XS Cargo Income Fund

Consolidated Financial Statements

December 31, 2008 and 2007

PRICEWATERHOUSECOOPERS

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March 25, 2009

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, 2008 and 2007 and the consolidated statements of operations and comprehensive (loss), (deficit) and cash flows for the years 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, 2008 and 2007 and the results of its operations and its cash flows for the years 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)

	2008	2007
	$	$
Assets		
Current		
Cash and cash equivalents	-	1,709,959
Rebate and other receivables	-	425,755
Inventory	17,677,390	21,144,060
Deposits on inventory	1,242,935	2,235,619
Prepaid expenses and deposits	770,988	399,188
	19,691,313	**25,914,581**
Deferred charges *(Note 8)*	**127,689**	**267,076**
Prepaid expenses and deposits	**439,362**	**375,216**
Property and equipment *(Note 4)*	**5,455,231**	**7,000,853**
Intangible assets *(Note 5)*	**1,534,876**	**2,076,500**
Goodwill *(Note 6)*	**-**	**36,226,599**
	27,248,471	**71,860,825**
Liabilities		
Current		
Bank indebtedness *(Note 7)*	2,776,346	-
Accounts payable and accrued liabilities	6,459,328	13,525,271
Deferred revenue *(Note 8)*	1,657,184	1,848,965
Term loan *(Note 7)*	6,665,444	11,250,000
Subordinated loan (*Note 7)*	13,199,409	12,162,695
	30,757,711	**38,786,931**
Deferred revenue *(Note 8)*	**604,423**	**538,676**
Unamortized lease inducements *(Note 9)*	**710,826**	**848,527**
	32,072,960	**40,174,134**
Non-controlling interest *(Note 11)*	**891,083**	**18,901,771**
	32,964,043	**59,075,905**
Commitments (Note 12)		
Unitholders' Equity		
Fund units *(Note 10)*	**56,110,332**	**56,116,612**
Warrants *(Note 10)*	**109,086**	**-**
Contributed surplus *(Note 13)*	**28,235**	**6,360**
Deficit	**(61,963,225)**	**(43,338,052)**
	(5,715,572)	**12,784,920**
	27,248,471	**71,860,825**

Approved on behalf of the Trustees:

(signed) *"David Margolus"*	(signed) *"Gordon Clanachan"*
David Margolus Trustee	Gordon Clanachan Trustee

The accompanying notes are an integral part of these financial statements

XS Cargo Income Fund
Consolidated Statements of Operations and Comprehensive (Loss)
For the years ended December 31, 2008 and December 31, 2007

	Year ended December 31, 2008	*Year ended December 31, 2007*
	$	$
Sales	**110,085,560**	**125,080,159**
Cost of goods sold	**69,442,097**	**86,128,554**
Gross margin	**40,643,463**	**38,951,605**
Expenses		
Administrative and operating	**34,664,557**	**37,986,282**
Amortization of property and equipment	**1,974,854**	**1,408,620**
Amortization of intangible assets	**541,624**	**1,256,500**
	37,181,035	**40,651,402**
	3,462,428	**(1,699,797)**
Other expenses		
Interest on operating loan	**544,779**	**583,086**
Interest on term and subordinated loans	**3,447,185**	**2,071,349**
Foreign exchange (gain)loss	**(120,274)**	**215,470**
Impairment of intangible assets *(Note 5)*	**-**	**3,385,000**
Impairment of goodwill *(Note 6)*	**36,226,599**	**65,561,827**
	40,098,289	**71,816,732**
(Loss) before non-controlling interest	**(36,635,861)**	**(73,516,529)**
Non-controlling interest *(Note 11)*	**(18,010,688)**	**(36,146,900)**
Net (loss) and comprehensive (loss) for the year	**(18,625,173)**	**(37,369,629)**
Basic (loss) per unit *(Note 16)*	**(3.05)**	**(6.12)**
Diluted (loss) per unit *(Note 16)*	**(3.05)**	**(6.13)**

The accompanying notes are an integral part of these financial statements

XS Cargo Income Fund
Consolidated Statements of (Deficit)
For the years ended December 31, 2008 and December 31, 2007

	Year ended December 31, 2008	*Year ended December 31, 2007*
	$	$
(Deficit), beginning of the year	(43,338,052)	(1,560,652)
Net (loss) for the year	(18,625,173)	(37,369,629)
Distributions declared in the year *(Note 10)*	-	(4,407,771)
(Deficit), end of the year	(61,963,225)	(43,338,052)

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, 2008 and December 31, 2007

Cash provided by (used for) the following activities	*Year ended December 31, 2008* $	*Year ended December 31, 2007* $
Operating Activities		
Net (loss) for the year	(18,625,173)	(37,369,629)
Items not affecting cash:		
Non-controlling interest	(18,010,688)	(36,146,900)
Impairment of goodwill	36,226,599	65,561,827
Impairment of intangible assets	-	3,385,000
Amortization of property and equipment	1,974,854	1,408,620
Amortization of intangible assets	541,624	1,256,500
Amortization of transaction costs on loans	397,748	131,834
Capitalized interest on loans	1,091,825	365,025
Unit based compensation	21,875	73,360
LTIP expense	-	13,993
Deferred charges, net of costs recognized	139,387	64,723
Deferred revenue, net of revenue recognized	(126,034)	206,696
Lease inducements received, net of amortization of lease inducements	(137,701)	530,552
Gain on sale of property plant and equipment	(27,500)	-
	3,466,816	(518,399)
Net change in non-cash working capital	(2,616,780)	8,554,358
	850,036	8,035,959
Financing Activities		
Proceeds from bank indebtedness	2,776,346	-
Treasury units acquired	(6,280)	-
Proceeds from subordinated loan	-	12,000,000
Capitalized transaction costs on loans	(428,329)	(334,164)
Proceeds from term loan	-	3,750,000
Repayment of term loan	(4,500,000)	(10,000,000)
Investment in LTIP trust	-	(22,897)
Distributions paid on Fund Units	-	(5,037,452)
Distributions paid to non-controlling interest	-	(3,621,866)
	(2,158,263)	(3,266,379)
Investing Activities		
Purchases of property and equipment	(438,466)	(4,077,445)
Proceeds from sale of property and equipment	36,734	-
	(401,732)	(4,077,445)
(Decrease) Increase in cash and cash equivalents	(1,709,959)	692,135
Cash and cash equivalents, beginning of year	1,709,959	1,017,824
Cash and cash equivalents, end of year	-	1,709,959
Supplementary cash flow information		
Interest paid	2,426,448	2,289,410

The accompanying notes are an integral part of these financial statements

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 (2007 – 40) 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, 2008, the Fund was not in compliance with its minimum adjusted twelve-month EBITDA covenant under the credit facilities described in note 7, giving the lenders the right to demand repayment. Subsequent to December 31, 2008, the Fund reached an agreement with its lenders and the lenders have provided a waiver covering the breach of the minimum adjusted twelve-month EBITDA covenant. The waiver has been received and is subject to signing by the lender and the Fund. For the year ended December 31, 2008, the Fund reported a net loss of $18,625,173 (2007 - $37,369,629) an accumulated deficit of $61,963,225 (2007 - $43,338,052) and a working capital deficiency of $11,066,348 (2007 - $12,872,350). In addition to its ongoing working capital requirements, the Fund will need to refinance its term and subordinated loans, which mature on April 30, 2009 and June 30, 2009 respectively. These circumstances lend significant doubt as to the ability of the Fund to continue as a going concern.

The Fund is working with its lenders to negotiate its credit renewals. Further, the Fund has implemented certain operational measures that management believes will return the Fund to profitability for fiscal 2009. 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. 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.

Loans and receivables

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.

Inventory

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

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.

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, database 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 property leases are amortized over the remaining terms of the leases. The intangible asset related to the database of the sales and purchasing history is amortized over its five year expected life. 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.

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 ClCA 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 expensed 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.

Other financial liabilities

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.

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.

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) Effective January 1, 2008, the Fund adopted the following CICA Handbook sections:

Section 1535: Capital Disclosures

This new standard established disclosure requirements concerning capital such as: qualitative information about the Fund's objectives, policies and processes for managing capital; quantitative data about what the Fund regards as capital; whether it has complied with any externally imposed capital requirements and, if not, the consequences of such non-compliance. The Fund has included the required disclosures as part of these consolidated financial statements.

Section 3031: Inventories

This new standard 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. This section did not have a significant impact on the Fund's consolidated financial statements.

Section 1400: General Standards of Financial Statement Presentation

This section was amended to include requirements for management to assess and disclose uncertainties related to the Fund's ability to continue as a going concern. These requirements are effective for years beginning on or after January 1, 2008, and have been incorporated into the Fund's consolidated financial statements in note 1.

(b) Future income taxes – Emerging Issues Committee Abstract EIC-171

On August 28, 2008, the CICA Emerging Issues Committee (the "Committee") issued guidance on the future income tax consequences of exchangeable interests in an income trust or specified investment flow-through as Abstract EIC-171. The Committee reached a consensus that future income taxes related to the temporary differences associated with the assets and liabilities attributable to the exchangeable interests should not be recorded prior to the conversion of the exchangeable interests. Retrospective application is required to any interim and annual financial statements issued after August 28, 2008, with restatement of prior periods.

The Fund evaluated the impact of this guidance on its financial statements, and concluded that for year ended December 31, 2007, the Fund had recorded those temporary differences associated with the Fund's exchangeable interests or non-controlling interest. As such, for the year ended December 31, 2007 the Fund has decreased future income tax assets and the related valuation allowance by $391,000. Thus, there was no effect on net loss or loss per unit for December 31, 2007.

(c) Future accounting changes

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, and does not anticipate any changes.

International Financial Reporting Standards

Also during 2008, the CICA Accounting Standards Board confirmed that International Financial Reporting Standards ("IFRS") will replace Canadian GAAP effective January 1, 2011 for Canadian publicly accountable entities. The Fund will be required to adopt IFRS for fiscal periods commencing January 1, 2011 and is currently assessing the potential impact of this change and developing a plan accordingly.

4. Property and equipment

	December 31, 2008		
	Cost	***Accumulated Amortization***	***Net book Value***
	$	**$**	**$**
Leasehold improvements	1,556,235	741,718	814,517
Office, computer and mobile equipment	5,193,071	2,909,797	2,283,274
Computer software	2,840,036	714,405	2,125,631
Signs	485,497	253,688	231,809
	10,074,839	4,619,608	5,455,231

	December 31, 2007		
	Cost	***Accumulated Amortization***	***Net book Value***
	$	**$**	**$**
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

5. Intangible assets

	December 31, 2008		
	Cost	*Accumulated Amortization*	*Net book Value*
Indefinite life	**$**	**$**	**$**
Brand name and trademark	690,000	-	690,000
Limited life			
Operating lease agreements	1,600,000	1,034,624	565,376
Database of sales and purchasing history	430,000	150,500	279,500
	2,030,000	1,185,124	844,876
	2,720,000	1,185,124	1,534,876

	December 31, 2007		
	Cost	*Accumulated Amortization*	*Net book Value*
Indefinite life	**$**	**$**	**$**
Brand name and trademark	690,000	-	690,000
Limited life			
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

During the year, the Fund recognized an impairment charge of $nil (2007 - $3,385,000) related to a 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 Non-competition agreements were fully amortized in 2008.

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 net losses, 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 $36,226,599 (2007 - $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:

	December 31, 2008	***December 31, 2007***
	$	**$**
Balance, beginning of the year	36,226,599	101,788,426
Impairment loss recognized	(36,226,599)	(65,561,827)
Balance, end of the year	-	36,226,599

The fair value of goodwill is determined using valuation techniques that take into account various factors including projected future cash flows, discount rates, and the market value of Fund units. While careful judgment has been used, the use of different estimates and assumptions in applying the impairment test could materially impact the result.

7. Credit facilities

Bank indebtedness

The Fund has available under its credit facilities a $20,000,000 ($12,500,000 available from January to July each year) demand revolving loan. Under the terms of the credit facility agreement, the operating loan is collateralized by a first charge on all present and after acquired personal property and an assignment of inventory. Interest on the operating loan will be charged at the lender's prime rate plus 2.50%. If funds are withdrawn in U.S. dollars, interest will be charged at the lender's U.S. base rate plus 2.50%. The Fund is also required to pay a standby charge of 0.50% based on the amount equal to the operating facility commitment amount less the aggregate principal amount under the operating facility. During the year, the Fund incurred interest of $544,779 (2007 - $583,086) on amounts drawn on the operating loan. As at December 31, 2008 prime rate was 3.5%, and $2,776,346 (2007 - $nil) was outstanding on the operating loan.

Term loan

On September 30, 2008, the Fund re-negotiated the credit facility agreement covering its term and operating loans. Under the amended credit facility agreement, the term loan has been extended to April 30, 2009 and 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. The term loan was permanently reduced by $4,500,000 on December 31, 2008 and was to be further permanently reduced on March 31, 2009 by an amount equal to 75% of 2008 excess cash flow as defined in the agreement. Management has determined that the Fund did not generate 2008 excess cash flow, as defined, such that no payment will be required.

The term loan is collateralized by a first charge on all present and after acquired personal property and an assignment of inventory. Under the amended agreement interest on the term loan facility is charged at the lender's Canadian prime rate plus 2.50%. Under the previous agreement, interest on the term facility was 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 expense recorded for the term loan totaled $985,896 (2007 - $1,211,352). As at December 31, 2008, prime rate was 3.5% (2007 – 6.0%).

The following table details the balance of the term loan:

	December 31, 2008	***December 31, 2007***
	$	**$**
Initial principal amount	11,250,000	11,250,000
Unamortized transaction costs	(84,556)	-
Repayment of term loan	(4,500,000)	-
	6,665,444	11,250,000

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 was initially due on August 20, 2008. On November 5, 2008, the Fund reached an agreement with its subordinated lenders to extend the maturity date of the subordinated loan agreements to June 30, 2009. Interest on the subordinated loan has increased from 16% to 18% effective September 26, 2008, with the Fund's option to capitalize up to 10.0% per annum (previously 8.0%). As part of the extension, the Fund also issued 1,000,000 fund unit purchase warrants, exercisable at $0.60 at any time within 36 months of issuance, with a cashless exercise feature at the option of subordinated lenders (note 10).

The cashless exercise feature allows the subordinated lenders the option of exercising the warrants to acquire units of the Fund without a cash payment, by netting out the difference between the trading price of units at the date of exercise of the warrant, and the warrant exercise price of $0.60 per unit and then issuing the proportionately reduced number of fully paid units to the warrant holder.

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.

During the year, interest expense totaling $2,461,289 (2007 - $859,997) was recorded, including $1,091,825 (2007 - $365,025) which was capitalized as part of the outstanding principal balance.

The following table details the balance of the subordinated loan:

	December 31, 2008	***December 31, 2007***
	$	**$**
Initial principal amount	12,000,000	12,000,000
Unamortized transaction costs	(175,627)	(202,330)
Unamortized issue of warrants	(81,814)	-
Interest capitalized	1,456,850	365,025
	13,199,409	12,162,695

Financial covenants

The bank indebtedness, term loan, and subordinated loan require the Fund to maintain certain financial covenants, including a maximum senior debt to adjusted EBITDA ratio of 3.5:1.0 until December 31, 2008, at which time the ratio reduces to 2.5:1.0; a minimum current ratio of 1.4:1.0, and a minimum adjusted trailing twelve months EBITDA value of $8,000,000 as at October 31, 2008 and thereafter. Additionally, the covenants limit the Fund's ability to undertake mergers, acquisitions, new indebtedness, declare distributions and other changes in the business without approval of the lenders.

The subordinated loan agreement also requires the Fund to maintain a total funded debt to adjusted EBITDA ratio of less than 5.0:1.0 until December 31, 2008, at which point the ratio reduces to 3.5:1.0.

As at December 31, 2008, the Fund was not in compliance with its minimum adjusted twelve-month EBITDA covenant. Subsequent to December 31, 2008, the Fund reached an agreement with its lenders and the lenders have provided a waiver covering the breach of the minimum adjusted twelve-month EBITDA covenant. The waiver has been received and is subject to signing by the lender and the Fund.

The Fund is working with its lenders to negotiate its credit renewals.

8. Deferred revenue and deferred charges

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

	December 31, 2008	*December 31, 2007*
Deferred revenue	**$**	**$**
Deferred PRP revenue, beginning of year	2,235,149	2,135,840
PRP sales	1,849,045	2,158,793
Amounts recognized as revenue	(2,107,881)	(2,059,484)
Deferred PRP revenue, end of year	1,976,313	2,235,149
Advertising deferred revenue	154,167	-
Gift card deferred revenue	131,127	152,492
Deferred revenue, end of year	2,261,607	2,387,641
Less: current portion of deferred revenue	1,657,184	1,848,965
	604,423	538,676
Deferred charges		
Deferred charges, beginning of year	267,076	331,799
Direct incremental selling costs	100,514	250,735
Costs recognized	(239,901)	(315,458)
Deferred charges, end of year	127,689	267,076

In February 2008, an advertising vendor paid the Fund $200,000 as an incentive for signing a four year contract. The benefit is recognized on a straight-line base over the four year period.

9. Unamortized lease inducements

	December 31, 2008	*December 31, 2007*
	$	**$**
Cost	1,142,205	1,142,205
Accumulated amortization	(431,379)	(293,678)
	710,826	848,527

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 $
Balance, December 31, 2006	6,106,000	4,928,124	56,131,876
Treasury Units acquired	(3,000)	-	(15,264)
Balance, December 31, 2007	6,103,000	-	56,116,612
Treasury Units acquired	(52,000)	-	(6,280)
Balance, December 31, 2008	6,051,000	-	56,110,332

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.

Treasury Units represent unvested units held for unit-based compensation.

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 on Fund Units were suspended effective December 2007. Distributions totaling $0.7222 per Fund Unit ($4,407,771) were declared by the Fund during the year ended December 31, 2007. No distributions were declared by the Fund during the year ended December 31, 2008.

Warrants

On November 5, 2008, pursuant to the extension of the subordinated loan agreements as described in note 7, the Fund issued 1,000,000 warrants to purchase fund units at $0.60 per unit. The warrants have a term of 36 months and are exercisable at any time. The proceeds from the extension were allocated to the subordinated loan and warrants based on the relative fair values. The fair value attributed to the warrants using the Black-Scholes option pricing model was $109,086. The assumptions used in the Black-Scholes calculation were:

Annualized volatility	100.0%
Risk-free interest rate	2.5%
Expected life	3 years
Exercise price	$0.600
Unit price	$0.247

No warrants were converted into fund units during the year.

11. Non-controlling interest

	XS Cargo LP Exchangeable LP Units	*XS Cargo LP Subordinated LP Units*	*Total*
	#	*#*	*#*
Balance – December 31, 2008 and December 31, 2007	3,492,802	2,408,847	5,901,649
	$	*$*	*$*
Balance – December 31, 2006	33,967,936	23,426,336	57,493,942
Unit based compensation award	102,405	70,625	173,030
Net accrued contingent unit based compensation award accrued as at December 31, 2007			(99,670)
Non-controlling interest – 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
Non-controlling interest – loss	(10,659,354)	(7,351,334)	(18,010,688)
Balance – December 31, 2008	(500,642)	1,391,725	891,083

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, 2008, the criteria were not met for the automatic exchange to occur.

Fund Special Voting Units

	Number	Amount
	#	$
Issued and outstanding – December 31, 2008 and 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 on all Exchangeable LP Units were suspended effective December 2007 and distributions on Subordinated LP Units were suspended in March 2007. Distributions totaling $0.42677 per Exchangeable LP Unit ($2,518,631) and $nil per Subordinated LP Unit ($nil) were declared by the Fund during the year ended December 31, 2007. No distributions were declared by the Fund during the year ended December 31, 2008.

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,	
2009	$5,031,180
2010	4,074,829
2011	3,316,889
2012	2,598,435
2013	2,156,050
Thereafter	3,824,523
Total	$21,001,906

13. Unit-based compensation

Under the terms of employment agreements, the Fund purchased 52,000 units to be issued to certain employees. Issuance of the units is conditional upon one year of service to June 16, 2009. During fiscal 2008, the Fund has accrued $21,875 of compensation cost to administrative expenses and contributed surplus based on the estimated fair value of the units at the grant date.

The Fund has also established an option plan for management and its directors which is subject to approval of its unitholders at its annual general meeting in June 2009. Subsequent to December 31, 2008, the Fund has awarded 300,000 options, subject to the plan being approved, that will vest over 3 years to January 2012.

14. 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 deposits on inventory to the extent of credits on account with suppliers. Deposits on inventory relate to specific inventory purchases with vendors requiring a deposit or advance payment prior to shipment of goods. The Fund has recorded a provision of $6,439 (2007 - $1,245,000) for certain of these receivables it has determined to be doubtful as at December 31, 2008.

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 foreign suppliers. As at December 31, 2008, the portion of accounts payable and accrued liabilities denominated in United States Dollars is $65,354 USD (2007 - $582,774 USD). As at December 31, 2008, the Fund had $8,278 USD in bank indebtedness (2007 – $174,489 USD in cash and cash equivalents). Although the Fund is not materially exposed to foreign currency risk on the basis of the December 31, 2008 USD accounts, these balances will fluctuate significantly over the course of the year in relation to inventory purchasing activity.

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 bank indebtedness and term 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 cash flow risk. A 1.0% increase in interest rates would have an impact of $95,263 annually on interest expense and cash flow based on $9,526,346 of debt outstanding at December 31, 2008.

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 7). 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, purchases, and expenses. The Fund's intention is to work with the lenders to renew their obligations and extend the maturity of the loans on mutually acceptable terms.

Fair value

The Fund's financial instruments consist of cash and cash equivalents, rebate and other receivables, accounts payable and accrued liabilities, distributions payable, bank indebtedness, term loan, and subordinated 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 bank indebtedness and term loan approximates fair value since the interest rate fluctuates and approximates rates currently available to the Fund.

15. Capital management

The Fund's capital management objectives are to ensure the longevity of its capital so as to support continued operations and unitholder returns, and maintain the most optimal capital structure possible with a view to keeping capital costs to a minimum.

In the management of capital, the Fund includes unitholders' equity and non-controlling interest. The Fund manages its capital structure in accordance with changes in economic conditions. In order to maintain or adjust its capital structure, the Fund may elect to adjust the amount of distributions paid to unitholders, return capital to its unitholders and repurchase its units in the marketplace or issue new units. There were no changes to the Fund's approach to capital management during the period.

16. Basic and diluted (loss) per unit

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

	Basic (Loss) per Unit	Dilution Adjustments		Diluted (Loss) per Unit
December 31, 2008				
Net loss	$(18,625,173)	$(18,010,688)	(a)	$(36,635,861)
Average Units outstanding	6,103,000	5,901,649	(b)	12,004,649
Loss per Unit	(3.052)			(3.052)

	Basic (Loss) per Unit	Dilution Adjustments		Diluted (Loss) per Unit
December 31, 2007				
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)

(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

(c) 1,000,000 Unit purchase warrants issued on November 5, 2008 that remain outstanding could potentially dilute basic earnings per unit in the future but were not included as their impact would be anti-dilutive to the periods presented.

(d) 52,000 Treasury units acquired on December 31, 2008 were not included in the calculation of average units outstanding during the year.

17. 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:

	December 31, 2008	**December 31, 2007**
	$	**$**
		restated – see note 3
Future income tax assets		
Property and equipment	-	243,450
Intangible assets	160,900	112,400
Goodwill	3,859,300	-
Unamortized lease inducements	60,700	48,150
Future income tax assets before valuation allowance	4,080,900	404,000
Valuation allowance	(4,080,900)	(404,000)
Net future income tax assets	-	-

18. 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 $1,169,765 (2007 - $433,040) was recorded on the portion of the loan outstanding to the related party. The loan has been initially recorded at the exchange amount, which represents fair value.

A director of XS Cargo GP Inc. is also a partner of Fleming LLP, a law firm which provides legal services to the Fund. Legal fees totaling approximately $148,000 (2007 - $108,000) were charged to the Fund by Fleming LLP during 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. Comparative figures

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