


### 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 judgments 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 fulfils 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 AND 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 January 1, 2005 and January 3, 2004 and the consolidated statements of earnings, retained earnings and cash flows for the 52 and 53 week periods, respectively, 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 January 1, 2005 and January 3, 2004 and the results of its operations and its cash flows for the 52 and 53 week periods, respectively, then ended, in accordance with Canadian generally accepted accounting principles.



**Chartered Accountants**

TORONTO, ONTARIO  
FEBRUARY 4, 2005

## Consolidated Statements of Earnings

52 weeks ended January 1, 2005 and 53 weeks ended January 3, 2004  
(in thousands of dollars, except per share amounts)

|  | 2004                | 2003         |
|--|---------------------|--------------|
| <b>Revenue</b>   | <b>\$ 4,723,119</b> | \$ 4,415,202 |
| <b>Operating expenses</b>                                |                     |              |
| Cost of goods sold and other operating expenses (Note 2) | 4,086,825           | 3,846,667    |
| Amortization   | 99,425              | 83,369       |
| <b>Operating income</b>                                  | <b>536,869</b>      | 485,166      |
| Interest expense (Note 3)                                | 47,450              | 76,329       |
| <b>Earnings before income taxes</b>                      | <b>489,419</b>      | 408,837      |
| <b>Income taxes</b> (Note 4)                             |                     |              |
| Current  | 160,286             | 140,803      |
| Future   | 13,263              | 11,406       |
|  | <b>173,549</b>      | 152,209      |
| <b>Net earnings</b>                                      | <b>\$ 315,870</b>   | \$ 256,628   |
| <b>Net earnings per common share</b> (Note 11):          |                     |              |
| Basic  | \$ 1.52             | \$ 1.24      |
| Diluted  | \$ 1.47             | \$ 1.20      |

## Consolidated Statements of Retained Earnings

52 weeks ended January 1, 2005 and 53 weeks ended January 3, 2004  
(in thousands of dollars)

|  | 2004              | 2003       |
|--|-------------------|------------|
| <b>Retained earnings, beginning of period as reported</b>                        | <b>\$ 435,304</b> | \$ 177,716 |
| Impact of new accounting standard – Consideration received from vendors (Note 2) | (17,364)          | (16,322)   |
| Net earnings   | 315,870           | 256,628    |
| Premium on share capital purchased for cancellation (Note 11)                    | (128)             | (82)       |
| <b>Retained earnings, end of period</b>  | <b>\$ 733,682</b> | \$ 417,940 |

## Consolidated Balance Sheets

As at January 1, 2005 and January 3, 2004  
(in thousands of dollars)

|   | 2004                | 2003                |
|---|---------------------|---------------------|
| <b>Assets</b>                                     |                     |                     |
| Current   |                     |                     |
| Cash  | \$ -                | \$ 8,813            |
| Accounts receivable                               | 376,190             | 340,667             |
| Inventory (Note 2)                                | 293,093             | 268,010             |
| Notes receivable from Associates (Notes 5 and 13) | 177,755             | -                   |
| Future income taxes (Note 4)                      | 8,098               | 7,213               |
| Prepaid expenses                                  | 15,763              | 10,600              |
|   | <b>870,899</b>      | 635,303             |
| Long-term receivables (Note 5)                    | 38,846              | 169,284             |
| Property and equipment (Note 6)                   | 571,846             | 470,599             |
| Deferred costs (Note 7)                           | 5,950               | 8,285               |
| Future income taxes (Note 4)                      | -                   | 2,280               |
| Goodwill  | 1,999,095           | 1,983,483           |
| Other intangible assets (Note 8)                  | 13,057              | 6,625               |
| <b>Total assets</b>                               | <b>\$ 3,499,693</b> | <b>\$ 3,275,859</b> |
| <b>Liabilities</b>                                |                     |                     |
| Current   |                     |                     |
| Bank indebtedness                                 | \$ 7,801            | \$ -                |
| Commercial paper (Notes 3 and 9)                  | 105,000             | 170,000             |
| Accounts payable and accrued liabilities          | 577,817             | 589,591             |
| Income taxes payable (Note 2)                     | 46,266              | 27,251              |
| Current portion of long-term debt (Note 9)        | 25,000              | -                   |
|   | <b>761,884</b>      | 786,842             |
| Long-term debt (Note 9)                           | 554,943             | 650,000             |
| Other long-term liabilities (Note 10)             | 12,465              | 8,983               |
| Future income taxes (Note 4)                      | 13,098              | -                   |
|   | <b>1,342,390</b>    | 1,445,825           |
| <b>Shareholders' equity</b>                       |                     |                     |
| Share capital (Note 11)                           | 1,421,980           | 1,411,878           |
| Contributed surplus (Note 11)                     | 1,641               | 216                 |
| Retained earnings (Note 2)                        | 733,682             | 417,940             |
|   | <b>2,157,303</b>    | 1,830,034           |
| <b>Total liabilities and shareholders' equity</b> | <b>\$ 3,499,693</b> | <b>\$ 3,275,859</b> |

On behalf of the Board of Directors:



**Glenn Murphy**  
DIRECTOR



**Paul E. Raether**  
DIRECTOR

## Consolidated Statements of Cash Flows

52 weeks ended January 1, 2005 and 53 weeks ended January 3, 2004  
(in thousands of dollars)

|   | 2004              | 2003            |
|---|-------------------|-----------------|
| <b>Operating activities</b>                               |                   |                 |
| Net earnings  | \$ 315,870        | \$ 256,628      |
| Items not affecting cash                                  |                   |                 |
| Amortization  | 99,520            | 96,178          |
| Future income taxes                                       | 13,263            | 11,406          |
| Loss on disposal of property and equipment                | 2,400             | 826             |
| Stock-based compensation (Note 11)                        | 1,425             | 216             |
|   | <b>432,478</b>    | <b>365,254</b>  |
| Net change in non-cash working capital balances (Note 12) | <b>(58,528)</b>   | 3,926           |
| Increase (decrease) in long-term liabilities              | <b>3,482</b>      | (4,706)         |
| Cash flows from operating activities                      | <b>377,432</b>    | 364,474         |
| <b>Investing activities</b>                               |                   |                 |
| Purchase of property and equipment                        | <b>(199,230)</b>  | (160,507)       |
| Business acquisitions                                     | <b>(22,256)</b>   | (17,908)        |
| Notes receivable from Associates (Notes 5 and 13)         | <b>(177,755)</b>  | -               |
| Long-term receivables                                     | <b>130,438</b>    | (57,679)        |
| Cash flows used in investing activities                   | <b>(268,803)</b>  | (236,094)       |
| <b>Financing activities</b>                               |                   |                 |
| Commercial paper, net                                     | <b>(65,000)</b>   | 170,000         |
| Issuance of long-term debt (Note 9)                       | -                 | 650,000         |
| Repayment of long-term debt (Note 9)                      | <b>(75,000)</b>   | (841,126)       |
| Revolving term debt, net                                  | <b>4,943</b>      | -               |
| Payments under derivative contracts                       | -                 | (85,999)        |
| Deferred financing costs                                  | <b>(160)</b>      | (3,765)         |
| Issuance of share capital                                 | <b>4,057</b>      | 86              |
| Repayment of share purchase loans                         | <b>6,107</b>      | 2,152           |
| Repurchase of share capital                               | <b>(190)</b>      | (141)           |
| Cash flows used in financing activities                   | <b>(125,243)</b>  | (108,793)       |
| <b>(Decrease) increase in cash</b>                        | <b>(16,614)</b>   | 19,587          |
| <b>Cash (bank indebtedness), beginning of period</b>      | <b>8,813</b>      | (10,774)        |
| <b>(Bank indebtedness) cash, end of period</b>            | <b>\$ (7,801)</b> | <b>\$ 8,813</b> |
| <b>Supplemental cash flow information</b>                 |                   |                 |
| Interest paid   | <b>\$ 43,994</b>  | \$ 60,236       |
| Income taxes paid   | <b>\$ 142,438</b> | \$ 177,361      |

## Notes to the Consolidated Financial Statements

January 1, 2005 and January 3, 2004 (in thousands of dollars, except share data)

### 1. Basis of Presentation

Shoppers Drug Mart Corporation (“the Company”) is a licensor of approximately 915 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 49 Shoppers 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”) were \$6,471,192 and \$6,056,571 for the 52 and 53 weeks ended January 1, 2005 and January 3, 2004, 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. The Company’s 2004 fiscal year consisted of 52 weeks as compared to 53 weeks for its 2003 fiscal year.

### 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 is generated from the sale of goods to Associates and is recognized when goods are shipped. Revenue also includes charges for services provided to Associates and is recognized when services have been rendered. The Company recognizes its share of Associate store profits in revenue 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.

#### **Cash and bank indebtedness**

Cash and bank indebtedness is comprised primarily of cash, net of outstanding cheques.

#### **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.

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|                                 |  |
|---------------------------------|--|
| Buildings                       | 20 years                                 |
| Equipment and fixtures          | 3 to 10 years                            |
| Computer software and equipment | 2 to 10 years                            |
| Leasehold improvements          | Lesser of term of the lease and 10 years |

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### Deferred financing costs

Deferred financing costs are amortized on a straight-line basis over the term of the debt to which they relate. Any unamortized amounts are charged against earnings when the related debt has been 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 other retirement benefit plans is 13 and 10 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 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.

### Goodwill and other intangible assets

The Company records as goodwill the excess amount of the purchase price of an acquired business over the fair value of the underlying net assets, including intangible assets, at the date of acquisition. Goodwill is not amortized but is tested for impairment on an annual basis. In the event of an impairment, the excess of the carrying amount over the fair value of these assets would be charged to earnings. Intangible assets, consisting of acquired prescription files, are amortized over their expected useful lives of seven years.

### Stock-based compensation

The Company has stock option compensation plans which are described in Note 11. Compensation expense is recognized for these plans for stock options granted to employees and directors after December 28, 2002 using the fair value method. Any consideration paid by employees and directors on exercise of stock options is credited to share capital.

## 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.

## Comparative amounts

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

### *Changes in Accounting Policies*

#### **EIC-144, Accounting by a customer for certain consideration received from a vendor**

In January 2004, the Emerging Issues Committee (the "EIC") of the Canadian Institute of Chartered Accountants issued EIC Abstract 144, "Accounting by a Customer (Including a Reseller) for Certain Consideration Received from a Vendor" (the "EIC Abstract"). The EIC Abstract requires a customer to record cash consideration received from a vendor as a reduction in the price of the vendor's products and reflect it as a reduction to cost of goods sold and related inventory when recognized in the income statement and balance sheet. Certain exceptions apply where the cash consideration received is either a reimbursement of incremental selling costs incurred by the reseller, or is a payment for assets or services delivered to the vendor. The EIC Abstract must be applied retroactively for annual and interim periods ending after August 15, 2004.

The Company receives allowances from certain of its merchandise vendors, which it records as a reduction to cost of goods sold. This new guidance has changed the timing of recognition of some vendor allowances. As a result, the Company has restated its 2003 comparative results and balances in its financial statements. The results for the year ended January 3, 2004 reflect an increase in cost of goods sold and other operating expenses and a decrease in operating income of \$1,644 and a decrease in net earnings of \$1,042, resulting in a decrease of \$0.01 to basic net earnings per share and no impact on diluted net earnings per share.

The implementation of the new standard has resulted in a reduction to 2004 and 2003 opening retained earnings of \$17,364 and \$16,322, respectively. The impact on balances as at January 3, 2004 was a decrease in inventory of \$27,432 and a decrease in taxes payable of \$10,068.

## 3. Interest Expense

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

|  | 2004             | 2003             |
|--|------------------|------------------|
| Interest on long-term debt               | \$ 36,076        | \$ 61,043        |
| Interest on commercial paper             | 8,879            | 1,651            |
| Amortization of deferred financing costs | 2,495            | 4,115            |
| Write-off of deferred financing costs    | -                | 9,520            |
|  | <b>\$ 47,450</b> | <b>\$ 76,329</b> |

Commercial paper is issued with maturities from overnight to 90 days at floating interest rates based on Bankers' Acceptance rates.

#### 4. Income Taxes

The effective income tax rate is comprised of the following:

|   | 2004  | 2003   |
|---|-------|--------|
| Combined Canadian federal and provincial statutory tax rate               | 35.1% | 36.7%  |
| Adjusted for:   |       |        |
| Large corporations tax  | –     | 0.3%   |
| Decrease in future income taxes resulting from statutory tax rate changes | –     | (0.2%) |
| Non-deductible charges  | 0.4%  | 0.4%   |
| Effective income tax rate   | 35.5% | 37.2%  |

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

|  | 2004        | 2003       |
|--|-------------|------------|
| <b>Current</b>                         |             |            |
| Accrued liabilities                    | \$ 9,578    | \$ 9,734   |
| Share issuance costs                   | 2,193       | 2,161      |
| Income not taxed in the current period | –           | (2,783)    |
| Other                                  | (3,673)     | (1,899)    |
|  | \$ 8,098    | \$ 7,213   |
| <b>Long-term</b>                       |             |            |
| Depreciable assets                     | \$ (13,397) | \$ (4,347) |
| Accrued liabilities                    | 3,743       | 2,563      |
| Financing costs                        | 78          | 3,859      |
| Share issuance costs                   | 26          | 2,187      |
| Other                                  | (3,548)     | (1,982)    |
|  | \$ (13,098) | \$ 2,280   |

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.

#### 5. Long-term Receivables

|                                       | 2004      | 2003       |
|---------------------------------------|-----------|------------|
| Long-term receivables from Associates | \$ 31,735 | \$ 163,653 |
| Other long-term receivables           | 7,111     | 5,631      |
|                                       | \$ 38,846 | \$ 169,284 |

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 interest rate is set annually and was 10.5% as at January 1, 2005 and January 3, 2004. The Company has arranged for a portion of the long-term receivables to be refinanced through an independent trust (Note 13) in the first quarter of fiscal 2005. As a result, the Company has reclassified \$177,755 of long-term receivables from Associates to current assets.

## 6. Property and Equipment

|   | 2004              |                          |                   | 2003              |                          |                   |
|---|-------------------|--------------------------|-------------------|-------------------|--------------------------|-------------------|
|   | Cost              | Accumulated Amortization | Net Book Value    | Cost              | Accumulated Amortization | Net Book Value    |
| Land                                      | \$ 33,487         | \$ -                     | \$ 33,487         | \$ 27,390         | \$ -                     | \$ 27,390         |
| Buildings                                 | 73,083            | 16,822                   | 56,261            | 60,194            | 13,167                   | 47,027            |
| Equipment, fixtures and computer software | 499,532           | 227,682                  | 271,850           | 389,001           | 173,517                  | 215,484           |
| Leasehold improvements                    | 302,956           | 92,708                   | 210,248           | 249,971           | 69,273                   | 180,698           |
|   | <b>\$ 909,058</b> | <b>\$ 337,212</b>        | <b>\$ 571,846</b> | <b>\$ 726,556</b> | <b>\$ 255,957</b>        | <b>\$ 470,599</b> |

## 7. Deferred Costs

|                          | 2004      |                          |                | 2003      |                          |                |
|--------------------------|-----------|--------------------------|----------------|-----------|--------------------------|----------------|
|                          | Cost      | Accumulated Amortization | Net Book Value | Cost      | Accumulated Amortization | Net Book Value |
| Deferred financing costs | \$ 14,587 | \$ 8,637                 | \$ 5,950       | \$ 14,428 | \$ 6,143                 | \$ 8,285       |

## 8. Other Intangible Assets

|                    | 2004      |                          |                | 2003     |                          |                |
|--------------------|-----------|--------------------------|----------------|----------|--------------------------|----------------|
|                    | Cost      | Accumulated Amortization | Net Book Value | Cost     | Accumulated Amortization | Net Book Value |
| Prescription files | \$ 15,057 | \$ 2,000                 | \$ 13,057      | \$ 7,183 | \$ 558                   | \$ 6,625       |

## Notes to the Consolidated Financial Statements (continued)

January 1, 2005 and January 3, 2004 (in thousands of dollars, except share data)

### 9. Long-term Debt

|  | Maturity      | 2004       | 2003       |
|--|---------------|------------|------------|
| Medium-term notes                      |               |            |            |
| Series 1 – 4.97%                       | October 2008  | \$ 300,000 | \$ 300,000 |
| Non-revolving term facilities          | January 2007  | 275,000    | 350,000    |
|  |               | \$ 575,000 | \$ 650,000 |
| \$250,000 revolving term facility      | February 2007 | 4,943      | –          |
|  |               | \$ 579,943 | \$ 650,000 |
| Less current portion of long-term debt |               | 25,000     | –          |
|  |               | \$ 554,943 | \$ 650,000 |

The non-revolving and revolving term facilities bear interest based on Prime and Bankers' Acceptance rates.

In addition to the bank credit facilities described in the table, the Company has a 364-day extendible revolving credit facility in the amount of \$300,000.

During 2003 the Company refinanced approximately \$1.2 billion of senior secured bank credit facilities with a combination of the debt described above and a commercial paper program. In connection with the refinancing, the Company expensed \$9,520 of the deferred financing costs associated with the original loans. The Company also terminated its currency derivative agreements and expensed \$1,122 as a result of the termination. These amounts are included in interest expense in 2003 (Note 3).

As at January 1, 2005, \$30,790 of the \$250,000 revolving term facility was utilized, including drawings of \$25,847 in respect of letters of credit and trade finance guarantees, of which \$20,500 relates to a letter of credit for the benefit of the independent trust (Note 13). As at January 3, 2004, \$9,080 of the \$250,000 revolving term facility was utilized, all in respect of letters of credit and trade finance guarantees.

#### Minimum repayments

Future minimum required repayments of long-term debt for the next four calendar years are as follows:

##### Term facility

|      |           |
|------|-----------|
| 2005 | \$ 25,000 |
| 2006 | 100,000   |
| 2007 | 150,000   |
|      | 275,000   |

##### Medium-term notes

|      |            |
|------|------------|
| 2008 | 300,000    |
|      | \$ 575,000 |

### 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 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 most recent actuarial valuation for funding purposes was performed as at December 31, 2003 and the next valuation will be required as at December 31, 2006.

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 \$9,558 as at January 1, 2005 and \$6,378 as at January 3, 2004 in respect of pension and other post-retirement benefit plans.

Information about the Company's pension and other post-retirement benefit plans, measured at November 30, 2004 and 2003, respectively, is as follows:

|  | 2004          |                     | 2003          |                     |
|--|---------------|---------------------|---------------|---------------------|
|  | Pension Plans | Other Benefit Plans | Pension Plans | Other Benefit Plans |
| Accrued benefit obligation                     | \$ 78,546     | \$ 3,998            | \$ 75,951     | \$ 3,411            |
| Fair value of plan assets                      | 61,245        | –                   | 55,122        | –                   |
| Funded status – plan deficit                   | 17,301        | 3,998               | 20,829        | 3,411               |
| Unrecognized plan amendments                   | (1,369)       | –                   | (1,200)       | –                   |
| Unrecognized losses                            | 13,110        | –                   | 19,062        | –                   |
| Accrued benefit liability                      | \$ 5,560      | \$ 3,998            | \$ 2,967      | \$ 3,411            |
| <b>Accrued benefit obligation</b>              |               |                     |               |                     |
| Benefit obligation, beginning of period        | \$ 75,951     | \$ 3,411            | \$ 65,609     | \$ 3,087            |
| Service cost                                   | 5,081         | 722                 | 4,393         | 399                 |
| Interest cost                                  | 3,639         | 222                 | 3,260         | 195                 |
| Participant contributions                      | 958           | –                   | 1,031         | –                   |
| Plan amendments                                | (289)         | –                   | (1,320)       | –                   |
| Actuarial (gain) loss                          | (3,824)       | –                   | 5,310         | –                   |
| Benefits paid                                  | (2,970)       | (357)               | (2,332)       | (270)               |
| Benefit obligation, end of period              | \$ 78,546     | \$ 3,998            | \$ 75,951     | \$ 3,411            |
| <b>Fair value of plan assets</b>               |               |                     |               |                     |
| Fair value of plan assets, beginning of period | \$ 55,122     | \$ –                | \$ 43,672     | \$ –                |
| Actual return on plan assets                   | 4,228         | –                   | 4,760         | –                   |
| Company contribution                           | 3,907         | 357                 | 7,991         | 270                 |
| Participant contributions                      | 958           | –                   | 1,031         | –                   |
| Benefits paid                                  | (2,970)       | (357)               | (2,332)       | (270)               |
| Fair value of plan assets, end of period       | \$ 61,245     | \$ –                | \$ 55,122     | \$ –                |

## Notes to the Consolidated Financial Statements (continued)

January 1, 2005 and January 3, 2004 (in thousands of dollars, except share data)

The significant actuarial assumptions adopted are as follows:

|  | 2004                     |                             |                     | 2003                     |                             |                     |
|--|--------------------------|-----------------------------|---------------------|--------------------------|-----------------------------|---------------------|
|  | Registered Pension Plans | Non-registered Pension Plan | Other Benefit Plans | Registered Pension Plans | Non-registered Pension Plan | Other Benefit Plans |
| <b>Accrued benefit obligation, end of period</b> |                          |                             |                     |                          |                             |                     |
| Discount rate                                    | 5.75%                    | 2.88%                       | 5.75%               | 6.00%                    | 3.00%                       | 6.00%               |
| Compensation increase                            | 4.00%                    | 4.00%                       | 4.00%               | 4.50%                    | 4.50%                       | 4.50%               |
| <b>Benefit expense, for the period</b>           |                          |                             |                     |                          |                             |                     |
| Discount rate                                    | 6.00%                    | 3.00%                       | 6.00%               | 6.50%                    | 3.25%                       | 6.50%               |
| 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 5.5% and 6.5% for 2004 and 2003, respectively, with 5.5% being the ultimate trend rate for later years. A 1% change in the assumed health care cost trend rate would not have a significant effect on the amounts reported for other benefit plans.

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

|   | 2004          |                     | 2003          |                     |
|---|---------------|---------------------|---------------|---------------------|
|   | Pension Plans | Other Benefit Plans | Pension Plans | Other Benefit Plans |
| Service cost  | \$ 5,081      | \$ 722              | \$ 4,393      | \$ 399              |
| Interest cost   | 3,639         | 222                 | 3,260         | 195                 |
| Actual return on plan assets  | (4,228)       | –                   | (4,760)       | –                   |
| Actuarial (gain) loss   | (3,824)       | –                   | 5,310         | –                   |
| Plan amendments   | (289)         | –                   | (1,320)       | –                   |
| Costs arising from events of the period   | 379           | 944                 | 6,883         | 594                 |
| Difference between actual and expected return on plan assets  | 1,298         | –                   | 2,372         | –                   |
| Difference between actuarial gain or loss recognized for the year and actual actuarial gain or loss on accrued benefit obligation | 4,649         | –                   | (4,540)       | –                   |
| Difference between amortization of plan amendments and actual plan amendments   | 169           | –                   | 1,200         | –                   |
| Net expense   | \$ 6,495      | \$ 944              | \$ 5,915      | \$ 594              |

Total cash payments for employee future benefits consist of the Company's contributions to the pension plans and cash payments made directly to beneficiaries of the other benefit plans and totalled \$4,264 (2003 – \$8,261).

The assets of the registered pension plans consist of cash, contributions receivable and a proportionate share of a Master Trust. The assets held by the Master Trust are invested in a limited number of pooled funds, based on market values as at November 30, 2004 and 2003, respectively, as follows:

|                           | 2004 | 2003 |
|---------------------------|------|------|
| Equity                    | 60%  | 61%  |
| Fixed income              | 40%  | 38%  |
| Cash and cash equivalents | –    | 1%   |

The assets of the non-registered plan consist of cash and investments. The investments are in pooled funds with an allocation of 60% equities and 40% bonds based on market values as at November 30, 2004 and 2003, respectively.

## 11. Share Capital

### Authorized

Unlimited number of common shares

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

### Outstanding

|                           | 2004                       |              | 2003                       |              |
|---------------------------|----------------------------|--------------|----------------------------|--------------|
|                           | Number of<br>Common Shares | Stated Value | Number of<br>Common Shares | Stated Value |
| Beginning balance         | 209,724,407                | \$ 1,411,878 | 209,703,488                | \$ 1,419,783 |
| Shares issued             | 275,632                    | 5,008        | 29,691                     | 377          |
| Shares repurchased        | (9,194)                    | (62)         | (8,772)                    | (59)         |
| Share purchase loans, net | -                          | 5,156        | -                          | (8,223)      |
| Ending balance            | 209,990,845                | \$ 1,421,980 | 209,724,407                | \$ 1,411,878 |

### Weighted average shares outstanding

#### January 1, 2005

|         |             |
|---------|-------------|
| Basic   | 208,149,810 |
| Diluted | 214,942,244 |

#### January 3, 2004

|         |             |
|---------|-------------|
| Basic   | 206,792,009 |
| Diluted | 213,953,746 |

During the period ended January 1, 2005, the Company issued 275,632 common shares (2003 – 29,691) with a stated value of \$5,008, net of tax of \$nil (2003 – \$377, net of tax of \$21), inclusive of 241,114 shares (2003 – 17,250) with a stated value of \$3,917 (2003 – \$91) issued upon the exercise of options. In addition, 9,194 common shares (2003 – 8,772) were repurchased for cancellation for \$190 (2003 – \$141) which includes a \$128 premium (2003 – \$82) over the stated capital, which has been charged against retained earnings.

The common shares that may be issued under the Company's stock option plans, including contingently returnable shares issued as part of those plans, have a dilutive impact on the weighted average number of shares of 6,792,434 (2003 – 7,161,737).

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 January 1, 2005, 203,061 and 860,157 shares issued to management and Associates, respectively, are subject to this restriction.

The Company has issued loans to certain key employees under a Stock Purchase Plan to acquire common shares of the Company. The share purchase loans receivable are non-interest bearing, mature in 2007 to 2010, are subject to certain terms of repayment pursuant to a Shareholders' Agreement and are secured by the shares to which the loans relate. Share purchase loans are presented as a reduction in share capital and the related shares are deducted in the determination of the weighted average shares outstanding for purposes of the basic net earnings per common share calculation.

### 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. The Company has established a deferred share unit plan for non-employee directors, which plan is also described below.

In 2003, the Company adopted the guidance of accounting standard 3870, "Stock-based Compensation and Other Stock-based Payments", on a prospective basis. The guidance requires the use of the fair value method to account for stock options issued under employee and director stock option programs. The Company expensed \$1,426 associated with stock options issued in 2004 (2003 – \$216) under the employee and director plans.

If compensation expense under the fair value method of accounting had been recognized on stock options issued in 2002, the Company's net earnings for the periods ended January 1, 2005 and January 3, 2004 would have been reduced by \$1,926 and \$3,804, respectively. Basic earnings per share would have been \$1.51 and \$1.23, and diluted earnings per share would have been \$1.46 and \$1.19, respectively.

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 |
|-------------------------|---------------|---------------|
| Fair value per option   | \$ 13.01      | \$ 13.28      |
| Valuation assumptions:  |               |               |
| Expected life           | 7.5 years     | 6.5 years     |
| Expected dividends      | nil           | nil           |
| Expected volatility     | 28.2%         | 28.6%         |
| Risk-free interest rate | 4.09%         | 4.39%         |

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

### 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 provides that the Company may pay, in cash, certain terminated option holders the 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 period is presented below:

|                                    | 2004                           |  | 2003                           |  |
|------------------------------------|--------------------------------|--|--------------------------------|--|
|                                    | Options on<br>Common<br>Shares | Weighted<br>Average<br>Exercise Price<br>Per Share | Options on<br>Common<br>Shares | Weighted<br>Average<br>Exercise Price<br>Per Share |
| Outstanding, beginning of period   | 7,185,592                      | \$ 7.11  | 7,202,542                      | \$ 7.01  |
| Granted                            | 207,108                        | 31.64  | 74,646                         | 26.00  |
| Exercised                          | (61,114)                       | 11.07  | (17,250)                       | 5.28   |
| Forfeited/cancelled                | (26,177)                       | 26.78  | (74,346)                       | 16.73  |
| Outstanding, end of period         | 7,305,409                      | \$ 7.70  | 7,185,592                      | \$ 7.11  |
| Options exercisable, end of period | 5,091,128                      | \$ 6.06  | 4,089,144                      | \$ 5.63  |

|                         | 2004 Outstanding Options            |  |  | 2004 Exercisable Options            |  |
|-------------------------|-------------------------------------|--|--|-------------------------------------|--|
| Range of Exercise Price | Number of<br>Options<br>Outstanding | Weighted<br>Average<br>Contractual Life<br>(Years) | Weighted<br>Average<br>Exercise Price<br>Per Share | Number of<br>Exercisable<br>Options | Weighted<br>Average<br>Exercise Price<br>Per Share |
| \$ 5.00 – \$ 5.60       | 6,289,884                           | 5.0  | \$ 5.22  | 4,796,534                           | \$ 5.16  |
| \$ 17.13 – \$ 24.84     | 748,615                             | 7.3  | 20.59  | 283,397                             | 20.42  |
| \$ 25.86 – \$ 26.57     | 74,646                              | 8.7  | 26.00  | 11,197                              | 26.00  |
| \$ 29.30 – \$ 36.41     | 192,264                             | 9.4  | 31.82  | –                                   | –  |
|                         | 7,305,409                           | 5.4  | \$ 7.70  | 5,091,128                           | \$ 6.06  |

#### 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 period is presented below.

|                                    | 2004                           |  | 2003                           |  |
|------------------------------------|--------------------------------|--|--------------------------------|--|
|                                    | Options on<br>Common<br>Shares | Weighted<br>Average<br>Exercise Price<br>Per Share | Options on<br>Common<br>Shares | Weighted<br>Average<br>Exercise Price<br>Per Share |
| Outstanding, beginning of period   | 600,000                        | \$ 19.98   | 540,000                        | \$ 19.20   |
| Granted                            | 60,000                         | 34.14  | 60,000                         | 26.95  |
| Exercised                          | (180,000)                      | 18.00  | —                              | —  |
| Outstanding, end of period         | 480,000                        | 22.49  | 600,000                        | 19.98  |
| Options exercisable, end of period | 340,000                        | \$ 19.80   | 320,000                        | \$ 18.68   |

|                         | 2004 Outstanding Options            |  |  | 2004 Exercisable Options            |  |
|-------------------------|-------------------------------------|--|--|-------------------------------------|--|
| Range of Exercise Price | Number of<br>Options<br>Outstanding | Weighted<br>Average<br>Contractual Life<br>(Years) | Weighted<br>Average<br>Exercise Price<br>Per Share | Number of<br>Exercisable<br>Options | Weighted<br>Average<br>Exercise Price<br>Per Share |
| \$18.00                 | 240,000                             | 6.9  | \$ 18.00   | 240,000                             | \$ 18.00   |
| \$23.35 – \$26.95       | 180,000                             | 8.0  | 24.59  | 100,000                             | 24.12  |
| \$34.14                 | 60,000                              | 9.8  | 34.14  | —                                   | —  |
|                         | 480,000                             | 7.7  | \$ 22.49   | 340,000                             | \$ 19.80   |

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

The Company maintains 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 period, the Company issued an aggregate of 8,207 DSUs (2003 – 8,999) and recorded \$424 (2003 – \$335) in director fee compensation.

## 12. Net Change in Non-cash Working Capital Balances

|  | 2004        | 2003        |
|--|-------------|-------------|
| Accounts receivable                      | \$ (35,523) | \$ (18,947) |
| Inventory                                | (25,083)    | (26,294)    |
| Prepaid expenses                         | (5,163)     | (6,607)     |
| Accounts payable and accrued liabilities | (11,774)    | 91,099      |
| Income tax payable                       | 19,015      | (35,325)    |
|  | \$ (58,528) | \$ 3,926    |

### 13. 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:

|                         | 2005       | 2006       | 2007       | 2008       | 2009       | Thereafter |
|-------------------------|------------|------------|------------|------------|------------|------------|
| Total lease obligations | \$ 193,428 | \$ 197,955 | \$ 186,213 | \$ 172,365 | \$ 152,650 | \$ 926,623 |

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, 2006. 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.

#### Information services

During 2004 the Company entered into a five-year agreement to outsource certain Information Services activities to a third party. The Company has committed to average annual payments of approximately \$7,000 over the term of the agreement.

#### Financing trust

During the fourth quarter of 2004, the Company arranged for its Associates to obtain additional financing from an independent trust (the "Trust") that was created to provide loans to facilitate their purchase of inventory and fund their working capital requirements. The Trust's activities are financed through the issuance of short-term, asset-backed notes to third-party investors. At January 1, 2005, the total amount of loans outstanding from the Trust to the Company's Associates was approximately \$198,000. The Company has arranged for a standby letter of credit for the benefit of the Trust from a syndicate of banks that is equal to approximately 10% of the aggregate principal amount of the loans, or \$20,500, as a form of credit enhancement which, in turn, enables the Trust to provide favourable financing terms to the Company's Associates.

If at any time the Trust's cost of borrowing and applicable fees are greater than the interest rate charged to Associates on their loans, the Trust has the right to request payment from the Company for any shortfall. In the opinion of the Company's management, the Company is unlikely to have to make any such payment as it is involved in setting the rate that Associates are charged on their loans. In the event that an Associate defaults on a loan from the Trust, the Company has the right to purchase the Associate's loan from the Trust, at which time the Company is assigned the Associate's loan agreement and related security documentation provided to the Trust. The assignment of this documentation would provide the Company with first priority security over the Associate's inventory, subject to certain prior ranking statutory claims. The Company expects that the net proceeds from secured assets would cover any payments made to purchase a defaulted loan from the Trust, including any related expenses, as it is involved in setting the amount borrowed from the Trust by its Associates. In the event that the Company does not elect to purchase a defaulted loan from the Trust, the Trust may draw upon the standby letter of credit or realize on its security. If the Trust draws against the standby letter of credit, the Company has agreed to reimburse the issuing syndicate of banks for the amount so drawn.

### **Guarantees**

As at January 1, 2005 and January 3, 2004, the Company has provided guarantees of approximately \$350,000 and \$449,000, respectively, to various banks in respect of borrowings by Associates. As of these dates, an aggregate amount of \$285,250 and \$412,525, respectively, in available lines of credit had been allocated to Associates by the various banks, against which aggregate amounts of \$185,462 and \$355,313, respectively, were drawn.

As recourse in the event that any payments are made under the guarantees, the Company holds a security interest on all assets of the Associate-owned stores, except inventory pledged as security for loans Associates have received from the above-mentioned Trust. As at January 1, 2005, the Company estimates the net proceeds from secured assets would exceed the amount of any payments required in respect of the guarantees.

### **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.

### **Other**

In the normal course of business, the Company enters into significant commitments for the purchase of goods and services, such as the purchase of inventory or capital assets, most of which are short-term in nature and are settled under normal trade terms.

## **14. 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 January 1, 2005 and January 3, 2004, the Company would have incurred losses of \$3,252 and \$14,835, respectively, to terminate these interest rate 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 of the Company's interest rate 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 fulfil 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 cash, accounts receivable, bank indebtedness, commercial paper and accounts payable 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, as noted above, is determined based on current market rates and on information received from the Company's counterparties to these agreements.

**15. Related Party Transactions**

The Company incurred management fees and expenses of \$584 and \$2,214 during the periods ended January 1, 2005 and January 3, 2004, respectively, to certain shareholders who collectively held 25.5% of the common shares of the Company at January 3, 2004. The management fees and expenses paid to these shareholders ceased upon the termination of an agreement between these shareholders effective April 6, 2004.

**Earnings Coverage Exhibit to the Consolidated Financial Statements**

52 weeks ended January 1, 2005

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|   |             |
|---|-------------|
| Earnings coverage on long-term debt obligations | 11.89 times |
|---|-------------|

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The earnings coverage ratio on long-term debt (including any current portion) is equal to net earnings (before interest and income taxes) divided by interest expense on long-term debt (including any current portion). Interest expense excludes any amounts in respect of amortization that were included in interest expense as shown in the consolidated statement of earnings of the Company for the period.