

SHOPPERS DRUG MART CORPORATION

2007 THIRD QUARTER REPORT TO SHAREHOLDERS

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SHOPPERS DRUG MART CORPORATION

MANAGEMENT'S DISCUSSION AND ANALYSIS

As at October 29, 2007

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 interim period consolidated financial statements of the Company and the notes thereto for the 16 and 40 week periods ended October 6, 2007. The Company's unaudited interim period consolidated 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 52 week period ended December 30, 2006.

FORWARD-LOOKING STATEMENTS

This discussion of the consolidated financial condition and results of operations of the Company contains forward-looking statements regarding, among other things, the Company's beliefs, plans, objectives, strategies, estimates, intentions and expectations, including as they relate to its operating and financial results, capital expenditures, dividend policy and the ability to execute on its operating, investing and financing strategies. These forward-looking statements are based on certain assumptions by management, certain of which are set out herein. Inherent in these forward-looking statements are known and unknown risks, uncertainties and other factors beyond the Company's ability to control or predict. Actual results or developments may differ materially from those contemplated by these statements depending on, among others, such factors as changes in the regulatory environment as it relates to the sale of prescription drugs, competition from other retailers, exposure to interest rate fluctuations, foreign currency risks, certain property and casualty risks, the ability to attract and retain pharmacists, risks in connection with third party service providers, the availability of suitable store locations, seasonality risks, changes in federal and provincial laws, rules and regulations relating to the Company's business and environmental matters, changes in tax regulations and accounting pronouncements, the success of the Company's Associate-owned stores, supplier and brand reputations and the accuracy of management's assumptions. This list is not exhaustive of the factors that may affect any of the Company's forward-looking statements. Investors and others should carefully consider these and other factors and not place undue reliance on these forward-looking statements. Further information regarding these and other factors is included in the Company's public filings with provincial securities regulatory authorities including, without limitation, the section entitled "Risks and Risk Management" in the Company's Management's Discussion and Analysis for the 52 week period ended December 30, 2006 and the section entitled "Risk Factors" in the Company's Annual Information Form for the same period. The forward-looking 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. 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 statements.

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 October 6, 2007, there were 1,035 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 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 ("OTC") 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 Life Brand®, Quo®, Bella® and Everyday Market® trademarks, and value-added services such as the HealthWatch® program, which offers patient counselling on medications and disease management, and the Shoppers Optimum™ program, one of the largest retail loyalty card programs in Canada. In fiscal 2006, the Company recorded consolidated sales of approximately \$7.8 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. In addition, the Company also provides a standby letter of credit to an independent trust (the "Trust") which provides additional financing to Associates to facilitate their purchase of inventory and to fund their working capital requirements. (See notes 1 and 7 to the accompanying unaudited consolidated financial statements of the Company.)

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 under the Pharmaprix® trade name. 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® stores and their Associates benefit from the same infrastructure and support provided to all other Shoppers Drug Mart® 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 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 61 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 also owns 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 16 and 40 week periods ended October 6, 2007 compared to the 16 and 40 week periods ended October 7, 2006, as well as certain other metrics with respect to investing activities for the 16 and 40 week periods ended October 6, 2007 and financial position as at October 6, 2007.

- Third quarter sales of \$2.543 billion, an increase of 9.2%.
 - Year-to-date sales of \$6.310 billion, an increase of 9.4%.
- Third quarter comparable store sales growth of 5.3%, comprised of comparable prescription sales growth of 5.4% and comparable front store sales growth of 5.3%.
 - Year-to-date comparable store sales growth of 5.6%, comprised of comparable prescription sales growth of 5.8% and comparable front store sales growth of 5.4%.
- Third quarter EBITDA⁽¹⁾ of \$284 million, an increase of 16.2%.
 - Year-to-date EBITDA of \$679 million, an increase of 16.8%.
- Third quarter EBITDA margin⁽²⁾ of 11.16%, an increase of 68 basis points.
 - Year-to-date EBITDA margin of 10.76%, an increase of 69 basis points.
- Third quarter net earnings of \$143 million or \$0.66 per share (diluted), an increase of 15.1%.
 - Year-to-date net earnings of \$340 million or \$1.57 per share (diluted), an increase of 17.2%.
- Third quarter capital expenditures of \$248 million, which includes the acquisition of the assets of Centre d'Escomptes Racine (\$77 million). This compares to \$210 million in the prior year, which included the acquisitions of MediSystem Technologies Inc. (\$90 million) and Therapy Supplies & Rental Limited (\$19 million). Opened or acquired 55 new drug stores, 20 of which were relocations, and added two home health care stores.
 - Year-to-date capital expenditures of \$370 million compared to \$298 million in the prior year. Opened or acquired 91 new drug stores, 37 of which were relocations, and added three home health care stores.
 - Year-over-year increase in drug store selling space of 13.0%.
- Net debt to total capitalization ratio of 0.26:1 at October 6, 2007 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)	16 Weeks Ended		40 Weeks Ended	
	October 6, 2007	October 7, 2006	October 6, 2007	October 7, 2006
	(unaudited)	(unaudited)	(unaudited)	(unaudited)
Sales	\$ 2,542,671	\$ 2,329,051	\$ 6,309,560	\$ 5,768,369
Cost of goods sold and other operating expenses	2,259,011	2,084,896	5,630,857	5,187,210
EBITDA ⁽¹⁾	283,660	244,155	678,703	581,159
Amortization	54,942	44,295	130,752	106,466
Operating income	228,718	199,860	547,951	474,693
Interest expense	15,920	14,632	38,688	38,977
Earnings before income taxes	212,798	185,228	509,263	435,716
Income taxes	70,224	61,348	169,294	145,725
Net earnings	\$ 142,574	\$ 123,880	\$ 339,969	\$ 289,991
Per common share				
- Basic net earnings	\$ 0.66	\$ 0.58	\$ 1.57	\$ 1.36
- Diluted net earnings	\$ 0.66	\$ 0.57	\$ 1.57	\$ 1.34

⁽¹⁾ Earnings before interest, taxes, depreciation and amortization.

Sales

Sales represent the combination of sales of the retail drug stores owned by the Associates and sales of the Company-owned home health care business and MediSystem Technologies Inc.

Sales in the third quarter were \$2.543 billion compared to \$2.329 billion in the same period last year, an increase of \$214 million or 9.2%, with continued strong sales growth experienced in all regions of the country, led by gains in Western Canada and Québec. On a same-store basis, sales increased 5.3% during the third quarter of 2007. Year-to-date, sales increased 9.4% to \$6.310 billion. The Company's capital investment program, which has resulted in a 13.0% increase in drug store selling space compared to a year ago, continues to have a positive impact on sales growth. On a same-store basis, sales increased 5.6% during the first three quarters of 2007.

Prescription sales were \$1.215 billion in the third quarter compared to \$1.116 billion in the same period last year, an increase of \$99 million or 8.9%. On a same-store basis, prescription sales increased 5.4% during the third quarter of 2007, driven by strong growth in the number of prescriptions filled, while greater generic prescription utilization continued to have a deflationary impact on prescription sales growth. Prescription sales represented 47.8% of the Company's sales mix during the third quarter of 2007 compared to 47.9% in the same period last year. Year-to-date, prescription sales increased 9.3% to \$3.014 billion and accounted for 47.8% of the Company's sales mix. On a same-store basis, prescription sales increased 5.8% during the first three quarters of 2007.

Front store sales were \$1.328 billion in the third quarter compared to \$1.213 billion in the same period last year, an increase of \$115 million or 9.5%, with the Company once again experiencing sales gains in all categories, led by OTC medications and cosmetics. On a same-store basis, front store sales increased 5.3% during the third quarter of 2007. Year-to-date, front store sales increased 9.5% to \$3.296 billion. On a same-store basis, front store sales increased 5.4% during the first three quarters of 2007.

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 and the cost of goods sold of the Company-owned home health care business 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, and operating expenses of the Company-owned home health care business and MediSystem Technologies Inc.

Total cost of goods sold and other operating expenses were \$2.259 billion in the third quarter compared to \$2.085 billion in the same period last year, an increase of \$174 million or 8.4%. Expressed as a percentage of sales, cost of goods sold declined by 118 basis points in the third quarter of 2007 versus the comparative prior year period, reflecting improvements in cost of goods and an enhanced sales mix. The acquisitions of MediSystem Technologies Inc. and Therapy Supplies & Rental Limited, both of which were acquired late in the third quarter of the prior year, also contributed to margin improvement in the quarter. Better margins continue to provide the Company with the operating leverage and financial flexibility to make certain strategic investments in order to further strengthen the business for the long-term. Examples of such investments include a national pharmacy marketing campaign designed to promote the new tools and services available under the Company's expanded HealthWatch[®] program, increased promotional activities in the front of the store, including initiatives to support the launch of new private label products, and costs associated with the enhancement of certain corporate and store-level information systems. Other operating expenses were also higher due to the inclusion of these expenses at MediSystem Technologies Inc. and Therapy Supplies & Rental Limited, as well as from additional costs incurred to self-distribute more consumable products, however these costs only partially offset the benefits of the higher gross margin rates described above. Accordingly, other operating expenses, expressed as a percentage of sales, increased by 50 basis points in the third quarter of 2007 when compared to the third quarter of the prior year.

Year-to-date, total cost of goods sold and other operating expenses increased 8.6% to \$5.631 billion. Expressed as a percentage of sales, cost of goods sold declined by 113 basis points in the first three quarters of 2007 versus the comparative prior year period, while other operating expenses increased by 44 basis points.

Amortization

Amortization of capital assets and other intangible assets was \$55 million in the third quarter compared to \$44 million in the same period last year, an increase of \$11 million or 24.0%. Expressed as a percentage of sales, amortization increased 26 basis points in the third quarter of 2007 versus the comparative prior year period, reflecting the continued growth of the Company's capital investment program.

Year-to-date, amortization of capital assets and other intangible assets increased 22.8% to \$131 million. Expressed as a percentage of sales, amortization increased 22 basis points in the first three quarters of 2007 versus the comparative prior year period.

Operating Income

Operating income was \$229 million in the third quarter compared to \$200 million in the same period last year, an increase of \$29 million or 14.4%. As described above, sales growth, combined with a reduction in cost of goods and an enhanced mix, partially offset by increased amortization and investments in other growth initiatives, resulted in a higher operating margin (operating income divided by sales). In 2007, third quarter operating margin improved by 42 basis points to 9.00% compared to 8.58% in the third quarter of last year. The Company's EBITDA margin (EBITDA divided by sales) was 11.16% in the third quarter of 2007, a 68 basis point improvement over the EBITDA margin of 10.48% posted in the third quarter of last year.

Year-to-date, operating income increased 15.4% to \$547 million and operating margin improved by 45 basis points to 8.68%. During the first three quarters of 2007, EBITDA margin was 10.76%, a 69 basis point improvement over the EBITDA margin of 10.07% posted during the first three quarters of 2006.

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 \$16 million in the third quarter of 2007 compared to \$15 million in the same period last year, an increase of \$1 million or 8.8%. This increase versus the comparative prior year period can be attributed to an increase in the amount of consolidated net debt outstanding, coupled with a market-driven increase in short-term interest rates. Year-to-date, interest expense was \$39 million, essentially unchanged from the first three quarters of the prior year. (See note 4 to the accompanying unaudited consolidated financial statements of the Company.)

Income Taxes

The Company's effective income tax rate in the third quarter of 2007 was 33.0% compared to 33.1% in the same period last year. Year-to-date, the Company's effective income tax rate was 33.2% compared to 33.4% during the first three quarters of the prior year.

Net Earnings

Third quarter net earnings were \$143 million compared to \$124 million in the same period last year, an increase of \$19 million or 15.1%. On a diluted basis, earnings per share were \$0.66 in the third quarter of 2007 compared to \$0.57 in the same period last year.

Year-to-date, net earnings increased 17.2% to \$340 million. On a diluted basis, earnings per share were \$1.57 in the first three quarters of 2007 compared to \$1.34 in the same period last year.

Financial Position

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

(\$000s)	October 6, 2007	December 30, 2006
Cash	\$ (17,477)	\$ (62,865)
Bank indebtedness	246,909	134,487
Commercial paper	537,201	503,550
Long-term debt	298,872	300,000
Net debt	1,065,505	875,172
Shareholders' equity	2,975,976	2,723,954
Total capitalization	\$ 4,041,481	\$ 3,599,126
Net debt:Shareholders' equity	0.36:1	0.32:1
Net debt:Total capitalization	0.26:1	0.24:1
Net debt:EBITDA ⁽¹⁾	1.15:1	1.06:1
EBITDA:Cash interest expense ⁽¹⁾⁽²⁾	18.94:1	17.16:1

⁽¹⁾ For purposes of calculating the ratios, EBITDA is comprised of EBITDA for each of the 52 week periods then ended.

⁽²⁾ Cash interest expense is comprised of interest expense for each of the 52 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 216,600,267 common shares outstanding at October 29, 2007. As at this same date, the Company had issued options to acquire 1,741,709 of its common shares pursuant to its stock-based compensation plans, of which 1,181,662 were exercisable.

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 \$550 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 \$300 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 Dominion Bond Rating Service. In the event that the Company's commercial paper program is unable to maintain this rating, the program is supported by the Company's \$550 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 from the following sources: (i) an independent trust (the "Trust") whose activities are financed through the issuance of short-term, asset-backed notes that are rated R-1 (middle) by Dominion Bond Rating Service to third-party investors; and (ii) by providing guarantees to various Canadian chartered banks that support Associate loans. Due to current liquidity constraints in the Canadian asset-backed commercial paper market, the aggregate amount of Trust funding available to the Company's Associates is currently limited to \$500 million. (See notes 1 and 7 to the accompanying unaudited consolidated financial statements of the Company.)

The Company has obtained additional long-term financing from the issuance of \$300 million of five-year medium-term notes maturing October 24, 2008, which bear interest at a fixed rate of 4.97% per annum (the "Notes"). The Notes were issued pursuant to a short form base shelf prospectus dated October 10, 2003, as supplemented by a pricing supplement dated October 20, 2003, and filed by the Company with Canadian securities regulators in all of the provinces of Canada. At the time of issuance, the Notes were assigned a rating of A (low) from Dominion Bond Rating Service and BBB from Standard & Poor's.

At the end of the third quarter, \$54 million of the Company's \$550 million revolving credit facility was utilized, all in respect of outstanding letters of credit and trade finance guarantees. At December 30, 2006, \$51 million of this facility was utilized, all in respect of outstanding letters of credit and trade finance guarantees. At October 6, 2007, the Company had \$40 million of commercial paper issued and outstanding under its commercial paper program compared to \$50 million at the end of the prior year. At the end of the third quarter, Associates had obtained an aggregate amount of \$498 million of Trust financing and had drawn an aggregate amount of \$247 million in the form of Associate loans from various Canadian chartered banks compared to \$454 million and \$141 million, respectively, at the end of the prior year.

In addition to the above, MediSystem Technologies Inc., a subsidiary of the Company, has arranged for up to \$1 million of revolving demand bank credit facilities. At the end of the third quarter, no amounts were outstanding on these facilities, unchanged from the end of the prior year.

Cash Flows from Operating Activities

Cash flows from operating activities were \$164 million in the third quarter of 2007 compared to \$172 million in the same period last year, a decrease of \$8 million or 4.9%. During the third quarter of 2007, growth in net earnings, adjusted for non-cash items, was reduced by an investment in non-cash working capital balances, whereas in the third quarter of 2006, the Company's investment in non-cash working capital balances declined.

Year-to-date, the Company has generated \$345 million of cash from operating activities compared to \$331 million in the first three quarters of 2006.

Cash Flows Used in Investing Activities

Cash flows used in investing activities were \$308 million in the third quarter of 2007 compared to \$172 million in the same period last year, an increase of \$136 million or 78.8%. Of these totals, investments in property and equipment amounted to \$138 million in the third quarter of this year compared to \$95 million in the same period last year, reflecting the continued expansion of the Company's store network growth and revitalization program. The Company also invested \$110 million in business acquisitions and \$67 million in deposits during the third quarter of 2007 compared to an investment of \$72 million in business acquisitions in the same period last year. Consistent with its stated growth objectives, these investments relate primarily to acquisitions of drug stores and prescription files, including funds deposited and held in escrow in respect of outstanding offers, as the Company continues to pursue attractive opportunities in the marketplace. Of the \$110 million invested in business acquisitions in the third quarter of this year, \$77 million was used to acquire the assets of Centre d'Escomptes Racine, a seven store pharmacy chain in the Québec City region. (See note 3 to the accompanying unaudited financial statements of the Company.)

Year-to-date, cash flows used in investing activities were \$439 million compared to \$262 million in the first three quarters of 2006. Of these totals, investments in property and equipment amounted to \$249 million in the first three quarters of this year compared to \$172 million in the same period last year. Investments in business acquisitions and deposits were \$121 million and \$75 million, respectively, in the first three quarters of 2007 compared to an investment of \$83 million in business acquisitions in the same period last year.

During the third quarter of 2007, 55 new drug stores were opened or acquired, 20 of which were relocations, and two drug stores were closed. The Company also added two home health care stores to its network during the quarter. Year-to-date, 91 new drug stores have been opened or acquired, 37 of which were relocations, and six drug stores have been closed. The Company has also added three home health care stores to its network thus far in 2007. As a result of this activity, drug store selling space has increased by 13.0% compared to a year ago. At the end of the third quarter there were 1,096 stores in the system, comprised of 1,035 drug stores and 61 Shoppers Home Health Care[®] stores.

Cash Flows From (Used in) Financing Activities

Cash flows from financing activities were \$50 million in the third quarter of 2007, as cash inflows of \$88 million were partially offset by cash outflows of \$39 million. Cash inflows were comprised of a \$20 million increase in bank indebtedness, a \$64 million increase in the amount of commercial paper issued and outstanding under the Company's commercial paper programs (a \$40 million increase in the amount of commercial paper issued and outstanding by the Company plus \$24 million of additional Trust financing obtained by Associates), and \$4 million of proceeds received from the issuance of common shares pursuant to the Company's stock-based incentive plans. Cash outflows were comprised of a \$4 million reduction in the amount of Associate investment and \$35 million for the payment of dividends.

In the third quarter of 2007, the net result of the Company's operating, investing and financing activities was a decrease in cash balances of \$94 million.

Year-to-date, cash flows from financing activities were \$49 million and the net result of the Company's operating, investing and financing activities was a decrease in cash balances of \$45 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. The Company does not foresee any 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 2007

Financial Instruments

In 2006, the Canadian Institute of Chartered Accountants (the “CICA”) issued new accounting standards concerning financial instruments: Financial Instruments – Recognition and Measurement (“Section 3855”); Hedges (“Section 3865”); and Comprehensive Income (“Section 1530”). These standards require prospective application and are effective for the Company’s 2007 fiscal year. The Company applied the new accounting standards at the beginning of its current fiscal year and their implementation did not have a significant impact on the Company’s results of operations or financial position.

Financial Assets and Liabilities

Section 3855 establishes standards for recognizing and measuring financial instruments. Under the new standards, all financial instruments are classified into one of the following five categories: held for trading; held-to-maturity investments; loans and receivables; available-for-sale financial assets; or, other financial liabilities. This classification drives the basis of measurement and the accounting treatment in the financial statements. (See note 2 to the accompanying unaudited consolidated financial statements of the Company.)

Derivatives and Hedge Accounting

The Company has entered into various interest rate derivative agreements converting an aggregate notional principal amount of \$250 million of floating rate short-term, asset-backed notes issued by the Trust into fixed rate debt. The fixed rates payable by the Company under these agreements range from 4.03% to 4.18%. These agreements mature as follows: \$150 million in December 2008; \$50 million in December 2009; and \$50 million in December 2010. These interest rate derivative agreements are designated as hedges in accordance with the new standards. Accordingly, the fair value of these agreements has been included in “other assets” on the consolidated balance sheet of the Company. Any after-tax adjustments related to the fair values of these interest rate derivative agreements have been included in “accumulated other comprehensive income” on the consolidated balance sheet of the Company. (See note 2 to the accompanying unaudited consolidated financial statements of the Company.)

In addition, the Company has entered into cash-settled equity forward agreements to limit its exposure to future changes in the market price of 197,745 of its common shares by virtue of its obligations under its stock-based, long-term incentive plan (“LTIP”). These agreements mature in December 2008 and December 2009. A percentage of these equity forward derivative agreements, related to the unearned units under the LTIP, has been designated as a hedge in accordance with the new standards. Accordingly, upon adoption of the new standards, the fair value of this hedge was reflected in the opening balance of “accumulated other comprehensive income”, net of tax.

During the first three quarters of 2007, the change in the fair value of the percentage of these equity forward agreements that relates to the unearned LTIP units has been recorded in “other comprehensive income”. (See note 2 to the accompanying unaudited consolidated financial statements of the Company).

Convertible and Other Debt Instruments with Embedded Derivatives

In March 2007, the Emerging Issues Committee of the CICA (the “EIC”) issued EIC-164, “Convertible and Other Debt Instruments with Embedded Derivatives” (“EIC-164”). EIC-164 addresses accounting for debt instruments with certain conversion features. EIC-164 applies retrospectively to financial instruments accounted for in accordance with Section 3855 in interim or annual financial statements ending on or after June 30, 2007. The implementation of EIC-164 did not have an impact on the Company’s results of operations or financial position.

Accounting by an Investor upon Loss of Significant Influence

In April 2007, the EIC issued EIC-165, “Accounting by an Investor upon Loss of Significant Influence” (“EIC-165”). EIC-165 addresses how an investor that loses significant influence in an investee should account for the amount the investor has in accumulated other comprehensive income for its proportionate share of the investee’s equity adjustments for other comprehensive income. EIC-165 applies retrospectively to financial statements for interim and annual periods ending after June 30, 2007. The implementation of EIC-165 did not have an impact on the Company’s results of operations or financial position.

Accounting Policy Choice for Transaction Costs

In June 2007, the EIC issued EIC-166, “Accounting Policy Choice for Transaction Costs” (“EIC-166”). EIC-166 addresses whether transaction costs related to financial assets and liabilities that are not classified as held for trading can be recognized in net income for certain of these financial assets and liabilities and added to the carrying amount for other financial assets and liabilities. EIC-166 applies retrospectively to financial statements issued for interim and annual reports ending on or after September 30, 2007. The implementation of EIC-166 did not have an impact on the Company’s results of operations or financial position.

OFF-BALANCE SHEET ARRANGEMENTS

Associate Loans

The Company has provided guarantees to various Canadian chartered banks that support Associate loans. At the end of the third quarter of 2007, the Company’s maximum obligation in respect of such guarantees was \$415 million compared to \$370 million at the end of the second quarter and end of the prior year. At October 6, 2007, an aggregate amount of \$347 million in available lines of credit had been allocated to the Associates by the various banks compared to \$332 million at the end of the second quarter and \$323 million at the end of the prior year. As at October 6, 2007, Associates had drawn an aggregate amount of \$247 million against these available lines of credit compared to \$232 million at the end of the second quarter and \$141 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, excluding inventory. 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.

Associate Financing Trust

The Company has arranged for its Associates to obtain financing from the Trust to facilitate their purchase of inventory and fund their working capital requirements. At the end of the third quarter of 2007, the total amount of loans outstanding from the Trust to the Company’s Associates was \$498 million compared to \$473 million at the end of the second quarter and \$454 million at the end of the prior year. The Company has determined that the Trust is a variable interest entity and that the Company is the primary beneficiary. As such, the Trust is subject to consolidation by the Company and these loans are included in commercial paper on the Company’s consolidated balance sheets. 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 \$51 million, as a form of credit enhancement which, in turn, enables the Trust to provide favourable financing terms to the Company’s Associates. (See notes 1 and 7 to the accompanying unaudited consolidated financial statements of the Company.)

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 Trust will assign to the Company the Associate's loan agreement and related security documentation. 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.

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

	Third Quarter		Second Quarter		First Quarter		Fourth Quarter	
	2007 (16 Weeks)	2006 (16 Weeks)	2007 (12 Weeks)	2006 (12 Weeks)	2007 (12 Weeks)	2006 (12 Weeks)	2006 (12 Weeks)	2005 (12 Weeks)
(\$000s, except per share data – unaudited)								
Sales	\$ 2,542,671	\$ 2,329,051	\$ 1,928,094	\$ 1,768,199	\$ 1,838,795	\$ 1,671,119	\$ 2,018,067	\$ 1,833,327
Net earnings	\$ 142,574	\$ 123,880	\$ 112,264	\$ 94,407	\$ 85,131	\$ 71,704	\$ 132,500	\$ 115,125
Per common share								
- Basic net earnings	\$ 0.66	\$ 0.58	\$ 0.52	\$ 0.44	\$ 0.40	\$ 0.34	\$ 0.62	\$ 0.54
- Diluted net earnings	\$ 0.66	\$ 0.57	\$ 0.52	\$ 0.44	\$ 0.39	\$ 0.33	\$ 0.61	\$ 0.53

The selected quarterly information has been prepared in accordance with Canadian generally accepted accounting principles.

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.

INTERNAL CONTROLS OVER FINANCIAL REPORTING

There were no changes in internal controls 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 controls 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.