

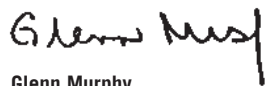
## Management Report

### 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 Murphy**

CHAIRMAN AND CHIEF EXECUTIVE OFFICER



**George Halatsis**

EXECUTIVE VICE-PRESIDENT & CHIEF FINANCIAL OFFICER

### 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 28, 2002 and December 29, 2001 and the consolidated statements of earnings, retained earnings and cash flows for the 52 week periods then ended. These financial statements are the responsibility of the Company's 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 28, 2002 and December 29, 2001 and the results of its operations and its cash flows for the 52 week periods then ended, in accordance with Canadian generally accepted accounting principles.



**Chartered Accountants**

TORONTO, ONTARIO  
FEBRUARY 11, 2003

## Consolidated Statements of Earnings

52 weeks ended December 28, 2002 and December 29, 2001

(in thousands of dollars, except per share amounts)	2002	2001
<b>Revenue</b>	<b>\$ 4,019,401</b>	\$ 3,634,567
<b>Operating expenses</b>		
Cost of goods sold and other operating expenses (note 3)	3,518,291	3,217,476
Amortization	77,827	72,967
<b>Operating income</b>	<b>423,283</b>	344,124
Interest expense (notes 2 and 4)	79,011	209,119
<b>Earnings before income taxes and goodwill amortization</b>	<b>344,272</b>	135,005
<b>Income taxes</b> (note 5)		
Current	131,829	59,291
Future	3,859	15,247
	<b>135,688</b>	74,538
<b>Earnings before goodwill amortization</b>	<b>208,584</b>	60,467
Goodwill amortization (note 2)	—	53,288
<b>Net earnings</b>	<b>\$ 208,584</b>	\$ 7,179
<b>Per common share (note 13):</b>		
<b>Net earnings</b>		
Basic	\$ 1.00	\$ 0.04
Diluted	\$ 0.98	\$ 0.04

## Consolidated Statements of Retained Earnings

52 weeks ended December 28, 2002 and December 29, 2001

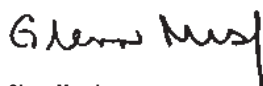
(in thousands of dollars)	2002	2001
<b>Retained earnings, beginning of period as reported</b>	<b>\$ 15,726</b>	\$ 2,337
Impact of new accounting standards (note 2)		
– Foreign currency translation	(43,770)	(28,036)
– Stock-based compensation	(478)	—
Net earnings	208,584	7,179
Premium on share capital purchased for cancellation (note 13)	(2,346)	(8,201)
Stock option plan cash payments, net of tax	—	(1,323)
<b>Retained earnings (deficit), end of period</b>	<b>\$ 177,716</b>	\$ (28,044)

## Consolidated Balance Sheets

As at December 28, 2002 and December 29, 2001

(in thousands of dollars)	2002	2001
<b>Assets</b>		
Current		
Accounts receivable	\$ 321,720	\$ 312,273
Inventory	267,504	243,878
Future income taxes (note 5)	7,009	7,971
Prepaid expenses	3,993	3,597
	<b>600,226</b>	567,719
Long-term receivables (note 6)	133,127	100,218
Property and equipment (note 7)	392,903	360,915
Deferred costs (notes 2 and 8)	18,155	41,019
Future income taxes (note 5)	14,912	17,809
Goodwill (note 9)	1,971,736	1,955,636
<b>Total assets</b>	<b>\$ 3,131,059</b>	<b>\$ 3,043,316</b>
<b>Liabilities</b>		
Current		
Bank indebtedness (note 10)	\$ 10,774	\$ 293
Accounts payable and accrued liabilities	498,492	480,492
Income taxes payable	72,042	43,337
Current portion of long-term debt (note 11)	12,500	—
	<b>593,808</b>	524,122
Long-term debt (note 11)	926,063	1,109,545
Other long-term liabilities (note 12)	13,689	19,088
	<b>1,533,560</b>	1,652,755
<b>Shareholders' equity</b>		
Share capital (note 13)	1,419,783	1,418,605
Retained earnings (deficit) (note 2)	177,716	(28,044)
	<b>1,597,499</b>	1,390,561
<b>Total liabilities and shareholders' equity</b>	<b>\$ 3,131,059</b>	<b>\$ 3,043,316</b>

ON BEHALF OF THE BOARD OF DIRECTORS:



Glenn Murphy  
DIRECTOR



Paul E. Raether  
DIRECTOR

## Consolidated Statements of Cash Flows

52 weeks ended December 28, 2002 and December 29, 2001

(in thousands of dollars)	2002	2001
<b>Operating activities</b>		
Net earnings	\$ 208,584	\$ 7,179
Items not affecting cash		
Amortization	97,784	164,750
Foreign currency (gain) loss (note 2)	(10,599)	20,715
Future income taxes	3,859	15,247
Loss on disposal of property and equipment	4,406	2,978
	<b>304,034</b>	210,869
Net change in non-cash working capital balances (note 14)	16,955	30,578
(Decrease) increase in long-term liabilities	(5,583)	2,281
Cash flows from operating activities	<b>315,406</b>	243,728
<b>Investing activities</b>		
Purchase of property and equipment	(109,398)	(99,701)
Business acquisitions	(19,787)	(2,444)
Long-term receivables	(39,699)	(16,631)
Cash flows used in investing activities	<b>(168,884)</b>	(118,776)
<b>Financing activities</b>		
Long-term debt	651,822	264
Revolving term debt	—	(4,215)
Repayment of long-term debt (note 11)	(811,742)	(591,232)
Proceeds from derivative contracts	8,066	—
Deferred financing charges	(1,500)	(72)
Issuance of share capital	340	520,579
Repurchase of share capital	(3,552)	(18,616)
Repurchase of stock options	(437)	(2,287)
Cash flows used in financing activities	<b>(157,003)</b>	(95,579)
<b>(Decrease) increase in cash</b>	<b>(10,481)</b>	29,373
<b>Bank indebtedness, beginning of period</b>	<b>(293)</b>	<b>(29,666)</b>
<b>Bank indebtedness, end of period</b>	<b>\$ (10,774)</b>	<b>\$ (293)</b>
<b>Supplemental cash flow information</b>		
Interest paid	\$ 65,497	\$ 165,668
Income taxes paid	\$ 103,526	\$ 23,489

# Notes to the Consolidated Financial Statements

December 28, 2002 and December 29, 2001 (in thousands of dollars, except share data)

## 1. BASIS OF PRESENTATION

Shoppers Drug Mart Corporation (“the Company”) is a licensor of approximately 844 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 46 Shoppers Home Health Care stores. The Company became publicly listed on the Toronto Stock Exchange on November 21, 2001.

Sales to external customers of the retail drug stores owned by the Associates and of the stores owned by the Company (“system sales”) were \$5,438,700 and \$4,996,360 for the 52 weeks ended December 28, 2002 and December 29, 2001, respectively. System sales, other than sales of the Company-owned stores, do not form part of the Company’s revenue.

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.

### Basis of consolidation

The consolidated financial statements include the accounts of Shoppers Drug Mart Corporation and its subsidiaries.

### 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 to Associates are recognized when services have been rendered. The Company recognizes its share of Associate store profits throughout the year by way of a service fee that is based on store profitability. Revenue is only recognized when collection is probable and the Company has reasonable assurance as to its measurement.

Revenue from Company-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.

### Property and equipment

Property and equipment are recorded at cost. 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

## Notes to the Consolidated Financial Statements

December 28, 2002 and December 29, 2001 (in thousands of dollars, except share data)

### Deferred financing costs

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

### 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.

### 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 the United States dollar denominated portion of its long-term debt.

The Company assesses, both at the hedge's inception and on an ongoing basis, whether the derivatives that are used in hedging transactions are highly effective in offsetting changes in fair values or cash flows of hedged items.

### 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. Actual results could differ from those estimates.

## CHANGES IN ACCOUNTING POLICIES

### Goodwill

For 2002, the Company adopted the new accounting standard 3062 “Goodwill and Other Intangible Assets” on a prospective basis. Goodwill is no longer amortized, but will be tested for impairment on an annual basis. The excess of the carrying amount over the fair value of these assets would be charged to earnings. Prior to 2002, goodwill was amortized on a straight-line basis over 40 years.

During the second quarter of 2002, the Company completed the transitional impairment test and concluded that no charge was required to the carrying value of goodwill.

The following table indicates the effect of applying new accounting standard 3062 on net earnings and basic and diluted earnings per share for the prior period:

	2002	2001
<b>Net earnings</b>		
Net earnings	\$ 208,584	\$ 7,179
Add: goodwill amortization	—	53,288
Adjusted net earnings	<u>\$ 208,584</u>	<u>\$ 60,467</u>
<b>Basic earnings per share</b>		
Net earnings	\$ 1.00	\$ 0.04
Add: goodwill amortization	—	0.29
Adjusted net earnings	<u>\$ 1.00</u>	<u>\$ 0.33</u>
<b>Diluted earnings per share</b>		
Net earnings	\$ 0.98	\$ 0.04
Add: goodwill amortization	—	0.29
Adjusted net earnings	<u>\$ 0.98</u>	<u>\$ 0.33</u>

### Foreign currency translation

For 2002, the Company adopted the new accounting standard 1650 “Foreign Currency Translation” on a retroactive basis with restatement of prior periods. The new standard eliminates the deferral and amortization method of accounting for unrealized translation gains and losses on non-current monetary assets and liabilities. The new standard also requires foreign exchange gains and losses to be included in net earnings.

The implementation of the new standard has resulted in a charge to fiscal 2002 and 2001 opening retained earnings of \$43,770 and \$28,036, respectively, with a corresponding reduction to deferred costs. In addition, interest expense has been increased and net earnings has been decreased in 2001 by \$15,734 to recognize the total unrealized foreign exchange loss applicable to the translation of the Company's long-term U.S. dollar denominated loans. Interest expense in 2002 includes a foreign exchange gain of \$10,599 (note 4).

## Notes to the Consolidated Financial Statements

December 28, 2002 and December 29, 2001 (in thousands of dollars, except share data)

### Stock-based compensation

The Company has stock option compensation plans which are described in note 13. No compensation expense is recognized for these plans when stock options are granted to employees and directors. Any consideration paid by employees and directors on exercise of stock options is credited to share capital.

For 2002, the Company adopted the new accounting standard 3870 “Stock-Based Compensation and Other Stock-Based Payments” on a prospective basis. The new standard requires recognition of compensation expense for certain types of stock-based compensation awards granted to employees and others. The new standard is applied to awards granted on or after January 1, 2002 and to certain forms of awards outstanding at the date of adoption. Certain awards outstanding at the date of adoption are to be recognized and charged to opening retained earnings. The implementation of the new standard resulted in a charge to fiscal 2002 opening retained earnings of \$478, net of tax.

The Company, as permitted under the new standard, has chosen not to use the fair value method to account for stock options issued under the employee and director stock option programs.

Pro forma disclosures relating to net earnings and earnings per share figures as if the fair value method of accounting had been used are presented in note 13.

### Comparative amounts

Certain comparative amounts have been reclassified to conform with the current year’s financial statement presentation.

## 3. CORPORATE RESTRUCTURING

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

## 4. INTEREST EXPENSE

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

	2002	2001
Interest on long-term debt	\$ 65,247	\$ 147,756
Amortization of deferred financing costs	5,380	11,324
Write-off of deferred financing costs	18,983	29,324
Foreign exchange (gain) loss	(10,599)	20,715
	<u>\$ 79,011</u>	<u>\$ 209,119</u>

## 5. INCOME TAXES

The effective income tax rate is comprised of the following:

	2002	2001
Combined Canadian federal and provincial statutory tax rate	38.8%	42.0%
Adjusted for:		
Large corporations tax	0.7%	2.8%
(Decrease) increase in future income taxes resulting from statutory tax rate changes	(0.2%)	1.5%
Non-taxable portion of capital (gains) losses	(0.6%)	7.1%
Recognition of previously unrecorded tax benefits	(0.1%)	(1.4%)
Non-deductible charges	0.8%	3.2%
Effective income tax rate before goodwill amortization	39.4%	55.2%
Non-deductible goodwill amortization	—	36.0%
Effective income tax rate	39.4%	91.2%

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

	2002	2001
<b>Current</b>		
Accrued liabilities	\$ 12,331	\$ 14,756
Share issuance costs	2,204	2,329
Income not taxed in current year	(6,467)	(7,921)
Other	(1,059)	(1,193)
	<b>\$ 7,009</b>	<b>\$ 7,971</b>
<b>Long-term</b>		
Depreciable assets	\$ 4,296	\$ 5,713
Share issuance costs	3,967	5,983
Accrued liabilities	3,872	6,226
Financing costs	3,742	(623)
Other	(965)	510
	<b>\$ 14,912</b>	<b>\$ 17,809</b>

The Company has \$41,206 of capital losses available to be applied against future capital gains. No income tax benefit related to the losses has been recognized.

## Notes to the Consolidated Financial Statements

December 28, 2002 and December 29, 2001 (in thousands of dollars, except share data)

### 6. LONG-TERM RECEIVABLES

	2002		2001	
Long-term receivables from Associates	\$	106,807	\$	67,030
Other long-term receivables		26,320		33,188
	\$	133,127	\$	100,218

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 28, 2002 and December 29, 2001.

Other long-term receivables consist primarily of loans to certain key employees under the Stock Purchase Plan to acquire common shares of the Company (note 13) and a currency adjustment receivable arising from the currency derivative agreements (note 16). The share purchase loans receivable are non-interest bearing, mature in 2007, 2008 and 2009, are subject to certain terms of repayment pursuant to a Shareholders' Agreement and are secured by the shares to which the loans relate. As at December 28, 2002, the shares held as collateral had a market value in excess of the loans receivable.

### 7. PROPERTY AND EQUIPMENT

	2002			2001		
	Cost	Accumulated Amortization	Net Book Value	Cost	Accumulated Amortization	Net Book Value
Land	\$ 26,063	\$ —	\$ 26,063	\$ 25,258	\$ —	\$ 25,258
Buildings	54,895	9,621	45,274	54,790	6,201	48,589
Equipment, fixtures and computer software and equipment	301,019	128,187	172,832	244,513	85,459	159,054
Leasehold improvements	198,913	50,179	148,734	160,974	32,960	128,014
	\$ 580,890	\$ 187,987	\$ 392,903	\$ 485,535	\$ 124,620	\$ 360,915

### 8. DEFERRED COSTS

	2002			2001		
	Cost	Accumulated Amortization	Net Book Value	Cost	Accumulated Amortization	Net Book Value
Deferred financing costs	\$ 30,206	\$ 12,051	\$ 18,155	\$ 54,722	\$ 13,703	\$ 41,019

## 9. GOODWILL

	2002			2001		
	Cost	Accumulated Amortization	Net Book Value	Cost	Accumulated Amortization	Net Book Value
Goodwill	\$ 2,074,741	\$ 103,005	\$ 1,971,736	\$ 2,058,641	\$ 103,005	\$ 1,955,636

## 10. BANK INDEBTEDNESS

Bank indebtedness as at December 28, 2002 and December 29, 2001 is comprised primarily of outstanding cheques, net of cash.

## 11. LONG-TERM DEBT

	Maturity	2002	2001
Non-revolving reducing term facilities			
Tranche A	January 2007	\$ 350,000	\$ 350,000
Tranche B		—	10,000
Tranche C (2002 – nil; 2001 – U.S. \$235,676)		—	374,772
Tranche E (2002 – nil; 2001 – U.S. \$235,676)		—	374,773
Tranche F (2002 – U.S. \$375,000; 2001 – nil)	February 2009	588,563	—
		938,563	1,109,545
\$350,000 revolving term facility	February 2007	—	—
Less current portion of long-term debt		12,500	—
		\$ 926,063	\$ 1,109,545

These facilities bear interest based on Prime and Bankers' Acceptance rates for Canadian dollar denominated loans and Prime and LIBOR rates for U.S. dollar denominated 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.

During 2002, \$10,000 (2001 – \$15,000) of borrowings under the Tranche B facility were repaid, reducing the amount of the facility to nil. In early 2002, U.S. \$23,176 (2001 – nil) of borrowings under both the Tranche C and Tranche E facilities were repaid, reducing the amount of each of these facilities to U.S. \$212,500.

On May 22, 2002, the Company negotiated an amendment to the terms of its senior bank credit facility to borrow an additional U.S. \$425,000 under a new Tranche F term loan. The proceeds of the Tranche F loan were applied to the repayment of the remaining amounts outstanding under the Tranche C and Tranche E term loans under the same credit facility as at that date. During 2002, U.S. \$50,000 of borrowings under the Tranche F term loan were repaid, reducing the amount of the loan to U.S. \$375,000.

No repayments were made on the Tranche A term loan during the year (2001 – \$25,000).

## Notes to the Consolidated Financial Statements

December 28, 2002 and December 29, 2001 (in thousands of dollars, except share data)

As at December 28, 2002 and December 29, 2001, \$8,561 and \$1,882, respectively, of the \$350,000 revolving term facility was utilized, all in respect of letters of credit and trade finance guarantees.

### Minimum repayments

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

2003	\$	12,500
2004		87,500
2005		100,000
2006		100,000
2007		50,000
2008–2009		588,563
	\$	938,563

## 12. 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 a non-registered pension 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 \$8,155 as at December 28, 2002 and \$9,345 as at December 29, 2001 in respect of pension and other post-retirement benefit plans.

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

	2002		2001	
	Pension Plans	Other Benefit Plans	Pension Plans	Other Benefit Plans
Accrued benefit obligation	\$ 65,609	\$ 3,087	\$ 57,546	\$ 2,703
Fair value of plan assets	43,672	—	39,533	—
Funded status – plan deficit	21,937	3,087	18,013	2,703
Unrecognized losses (gains)	16,869	—	11,378	(7)
Accrued benefit liability	\$ 5,068	\$ 3,087	\$ 6,635	\$ 2,710
<b>Accrued benefit obligation</b>				
Benefit obligation, beginning of period	\$ 57,546	\$ 2,703	\$ 48,186	\$ 2,403
Service cost	4,114	378	3,357	409
Interest cost	2,815	216	2,441	187
Participant contributions	919	—	910	—
Actuarial loss	2,369	—	4,012	—
Benefits paid	(2,154)	(210)	(1,360)	(296)
Accrued benefit obligation, end of period	\$ 65,609	\$ 3,087	\$ 57,546	\$ 2,703
<b>Fair value of plan assets</b>				
Market value of plan assets, beginning of period	\$ 39,533	\$ —	\$ 34,172	\$ —
Actual return on plan assets	(1,401)	—	(1,213)	—
Company contributions	6,775	210	7,024	296
Participant contributions	919	—	910	—
Benefits paid	(2,154)	(210)	(1,360)	(296)
Fair value of plan assets, end of period	\$ 43,672	\$ —	\$ 39,533	\$ —

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

	2002			2001		
	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%	6.50%	3.25%	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%	4.50%

The health care cost trend rates used were 7.5% and 8.5% for 2002 and 2001, respectively, which is reduced 1% each year, to an ultimate rate of 5.5% for 2004 and later years.

## Notes to the Consolidated Financial Statements

December 28, 2002 and December 29, 2001 (in thousands of dollars, except share data)

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

	2002		2001	
	Pension Plans	Other Benefit Plans	Pension Plans	Other Benefit Plans
Service cost	\$ 4,114	\$ 378	\$ 3,357	\$ 409
Interest cost	2,815	216	2,441	187
Expected return on assets	(2,099)	—	(1,826)	—
Amortization	378	—	52	—
Net expense	\$ 5,208	\$ 594	\$ 4,024	\$ 596

### 13. SHARE CAPITAL

#### Authorized

Unlimited number of common shares.

Unlimited number of preferred shares, issuable in series without nominal or par value.

#### Outstanding

	2002		2001	
	Number of Common Shares	Stated Value	Number of Common Shares	Stated Value
Beginning balance	209,671,705	\$ 1,418,605	171,310,000	\$ 856,553
Shares issued	210,045	2,384	31,935,440	531,408
Shares repurchased	(178,262)	(1,206)	(1,785,440)	(10,415)
Shares converted to common	—	—	8,211,705	41,059
Ending balance	209,703,488	\$ 1,419,783	209,671,705	\$ 1,418,605

#### Weighted average shares outstanding

December 28, 2002

Basic 209,590,542

Diluted 213,468,576

December 29, 2001

Basic 183,306,247

Diluted 184,291,972

At December 30, 2000, the Company had 8,211,705 outstanding non-voting shares at \$5.00 per share. The non-voting shares were converted to common shares upon the Company becoming public.

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 year ended 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 included an \$8,201 premium over the stated capital that has been charged against retained earnings.

During the year ended December 28, 2002, the Company issued 210,045 common shares with a stated value of \$2,384, net of tax of \$145, inclusive of 14,037 common shares with a stated value of \$74 issued upon the exercise of options. In addition, 178,262 common shares were repurchased for cancellation for \$3,552, which included a \$2,346 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 plans have a dilutive impact on the weighted average number of shares of 3,878,034 (985,725 in 2001).

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 Associate's shares for a period of five years from the date that the individual entered into the shareholder agreement. As at December 28, 2002, 5,166,092 and 6,414,915 shares issued to management and Associates, respectively, were subject to this restriction.

### Stock-based compensation

The Company has established stock option plans for certain employees and its board of directors as described below and has reserved 20,000,000 common shares for issuance under the plans. Stock options are reflected in the financial statements at the exercise price only upon the exercise of the options. If compensation expense under the fair value method of accounting had been recognized on stock options, the Company's net earnings for the period ended December 28, 2002 would have been reduced by \$2,575. Basic earnings per share would have been \$0.98 and diluted earnings per share would have been \$0.97.

The fair value of each option was estimated on the date of the grant using the Black-Scholes option-pricing model. The following weighted average assumptions were used to calculate the option value for options issued under each of the employee and director option plans:

	Employee Plan	Director Plan
Expected life	7.5 years	6.5 years
Expected dividends	nil	nil
Expected volatility	28.0%	28.4%
Risk-free interest rate	5.13%	4.90%

Pro forma earnings and earnings per share do not reflect options granted prior to 2002.

## Notes to the Consolidated Financial Statements

December 28, 2002 and December 29, 2001 (in thousands of dollars, except share data)

### Employee stock option plan

Options issued to certain employees have an exercise price per share of no less than the fair market value on the date of the option grant and are granted in equal proportions between time-based vesting and performance-based vesting criteria. Time-based options are exercisable 20% per year on the 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 appreciated value of the options to cancel exercisable options.

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.

A summary of the status of the employee stock option plan and changes during the year are presented below:

	2002		2001	
	Options on Common Shares	Weighted Average Exercise Price Per Share	Options on Common Shares	Weighted Average Exercise Price Per Share
Outstanding, beginning of period	6,600,500	\$ 5.22	9,995,000	\$ 5.00
Granted	825,792	20.86	3,946,600	5.45
Exercised	(14,037)	5.30	—	—
Forfeited/cancelled	(209,713)	5.12	(7,341,100)	5.05
Outstanding, end of period	7,202,542	\$ 7.01	6,600,500	\$ 5.22
Options exercisable, end of period	3,005,700	\$ 5.07	2,297,400	\$ 5.01

Range of Exercise Price	2002 Outstanding Options			2002 Exercisable Options	
	Number of Options Outstanding	Weighted Average Contractual Life	Weighted Average Exercise Price Per Share	Number of Exercisable Options	Weighted Average Exercise Price Per Share
\$5.00 – \$5.60	6,376,750	7.0 years	\$ 5.22	3,005,700	\$ 5.07
\$17.13 – \$24.84	825,792	9.3 years	\$ 20.86	—	—
	7,202,542	7.3 years	\$ 7.01	3,005,700	\$ 5.07

## Director stock option plan

Under the director stock option plan, each director is issued time-based options to purchase 60,000 common shares. The options have an exercise price per share at fair market value on the date of the option grant, which is normally the date the optionee becomes a director. One-third of the options become exercisable in each of the following three years on the anniversary of the date of grant. Unexercisable options expire upon the optionee ceasing to be a director. Exercisable options expire on the earlier of 180 days of the optionee ceasing to be a director or the expiry date of the options, which is on the tenth anniversary of the date of grant.

A summary of the status of the director stock option plan and changes during the year are presented below.

	2002		2001	
	Options on Common Shares	Weighted Average Exercise Price Per Share	Options on Common Shares	Weighted Average Exercise Price Per Share
Outstanding, beginning of period	420,000	\$ 18.00	—	\$ —
Granted	120,000	23.42	420,000	18.00
Outstanding, end of period	540,000	\$ 19.20	420,000	\$ 18.00
Options exercisable, end of period	140,000	\$ 18.00	—	\$ —

Range of Exercise Price	2002 Outstanding Options			2002 Exercisable Options	
	Number of Options Outstanding	Weighted Average Contractual Life	Weighted Average Exercise Price Per Share	Number of Exercisable Options	Weighted Average Exercise Price Per Share
\$18.00 – \$23.48	540,000	9.1 years	\$ 19.20	140,000	\$ 18.00

## Deferred share unit plan for non-employee directors

In 2002, 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. 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 divided by the fair market value of the common shares. 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. During the year ended December 28, 2002, the Company issued an aggregate of 9,470 DSUs and recorded \$243 in director fee compensation.

## Notes to the Consolidated Financial Statements

December 28, 2002 and December 29, 2001 (in thousands of dollars, except share data)

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

	2002	2001
Accounts receivable	\$ (6,969)	\$ 26,280
Inventory	(19,447)	(92,566)
Prepaid expenses	(288)	(371)
Accounts payable and accrued liabilities	14,686	59,049
Income tax payable	28,973	38,186
	<b>\$ 16,955</b>	<b>\$ 30,578</b>

### 15. COMMITMENTS AND CONTINGENT LIABILITIES

#### 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:

	2003	2004	2005	2006	2007	Thereafter
Total lease obligations	\$ 144,851	\$ 136,908	\$ 126,108	\$ 114,301	\$ 101,692	\$ 482,027

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

#### Distribution services

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.

#### Guarantees

As at December 28, 2002 and December 29, 2001, the Company had provided guarantees of approximately \$429,000 and \$331,000, respectively, to various banks in respect of borrowings by Associates. As of these dates, an aggregate amount of \$378,975 and \$285,400, respectively, in available lines of credit had been allocated to Associates by the various banks, against which aggregate amounts of \$307,474 and \$220,014, respectively, were drawn.

#### Litigation

The Company has indemnified Imperial Tobacco Canada Limited 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 its best estimate of the final settlements.

## 16. 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 28, 2002 and December 29, 2001, the Company would have incurred losses of \$21,804 and \$20,966, respectively, to terminate these interest rate derivative agreements. Market values were determined based on information received from the Company's counterparties to these agreements.

### Currency derivatives

The Company has entered into currency derivative agreements to exchange a notional principal amount of U.S. \$375,000 of debt for Canadian dollar denominated debt. These agreements mature on June 14, 2004. Currency adjustments receivable or payable arising from these agreements may be settled in cash on maturity. As at December 28, 2002 and December 29, 2001, a currency adjustment of \$11,438 and \$19,967, respectively, related to currency derivative agreements was included in long-term receivables.

Based on market values at December 28, 2002 and December 29, 2001, excluding the currency adjustments noted above, the Company would have incurred a loss of \$264 and a gain of \$1,028, 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 are spread over a large 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 values of the interest rate and currency derivatives, as noted above, are determined based on current market rates and on information received from the Company's counterparties to these agreements.

## 17. RELATED PARTY TRANSACTIONS

The Corporation incurred management fees and expenses of \$2,295 and \$2,165 during the years ended December 28, 2002 and December 29, 2001, respectively, to certain shareholders who collectively hold 60% of the common shares of the Company at December 28, 2002.