

management's discussion and analysis

As at March 10, 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 consolidated audited financial statements of the Company and the notes thereto for the 52 week period ended December 30, 2006 (the "consolidated financial statements"). The fiscal year of the Company consists of a 52 or 53 week period ending on the Saturday closest to December 31.

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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 is not an exhaustive list 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. 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 December 30, 2006, there were 987 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 medications ("OTC medications"), health and beauty aids ("HBA"), 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® and Quo® 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 customer 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 ten 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 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 discussions on "Associate Loans" and "Associate Financing Trust" under "Off-balance Sheet Arrangements" in this Management's Discussion and Analysis and note 13 to the 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 licence 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 consolidated financial statements of the Company.)

The Company also owns and operates 58 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.

Strategies and Outlook

The Company's business strategies are designed to drive sales growth, maximize gross margin dollars and operating cash flow, leverage cost reduction opportunities and build customer loyalty. The Company believes that proper execution of its strategies will strengthen its position as the licensor of Canada's leading drug store group, thereby generating increased revenue and profitability, and will continue to provide superior returns to its shareholders.

In the opinion of the Company, the demographic trends of the aging Canadian population are expected to fuel continued strong growth in the pharmacy and beauty categories. The Company believes that it is well positioned to continue to capitalize on the projected growth in the retail drug store industry given its strong brand recognition, focus on pharmacy, health care and beauty products and services, convenient locations and the dedication of its Associate-owners. The Company intends to build upon its leadership position in pharmacy by investing in new services and technology and, more importantly, in the recruitment, retention and training of pharmacists. The Company believes that its primary focus on pharmacy products and services will continue to drive customer traffic and provide profitable growth in its beauty and other front store categories. The Company intends to increase its front store sales and gross margin dollars through a reinvigorated category management process and by focusing on value-added services. The Company believes that improved merchandising, a continued focus on operational excellence and the introduction of new products and services, including the tactical use of private label products, will increase customer satisfaction, thereby improving the attractiveness of Shoppers Drug Mart® and Pharmaprix® stores as a destination for the purchase of OTC medications, HBA, cosmetics, seasonal merchandise and convenient household products.

Sales growth is also being driven by the Company's store network investment program as it seeks to accelerate new store openings and acquisitions, expand and remodel existing stores and relocate other stores to superior locations. Also, due to the fragmented nature of the Canadian retail drug store industry, the Company believes that it is well positioned to capitalize on consolidation opportunities, given its strong cash flow and balance sheet. In fiscal 2006, the Company opened or acquired 95 drug stores, 48 of which were relocations, and closed 10 stores. In addition to this activity, the Company also completed nine major drug store expansions during the year. The Company also added seven home health care stores to its network during fiscal 2006. As a result of this activity, the selling square footage of the store network increased by 10.6% during fiscal 2006. The Company intends to continue making significant investments in its store base, with the goal of increasing the number and average size of its stores. These large-format stores offer customers greater convenience and a broader selection of front store products, while maintaining the high level of service for which Shoppers Drug Mart® and Pharmaprix® stores are known. The Company's capital expenditures are typically financed from internally generated cash flow.

In fiscal 2007, the Company plans to allocate approximately \$400 million to capital expenditures, with approximately 80% of this amount being invested in the store network, including acquisitions and land. This should result in an increase in selling square footage of more than 10%. This will be accomplished through the addition of between 110 and 120 new drug stores, approximately 50 of which will be relocations, and through the completion of between 10 and 15 major expansions. The Company also plans to add approximately five home health care stores to its network in fiscal 2007.

The Company is confident in its ability to execute upon its operating, investing and financing strategies in fiscal 2007 and beyond. The Company believes that the appropriate balance and successful implementation of these strategies and initiatives will result in long-term market share gains, while delivering consistent and meaningful growth in earnings per share. This in turn should provide superior returns to shareholders, through a combination of share price appreciation and dividends, which are sustainable over time.

Overall Financial Performance

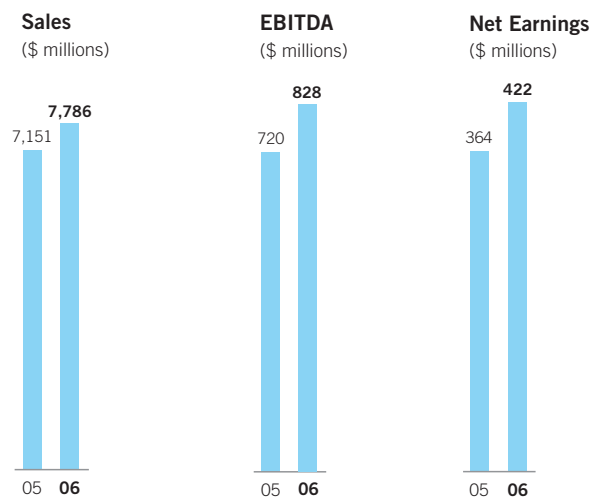
Key Operating, Investing and Financial Metrics

The following provides an overview of the Company's operating performance for the 52 week period ended December 30, 2006 compared to the 52 week period ended December 31, 2005, as well as certain other metrics with respect to investing activities for the 52 week period ended December 30, 2006 and financial position as at that same date.

- Sales of \$7.8 billion, an increase of 8.9%.
- Comparable store total sales growth of 6.5%.
 - > Comparable store prescription sales growth of 7.9%.
 - > Comparable store front store sales growth of 5.3%.
- Sales per square foot (annualized) of \$975.
- EBITDA⁽¹⁾ of \$828 million, an increase of 15.0%.
 - > EBITDA margin⁽²⁾ of 10.63%, an increase of 56 basis points.
- Net earnings of \$422 million or \$1.95 per share (diluted), an increase of 15.9%.
- Capital expenditure program of \$430 million compared to \$275 million in the prior year.
 - > Acquired MediSystem Technologies Inc. (\$90 million) and Therapy Supplies & Rental Limited (\$19 million).
 - > 95 new drug stores opened or acquired, 48 of which were relocations.
 - > 29 drug stores expanded and/or renovated.
 - > 10 new home health care stores opened or acquired, three of which were relocations.
 - > 10.6% increase in selling square footage to 8.7 million square feet.
- Net debt reduced by \$59 million to \$875 million.
 - > Net debt to equity ratio reduced to 0.32:1 compared to 0.39:1 at the end of the prior year.
 - > Net debt to total capitalization ratio reduced to 0.24:1 compared to 0.28:1 at the end of the prior year.
- Increased quarterly dividend payments by 20%.
 - > Declared four quarterly dividends of 12 cents per share.

⁽¹⁾ Earnings before interest, taxes, depreciation and amortization. (See reconciliation to the most directly comparable GAAP measure under "Results of Operations – Fiscal 2006" in this Management's Discussion and Analysis.)

⁽²⁾ EBITDA divided by sales.



Results of Operations – Fiscal 2006

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

(\$000's, except per share data)	2006	2005	\$ Change	% Change
Sales	\$ 7,786,436	\$ 7,151,115	\$ 635,321	8.9%
Cost of goods sold and other operating expenses	6,958,361	6,430,933	(527,428)	(8.2%)
EBITDA ⁽¹⁾	828,075	720,182	107,893	15.0%
Amortization	144,549	120,937	(23,612)	(19.5%)
Operating income	683,526	599,245	84,281	14.1%
Interest expense	49,872	48,649	(1,223)	(2.5%)
Earnings before income taxes	633,654	550,596	83,058	15.1%
Income taxes	211,163	186,102	(25,061)	(13.5%)
Net earnings	\$ 422,491	\$ 364,494	\$ 57,997	15.9%
Per common share				
– Basic net earnings	\$ 1.97	\$ 1.72	\$ 0.25	
– Diluted net earnings	\$ 1.95	\$ 1.69	\$ 0.26	

⁽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 2006 were \$7.786 billion compared to \$7.151 billion in 2005, an increase of \$635 million or 8.9%. During 2006, the Company continued to experience strong sales growth in all regions of the country, led by gains in Western Canada and Québec. On a same-store basis, sales increased 6.5% in 2006. The Company's capital investment program, which resulted in a 10.6% increase in selling space versus a year ago, continues to have a positive impact on sales growth.

Prescription sales were \$3.655 billion in 2006 compared to \$3.337 billion in 2005, an increase of \$318 million or 9.5%. In addition to new real estate, the launch of enhanced pharmacy services under the HealthWATCH® brand and the third quarter acquisition of MediSystem Technologies Inc. contributed to pharmacy sales growth. On a same-store basis, prescription sales increased 7.9% during the year. In 2006, prescription sales accounted for 46.9% of the Company's sales mix compared to 46.7% in the prior year.

Front store sales were \$4.131 billion in 2006 compared to \$3.814 billion in 2005, an increase of \$317 million or 8.3%. The Company continues to experience sales gains in all categories, led by strong growth in HBA, OTC medications and beauty. On a same-store basis, front store sales increased 5.3% in 2006. The continued roll-out of new, larger-format stores, where the bulk of the incremental selling square footage is devoted to front store categories, combined with innovative marketing tactics and a differentiated product and service offering, is driving sales growth in the front of the store.

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 at 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 at the Company-owned home health care business and MediSystem Technologies Inc.

Total cost of goods sold and other operating expenses were \$6.958 billion in 2006 compared to \$6.431 billion in 2005, an increase of \$527 million or 8.2%. Expressed as a percentage of sales, cost of goods sold declined by 77 basis points in 2006 compared to the prior year, reflecting an enhanced sales mix, better buying and reduced shrink. This improvement was partially mitigated by growth in other operating expenses which increased by 21 basis points over the prior year when expressed as a percentage of sales. Higher operating expenses at store level, primarily in the form of increased rent, labour and Associate earnings tied to the expansion of the store network, were largely responsible for this increase, although it was partially offset by labour and productivity improvements at existing stores.

Amortization

Amortization of capital assets was \$145 million in 2006 compared to \$121 million in 2005, an increase of \$24 million or 19.5%. Expressed as a percentage of sales, amortization increased 17 basis points in 2006 compared to the prior year, reflecting the continued growth of the Company's capital investment and store development program.

Operating Income

Operating income was \$684 million in 2006 compared to \$599 million in 2005, an increase of \$85 million or 14.1%. As described above, sales growth, an enhanced mix and an ongoing commitment to cost reduction, productivity and efficiency, partially offset by higher operating costs and increased amortization in new and relocated stores, resulted in a higher operating margin (operating income divided by sales). In 2006, operating margin improved by 40 basis points to 8.78% compared to 8.38% in 2005. The Company's EBITDA margin was 10.63% in 2006, a 56 basis point improvement over the EBITDA margin of 10.07% posted in 2005.

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 \$50 million in 2006 compared to \$49 million in 2005, an increase of \$1 million or 2.5%. This increase over the prior year can be attributed to a market-driven increase in short-term interest rates, partially offset by a reduction in the amount of consolidated net debt outstanding.

Interest expense for 2006 includes \$2 million for the amortization of deferred financing costs compared to \$3 million in 2005. (See note 3 to the consolidated financial statements of the Company.)

Income Taxes

The Company's effective income tax rate in 2006 was 33.3% compared to 33.8% in 2005. This decrease in the effective income tax rate can be attributed to a number of factors, including a reduction in statutory rates in certain jurisdictions and changes to the Company's internal capital structure, combined with favourable outcomes of a tax audit and the recognition of the tax benefit related to available capital losses, all of which was partially offset by an income tax reassessment in one provincial jurisdiction. (See discussion on "Income Taxes" under "Critical Accounting Estimates" in this Management's Discussion and Analysis and notes 1 and 4 to the consolidated financial statements of the Company.)

Net Earnings

Net earnings were \$422 million in 2006 compared to \$364 million in 2005, an increase of \$58 million or 15.9%. On a diluted basis, earnings per share were \$1.95 in 2006 compared to \$1.69 in 2005.

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.

(\$000's)	2006	2005
Cash	\$ (62,865)	\$ (24,524)
Bank indebtedness	134,487	163,503
Commercial paper	503,550	469,850
Long-term debt	300,000	325,000
Net debt	875,172	933,829
Shareholders' equity	2,723,954	2,386,508
Total capitalization	\$ 3,599,126	\$ 3,320,337
Net debt:Shareholders' equity	0.32:1	0.39:1
Net debt:Total capitalization	0.24:1	0.28:1
Net debt:EBITDA	1.06:1	1.30:1
EBITDA:Cash interest expense ⁽¹⁾	17.16:1	15.62:1

⁽¹⁾ Cash interest expense excludes the amortization of deferred financing costs. (See note 3 to the consolidated financial statements of the Company.)

Financial Ratios and Credit Ratings

As measured by the ratios set out above, the Company continued to strengthen its balance sheet and improve its financial position in 2006, as cash flow generated from operating activities was sufficient to fund the Company's investing and financing activities, including dividends paid on the Company's common shares. The Company expects these trends to continue in 2007.

The following table provides a summary of the Company's credit ratings at the end of 2006.

	Standard & Poor's	Dominion Bond Rating Service
Corporate credit rating	BBB+	–
Senior unsecured debt	BBB+	A (low)
Commercial paper	–	R-1 (low)

On December 22, 2006, Standard & Poor's Ratings Services raised its ratings on the Company's corporate credit and senior unsecured debt to BBB+ from BBB.

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 215,302,145 common shares outstanding at March 10, 2007. As at this same date, the Company had issued options to acquire 3,050,249 of its common shares pursuant to its stock-based compensation plans, of which 2,223,032 were exercisable. (See notes 10 and 11 to the consolidated financial statements of the Company.)

Dividend Policy

On February 8, 2006, the Company announced that its Board of Directors had declared a dividend of 12 cents per common share, payable April 13, 2006 to shareholders of record as of the close of business on March 31, 2006. This represented an increase in the amount of the Company's quarterly dividend payments of 20%, resulting in an annualized dividend payment of 48 cents per common share.

The following table provides a summary of dividends declared by the Company in 2006:

Declaration Date	Record Date	Payment Date	Dividend
February 8, 2006	March 31, 2006	April 13, 2006	\$ 0.12
May 1, 2006	June 30, 2006	July 14, 2006	\$ 0.12
July 19, 2006	September 29, 2006	October 13, 2006	\$ 0.12
November 8, 2006	December 29, 2006	January 15, 2007	\$ 0.12

Subsequent to year-end, the Company announced, on February 8, 2007, that its Board of Directors declared a dividend of 16 cents per common share, payable April 13, 2007 to shareholders of record as of the close of business on March 30, 2007. This represents an increase in the amount of the Company's quarterly dividend payments of 33.3%, resulting in an annualized dividend payment of 64 cents per common share.

Subject to financial results, capital requirements, available cash flow and any other factors that the Board of Directors may consider relevant, it is the intention of the Board of Directors to declare a comparable quarterly dividend on an ongoing basis. It is expected that future dividend payments will be made to shareholders of record as of the close of business on the last business day of each calendar quarter and that the related payment date will be the fifteenth day of the month following the record date, or if such day is not a business day, the immediately preceding business day.

All dividends paid by the Company in 2006 and, unless otherwise indicated, all dividends to be paid by the Company subsequent to 2006, are designated as *eligible dividends* in accordance with subsection 89(14) of the *Income Tax Act* (Canada) and any applicable corresponding provincial provisions.

Normal Course Issuer Bid

On September 6, 2006, the Company announced that its Board of Directors authorized the purchase of up to 5,350,000 of its common shares, representing approximately 2.5% of its common shares then outstanding, by way of normal course purchases on the Toronto Stock Exchange (the "TSX"). The Company was able to commence purchases under the program on September 8, 2006. The program will terminate on September 7, 2007, or on such earlier date as the Company may complete its purchases pursuant to a Notice of Intention filed with the TSX. Purchases will be made by the Company in accordance with the requirements of the TSX and the price that the Company pays for any such common shares will be the market price of such common shares at the time of acquisition. Common shares purchased under the program will be cancelled.

From September 8, 2006 to December 30, 2006, the Company purchased and cancelled 913,600 common shares under the program at a cost of \$41.8 million. The premium paid over the average book value of the purchased common shares has been charged to retained earnings. (See note 10 to the consolidated financial statements of the Company.)

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 its \$550 million revolving bank credit facility. The Company does not currently foresee any reasonable circumstances under which this credit rating would not be maintained. (See note 8 to the consolidated financial statements of the Company.)

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. (See discussions on "Associate Loans" and "Associate Financing Trust" under "Off-balance Sheet Arrangements" in this Management's Discussion and Analysis and notes 8 and 13 to the 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. (See note 8 to the consolidated financial statements of the Company.)

At December 30, 2006, \$51 million of the Company's \$550 million revolving credit facility was utilized, all in respect of letters of credit and trade finance guarantees. At the end of the prior year, \$48 million of the Company's then existing \$250 million revolving credit facility was utilized, all in respect of letters of credit and trade finance guarantees. At December 30, 2006, the Company had \$50 million of commercial paper issued and outstanding under its commercial paper program, unchanged from the amount outstanding at the end of the prior year. At year-end, Associates had obtained an aggregate amount of \$454 million of Trust financing and had drawn an aggregate amount of \$141 million in the form of Associate loans from various Canadian chartered banks compared to \$420 million and \$164 million, respectively, at the end of the prior year. (See notes 8 and 13 to the consolidated financial statements of the Company.)

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 2006, no amounts were outstanding on these facilities.

Cash Flows from Operating Activities

Cash flows from operating activities were \$579 million in 2006 compared to \$451 million in 2005, an increase of \$128 million or 28.5%. This increase can be primarily attributed to higher operating income, combined with a decreased investment in non-cash working capital balances versus the prior year. Growth in inventory and accounts receivable, tied largely to expansion of the store network and increased sales activity, was more than offset by increased balances in income taxes payable and in accounts payable and accrued liabilities. (See note 12 to the consolidated financial statements of the Company.)

Cash Flows Used in Investing Activities

Cash flows used in investing activities were \$391 million in 2006 compared to \$274 million in 2005, an increase of \$117 million or 42.5%. Of these totals, purchases of property and equipment amounted to \$293 million in 2006 compared to \$250 million in 2005, reflecting the Company's stepped-up capital investment and store revitalization program. In 2006, approximately 77% of the amount invested in property and equipment was allocated to the store network, compared to 86% in the prior year. In order to support future growth and expansion of the store network, the Company also allocated additional capital to certain infrastructure projects in information technology and distribution. In 2006, the Company completed the expansion of its central distribution centre located in Mississauga, Ontario, having completed the expansion of its eastern distribution centre located in Moncton, New Brunswick, during the prior year. In 2007, the Company will complete the expansion of its western distribution centre, located in Calgary, Alberta.

In 2006, the Company invested an additional \$94 million in business acquisitions compared to \$25 million in the prior year. Of the amount invested in 2006, \$47 million (plus an additional \$43 million of common shares issued by the Company) was used to acquire all of the common shares of MediSystem Technologies Inc., and \$19 million was used to acquire all of the common shares of Therapy Supplies & Rental Limited, an Ontario-based company engaged in the sales and service of durable mobility equipment. (See note 2 to the consolidated financial statements of the Company.) The balance of the amount invested in business acquisitions in 2006 consisted primarily of purchases of single drug store prescription files; however, in some instances, the Company will acquire a drug store and continue to operate it at its existing location as a Shoppers Drug Mart® or Pharmaprix® store. In 2007, the Company will continue to pursue attractive acquisition opportunities in Canada's fragmented retail drug store marketplace.

During 2006, 95 new drug stores were opened or acquired, 48 of which were relocations, 10 were closed and 29 were expanded and/or renovated. The Company also opened 10 new home health care stores in 2006, three of which were relocations. At the end of 2006, there were 1,045 stores in the system, comprised of 987 drug stores and 58 Shoppers Home Health Care® stores. During 2006, the selling square footage of the store network increased by 10.6% to 8.7 million square feet. On a regional basis, proportionately more square footage was added in Western Canada and Québec, two markets in which the Company has been historically underrepresented. At year-end, the average selling space per drug store was approximately 8,700 square feet compared to 8,200 square feet at the end of the prior year.

The following table provides a summary of the Company's store network, and changes thereto, for the periods indicated.

	2006		2005	
	Drug Stores	Home Health Care Stores	Drug Stores	Home Health Care Stores
Store count – beginning of year	950	51	915	49
Stores opened/acquired	47	7	48	2
Stores closed	10	–	13	–
Store count – end of year	987	58	950	51
Stores relocated	48	3	47	1
Stores renovated/expanded	29	1	27	3

The Company intends to continue making significant investments in its store base, with the goal of increasing the number and average size of its stores. In fiscal 2007, the Company plans to allocate approximately \$400 million to capital expenditures, with approximately 80% of this amount being invested in the store network, including acquisitions and land. This should result in an increase in selling square footage of more than 10%. This will be accomplished through the addition of between 110 and 120 new drug stores, approximately 50 of which will be relocations, and through the completion of between 10 and 15 major expansions. The Company also plans to add approximately five home health care stores to its network in fiscal 2007.

Financing Activities

Cash flows used in financing activities were \$150 million in 2006, as cash outflows of \$197 million were partially offset by cash inflows of \$47 million. Cash outflows were comprised of \$29 million to reduce bank indebtedness, \$25 million to repay long-term debt outstanding under the Company's previously existing \$25 million non-revolving bank credit facility, \$2 million to repay long-term debt outstanding under a previously existing non-revolving, amortizing bank credit facility at MediSystem Technologies Inc., \$98 million for the payment of dividends and \$42 million to repurchase, for cancellation, 913,600 of the Company's common shares pursuant to its normal course issuer bid. Cash inflows were comprised of a \$34 million increase in the amount of commercial paper issued and outstanding in the form of additional Trust financing obtained by Associates and \$13 million of proceeds received from the issuance of common shares and loan repayments under the Company's stock-based incentive plans.

In 2006, the net result of the Company's operating, investing and financing activities was an increase in cash balances of \$38 million.

On June 6, 2006, the Company entered into a \$550 million restated and amended senior unsecured bank credit facility that matures on June 6, 2011. The restated and amended bank credit facility combined the Company's \$250 million revolving bank credit facility that was to mature on February 2, 2007 with its \$300 million 364-day extendible revolving credit facility that was available for general corporate purposes, including back-stopping the Company's commercial paper program.

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 long-term financing given its current credit ratings and past experiences in the capital markets.

Contractual Obligations

The following table presents a summary of the maturity periods of the Company's contractual obligations as at the end of 2006.

(\$000's)	Payments Due during 2007	Payments Due in 2008 and 2009	Payments Due in 2010 and 2011	Payments Due after 2011	Obligations with No Fixed Maturity	Total
Medium-term notes	\$ –	\$ 300,000	\$ –	\$ –	\$ –	\$ 300,000
Employee future benefits ⁽¹⁾	–	–	–	–	13,648	13,648
Other	1,866	7,088	443	231	652	10,280
Operating leases ⁽²⁾	247,801	496,783	425,674	1,401,611	–	2,571,869
Total	\$ 249,667	\$ 803,871	\$ 426,117	\$ 1,401,842	\$ 14,300	\$ 2,895,797

⁽¹⁾ See discussion on "Employee Future Benefits" under "Critical Accounting Estimates" in this Management's Discussion and Analysis and note 9 to the consolidated financial statements of the Company.

⁽²⁾ Represents the minimum lease payments under long-term leases for store locations and office space as at December 30, 2006. (See note 13 to the consolidated financial statements of the Company.)

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

The Company has entered into an agreement with a third party to provide distribution services to the Company's store network. Under the terms of the distribution services agreement, which expires on December 31, 2009, the third party will charge the Company specified costs incurred to provide the distribution services, plus an annual management fee. In addition, the Company has entered into an agreement to outsource certain information services activities from a third party. The Company has committed to average annual payments of approximately \$7 million over the term of the information services agreement, which expires in 2009.

Off-balance Sheet Arrangements

Derivative Financial Instruments

In the normal course of its business, the Company is exposed to financial risks that have the potential to negatively impact its financial performance. 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. The Company may be exposed to losses should any counterparty to its derivative financial instruments fail to fulfil its obligations. The Company has sought to minimize counterparty risk by transacting with counterparties that are large financial institutions. (See notes 1 and 14 to the consolidated financial statements of the Company.)

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 in interest rates will have an adverse effect on the earnings of the Company.

In December 2005, the Company 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. Changes in the underlying interest rates of the Company's interest rate derivative agreements will result in market gains and losses. (See notes 3 and 14 to the consolidated financial statements of the Company.)

The Company is exposed to fluctuations in the market price of its common shares by virtue of its obligations under its stock-based, long-term incentive plan (the "LTIP"). In February 2006, the Company entered into a cash-settled equity forward agreement to manage this exposure. Under this agreement, the Company has hedged the variability in cash flows on forecasted payments under the LTIP arising from changes in the value of 138,564 of its common shares awarded under the LTIP between the "Award Date" and the "Final Vesting Date", as such terms are defined in the LTIP. This agreement matures in December 2008. (See notes 11 and 14 to the consolidated financial statements of the Company.)

Associate Loans

The Company has provided guarantees to various Canadian chartered banks that support Associate loans. At the end of 2006, the Company's maximum obligation in respect of such guarantees was \$370 million compared to \$350 million at the end of the prior year. At December 30, 2006, an aggregate amount of \$323 million in available lines of credit had been allocated to the Associates by the various banks compared to \$299 million at the end of the prior year. As at December 30, 2006, Associates had drawn an aggregate amount of \$141 million against these available lines of credit compared to \$164 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 2006, the total amount of loans outstanding from the Trust to the Company's Associates was \$454 million compared to \$420 million at the end of the prior year. The Company has determined that the Trust is deemed to be a variable interest entity and that the Company is the primary beneficiary in accordance with AcG-15. 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 \$46 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 13 to the 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 Annual Information

The following table provides a summary of certain selected consolidated annual financial information for the Company. The Company's fiscal year consists of a 52 or 53 week period ending on the Saturday closest to December 31. This information has been prepared in accordance with Canadian generally accepted accounting principles.

(\$000's, except per share data)	2006	2005	2004
	(52 weeks)	(52 weeks)	(52 weeks)
Sales	7,786,436	7,151,115	6,566,399
Net earnings	422,491	364,494	307,322
Per common share			
– Basic net earnings	\$ 1.97	\$ 1.72	\$ 1.48
– Diluted net earnings	\$ 1.95	\$ 1.69	\$ 1.43
Dividends declared per common share	\$ 0.48	\$ 0.40	\$ –
Total assets	4,929,014	4,375,383	4,117,406
Total long-term liabilities	510,627	479,873	652,732

Sales

2006 Compared to 2005

Sales in 2006 were \$7.786 billion compared to \$7.151 billion in 2005, an increase of \$635 million or 8.9%. During 2006, the Company continued to experience strong sales growth in all regions of the country, led once again by gains in Western Canada and Québec. On a same-store basis, sales increased 6.5% in 2006. The Company's capital investment program, which resulted in a 10.6% increase in selling space versus a year ago, continues to have a positive impact on sales growth.

Prescription sales were \$3.655 billion in 2006 compared to \$3.337 billion in 2005, an increase of \$318 million or 9.5%. In addition to new real estate, the launch of enhanced pharmacy services under the HealthWATCH® brand and the third quarter acquisition of MediSystem Technologies Inc. contributed to pharmacy sales growth. On a same-store basis, prescription sales increased 7.9% during the year. In 2006, prescription sales accounted for 46.9% of the Company's sales mix compared to 46.7% in the prior year.

Front store sales were \$4.131 billion in 2006 compared to \$3.814 billion in 2005, an increase of \$317 million or 8.3%. The Company continues to experience sales gains in all categories, led by strong growth in HBA, OTC medications and beauty. On a same-store basis, front store sales increased 5.3% in 2006. The continued roll-out of new, larger-format stores, where the bulk of the incremental selling square footage is devoted to front store categories, combined with innovative marketing tactics and a differentiated product and service offering, is driving sales growth in the front of the store.

2005 Compared to 2004

Sales in 2005 were \$7.151 billion compared to \$6.566 billion in 2004, an increase of \$585 million or 8.9%. During 2005, the Company continued to experience strong sales growth in all regions of the country, led by gains in Western Canada and Québec. On a same-store basis, sales increased 5.8% in 2005. The Company's capital investment program, which resulted in a 10.2% increase in drug store selling space versus the prior year, had a positive impact on sales growth.

Prescription sales were \$3.337 billion in 2005 compared to \$3.068 billion in 2004, an increase of \$269 million or 8.8%. On a same-store basis, prescription sales increased 6.9% during 2005, with increased generic prescription utilization having a deflationary impact on prescription sales growth. In 2005, prescription sales accounted for 46.7% of the Company's sales mix, unchanged from the prior year.

Front store sales were \$3.814 billion in 2005 compared to \$3.498 billion in 2004, an increase of \$316 million or 9.0%, as the Company experienced sales gains in all categories. On a same-store basis, front store sales increased 4.9% in 2005. These results were driven by gains in the Company's traditional HBA and OTC medications categories, as well as by strong growth in cosmetics and food and confection. The result of growth in these categories, combined with increased sales of the Company's private label products, is an enhanced sales mix and margin rate. The continued roll-out of the Company's larger store format, with the bulk of the incremental selling square footage being devoted to front store categories, drove this improvement in the Company's sales mix.

Net Earnings

2006 Compared to 2005

Net earnings were \$422 million in 2006 compared to \$364 million in 2005, an increase of \$58 million or 15.9%. On a diluted basis, earnings per share were \$1.95 in 2006 compared to \$1.69 in 2005. Sales growth, an enhanced mix and an ongoing commitment to cost reduction, productivity and efficiency, partially offset by higher operating costs and increased amortization in new and relocated stores, resulted in higher operating income and net earnings.

Net earnings growth also benefited from a modest decline in the Company's effective income tax rate in 2006 to 33.3% from 33.8% in the prior year.

2005 Compared to 2004

Net earnings were \$364 million in 2005 compared to \$307 million in 2004, an increase of \$57 million or 18.6%. On a diluted basis, earnings per share were \$1.69 in 2005 compared to \$1.43 in 2004. Solid top-line growth, an enhanced sales mix and a focus on cost reduction, productivity and efficiency, all had a positive impact on growth in operating income and net earnings. These gains were partially offset by increased rent and labour in new and relocated stores, as well as higher amortization expense, as the Company invested aggressively in the expansion of its store network.

Net earnings growth also benefited from a reduction in interest expense and a lower effective income tax rate. The reduction in interest expense can be attributed to reduced levels of consolidated net debt, combined with lower costs of funding. In 2005, the Company's effective income tax rate was 33.8% compared to 35.4% in 2004.

Dividends Declared per Common Share

On February 8, 2006, the Company announced that its Board of Directors had declared a dividend of 12 cents per common share, payable April 13, 2006 to shareholders of record as of the close of business on March 31, 2006. This represented an increase in the amount of the Company's quarterly dividend payments of 20%. Subject to financial results, capital requirements, available cash flow and any other factors that the Board of Directors may consider relevant, it is the intention of the Board of Directors to declare a comparable quarterly dividend on an ongoing basis.

The following table provides a summary of dividends declared by the Company in 2006 and 2005:

Declaration Date	Record Date	Payment Date	Dividend
February 8, 2006	March 31, 2006	April 13, 2006	\$ 0.12
May 1, 2006	June 30, 2006	July 14, 2006	\$ 0.12
July 19, 2006	September 29, 2006	October 13, 2006	\$ 0.12
November 8, 2006	December 29, 2006	January 15, 2007	\$ 0.12
February 10, 2005	March 31, 2005	April 15, 2005	\$ 0.10
May 5, 2005	June 30, 2005	July 15, 2005	\$ 0.10
July 19, 2005	September 30, 2005	October 14, 2005	\$ 0.10
November 4, 2005	December 30, 2005	January 13, 2006	\$ 0.10

Prior to February 10, 2005, the Company's Board of Directors had not declared any dividend payments.

Total Assets

2006 Compared to 2005

Total assets were \$4.929 billion at the end of 2006 compared to \$4.375 billion at the end of 2005, an increase of \$554 million or 12.7%. Of this increase, \$257 million can be attributed to higher current asset balances, primarily accounts receivable and inventory, tied largely to growth in the store network and increased sales activity. Net property and equipment balances increased by \$159 million or 21.2% over the prior year, reflecting the Company's stepped-up capital investment and store revitalization program. Combined, the net balance of goodwill and other intangible assets accounted for a further \$130 million of the increase in total assets, driven in large part by the acquisitions of MediSystem Technologies Inc. and Therapy Supplies & Rental Limited in the third quarter of 2006. (See notes 2 and 7 to the consolidated financial statements of the Company.)

2005 Compared to 2004

Total assets were \$4.375 billion at the end of 2005 compared to \$4.117 billion at the end of 2004, an increase of \$258 million or 6.3%. Combined, higher inventory and property and equipment values accounted for \$212 million of the increase in total assets in 2005, rising to \$1.965 billion at the end of the year compared to \$1.753 billion at the end of 2004. This 12.1% increase reflected the Company's focus on, and investment in, its store development program as it expanded the store network, opened more large-format stores and continued to introduce new merchandising programs to its network of Associate-owned drug stores. Taken together, goodwill and other intangible assets were \$2.037 billion at the end of 2005 compared to \$2.013 billion at the end of 2004, an increase of \$24 million or 1.2%. This increase reflected the Company's stepped-up acquisition activities as it continued to pursue attractive opportunities in Canada's fragmented retail drug store marketplace.

Total Long-term Liabilities

2006 Compared to 2005

Total long-term liabilities were \$511 million at the end of 2006 compared to \$480 million at the end of 2005, an increase of \$31 million or 6.4%. This increase is largely attributable to a \$48 million increase in other long-term liabilities, partially offset by a \$25 million reduction in long-term debt outstanding. The \$48 million increase in other long-term liabilities was driven largely by a \$42 million increase in deferred rent obligations at store-level, stemming from the stepped-up store network development program. (See notes 1 and 9 to the consolidated financial statements of the Company.)

2005 Compared to 2004

Total long-term liabilities were \$480 million at the end of 2005 compared to \$653 million at the end of 2004, a decrease of \$173 million or 26.5%. This decrease was largely attributable to a \$230 million reduction in long-term debt outstanding under the Company's bank credit facilities, partially offset by a \$44 million increase in other long-term liabilities. The increase in other long-term liabilities was tied principally to an increase in deferred rent obligations at store-level.

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.

(\$000's, except per share data – unaudited)	2006 (12 weeks)	Fourth Quarter 2005 (12 weeks)	2006 (16 weeks)	Third Quarter 2005 (16 weeks)	2006 (12 weeks)	Second Quarter 2005 (12 weeks)	2006 (12 weeks)	First Quarter 2005 (12 weeks)
Sales	\$ 2,018,067	\$ 1,833,327	\$ 2,329,051	\$ 2,138,085	\$ 1,768,199	\$ 1,624,354	\$ 1,671,119	\$ 1,555,349
Net earnings	\$ 132,500	\$ 115,125	\$ 123,880	\$ 107,672	\$ 94,407	\$ 80,011	\$ 71,704	\$ 61,686
Per common share								
– Basic net earnings	\$ 0.62	\$ 0.54	\$ 0.58	\$ 0.51	\$ 0.44	\$ 0.38	\$ 0.34	\$ 0.29
– Diluted net earnings	\$ 0.61	\$ 0.53	\$ 0.57	\$ 0.50	\$ 0.44	\$ 0.37	\$ 0.33	\$ 0.29

The Company experienced growth in sales and net earnings in each of the four most recent quarters when compared to the corresponding 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 comparative quarterly results, particularly when a 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.

Results of Operations – Fourth Quarter of Fiscal 2006

The Company released its unaudited financial statements and the notes thereto for the fourth quarter and fiscal year ended December 30, 2006 on February 8, 2007. This information can be found on the Canadian Securities Administrators' website at www.sedar.com.

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

(\$000's, except per share data)	12 Weeks Ended	
	December 30, 2006	December 31, 2005
	(unaudited)	(unaudited)
Sales	\$ 2,018,067	\$ 1,833,327
Cost of goods sold and other operating expenses	1,771,151	1,620,992
EBITDA ⁽¹⁾	246,916	212,335
Amortization	38,083	29,661
Operating income	208,833	182,674
Interest expense	10,895	10,323
Earnings before income taxes	197,938	172,351
Income taxes	65,438	57,226
Net earnings	\$ 132,500	\$ 115,125
Per common share		
– Basic net earnings	\$ 0.62	\$ 0.54
– Diluted net earnings	\$ 0.61	\$ 0.53

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

Sales

Sales in the fourth quarter were \$2.018 billion compared to \$1.833 billion in the same period last year, an increase of \$185 million or 10.1%, with strong sales growth experienced in all regions of the country. New real estate, combined with solid program execution at existing stores, drove this top-line growth. Sales growth was also aided by the third quarter acquisitions of MediSystem Technologies Inc. and Therapy Supplies & Rental Limited. On a same-store basis, sales increased 6.5% during the fourth quarter of 2006.

Prescription sales were \$897 million in the fourth quarter compared to \$805 million in the fourth quarter of 2005, an increase of \$92 million or 11.4%. On a same-store basis, prescription sales increased 8.2% during the fourth quarter of 2006, with increased generic prescription utilization continuing to temper the inflationary impact on prescription sales growth. Prescription sales accounted for 44.4% of the Company's sales mix during the fourth quarter of 2006 compared to 43.9% in the same period last year.

Front store sales were \$1.121 billion in the fourth quarter compared to \$1.029 billion in the fourth quarter of 2005, an increase of \$92 million or 9.0%, with the Company continuing to experience sales gains in all core categories. In addition to new real estate, stronger seasonal programs and innovative marketing tactics contributed to sales growth in the front of the store. On a same-store basis, front store sales increased 5.1% during the fourth quarter of 2006.

Cost of Goods Sold and Other Operating Expenses

Cost of goods sold and other operating expenses were \$1.771 billion in the fourth quarter of 2006 compared to \$1.621 billion in the same period last year, an increase of \$150 million or 9.3%. Expressed as a percentage of sales, cost of goods sold declined by 111 basis points versus the comparative prior year period, reflecting an enhanced sales mix and the benefits from improved buying synergies. Partially offsetting this improvement were higher fourth quarter operating expenses which, when expressed as a percentage of sales, increased by 45 basis points over the prior year period. Operating expenses were higher due in large part to increased store-level expenses associated with the continued investment in, and expansion of, the store network.

Amortization

Amortization of capital assets was \$38 million in the fourth quarter of 2006 compared to \$30 million in the same period last year, an increase of \$8 million or 28.4%. Expressed as a percentage of sales, amortization increased 27 basis points versus the comparative prior year period, reflecting the continued growth of the Company's capital investment program.

Operating Income

Operating income was \$209 million in the fourth quarter of 2006 compared to \$183 million in the same period last year, an increase of \$26 million or 14.3%. Fourth quarter operating margin (operating income divided by sales) improved by 39 basis points to 10.35% from 9.96% in same period last year. The Company's EBITDA margin (EBITDA divided by sales) was 12.24% in the fourth quarter of 2006, a 66 basis point improvement over the EBITDA margin of 11.58% posted in the fourth quarter of last year.

Interest Expense

Interest expense was \$11 million in the fourth quarter of 2006 compared to \$10 million in the same period last year, an increase of \$1 million or 5.5%. This increase versus the comparative prior year period can be attributed to a market-driven increase in short-term interest rates, partially offset by a reduction in the amount of consolidated net debt outstanding.

Income Taxes

The Company's effective income tax rate in the fourth quarter of 2006 was 33.1%, essentially unchanged from the rate of 33.2% in the same period last year.

Net Earnings

Fourth quarter net earnings were \$133 million compared to \$115 million in the same period last year, an increase of \$18 million or 15.1%. On a diluted basis, earnings per share were \$0.61 in the fourth quarter of 2006 compared to \$0.53 in the same period last year.

Cash Flows

Cash flows from operating activities were \$241 million in the fourth quarter of 2006 compared to a \$158 million in the same period last year, an increase of \$83 million or 52.5%. This increase can be primarily attributed to higher operating income, combined with a lower investment in non-cash working capital balances. Compared to the same period last year, growth in inventory and accounts receivable balances was more than offset by an increase in accounts payable.

Cash flows used in investing activities were \$121 million in the fourth quarter of 2006 compared to \$89 million in the same period last year, an increase of \$32 million or 36.6%. Of these totals, purchases of property and equipment amounted to \$114 million in the fourth quarter of 2006 compared to \$86 million in the fourth quarter of 2005, reflecting a step-up in the Company's real estate program versus the same period a year ago. The Company also invested \$11 million in other business acquisitions in the fourth quarter of 2006 compared to \$3 million in the same period last year. During the fourth quarter of 2006, 40 new drug stores were opened or acquired, 24 of which were relocations, and three drug stores were closed.

Cash flows used in financing activities were close to \$76 million in the fourth quarter of 2006, as cash outflows of \$86 million were partially offset by cash inflows of \$10 million. Cash outflows were comprised of \$37 million to reduce bank indebtedness, \$15 million to reduce the amount of commercial paper issued and outstanding under the Company's commercial paper programs (a \$45 million reduction in the amount of commercial paper issued and outstanding by the Company, offset by a \$30 million increase in the amount of Trust financing obtained by Associates), \$2 million to repay long-term debt assumed upon the acquisition of MediSystem Technologies Inc., \$6 million to reduce long-term debt outstanding under the Company's non-revolving bank credit facility and \$26 million for the payment of dividends. Cash inflows were comprised of \$9 million of additional Associate investment and \$1 million of proceeds received from the issuance of common shares and loan repayments under the Company's stock-based incentive plans.

In the fourth quarter of 2006, the net result of the Company's operating, investing and financing activities was an increase in cash balances of \$44 million.

Critical Accounting Estimates

The Company's consolidated financial statements are prepared in accordance with Canadian GAAP, which require management to make certain estimates, judgements and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities as at the date of the consolidated financial statements, and the reported amounts of revenues and expenses during the reporting period. The Company bases its estimates, judgements and assumptions on historical experience, current trends and other factors that management believes to be important at the time the consolidated financial statements are prepared. The Company reviews its accounting policies and how they are applied on a regular basis. While the Company believes that the historical experience, current trends and other factors considered support the preparation of its consolidated financial statements in accordance with Canadian GAAP, actual results could differ from its estimates and such differences could be material.

The Company's significant accounting policies are discussed in note 1 to the consolidated financial statements of the Company. The following accounting policies incorporate a higher degree of judgement and/or complexity and, accordingly, are considered to be critical accounting policies.

Inventory

Inventory is valued at the lower of cost and estimated net realizable value, with cost being determined on a first-in, first-out basis. Significant estimation or judgement is required in the determination of estimated inventory losses, or shrinkage, occurring between the date of the last physical inventory count and the balance sheet date.

Shrinkage is estimated as a percentage of sales for the period from the date of the last physical inventory count to the balance sheet date. Such estimates are based on experience and recent physical inventory count results. To the extent that actual inventory losses experienced vary from estimates, both inventories and operating income could be impacted.

Shoppers Optimum™

The Shoppers Optimum™ loyalty card program (the "Program") allows members to earn points on their purchases in Shoppers Drug Mart®, Pharmaprix® and Shoppers Home Health Care® stores at a rate of 10 points for each dollar spent on eligible products and services, plus any applicable bonus points. Members can then redeem points, in accordance with the Program rewards schedule or other offers, for discounts on front store merchandise at the time of a future purchase transaction. When points are earned by Program members, the Company records an expense and establishes a liability for future redemptions by multiplying the number of points issued by the estimated cost per point. The Program liability is included in accounts payable and accrued liabilities on the Company's consolidated balance sheets. The actual cost of Program redemptions is charged against the liability account.

The estimated cost per point is determined based on many factors, including the historical behaviour of Program members, expected future redemption patterns and associated costs. The Company monitors, on an ongoing basis, trends in redemption rates (points redeemed as a percentage of points issued) and net redemption values, and adjusts the estimated cost per point based upon expected future activity. To the extent that estimates differ from actual experience, the Program costs could be higher or lower.

At the beginning of 2006, the Company changed the Program rewards schedule and, accordingly, adjusted certain of the assumptions used to determine the estimated cost per point issued thereafter.

Employee Future Benefits

The cost and accrued benefit plan obligations of the Company's registered and non-registered defined benefit pension plans and other post-employment benefit plans are accrued based on actuarial valuations which are dependent upon assumptions determined by management. These assumptions include the discount rate, the expected long-term rate of return on plan assets, the rate of compensation increases, retirement ages, mortality rates and the expected inflation rate of health care costs. These assumptions are reviewed annually by the Company's management and its actuaries.

The most significant of these actuarial assumptions are set out in the following table.

	2006			2005		
	Registered Defined Benefit Pension Plans	Non-registered Defined Benefit Pension Plan	Other Post- employment Benefit Plans	Registered Defined Benefit Pension Plans	Non-registered Defined Benefit Pension Plan	Other Post- employment Benefit Plans
Accrued benefit obligation, end of period						
Discount rate	5.00%	2.50%	5.00%	5.00%	2.50%	5.00%
Compensation increase	4.00%	4.00%	4.00%	4.00%	4.00%	4.00%
Benefit expense, for the period						
Discount rate	5.00%	2.50%	5.00%	5.75%	2.88%	5.75%
Expected return on assets	7.50%	3.75%	N/A	7.50%	3.75%	N/A
Compensation increase	4.00%	4.00%	4.00%	4.00%	4.00%	4.00%

The discount rate is based on current market interest rates at the end of the Company's fiscal year, assuming a portfolio of corporate AA rated bonds with terms to maturity that, on average, match the terms of the accrued benefit plan obligations. A 1% increase in the assumed discount rate would decrease the amount of the Company's accrued benefit obligation and benefit expense in respect of its registered and non-registered defined benefit plans by \$14 million and \$2 million, respectively. Conversely, a 1% decrease in the assumed discount rate would increase the amount of the Company's accrued benefit obligation and benefit expense in respect of its registered and non-registered defined benefit plans by \$17 million and \$3 million, respectively.

The expected long-term rate of return on plan assets is based on the asset mix of invested assets and historical returns. A 1% increase in the assumed long-term rate of return on plan assets would decrease the amount of the Company's benefit expense in respect of its registered and non-registered defined benefit plans by \$1 million. Conversely, a 1% decrease in the assumed long-term rate of return on plan assets would increase the amount of the Company's benefit expense in respect of its registered and non-registered defined benefit plans by \$1 million. In calculating the benefit expense for its registered and non-registered defined benefit plans for 2007, the Company has assumed a long-term rate of return on plan assets of 7.5%.

A 1% increase in the assumed rate of compensation increases would increase the amount of the Company's accrued benefit obligation and benefit expense in respect of its registered and non-registered defined benefit plans by \$6 million and \$1 million, respectively. Conversely, a 1% decrease in the assumed rate of compensation increases would decrease the amount of the Company's accrued benefit obligation and benefit expense in respect of its registered and non-registered defined benefit plans by \$5 million and \$1 million, respectively.

The expected inflation rate of health care costs is based on historical trends and external data. The growth rate assumption used by the Company in determining its accrued benefit obligation and benefit expense in respect of its other post-employment benefit plans was 5.5% in 2006, unchanged from the prior year. This is also the assumed growth rate for future years. A 1% change in the assumed growth rate of health care costs would not have a significant impact on the Company's accrued benefit obligation and benefit expense in respect of its other post-employment benefit plans.

These assumptions may change in the future and any changes could have a material impact on the accrued benefit plan obligations of the Company and the cost of these plans which are reflected in the Company's consolidated statements of earnings. However, the magnitude of any immediate impact on net earnings of the Company is mitigated by the fact that, in accordance with Canadian GAAP, the excess of any net accumulated actuarial gain or loss over 10% of the greater of the accrued benefit obligation and the fair value of plan assets is amortized, on a straight-line basis, over the expected average remaining service period of the active employees covered by the plans. At December 30, 2006, the expected average remaining service period of active employees covered by the Company's registered and non-registered defined benefit pension plans and other post-employment benefit plans was 14 and 10 years, respectively.

At December 30, 2006, the funded status of the Company's obligations under its registered and non-registered defined benefit pension plans and other post-employment benefit plans was a deficit of \$30 million, compared to a deficit of \$31 million at the end of the prior year. Included in other long-term liabilities on the Company's consolidated balance sheets at December 30, 2006, was an amount of \$14 million in respect of the Company's obligations under its registered and non-registered defined benefit pension plans and other post-employment benefit plans, compared to \$11 million at the end of the prior year. As of this same date, the unamortized net actuarial loss in respect of the Company's obligations under its registered and non-registered defined benefit pension plans and other post-employment benefit plans was \$16 million, compared to \$20 million at the end of the prior year. (See note 9 to the consolidated financial statements of the Company.)

The actual rate of return on plan assets and changes in interest rates could also result in changes in the Company's funding requirements for its defined benefit pension plans.

Income Taxes

The Company accounts for income taxes using the liability method of accounting. Under the liability method, future income tax assets and liabilities are determined based on differences between the carrying amounts of balance sheet items and their corresponding tax values. The determination of the income tax provision requires management to interpret regulatory requirements and to make certain judgements. While income tax filings are subject to audits and reassessments, management believes that adequate provision has been made for all income tax obligations. However, changes in the interpretations or judgements may result in an increase or decrease in the Company's income tax provision in the future. The amount of any such increase or decrease cannot be reasonably estimated.

Goodwill and Other Intangible Assets

The Company records as goodwill the excess amount of the purchase price of an acquired business over the fair value of the underlying net assets, including intangible assets, at the date of acquisition. Goodwill accounts for a significant amount of the Company's total assets. In accordance with Canadian GAAP, goodwill is no longer amortized, but is tested for impairment on an annual basis. Testing for impairment requires management to make judgements and estimates regarding fair values and in doing so, the Company considers such factors as current results, trends and future prospects, competition and general economic conditions. These judgements and estimates may change in the future due to uncertain competitive, market and general economic conditions, or as a result of changes in the business strategies and outlook of the Company.

A goodwill impairment loss would be recognized to the extent that the carrying value of goodwill exceeds the implied fair value. Any goodwill impairment would result in a reduction in the carrying value of goodwill on the consolidated balance sheets of the Company and the recognition of a non-cash impairment charge in operating income. Based on the analysis performed to date, the Company has not identified any goodwill impairment.

Intangible assets are amortized on a straight-line basis over the estimated useful lives of the assets at the rates indicated below.

Prescription files	7 years
Developed technology	3 years
Customer relationships	25 years
Other	Indefinite

New Accounting Pronouncements

Accounting Standards Implemented in 2006

Non-monetary Transactions

In June 2005, the Canadian Institute of Chartered Accountants (the "CICA") issued new accounting standards for non-monetary transactions. The new standards still require an asset or liability exchanged or transferred in a non-monetary transaction to be measured at fair value. An asset exchanged or transferred in a non-monetary transaction is measured at its carrying amount when: i) the transaction lacks commercial substance; ii) the transaction is an exchange of a product or property held for sale in the ordinary course of business for a product or property to be sold in the same line of business to facilitate sales to customers other than the parties to the exchange; iii) neither the fair value of the asset received nor the fair value of the asset given up is reliably measurable; or iv) the transaction is a non-monetary, non-reciprocal transfer to owners that represents a spin-off or other form of restructuring or liquidation. The "commercial substance" criterion replaces the "culmination of the earnings process" in the previous standards. The standards are effective for all non-monetary transactions initiated in periods beginning on or after January 1, 2006. The Company applied the new accounting standards beginning January 2006 and their implementation did not have a significant impact on the Company's results of operations or financial position.

Accounting for Consideration Given by a Vendor to a Customer (Including a Reseller of the Vendor's Products)

In August 2005, the Emerging Issues Committee of the CICA (the "EIC") issued EIC-156, "Accounting for Consideration Given by a Vendor to a Customer (Including a Reseller of the Vendor's Products)" ("EIC-156"). EIC-156 provides guidance on: i) whether consideration given by a vendor should be considered an adjustment of the selling price of the vendor's products or services, or a cost incurred by the vendor for assets or services received from the customer; and ii) how that consideration should be measured and recognized. EIC-156 applies to interim and annual financial statements for fiscal years beginning on or after January 1, 2006. The Company applied EIC-156 beginning January 2006 and its implementation did not have an impact on the Company's results of operations or financial position.

Implicit Variable Interest Under AcG-15

In October 2005, the EIC issued EIC-157, "Implicit Variable Interests Under AcG-15" ("EIC-157"). EIC-157 requires that an entity consider whether it holds an implicit variable interest in a variable interest entity (a "VIE"). The determination should be based on whether the reporting enterprise may absorb variability of the VIE and disclosure is required when the reporting enterprise holds a significant implicit variable interest, but is not the primary beneficiary. EIC-157 applies to the first interim or annual period beginning after the issuance of EIC-157. The Company applied EIC-157 beginning January 2006 and its implementation did not have an impact on the Company's results of operations or financial position.

Conditional Asset Retirement Obligations

In November 2005, the EIC issued EIC-159, "Conditional Asset Retirement Obligations" ("EIC-159"). EIC-159 is intended to harmonize Canadian GAAP with FASB Statement of Accounting Standards No. 143. EIC-159 provides guidance on recognition and measurement of a conditional asset retirement obligation. EIC-159 applies to interim and annual periods ending after March 31, 2006. The Company applied EIC-159 beginning in its second quarter of 2006 and its implementation did not have an impact on the Company's results of operations or financial position.

Discontinued Operations

In April 2006, the EIC issued EIC-161, "Discontinued Operations" ("EIC-161"). EIC-161 addresses the allocation of interest expense to discontinued operations based on the principal amount of debt that will or could be paid with the proceeds from the sale of such operations. EIC-161 also specifies that general corporate overhead expenses may not be allocated to discontinued operations. EIC-161 applies to all disposal transactions initiated after the date of issuance of EIC-161 and may be applied prospectively or retroactively. The implementation of EIC-161 did not have an impact on the Company's results of operations or financial position.

Stock-based Compensation for Employees Eligible to Retire Before the Vesting Date

In July, 2006, the EIC issued EIC-162, "Stock-based Compensation for Employees Eligible to Retire Before the Vesting Date" ("EIC-162"). EIC-162 addresses the accounting treatment of stock-based awards for employees who are eligible to retire at the grant date or who will be eligible for retirement during the vesting period. The compensation cost attributable to awards for employees eligible to retire at the grant date should be recognized at the grant date; for employees eligible to retire during the vesting period, the cost should be recognized over the period from the grant date to the date the employee becomes eligible for retirement. EIC-162 is to be applied retroactively and is effective for interim and annual periods ending on or after December 31, 2006. The implementation of EIC-162 did not have an impact on the Company's results of operations or financial position.

Future Accounting Standards

Financial Instruments

The CICA issued new accounting standards for the recognition and measurement of financial instruments, hedge accounting and comprehensive income. The standards have been based on existing U.S. and international accounting standards. The standards are based on several key principles: financial instruments and non-financial derivatives represent rights or obligations that meet the definition of assets or liabilities and should be reported in the financial statements; fair value is the most relevant measure for financial instruments and the only relevant measure for derivative financial instruments; only items that are assets or liabilities should be reported as such in the financial statements; and, special accounting for items designated as being part of a hedging relationship should be provided only for qualifying items. The standards are effective for interim and annual financial statements for fiscal years beginning on or after October 1, 2006. The Company will apply the new accounting standards beginning January 2007 and does not expect their implementation to have a significant impact on the Company's results of operations or financial position.

Accounting Changes

The CICA issued new accounting standards to establish criteria for changing accounting policies, together with the accounting treatment and disclosure of changes in accounting policies and estimates, and correction of errors. The new standards specify that voluntary changes in accounting policy are to be made only if they result in the financial statements providing reliable and more relevant information. Changes in accounting policy are applied retrospectively unless doing so is impractical. The standards are effective for interim and annual financial statements for fiscal years beginning on or after January 1, 2007. The Company does not expect their implementation to have a significant impact on the Company's results of operations or financial position.

Leveraged Leases

In September 2006, the EIC amended EIC-46, "Accounting for Leveraged Leases" ("EIC-46"), to expand its scope and include additional U.S. guidance. The amendments address the accounting effect of a change in the timing of cash flows related to income taxes generated by a leveraged lease transaction. The amendments to EIC-46 should be applied in fiscal years beginning after December 15, 2006. The Company will apply EIC-46, as amended, beginning January 2007 and does not expect its implementation to have a significant impact on the Company's results of operations or financial position.

Variability to Be Considered in Applying Accounting Guideline 15

In September 2006, the EIC issued EIC-163, "Determining the Variability to Be Considered in Applying AcG-15" ("EIC-163"), to address the diversity in practice in determining the variability that should be considered in applying AcG-15. EIC-163 should be applied in the first interim or annual period beginning on or after January 1, 2007. The Company will apply EIC-163 beginning January 2007 and does not expect its implementation to have a significant impact on the Company's results of operations or financial position.

Risks and Risk Management

The Company is exposed to a number of risks in the normal course of its business that have the potential to affect its operating and financial performance.

Industry and Regulatory

The Company is reliant on prescription drug sales for a significant and growing portion of its sales and profits. Prescription drug sales are subject to numerous federal, provincial, territorial and local laws and regulations governing their packaging, disposal, sale, marketing, advertising, handling, storage, distribution and dispensing, as well as the approval of new drugs. Non-compliance with any such laws or regulations, particularly those that provide for the licensing and conduct of wholesalers, the licensing and conduct of pharmacists, the regulation and ownership of pharmacies, the advertising of pharmacies and prescription services, and the pricing of prescription drugs, could result in civil or regulatory proceedings, fines, injunctions, recalls or seizures, any of which may have a material adverse effect on the Company's financial performance. In addition, the Company may incur significant costs in the course of complying with any changes in the regulatory regime affecting prescription drugs. Sales of prescription drugs may be affected by changes in the health care industry, including changes to programs providing for reimbursement of the cost of prescription drugs by third-party payers, such as government, insurers or corporate employers. Federal or provincial legislative changes affecting prescription drug coverage, the allowable cost of a drug, allowable mark-ups to the cost of a drug, professional fees or permitted manufacturer allowances, could also affect the Company's sales and profitability. In order to assist in controlling increasing drug costs, government payers may look to benefit from or implement similar legislative changes to prescription drug coverage, allowable costs of a drug, allowable mark-ups to the cost of the drug, professional fees or permitted manufacturer allowances that have reduced drug costs for government payers in other jurisdictions. In addition, private third-party payers (such as corporate employers and/or their insurers) may look to benefit from any measures that are implemented by government payers to reduce drug costs by attempting to extend these measures to their own drug plans. In October 2006, changes to allowable cost, the allowable mark-up and professional fees for the public sector and changes to permitted manufacturer allowances for both the public and the private sectors were implemented in the province of Ontario. (See discussion under "Recent Regulatory Changes in Ontario" below.)

Provincial governments have implemented and are implementing a number of measures directed towards managing pharmacy services and there are ongoing discussions regarding controlling increasing drug costs. Based on some of these measures and ongoing discussions, governments have indicated that they intend for retail pharmacy to play an expanded role, and the Company believes that there will be continued interest by governments for retail pharmacy to play an expanded role, in the delivery of health care services to Canadians. Examples of this include the pronouncement from the Ontario Ministry of Health and Long-Term Care that it is planning to begin paying pharmacists for certain professional services, to be prescribed by regulations, by no later than April 1, 2007 and the establishment of a \$50 million annual fund for payment of these professional services, and recent amendments to Alberta's pharmacy legislation that will permit pharmacists to be able to prescribe some drug treatments, continue prescriptions made by other health practitioners and administer some injectable drug treatments, such as certain vaccines. There are also continuing discussions in Québec to consider providing pharmacists with enhanced professional responsibilities. The Company has been, and continues to be, an active proponent of retail pharmacy playing an expanded role and believes that properly managed pharmacy services are part of the solution to controlling rising health care costs. Accordingly, as a means to managing this risk, the Company has a proactive government and industry relations program in order to build awareness of pharmacy issues and influence the policy-making process.

Certain third-party payers continue to seek ways to manage the costs of their drug programs. While traditional cost control mechanisms such as the capping of dispensing fees and the sharing of costs with employees are still in use, the Company believes that corporate employers are becoming more aware of the beneficial role that pharmacy can play in improving the health of their employees. The Company's approach to this issue is to demonstrate to employers and/or their insurers that properly managed pharmacy services result in a workforce that is better educated about the importance of drug therapy in disease management and the benefits of health and wellness. This in turn provides savings to employers in areas such as absenteeism and long-term disability, while increasing productivity. Furthermore, the Company believes that any enhanced professional responsibilities that may be reimbursed by governments for those patients covered by a public drug plan will be similarly reimbursed for patients covered by private drug programs by third-party payers.

Recent Regulatory Changes in Ontario

Bill 102, the *Transparent Drug System for Patients Act, 2006* (the "Act") came into force on October 1, 2006. The Act incorporated legislative changes required to implement certain recommendations proposed by the Drug System Secretariat (established by the provincial Ministry of Health and Long-Term Care (the "Ministry") to conduct an objective, system-wide review of Ontario's entire drug system) to reform and more aggressively manage the provincial drug system framework in Ontario.

The Act amended the *Ontario Drug Benefit Act* (the "ODBA") and the *Drug Interchangeability and Dispensing Fee Act* (the "DIDFA"), with amendments to the latter aimed at facilitating increased generic substitution for branded drug products. To support the amendments made by the Act to the ODBA and the DIDFA, and the Ministry's initiative to reform the drug system, a number of amendments to regulations under the ODBA and the DIDFA were passed on September 28, 2006 and on December 13, 2006. Some of the pertinent highlights of the changes that are effected by the Act and the amendments to the regulations are summarized below.

(a) Lowering of the Drug Benefit Price

While, prior to the amendments, generic drug products were generally priced according to the 70/90 rule (the drug benefit price for the first generic product listed on the Ontario Formulary being 70% of the original listed comparator product (typically the brand product) and the drug benefit price of any subsequent generic products listed on the Ontario Formulary being 90% of the first listed generic product), effective October 1, 2006, except in certain prescribed instances, the drug benefit price of generic products listed on the Ontario Formulary must be priced at no more than 50% of the original listed comparator product.

(b) Sales at the Drug Benefit Price

Manufacturers who sell listed drug products at prices higher than the drug benefit price may be ordered to repay to the government the excess amounts charged. In the past, the legislation did not include an effective process to control situations where a manufacturer chose to charge pharmacists a price higher than the drug benefit price for a listed drug product, and pharmacists often had to absorb this increased cost.

(c) Increased Dispensing Fee

Effective October 1, 2006, dispensing fees for prescriptions reimbursed by the Ontario government have been increased from \$6.54 to \$7.00.

(d) Reduction in Mark-up

Effective April 1, 2007, the mark-up paid on the drug benefit price for prescriptions reimbursed by the Ontario government will be reduced from 10% to 8%.

(e) Professional Allowances

Effective October 1, 2006, the provision and acceptance of rebates from manufacturers on listed drug products is prohibited. However, pharmacists are permitted to receive from manufacturers defined professional allowances for direct patient benefit, under a new code of conduct. The code of conduct is intended to establish system-wide guidance governing the use of professional allowances (including prohibiting professional allowance funding for certain prescribed activities). The amount of professional allowances is capped for Ontario Drug Benefit sales at 20% of the total generic drug costs reimbursed under the Ontario Drug Benefit Program, but there is no percentage limit imposed on the amount of professional allowances that may be provided in the private sector.

(f) Professional Service Fees

The Act established a mechanism for paying pharmacists for certain professional services, which will be prescribed in the regulations. The Ontario Ministry of Health and Long-Term Care has indicated that it is planning to begin paying pharmacists for these prescribed professional services by no later than April 1, 2007 and has established a \$50 million annual fund for this purpose.

At this point in time, the Company continues to believe that considering the overall net results of the legislation, the recent regulatory changes in Ontario will not have a material impact, positive or negative, on its results of operations or financial position.

Competition

The Company faces competition from many retailers in the front store merchandise and non-prescription drug categories. The Company's competitors in the retail pharmacy business include independent operators, banner groups, retail chains, mass merchandisers and larger supermarket chains with combination food/drug retail operations. These competitors may reduce prices in front store merchandise or reduce dispensing fees to increase market share, which could have an adverse impact on the Company's market share and/or earnings.

The Company believes that it is well positioned to compete against drug store chains, as well as supermarkets, mass merchandisers and independent drug stores, by concentrating on providing high levels of professional service and focusing on improving patient self-management and outcomes. While mass merchandisers compete aggressively on price, the Company believes that consumers will pay for its value-added pharmacy services such as patient counselling and disease management programs, and will be attracted by its convenient locations, extended hours of service and broad selection of health, beauty and everyday household essentials.

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 in interest rates will have an adverse effect on the earnings 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.

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.

Foreign Currency Exchange Risk

The Company has no foreign operations and 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.

Property and Casualty Exposures

Certain property and casualty risks and exposures are inherent in the operation of the Company's business. The Company has a number of integrated risk management programs in place which are designed to reduce its exposures and mitigate any losses. These include self-insuring certain exposures to levels appropriate and customary for the Company given its relative size and financial condition, as well as purchasing excess coverage from financially stable third-party insurance companies to provide adequate coverage for normal insurable commercial risks.

Ability to Attract and Retain Pharmacists

The Company is dependent upon its ability to attract, motivate and retain pharmacists for the stores in its network. Demographic trends and increased competition have led to a shortage of pharmacists in certain markets in Canada. The inability to attract and retain pharmacists could adversely affect the Company's business, financial condition and results of operations.

The Company believes that its Associate Concept provides it with a competitive advantage when recruiting pharmacists. In particular, pharmacy school graduates are attracted to the Company because its Associate Concept enables pharmacists to own their own businesses while benefiting from the training, capital and operational support provided by the Company. The Company has also implemented an aggressive recruitment strategy to increase the number of domestic and foreign trained pharmacists hired each year. Moreover, the Associate-owned stores in the Company's network continue to employ more pharmacy students and interns to ensure a source of supply of new graduates in future years. In recent years, the Company has made a number of enhancements to its pharmacist compensation and benefit plans in order to further improve its retention rate of existing pharmacists.

Third-Party Service Providers

The Company is reliant upon third-party service providers in respect of certain of its operations. It is possible that negative events affecting these third-party service providers could, in turn, negatively impact the Company. While the Company has no direct influence over how such third parties are managed, it has entered into contractual arrangements to formalize these relationships. In order to minimize operating risks, the Company actively monitors and manages its relationships with its third-party service providers.

Real Estate

Successful implementation of the Company's growth strategies is dependent upon the Company's ability to increase the selling square footage of its Associate-owned store network through new store openings and acquisitions, expansions of existing stores and by relocating other stores to superior sites. The availability of suitable store locations and redevelopment opportunities respecting existing stores, and the lease terms that the Company is able to negotiate in connection with new leases and store upgrading, may impact the Company's ability to execute its strategic plan to the extent that desirable locations and/or redevelopment opportunities are not available on reasonable commercial terms.

Seasonality

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 comparative quarterly results, particularly when a 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.

Environmental Compliance

As an owner or lessee of property, the Company is subject to various federal and provincial laws and regulations relating to environmental matters. Non-compliance with environmental laws and regulations may result in regulatory action including orders, fines and other penalties. Such laws also provide that the owner or lessee could be liable for costs of assessment, monitoring, removal and remediation of certain hazardous substances on its properties, or disposed of at other locations. The failure to remove or remediate such substances, if any, could lead to regulatory action or claims against the Company. Future developments and increasingly stringent environmental regulation may require the Company to incur additional expenditures.

The Company endeavours to be socially and environmentally responsible. To that end, the Company has established policies and procedures aimed at ensuring compliance with applicable environmental laws and regulations. Environmental protection measurements do not have, and are not expected to have, a material effect on the Company's operations, business practices and/or financial performance.

Ethical Business Conduct

Any violation of law, breach of Company policies or unethical behaviour could significantly affect the Company's reputation and ability to operate, which could have an adverse impact on the Company's financial performance. The Company is committed to ethical business practices and maintenance of the Company's reputation for honesty, and integrity is the cornerstone of this business philosophy. To that end, the Company has established policies and practices to ensure that employees and directors uphold the highest standards of ethical behaviour.

Workplace Health and Safety

The Company recognizes that ensuring a healthy and safe workplace minimizes injuries and other risks employees may face in carrying out their duties, improves productivity and helps to minimize the liability or penalties which could be incurred in connection with workplace injuries. The Company has health and workplace safety programs in place and has established policies and procedures aimed at ensuring compliance with applicable legislative requirements.

Employee Future Benefits

The Company has certain obligations under its registered and non-registered defined benefit pension plans and other post-employment benefit plans. There is no assurance that the Company's benefit plans will be able to earn the assumed rate of return. New regulations and market-driven changes may result in changes in the discount rates and other variables which would result in the Company being required to make contributions in the future that differ significantly from estimates. An extended period of depressed capital markets and low interest rates could require the Company to make contributions to these plans in excess of those currently contemplated which, in turn, could have an adverse impact on the financial performance of the Company.

Legal, Tax and Accounting

Changes to any of the various federal and provincial laws, rules, regulations or policies related to the Company's business could have a material impact on its operations and financial results. Compliance with any proposed changes could also result in a significant cost to the Company. Failure to fully comply with various laws, rules, regulations or policies may expose the Company to proceedings or actions which may materially affect its performance. Similarly, changes in tax regulations and/or accounting pronouncements introduced by appropriate authoritative bodies may adversely impact the Company's financial performance.

Associate-owned Store Network

The success of the Company and reputation of its brands is closely tied to the performance of its Associate-owned drug stores. Accordingly, the Company relies on its Associates to successfully operate, manage and execute the retail programs and strategies of the Company at their respective locations.

The Company supports the operations of its Associates in many ways, including the provision of training and continuing education programs, as well as assistance with various administrative tasks. In addition, each Associate agrees to comply with the policies, marketing plans and operating standards prescribed by the Company, as specified in the Associate agreements with individual Associates. As well, through head lease control, the Company maintains control of all locations in its Associate-owned store network.

Supplier and Brand Reputations

The Company promotes national branded, non-proprietary products, as well as private label, proprietary products. Damage to the reputation of any of these brands, or to the reputation of any supplier or manufacturer of these brands, could negatively impact consumer opinion of the Company or the related products, which could have an adverse impact on the financial performance of the Company.

Other

The Company's operating and financial performance may also be affected by other specific risks that may be highlighted from time to time in other public filings of the Company available on the Canadian Securities Administrators' website at www.sedar.com.

Disclosure Controls and Procedures

The Company maintains a system of disclosure controls and procedures that has been designed to provide reasonable assurance that information required to be disclosed by the Company in its filings is recorded, processed, summarized and reported within required time periods and includes controls and procedures designed to ensure that all relevant information is accumulated and communicated to senior management, including the Company's Chief Executive Officer ("CEO") and Chief Financial Officer ("CFO"), to allow timely decisions regarding required disclosure.

Management, with the participation of the CEO and CFO and members of the Company's Disclosure Committee, has evaluated the effectiveness of the Company's disclosure controls and procedures as of December 30, 2006 and has concluded that the disclosure controls and procedures were designed and operating effectively to provide reasonable assurance that information required to be disclosed relating to the Company, including its consolidated subsidiaries and Associate-owned store network, was recorded, processed, summarized and reported to the CEO and CFO by others within the Company, particularly during the period in which the annual filings were being prepared.

Internal Controls over Financial Reporting

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.

In addition, the CEO and CFO 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 GAAP and the preparation of financial statements for external purposes.

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.