

**XS Cargo Income Fund**  
**Consolidated Financial Statements**  
*December 31, 2007 and 2006*

March 18, 2008

**Auditors' Report**

**To the Unitholders of  
XS Cargo Income Fund**

We have audited the consolidated balance sheets of **XS Cargo Income Fund** as at December 31, 2007 and 2006 and the consolidated statements of operations and comprehensive income, (deficit) retained earnings and cash flows for the periods then ended. These financial statements are the responsibility of the Fund's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the Fund as at December 31, 2007 and 2006 and the results of its operations and its cash flows for the periods then ended in accordance with Canadian generally accepted accounting principles.

**(Signed) "PricewaterhouseCoopers LLP"**

**Chartered Accountants**

**XS Cargo Income Fund**  
**Consolidated Balance Sheets**

As at December 31

(see note 1 – going concern discussion)

	2007	2006
	\$	\$
<b>Assets</b>		
<b>Current</b>		
Cash and cash equivalents	1,709,959	1,017,824
Rebate and other receivables	425,755	439,384
Inventory	21,144,060	22,288,806
Deposits on inventory	2,235,619	6,604,788
Prepaid expenses and deposits	399,188	483,600
	<b>25,914,581</b>	<b>30,834,402</b>
<b>Deferred charges (Note 8)</b>	<b>267,076</b>	<b>331,799</b>
<b>Prepaid expenses and deposits</b>	<b>375,216</b>	<b>345,175</b>
<b>Property and equipment (Note 4)</b>	<b>7,000,853</b>	<b>4,332,028</b>
<b>Intangible assets (Note 5)</b>	<b>2,076,500</b>	<b>6,718,000</b>
<b>Goodwill (Note 6)</b>	<b>36,226,599</b>	<b>101,788,426</b>
	<b>71,860,825</b>	<b>144,349,830</b>
<b>Liabilities</b>		
<b>Current</b>		
Accounts payable and accrued liabilities	13,525,271	10,552,828
Deferred revenue (Note 8)	1,848,965	1,573,432
Distributions payable to unitholders (Note 10)	-	629,681
Distributions payable to non-controlling interest (Note 11)	-	1,103,235
Term loan (Note 7)	11,250,000	2,500,000
Subordinated loan (Note 7)	12,162,695	-
	<b>38,786,931</b>	<b>16,359,176</b>
<b>Term loan (Note 7)</b>	<b>-</b>	<b>15,000,000</b>
<b>Deferred revenue (Note 8)</b>	<b>538,676</b>	<b>607,513</b>
<b>Unamortized lease inducements (Note 9)</b>	<b>848,527</b>	<b>317,975</b>
	<b>40,174,134</b>	<b>32,284,664</b>
<b>Non-controlling interest (Note 11)</b>	<b>18,901,771</b>	<b>57,493,942</b>
	<b>59,075,905</b>	<b>89,778,606</b>
Commitments (Note 12)		
<b>Unitholders' Equity</b>		
<b>Fund units (Note 10)</b>	<b>56,116,612</b>	<b>56,131,876</b>
<b>Contributed surplus</b>	<b>6,360</b>	<b>-</b>
<b>Deficit</b>	<b>(43,338,052)</b>	<b>(1,560,652)</b>
	<b>12,784,920</b>	<b>54,571,224</b>
	<b>71,860,825</b>	<b>144,349,830</b>

Approved on behalf of the Trustees:

(signed) "Jonathan Legg"

Jonathan Legg  
Trustee

(signed) "Gordon Clanachan"

Gordon Clanachan  
Trustee

**XS Cargo Income Fund**  
**Consolidated Statements of Operations and Comprehensive Income**

For the years ended December 31, 2007 and December 31, 2006

	<i>Year ended December 31, 2007</i>	<i>Year ended December 31, 2006</i>
	\$	\$
<b>Sales</b>	<b>125,080,159</b>	<b>116,793,895</b>
<b>Cost of goods sold</b>	<b>86,128,554</b>	<b>74,328,664</b>
<b>Gross Margin</b>	<b>38,951,605</b>	<b>42,465,231</b>
<b>Expenses</b>		
Administrative and operating	37,986,282	28,676,052
Amortization of property and equipment	1,408,620	898,878
Amortization of intangible assets	1,256,500	1,192,000
	<b>40,651,402</b>	<b>30,766,930</b>
	<b>(1,699,797)</b>	<b>11,698,301</b>
<b>Other expenses</b>		
Interest on operating loan	583,086	291,060
Interest on term and subordinated loans	2,071,349	1,042,066
Foreign exchange loss	215,470	194,091
Impairment of intangible assets <i>(Note 5)</i>	3,385,000	-
Impairment of goodwill <i>(Note 6)</i>	65,561,827	-
	<b>71,816,732</b>	<b>1,527,217</b>
<b>Earnings (loss) before non-controlling interest</b>	<b>(73,516,529)</b>	<b>10,171,084</b>
<b>Non-controlling interest <i>(Note 11)</i></b>	<b>(36,146,900)</b>	<b>4,991,919</b>
<b>Net (loss) earnings and comprehensive (loss) income for the year</b>	<b>(37,369,629)</b>	<b>5,179,165</b>
<b>Basic (loss) earnings per unit <i>(Note 17)</i></b>	<b>(6.121)</b>	<b>0.848</b>
<b>Diluted (loss) earnings per unit <i>(Note 17)</i></b>	<b>(6.125)</b>	<b>0.848</b>

The accompanying notes are an integral part of these financial statements

**XS Cargo Income Fund**  
**Consolidated Statements of (Deficit) Retained Earnings**

For the years ended December 31, 2007 and December 31, 2006

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	<i>Year ended December 31, 2007</i>	<i>Year ended December 31, 2006</i>
	\$	\$
<b>Retained (Deficit) earnings, beginning of the year</b>	(1,560,652)	701,871
<b>Net (loss) earnings for the year</b>	(37,369,629)	5,179,165
<b>Distributions declared in the year (Note 10)</b>	(4,407,771)	(7,441,688)
<b>(Deficit) retained earnings, end of the year</b>	(43,338,052)	(1,560,652)

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The accompanying notes are an integral part of these financial statements

**XS Cargo Income Fund**  
**Consolidated Statements of Cash Flows**

For the years ended December 31, 2007 and December 31, 2006

	<i>Year ended December 31, 2007</i>	<i>Year ended December 31, 2006</i>
	\$	\$
<b>Cash provided by (used for) the following activities</b>		
<b>Operating Activities</b>		
Net earnings (loss) for the year	(37,369,629)	5,179,165
Items not affecting cash:		
Non-controlling interest	(36,146,900)	4,991,919
Impairment of goodwill <i>(Note 6)</i>	65,561,827	-
Impairment of intangible assets <i>(Note 5)</i>	3,385,000	-
Amortization of property and equipment	1,408,620	898,878
Amortization of intangible assets	1,256,500	1,192,000
Amortization of transaction costs on subordinated loan	131,834	-
Capitalized interest on subordinated loan	365,025	-
Unit based compensation <i>(Note 14)</i>	73,360	147,000
LTIP expense <i>(Note 13)</i>	13,993	-
Deferred charges, net of costs recognized	64,723	(207,385)
Deferred revenue, net of revenue recognized	206,696	1,411,040
Lease inducements received, net of amortization of lease inducements	530,552	175,859
	(518,399)	13,788,476
Net change in non-cash working capital	8,554,358	(5,758,367)
	8,035,959	8,030,109
<b>Financing Activities</b>		
Proceeds from subordinated loan, net of transaction costs	11,665,836	-
Proceeds from term loan	3,750,000	2,500,000
Repayment of term loan	(10,000,000)	-
Distributions paid on Fund Units	(5,037,452)	(7,384,445)
Distributions paid to non-controlling interest	(3,621,866)	(7,070,213)
	(3,243,482)	(11,954,658)
<b>Investing Activities</b>		
Purchases of property and equipment	(4,077,445)	(2,500,123)
Investment in LTIP trust <i>(Note 13)</i>	(22,897)	-
	(4,100,342)	(2,500,123)
<b>(Decrease) Increase in cash and cash equivalents</b>	692,135	(6,424,672)
<b>Cash and cash equivalents, beginning of year</b>	1,017,824	7,442,496
<b>Cash and cash equivalents, end of year</b>	1,709,959	1,017,824
<b>Supplementary cash flow information</b>		
Interest paid	2,289,410	1,333,126

**1. Nature of the Fund and going concern**

XS Cargo Income Fund (the "Fund") is an unincorporated open-ended trust established under the laws of the Province of Alberta pursuant to the Fund Declaration of Trust dated April 6, 2005. The Fund has been created to invest in the broadline closeout retail business, through an indirect acquisition of the controlling interest of XS Cargo Limited Partnership ("XS Cargo LP") and its general partner ("GP") (collectively "XS Cargo"), and such other investments as the Trustees may determine. Income tax obligations related to the distributions of the Fund are obligations of the Unitholder.

The Fund commenced business operations on May 17, 2005, when it completed an initial public offering (the "IPO") of 6,106,000 trust units ("Fund Units"), at a price of \$10 per unit, for aggregate gross proceeds of \$61,060,000. Concurrent with the closing of the IPO, the Fund acquired a 51% indirect interest in XS Cargo LP and XS Cargo LP acquired the net assets (the "Acquired Business") of Famous Brands (Edmonton) Inc. (the "Vendor"). XS Cargo LP operates 40 (2006 – 35) closeout retail stores in Alberta, British Columbia, Manitoba, Saskatchewan, Ontario, Newfoundland, Nova Scotia and New Brunswick.

These consolidated financial statements have been prepared using Canadian generally accepted accounting principles applicable to a going concern, which contemplates the realization of assets and settlement of liabilities in the normal course of operations. At December 31, 2007, the Fund was in breach of certain financial covenants under the credit facilities described in note 7, giving the lenders the right to demand repayment. The Fund also incurred a net loss of \$37,369,629 for the year ended December 31, 2007, which includes impairment charges to goodwill and other intangible assets totaling \$68,946,827. As at December 31, 2007, the Fund had an accumulated deficit of \$43,338,052. As a result of these circumstances, there is substantial doubt that the Fund would be able to continue as a going concern.

The Fund is working with its lenders to remedy the breaches and negotiate mutually acceptable terms as quickly as possible. Further, the Fund has implemented certain supply chain improvements and other operational measures that management feels will return the Fund to profitability in 2008. Nevertheless, there can be no assurance that these initiatives will be successful.

These financial statements do not reflect any adjustments relating to the carrying values of the Fund's assets and liabilities, the balance sheet classifications used, and the results of operations that might be necessary if the going concern assumption were not appropriate, and these adjustments could be material.

**2. Accounting policies**

These consolidated financial statements have been prepared in accordance with Canadian generally accepted accounting principles and include the following significant accounting policies:

***Basis of presentation***

These financial statements are prepared on a consolidated basis and include the accounts of the Fund, XS Cargo Operating Trust, XS Cargo LP and GP. All inter-entity balances and transactions have been eliminated on consolidation.

***Cash and cash equivalents***

Cash and cash equivalents include balances with banks and short-term investments with maturities of three months or less at acquisition.

***Inventory***

Inventory, consisting of retail merchandise, is valued at the lower of cost, determined using the average cost basis, and net realizable value.

***Vendor volume rebate***

The Fund receives a volume rebate from a particular vendor, which is accrued based on purchases from that vendor and included in rebate and other receivables. The portion of the rebate related to goods that the Fund has subsequently sold is recorded as a reduction of cost of sales and the portion related to goods that remain in inventory is recorded as a reduction of inventory.

***Deposits on inventory***

On certain inventory purchases the Fund pays either a deposit or the balance in full prior to taking possession of the goods. Such payments are recorded as deposits on inventory until the Fund takes possession of the goods, at which time the balance is transferred to inventory.

***Property and equipment***

Property and equipment are recorded at cost. Amortization is provided using methods and rates intended to amortize the cost of assets over their estimated useful lives. The Fund will test its property and equipment for impairment when events and circumstances warrant such a review. An impairment loss is recorded when it is determined that the carrying amount is no longer recoverable and exceeds its fair value. Amortization rates are set forth below:

	Method	Rate
Leasehold improvements	straight-line	Shorter of lease term and 5 years
Office, computer and mobile equipment	straight-line	20%
Computer software	straight-line	20%
Signs	straight-line	20%

***Goodwill***

Goodwill represents the excess of the cost of an acquired business over the estimated fair value of the identifiable net assets acquired. Goodwill is not amortized, but is tested for impairment annually or more frequently if changes in circumstances indicate a potential impairment. The Fund uses the two-step impairment test as outlined in the Canadian Institute of Chartered Accountants ("CICA") Handbook to assess whether the carrying value of goodwill is impaired (note 6).

***Intangible assets***

Intangible assets acquired at the time of the IPO represent management's estimate of the fair value of the XS Cargo brand name and trademark, supplier agreements, databases of sales and purchasing history, non-competition agreements and the value attributed to property leases at less than market rates. The intangible asset related to the brand name and trademark has an indefinite life and is not amortized. The intangible assets related to the non-competition agreements are amortized on a straight-line basis over the 3-year term of the agreements and the amount attributable to property leases is amortized over the remaining terms of the leases. The Fund will assess the carrying value of intangible assets that are not subject to amortization annually, or more frequently if events or changes in circumstances indicate a potential impairment. Intangible assets that are amortized are assessed for impairment when events or changes in circumstances warrant such a review. An impairment loss is recorded when it is determined that the carrying amount of the assets is not recoverable and exceeds the fair value.

During the year, the Fund reclassified the database of sales and purchasing history from an indefinite life intangible asset to a limited life intangible asset (note 5), which is being amortized over its 5 year expected remaining life. In addition, the Fund recognized an impairment charge of \$3,385,000 related to the supplier agreement intangible asset (note 5).

***Future income taxes***

The Fund follows the liability method of tax allocation to account for income taxes. Under this method of tax allocation, future income tax assets and liabilities are determined based upon the differences between the financial reporting and tax bases of assets and liabilities and are measured using the substantively enacted tax rates and laws that will be in effect when the differences are expected to reverse.

Under the terms of the Income Tax Act (Canada), the Fund is not subject to income taxes to the extent that its taxable income in a year is paid or payable to unitholders. Accordingly, no provision for current income taxes for the Fund is made. The Fund intends to distribute to its unitholders all or virtually all of its taxable income and taxable capital gains that would otherwise be taxable in the Fund and intends to continue to meet the requirements under the Income Tax Act (Canada) applicable to such trusts. Currently, the Fund does not pay income tax as long as distributions to unitholders meet or exceed the amount of the Fund's income that would otherwise be taxable.

Proposed changes to the taxation of income trusts were substantively enacted on June 12, 2007. The changes are not intended to apply to taxation years ending prior to 2011, for income trusts that commenced trading prior to November 2006. However, in accordance with the recommendations of the CICA contained in Section 3465, the Fund has estimated its temporary differences reversing in the 2011 taxation year and beyond and applied the current substantively enacted tax rates that will apply in the periods those temporary differences are expected to reverse. Future tax assets are evaluated as to the likelihood of their realization. In instances where it is not more likely than not that the future tax asset will be realized, a valuation allowance is recorded to reduce all or a portion of the future tax asset to its realizable amount.

Taxable income that is not distributed to unitholders is generally taxed in the Trust at the highest federal and provincial income tax rates that are applicable to individuals. Beginning with the 2011 taxation year, distributions will be taxed at the Specified Investment Flow-Through Entity rate.

***Revenue recognition***

Revenue from retail product sales is recognized at the point of sale. Revenue from sales of product replacement extended warranty plans is recognized on a straight-line basis over the plan terms as described below.

***Product replacement extended warranty plan***

Revenue from sales of product replacement extended warranty plans ("PRPs") is recognized on a straight-line basis over the two-year term of the plans. Amounts received but not yet recognized as revenue are included as deferred revenue on the balance sheet, with the amount to be recognized within twelve months of the balance sheet date separately classified as current.

Costs of product replacement and general administration of the PRPs are recognized as incurred. Direct incremental selling costs of PRPs are deferred and recognized on the same basis as the related PRP revenue.

***Lease inducements***

Lease inducements are received from certain of the Fund's landlords, primarily in the form of rent-free periods. Lease inducements are recorded as a liability when received and are amortized as a reduction of rent expense over the terms of the related leases.

***Foreign currency translation***

Transaction amounts denominated in foreign currencies are translated into their Canadian dollar equivalents at exchange rates prevailing at the transaction dates. Carrying values of monetary assets and liabilities reflect the exchange rates at the balance sheet date. Translation gains and losses are included in current earnings.

***Forward contracts***

The Fund may enter into forward currency exchange contracts to manage its risk associated with purchases denominated in US dollars. These contracts are recognized at fair value with any changes in the fair value recorded in net income when those changes occur. There were no such contracts outstanding as at December 31, 2007 or December 31, 2006.

***Variable interest entities***

The Fund undertakes a regular review to identify entities in which it has a variable interest by either contract, ownership or other pecuniary interests. Where the Fund is the primary beneficiary of an entity in which it has a variable interest, that entity is consolidated. As disclosed in note 16, the Fund has a variable interest in one entity, but has determined that it is not the primary beneficiary of that entity.

***Unit-based compensation***

Under the terms of an employment agreement, XS Cargo LP was able to issue a maximum of 6,944 additional XS Cargo LP Exchangeable LP Units and 4,789 additional XS Cargo LP Subordinated LP Units per annum to the Fund's former Chief Financial Officer as performance based compensation, on approval of the Chief Executive Officer and the Fund's Governance and Compensation Committee. Compensation expense, which is included in administrative and operating expenses, is measured at the estimated fair value of the units awarded on the grant date.

***Measurement uncertainty and use of estimates***

The preparation of financial statements in conformity with Canadian generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of financial statements and the reported amounts of revenues and expenses during the reporting period. For example, amortization is based on the estimated useful lives of property and equipment and inventory is recorded after an evaluation as to the net realizable value and is appropriately reduced if net realizable value is estimated to be below cost. As well, freight costs are allocated to inventory based on a percentage of the freight paid in the period in comparison to the total purchases made in the period. This percentage is then applied to the ending inventory balance.

These estimates are reviewed periodically and, as adjustments become necessary, they are reported in earnings in the periods in which they become known.

**3. Change in accounting policies**

(a) On January 1, 2007, the Fund adopted the following recommendations of the CICA Handbook:

*Section 3855: Financial Instruments – Recognition and Measurement*

This Section describes the standards for recognizing and measuring financial assets, financial liabilities and non-financial derivatives. The adoption of these new standards has had no material impact on the consolidated financial statements.

The Fund has made the following classifications:

- Cash and cash equivalents are classified as “held for trading”, which are carried at fair value, with changes in fair value recognized through net income in the period they arise.
- Rebate and other receivables are classified as “loans and receivables”, which are initially measured at fair value, and subsequently measured at amortized cost using the effective interest method.
- Accounts payable and accrued liabilities, operating, term and subordinated loans have been classified as “other financial liabilities”, which are initially measured at fair value and subsequently measured at amortized cost using the effective interest method. For the term and subordinated loans and any other non-operating loans, the Fund has elected to add transaction costs that are directly attributable to issuance to the initial carrying amount.

*Section 1530: Comprehensive Income*

This Section describes how to report and disclose comprehensive income and its components. Comprehensive income is the change in the Fund's net assets that result from transactions, events or circumstances from sources other than the Fund's Unitholders. The adoption of this new standard has had no material impact on the consolidated financial statements, as the Fund does not have any items that should be presented as other comprehensive income.

*Section 3865: Hedges*

This Section establishes standards for when and how hedge accounting, which is optional, may be applied. As the Fund does not use hedge accounting, the adoption of this new standard has had no impact on the consolidated financial statements.

On December 31, 2007, the Fund adopted the following additional financial instruments sections:

*Section 3862: Financial Instruments – Disclosures and Section 3863: Financial Instruments – Presentation*

Section 3862 modifies the disclosure requirements for financial instruments that had previously been included in Section 3861, Financial Instruments – Disclosure and Presentation. The objective of this Section is to require entities to provide disclosures in their financial statements that enable users to evaluate:

- (a) the significance of financial instruments for the entity's financial position and performance; and
- (b) the nature and extent of risks arising from financial instruments to which the entity is exposed during the period and at the balance sheet date, and how the entity manages those risks.

Section 3863 deals with the classification of financial instruments between liabilities and equity, the classification of related interest, dividends, losses and gains, and the circumstances in which financial assets and financial liabilities are offset.

The disclosures related to these sections have been reflected in these consolidated financial statements.

(b) *Section 1506: Accounting Changes*

This standard establishes criteria for changing accounting policies, together with the accounting treatment and disclosure of changes in accounting policies and estimates, and correction of errors, and was amended to prescribe the criteria for changing accounting policies and related accounting treatment and disclosures of accounting principles.

The adoption of this amended accounting standard impacted the change in accounting policy with respect to future income taxes, as described in note 2 and note 18.

(c) Future Accounting Changes

Section 1535: Capital Disclosures

In December 2006, the CICA issued Section 1535, Capital Disclosures which will be adopted by the Fund on January 1, 2008. This new standard established disclosure requirements concerning capital such as: qualitative information about its objectives, policies and processes for managing capital; quantitative data about what it regards as capital; whether it has complied with any externally imposed capital requirements and, if not, the consequences of such non-compliance. The Fund is presently evaluating the impact of this new standard.

Section 3031: Inventories

In June 2007, the CICA issued this new standard which provides guidance in determining the cost of inventory and its subsequent recognition as an expense. The standard is effective for fiscal periods beginning on or after January 1, 2008 and requires the retrospective application to prior period financial statements. The Fund does not expect this section to have a significant impact on the consolidated financial statements.

Section 1400: General Standards of Financial Statement Presentation

In June 2007, this section was amended to include requirements for management to assess and disclose an entity's ability to continue as a going concern. These requirements are effective for interim and annual financial statements for years beginning on or after January 1, 2008.

Section 3064: Goodwill and intangible assets

In February 2008, the CICA issued this new standard which provides guidance over the recognition, measurement, presentation and disclosure of goodwill and intangible assets. The standard is effective for fiscal periods beginning on or after October 1, 2008 and requires retrospective application to prior period financial statements. The Fund is presently evaluating the impact of this new standard.

**XS Cargo Income Fund**  
**Notes to the Consolidated Financial Statements**

*December 31, 2007 and 2006*

**4. Property and equipment**

	<i>December 31, 2007</i>		
	<i>Cost</i>	<i>Accumulated Amortization</i>	<i>Net book Value</i>
	\$	\$	\$
Leasehold improvements	1,524,097	431,006	1,093,091
Office, computer and mobile equipment	5,053,395	1,889,204	3,164,191
Computer software	2,582,639	167,981	2,414,658
Signs	485,497	156,584	328,913
	9,645,628	2,644,775	7,000,853

	<i>December 31, 2006</i>		
	<i>Cost</i>	<i>Accumulated Amortization</i>	<i>Net book Value</i>
	\$	\$	\$
Leasehold improvements	977,707	191,055	786,652
Office, computer and mobile equipment	4,247,763	974,893	3,272,870
Signs	342,584	70,078	272,506
	5,568,054	1,236,026	4,332,028

**XS Cargo Income Fund**  
**Notes to the Consolidated Financial Statements**  
*December 31, 2007 and 2006*

5. **Intangible assets**

	<i>December 31, 2007</i>		
	<i>Cost</i>	<i>Accumulated Amortization</i>	<i>Net book Value</i>
<b>Indefinite life</b>	<b>\$</b>	<b>\$</b>	<b>\$</b>
Brand name and trademark	690,000	-	690,000
	690,000	-	690,000
<b>Limited life</b>			
Operating lease agreements	1,600,000	897,750	702,250
Non-competition agreements	2,550,000	2,231,250	318,750
Database of sales and purchasing history	430,000	64,500	365,500
	4,580,000	3,193,500	1,386,500
	5,270,000	3,193,500	2,076,500
	<i>December 31, 2006</i>		
	<i>Cost</i>	<i>Accumulated Amortization</i>	<i>Net book Value</i>
<b>Indefinite life</b>	<b>\$</b>	<b>\$</b>	<b>\$</b>
Brand name and trademark	690,000	-	690,000
Supplier agreement	3,385,000	-	3,385,000
Database of sales and purchasing history	430,000	-	430,000
	4,505,000	-	4,505,000
<b>Limited life</b>			
Operating lease agreements	1,600,000	555,750	1,044,250
Non-competition agreements	2,550,000	1,381,250	1,168,750
	4,150,000	1,937,000	2,213,000
	8,655,000	1,937,000	6,718,000

During the year, the Fund recognized an impairment charge of \$3,385,000 related to the supplier agreement intangible asset. Certain changes to the supplier agreement and expected life of the agreement resulted in a full reduction in the value of this agreement to the Fund.

In addition, the Fund has reclassified the database of sales and purchasing history as a limited life intangible asset due to a change in the estimated useful life of the asset, and changes in use of the asset.

**XS Cargo Income Fund**  
**Notes to the Consolidated Financial Statements**  
*December 31, 2007 and 2006*

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**6. Goodwill**

As described in the Fund's accounting policies in note 2, Goodwill is tested for impairment annually. The initial cost of Goodwill of \$101,788,426 recognized in the Fund's consolidated financial statements arose upon the business acquisition completed on May 17, 2005, in connection with the IPO.

Due to the net loss in the current year, coupled with a reduction in the trading price of the Fund Units, the two-step impairment test identified that the carrying amount of goodwill exceeded its fair value. As such, a non-cash impairment charge of \$65,561,827 has been recognized to reduce the carrying amount of goodwill to its fair value.

The following table details the changes in Goodwill:

	<i>December 31, 2007</i>	<i>December 31, 2006</i>
	\$	\$
Balance, beginning of the year	101,788,426	101,788,426
Impairment loss recognized	(65,561,827)	-
Balance, end of the year	36,226,599	101,788,426

**7. Credit facilities**

**Term loan**

Term loan consists of a committed non-revolving term loan facility. The maximum available on the term loan facility was \$21,250,000 until July 31, 2007, at which time it was reduced to \$11,250,000. As at December 31, 2007, \$11,250,000 remains outstanding on the term loan (December 31, 2006 - \$17,500,000). The term loan is collateralized by a first charge on all present and after acquired personal property and an assignment of inventory. Interest on the term facility is charged at the lender's Canadian prime rate or U.S. base rate plus 0.25% to 1.25% or the bankers' acceptance rate plus 1.75% to 2.75%, depending on the Fund's senior debt to earnings before interest, taxes, depreciation and amortization ("EBITDA") ratio.

During the year interest was charged at rates of between prime plus 0.25% and prime plus 1.25% and totaled \$1,211,352 (2006 - \$1,042,066). As at December 31, 2007, prime rate was 6.0% (2006 - 6.0%). The principal balance of the term loan is due on May 16, 2008.

**XS Cargo Income Fund**  
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**Subordinated loan**

On August 20, 2007, the Fund entered into a subordinated loan agreement for \$12,000,000, funded 50% by an independent third party and 50% by a company owned by the President and CEO of the Fund. The principal balance is due on August 20, 2008, but is renewable for an additional six months at the request of the Fund, conditional upon the Fund's compliance with the agreements and the lenders' approval. The subordinated loan is collateralized by a second charge on all of the present and future undertakings and property including an acknowledged assignment of leases and material contracts. Interest on the subordinated loan is charged at 16%, with the Fund's option to capitalize up to 8.0% per annum. During the year, interest expense totaling \$859,997 was recorded, including \$365,025 which was capitalized as part of the outstanding principal balance.

The following table details the balance of the subordinated loan:

	<i>December 31, 2007</i>	<i>December 31, 2006</i>
	\$	\$
Initial principal amount	12,000,000	-
Unamortized transaction costs	(202,330)	-
Interest capitalized	365,025	-
	12,162,695	-

**Operating loan**

The Fund has available under its credit facilities a \$20,000,000 (\$12,500,000 available from January to July) demand revolving loan. Under the terms of the credit facility agreement, the operating loan is collateralized along with the term loan as described above. Interest on the operating loan will vary between the lender's prime rate and the lender's prime rate plus 1.00% depending on the Fund's ratio of senior debt to EBITDA. If funds are withdrawn in U.S. dollars, interest will vary between the lender's U.S. base rate and the lender's U.S. base rate plus 1.00%, depending on the Fund's ratio of senior debt to EBITDA. During the year, the Fund paid interest of \$583,086 (2006 - \$291,060) on amounts drawn on the operating loan at a rate of prime. As at December 31, 2007 prime rate was 6.0%, and there was no amount outstanding on the operating loan at the end of the December 31, 2007 or December 31, 2006.

**Financial covenants**

Both the term loan and operating loan ("Loans") require the Fund to maintain certain financial covenants, including a maximum senior debt to EBITDA ratio of 3.5:1.0 until December 31, 2007, at which time the ratio reduces to 2.0:1.0; a minimum current ratio of 1.5:1.0, a minimum fixed charge coverage ratio of 1.0:1.0 and a minimum EBITDA value of \$5,500,000 on a rolling twelve month basis. For 2007, the minimum fixed charge coverage ratio was waived by the lender. Additionally, the covenants limit the Fund's ability to undertake mergers, acquisitions, new indebtedness, declare distributions in excess of distributable cash and other changes in the business without approval of the lender. The limitation on declaring distributions in excess of distributable cash has been waived by the lender until December 31, 2007.

The subordinated loan agreement requires the Fund to maintain certain financial covenants, including a total funded debt to EBITDA ratio of less than 5.0:1.0 until December 31, 2007, at which point the ratio reduces to 3.75:1.0. There are additional restrictive covenants that limit the Fund's ability to undertake mergers, acquisitions, new indebtedness and other changes in the business without approval of the lenders.

As at December 31, 2007, the Fund was not in compliance with its senior debt to EBITDA covenant, total debt to EBITDA covenant and the minimum twelve-month EBITDA covenant. All loans are presented as current liabilities. See discussion in note 1 regarding going concern.

**XS Cargo Income Fund**  
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**8. Deferred revenue and deferred charges**

The following tables detail the deferred revenue and charges associated with the product replacement extended warranty plans ("PRP") and gift cards issued:

	<i>December 31, 2007</i>	<i>December 31, 2006</i>
<b>Deferred revenue</b>	<b>\$</b>	<b>\$</b>
Deferred PRP revenue, beginning of year	2,135,840	769,905
PRP sales	2,158,793	2,350,321
Amounts recognized as revenue	(2,059,484)	(984,386)
Deferred PRP revenue, end of year	2,235,149	2,135,840
 Gift card deferred revenue	 152,492	 45,105
Deferred revenue, end of year	2,387,641	2,180,945
 Less: current portion of deferred revenue	 1,848,965	 1,573,432
	538,676	607,513
 <b>Deferred charges</b>		
Deferred charges, beginning of year	331,799	124,414
Direct incremental selling costs	250,735	352,280
Costs recognized	(315,458)	(144,895)
Deferred charges, end of year	267,076	331,799

**XS Cargo Income Fund**  
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**9. Unamortized lease inducements**

	<i>December 31, 2007</i>	<i>December 31, 2006</i>
	\$	\$
Cost	1,142,205	506,625
Accumulated amortization	(293,678)	(188,650)
	848,527	317,975

Lease inducements received are non-cash transactions in the form of rent-free periods and, as such, have been added back as a non-cash item in operating activities on the statement of cash flows. Amortization of lease inducements represents a non-cash reduction in rent expense and, as such, is a deduction in cash flow from operating activities on the statement of cash flows.

**10. Unitholders' Equity**

**Fund Units**

The following units are issued and outstanding:

	Number of Units #	Issue Costs \$	Net Capital Contributions \$
Fund Units Issued, December 31, 2006 and 2005	6,106,000	4,928,124	56,131,876
Fund Units held by LTIP trust ( <i>Note 13</i> )	(3,000)	-	(15,264)
Balance, December 31, 2007	6,103,000	-	56,116,612

An unlimited number of Fund Units may be created and issued pursuant to the Declaration of Trust. Each Fund Unit is transferable and represents an equal undivided beneficial interest in any distributions from the Fund, whether of net income, net realized capital gains or other amounts and in the net assets of the Fund in the event of a termination or winding up of the Fund. All Fund Units have equal voting rights and privileges.

Fund Units acquired by LTIP Trust represents the value of unvested units held in the LTIP Trust (note 13).

**Distributions to Unitholders**

The Fund's policy is to distribute annually to unitholders available cash from operations after cash required for capital expenditures, working capital reserve and other reserves considered advisable by the trustees of the Fund. Distributions totaling \$0.7222 per Fund Unit (\$4,407,771) were declared by the Fund during the year (2006 - \$7,441,688). As at December 31, 2007 there were no outstanding distributions payable. The distribution declared for the month of December 2006 in the amount of \$0.103125 per Fund Unit (\$629,681) was included in distributions payable to unitholders at December 31, 2006 and was paid on January 15, 2007. Distributions on Fund Units were suspended effective December 2007.

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**11. Non-controlling interest**

	<i>XS Cargo LP Exchangeable LP Units #</i>	<i>XS Cargo LP Subordinated LP Units #</i>	<i>Total #</i>
Balance – December 31, 2005	3,478,914	2,399,269	5,878,183
Unit based compensation award ( <i>Note 14</i> )	6,944	4,789	11,733
Balance – December 31, 2006	3,485,858	2,404,058	5,889,916
Unit based compensation award ( <i>Note 14</i> )	6,944	4,789	11,733
Balance – December 31, 2007	3,492,802	2,408,847	5,901,649
	\$	\$	\$
Balance – December 31, 2005	35,189,043	24,268,486	59,527,529
Unit based compensation award ( <i>Note 14</i> )	69,440	47,890	117,330
Non-controlling interest – earnings	2,954,392	2,037,527	4,991,919
Distributions declared	(4,244,939)	(2,927,567)	(7,172,506)
Net accrued contingent unit based compensation award ( <i>Note 14</i> )			29,670
Balance – December 31, 2006	33,967,936	23,426,336	57,493,942
Unit based compensation award ( <i>Note 14</i> )	102,405	70,625	173,030
Net accrued contingent unit based compensation award accrued as at December 31, 2006 ( <i>Note 14</i> )			(99,670)
Non-controlling interest – earnings (loss)	(21,392,998)	(14,753,902)	(36,146,900)
Distributions declared	(2,518,631)	-	(2,518,631)
Balance – December 31, 2007	10,158,712	8,743,059	18,901,771

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**XS Cargo LP Exchangeable LP Units (“Exchangeable LP Units”)**

The Exchangeable LP Units issued by XS Cargo LP have economic and voting rights equivalent to the Fund Units (note 10), except in connection with the exchangeability terms as described below. They are exchangeable directly or indirectly, on a one-for-one basis for Fund Units at the option of the holder, under the terms of the Exchange Agreement. The Exchangeable LP Units are not required to be exchanged for Fund Units before transferring to third parties. As a result, they have been presented as non-controlling interest, in accordance with the CICA Emerging Issues Committee Abstract #151.

Each Exchangeable LP Unit entitles the holder to receive distributions from XS Cargo LP pro rata with distributions made by XS Cargo LP on Fund Units.

**XS Cargo LP Subordinated LP Units (“Subordinated LP Units”)**

The Subordinated LP Units have economic and voting rights equivalent to the Fund Units (note 10), except in connection with the subordination terms as described below. As a result, they have been treated as non-controlling interest, in accordance with the CICA Emerging Issues Committee Abstract #151.

Distributions are to be made monthly on the Fund Units (note 10) and Exchangeable LP Units to the extent cash is available to make cash distributions. Distributions on the Subordinated LP Units are subordinated and are made quarterly in an amount equal to the amount distributed on Fund Units and Exchangeable LP Units and to the extent cash is available to make such distributions.

The Subordinated LP Units will be automatically exchanged for Exchangeable LP Units on a one-for-one basis and the subordination provisions will apply until the end of any fiscal year ending on or after December 31, 2006 if, for that fiscal year the Fund has earned EBITDA (earnings before interest, taxes, depreciation and amortization) of at least \$14.432 million and the Fund has paid distributions of at least \$1.125 per Fund Unit for such fiscal year. For the year ended December 31, 2007, the criteria were not met for the automatic exchange to occur.

**Fund Special Voting Units**

	Number #	Amount \$
Issued and outstanding – December 31, 2005	5,878,183	-
Issued during the year ended December 31, 2006	11,733	-
<hr/>		
Issued and outstanding – December 31, 2006	5,889,916	-
Issued during the year ended December 31, 2007	11,733	-
<hr/>		
Issued and outstanding – December 31, 2007	5,901,649	-

Fund Special Voting Units are non-participating and are used solely for providing voting rights to persons holding Exchangeable LP Units and Subordinated LP Units. Fund Special Voting Units are not transferable separately from Exchangeable LP Units and Subordinated LP Units to which they relate. The Fund Special Voting Units are not entitled to any beneficial interest in any distribution from the Fund or in the net assets of the Fund in the event of a termination or winding up of the Fund. Each Fund Unit and Fund Special Voting Unit entitles the holder thereof to one vote at all meetings of the Unitholders.

If the Exchangeable LP Units or the Subordinated LP Units are purchased in accordance with the Exchange Agreement, a like number of Fund Special Voting Units will be redeemed by the Fund for a nominal amount.

**Distributions to non-controlling interest**

The Fund's policy is to distribute annually to holders of Fund Units, Exchangeable LP Units and Subordinated LP Units available cash from operations after cash required for capital expenditures, working capital reserve and other reserves considered advisable by the trustees of the Fund. Distributions totaling \$0.42677 per Exchangeable LP Unit (\$2,518,631) and \$nil per Subordinated LP Unit (\$nil) were declared by the Fund during year. For 2006, distributions totaling \$1.21875 per Exchangeable LP Unit (\$4,244,939) and \$1.21875 per Subordinated LP Unit (\$2,927,567) were declared by the Fund. There were no distributions payable to non-controlling interest at December 31, 2007. For 2006, distributions declared on Exchangeable LP Units for the month of December in the amount of \$0.103125 per unit (\$359,479) and distributions on Subordinated LP Units for the three months ended December 31, 2006 in the amount of \$0.309375 per unit (\$743,756) were included in distributions payable to non-controlling interest at the balance sheet date and were paid on January 15, 2007. Distributions on all Exchangeable LP Units were suspended effective December 2007 and distributions on Subordinated LP Units were suspended in March 2007.

**12. Commitments**

The Fund occupies the premises of its stores, warehouses and office under lease agreements requiring basic monthly rents for the years indicated and in aggregate as follows:

Years ending December 31,	
2008	5,041,045
2009	4,630,737
2010	3,728,341
2011	2,951,188
2012	2,166,824
<u>Thereafter</u>	<u>5,521,013</u>
<u>Total</u>	<u>24,039,148</u>

**13. Long-term incentive plan**

The Fund has adopted a long-term incentive plan (the "Plan") to provide key senior management, officers and directors of the Fund with compensation opportunities that will enhance the ability of the Fund to attract, retain and motivate key personnel and reward these key employees for significant performance and associated per unit cash flow growth. Fund bonuses, in the form of the Units of the Fund, will be provided to eligible employees on an annual basis where the distributable cash of the Fund exceeds certain specified threshold amounts. The Plan is managed through a separate trust, which is considered a variable interest entity. As the Fund is the primary beneficiary, the Fund consolidates the Plan in its financial statements.

**XS Cargo Income Fund**  
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If the distributable cash flow per unit exceeds the base distribution, a percentage of the distributable cash (the participation rate) is contributed by the Fund into a separate trust. The funds in the trust are used to purchase units of the Fund in the open market, to be provided to eligible employees as bonus compensation. Threshold amounts and participation rates are as follows:

<b>Excess percentage</b>	<b>Participation rate</b>
5% or less	Nil
Greater than 5% and up to 10%	10% of any excess over 5%
Greater than 10% and up to 20%	10% of any excess over 5%, plus 20% of any excess over 10%
Greater than 20%	10% of any excess over 5%, plus 20% of any excess over 10%, plus 25% of any excess over 20%

The Fund records annual awards under the Plan as compensation expense over the vesting period. For the year ended December 31, 2007, the distributable cash per unit of the Fund did not exceed the threshold amount. For the year ended December 31, 2006, the distributable cash per unit of the Fund exceeded the threshold amount. As a result, the Fund transferred \$22,897 to the LTIP trust in 2007. On May 9, 2007, the LTIP award was granted and will vest over three years. Compensation expense of \$13,993 was recorded for the year ended December 31, 2007 (2006 - \$Nil).

The following table summarizes the status of the Plan:

	Year Ended December 31	
	2007	2006
	#	#
Unvested Units, beginning of period	-	-
Granted	4,500	-
Vested Units transferred to participants	<u>(1,500)</u>	-
Unvested Units, end of period	<u><u>3,000</u></u>	-

**14. Unit-based compensation**

Under the terms of the Acquisition Agreement between the Vendor and the Fund, the Fund assumed certain obligations under an employment agreement with the former Chief Financial Officer. Under the terms of that agreement, XS Cargo LP issued 6,944 XS Cargo Exchangeable Units and 4,789 Subordinated LP Units to the Chief Financial Officer on June 30, 2007. The unit-based award was recorded as administration and operating costs in the amount of \$73,360 (2006 - \$147,000), the estimated fair value of the units on the grant date, resulting in an increase in non-controlling interest. Due to the departure of the Chief Financial Officer, there is no accrued award as at December 31, 2007 (2006 - \$99,670).

**15. Financial instruments**

**Credit risk**

As the Fund does not sell its products to consumers on terms of credit, the Fund is exposed to credit risk only through the Rebate and other receivables, and Deposits on inventory to the extent of credits on account with suppliers. As the Rebate and other receivables primarily consist of the rebate receivable from Samra Imports Ltd. (note 16) based upon historical purchases and other receivables not related to merchandise sales, management has assessed credit risk as minimal for these balances. Deposits on inventory relate to specific inventory purchases with vendors. The Fund has recorded a provision of \$1,245,000 for certain of these receivables it has determined to be uncollectible as at December 31, 2007.

**Foreign currency risk**

Foreign currency risk is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in foreign exchange rates. The Fund purchases a significant amount of its inventory from suppliers in the United States and China, mostly denominated in United States dollars. Consequently, the Fund's gross margin is exposed to foreign exchange fluctuations. This exposure is limited because the Fund does not enter into significant future purchase commitments, but generally wires funds in advance upon placing orders with United States suppliers. As at December 31, 2007, the portion of the accounts payable balance denominated in United States Dollars is \$582,774 USD (2006 - \$345,594 USD). As at December 31, 2007, the Fund had \$174,489 USD included in cash and cash equivalents (2006 – bank indebtedness of \$1,922,336 USD).

**Interest rate risk**

Interest rate risk is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in interest rates. The Fund's term loan and operating loan credit facilities, as described in note 7, bear interest with floating rates over prime or the appropriate bankers' acceptance rate, thus exposing the Fund to interest rate risk. A 1.0% increase in interest rates would have an impact of \$112,500 annually on interest expense and cash flow based on \$11,250,000 of debt outstanding at December 31, 2007.

**Liquidity risk**

Liquidity risk is the risk that the Fund will encounter difficulty in meeting obligations associated with financial liabilities. The Fund enters into transactions to purchase goods and services on credit, lease premises from various landlords, and borrow funds from financial institutions or other creditors, for which repayment is required at various maturity dates (note 1 and 17). Liquidity risk is managed by reviewing the Fund's future expected net cash flows for the possibility of a negative cash position. The Fund manages liquidity risk by monitoring actual and projected cash flows, taking into account the seasonality of the Fund's sales and purchases.

**Fair value**

The Fund's financial instruments consist of cash and cash equivalents, rebate and other receivables, accounts payable and accrued liabilities, distributions payable, operating loan, subordinated loan and term loan. The carrying amount of financial instruments that are included in working capital and the subordinated loan approximate their fair values due to their relatively short terms to maturity. The carrying value of the term loan approximates fair value since the interest rate fluctuates and approximates rates currently available to the Fund.

**16. Variable interest entity**

The Fund has a vendor supply and volume rebate agreement with Samra Imports Ltd., (“Samra”). Samra imports products from China which it sells to the Fund and other customers. Samra is the Fund’s largest supplier accounting for approximately 13% of the Fund’s purchases since the commencement of the agreement and the Fund is Samra’s largest customer. The purpose of the agreement is to outline the supply terms and to provide the Fund with a rebate based on its significant volume of purchases from Samra. The Fund has determined that Samra is a variable interest entity and that the supply and rebate agreement represents a variable interest in Samra. The Fund has determined, however, that it is not the primary beneficiary under the supply and rebate agreement since the Fund is not entitled to receive a majority of Samra’s expected residual returns or absorb a majority of its expected losses. As Samra is a separate legal entity, XS Cargo does not have direct access to Samra’s assets and Samra’s creditors do not have recourse against XS Cargo.

During the year, the Fund purchased approximately \$5,500,000 (2006 - \$13,652,000) of inventory from Samra. Included in deposits on inventory, is a balance of \$282,369 (2006 - \$520,614), outstanding from Samra related to those purchases. In addition, included in accounts payable and accrued liabilities is a balance of \$1,477,750 (2006 - \$Nil) owing to Samra. Samra issued the Fund a volume rebate for purchases made during the year in the amount of \$555,400 (2006 - \$1,060,540), of which \$178,835 is included in rebate and other receivables (2006 - \$435,914).

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**17. Basic and diluted (loss) earnings per unit**

The following table outlines the adjustments to the numerator and denominator to calculate the basic and diluted (loss) earning per unit:

	<b>Basic (Loss) Earnings per Unit</b>		<b>Dilution Adjustments</b>		<b>Diluted (Loss) Earnings per Unit</b>
<b>December 31, 2007</b>					
Net loss	\$(37,369,629)		\$(36,146,900)	(a)	\$(73,516,529)
Average Units outstanding	6,105,244		5,897,245	(b)	12,002,489
Loss per Unit	(6.121)				(6.125)
	<b>Basic (Loss) Earnings per Unit</b>		<b>Dilution Adjustments</b>		<b>Diluted (Loss) Earnings per Unit</b>
<b>December 31, 2006</b>					
Net earnings	\$5,179,165		\$4,991,919	(a)	\$10,171,084
Average Units outstanding	6,106,000		5,884,098	(b)	11,990,098
Earnings per Unit	0.848				0.848

(a) Adjustment to add back non-controlling interest if Exchangeable LP Units and Subordinated LP Units are converted to Fund Units

(b) Adjustment to reflect the conversion of Exchangeable LP Units and Subordinated LP Units to Fund Units on a one-for-one basis

**18. Future income taxes**

Prior to June 12, 2007, the Fund was effectively exempt from income taxes and, accordingly, its consolidated financial statements did not include a provision for Canadian income taxes related to the Fund's income. On October 31, 2006, the Minister of Finance (Canada) announced proposed tax legislation Bill C-52 ("trust legislation") that will change the income tax rules applicable to publicly traded trusts rendering income trusts taxable in 2011.

The October 31, 2006 trust legislation was substantively enacted into law on June 12, 2007, at which time the Fund gave accounting recognition to these new tax rules. While the Fund will not be liable for current taxes until January 1, 2011, it was required to give recognition in the quarter ended June 30, 2007 to future income taxes arising from those temporary tax differences expected to reverse after January 1, 2011, at the 28% tax rate applicable to the Fund. The fund then continues to recognize changes in future income taxes in each subsequent quarter as they arise.

The components of future income taxes are as follows:

	<b>December 31, 2007</b>	<b>December 31, 2006</b>
	\$	\$
<i>Future income tax assets</i>		
Property and equipment	478,907	-
Intangible assets	221,058	-
Unamortized lease inducements	95,035	-
Future income tax assets before valuation allowance	795,000	-
Valuation allowance	(795,000)	-
Net future income tax assets	-	-

The Fund's valuation allowance of \$795,000 at December 31, 2007 relates principally to the uncertainty of the utilization of the future tax assets due to the breach of financial covenants as described in notes 1 and 7.

**19. Related party transactions**

On August 20, 2007, the Fund entered into a subordinated loan agreement for \$12,000,000, funded 50% by an independent third party and 50% by a company owned by the President and CEO of the Fund, as described in note 7. Interest expense totaling \$433,040 was recorded on the portion of the loan outstanding to the related party. The loan has been recorded at the exchange amount, which represents fair value.

**20. Segmented information**

The Fund identifies operating segments based on business activities, management responsibility and geography. The Fund operates within a single operating segment, being the operation of closeout retail stores in Canada. All of the Fund's assets are located in Canada.

**21. Comparative Figures**

Certain comparative figures have been reclassified to conform with the current year's presentation.