

# Management's Discussion and Analysis

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(1) See Non-GAAP Financial Measures on page 37.

## 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 40 to 84 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 ("AcG") 15, "*Consolidation of Variable Interest Entities*". A glossary of terms used throughout this Financial Report can be found on page 86. The information in this MD&A is current to March 12, 2010, unless otherwise noted.

### 1. Forward-Looking Statements

This Annual Report – Financial Review for Loblaw Companies Limited 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", "foresee", "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, including, but not limited to:

- the possibility that the Company's plans and objectives will not be achieved;
- changes in economic conditions including the rate of inflation or deflation;
- 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 franchisees;
- failure of the Company to realize the anticipated benefits of business acquisitions or divestitures;
- failure to realize sales growth, anticipated cost savings or operating efficiencies from the Company's major initiatives, including investments in the Company's information technology systems, supply chain investments and other cost reduction initiatives, or unanticipated results from these initiatives;
- increased costs relating to utilities, including electricity and fuel;
- 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 inventory and to control shrink;
- failure to execute successfully and in a timely manner the Company's introduction of innovative and reformulated products or new and renovated stores;
- 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 which could lead to work stoppages;
- 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 stock based compensation and 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;
- changes in interest and currency exchange rates;
- the inability of the Company or its franchisees to obtain external financing;
- the inability of the Company to collect on its credit card receivables;

- any requirement of the Company to make contributions to its registered funded defined benefit pension plans in excess of those currently contemplated;
- 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 the Management's Discussion and Analysis ("MD&A") included in the Company's 2009 Annual Report. These forward looking statements reflect management's current assumptions regarding these risks and uncertainties and their respective impact on the Company.

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. 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 Information Form. 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

The Company is a subsidiary of George Weston Limited ("Weston") and is Canada's largest food distributor and a leading provider of drugstore, general merchandise and financial products and services. Loblaw is one of the largest private sector employers in Canada. With more than 1,000 corporate and franchised stores from coast to coast, Loblaw and its franchisees employ approximately 138,000 full-time and part-time employees. Through its portfolio of store formats, Loblaw is committed to providing Canadians with a wide, growing and successful range of products and services to meet the everyday household demands of Canadian consumers. Loblaw is known for the quality, innovation and value of its food offering. It offers Canada's strongest control (private) label program, including the unique *President's Choice*, *no name* and *Joe Fresh* brands. In addition, through its subsidiaries, the Company makes available to consumers *President's Choice Financial* services and offers the *PC* points loyalty program.

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 three year period.

(\$ millions except where otherwise indicated)	<b>2009</b> (52 weeks)	2008 <sup>(1)</sup> (53 weeks)	2007 <sup>(2)</sup> (52 weeks)
Sales	<b>\$ 30,735</b>	\$ 30,802	\$ 29,384
Net earnings	<b>656</b>	550	336
Basic net earnings per common share(\$)	<b>2.39</b>	2.01	1.23
Total assets	<b>14,991</b>	13,943	13,625
Long term debt and capital securities	<b>4,725</b>	4,454	4,284
Dividends declared per common share(\$)	<b>\$ 0.84</b>	\$ 0.84	\$ 0.84

(1) Certain 2008 information has been restated to conform with the new Canadian Institute of Chartered Accountants ("CICA") Handbook Section 3064, "Goodwill and Intangible Assets". See note 2 to the consolidated financial statements.

(2) Certain 2007 information has been restated to conform with the new CICA Handbook Section 3064, "Goodwill and Intangible Assets".

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Total sales and same-store sales declined 0.2% and 1.1%, respectively in 2009 compared to 2008. Sales and same-store sales increased 4.8% and 4.2%, respectively in 2008 compared to 2007. During the year, the number of corporate stores increased to 613 (2008 – 609, 2007 – 628) and the number of franchised stores decreased to 416 (2008 – 427, 2007 – 408). In 2009, the increase in corporate stores was primarily due to the acquisition of 17 T&T Supermarket Inc. ("T&T") stores partially offset by a conversion of corporate stores to franchises. The number of franchised stores decreased in 2009 due to the conversion of franchised stores to independent affiliates. In 2008, the change was a result of store conversions as corporate stores were converted to franchises. Also, during the year corporate store sales per average square foot decreased to \$597 (2008 – \$624, 2007 – \$591) while the retail square footage remained flat during this period (2009 – 50.6 million, 2008 – 49.8 million, 2007 – 49.6 million).

Net earnings and basic net earnings per common share increased by \$106 million and \$0.38, respectively, in 2009 compared to 2008. The increase was a result of the increase in operating income. In 2009, the increase in operating income was primarily due to the improvement in gross profit partially offset by a higher stock-based compensation charge, the incremental costs of \$73 million related to the Company's investment in information technology and supply chain and a lower gain on the sale of financial investments by President's Choice Bank ("PC Bank"), a wholly owned subsidiary of the Company. In 2008 net earnings and basic net earnings per common share increased by \$214 million and \$0.78 compared to 2007 as a result of an increase in operating income and a decrease in the effective tax rate. Net earnings in 2007 were negatively impacted by the costs associated with the Company's restructuring initiatives.

Total assets in 2009 increased by 7.5% compared to 2008, primarily as a result of an increase in cash and short term investment balances, an increase in goodwill and intangible assets from the acquisition of T&T and an increase in fixed assets primarily as a result of the Company's incremental investment in information technology and supply chain as well as the acquisition of a distribution centre that was sold in 2007. In 2008, total assets increased by 2.3% compared to 2007 as a result of an increase in cash balances, an increase in inventories and an increase in fixed assets.

Long term debt and capital securities increased by 6.1% in 2009 compared to 2008 primarily due to a net increase in Medium Term Notes outstanding and the assumption of a mortgage. In 2008 compared to 2007 long term debt and capital securities increased by 4.0% as a result of the 2008 issuance of capital securities and unsecured notes partially offset by the repayment of debt maturities. Cash flows from operating activities covered the Company's funding requirements and exceeded the capital investment program in both 2009 and 2008.

### 3. Vision and Strategies

The Company's mission is to be Canada's best food, health and home retailer by exceeding customer expectations through innovative products at great prices. The Company initiated renewal plans three years ago to achieve its mission by transforming into a centralized marketing-led organization focused on customers, value, innovative and fresh products and stores, while leveraging its scale and asset base to drive profitable growth.

In 2009, the Company moved forward in its renewal program during a challenging economic environment. In the first half of the year the Company saw high inflation, higher food prices and lower volumes. In the second half, inflation declined and price competition emerged. Throughout the year, the Company delivered enhanced fresh food offerings, renovated and revitalized stores, and introduced innovative and differentiated control label brands to provide an enhanced customer shopping experience. In addition, the Company continued to invest and build its core infrastructure, including both information technology and supply chain.

Some of Loblaw's key accomplishments in 2009 include:

- Improved fresh food quality and assortment;
- Delivered targeted price positions through ongoing price management and implemented banner-specific price programs in each region;
- Enhanced store standards that resulted in improved product availability;
- Renovated and refreshed more than 200 stores, including 26 Western Canada *Real Canadian Superstore* upgrades and the rollout of the 2008 "Back to Best" pilot programs for food renewal and enhanced customer service programs;
- Converted an additional five *Extra Foods* stores to *no frills* stores, opened two new *no frills* in Western Canada and opened the first *no frills* in Atlantic Canada;

- Celebrated the 25<sup>th</sup> anniversary of the *President's Choice* brand, supported by the introduction of 524 new products, the launch of 718 improved products and the packaging redesign for over 1,800 products;
- Opened and renovated three distribution centres and successfully commenced the roll out of new transportation and warehouse management systems, which significantly improved supply chain service levels;
- Acquired T&T, Canada's largest Asian food retailer;
- Strengthened balance sheet providing enhanced financial flexibility;
- Recognized as one of Canada's Top 100 employers; and
- Subsequent to year end, the Company successfully deployed the first Enterprise Resource Planning ("ERP") system release (finance and general ledger systems across Loblaw Properties Limited and President's Choice Financial).

While the Company achieved many of its goals in 2009, consistent execution remains the Company's focus in order to drive sustainable performance. In 2010, the Company intends to intensify its investments in infrastructure and condense its project timelines while keeping a vigilant watch on cost control and cash management. Entering into 2010, the Company continues to expect a challenging economic environment and heightened competitive intensity. With significant investments in supply chain and information technology, the Company remains committed to strategically balance trading for today while building for tomorrow by:

- Continuing to invest in and execute its information technology strategy through the rollout of subsequent ERP and supply chain functionality releases;
- Improving in-store, distribution centre, and store support centre processes in an effort to make the business simpler and more efficient;
- Continuing its store upgrade program that will roll out the food renewal and customer service enhancement programs;
- Continuing to innovate our control label offering while enhancing profitability; and
- Focusing on in-store customer service and providing unmatched value.

#### 4. Key Performance Indicators

The Company has identified specific key performance indicators to measure the progress of short and long term strategies. 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 returns to its shareholders.

Key financial performance indicators are set out below:

	2009 (52 weeks)	2008 <sup>(1)</sup> (53 weeks)
Sales (decline) growth	(0.2%)	4.8%
Same-store sales (decline) growth	(1.1%)	4.2%
EBITDA <sup>(2)</sup> (\$ millions)	\$ 1,794	\$ 1,602
EBITDA margin <sup>(2)</sup>	5.8%	5.2%
Basic net earnings per common share increase	18.9%	63.4%
Cash flows from operating activities (\$ millions)	\$ 1,945	\$ 960
Net debt <sup>(2)</sup> (\$ millions)	2,783	3,293
Net debt <sup>(2)</sup> to EBITDA <sup>(2)</sup>	1.6x	2.1x
Net debt <sup>(2)</sup> to equity <sup>(2)</sup>	0.4:1	0.5:1
Interest coverage <sup>(3)</sup>	4.2x	3.7x
Return on average shareholders' equity	10.9%	9.7%
Return on average net assets <sup>(2)</sup>	12.0%	10.7%

(1) Certain 2008 information has been restated to conform with the new CICA Handbook Section 3064, "Goodwill and Intangible Assets". See note 2 to the consolidated financial statements.

(2) See Non-GAAP Financial Measures on page 37.

(3) See glossary of terms on page 86.

## Management's Discussion and Analysis

### 5. Financial Performance

The Company continues to progress in its turnaround efforts by focusing on innovating and enhancing its food offering, providing unmatched customer value, standardizing processes for efficiency, and improving its store, supply chain and information technology infrastructure.

#### 5.1 Results of Operations

##### Sales

Sales in 2009 (52 weeks) decreased \$67 million, or 0.2%, to \$30.7 billion compared to \$30.8 billion in 2008 (53 weeks).

Total Sales, Sales (Decline) Growth and Same-Store Sales (Decline) Growth

For the years ended January 2, 2010 and January 3, 2009 (\$ millions)	2009 (52 weeks)	2008 (53 weeks)
Total sales	\$ 30,735	\$ 30,802
Total sales (decline) growth	(0.2%)	4.8%
Same-store sales (decline) growth	(1.1%)	4.2%

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

- same-store sales declined 1.1% including a decline in sales and same-store sales of approximately 1.8% due to the extra selling week in the fourth quarter of 2008;
- T&T sales positively impacted sales by 0.5%;
- sales were negatively impacted by 0.5% by the sale of the Company's food service business in the fourth quarter of 2008;
- on an equivalent 52 week basis:
  - sales growth in food and drugstore were moderate;
  - sales growth in apparel was strong while sales of other general merchandise declined significantly due to lower discretionary consumer spending and reductions in assortment and square footage;
- gas bar sales declined significantly as a result of lower retail gas prices despite strong volume growth;
- internal retail food price inflation was below national food price inflation of 5.5% (2008 – 4.0%) as measured by "The Consumer Price Index for Food Purchased from Stores" ("CPI") but higher than in 2008. CPI does not necessarily reflect the effect of inflation on the specific mix of goods sold in Loblaw stores; and
- 41 (2008 – 37) corporate and franchised stores were opened, including 17 acquired T&T stores, and 33 (2008 – 37) corporate and franchised stores were closed, resulting in a net increase of 0.5 million square feet, or 1.0%.

Sales of control label products for 2009 were \$7.6 billion compared to \$7.4 billion in 2008. In 2009, the Company launched over 800 new products, redesigned the packaging of over 4,000 products and celebrated the 25<sup>th</sup> anniversary of *President's Choice*.

##### Gross Profit

2009 gross profit increased by \$285 million to \$7,196 million compared to \$6,911 million in 2008. 2009 gross profit as a percentage of sales was 23.4% compared to 22.4% in 2008. Improved buying synergies, more disciplined vendor management, lower fuel costs and the efficiency of transportation operations contributed to the increase in gross profit and gross profit as a percentage of sales. Investments in pricing partially offset the improvement.

## Operating Income

Operating income for 2009 increased by \$153 million, or 14.5%, to \$1,205 million, and resulted in an operating margin of 3.9% compared to 3.4% in 2008. Included in 2009 operating income was a charge of \$22 million (2008 - \$7 million) related to stock-based compensation including the equity forwards. The increases in operating income and operating margin for 2009 were primarily due to the improvement in gross profit partially offset by an increased stock-based compensation charge, incremental costs of \$73 million related to the Company's investment in information technology and supply chain and a lower gain on the sale of financial investments by PC Bank of \$8 million (2008 - \$14 million). Included in 2009 operating income was a charge of \$27 million (2008 - \$29 million) for fixed asset impairments related to asset carrying values in excess of fair values for specific store locations. Included in 2008 operating income was a gain of \$22 million on the sale of the Company's food service business.

Cost reduction initiatives throughout the business contributed to the improvement in operating income in 2009 compared to the prior year. Specifically, labour and supply chain costs decreased as a result of continued labour productivity improvements and efficiency enhancements at distribution centres.

## EBITDA<sup>(1)</sup>

2009 EBITDA<sup>(1)</sup> increased by \$192 million, or 12.0%, to \$1,794 million compared to \$1,602 million in 2008. 2009 EBITDA margin<sup>(1)</sup> increased to 5.8% compared to 5.2% in 2008. The increases in EBITDA<sup>(1)</sup> and EBITDA margin<sup>(1)</sup> were primarily due to the increases in operating income and operating margin as described above.

## Interest Expense and Other Financing Charges

Interest expense consists primarily of interest on short term and long term debt, the interest on derivative instruments, the amortization of financing costs, and interest earned on short term investments and security deposits net of interest capitalized to fixed assets. Other financing charges consist of dividends on capital securities. In 2009 interest and other financing charges increased \$6 million, or 2.3%, to \$269 million from \$263 million in 2008:

- interest on long term debt decreased to \$282 million (2008 - \$286 million). The change was primarily due to the 53<sup>rd</sup> week in 2008. The 2009 weighted average fixed interest rate on long term debt (excluding capital lease obligations) was 6.4% (2008 - 6.6%) and the weighted average term to maturity was 14 years (2008 - 16 years);
- interest expense on financial derivative instruments of \$2 million (2008 - income of \$4 million) includes the net effect of interest rate swaps, cross currency swaps and equity forwards. The change was primarily a result of a decline in Canadian and United States short term interest rates;
- interest income on short term investments net of interest expense on short term debt increased to \$8 million (2008 - \$7 million) due to lower levels of short term debt partially offset by lower United States short term interest rates;
- dividends on capital securities increased to \$14 million (2008 - \$8 million) which reflects a full year of dividends related to the issuance of capital securities in 2008; and
- interest related to real estate properties under development of \$21 million (2008 - \$20 million) was capitalized to fixed assets.

## Income Taxes

The Company's 2009 effective income tax rate decreased to 28.7% from 29.0% in 2008. The decrease in the effective income tax rate was primarily related to the cumulative reduction in the income tax expense as a result of a reduction in Ontario statutory income tax rates enacted in the fourth quarter of 2009, an accelerated utilization of loss carryforwards and a decrease in income tax accruals relating to certain prior year income tax matters.

## Net Earnings

In 2009, net earnings increased by \$106 million, or 19.3%, to \$656 million from \$550 million in 2008. Basic net earnings per common share increased by \$0.38, or 18.9% to \$2.39 from \$2.01 in 2008.

Basic net earnings per common share were impacted in 2009 by a charge of \$0.08 (2008 - \$0.04) per common share for the net effect of stock-based compensation including equity forwards. 2008 basic net earnings per common share were impacted by a gain of \$0.06 by the sale of the Company's food service business.

(1) See Non-GAAP Financial Measures on page 37.

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### 5.2 Financial Condition

#### Financial Ratios

The Company's net debt<sup>(1)</sup> to equity<sup>(1)</sup> ratio was 0.4:1 at the end of 2009 compared to 0.5:1 at the end of 2008 and within the Company's internal guideline of less than 1:1. Equity<sup>(1)</sup> for the purpose of calculating the net debt<sup>(1)</sup> to equity<sup>(1)</sup> ratio is defined by the Company as capital securities plus shareholders' equity. The decrease in this measure was due to the decrease in net debt as described in Section 6.1 of this MD&A. The net debt<sup>(1)</sup> to EBITDA<sup>(1)</sup> ratio was 1.6 times at the end of 2009 compared to 2.1 times at the end of 2008. The decrease in these ratios was due to the decrease in net debt<sup>(1)</sup> as described in Section 6.1 of this MD&A and the increase in EBITDA<sup>(1)</sup> as described in Section 5.1 of this MD&A. The increase in shareholders' equity also contributed to the decrease in the net debt<sup>(1)</sup> to equity<sup>(1)</sup> ratio. In 2009, shareholders' equity increased by \$470 million, or 8.1% to \$6.3 billion as a result of 2009 net earnings and the increase in common shares as a result of the introduction of a Dividend Reinvestment Plan ("DRIP"), partially offset by the purchase for cancellation of common shares in the fourth quarter of 2009.

The increase in operating income as described in Section 5.1 of this MD&A resulted in an improvement in the interest coverage ratio to 4.2 times in 2009 from 3.7 times in 2008.

The 2009 return on average net assets<sup>(1)</sup> was 12.0% compared to 10.7% in 2008. The 2009 return on average shareholders' equity was 10.9% compared to the 2008 return of 9.7%. These ratios were positively impacted by the increase in operating income as described in Section 5.1 of this MD&A.

#### Capital Securities

12.0 million non-voting Second Preferred Shares, Series A, are authorized, 9.0 million of which were outstanding at year end. These preferred shares are classified as capital securities and included in long term liabilities on the consolidated balance sheet.

#### First Preferred Shares

1.0 million non-voting First Preferred Shares are authorized, none of which was outstanding at year end.

#### Common Share Capital

An unlimited number of common shares is authorized, 276,188,258 of which were outstanding at year end. Further information on the Company's outstanding share capital is provided in note 20 to the consolidated financial statements.

At year end, a total of 9,207,816 stock options were outstanding, representing 3.3% of the Company's issued and outstanding common shares, which was within the Company's internal guideline of no more than 5%. Further information on the Company's stock option plans is provided in note 22 to the consolidated financial statements.

#### Dividends

The declaration and payment of common share dividends are at the discretion of the Board of Directors of the Company ("Board") which takes into account the Company's financial results, capital requirements, available cash flow and other factors considered relevant from time to time. Over the long term, the Company's objective is for its common share dividend payment ratio to be in the range of 20% to 25% of the prior year's basic net earnings per common share adjusted as appropriate for items which are not regarded to be reflective of ongoing operations giving consideration to the year end cash position, future cash flow requirements and investment opportunities. Dividends on the preferred shares shall be entitled to preference over the common shares with respect to the priority in the payment of dividends and with respect to the priority in the distribution of assets of the Company in the event of liquidation, dissolution, or winding up of the Company. During 2009, the Board declared dividends of \$0.84 (2008 - \$0.84) per common share. During 2009, the Board declared dividends of \$1.49 (2008 - \$0.91) per Second Preferred Share, Series A. For financial statement presentation purposes, Second Preferred Share, Series A have been classified as Capital Securities and the associated dividend of \$14 million (2008 - \$8 million) is included as a component of interest expense and other financing charges in the Consolidated Statement of Earnings (see note 4). Subsequent to year end, the Board declared a quarterly dividend of \$0.21 per common share payable April 1, 2010 and a quarterly dividend of \$0.37 per Second Preferred Share, Series A payable April 30, 2010.

(1) See Non-GAAP Financial Measures on page 37.

### Dividend Reinvestment Plan

During the second quarter of 2009, the Company commenced a DRIP with the objective of raising \$300 million in common share equity. Under the terms of the DRIP, eligible holders of common shares may elect to automatically reinvest their regular quarterly dividends in additional common shares of the Company without incurring any commissions, service charges or brokerage fees. The common shares issued to shareholders under the DRIP will be, at the Company's option, either issued from treasury or purchased on the open market. The Board may from time to time approve a discount on the issuance of common shares from treasury under the DRIP. During the year, the Company issued 3,713,094 common shares from treasury under the DRIP at a three percent (3%) discount to market resulting in net cash savings and incremental common share equity to the Company of \$120 million for the year.

## 6. Liquidity and Capital Resources

### 6.1 Cash Flows

#### Major Cash Flow Components

(\$ millions)	2009 (52 weeks)	2008 <sup>(1)</sup> (53 weeks)	Change
Cash flows from (used in):			
Operating activities	\$ 1,945	\$ 960	\$ 985
Investing activities	\$ (1,248)	\$ (578)	\$ (670)
Financing activities	\$ (173)	\$ (371)	\$ 198

#### Cash Flows from Operating Activities

Cash flows from operating activities for 2009 were \$1,945 million compared to \$960 million in 2008. The increase in cash flows from operating activities was primarily due to the increase in operating income and a change in non-cash working capital as a result of changes in inventory and accounts payable and accrued liabilities, partially offset by the settlement of equity forward contracts by Glenhuron Bank Limited ("Glenhuron"), a wholly owned subsidiary of the Company.

#### Cash Flows used in Investing Activities

Cash flows used in investing activities were \$1,248 million compared to \$578 million in 2008. The change was primarily due to the acquisition of T&T, an increase in fixed asset purchases and a change in short term investments, partially offset by a change in security deposits.

Capital investment in 2009 was \$1.1 billion (2008 – \$750 million). Approximately 9% (2008 – 18%) of the investment was for new store development, expansions and land, approximately 38% (2008 – 36%) was for store conversions and renovations, and approximately 53% (2008 – 46%) was for infrastructure investment. The capital investment activity benefited all regions to varying degrees and strengthened the existing store base. Capital investment of \$1.1 billion includes the purchase of a distribution centre for consideration of \$140 million plus closing costs. The Company assumed long term debt secured by a mortgage of \$96 million in connection with the purchase. In addition, the Company acquired T&T in the third quarter of 2009 for \$204 million.

The 2009 corporate and franchised store capital investment program, which included the impact of store openings and closures, resulted in an increase in net retail square footage of 1.0% compared to 2008. During 2009, 41 (2008 – 37) corporate and franchised stores were opened, including 17 acquired T&T stores, 33 (2008 – 37) corporate and franchised stores were closed, resulting in a net increase of 0.5 million square feet (2008 – 0.2 million square feet). Additionally, 128 (2008 – 88) corporate and franchised stores were renovated. The 2009 average corporate store size remained relatively flat at 62,300 square feet (2008 – 61,900) and the average franchised store size increased 4.6% to 29,700 square feet (2008 – 28,400).

(1) Certain 2008 information has been restated to conform with the new CICA Handbook Section 3064, "Goodwill and Intangible Assets". See note 2 to the consolidated financial statements.

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As at January 2, 2010, the Company had committed approximately \$76 million (2008 – \$46 million) for the construction, expansion and renovation of buildings and the purchase of real property.

During 2009, the Company also generated \$27 million (2008 – \$125 million) from fixed asset sales.

The Company expects to invest approximately \$1.0 billion in capital expenditures in 2010. Approximately 50% of these funds are expected to be expended upgrading its information technology and supply chain infrastructure. The remainder will be spent on retail operations as the Company plans to renovate certain banners and to add approximately 300,000 square feet of retail space.

### Capital Investment and Store Activity

	2009 (52 weeks)	2008 (53 weeks)	Change
Capital investment (\$ millions)	\$ 1,067	\$ 750	\$ 317
Corporate square footage (in millions)	38.2	37.7	1.3%
Franchise square footage (in millions)	12.4	12.1	2.5%
Retail square footage (in millions)	50.6	49.8	1.6%
Number of corporate stores	613	609	0.7%
Number of franchised stores	416	427	(2.6%)
Percentage of corporate real estate owned	72%	74%	
Percentage of franchise real estate owned	48%	48%	
Average store size (sq. ft.)			
Corporate	62,300	61,900	0.6%
Franchised	29,700	28,400	4.6%

### Cash Flows used in Financing Activities

In 2009, cash flows used in financing activities were \$173 million compared to \$371 million in 2008. The decrease in cash flows used in financing activities was primarily due to the decrease in cash dividend payments as a result of the DRIP, the timing of common share dividend payments and lower debt maturities net of the refinancing of debt in 2008, partially offset by a purchase of common shares in the fourth quarter of 2009 and the issuance of capital securities in the third quarter of 2008.

During the second quarter of 2009, the Company renewed its Normal Course Issuer Bid ("NCIB") 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 rules and by-laws of the Toronto Stock Exchange, the Company may purchase its shares at the then market price of such shares. During 2009, the Company purchased for cancellation 1,698,400 (2008- nil) of its common shares at a price of \$33.14.

During the second quarter of 2009, the Company issued \$350 million principal amount of 5 year unsecured Medium Term Notes, Series 2-A pursuant to its Medium Term Notes, Series 2 Program. Interest on the notes is payable semi-annually at a fixed rate of 4.85%. The notes are unsecured obligations and are redeemable at the option of the Company.

In the first quarter of 2009, \$125 million of 5.75% medium term notes due January 22, 2009 matured and were repaid.

In 2008, the Company issued USD \$300 million of fixed rate unsecured notes in a private placement debt financing and raised \$218 million through a Canadian public offering of 9 million cumulative redeemable convertible Second Preferred Shares, Series A. The net proceeds from these financings were used to repay maturing debt obligations and for general corporate purposes.

## **Net Debt<sup>(1)</sup>**

In the first quarter of 2009, the Company revised its definition of net debt<sup>(1)</sup> to include the fair value of financial derivative assets and liabilities as the Company believes the measure should contain all interest bearing financing arrangements.

Net debt<sup>(1)</sup> was \$2,783 million as at January 2, 2010 compared to \$3,293 million as at January 3, 2009. The decrease of \$510 million was primarily due to improvements in non-cash working capital and cash savings associated with the DRIP. The decrease was partially offset by the acquisition of T&T, the long term debt secured by a mortgage associated with the acquisition of a distribution centre and a purchase of common shares for cancellation in the fourth quarter of 2009.

As at January 3, 2009, net debt<sup>(1)</sup> was \$3,293 million, a decrease of \$276 million compared to \$3,569 as at December 29, 2007. The decrease was primarily due to the issuance of capital securities for \$218 million in 2008, which were used to refinance a portion of the Company's debt maturities.

## **6.2 Sources of Liquidity**

The Company expects that cash and cash equivalents, short term investments, future operating cash flows and the amounts available to be drawn against its credit facility will enable the Company to finance its capital investment program and fund its ongoing business requirements, including working capital, pension plan funding and financial obligations over the next twelve months. In addition, given reasonable access to capital markets, the Company does not foresee any impediments in securing financing to satisfy its long term obligations.

During 2008, the Company entered into an \$800 million, 5-year committed credit facility, provided by a syndicate of third party lenders. The facility contains certain financial covenants with which the Company was in compliance throughout the year. This facility is the primary source of the Company's short term funding requirements and permits borrowings having up to a 180-day term that accrue interest based on short term floating interest rates. As at January 2, 2010, nil (2008 - \$190 million) was drawn on the 5-year committed credit facility.

PC Bank participates in bank supported and term securitization programs which provide the primary source of funds for the operation of its business. Under these securitization programs, a portion of the total interest in the credit card receivables is sold to independent trusts. In 2009, no incremental (2008 - \$300 million) credit card receivables were securitized. During the fourth quarter of 2009, PC Bank repurchased \$50 million (2008 - nil) of co-ownership interest in the securitized receivables from an independent trust and an additional \$90 million was repurchased after January 2, 2010. The Independent trusts' recourse to PC Bank's assets is limited to PC Bank's excess collateral (2009 - \$121 million; 2008 - \$124 million) as well as standby letters of credit (2009 - \$116 million; 2008 - \$116 million) on a portion of the securitized amount. A portion of the securitized receivables held by an independent trust facility was renewed for a 364 day term in the third quarter of 2009. In the absence of renewal or other securitization, the Company would be required to use its cash and short term investments or raise alternative financing by issuing additional debt or equity instruments. During the first quarter of 2009, one of these independent trusts filed a base shelf prospectus which permits it to issue up to \$1.5 billion of notes over a 25 month period. Any issuance of notes is subject to the availability of credit markets. Further information about PC Bank's credit card receivables and securitization is provided in notes 1 and 8 to the consolidated financial statements and in the Off-Balance Sheet Arrangements section of this MD&A.

The Company has traditionally obtained its long term financing primarily through a medium term notes program. The Company may refinance maturing long term debt with medium term notes if market conditions are appropriate or it may consider other alternatives.

(1) See Non-GAAP Financial Measures on page 37.

## Management's Discussion and Analysis

In the normal course of business, the Company provides comfort letters to third party lenders in connection with financing activities of certain independent franchisees. In addition, the Company establishes standby and documentary 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, pension and benefit programs and performance guarantees associated with real estate and other obligations associated with normal course operating activities. At year end, the aggregate gross potential liability related to the Company's standby letters of credit was approximately \$428 million (2008 – \$398 million), against which the Company had \$686 million (2008 – \$441 million) in credit facilities available to draw on.

During 2009, DBRS revised the trend on the Company's long term ratings to stable from negative and S&P revised the outlook to stable from negative. 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 (middle)	Stable	A-2	Stable
Medium term notes	BBB	Stable	BBB	Stable
Preferred shares	Pfd-3	Stable	P-3 (high)	Stable
Other notes and debentures	BBB	Stable	BBB	Stable

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.

The Company's and PC Bank's ability to obtain funding from external sources may be restricted by downgrades in the Company's current credit ratings should the Company's financial performance and condition deteriorate. In addition, credit and capital markets are subject to inherent global risks that may negatively affect the Company's access and ability to fund its financial and other liabilities. The Company mitigates these risks by maintaining appropriate levels of cash and cash equivalents and short term investments, committed lines of credit and diversifying its sources of funding and the maturity profile of its debt and capital obligations.

### 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 gross principal amount of loans issued to the Company's independent franchisees outstanding as at January 2, 2010 was \$390 million (2008 – \$388 million) including \$163 million (2008 – \$152 million) of loans payable by VIEs consolidated by the Company. 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 not less than 15% (2008 – 15%) of the principal amount of the loans outstanding at any time. As at January 2, 2010, \$66 million (2008 – \$66 million) was outstanding as a standby letter of credit. This standby letter of credit has never been drawn upon. This credit enhancement allows the independent funding trust to provide financing 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 would assign the loan to the Company and draw upon this standby letter of credit.

During the second quarter of 2009, a 364-day revolving committed credit facility provided by a syndicate of third party lenders in the amount of \$475 million was renewed for 12 months. This facility is the source of funding to the independent trusts and has a 12 month repayment term at the end of the renewal period. In accordance with Canadian GAAP, the financial statements of the independent funding trust are not consolidated with those of the Company.

### Equity Forward Contracts

During 2009, Glenhuron paid \$55 million to terminate equity forwards representing 3.3 million shares, which led to the extinguishment of a corresponding portion of the associated liability.

As at January 2, 2010, Glenhuron had equity forwards to buy 1.5 million (2008 – 4.8 million) of the Company's common shares at an average forward price of \$66.25 (2008 – \$54.46) including \$10.03 (2008 – \$9.59) per common share of interest expense. At the end of 2009 the interest and unrealized market loss of \$48 million (2008 - \$92 million) was included in accounts payable and accrued liabilities.

### 6.3 Contractual Obligations

The following illustrates certain of the Company's significant contractual obligations and discusses other obligations as at January 2, 2010:

#### Summary of Contractual Obligations

(\$ millions)	Payments due by year						Total
	2010	2011	2012	2013	2014	Thereafter	
Long term debt (including capital lease obligations)	\$ 343	\$ 390	\$ 38	\$ 391	\$ 474	\$ 2,869	\$ 4,505
Operating leases <sup>(1)</sup>	211	192	166	146	126	664	1,505
Contracts for purchases of Real property and capital Investment projects <sup>(2)</sup>	76	–	–	–	–	–	76
Purchase obligations <sup>(3)</sup>	688	671	479	16	–	–	1,854
<b>Total contractual obligations</b>	<b>\$ 1,318</b>	<b>\$ 1,253</b>	<b>\$ 683</b>	<b>\$ 553</b>	<b>\$ 600</b>	<b>\$ 3,533</b>	<b>\$ 7,940</b>

At year end, the Company had other long term liabilities which included accrued benefit plan liability, future income taxes liability, stock-based compensation 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 colleagues exercise those stock options;
- future payments of restricted share units 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.

(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 underlying transactions.

(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.

## Management's Discussion and Analysis

### 6.4 Off-Balance Sheet Arrangements

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

#### **Standby Letters of Credit**

Standby and documentary letters of credit are used in connection with certain obligations mainly related to pension and benefit programs and performance guarantees associated with real estate and other obligations associated with normal course operating activities. The aggregate gross potential liability related to the Company's standby letters of credit is approximately \$246 million (2008 – \$216 million).

#### **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 27 to the consolidated financial statements.

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

PC Bank participates in bank supported and term securitization programs. Under these programs, PC Bank sells a portion of the total interest in its credit card receivables to independent trusts in exchange for cash. The trusts fund these purchases by issuing debt securities in the form of asset-backed commercial paper or asset-backed term notes 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 AcG 12, "*Transfers of Receivables*". The trusts are either not controlled by PC Bank or are qualifying special purpose entities and therefore the financial results of the trusts are not included in the Company's consolidated financial statements.

PC Bank sells interest in its credit card receivables to the trusts on a fully serviced basis. 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 independent trusts' recourse to PC Bank's assets is limited to PC Bank's excess collateral as well as standby letters of credit provided by major Canadian chartered banks for 9% (2008 – 9%) on a portion of the securitized amount. These standby letters 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 subordinated notes issued by Eagle Credit Card Trust ("Eagle") provide credit support to those notes which are more senior. The retained interest is recorded at fair value.

As at year end 2009, the total amount of securitized credit card receivables outstanding which PC Bank continues to service was \$1.7 billion (2008 – \$1.8 billion) and the associated retained interest was \$13 million (2008 – \$14 million). During 2009, PC Bank received income of \$235 million (2008 – \$176 million) related primarily to PC Bank's rights to excess cash flows earned on the securitized credit card receivables. In the absence of securitization, the Company would be required to use its cash and short term investments or raise alternative financing by issuing debt or equity instruments. Further disclosure regarding this arrangement is provided in notes 1 and 8 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. Further disclosure regarding this arrangement is provided in Section 6.2, "Independent Funding Trusts" and in note 27 to the consolidated financial statements.

## 7. Quarterly Results of Operations

### 7.1 Results by Quarter

Under an accounting convention common in the food distribution industry the Company follows a 52-week reporting cycle which periodically necessitates a fiscal year of 53 weeks. 2008 was a 53-week fiscal year. The 52-week reporting cycle 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.

#### Summary of Quarterly Results

(unaudited)

(\$ millions except where otherwise indicated)	2009					2008				
	First Quarter (12 weeks)	Second Quarter (12 weeks)	Third Quarter (16 weeks)	Fourth Quarter (12 weeks)	Total (audited) (52 weeks)	First Quarter <sup>(1)</sup> (12 weeks)	Second Quarter <sup>(1)</sup> (12 weeks)	Third Quarter <sup>(1)</sup> (16 weeks)	Fourth Quarter <sup>(1)</sup> (13 weeks)	Total <sup>(1)</sup> (audited) (53 weeks)
Sales	\$6,718	\$7,233	\$9,473	\$7,311	\$30,735	\$6,527	\$7,037	\$9,493	\$7,745	\$30,802
Net earnings	109	193	189	165	656	63	140	157	190	550
Net earnings per common share										
Basic (\$)	\$ 0.40	\$ 0.70	\$ 0.69	\$ 0.60	\$ 2.39	\$ 0.23	\$ 0.51	\$ 0.57	\$ 0.70	\$ 2.01
Diluted (\$)	\$ 0.40	\$ 0.70	\$ 0.69	\$ 0.59	\$ 2.38	\$ 0.23	\$ 0.51	\$ 0.57	\$ 0.70	\$ 2.01

Sales and same-store sales growth were positive in the first two quarters of 2009 compared to 2008. Sales and same-store sales declined in the third and fourth quarters of 2009 compared to 2008. Quarterly same-store sales increases were 2.1% and 2.5% for the first two quarters of 2009 compared to 2008, respectively. Quarterly same-store sales declines were 0.6%, and 7.8%, for the third and fourth quarters of 2009 compared to 2008, respectively. The sale of the Company's food service business in the fourth quarter of 2008 negatively impacted sales in 2009 compared to 2008 by 0.5% for each of the first three quarters and by 0.3% in the fourth quarter. The acquisition of T&T in the third quarter of 2009 positively impacted the Company's sales by 0.2% and 1.8% in the third and fourth quarters of 2009, respectively, compared to 2008. Quarterly same-store sales increases for the four quarters of 2008 were 2.8%, 0.7%, 3.0% and 10.6%, respectively. The extra selling week in the fourth quarter of 2008 negatively impacted sales and same-store sales by approximately 7.0% in the fourth quarter of 2009 compared to 2008 and positively impacted sales and same-store sales by approximately 7.9% in the fourth quarter of 2008 compared to 2007. Quarterly sales and same-stores sales are also impacted by seasonality and the timing of holidays.

Internal retail food price inflation decreased throughout each of the last eight quarters and was lower than national food price inflation as measured by CPI. In the fourth quarter of 2009, the Company experienced internal retail food price deflation. CPI decreased to 1.6% in the fourth quarter of 2009 from 9.0% in the first quarter of 2009 and increased to 8.4% in the fourth quarter of 2008 from 0.1% in the first quarter of 2008. This measure of inflation does not necessarily reflect the effect of inflation on the specific mix of goods sold in Loblaw stores.

Net retail square footage increased by 1.0 million square feet since the end of fiscal 2007, to 50.6 million square feet, including the acquisition of 17 T&T stores in the third quarter of 2009 which increased net retail square footage by 0.8 million square feet.

(1) Certain 2008 information has been restated to conform with the new CICA Handbook Section 3064, "Goodwill and Intangible Assets". See note 2 to the consolidated financial statements.

## Management's Discussion and Analysis

Fluctuations in quarterly net earnings during 2009 reflect the underlying operations of the Company as well as the impact of specific charges including the impact of stock-based compensation including the equity forwards and costs related to the incremental investment in information technology and supply chain. Since the third quarter of 2008, quarterly net earnings have benefited from the Company's cost reduction initiatives. Earnings in the third and fourth quarters of 2009 and the first and second quarters of 2008 were pressured by investments in pricing. Quarterly net earnings are also impacted by seasonality and the timing of holidays. The impact of seasonality is greatest in the fourth quarter and least in the first quarter.

The change in the effective income tax rate for 2009 over 2008 was primarily related to the cumulative reduction in the income tax expense as a result of a reduction in Ontario statutory income tax rates enacted in the fourth quarter of 2009, an accelerated utilization of loss carryforwards and a decrease in income tax accruals relating to certain prior year income tax matters.

### 7.2 Fourth Quarter Results

The following is a summary of selected consolidated unaudited financial information for the fourth quarter of 2009. 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)	<b>2009</b> <b>(12 weeks)</b>	2008 <sup>(1)</sup> (13 weeks)
Sales	<b>\$ 7,311</b>	\$ 7,745
Gross profit	<b>1,728</b>	1,740
Operating income	<b>277</b>	320
Interest expense and other financing charges	<b>64</b>	65
Income taxes	<b>39</b>	62
Net earnings	<b>165</b>	190
Net earnings per common share (\$)		
Basic	<b>0.60</b>	0.70
Cash flows from (used in):		
Operating activities	<b>615</b>	619
Investing activities	<b>(753)</b>	(419)
Financing activities	<b>(51)</b>	(161)
Dividends declared per common share (\$)	<b>0.21</b>	0.21
Dividends declared on second preferred share Series A (\$)	<b>0.37</b>	0.37

(1) Certain 2008 information has been restated to conform with the new CICA Handbook Section 3064, "Goodwill and Intangible Assets". See note 2 to the consolidated financial statements.

## Total Sales, Sales Growth and Same-Store Sales Growth

(\$ millions)	2009 (12 weeks)	2008 (13 weeks)
Total sales	\$ 7,311	\$ 7,745
Total sales (decline) growth	(5.6%)	11.2%
Same-store sales (decline) growth	(7.8%)	10.6%

Sales for the fourth quarter decreased 5.6% to \$7,311 million (12 weeks) compared to \$7,745 million (13 weeks) in the fourth quarter of 2008.

The following factors explain the major components that influenced sales for the fourth quarter of 2009 compared to the fourth quarter of 2008:

- same-store sales declined 7.8%, including a decline in sales and same-store sales of approximately 7.0%, due to the extra selling week in the fourth quarter of 2008;
- T&T sales positively impacted sales by 1.8%;
- sales were negatively impacted by 0.3% by the sale of the Company's food service business in the fourth quarter of 2008;
- sales and same-store sales were negatively impacted by approximately 0.7% as a result of the shift of Thanksgiving holiday sales into the third quarter of 2009 from the fourth quarter of 2008;
- sales and same-store sales were positively impacted by approximately 0.6% as a result of a labour disruption in certain *Maxi* stores in Quebec in the fourth quarter of 2008. These stores reopened in the first quarter of 2009, except for two stores that were permanently closed;
- on an equivalent 12 week basis, sales growth in food was flat and sales growth in drugstore was moderate;
- on an equivalent 12 week basis, sales growth in apparel was strong while sales of other general merchandise declined significantly due to lower discretionary consumer spending and reductions in assortment and square footage;
- on an equivalent 12 week basis, gas bar sales increased as a result of higher retail gas prices and strong volume growth;
- the Company experienced internal retail food price deflation compared to modest national food price inflation of 1.6% as measured by CPI. CPI does not necessarily reflect the effect of inflation on the specific mix of goods sold in Loblaw stores; and
- during the fourth quarter of 2009, 7 corporate and franchised stores were opened and 10 corporate and franchised stores were closed, resulting in a net decrease of 0.2 million square feet or 0.5%.

Gross profit decreased by \$12 million to \$1,728 million in the fourth quarter of 2009 compared to \$1,740 million in 2008, as a result of the additional selling week in 2008. Gross profit as a percentage of sales was 23.6% in the fourth quarter of 2009 compared to 22.5% in 2008.

Operating income decreased by \$43 million to \$277 million for the fourth quarter of 2009 compared to \$320 million in 2008, primarily as a result of the additional selling week in 2008. Operating margin was 3.8% for the fourth quarter of 2009 compared to 4.1% in 2008. Contributing to the decrease in operating income was a charge of \$5 million (2008 – income of \$17 million) related to stock-based compensation including the equity forwards and incremental costs of \$12 million related to the Company's investment in information technology and supply chain. Included in 2009 fourth quarter operating income was a charge of \$27 million (2008 - \$29 million) for fixed asset impairments related to asset carrying values in excess of fair values for specific store locations. The fourth quarter of 2008 was positively impacted by \$8 million related to lower than anticipated restructuring costs and a gain of \$22 million on the sale of the Company's food service business.

EBITDA<sup>(1)</sup> decreased by \$14 million, or 3.2%, to \$420 million in the fourth quarter of 2009 compared to \$434 million in the fourth quarter of 2008. EBITDA margin<sup>(1)</sup> increased to 5.7% compared to 5.6% in the fourth quarter of 2008. The decrease in EBITDA<sup>(1)</sup> was primarily due to the decrease in operating income and operating margin.

(1) See Non-GAAP Financial Measures on page 37.

## Management's Discussion and Analysis

On an equivalent 12 week basis and excluding the above items, operating income and EBITDA<sup>(1)</sup> in the fourth quarter of 2009 improved significantly compared to the fourth quarter of 2008.

Total interest expense and other financing charges for the fourth quarter of 2009 were \$64 million compared to \$65 million in 2008.

The effective income tax rate in the fourth quarter of 2009 was 18.3% (2008 – 24.3%). The decrease in the effective income tax rate was primarily related to the cumulative reduction in the income tax expense as a result of a reduction in Ontario statutory income tax rates enacted in the fourth quarter of 2009, the accelerated utilization of loss carryforwards and a decrease in income tax accruals relating to certain prior year income tax matters.

Net earnings for the fourth quarter decreased by \$25 million, or 13.2%, to \$165 million from \$190 million in the fourth quarter of 2008. Basic net earnings per common share for the fourth quarter decreased by \$0.10, or 14.3%, to \$0.60 from \$0.70 in the fourth quarter of 2008.

Basic net earnings per common share were impacted in the fourth quarter of 2009 by a charge of \$0.01 (2008 – income of \$0.07) and a 2009 charge of \$0.08 (2008 – \$0.04) per common share for the net effect of the stock-based compensation including equity forwards.

Fourth quarter cash flows from operating activities were \$615 million in 2009 compared to \$619 million in the fourth quarter of 2008. The decrease can be attributed to the decrease in operating income primarily related to the additional selling week in 2008 and the settlement of equity forward contracts, partially offset by the change in non-cash working capital. Fourth quarter cash flows used in investing activities were \$753 million in 2009 compared to \$419 million in 2008. The increase was primarily due to the change in short term investments and a change in cash flows from credit card receivables, after securitization. During the fourth quarter of 2009, a distribution centre that was sold in 2007 was acquired for approximately \$140 million including the assumption of a mortgage for \$96 million. Capital expenditures for the fourth quarter were approximately \$460 million (2008 – \$353 million). Fourth quarter cash flows used in financing activities were \$51 million in 2009 compared to \$161 million in 2008. The decrease was primarily due to the decrease in cash dividend payments as a result of the DRIP and the repayment of short term debt in the fourth quarter of 2008, partially offset by the purchase of common shares in the fourth quarter of 2009.

### 8. Disclosure Controls and Procedures

Management is responsible for establishing and maintaining a system of 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 National Instrument 52-109 (Certification of Disclosure in Issuers' Annual and Interim Filings), the Executive Chairman, as Chief Executive Officer, and the Chief Financial Officer have caused to be evaluated under their supervision the effectiveness of such disclosure controls and procedures. Based on that evaluation, they have concluded that the design and operation of the system of disclosure controls and procedures were effective as at January 2, 2010.

### 9. Internal Control over Financial Reporting

Management is also responsible for establishing and maintaining adequate internal controls 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.

(1) See Non-GAAP Financial Measures on page 37.

As required by National Instrument 52-109 (Certification of Disclosure in Issuers' Annual and Interim Filings), the Executive Chairman, as Chief Executive Officer, and the Chief Financial Officer have caused to be evaluated under their supervision the effectiveness of such internal controls over financial reporting using the framework established in 'Internal Control – Integrated Framework (COSO Framework) published by The Committee of Sponsoring Organizations of the Treadway Commission (COSO)'. Based on that evaluation, they have concluded that the design and operation of the Company's internal controls over financial reporting were effective as at January 2, 2010.

In designing and evaluating such controls, it should be recognized that due to inherent limitations, any controls, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives and may not prevent or detect misstatements. Projections of any evaluations of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate. Additionally, management is required to use judgment in evaluating controls and procedures.

#### **Changes in Internal Control over Financial Reporting**

Management has also evaluated whether there were changes in the Company's internal controls over financial reporting that occurred during the period beginning on October 11, 2009 and ended on January 2, 2010 that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting. Management has determined that no material changes occurred during this period.

### **10. Enterprise Risks and Risk Management**

The Company is committed to establishing a framework that ensures risk management is an integral part of its activities. To ensure the continued growth and success of the Company, risks are managed through an Enterprise Risk Management ("ERM") program. The Board has approved an ERM policy and oversees the ERM program, which assists all areas of the business in achieving the Company's strategic objectives by bringing a systematic approach, methodology and tools for evaluating and improving the effectiveness of risk management and control. The results of the ERM program and other business planning processes are used to prioritize risk management activities, allocate resources effectively and develop a risk-based internal audit plan.

The Company identifies and manages its risks in support of its vision, mission and goals to assist in achieving its strategic objectives. Risk is not eliminated through the ERM program; rather risks are identified and managed within acceptable risk tolerances. The ERM program is designed to:

- Promote a cultural awareness of risk management and compliance within the Company;
- Facilitate corporate governance by providing a consolidated view of risks across the Company and insight into the identification, assessment, measurement and monitoring of the risks;
- Ensure that resources are acquired economically, used efficiently and adequately protected; and
- Allow the Company to focus on its key risks in the business planning process and optimize financial performance through responsible risk management.

An annual ERM assessment is completed to assist in the update and identification of financial, operational or reputational risks affecting the Company. The ERM program is primarily carried out through interviews and risk assessments with senior management. Risks are assessed based on the likelihood and impact that the underlying risk would have on the Company's ability to execute its strategies and achieve its objectives. Each quarter, management provides an update to the Audit Committee as to the status of the top ten risks in relation to how they have changed from the previous quarter. The accountability for oversight of the management of each risk is allocated by the Audit Committee to either the full Board of Directors or to a Committee of the Board. At least once a year, the relevant business owners update the applicable Committee or the full Board of Directors on their risk management activities over the course of the preceding year.

## Management's Discussion and Analysis

In the normal course of business, the Company is exposed to financial and market risks that have the potential to negatively affect its financial performance. As such, the Company operates with policies and guidelines covering funding, investing, equity, commodity, foreign currency exchange and interest rate management. Policies and guidelines prohibit the use of any financial derivative instrument for trading or speculative purposes.

The operating, financial and reputational risks and risk management strategies identified by management are discussed below. Any of these risks has the potential to negatively affect financial performance. The Company has risk management strategies including insurance programs, which are intended to mitigate the potential impact of these risks. Although these strategies are designed to minimize these risks, some of which are discussed below, the strategies do not guarantee that the associated risks will be mitigated or not materialize or that events or circumstances will not occur which could negatively affect the Company's financial condition or performance.

### 10.1 Operating Risks and Risk Management

#### Change Management and Execution

Significant initiatives in support of the Company's multi-year turnaround plan are currently underway or in the planning stages. These initiatives include the restructuring of the Company's supply chain, execution of the information technology strategic plan and changes in the Company's organizational structure. Success of these initiatives 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 change or implement and achieve its long term strategic objectives. In addition, the centralization of the Company may create synergies in some areas of the business but also increase the risk of losing valuable market knowledge at the regional levels and across the various banners.

To assist in the management of change throughout the organization, the Company has positioned a team to support the major change initiatives in the Company. A department of human resource colleagues is dedicated to business change management and has a focus on communication, training and other support functions for major change initiatives within the Company. In addition, the Company has a Strategic Program Office which tracks progress on strategic initiatives and reviews new initiatives for alignment to the strategy. Despite these activities, any of the events noted above 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, Integrity & Reliability

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 relevant, reliable and accurate information for decision making, including its key performance indicators. Any significant failure or disruption of these systems or the failure to successfully migrate from legacy systems to new systems as part of the Company's significant IT infrastructure initiatives could negatively affect the Company's reputation, ability to carry on business, revenues and financial performance. If the information provided by the information technology systems is inaccurate, the risk of disclosing inaccurate or incomplete information is increased.

The Company has under invested in its IT infrastructure in the past and its systems are in need of upgrading. An IT strategic plan was developed to guide the new systems environment that the Company requires. The Company recently completed the first year of its ERP implementation to integrate and simplify finance and general ledger systems across Loblaw Properties Limited and President's Choice Financial. The Company is planning for additional system implementations in 2010 to streamline merchandising and operations activities. This is one of the largest technology infrastructure programs ever implemented by the Company and is fundamental to the Company's long-term growth strategies. Completing it will require intense focus and significant investment over the next two years.

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.

Information security risk and other associated risks will also arise from undertaking the various projects to upgrade existing systems and introduce new systems. The IT strategic plan includes upgrading information security systems through adherence to information security standards by instituting stricter security system protocols and corporate information security policies. However, 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.

### **Economic Environment**

The Company remains cautious that the economic factors that impact consumer spending patterns could deteriorate. These factors include continued high levels of unemployment, changes in interest rates, household debt, reduced disposable incomes and access to consumer credit and changes in inflation. Management regularly monitors economic conditions and estimates their impact on the Company's operations and incorporates these estimates in short term operating and longer term strategic decisions. Despite these activities, one or more of these factors could negatively affect the Company's sales and margins. Inflationary trends are unpredictable and changes in the rate of inflation will affect consumer prices, which in turn could have a negative impact on the results of the Company.

### **Competitive Environment**

The retail industry in Canada is highly competitive. If the Company is ineffective in responding to consumer 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 or combination of existing competitors, particularly those expanding into the grocery market. These competitors may have extensive resources to allow them to compete effectively with the Company in the long term. 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. 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, reduced market share and growth opportunities, as well as lower pricing in response to its competitors' pricing activities.

In addition, competitors could acquire or develop partnerships with other businesses, which could increase their market share or otherwise improve their competitiveness. If significant acquisitions or alliances are undertaken by competitors, the Company could lose opportunities for growth and partnerships in the market or otherwise experience adverse consequences.

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 and adjusting pricing, product offerings and marketing programs. However, the Company's competitive position and financial performance could be negatively impacted should any of the above events occur.

## Management's Discussion and Analysis

### **Food Safety and Public Health**

The Company is subject to risks associated with food safety and non-food product defects. Such liabilities may arise as part of product procurement, distribution and product preparation and display, including the development and manufacture of the Company's control label products. A majority of the Company's sales are generated from food products and thus could be vulnerable in the event of a significant outbreak of food-borne illness or other public health concerns related to food products. Such an event could negatively affect the Company's financial performance. The traceability of products to the consumer level may affect the Company's ability to be effective in a recall situation.

A product recall program is in place to manage such events, should they occur. The program identifies risks, provides clear procedures for communication to employees and consumers and is aimed at ensuring that potentially harmful products are expeditiously removed from inventory and are not available for sale. The Company has food safety procedures and training programs which address safe food handling and preparation standards. The Company endeavours to employ current best practices for the procurement, distribution and preparation and display of food products. Also, it actively supports customer awareness of safe food handling and healthy choices. The Company places special focus on applying a safety and quality management system to ensure its control label products meet all food safety, regulatory nutritional requirements and quality standards for today's health conscious consumer to make informed choices. The ability of these programs and 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 the underlying risks and any event related to these matters has the potential to adversely affect the Company's reputation and its financial performance.

### **Colleague Attraction, Development and Retention**

The degree to which the Company is not effective in attracting and retaining talented employees, developing its employees, managing performance and implementing appropriate succession planning processes and retention strategies could lead to a lack of requisite knowledge, skills and experience. Effective talent attraction, colleague development, performance management, succession planning and colleague retention are essential to sustaining the growth and success of the Company. Management has implemented new programs throughout 2009 which will be ongoing into 2010 to assist in colleague attraction, retention, and development. The initiatives are focused on improving colleague engagement and supporting the Company's "Be a Great Place to Work" principle. Should these initiatives not be successful, the Company may not be able to execute its strategies, efficiently run its operations and its goals for financial performance may be adversely affected.

### **Distribution and 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 attract and retain current and potential customers. A significant restructuring of the Company's supply chain will continue for the next two 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.

### **Labour Relations**

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. In 2010, 73 collective agreements affecting approximately 35,000 colleagues will expire including the Company's single largest agreement covering approximately 13,700 colleagues. The Company will also continue to negotiate the 66 collective agreements carried over from 2005 to 2009 inclusively. 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. Although the labour relations leadership team attempts to mitigate work stoppages and disputes through early negotiations, where possible, or through delaying negotiations through busy periods, work stoppages or slowdowns are possible.

### **Merchandising and Excess Inventory**

The Company may have inventory that customers don't want or need, is not reflective of current trends in customer tastes or habits, is priced at a level customers are not willing to pay, or that is late in reaching the market. The Company's operations as they relate to food, 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. The Company focuses effort on reducing inventory levels and early identification of inventory at risk. New information systems are being implemented that are expected to improve demand forecasting. In order to reduce the amount of excess inventory, the Company monitors the impact of customer trends. Innovation is critical to the Company in order to respond to these customer demands and to stay competitive in the marketplace. Despite these efforts, the Company may experience excess inventory that cannot be sold profitably which may negatively impact the Company's financial performance.

### **Strategic**

Strategies must be understood and properly managed in order to deliver long term growth for the Company. If the strategy for the various banners is not clear, the stores may not be properly positioned in the marketplace. The execution of the Company's capital plans could pose a risk if they are not aligned with the strategy of the Company. In addition, the Company's ability to operate in the long term is affected by the development and location of real estate and spending decisions made in the short term. Decisions over rebuilding old networks of assets or increasing new assets could affect the Company's ability to compete in the long term. The strategy is formulated annually by Senior Management and is communicated throughout the organization. It is reviewed on a periodic basis to drive execution and ensure ongoing relevance. If the Company's strategy is not effectively communicated and executed, performance of the Company could suffer.

### **Vendor Management and Business Partnership**

Certain aspects of the Company's business rely on suppliers that provide the Company with goods and services. Although appropriate contractual arrangements are put in place with these suppliers, the Company has no direct influence over how the companies are managed. Negative events affecting the suppliers could in turn negatively impact the Company's operations and its financial performance. Inefficient, ineffective or incomplete supplier management strategies, policies and/or procedures may impact the Company's ability to optimize financial performance, meet customer needs and/or control costs and quality.

The Company's control label products are manufactured under contract by third-party suppliers. In order to preserve the brands' equity, these suppliers are held to high standards of quality. The Company also uses third-party logistic services including the operation of dedicated warehouse and distribution facilities, and third-party common carriers. The Company maintains a strategy of multiple sources for logistics providers so that in the event of a disruption of service from one supplier, their services can be replaced by another. However, disruption in these services is possible which could interrupt the delivery of merchandise to the stores and therefore could negatively impact sales.

Offshore sourcing could provide products which contain harmful or banned substances or that do not meet Canadian standards. The Company continues to implement practices and performance expectations with its supplier base, including asking suppliers to support sales plans, cost reduction initiatives and to align with major program changes. Failure to effectively implement this program will have an impact on the Company's ability to realize the expected benefits.

*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 operationalize certain risk management strategies 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.

The Company relies on third parties for investment management, custody and other services for its cash equivalents, short term investments, security deposits and pension assets. Any disruption in the services provided by these suppliers could affect the return on these assets or liquidity of the Company.

## Management's Discussion and Analysis

### **Business Continuity**

Events or series of events may cause business interruptions which could potentially impact sales, profitability, colleague safety, reputation and customer service. The Company has an enterprise wide business continuity program which is being continually matured. However, there can be no assurance that the existence of a business continuity program will ensure the Company responds appropriately in the event of business interruptions, crises and potential disasters.

### **Trademark and Brand Protection**

Decrease in value of the Company's trademarks or brands, either because of adverse events or otherwise over time may threaten the demand for the Company's products or services or damage the Company's reputation. The Company endeavours to have the appropriate contractual protections in its arrangements with control label vendors and suppliers of all marketing elements (printing, flyers, advertising etc). The Company actively monitors and manages its trademark portfolio. Notwithstanding these activities, any negative impact to the value of the Company's trademarks or brands may impair its ability to maintain or grow current and future sales and profitability.

### **Tax and Regulatory**

Changes to any of the laws, rules, regulations or policies related to the Company's business including taxation, accounting and 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. Changing regulations or enhanced enforcement of existing regulations could threaten the Company's competitive position and its capacity to efficiently conduct business. 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, assessment, 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 jurisdiction 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.

### **Franchise Independence and Relationships**

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 could 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 legislation 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, any of which could affect the Company's relationship with its franchisees. Relationships with franchisees could pose significant risks if they are disrupted which could result in legal action, reputational damage and/or adverse financial consequences.

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

The Company maintains a large portfolio of real estate and is subject to environmental risks associated with the contamination of such properties, whether by previous owners or occupants, neighbouring properties or from its own operations. The Company could be subject to increased or unexpected costs associated with the related remediation activities.

The Company has environmental, health and workplace safety programs and has established policies and procedures aimed at ensuring compliance with applicable environmental 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. In the area of health and safety, the Company has established a national health and safety policy and a 5 year injury reduction plan, which is administered by functional corporate and regional safety steering committees.

The Environmental, Health and Safety Committee of the Board receives regular reporting from management addressing current and potential future issues, risks, programs/initiatives, identifying new regulatory concerns and related communication efforts. The Company's dedicated environmental affairs department works closely with operations to help ensure requirements are met.

Despite these efforts, adverse environmental, health and safety events could negatively affect the Company's reputation and financial performance. In addition, in recent years, provincial and municipal governments have introduced legislation that imposes liabilities on retailers, brand owners and importers for costs associated with recycling and disposal of consumer goods packaging and printing materials distributed to consumers. This is a growing trend and the Company expects to be subject to increased costs associated with these laws.

### **Employee Future Benefit Contributions**

The Company manages the assets in its defined benefit pension plans by engaging professional investment managers who operate under prescribed investment policies and procedures in respect of permitted investments and asset allocations. The future contributions to the Company's pension plans are impacted by the investment performance of the plan assets and the discount rate used to value the liabilities of the plans. The Company regularly monitors and assesses plan experience and the impact of changes in participant demographics, changes in capital markets and other economic factors that may impact funding requirements, employee future benefit costs and actuarial assumptions. If capital market returns are below assumed levels, or if the discount rate drops, the Company may be required to make contributions to its registered funded defined benefit pension plans in excess of those currently contemplated, which in turn may have a negative effect on the Company's financial performance and cash flow.

### **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 39% (2008 – 40%) 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, the Company 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.

### **Real Estate and Store Renovations**

Real estate development plans may be contingent on successful negotiation of labour agreements with respect to same-site expansion or redevelopment. 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. As part of ongoing review of performance of, and customer satisfaction with, the Company's stores, the Company from time to time undertakes store renovations and remodelling. Efforts are made to minimize the duration of renovation and remodelling projects in order to limit the disruption at store level. However, the Company could be negatively impacted if such renovations and remodelling are carried out in a manner that is disruptive to the ongoing store operations or results in a poor customer experience.

### **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, natural gas and fuel. However, cost increases in these items could negatively affect the Company's financial performance.

## Management's Discussion and Analysis

### **Ethical Business Conduct**

Any failure of the Company or its vendors to adhere to ethical business conduct policies, the law or ethical business practices could significantly affect the Company's reputation and brands and could, therefore, negatively impact the Company's financial performance.

The Company has adopted a Code of Business Conduct which employees and directors of the Company are required to acknowledge 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.

### **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.

## **10.2 Financial Risks and Risk Management**

### **Liquidity and Capital Availability**

Liquidity risk is the risk that the Company cannot meet a demand for cash or fund its obligations as they come due. Liquidity risk also includes the risk of not being able to liquidate assets in a timely manner at a reasonable price. Insufficient access to capital would impair the Company's capacity to grow, execute its business model and generate financial returns.

Should the Company's financial performance and condition deteriorate or downgrades in the Company's credit ratings occur, the Company's ability to obtain funding from external sources may be restricted. In addition, credit and capital markets are subject to inherent global risks that may negatively affect the Company's short term investments as well as its access to external capital to fund its liabilities including financial liabilities. The Company mitigates these risks by maintaining appropriate levels of cash and cash equivalents and short term investments in highly rated liquid securities, committed lines of credit and diversifying the sources and maturity profile of its external capital.

In March 2011, \$500 million of credit card receivables-backed notes issued by Eagle will mature. The notes were issued by Eagle to fund the purchase of an interest in PC Bank originated credit card receivables. An accumulation period that requires PC Bank to set aside cash collections will begin approximately 6 months prior to the maturity of the notes, or at such earlier or later date declared by the Trust. PC Bank and the Company expect to have sufficient access to short term liquidity to fund the accumulation and long term funding and securitization facilities to replace or refinance this facility.

### **Credit**

The Company is exposed to credit risk resulting from the possibility that counterparties may default on their financial obligations. Exposure to credit risk relates to derivative instruments, cash equivalents, short term investments, security deposits included in other assets, pension assets held in the Company's defined benefit plans, PC Bank's credit card receivables and other receivables from independent franchisees, associated stores and independent accounts.

The Company may be exposed to losses if a counterparty to the Company's financial or non-financial derivative agreements fails to fulfill its obligations. Potential counterparty risk and losses are limited to the net amounts recoverable under such derivative agreements with any specific counterparty. These risks are further reduced by entering into 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 exposure to any single counterparty for financial derivative agreements. Internal policies, controls and reporting processes, which require ongoing assessment and corrective action, if necessary, are in place with respect to derivative transactions.

Credit risk associated with cash equivalents, short term investments and security deposits included in other assets results from the possibility that a counterparty may default on the repayment of a security. 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 industries, issuers and types of investment instruments attempt to mitigate credit risk. These investments are purchased and held directly in custody accounts and there is limited exposure to any third party money market portfolios and funds.

Credit risk from PC Bank's credit card receivables and receivables from independent franchisees, associated stores 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, 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, associated stores 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.

### **Foreign Currency Exchange Rate**

The Company is exposed to foreign currency exchange rate variability, primarily on United States dollar denominated cash and cash equivalents, short term investments, security deposits included in other assets held by Glenhuron, foreign denominated and foreign currency based purchases in accounts payable and accrued liabilities, and USD private placement notes included in long term debt. The Company and Glenhuron have cross currency swaps that partially offset their respective exposure to fluctuations in foreign currency exchange rates. Cross currency swaps are transactions in which interest payments and principal amounts in one currency are exchanged against the receipt of interest payments and principal amounts in a second currency.

### **Commodity Price**

The Company uses financial and non-financial derivative 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 Company is exposed to increases in the prices of commodities in operating its stores and distribution centres, as well as the indirect link of commodities to its consumer products. To manage a portion of this exposure, the Company uses purchase commitments for a portion of its needs for certain consumer products that may be commodities based and the Company expects to take delivery of these consumer products in the normal course of business. A non-financial derivative contract is used to hedge electricity price risk for a portion of the Company's expected electricity consumption in Alberta. The Company also enters into exchange traded futures and option contracts to minimize cost volatility in fuel prices.

### **Common Share Market Price**

The Company issues stock-based compensation to its employees in the form of stock options and RSU's based on its common shares. Consequently, the operating results of the Company are negatively impacted when the common share price increases and positively when the share price declines. Glenhuron's equity forwards provide a partial offset to fluctuations in stock-based compensation cost. The equity forwards allow for settlement in cash, common shares or net settlement. These forwards change in value as the market price of the Company's common shares changes and provide a partial offset to fluctuations in the Company's stock-based compensation cost, including RSU plan expense. The partial offset between the Company's stock-based compensation costs, including RSU plan expense, and the equity forwards is more effective when the market price of the Company's common shares exceeds the exercise price of the employee stock options. When the market price of the common shares is lower than the exercise price of the employee stock options, only RSUs will provide a partial offset to these equity forwards. The amount of net stock-based compensation cost recorded in operating income is mainly dependent upon the number of unexercised stock options and RSUs, their vesting schedules relative to the number of underlying common shares on the equity forwards, and the level of fluctuations in the market price of the underlying common shares. As at the 2009 year end, 4,118,464 stock options had exercise prices which were greater than the market price of the Company's common shares at year end.

## Management's Discussion and Analysis

### Interest Rate

Interest rate risk arises from the issuance of short term debt by the Company and equity forwards by Glenhuron, net of cash and cash equivalents, short term investments and security deposits included in other assets. The Company is exposed to changes in short term interest rate volatility which are offset partly by Glenhuron's and the Company's interest rate swaps. Interest rate swaps are transactions in which interest flows are exchanged with a counterparty on a specified notional amount for a pre-determined period based on agreed-upon fixed and floating interest rates.

### Derivative Instruments

Over-the counter derivative instruments offset certain risks. The fair value of derivative instruments is subject to changing market conditions which could negatively impact earnings. Policies and guidelines prohibit the use of any derivative instrument for trading or speculative purposes. See notes 1 and 24 to the consolidated financial statements for additional information about the Company's financial derivative instruments.

## 11. Related Party Transactions

The Company's majority shareholder, Weston and its affiliates other than the Company, 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% (2008 – 3%) of the cost of merchandise inventories sold.

### 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 2009 were approximately \$30 million (2008 – \$28 million).

### Real Estate

The Company leases office space from an affiliate of Weston for approximately \$3 million (2008 – \$2 million).

### 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 amounts (2008 – nil) 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.

### Supply Agreement

In 2008, the Company entered into a long term supply agreement with a subsidiary of Weston, and in exchange received cash proceeds of \$65 million which will be recognized into income over the term of the agreement, of which \$8 million (2008 – \$1 million) was recognized in 2009. As at January 2, 2010, \$8 million was included in accounts payable and accrued liabilities and \$48 million in other liabilities. Certain assets and liabilities of a wholly owned subsidiary were sold by Weston in 2009.

## **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 2009 were \$16 million (2008 – \$13 million). Fees paid under this agreement are reviewed each year by the Audit Committee.

Glenhuron 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. In 2008, Glenhuron had an agreement with a subsidiary of Weston for the administration of a loan portfolio of third party long term loans receivable. During 2009, Weston disposed of this subsidiary.

## **12. 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.

### **12.1 Inventories**

Certain retail store inventories are stated at the lower of cost and estimated net realizable value. 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 the category 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 will 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.

Additional information on inventories is provided in note 10 to the consolidated financial statements.

### **12.2 Fixed Assets**

Fixed assets are reviewed for impairment annually and also 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 note 11 to the consolidated financial statements in 2009, the Company recorded a fixed asset impairment charge of \$27 million (2008 – \$29 million) and other charges of \$19 million (2008 – \$18 million).

## Management's Discussion and Analysis

The factor that most significantly influences the impairment assessments is the determination of fair value based on 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.

### 12.3 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 rates, termination rates 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 2009 net cost for defined benefit pension and other benefit plans were 6.0% and 5.7%, respectively, on a weighted average basis, compared to 5.5% and 5.3%, respectively, in 2008. The discount rates which will be used to determine the net 2010 defined benefit pension and other benefit plans costs have decreased to 5.75% and 5.5%, 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 historical returns. The Company has reduced the expected long term rate of return on plan assets to 6.75% in calculating its defined benefit pension plans cost for 2010. The Company's defined benefit pension plan assets had a 10 year annualized return of 5.3% as at the 2009 measurement date. The actual annual returns within this 10 year period varied with market conditions.

The expected growth rate in health care costs for 2009 was based on external data and the Company's historical trends for health care costs. In 2010, the growth rate of health care costs is estimated at 9.0% and is assumed to gradually decrease to 5.0% by 2015, remaining at that level thereafter.

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.

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.

## 12.4 Goodwill and Indefinite Life Intangible Assets

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 of its reporting units 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 2009 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.

Intangible assets with indefinite useful lives, primarily consisting of T&T trademarks and brand names, are assessed for impairment at least annually. Any potential intangible asset impairment is identified by comparing the fair value of the indefinite life intangible asset to its carrying value. If the fair value of the intangible asset exceeds its carrying value, the intangible asset is considered not to be impaired. If the carrying value of the intangible asset exceeds its fair value, impairment is identified as the difference between the fair value and the carrying value and will result in a reduction in the carrying value of the intangible asset on the consolidated balance sheet and the recognition of a non-cash impairment charge in operating income in the consolidated statement of earnings.

The Company determines the fair value of its trademarks and brand names by using the "Relief from Royalty Method", a discounted cash flow model. The process of determining the fair values requires management to make assumptions of a long term nature regarding projected future sales, terminal growth rates, royalty rates and discount rates. Projected future sales are consistent with strategic plans presented to the Company's Board and discount rates are based on an industry after-tax cost of equity. These estimates and assumptions may change in the future due to uncertain competitive and economic market conditions or changes in business strategies.

The impairment test was not performed in 2009 as the assets were acquired in the third quarter.

## 12.5 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.

At each balance sheet date, future income tax assets are reviewed to determine whether a valuation allowance is required. Such an allowance is required when it is deemed unlikely that projected future taxable income will be sufficient to realize the future income tax benefits.

## Management's Discussion and Analysis

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. Accounting Standards

#### 13.1 Accounting Standards Implemented in 2009

**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" ("Section 3064") to replace Section 3062 "Goodwill and Other Intangible Assets", withdrew Section 3450 "Research and Development Costs" and amended Emerging Issues Committee ("EIC") Abstract 27 "Revenues and Expenditures During the Pre-operating Period" to not apply to entities that have adopted Section 3064. These amendments, in conjunction with Section 3064, provide guidance for the recognition of intangible assets, including internally developed assets from research and development activities, ensuring consistent treatment of all intangible assets, whether separately acquired or internally developed. The Company implemented these requirements in 2009, retroactively with restatement of the comparative period. Restatement of the comparative period resulted in an increase in selling and administrative expenses of \$29 million, a decrease in depreciation and amortization of \$35 million and an increase to future tax expense of \$1 million. Restatement of the comparative period also resulted in a decrease to other assets of \$42 million, a decrease to retained earnings of \$27 million and a decrease to the future income taxes liability of \$15 million.

**Credit Risk and the Fair Value of Financial Assets and Financial Liabilities** On January 20, 2009 EIC Abstract No.173 "Credit Risk and the Fair Value of Financial Assets and Financial Liabilities" ("EIC 173") was issued. The committee reached a consensus that a company's credit risk and the credit risk of its counterparties should be considered when determining the fair value of its financial assets and financial liabilities, including derivative instruments. The transitional provisions require the abstract to be applied retrospectively without restatement of prior periods. Financial assets and financial liabilities, including derivative instruments, have been remeasured as at January 4, 2009 to take into account the appropriate Company's credit risk and counterparty credit risk. As a result, a decrease in other assets of \$12 million, a decrease in other liabilities of \$4 million, a decrease net of income taxes in accumulated other comprehensive income of \$2 million and a decrease in retained earnings of \$6 million were recorded in the consolidated balance sheet.

**Financial Instruments – Disclosures** In June 2009, the CICA amended Section 3862, "Financial Instruments – Disclosures" to include additional disclosure relating to the measurement of fair value for financial instruments and liquidity risk. The amendment establishes a three level hierarchy that reflects the significance of the inputs used in fair value measurements on financial instruments. The amendment is effective for annual financial statements relating to fiscal years ending after September 30, 2009. See note 25 to the consolidated financial statements for the additional disclosures.

#### 13.2 Future Accounting Standards

The Company closely monitors new accounting standards to assess the impact, if any, on its consolidated financial statements. In 2010 and 2011, the Company will be reviewing the implications of the following standards and implementing the recommendations as required:

**Business Combinations** In January 2009, the CICA issued Section 1582, "Business Combinations," which will replace Section 1581 of the same title and issued Sections 1601 "Consolidated Financial Statements" and 1602 "Non-Controlling Interests". These standards will harmonize Canadian GAAP with International Financial Reporting Standards ("IFRS"). The amendments establish principles and requirements for determining how an enterprise recognizes and measures the fair value of certain assets and liabilities acquired in a business combination, including non-controlling interests, contingent consideration, and certain acquired contingencies. The amendments also require that acquisition related transaction expenses and restructuring costs be expensed as incurred rather than capitalized as a component of the business combination. These amendments are effective for business combinations with an acquisition date on or after January 1, 2011 and early adoption is permitted. The impact of implementing these amendments on the Company's financial statements is currently being assessed.

**Multiple Deliverable Revenue Arrangements** On December 24, 2009 the EIC issued EIC 175 "Multiple Deliverable Revenue Arrangements" which replaces EIC 142 "Revenue Arrangements with Multiple Deliverables". The Abstract provides guidance on the identification and accounting for multiple revenue generating activities and specifically requires a vendor to allocate consideration to multiple deliverables based on their relative selling price. The Abstract may be applied prospectively for annual fiscal periods beginning on or after January 1, 2011 with permitted early adoption. The impact of implementing this Abstract on the Company's financial statements is currently being assessed.

### 13.3 International Financial Reporting Standards

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.

#### Project Structure and Status

The Company has an IFRS team led by the Chief Financial Officer to ensure the timely and appropriate implementation of IFRS. The IFRS team consists of dedicated resources as well as consultants and other employees on an as needed basis. This team reports regularly to a steering committee comprised of senior management, as well as to the Audit Committee.

The Company has developed an IFRS conversion project plan consisting of three main phases:

**Phase One: Diagnostic Impact Assessment** This phase consisted of a high-level impact assessment that identified the key areas of accounting differences between Canadian GAAP and IFRS that were likely to impact the Company. The diagnostic impact assessment was completed in 2008 and resulted in the ranking of accounting differences as high, medium, or low priority for further analysis.

**Phase Two: Detailed Assessment** This phase involved a comprehensive assessment of the differences between IFRS and the Company's current accounting policies and included reviews with the various finance groups and business process owners to further understand the impact of these differences. The detailed assessment was completed in April 2009 at which time the potential changes to existing accounting policies, business process and information systems were identified. Further analysis to finalize these impacts continued through 2009 and will be concluded in 2010.

**Phase Three: Implementation** This phase includes two components: implementation development and implementation transition and will result in the compilation of IFRS transitional adjustments, as required, as well as IFRS financial statements with required reconciliations to Canadian GAAP.

## Management's Discussion and Analysis

The implementation development phase is currently in progress and involves an analysis of policy alternatives under IFRS, including certain exemptions and elections available on transition. To date, management has determined preliminary conclusions for certain policy alternatives, as discussed below, while certain others remain under review. In addition, during this phase the required changes to supporting information systems and business processes, including the budgeting and planning process, financial covenants, key performance indicators, compensation arrangements that rely on financial statement indicators and contractual agreements, are being reviewed. The design and development of the required changes in these areas is in process and are expected to be completed by the end of 2010.

The implementation transition phase involves the final approval of accounting policies, including transitional elections, the execution of changes to business processes and supporting information systems, and the training of finance, operational and other staff. These activities are currently in process and will continue throughout 2010 in preparation for IFRS reporting, beginning in the first quarter of 2011.

Throughout 2010, the Company will prepare its internal opening balance sheet and quarterly financial statements in accordance with IFRS, based on management's preliminary conclusions for various policy alternatives. Changes to information systems required to prepare the opening balance sheet have been completed, while further changes necessary to gather appropriate information for dual reporting throughout 2010 are in process and nearing completion. Preparation of the opening balance sheet is currently in progress, and quarterly financial statements are expected to be prepared throughout 2010.

The Company has provided high level training to affected employees, senior management and the Board. Further detailed training regarding specific changes has been provided to individuals responsible for affected areas and will continue throughout 2010.

For all accounting policy changes identified, an assessment of the design and effectiveness implications on Internal Controls over Financial Reporting and Disclosure Controls and Procedures will be completed. Documentation of internal controls related to accounting policy changes has commenced and is expected to be completed during the third quarter of 2010.

The Company will continue to provide quarterly updates on its progress throughout the conversion period, to allow stakeholders to assess the impact of the conversion on the Company's financial performance, and the Company's ability to transition to IFRS in the first quarter of 2011. The Company anticipates communicating decisions about accounting policy alternatives and the impact of these decisions on the Company's consolidated financial statements once these items are finalized.

The information below is provided to allow investors and others to obtain a better understanding of the possible effects on, the Company's consolidated financial statements and operating performance measures. Readers are cautioned, however, that it may not be appropriate to use such information for any other purpose.

### **Changes in Accounting Policies**

The Company continues to assess the aggregate effect of adopting IFRS, and the relevant changes in accounting policies. The changes identified below should not be regarded as a complete list of changes that will result from the transition to IFRS as it is intended to highlight those areas that are believed to be most significant at this point in the project. The International Accounting Standards Board has significant ongoing projects that could affect the ultimate differences between Canadian GAAP and IFRS and their impact on the Company's consolidated financial statements. Therefore, the Company's analysis of changes and accounting policy decisions have been made based on the accounting standards that are currently effective.

The Company is currently assessing the quantitative impact of the transitional adjustments on the consolidated financial statements and expects to be able to report later in fiscal 2010.

**Securitization of Receivables** International Accounting Standard (“IAS”) 39, “Financial Instruments: Recognition and Measurement”, contains different criteria than Canadian GAAP for the derecognition of financial assets and requires an evaluation of the extent to which an entity retains the risks and rewards of ownership. Under Canadian GAAP these financial assets qualify for sale treatment pursuant to AcG 12. The Company has determined that under IFRS credit card receivables will not qualify for derecognition.

**Consolidation** The Company consolidates certain independent franchisees and other entities subject to warehouse and distribution service agreements. Under IAS 27, “Consolidated and Separate Financial Statements” and Standing Interpretations Committee 12, “Consolidation – Special Purpose Entities” consolidation is assessed using a control model that does not include the concept of a variable interest entity. Under IFRS it is anticipated that the above noted entities will no longer be consolidated, while other financing entities, specifically the Independent Funding Trust through which franchisees obtain financing and Eagle, the independent trust that finances certain PC Bank credit card receivables, will likely be consolidated.

**Employee Benefits** IAS 19, “Employee Benefits” (“IAS 19”) requires the past service cost element of defined benefit plans to be expensed on an accelerated basis, with vested past service costs expensed immediately and unvested past service costs recognized on a straight-line basis until the benefits become vested. Under Canadian GAAP, the Company generally amortizes past service costs on a straight-line basis over the average remaining service period of active employees expected under the plan. This difference will likely result in a reduction of unamortized past service costs on transition to IFRS.

IAS 19 provides a policy choice regarding recognition of actuarial gains and losses for defined benefit pension plans and post retirement benefit plans, permitting deferred recognition using the corridor method, or immediate recognition in either equity or through earnings. Under Canadian GAAP the Company applies the corridor method. The Company continues to review the impact of this policy choice.

**Property Plant and Equipment** IAS 16, “Property, Plant and Equipment” (“IAS 16”) provides specific guidance such that when an individual part of an item of property, plant and equipment is replaced and capitalized as part of property, plant and equipment, the replaced part of the original asset must be de-recognized even if the replacement part was not originally componentized. The guidance in IAS 16 also provides more specific guidance with respect to the costs that are required and those that are eligible for capitalization, and the basis of their initial recognition. The Company is currently quantifying the potential impact of these changes on the opening balance sheet but they will likely result in the reduction of property, plant and equipment balances on transition to IFRS.

IAS 16 provides a policy choice in measuring each class of property, plant and equipment after initial recognition permitting the use of the cost or the revaluation model. The cost method is currently used under Canadian GAAP. The Company currently intends to continue to use the cost model as its accounting policy for the measurement of property, plant and equipment after initial recognition.

**Impairment of Assets** IAS 36, “Impairment of Assets”, uses a one-step approach for testing and measuring impairment, with asset carrying values compared directly with the higher of fair value less costs to sell and value in use using discounted future cash flows. Canadian GAAP generally uses a two-step approach to impairment testing of long-lived assets: first comparing asset carrying values with undiscounted future cash flows to determine whether impairment exists; and then measuring any impairment by comparing asset carrying values with fair values. The difference in methodologies may potentially result in additional asset impairments under IFRS.

IFRS also requires that assets be tested for impairment at the level of cash generating units, which are defined as the lowest level of assets that generate largely independent cash inflows. Canadian GAAP requires assets to be grouped at the lowest level for which identifiable cash flows are largely independent of the cash flows of other assets and liabilities for impairment testing purposes. As a result, IFRS is expected to result in a lower level grouping of assets and therefore, may result in additional asset impairment charges under IFRS.

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**Provisions** IAS 37, "Provision, Contingent Liabilities and Contingent Assets" ("IAS 37"), requires an entity to recognize a provision when a contract is determined to be onerous. A contract is onerous when the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it. Canadian GAAP only requires the recognition of such a liability in certain prescribed situations. This difference could result in recognition of a liability under IFRS that was not previously recognized under Canadian GAAP. In addition, the measurement provisions under IAS 37 differ from the corresponding requirements under Canadian GAAP, which could result in the recording of provisions earlier or at a different amount than under Canadian GAAP. The Company is currently reviewing contracts and assessing the impact of measurement differences throughout the business to determine the overall impact of IAS 37 on transition to IFRS.

**Share-based Payments** IFRS 2, "Share-based Payments", requires that cash-settled share-based payments to employees be measured (both initially and at each reporting date) based on the fair value of the awards. Canadian GAAP requires that such payments be measured based on the intrinsic value of the awards at each reporting date. This difference is expected to impact the compensation expense recognized related to the Company's share-based payments, including stock options, share appreciation rights, and restricted share units and will likely result in an increase to the Company's liability on transition to IFRS.

**Customer Loyalty Programs** International Financial Reporting Interpretations Committee 13, Customer Loyalty Programs, requires the fair value of loyalty programs to be recognized as a component of sales transactions. The Company will be required to defer a portion of the revenue for the initial sales transaction in which the awards are granted based on their fair value. Under Canadian GAAP, the Company recognizes the net cost of the program in operating expenses. Although the amount of the impact is currently being assessed, the Company expects the impact will be not significant on transition to IFRS.

### First-Time Adoption of IFRS

The adoption of IFRS will require the application of IFRS 1, "First Time Adoption of IFRS" ("IFRS 1"), which provides guidance for an entity's initial adoption of IFRS. IFRS 1 generally requires retrospective application of all IFRS effective at the reporting date, with the exception of certain mandatory exceptions and limited optional exemptions provided in the standard. The following are the significant optional exemptions available under IFRS 1 that the Company expects to apply in preparing its opening balance sheet in accordance with IFRS:

**Employee Benefits** The Company expects to apply an election which will recognize all cumulative actuarial gains and losses through retained earnings. If this exemption is not taken, actuarial gains and losses would have to be recalculated based on the requirements of IAS 19 from the inception of each of the Company's defined benefit plans. The Company's choice must be applied to all defined benefit plans consistently.

**Borrowing Costs** IFRS 1 allows prospective application of IAS 23, "Borrowing Costs" ("IAS 23"), which requires capitalization of borrowing costs to all qualifying assets. The Company currently expects to elect to apply IAS 23 prospectively, which will result in derecognition of borrowing costs previously capitalized.

**Business Combinations** The Company expects to apply IFRS 3, "Business Combinations" ("IFRS 3") prospectively only to those business combinations that occur after the date of transition. If this election is not made, the Company would have to select a historical transition date from which to apply the requirements of IFRS 3 prospectively.

## 14. Outlook<sup>(1)</sup>

The Company has completed three years of its renewal program and is making progress, with two of the toughest years ahead. Entering into 2010 sales and margins will continue to be challenged by deflation and increased competitive intensity. In 2010 the Company plans to step up investments in information technology and supply chain which will negatively impact operating income by approximately \$185 million over 2009, while at the same time maintaining its capital expenditures at approximately \$1 billion.

(1) To be read in conjunction with "Forward-Looking Statements" on page 2.

## 15. Non-GAAP Financial Measures

The Company uses the following non-GAAP financial measures: EBITDA and EBITDA margin, net debt, net debt to equity, net debt to EBITDA and return on average net assets. The Company believes these non-GAAP financial measures provide useful information to both management and investors in measuring the financial performance and financial condition of the Company for the reasons outlined below. These measures do not have a standardized meaning prescribed by Canadian GAAP and therefore they may not be comparable to similarly titled measures presented by other publicly traded companies, and they should not be construed as an alternative to other financial measures determined in accordance with Canadian GAAP.

### EBITDA and EBITDA Margin

The following table reconciles earnings before minority interest, income taxes, interest expense and depreciation and amortization ("EBITDA") to operating income which is reconciled to Canadian GAAP net earnings measures reported in the consolidated statements of earnings for the years ended January 2, 2010, January 3, 2009 and December 29, 2007. 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.

EBITDA margin is calculated as EBITDA divided by sales.

(\$ millions)	2009 (52 weeks)	2008 <sup>(1)</sup> (53 weeks)	2007 <sup>(2)</sup> (52 weeks)
Net earnings	\$ 656	\$ 550	\$ 336
Add impact of the following:			
Minority interest	11	10	4
Income taxes	269	229	152
Interest expense and other financing charges	269	263	252
Operating income	1,205	1,052	744
Add impact of the following:			
Depreciation and amortization	589	550	556
EBITDA	\$ 1,794	\$ 1,602	\$ 1,300

### Net Debt

In the first quarter of 2009, the Company revised its definition of net debt to include the fair value of certain financial derivative assets and liabilities as the Company believes that the measure should include all interest bearing financing arrangements.

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. The Company calculates net debt as the sum of bank indebtedness, short term debt, long term debt, other liabilities and the fair value of financial derivatives less cash and cash equivalents, short term investments, security deposits included in other assets and the fair value of financial derivatives. The Company believes that this measure is useful in assessing the amount of financial leverage employed.

(1) Certain 2008 information has been restated to conform with the new CICA Handbook Section 3064, "Goodwill and Intangible Assets". See note 2 to the consolidated financial statements.

(2) Certain 2007 information has been restated to conform with the new CICA Handbook Section 3064, "Goodwill and Intangible Assets".

## Management's Discussion and Analysis

(\$ millions)	As at January 2, 2010	As at January 3, 2009	As at December 29, 2007
Bank indebtedness	\$ 2	\$ 52	\$ 3
Short term debt	-	190	418
Long term debt due within one year	343	165	432
Long term debt	4,162	4,070	3,852
Other liabilities	36	-	-
Fair value of financial derivatives related to the above	58	63	119
	<b>4,601</b>	<b>4,540</b>	<b>4,824</b>
Less: Cash and cash equivalents	993	528	430
Short term investments	397	225	225
Security deposits included in other assets	250	437	322
Fair value of financial derivatives related to the above	178	57	278
	<b>1,818</b>	<b>1,247</b>	<b>1,255</b>
Net debt	<b>\$ 2,783</b>	<b>\$ 3,293</b>	<b>\$ 3,569</b>

The Second Preferred Shares, Series A are classified as capital securities and are excluded from the calculation of net debt. For the purpose of calculating net debt, fair value of financial derivatives is not credit value adjusted in accordance with EIC 173. As at January 2, 2010 the credit value adjustment was \$4 million.

### Net Assets

The following table reconciles net assets used in the return on average net assets ratio to Canadian GAAP measures reported in the audited consolidated balance sheets as at the years ended. The Company believes the return on average net assets ratio is useful in assessing the return on productive assets.

Net assets is calculated as total assets less cash and cash equivalents, short term investments, security deposits included in other assets and accounts payable and accrued liabilities. Return on average net assets is calculated as operating income for the year divided by average net assets.

(\$ millions)	As at January 2, 2010	As at January 3, 2009 <sup>(1)</sup>	As at December 29, 2007 <sup>(2)</sup>
Canadian GAAP total assets	\$ 14,991	\$ 13,943	\$ 13,625
Less: Cash and cash equivalents	993	528	430
Short term investments	397	225	225
Security deposits included in other assets	250	437	322
Accounts payable and accrued liabilities	3,242	2,823	2,860
Net assets	<b>\$ 10,109</b>	<b>\$ 9,930</b>	<b>\$ 9,788</b>

(1) Certain 2008 information has been restated to conform with the new CICA Handbook Section 3064, "Goodwill and Intangible Assets". See note 2 to the consolidated financial statements.

(2) Certain 2007 information has been restated to conform with the new CICA Handbook Section 3064, "Goodwill and Intangible Assets".

## Equity

The following table reconciles equity used in the net debt to equity ratio to Canadian GAAP measures reported in the audited consolidated financial statements as at the years ended.

Equity is calculated as the sum of capital securities and shareholder's equity.

(\$ millions)	As at January 2, 2010	As at January 3, 2009 <sup>(1)</sup>	As at December 29, 2007 <sup>(2)</sup>
Capital securities	220	219	–
Shareholders' equity	6,273	5,803	5,513
Equity	6,493	6,022	5,513

## 16. 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, PC Bank.

March 12, 2010  
Toronto, Canada

(1) Certain 2008 information has been restated to conform with the new CICA Handbook Section 3064, "Goodwill and Intangible Assets". See note 2 to the consolidated financial statements.

(2) Certain 2007 information has been restated to conform with the new CICA Handbook Section 3064, "Goodwill and Intangible Assets".