

8. Quarterly Results of Operations

8.1 Results by Quarter

The 52 week reporting cycle followed by the Company is divided into four quarters of 12 weeks each except for the third quarter which is 16 weeks in duration. The following is a summary of selected consolidated financial information derived from the Company's unaudited interim consolidated financial statements for each of the eight most recently completed quarters. This information was prepared in accordance with Canadian GAAP and is reported in Canadian dollars.

Summary of Quarterly Results

(unaudited)

(\$ millions except where otherwise indicated)	2006					2005				
	First Quarter	Second Quarter	Third Quarter	Fourth Quarter	Total (audited)	First Quarter	Second Quarter	Third Quarter	Fourth Quarter	Total (audited)
Sales ⁽¹⁾	\$6,147	\$6,699	\$9,010	\$6,784	\$28,640	\$6,060	\$6,405	\$8,610	\$6,552	\$27,627
Net (loss) earnings	140	194	203	(756)	(219)	142	211	192	201	746
Net (loss) earnings per common share										
Basic (\$)	\$.51	\$.71	\$.74	\$ (2.76)	\$ (.80)	\$.52	\$.77	\$.70	\$.73	\$ 2.72
Diluted (\$)	\$.51	\$.71	\$.74	\$ (2.76)	\$ (.80)	\$.52	\$.76	\$.70	\$.73	\$ 2.71

(1) During 2006, the Company implemented Emerging Issues Committee Abstract 156, "Accounting by a Vendor for Consideration Given to a Customer (Including a Reseller of the Vendor's Products)" on a retroactive basis. Accordingly certain sales incentives paid to independent franchisees, associates and independent accounts for the prior year have been reclassified between sales and cost of sales, selling and administrative expenses. For a further discussion, see the Accounting Standards Implemented in 2006 section included in this MD&A.

Sales growth in 2006 was impacted by various factors. Sales growth during the last two quarters of 2006 continued to be negatively impacted by the loss in tobacco sales as discussed previously. Sales and same-store sales in the fourth quarter were higher by approximately 2.0% excluding the loss in tobacco sales. Tobacco sales are not a large earnings contributor. Quarterly same-store sales growth for 2006 improved during the year from a decline of 2.5% in the first quarter to an increase of approximately 1.3% in the fourth quarter. Overall national food price inflation, as measured by CPI, during 2006 was approximately 2.3%. The adverse effects of the 2005 systems conversions and the start-up of the third-party warehouse continued into 2006. Early in 2006, service levels for general merchandise were below expected running rates but improved throughout 2006 with increasing stability. Net retail square footage increased by 1.2 million square feet in 2006 and was more heavily weighted over the last two quarters.

Fluctuations in quarterly net earnings in 2006 reflect the impact of a number of specific charges outlined previously resulting from the ongoing transformative changes. Softening sales in the first quarter of 2006, from continued product supply issues and deliberate delays in program activities, resulted in lost leverage on the fixed components in administrative and operating expenses. In the second, third and fourth quarters, higher store and distribution centre operational costs were incurred to stabilize the flow of product to the stores and additional storage costs were absorbed to quicken the supply chain stabilization process. Fourth quarter performance reflects the adverse impact on operating income of the following:

- Higher inventory shrink of approximately \$35 million and higher store labour costs of approximately \$20 million;
- An investment of approximately 0.5% in food pricing, resulting in an impact of approximately \$30 million;
- Higher general merchandise mark downs in the range of \$15 million to \$20 million to clear inventory through retail stores;
- A fixed asset impairment charge of \$24 million due in part to a decision to suspend plans for a number of sites scheduled for future development; and
- Incremental supply chain costs and information technology investments of approximately \$15 million.

Investments in the form of lower food prices continue to be made in specific markets in support of the Company's business strategy to grow sales levels.

Management's Discussion and Analysis

Interest expense, relative to 2005, increased marginally in the first half of 2006, but was reasonably consistent with 2005 in the second half of 2006.

The change in the effective income tax rate for 2006 over 2005 was primarily due to the non-cash goodwill impairment charge which is not deductible for income tax, the change in the proportion of taxable income earned across different tax jurisdictions, and a reduction to future income tax expense resulting from a reduction in statutory income tax rates.

During 2006, the Company did not purchase common shares for cancellation pursuant to its NCIB (2005 – 226,100).

8.2 Fourth Quarter Results

The following is a summary of selected consolidated information for the fourth quarter of 2006. This information was prepared in accordance with Canadian GAAP and is reported in Canadian dollars. The analysis of the data contained in the table focuses on the results of operations and changes in the financial condition and cash flows in the fourth quarter.

Selected Consolidated Information for the Fourth Quarter

(unaudited)

(\$ millions except where otherwise indicated)	2006 (12 weeks)	2005 (12 weeks)
Sales ⁽²⁾	\$ 6,784	\$ 6,552
Sales excluding the impact of VIEs ⁽¹⁾⁽²⁾	6,692	6,454
Operating (loss) income	(695)	394
Adjusted operating income ⁽¹⁾	286	441
Interest expense	60	61
Income taxes	2	132
Net (loss) earnings	(756)	201
Net (loss) earnings per common share (\$)		
Basic	(2.76)	.73
Adjusted basic ⁽¹⁾	.58	.94
Diluted	(2.76)	.73
Cash flows from (used in):		
Operating activities	777	830
Investing activities	(409)	(456)
Financing activities	(267)	(333)
Dividends declared per common share (\$)	.21	.21

(1) See Non-GAAP Financial Measures on page 40.

(2) During 2006, the Company implemented Emerging Issues Committee Abstract 156, "Accounting by a Vendor for Consideration Given to a Customer (Including a Reseller of the Vendor's Products)" on a retroactive basis. Accordingly certain sales incentives paid to independent franchisees, associates and independent accounts for the prior year have been reclassified between sales and cost of sales, selling and administrative expenses. For a further discussion, see the Accounting Standards Implemented in 2006 section included in this MD&A.

Sales for the fourth quarter of 2006 increased 3.5% or \$232 million to \$6.8 billion from \$6.6 billion reported in the fourth quarter of 2005, including a decrease of 0.2% related to the consolidation of certain independent franchisees.

Sales and Sales Growth Excluding the Impact of VIEs⁽¹⁾

(\$ millions except where otherwise indicated)	2006 (12 weeks)	2005 ⁽²⁾ (12 weeks)
Total sales	\$ 6,784	\$ 6,552
Less: Sales attributable to the consolidation of VIEs	92	98
Sales excluding the impact of VIEs	\$ 6,692	\$ 6,454
Total sales growth	3.5%	4.3%
Less: Impact on sales growth attributable to the consolidation of VIEs	(.2%)	1.6%
Sales growth excluding the impact of VIEs ⁽¹⁾	3.7%	2.7%

(1) See Non-GAAP Financial Measures on page 40.

(2) During 2006, the Company implemented Emerging Issues Committee Abstract 156, "Accounting by a Vendor for Consideration Given to a Customer (Including a Reseller of the Vendor's Products)" on a retroactive basis. Accordingly certain sales incentives paid to independent franchisees, associates and independent accounts for the prior years have been reclassified between sales and cost of sales, selling and administrative expenses. For a further discussion, see the Accounting Standards Implemented in 2006 section included in this MD&A.

Sales increases were realized across all regions of the country and in all areas of food, general merchandise and drugstore.

Fourth quarter same-store sales increased approximately 1.3% when compared to the same period last year. The growth in sales and same-store sales in the quarter is higher by approximately 2.0% excluding the loss in tobacco sales. During the fourth quarter of 2006, 8 new corporate and franchised stores were opened and 4 stores were closed, resulting in a net increase of 0.3 million square feet or 0.6%. The Company's calculation of food price inflation was consistent with the national food price inflation as measured by CPI of approximately 1.5% for the quarter.

During the fourth quarter of 2006, the business focused on on-shelf availability, targeted pricing investments and incremental marketing. The Company experienced some positive sales momentum particularly when the decrease in tobacco sales is excluded. A successful *Holiday Insider's Report* contributed to this improved sales performance.

Operating income for the fourth quarter of 2006 decreased \$1.1 billion from the fourth quarter of 2005 to an operating loss of \$695 million and operating margin declined to (10.2)% from 6.0% in the comparable period of 2005 due to the effects of the charges described below, all of which have been previously detailed in the Results of Operations section of this MD&A:

- A non-cash goodwill impairment charge of \$800 million related to the goodwill established on the acquisition of Provigo Inc. in 1998;
- A one-time charge of \$84 million in the fourth quarter related to the ratification of a new four-year collective agreement with members of certain Ontario locals of the UFCW;
- A charge of \$68 million in connection with the liquidation process for selected general merchandise inventory reflecting the expected inventory value through liquidation as well as the associated costs of facilitating the disposition incurred to date; and
- A charge of \$35 million recorded upon management's approval and announcement of its plans to close 19 underperforming stores in Quebec, mainly within the *Provigo* banner, 8 stores in the Atlantic region, and 24 wholesale outlets. These closures are expected to result in total costs of \$54 million.

(1) See Non-GAAP Financial Measures on page 40.

Management's Discussion and Analysis

Adjusted operating income⁽¹⁾ in the fourth quarter of 2006 was \$286 million compared to \$441 million in 2005, resulting in adjusted operating margins⁽¹⁾ of 4.3% and 6.8% respectively. During the fourth quarter of 2006, the Company continued to incur higher than anticipated store and distribution centre operational costs, particularly in higher inventory shrinkage and labour of approximately \$35 million and approximately \$20 million, respectively. Investments in lower food prices continued into the fourth quarter with an approximate 0.5% investment in food pricing, which resulted in an adverse impact to operating income of approximately \$30 million when compared to the same period last year. As the Company continued to manage its inventory levels down to more desirable levels in store backrooms, outside storage and distribution centres, some success was realized in the fourth quarter from the focused clearance pricing of certain categories resulting in higher general merchandise mark downs in the range of \$15 million to \$20 million from the clearance of inventory through retail stores. Incremental supply chain costs and information technology investments of approximately \$15 million were also absorbed in the fourth quarter.

Adjusted EBITDA⁽¹⁾ and EBITDA margin⁽¹⁾ for the fourth quarter were \$414 million and 6.2%, respectively. For the comparable period of 2005, adjusted EBITDA⁽¹⁾ and EBITDA margin⁽¹⁾ were \$573 million and 8.9%, respectively.

Total interest expense for the fourth quarter was flat compared to that of last year for the same period.

The effective income tax rate for the fourth quarter of 2006 was negative 0.3% compared to 39.6% in 2005. This significant change in the effective income tax rate was due to the non-cash goodwill impairment recorded in the quarter which is not subject to income tax. In addition, the effective income tax rate was impacted by a change in the proportion of taxable income earned across different tax jurisdictions.

Net loss for the quarter was \$756 million, a decrease of \$957 million from the same period last year. Basic net loss per common share was \$2.76, a decrease of \$3.49 from a basic net earnings per common share of 73 cents in 2005. Adjusted basic net earnings per common share⁽¹⁾ decreased 36 cents or 38.3% to 58 cents in 2006 from 94 cents in 2005.

Fourth quarter cash flows from operating activities were \$777 million in 2006 compared to \$830 million in 2005. The decrease was mainly a result of lower net earnings before minority interest. Fourth quarter cash flows used in investing activities were \$409 million in 2006 compared to \$456 million in 2005. Capital investment for the fourth quarter amounted to \$261 million (2005 – \$335 million). Fourth quarter cash flows used in financing activities were \$267 million in 2006 compared to \$333 million in 2005.