

SHOPPERS DRUG MART CORPORATION
2009 SECOND QUARTER REPORT TO SHAREHOLDERS

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SHOPPERS DRUG MART CORPORATION
MANAGEMENT'S DISCUSSION AND ANALYSIS

As at July 14, 2009

The following is a discussion of the consolidated financial condition and results of operations of Shoppers Drug Mart Corporation (the "Company") for the periods indicated and of certain factors that the Company believes may affect its prospective financial condition, cash flows and results of operations. This discussion and analysis should be read in conjunction with the unaudited consolidated financial statements of the Company and the notes thereto for the 12 and 24 week periods ended June 20, 2009. The Company's unaudited interim period financial statements and the notes thereto have been prepared in accordance with Canadian generally accepted accounting principles ("GAAP") and are reported in Canadian dollars. These financial statements do not contain all disclosures required by Canadian GAAP for annual financial statements and, accordingly, should be read in conjunction with the most recently prepared annual consolidated financial statements for the 53 week period ended January 3, 2009.

FORWARD-LOOKING INFORMATION AND STATEMENTS

This discussion of the consolidated financial condition and results of operations of the Company contains forward-looking information and statements which constitute "forward-looking information" under Canadian securities law and which may be material regarding, among other things, the Company's beliefs, plans, objectives, strategies, estimates, intentions and expectations. Forward-looking information and statements are typically identified by words such as "anticipate", "believe", "expect", "estimate", "forecast", "goal", "intend", "plan", "will", "may", "should", "could" and similar expressions. Specific forward-looking information in this discussion includes, but is not limited to, statements with respect to the Company's future operating and financial results, its capital expenditure plans, the ability to execute on its future operating, investing and financing strategies and the impact on the Company's financial results of the potential changes to the Ontario drug system.

The forward-looking information and statements contained herein are based on certain factors and assumptions, certain of which appear proximate to the applicable forward-looking information and statements contained herein. Inherent in the forward-looking information and statements are known and unknown risks, uncertainties and other factors beyond the Company's ability to control or predict, which give rise to the possibility that the Company's predictions, forecasts, expectations or conclusions will not prove to be accurate, that its assumptions may not be correct and that the Company's plans, objectives and statements will not be achieved. Actual results or developments may differ materially from those contemplated by the forward-looking information and statements.

The material risk factors that could cause actual results to differ materially from the forward-looking information and statements contained herein include, without limitation: the risk of adverse changes to laws and regulations relating to prescription drugs and their sale, including pharmacy reimbursement programs and the availability of manufacturer allowances, or changes to such laws and regulations that increase compliance costs; the risk of adverse changes in economic and financial conditions in Canada and globally; the risk of increased competition from other retailers; the risk of an inability of the Company to manage growth and maintain its profitability; the risk of exposure to fluctuations in interest rates; the risk of material adverse changes in foreign currency exchange rates; the risk of an inability to attract and retain pharmacists and key employees; the risk of an inability of the Company's information technology systems to support the requirements of the Company's business; the risk of changes to the estimated contributions of the Company in respect of its pension plans or post-employment benefit plans which may adversely impact the Company's financial performance; the risk of changes to the relationships of the Company with third-party service providers; the risk that the Company will not be able to lease or obtain suitable store locations on economically favourable terms; the risk of adverse changes to the Company's results of operations due to seasonal fluctuations; the risk that new, or changes to current, federal and provincial laws, rules and regulations, including environmental and privacy laws, rules and regulations, may adversely impact the Company's business and operations; the risk that violations of law, breaches of Company policies or unethical behaviour may adversely impact the Company's financial performance; property and casualty risks; the risk of injuries at the workplace or health issues; the risk that changes in tax law, or changes in the way that tax law is expected to be interpreted, may

adversely impact the Company's business and operations; the risk that new, or changes to existing, accounting pronouncements may adversely impact the Company; the risks associated with the performance of the Associate-owned store network; and the risk of damage to the reputation of brands promoted by the Company, or to the reputation of any supplier or manufacturer of these brands.

This is not an exhaustive list of the factors that may affect any of the Company's forward-looking information and statements. Investors and others should carefully consider these and other factors and not place undue reliance on the forward-looking information and statements. Further information regarding these and other risk factors is included in the Company's public filings with provincial securities regulatory authorities including, without limitation, the sections entitled "Risks and Risk Management" and "Risks Associated with Financial Instruments" in the Company's Management's Discussion and Analysis for the 53 week period ended January 3, 2009. The forward-looking information and statements contained in this discussion of the consolidated financial condition and results of operations of the Company represent the Company's views only as of the date hereof. Forward-looking information and statements contained in this Management's Discussion and Analysis about prospective results of operations, financial position or cash flows that are based upon assumptions about future economic conditions and courses of action are presented for the purpose of assisting the Company's shareholders in understanding management's current views regarding those future outcomes and may not be appropriate for other purposes. While the Company anticipates that subsequent events and developments may cause the Company's views to change, the Company does not undertake to update any forward-looking information and statements, except to the extent required by applicable securities laws.

Additional information about the Company, including the Annual Information Form, can be found at www.sedar.com.

OVERVIEW

The Company is the licensor of full-service retail drug stores operating under the name Shoppers Drug Mart[®] (Pharmaprix[®] in Québec). As at June 20, 2009, there were 1,159 Shoppers Drug Mart/Pharmaprix retail drug stores owned and operated by the Company's licensees ("Associates"). An Associate is a pharmacist-owner of a corporation that is licensed to operate a retail drug store at a specific location using the Company's trademarks. The Company's licensed stores are located in prime locations in each province and two territories, making Shoppers Drug Mart/Pharmaprix stores among the most convenient retail outlets in Canada. The Company also licenses or owns 32 medical clinic pharmacies operating under the name Shoppers Simply Pharmacy[™] (Pharmaprix Simplement Santé^{MC} in Québec) and two luxury beauty destinations operating as Murale[™].

The Company has successfully leveraged its leadership position in pharmacy and its convenient store locations to capture a significant share of the market in front store merchandise. Front store merchandise categories include over-the-counter medications, health and beauty aids, cosmetics and fragrances (including prestige brands), everyday household needs and seasonal products. The Company also offers a broad range of high-quality private label products marketed under the trademarks Life Brand[®], Quo[®], Everyday Market[®], Bio-Life[®], Nativa[®] and Easypix[®], among others, and value-added services such as the HealthWatch[®] program, which offers patient counselling and advice on medications, disease management and health and wellness, and the Shoppers Optimum[®] program, one of the largest retail loyalty card programs in Canada. In fiscal 2008, the Company recorded consolidated sales in excess of \$9.4 billion.

Under the licensing arrangement with Associates, the Company provides the capital and financial support to enable Associates to operate Shoppers Drug Mart[®] and Pharmaprix[®] stores without any initial investment. The Company also provides a package of services to facilitate the growth and profitability of each Associate's business. These services include the use of trademarks, operational support, marketing and advertising, purchasing and distribution, information technology and accounting. In return for being provided these and other services, Associates pay fees to the Company. Fixtures, leasehold improvements and equipment are purchased by the Company and leased to Associates over periods ranging from two to 15 years, with title retained by the Company. The Company also provides its Associates with assistance in meeting their working capital and long-term financing requirements through the provision of loans and loan guarantees. (See discussion on "Associate Loans Guarantees" under "Off-balance Sheet Arrangements" in this Management's Discussion and Analysis.)

Under the licensing arrangement, the Company receives a substantial share of Associate store profits. The Company's share of Associate store profits is reflective of its investment in, and commitment to, the operations of the Associates' stores.

The Company operates in Québec primarily under the Pharmaprix[®] and Pharmaprix Simplement Santé^{MC} trade names. Under Québec law, profits generated from the prescription area or dispensary may only be earned by a pharmacist or a corporation controlled by a pharmacist. As a result of these restrictions, the licence agreement used for Québec Associates differs from the Associate agreement used in other provinces. Pharmaprix[®] and Pharmaprix Simplement Santé^{MC} stores and their Associates benefit from the same infrastructure and support provided to all other Shoppers Drug Mart[®] and Shoppers Simply Pharmacy[™] stores and Associates.

The Company has determined that the individual Associate-owned stores that comprise its store network are deemed to be variable interest entities and that the Company is the primary beneficiary in accordance with the Canadian Institute of Chartered Accountants Accounting Guideline 15, "Consolidation of Variable Interest Entities" ("AcG-15"). As such, the Associate-owned stores are subject to consolidation by the Company. However, as the Associate-owned stores remain separate legal entities from the Company, consolidation of these stores has no impact on the underlying risks facing the Company. (See note 1 to the accompanying unaudited consolidated financial statements of the Company.)

The Company also owns and operates 66 Shoppers Home Health Care[®] stores. These retail stores are engaged in the sale and service of assisted-living devices, medical equipment, home-care products and durable mobility equipment to institutional and retail customers.

In addition to its retail store network, the Company owns Shoppers Drug Mart Specialty Health Network Inc., a provider of specialty drug distribution, pharmacy and comprehensive patient support services, and MediSystem Technologies Inc., a provider of pharmaceutical products and services to long-term care facilities in Ontario and Alberta.

OVERALL FINANCIAL PERFORMANCE

Key Operating, Investing and Financial Metrics

The following provides an overview of the Company's operating performance for the 12 and 24 week periods ended June 20, 2009 compared to the 12 and 24 week periods ended June 14, 2008, as well as certain other metrics with respect to investing activities for the 12 and 24 week periods ended June 20, 2009 and financial position as at that same date.

- Second quarter sales of \$2.289 billion, an increase of 8.5%.
 - First half sales of \$4.484 billion, an increase of 8.5%.
- Second quarter comparable store sales growth, excluding tobacco products, of 5.7%, comprised of comparable prescription sales growth of 5.6% and comparable front store sales growth, excluding tobacco products of 5.8%.
 - First half comparable store sales growth, excluding tobacco products, of 4.8%, comprised of comparable prescription sales growth of 5.7% and comparable front store sales growth, excluding tobacco products, of 4.0%.
- Second quarter EBITDA⁽¹⁾ of \$266 million, an increase of 8.6%.
 - First half EBITDA of \$489 million, an increase of 8.8%.
- Second quarter EBITDA margin⁽²⁾ of 11.61%, an increase of 1 basis point.
 - First half EBITDA margin of 10.92%, an increase of 4 basis points.
- Second quarter net earnings of \$136 million or \$0.63 per share (diluted), an increase of 7.5%.
 - First half net earnings of \$243 million or \$1.12 per share (diluted), an increase of 6.9%.
- Second quarter capital expenditure program of \$129 million compared to \$97 million in the prior year. Opened or acquired 27 new drug stores, eight of which were relocations.
 - First half capital expenditure program of \$240 million compared to \$244 million in the prior year. Opened or acquired 67 new drug stores, 22 of which were relocations.
 - Year-over-year increase in drug store selling space of 11.9%.
- Maintained desired capital structure and financial position.
 - Net debt to total capitalization ratio of 0.29:1 at June 20, 2009 compared to 0.27:1 a year ago.

⁽¹⁾ Earnings before interest, taxes, depreciation and amortization. (See reconciliation to the most directly comparable GAAP measure under "Results of Operations" in this Management's Discussion and Analysis.)

⁽²⁾ EBITDA divided by sales.

Results of Operations

The following table presents a summary of certain selected consolidated financial information for the Company for the periods indicated.

| (\$000s, except per share data) | 12 Weeks Ended | | 24 Weeks Ended | |
|--|------------------|------------------|------------------|------------------|
| | June 20, 2009 | June 14, 2008 | June 20, 2009 | June 14, 2008 |
| | (unaudited) | (unaudited) | (unaudited) | (unaudited) |
| Sales | \$ 2,288,789 | \$ 2,109,308 | \$ 4,484,049 | \$ 4,133,107 |
| Cost of goods sold and other operating expenses ⁽¹⁾ | 2,023,150 | 1,864,620 | 3,994,572 | 3,683,287 |
| EBITDA ⁽²⁾ | 265,639 | 244,688 | 489,477 | 449,820 |
| Amortization | 56,279 | 46,324 | 111,882 | 91,095 |
| Operating income | 209,360 | 198,364 | 377,595 | 358,725 |
| Interest expense | 13,881 | 14,152 | 28,387 | 27,912 |
| Earnings before income taxes | 195,479 | 184,212 | 349,208 | 330,813 |
| Income taxes | 59,367 | 57,619 | 106,254 | 103,480 |
| Net earnings | \$ 136,112 | \$ 126,593 | \$ 242,954 | \$ 227,333 |
| Per common share | | | | |
| - Basic net earnings | \$ 0.63 | \$ 0.58 | \$ 1.12 | \$ 1.05 |
| - Diluted net earnings | \$ 0.63 | \$ 0.58 | \$ 1.12 | \$ 1.05 |

⁽¹⁾ Reflects the impact of the retrospective application of the new accounting standard concerning Goodwill and Other Intangible Assets – CICA Handbook Section 3064. (See discussion on “Accounting Standards Implemented in 2009” under “New Accounting Pronouncements” in this Management’s Discussion and Analysis and in note 2 to the accompanying unaudited consolidated financial statements of the Company.)

⁽²⁾ Earnings before interest, taxes, depreciation and amortization.

Sales

Sales represent the combination of sales of the retail drug stores owned by the Associates, sales at the Murale™ stores and sales of the Company-owned home health care business, Shoppers Drug Mart Specialty Health Network Inc. and MediSystem Technologies Inc.

Sales in the second quarter were \$2.289 billion compared to \$2.109 billion in the same period last year, an increase of \$180 million or 8.5%, with the Company continuing to experience strong sales growth in all regions of the country. The Company's capital investment program, which resulted in an 11.9% increase in selling square footage compared to a year ago, continues to have a positive impact on sales growth. On a same-store basis and excluding tobacco products, sales increased 5.7% during the second quarter of 2009. Year-to-date, sales increased 8.5% to \$4.484 billion. On a same-store basis and excluding tobacco products, sales increased 4.8% during the first half of 2009.

Prescription sales were \$1.109 billion in the second quarter compared to \$1.010 billion in the second quarter of 2008, an increase of \$99 million or 9.8%. During the second quarter of 2009, prescription sales accounted for 48.5% of the Company's sales mix compared to 47.9% in the same period last year. On a same-store basis, prescription sales increased 5.6% during the second quarter of 2009, driven by strong growth in the number of prescriptions filled, while increased generic utilization continued to have a deflationary impact on sales growth in the category. In the second quarter of 2009, generic molecules represented 52.7% of prescriptions dispensed compared to 50.9% of prescriptions dispensed in the second quarter of 2008. Year-to-date, prescription sales increased 10.7% to \$2.195 billion and accounted for 49.0% of the Company's sales mix. On a same-store basis, prescription sales increased 5.7% during the first half of 2009.

Front store sales were \$1.180 billion in the second quarter compared to \$1.099 billion in the second quarter of 2008, an increase of \$81 million or 7.4%, with the Company continuing to experience sales gains in all categories except tobacco. On a same-store basis and excluding tobacco products, front store sales increased 5.8% during the second quarter of 2009. The Company estimates that the shift in the Easter selling season to the second quarter of this year from the first quarter last year had a positive impact on comparable front store sales growth of approximately 150 basis points. Year-to-date, front store sales increased 6.4% to \$2.289 billion. On a same-store basis and excluding tobacco products, front store sales increased 4.0% during the first half of 2009.

Cost of Goods Sold and Other Operating Expenses

Cost of goods sold is comprised of the cost of goods sold at the retail drug stores owned by the Associates, the cost of goods sold at the Murale™ stores and the cost of goods sold at the Company-owned home health care business, Shoppers Drug Mart Specialty Health Network Inc. and MediSystem Technologies Inc. Other operating expenses include corporate selling, general and administrative expenses, operating expenses at the retail drug stores owned by the Associates, including Associates' earnings, operating expenses at the Murale™ stores and operating expenses at the Company-owned home health care business, Shoppers Drug Mart Specialty Health Network Inc. and MediSystem Technologies Inc.

Total cost of goods sold and other operating expenses were \$2.023 billion in the second quarter compared to \$1.865 billion in the same period last year, an increase of \$158 million or 8.5%. Expressed as a percentage of sales, cost of goods sold declined by 66 basis points in the second quarter of 2009 versus the comparative prior year period, reflecting an enhanced sales mix and the benefits from improved buying synergies. Offsetting this improvement were higher operating expenses which, when expressed as a percentage of sales, increased by 65 basis points over the prior year period. Operating expenses were higher due in large part to increased store-level expenses, primarily occupancy, wages and benefits associated with the continued growth and expansion of the store network.

Year-to-date, total cost of goods sold and other operating expenses increased by 8.5% to \$3.995 billion. Expressed as a percentage of sales, cost of goods sold declined by 62 basis points in the first half of 2009 versus the comparative prior year period, while other operating expenses increased by 58 basis points.

Amortization

Amortization of capital assets and other intangible assets was \$56 million in the second quarter compared to \$46 million in the same period last year, an increase of \$10 million or 21.5%. Expressed as a percentage of sales, amortization increased 26 basis points in the second quarter of 2009 versus the comparative prior year period, reflecting the continued growth of the Company's capital investment and store development program.

Year-to-date, amortization of capital assets and other intangible assets increased 22.8% to \$111.9 million. Expressed as a percentage of sales, amortization increased 30 basis points in the first half of 2009 versus the comparative prior year period.

Operating Income

Operating income was \$209 million in the second quarter of 2009 compared to \$198 million in the same period last year, an increase of \$11 million or 5.5%. This increase was driven by strong top line growth, improved purchasing synergies and a continued emphasis on cost reduction, productivity and efficiency, the benefits of which were partially offset by increased amortization and higher expenses at store-level associated with the continued expansion of the store network, along with stepped-up investments in marketing and promotional activities. In 2009, second quarter operating margin (operating income divided by sales) declined by 25 basis points to 9.15% compared to 9.40% in the second quarter of last year. The Company's EBITDA margin (EBITDA divided by sales) was 11.61% in the second quarter of 2009, a one basis point improvement over the EBITDA margin of 11.60% posted in the second quarter of last year.

Year-to-date, operating income increased 5.3% to \$378 million and operating margin declined by 26 basis points to 8.42%. During the first half of 2009, EBITDA margin was 10.92%, a four basis point improvement over the EBITDA margin of 10.88% posted during the first half of 2008.

Interest Expense

Interest expense is comprised of interest expense arising from borrowings at the Associate-owned stores and from debt obligations of the Company.

Interest expense was \$14 million in the second quarter of 2009 and \$28 million year-to-date, essentially unchanged from the amounts recorded in the same periods last year. Growth in the amount of consolidated net debt outstanding and the Company's decision to extend the term on a portion of its floating rate, short-term debt obligations, along with higher amortization of deferred financing costs related to the Company's financing activities in 2008 and the first quarter of 2009, were offset by a market-driven decrease in short-term interest rates on the Company's remaining floating rate debt obligations. (See note 5 to the accompanying unaudited consolidated financial statements of the Company.)

Income Taxes

The Company's effective income tax rate in the second quarter and first half of 2009 was 30.4% compared to 31.3% in the same periods last year. This decrease in the effective income tax rate can be attributed to a reduction in statutory rates.

Net Earnings

Second quarter net earnings were \$136 million compared to \$127 million in the same period last year, an increase of \$9 million or 7.5%. On a diluted basis, earnings per share were \$0.63 in the second quarter of 2009 compared to \$0.58 in the same period last year.

Year-to-date, net earnings increased 6.9% to \$243 million. On a diluted basis, earnings per share were \$1.12 in the first half of 2009 compared to \$1.05 in the same period last year.

Capitalization and Financial Position

The following table provides a summary of certain information with respect to the Company's capitalization and consolidated financial position at the end of the periods indicated.

| (\$000s) | June 20, 2009 | January 3, 2009 |
|--|---------------------|---------------------|
| Cash | \$ (26,059) | \$ (36,567) |
| Bank indebtedness | 277,617 | 240,844 |
| Commercial paper | 240,148 | 339,943 |
| Short-term debt | - | 197,845 |
| Long-term debt | 943,809 | 647,250 |
| Net debt | 1,435,515 | 1,389,315 |
| Shareholders' equity ⁽¹⁾ | 3,575,032 | 3,420,529 |
| Total capitalization | <u>\$ 5,010,547</u> | <u>\$ 4,809,844</u> |
| Net debt:Shareholders' equity | 0.40:1 | 0.41:1 |
| Net debt:Total capitalization | 0.29:1 | 0.29:1 |
| Net debt:EBITDA ⁽²⁾ | 1.29:1 | 1.30:1 |
| EBITDA:Cash interest expense ⁽²⁾⁽³⁾ | 17.86:1 | 17.21:1 |

⁽¹⁾ Reflects the impact of the retrospective application of the new accounting standard concerning Goodwill and Other Intangible Assets – CICA Handbook Section 3064. (See discussion on "Accounting Standards Implemented in 2009" under "New Accounting Pronouncements" in this Management's Discussion and Analysis and in note 2 to the accompanying unaudited consolidated financial statements of the Company.)

⁽²⁾ For purposes of calculating the ratios, EBITDA is comprised of EBITDA for each of the 53 week periods then ended and reflects the impact of the new accounting standard concerning Goodwill and Other Intangible Assets – CICA Handbook Section 3064.

⁽³⁾ Cash interest expense is comprised of interest expense for each of the 53 week periods then ended and excludes the amortization of deferred financing costs.

Outstanding Share Capital

The Company's outstanding share capital is comprised of common shares. An unlimited number of common shares is authorized and the Company had 217,393,945 common shares outstanding at July 14, 2009. As at this same date, the Company had issued options to acquire 928,015 of its common shares pursuant to its stock-based compensation plans, of which 705,142 were exercisable.

Financing Activities

On January 20, 2009, the Company issued \$250 million of three-year medium-term notes maturing January 20, 2012, which bear interest at a fixed rate of 4.80% per annum (the “Series 3 Notes”) and \$250 million of five-year medium-term notes maturing January 20, 2014, which bear interest at a fixed rate of 5.19% per annum (the “Series 4 Notes”). The Series 3 Notes and Series 4 Notes were issued pursuant to a final short form base shelf prospectus dated May 22, 2008 (the “Prospectus”), as supplemented by pricing supplements dated January 14, 2009, and filed by the Company with Canadian securities regulators in all of the provinces of Canada. At the time of issuance, the Series 3 Notes and Series 4 Notes were assigned ratings of A (low) from DBRS Limited and BBB+ from Standard & Poor’s. The net proceeds from the issuance of the Series 3 Notes and Series 4 Notes were used to refinance existing indebtedness, including repayment of all amounts outstanding under the Company’s then existing senior unsecured 364-day bank credit facility. As a result of applying the net proceeds from the issuance of the Series 3 Notes and Series 4 Notes to refinance existing indebtedness, the consolidated net debt position of the Company remained substantially unchanged. (See note 8 to the accompanying unaudited consolidated financial statements of the Company.)

Subsequent to the end of the second quarter, on June 22, 2009, the Company filed with the securities regulators in all of the provinces of Canada, an amendment (the “Amendment”) to the Prospectus (as amended, the “Amended Prospectus”) increasing the aggregate principal amount of medium-term notes that can be issued from time to time pursuant to the Amended Prospectus to \$1.5 billion from \$1.0 billion. To date, the Company has issued an aggregate principal amount of \$950 million of medium-term notes pursuant to the Prospectus. No incremental debt was incurred by the Company as a result of filing the Amendment.

Liquidity and Capital Resources

Sources of Liquidity

The Company has the following sources of liquidity: (i) cash provided by operating activities; (ii) cash available from a committed \$800 million revolving bank credit facility maturing June 6, 2011, less what is currently drawn and/or being utilized to support commercial paper issued and outstanding; and (iii) up to \$500 million in availability under its commercial paper program, less what is currently issued. The Company’s commercial paper program is rated R-1 (low) by DBRS Limited. In the event that the Company’s commercial paper program is unable to maintain this rating, the program is supported by the Company’s \$800 million revolving bank credit facility. The Company does not currently foresee any reasonable circumstances under which this credit rating would not be maintained.

The Company has also arranged for its Associates to obtain financing to facilitate their purchase of inventory and fund their working capital requirements by providing guarantees to various Canadian chartered banks that support Associate loans. (See discussion on “Associate Loans Guarantees” under “Off-balance Sheet Arrangements” in this Management’s Discussion and Analysis.)

The Company has obtained additional long-term financing from the issuance of \$450 million of five-year medium-term notes maturing June 3, 2013, which bear interest at a fixed rate of 4.99% per annum (the “Series 2 Notes”), the Series 3 Notes and the Series 4 Notes. The Series 2 Notes were issued pursuant to the Prospectus, as supplemented by a pricing supplement dated May 28, 2008. The Series 3 Notes and Series 4 Notes were issued pursuant to the Prospectus, as supplemented by pricing supplements dated January 14, 2009. The pricing supplements were filed by the Company with Canadian securities regulators in all of the provinces of Canada. At the time of issuance, the medium-term notes were assigned ratings of A (low) from DBRS Limited and BBB+ from Standard & Poor’s.

At the end of the second quarter of 2009, \$8 million of the Company's \$800 million revolving bank credit facility was utilized, all in respect of outstanding letters of credit. At January 3, 2009, \$209 million of this facility was utilized, including \$9 million in respect of outstanding letters of credit. At June 20, 2009, the Company had \$241 million of commercial paper issued and outstanding under its commercial paper program compared to \$341 million at the end of 2008. At the end of the second quarter of 2009, Associates had drawn an aggregate amount of \$293 million in the form of Associate loans from various Canadian chartered banks compared to \$264 million at the end of the 2008. (See discussion on "Associate Loans Guarantees" under "Off-balance Sheet Arrangements" in this Management's Discussion and Analysis.)

Cash Flows from Operating Activities

Cash flows from operating activities were \$210 million in the second quarter of 2009 compared to \$160 million in the same period last year. This increase can be largely attributed to growth in net earnings adjusted for non-cash items, principally amortization, combined with a reduction in the amount invested in non-cash working balances versus an increased investment in the comparative quarter.

Year-to-date, the Company has generated \$282 million of cash from operating activities compared to \$153 million in the first half of 2008.

Cash Flows Used in Investing Activities

Cash flows used in investing activities were \$122 million in the second quarter of 2009 compared to \$99 million in the same period last year. Of these totals, investments in property and equipment, net of proceeds from any dispositions, amounted to \$77 million in the second quarter of this year compared to \$78 million in the same period last year, as the Company continues to invest in the expansion and optimization of its store network. The Company also invested \$33 million in business acquisitions and a combined \$10 million in the purchase and development of intangible and other assets during the second quarter of 2009 compared to \$10 and \$6 million, respectively, in the same period last year. Consistent with the Company's stated growth objectives, these investments relate primarily to acquisitions of drug stores and prescription files, as the Company continues to pursue attractive opportunities in the marketplace. During the second quarter of 2009, the balance of funds deposited and held in escrow in respect of outstanding offers to purchase drug stores and land increased by \$2 million compared to an increase of \$5 million in the same period last year.

Year-to-date, cash flows used in investing activities were \$227 million compared to \$201 million in the first half of 2008. Of these totals, investments in property and equipment, net of proceeds from any dispositions, amounted to \$153 million in the first half of 2009 compared to \$135 million in the same period last year. Investments in business acquisitions and in the purchase and development of intangible and other assets were \$60 million and \$12 million, respectively, in the first half of 2009 compared to \$87 million and \$17 million, respectively, in the same period last year. During the first half of 2009, the balance of funds deposited and held in escrow in respect of outstanding offers to purchase drug stores and land increased by \$1 million compared to a decrease of \$39 million in the same period last year.

During the second quarter of 2009, 27 new drug stores were opened or acquired, eight of which were relocations, and two smaller drug stores were closed. Year-to-date, 67 new drug stores have been opened or acquired, 22 of which were relocations, and three smaller drug stores were closed. As a result of this activity, drug store selling space increased by 11.9% compared to a year ago. At the end of the second quarter of 2009, there were 1,259 stores in the Company's retail network, comprised of 1,191 drug stores (1,159 Shoppers Drug Mart/Pharmaprix stores and 32 Shoppers Simply Pharmacy/Pharmaprix Simplement Santé stores), 66 Shoppers Home Health Care® stores and two Murale™ stores.

Cash Flows Used in Financing Activities

Cash flows used in financing activities were \$89 million in the second quarter of 2009, as cash inflows of \$14 million were more than offset by cash outflows of \$103 million. Cash inflows were comprised of a \$13 million increase in the amount of bank indebtedness and \$1 million of proceeds received from the issuance of common shares and loan repayments under the Company's stock-based incentive plans. Cash outflows were comprised of a \$53 million decrease in the amount of commercial paper issued and outstanding by the Company under its commercial paper program, a \$3 million reduction in the amount of Associate investment and \$47 million for the payment of dividends.

In the second quarter of 2009, the net result of the Company's operating, investing and financing activities was a decrease in cash balances of less than \$1 million.

Year-to-date, cash flows used in financing activities was \$66 million and the net result of the Company's operating, investing and financing activities was a decrease in cash of \$11 million.

Future Liquidity

The Company believes that its current credit facilities, commercial paper program and financing programs available to its Associates, together with cash generated from operating activities, will be sufficient to fund its operations, including the operations of its Associate-owned store network, investing activities and commitments for the foreseeable future. While credit markets in Canada and globally have tightened, causing credit spreads to widen and liquidity risk to intensify, the Company does not foresee any major difficulty in obtaining additional short or long-term financing given its current credit ratings and past experiences in the capital markets.

NEW ACCOUNTING PRONOUNCEMENTS

Accounting Standards Implemented in 2009

Financial Statement Concepts

In February 2008, the Canadian Institute of Chartered Accountants (the "CICA") issued amendments to CICA Handbook Section 1000, "Financial Statement Concepts" ("Section 1000"), to clarify the criteria for recognition of an asset and the timing of expense recognition; specifically deleting the guidance permitting the deferral of costs. The new requirements are effective for interim and annual financial statements relating to fiscal years beginning on or after October 1, 2008. The Company applied the amendments to Section 1000 at the beginning of its current fiscal year in conjunction with CICA Handbook Section 3064, "Goodwill and Intangible Assets".

Goodwill and Intangible Assets

In February 2008, the CICA issued a new accounting standard concerning Goodwill and Intangible Assets ("Section 3064"), which is based on the International Accounting Standards Board's (the "IASB") International Accounting Standard 38, "Intangible Assets". The new section replaced the existing guidance on goodwill and other intangible assets and research and development costs. The objective of the new standard is to eliminate the practice of deferring costs that do not meet the definition and recognition criteria of assets. The standard is effective for interim and annual financial statements for fiscal years beginning on or after October 1, 2008. The Company applied the new accounting standard retrospectively at the beginning of its current fiscal year, with restatement of prior periods. Intangible assets recognized prior to the Company's current fiscal year that no longer meet the new recognition or measurement criteria and the definition of an asset were removed from the consolidated balance sheets in accordance with CICA Handbook Section 1506, "Accounting Changes". The balance of such deferred costs as at the end of the Company's 2007 and 2008 fiscal years was reflected as a charge to opening retained earnings.

The implementation of the new standard has resulted in a reduction to the Company's 2009 and 2008 fiscal years' opening retained earnings of \$38.9 million and \$27.8 million, respectively. The impacts on other balances are described in the following paragraphs.

The impact for the year ended January 3, 2009 is an increase in cost of goods sold and other operating expenses and a decrease in operating income of \$15.3 million and a decrease in net earnings of \$11.1 million, resulting in a decrease of \$0.05 in basic and diluted net earnings per share. The adjustment relates to previously deferred costs that no longer qualify for recognition as an asset, primarily store opening costs.

The impact for the 12 and 24 week periods ended June 14, 2008 is an increase in cost of goods sold and other operating expenses and a decrease in operating income of \$2.4 million and \$3.2 million, respectively, and a decrease in net earnings of \$1.7 million and \$2.3 million, respectively, resulting in a decrease in basic and diluted earnings per share of \$0.01 and \$0.02, respectively. The adjustment relates to previously deferred costs that no longer qualify for recognition as an asset, primarily store opening costs.

The impact on balances as at January 3, 2009 was primarily an increase in net future income tax assets of \$17.7 million, a decrease in prepaid expenses and deposits of \$4.7 million, a decrease in property and equipment of \$110.8 million, a decrease in deferred costs of \$47.2 million, an increase in intangible assets of \$114.5 million and a decrease in other assets of \$8.3 million. The increase in intangible assets and decrease in property and equipment primarily reflects the reclassification of certain computer software costs previously included in property and equipment.

The impact on balances as at June 14, 2008 was primarily an increase in net future income tax assets of \$14.3 million, a decrease in prepaid expenses and deposits of \$3.4 million, a decrease in property and equipment of \$84.8 million, a decrease in deferred costs of \$36.2 million, an increase in intangible assets of \$86.9 million and a decrease in other assets of \$6.9 million. The increase in intangible assets and decrease in property and equipment primarily reflects the reclassification of certain computer software costs previously included in property and equipment.

Goodwill is recorded as 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 at least on an annual basis. In the event of impairment, the excess of the carrying amount over the fair value of goodwill would be charged to earnings.

Intangible assets are amortized on a straight-line basis over the estimated useful lives of the assets. Intangible assets are tested for impairment at least on an annual basis. In the event of impairment, the excess of the carrying amount over the fair value of intangible assets would be charged to earnings.

Credit Risk and the Fair Value of Financial Assets and Financial Liabilities

The Emerging Issues Committee of the CICA (the “EIC”) issued a new abstract on January 20, 2009 concerning the measurement of financial assets and financial liabilities (“EIC-173 – Credit Risk and the Fair Value of Financial Assets and Financial Liabilities”) (the “Abstract”). There had been diversity in practice as to whether an entity’s own credit risk and the credit risk of the counterparty were taken into account in determining the fair value of financial instruments. The EIC reached a consensus that these risks should be taken into account in the measurement of financial assets and financial liabilities. The Abstract is effective for all financial assets and financial liabilities measured at fair value in interim and annual financial statements issued for periods ending on or after the date of issuance of the Abstract, with retrospective application without restatement of prior periods. The Company applied the new Abstract at the beginning of its current fiscal year. The implementation did not have a significant impact on the Company’s results of operations, financial position and disclosures.

Financial Instruments – Disclosures

In June 2009, the CICA issued amendments to CICA Handbook Section 3862, “Financial Instruments – Disclosures” (“Section 3862”), to adopt the amendments recently issued by the IASB to International Financial Reporting Standard 7, “Financial Instruments: Disclosures” (“IFRS 7”), in March 2009. These amendments are applicable to publicly accountable enterprises and those private enterprises, co-operative business enterprises, rate-regulated enterprises and not-for-profit organizations that choose to apply Section 3862. The amendments were made to enhance disclosures about fair value measurements, including the relative reliability of the inputs used in those measurements, and about the liquidity risk of financial instruments.

The amendments are effective for annual financial statements for fiscal years ending after September 30, 2009, with early adoption permitted. To provide relief for preparers, and consistent with IFRS 7, the CICA decided that an entity need not provide comparative information for the disclosures required by the amendments in the first year of application. The Company will apply these amendments for its 2009 annual consolidated financial statements. The impacts of the amendments to the fair value measurement and liquidity risk disclosure requirements of the Company are not expected to be significant.

Future Accounting Standards

Business Combinations

In January 2009, the CICA issued new accounting standards concerning Business Combinations (“Section 1582”), Non-controlling Interests (“Section 1602”) and Consolidated Financial Statements (“Section 1601”), which are based on the IASB’s International Financial Reporting Standard 3, “Business Combinations”. The new standards replace the existing guidance on business combinations and consolidated financial statements. The objective of the new standards is to harmonize Canadian accounting for business combinations with the international and U.S. accounting standards. The new standards are to be applied prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after January 1, 2011, with earlier application permitted. Assets and liabilities that arose from business combinations whose acquisition dates preceded the application of the new standards shall not be adjusted upon application of these new standards. Section 1602 should be applied retrospectively except for certain items.

The Company is assessing whether it will apply the new accounting standards at the beginning of its 2011 fiscal year or elect to early adopt the new accounting standards at the beginning of its 2010 fiscal year in order to minimize the amount of restatement when the Company adopts International Financial Reporting Standards (“IFRS”). The impact of the new standards on the Company’s results of operations, financial position and disclosures will be assessed as part of the Company’s IFRS transition project.

Financial Instruments – Recognition and Measurement

On April 29, 2009, the CICA amended CICA Handbook Section 3855, “Financial Instruments – Recognition and Measurement”, adding and amending paragraphs regarding the application of the effective interest method to previously impaired financial asset and embedded prepayment options. The amendments are effective for interim and annual financial statements relating to fiscal years beginning on or after January 1, 2011, with early adoption permitted. The amendments are not expected to have a significant impact on the Company’s accounting for its financial instruments.

Transition to International Financial Reporting Standards

In January 2006, the Accounting Standards Board (the “AcSB”) announced its decision to require all publicly accountable enterprises to report under International Financial Reporting Standards (“IFRS”) for years beginning on or after January 1, 2011. As a result, financial reporting by Canadian publicly accountable enterprises will change significantly from current Canadian generally accepted accounting principles to IFRS.

On February 13, 2008, the AcSB confirmed that publicly accountable enterprises will be required to use IFRS, as issued by the International Accounting Standards Board, unless modifications or additions to the requirements of IFRS are issued by the AcSB. IFRS must be adopted for interim and annual financial statements related to fiscal years beginning on or after January 1, 2011.

The Company launched its IFRS transition project in 2008 with a high level assessment of the key areas where conversion to IFRS may have a significant impact, or present a significant challenge. The Company has engaged an external advisor, established a working team and developed documentation and status reporting protocols. The Company has delivered its initial training program and is ensuring that the working team has an in-depth understanding of relevant IFRS as well as new developments in IFRS.

The Company’s working team is completing a detailed assessment of IFRS focused on the identification of differences between the Company’s current policies and those under IFRS. In this regard, a topic specific issues list is being developed, identifying the activities required for resolution and timelines for completion including potential impacts on taxation, information technology and data systems. In conjunction with this analysis, the Company is scoping the associated disclosure requirements.

The options under IFRS 1, First-time Adoption of International Reporting Standards, have been identified and will be further analyzed as the Company progresses through its detailed assessment of the individual standards. The impact on other business activities, disclosure controls and procedures and internal control over financial reporting will be assessed once the impacts of the standards as a whole are identified.

OFF-BALANCE SHEET ARRANGEMENTS

Associate Loans Guarantees

The Company has provided guarantees to various Canadian chartered banks that support Associate loans. At the end of the second quarter of 2009, the Company's maximum obligation in respect of such guarantees was \$505 million compared to \$425 million at the end of the first quarter and prior year. At June 20, 2009, an aggregate amount of \$415 million in available lines of credit had been allocated to the Associates by the various banks compared to \$407 million at the end of the first quarter and \$398 million at the end of the prior year. As at June 20, 2009, Associates had drawn an aggregate amount of \$293 million against these available lines of credit compared to \$278 million at the end of the first quarter and \$264 million at the end of the prior year. Any amounts drawn by the Associates are included in bank indebtedness on the Company's consolidated balance sheets. As recourse in the event that any payments are made under the guarantees, the Company holds a first ranking security interest on all assets of Associate-owned stores, subject to certain prior-ranking statutory claims. As the Company is involved in allocating the available lines of credit to its Associates, it estimates that the net proceeds from secured assets would exceed the amount of any payments required in respect of the guarantees.

SELECTED QUARTERLY INFORMATION

Reporting Cycle

The annual reporting cycle of the Company is divided into four quarters of 12 weeks each, except for the third quarter which is 16 weeks in duration. The fiscal year of the Company consists of a 52 or 53 week period ending on the Saturday closest to December 31. When a fiscal year consists of 53 weeks, the fourth quarter is 13 weeks in duration.

Summary of Quarterly Results

The following table provides a summary of certain selected consolidated financial information for the Company for each of the eight most recently completed fiscal quarters. This information has been prepared in accordance with Canadian generally accepted accounting principles.

| | Second Quarter | | First Quarter | | Fourth Quarter | | Third Quarter | |
|---|--------------------|--------------------|--------------------|--------------------|--------------------|-----------------------------------|--------------------|-----------------------------------|
| | 2009 (12 Weeks) | 2008 (12 Weeks) | 2009 (12 Weeks) | 2008 (12 Weeks) | 2008 (13 Weeks) | 2007 ⁽¹⁾ (12 Weeks) | 2008 (16 Weeks) | 2007 ⁽¹⁾ (16 Weeks) |
| (\$000s, except per share data – unaudited) | | | | | | | | |
| Sales | \$ 2,288,789 | \$ 2,109,308 | \$ 2,195,260 | \$ 2,023,799 | \$ 2,496,799 | \$ 2,168,822 | \$ 2,793,005 | \$ 2,542,671 |
| Net earnings | \$ 136,112 | \$ 126,593 | \$ 106,842 | \$ 100,740 | \$ 166,537 | \$ 151,331 | \$ 160,276 | \$ 141,672 |
| Per common share | | | | | | | | |
| - Basic net earnings | \$ 0.63 | \$ 0.58 | \$ 0.49 | \$ 0.46 | \$ 0.77 | \$ 0.70 | \$ 0.74 | \$ 0.65 |
| - Diluted net earnings | \$ 0.63 | \$ 0.58 | \$ 0.49 | \$ 0.46 | \$ 0.77 | \$ 0.70 | \$ 0.74 | \$ 0.65 |

⁽¹⁾ Does not reflect the impact of the retrospective application of the new accounting standard concerning Goodwill and Other Intangible Assets – CICA Handbook Section 3064. (See discussion on “Accounting Standards Implemented in 2009” under “New Accounting Pronouncements” in this Management's Discussion and Analysis and in note 2 to the accompanying unaudited consolidated financial statements of the Company.)

The Company experienced growth in sales and net earnings in each of the four most recent quarters when compared to the same quarter of the prior year. The Company continues to invest capital in expanded and relocated stores and in new store development, which has allowed the Company to increase the selling square footage of its store network, resulting in increased sales and profitability.

The Company's core prescription drug operations are not typically subject to seasonal fluctuations. The Company's front store operations include seasonal promotions which may have an impact on quarterly results, particularly when the season, notably Easter, does not fall in the same quarter each year. Also, as the Company continues to expand its front store product and service offerings, including seasonal promotions, its results of operations may become subject to more seasonal fluctuations.

RISKS AND RISK MANAGEMENT

Industry and Regulatory Developments

The Company is reliant on prescription drug sales for a significant and growing portion of its sales and profits. Information regarding industry and regulatory risk factors is included in the section entitled "Risks and Risk Management" in the Company's Management's Discussion and Analysis for the 53 week period ended January 3, 2009.

On July 10, 2009, the Ontario Ministry of Health and Long-Term Care (the "Ministry") announced at a "Drug System Renewal Forum" that it will be introducing reforms to the Ontario drug system intended to implement substantive changes across the supply chain for prescription drug products and pharmacy services. The stated objective of these reforms is to ensure that Ontario receives value for money in all aspects of the provincial drug plan while maintaining or improving patient care. The Ministry indicated that it will be considering a range of options to improve the value for money equation, including reducing professional allowance funding, expanding the scope of pharmacy services and reimbursing pharmacy appropriately for the services provided, promoting alternative drug distribution channels and pricing mechanisms to decrease the costs of prescription drugs, any of which may have an adverse impact on the Company's business, sales and profitability. As part of the reforms, the Ministry stated that it will also be considering applying some of the options for reform to the private sector. The Ministry indicated that it would be unlikely that any of the options for reform will be implemented in isolation but that the integration of multiple options would be part of the solution. The Ministry intends to make decisions on the options after a series of consultations and discussions with industry participants and other parties which are scheduled for late July and early August of 2009. The Ministry stated that, with respect to those options that are ultimately determined to be part of the reforms implemented by the Ministry, the introduction of certain of the reforms could begin as early as the fall or winter of 2009 if such reform could be accommodated under the existing legislative regime. If any reforms require legislative changes to the Ontario Drug Benefit Act and the Drug Interchangeability and Dispensing Fee Act for implementation, the Ministry anticipates that to accommodate the legislative process required for such change, such reforms would not be implemented before the spring of 2010.

RISKS ASSOCIATED WITH FINANCIAL INSTRUMENTS

The Company is exposed to a number of risks associated with financial instruments that have the potential to affect its operating and financial performance. The Company's primary financial instrument risk exposures are interest rate risk and liquidity risk. The Company's exposures to foreign currency risk, credit risk and other price risk are not considered to be material. The Company may use derivative financial instruments to manage certain of these risks. The Company does not use derivative financial instruments for trading or speculative purposes.

Exposure to Interest Rate Fluctuations

The Company, including its Associate-owned store network, is exposed to fluctuations in interest rates by virtue of its borrowings under its bank credit facilities, commercial paper program and financing programs available to its Associates. Increases or decreases in interest rates will positively or negatively impact the financial performance of the Company.

The Company uses interest rate derivatives to manage this exposure and monitors market conditions and the impact of interest rate fluctuations on its fixed and floating rate debt instruments on an ongoing basis. The Company has interest rate derivative agreements converting an aggregate notional principal amount of \$100 million (2008 - \$250 million) of floating rate debt into fixed rate debt. The fixed rates payable by the Company under these agreements range from 4.11% to 4.18% (2008 - 4.03% to 4.18%). These agreements mature as follows: \$50 million in December 2009 and \$50 million in December 2010, with reset terms of one month.

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 financial institutions. There is no unrecognized exposure as at June 20, 2009, as the interest rate derivative agreements are in a liability position, unchanged from a year ago.

As at June 20, 2009, the Company had \$434 million (2008 - \$262 million) of unhedged floating rate debt. During the 12 and 24 week periods ended June 20, 2009, the Company's average outstanding unhedged floating rate debt was \$581 million and \$626 million (2008 - \$716 million and \$733 million), respectively. Had interest rates been higher or lower by 50 basis points during the 12 and 24 week periods ended June 20, 2009, net earnings would have decreased or increased, respectively, by approximately \$0.5 million and \$1.0 million (2008 - \$0.6 million and \$1.2 million), respectively, as a result of the Company's exposure to interest rate fluctuations on its unhedged floating rate debt.

Foreign Currency Exchange Risk

The Company conducts the vast majority of its business in Canadian dollars. The Company's foreign currency exchange risk principally relates to purchases made in U.S. dollars and this risk is tied to fluctuations in the exchange rate of the Canadian dollar, vis-à-vis the U.S. dollar. The Company monitors its foreign currency purchases in order to monitor its foreign currency exchange risk. The Company does not consider its exposure to foreign currency exchange rate risk to be material.

Credit Risk

Accounts receivable arise primarily in respect of prescription sales billed to governments and third-party drug plans and as a result, collection risk is low. There is no concentration of balances with debtors in the remaining accounts receivable. The Company does not consider its exposure to credit risk to be material.

Other Price Risk

The Company uses cash-settled equity forward agreements to limit its exposure to future changes in the market price of its common shares by virtue of its obligations under its long-term incentive plan ("LTIP"). The income or expense arising from the use of these instruments is included in cost of goods sold and other operating expenses.

Based on market values of the equity forward agreements in place at June 20, 2009, the Company recognized a net liability of \$0.7 million, of which \$0.9 million is presented in other assets, \$0.8 million is presented in accounts payable and accrued liabilities and \$0.8 million is presented in other long-term liabilities. Based on market values of the equity forward agreements in place at June 14, 2008, the Company recognized an asset of \$1.6 million, of which \$0.6 million was presented in accounts receivable and \$1.0 million was presented in other assets. During the 12 and 24 week periods ended June 20, 2009 and June 14, 2008, the Company assessed that the percentage of the equity forward agreements in place related to unearned units under the LTIP were an effective hedge for its exposure to future changes in the market price of its common shares in respect of the unearned units. Market values were determined based on information received from the Company's counterparty to these equity forward agreements.

Capital Management and Liquidity Risk

The Company's primary objectives when managing its capital and liquidity are to profitably grow its business while maintaining adequate financing flexibility to fund attractive new investment opportunities and other unanticipated requirements or opportunities that may arise. Profitable growth is defined as earnings growth commensurate with the additional capital being invested in the business in order that the Company earns an attractive rate of return on that capital. The primary investments undertaken by the Company to drive profitable growth include additions to the selling square footage of its store network via the construction of new, relocated and expanded stores, including related leasehold improvements and fixtures, the acquisition of sites as part of a land bank program, as well as through the acquisition of independent drug stores or their prescription files. In addition, the Company makes capital investments in information technology and its distribution capabilities to support an expanding store network. The Company also provides working capital to its Associates via loans and/or loan guarantees. The Company largely relies on its cash flow from operations to fund its capital investment program and dividend distributions to its shareholders. This cash flow is supplemented, when necessary, through the borrowing of additional debt. No changes were made to these objectives during the period.

The Company considers its total capitalization to be bank indebtedness, commercial paper, short-term debt, long-term debt (including the current portion thereof) and shareholders' equity, net of cash. The Company also gives consideration to its obligations under operating leases when assessing its total capitalization. The Company manages its capital structure with a view to maintaining investment grade credit ratings from two credit rating agencies. In order to maintain its desired capital structure, the Company may adjust the level of dividends paid to shareholders, issue additional equity, repurchase shares for cancellation or issue or repay indebtedness. The Company has certain debt covenants and is in compliance with those covenants.

The Company monitors its capital structure principally through measuring its net debt to shareholders' equity ratio and net debt to total capitalization ratio, and ensures its ability to service its debt and meet other fixed obligations by tracking its interest and other fixed charges coverage ratios. (See discussion under "Capitalization and Financial Position" in this Management's Discussion and Analysis.)

Liquidity risk is the risk that the Company will be unable to meet its obligations relating to its financial liabilities. The Company prepares cash flow budgets and forecasts to ensure that it has sufficient funds through operations, access to bank credit facilities and access to debt and capital markets to meet its financial obligations, capital investment program and fund new investment opportunities or other unanticipated requirements as they arise. The Company manages its liquidity risk as it relates to financial liabilities by monitoring its cash flow from operating activities to meet its short-term financial liability obligations and planning for the repayment of its long-term financial liability obligations through cash flow from operating activities and/or the issuance of new debt.

For a complete description of the Company's sources of liquidity, see the discussions on "Sources of Liquidity" and "Future Liquidity" under "Liquidity and Capital Resources" in this Management's Discussion and Analysis.

INTERNAL CONTROLS OVER FINANCIAL REPORTING

The Chief Executive Officer and the Chief Financial Officer have designed, or caused to be designed under their supervision, internal controls over financial reporting to provide reasonable assurance regarding the reliability of financial reporting, its compliance with Canadian GAAP and the preparation of financial statements for external purposes. Internal control systems, no matter how well designed, have inherent limitations. Therefore, even those systems determined to be designed effectively can provide only reasonable assurance with respect to financial reporting and financial statement preparation.

There were no changes in internal control over financial reporting that occurred during the Company's most recent interim period that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

NON-GAAP FINANCIAL MEASURES

The Company reports its financial results in accordance with Canadian GAAP. However, the foregoing contains references to non-GAAP financial measures, such as operating margin, EBITDA (earnings before interest, taxes, depreciation and amortization), EBITDA margin and cash interest expense. Non-GAAP financial measures do not have standardized meanings prescribed by GAAP and therefore may not be comparable to similar measures presented by other reporting issuers.

These non-GAAP financial measures have been included in this Management's Discussion and Analysis as they are measures which management uses to assist in evaluating the Company's operating performance against its expectations and against other companies in the retail drug store industry. Management believes that non-GAAP financial measures assist in identifying underlying operating trends.

These non-GAAP financial measures, particularly EBITDA and EBITDA margin, are also common measures used by investors, financial analysts and rating agencies. These groups may use EBITDA and other non-GAAP financial measures to value the Company and assess the Company's ability to service its debt.