

# Management's Discussion and Analysis

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## Management's Discussion and Analysis

The following Management's Discussion and Analysis ("MD&A") for Loblaw Companies Limited and its subsidiaries (collectively, the "Company" or "Loblaw") should be read in conjunction with the consolidated financial statements and the accompanying notes on pages 44 to 83 of this Financial Report. The consolidated financial statements and the accompanying notes have been prepared in accordance with Canadian generally accepted accounting principles ("GAAP") and are reported in Canadian dollars. The consolidated financial statements include the accounts of the Company and its subsidiaries and variable interest entities ("VIEs") that the Company is required to consolidate in accordance with Accounting Guideline 15, "*Consolidation of Variable Interest Entities*", ("AcG 15"). A glossary of terms used throughout this Financial Report can be found on page 85. The information in this MD&A is current to March 12, 2008, unless otherwise noted.

### 1. Forward-Looking Statements

This Annual Report for Loblaw Companies Limited and its subsidiaries including this MD&A, contains forward-looking statements about the Company's objectives, plans, goals, aspirations, strategies, financial condition, results of operations, cash flows, performance, prospects and opportunities. Words such as "anticipate", "expect", "believe", "could", "estimate", "goal", "intend", "plan", "seek", "strive", "will", "may" and "should" and similar expressions, as they relate to the Company and its management, are intended to identify forward-looking statements. These forward-looking statements are not historical facts but reflect the Company's current expectations concerning future results and events.

These forward-looking statements are subject to a number of risks and uncertainties that could cause actual results or events to differ materially from current expectations. These risks and uncertainties include, but are not limited to: changes in economic conditions; changes in consumer spending and preferences; heightened competition, whether from new competitors or current competitors; changes in the Company's or its competitors' pricing strategies; failure of the Company's franchised stores to perform as expected; risks associated with the terms and conditions of financing programs offered to the Company's independent franchisees; failure to realize anticipated cost savings and operating efficiencies from the Company's major initiatives, including investments in the Company's information technology systems, supply chain investments and other cost reduction and simplification initiatives; the inability of the Company's information technology infrastructure to support the requirements of the Company's business; the inability of the Company to manage inventory to minimize the impact of obsolete or excess issues and to control shrink; failure to execute successfully and in a timely manner the Company's major initiatives, including the implementation of strategies and introduction of innovative products; unanticipated costs associated with the Company's strategic initiatives, including those related to compensation costs; the inability of the Company's supply chain to service the needs of the Company's stores; deterioration in the Company's relationship with its employees, particularly through periods of change in the Company's business; failure to achieve desired results in labour negotiations, including the terms of future collective bargaining agreements; changes to the regulatory environment in which the Company operates; the adoption of new accounting standards and changes in the Company's use of accounting estimates including in relation to inventory valuation; fluctuations in the Company's earnings due to changes in the value of equity forward contracts relating to its common shares; changes in the Company's tax liabilities resulting from changes in tax laws or future assessments; detrimental reliance on the performance of third-party service providers; public health events; the inability of the Company to obtain external financing; the inability of the Company to attract and retain key executives; and supply and quality control issues with vendors. These and other risks and uncertainties are discussed in the Company's materials filed with the Canadian securities regulatory authorities from time to time, including the Risks and Risk Management section of this MD&A. Other risks and uncertainties not presently known to the Company or that the Company presently believes are not material could also cause actual results or events to differ materially from those expressed in its forward-looking statements.

In addition to these risks and uncertainties, the material assumptions used in making the forward looking statements contained herein and in particular in the Report to Shareholders, the section entitled "Key Performance Indicators" on page 6 and in the section entitled "Outlook" on page 39 of this Annual Report, include: there is no material change in economic conditions from those of 2007; patterns of consumer spending and preferences are reasonably consistent with historical trends; there is no significant change in competitive conditions, whether related to new competitors or current competitors; there is no unexpected change in the Company's or its competitors' current pricing strategies; the Company's franchised stores perform as expected; anticipated cost savings and operating efficiencies are achieved, including those from the Company's cost reduction and simplification initiatives; there is no unexpected change in the Company's access to liquidity; and there are no significant regulatory, tax or accounting changes or other significant events occurring outside the ordinary course of business.

Readers are cautioned not to place undue reliance on these forward-looking statements, which reflect the Company's expectations only as of the date of this Annual Report. The Company disclaims any intention or obligation to update or revise these forward-looking statements, whether as a result of new information, future events or otherwise, except as required by law.

## 2. Overview

Loblaw, a subsidiary of George Weston Limited, is Canada's largest food distributor and a leading provider of general merchandise, drugstore and financial products and services. Traditional food offerings remain at the core of the Company's business. Through its various operating banners, including 628 corporate stores and 408 franchised stores, Loblaw is committed to providing Canadians across the country with a one-stop destination in meeting their food and everyday household needs. For 50 years, the Company has supplied the Canadian market with innovative products and services through a portfolio of store formats across Canada.

Corporate owned store banners include *Atlantic Superstore*, *Dominion*<sup>(1)</sup> (in Newfoundland and Labrador only), *Extra Foods*, *Loblaws*, *Maxi*, *Maxi & Cie*, *Provigo*, the *Real Canadian Superstore* and *Zehrs* and wholesale outlets operating as *Cash & Carry*, *Presto* and *The Real Canadian Wholesale Club*. The Company's franchised and associated stores operate under the trade names *Atlantic SaveEasy*, *Fortinos*, *no frills*, *SuperValu*, *Valu-mart* and *Your Independent Grocer*. The store network is supported by 25 Company-operated and three third-party warehouse facilities located across Canada as well as temporary storage facilities when required.

The Company offers a strong control label program, including the *President's Choice*, *no name* and *Joe Fresh Style* brands. In addition, the Company makes available to consumers *President's Choice Financial* services and products, including the *President's Choice Financial MasterCard*®, and *PC Financial* auto, home, travel and pet insurance. The Company also offers *PC Mobile* phone service, as well as a loyalty program known as *PC points*.

The retail industry in Canada is highly competitive. The industry is driven primarily by consumer demand, which is impacted by economic trends, changing demographics, ethnic diversity, health and environmental awareness and time availability. Recent consumer trends that dominate the industry include customer's concerns for their own and their family's health, lack of time, increasing demand for value and premium products in one location, a willingness to buy certain general merchandise on food-focused shopping trips and an increasing demand that retailers source ethically and in a way that demonstrates care for the environment and the community.

The Company's competitors include traditional supermarket operators, as well as mass merchandisers, warehouse clubs, drugstores, limited assortment stores, discount stores, convenience stores and specialty stores. Many of these competitors now offer a selection of food, drugstore and general merchandise. Others remain focused on supermarket-type merchandise. Generally, the Canadian retail landscape has in recent years been characterized by an increase in square footage that is greater than the increase in consumer demand which has resulted in pressure on retailers to lower their prices and reduce operating and labour costs.

## 3. Vision and Strategies

### Vision

The Company's vision is Making Loblaw the Best Again by implementing the three main imperatives of "Simplify, Innovate, Grow". The Company strives to be consumer focused, cost effective and agile. While accepting prudent operating risks, Loblaw seeks long term, stable growth supported by a strong balance sheet, with the goal of providing sustainable superior returns to its shareholders through a combination of common share price appreciation and dividends.

### Strategies

Loblaw's mission is to be Canada's best food, health and home retailer by exceeding customer expectations through innovative products at great prices. Under the principles of Simplify, Innovate, Grow, the Company employs various operating and financial strategies which guide the Company over the long term and represent a philosophy for the way in which it conducts its business.

(1) Trademark used under license.

## Management's Discussion and Analysis

Loblaw's three to five year turnaround commenced in 2007 and the Company has made good progress. Loblaw has simplified the organization by more clearly defining accountabilities, eliminating duplication and establishing consistent, simple and efficient processes. A less complex organizational structure and a short list of key performance indicators are expected to lead to more focus in 2008 on customers and store operations, and for the first time ever, to enable Loblaw to fully leverage its national scale.

Innovation is one of the many strengths of Loblaw, most clearly exhibited by its control label offerings. The Company supports innovation based on the belief that providing consumers with new products and convenient services at competitive prices and stimulating shopping environments is critical to its success. Innovation in food and across the Company's entire range of control label products and services make Loblaw brands and assortments "*worth switching supermarkets for*".

In 2006, the Company developed its Formula for Growth to define priorities for a three to five year turnaround plan. To provide an integrated offering of food, general merchandise and drugstore, the Company's Formula for Growth focuses on the following:

- best format: truly distinctive formats meeting customers' different needs;
- fresh first: best fresh food offering;
- control label advantage: leading in the development of unique, high quality control label products and services;
- 10% Joe: grow *Joe Fresh Style* brand by offering great style at an affordable price;
- health, home and wholesome: making healthy living affordable for all Canadians;
- priced right: providing best value for money, when compared to all relevant shopping choices;
- always available: best in-stock positions; and
- friendly colleagues motivated to serve : investing in colleagues to support customer satisfaction.

The Company's long term operating strategies are consistent with its Formula for Growth and continue to be as follows:

- use the cash flow generated in the business to invest in its future;
- own its real estate, where possible, to maximize flexibility for product and business opportunities in the future;
- use a multi-format approach to maximize market share over the longer term;
- focus on food but serving the consumer's everyday household needs;
- create customer loyalty and enhancing price competitiveness through a superior control label program;
- implement and execute plans and programs flawlessly; and
- constantly strive to improve the Company's value proposition.

The Company's long term financial strategies are as follows:

- maintain a strong balance sheet;
- minimize the risks and costs of its operating and financing activities; and
- maintain liquidity and access to capital markets.

The success of these and other plans and strategies discussed in this MD&A may be affected by risks and uncertainties, including those described in the Risks and Risk Management section of this MD&A, found on pages 26 to 33.

The table below summarizes the Company's strategic imperatives and the activities undertaken in 2007 to advance these Simplify and Innovate imperatives.

Simplify	<ul style="list-style-type: none"> <li>▪ Organizational restructuring completed for effectiveness and efficiency resulting in a net reduction of approximately 900 employees.</li> <li>▪ New tools and systems utilized for more effective store communication to improve customer service.</li> <li>▪ Improved on-shelf availability of grocery, dairy, frozen, natural value and health and beauty care using the Always Available program by eliminating ineffective store processes.</li> <li>▪ Detailed cost reduction plan initiated identifying cost reduction opportunities in shrink, store labour, the supply chain, and administrative expenses.</li> <li>▪ New Supply Chain and Information System infrastructure roadmaps developed for new forecasting, replenishment, distribution and transportation capabilities that will improve store availability and operational productivity over time.</li> <li>▪ New price checking processes and scorecards implemented to accurately monitor weekly price position against relevant competitors to improve value competitiveness.</li> </ul>
Innovate	<ul style="list-style-type: none"> <li>▪ <b>PC Signature Campaign</b> resulted in strong sales of <i>PC</i> products such as <i>Blue Menu</i> Lean Burgers, <i>PC</i> Indian Naan flat bread, <i>PC 2X</i> Concentrated Detergent, and <i>PC Organics</i> Baby Food.</li> <li>▪ <i>Joe Fresh Style</i> extended into <i>Joe Kids</i> and intimates lines into 350 stores from 100 with positive sales and plans to expand into all stores over 80,000 square feet.</li> <li>▪ Repositioning of <b>President's Choice Home Line of Products</b> to offer superior functional advantage at a reduced cost.</li> <li>▪ Continued <b>Product Development</b> excellence resulted in the launch of over 600 new food products, primarily in the <i>PC</i> line e.g., <i>PC Organics</i>, <i>Blue Menu</i>, <i>Mini Chefs</i>, and <i>PC Green</i>, plus over 800 new home products.</li> <li>▪ <b>Best Format</b> teams which act as retail "brand managers" of Hard Discount, Superstore, and Great Food stores created go-to-market strategies for Hard Discount and Superstore formats based on competitive considerations and market opportunities. The strategy for Great Food stores is under development.</li> </ul>
Grow <sup>(1)</sup>	<ul style="list-style-type: none"> <li>▪ <b>Best Format</b> reflects Loblaw's advantage of having three retail formats to place in the market to maximize the Company's ability to serve our customers and maximize our market share. The three formats offer distinctive shopping experiences for customers: <ul style="list-style-type: none"> <li>- <b>Great Food</b> stores will offer the best fresh and packaged food, knowledgeable staff, outstanding customer service, and an exciting shopping experience.</li> <li>- <b>Hard discount</b> stores will deliver the lowest effective prices and traffic oriented promotions for customers willing to make tradeoffs on brands and service for price and convenience.</li> <li>- <b>Superstores</b> will offer great value in an innovative and fun one-stop shop for great food, healthy living, and a stylish home.</li> </ul> </li> <li>▪ <b>Fresh First</b> is Loblaw's goal to provide the best fresh food in Canadian grocery.</li> <li>▪ <b>Control Label Advantage</b> is at heart of the Company's innovation culture. Through continued product development excellence, Loblaw will strive to grow its control label sales to 30% of total sales, from the current penetration of 24%.</li> <li>▪ <b>10% Joe</b> is the Company's vision to grow the <i>Joe Fresh Style</i> brand to a \$1 billion brand through line extensions into Kids and Intimates, as well as rolling out <i>Joe Fresh Style</i> departments from the current 350 stores to all stores larger than 80,000 square feet.</li> <li>▪ <b>Health, Home and Wholesome</b> is the Company's goal to be recognized as making healthy living affordable for all Canadians with such offerings as <i>Blue Menu</i> and <i>PC Organics</i> lines, as well as fresh foods.</li> <li>▪ <b>Priced Right</b> is Loblaw's commitment to provide the best value-for-money, when compared to all relevant shopping choices. Pricing investments will be made in those formats, categories and product lines that are most important to customers.</li> <li>▪ The continued roll out of the <b>Always Available</b> program will address the in-store replenishment processes focusing on providing the best availability of any food and general merchandise retailer in Canada.</li> <li>▪ The Company's single most important asset is its over 140,000 store and store support colleagues: "<b>Friendly Colleagues, Motivated To Serve</b>". Loblaw is investing so that the Company can deliver on this promise to our customers. This includes on the job training to allow Loblaw colleagues to better serve customers' needs.</li> </ul>

(1) To be read in conjunction with "Forward Looking Statements" on page 2 of this Annual Report.

## Management's Discussion and Analysis

### Board Commitment

The Company's Board of Directors ("Board") and senior management meet annually to review the strategic imperatives. These strategic imperatives, which generally span a three to five year timeframe, target specific issues in response to the Company's performance and changes in consumer needs and the competitive retail landscape.

### 4. Key Performance Indicators

As a result of the priorities established under the new management's Formula for Growth and following the 100 Day Review, which was completed in early 2007, the Company has identified and is developing specific key performance indicators to measure the progress of short and long term strategies. These key performance indicators will measure format same-store sales, fresh first, penetration of control label sales, *Joe Fresh Style* brand sales in apparel and related merchandise, price index level targets, targeted on-shelf availability and employee satisfaction. In 2007, targets were developed that will enable management to assess progress made on each imperative as well as the effectiveness of implementation of the Company's strategy. The Company believes that if it successfully implements and executes its various strategic imperatives in support of its long term operating and financial strategies, it will be well positioned to pursue its vision of providing sustainable returns to its shareholders.

Additional key financial performance indicators are set out below:

#### Key Financial Performance Indicators

	2007 (52 weeks)	2006 (52 weeks)
Sales growth	2.6%	3.7%
Sales growth excluding the impact of tobacco sales and VIEs <sup>(1)</sup>	4.0%	5.0%
Basic net earnings per common share increase (decrease)	250.0%	(129.4%)
Adjusted basic net earnings per common share <sup>(1)</sup> (decrease)	(24.6%)	(18.8%)
Cash flows from operating activities (\$ millions)	\$ 1,245	\$ 1,180
Free cash flow <sup>(1)</sup> (\$ millions)	\$ 402	\$ 70
Net debt <sup>(1)</sup> to equity ratio	.67:1	.72:1
Return on average shareholders' equity	6.0%	(3.9%)

By effectively implementing the Formula for Growth, management aspires to achieve, on average, 5% sales growth, 10% adjusted net earnings<sup>(1)</sup> growth and \$250 million of free cash flow<sup>(1),(2)</sup>

### 5. Financial Performance

Financial results for 2007 were negatively affected by the short term costs associated with the largest transformation in the Company's history. The need for this transformative process was necessitated by the Company's recent poor financial performance, its assessment of a fast-changing retail environment and a strategic review of processes, structure and key drivers of its operations.

Operating income of \$736 million for 2007 increased by \$447 million, or 154.7%, compared to \$289 million in 2006, and resulted in an operating margin of 2.5% as compared to 1.0% in 2006. The 2006 operating income was negatively affected by an \$800 million non-cash goodwill impairment charge related to the goodwill associated with the acquisition of Provigo Inc. in 1998. Details of specific items that were included in operating income for 2007 and 2006 are described on page 10 of this MD&A.

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

(2) To be read in conjunction with "Forward Looking Statements" on page 2 of this Annual Report.

Adjusted operating income<sup>(1)</sup> for 2007 decreased by \$292 million, or 22.0%, to \$1,034 million compared to \$1,326 million in 2006. Adjusted operating margin<sup>(1)</sup> decreased to 3.7% in 2007 compared to 4.9% in 2006 as growth in operating expenses exceeded growth in sales. Adjusted EBITDA margin<sup>(1)</sup> decreased to 5.7% from 7.1% in 2006. Details of specific items included in adjusted operating income<sup>(1)</sup> for 2007 and 2006 are described on pages 9 to 10 of this MD&A.

Basic net earnings per common share for 2007 were \$1.20, an increase of \$2.00 when compared to basic net loss per common share of \$0.80 in 2006. Basic net earnings per common share was impacted in 2007 by the following:

- a charge of \$0.04 per common share related to inventory liquidation;
- a charge of \$0.30 per common share for the net effect of stock-based compensation and the associated equity forwards;
- a charge of \$0.53 per common share related to restructuring and other charges;
- a charge of \$0.02 per common share related to the consolidation of VIEs;
- income of \$0.04 cents per common share related to the adjustment to future income tax balances resulting from changes in the Canadian federal and certain provincial statutory income tax rates.

After adjusting for the above-noted items, adjusted basic net earnings per common share<sup>(1)</sup> were \$2.05 for 2007 compared to \$2.72 in 2006, a decline of 24.6%, which excluded the impact of the following:

- a charge of \$0.17 per common share for the net effect of stock-based compensation and the associated equity forwards;
- a charge of \$0.11 per common share related to restructuring and other charges;
- a charge of \$0.16 cents per common share related to inventory liquidation;
- a charge of \$2.92 per common share related to a goodwill impairment charge;
- a charge of \$0.20 per common share related to an Ontario collective labour agreement;
- a charge of \$0.03 per common share related to a departure entitlement charge;
- income of \$0.06 per common share related to the adjustment to future income tax balances resulting from changes in the Canadian federal and certain provincial statutory income tax rates; and
- income of \$0.01 per common share related to the consolidation of VIEs.

Adjusted basic net earnings per common share<sup>(1)</sup> decreased in 2007 as a result of Loblaw's continued investment in lower retail prices to drive same-store sales growth in a targeted manner across the country. Sales increases in 2007 were insufficient to offset gross margin declines and increases in operating expenses. Operating expenses in 2007 compared to 2006 included significant incremental costs including restructuring charges and consulting.

In 2007, the Company reduced capital expenditures and concentrated on same-store sales growth, rather than space-driven growth, which resulted in significant improved cash flow. Capital investment, funded through cash flows from operating and financing activities, was \$613 million in 2007, a reduction of \$324 million compared to \$937 million capital investment in 2006. Despite the decision to reduce capital investment, Loblaw experienced total sales growth in all its regions and maintained its market share, during a period of low food price inflation in the market.

In pursuit of improving its value proposition, Loblaw invested in pricing in specific markets by adopting everyday low pricing strategies. The organizational restructuring has enhanced management's ability to identify cost reduction opportunities in shrink, store labour, supply chain, and administrative expenses. However, further cost reductions are required to help rebuild the reduction in margins resulting from the price investments. A detailed cost reduction plan was defined near the end of 2007. Cost reductions remain a critical focus for management moving forward.

The Company's three to five year turnaround commenced in 2007 and the Company has made good progress. The single most important accomplishment has been the organizational restructuring. This is a transformational change that will enable Loblaw, for the first time ever, to fully leverage its national scale. Supply Chain and Information Technology also produced roadmaps that will make the Company's infrastructure more competitive.

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

## Management's Discussion and Analysis

### 5.1 Results of Operations

#### Sales

Full year sales in 2007 increased \$744 million, or 2.6%, to \$29.4 billion compared to \$28.6 billion in 2006. Total sales excluding the impact of tobacco sales and VIEs<sup>(1)</sup> increased by \$1.1 billion or 4.0% over 2006.

#### Total Sales and Sales Excluding the Impact of Tobacco Sales and VIEs<sup>(1)</sup>

For the years ended December 29, 2007 and December 30, 2006 (\$ millions)	2007 (52 weeks)	2006 (52 weeks)
Total sales	\$ 29,384	\$ 28,640
Less: Sales attributable to tobacco sales	1,013	1,423
Sales attributable to the consolidation of VIEs	456	383
Sales excluding the impact of tobacco sales and VIEs <sup>(1)</sup>	\$ 27,915	\$ 26,834

#### Sales Growth and Same-Store Sales Growth

For the years ended December 29, 2007 and December 30, 2006 (percentage)	2007 (52 weeks)	2006 (52 weeks)
Total sales growth	2.6%	3.7%
Less: Impact on sales growth attributable to tobacco sales	(1.7%)	(1.2%)
Impact on sales growth attributable to the consolidation of VIEs	0.3%	(0.1%)
Sales growth excluding the impact of tobacco sales and VIEs <sup>(1)</sup>	4.0%	5.0%
Same-store sales growth	2.4%	0.8%
Same-store sales growth excluding the impact of decreased tobacco sales <sup>(1)</sup>	3.4%	2.0%

The following factors further explain the major components in the change in sales over the prior year:

- same-store sales growth excluding the impact of decreased tobacco sales<sup>(1)</sup> increased 3.4% (2006 – 2.0%). In the third quarter of 2006, a major tobacco supplier commenced shipping directly to certain customers of our cash & carry and wholesale club network, adversely impacting sales. This loss of sales affects comparisons to 2006 for the first three quarters of 2007;
- same-store sales growth by format in 2007 for Superstore, Hard Discount, and Great Food were 3.8%, 4.6%, and 0.4% respectively compared to 2006. The pricing investments in 2007 were targeted primarily within the Superstore and Hard Discount formats;
- national food price inflation as measured by “The Consumer Price Index for Food Purchased from Stores” (“CPI”) in 2007 was 2.7% (2006 – 2.3%). The Company’s analysis indicates that its internal retail food price inflation for 2007 was approximately 1.3% compared to 2006;
- positive volume growth based on retail units sold in 2007 of 1.9% (2006 – 1.6%); and
- 34 (2006 – 37) new corporate and franchised stores were opened and 79 (2006 – 33) stores were closed, including 46 stores that were closed as part of a previously announced store operations restructuring plan, and stores which underwent conversions and major expansions. Net retail square footage decreased 0.1 million square feet (2006 – increased 1.2 million square feet), or (0.2%), in 2007 from year end 2006.

Sales of control label products for 2007 amounted to \$6.6 billion compared to \$6.2 billion in 2006. Control label penetration, which is measured as control label retail sales as a percentage of total retail sales, was 24.0% for 2007, compared to 22.9% for 2006. The Company introduced over 600 new control label products in 2007, plus 800 new home products. The Company’s control label program, which includes *President’s Choice*, *PC*, *President’s Choice Organics*, *Blue Menu*, *Mini Chefs*, *no name*, *Joe Fresh Style*, *Club Pack*, *President’s Choice GREEN*, *EXACT*, *Teddy’s Choice* and *Life@Home*, provides additional sales growth potential.

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

Loblaw will be focusing on the following initiatives, coupled with continued focus on value-for-money, promotions and advertising where appropriate:

- focus on on-shelf availability of product through an enhancement of customer focus and supply chain, and stronger store processes;
- restoring innovation as a competitive advantage both for control label products as well as distinctive environments in each retail format;
- refining three distinctive retail formats: Superstore, Great Food and Hard Discount;
- increasing the number of stores carrying the *Joe Fresh Style* brand apparel offering;
- emphasizing a fresh first focus by raising presentation and quality standards; and
- investing in employees and providing training to encourage meeting customer needs.

### Operating Income

Operating income of \$736 million for 2007 increased \$447 million, or 154.7% compared to \$289 million in 2006 resulting in an increase in operating margin to 2.5% in 2007 from 1.0% in 2006.

Operating Income, Adjusted Operating Income<sup>(1)</sup>, Adjusted EBITDA<sup>(1)</sup> and Margins<sup>(1)</sup>

(\$ millions except where otherwise indicated)	2007 (52 weeks)	2006 (52 weeks)	Change
Operating income	\$ 736	\$ 289	154.7%
Adjusted operating income <sup>(1)</sup>	\$ 1,034	\$ 1,326	(22.0%)
Adjusted EBITDA <sup>(1)</sup>	\$ 1,589	\$ 1,892	(16.0%)
Operating margin	2.5%	1.0%	
Adjusted operating margin <sup>(1)</sup>	3.7%	4.9%	
Adjusted EBITDA margin <sup>(1)</sup>	5.7%	7.1%	

Operating income in both 2007 and 2006 was affected by a number of specific items as outlined below:

- charge of \$197 million (2006 – nil) related to Project Simplify involving restructuring and streamlining of merchandising and store operations. Costs were comprised of \$139 million for employee termination benefits including severance, additional pension costs resulting from the termination of employees and retention costs; and \$58 million of other costs, primarily consulting. Total restructuring costs under this plan, comprised primarily of severance costs, are now anticipated to be approximately \$200 million, with the remaining costs to be expensed in 2008;
- charge of \$9 million (2006 – \$8 million) in connection with the previously announced plan to restructure the Company's supply chain network;
- charge of \$16 million (2006 – \$35 million) in connection with the previously announced closure of certain stores in the Quebec and Atlantic markets and in the wholesale network that were part of store operations restructuring activities;
- charge of \$72 million (2006 – \$37 million) for the net effect of stock-based compensation and the associated equity forwards. The majority of the expense in 2007 included a non-cash loss on equity forwards of \$67 million (2006 – \$32 million) resulting from a decline in the Company's share price during the year;
- charge of \$15 million (2006 – \$68 million) for the liquidation of general merchandise inventory;
- income of \$11 million (2006 – \$8 million) resulting from the consolidation of VIEs;
- nil (2006 – charge of \$1 million) related to the head office move and reorganization of our operation support functions;
- nil (2006 – charge of \$800 million) for a non-cash goodwill impairment charge related to the goodwill established on the acquisition of Provigo Inc. in 1998;
- nil (2006 – charge of \$84 million) related to the ratification of a new four-year collective agreement with members of certain Ontario locals of the UFCW; and
- nil (2006 – charge of \$12 million) related to a departure entitlement charge.

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

## Management's Discussion and Analysis

In 2007, restructuring and other charges of \$222 million (2006 – \$44 million) were recorded within operating income. A summary of restructuring and other charges is included in the table below:

(\$ millions)	<b>Costs Recognized 2007 (52 weeks)</b>	Costs Recognized 2006 (52 weeks)	Costs Recognized 2005 (52 weeks)	Total Expected Costs	Total Expected Costs Remaining
Project Simplify	<b>\$ 197</b>	\$ –	\$ –	\$ 200	\$ 3
Store operations	<b>16</b>	35	–	51	–
Supply chain network	<b>9</b>	8	62	90	11
Office move and reorganization of the operation support functions	–	1	24	25	–
<b>Total restructuring and other charges</b>	<b>\$ 222</b>	<b>\$ 44</b>	<b>\$ 86</b>	<b>\$ 366</b>	<b>\$ 14</b>

Details regarding the nature of the above charges are described in note 4 to the consolidated financial statements.

After adjusting for the above noted items, adjusted operating income<sup>(1)</sup> for 2007 decreased by \$292 million, or 22.0% to \$1,034 million compared to \$1,326 million in 2006. Adjusted operating margin<sup>(1)</sup> decreased to 3.7% in 2007 compared to 4.9% in 2006 as growth in operating expenses exceeded growth in sales. Adjusted EBITDA margin<sup>(1)</sup> decreased to 5.7% from 7.1% in 2006.

In addition, the 2007 adjusted operating income<sup>(1)</sup> was influenced by the following items:

- incremental consulting costs compared to the prior year, other than those in connection with Project Simplify, amounted to \$75 million including expenses related to new supply chain and information technology improvement initiatives of \$16 million;
- pharmacy-related operating income was reduced by \$25 million due to legislative changes introduced in 2006 by the Ontario government;
- adjustments in estimates related to post-employment and long term disability benefits and deferred product development and information technology costs reduced operating income by \$24 million;
- costs associated with the change in the Company's executive bonus plan were \$11 million;
- a gain of \$11 million from the sale of an office building in Calgary, Alberta;
- an incremental non-cash fixed asset impairment charge of \$6 million related to asset carrying values in excess of fair values at specific store locations. The 2007 charge was \$33 million compared to \$27 million in 2006; and
- a decline in gross margin, primarily due to targeted price reductions to provide value to customers and changes in sales mix partially offset by improvements in shrink.

### Interest Expense

Interest expense consists primarily of interest on short and long term debt, interest on financial derivative instruments net of interest income earned on short term investments and interest capitalized to fixed assets. In 2007, total interest expense decreased \$7 million, or 2.7%, to \$252 million from \$259 million in 2006.

Interest on long term debt was \$285 million compared to \$284 million in 2006. The 2007 weighted average fixed interest rate on long term debt (excluding capital lease obligations) was 6.6% (2006 – 6.7%) and the weighted average term to maturity was 16 years (2006 – 17 years).

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

Interest on financial derivative instruments includes the net effect of the Company's interest rate swaps, cross currency basis swaps and equity forwards, and amounted to a charge of \$12 million in 2007 (2006 – \$7 million). The change in interest on financial derivative instruments was due mainly to an increase in United States short term interest rates and the cumulative loss transferred from Other Comprehensive Income and subsequent change in fair market value of the interest rate swaps previously designated as a cash flow hedge of the variable interest rate exposure on commercial paper. Net short term interest income in 2007 was \$23 million (2006 – \$11 million). This change was due primarily to a decrease in short term debt.

During 2007, \$22 million (2006 – \$21 million) of interest incurred on debt related to real estate properties under development was capitalized to fixed assets.

#### Analysis of Long Term Financing Costs

(\$ millions except where otherwise indicated)	2007 (52 weeks)	2006 (52 weeks)
Total long term debt at year end (including portion due within one year)	\$ 4,284	\$ 4,239
Interest on long term debt	\$ 285	\$ 284
Weighted average fixed interest rate on long term debt (excluding capital lease obligations)	6.6%	6.7%

#### Income Taxes

The Company's 2007 effective income tax rate decreased to 31.0% from 826.7% in 2006. The effective income tax rate in 2006 before the impact of the non-deductible goodwill impairment charge was 29.9%, as presented in note 7 to the consolidated financial statements. The increase from 29.9% in 2006 to 31.0% in 2007 was mainly the result of the following factors:

- a change in the proportion of taxable income earned across different tax jurisdictions; and
- an \$11 million reduction (2006 – \$16 million) to the future income tax expense recognized as a result of the change in the Canadian federal and certain provincial statutory income tax rates, the cumulative effect of which was included in the consolidated financial statements at the time of substantive enactment.

#### Net Earnings

In 2007, net earnings increased \$549 million to \$330 million from a net loss of \$219 million in 2006 and basic net earnings per common share increased \$2.00 to a basic net earnings per common share of \$1.20 from a basic net loss per common share of \$0.80 in 2006 due to the factors described in the preceding sections.

## Management's Discussion and Analysis

### 5.2 Financial Condition

#### Financial Ratios

The net debt<sup>(1)</sup> to equity ratio continued to be within the Company's internal guideline of less than 1:1. The 2007 net debt<sup>(1)</sup> to equity ratio was .67:1 compared to the 2006 ratio of .72:1. In 2006, the non-cash goodwill impairment charge negatively impacted the net debt<sup>(1)</sup> to equity ratio by .10:1 as a result of an \$800 million reduction in shareholders' equity.

Cash flows from operating activities cover a large portion of the Company's funding requirements and in 2007 exceeded the capital investment program. In 2007, funding requirements resulted primarily from the capital investment program, the funding of the credit card receivables, after securitization and dividends paid on the Company's common shares.

In 2007, shareholders' equity increased \$104 million, or 1.9%, to \$5.5 billion. The increase in operating income resulted in an interest coverage ratio of 2.7 times in 2007 compared to 1.0 times in 2006. The goodwill impairment charge was a significant non-cash item in operating income in 2006, which adversely impacted the interest coverage ratio by approximately 3.1 times.

At year end, the working capital position increased over the prior year. The 2007 return on average total assets<sup>(1)</sup> was 5.8% compared to 2.3% in 2006. The 2007 return on average shareholders' equity was 6.0% compared to the 2006 return of (3.9)%. The five year average return on shareholders' equity was 10.2% (2006 – 12.5%).

#### Common Share Dividends

The Company has paid quarterly dividends on its common shares for over 50 years. The declaration and payment of dividends and the amount thereof are at the discretion of the Board, which takes into account the Company's financial results, capital requirements, available cash flow and other factors the Board considers relevant from time to time. Over the long term, the Company's objective is for its dividend payment ratio to be in the range of 20% to 25% of the prior year's adjusted basic net earnings per common share<sup>(1)</sup>. Currently, there is no restriction that would prevent the Company from paying dividends at historical levels. During 2007, the Board declared quarterly dividends of 21 cents per common share. The 2007 annualized dividend per common share of 84 cents was equal to 30.9% of the 2006 adjusted basic net earnings per common share<sup>(1)</sup>. Subsequent to year end, the Board declared a quarterly dividend of 21 cents per common share, payable April 1, 2008.

#### Outstanding Share Capital

The Company's outstanding share capital is comprised of common shares. An unlimited number of common shares is authorized and 274,173,564 common shares were issued and outstanding at year end. Further information on the Company's outstanding share capital is provided in note 19 to the consolidated financial statements.

At year end, a total of 6,532,756 stock options were outstanding and represented 2.4% of the Company's issued and outstanding common shares, which was within the Company's guideline of 5%. Further information on the Company's stock-based compensation is provided in note 21 to the consolidated financial statements.

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

## 6. Liquidity and Capital Resources

### 6.1 Cash Flows

#### Major Cash Flow Components

(\$ millions)	2007 (52 weeks)	2006 (52 weeks)	Change
Cash flows from (used in):			
Operating activities	\$ 1,245	\$ 1,180	\$ 65
Investing activities	\$ (671)	\$ (1,308)	\$ 637
Financing activities	\$ (472)	\$ (120)	\$ (352)

#### Cash Flows from Operating Activities

2007 cash flows from operating activities increased to \$1,245 million compared to \$1,180 million in 2006. The improvement in cash flows from operating activities for the year was mainly due to an increase of \$552 million in net earnings before minority interest, an increase of \$178 million in restructuring charges, an increase of \$110 million in other operating activities and a decrease of \$800 million from the effect of a goodwill impairment charge recorded in 2006. The change in other operating activities was primarily driven by an increase in accrued benefit plan liability, due to changes in funding and expenses for pension, post-retirement and post-employment benefits, and an increase in unrealized equity forwards payable.

#### Cash Flows used in Investing Activities

2007 cash flows used in investing activities were \$671 million compared to \$1,308 million in 2006. The majority of the change in cash flows used in investing activities resulted from a decline in capital investments of \$324 million; less movement in short term investments from cash and cash equivalents relative to year end, when compared to the prior year, due to the change in the term to maturity profile of the Company's short term investments resulting in an inflow of \$292 million; and an increase in proceeds from fixed asset sales of \$124 million. These were partially offset by an outflow of \$156 million due to an increase in credit card receivables, after securitization.

Capital investment amounted to \$613 million (2006 – \$937 million) for the year as the Company restrained capital spending in an over-spaced market. Approximately 31% (2006 – 38%) of the capital investment was for new store development, expansions and land, approximately 43% (2006 – 51%) for store conversions and remodels, and approximately 26% (2006 – 11%) for infrastructure investment. The continued capital investment activity benefited all regions to varying degrees and strengthened the existing store base. Some of the new, larger stores replaced older, smaller, less efficient stores that did not offer the broad range of products and services demanded by today's consumer.

The Company is investing in higher return expansions and renovations to its existing store base, with a focus on improving same-store sales. Loblaw expects to invest in 2008 an estimated \$700 to \$800 million in net capital expenditures. Approximately two-thirds of these funds are expected to be used in remodeling, expanding and maintaining existing stores and a small increase in square footage, with the remainder split two-thirds in upgrading information systems and one-third on supply chain infrastructure.

The 2007 corporate and franchised store capital investment program, which includes the impact of store openings and closures, resulted in a decrease in net retail square footage of 0.2% compared to 2006. During 2007, 34 (2006 – 37) new corporate and franchised stores were opened and 73 (2006 – 147) underwent renovation or minor expansion. The 34 new stores, net of 79 (2006 – 33) store closures, including 46 stores that were closed as part of the store operations restructuring plan, and stores which underwent conversions and major expansion, decreased net retail square footage 0.1 million square feet (2006 – increased 1.2 million square feet). The 2007 average corporate store size increased 5.9% to 60,800 square feet (2006 – 57,400) and the average franchised store size increased 2.2% to 28,000 square feet (2006 – 27,400).

At year end 2007, the Company had committed approximately \$113 million (2006 – \$153 million) with respect to capital investment projects such as the construction, expansion and renovation of buildings and the purchase of real property.

## Management's Discussion and Analysis

During 2007, the Company also generated \$223 million (2006 – \$99 million) from fixed asset sales.

### Capital Investment and Store Activity

	2007 (52 weeks)	2006 (52 weeks)	Change
Capital investment (\$ millions)	\$ 613	\$ 937	\$ (324)
Retail square footage (in millions)	49.6	49.7	(0.2%)
Number of corporate stores	628	672	(6.5%)
Number of franchised stores	408	405	0.7%
Percentage of corporate real estate owned	73%	72%	
Percentage of franchise real estate owned	46%	45%	
Average store size (sq. ft.)			
Corporate	60,800	57,400	5.9%
Franchised	28,000	27,400	2.2%

### Cash Flows used in Financing Activities

Cash flows used in financing activities increased to \$472 million in 2007 compared to \$120 million in 2006 mainly due to the repayment of commercial paper and the timing of one additional quarterly dividend payment in 2007 compared to last year.

During the first quarter of 2007, Loblaw renewed its Normal Course Issuer Bid to purchase on the Toronto Stock Exchange, or enter into equity derivatives to purchase, up to 13,708,678 of the Company's common shares, representing approximately 5% of the common shares outstanding. In accordance with the requirements of the Toronto Stock Exchange, Loblaw may purchase its shares at the then market prices of such shares. The Company intends to renew its Normal Course Issuer Bid in 2008. The Company did not purchase any shares under its Normal Course Issuer Bid during 2007 or 2006.

## 6.2 Sources of Liquidity

The Company obtains short term financing through a combination of cash generated from operating activities, cash, cash equivalents, short term investments, bank indebtedness and has limited access to commercial paper. The Company relies on a \$500 million committed credit facility provided by several banks, cash, cash equivalents and short term investments of \$977 million, as well as \$845 million in uncommitted operating lines of credit provided by several banks for its short term funding requirements.

In the first quarter of 2007, the Company entered into the 364-day revolving committed credit facility of \$500 million, provided by several banks for general corporate purposes, which matures in March 2008 and does not have any financial covenants. At the end of the year, no amounts were drawn on the committed or uncommitted facilities. Borrowings under these credit facilities are based on short term floating interest rates.

Subsequent to year end, the Company entered into discussions, which have not yet been finalized, with a syndicate of banks to replace its \$500 million committed credit facility with a new, longer term committed credit facility of a higher amount. It is anticipated that any new credit facility will contain financial covenants and will be the primary source of the Company's short term funding requirements. Concurrent with these discussions, the Company obtained a 60-day extension of the existing facility, extending the maturity date to May 2008. The new facility is expected to close prior to the expiry of the existing facility.

Securitization of credit card receivables provides President's Choice Bank ("PC" Bank), a wholly owned subsidiary of the Company, with an additional source of funds for the operation of its business. Under PC Bank's securitization program, a portion of the total interest in the credit card receivables is sold to independent trusts. PC Bank securitized an aggregate \$225 million of credit card receivables during 2007 (2006 – \$240 million). In the absence of securitization, the Company would be required to raise alternative financing by issuing additional debt or equity instruments. Further information about PC Bank's credit card receivables and securitization is provided in notes 1 and 10 to the consolidated financial statements and in the Off-Balance Sheet Arrangements section of this MD&A.

In 2006, *PC* Bank restructured its credit card securitization program and Eagle Credit Trust (“Eagle”), a previously established independent trust, issued \$500 million of five year senior notes and subordinated notes due in 2011 at a weighted-average rate of 4.5%. The restructuring of the portfolio yielded a nominal net loss.

The Company has obtained its long term financing primarily through a Medium Term Notes (“MTN”) program. The Company may also refinance maturing long term debt, including \$390 million of 6.00% MTN maturing in 2008, with MTN if market conditions are appropriate following the refiling of a Base Shelf Prospectus or it may consider other alternatives.

In the normal course of business, the Company enters into certain arrangements, such as providing comfort letters to third-party lenders in connection with financing activities of certain franchisees, with no recourse liability to the Company. In addition, the Company establishes standby letters of credit used in connection with certain obligations related to the financing program for its independent franchisees, securitization of *PC* Bank’s credit card receivables, real estate transactions and benefit programs. At year end, the aggregate gross potential liability related to the Company’s standby letters of credit was approximately \$354 million (2006 – \$333 million), against which the Company had \$444 million (2006 – \$371 million) in credit facilities available to draw on.

Between the second quarter of 2007 and February 7, 2008, the Company’s MTN, other notes and debentures ratings were downgraded twice and the commercial paper ratings once by each of Dominion Bond Rating Service (“DBRS”) and Standard & Poor’s (“S&P”). The following table sets out the current credit ratings of the Company.

Credit Ratings (Canadian Standards)	Dominion Bond Rating Service		Standard & Poor’s	
	Credit Rating	Trend	Credit Rating	Outlook
Commercial paper	R-2 (high)	Stable	A-2	Negative
Medium term notes	BBB (high)	Negative	BBB	Negative
Other notes and debentures	BBB (high)	Negative	BBB	Negative

The rating organizations listed above base their credit ratings on quantitative and qualitative considerations. These credit ratings are forward-looking and intended to give an indication of the risk that the Company will not fulfill its obligations in a timely manner.

As a result of the DBRS downgrade of the short term credit rating, the Company has limited access to commercial paper. The Company expects it will be able to secure short term funding from other sources, primarily a new longer term committed credit facility of a higher amount.

The Company’s ability to obtain funding from external sources may be restricted by further downgrades in the Company’s credit ratings, should the Company’s financial performance and condition deteriorate. In addition, credit and capital markets are subjected to inherent global risks that may negatively affect the Company’s access and ability to fund its short term and long term debt requirements. The Company mitigates these risks by actively maintaining appropriate levels of cash and cash equivalents, actively monitoring market conditions and diversifying its sources of funding and maturity profile. The Company also employs risk management strategies including forward-looking liquidity contingency plans.

### Independent Funding Trust

Certain independent franchisees of the Company obtain financing through a structure involving independent trusts, which were created to provide loans to the independent franchisees to facilitate their purchase of inventory and fixed assets, consisting mainly of fixtures and equipment. The gross principal amount of loans issued to the Company’s independent franchisees outstanding as of year end 2007 was \$418 million (2006 – \$419 million) including \$153 million (2006 – \$124 million) of loans payable by VIEs consolidated by the Company in 2007. Based on a formula, the Company has agreed to provide credit enhancement in the form of a standby letter of credit for the benefit of the independent funding trust equal to approximately 10% of the principal amount of the loans outstanding at any point in time, \$44 million (2006 – \$44 million) as of year end 2007. This credit enhancement allows the independent funding trust to provide favourable financing terms to the Company’s independent franchisees. As well, each independent franchisee provides security to the

## Management's Discussion and Analysis

independent funding trust for its obligations by way of a general security agreement. In the event that an independent franchisee defaults on its loan and the Company has not, within a specified time period, assumed the loan, or the default is not otherwise remedied, the independent funding trust shall assign the loan to the Company and draw upon this standby letter of credit. The Company has agreed to reimburse the issuing bank for any amount drawn on the standby letter of credit.

Automatic termination of the agreement can only occur if specific, predetermined events occur and are not remedied within the time periods required including downgrades of the Company below a long term credit rating of "A (low)" or a short term credit rating of "R-1 (low)" as issued by DBRS. On February 7, 2008, DBRS downgraded the Company's long term credit rating to "BBB (high)" from "A (low)" and also lowered the Company's short term credit rating to "R-2 (high)" from "R-1 (low)". Subsequent to the DBRS downgrades, the Company was notified that an Event of Termination of the independent funding trust agreement for the Company's franchisees had occurred as a result of the credit rating downgrades. The \$44 million (2006 - \$44 million) standby letter of credit provided to the independent funding trust by the Company has not been drawn upon.

To address this issue, the Company is currently in the process of securing alternative financing with a syndicate of banks, in the form of a 364-day committed credit facility for the benefit of its franchisees. This new financing is expected to be completed during the second quarter of 2008. Upon closing, this new alternative financing that might be arranged could result in higher financing costs to the franchisees, which in turn could adversely affect operating results. Although the Company anticipates that appropriate financing for the franchisees will continue to be secured in the future, any failure to do so could adversely affect the Company's franchise programs and may impact its operating results. In addition, any new financing structure which might be implemented would need to be reviewed to determine if there are any implications with respect to the consolidation of VIEs.

### 6.3 Contractual Obligations

The following illustrates certain of the Company's significant contractual obligations and discusses other obligations as at December 29, 2007:

#### Summary of Contractual Obligations

(\$ millions)	Payments due by year						Total
	2008	2009	2010	2011	2012	Thereafter	
Long term debt (including capital lease obligations)	\$ 432	\$ 149	\$ 326	\$ 376	\$ 24	\$ 2,977	\$ 4,284
Operating leases <sup>(1)</sup>	192	172	150	128	108	673	1,423
Contracts for purchases of real property and capital investment projects <sup>(2)</sup>	109	4					113
Purchase obligations <sup>(3)</sup>	574	572	564	564	372	-	2,646
<b>Total contractual obligations</b>	<b>\$ 1,307</b>	<b>\$ 897</b>	<b>\$ 1,040</b>	<b>\$ 1,068</b>	<b>\$ 504</b>	<b>\$ 3,650</b>	<b>\$ 8,466</b>

(1) Represents the minimum or base rents payable. Amounts are not offset by any expected sub-lease income.

(2) These obligations include agreements for the purchase of real property and capital commitments for construction, expansion and renovation of buildings. These agreements may contain conditions that may or may not be satisfied. If the conditions are not satisfied, it is possible the Company will no longer have the obligation to proceed with the transaction.

(3) These include contractual obligations of a material amount to purchase goods or services where the contract prescribes fixed or minimum volumes to be purchased or payments to be made within a fixed period of time for a set or variable price. These are only estimates of anticipated financial commitments under these arrangements and the amount of actual payments will vary. These purchase obligations do not include purchase orders issued or agreements made in the ordinary course of business which are solely for goods which are meant for resale, nor do they include any contracts which may be terminated on relatively short notice or with relatively insignificant cost or liability to the Company.

At year end, the Company had other long term liabilities which included accrued benefit plan liability, future income taxes liability, stock-based compensation liability, unrealized equity forwards liability, and an accrued insurance liability. These long term liabilities have not been included in the table for the following reasons:

- future payments of accrued benefit plan liability, principally post-retirement benefits, depend on when and if retirees submit claims;
- future payments of income taxes depend on the levels of taxable earnings and income tax rates;
- future payments of the share appreciation value on employee stock options depend on whether employees exercise their stock options, the market price of the Company's common shares on the exercise date and the manner in which they exercise those stock options;
- future payments of restricted share units depend on the market price of the Company's common shares;
- future payments related to equity forwards depend on the market price of the Company's common shares; and
- future payments of insurance claims can extend over several years and depend on the timing of anticipated settlements and results of litigation.

#### **6.4 Off-Balance Sheet Arrangements**

In the normal course of business, the Company enters into the following off-balance sheet arrangements:

- standby letters of credit used in connection with certain obligations mainly related to real estate transactions and benefit programs, the aggregate gross potential liability of which is approximately \$221 million (2006 – \$221 million);
- guarantees; and
- the securitization of a portion of *PC* Bank's credit card receivables through independent trusts.

##### **Guarantees**

The Company has entered into various guarantee agreements including standby letters of credit in relation to the securitization of *PC* Bank's credit card receivables, third-party financing made available to the Company's independent franchisees, and obligations to indemnify third parties in connection with leases, business dispositions and other transactions in the normal course of the Company's business. For a detailed description of the Company's guarantees, see note 23 to the consolidated financial statements.

##### **Securitization of Credit Card Receivables**

The Company, through *PC* Bank, securitizes credit card receivables through an independent trust administered by a major Canadian chartered bank and through Eagle, also an independent trust. In these securitizations, *PC* Bank sells a portion of its credit card receivables to the trusts in exchange for cash. The trusts fund these purchases by issuing debt securities in the form of asset-backed commercial paper ("ABCP") and asset-backed term notes respectively, to third-party investors. The securitizations are accounted for as asset sales only when *PC* Bank transfers control of the transferred assets and receives consideration other than beneficial interests in the transferred assets. All transactions between the trusts and *PC* Bank have been, and are expected to continue to be, accounted for as sales as contemplated by Canadian GAAP, specifically Accounting Guideline ("AcG") 12, "*Transfers of Receivables*". As *PC* Bank does not control or exercise any measure of influence over the trusts, the financial results of the trusts have not been included in the Company's consolidated financial statements.

When *PC* Bank sells credit card receivables to the trusts, it no longer has access to the receivables but continues to maintain credit card customer account relationships, and certain servicing and administrative responsibilities. *PC* Bank does not receive a servicing fee from the trusts for its servicing responsibilities and accordingly, a servicing obligation is recorded. When a sale occurs, *PC* Bank retains rights to future cash flows after obligations to the investors in the trusts have been met, which is considered to be a retained interest. The ABCP issuing trusts' recourse to *PC* Bank's assets is limited to *PC* Bank's retained interests and is further supported through a standby letter of credit provided by a major Canadian chartered bank for 9% (2006 – 9%) on a portion of the securitized amount. This standby letter of credit could be drawn upon in the event of a major decline in the income flow from, or in the value of, the securitized credit card receivables. The Company has agreed to reimburse the issuing bank for any amount drawn on the standby letter of credit. The subordinated notes issued by Eagle provide credit support to those notes which are more senior. Effective January 1, 2007, the retained interests are recorded at fair value.

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As at year end 2007, the total amount of securitized credit card receivables outstanding which *PC* Bank continues to service was \$1.5 billion (2006 – \$1.3 billion) and the associated retained interests amounted to \$8 million (2006 – \$5 million). The standby letter of credit supporting a portion of these securitized receivables amounted to approximately \$89 million (2006 – \$68 million). During 2007, *PC* Bank received income of \$141 million (2006 – \$114 million) in securitization revenue from the independent trusts relating to the securitized credit card receivables. In the absence of securitization, the Company would be required to raise alternative financing by issuing debt or equity instruments. Further disclosure regarding this arrangement is provided in notes 10 and 23 to the consolidated financial statements.

### Independent Funding Trust

Certain independent franchisees of the Company obtain financing through a structure involving independent trusts, which were created to provide loans to the independent franchisees to facilitate their purchase of inventory and fixed assets, consisting mainly of fixtures and equipment. These trusts are administered by a major Canadian chartered bank. The independent funding trust within the structure finances its activities through the issuance of short term ABCP to third-party investors. The independent funding trust has a global style liquidity agreement from a major Canadian chartered bank in the event that it is unable to issue short term ABCP. The gross principal amount of loans issued to the Company's independent franchisees outstanding as of year end 2007 was \$418 million (2006 – \$419 million) including \$153 million (2006 – \$124 million) of loans payable by VIEs consolidated by the Company in 2007. Based on a formula, the Company has agreed to provide credit enhancement in the form of a standby letter of credit for the benefit of the independent funding trust equal to approximately 10% of the principal amount of the loans outstanding at any point in time, \$44 million (2006 – \$44 million) as of year end 2007. This credit enhancement allows the independent funding trust to provide favourable financing terms to the Company's independent franchisees. As well, each independent franchisee provides security to the independent funding trust for its obligations by way of a general security agreement. In the event that an independent franchisee defaults on its loan and the Company has not, within a specified time period, assumed the loan, or the default is not otherwise remedied, the independent funding trust shall assign the loan to the Company and draw upon this standby letter of credit. The Company has agreed to reimburse the issuing bank for any amount drawn on the standby letter of credit.

Neither the independent funding trust nor the Company can voluntarily terminate the agreement prior to December 2009, and following that date only upon six months' prior notice. Automatic termination of the agreement can only occur if specific, predetermined events occur and are not remedied within the time periods required including downgrades of the Company below a long term credit rating of "A (low)" or a short term credit rating of "R-1 (low)" as issued by DBRS. On February 7, 2008, DBRS downgraded the Company's long term credit rating to "BBB (high)" from "A (low)" and also lowered the Company's short term credit rating to "R-2 (high)" from "R-1 (low)". Subsequent to the DBRS downgrades, the Company was notified that an Event of Termination of the independent funding trust agreement for the Company's franchisees had occurred as a result of the credit rating downgrades. The \$44 million standby letter of credit provided to the independent funding trust by the Company has not been drawn upon. If such an event were to occur, long term debt in the amount of \$126 million would need to be reclassified to short term liabilities. This amount relates to certain franchisees that are VIEs that the Company currently consolidates. The Company is currently in the process of securing alternative financing with a syndicate of banks in the form of a 364-day committed credit facility for the benefit of its franchisees to address this issue. Any new alternative financing structure, which might be implemented, would need to be reviewed to determine if there are any implications with respect to the consolidation of VIEs.

### 6.5 Derivative Instruments

The Company uses derivative instruments to manage its exposure to changes in foreign currency exchange rates, interest rates, commodity prices, and the market price of the Company's common shares. Commencing December 31, 2006, the Company adopted accounting standards which impacted the presentation and disclosure of its derivative instruments. With the adoption of these standards, all financial derivative instruments are accounted for in the Company's balance sheet. In addition, non-financial derivative instruments, such as certain contracts that are linked to commodity prices, are recorded at fair value on the consolidated balance sheet unless they are exempt from this treatment based upon expected purchase, sale or usage requirements. Prior to December 31, 2006, interest rate swaps which were designated within a hedging relationship were not recorded on the balance sheet. For a detailed description of the Company's derivative instruments and the related accounting policies, see notes 1, 2 and 22 to the consolidated financial statements.

## 7. Selected Consolidated Annual Information

The following is a summary of selected consolidated annual information extracted from the Company's audited consolidated financial statements. 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 trends affecting the financial condition and results of operations over the latest two year period.

### Selected Consolidated Annual Information

(\$ millions except where otherwise indicated)	2007 (52 weeks)	2006 (52 weeks)	2005 (52 weeks)
Sales <sup>(2)</sup>	\$ 29,384	\$ 28,640	\$ 27,627
Sales excluding the impact of tobacco sales and VIEs <sup>(1)</sup>	27,915	26,834	25,558
Net earnings (loss)	330	(219)	746
Net earnings (loss) per common share(\$)			
Basic	1.20	(.80)	2.72
Adjusted basic <sup>(1)</sup>	2.05	2.72	3.35
Diluted	1.20	(.80)	2.71
Total assets	13,674	13,486	13,761
Long term debt (excluding amount due within one year)	3,852	4,212	4,194
Dividends declared per common share (\$)	.84	.84	.84

(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.

2007 was a year of transformational change amid intense competition and pressured earnings. Loblaw's declining financial performance since the beginning of 2005 required action to prevent further erosion. Late in 2006, a significant number of changes in the senior leadership occurred and a strategic review was undertaken which resulted in the identification of a turnaround plan to Make Loblaw the Best Again. The approach was built upon three core pillars:

- **Simplify** and sharpen Loblaw by making accountabilities clear and centralizing where it counts, while fixing the basics that matter to customers and matter financially;
- Restore **innovation** to the heart of the Company's culture in food and across all of its control label – make Loblaw brands and assortments "worth switching supermarkets for"; and
- **Grow** Loblaw through its Formula for Growth, but spend capital wisely in an over-spaced market.

Total sales increased 2.6% and same-store sales increased 2.4% in 2007 compared to 2006. The number of corporate stores decreased to 628 from 672 primarily as a result of the Company's store operations restructuring initiative which included the targeted closure of underperforming stores in early 2007. The number of franchised stores increased marginally to 408 in 2007 from 405 in 2006.

2007 was not an easy year for Loblaw. There were challenges, as would be expected, with an organizational change of such magnitude. Net earnings in 2007 were pressured by the Company's investment in lower retail prices and increased costs including significant expenses in restructuring and consulting. Sales for 2007 increased \$744 million, or 2.6%, to \$29.4 billion compared to \$28.6 billion in 2006. Total sales excluding the impact of tobacco sales and VIEs<sup>(1)</sup> increased by 4.0%. The factors explaining the change in 2007 sales compared to 2006 were previously discussed on pages 8 to 9 of this MD&A.

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

## Management's Discussion and Analysis

Corporate store sales per average square foot increased to \$591 in 2007 from \$585 in 2006.

2007 net earnings increased \$549 million to net earnings of \$330 million and basic net earnings per common share increased \$2.00 to a basic net earnings per common share of \$1.20. This increase included an increase of 154.7% in operating income and a 2.7% decrease in interest expense. The effective income tax rate decreased to 31.0% in 2007 from 826.7% in 2006.

Operating income of \$736 million for 2007 increased by \$447 million, or 154.7%, compared to \$289 million in 2006, and resulted in an operating margin of 2.5% as compared to 1.0% in 2006. The items included in operating income were previously described on page 9 of this MD&A.

Adjusted operating income<sup>(1)</sup> for 2007 decreased by \$292 million, or 22.0%, to \$1,034 million compared to \$1,326 million in 2006. Adjusted basic net earnings per common share<sup>(1)</sup> decreased 24.6% to \$2.05 in 2007 from \$2.72 in 2006 and decreased 18.8% to \$2.72 in 2006 from \$3.35 in 2005.

2006 was also a difficult year for Loblaw as it continued to feel the effects in 2006 of certain of its 2005 initiatives, which included restructuring of the supply chain operations, supply chain systems conversions, the reorganization of its merchandising, procurement and operations groups and the move of personnel to the head office in Brampton, Ontario. Additional activities undertaken by Loblaw in 2006 included the negotiation of a new four-year collective agreement with members of certain Ontario locals of the United Food and Commercial Workers union ("UFCW"), the liquidation of certain general merchandise inventory and the closure of certain underperforming stores. During the third quarter of 2006, a major tobacco supplier commenced shipping directly to certain customers of Loblaw's Cash and Carry and wholesale club network, adversely impacting sales in 2006 and 2007.

Sales in 2006 increased 3.7% to \$28.6 billion from \$27.6 billion in 2005. Sales growth in 2006 included a negative impact of approximately 1.2% from declining tobacco sales, and a negative impact of 0.1% from the consolidation of certain Loblaw independent franchisees as required by AcG 15. Sales excluding the impact of tobacco sales and VIEs<sup>(1)</sup> were \$26.8 billion, or 5.0% higher, compared to \$25.6 billion in 2005. Same-store sales increased 0.8% and same-store sales growth excluding the impact of decreased tobacco sales<sup>(1)</sup> increased by 2.0%. Net retail square footage increased 1.2 million square feet, or 2.5%, in 2006 compared to 2005. Corporate store sales per average square foot increased to \$585 in 2006 from \$579 in 2005.

In 2006, net earnings decreased \$965 million compared to 2005, or 129.4%, to a net loss of \$219 million and basic net earnings per common share decreased \$3.52, or 129.4%, to a basic net loss per common share of 80 cents from basic net earnings per common share of \$2.72 in 2005. The decline included a decrease in operating income of \$1,112 million, or 79.4%, to \$289 million compared to \$1,401 million in 2005. Operating income in 2006 was lower than 2005 partially as a result of recording a \$800 million non-cash goodwill impairment charge. The effective income tax rate increased to 826.7% in 2006 from 34.8% in 2005.

Adjusted operating income<sup>(1)</sup> decreased \$274 million in 2006, or 17.1%, to \$1,326 million from \$1,600 million in 2005. Adjusted operating income<sup>(1)</sup> in 2006 was adversely impacted from challenges encountered in 2005 during the execution of planned changes to its systems, supply chain and general merchandise areas, including certain supply chain systems conversions and the start-up of a new third-party owned and operated general merchandise warehouse and distribution centre for eastern Canada which handles general merchandise and certain drugstore products. These challenges disrupted the flow of inventory to Loblaw's stores and resulted in additional operating costs. Fixed asset impairment charges were recorded, due in part to a decision in 2006 to suspend plans for a number of sites scheduled for future development as well as higher general merchandise mark downs taken to clear inventory through normal channels.

Adjusted basic net earnings per common share<sup>(1)</sup> decreased 18.8% to \$2.72 in 2006 from \$3.35 in 2005 and decreased 3.7% to \$3.35 in 2005 from \$3.48 in 2004.

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

Total assets of the Company increased to \$13.7 billion in 2007 from \$13.5 billion in 2006. The increase in total assets was primarily driven by a \$157 million increase in accounts receivable, an increase in other assets of \$133 million, and a decrease in fixed assets of \$102 million. An increase in net credit card receivables was the primary reason for higher accounts receivable. A substantial portion of credit card receivables is sold to independent trusts and the unsecuritized balance net of the allowance for credit losses increased by \$227 million in 2007 and \$74 million in 2006 compared to the previous years respectively. The increase in other assets was primarily due to an increase in unrealized cross currency basis swaps receivable. Fixed assets declined in 2007 as a result of the decision to reduce capital expenditures and concentrate on same-store sales growth rather than space-driven growth in addition to increased sales of fixed assets. Inventory at the end of 2007 remained relatively flat compared to the previous two years. Inventory turns of general merchandise categories are lower than those of food categories, resulting in higher aggregate levels of investment in general merchandise inventory as compared to food inventory. In 2006, goodwill decreased as a result of the non-cash Loblaw goodwill impairment charge.

In 2007, cash flows from operating activities exceeded the funding requirements for the Company including capital expenditures and dividends. Additional details of cash flows were previously discussed on pages 13 to 14 of this MD&A. Free cash flow<sup>(1)</sup> improved to \$402 million in 2007 compared to \$70 million in 2006 and \$103 million in 2005. In 2006, cash flows from operating activities covered a large portion of the funding requirements for the Company including capital expenditures and dividends. While the Company issued long term debt net of amounts retired in 2005, long term debt was repaid in 2006.

The annualized dividend per common share was equal to 30.9% in 2007 and 25.1% in 2006 of the previous years adjusted basic net earnings per common share<sup>(1)</sup>.

During 2007, the Company did not purchase common shares for cancellation pursuant to its NCIB (2006 – nil).

During the two year period ended December 29, 2007, the Company implemented several new accounting standards issued by the Canadian Institute of Chartered Accountants (“CICA”). The new accounting standards implemented in 2007 and the resulting impact on the financial position and results of operations are outlined in the Accounting Standards Implemented in 2007 section of this MD&A. The accounting standards implemented in 2006 did not have a material impact on the financial position and results of operations of the Company.

## **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.

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

## Management's Discussion and Analysis

### Summary of Quarterly Results (unaudited)

(\$ millions except where otherwise indicated)	2007					2006				
	First Quarter	Second Quarter	Third Quarter	Fourth Quarter	Total (audited)	First Quarter	Second Quarter	Third Quarter	Fourth Quarter	Total (audited)
Sales	\$6,347	\$6,933	\$9,137	\$6,967	\$29,384	\$6,147	\$6,699	\$9,010	\$6,784	\$28,640
Net earnings (loss)	54	119	117	40	330	140	194	203	(756)	(219)
Net earnings (loss) per common share										
Basic (\$)	\$ 0.20	\$ 0.43	\$ 0.43	\$ 0.14	\$ 1.20	\$ 0.51	\$ 0.71	\$ 0.74	\$ (2.76)	\$ (0.80)
Diluted (\$)	\$ 0.20	\$ 0.43	\$ 0.43	\$ 0.14	\$ 1.20	\$ 0.51	\$ 0.71	\$ 0.74	\$ (2.76)	\$ (0.80)

Sales growth in 2007 was impacted by various factors. Sales and same-store sales growth were positive in all four quarters of 2007 compared to 2006. Sales growth during the first three quarters of 2007 continued to be negatively impacted by the loss of tobacco sales as discussed previously. Tobacco sales are not a large earnings contributor. Quarterly same-store sales growth for 2007 for the first through fourth quarters of 2007 were 2.4%, 2.7%, 1.6%, and 2.6%, respectively. Quarterly same-store sales growth excluding the impact of decreased tobacco sales<sup>(1)</sup> for the first through fourth quarters of 2007 were 4.0%, 4.2%, 2.8%, and 2.7%, respectively.

Food price inflation fell as the year progressed resulting, in part, from the Company's investment in lower retail pricing during 2007 as well as pricing activity within the industry. National food price inflation as measured by CPI was 3.8% in the first quarter of 2007 but decreased to 0.8% in the fourth quarter of 2007. During each consecutive quarter of 2007, the Company's internal retail food price inflation decreased ranging from 3.0% inflation in the first quarter of 2007 to 1.6% deflation in the fourth quarter.

Net retail square footage decreased in 2007 by 0.1 million square feet, to 49.6 million square feet, with no significant changes in any quarters during the year.

Fluctuations in quarterly net earnings during 2007 reflect the impact of a number of specific charges outlined previously including the implementation of transformative changes. Solid sales were achieved in all four quarters of 2007 but earnings were pressured from investments in pricing, particularly in the third and fourth quarters as cost reduction lagged the pricing investments.

Interest expense was reasonably consistent during each quarter of 2007 and was \$252 million in 2007 compared to \$259 million in 2006.

The change in the effective income tax rates for 2007 over 2006 was primarily due to the non-cash goodwill impairment charge recorded in 2006 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.

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

## 8.2 Fourth Quarter Results

The following is a summary of selected consolidated unaudited financial information for the fourth quarter of 2007. 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)	2007 (12 weeks)	2006 (12 weeks)
Sales	\$ 6,967	\$ 6,784
Sales excluding the impact of tobacco sales and VIEs <sup>(1)</sup>	6,640	6,450
Operating income (loss)	134	(695)
Adjusted operating income <sup>(1)</sup>	221	286
Interest expense	59	60
Income taxes	27	2
Net earnings (loss)	40	(756)
Net earnings (loss) per common share (\$)		
Basic	0.14	(2.76)
Adjusted basic <sup>(1)</sup>	0.43	.58
Diluted	0.14	(2.76)
Cash flows from (used in):		
Operating activities	508	777
Investing activities	(230)	(409)
Financing activities	(166)	(267)
Dividends declared per common share (\$)	.21	.21

Total sales for the fourth quarter of 2007 increased \$183 million, or 2.7%, to \$7.0 billion compared to \$6.8 billion in the fourth quarter of 2006. Sales volume based on retail units sold grew by 3.6% (2006 – 2.4%) in the fourth quarter compared to the same period last year. Same-store sales increased by 2.6%. Total sales excluding the impact of tobacco sales and variable interest entities<sup>(1)</sup> increased by 2.9%.

### Total Sales and Sales Excluding the Impact of Tobacco Sales and VIEs<sup>(1)</sup>

For the periods ended December 29, 2007 and December 30, 2006 (unaudited) (\$ millions)	2007 (12 weeks)	2006 (12 weeks)
Total sales	\$ 6,967	\$ 6,784
Less: Sales attributable to tobacco sales	219	242
Sales attributable to the consolidation of VIEs	108	92
Sales excluding the impact of tobacco sales and VIEs <sup>(1)</sup>	\$ 6,640	\$ 6,450

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

## Management's Discussion and Analysis

### Sales Growth and Same-Store Sales Growth

For the periods ended December 29, 2007 and December 30, 2006 (unaudited) (percentage)	2007 (12 weeks)	2006 (12 weeks)
Total sales growth	2.7%	3.5%
Less: Impact on sales growth attributable to tobacco sales	(0.4%)	(2.0%)
Impact on sales growth attributable to the consolidation of VIEs	0.2%	(0.2%)
Sales growth excluding the impact of tobacco sales and VIEs <sup>(1)</sup>	2.9%	5.7%
Same-store sales growth	2.6%	1.3%
Same-store sales growth excluding the impact of decreased tobacco sales <sup>(1)</sup>	2.7%	3.3%

Total sales increases in the fourth quarter of 2007 were achieved by positive growth in both item and customer counts despite internal food price deflation. Total sales increases were realized in Ontario, Quebec and western Canada. Total sales increased in food and drugstore while general merchandise sales were lower because of the intentional restriction of inventory as Loblaw continued to work on optimizing inventory controls, product mix and markdown strategies.

*The Real Canadian Superstore* banner in Ontario continued to achieve solid sales growth in the fourth quarter of 2007. The Company also experienced positive volume growth, based on retail units sold, of 3.6% in the fourth quarter of 2007 compared to the fourth quarter of 2006. The volume growth in the fourth quarter of 2006 was 2.4% compared to the fourth quarter of 2005.

The Company's analysis indicates that it had internal retail food price deflation of approximately 1.6% compared to the fourth quarter of 2006. National food price inflation as measured by CPI was 0.8% for the fourth quarter of 2007 compared to approximately 1.5% in the same period of 2006. This measure of inflation does not necessarily reflect the effect of inflation on the specific mix of goods offered in Loblaw stores.

During the fourth quarter of 2007, 8 new corporate and franchised stores were opened and 8 were closed, resulting in a net increase of 0.1 million square feet, or 0.1%, compared to the third quarter of 2007.

Operating income of \$134 million for the fourth quarter of 2007 increased by \$829 million, or 119.3%, compared to an operating loss of \$695 million in 2006. Operating margin was 1.9% compared to (10.2%) in the fourth quarter of 2006. The 2006 operating loss was affected by an \$800 million non-cash goodwill impairment charge related to the goodwill associated with the acquisition of Provigo Inc. in 1998.

In the fourth quarter of 2007, the Company recognized the following in operating income:

- charge of \$29 million (2006 – nil) related to Project Simplify involving restructuring and streamlining of merchandising and store operations. Costs were comprised of \$19 million for employee termination benefits including severance, additional pension costs resulting from the termination of employees and retention costs; and \$10 million of other costs, primarily consulting;
- charge of \$7 million (2006 – nil) in connection with restructuring the Company's supply chain network;
- nil (2006 – \$35 million) in connection with the closure of certain stores in the Quebec and Atlantic markets and in the wholesale network that was part of the store operations restructuring activities;
- charge of \$52 million (2006 – income of \$6 million) for the net effect of stock-based compensation and the associated equity forwards. The majority of the expense in the fourth quarter of 2007 included a non-cash loss on equity forwards of \$55 million (2006 – income of \$10 million) resulting from a decline in the Company's share price during the fourth quarter of 2007. At the end of the fourth quarter of 2007, the Company had cumulative equity forwards to buy 4.8 million (2006 – 4.8 million) of its common shares;
- charge of \$3 million (2006 – \$68 million) from the liquidation of excess general merchandise inventory. The liquidation was completed as expected in the fourth quarter of 2007;
- income of \$4 million (2006 – nil) resulting from the consolidation of VIEs;
- nil (2006 – charge of \$800 million) for a non-cash goodwill impairment charge related to the goodwill established on the acquisition of Provigo Inc. in 1998; and

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

- nil (2006 – charge of \$84 million) related to the ratification of a new four-year collective agreement with members of certain Ontario locals of the UFCW.

After adjusting for the above-noted items, adjusted operating income<sup>(1)</sup> in the fourth quarter of 2007 decreased by \$65 million, or 22.7%, to \$221 million compared to \$286 million in the fourth quarter of 2006. Adjusted operating margin<sup>(1)</sup> decreased to 3.3% in the fourth quarter of 2007 compared to 4.4% in 2006 as growth in operating expenses exceeded growth in sales.

In addition, adjusted operating income<sup>(1)</sup> in the fourth quarter of 2007 was influenced by the following items:

- gross margin declined approximately \$60 million from 2006, which represents 0.9% of sales, primarily due to targeted price reductions, to provide value to customers and drive same-store sales and sales volumes, and changes in sales mix partially offset by improvements in shrink;
- incremental consulting costs compared to the prior year, other than those in connection with Project Simplify, amounted to \$12 million including expenses related to new supply chain and information technology improvement initiatives of \$6 million;
- a gain of \$11 million from the sale of an office building in Calgary, Alberta; and
- incremental non-cash fixed asset impairment charge of \$9 million related to asset carrying values in excess of fair values at specific store locations. The charge in the fourth quarter of 2007 was \$33 million compared to \$24 million in the fourth quarter of 2006.

Gross margin percentage continued to decline in the fourth quarter of 2007 as a result of the Company's continued investment in lower prices, as part of its Credit for Value initiative, to drive same-store sales growth in a targeted manner across the country. Sales increases in the quarter were insufficient to offset margin declines. The Company continued to experience higher store labour costs due to marketplace pressures and achieved reduced inventory shrink expenses in the fourth quarter of 2007 compared to the same quarter in 2006.

Adjusted EBITDA<sup>(1)</sup> and EBITDA margin<sup>(1)</sup> for the fourth quarter were \$349 million and 5.3%, respectively. For the comparable period of 2006, adjusted EBITDA<sup>(1)</sup> and EBITDA margin<sup>(1)</sup> were \$414 million and 6.4%, respectively.

Total interest expense for the fourth quarter of 2007 was \$59 million, similar to the \$60 million interest expense in the fourth quarter of 2006.

The effective income tax rate for the fourth quarter of 2007 was 36.4% compared to negative 0.3% in 2006. This significant change in the effective income tax rate was due to the non-cash goodwill impairment charge recorded in the fourth quarter of 2006 which is non-deductible for income tax purposes. In addition, the effective income tax rate was impacted due to the change in the proportion of taxable income earned across the different tax jurisdictions in which the Company operated. A reduction to the future income tax expense was recognized in the fourth quarter of 2007 as a result of the change in the Canadian statutory income tax rates.

Net earnings for the quarter were \$40 million, an increase of \$796 million compared to a net loss of \$756 million during the same period in 2006. Basic net earnings per common share were \$0.14, an increase of \$2.90, or 105.1%, from a basic net loss per common share of \$2.76 in the fourth quarter of 2006. Adjusted basic net earnings per common share<sup>(1)</sup> decreased \$0.15, or 25.9%, to \$0.43 in 2007 from \$0.58 in 2006.

Fourth quarter cash flows from operating activities were \$508 million in 2007 compared to \$777 million in 2006. The decrease was mainly due to the change in non-cash working capital, primarily as a result of changes in inventory and accounts payable and accrued liabilities. Fourth quarter cash flows used in investing activities were \$230 million in 2007 compared to \$409 million in 2006, primarily driven by an increase in proceeds from fixed asset sales of \$157 million. Capital investment for the fourth quarter amounted to \$173 million (2006 – \$261 million). Fourth quarter cash flows used in financing activities were \$166 million in 2007 compared to \$267 million in 2006 mainly due to changes in commercial paper levels partially offset by changes in short term debt.

During the fourth quarter, the Company sold property and a partially constructed building for a purchase price of approximately \$110 million. Loblaw leased back the property from the buyer for a term of 20 years, with options to renew, and in turn, subleased the property to a third-party logistics provider. The Company also entered into a warehousing and distribution agreement with the third-party logistics provider, which will use this property to provide services to Loblaw.

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

## Management's Discussion and Analysis

### 9. Internal Control over Financial Reporting

Management is responsible for establishing and maintaining adequate internal control over financial reporting to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with Canadian GAAP.

Management has concluded that, as of December 29, 2007, a previously reported weakness no longer exists in the design of the Company's internal control over financial reporting in the area of inventory controls. This design weakness was first identified in the first quarter of 2007 and was caused primarily by the lack of sufficient compensating controls in the absence of a perpetual inventory system.

Management continues to monitor and improve controls related to inventory and has designed and implemented the following compensating controls:

- New policies and procedures were developed and implemented throughout the third and fourth quarters of 2007 relating to:
  - Authorization procedures for the recommendation and processing of inventory markdowns;
  - Excess inventory review procedures; and
  - Regular assessments of the appropriateness of assumptions used in identifying excess inventory.
- Management has enhanced the quarterly retail count process by designing and implementing a statistically sound count method that is able to be extrapolated across Loblaw inventory.
- The assumptions used to determine the discount rate to calculate the cost value of inventory are now evaluated on a more standardized and regular basis.
- The assumptions and guidance used to identify excess inventory and apply related markdowns are now evaluated on a more standardized and regular basis.

Other than the remediation steps discussed above, there was no change in the Company's internal controls over financial reporting that occurred during the 12 weeks ended December 29, 2007 that materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

### 10. Management's Certification of Disclosure Controls and Procedures

Management is responsible for designing disclosure controls and procedures to provide reasonable assurance that all material information relating to the Company and its subsidiaries is gathered and reported to senior management on a timely basis so that appropriate decisions can be made regarding public disclosure. As required by Multilateral Instrument 52-109 (Certification of Disclosure in Issuers' Annual and Interim Filings) of the Canadian Securities Administrators, the Executive Chairman, as Chief Executive Officer, and the Chief Financial Officer have evaluated the effectiveness of such disclosure controls and procedures and have concluded that the Company's disclosure controls and procedures were effective as at December 29, 2007.

### 11. Risks and Risk Management

#### 11.1 Operating Risks and Risk Management

In 2007, the Company assessed key operating risks by conducting risk interviews with members of the senior management team. Risks identified through these interviews were analyzed and discussed as part of the Company's annual business planning process and were also factored into the development of a risk-based internal audit plan.

Descriptions of the risks and risk management strategies identified through risk interviews and the business planning process are included in the operational risks discussed below, any of which has the potential to negatively affect the financial performance of the Company. The Company has operating and risk management strategies, including insurance programs, which help to mitigate the potential financial impact of these operating risks. While the Company employs strategies to minimize these risks, these strategies do not guarantee that events or circumstances will not occur which could negatively affect the Company's financial condition and performance.

## **Industry and Competitive Environment**

The retail industry in Canada is highly competitive. The industry is driven primarily by consumer demand, which is impacted by economic trends, changing demographics, ethnic diversity, health and environmental awareness and time availability. Recent consumer trends that dominate the industry include customer's concerns for their own and their family's health, lack of time, increasing demand for value and premium products in one location, a willingness to buy certain general merchandise on food-focused shopping trips and an increasing demand that retailers source ethically and in a way that demonstrates care for the environment and the community. If the Company is ineffective in responding to these trends or ineffective in executing its strategies, its financial performance could be negatively impacted.

The Company's competitors include traditional supermarket operators, as well as mass merchandisers, warehouse clubs, drugstores, limited assortment stores, discount stores, convenience stores and specialty stores. Many of these competitors now offer a selection of food, drugstore and general merchandise. Others remain focused on supermarket-type merchandise. The Company is also subject to competitive pressures from new entrants into the marketplace and from the expansion of existing competitors, particularly those expanding into the grocery market. These competitors may have extensive resources which will allow them to compete effectively with the Company in the long term. Increased competition could adversely affect the Company's ability to achieve its objectives. The Company's inability to compete effectively with its current or any future competitors could result in, among other things, lessening of market share and lower pricing in response to its competitors' pricing activities. Accordingly, the Company's competitive position and financial performance could be negatively impacted.

The Company monitors its market share and the markets in which it operates and will adjust its operating strategies, which include, but are not limited to, closing underperforming stores, relocating stores or reformatting them under a different banner, reviewing pricing and adjusting product offerings and marketing programs. The Company's control label program represents a competitive advantage because it enhances customer loyalty by offering superior value and provides some protection against national brand pricing strategies.

## **Change Management and Execution**

2007 was a year of significant change for the Company. Project Simplify resulted in changes to the Company's structures and business processes. Other significant initiatives in support of the Company's multi-year turnaround plan are underway or planned. While these changes are expected to bring benefits to the Company in the form of a more agile and consumer-focused business, success is dependent on management effectively realizing the intended benefits. Ineffective change management may result in disruptions to the operations of the business or affect the ability of the Company to implement and achieve its strategic objectives due to a lack of clear accountabilities or lack of requisite knowledge, which may cause employees to act in a manner which is inconsistent with Company objectives. Any of these events could negatively impact the Company's performance. The Company may not always achieve the expected cost savings and other benefits of its initiatives.

## **Information Technology**

To support the current and future requirements of the business in an efficient, cost-effective and well-controlled manner, the Company is reliant on information technology (IT) systems. These systems are essential in providing management with the appropriate information for decision making, including its key performance indicators. Any significant failure or disruption of these systems could negatively affect the Company's reputation, revenues and financial performance.

The Company has under invested in its IT infrastructure in the past and its systems were in need of being upgraded. These systems may not properly support the required business processes of the Company. During 2007, an IT strategic plan was developed to guide the new systems environment that Loblaw requires. This plan will begin to be implemented in 2008. Change management risk and other associated risks will arise from the various projects which will be undertaken to upgrade existing systems and introduce new systems to effectively manage the business going forward. Failure by the Company to appropriately invest in information technology or failure to implement information technology infrastructure in a timely or effective manner may negatively impact the Company's financial performance.

Any failures in the Company's information security systems or non-compliance with information security standards, including those in relation to personal information belonging to the Company's customers, could result in harm to the reputation or competitive position of the Company and could negatively affect financial performance.

## Management's Discussion and Analysis

### Supply Chain

The need to invest in and improve the Company's supply chain may adversely affect the Company's capacity to effectively and efficiently access current and potential customers. A significant restructuring of the Company's supply chain is planned for the next several years. Although this initiative is expected to result in improved service levels for the Company's stores, the scale of the change and the implementation of new processes could cause disruption in the flow of goods to stores, which would negatively affect sales. The Company's plans to grow its apparel business depend on improvements to the current supply chain processes related to that merchandise. Before and as these changes are implemented, it is possible that the flow of these goods could also be negatively affected, which could negatively affect sales.

### Food Safety and Public Health

The Company is subject to risks associated with product defects, food safety and product handling. Such liabilities may arise in relation to the storage, distribution and display of products and, with respect to the Company's control label products, in relation to the production, packaging and design of products. Any event related to these matters has the potential to adversely affect the Company's reputation and its financial performance.

A majority of the Company's sales are generated from food products and the Company could be vulnerable in the event of a significant outbreak of food-borne illness or increased public health concerns in connection with certain food products. Such an event could negatively affect the Company's financial performance. Procedures are in place to manage such events, should they occur. These procedures identify risks, provide clear communication to employees and consumers and are aimed at ensuring that potentially harmful products are expeditiously removed from inventory. The Company has food safety procedures and programs which address safe food handling and preparation standards. The Company endeavours to employ best practices for the storage and distribution of food products and also actively supports consumer awareness of safe food handling and consumption. The ability of these procedures to address such events is dependent on their successful execution. The existence of these procedures does not mean that the Company will in all circumstances be able to mitigate these risks.

The Company strives to ensure its control label products meet all applicable regulatory requirements including having nutritional labelling so that today's health conscious consumer can make informed choices.

### Labour

A majority of the Company's store level and distribution centre workforce is unionized. Renegotiating collective agreements may result in work stoppages or slowdowns, which could negatively affect the Company's financial performance, depending on their nature and duration. The Company is willing to accept the short term costs of labour disruption in order to negotiate competitive labour costs and operating conditions for the longer term. Significant labour negotiations took place across the Company in 2007 as 73 collective agreements expired and 68 collective agreements were successfully negotiated, which represented a combination of agreements expiring in 2007, those carried over from prior years, and those negotiated early. In 2008, 73 collective agreements affecting approximately 14,000 employees will expire, with the single largest agreement covering approximately 3,100 employees. The Company will also continue to negotiate the 67 collective agreements carried over from 2005, 2006 and 2007. The Company has good relations with its employees and unions and, although it is possible, Loblaw does not anticipate any unusual difficulties in renegotiating these agreements.

Several of the Company's competitors operate in a non-union environment. These competitors may benefit from lower labour costs and more favourable operating efficiencies, making it more difficult for the Company to compete.

## **Franchisees**

A substantial portion of the Company's revenues and earnings come from amounts paid by franchisees. Franchisees are independent businesses and, as a result, their operations may be negatively affected by factors beyond the Company's control which in turn may damage the Company's reputation and potentially affect revenues and earnings. Revenues and earnings would also be negatively affected and the Company's reputation could be harmed, if a significant number of franchisees were to: experience operational failures, including health and safety exposures; experience financial difficulty; be unwilling or unable to pay the Company for products rent or other fees; or fail to enter into renewals of franchise agreements. The Company's franchise system is also subject to franchise laws and regulations enacted by a number of provinces. Any new legislation or failure to comply with existing legislation may negatively affect operations, and could add administrative costs and burdens associated with these regulations, all of which could affect the Company's relationship with its franchisees.

## **Employee Future Benefit Contributions**

While the Company's registered funded defined benefit pension plans are currently adequately funded and returns on defined pension plan assets are in line with expectations, there is no assurance that these trends will continue. An extended period of depressed capital markets and low interest rates could require the Company to make contributions to its registered funded defined benefit pension plans in excess of those currently contemplated, which in turn could have a negative effect on the Company's financial performance.

During 2007, the Company contributed \$74 million (2006 – \$88 million) to its registered funded defined benefit pension plans. During 2008, the Company expects to contribute approximately \$76 million to these plans. This estimate may vary subject to actuarial valuations being completed, market performance and regulatory requirements. The Company also expects to make contributions in 2008 to defined contribution pension plans and multi-employer pension plans, as well as benefit payments to the beneficiaries of the unfunded defined benefit pension and other benefit plans.

## **Multi-Employer Pension Plans**

In addition to the Company-sponsored pension plans, the Company participates in various multi-employer pension plans, providing pension benefits in which approximately 41% (2006 – 41%) of employees of the Company and of its independent franchisees participate. The administration of these plans and the investment of their assets are legally controlled by a board of independent trustees generally consisting of an equal number of union and employer representatives. In some circumstances, Loblaw may have a representative on the board of trustees of these multi-employer pension plans. The Company's responsibility to make contributions to these plans is limited by the amounts established pursuant to its collective agreements; however, poor performance of these plans could have an adverse impact on the Company's employees and former employees who are members of these plans. Pension cost for these plans is recognized as contributions are due.

During the first quarter of 2007, the Company was one of 17 defendants served with an action brought in the Superior Court of Ontario by certain beneficiaries of a multi-employer pension plan in which the Company's employees and those of its independent franchisees participate. In their claim against the employers and the trustees of the multi-employer pension plan, the plaintiffs claim that assets of the multi-employer pension plan have been mismanaged and are seeking, among other demands, damages of \$1 billion. The action is framed as a representative action on behalf of all the beneficiaries of the multi-employer pension plan. The Company has received notice from counsel for the plaintiffs indicating that he has received instructions from his client to discontinue the action against the employers including the Company. The action against the trustees is ongoing and one of the trustees, an officer of the Company, may be entitled to indemnification from the Company.

## **Third-Party Suppliers**

Certain aspects of the Company's business are significantly affected by third parties who provide Loblaw with goods and services. Although appropriate contractual arrangements are put in place with these third parties, the Company has no direct influence over how such third parties are managed. It is possible that negative events affecting these third parties could in turn negatively impact the Company's operations and its financial performance.

## Management's Discussion and Analysis

A large portion of the Company's case-ready meat products are produced by a third party which operates facilities dedicated to Loblaw. The Company's control label products, which are among the most recognized brands in Canada, are manufactured under contract by third-party vendors. In order to preserve the brands' equity, these vendors are held to high standards of quality. The Company also uses third-party logistic services including those in connection with a dedicated warehouse and distribution centre in Pickering, Ontario, a planned warehouse and distribution centre in Ajax, Ontario, and third-party common carriers. Any disruption in these services could interrupt the delivery of merchandise to the stores and therefore could negatively impact sales.

*President's Choice Financial* banking services are provided by a major Canadian chartered bank. *PC Bank* uses third-party service providers to process credit card transactions, operate call centres and monitor a portion of credit and fraud for the *President's Choice Financial MasterCard®*. To minimize operating risk, *PC Bank* and the Company actively manage and monitor their relationships with all third-party service providers. *PC Bank* has developed a vendor management policy, approved by its Board of Directors, and has established a vendor management team that provides its Board with regular reports on vendor management and risk assessment. *PC Financial* home and auto insurance products are provided by companies within the Aviva Canada group, the Canadian subsidiary of a major international property and casualty insurance provider.

### **Excess Inventory**

It is possible that certain of the Company's general merchandising programs will result in excess inventory that cannot be sold profitably through the Company's stores. Excess inventory may result in mark downs, shrink or the need to liquidate the inventory, all of which may negatively impact the Company's financial performance. In addition, the Company's current inventory management infrastructure, including its information technology systems, is not efficient in its tracking of inventory through all stages of the supply chain, although, the Company has implemented procedures and information technology workarounds which provide management with the ability to adequately detect and quantify excess and obsolete inventory.

### **Real Estate**

Real estate development plans may be contingent on successful negotiation of labour agreements with respect to same-site expansion or redevelopment. As the Company continues to offer general merchandise, on-time execution of the real estate program becomes increasingly important due to significantly longer lead times required for ordering this merchandise. Delays in execution could lead to inventory management issues. The Company maintains a significant portfolio of owned retail real estate and, whenever practical, pursues a strategy of purchasing sites for future store locations. This enhances the Company's operating flexibility by enabling the Company to introduce new departments and services that could be precluded under third party operating leases. At year end 2007, the Company owned 73% (2006 – 72%) of its corporate store square footage and owned 46% (2006 – 45%) of its franchise square footage.

### **Seasonality**

The Company's operations as they relate to food, specifically inventory levels, sales volume and product mix, are impacted to some degree by certain holiday periods in the year. Certain general merchandise items are subject to more seasonal fluctuations.

### **Colleague Development and Retention**

The degree to which the Company is not effective in developing its employees and establishing appropriate succession planning processes and retention strategies could lead to a lack of requisite knowledge, skills and experience which could, in turn, affect Loblaw's ability to execute its strategies, efficiently run its operations and meet its goals for financial performance. The Company continues to focus on the development of colleagues at all levels and across all regions. Effective colleague development and succession planning are essential to sustaining the growth and success of the Company. However, these areas are not yet fully developed and the Company is implementing such processes.

The tight labour market in Western Canada has created unique challenges to effectively operate stores and distribution centres, thereby affecting the Company's ability to meet its business objectives. The Company has implemented programs to attract the appropriate calibre of employee in a very competitive environment, but there is no certainty that these programs will continue to be effective.

### **Utility and Fuel Prices**

The Company is a significant consumer of electricity, other utilities and fuel. The Company has entered into contracts to fix the price of a portion of its future variable costs associated with electricity and natural gas. Despite these arrangements, unanticipated cost increases in these items could negatively affect the Company's financial performance.

### **Environmental, Health and Safety**

Adverse environmental and health and safety events could negatively affect the Company's reputation and financial performance. The Company has environmental, health and workplace safety programs in place and has established policies and procedures aimed at ensuring compliance with applicable legislative requirements. To this end, the Company employs environmental risk assessments and audits using internal and external resources together with employee awareness programs throughout its operating locations. The Company endeavours to be socially and environmentally responsible, and recognizes that the competitive pressures for economic growth and cost efficiency must be integrated with sound environmental stewardship and ecological considerations. Environmental protection requirements do not and are not expected to have a material effect on the Company's financial performance.

The Environmental, Health and Safety Committee of the Board receives regular reporting from management, addressing current and potential future issues, identifying new regulatory concerns and related communication efforts. The Company's dedicated Environmental Affairs staff work closely with the operations to help ensure that corporate requirements are met.

### **Ethical Business Conduct**

The Company has adopted a Code of Business Conduct which employees and directors of the Company are required to acknowledge and agree to on a regular basis. The Company has in place an Ethics and Business Conduct Committee which monitors compliance with the Code of Business Conduct and determines how the Company can best ensure it is conducting its business in an ethical manner. The Company has also adopted a Vendor Code of Conduct which outlines its ethical expectations to its vendor community in a number of areas, including social responsibility. Any failure of the Company or its vendors to adhere to these policies, the law or ethical business practices could significantly affect Loblaw's reputation and brands and could, therefore, negatively impact the Company's financial performance.

### **Legal, Taxation and Accounting**

Changes to any of the laws, rules, regulations or policies related to the Company's business including the production, processing, preparation, distribution, packaging and labelling of its products could have an adverse impact on Loblaw's financial and operational performance. In the course of complying with such changes, the Company may incur significant costs. Failure by the Company to fully comply with applicable laws, rules, regulations and policies may subject it to civil or regulatory actions or proceedings, including fines, assessments, injunctions, recalls or seizures, which may have an adverse effect on the Company's financial results.

The Company is subject to various laws regarding the protection of personal information and has adopted a Privacy Code setting out guidelines for the handling of personal information. Any failure of the Company to comply with these laws may result in damage to its reputation and negatively affect financial performance.

There can be no assurance that the tax laws and regulations in the jurisdictions affecting the Company will not be changed in a manner which could adversely affect the Company. New accounting pronouncements introduced by appropriate authoritative bodies may also impact the Company's financial results.

### **Insurance**

The Company attempts to limit its exposure to certain risks through a combination of appropriate levels of self-insurance and the purchase of various insurance coverages, including an integrated insurance program. The Company's insurance program is based on various lines and limits of coverage. Insurance is arranged on a multi-year basis with reliable, financially stable insurance companies as rated by A.M. Best Company, Inc. The Company combines comprehensive risk management programs and the active management of claims handling and litigation processes by using internal professionals and external technical expertise. These programs do not guarantee that any given risk will be mitigated in all circumstances.

## Management's Discussion and Analysis

### Holding Company Structure

Loblaw Companies Limited is a holding company. As such, it does not carry on business directly but does so through its subsidiaries. It has no major source of income or assets of its own, other than the interests it has in its subsidiaries, which are all separate legal entities. Loblaw Companies Limited is therefore financially dependent on dividends and other distributions it receives from its subsidiaries.

### 11.2 Financial Risks and Risk Management

In the normal course of business, the Company is exposed to financial risks that have the potential to negatively affect its financial performance including financial risks related to changes in foreign currency exchange rates, interest rates and the market price of the Company's common shares. These risks and the actions taken to minimize them are discussed below. The Company is also exposed to credit risk on certain of its financial instruments. While the Company employs strategies to minimize these risks, these strategies do not guarantee that events or circumstances will not occur that negatively affect the Company's financial condition and performance.

#### Liquidity

The Company's ability to obtain funding from external sources may be restricted by further downgrades in the Company's credit ratings, should the Company's financial performance and condition deteriorate. In addition, credit and capital markets are subjected to inherent global risks that may negatively affect the Company's access and ability to fund its short term and long term debt requirements. The Company mitigates these risks by actively maintaining appropriate levels of cash and cash equivalents, actively monitoring market conditions and diversifying its sources of funding and maturity profile. The Company also employs risk management strategies including forward-looking liquidity contingency plans.

#### Common Share Market Price

Fluctuations in the Company's earnings can occur from changes in the value of equity forward contracts and stock-based compensation costs resulting from movements in the Company's common share market price. The Company enters into equity forwards to manage its exposure to fluctuations in its stock-based compensation cost as a result of changes in the market price of its common shares. These equity forwards change in value as the market price of the underlying common shares changes, which results in a partial offset to fluctuations in the Company's stock-based compensation costs. The partial offset between the Company's stock-based compensation costs and the equity forwards exists as long as the market price of the Company's common shares exceeds the exercise price of employee stock options. As at year end 2007, 6,431,699 stock options had exercise prices which were greater than the market price of the Company's common shares at year end.

#### Credit

The Company is exposed to credit risk resulting from the possibility that counterparties may default on their financial obligations, or if there is a concentration of transactions carried out with the same counterparty or of financial obligations which have similar economic characteristics such that they could be similarly affected by changes in economic conditions. Exposure to credit risk relates to derivative instruments, cash equivalents and short term investments, *PC Bank's* credit card receivables and accounts receivable from independent franchisees, associates and independent accounts.

The Company may be exposed to losses should any counterparty to the Company's financial or non-financial derivative agreements fail to fulfill its obligations. The Company has sought to minimize potential counterparty risk and losses by conducting transactions for its derivative agreements with counterparties that have at minimum a long term "A" credit rating from a recognized credit rating agency and by placing risk adjusted limits on its exposure to any single counterparty for its financial derivative agreements. The Company has internal policies, controls and reporting processes, which require ongoing assessment and corrective action, if necessary, with respect to its derivative transactions. In addition, principal amounts on cross currency basis swaps and equity forwards are each netted by agreement and there is no exposure to loss of the original notional principal amounts on the interest rate swaps and equity forwards.

Credit risk associated with the Company's cash equivalents and short term investments results from the possibility that a counterparty may default on the repayment of a security. The Company attempts to mitigate this risk through policies and guidelines that require issuers of permissible investments to have at minimum a long term "A" credit rating from a recognized credit rating agency and that specify minimum and maximum exposures to specific issuers, and that specify the type of instruments to be held by the Company.

Credit risk from *PC* Bank's credit card receivables and receivables from independent franchisees, associates and independent accounts results from the possibility that customers may default on their payment obligation. *PC* Bank manages the credit card receivable risk by employing stringent credit scoring techniques and actively monitoring the credit card portfolio and reviewing techniques and technology that can improve the effectiveness of the collection process. In addition, these receivables are dispersed among a large, diversified group of credit card customers.

Accounts receivable from independent franchisees, associates and independent accounts are actively monitored on an ongoing basis and settled on a frequent basis in accordance with the terms specified in the applicable agreements.

### **Derivative Instruments**

The Company uses over-the-counter financial derivative instruments, specifically cross currency basis swaps, interest rate swaps and equity forwards to manage its risks and costs associated with its financing and stock-based compensation plans. The Company uses financial and non-financial derivatives instruments in the form of future contracts, option contracts and forward contracts to manage its current and anticipated exposure to fluctuations in commodity prices. The fair value of derivative instruments is subject to changing market conditions which could negatively impact earnings. The Company maintains treasury centres that operate under policies and guidelines approved by the Board covering funding, investing, equity, commodity, foreign currency exchange and interest rate management. The Company's policies and guidelines prohibit the use of any financial derivative instrument for trading or speculative purposes. See notes 1 and 22 to the consolidated financial statements for additional information about the Company's financial derivative instruments.

### **Foreign Currency Exchange Rate**

The Company enters into cross currency basis swaps to manage its current and anticipated exposure to fluctuations in foreign currency exchange rates. The Company's cross currency basis swaps are transactions in which floating interest payments and principal amounts in United States dollars are exchanged against the receipt of floating interest payments and principal amounts in Canadian dollars. These cross currency basis swaps limit the Company's exposure against foreign currency exchange rate fluctuations on a portion of its United States dollar denominated assets, principally cash, cash equivalents and short term investments.

### **Interest Rate**

The Company enters into interest rate swaps to manage its current and anticipated exposure to fluctuations in interest rates impacted by market liquidity. Interest rate swaps are transactions in which the Company exchanges interest flows with a counterparty on a specified notional amount for a predetermined period based on agreed upon fixed and floating interest rates. Notional amounts are not exchanged. The Company monitors market conditions and the impact of interest rate fluctuations on its fixed and floating interest rate exposure mix on an ongoing basis.

## **12. Related Party Transactions**

The Company's majority shareholder, George Weston Limited and its affiliates other than Loblaw ("Weston"), are related parties. It is the Company's policy to conduct all transactions and settle all balances with related parties on market terms and conditions. Related party transactions include:

**Inventory Purchases** Purchases of inventory from related parties for resale in the distribution network represented approximately 3% (2006 – 3%) of the cost of sales, selling and administrative expenses.

## Management's Discussion and Analysis

**Cost Sharing Agreements** Weston has entered into certain contracts with third parties for administrative and corporate services, including telecommunication services and information technology related matters on behalf of the Company. Through cost sharing agreements that have been established between the Company and Weston concerning these costs, the Company has agreed to be responsible to Weston for its proportionate share of the costs incurred on its behalf. Payments by the Company pursuant to these cost sharing agreements in 2007 were approximately \$27 million (2006 – \$25 million).

**Real Estate Matters** The Company leases certain properties from an affiliate of Weston, namely office space for approximately \$2 million (2006 – \$4 million). During 2006, the Company purchased from an affiliate of Weston, a property designated for future development for consideration of \$8 million, which was prepaid in accordance with a former ground lease between the parties.

**Borrowings/Lendings** The Company, from time to time, may borrow funds from or may lend funds to Weston on a short term basis at short term market borrowing rates. There were no such amounts outstanding as at year end.

**Income Tax Matters** From time to time, the Company and Weston and its affiliates may make elections that are permitted or required under applicable income tax legislation with respect to affiliated corporations and, as a result, may enter into agreements in that regard. These elections and accompanying agreements did not have any material impact on the Company.

**Management Agreements** The Company has an agreement with Weston to provide certain administrative services by each company to the other. The services to be provided under this agreement include those related to commodity management, pension and benefits, tax, medical, travel, information system, risk management, treasury and legal. Payments are made quarterly based on the actual costs of providing these services. Where services are provided on a joint basis for the benefit of the Company and Weston together, each party pays the appropriate proportion of such costs. Net payments under this agreement in 2007 were \$9 million. Fees paid under this agreement are reviewed each year by the Audit Committee.

The Company, through Glenhuron Bank Limited ("Glenhuron"), a wholly-owned subsidiary of the Company, manages certain United States cash, cash equivalents and short term investments for wholly owned non-Canadian subsidiaries of Weston and management fees earned are based on market rates. Glenhuron has an agreement with a subsidiary of Weston for the administration of a loan portfolio of third-party long term loans receivable.

### 13. Critical Accounting Estimates

The preparation of financial statements in accordance with Canadian GAAP requires management to make estimates and assumptions that affect the reported amounts and disclosures made in the consolidated financial statements and accompanying notes.

Management continually evaluates the estimates and assumptions it uses. These estimates and assumptions are based on management's historical experience, best knowledge of current events and conditions and activities that the Company may undertake in the future. Actual results could differ from these estimates.

The estimates and assumptions described in this section depend upon subjective or complex judgments about matters that may be uncertain and changes in these estimates and assumptions could materially impact the consolidated financial statements.

#### 13.1 Inventories

Certain retail store inventories are stated at the lower of cost and estimated net realizable value less normal gross profit margin. Significant estimation or judgment is required in the determination of (i) discount factors used to convert inventory to cost after a physical count at retail has been completed and (ii) estimated inventory losses, or shrinkage, occurring between the last physical inventory count and the balance sheet date.

Inventories counted at retail are converted to cost by applying a discount factor to retail selling prices. This discount factor is determined at a category or department level, is calculated in relation to historical gross margins and is reviewed on a regular basis for reasonableness. Inventory shrinkage, which is calculated as a percentage of sales, is evaluated throughout the year and provides for estimated inventory shortages from the last physical count to the balance sheet date. To the extent that actual losses experienced vary from those estimated, both inventories and operating income may be impacted.

Changes or differences in these estimates may result in changes to inventories on the consolidated balance sheet and a charge or credit to operating income in the consolidated statement of earnings.

The Company will be implementing the new Section 3031, "Inventories", issued by the CICA, in the first quarter of 2008 to the opening inventory for the period with an adjustment to opening retained earnings, net of income taxes, for the difference in measurement of the opening inventory with no prior periods restated. The Company expects to record, upon implementation of this standard, a decrease in the measurement of opening inventory of less than 4% of the inventory value with a corresponding decrease to opening retained earnings of less than \$50 million net of income taxes. Additional information on inventories is provided in note 1 to the consolidated financial statements.

### **13.2 Employee Future Benefits**

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

The discount rate, the expected long term rate of return on plan assets and the expected growth rate in health care costs are the three most significant assumptions.

The discount rates are based on market interest rates as at the Company's measurement date of September 30 on a portfolio of Corporate AA bonds with terms to maturity that, on average, match the terms of the accrued benefit plan obligations. The discount rates used to determine the 2007 net cost for defined benefit pension and other benefit plans were 5.0% and 5.0%, respectively, on a weighted average basis, compared to 5.25% and 5.2%, respectively, in 2006. The discount rates used to determine the net 2008 defined benefit pension and other benefit plans costs increased to 5.5% and 5.3%, respectively.

The expected long term rate of return on plan assets is based on current market conditions, the asset mix, the active management of defined benefit pension plan assets and on historical returns. The Company's defined benefit pension plan assets had a 10 year annualized return of 7.2% as at the 2007 measurement date. The actual annual returns within this 10 year period varied with market conditions. The Company has assumed a 7.5% expected long term rate of return on plan assets in calculating its defined benefit pension plans cost for 2008.

The expected growth rate in health care costs for 2007 was based on external data and the Company's historical trends for health care costs, and in 2008 initial growth rates will be relatively consistent with those in 2007.

Since the three key assumptions discussed above are forward-looking and long term in nature, they are subject to uncertainty and actual results may differ. In accordance with Canadian GAAP, differences between actual experience and the assumptions, as well as the impact of changes in the assumptions, are accumulated as unamortized net actuarial gains or losses and amortized over future periods, affecting the recognized cost of defined benefit pension plans and other benefit plans and the accrued benefit plan obligation in future periods. While the Company believes that its assumptions are appropriate, significant differences in actual experience or significant changes in the Company's assumptions may materially affect its defined benefit pension plans and other benefit plans accrued benefit plan obligations and future cost.

## Management's Discussion and Analysis

Additional information regarding the Company's pension and other benefit plans, including a sensitivity analysis for changes in key assumptions, is provided in note 14 to the consolidated financial statements and in the Employee Future Benefit Contributions discussion in the Operating Risks and Risk Management section of this MD&A.

### 13.3 Goodwill

Goodwill is not amortized and is assessed for impairment at the reporting unit level at least annually. Any potential goodwill impairment is identified by comparing the fair value of a reporting unit to its carrying value. If the fair value of the reporting unit exceeds its carrying value, goodwill is considered not to be impaired. If the carrying value of the reporting unit exceeds its fair value, a more detailed goodwill impairment assessment must be undertaken. A goodwill impairment charge is recognized to the extent that, at the reporting unit level, the carrying value of goodwill exceeds the implied fair value.

The Company determines the fair value using a discounted cash flow model corroborated by other valuation techniques such as market multiples. The process of determining these fair values requires management to make estimates and assumptions including, but not limited to, projected future sales, earnings and capital investment, discount rates and terminal growth rates. Projected future sales, earnings and capital investment are consistent with strategic plans presented to the Company's Board. Discount rates are based on an industry weighted average cost of capital. These estimates and assumptions are subject to change in the future due to uncertain competitive and economic market conditions or changes in business strategies.

The Company performed the annual goodwill impairment test in 2007 and it was determined that the fair value of each of the reporting units exceeded its respective carrying value and therefore, no goodwill impairment was identified.

In 2006, the Company's annual goodwill impairment test determined that the carrying value of the goodwill established on the acquisition of Provigo Inc. in 1998 exceeded its respective fair value. As a result, in 2006 the Company recorded in operating income a non-cash goodwill impairment charge of \$800 million relating to this goodwill. The determination that the fair value of goodwill was less than its carrying value resulted from a decline in market multiples, both from an industry and Company perspective, and a reduction of fair value as determined using the discounted cash flow methodology, incorporating both current Company and market assumptions, which in combination resulted in the goodwill impairment. This \$800 million non-cash goodwill impairment charge recorded in 2006 was finalized in the second quarter of 2007.

### 13.4 Income Taxes

Future income tax assets and liabilities are recognized for the future income tax consequences attributable to temporary differences between the financial statement carrying values of assets and liabilities and their respective income tax bases. Future income tax assets or liabilities are measured using enacted or substantively enacted income tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The calculation of current and future income taxes requires management to make estimates and assumptions and to exercise judgment regarding the financial statement carrying values of assets and liabilities which are subject to accounting estimates inherent in those balances, the interpretation of income tax legislation across various jurisdictions, expectations about future operating results, the timing of reversal of temporary differences and possible audits of income tax filings by the tax authorities. Management believes it has adequately provided for income taxes based on currently available information. Changes or differences in underlying estimates or assumptions may result in changes to the current or future income tax balances on the consolidated balance sheet, a charge or credit to income tax expense in the consolidated statement of earnings and may result in cash payments or receipts.

### **13.5 Goods and Services Tax and Provincial Sales Taxes**

During 2005, the Company recorded a charge relating to an audit and proposed assessment by the Canada Revenue Agency relating to GST on certain products sold on which GST was not appropriately charged and remitted. In light of this proposed assessment, the Company assessed and estimated the potential liabilities for GST and PST in other areas of its operations for various periods. Accordingly, a charge of \$40 million was recorded in operating income in 2005. Approximately \$4 million was paid in 2007 (2006 – \$1 million) and approximately \$20 million remains accrued as at December 29, 2007. The ultimate remaining amount paid will depend on the outcome of audits performed by or settlements reached with the various tax authorities, and therefore may differ from this estimate. Management will continue to assess the remaining accrual as progress towards resolution with the various tax authorities is made and will adjust the remaining accrual accordingly. Changes in this accrual may result in a charge or credit to operating income in the consolidated statement of earnings.

### **13.6 Fixed Assets**

Fixed assets to be held and used are reviewed for impairment annually and when events or circumstances indicate that their carrying value exceeds the sum of the undiscounted cash flows expected from their use and eventual disposition. An impairment loss is measured as the amount by which the fixed assets carrying value exceeds the fair value. As discussed in notes 4 and 12 to the consolidated financial statements, the Company recorded fixed asset impairment charge of \$33 million (2006 – \$27 million), accelerated depreciation charge of \$3 million (2006 – \$5 million), and a charge of nominal amount (2006 – \$27 million) was recorded in restructuring and other charges.

The factor that most significantly influences the impairment assessments and calculations is estimates of future cash flows. The Company uses its internal plans in estimating future cash flows. These plans reflect the Company's current best estimate of future cash flows but may change due to uncertain competitive and economic market conditions or changes in business strategies. Changes or differences in these estimates may result in changes to fixed assets on the consolidated balance sheet and a charge to operating income on the consolidated statement of earnings.

## **14. Accounting Standards**

### **14.1 Accounting Standards Implemented in 2007**

On December 31, 2006, the Company implemented the CICA Handbook Section 3855 "Financial Instruments – Recognition and Measurement", Section 3865 "Hedges", Section 1530 "Comprehensive Income", Section 3251 "Equity" and Section 3861 "Financial Instruments – Disclosure and Presentation". These standards have been applied without restatement of prior periods. The transitional adjustments resulting from these standards are recognized in the opening balances of retained earnings and accumulated other comprehensive income.

The new accounting standards require that all financial instruments be classified into a defined category, namely, held-for-trading financial assets or financial liabilities, held-to-maturity investments, loans and receivables, available-for-sale financial assets, or other financial liabilities. The financial instruments within scope, including derivative instruments, are included on the Company's balance sheet and measured at fair value except for loans and receivables, held-to-maturity financial assets and other financial liabilities which are measured at cost or amortized cost. Held-for-trading financial assets and financial liabilities are measured at fair value with gains and losses recognized in net earnings in the period in which they arise. Available-for-sale financial assets are measured at fair value, with unrealized gains and losses, including changes in foreign exchange rates, recognized in other comprehensive income until the financial asset is derecognized or impaired, at which time any unrealized gains or losses are recorded in net earnings. In cash flow hedges, the effective portion of the change in fair value of the hedging item is recorded in other comprehensive income. To the extent the change in fair value of the derivative instrument is not completely offset by the change in fair value of the hedged item, the ineffective portion of the hedging relationship is recorded immediately in net earnings.

## Management's Discussion and Analysis

Upon implementation of these standards, the Company has recorded the following transitional adjustments:

	Transitional Adjustments
<b>Consolidated Balance Sheet</b>	
Other assets	\$ 35
Future income taxes	(7)
Other liabilities	41
Retained earnings	(15)
Accumulated other comprehensive income	16

For further details of the specific accounting changes and related impacts, see note 2 to the audited consolidated financial statements.

### 14.2 Future Accounting Standards

The Company closely monitors new accounting standards to assess the impact, if any, on its consolidated financial statements. In 2008, the Company will be reviewing the implications of the following standards and implementing the recommendations as required:

*Capital Disclosures and Financial Instruments – Disclosure and Presentation* In December 2006, the CICA issued three new accounting standards: Section 1535 “Capital Disclosures” (“Section 1535”), Section 3862 “Financial Instruments-Disclosures” (“Section 3862”) and Section 3863 “Financial Instruments-Presentation” (“Section 3863”).

Section 1535 establishes guidelines for the disclosure of information regarding a company's capital and how it is managed. The standard requires enhanced disclosures with respect to (i) an entity's objectives, policies and processes for managing capital; (ii) quantitative data about what the entity regards as capital; and (iii) whether the entity has complied with any capital requirements, and if it has not complied, the consequences of such non-compliance.

Section 3862 and Section 3863 replace Section 3861, “Financial Instruments – Disclosure and Presentation”. Section 3862 requires increased disclosures regarding the risks associated with financial instruments such as credit risk, liquidity risk and market risks and the techniques used to identify, monitor and manage these risks. Section 3863 carries forward standards for presentation of financial instruments and non-financial derivative instruments and provides additional guidance for the classification of financial instruments, from the perspective of the issuer, between liabilities and equity.

These standards are effective for fiscal years beginning on or after October 1, 2007 and therefore the Company will implement them in the first quarter of 2008.

*Inventories* In June 2007, the CICA issued a new Section 3031, "Inventories", which will replace existing Section 3030 of the same title. The new standard requires inventories to be measured at the lower of cost and net realizable value with more specific guidance of costs to include in the cost of inventory. Costs such as storage costs and administrative overhead that do not contribute to bringing inventories to their present location and condition are specifically excluded from the cost of inventories and expensed in the period incurred. This standard is effective for fiscal years beginning on or after January 1, 2008 and will be implemented by the Company in the first quarter of 2008 to the opening inventory for the period with an adjustment to opening retained earnings, net of income taxes, for the difference in measurement of the opening inventory with no prior periods restated. The Company expects to record, upon implementation of this standard, a decrease in the measurement of opening inventory of less than 4% of the inventory value with a corresponding decrease of less than \$50 million to opening retained earnings net of income taxes.

*Goodwill and Intangible Assets* In November 2007, the CICA issued amendments to Section 1000 "Financial Statement Concepts," and AcG 11 "Enterprises in the Development Stage," issued a new Handbook Section 3064 "Goodwill and Intangible Assets" to replace Section 3062 "Goodwill and Other Intangible Assets", withdrew Section 3450 "Research and Development Costs" and amended EIC 27 "Revenues and Expenditures During the Pre-operating Period" to not apply to entities that have adopted Section 3064. These amendments provide guidance for the recognition of internally developed intangible assets, including assets developed from research and development activities, ensuring consistent treatment of all intangible assets, whether separately acquired or internally developed. The amendments are effective for annual and interim financial statements relating to fiscal years beginning on or after October 1, 2008 and therefore the Company will implement them in the first quarter of 2009, retroactively with restatement of the comparative periods for the current and prior year. At this time the impact of implementing these amendments on the Company's financial statements is currently being assessed.

*International Financial Reporting Standards ("IFRS")* The Canadian Accounting Standards Board will require all public companies to adopt IFRS for interim and annual financial statements relating to fiscal years beginning on or after January 1, 2011. Companies will be required to provide IFRS comparative information for the previous fiscal year. The convergence from Canadian GAAP to IFRS will be applicable for the Company for the first quarter of 2011 when the Company will prepare both the current and comparative financial information using IFRS. The Company expects the transition to IFRS to impact financial reporting, business processes and information systems. The Company will assess the impact of the transition to IFRS and will continue to invest in training and resources throughout the transition period to facilitate a timely conversion.

For further details on the above future accounting standards see note 1 to the unaudited interim period consolidated financial statements.

## **15. Outlook<sup>(1)</sup>**

Sales volumes have been positively responding to the Company's investments in lower prices to give value to its customers. The Company expects this to continue in 2008. Investments in price will also continue. However, the Company expects that cost reductions in 2008 will help to support its profitability. Sales, margins and profitability in the first half of 2008 in relation to 2007 may be affected by more difficult comparables.

(1) To be read in conjunction with "Forward Looking Statements" on page 2 of this Annual Report.

## Management's Discussion and Analysis

### 16. Non-GAAP Financial Measures

The Company reports its financial results in accordance with Canadian GAAP. However, the Company has included certain non-GAAP financial measures and ratios, which it believes provide useful information to both management and readers of this Annual Report in measuring the financial performance and financial condition of the Company for the reasons set out below. These measures do not have a standardized meaning prescribed by Canadian GAAP and, therefore, may not be comparable to similarly titled measures presented by other publicly traded companies. They should not be construed as an alternative to other financial measures determined in accordance with Canadian GAAP. For the following tables, the annual non-GAAP financial measures for the years 2007 through to 2003, are for the 52 or 53 weeks ended or as at December 29, 2007; December 30, 2006; December 31, 2005; January 1, 2005; and January 3, 2004, respectively.

#### **Sales and Sales Growth Excluding the Impact of Tobacco Sales and VIEs**

These financial measures exclude the impact on sales from the decrease in tobacco sales and from the consolidation by the Company of certain independent franchisees. Tobacco sales continued to decrease through the end of third quarter 2007 as a result of a major tobacco supplier shipping directly to certain customers of the Company's cash & carry and wholesale club network commencing in the third quarter of 2006. These impacts on sales are excluded because the Company believes this allows for a more effective analysis of the operating performance of the Company. A reconciliation of the financial measures to the Canadian GAAP financial measures is included in the table "Total Sales and Sales Excluding the Impact of Tobacco Sales and VIEs" on page 23 of this Annual Report. Same-store sales growth and same-store sales growth excluding the impact of decreased tobacco sales is included in the tables "Sales Growth and Same-Store Sales Growth" on page 24 of this Annual Report.

#### **Adjusted Operating Income and Margin**

The following table reconciles operating income and adjusted operating income to Canadian GAAP net earnings measures based on the audited results for the twelve and fifty-two week periods ended December 29, 2007 and December 30, 2006 and the years ended as previously indicated. Items listed in the reconciliation are excluded because the Company believes this allows for a more effective analysis of the operating performance of the Company. In addition, the excluded items affect the comparability of the financial results and could potentially distort the analysis of trends. The exclusion of these items does not imply they are non-recurring. Adjusted operating income and margin are useful to management in assessing the Company's performance and in making decisions regarding the ongoing operations of its business.

Adjusted operating margin is calculated as adjusted operating income divided by sales excluding the impact of tobacco sales and VIEs.

#### **Adjusted EBITDA and Margin**

The following table reconciles adjusted earnings before interest, income taxes, depreciation and amortization ("EBITDA") to adjusted operating income which is reconciled to Canadian GAAP net earnings measures based on management's review of the audited results for the twelve and fifty-two week periods ended December 29, 2007 and December 30, 2006 and the years ended as previously indicated. Adjusted EBITDA is useful to management in assessing the Company's performance of its ongoing operations and its ability to generate cash flows to fund its cash requirements, including the Company's capital investment program.

Adjusted EBITDA margin is calculated as adjusted EBITDA divided by sales excluding the impact of tobacco sales and VIEs.

The following table outlines items which were excluded in arriving at adjusted operating income, adjusted operating margin, adjusted EBITDA and adjusted EBITDA margin:

	(unaudited) 2007 (12 weeks)	(unaudited) 2006 (12 weeks)	2007 (52 weeks)	2006 (52 weeks)	2005 (52 weeks)	2004 (52 weeks)	2003 (53 weeks)
(\$ millions)							
Net earnings (loss)	\$ 40	\$ (756)	\$ 330	\$ (219)	\$ 746	\$ 968	\$ 845
Add (deduct) impact of the following:							
Minority interest	8	(1)	4	1	3	-	-
Income taxes	27	2	150	248	400	445	426
Interest expense	59	60	252	259	252	239	196
Operating income (loss)	134	(695)	736	289	1,401	1,652	1,467
Add (deduct) impact of the following:							
Net effect of stock-based compensation and the associated equity forwards	52	(6)	72	37	43	-	(4)
Restructuring and other charges	36	35	222	44	86	-	-
Inventory liquidation	3	68	15	68	-	-	-
VIEs	(4)	-	(11)	(8)	-	-	-
Goodwill impairment charge	-	800	-	800	-	-	-
Ontario collective labour agreement	-	84	-	84	-	-	-
Departure entitlement charge	-	-	-	12	-	-	-
Goods and Services Tax and provincial sales taxes	-	-	-	-	40	-	-
Direct costs associated with supply chain disruptions	-	-	-	-	30	-	-
<i>The Real Canadian Superstore</i> labour arrangement	-	-	-	-	-	-	25
Adjusted operating income	221	286	1,034	1,326	1,600	1,652	1,488
Add (deduct) impact of the following:							
Depreciation and amortization	134	133	588	590	558	473	393
VIE depreciation and amortization	(6)	(5)	(33)	(24)	(26)	-	-
Adjusted EBITDA	\$ 349	\$ 414	\$ 1,589	\$ 1,892	\$ 2,132	\$ 2,125	\$ 1,881

## Management's Discussion and Analysis

### Adjusted Basic Net Earnings per Common Share

The following table reconciles adjusted basic net earnings per common share to Canadian GAAP basic net earnings (loss) per common share measures based on management's review of the audited results for the twelve and fifty-two week periods ended December 29, 2007 and December 30, 2006 and the years ended as previously indicated. Items listed in the reconciliation are excluded because the Company believes this allows for a more effective analysis of the operating performance of the Company. In addition, the excluded items affect the comparability of the financial results and could potentially distort the analysis of trends. The exclusion of these items does not imply they are non-recurring. Adjusted basic net earnings per common share is useful to management in assessing the Company's performance and in making decisions regarding the ongoing operations of its business.

	(unaudited) 2007 (12 weeks)	(unaudited) 2006 (12 weeks)	2007 (52 weeks)	2006 (52 weeks)	2005 (52 weeks)	2004 (52 weeks)	2003 (53 weeks)
Basic net earnings (loss) per common share	\$ 0.14	\$ (2.76)	\$ 1.20	\$ (0.80)	\$ 2.72	\$ 3.53	\$ 3.07
Add (deduct) impact of the following:							
Net effect of stock-based compensation and the associated equity forwards	0.21	(0.02)	0.30	0.17	0.22	-	(0.06)
Restructuring and other charges	0.09	0.09	0.53	0.11	0.20	-	-
Inventory liquidation	0.01	0.16	0.04	0.16	-	-	-
VIEs	0.02	(0.01)	0.02	(0.01)	0.03	-	-
Changes in statutory income tax rates	(0.04)	-	(0.04)	(0.06)	0.01	-	0.03
Goodwill impairment charge	-	2.92	-	2.92	-	-	-
Ontario collective labour agreement	-	0.20	-	0.20	-	-	-
Departure entitlement charge	-	-	-	0.03	-	-	-
Goods and Services Tax and provincial sales taxes	-	-	-	-	0.10	-	-
Direct costs associated with supply chain disruptions	-	-	-	-	0.07	-	-
Resolution of certain income tax matters	-	-	-	-	-	(0.05)	-
<i>The Real Canadian Superstore</i> labour arrangement	-	-	-	-	-	-	0.06
Adjusted basic net earnings per common share	\$ 0.43	\$ 0.58	\$ 2.05	\$ 2.72	\$ 3.35	\$ 3.48	\$ 3.10

### Net Debt

The following table reconciles net debt used in the net debt to equity ratio to Canadian GAAP measures reported in the audited consolidated balance sheets as at the years ended as previously indicated. The Company calculates net debt as the sum of long term debt and short term debt less cash, cash equivalents and short term investments. The net debt to equity ratio is useful in assessing the amount of leverage employed.

(\$ millions)	2007	2006	2005	2004	2003
Bank indebtedness	\$ 3	\$ 1	\$ 30	\$ 28	\$ 38
Commercial paper	418	647	436	473	603
Long term debt due within one year	432	27	161	216	106
Long term debt	3,852	4,212	4,194	3,935	3,956
Less: Cash and cash equivalents	674	669	916	549	618
Short term investments	303	327	4	275	378
Net debt	\$ 3,728	\$ 3,891	\$ 3,901	\$ 3,828	\$ 3,707

### Free Cash Flow

The following table reconciles free cash flow to Canadian GAAP measures reported in the consolidated cash flow statements as at the years ended as previously indicated. The Company calculates free cash flow as cash flows from operating activities less fixed asset purchases and dividends. The Company believes free cash flow is a useful measure of the Company's cash available for additional funding and investing activities.

(\$ millions)	2007	2006	2005	2004	2003
Cash flows from operating activities	\$ 1,245	\$ 1,180	\$ 1,489	\$ 1,443	\$ 1,032
Less: Fixed asset purchases	613	937	1,156	1,258	1,271
Dividends	230	173	230	209	198
Free cash flow	\$ 402	\$ 70	\$ 103	\$ (24)	\$ (437)

### Total Assets

The following table reconciles total assets used in the return on average total assets to Canadian GAAP measures reported in the audited consolidated balance sheets as at the years ended as previously indicated. The Company believes the return on average total assets ratio is useful in assessing the performance of its operating assets and therefore excludes cash, cash equivalents and short term investments from the total assets used in the ratio.

(\$ millions)	2007	2006	2005	2004	2003
Total assets	\$ 13,674	\$ 13,486	\$ 13,761	\$ 12,949	\$ 12,113
Less: Cash and cash equivalents	674	669	916	549	618
Short term investments	303	327	4	275	378
Total assets	\$ 12,697	\$ 12,490	\$ 12,841	\$ 12,125	\$ 11,117

### 17. Additional Information

Additional information about the Company, including its Annual Information Form and other disclosure documents, has been filed electronically with various securities regulators in Canada through the System for Electronic Document Analysis and Retrieval (SEDAR) and is available online at [www.sedar.com](http://www.sedar.com) and with the Office of the Superintendent of Financial Institutions (OSFI) as the primary regulator for the Company's subsidiary, President's Choice Bank.

March 12, 2008  
Toronto, Canada