

## Management's Discussion and Analysis

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(1) See Non-GAAP Financial Measures on page 38.

## 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 48 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 87. The information in this MD&A is current to February 23, 2011, 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 and changes in interest and currency exchange rates;
- 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;
- 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 to successfully implement its infrastructure and information technology components of its plan;
- 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;
- failure to achieve desired results in labour negotiations, including the terms of future collective bargaining agreements, which could lead to work stoppages;
- changes to and failure to comply with the legislative/regulatory environment in which the Company operates, including failure to comply with environmental laws and regulations;
- the adoption of new accounting standards and changes in the Company's use of accounting estimates;
- 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 income, commodity and other tax liabilities including changes in tax laws or future assessments;
- reliance on the performance and retention of third-party service providers including those associated with the Company's supply chain and apparel business;
- public health events including those related to food safety;
- 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;
- supply and quality control issues with vendors; and
- failure by the Company to maintain appropriate documentation to support its compliance with accounting, tax or legal rules, regulations and policies.

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 Enterprise Risks and Risk Management section of this MD&A. 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 MD&A. 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 136,000 full-time and part-time employees. Through its portfolio of store formats, Loblaw is committed to providing Canadians with a wide 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.

	<b>2010</b>	2009	2008
	<b>(52 weeks)</b>	(52 weeks)	(53 weeks)
(\$ millions except where otherwise indicated)			
Sales	<b>\$ 30,997</b>	\$ 30,735	\$ 30,802
Net earnings	<b>681</b>	656	550
Basic net earnings per common share (\$)	<b>2.45</b>	2.39	2.01
Diluted net earnings per common share (\$)	<b>2.44</b>	2.38	2.01
Total assets	<b>\$ 15,919</b>	\$ 14,991	\$ 13,943
Long term debt	<b>4,646</b>	4,505	4,235
Capital securities	<b>221</b>	220	219
Dividends declared per common share(\$)	<b>0.84</b>	0.84	0.84
Dividends declared per Second Preferred Shares, Series A (\$)	<b>1.49</b>	1.49	0.91

## Management's Discussion and Analysis

Total sales increased 0.9% and same-store sales declined 0.6% in 2010 compared to 2009. Sales and same store sales declined 0.2% and 1.1% respectively in 2009 compared to 2008. During the year, the number of corporate stores decreased to 576 (2009 – 613, 2008 – 609) and the number of franchised stores increased to 451 (2009 – 416, 2008 – 427). In 2010, the Company converted 31 corporate stores to franchised stores. In 2009, the number of corporate stores increased due to the addition of 17 stores related to the acquisition of T&T Supermarket Inc. ("T&T"), partially offset by a conversion of corporate stores to franchised stores. The number of franchised stores decreased in 2009 due to the conversion of franchised stores to independent affiliates. During 2010, corporate store sales per average square foot was \$601 (2009 – \$597, 2008 - \$624), with retail square footage increasing to 50.7 million (2009 – 50.6 million, 2008 – 49.8 million).

Net earnings and basic net earnings per common share increased in 2010 by \$25 million and \$0.06, respectively compared to 2009. The improvement was a result of an increase in operating income, substantially offset by an increase in income tax expense, including the impact of a \$12 million charge due to changes in the federal tax legislation that resulted in the elimination of the Company's ability to deduct costs associated with cash-settled stock options. The increase in operating income was primarily due to an improvement in gross profit of \$408 million, which was offset by an increase in selling and administrative expenses of \$278 million and an increase in depreciation and amortization of \$66 million. Operating income in 2010 included incremental costs of \$142 million related to the Company's investment in information technology and supply chain, an asset impairment charge of \$26 million incurred on the closure of a distribution centre in Quebec, a charge of \$17 million incurred in connection with the ratification of new collective agreements with certain Ontario union locals, and an incremental charge of \$15 million in stock-based compensation, net of equity forwards.

In 2009 net earnings and basic net earnings per common share increased by \$106 million and \$0.38 compared to 2008 as a result of an increase in operating income primarily due to an improvement in gross profit of \$285 million, offset by an increase in selling and administrative expenses of \$93 million and an increase in depreciation and amortization of \$39 million. Operating income in 2009 included incremental costs of \$73 million related to the Company's investment in information technology and supply chain, an incremental charge of \$15 million in stock-based compensation, net of equity forwards, and a lower gain on the sale of financial investments by President's Choice Bank ("PC Bank"), a wholly owned subsidiary of the Company.

Total assets in 2010 increased by 6.2% mainly due to an increase in the Company's cash and cash equivalents, short term investments, security deposits and fixed assets as a result of the Company's capital investment program, including its incremental investment in information technology and supply chain. In 2009, total assets increased by 7.5%, 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 capital investment program including its incremental investment in information technology and supply chain as well as the acquisition of a distribution centre.

Long term debt and capital securities increased by 3.0% in 2010 compared to 2009 primarily due to new capital lease obligations, a net increase in Medium Term Notes and the issuance of guaranteed investment certificates, partially offset by a revaluation for foreign exchange rates on US dollar fixed rate private placement notes. Long term debt and capital securities increased by 6.1% in 2009 compared to 2008 due to a net increase in Medium Term Notes and the assumption of a mortgage on the acquisition of a distribution centre. Cash flows from operating activities covered the Company's funding requirements and exceeded the capital investment program in both 2010 and 2009.

### 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 four 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 2010, the Company continued to make steady progress in its renewal program. Progress during the year was achieved despite a difficult economic environment. Deflationary pressures combined with heightened promotional and competitive activity resulted in soft sales throughout 2010. 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 2010 included:

- Improved fresh food quality and assortment;
- Touched over 200 stores as part of the Company's store revitalization program of which 160 were considered renovations;
- Continued *nofrills* expansion program with an additional nine *nofrills* stores in Western Canada and six more *nofrills* stores in Atlantic Canada;
- Improved overall control brand profitability;
- Completed the roll-out of a new transportation management system and continued to implement a new warehouse management system;
- Enhanced supply chain efficiency that resulted in improved product availability;
- Moved forward in implementing the Enterprise Resource Planning ("ERP") system by integrating the real estate and financial services divisions and the general ledger and related financial reporting across the business onto the new system with nearly 1,000 colleagues now using the system;
- Initiated the next wave of ERP implementation with two successful pilots in merchandising involving approximately 20 categories;
- Strengthened the balance sheet providing enhanced financial flexibility;
- Successfully completed labour negotiations in Ontario and British Columbia providing new and critical scheduling flexibility; and
- Recognized as one of Canada's Top 100 employers.

While the Company achieved many of its goals in 2010, the Company expects to continue the pace and focus on execution of its renewal plan in a market environment that remains unpredictable and competitively intense. In 2011, the Company intends to continue to drive initiatives that strengthen its base business including investments in infrastructure, and keeping a vigilant watch on cost control and cash management as it turns its sights on new opportunities by:

- Building out from its core food business to capitalize on opportunities in apparel, financial services, health and wellness and Canada's multicultural population.
- Continuing to invest in and execute its information technology strategy through the rollout of subsequent supply chain and ERP functionality releases with a focus on rolling-out to its merchandising organization and ensuring converted data has integrity for its ERP implementation;
- 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 its control label offering while enhancing profitability;
- Continuing to improve its general merchandise range, assortment and profitability;
- Focusing on in-store customer service and providing unmatched value; and
- Optimizing its customer offering and shopping experience by re-aligning around a new organizational structure.

#### **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 strategic imperatives in support of its long term operating and financial strategies, it will be well positioned to pursue its vision of providing long term value to its shareholders.

## Management's Discussion and Analysis

Key financial performance indicators are set out below:

	2010 (52 weeks)	2009 <sup>(3)</sup> (52 weeks)
Sales growth (decline)	0.9%	(0.2%)
Same-store sales decline	(0.6%)	(1.1%)
EBITDA <sup>(1)</sup> (\$ millions)	\$ 1,924	\$ 1,794
EBITDA margin <sup>(1)</sup>	6.2%	5.8%
Net earnings (\$ millions)	\$ 681	\$ 656
Basic net earnings per common share (\$)	\$ 2.45	\$ 2.39
Basic net earnings per common share increase	2.5%	18.9%
Cash flows from operating activities (\$ millions)	\$ 1,594	\$ 1,945
Net debt <sup>(1)</sup> (\$ millions)	2,513	2,783
Net debt <sup>(1)</sup> to EBITDA <sup>(1)</sup>	1.3x	1.6x
Net debt <sup>(1)</sup> to equity <sup>(1)</sup>	0.4:1	0.4:1
Interest coverage <sup>(2)</sup>	4.3x	4.2x
Return on average shareholders' equity	10.4%	10.9%
Return on average net assets <sup>(1)</sup>	12.4%	12.0%

(1) See Non-GAAP Financial Measures on page 38.

(2) See glossary of terms on page 87.

(3) Compared to a 53-week year in 2008.

### 5. Financial Performance

While the Company delivered solid earnings growth, deflationary pressures and competitive intensity resulted in declines in sales and same-store sales, particularly in the fourth quarter 2010.

#### 5.1 Results of Operations

**Sales** Sales in 2010 increased \$262 million, or 0.9%, to \$31.0 billion compared to \$30.7 billion in 2009.

Total sales, sales growth (decline) and same-store sales declines were as follows:

For the years ended January 1, 2011 and January 2, 2010 (\$ millions)	2010 (52 weeks)	2009 <sup>(1)</sup> (52 weeks)
Total sales	\$ 30,997	\$ 30,735
Total sales growth (decline)	0.9%	(0.2%)
Same-store sales decline	(0.6%)	(1.1%)

(1) Compared to a 53-week year in 2008.

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

- same-store sales declined 0.6%;
- T&T sales positively impacted sales by 1.4%;
- sales in food and drugstore were flat;
- 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 increased significantly as a result of higher retail gas prices and strong volume growth;
- the Company's average annual internal retail food price index was deflated. This compared to average annual internal food price inflation in 2009. Average annual national food price inflation was 1.0% (2009 – 5.5%) as measured by "The Consumer Price Index for Food Purchased from Stores" ("CPI"). CPI does not necessarily reflect the effect of inflation on the specific mix of goods sold in Loblaw stores; and
- 11 (2009 – 41) corporate and franchised stores were opened and 13 (2009 – 33) corporate and franchised stores were closed, resulting in a net increase of 0.1 million square feet, or 0.2%.

In 2010, the Company launched over 1,200 new control label products and redesigned the packaging of approximately 300 products. Sales of control label products in 2010 were \$8.2 billion compared to \$8.3 billion in 2009.

**Gross Profit** 2010 gross profit increased by \$408 million to \$7,604 million (24.5% of sales) compared to \$7,196 million in 2009 (23.4% of sales). The increase in gross profit was attributable to improved control label profitability and continued buying synergies and more disciplined vendor management, a stronger Canadian dollar, improved shrink and the shift of pharmaceutical vendor rebates from selling and administrative expenses to gross profit. Increased transportation costs partially offset these improvements.

**Operating Income** Operating income for 2010 increased by \$64 million, or 5.3%, to \$1,269 million, resulting in an operating margin of 4.1% compared to 3.9% in 2009. The increases in operating income and operating margin for 2010 were primarily due to the improvement in gross profit and the impact of the acquisition of T&T, partially offset by incremental costs of \$142 million related to the Company's investment in information technology and supply chain including incremental depreciation and amortization of \$59 million, a charge of \$37 million (2009 – \$22 million) related to stock-based compensation net of equity forwards, a \$26 million asset impairment charge on the closure of a distribution centre in Quebec, a charge of \$17 million in connection with the ratification of new collective agreements with certain Ontario union locals, and a charge of \$28 million (2009 – \$27 million) for fixed asset impairments related to asset carrying values in excess of fair values for specific store locations. Operating income in 2009 included a gain of \$8 million from the sale of financial investments by PC Bank.

**EBITDA<sup>(1)</sup>** 2010 EBITDA<sup>(1)</sup> increased by \$130 million, or 7.2%, to \$1,924 million resulting in an EBITDA margin<sup>(1)</sup> of 6.2% (2009 – 5.8%). 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 2010 interest and other financing charges increased \$4 million, or 1.5%, to \$273 million from \$269 million in 2009 primarily due to an increase in interest on long term debt to \$288 million (2009 – \$282 million). The 2010 weighted average fixed interest rate on long term debt (excluding capital lease obligations) was 6.3% (2009 – 6.4%) and the weighted average term to maturity was 14 years (2009 – 14 years).

**Income Taxes** The Company's 2010 effective income tax rate increased to 29.8% from 28.7% in 2009. The 2009 tax rate was affected by the inclusion of the impact of a statutory income tax rate reduction and accelerated utilization of loss carry forwards, which did not reoccur in 2010. The 2010 tax rate was further affected by a \$12 million charge related to the changes in the federal tax legislation that resulted in the elimination of the Company's ability to deduct costs associated with cash-settled stock options. Net income taxes paid in 2010 were \$298 million (2009 – \$199 million).

(1) See Non-GAAP Financial Measures on page 38.

## Management's Discussion and Analysis

**Net Earnings** In 2010, net earnings increased by \$25 million, or 3.8%, to \$681 million from \$656 million in 2009. Basic net earnings per common share increased by \$0.06, or 2.5%, to \$2.45 from \$2.39 in 2009.

Basic net earnings per common share were impacted in 2010 by a charge of \$0.10 (2009 – \$0.08) per common share for the net effect of stock-based compensation including equity forwards. The impact of the changes in the federal tax legislation that resulted in the elimination of the Company's ability to deduct costs associated with cash-settled stock options was a charge of \$0.04 (2009 – nil) to basic net earnings per common share. The incremental costs associated with the Company's investment in information technology and supply chain impacted basic net earnings per common share by a charge of \$0.36 (2009 – \$0.19). A charge of \$0.07 (2009 – nil) to basic net earnings per common share was incurred in relation to an asset impairment charge incurred on the closure of a distribution centre in Quebec. Additional fixed asset impairments resulted in a charge of \$0.07 (2009 – \$0.07) to basic net earnings per common share.

### 5.2 Financial Condition

**Financial Ratios** The Company's net debt<sup>(1)</sup> to equity<sup>(1)</sup> ratio was flat at 0.4:1 at the end of 2010 and is consistent with 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 net debt<sup>(1)</sup> to EBITDA<sup>(1)</sup> ratio was 1.3 times at the end of 2010 compared to 1.6 times at the end of 2009. The decrease in this ratio was due to the decrease in net debt<sup>(1)</sup> as described below and the increase in EBITDA<sup>(1)</sup> as described in Section 5.1.

The increase in operating income as described in Section 5.1 resulted in an improvement in the interest coverage ratio to 4.3 times in 2010 from 4.2 times in 2009.

The 2010 return on average net assets<sup>(1)</sup> was 12.4% compared to 12.0% in 2009. This ratio was positively impacted by the increase in operating income as described in Section 5.1, partially offset by an increase in average net assets. The 2010 return on average shareholders' equity was 10.4% compared to the 2009 return of 10.9%. The decrease in this ratio was primarily a result of the increase in common shares related to the Dividend Reinvestment Plan ("DRIP").

**Equity Forward Contracts** As at January 1, 2011, Glenhuron Bank Limited ("Glenhuron") a wholly owned subsidiary of the Company, had cumulative equity forward contracts to buy 1.5 million (2009 – 1.5 million) of the Company's common shares at an average forward price of \$56.26 (2009 – \$66.25) including \$0.04 (2009 – \$10.03) per common share of interest expense. As at January 1, 2011, the cumulative interest, dividends and unrealized market loss of \$24 million (2009 – \$48 million) was included in accounts payable and accrued liabilities. 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.

**Net Debt<sup>(1)</sup>** As at January 1, 2011, net debt<sup>(1)</sup> was \$2,513 million compared to \$2,783 million as at January 2, 2010. The decrease of \$270 million was primarily due to positive cash flows from operating activities and proceeds from fixed asset sales, partially offset by fixed asset purchases.

In 2009, net debt<sup>(1)</sup> decreased by \$510 million 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.

(1) See Non-GAAP Financial Measures on page 38.

## 6. Liquidity and Capital Resources

### 6.1 Cash Flows

#### Major Cash Flow Components

(\$ millions)	2010 (52 weeks)	2009 (52 weeks)	Change
Cash flows from (used in):			
Operating activities	\$ 1,594	\$ 1,945	\$ (351)
Investing activities	(1,448)	(1,212)	(236)
Financing activities	18	(173)	191

**Cash Flows from Operating Activities** Cash flows from operating activities for 2010 were \$1,594 million, which included net earnings of \$681 million, depreciation and amortization of \$655 million and an improvement in non-cash working capital of \$66 million due to changes in accounts payable and accrued liabilities, partially offset by accounts receivable.

Cash flows from operating activities decreased by \$351 million in 2010 to \$1,594 million from \$1,945 million in 2009. In 2009, the cash flows from operating activities were positively impacted by a significant improvement in non-cash working capital as a result of the improvement in inventory levels and changes in accounts payable and accrued liabilities. Improvements in non-cash working capital in 2010 were less than those in 2009 and contributed to the year-over-year decrease in cash flows from operating activities.

**Cash Flows used in Investing Activities** Cash flows used in investing activities were \$1,448 million compared to \$1,212 million in 2009. The change was primarily due to an increase in fixed asset purchases of \$309 million and a change in security deposits of \$263 million primarily as a result of PC Bank's accumulation of cash of \$167 million in 2010, partially offset by an increase in proceeds from fixed assets sales of \$63 million, and the acquisition of T&T of \$204 million which was completed in 2009.

Capital investment in 2010 was \$1.3 billion (2009 – \$1.1 billion). Approximately 10% (2009 – 9%) of these investments were for new store developments, expansions and land, approximately 44% (2009 – 38%) were for store conversions and renovations, and approximately 46% (2009 – 53%) were for infrastructure investments. The capital investment benefited the regions to varying degrees and strengthened the existing store base. In 2009, the capital investment of \$1.1 billion included the purchase of a distribution centre for \$140 million plus closing costs. The Company assumed long term debt secured by a mortgage of \$96 million in connection with the purchase, resulting in net fixed asset purchases of \$971 million in 2009.

The 2010 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 0.2% compared to 2009. During 2010, 11 (2009 – 41) corporate and franchised stores were opened, 13 (2009 – 33) corporate and franchised stores were closed, resulting in a net increase of 0.1 million square feet (2009 – 0.5 million square feet). In 2010, 160 (2009 – 211) corporate and franchised stores underwent renovations.

As at January 1, 2011, the Company had committed approximately \$95 million (2009 – \$76 million) for the construction, expansion and renovation of buildings and the purchase of real property.

The Company expects to invest approximately \$1.0 billion in capital expenditures in 2011. Approximately 50% of these funds are expected to be expended upgrading the 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 1.1 million square feet of retail space.

## Management's Discussion and Analysis

### Capital Investment and Store Activity

	2010 (52 weeks)	2009 (52 weeks)	% Change
Capital investment (\$ millions)	\$ 1,280	\$ 1,067	20.0%
Corporate square footage (in millions)	37.3	38.2	(2.4%)
Franchise square footage (in millions)	13.4	12.4	8.1%
Retail square footage (in millions)	50.7	50.6	0.2%
Number of corporate stores	576	613	(6.0%)
Number of franchised stores	451	416	8.4%
Percentage of corporate real estate owned	74%	72%	
Percentage of franchise real estate owned	46%	48%	
Average store size (square feet)			
Corporate	64,800	62,300	4.0%
Franchised	29,500	29,700	(0.7%)

**Cash Flows from Financing Activities** In 2010, cash flows from financing activities were \$18 million compared to cash flows used in financing activities of \$173 million in 2009. The increase in cash flows from financing activities was primarily due to the repayment of the Company's short term debt and bank indebtedness in the second quarter of 2009, an increase in long term debt issued, the purchase of common shares in 2009 and the cash savings associated with the DRIP during 2010, partially offset by repayment of long term debt in 2010.

During the third quarter of 2010, PC Bank began accepting deposits under a new Guaranteed Investment Certificate ("GIC") program. The GICs, which are sold through the broker channel, are issued with fixed terms ranging from 12 to 60 months and are non-redeemable prior to maturity. Individual balances up to \$100,000 are insured by Canada Deposit Insurance Corporation (CDIC). As at January 1, 2011, \$18 million of GICs was recorded as long term debt on the consolidated balance sheet, of which \$5 million is due within one year.

During the second quarter of 2010, the Company issued \$350 million principal amount of 10 year unsecured Medium Term Notes, Series 2-B pursuant to its Medium Term Notes, Series 2 program. Interest on the notes is payable semi-annually at a fixed rate of 5.22%. The notes are unsecured obligations and are redeemable at the option of the Company. In the second quarter of 2009, the Company issued \$350 million principal amount of 5 year unsecured Medium Term Notes, Series 2-A which pay a fixed rate of interest of 4.85% payable semi-annually.

During the second quarter of 2010, the \$300 million, 7.10% Medium Term Note due May 11, 2010 matured and was repaid. In the first quarter of 2009, the \$125 million, 5.75% Medium Term Note matured and was repaid. Subsequent to the end of the year, the \$350 million 6.50% Medium Term Note due January 19, 2011, matured and was repaid.

**Employee Future Benefits** During 2011, the Company expects to contribute approximately \$100 million to its registered funded defined benefits plans. The actual amount paid may vary from the estimate based on actuarial valuations being completed, market performance and regulatory requirements. The Company also expects to make contributions in 2011 to defined contribution plans and multi-employer pension plans as well as benefit payments to the beneficiaries of the supplemental unfunded defined benefit pension plans and other benefit plans.

## 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 committed 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 12 months. 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. In addition, given reasonable access to capital markets, the Company does not foresee any impediments in obtaining financing to satisfy its long term obligations.

During the third quarter of 2010, the Company's Short Form Base Shelf Prospectus dated June 5, 2008 which allowed for the issuance of up to \$1.0 billion of unsecured debentures and/or preferred shares, expired. During the fourth quarter of 2010, the Company filed a Short Form Base Shelf Prospectus which allows for the issuance of up to \$1.0 billion of unsecured debentures and/or preferred shares over a 25-month period.

During 2008, the Company entered into an \$800 million, 5-year committed credit facility with a syndicate of third party lenders. The facility contains certain financial covenants with which the Company was in compliance throughout the year. In addition to cash and short term investments, 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 1, 2011 and January 2, 2010, the Company had not drawn on the 5-year committed credit facility.

PC Bank participates in various securitization programs that provide the primary source of funds for the operation of its credit card business. Under these securitization programs, a portion of the total interest in the credit card receivables is sold to independent trusts pursuant to co-ownership agreements. PC Bank purchases receivables from and sells receivables to the trusts from time to time depending on PC Bank's financing requirements. In 2010, PC Bank securitized \$600 million (2009 – nil) credit card receivables and repurchased \$690 million (2009 – \$50 million) of co-ownership interests in the securitized receivables from independent trusts. On December 15, 2010, Eagle Credit Card Trust ("Eagle"), an independent trust through which the Company securitizes its accounts receivable, issued two series of senior and subordinated notes maturing December 17, 2013 and December 17, 2015 for notional amounts of \$250 million and \$350 million respectively. A portion of the securitized receivables was also renewed for two years during 2010.

The independent trusts' recourse to PC Bank's assets is limited to PC Bank's excess collateral of \$114 million as at January 1, 2011 (January 2, 2010 – \$121 million) as well as standby letters of credit issued by the Company as at January 1, 2011 of \$48 million (January 2, 2010 – \$116 million) based on a portion of the securitized amount.

On March 17, 2011, the five-year \$500 million senior notes and subordinated notes issued by Eagle will mature. In conjunction with this upcoming maturity, the Company accumulated \$167 million of cash on December 1, 2010. Subsequent to the end of the year, the Company accumulated \$167 million in January 2011 and will continue to accumulate a further \$166 million by the end of February 2011. In addition, subsequent to year end, the Company increased its securitization of accounts receivable by approximately \$230 million under one of the independent trusts and expects to securitize further amounts coincident with the maturity of the Eagle Notes.

During 2010, Dominion Bond Rating Service and Standard & Poor's reaffirmed the Company's credit ratings and trend and outlook, respectively. These rating organizations base their forward-looking credit ratings on both quantitative and qualitative considerations.

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

## Management's Discussion and Analysis

During the second quarter of 2010, Loblaw renewed its Normal Course Issuer Bid ("NCIB") to purchase on the Toronto Stock Exchange ("TSX"), or to enter into equity derivatives to purchase, up to 13,865,435 of the Company's common shares, representing approximately 5% of the common shares outstanding. In accordance with the requirements of the TSX, any purchases must be at the then market prices of such shares. During 2010, the Company did not purchase any shares under its NCIB. During 2009, the Company purchased for cancellation 1,698,400 of its common shares at a price of \$33.14. In 2011, the Company intends to renew its NCIB.

**Independent Funding Trusts** Certain independent franchisees of the Company obtain financing through a structure involving independent funding 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 by the independent funding trusts as at January 1, 2011 was \$405 million (2009 – \$390 million) including \$202 million (January 2, 2010 – \$163 million) of loans payable by VIEs consolidated by the Company. The Company has agreed to provide credit enhancement of \$66 million (2009 – \$66 million) in the form of a standby letter of credit for the benefit of the independent funding trust representing not less than 15% of the principal amount of the loans outstanding. 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 2010, the \$475 million, 364-day revolving committed credit facility that is the source of funding to the independent trusts was renewed. The financing structure has been reviewed and the Company has determined there were no additional VIEs to consolidate as a result of this financing.

**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 were outstanding at year end.

**Common Share Capital** An unlimited number of common shares is authorized, 280,578,130 of which were outstanding at year end. Further information on the Company's outstanding share capital is provided in note 19 to the consolidated financial statements.

At year end, a total of 9,320,865 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%. Each stock option is exercisable into one common share of the Company at the price specified in the terms of the option agreement, or option holders may elect to receive in cash the share appreciation value equal to the excess of the market price at the date of exercise over the specified option price. Subsequent to the end of 2010, the right to receive a cash payment in lieu of exercising an option for shares was removed. Further information on the Company's stock option plans is provided in note 21 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 2010, the Board declared dividends of \$0.84 (2009 - \$0.84) per common share. During 2010, the Board declared dividends of \$1.49 (2009 – \$1.49) 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 (2009 – \$14 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, 2011 and a quarterly dividend of \$0.37 per Second Preferred Share, Series A payable April 30, 2011. At the time such dividends are declared, the Company identifies on its website ([www.loblaw.ca](http://www.loblaw.ca)) the designation of eligible and ineligible dividends in accordance with the administrative position of the Canada Revenue Agency (CRA).

**Dividend Reinvestment Plan (“DRIP”)** 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 4,389,872 (2009 – 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 \$167 million (2009 – \$120 million) for the year. Subsequent to year end, the Board of Directors approved discontinuing the DRIP after the dividend payment on April 1, 2011, when approximately \$300 million in common share equity will be raised through the program as planned.

### 6.3 Contractual Obligations

The following illustrates certain of the Company’s significant contractual obligations and discusses other obligations as at January 1, 2011:

#### Summary of Contractual Obligations

(\$ millions)	Payments due by year						Total
	2011	2012	2013	2014	2015	Thereafter	
Long term debt (including capital lease obligations)	\$ 433	\$ 77	\$ 419	\$ 482	\$ 182	\$ 3,053	\$ 4,646
Operating leases <sup>(1)</sup>	219	199	177	156	128	629	1,508
Contracts for purchases of Real property and capital Investment projects <sup>(2)</sup>	92	–	–	3	–	–	95
Purchase obligations <sup>(3)</sup>	39	33	26	10	10	–	118
<b>Total contractual obligations</b>	<b>\$ 783</b>	<b>\$ 309</b>	<b>\$ 622</b>	<b>\$ 651</b>	<b>\$ 320</b>	<b>\$ 3,682</b>	<b>\$ 6,367</b>

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

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

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 self 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.

## 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:

**Letters of Credit** Standby and documentary letters of credit are used in connection with certain obligations mainly related to real estate transactions, benefit programs, purchase orders and performance guarantees. The aggregate gross potential liability related to the Company's letters of credit is approximately \$325 million (2009 – \$277 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. Additionally, the Company has a guarantee on behalf of PC Bank in the amount of US \$180 million. For a detailed description of the Company's guarantees, see note 26 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 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% (2009 – 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 provide credit support to those notes which are more senior. The retained interest is recorded at fair value.

As at year end 2010, the total amount of securitized credit card receivables outstanding which PC Bank continues to service was \$1.6 billion (2009 – \$1.7 billion) and the associated retained interest was \$21 million (2009 – \$13 million). During 2010, PC Bank earned income of \$245 million (2009 – \$235 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 8 and 26 to the consolidated financial statements.

**Independent Funding Trusts** 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 26 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)	2010					2009				
	First Quarter (12 weeks)	Second Quarter (12 weeks)	Third Quarter (16 weeks)	Fourth Quarter (12 weeks)	Total (audited) (52 weeks)	First Quarter (12 weeks)	Second Quarter (12 weeks)	Third Quarter (16 weeks)	Fourth Quarter (12 weeks) <sup>(1)</sup>	Total (audited) (52 weeks) <sup>(2)</sup>
Sales	\$6,926	\$7,317	\$9,593	\$7,161	\$30,997	\$6,718	\$7,233	\$9,473	\$7,311	\$30,735
Net earnings	137	180	213	151	681	109	193	189	165	656
Net earnings per common share										
Basic (\$)	0.50	0.64	0.77	0.54	2.45	0.40	0.70	0.69	0.60	2.39
Diluted (\$)	0.49	0.64	0.76	0.54	2.44	0.40	0.70	0.69	0.59	2.38
Average national food price inflation	0.7%	0.2%	1.3%	1.5%	1.0%	9.0%	7.4%	4.2%	1.6%	5.5%
Sales growth (decline)	3.1%	1.2%	1.3%	(2.1%)	0.9%	2.9%	2.8%	(0.2%)	(5.6%)	(0.2%)
Same-store sales growth (decline)	0.3%	(0.3%)	(0.4%)	(1.6%)	(0.6%)	2.1%	2.5%	(0.6%)	(7.8%)	(1.1%)
T&T acquisition impact on sales	2.0%	1.9%	1.7%	0.0%	1.4%	n/a	n/a	0.2%	1.8%	0.5%

(1) As compared to a 13-week quarter in 2008

(2) As compared to a 53-week year in 2008.

The Company's average quarterly internal retail food price inflation/deflation for 2009 and 2010 remained lower than the average quarterly national food price inflation as measured by CPI. CPI does not necessarily reflect the effect of inflation on the specific mix of goods sold in Loblaw stores.

In the last eight quarters, net retail square footage increased by 0.9 million square feet, to 50.7 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.

Fluctuations in quarterly net earnings during 2010 reflect the underlying operations of the Company as well as the impact of specific charges including the impact of stock-based compensation, net of equity forwards and costs related to the incremental investment in information technology and supply chain. Quarterly net earnings are also impacted by seasonality and the timing of holidays.

### 7.2 Fourth Quarter Results

The following is a summary of selected consolidated unaudited financial information for the fourth quarter of 2010. This information was prepared in accordance with Canadian GAAP and is reported in Canadian dollars.

## Management's Discussion and Analysis

### Selected Consolidated Information for the Fourth Quarter

(unaudited)

(\$ millions except where otherwise indicated)	2010 (12 weeks)	2009 (12 weeks)
Sales	\$ 7,161	\$ 7,311
Gross profit	1,774	1,728
Operating income	289	277
Interest expense and other financing charges	63	64
Income taxes	71	39
Net earnings	151	165
Basic net earnings per common share (\$)	0.54	0.60
Cash flows from (used in):		
Operating activities	603	615
Investing activities	(481)	(647)
Financing activities	6	(51)
Dividends declared per common share (\$)	0.21	0.21
Dividends declared on second preferred share Series A (\$)	0.37	0.37

Total sales, sales declines and same-store sales declines were as follows:

(\$ millions)	2010 (12 weeks)	2009 <sup>(1)</sup> (12 weeks)
Total sales	\$ 7,161	\$ 7,311
Total sales decline	(2.1%)	(5.6%)
Same-store sales decline	(1.6%)	(7.8%)

(1) As compared to a 13-week quarter in 2008.

Sales for the fourth quarter decreased 2.1% to \$7,161 million compared to \$7,311 million in the fourth quarter of 2009.

The following factors explain the major components that influenced sales for the fourth quarter of 2010 compared to the fourth quarter of 2009:

- same-store sales declined 1.6%;
- sales in food declined marginally;
- sales in drugstore declined moderately, impacted by deflation due to regulatory changes in Ontario and the impact of generic versions of certain prescription drugs;
- sales growth in apparel was moderate while sales of other general merchandise declined significantly due to lower discretionary consumer spending and reductions in assortment and square footage;
- gas bar sales growth was strong as a result of higher retail gas prices and moderate volume growth;
- the Company's average quarterly internal retail food price index was flat. This compared to average quarterly internal food price deflation in the fourth quarter of 2009. Average quarterly national food price inflation was 1.5% 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 2010, six corporate and franchised stores were opened and one corporate store was closed, resulting in a net increase of 0.1 million square feet or 0.3%.

Gross profit increased by \$46 million to \$1,774 million (24.8% of sales) in the fourth quarter of 2010 compared to \$1,728 million (23.6% of sales) in 2009. This increase was primarily attributable to improved control label profitability and continued buying synergies and disciplined vendor management, the shift of pharmaceutical vendor rebates from selling and administrative expenses to gross profit, improved shrink and a stronger Canadian dollar. Increased transportation costs partially offset these improvements.

Operating income increased by \$12 million to \$289 million for the fourth quarter of 2010 compared to \$277 million in 2009. Operating margin was 4.0% for the fourth quarter of 2010 compared to 3.8% in 2009. Contributing to the increase in operating income was improved gross profit as described above, partially offset by incremental costs of \$27 million related to the Company's investment in information technology and supply chain including incremental depreciation and amortization of \$14 million, a charge of \$7 million (2009 –\$5 million) related to stock-based compensation net of equity forwards and a charge of \$28 million (2009 - \$27 million) for fixed asset impairments related to asset carrying values in excess of fair values for specific store locations.

EBITDA<sup>(1)</sup> increased by \$22 million, or 5.2%, to \$442 million in the fourth quarter of 2010 compared to \$420 million in the fourth quarter of 2009. EBITDA margin<sup>(1)</sup> increased to 6.2% compared to 5.7% in the fourth quarter of 2009. The increases in EBITDA<sup>(1)</sup> and EBITDA margin<sup>(1)</sup> were primarily due to the increase in operating income and operating margin.

Total interest expense and other financing charges for the fourth quarter of 2010 were \$63 million compared to \$64 million in 2009.

The effective income tax rate in the fourth quarter of 2010 was 31.4% (2009 – 18.3%). The 2009 tax rate was affected by the inclusion of the impact of a statutory income tax rate reduction and accelerated utilization of loss carry forwards, which did not reoccur in 2010. The 2010 tax rate was further affected by a \$12 million charge related to the changes in the federal tax legislation that resulted in the elimination of the Company's ability to deduct costs associated with cash-settled stock options. Net income taxes paid in the fourth quarter were \$81 (2009 – \$15).

Net earnings for the fourth quarter decreased by \$14 million, or 8.5%, to \$151 million from \$165 million in the fourth quarter of 2009. Basic net earnings per common share for the fourth quarter decreased by \$0.06, or 10%, to \$0.54 from \$0.60 in the fourth quarter of 2009. Basic net earnings per common share were impacted in the fourth quarter of 2010 by a charge of \$0.02 (2009 – \$0.01) per common share for the net effect of the stock-based compensation net of equity forwards. The impact of the change in federal tax legislation that resulted in the elimination of the Company's ability to deduct costs associated with cash-settled stock options was a charge of \$0.04 to basic net earnings per common share in the fourth quarter of 2010. The incremental costs associated with the Company's investments in information technology and supply chain impacted basic net earnings per common share by a charge of \$0.07 (2009 – \$0.03). Fixed asset impairments resulted in a charge of \$0.07 (2009 – \$0.07) to basic net earnings per common share.

Fourth quarter cash flows from operating activities were \$603 million in 2010 compared to \$615 million in the fourth quarter of 2009. The increase can be attributed to the settlement of equity forward contracts which occurred in 2009 and the increase in depreciation and amortization, partially offset by the change in non-cash working capital and a decrease in net earnings for the quarter. Fourth quarter cash flows used in investing activities were \$481 million in 2010 compared to \$647 million in 2009. The change was primarily due to the change in short term investments, a change in cash flows from credit card receivables, after securitization, an increase in proceeds from fixed asset sales, partially offset by an increase in fixed asset purchases and the change in security deposits. 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 \$453 million (2009 – \$461 million). Fourth quarter cash flows from financing activities were \$6 million in 2010 compared to cash flows used in financing activities of \$51 million in 2009. The change was primarily due to 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.

(1) See Non-GAAP Financial Measures on page 38.

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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 1, 2011.

### 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.

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 1, 2011.

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 10, 2010 and ended on January 1, 2011 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.

During the first and third quarters of 2010, the Company successfully implemented the first and second phases of its Enterprise Resource Planning system. The implementation resulted in material changes in those periods to the internal controls over financial reporting for the Company's real estate and financial services divisions, corporate administration functions and the general ledger.

### 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 identified and managed through an Enterprise Risk Management ("ERM") program. The Board has approved an ERM policy and oversees the ERM program through approval of the Company's risks and risk prioritization. The ERM program assists all areas of the business in managing appropriate levels of risk tolerance by bringing a systematic approach, methodology and tools for evaluating, measuring and monitoring key risks. The results of the ERM program and other business planning processes are used to identify emerging risks to the Company, prioritize risk management activities and develop a risk-based internal audit plan.

Risk is not eliminated through the ERM program. 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 methodologies for identification, assessment, measurement and monitoring of the risks;
- Assist in developing consistent risk management methodology and tools across the organization;
- 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.

Risk identification and assessments are important elements to the Company's ERM framework. An annual ERM assessment is completed to assist in the update and identification of financial, operational or reputational risks affecting the Company and to effectively prioritize the risks. The annual ERM assessment is primarily carried out through interviews and risk assessments with senior management. Risks are assessed and evaluated based on the Company's vulnerability to the risk and the potential impact that the underlying risk would have on the Company's ability to execute its strategies and achieve its objectives. Risk owners are assigned relevant risks and metrics are developed for the top risks for quarterly monitoring. Each quarter, management provides an update to the Audit Committee of the status of the top risks based on significant changes from the prior quarter, anticipated impacts in future quarters and significant changes in key risk metrics. In addition, the long-term (1-3 year) risk level is assessed in order to monitor potential long term impacts on the risk which may assist in risk mitigation planning activities.

The Internal Audit and Risk Management group manages the ERM program through the development of the risk framework and methodologies, completion of the annual ERM assessment, continuous monitoring of the key risks and quarterly reporting to the Audit Committee. 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.

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. 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 speculative purposes.

The operating, financial and reputational risks and risk management strategies 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, 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

**ERP and Other Systems Implementations** The Company has under-invested in its information technology ("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.

In 2010, the Company began to deploy its new ERP system. This project, along with other systems implementations planned for 2011 and beyond, is one of the largest technology infrastructure programs ever implemented by the Company and is fundamental to its long-term growth strategies. The work will transform the systems used in virtually every area of the Company's business. Completing it will require continued focus and significant investment over the next two years. The failure to successfully migrate from legacy systems to the ERP could negatively affect the Company's reputation, operations and its revenues and financial performance. Failure or disruption in the Company's IT systems during the implementation of the ERP or other new systems may result in a lack of relevant and reliable information to enable

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management to effectively achieve its strategic plan or manage the day-to-day operations of the business, causing significant disruptions to business and potential financial losses. In addition, the failure to implement appropriate processes to support the ERP system may result in inefficiencies and duplication in current processes.

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. Failure by the Company to appropriately invest in IT or failure to implement IT infrastructure in a timely or effective manner may negatively impact the Company's financial performance.

**Information Integrity and Reliability** To support the current and future requirements of the business the Company is reliant on IT systems. These systems are essential to provide management with the appropriate information for decision making, including its key performance indicators, and when necessary must be appropriately supported through systems upgrades to and maintenance of infrastructure.

Although the Company has the appropriate controls in place over the conversion of data, the process of converting data from legacy systems to the ERP and other new systems increases the risk of poor data integrity and reliability if the data are not accurate and complete upon conversion. In addition, for the next few years the business will operate in new and old systems at the same time. Ensuring that the data is flowing accurately between all systems and ensuring the integrity of this data once it is converted will be critical to maintain the integrity and reliability of the Company's financial information. Ownership of data management is essential to ensure ongoing reliability and relevancy of the data. Any failure or disruption of these systems or during the data conversion process for the ERP could negatively affect the Company's reputation, its operations, revenues and financial performance. Lack of relevant, reliable and accessible information that enables management to effectively manage the business may preclude the Company from optimizing its overall performance.

**Change Management and Process Execution** Significant initiatives in support of the Company's renewal plan are underway or planned. These initiatives include the execution of the IT strategic plan and ongoing organizational changes. Success of these initiatives is dependent on management effectively realizing the intended benefits and effectively executing the related processes. 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 team of colleagues has been assigned and is dedicated to business change management activities with a focus on integration of the business process and systems changes through communication, training and other change events in support of major change initiatives within the Company.

Ineffective change management or inexperienced colleagues leading change management could result in disruptions to the operations of the business or affect the ability of the Company to implement and achieve its long term strategic objectives. This could result from a lack of clear accountabilities, communication, training or lack of requisite knowledge, which may cause colleagues to act in a manner which is inconsistent with Company objectives. Failure to properly execute the various processes may increase the risk of customer dissatisfaction, which in turn could adversely affect the reputation, operations and financial performance of the Company. The failure to properly integrate several large, complex initiatives in a timely manner will adversely impact the operations of the Company. If colleagues are not able to develop and perform new roles, processes and disciplines, the Company may not always achieve the expected cost savings and other benefits of its initiatives.

**Economic Environment** Economic factors that impact consumer spending patterns could deteriorate or remain unpredictable due to global economic volatility. These factors include continued high levels of unemployment, household debt, changes in interest rates, changes in inflation, changes in exchange rates and access to consumer credit. 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 or deflation 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 in executing its strategies, its revenues and 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 renovation of existing competitors, particularly those expanding into the grocery market. Some of these competitors have extensive resources that allow them to compete vigorously in the market. Several of these competitors operate in a non-union environment. The Company's unionized workforce environment may reduce the ability of the Company to compete on labour costs or may adversely impact the Company's ability to react to the competition in a timely manner. Increased competition and pressures on growth and pricing could adversely affect the Company's ability to achieve its objectives. The Company's inability to effectively predict market activity or compete effectively with its current or future competitors could result in, among other things, reduced market share and 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 adjusts its operating strategies by closing underperforming stores, relocating stores or reformatting them under a different banner, reviewing and adjusting pricing, product offerings and marketing programs. Failure by the Company to sustain its competitive position could have a negative impact on the revenues and financial performance of the Company.

**Food Safety and Public Health** The Company is subject to risks associated with food safety and general merchandise product defects. These risks may arise as part of product procurement, distribution, preparation or display, including the development and manufacturing 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. The occurrence of such events or incidents could result in negative publicity, damage to the Company's brands and potentially lead to legal claims. In addition, failure to trace or locate any contaminated or defective products may affect the Company's ability to be effective in a recall situation. Any of these events could negatively impact the Company's revenues and financial performance

In addition, failure to maintain the cleanliness and health standards at store level, including pest control, may negatively impact revenues and the reputation of the Company.

The Company has an incident management process 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 also has extensive 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 and regulatory requirements. 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.

**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 eighteen months. Although this initiative is expected to result in improved service levels and product availability 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 revenues and financial performance. In addition, the integration of new supply chain systems with the ERP could cause disruptions to the network if not properly executed which would also negatively affect revenues and financial performance.

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**Colleague Retention and Succession Planning** The degree to which the Company is not effective in establishing appropriate succession planning processes and retention strategies could lead to a lack of requisite knowledge, skills and experience on the part of management. This, in turn, could affect the Company's ability to execute its strategies, efficiently run its operations and meet its goals for financial performance. Effective succession planning for senior management and colleague retention are essential to sustaining the growth and success of the Company. In addition, loss of talent to the competition can be a significant risk to the Company's business strategy. Effective retention strategies will be necessary due to the significant changes, potential increase in workload and marketability of those colleagues who have developed specialized skills during the implementation of the ERP and other significant initiatives in the Company.

Management has implemented new programs throughout 2010 to assist in colleague retention, succession planning and development. These will continue into 2011. The initiatives are focused on improving colleague engagement and succession plans as well as supporting the Company's goal to "Be a Great Place to Work". Should these initiatives not be successful, the Company may not be able to execute its strategies or efficiently run its operations which in turn could negatively affect financial performance.

**Merchandising** The Company may have inventory that customers don't want or need, is not reflective of current trends in customer tastes, habits, or regional preferences, is priced at a level customers are not willing to pay, is late in reaching the market or does not have optimal commercial product placement on store shelves. Innovation is critical to the Company in order to respond to customer demands and to stay competitive in the marketplace. In addition, the Company's operations as they relate to food, sales volumes and product mix are impacted to some degree by certain holiday periods in the year. In 2010, the active trading initiative was rolled out which included a focus on the merchandising group strategy, structure, roles and process improvements, to assist in installing best practices and efficiencies throughout the merchandising organization. If the Company is not successful with these initiatives, or if merchandising efforts are not effective or responsive to customer demand, the Company's revenues and financial performance could be negatively impacted.

**Strategy Development and Execution** The long term vision and strategies of the Company must be understood, communicated and properly managed in order to deliver growth for the Company. If these strategies are not clear or if consumer trends and expectations are not considered, 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. Areas of strategic focus are formulated annually by senior management and then communicated throughout the Company. These are reviewed on a periodic basis to drive execution and ensure ongoing relevance. If the Company's vision and strategies are not effectively developed, communicated and executed in the short term and long term, the financial performance of the Company could suffer.

**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, delays to construction projects and increases in costs. Any of these could negatively affect the Company's financial performance. The Company successfully negotiated 58 collective agreements in 2010 and the Company continues to negotiate the 86 remaining collective agreements carried over from prior years. In 2011, 49 collective agreements affecting approximately 15,000 colleagues expire with the largest of the agreements covering approximately 11,000 colleagues in Ontario expiring in June 2011. Although the Company attempts to mitigate work stoppages and disputes through early negotiations, work stoppages or slowdowns and the resulting negative effects on revenues and financial performance are possible.

**Disaster Recovery and Business Continuity** The Company's ability to continue critical operations and processes could be negatively impacted by a weather disaster, work stoppage, prolonged IT failure, terrorist activity, power failures, border closures, a pandemic or other national or international catastrophe. The Company has an enterprise wide business continuity program which is being continually matured. However, ineffective contingency planning could result in reputational and/or financial losses to the Company. There can be no assurance that the existence of the program will ensure that the Company responds appropriately in the event of business interruptions, crises or potential disasters and negative impacts on revenue and financial performance could occur.

**Inventory Management** Inappropriate inventory management may lead to excess inventory or a shortage of inventory which may impact customer satisfaction and overall financial performance. The Company may experience excess inventory that cannot be sold profitably or which could increase levels of inventory shrink which in turn could negatively impact the Company's financial performance. The Company focuses 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. Despite these efforts, the Company may experience excess inventory that cannot be sold profitably, which may negatively impact the Company's financial performance.

**Privacy and Information Security** The Company is subject to various laws regarding the protection of personal information of its customers and colleagues 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 could result in damage to its reputation and negatively affect financial performance. The Company's information systems contain personal information of customers and colleagues. Any failures or vulnerabilities in these security systems or non-compliance with information security standards, including those in relation to personal information belonging to the Company's customers and colleagues, could result in harm to the reputation of the Company and negatively affect financial performance.

Information security risks will also arise in the implementation of the Company's IT strategic plan. The strategic plan includes the upgrading of information security systems to adhere to information security standards by instituting more stringent security system protocols and corporate information security policies. A failure in these information systems or non-compliance with information security standards, including those in relation to personal information belonging to the Company's customers and colleagues, could result in harm to the reputation or competitive position of the Company and could negatively affect financial performance.

**Tax and Regulatory** Changes to any of the laws, rules, regulations or policies related to the Company's business including income, commodity and other taxes, and the production, processing, preparation, distribution, packaging and labelling of its products could have an adverse impact on the Company's financial and operational performance. New accounting pronouncements introduced by appropriate authoritative bodies may also impact the Company's financial results including the Company's transition to International Financial Reporting Standards. In the course of complying with such changes, the Company may incur significant costs. Changing regulations or enhanced enforcement of existing regulations could restrict its operations or profitability and thereby threaten the Company's competitive position and its capacity to efficiently conduct business. Failure by the Company to comply with applicable laws, rules, regulation and policies may subject it to civil or regulatory actions or proceedings, including fines, assessment, injunctions, recalls or seizures, which in turn could have an adverse effect on the Company's financial results. PC Bank operates in a highly regulated environment, failure to comply, understand, acknowledge and effectively respond to the regulators could result in monetary penalties, regulatory intervention and reputational damage. Taxing authorities may also disagree with the positions and conclusions taken by the Company in its filings with such authorities. An unfavourable resolution to any such dispute could have an adverse effect on the Company's financial results.

In 2010, the provincial governments of Quebec, Ontario, Alberta, Nova Scotia and British Columbia introduced amendments to the regulation of generic prescription drug prices paid by provincial governments pursuant to their respective public drug benefit plans. Under these amendments, manufacturer costs of generic drugs paid by the provincial drug plans are being reduced, and in Ontario, the current system of drug manufacturers paying professional allowances to pharmacies will be eliminated. The amendments also reduce the manufacturer costs of generic drugs purchased out-of-pocket or through private employer drug plans. The Company continues to identify opportunities to mitigate the impact of these amendments, including the introduction of programs to add new services and enhance existing services to attract customers. The amendments could have a material impact on the financial results of the Company if it is not able to effectively mitigate their negative impact.

**Vendor Management and Third Party Service Providers** The Company relies on suppliers that provide the Company with goods and services. Although 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 reputation in operations and its financial performance. Inefficient, ineffective or incomplete vendor management strategies, policies and/or procedures may impact the Company's ability to optimize financial performance, meet customer needs and control costs and quality.

Vendor production capacity or information technology capabilities may limit the Company's ability to service its customers or implement new processes to increase efficiencies and consistencies across vendors. Sourcing from developing markets results in enhanced risk which requires mitigation through additional safety, quality and management reviews.

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The Company's control label products are manufactured under contract by third-party suppliers. Product development and sourcing of the Company's control brand apparel products is conducted by a third party. In order to preserve brand equity, these suppliers are held to high standards of quality. Ineffective selection, contract terms, management and reliance on third party service providers may impact the Company's ability to source control brand products, to have products available for customers, to market to customers and to operate efficiently and effectively on a day to day basis.

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 another supplier can be used. However, disruption in these services is possible which could interrupt the delivery of merchandise to stores thereby negatively affecting sales.

The Company continues to implement practices and performance expectations with its supplier base, including asking suppliers to support sales plans and cost reduction initiatives and to align with major program changes. However, failure to effectively implement these programs will have a negative impact on the Company's ability to realize the expected benefits and could negatively impact revenues and financial performance.

*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. In addition, PC Bank has developed an outsourcing risk policy, approved by its Board of Directors, and has established a vendor governance team that provides its Board with regular reports on vendor governance and annual vendor risk assessments. Despite these activities, a significant disruption in the services provided by the bank would negatively impact revenues and the financial performance of PC Bank and the Company.

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.

**Workplace Health and Safety** The failure of the Company to adhere to appropriate health and safety procedures and to ensure compliance with applicable laws and regulations could have an adverse effect on the organization's operations and financial performance.

The Company has established a national health and safety policy, a national health and safety management system and a 5 year injury reduction plan. Periodic updates are provided by health and safety colleagues to the executive team and quarterly updates are made to the Environmental, Health and Safety Committee of the Board. The Company has also developed a 3 year plan to establish a corporate wellness program. These initiatives cannot, however, prevent all workplace incidents. It remains possible that any such incident or series of incidents could have a negative impact on the Company's reputation, operations or financial performance.

**Environmental** The Company maintains a large portfolio of real estate and infrastructure and is subject to environmental risks associated with the contamination of such properties and facilities, whether by previous owners or occupants, neighbouring properties or from its own operations.

The Company operates a number of underground storage tanks, the majority of which are used for the retailing of automotive fuel. Contamination resulting from leaks from these tanks is possible. The Company employs monitoring and testing regimens, in addition to risk assessments and audits, to minimize the potential for subsurface impacts from fuel losses. The Company also operates refrigerant equipment in its stores and distribution centres to preserve perishable products through the supply chain. These systems contain refrigerant gases which could be released if the related equipment fails. It is possible that a release of these gases could have adverse effects on the environment. To minimize the potential for refrigerant releases, the Company has implemented preventative maintenance programs and refrigeration system inspections and is considering the implementation of new refrigeration system technologies.

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 printed materials distributed to consumers. This is a growing trend and the Company expects to be subject to increased costs associated with these laws.

The Company has environmental 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. 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 environmental affairs department works closely with operations to help ensure requirements are met.

Despite these mitigation activities, the Company could be subject to increased or unexpected costs associated with environmental incidents and the related remediation activities, including litigation and regulatory related costs, all of which could negatively impact the Company's reputation and financial performance.

Recent consumer trends include an increasing demand for products with less impact on the environment and that the Company's operations demonstrate environmentally responsible practices. As set out in its annual Corporate Social Responsibility report, the Company sets environmental goals and monitors its progress towards their achievement. Should the Company fail to meet consumer demand in this area or otherwise face adverse publicity with respect to the environmental impact of its business practices, its reputation may be negatively affected which may lead to decreased revenues and a negative impact on financial performance.

**Franchise Independence and Relationships** A substantial portion of the Company's revenues and earnings comes 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 financial performance. 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, financial difficulty, or were 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. Supply chain or system changes by the Company could cause or be perceived to cause disruptions to franchise operations and could result in negative effects on franchisee revenues or earnings. Reputational damage or adverse consequences for the Company, including litigation and disruption to sales from franchised stores, could result.

**Contract Management and Records Retention** The Company's contract management and records management processes are being upgraded. A lack of effective processes for the tendering, drafting, review and approval of Company contracts and the appropriate level of management and legal involvement increases the risk of financial losses to the business. In addition, inefficient, ineffective or incomplete document management and retention policies, procedures and practices increase the risk of incomplete Company records and potential non-compliance with laws and regulations, which could negatively impact the Company's reputation and financial performance.

**Trademark and Brand Protection** Decrease in value of the Company's trademarks, banners or control brands, as a result of adverse events, changes to the branding strategies or otherwise, could weaken 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 including, printing, flyers and advertising agencies. The Company actively monitors and manages its trademark portfolio. Despite these activities, adverse events could impact the value of the Company's trademarks, banners or brands and may negatively affect revenues and financial performance.

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**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 a number of variables, including 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 performance 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 flows.

**Multi-Employer Pension Plans** In addition to the Company-sponsored pension plans, the Company participates in various multi-employer pension plans, providing pension benefits to union employees pursuant to provisions of collective bargaining agreements. Approximately 40% (2009 – 40%) of employees of the Company and of its independent franchisees participate in these plans. The administration of these plans and the investment of their assets are 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.

The Company is the largest participating employer in the Canadian Commercial Workers Industry Pension Plan (CCWIPP), with approximately 54,000 (2009 – 55,000) employees as members. In 2010, the Company contributed \$55 million (2009 - \$54 million) to CCWIPP. At the end of 2010, the CCWIPP actuarial accrued benefit obligations exceeded the value of the assets held in trust. As a result of this underfunding, CCWIPP received approval from the pension regulator to reduce the accrued benefits and future service benefits of certain participants. Further benefit reductions would negatively affect the retirement benefits of the Company's employees, which in turn could negatively affect their morale and performance.

**Real Estate and Store Renovations** 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 the performance of the Company's stores, the Company from time to time undertakes store renovations. Efforts are made to minimize the duration of these projects in order to limit the disruption at store level. However, the Company's revenues and financial performance will 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.

**Ethical Business Conduct** The Company has adopted a Code of Business Conduct which colleagues 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. Any failure of the Company or its vendors to adhere to ethical business conduct policies could significantly affect the Company's reputation and brands and could, therefore, negatively impact the Company's financial performance.

**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.

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

**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 and cash equivalents, short term investments, security deposits, pension assets held in the Company's defined benefit plans, PC Bank's credit card receivables and other receivables from vendors, 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 results from the possibility that a counterparty may default on the repayment of a security. Efforts to mitigate credit risk include 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. 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 obligations. 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.

Despite the mitigation strategies described above, it is possible that the Company's financial performance could be negatively impacted by the failure of a counterparty to fulfill its obligations, whether as a result of loss of value of receivables or increased costs associated with counterparty default.

**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 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. Despite these mitigation strategies the Company's financial performance could be negatively impacted by foreign currency variability.

## Management's Discussion and Analysis

**Commodity Prices** 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 and is also exposed as a result of the direct link between commodities and the cost of 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, which expires at the end of 2011, 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. Despite these strategies, high commodity prices could negatively affect the Company's financial performance.

**Common Share Market Price** The Company issues stock-based compensation to certain of its employees in the form of stock options and Restricted Share Units ("RSUs") based on its common shares. 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 January 1, 2011, 2,840,638 stock options had exercise prices which were greater than the market price of the Company's common shares at year end. High share prices could negatively affect the Company's financial performance.

**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. The Company is exposed to changes in short term interest rates which is 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. Despite these strategies, changes in interest rates could negatively affect the Company's cash flows and financial performance.

**Derivative Instruments** Over-the counter derivative instruments offset certain risks. Policies and guidelines prohibit the use of any derivative instrument for trading or speculative purposes. See notes 1 and 23 to the consolidated financial statements for additional information about the Company's financial derivative instruments. The fair value of derivative instruments is subject to changing market conditions which could negatively impact the Company's cash flow and financial performance.

### 11. Related Party Transactions

The Company's majority shareholder, Weston and its affiliates other than the Company are related parties. The Company's policy is 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% (2009 – 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 assume its proportionate share of costs incurred on its behalf. Payments by the Company pursuant to these cost sharing agreements in 2010 were approximately \$9 million (2009 – \$10 million).

**Real Estate Matters** The Company leases office space from an affiliate of Weston for approximately \$3 million (2009 – \$3 million).

**Borrowings/Lending** From time to time the Company 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 outstanding as at January 1, 2011 or January 2, 2010.

**Income Tax Matters** From time to time, the Company, Weston and its affiliates may enter into agreements to make elections that are permitted or required under applicable income tax legislation with respect to affiliated corporations. These elections and accompanying agreements did not have a material impact on the Company in 2010.

**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. When 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 by the Company under this agreement in 2010 were \$16 million (2009 – \$16 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.

**Dividend Reinvestment Plan** During the year, the Company issued 3,621,086 (2009 – 3,163,375) common shares to Weston under the DRIP (see note 19 of the consolidated financial statements for more information).

## 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 9 to the consolidated financial statements.

## Management's Discussion and Analysis

### 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 10 to the consolidated financial statements, the Company recorded a fixed asset impairment charge of \$28 million (2009 – \$27 million) and other related charges of \$18 million (2009 – \$19 million) in 2010. In addition, the Company recorded in operating income an asset impairment charge of \$26 million (2009 – nil) related to the closure of a distribution centre in Quebec.

The factor that most significantly influences the impairment assessments is the determination 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 2010 net cost for defined benefit pension and other benefit plans were 5.75% and 5.5%, respectively, on a weighted average basis, compared to 6.0% and 5.7%, respectively, in 2009.

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 2010 expected long term rate of return on plan assets was 6.75%.

The expected growth rate in health care costs for 2010 was based on external data and the Company's historical trends for health care costs. In 2011, the growth rate of health care costs is estimated at 8.0% 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 materially. In accordance with Canadian GAAP, differences between actual results 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. Although the Company believes that its assumptions are appropriate, differences in actual results or changes in the Company's assumptions may materially affect its defined benefit pension plans and other benefit plans accrued benefit plan obligations and future costs.

Additional information regarding the Company's pension and other benefit plans, including a sensitivity analysis for changes in key assumptions, is provided in note 13 to the consolidated financial statements and in the Employee Future Benefit Contributions discussion in Section 10.1.

## 12.4 Goodwill and Indefinite Life Intangible Assets

Goodwill is assessed for impairment at the reporting unit level annually and whenever events or circumstances indicate that it is more likely than not that the carrying value may not be recoverable. 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 of a long term nature including 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 a weighted average cost of capital. These estimates and assumptions are subject to change in the future due to uncertain competitive and economic market conditions and changes in business strategies.

The Company performed the annual goodwill impairment test in 2010 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 consist of T&T trademarks and brand names and are assessed for impairment annually and whenever events or circumstances indicate that it is more likely than not that the carrying value may not be recoverable. 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 an 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 an income approach, specifically the "Relief from Royalty" method. The process of determining the fair values requires management to make assumptions of a long term nature regarding projected future sales, terminal growth rates, notional royalty rates and discount rates. Projected future sales are consistent with strategic plans presented to the Company's Board and discount rates correspond with the risk profile of the subject intangible assets. These estimates and assumptions may change in the future due to uncertain competitive and economic market conditions or changes in business strategies.

The Company performed the annual impairment test of its indefinite life intangible assets in 2010 and determined that there was no impairment of the carrying value of indefinite life intangible assets.

## 12.5 Income and Other 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 not required when it is deemed more likely than not 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.

All income, capital and commodity tax filings are subject to audits and reassessments. Management believes that adequate provisions have been made for all income and other tax obligations. However, changes in interpretations or judgments may result in a change in the Company's income, capital or commodity tax provisions in the future. The amount of such a change cannot be reasonably estimated.

### 13. Accounting Standards

#### 13.1 Accounting Standards Implemented in 2009

**Goodwill and Intangible Assets** In November 2007, the Canadian Institute of Chartered Accountants ("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 effective 2009, retroactively with restatement.

**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 required the abstract to be applied retrospectively without restatement of prior periods. Financial assets and financial liabilities, including derivative instruments, were 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 was effective for annual financial statements relating to fiscal years ending after September 30, 2009. See note 24 for disclosures.

#### 13.2 International Financial Reporting Standards

The Canadian Accounting Standards Board requires that all public companies adopt International Financial Reporting Standards ("IFRS") for interim and annual financial statements relating to fiscal years beginning on or after January 1, 2011. As a result, the Company's audited annual consolidated financial statements for the year ending December 31, 2011 will be the first audited annual consolidated financial statements that will be prepared in accordance with the requirements of IFRS. Starting in the first quarter of 2011 the unaudited interim period consolidated financial statements will be prepared in accordance with International Accounting Standard ("IAS") 34, "Interim Financial Reporting", including 2010 comparative figures and required reconciliations prepared in accordance with IFRS 1, "First-Time Adoption of International Financial Reporting Standards" ("IFRS 1").

**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's IFRS conversion project plan consists 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.

**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 changes required to existing accounting policies, business process and information systems were identified.

**Phase Three: Implementation** This phase includes two components: implementation development and implementation transition and resulted in the compilation of IFRS transitional adjustments, as required, as well as IFRS financial statements for 2010 with required reconciliations to Canadian GAAP. To achieve this result the changes identified in the detailed assessment phase were implemented as discussed below.

*Policy selection* The analysis of policy alternatives under IFRS, including certain exemptions and elections available on transition in accordance with IFRS 1, was completed in 2010. Management has preliminarily concluded on all of its policy alternatives, and obtained preliminary audit committee approval of these choices. These preliminary conclusions and approvals will be finalized prior to the end of the first quarter of 2011.

*Business Processes* Changes to business processes, including the budgeting and planning process, arising as a result of IFRS were also identified in the detailed assessment phase. Certain immaterial changes were taken into account in the budgeting and planning cycle that occurred throughout 2010. All other required business process changes were also implemented by the end of 2010.

*Information Systems* Changes to supporting information systems were identified in the detailed assessment phase. Required changes to supporting information systems were designed, developed and implemented by the end of 2010. The IFRS conversion project is integrated with the Company's ERP implementation. As ERP phases have been deployed, the Company has ensured that the requirements of IFRS adoption were incorporated. For ERP phases that have not yet been deployed, the Company is ensuring that the requirements of IFRS are identified and incorporated.

*Financial Statement Presentation* In accordance with the Company's transition plan, the Company also completed its preliminary first quarter 2011 IFRS financial statement format and draft note disclosures. In addition, the Company has completed its preliminary unaudited opening transitional balance sheet as well as financial statements for each of the quarters of 2010 based on the preliminary elections and exemptions as discussed below. A summary of the significant impacts is provided below.

*Training* Targeted training regarding anticipated changes resulting from IFRS implementation was provided to appropriate business units and finance colleagues throughout 2010 and will continue as appropriate into 2011. In addition, the Company provided quarterly and supplementary IFRS information sessions to the Board which included updates on certain preliminary transitional and 2010 quarterly IFRS adjustments including preliminary policy choices, implications of IFRS standards to the business, and their impacts on financial statement disclosures. As previously announced, the Company will provide an information session on March 3, 2011 to key external stakeholders regarding the impacts of IFRS.

*Contractual Arrangements and Covenants* The implementation of IFRS is expected to have an impact on certain financial metrics that are used in calculating the Company's financial covenants under certain of its debt agreements. These debt agreements provide for the opportunity to renegotiate the covenants to reflect the impact of the transition to IFRS. The Company has reached an understanding with certain of its lenders to defer any adjustments that may be required to its borrowing agreements until such later date that the parties may agree following the adoption of IFRS. The Company will continue to demonstrate compliance with its borrowing agreements on a basis that is consistent with Canadian GAAP as it exists immediately prior to the conversion to IFRS, until such time that the parties agree to formalize the adjustments for IFRS.

## Management's Discussion and Analysis

*Internal Control Compliance* Changes to the Company's internal controls over financial reporting and disclosure controls and procedures, which include enhancement of existing controls and the design and implementation of new controls, where needed, are in process and progressing to plan. At this time the Company expects no material change in internal controls over financial reporting or disclosure controls and procedures resulting from the adoption and implementation of IFRS.

**Preliminary Estimated Impact of Conversion** The information below is provided to allow investors and others to obtain an understanding of the preliminary unaudited effects on the Company's consolidated financial statements and operating performance measures. The changes described below should not be regarded as a complete description of the changes resulting from the transition to IFRS. Readers are cautioned that it may not be appropriate to use such information for any other purpose and the information is subject to change.

The International Accounting Standards Board has significant ongoing projects that could change the current standards under 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 in effect. To date, the Company has made preliminary decisions relating to certain IFRS policies as discussed below. The following information is contingent on the standards that will be effective as at December 31, 2011, the date of the Company's first audited annual consolidated financial statements prepared in accordance with IFRS.

The table below summarizes the estimated impact of conversion to IFRS on the Company's key financial highlights from the unaudited (except where otherwise noted) consolidated statements of earnings for each of the interim periods and year ended January 1, 2011, based on the preliminary elections and exemptions noted below:

(\$ millions except where otherwise indicated)	First Quarter		Second Quarter		Third Quarter		Fourth Quarter		For the year ended January 1, 2011	
	Canadian GAAP	IFRS	Canadian GAAP	IFRS	Canadian GAAP	IFRS	Canadian GAAP	IFRS	Canadian GAAP (audited)	IFRS
Revenues	\$ 6,926	\$ 6,914	\$ 7,317	\$ 7,267	\$ 9,593	\$ 9,536	\$ 7,161	\$ 7,110	\$ 30,997	\$ 30,827
Operating income	260	294	330	334	390	389	289	278	1,269	1,295
Net earnings	137	138	180	174	213	196	151	126	681	634
Basic net earnings per common share (\$)	0.50	0.50	0.64	0.63	0.77	0.70	0.54	0.45	2.45	2.28
Diluted net earnings per common share (\$)	0.49	0.47	0.64	0.61	0.76	0.70	0.54	0.45	2.44	2.24
EBITDA	\$ 412	\$ 436	\$ 479	\$ 474	\$ 591	\$ 584	\$ 442	\$ 430	\$ 1,924	\$ 1,924

The table below reconciles EBITDA to the unaudited IFRS net earnings for each of the interim periods and year ended January 1, 2011, based on the preliminary elections and exemptions noted below:

(\$ millions)	First Quarter	Second Quarter	Third Quarter	Fourth Quarter	For the year ended January 1, 2011
Net earnings	\$ 138	\$ 174	\$ 196	\$ 126	\$ 634
Add impact of the following:					
Income taxes	67	79	89	67	302
Net interest expense and other financing charges	89	81	104	85	359
Operating income	294	334	389	278	1,295
Add impact of the following:					
Depreciation and amortization	142	140	195	152	629
EBITDA	\$ 436	\$ 474	\$ 584	\$ 430	\$ 1,924

In addition, the table below summarizes the estimated impact of conversion to IFRS on the Company's unaudited opening transitional balance sheet as at January 3, 2010 and as at January 1, 2011, based on the preliminary elections and exemptions noted below:

(\$ millions)	As at January 1, 2011			As at January 3, 2010		
	Canadian GAAP (audited)	IFRS (unaudited)	Change	Canadian GAAP (audited)	IFRS (unaudited)	Change
Total assets	\$ 15,919	\$ 16,798	6%	\$ 14,991	\$ 16,058	7%
Total liabilities	9,039	11,255	25%	8,718	10,997	26%
Shareholders' equity	6,880	5,543	(19%)	6,273	5,061	(19%)

### First-Time Adoption of IFRS

The adoption of IFRS will require the application of IFRS 1, which provides guidance for an entity's initial adoption of IFRS. IFRS 1 generally requires retrospective application of all IFRS standards, with the exception of certain mandatory exceptions and limited optional exemptions provided in the standard. The following are the significant optional exemptions that the Company expects to apply in preparing the opening transitional balance sheet in accordance with IFRS 1.

**Employee Benefits** The Company expects to apply the election to recognize, for all defined benefit plans, all cumulative unamortized actuarial gains and losses, which are currently deferred under Canadian GAAP, through opening retained earnings. The Company will apply this exemption to all defined benefit plans consistently and the expected impact has been quantified by the Company's external actuaries. The expected impact of IAS 19, "Employee Benefits" ("IAS 19"), including this IFRS 1 exemption is disclosed in the Changes in Accounting Policies – Employee Benefits section below.

**Borrowing Costs** The Company expects to apply IAS 23, "Borrowing Costs", prospectively and expects to eliminate all previously capitalized interest costs as at the date of transition through opening retained earnings. Upon implementation of IFRS, the Company expects to record a decrease in total assets and liabilities of approximately \$220 million and \$21 million, respectively, with a corresponding impact to shareholders' equity of \$199 million.

**Business Combinations** The Company expects to apply IFRS 3, "Business Combinations" prospectively only to those business combinations that occur after the date of transition.

### Changes in Accounting Policies

**Consolidation** IAS 27, "Consolidated and Separate Financial Statements" and Standing Interpretations Committee Interpretation 12, "Consolidation – Special Purpose Entities" ("IAS 27") assess consolidation based on the control model and IFRS does not include the concept of a variable interest entity. Accordingly, the Company will no longer be required to consolidate certain independent franchisees and other entities subject to warehouse and distribution service agreements that were previously consolidated under Canadian GAAP pursuant to the requirements of Accounting Guideline 15, "Consolidation of Variable Interest Entities" ("AcG 15"). The independent funding trust through which franchisees obtain financing and Eagle, the independent credit card trust that finances certain PC Bank credit card receivables, will be subject to consolidation under IFRS based on the indicators of control as assessed in accordance with Standing Interpretations Committee Interpretation 12. As a result of the above, the Company will be required to re-measure the initial consideration received from the independent franchisee, in the form of a loan receivable, to exclude the benefit of the credit enhancement provided to the independent funding trust by the Company. Upon implementation of IFRS, the Company expects to record an increase in total assets and liabilities of approximately \$719 million and \$739 million, respectively, with a corresponding impact to shareholders' equity of \$20 million primarily resulting from the items described above. In addition, upon implementation the Company expects to record additional total assets and liabilities of \$39 million and \$117 million, respectively, with a corresponding impact to shareholders' equity of \$78 million related to immaterial adjustments of prior period balances. The Company has determined that these amounts were not material to its consolidated financial statements for any prior interim or annual periods.

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**Revenue** Under Canadian GAAP each franchise arrangement was evaluated under AcG 15. Revenues for independent franchisees that were not consolidated under AcG 15 were accounted for under AcG 2 "Franchise Fee Revenue". As a result of the Company no longer consolidating certain independent franchisees the Company was required to evaluate the sale of each franchise arrangement under IAS 18, "Revenue" ("IAS 18") at its inception. Based on the guidance in IAS 18, the Company concluded that each franchise arrangement contains separately identifiable components. As a result of this multi-element arrangement the Company will be required to determine the fair value of all consideration exchanged including certain loans and receivables. The impact of applying these requirements will result in the fair value of certain consideration being less than the amounts recorded at inception. Furthermore, the Company allocated the consideration to each component in the multi-element arrangement, on a relative fair value basis to both the delivered and undelivered components. The total impact of these items is included within the overall financial instruments impacts described below.

**Financial Instruments** As a result of no longer consolidating the franchise arrangements under IAS 27, the Company will recognize and evaluate additional financial assets and financial liabilities in accordance with IAS 39, "Financial Instruments: Recognition and Measurement" ("IAS 39") which requires application retrospectively to the inception of each arrangement. The Company's evaluation has identified one or more events that provide objective evidence that the cash flows associated with certain of these financial assets are such that the fair value has been determined to be impaired. Upon implementation of IFRS, the Company expects to record a decrease in certain financial assets and a corresponding decrease to shareholders' equity.

IAS 39 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 as well as control over the transferred assets. Under Canadian GAAP these financial assets qualify for sale treatment. The Company has determined that under IFRS, securitized credit card receivables will not qualify for derecognition. Upon implementation of IFRS, the Company expects to record an increase in credit card receivables of approximately \$1,179 million (excluding Eagle of \$500 million which is discussed above) before the provision for loan losses with a corresponding increase to liabilities.

Cross-currency and interest rate swaps were effective cash flow hedging relationships under Canadian GAAP. Certain tranches of the swaps that were part of the hedging relationship have expired in 2010 and will continue to expire up to mid-2011. The Company has decided not to apply hedge accounting under IFRS which will result in derecognition at the date of transition to IFRS. Upon implementation of IFRS, the Company expects to reclassify approximately \$16 million of deferred gains from accumulated other comprehensive income to retained earnings within shareholders' equity.

As a result of IAS 39 and IAS 18, the Company expects to record an increase in total assets and liabilities of approximately \$959 million and \$1,290 million, respectively, with a corresponding impact to shareholders' equity of \$331 million primarily resulting from the items described in IAS 18 and IAS 39 above.

**Employee Benefits** IAS 19 provides a policy choice regarding recognition of actuarial gains and losses for defined benefit pension plans and other defined benefit plans, permitting deferred recognition using the corridor method or immediate recognition in either other comprehensive income within equity or through earnings. Under Canadian GAAP the Company applies the corridor method. Upon implementation of IFRS, the Company intends to recognize actuarial gains and losses immediately in other comprehensive income within equity for defined benefit pension plans and other defined benefit plans and immediately in net earnings for other long term employee benefits. Upon implementation of IFRS, the Company expects to record a decrease in total assets and an increase in total liabilities of approximately \$242 million and \$25 million, respectively, with a corresponding impact to shareholders' equity of \$267 million primarily resulting from the items described above and the IFRS 1 exemption described in the First-Time Adoption of IFRS section above. In addition, upon implementation the Company expects to record additional total assets and liabilities of \$14 million and \$52 million, respectively, with a corresponding impact to shareholders' equity of \$38 million related to immaterial adjustments of prior period balances. The Company has determined that these amounts were not material to its consolidated financial statements for any prior interim or annual periods.

**Share-based Payments** IFRS 2, "Share-Based Payments", requires that cash-settled stock-based compensation be measured based on the fair value of the awards. Canadian GAAP requires that such compensation be measured based on the intrinsic value of the awards. This difference is expected to impact the accounting measurement of the Company's stock options, restricted share units and

deferred share units. Upon implementation of IFRS, the Company expects to record an increase in total assets and liabilities of approximately \$3 million and \$9 million, respectively, with a corresponding impact to shareholders' equity of \$6 million primarily resulting from the items described above.

**Property, Plant and Equipment** IAS 16, "Property, Plant and Equipment", provides specific guidance such that when an individual component of an item within property, plant and equipment is replaced and capitalized, the carrying value of the replaced component of the original asset must be derecognized even if the replacement part was not separately accounted for. In addition IFRS is more prescriptive with respect to eligible costs such as site-dismantling and restoration costs. Upon implementation of IFRS, the Company expects to record a decrease in total assets and liabilities of approximately \$60 million and \$2 million, respectively, with a corresponding impact to shareholders' equity of \$58 million primarily resulting from the items described above.

**Impairment of Assets** IAS 36, "Impairment of Assets", requires that assets be tested for impairment at the level of cash generating units ("CGU"), which are defined as the smallest group of assets that generate largely independent cash inflows. The Company has completed its analysis and has concluded that the CGU will predominantly be an individual retail location compared to Canadian GAAP where store net cash flows are grouped together by primary market areas, where they are largely dependent on each other. The Company has completed its preliminary assessment of the events triggering potential impairments and the events triggering the reversal of previously recorded impairments. Upon implementation of IFRS, the Company expects to record a decrease in total assets and liabilities of approximately \$216 million and \$29 million, respectively, with a corresponding impact to shareholders' equity of \$187 million primarily resulting from the items described above.

**Leases** IAS 17, "Leases" ("IAS 17"), requires the allocation of minimum lease payments between the land and building elements of a lease to be in proportion to the relative fair values of the leasehold interests in the land and building, whereas under Canadian GAAP it is based on the fair value of the land and building in aggregate. In addition, IFRS permits the immediate recognition of gains and losses on sale leaseback transactions which result in an operating lease, provided that the transaction is established at fair value. Under Canadian GAAP, gains and losses are generally deferred and amortized in proportion to the lease payments over the lease term. IAS 17 also provides additional indicators of a capital lease that were not provided under Canadian GAAP. Capital leases are referred to as finance leases under IFRS. Upon implementation of IFRS, the Company expects to record an increase in total assets and liabilities of approximately \$62 million and \$78 million, respectively, with a corresponding impact to shareholders' equity of \$16 million primarily resulting from the items described above. In addition, upon implementation the Company expects to record additional total assets and liabilities of \$50 million and \$61 million, respectively, with a corresponding impact to shareholders' equity of \$11 million related to immaterial unrecorded capital leases from prior periods. The Company has determined that these immaterial unrecorded amounts were not material to its consolidated financial statements for any prior interim or annual periods.

**Customer Loyalty Programs** International Financial Reporting Interpretations Committee 13, "Customer Loyalty Programs", requires the fair value of loyalty programs to be recognized as a separate component of the related sales transaction, such that a portion of the revenue from the initial sales transaction in which the awards were granted is deferred until the points are redeemed. The Company has made a policy choice to defer the relevant portion of the sales transaction based on the relative fair value of the awards granted. Under Canadian GAAP, the Company recognizes the net cost of the program in operating expenses measured at the cost to service the liability. Upon implementation of IFRS, the Company expects to record an increase in total assets and liabilities of approximately \$5 million and \$19 million, respectively, with a corresponding impact to shareholders' equity of \$14 million primarily resulting from the items described above.

**Provisions** IAS 37, "Provision, Contingent Liabilities and Contingent Assets" 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 the recognition of a liability under IFRS that was not previously recognized under Canadian GAAP. Other measurement differences under IFRS could result in the earlier recognition of provisions or the recognition of a different amount than under Canadian GAAP. Upon implementation of IFRS, the Company expects to record an increase in total assets and liabilities of approximately \$4 million and \$22 million, respectively, with a corresponding impact to shareholders' equity of \$18 million primarily resulting from the items described above.

## Management's Discussion and Analysis

### Changes in Financial Statement Presentation and Cash Flows

In addition to the changes in recognition and measurement described above, the conversion to IFRS will result in a number of changes to financial statement presentation.

IFRS 8, "Operating Segments" is substantially converged with Canadian GAAP, however with the combined impact of IAS 39, resulting in securitized credit card receivables not qualifying for derecognition and the impact of IAS 27, resulting in the consolidation of Eagle, *PC Financial* will now meet quantitative thresholds requiring it to be disclosed as a reportable segment under IFRS.

On the consolidated balance sheets, the significant required reclassifications from Canadian GAAP to IFRS include: presenting all future income taxes as long-term, rather than presenting current and long term future income taxes separately; presenting investment properties separately from fixed assets; presenting current and long-term provisions separately from accounts payable and accrued liabilities and other liabilities, respectively; and presenting non-controlling interest as a component of equity instead of as a liability.

On the statement of earnings, minority interests will be presented as an allocation of net earnings rather than as a deduction in the calculation of net earnings. In addition, the Company has made a policy choice under IAS 19 to disaggregate pension costs and post retirement benefits on the statement of net earnings, and present the interest and expected return on asset components of total pension cost within interest and other financing charges. This change related to pension costs will have the effect of increasing operating income and EBITDA<sup>(1)</sup>, and increasing interest and other financing charges reported under Canadian GAAP in 2010.

The impact of IFRS on total consolidated cash flows is due only to the change in entities that are recognized on-balance sheet under IFRS as compared to Canadian GAAP, as discussed above related to IAS 27 and IAS 39. In addition, within the consolidated statements of cash flows, there will be differences in the presentation of cash flows between operating, investing and financing.

### 14. Outlook<sup>(2)</sup>

2010 was a year of real progress towards completing the Company's renewal plan. Now entering its fifth and final year of renewal, the Company expects to continue its focus on executing the plan in a market environment that remains unpredictable and competitively intense. In 2011, the Company plans to continue its investments in information technology and supply chain which will negatively impact operating income by approximately \$135 million over 2010, and estimates capital expenditures for the year to be roughly \$1.0 billion.

### 15. Non-GAAP Financial Measures

The Company uses the following non-GAAP financial measures: EBITDA and EBITDA margin, net debt, net debt to EBITDA, net debt to equity 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.

(1) See Non-GAAP financial measures beginning on page 38.

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

**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 1, 2011, January 2, 2010 and January 3, 2009. 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.

(\$ millions)	2010 (unaudited) (12 weeks)	2009 (unaudited) (12 weeks)	2010 (audited) (52 weeks)	2009 (audited) (52 weeks)	2008 (audited) (53 weeks)
Net earnings	\$ 151	\$ 165	\$ 681	\$ 656	\$ 550
Add impact of the following:					
Minority interest	4	9	18	11	10
Income taxes	71	39	297	269	229
Interest expense and other financing charges	63	64	273	269	263
Operating income	289	277	1,269	1,205	1,052
Add impact of the following:					
Depreciation and amortization	153	143	655	589	550
EBITDA	\$ 442	\$ 420	\$ 1,924	\$ 1,794	\$ 1,602

EBITDA margin is calculated as EBITDA divided by sales.

**Net Debt** The following table reconciles net debt used in the net debt to EBITDA and net debt to equity ratios 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 and the fair value of financial derivatives. The Company believes that this measure is useful in assessing the amount of financial leverage employed.

(\$ millions)	As at January 1, 2011	As at January 2, 2010	As at January 3, 2009
Bank indebtedness	\$ 3	\$ 2	\$ 52
Short term debt	-	-	190
Long term debt due within one year	433	343	165
Long term debt	4,213	4,162	4,070
Certain other liabilities	35	36	-
Fair value of financial derivatives related to the above	37	58	63
	4,721	4,601	4,540
Less: Cash and cash equivalents	932	776	243
Short term investments	735	614	510
Security deposits	354	250	437
Fair value of financial derivatives related to the above	187	178	57
	2,208	1,818	1,247
Net debt	\$ 2,513	\$ 2,783	\$ 3,293

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 1, 2011 the credit value adjustment was \$4 million (2009 – \$4 million).

## Management's Discussion and Analysis

**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 as reported under Canadian GAAP less cash and cash equivalents, short term investments, security deposits 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 1, 2011	As at January 2, 2010	As at January 3, 2009
Canadian GAAP total assets	\$ 15,919	\$ 14,991	\$ 13,943
Less: Cash and cash equivalents	932	776	243
Short term investments	735	614	510
Security deposits	354	250	437
Accounts payable and accrued liabilities	3,416	3,279	2,823
<b>Net assets</b>	<b>\$ 10,482</b>	<b>\$ 10,072</b>	<b>\$ 9,930</b>

**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 1, 2011	As at January 2, 2010	As at January 3, 2009
Capital securities	221	220	219
Shareholders' equity	6,880	6,273	5,803
<b>Equity</b>	<b>7,101</b>	<b>6,493</b>	<b>6,022</b>

### 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.

February 23, 2011  
Toronto, Canada