

## Management Report

### MANAGEMENT'S RESPONSIBILITY FOR FINANCIAL STATEMENTS

Management is responsible for the preparation and presentation of the accompanying consolidated financial statements and all other information in the Annual Report. This responsibility includes the selection and consistent application of appropriate accounting principles and methods in addition to making the judgements and estimates necessary to prepare the consolidated financial statements in accordance with Canadian generally accepted accounting principles. It also includes ensuring that the financial information presented elsewhere in the Annual Report is consistent with the consolidated financial statements.

In fulfilling its responsibilities, management has developed and maintains systems of internal controls. Although no cost-effective system of internal controls will prevent or detect all errors and irregularities, these systems are designed to provide reasonable assurance that resources are safeguarded from material loss or inappropriate use, that transactions are authorized, recorded and reported properly and that financial records are reliable for preparing the consolidated financial statements. Internal auditors, who are employees of the Company, review and evaluate internal controls on management's behalf. The consolidated financial statements have been audited by the independent auditors, Deloitte & Touche LLP, in accordance with generally accepted auditing standards. Their report follows.

The Board of Directors, acting through an Audit Committee which is comprised solely of directors who are not employees of the Company, is responsible for determining that management fulfills its responsibility for financial reporting and internal control. This responsibility is carried out through periodic meetings with senior officers, financial management, internal audit and the independent auditors, to discuss audit activities, the adequacy of internal financial controls and financial reporting matters. The Audit Committee has reviewed these consolidated financial statements and the Management's Discussion and Analysis and has recommended their approval by the Board of Directors prior to their inclusion in this Annual Report.

**Glenn K. Murphy** (SIGNED)  
CHAIRMAN AND CHIEF EXECUTIVE OFFICER

**Bradley S. Lukow** (SIGNED)  
SENIOR VICE-PRESIDENT, FINANCE

## Auditors' Report

### TO THE SHAREHOLDERS OF SHOPPERS DRUG MART CORPORATION

We have audited the consolidated balance sheets of Shoppers Drug Mart Corporation as at December 29, 2001 and December 30, 2000 and the consolidated statements of earnings, retained earnings and cash flows for the period from December 31, 2000 to December 29, 2001 and for the period from February 4, 2000 to December 30, 2000. We have also audited the combined statements of earnings and cash flows for the period from January 2, 2000 to February 3, 2000 of Shoppers Drug Mart Group, the Predecessor Entity. These financial statements are the responsibility of the respective companies' management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of Shoppers Drug Mart Corporation as at December 29, 2001 and December 30, 2000 and the results of its operations and its cash flows for the periods from December 31, 2000 to December 29, 2001 and February 4, 2000 to December 30, 2000, in accordance with Canadian generally accepted accounting principles. Further, in our opinion, the combined financial statements present fairly, in all material respects, the results of operations and cash flows of Shoppers Drug Mart Group for the period from January 2, 2000 to February 3, 2000 in accordance with Canadian generally accepted accounting principles.

CHARTERED ACCOUNTANTS (SIGNED)  
TORONTO, ONTARIO  
FEBRUARY 7, 2002

## Consolidated Statements of Earnings

	Shoppers Drug Mart Corporation	Predecessor Entity	Shoppers Drug Mart Corporation	"Cumulative"
	For the period December 31, 2000 to December 29,	For the period January 2, 2000 to February 3,	For the period February 4, 2000 to December 30,	For the period January 2, 2000 to December 30,
(in thousands of dollars, except per share amounts)	<b>2001</b>	2000	2000	2000
		(note 1)	(note 1)	(note 1)
<b>Revenue</b>	<b>\$ 3,634,567</b>	\$ 258,561	\$ 2,929,587	\$ 3,188,148
<b>Operating expenses</b>				
Cost of goods sold and other operating expenses (note 16)	<b>3,217,476</b>	223,066	2,575,538	2,798,604
Depreciation and amortization	<b>72,967</b>	6,199	65,472	71,671
<b>Operating income</b>	<b>344,124</b>	29,296	288,577	317,873
Interest expense (note 17)	<b>193,385</b>	1,597	178,788	180,385
<b>Earnings before income taxes and goodwill amortization</b>	<b>150,739</b>	27,699	109,789	137,488
<b>Income taxes</b> (note 18)				
Current	<b>59,291</b>	(283)	57,434	57,151
Future	<b>15,247</b>	12,836	1,061	13,897
	<b>74,538</b>	12,553	58,495	71,048
<b>Earnings before goodwill amortization</b>	<b>76,201</b>	15,146	51,294	66,440
Goodwill amortization (note 7)	<b>53,288</b>	1,469	48,874	50,343
<b>Net earnings</b>	<b>\$ 22,913</b>	\$ 13,677	\$ 2,420	\$ 16,097
<b>Per common share</b> (note 11):				
<b>Earnings before goodwill amortization<sup>(1)</sup></b>				
Basic	<b>\$ 0.42</b>			
Diluted	<b>\$ 0.41</b>			
<b>Net earnings<sup>(1)</sup></b>				
Basic	<b>\$ 0.12</b>			
Diluted	<b>\$ 0.12</b>			

(1) Not applicable for the cumulative period ended December 30, 2000.

## Consolidated Statements of Retained Earnings

	For the period December 31, 2000 to December 29,	For the period February 4, 2000 to December 30,
(in thousands of dollars)	<b>2001</b>	2000
		(note 1)
<b>Retained earnings, beginning of period</b>	<b>\$ 2,337</b>	\$ —
Net earnings for the period	<b>22,913</b>	2,420
Premium on share capital purchased for cancellation (note 11)	<b>(8,201)</b>	(83)
Stock option plan cash payments, net of tax (note 11)	<b>(1,323)</b>	—
<b>Retained earnings, end of period</b>	<b>\$ 15,726</b>	\$ 2,337

## Consolidated Balance Sheets

As at December 29, 2001 and December 30, 2000 (in thousands of dollars)

2001

2000

### Assets

#### CURRENT

Accounts receivable	<b>\$ 312,273</b>	\$ 338,553
Inventory	<b>243,878</b>	151,312
Prepaid expenses	<b>3,597</b>	3,226
Future income taxes (note 18)	<b>7,971</b>	15,646
	<b>567,719</b>	508,737
Long-term receivables (note 4)	<b>100,218</b>	63,620
Capital assets (note 5)	<b>360,915</b>	334,183
Deferred costs (note 6)	<b>84,789</b>	109,631
Future income taxes (note 18)	<b>17,809</b>	17,069
Goodwill and other intangibles (note 7)	<b>1,955,636</b>	2,007,305
<b>Total assets</b>	<b>\$ 3,087,086</b>	<b>\$ 3,040,545</b>

### Liabilities

#### CURRENT

Bank indebtedness (note 8)	<b>\$ 293</b>	\$ 29,666
Accounts payable and accrued liabilities	<b>480,492</b>	421,443
Income taxes payable	<b>43,337</b>	8,633
	<b>524,122</b>	459,742
Long-term debt (note 9)	<b>1,109,545</b>	1,661,977
Other long-term liabilities (note 10)	<b>19,088</b>	18,877
	<b>1,652,755</b>	2,140,596

### Shareholders' equity

Share capital (note 11)	<b>1,418,605</b>	897,612
Retained earnings	<b>15,726</b>	2,337
	<b>1,434,331</b>	899,949
<b>Total liabilities and shareholders' equity</b>	<b>\$ 3,087,086</b>	<b>\$ 3,040,545</b>

ON BEHALF OF THE BOARD OF DIRECTORS:

**Glenn K. Murphy** (SIGNED)  
DIRECTOR

**Paul E. Raether** (SIGNED)  
DIRECTOR

## Consolidated Statements of Cash Flows

	Shoppers Drug Mart Corporation	Predecessor Entity	Shoppers Drug Mart Corporation	"Cumulative"
	For the period December 31, 2000 to December 29,	For the period January 2, 2000 to February 3,	For the period February 4, 2000 to December 30,	For the period January 2, 2000 to December 30,
(in thousands of dollars)	<b>2001</b>	2000	2000	2000
		(note 1)	(note 1)	(note 1)
<b>Operating activities</b>				
Net earnings for the period	\$ 22,913	\$ 13,677	\$ 2,420	\$ 16,097
Items not affecting cash				
Depreciation and amortization	169,731	7,265	126,524	133,789
Future income taxes	15,247	9,629	1,061	10,690
Loss on disposal of capital assets	2,978	403	945	1,348
	<b>210,869</b>	30,974	130,950	161,924
Net change in non-cash working capital balances (note 14)	<b>30,578</b>	12,825	89,516	102,341
Increase (decrease) in long-term liabilities	<b>2,281</b>	(2,376)	5,140	2,764
Cash flows from operating activities	<b>243,728</b>	41,423	225,606	267,029
<b>Investing activities</b>				
Acquisition of predecessor entity including bank debt (note 3)	—	—	(2,590,442)	(2,590,442)
Other business acquisitions	(2,444)	(136)	(1,611)	(1,747)
Capital asset expenditures	(99,701)	(10,624)	(80,518)	(91,142)
Long-term receivables	(16,631)	4,127	(7,203)	(3,076)
Cash flows used in investing activities	<b>(118,776)</b>	(6,633)	(2,679,774)	(2,686,407)
<b>Financing activities</b>				
Deferred financing charges	(72)	—	(91,472)	(91,472)
Long-term debt	264	—	1,725,969	1,725,969
Revolving term debt	(4,215)	—	4,215	4,215
Repayment of long-term debt	(591,232)	—	(96,574)	(96,574)
Issuance of share capital	520,579	—	900,248	900,248
Repurchase of share capital	(18,616)	—	(2,718)	(2,718)
Repurchase of stock options	(2,287)	—	—	—
Cash flows (used in) from financing activities	<b>(95,579)</b>	—	2,439,668	2,439,668
<b>Increase (decrease) in cash</b>	<b>29,373</b>	34,790	(14,500)	20,290
<b>Bank indebtedness, beginning of period</b>	<b>(29,666)</b>	(49,956)	(15,166)	(49,956)
<b>Bank indebtedness, end of period</b>	<b>\$ (293)</b>	\$ (15,166)	\$ (29,666)	\$ (29,666)
<b>Supplemental cash flow information</b>				
Interest paid	\$ 165,668	\$ 2,844	\$ 129,025	\$ 131,869
Income taxes paid	\$ 23,489	\$ 1,288	\$ 53,885	\$ 55,173

## Notes to the Consolidated Financial Statements

December 29, 2001 and December 30, 2000 (in thousands of dollars, except per share data)

### 1. BASIS OF PRESENTATION

Shoppers Drug Mart Corporation (formerly SDM Corporation) (the "Company"), incorporated on November 16, 1999, commenced operations upon acquiring Shoppers Drug Mart Group (the "Predecessor Entity"), a group of companies which were subsidiaries of Imperial Tobacco Canada Limited ("ITCL"), a wholly-owned subsidiary of British American Tobacco p.l.c., for cash consideration of \$2,590,442 on February 4, 2000. The Company became publicly listed on the Toronto Stock Exchange on November 21, 2001.

The Company is a licensor of approximately 830 Shoppers Drug Mart/Pharmaprix full-service retail drug stores across Canada. The Shoppers Drug Mart/Pharmaprix stores are licensed to associate owners ("Associates"). In addition, the Company owns and operates 37 Home Health Care stores. Sales to external customers of the retail drug stores owned by the Associates and of the stores owned by the Company ("system sales") are \$4,996,360 and \$4,535,026 for the periods December 31, 2000 to December 29, 2001 and January 2, 2000 to December 30, 2000, respectively. System sales, other than sales of Company owned stores, do not form part of the Company's revenue.

The acquisition of the Predecessor Entity has been accounted for using the purchase method of accounting (note 3). The consolidated balance sheets include the accounts of the Company and its wholly-owned subsidiaries. The statement of earnings, retained earnings and cash flows for the period February 4, 2000 to December 30, 2000 include the consolidated results of the operations of the Company from the date of acquisition. The Company had no operations from its incorporation to February 3, 2000.

The statements of income and cash flows for the period January 2, 2000 to December 30, 2000 represent the "cumulative" results of the operations of the Predecessor Entity for the period January 2, 2000 to February 3, 2000, and the results of operations of the Company from the date of acquisition to December 30, 2000. The results of operations prior to February 4, 2000 do not represent the Company's ownership of those operations; however, the "cumulative" amounts are presented herein to facilitate comparison of the current year with the "cumulative" prior period.

The fiscal year of the Company consists of a 52 or 53 week period ending on the Saturday closest to December 31.

### 2. SIGNIFICANT ACCOUNTING POLICIES

These financial statements have been prepared in accordance with Canadian generally accepted accounting principles.

#### Revenue recognition

Revenue, as presented in the Consolidated Statements of Earnings, is generated from the sale of goods to Associates and is recognized when goods are shipped. Charges for services provided are recognized when services have been rendered. The Company collects its share of Associate store profits throughout the year by way of a service fee that is based on estimated store profitability. Service fees are adjusted based on the actual year-end results of Associate stores, which have fiscal year-ends at varying dates throughout the year. Revenue is only recognized when collection is probable and the Company has reasonable assurance as to its measurement.

Revenue from corporate-owned stores is recognized at the time goods are sold to external customers, net of returns.

#### Inventory

Inventory is valued at the lower of cost and estimated net realizable value, with cost being determined on the first-in, first-out basis.

### **Capital assets**

Capital assets are recorded at cost. Depreciation and amortization is recorded on a straight-line basis over the estimated useful lives of the assets at the rates indicated below.

Buildings	20 years
Equipment and fixtures	5 or 10 years
Computer software and equipment	3 to 5 years
Leasehold improvements	Lesser of term of the lease and 10 years

### **Deferred financing costs**

Deferred financing costs are being amortized on a straight-line basis over the terms of the debt to which they relate, which range from 7 to 10 years. Any unamortized amounts are charged against earnings when the related debt has been substantially settled.

### **Goodwill and other intangibles**

Goodwill and other intangibles are amortized on a straight-line basis over 40 years. Goodwill and other intangibles recorded by the Predecessor Entity were being amortized on a straight-line basis over a period not to exceed 15 years.

Management reviews the value of goodwill and other intangibles annually to assess whether the value has been impaired based primarily on the ability to recover the balance of the goodwill from expected future operating cash flows on an undiscounted basis. Any permanent impairment in the value for the unamortized portion of goodwill and other intangibles is written-down with a charge against earnings.

### **Foreign currency translation**

Transactions in foreign currencies are translated into Canadian dollars at rates in effect at the date of the transaction. At the balance sheet date, monetary foreign currency assets and liabilities are translated at exchange rates then in effect. Exchange gains or losses are included in the determination of net earnings, except for gains and losses related to long-term monetary items, which are deferred and amortized over the remaining term to maturity.

### **Employee future benefits**

The Company accrues its obligations for employee benefit plans under the following policies:

- The cost of pensions and other retirement benefits earned by employees is actuarially determined using the projected benefit method pro-rated on service and management's best estimate of expected plan investment performance, salary escalation, retirement ages of employees and expected health care costs.
- For the purpose of calculating the expected return on plan assets, those assets are valued at fair value.
- The excess of the net actuarial gain (loss) over 10% of the greater of the benefit obligation and the fair value of plan assets is amortized over the average remaining service period of active employees. The average remaining service period of the active employees covered by the pension plans and covered by the other retirement benefit plans is 12 and 15 years, respectively.

## Notes to the Consolidated Financial Statements

December 29, 2001 and December 30, 2000 (in thousands of dollars, except per share data)

### Income taxes

The Company accounts for income taxes using the liability method of accounting. Under the liability method, future income tax assets and liabilities are determined based on differences between the carrying amounts of balance sheet items and their corresponding tax values. The liability method requires the computation of future income taxes using the substantively enacted corporate income tax rates for the years in which the differences are expected to reverse.

### Financial instruments

The Company uses interest rate derivatives to manage its exposure to fluctuations in interest rates related to the Company's long-term debt. The income or expense arising from the use of these instruments is included in interest expense for the year. The Company also enters into currency derivatives to hedge a portion of its United States dollar denominated debt. Unrealized gains or losses on currency derivatives offset unrealized gains or losses on the hedged portion of the related debt.

### Estimates

The preparation of the consolidated financial statements in conformity with Canadian generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Significant areas requiring the use of management estimates relate to the determination of impairment of assets, pension and other employee benefits, useful lives for amortization, income taxes and future income taxes, the redemption obligation under the Company's loyalty program, and service fees. These estimates are revised periodically to reflect current expectations. Results, as determined by actual events, could differ materially from the above estimates.

### 3. ACQUISITION

As explained in note 1, on February 4, 2000, the Company acquired the Predecessor Entity for cash consideration of \$2,590,442, including costs incurred in connection with the acquisition. The total cost of the purchase was allocated to the net assets on the basis of their fair market values as follows:

Current assets	\$ 370,316
Capital assets	319,134
Other long-term assets	64,170
Current bank indebtedness	(15,166)
Other current liabilities	(191,755)
Long-term liabilities	(11,668)
Net assets acquired	535,031
Goodwill and other intangibles	2,055,411
Purchase price	<u>\$ 2,590,442</u>

#### 4. LONG-TERM RECEIVABLES

	2001		2000	
Long-term receivables from Associates	\$	67,030	\$	58,823
Other long-term receivables		33,188		4,797
	\$	100,218	\$	63,620

Long-term receivables from Associates are comprised primarily of notes receivable which are interest bearing, due on demand, have no fixed terms of repayment and are partially secured by the assets of the Associates' stores. The Company does not plan to redeem the notes within the next year. The interest rate is set annually and was 10.5% as at December 29, 2001 and 8.0% as at December 30, 2000.

Other long-term receivables consist of loans to certain key employees under the Stock Purchase Plan to acquire common shares of the Company (note 11), employee relocation loans and a currency adjustment receivable arising from the currency derivative agreements (note 19). The share purchase loans receivable are non-interest bearing, mature in 2007 and 2008, are subject to certain terms of repayment pursuant to a Shareholders' Agreement and are secured by the shares to which the loans relate.

#### 5. CAPITAL ASSETS

	2001			2000		
	Cost	Accumulated depreciation/amortization	Net book value	Cost	Accumulated depreciation/amortization	Net book value
Land	\$ 25,258	\$ —	\$ 25,258	\$ 25,245	\$ —	\$ 25,245
Buildings	54,790	6,201	48,589	54,466	2,789	51,677
Equipment, fixtures and computer software and equipment	244,513	85,459	159,054	188,579	44,350	144,229
Leasehold improvements	160,974	32,960	128,014	128,224	15,192	113,032
	\$ 485,535	\$ 124,620	\$ 360,915	\$ 396,514	\$ 62,331	\$ 334,183

#### 6. DEFERRED COSTS

	2001			2000		
	Cost	Accumulated amortization	Net book value	Cost	Accumulated amortization	Net book value
Deferred financing costs	\$ 54,722	\$ 13,703	\$ 41,019	\$ 91,472	\$ 9,877	\$ 81,595
Deferred foreign exchange loss	50,359	6,589	43,770	29,895	1,859	28,036
	\$ 105,081	\$ 20,292	\$ 84,789	\$ 121,367	\$ 11,736	\$ 109,631

## Notes to the Consolidated Financial Statements

December 29, 2001 and December 30, 2000 (in thousands of dollars, except per share data)

### 7. GOODWILL AND OTHER INTANGIBLES

	2001			2000		
	Cost	Accumulated amortization	Net book value	Cost	Accumulated amortization	Net book value
Goodwill and other intangibles	<b>\$ 2,058,641</b>	<b>\$ 103,005</b>	<b>\$ 1,955,636</b>	\$ 2,057,022	\$ 49,717	\$ 2,007,305

Amortization recorded on the consolidated statements of earnings of the Company for the period February 4, 2000 to December 30, 2000 and for the period December 31, 2000 to December 29, 2001 is net of income tax recoveries of \$843 and \$825, respectively. Amortization recorded on the combined statement of earnings of the Predecessor Entity for the period January 2, 2000 to February 3, 2000 is net of income tax recoveries of \$85.

### 8. BANK INDEBTEDNESS

Bank indebtedness as at December 29, 2001 and December 30, 2000 is comprised primarily of outstanding cheques, net of cash.

### 9. LONG-TERM DEBT

	2001	2000
Non-revolving term facilities	<b>\$ 1,109,545</b>	\$ 1,131,793
Senior subordinated loans	—	525,969
Revolving term facility	—	4,215
	<b>1,109,545</b>	1,661,977
Less current portion of long-term debt	—	—
	<b>\$ 1,109,545</b>	\$ 1,661,977

#### Term facilities

On February 4, 2000, the Company entered into a credit agreement with a syndicate of banks providing for the following loan facilities:

- (a) a \$350,000, seven-year, revolving term facility maturing February 2, 2007;
- (b) a \$450,000, non-revolving, reducing term facility maturing January 26, 2007;
- (c) a \$25,000, non-revolving, reducing term facility maturing February 4, 2008;
- (d) a U.S. \$242,976, non-revolving, reducing term facility maturing February 4, 2008;
- (e) a \$25,000, non-revolving, reducing term facility maturing February 4, 2009; and
- (f) a U.S. \$242,976, non-revolving, reducing term facility maturing February 4, 2009.

These facilities bear interest based on Prime and Bankers' Acceptance rates for Canadian dollar loans, and Prime and LIBOR rates for U.S. dollar loans. As security for these facilities, the Company has provided a general security agreement covering substantially all of the assets of the Company. The credit agreement specifies the priority of security under each facility and provides for certain restrictive undertakings and covenants to be complied with by the Company.

On February 4, 2000, the full amount of the facilities noted in (b) through (f) above, together with \$35,000 of the facility noted in (a), above, were drawn in conjunction with the acquisition of the Predecessor Entity (see note 1). During 2000 and 2001,

\$75,000 and \$25,000, respectively, of borrowings under the \$450,000 facility noted in (b) above were repaid, reducing the amount of this facility to \$350,000. During 2001, \$15,000 of borrowings under the \$25,000 facility noted in (c) above and \$25,000 of borrowings under the facility noted in (e) above were repaid, reducing the amount of each of these facilities to \$10,000 and nil, respectively. During 2000, U.S. \$7,300 of borrowings under each of the U.S. \$242,976 facilities noted in (d) and (f) above were repaid, reducing the amount of each of these facilities to U.S. \$235,676.

As at December 29, 2001, \$1,882 of the \$350,000 revolving facility noted in (a) above was utilized, all in respect of letters of credit and trade finance guarantees. As at December 30, 2000, \$8,431 of the \$350,000 revolving facility noted in (a) above was utilized, including \$4,216 in respect of letters of credit and trade finance guarantees.

#### **Senior subordinated loan agreement**

During 2001, the Company fully repaid the senior subordinated loans with the net proceeds from its initial public offering (note 11) together with cash flow from operations.

#### **Minimum repayments**

Minimum required repayments of long-term debt for the next five calendar years are as follows:

2002	\$ —
2003	12,500
2004	87,500
2005	107,694
2006	107,728
2007–2009	794,123
	<u>\$ 1,109,545</u>

## **10. OTHER LONG-TERM LIABILITIES**

#### **Employee future benefits**

The Company maintains registered defined benefit pension plans under which benefits are available to substantially all employees. The Company also makes supplementary retirement benefits available to certain employees under an unregistered plan.

The pension plans are funded through contributions based on actuarial cost methods as permitted by pension regulatory bodies as applicable. Earnings are charged with the cost of benefits earned by employees as services are rendered. Benefits under these plans are based on the employee's years of service and final average earnings.

The Company also maintains post-retirement benefit plans, other than pensions, covering benefits such as health and life insurance benefits for retirees. The cost of these plans is charged to earnings as benefits are earned by employees on the basis of service rendered.

Included in other long-term liabilities are employee future benefits in the amount of \$9,345 as at December 29, 2001 and \$11,345 as at December 30, 2000 in respect of pension and other post-retirement benefit plans.

## Notes to the Consolidated Financial Statements

December 29, 2001 and December 30, 2000 (in thousands of dollars, except per share data)

Information about the Company's pension and other post-retirement benefit plans is as follows:

	2001		2000	
	Pension plans	Other benefit plans	Pension plans	Other benefit plans
Accrued benefit obligation	\$ 57,546	\$ 2,703	\$ 48,186	\$ 2,403
Fair value of plan assets	39,533	—	34,172	—
Funded status – plan deficit	18,013	2,703	14,014	2,403
Unrecognized losses (gains)	11,378	(7)	5,079	(7)
Accrued benefit liability	\$ 6,635	\$ 2,710	\$ 8,935	\$ 2,410
<b>Accrued benefit obligations</b>				
Benefit obligation, beginning of period	\$ 48,186	\$ 2,403	\$ 41,572	\$ 2,127
Service cost	3,357	409	2,539	359
Interest cost	2,441	187	1,975	162
Participant contributions	910	—	688	—
Actuarial loss (gain)	4,012	—	3,783	(7)
Benefits paid	(1,360)	(296)	(2,371)	(238)
Accrued benefit obligation, end of period	\$ 57,546	\$ 2,703	\$ 48,186	\$ 2,403
<b>Fair value of plan assets</b>				
Market value of plan assets, beginning of period	\$ 34,172	\$ —	\$ 32,155	\$ —
Actual return on plan assets	(1,213)	—	251	—
Company contribution	7,024	296	3,449	238
Participant contributions	910	—	688	—
Benefits paid	(1,360)	(296)	(2,371)	(238)
Fair value of plan assets, end of period	\$ 39,533	\$ —	\$ 34,172	\$ —

The significant actuarial assumptions adopted in measuring the Company's accrued benefit liability are as follows:

	2001			2000		
	Registered pension plans	Non-registered pension plan	Other benefit plans	Registered pension plans	Non-registered pension plan	Other benefit plans
Discount rate	6.50%	3.25%	7.00%	7.00%	3.50%	7.00%
Expected return on assets	7.50%	3.75%	N/A	7.50%	3.75%	N/A
Compensation increase	4.50%	4.50%	4.50%	4.50%	4.50%	4.00%

The health care cost trend rate used was 8.5%, which is reduced 1% each year after 2001, to an ultimate rate of 5.5% for 2004 and later years. A one percentage point decrease (increase) in the assumed health care costs trend rate, holding all other assumptions constant, would increase (decrease) the service and interest cost components of 2001 net periodic benefit cost by \$23 (\$20) and would increase (decrease) the December 29, 2001 benefit obligation by \$182 (\$149).

The components of the Company's pension and other post-retirement benefit plans expense are as follows:

	2001		2000	
	Pension plans	Other benefit plans	Pension plans	Other benefit plans
Service cost	\$ 3,357	\$ 409	\$ 2,539	\$ 359
Interest on benefit obligation and service cost	2,441	187	1,975	162
Expected return on assets	(1,826)	—	(1,547)	—
Amortization	52	—	—	—
Net expense	\$ 4,024	\$ 596	\$ 2,967	\$ 521

## 11. SHARE CAPITAL

	2001	2000
<b>Authorized</b>		
Unlimited number of common shares		
Unlimited number of non-voting shares		
<b>Issued</b>		
<b>Common shares</b>	<b>\$ 1,418,605</b>	\$ 856,553
December 29, 2001 – 209,671,705		
December 30, 2000 – 171,310,000		
<b>Non-voting shares</b>	—	41,059
December 29, 2001 – nil		
December 30, 2000 – 8,211,705		
	<b>\$ 1,418,605</b>	<b>\$ 897,612</b>

### Weighted average shares outstanding

December 29, 2001	
Basic	– 183,306,247
Diluted	– 184,291,972
December 30, 2000 – not applicable	

The Company was capitalized on February 4, 2000 by the issuance of 171,622,000 common shares and 8,281,705 non-voting shares at \$5.00 per share for total proceeds of \$899,519. The non-voting shares were issued to certain Associates and converted to common shares upon the Company becoming public.

During the period February 4, 2000 to December 30, 2000, an additional 145,000 common shares were issued for net proceeds of \$728 and 457,000 common shares were repurchased for cancellation for \$2,363 which includes a \$78 premium, over the stated capital, that has been charged against the retained earnings. In addition, 70,000 non-voting shares were repurchased for cancellation for \$355 which includes a \$5 premium, over the stated capital, that has been charged against the retained earnings.

On November 21, 2001, the Company issued 30,000,000 common shares through an initial public offering at \$18.00 per common share for gross proceeds of \$540,000 and incurred \$19,054 of share issuance costs, net of tax of \$10,774. In addition, during the period December 31, 2000 to December 29, 2001, 1,935,440 common shares were issued for net proceeds of \$10,462, net of tax of \$55, and 1,785,440 common shares were repurchased for cancellation for \$18,616 which includes an \$8,201 premium, over the stated capital, that has been charged against retained earnings.

The common shares that may be issued under the Company's stock option plan have a dilutive impact on the weighted average number of shares of 985,725.

Individual shareholder agreements address matters related to the transfer of certain shares issued to the Company's management and Associates, including shares issued under options granted to management. In particular, each provides, subject to certain exceptions, for a general prohibition on any transfer of a member of management's or an Associate's shares for a period of five years from the date that the individual entered into the shareholder agreement. As at December 29, 2001, 6,470,000 and 8,301,705 shares issued to management and Associates, respectively are subject to this restriction.

### Stock option plan

The Company has issued to certain employees options to purchase common shares. Options are granted in equal proportions between time-based vesting and performance-based vesting criteria. Time-based options are exercisable 20% per year on the

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anniversary of the grant date in each of the five subsequent years. Performance-based options are exercisable 20% per year on the anniversary of the grant date in each of the five subsequent years provided that the Company achieves specified earnings-based performance targets. Performance targets not achieved are considered to be met if the performance is achieved on a cumulative basis in subsequent years. The performance-based options become fully exercisable on the ninth anniversary of the date of grant, provided that they have not otherwise been terminated, whether or not the performance targets are achieved.

Upon the termination of an optionee's employment, all unexercisable options expire immediately and exercisable options expire within 180 days of the date of termination. The plan and certain termination agreements provide for the Company to pay, in cash, terminated option holders any appreciation value of the options to cancel exercisable options. The Company's payments of \$2,287 (\$1,323, net of tax) to option holders in respect of the appreciation value of the exercisable options have been charged to retained earnings. Subject to certain prior events of expiry, such as the termination of the employee's employment for cause, all exercisable options expire on the tenth anniversary of the date of grant.

On November 21, 2001, the Company issued time-based options to purchase 60,000 common shares at an exercise price equal to the initial public offering price to each of seven of its directors. One-third of the options become exercisable in each of the following three years on the anniversary of the date of the grant. Unexercisable options expire upon the optionee ceasing to be a director.

A summary of the status of the Company's stock option plan as at December 29, 2001 and December 30, 2000, and changes during the respective periods then ended are presented below:

	For the period December 31, 2000 to December 29,		For the period February 4, 2000 to December 30,	
	2001		2000	
	Options on common shares	Weighted average exercise price per share	Options on common shares	Exercise price per share
Outstanding, beginning of period	9,995,000	\$ 5.00	—	\$ —
Granted	4,366,600	6.65	11,314,500	5.00
Exercised	—	—	—	—
Expired	(7,341,100)	5.05	(1,319,500)	5.00
Outstanding, end of period	7,020,500	\$ 5.98	9,995,000	\$ 5.00
Options exercisable, end of period	2,297,400	\$ 5.01	—	—
Weighted average remaining contractual life	8.0 years		9.0 years	

### Deferred share unit plan for non-employee directors

During the year, the Company established a deferred share unit (DSU) plan to provide directors with the option to elect to receive DSUs in lieu of cash payment for all or a portion of their director fees to be earned in the following year. When elected, the Company will credit to the account of each director a number of DSUs (each equivalent in value to a common share) equal to the amount of fees deferred divided by the fair market value of the common shares on the date of deferral. The directors' accounts shall be credited with dividend equivalents in the form of additional DSUs if and when the Company pays dividends on the common shares. Upon the director ceasing to be a member of the Board of Directors, the director shall receive a cash amount equal to the number of DSUs in his or her account multiplied by the fair market value of the common shares on the date the director ceases to be a member of the Board of Directors or on a later date selected by the director, which shall in any event be a date prior to the end of the following calendar year. The plan became active subsequent to December 29, 2001.

## 12. OBLIGATIONS UNDER OPERATING LEASES

The minimum lease payments on a calendar year basis under long-term leases for store locations and office space are as follows:

	2002	2003	2004	2005	2006	Thereafter
Total lease obligations	\$ 122,641	\$ 112,402	\$ 98,297	\$ 87,529	\$ 75,624	\$ 282,722

The Company charges Associates rent to recover rentals payable for store locations.

## 13. CONTRACTUAL OBLIGATIONS

The Company has entered into an agreement with a third party to provide distribution services to the Company's locations to December 31, 2005. Under the terms of this agreement, the third party will charge the Company specified costs incurred to provide the distribution services, plus an annual management fee.

## 14. NET CHANGE IN NON-CASH WORKING CAPITAL BALANCES

	Shoppers Drug Mart Corporation	Predecessor Entity	Shoppers Drug Mart Corporation	"Cumulative"
	For the period December 31, 2000 to December 29, 2001	For the period January 2, 2000 to February 3, 2000	For the period February 4, 2000 to December 30, 2000	For the period January 2, 2000 to December 30, 2000
		(note 1)	(note 1)	(note 1)
Accounts receivable	\$ 26,280	\$ 78,206	\$ (144,476)	\$ (66,270)
Inventory	(92,566)	47,088	(6,382)	40,706
Prepaid expenses	(371)	(106)	477	371
Accounts payable and accrued liabilities	59,049	(74,670)	229,688	155,018
Due to ITCL	—	(30,744)	—	(30,744)
Income tax payable	38,186	(6,949)	10,209	3,260
	<b>\$ 30,578</b>	\$ 12,825	\$ 89,516	\$ 102,341

## 15. CONTINGENT LIABILITIES

### Guarantees

As at December 29, 2001 and December 30, 2000, the Company has provided guarantees of approximately \$331,000 and \$296,000, respectively, to various banks in respect of borrowings by Associates.

### Lawsuits

Under the terms of its acquisition of the Predecessor Entity (note 1), the Company has indemnified ITCL for all legal claims against the Company for the period prior to February 4, 2000. In addition, the Company is involved in certain legal claims arising in the normal course of business.

In the opinion of management, the eventual settlement of such claims will not have a significant effect on the Company's financial position or results of operations. Management has recorded a provision for these claims based on their best estimate of the final settlements.

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### 16. CORPORATE RESTRUCTURING

Included in cost of goods sold and other operating expenses for the period ended December 29, 2001 is a charge of \$19,500 in respect of staff restructuring costs related to the streamlining of business processes.

### 17. INTEREST EXPENSE

The significant components of the Company's interest expense are as follows:

	Shoppers Drug Mart Corporation	Predecessor Entity	Shoppers Drug Mart Corporation	"Cumulative"
	For the period December 31, 2000 to December 29,	For the period January 2, 2000 to February 3,	For the period February 4, 2000 to December 30,	For the period January 2, 2000 to December 30,
	<b>2001</b>	2000	2000	2000
		(note 1)	(note 1)	(note 1)
Interest on long-term debt	\$ 146,900	\$ —	\$ 166,748	\$ 166,748
Amortization of:				
Deferred financing costs	40,648	—	9,877	9,877
Foreign exchange losses	4,981	—	1,859	1,859
Other interest expense	856	1,597	304	1,901
	<b>\$ 193,385</b>	\$ 1,597	\$ 178,788	\$ 180,385

Included in the amortization of deferred financing costs for the period ended December 29, 2001 is a \$29,324 write-off of deferred financing costs related to the senior subordinated debt facility that was fully repaid during the period (note 9).

### 18. INCOME TAXES

The significant components of the Company's future income tax assets are as follows:

	<b>2001</b>	2000
<b>Current</b>		
Non-deductible accruals	\$ 14,756	\$ 16,976
Deductible share issuance costs	2,329	—
Income not taxed in current year	(7,921)	—
Other	(1,193)	(1,330)
	<b>\$ 7,971</b>	\$ 15,646
<b>Long-term</b>		
Non-deductible accruals	\$ 6,226	\$ 6,129
Deductible share issuance costs	5,983	—
Depreciable assets	5,713	12,741
Deductible financing costs	(623)	(1,620)
Other	510	(181)
	<b>\$ 17,809</b>	\$ 17,069

The significant components of the income tax expense are as follows:

	<b>Shoppers Drug Mart Corporation</b>	Predecessor Entity	Shoppers Drug Mart Corporation	"Cumulative"
	<b>For the period December 31, 2000 to December 29,</b>	For the period January 2, 2000 to February 3,	For the period February 4, 2000 to December 30,	For the period January 2, 2000 to December 30,
	<b>2001</b>	2000	2000	2000
		(note 1)	(note 1)	(note 1)
Current income tax	<b>\$ 55,532</b>	\$ (283)	\$ 53,347	\$ 53,064
Large corporations tax	<b>3,759</b>	—	4,087	4,087
Future income tax resulting from reversal of temporary differences	<b>13,155</b>	12,836	(2,017)	10,819
Future income tax resulting from tax rate change	<b>2,092</b>	—	3,078	3,078
	<b>\$ 74,538</b>	\$ 12,553	\$ 58,495	\$ 71,048

The effective income tax rate is comprised of the following:

	<b>Shoppers Drug Mart Corporation</b>	Predecessor Entity	Shoppers Drug Mart Corporation	"Cumulative"
	<b>For the period December 31, 2000 to December 29,</b>	For the period January 2, 2000 to February 3,	For the period February 4, 2000 to December 30,	For the period January 2, 2000 to December 30,
	<b>2001</b>	2000	2000	2000
		(note 1)	(note 1)	(note 1)
Combined Canadian federal and provincial statutory tax rate	<b>42.0%</b>	44.4%	43.8%	44.0%
Adjusted for:				
Large corporations tax	<b>2.5%</b>	—	3.7%	3.0%
Decrease in future income taxes resulting from statutory tax rate reduction	<b>1.4%</b>	—	2.8%	2.2%
Non-deductible charges	<b>3.5%</b>	0.9%	2.9%	2.5%
Effective income tax rate before goodwill amortization	<b>49.4%</b>	45.3%	53.2%	51.7%
Non-deductible goodwill amortization	<b>26.9%</b>	2.6%	42.7%	29.6%
Effective income tax rate	<b>76.3%</b>	47.9%	95.9%	81.3%

## 19. FINANCIAL INSTRUMENTS

### Interest rate derivatives

The Company has entered into interest rate derivative agreements converting an aggregate notional principal amount of \$350,000 of floating rate debt into fixed rate debt. The fixed rates payable by the Company under these agreements range from 6.07% to 6.10%. These agreements mature on April 14, 2005.

Based on market values at December 29, 2001 and December 30, 2000, the Company would have incurred losses of \$20,966 and \$7,479, respectively, to terminate these interest rate derivative agreements. Market values were determined based on information received from the Company's counterparties to these agreements.

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### Currency derivatives

The Company has entered into currency derivative agreements to exchange a notional principal amount of U.S. \$242,976 of debt for Canadian dollar denominated debt. These agreements mature on June 16, 2003. Currency adjustments receivable or payable arising from these agreements may be settled in cash on maturity. As at December 29, 2001 and December 30, 2000, a currency adjustment of \$19,967 and \$2,071, respectively, related to these agreements was included in long-term receivables and other long-term liabilities, respectively.

Based on market values at December 29, 2001 and December 30, 2000, excluding the currency adjustments noted above, the Company would have incurred a gain of \$1,028 and a loss of \$674, respectively, to terminate these currency derivative agreements. Market values were determined based on information received from the Company's counterparties to these agreements.

### Counterparty risk

Changes in the underlying interest rates and exchange rates of the Company's interest rate and currency derivative agreements will result in market gains and losses. Furthermore, the Company may be exposed to losses should any counterparty to its derivative agreements fail to fulfill its obligations. The Company has sought to minimize counterparty risk by transacting with counterparties that are large international financial institutions.

### Credit risk

The Company has credit risk associated with accounts receivable and long-term receivables from Associates. The risk of collection is mitigated since these balances owed are spread over a number of different Associates.

### Fair value of financial instruments

The fair value of a financial instrument is the estimated amount that the Company would receive or pay to terminate the contracts at the reporting date.

The fair values of accounts receivable, bank indebtedness, accounts payable and accrued liabilities approximate their carrying values given their short-term maturities. The fair values of long-term receivables, long-term liabilities and long-term debt approximate their carrying values given the current market rates associated with these instruments.

The fair value of the interest rate and currency derivatives, as noted above, is determined based on current market rates and on information received from the Company's counterparties to these agreements.

## 20. RELATED PARTY TRANSACTIONS

The Corporation incurred management fees and expenses of \$2,165 and \$2,206 during the period ended December 29, 2001 and the period February 4, 2000 to December 30, 2000, respectively, and financing and acquisition related fees of \$30,414 during the period February 4, 2000 to December 30, 2000, to certain shareholders who collectively hold 78.7% of the common shares of the Company at December 29, 2001.