31, 2011	March 31, 2010
SALES	\$ 22,011	\$ 26,855
COST OF SALES	12,259	13,337
GROSS MARGIN	9,752	13,518
EXPENSES		
Store and selling	10,222	11,146
General and administrative	2,238	1,743
Amortization of leaseholds and equipment	790	946
	13,250	13,835
Income/(Loss) before interest, financing expense and disposal	(3,498)	(317)
Interest and financing expense	667	644
Unrealized loss on foreign exchange	146	-
Loss on disposal of leaseholds and equipment	152	-
NET LOSS BEFORE TAXES	(4,463)	(961)
Deferred income taxes recovery [note 15]	1,106	-
NET LOSS AND TOTAL COMPREHENSIVE LOSS	(3,357)	(961)
Basic and Diluted net income/(loss) per share	\$ (0.51)	\$ (0.14)
Basic weighted average number of shares outstanding	6,641,860	6,641,860
Diluted weighted average number of shares outstanding	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 Three month period ended March 31, 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			-	-	(961)	(961)
BALANCE, March 31, 2010	6,641,860	\$ 9.00	59,809	2,657	(33,209)	\$ 29,257
Net loss for the period			-	-	(4,347)	(4,347)
BALANCE, December 31, 2010	6,641,860	\$ 9.00	59,809	2,657	(37,556)	\$ 24,910
Net loss for the period			-	-	(3,357)	(3,357)
BALANCE, March 31, 2011	6,641,860	\$ 9.00	59,809	2,657	(40,913)	\$ 21,553

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	
	March 31, 2011	March 31, 2010
	<i>(unaudited)</i>	<i>(unaudited)</i>
OPERATING ACTIVITIES		
Net Income/ (Loss)	\$ (3,357)	\$ (961)
Items not involving cash		
Deferred income taxes recovery	(1,106)	-
Amortization of leaseholds and equipment	790	946
Loss on disposal of leaseholds and equipment	152	-
Amortization of deferred lease inducements	(82)	(96)
Accreted interest expense	199	179
	<u>(3,404)</u>	<u>68</u>
Change in non-cash working capital balances related to operations		
Accounts receivable	(565)	(248)
Inventory [note 5]	(5,208)	(4,718)
Prepaid expenses and deposits	(164)	(47)
Accounts payable and accrued liabilities	1,602	1,352
	<u>(4,335)</u>	<u>(3,661)</u>
Cash used in operating activities	<u>(7,739)</u>	<u>(3,593)</u>
INVESTING ACTIVITIES		
Acquisition of leaseholds and equipment	(605)	(218)
Cash used in investing activities	<u>(605)</u>	<u>(218)</u>
FINANCING ACTIVITIES		
Term loan [note 8]	(250)	-
Cash used in financing activities	<u>(250)</u>	<u>-</u>
CASH OUTFLOW DURING THE PERIOD	(8,594)	(3,811)
CASH, BEGINNING OF PERIOD	7,444	4,119
CASH, END OF PERIOD	\$ (1,150)	\$ 308
Supplemental cash flow information		
Interest paid	\$ 62	\$ 59

See accompanying notes to the interim consolidated financial statements

STERLING SHOES INC.

Notes to Interim Consolidated Financial Statements

March 31, 2011

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

1. ORGANIZATION AND 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 leading 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.

Prior to July 1, 2010, these operations were owned by Sterling Shoes Income Fund, (the “Fund”). On July 1, 2010, the Fund was converted, on a tax deferred basis, from an open-ended limited purpose trust to a corporation (the “Conversion”) pursuant to a plan of arrangement under the Business Corporations Act (British Columbia). Pursuant to the Conversion, the Company acquired all of the outstanding units of the Fund (“Units”), in exchange for Common Shares, on the basis of one Common Share for each Unit. As a result of the Conversion, the Company became the sole holder of the outstanding Units. On July 1, 2010, the Fund was dissolved and all of its assets were transferred to, and all of its liabilities were assumed by the Company. The exchange of the units of the Fund to the Company was recorded at the carrying values of the Fund’s assets and liabilities on July 1, 2010 in accordance with the continuity of interest method of accounting as the Company is considered to be a continuation of the Fund.

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2. BASIS OF PRESENTATION AND FIRST TIME ADOPTION OF IFRS

We prepare our financial statements in accordance with Canadian generally accepted accounting principles as set out in the Handbook of the Canadian Institute of Chartered Accountants (“CICA Handbook”). In 2010, the CICA Handbook was revised to incorporate International Financial Reporting Standards (“IFRS”), and require publicly accountable enterprises to apply such standards effective for years beginning on or after January 1, 2011. Accordingly, we have commenced reporting on this basis in these interim consolidated financial statements. In these financial statements, the term “Canadian GAAP” refers to Canadian GAAP before the adoption of IFRS.

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 4 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 3 and are based on 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.

These interim consolidated financial statements were approved and authorized for issue by the Audit Committee of the Board of Directors on May 12, 2011. In previous periods, the Company prepared its interim consolidated financial statements in accordance with Canadian GAAP.

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 March 31, 2011 are as follows:

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

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3. 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

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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

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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 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

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assessment, the Company estimates the recoverable amount of the asset by performing a 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 8.3%.

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 9), 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 March 31, 2011 the Convertible Debentures were not included in the computation of diluted net loss per share for the three month period ended March 31, 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.

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LTIP shares will vest on the 3rd anniversary of the purchase 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 March 31, 2011, the Company did not accrue any liability in respect of the LTIP (2010 - \$nil). During the three month period ended March 31, 2011 the Company recorded \$17 compensation expense (2010 - \$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.

4. **ADOPTION OF INTERNATIONAL REPORTING STANDARDS (“IFRS”)**

These are the Company’s first interim consolidated financial statements that 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.

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Borrowing Costs

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

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5. INVENTORY

	March 31, 2011	December 31, 2010	January 1, 2010
Inventory at carrying value	\$ 34,771	\$ 30,665	37,278
Obsolescence provision	(949)	(2,051)	(832)
Inventory at lower of cost or net realizable value	\$ 33,822	\$ 28,614	36,446

6. LEASEHOLDS AND EQUIPMENT

	Leasehold Improvements	Furniture and Equipment	Computer Equipment and Software	Total
Balance at January 1, 2010	\$ 14,981	\$ 11,704	\$ 4,470	\$ 31,155
Additions	768	409	953	2,130
Disposals	(261)	(165)		(426)
Cost at December 31, 2010	15,488	11,948	5,423	32,859
Accumulated depreciation at January 1, 2010	(5,576)	\$ (4,348)	\$ (1,636)	(11,560)
Retirements	127	79		206
Depreciation/depletion	(1,557)	(1,474)	(505)	(3,536)
Accumulated Depreciation at December 31, 2010	\$ (7,006)	\$ (5,743)	\$ (2,141)	\$ (14,890)
Net book value at December 31, 2010	\$ 8,482	\$ 6,205	\$ 3,282	\$ 17,969

	Leasehold Improvements	Furniture and Equipment	Computer Equipment and Software	Total
Balance at January 1, 2011	\$ 15,488	\$ 11,948	\$ 5,423	\$ 32,859
Additions	119	121	365	605
Disposals	(104)	(125)		(229)
Cost at March 31, 2011	15,503	11,944	5,788	33,235
Accumulated depreciation at January 1, 2011	(7,006)	\$ (5,743)	\$ (2,141)	(14,890)
Retirements	36	42		78
Depreciation/depletion	(368)	(290)	(133)	(791)
Accumulated Depreciation at March 31, 2011	\$ (7,338)	\$ (5,991)	\$ (2,274)	\$ (15,603)
Net book value at March 31, 2011	\$ 8,165	\$ 5,953	\$ 3,514	\$ 17,632

As at March 31, 2011, the Company has invested \$2.4 million (December 31, 2010 - \$2.2 million and January 1, 2010 - \$1.4 million) in the development of a new enterprise resource planning (ERP) system.

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7. INTANGIBLE ASSETS

	March 31, 2011	December 31, 2010	January 1, 2010
Store banners	\$ 10,005	\$ 10,005	\$ 10,005
Private label brand names	6,618	6,618	6,618
	\$ 16,623	\$ 16,623	\$ 16,623

At March 31, 2011 the Company determined that no impairment was required.

8. TERM LOAN & BANK INDEBTEDNESS

	March 31, 2011	December 31, 2010	January 1, 2010
Term loan	\$ 4,250	\$ 4,500	\$ 5,000

The Company has utilized \$4.3 million (December 31, 2010 - \$4.5 million and January 1, 2010 - \$5.0 million) of an available \$5 million term facility (the "Term Loan"). The Term Loan began amortizing upon renewal of the credit facilities, with repayment terms calling for quarterly principal payments of \$250,000, plus interest, to effect a 5 year amortization. The third payment was made on December 31, 2010. Interest, term, and security are the same as for the Operating Loan, noted below.

The Company has a \$15 million, 3-year committed revolving loan (the "Operating Loan") due on July 31, 2013. The Operating Loan is available for working capital requirements, capital expenditures and for general corporate purposes. Advances bear interest at the lender's prime rate plus 1.25% to 2.75% or at the banker's acceptance rate plus 2.75% to 4.25% based on the ratio of debt to earnings before interest, taxes, depreciation and amortization, calculated on a quarterly basis. This loan is secured by a general security agreement covering all assets of Sterling Shoes LP.

9. CONVERTIBLE DEBENTURES

	March 31, 2011	December 31, 2010	January 1, 2010
Principal amount	\$ 25,000	\$ 25,000	\$ 25,000
Equity component	(2,657)	(2,657)	(2,657)
Accretion	1,529	1,400	920
Deferred financing fees, net of amortization	(409)	(479)	(743)
Convertible unsecured subordinated debentures	\$ 23,463	\$ 23,264	\$ 22,520

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 maturity date for the Debentures is October 31, 2012.

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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 8.3% (2010 - 8.3%). Transaction costs consisting of commissions and professional fees related to the issuance of the Debentures amounted to \$1,231.

10. 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	\$	11,006
2012		14,944
2013		13,627
2014		12,753
2015		10,354
Thereafter		19,258
	\$	81,942

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

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(b) *Letters of credit*

The Company had letters of credit outstanding on March 31, 2011 securing inventory purchase commitments totaling \$2.1 million (December 31, 2010 - \$3.4 million and January 1, 2010 - \$2.7 million). The last of these letters of credit expires on July 31, 2011 for \$1.5 million.

11. 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 9), and the foreign exchange contracts, approximate their carrying values due to their short term or floating rate nature.

Cash is stated at fair value. The fair value of the Debentures is determined by calculating its present value using the estimated market interest rate for loans with similar terms, conditions, and maturities. By using this valuation method, the estimated fair value of the Debentures at March 31, 2011 was \$21.9 million (December 31, 2010 - \$21.9 million and January 1, 2010 - \$19.9 million) compared to its carrying value of \$23.5 million (December 31, 2010 - \$23.3 million and January 1, 2010 - \$22.5 million). As the Debentures are other financial liabilities and are measured at amortized cost, no gain or loss has been recognized in net income relating to the difference between the Debentures' estimated fair value and carrying value.

(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. The following table shows the maturity dates for the Company's liabilities:

<u>in \$000's</u>	<u>2011</u>	<u>2012</u>	<u>2013</u>	<u>2014</u>	<u>2015</u>
Bank indebtedness	1,150				
Accounts payable and accrued liabilities	17,828				
Convertible Debentures		25,000			
Term Loan	750	1,000	2,500		
	<u>19,728</u>	<u>26,000</u>	<u>2,500</u>	<u>0</u>	<u>0</u>

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The Company's future income tax obligation is discussed in Note 15, while its future obligations under operating leases are discussed in Note 10. Deferred lease inducements will not result in cash outflow for the Fund.

The Company manages liquidity risk by managing its capital and debt structure, its cash flows, and its inventory levels. The Company monitors the cash flows generated from operations and evaluates on a regular basis whether it needs to access the capital and banking markets to meet its financial obligations.

(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. The interest rate on the Debentures is at a fixed rate (Note 9). The loans under the Operating Loan and Term Loan 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. Based on the average carrying value of these facilities, a fluctuation in interest rate of 1% would represent a \$11.2 change to the net loss for the three months ended March 31, 2011 (2010 - \$12.5). The interest rate risk would be mitigated by income received on cash balances.

(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 months ended March 31, 2011, approximately 27% (2010- 43%) 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 March 31, 2011, the Company had forward foreign exchange contracts as follows:

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Settlement dates	Face Value \$US	Average rate \$Cdn
April 2011	1,525	1.023
May 2011	1,050	1.014
June 2011	1,050	1.003
July 2011	1,820	0.995
Aug 2011	1,820	0.996
Sept 2011	1,820	0.996
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	1,000	0.977
Mar 2012	500	0.976

As at March 31, 2011, the cumulative unrealized loss on these contracts was \$408 (2010 - \$20).

(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.

12. MANAGEMENT OF CAPITAL

The Company's capital structure consisted of the following components at March 31, 2011: Shareholders' equity of \$21.6 million (2010 - \$29.3 million) and the Debentures of \$23.5 million (2010 - \$22.7 million). The Company's objectives when managing its capital is to maintain compliance with its bank covenants. The covenants include non-GAAP measures such as adjusted EBITDA. The Company was in compliance with its bank covenants at March 31, 2011.

The Company reviews its historical and expected operating results on a regular basis. This review includes consideration of economic conditions, including seasonality, and the competitive environment. In order to maintain or adjust the capital structure, the Company may adjust the amount of dividends paid to its shareholders, issue new shares, or issue or reduce debt.

The Company expects its current capital resources will be sufficient to carry out its plans and operations through its current operating period.

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13. RELATED PARTY TRANSACTIONS

- (a) The Company leases its head office location from a company in which a director and officer of the Company has an interest. Rent expense recognized on this lease was \$79 for the three months ended March 31, 2011 (2010 - \$74) and is included in general and administrative expenses in the statement of income.
- (b) The Company purchased equipment from a company in which a director and officer of the Company has an interest for \$46 during the three months ended March 31, 2011 (2010 - \$6).

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.

14. KEY MANAGEMENT COMPENSATION

Remuneration of directors and key management personnel comprises:

	March 31, 2011	March 31, 2010
Short-term benefits	\$ 414	\$ 311
	414	311

Short-term benefits comprise salaries, bonuses and directors' fees.

15. 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.

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(a) *Income tax expense:*

For the three months period ended March 31		2011
Current tax expense		
Current period	\$	-
Adjustment to prior year		-
	\$	-
Deferred tax expense		
Origination and reversal of temporary differences	\$	(1,106)
Other		
	\$	(1,106)
Total income tax expense (recovery)	\$	(1,106)

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:

For the three months period ended March 31	2011
Earnings (loss) before income taxes	(4,463)
Income tax / (recovery) at statutory rates (26.5%)	(1,183)
Non-deductible expenses	5
Change in deferred income tax on application of future enacted rates	67
Other	5
Provision for (recovery of) deferred income taxes	(1,106)

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(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:

	March 31, 2011	December 31, 2010	January 1, 2010
Operating losses	\$ (1,567)	\$ (704)	\$ -
Leasehold & improvements	(902)	(814)	-
Other temporary differences	-	-	(5)
Deferred income tax asset	(2,469)	(1,518)	(5)
Intangible Asset - store banners	1,251	1,251	1,426
Intangible asset - private label brand names	827	827	943
Other temporary differences	78	233	-
Deferred income tax liability	2,156	2,311	2,369
Net deferred income tax (asset)/liability	\$ (313)	\$ 793	\$ 2,364

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.

16. 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.