

**XS Cargo Income Fund**  
**Consolidated Financial Statements**  
*December 31, 2006 and 2005*

March 16, 2007

**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, 2006 and 2005 and the consolidated statements of earnings, (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, 2006 and 2005 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**

	2006	2005
	\$	\$
<b>Assets</b>		
<b>Current</b>		
Cash and cash equivalents	1,017,824	7,442,496
Rebate and other receivables	439,384	501,486
Inventory	22,288,806	15,752,388
Deposits on inventory	6,604,788	4,079,482
Prepaid expenses and deposits	828,775	612,151
	<b>31,179,577</b>	<b>28,388,003</b>
<b>Deferred charges (Note 7)</b>	<b>331,799</b>	<b>124,414</b>
<b>Property and equipment (Note 4)</b>	<b>4,332,028</b>	<b>2,730,783</b>
<b>Intangible assets (Note 5)</b>	<b>6,718,000</b>	<b>7,910,000</b>
<b>Goodwill (Note 3)</b>	<b>101,788,426</b>	<b>101,788,426</b>
	<b>144,349,830</b>	<b>140,941,626</b>
<b>Liabilities</b>		
<b>Current</b>		
Accounts payable and accrued liabilities	10,597,933	7,094,948
Deferred revenue (Note 7)	1,528,327	417,152
Distributions payable to unitholders (Note 9)	629,681	572,438
Distributions payable to non-controlling interest (Note 10)	1,103,235	1,000,943
Term loan (Note 6)	2,500,000	-
	<b>16,359,176</b>	<b>9,085,481</b>
<b>Term Loan (Note 6)</b>	<b>15,000,000</b>	<b>15,000,000</b>
<b>Deferred revenue (Note 7)</b>	<b>607,513</b>	<b>352,753</b>
<b>Unamortized lease inducements (Note 8)</b>	<b>317,975</b>	<b>142,116</b>
	<b>32,284,664</b>	<b>24,580,350</b>
<b>Non-controlling interest (Note 10)</b>	<b>57,493,942</b>	<b>59,527,529</b>
	<b>89,778,606</b>	<b>84,107,879</b>
Commitments (Note 11)		
<b>Unitholders' Equity</b>		
<b>Fund Units (Note 9)</b>	<b>56,131,876</b>	<b>56,131,876</b>
<b>(Deficit) retained earnings</b>	<b>(1,560,652)</b>	<b>701,871</b>
	<b>54,571,224</b>	<b>56,833,747</b>
	<b>144,349,830</b>	<b>140,941,626</b>

The accompanying notes are an integral part of these financial statements

## XS Cargo Income Fund

### Consolidated Statements of Earnings

For the year ended December 31, 2006 and for the period from April 6, 2005, including operations from May 17, 2005 (date of commencement of business operations) to December 31, 2005

	<i>Year ended December 31, 2006</i>	<i>Eight-month period ended December 31, 2005</i>
	\$	\$
<b>Sales</b>	<b>116,793,895</b>	<b>68,967,157</b>
<b>Cost of goods sold</b>	<b>74,328,664</b>	<b>42,967,715</b>
<b>Gross Margin</b>	<b>42,465,231</b>	<b>25,999,442</b>
<b>Expenses</b>		
Administrative and operating	28,676,052	14,594,401
Amortization of property and equipment	898,878	337,148
Amortization of intangible assets	1,192,000	745,000
	<b>30,766,930</b>	<b>15,676,549</b>
<b>Earnings before the undernoted</b>	<b>11,698,301</b>	<b>10,322,893</b>
<b>Other expenses</b>		
Interest on bank indebtedness	291,060	21,689
Interest on term loan	1,042,066	483,233
Foreign exchange loss	194,091	37,091
	<b>1,527,217</b>	<b>542,013</b>
<b>Earnings before non-controlling interest</b>	<b>10,171,084</b>	<b>9,780,880</b>
<b>Non-controlling interest (Note 10)</b>	<b>4,991,919</b>	<b>4,797,481</b>
<b>Net earnings for the period</b>	<b>5,179,165</b>	<b>4,983,399</b>
<b>Basic and diluted earnings per unit (Note 16)</b>	<b>0.848</b>	<b>0.816</b>

The accompanying notes are an integral part of these financial statements

## XS Cargo Income Fund

### Consolidated Statements of (Deficit) Retained Earnings

For the year ended December 31, 2006 and for the period from April 6, 2005, including operations from May 17, 2005 (date of commencement of business operations) to December 31, 2005

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	<i>Year ended December 31, 2006</i>	<i>Eight-month period ended December 31, 2005</i>
	\$	\$
<b>Retained earnings, beginning of the period</b>	701,871	-
<b>Net earnings for the period</b>	5,179,165	4,983,399
<b>Distributions declared in the period</b>	(7,441,688)	(4,281,528)
<b>(Deficit) retained earnings, end of the period</b>	(1,560,652)	701,871

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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 year ended December 31, 2006 and for the period from April 6, 2005, including operations from May 17, 2005 (date of commencement of business operations) to December 31, 2005

	<i>Year ended December 31, 2006</i>	<i>Eight-month period ended December 31, 2005</i>
	\$	\$
<b>Cash provided by (used for) the following activities</b>		
<b>Operating Activities</b>		
Net earnings for the period	5,179,165	4,983,399
Items not affecting cash:		
Non-controlling interest	4,991,919	4,797,481
Amortization of property and equipment	898,878	337,148
Amortization of intangible assets	1,192,000	745,000
Unit based compensation <i>(Note 13)</i>	147,000	187,330
Deferred charges, net of costs recognized	(207,385)	(124,414)
Deferred revenue, net of revenue recognized	1,365,935	769,905
Lease inducements received, net of amortization of lease inducements	175,859	142,116
	13,743,371	11,837,965
Net change in non-cash working capital	(5,713,262)	3,841,158
	8,030,109	15,679,123
<b>Financing Activities</b>		
Repayment of amounts due to Vendor	-	(901,394)
Net proceeds from the issuance of Units	-	56,131,876
Proceeds from term loan	2,500,000	15,000,000
Distributions paid on Fund Units	(7,384,445)	(3,709,089)
Distributions paid to non-controlling interest	(7,070,213)	(3,120,839)
	(11,954,658)	63,400,554
<b>Investing Activities</b>		
Purchases of property and equipment	(2,500,123)	(569,400)
Business acquisition – net of cash acquired <i>(Note 3)</i>	-	(71,067,781)
	(2,500,123)	(71,637,181)
<b>(Decrease) Increase in cash and cash equivalents</b>	<b>(6,424,672)</b>	<b>7,442,496</b>
<b>Cash and cash equivalents, beginning of period</b>	<b>7,442,496</b>	<b>-</b>
<b>Cash and cash equivalents, end of period</b>	<b>1,017,824</b>	<b>7,442,496</b>
<b>Supplementary cash flow information</b>		
Interest paid	1,333,126	504,922

The accompanying notes are an integral part of these financial statements

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

*December 31, 2006 and 2005*

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**1. The Fund**

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 (note 3) and XS Cargo LP acquired the net assets (the "Acquired Business") of Famous Brands (Edmonton) Inc. (the "Vendor"). XS Cargo LP operates 35 (2005 – 27) closeout retail stores in Alberta, British Columbia, Manitoba, Saskatchewan, Ontario, Newfoundland and Nova Scotia.

**2. Accounting policies**

These 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%
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 CICA Handbook to assess whether the carrying value of goodwill is impaired.

***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 assets related to the brand name and trademark, supplier agreement and databases of sales and purchasing history have indefinite lives and are 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 the 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.

***Future income taxes***

The Fund complies with the Income Tax Act (Canada) to qualify as a mutual fund trust. A mutual fund trust is subject to tax in each taxation year on the amount of its income for the year, including the net realized taxable capital gains, less the portion thereof that it claims in respect of the amounts paid or payable to the unitholders for the year. The Fund intends to allocate all of its income and net realized capital gains, including those amounts derived from XS Cargo LP, so that the Fund will not generally be liable for income tax and as such, corporate income taxes have not been provided for in the Fund.

***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.

***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 15, 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 may 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 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.

**XS Cargo Income Fund**  
**Notes to the Consolidated Financial Statements**  
*December 31, 2006 and 2005*

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**3. Issuance of Units and business acquisition**

On May 17, 2005, the Fund completed the IPO for aggregate proceeds of \$61,060,000. The cost of the issuance of Units was \$4,928,124 resulting in net proceeds of \$56,131,876. The Fund used the net proceeds from the IPO to acquire an indirect 51% interest in XS Cargo LP, represented by 6,106,000 Ordinary LP Units. XS Cargo LP combined these funds with proceeds from credit facilities (note 6) to acquire 100% of the net business assets of the Vendor.

The acquisition of the Fund's interest in the Acquired Business has been accounted for using the purchase method and has been allocated to the assets acquired and liabilities assumed, as follows:

Property and equipment	\$
Goodwill	2,373,558
Intangible assets	101,788,426
	<hr/> 8,655,000
	112,816,984
Net working capital	<hr/> 16,979,392
	<hr/> 129,796,376
Consideration, being cash from IPO and new credit facilities	71,131,876
XS Cargo LP Exchangeable LP Units	34,719,700
XS Cargo LP Subordinated LP Units	23,944,800
Total Consideration	<hr/> 129,796,376

Included in net working capital is cash acquired of \$64,095.

**XS Cargo Income Fund**  
**Notes to the Consolidated Financial Statements**  
*December 31, 2006 and 2005*

**4. Property and equipment**

	<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

	<i>December 31, 2005</i>		
	<i>Cost</i>	<i>Accumulated Amortization</i>	<i>Net book Value</i>
	\$	\$	\$
Leasehold improvements	426,757	42,264	384,493
Office, computer and mobile equipment	2,463,416	275,296	2,188,120
Signs	177,758	19,588	158,170
	3,067,931	337,148	2,730,783



**6. Credit facilities**

**Term loan**

Term loan consists of a committed non-revolving term loan facility. The maximum available on the term loan facility is \$17,500,000, of which \$17,500,000 was outstanding at December 31, 2006 (2005 - \$15,000,000). 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 0.75% or the bankers' acceptance rate plus 1.75% to 2.25%, depending on the Fund's senior debt to earnings before interest, taxes, depreciation and amortization ("EBITDA") ratio. The credit facility includes limits on incurring additional indebtedness or granting encumbrances without the consent of the lender and is subject to the maintenance of senior debt to EBITDA, current assets to current liabilities and fixed charge coverage ratios and minimum equity.

The term loan was drawn in the form of prime rate loans on May 17, 2005 concurrent with the acquisition described in note 3. During the year interest was charged at a rate of prime plus 0.25% and totaled \$1,042,066 (2005 - \$483,233). As at December 31, 2006, prime rate was 6.0% (2005 - 5.0%). The principal balance of the term loan is due on May 17, 2007 and may be extended for an additional year to May 17, 2008 based on approval by the lender. Subsequent to the balance sheet date, the term loan was extended and principal balance is due on May 16, 2008. The credit available on the term loan was also increased to \$25,000,000; with the principal required to be reduced to \$15,000,000 by September 30, 2007, resulting in \$2,500,000 classified as a current liability at December 31, 2006.

**Operating loan**

The Fund has available under its credit facilities a \$12,500,000 (\$10,000,000 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 0.50% depending on the Fund's ratio of senior debt to EBITDA. During the year, the Fund paid interest of \$291,060 (2005 - \$21,689) on amounts drawn on the operating loan at a rate of prime. As at December 31, 2006 prime rate was 6.0%, and there was no amount outstanding on the operating loan at the end of the December 31, 2006 or December 31, 2005. Subsequent to the balance sheet date, the demand revolving loan limit was increased to \$20,000,000 (\$12,500,000 available from January to July).

**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 1.5:1.0, a minimum current ratio of 1.5:1.0 and a minimum fixed charge coverage ratio of 1.0:1.0. 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.

In March 2007, the Fund entered into amending agreements for the Loans that amended or waived certain financial covenants as of December 31, 2006, with which the Fund otherwise would not have complied. After obtaining waivers on two covenants the Fund was in compliance with all Loan agreements as of December 31, 2006. The new covenants include a maximum senior debt to EBITDA ratio of 2.5:1.0, a minimum current ratio of 1.5:1.0 and a minimum fixed charge coverage ratio of 0.85:1.0.

**XS Cargo Income Fund**  
**Notes to the Consolidated Financial Statements**  
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**7. Deferred revenue and deferred charges**

The following tables detail the deferred revenue and charges associated with the product replacement extended warranty plans:

	<i>December 31, 2006</i>	<i>December 31, 2005</i>
<b>Deferred revenue</b>	<b>\$</b>	<b>\$</b>
Deferred revenue, beginning of period	769,905	-
PRP sales	2,350,321	827,067
Amounts recognized as revenue	(984,386)	(57,162)
<hr/>		
Deferred revenue, end of period	2,135,840	769,905
<hr/>		
Less: current portion of deferred revenue	1,528,327	417,152
<hr/>		
	607,513	352,753
<hr/>		
<b>Deferred charges</b>		
Deferred charges, beginning of period	124,414	-
Direct incremental selling costs	352,280	134,230
Costs recognized	(144,895)	(9,816)
<hr/>		
Deferred charges, end of period	331,799	124,414

**8. Unamortized lease inducements**

	<i>December 31, 2006</i>	<i>December 31, 2005</i>
	<b>\$</b>	<b>\$</b>
Cost	506,625	272,151
Accumulated amortization	(188,650)	(130,035)
<hr/>		
	317,975	142,116

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 operations on the statement of cash flows.

**XS Cargo Income Fund**  
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**9. 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

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. There were no changes in the number or amount of Fund Units issued during the year.

**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. The policy allows the Fund to make stable monthly distributions to its unitholders based on its estimate of distributable cash for the year. Distributions totaling \$1.21875 per Fund Unit (\$7,441,688) were declared by the Fund during the year (2005 - \$4,281,528). 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. The distribution declared for the month of December 2005 in the amount of \$0.09375 per Fund unit (\$572,438) was included in distributions payable to unitholders at December 31, 2005 and was paid on January 15, 2006. On March 19, 2007, the Fund announced a decrease in the monthly distribution rate back to the level at the time of the IPO of \$0.09375 per unit (\$1.125 on an annualized basis).

**XS Cargo Income Fund**  
**Notes to the Consolidated Financial Statements**  
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**10. Non-controlling interest**

	<i>XS Cargo LP Exchangeable LP Units #</i>	<i>XS Cargo LP Subordinated LP Units #</i>	<i>Total #</i>
Balance – May 17, 2005	3,471,940	2,394,480	5,866,450
Unit based compensation award (Note 13)	6,944	4,789	11,733
Balance – December 31, 2005	3,478,914	2,399,269	5,878,183
Unit based compensation award (Note 13)	6,944	4,789	11,733
Balance – December 31, 2006	3,485,858	2,404,058	5,889,916
	\$	\$	\$
Balance – May 17, 2005	34,719,700	23,944,800	58,664,500
Unit based compensation award (Note 13)	69,440	47,890	117,330
Non-controlling interest – earnings	2,839,317	1,958,164	4,797,481
Distributions declared	(2,439,414)	(1,682,368)	(4,121,782)
Accrued contingent unit based compensation award (Note 13)			70,000
Balance – December 31, 2005	35,189,043	24,268,486	59,527,529
Unit based compensation award (Note 13)	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)
	33,967,936	23,426,336	57,464,272
Net accrued contingent unit based compensation award (Note 13)			29,670
			57,493,942

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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 9), 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 9), 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 9) 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, 2006, the criteria were not met for the automatic exchange to occur.

**Fund Special Voting Units**

	Number #	Amount \$
Issued and outstanding – May 17, 2005	5,866,450	-
Issued during the period ended December 31, 2005	11,733	-
<hr/>		
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	-

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. The policy allows the Fund to make stable monthly distributions to holders of Exchangeable LP Units and quarterly distributions to holders of Subordinated LP Units based on its estimate of distributable cash for the year. 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 during year. 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. For 2005, distributions declared on Exchangeable LP Units for the month of December in the amount of \$0.09375 per unit (\$326,148) and distributions on Subordinated LP Units for the three months ended December 31, 2005 in the amount of \$0.28125 per unit (\$674,795) were included in distributions payable to non-controlling interest at the balance sheet date were paid on January 15, 2006. On March 19, 2007, the Fund announced a decrease in the monthly distribution rate on Exchangeable LP Units back to the level at the time of the IPO of \$0.09375 per unit (\$1.125 on an annualized basis). Distributions on Subordinated LP Units have been suspended.

**11. 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,	
2007	4,399,644
2008	4,258,081
2009	3,831,128
2010	2,794,582
2011	2,016,472
Thereafter	5,954,491
<u>Total</u>	<u>23,254,398</u>

The Fund has capital expenditures commitments of approximately \$700,000 related to two new stores, approximately \$280,000 of which will be incurred in the first quarter of 2007 and approximately \$420,000 of which will be incurred in the second quarter of 2007.

**12. 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.

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, 2006, the distributable cash per unit of the Fund exceeded the threshold amount. As a result, the Fund will transfer \$22,898 to the LTIP trust in 2007. No compensation expense was recorded under the Plan in the year ended December 31, 2006 (2005 - \$Nil).

**13. 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 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, 2006. The unit-based award was recorded as administration and operating costs in the amount of \$147,000 (2005 - \$117,330), the estimated fair value of the units on the grant date, resulting in an increase in non-controlling interest. Under the employment agreement, the Fund may issue a maximum of 6,944 of XS Cargo Exchangeable LP Units and 4,789 Subordinated LP Units per year based on performance until 2009. If awarded, the units are issued on the anniversary date of the IPO, May 17, 2005. The Fund accrues a contingent award throughout the year, based on the estimated fair value of the units at the grant date. The Fund has accrued a contingent award of \$99,670 (2005 - \$70,000), which if granted, will be issued in May 2007.

**14. Financial instruments**

**Foreign currency risk**

The Fund purchases a significant amount of its inventory from suppliers in the United States. 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 wires funds in advance upon placing orders with United States suppliers.

**Interest rate risk**

The Fund's credit facilities, as described in note 6 bear interest with floating rates over prime or the appropriate bankers' acceptance rate, thus exposing the Fund to interest rate fluctuations.

**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 and term loan. The carrying amount of financial instruments that are included in working capital 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.

**15. 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 19% 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 \$13,652,000 (2005 - \$5,597,000) of inventory from Samra. Included in deposits on inventory, is a balance of \$520,614 (2005 - \$Nil), outstanding from Samra related to those purchases. In addition, included in accounts payable and accrued liabilities is a balance of \$Nil (2005 - \$378,292) owing to Samra related to those purchases. Samra issued the Fund a volume rebate for purchases made from the year in the amount of \$1,060,540 (2005 - \$671,731), of which \$435,914 is included in rebate and other receivables (2005 - \$501,486)

**XS Cargo Income Fund**  
**Notes to the Consolidated Financial Statements**  
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**16. Basic and diluted earnings per unit**

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

	<b>Basic Earnings per Unit</b>	<b>Dilution Adjustments</b>		<b>Diluted 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
	<b>Basic Earnings per Unit</b>	<b>Dilution Adjustments</b>		<b>Diluted Earnings per Unit</b>
<b>December 31, 2005</b>				
Net earnings	\$4,983,399	\$4,797,481	(a)	\$9,780,880
Average Units outstanding	6,106,000	5,878,183	(b)	11,984,183
Earnings per Unit	0.816			0.816

(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

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**17. Future income taxes**

The Fund does not record income taxes relating to the temporary differences nor income earned by the Fund. Unitholders and partners of XS Cargo LP will be responsible for these income taxes. The differences between the tax bases and the reported amounts of the Fund's assets and liabilities, for which future income taxes are not recorded, are as follows:

	<i>December 31, 2006</i>	<i>December 31, 2005</i>
	\$	\$
Goodwill	42,635,365	42,241,274
Intangible assets	3,852,006	5,010,497
Property and equipment	(922,678)	(23,799)
Issue costs	(2,919,359)	(3,814,792)
Deferred revenue	(2,135,840)	(769,905)
Other	13,824	(17,702)
	40,523,318	42,625,573

Of the difference relating to goodwill, \$40,387,625 (2005 - \$40,387,625) is not deductible for tax purposes.

**18. Seasonal nature of the business**

The Fund's results for the period are not necessarily indicative of the results that may be expected for the full year due to seasonal variations in sales levels. The business historically experiences a higher level of sales in the fourth quarter and a lower level of sales in the first quarter due to seasonal shopping patterns. Occupancy-related expenses, certain administrative and operating expenses, amortization, and interest expense remain relatively steady throughout the year.

**19. 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.

**20. Subsequent events**

Subsequent to December 31, 2006, XS Cargo entered into lease agreements to open new stores in Moncton, New Brunswick; Kamloops, British Columbia; Belleville, Ontario; Peterborough, Ontario and Sarnia, Ontario.