

SECOND QUARTER REPORT  
FOR THE 13-WEEK PERIOD ENDED SEPTEMBER 26, 2009

“The road to  
knowledge  
begins with  
the turn of  
the page.”

– Anonymous

**!ndigo**

Books & Music Inc.

[www.indigo.ca](http://www.indigo.ca)

# Management's Discussion and Analysis

The following management's discussion and analysis is prepared as at October 26, 2009, and is based primarily on the unaudited interim consolidated financial statements of Indigo Books & Music Inc. (the "Company" or "Indigo") for the 13-week periods ended September 26, 2009 and September 27, 2008. It should be read in conjunction with the unaudited interim consolidated financial statements and notes contained in this Quarterly Report, the audited annual consolidated financial statements and accompanying notes for the year ended March 28, 2009, and Management's Discussion and Analysis ("MD&A") included in the Company's fiscal 2009 Annual Report. The Annual Report and additional information about the Company, including the Annual Information Form, can be found on SEDAR at [www.sedar.com](http://www.sedar.com).

## Overview

Indigo is the nation's largest book retailer, operating stores in all 10 provinces and one territory in Canada and offering online sales through its [www.chapters.indigo.ca](http://www.chapters.indigo.ca) website. As at September 26, 2009, the Company operated 95 superstores under the banners *Chapters*, *Indigo* and the *World's Biggest Bookstore*, 151 small format stores under the banners *Coles*, *Indigo*, *Indigospirit*, *SmithBooks* and *The Book Company* and two new concept stores under the banner *Pistachio*. During the second quarter of fiscal 2010, the Company opened four superstores and closed two small format stores. The Company also has a 50% interest in Calendar Club of Canada Limited Partnership ("Calendar Club"), which operates seasonal kiosks and year-round stores in shopping malls across Canada. In February 2009, Indigo launched *Shortcovers* ([www.shortcovers.com](http://www.shortcovers.com)), a new digital destination offering online and mobile service that provides instant access to books, articles and blogs.

Indigo operates a separate registered charity under the name Indigo Love of Reading Foundation (the "Foundation"). The Foundation provides new books and learning material to high-needs elementary schools across the country through donations from Indigo, its customers, suppliers and employees.

As at October 26, 2009, the number of common shares outstanding was 24,544,572 with a book value of \$196.6 million. As at September 26, 2009, there were 2,020,719 stock options outstanding of which 896,419 were exercisable. The number of common shares reserved for issuance under the employee stock option plan is 2,204,457.

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## Results of Operations

The following table summarizes the consolidated statement of operations for the periods indicated. The classification of financial information presented below is specific to Indigo and may not be comparable to that of other retailers.

(millions of dollars)	13-week period ended September 26, 2009		13-week period ended September 27, 2008		26-week period ended September 26, 2009		26-week period ended September 27, 2008	
	Revenues	%	Revenues	%	Revenues	%	Revenues	%
Revenues	207.0	100.0%	205.3	100.0%	400.5	100.0%	395.9	100.0%
Cost of sales	114.7	55.4%	115.5	56.3%	222.5	55.6%	222.9	56.3%
Cost of operations	63.2	30.5%	61.5	30.0%	126.2	31.5%	122.3	30.9%
Selling and administrative expenses	19.2	9.3%	16.7	8.1%	37.9	9.5%	33.9	8.6%
EBITDA <sup>1</sup>	9.9	4.8%	11.6	5.7%	13.9	3.5%	16.8	4.2%

<sup>1</sup> Earnings before interest, taxes, depreciation and amortization. Also see "Non-GAAP Financial Measures".

### Revenue Increase Driven by New Store Openings

Total consolidated revenues for the 13-week period ended September 26, 2009 increased \$1.7 million or 0.8% to \$207.0 million from \$205.3 million for the period ended September 27, 2008. The increase was attributable to the opening of four new superstores in the current quarter and was partially offset by the closure of two small format stores. Compared to the same period last year, the Company operated seven more superstores and eight fewer small format stores. Comparable store sales for the quarter decreased 0.9% in superstores and 2.1% in small format stores primarily due to the phenomenal success of the Twilight Series by Stephenie Meyer in the second quarter last year. Comparable store sales are defined as sales generated by stores that have been open for more than 12 months. It is a key performance indicator for the Company as this measure excludes sales fluctuations due to store closings, permanent relocation and chain expansion.

Online sales in the second quarter decreased by \$1.1 million or 5.2% to \$20.0 million for the 13-week period ended September 26, 2009 from \$21.1 million in the same period last year. The decrease in the online channel was directly attributable to the Company selectively choosing to exit certain unprofitable titles.

Revenues from other sources include revenues generated through corporate sales, revenues from the sale of loyalty cards, the Company's proportionate revenue generated through Calendar Club, gift card breakage, and revenues from Pistachio and Shortcovers. Revenues from other sources increased \$1.8 million

or 30.5% from \$5.9 million in the second quarter last year to \$7.7 million in the same period this year, driven by the continued growth in sales of the Company's loyalty card program, increase in gift card breakage amount and sales from the two Pistachio concept stores.

On a year-to-date basis, total consolidated revenues increased \$4.6 million or 1.2% from \$395.9 million last year to \$400.5 million this year. Year-to-date comparable store sales were up 0.2% for superstores and down 0.7% for small format stores.

Revenues by channel are highlighted below:

(millions of dollars)	13-week period ended September 26, 2009	13-week period ended September 27, 2008	% increase	Comparable store sales % increase
Superstores	145.6	142.2	2.4	(0.9)
Small format stores	33.7	36.1	(6.5)	(2.1)
Online (including store kiosks)	20.0	21.1	(5.2)	N/A
Other	7.7	5.9	30.5	N/A
	207.0	205.3	0.8	(1.2)

A reconciliation between total revenues and comparable store sales is provided below:

(millions of dollars)	Superstores		Small format stores	
	13-week period ended September 26, 2009	13-week period ended September 27, 2008	13-week period ended September 26, 2009	13-week period ended September 27, 2008
Total revenues	145.6	142.2	33.7	36.1
Adjustments for stores not in both fiscal periods	(7.1)	(2.4)	(0.8)	(2.5)
Comparable store sales	138.5	139.8	32.9	33.6

### Cost of Sales (as a Percent of Revenues) Improved Compared to Last Year

Cost of sales include the landed cost of goods sold, online shipping costs, inventory shrink and damage provision, less all vendor support programs. In absolute dollar terms, cost of sales decreased \$0.8 million to \$114.7 million. As a percent of total revenues, cost of sales decreased 0.9% to 55.4% in the second quarter, compared to 56.3% in the same period last year. Cost of sales were lower in the second quarter as the Company continues to benefit from the online shipping cost improvements implemented during the third quarter of last fiscal year. In

addition, the Company increased the percentage of products processed centrally at its distribution centre versus shipping the product directly to stores. The Company receives better margins from its vendors on product shipped to its distribution centre. On a year-to-date basis, cost of sales as a percent of total revenues decreased 0.7% from 56.3% last year to 55.6% this year, for the same reasons outlined above.

#### **Cost of Operations Increased over Same Period Last Year**

Cost of operations include all store, online, distribution centre, Calendar Club and Pistachio costs. Cost of operations increased \$1.7 million primarily due to an increase in occupancy, labour, transaction costs and Pistachio store expenses. Occupancy costs increased \$0.6 million primarily due to the operation of seven additional superstores compared to the second quarter last year. Labour costs increased \$0.5 million compared to the same period last year as a result of higher minimum wage rates in most provinces and the opening of new superstores as mentioned above. Transaction costs increased by \$0.2 million because of higher interchange rates charged by credit card companies. Pistachio store expenses increased \$0.2 million as there were no Pistachio stores open in the second quarter of last fiscal year. As a percent of total revenues, cost of operations increased by 0.5% in the second quarter as compared to the same period last year. On a year-to-date basis, costs of operations increased by 0.6% to 31.5% of total revenues this year from 30.9% last year.

#### **Selling and Administrative Expenses Increased due to Strategic Investments in Shortcovers**

Selling and administrative expenses include all marketing, head office costs and investments in strategic initiatives such as Shortcovers and Pistachio. In absolute dollar terms, selling and administrative expenses increased \$2.5 million compared to the same quarter last year. As a percent of total revenues, selling and administrative expenses increased 1.2% to 9.3% this quarter compared to 8.1% in the same period last year. The Company spent \$2.3 million on various strategic projects this quarter, a \$1.0 million increase from the same quarter last year. The Company also had a one-time gain due to a settlement with its payment processing provider last year which was not repeated in the current quarter. On a year-to-date basis, selling and administrative expenses increased \$4.0 million due to the same factors mentioned above. As a percent of total revenues, selling and administrative expenses increased from 8.6% last year to 9.5% this year.

#### **EBITDA Decreased to 4.8% of Revenues**

EBITDA, defined as earnings before interest, taxes, depreciation and amortization decreased \$1.7 million to \$9.9 million for the 13-week period ended September 26, 2009, compared to \$11.6 million for the 13-week period ended September 27, 2008. EBITDA as a percent of revenues decreased to 4.8% this quarter from 5.7% in the same quarter last year. The decline in EBITDA was the result of higher cost of operations and selling and administrative expenses, as explained above.

#### **Amortization Remained Flat from Last Year**

Amortization for the 13-week period ended September 26, 2009 remained unchanged at \$7.0 million compared to last year. Capital expenditures in the current quarter totaled \$17.1 million and included \$12.1 million on store construction, renovations and equipment, \$2.9 million on intangible assets (primarily application software and internal development costs) and \$2.1 million on technology equipment. Of the \$2.1 million expenditure in technology equipment, \$0.6 million was financed through capital leases. Year-to-date, the Company has spent \$23.6 million on capital expenditures including \$14.7 million on store construction, renovations and equipment, \$6.1 million on intangible assets and \$2.8 million on technology equipment. Of these capital expenditures, \$0.7 million was financed through capital leases.

#### **Interest Income Recorded in Second Quarter**

The Company recognized interest income of \$0.1 million in the second quarter of this year compared to \$0.3 million in the same period last year. The decline in market interest rates caused the Company to earn less interest income on its cash and cash equivalents in both the current quarter and on a year-to-date basis.

#### **Income Tax Expense Decreased from Last Year**

The Company recognized an income tax expense of \$0.7 million in the second quarter of this year. In the same period last year, the Company recognized an income tax expense of \$1.7 million. The decrease was a result of reduced earnings before tax in the current quarter compared to last year and the amortization of a deferred credit which reduced income tax expense. At the end of its last fiscal year, the Company acquired non-capital tax losses from a related company. The difference between the net cash consideration and the value of the future tax asset was recorded as a deferred credit, which is being recognized as a reduction in income tax expense as these non-capital losses are utilized.

## Net Income Recorded for the Current Fiscal Quarter

The Company recognized a net income of \$2.2 million for the second quarter or \$0.09 net earnings per common share, compared to a net income of \$3.2 million or \$0.13 net earnings per common share last year. Year-to-date, the Company recognized a net loss of \$0.1 million (\$0.00 net loss per common share), compared to net earnings of \$2.0 million last year (\$0.08 net earnings per common share). The decrease in net earnings was primarily due to the decrease in EBITDA, partially offset by the reduction in income tax expense.

## Seasonality and Second Quarter Results

Indigo's business is highly seasonal and follows quarterly sales and profit (loss) fluctuation patterns, which are similar to those of other retailers that are highly dependent on the December holiday sales season. A disproportionate amount of revenues and profits are earned in the third quarter. As a result, quarterly performance is not necessarily indicative of the Company's performance for the rest of the year. The following table sets out revenues, net earnings (loss), basic and diluted earnings (loss) per share for the preceding eight fiscal quarters.

	Fiscal quarters							
	Q2 Fiscal 2010	Q1 Fiscal 2010	Q4 Fiscal 2009	Q3 Fiscal 2009	Q2 Fiscal 2009	Q1 Fiscal 2009	Q4 Fiscal 2008	Q3 Fiscal 2008
(thousands of dollars, except per share data)								
Revenues	206,990	193,551	214,522	330,014	205,261	190,602	206,236	322,552
Net earnings (loss)	2,200	(2,304)	1,917	26,770	3,188	(1,225)	3,130	49,179
Basic earnings (loss) per share	\$ 0.09	\$ (0.09)	\$ 0.08	\$ 1.09	\$ 0.13	\$ (0.05)	\$ 0.13	\$ 1.98
Diluted earnings (loss) per share	\$ 0.09	\$ (0.09)	\$ 0.08	\$ 1.07	\$ 0.13	\$ (0.05)	\$ 0.12	\$ 1.94

## Overview of Consolidated Balance Sheets

### Total Assets

As at September 26, 2009, total assets were \$51.0 million greater than total assets at September 27, 2008. The increase in assets was primarily due to an increase in the Company's cash and cash equivalents, property, plant and equipment and inventory position. Cash and cash equivalents increased \$9.0 million primarily due to improved earnings compared to last year. Property, plant and equipment increased \$20.5 million compared to the second quarter last year due to expenditures for store construction, renovations, equipment and technology-related projects. The Company's inventory position increased \$19.0 million mainly due to the opening of new superstores and the expansion of the gift, paper and toy businesses.

On a fiscal year-to-date basis, total assets increased \$9.5 million compared to March 28, 2009. The increase in total assets was primarily due to the increased investment in inventories and property, plant and equipment. The Company's inventory position increased by \$12.4 million while property, plant and equipment increased by \$7.5 million compared to March 28, 2009. This increase was offset with a \$13.1 million reduction in cash and cash equivalents. The reduction in cash and cash equivalents and the increase in inventories are consistent with the seasonal nature of the business.

### Total Liabilities

As at September 26, 2009, total liabilities were \$28.3 million higher than total liabilities at September 27, 2008. The increase in liabilities was primarily due to a \$1.0 million increase in deferred revenue and a \$28.5 million increase in accounts payable and accrued liabilities that is consistent with the increase in the Company's inventory position, as noted above. This was partially offset with a \$0.7 million decrease in long-term debt.

On a year-to-date basis, total liabilities increased \$13.7 million compared to March 28, 2009. The increase in total liabilities was mainly due to a \$0.9 million increase in deferred revenue and an increase in accounts payable and accrued liabilities of \$13.9 million and partially offset by a \$0.8 million reduction in long-term debt.

### Shareholders' Equity

Shareholders' equity at September 26, 2009 increased \$22.7 million compared to September 27, 2008. The increase in shareholders' equity was primarily due to net earnings of \$28.6 million in the last four quarters. It was partially offset by: (i) a \$1.2 million decrease in share capital due to the repurchase of common shares under the normal course issuer bid; and (ii) a \$5.9 million decrease in retained earnings due to \$4.9 million of dividends payment and cash consideration exceeding the carrying value of the share repurchased in fiscal 2009. Contributed surplus increased \$1.3 million due to the expensing of employee stock options and directors' deferred stock units. Year-to-date, \$0.5 million was recorded for stock option expense and \$0.2 million was recorded for Directors' deferred stock units in contributed surplus.

### Working Capital and Leverage

The Company's working capital position usually declines from the end of its fiscal year until the third fiscal quarter due to the seasonal nature of the business. The Company relies on cash, a short term operating line of credit, and accounts

payable as three of the primary vehicles to fund the business before generating a disproportionate amount of cash during the December holiday season. The Company reported working capital of \$72.8 million as at September 26, 2009, compared to \$72.4 million as at September 27, 2008 and \$87.1 million at the end of fiscal 2009.

The Company's leverage position (defined as Total Liabilities to Total Shareholders' Equity) remained stable at 1.2:1 at the end of the current quarter compared to last year. The Company's leverage position increased slightly from 1.1:1 as at March 28, 2009 due to the increase in total liabilities and the decrease in shareholders' equity, as mentioned above.

### Overview of Consolidated Statements of Cash Flows

Cash and cash equivalents increased \$9.5 million during the second quarter of fiscal 2010 compared to an increase of \$13.0 million last year. Year-to-date, cash and cash equivalents decreased \$13.1 million compared to an increase of \$14.1 million for the same period last year.

### Cash Flows from Operating Activities

Cash flows generated from operating activities were \$31.6 million in the second quarter. This was an improvement of \$5.6 million over the same period a year ago, when cash flow generated from operating activities was \$26.0 million. Cash flows for the current quarter were primarily generated from reduction in accounts payable and accrued liabilities of \$49.6 million, non-cash items of \$10.6 million, partially offset by a \$26.0 million investments in inventories. On a year-to-date basis, cash flows generated from operating activities were \$16.0 million compared to \$35.6 million last year.

### Cash Flows Used in Investing Activities

In the second quarter, net cash flows used in investing activities were \$16.5 million compared to \$11.0 million used in the same quarter last year. The Company spent \$16.5 million of cash on capital projects in the current quarter, including \$12.1 million in store construction, renovations and equipment, \$2.9 million on intangible assets (primarily application software and internal development costs) and \$1.5 million in technology-related projects. During the second quarter last year, the Company spent \$11.0 million on capital projects including \$4.5 million for store construction, renovations and equipment, \$3.1 million on intangible assets and \$3.4 million for technology-related projects.

On a year-to-date basis, net cash flows used in investing activities were \$22.9 million compared to \$16.9 million last year. Capital expenditures this year included \$14.7 million in store construction, renovations and equipment, \$6.1 million on intangible assets and \$2.1 million in technology-related products. Capital expenditures in the same period last year included \$8.0 million in store construction, renovations and equipment, \$4.9 million on intangible assets and \$4.0 million in technology-related projects.

### Cash Flows Used in Financing Activities

Net cash flows used in financing activities were \$5.6 million during the second quarter compared to \$2.0 million in the same period last year. The increase in cash flows used in financing activities was primarily due to \$4.9 million of dividend payments made this quarter. The Company did not pay any dividends in the previous fiscal year. This increase was partially offset as the Company did not repurchase any common shares under the normal course issuer bid in the current quarter compared to \$1.5 million in the same period last year.

On a year-to-date basis, net cash flows used in financing activities were \$6.3 million, compared to \$4.6 million of cash used last year. The change in cash flow between the two years was primarily due to the dividend payments this year and the share repurchase last year, as explained above.

### Liquidity and Capital Resources

The Company has a highly seasonal business which generates the majority of its revenues and cash flows during the December holiday season. Indigo has minimal accounts receivable, as its customers pay largely by cash or credit card, and it purchases products on trade terms with the right to return a significant portion of its products. Indigo's main sources of capital are cash flow generated from operations, a revolving line of credit and long-term debt. Indigo invests its cash in highly liquid assets. The Company does not invest in asset-backed commercial paper. In the third quarter of last fiscal year, the Company extended the revolving line of credit for an additional year and reduced the borrowing capacity from \$60.0 million to \$30.0 million based on lower borrowing needs. As at September 26, 2009, no funds were drawn against this facility. On October 15, 2009, the revolving line of credit expired and was not renewed by the Company.

Based on the Company's liquidity position and cash flow forecast, the Board of Directors approved the payment of a quarterly cash dividend of \$0.10 per common share or \$0.40 per common share annually, starting in the first quarter

of the current fiscal year. Based on current operating levels, management expects cash flow generated from operations to be sufficient to meet its working capital needs, debt service requirements and dividend payments for the current fiscal year. In addition, Indigo has the ability to reduce capital spending to fund debt requirements if necessary; however a long-term decline in capital expenditures may negatively impact revenues and profit growth. Future declaration of quarterly dividends and the establishment of future record and payment dates are subject to the final determination of the Company's Board of Directors. Dividends may be reduced or eliminated if required to maintain appropriate capital resources.

There can be no assurance that operating levels will not deteriorate over the ensuing fiscal year, which could result in the Company being unable to meet its current working capital and debt service requirements. In addition, other factors not presently known to management could materially and adversely affect Indigo's future cash flows. In such events, the Company would be required to obtain additional capital as is necessary to satisfy its working capital and debt service requirements from other sources. Alternative sources of capital could result in increased dilution to shareholders and may be on terms that are not favourable to the Company.

## Accounting Policies

### Critical Accounting Estimates

The discussion and analysis of Indigo's operations and financial condition are based upon the unaudited interim consolidated financial statements, which have been prepared in accordance with Canadian generally accepted accounting principles ("GAAP"). The preparation of these consolidated financial statements requires the Company to estimate the effect of several variables that are inherently uncertain. These estimates and assumptions can affect the reported amounts of assets, liabilities, revenues and expenses. Indigo bases its estimates on historical experience and other assumptions which the Company believes to be reasonable under the circumstances. The Company also evaluates its estimates on an ongoing basis. The significant accounting policies of the Company are described in Note 2 of the consolidated financial statements in the fiscal 2009 Annual Report, and the Company's critical accounting estimates are disclosed in the MD&A section of its fiscal 2009 Annual Report.

In the second quarter of fiscal 2010, there were no significant changes to the provisions for slow-moving and damaged products and for gift and paper products that have been marked down. There were also no material changes to the provision for restructuring costs, future tax assets and goodwill. Furthermore, the method of determining gift card breakage is consistent with that used in

previous periods.

### New Accounting Pronouncements

The following accounting standards will be adopted by the Company in the future.

#### Business Combinations

Section 1582 of the CICA Handbook, "Business Combinations", replaces the existing Section 1580, "Business Combinations." The CICA also issued Section 1601, "Consolidated Financial Statements" and Section 1602, "Non-Controlling Interests", which replaces Section 1600, "Consolidated Financial Statements." These new sections are based on the International Accounting Standards Board's ("IASB") International Financial Reporting Standard 3, "Business Combinations" and will replace the existing guidance on business combinations and consolidated financial statements. The objective of the new standards is to harmonize Canadian accounting for business combinations with the international and U.S. accounting standards. The three new standards have to be adopted concurrently and will apply to interim and annual consolidated financial statements relating to fiscal years beginning on or after January 1, 2011. Assets and liabilities that arose from business combinations whose acquisition dates preceded the application of the new standards will not be adjusted upon application of these new standards. Section 1602 should be applied retrospectively except for certain items. The Company is currently assessing whether it will apply the new accounting standards at the beginning of its fiscal 2012 year or elect to early adopt.

#### International Financial Reporting Standards

In February 2008, the Canadian Accounting Standards Board confirmed its plan to converge with IFRS. The Company must prepare interim and annual financial statements in accordance with IFRS for fiscal years beginning on or after January 1, 2011. The Company's launch of its IFRS conversion project began in 2008 where it engaged an external consultant to conduct a preliminary diagnosis and scoping exercise. To date, a project team has been established to complete a detailed assessment of each standard, including identifying the differences between the Company's current policies and those under IFRS, and determining the financial implications that result from the adoption of these new standards. The team, with the assistance of its external consultant, has prepared a sample of the Company's historical financial statements using IFRS. Project plans are also being developed to address the information technology and data system impacts, disclosure controls and procedures and internal controls over financial reporting.

The Company continues to monitor and assess the impact of evolving differences between Canadian GAAP and IFRS, since the IASB is expected to continue issuing new accounting standards during the transition period. As a result, the final impact of IFRS on the Company's consolidated financial statements can only be measured once all the applicable IFRS at the conversion date are known.

### Risks and Uncertainties

The risks and uncertainties faced by the Company are substantially the same as those disclosed in the MD&A section of its fiscal 2009 Annual Report.

### Disclosure Controls & Procedures

Management is responsible for establishing and maintaining a system of disclosure controls and procedures to provide reasonable assurance that all material information relating to the Company is gathered and reported on a timely basis to senior management, including the Chief Executive Officer (CEO) and Chief Financial Officer (CFO), so that appropriate decisions can be made by them regarding public disclosure.

### Internal Control over Financial Reporting

Management is also responsible for establishing and maintaining adequate internal control over financial reporting to provide reasonable assurance regarding the reliability of financial reporting and the preparation of consolidated financial statements for external purposes in accordance with Canadian generally accepted accounting principles.

All internal control systems, no matter how well designed, have inherent limitations. Therefore, even those systems determined to be effective can provide only reasonable assurance with respect to consolidated financial statement preparation and presentation. Additionally, management is necessarily required to use judgment in evaluating controls and procedures.

### Changes in Internal Control over Financial Reporting

Management has evaluated whether there were changes in the Company's internal control over financial reporting that occurred during the period beginning on June 28, 2009 and ended on September 26, 2009 that have materially affected, or are reasonably likely to material affect the Company's internal control over financial reporting and has determined that no material changes occurred during this period.

### Cautionary Statement Regarding Forward-Looking Statements

The above discussion includes forward-looking statements. All statements other than statements of historical facts included in this discussion that address activities, events or developments that the Company expects or anticipates will or may occur in the future are forward-looking statements. These statements are based on certain assumptions and analysis made by the Company in light of its experience, analysis and its perception of historical trends, current conditions and expected future developments as well as other factors it believes are appropriate in the circumstances. However, whether actual results and developments will conform with the expectations and predictions of the Company is subject to a number of risks and uncertainties, including the general economic, market or business conditions; competitive actions by other companies; changes in laws or regulations; and other factors, many of which are beyond the control of the Company. Consequently all the forward-looking statements made in this discussion are qualified by these cautionary statements and there can be no assurance that results or developments anticipated by the Company will be realized or, even if substantially realized, that they will have the expected consequences to, or effects on, the Company.

### Non-GAAP Financial Measures

The Company prepares its consolidated financial statements in accordance with Canadian generally accepted accounting principles. In order to provide additional insight into the business, the Company has also provided non-GAAP data, including comparable store sales and EBITDA, in the discussion and analysis section above. Neither measure has a standardized meaning prescribed by GAAP, and is therefore specific to Indigo and may not be comparable to similar measures presented by other companies.

Comparable stores sales and EBITDA are key indicators used by the Company to measure performance against internal targets and prior period results. Both measures are commonly used by financial analysts and investors to compare Indigo to other retailers. Comparable store sales are defined as sales generated by stores that have been open for more than 12 months. It is a key performance indicator for the Company as this measure excludes sales fluctuations due to store closings, permanent relocation and chain expansion. EBITDA is defined as earnings before interest, taxes, depreciation and amortization.

A reconciliation between comparable store sales and revenues (the most comparable GAAP measure) was included earlier in this report. A reconciliation between EBITDA and earnings before income taxes (the most comparable GAAP measure) is provided below:

(millions of dollars)	13-week period ended September 26, 2009	13-week period ended September 27, 2008	26-week period ended September 26, 2009	26-week period ended September 27, 2008
EBITDA	9.9	11.6	13.9	16.8
Amortization of property, plant and equipment	4.9	5.7	9.8	11.6
Amortization of intangible assets	2.1	1.3	4.0	2.6
Interest on long-term debt and financing charges	0.1	0.1	0.1	0.2
Interest income on cash and cash equivalents	(0.1)	(0.4)	(0.1)	(0.8)
Earnings before income taxes	2.9	4.9	0.1	3.2

Indigo Books & Music Inc.  
468 King Street West, Suite 500  
Toronto, ON M5V 1L8  
Phone: (416) 364-4499 Fax: (416) 364-0355

#### NOTICE OF NO AUDITOR REVIEW OF INTERIM FINANCIAL STATEMENTS

Under National Instrument 51-102, Part 4, subsection 4.3(3)(a), if an auditor has not performed a review of the interim financial statements, they must be accompanied by a notice indicating that the financial statements have not been reviewed by an auditor.

The accompanying unaudited interim consolidated financial statements of the Company have been prepared by and are the responsibility of the Company's management.

The Company's independent auditor has not performed a review of these financial statements.



Heather Reisman  
*Chair & Chief Executive Officer*



Jim McGill  
*Chief Financial Officer*

Dated as of the 26<sup>th</sup> day of October, 2009.

## Consolidated Balance Sheets

(Unaudited)

	As at September 26, 2009	As at September 27, 2008 (Restated – Note 7)	As at March 28, 2009
(thousands of dollars)			
<b>ASSETS</b>			
<b>Current</b>			
Cash and cash equivalents	79,055	70,036	92,169
Accounts receivable	8,470	8,234	9,890
Inventories (note 8)	234,190	215,174	221,767
Income taxes recoverable	866	21	–
Prepaid expenses	6,577	5,138	5,118
Future tax assets	5,885	6,745	6,181
<b>Total current assets</b>	<b>335,043</b>	<b>305,348</b>	<b>335,125</b>
Property, plant and equipment (note 7)	79,672	59,145	72,137
Future tax assets	36,422	41,951	36,422
Intangible assets (note 7)	18,393	12,069	16,299
Goodwill (note 7)	27,523	27,523	27,523
<b>Total assets</b>	<b>497,053</b>	<b>446,036</b>	<b>487,506</b>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>			
<b>Current</b>			
Accounts payable and accrued liabilities	247,273	218,785	233,353
Deferred revenue	12,537	11,553	11,612
Income taxes payable	–	–	344
Current portion of long-term debt	2,408	2,589	2,734
<b>Total current liabilities</b>	<b>262,218</b>	<b>232,927</b>	<b>248,043</b>
Long-term accrued liabilities	6,296	6,844	6,301
Long-term debt	1,827	2,302	2,272
<b>Total liabilities</b>	<b>270,341</b>	<b>242,073</b>	<b>256,616</b>
<b>Shareholders' equity</b>			
Share capital (note 5)	196,638	197,877	196,471
Contributed surplus (notes 5 and 6)	4,351	3,062	3,685
Retained earnings	25,723	3,024	30,734
<b>Total shareholders' equity</b>	<b>226,712</b>	<b>203,963</b>	<b>230,890</b>
<b>Total liabilities and shareholders' equity</b>	<b>497,053</b>	<b>446,036</b>	<b>487,506</b>

See accompanying notes

## Consolidated Statements of Earnings (Loss)

(Unaudited)

	13-week period ended September 26, 2009	13-week period ended September 27, 2008 (Restated – Note 7)	26-week period ended September 26, 2009	26-week period ended September 27, 2008 (Restated – Note 7)
(thousands of dollars, except per share data)				
<b>Revenues</b>	<b>206,990</b>	205,261	<b>400,541</b>	395,863
Cost of sales, operations, selling and administration	<b>197,075</b>	193,659	<b>386,667</b>	379,057
	<b>9,915</b>	11,602	<b>13,874</b>	16,806
Amortization of property, plant and equipment (note 7)	<b>4,918</b>	5,758	<b>9,830</b>	11,558
Amortization of intangible assets (note 7)	<b>2,124</b>	1,289	<b>3,965</b>	2,600
	<b>7,042</b>	7,047	<b>13,795</b>	14,158
Earnings before the undernoted items	<b>2,873</b>	4,555	<b>79</b>	2,648
Interest on long-term debt and financing charges	<b>61</b>	71	<b>118</b>	179
Interest income on cash and cash equivalents	<b>(125)</b>	(400)	<b>(136)</b>	(793)
Earnings before income taxes	<b>2,937</b>	4,884	<b>97</b>	3,262
Income tax expense	<b>737</b>	1,696	<b>201</b>	1,299
<b>Net earnings (loss) for the period</b>	<b>2,200</b>	3,188	<b>(104)</b>	1,963
<b>Net earnings (loss) per common share (note 4)</b>				
Basic	\$ <b>0.09</b>	\$ 0.13	\$ <b>(0.00)</b>	\$ 0.08
Diluted	\$ <b>0.09</b>	\$ 0.13	\$ <b>(0.00)</b>	\$ 0.08

See accompanying notes

# Consolidated Statements of Retained Earnings

(Unaudited)

	26-week period ended September 26, 2009	26-week period ended September 27, 2008 <small>(Restated – Note 7)</small>
<small>(thousands of dollars)</small>		
<b>Retained earnings, beginning of period</b>	<b>30,734</b>	2,252
Net earnings (loss) for the period	(104)	1,963
Shares repurchase excess (note 5)	–	(1,191)
Dividends	(4,907)	–
<b>Retained earnings, end of period</b>	<b>25,723</b>	3,024

See accompanying notes

# Consolidated Statements of Cash Flows

(Unaudited)

	13-week period ended September 26, 2009	13-week period ended September 27, 2008 <small>(Restated – Note 7)</small>	26-week period ended September 26, 2009	26-week period ended September 27, 2008 <small>(Restated – Note 7)</small>
<small>(thousands of dollars)</small>				
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>				
Net earnings (loss)	2,200	3,188	(104)	1,963
Add items not affecting cash				
Amortization of property, plant and equipment (note 7)	4,918	5,758	9,830	11,558
Stock-based compensation (note 6)	268	189	511	422
Directors' compensation (note 5)	68	72	193	177
Future tax assets	832	1,696	296	1,299
Loss on disposal of property, plant and equipment	165	–	173	13
Amortization of intangible assets (note 7)	2,124	1,289	3,965	2,600
Net change in non-cash working capital balances related to operations				
Accounts receivable	(560)	(845)	1,420	762
Inventories	(25,982)	(17,986)	(12,423)	(8,915)
Prepaid expenses	(946)	112	(1,459)	(209)
Income taxes recoverable/payable	(1,210)	–	(1,210)	–
Deferred revenue	103	721	925	1,203
Accounts payable and accrued liabilities	49,587	31,767	13,915	24,757
<b>Cash flows from operating activities</b>	<b>31,567</b>	25,961	<b>16,032</b>	35,630
<b>CASH FLOWS FROM INVESTING ACTIVITIES</b>				
Purchase of property, plant and equipment	(13,567)	(7,879)	(16,805)	(11,993)
Addition of intangible assets (note 7)	(2,905)	(3,135)	(6,059)	(4,909)
<b>Cash flows used in investing activities</b>	<b>(16,472)</b>	(11,014)	<b>(22,864)</b>	(16,902)
<b>CASH FLOWS FROM FINANCING ACTIVITIES</b>				
Repayment of long-term debt	(762)	(675)	(1,504)	(2,272)
Proceeds from share issuances (note 5)	101	178	129	277
Dividends paid	(4,907)	–	(4,907)	–
Repurchase of common shares (note 5)	–	(1,466)	–	(2,630)
<b>Cash flows used in financing activities</b>	<b>(5,568)</b>	(1,963)	<b>(6,282)</b>	(4,625)
<b>Net increase (decrease) in cash and cash equivalents during the period</b>	<b>9,527</b>	12,984	<b>(13,114)</b>	14,103
Cash and cash equivalents, beginning of period	69,528	57,052	92,169	55,933
<b>Cash and cash equivalents, end of period</b>	<b>79,055</b>	70,036	<b>79,055</b>	70,036

See accompanying notes

# Notes to the Interim Consolidated Financial Statements

September 26, 2009  
(Unaudited)

## 1. DISCLOSURE

These unaudited interim consolidated financial statements do not contain all disclosures required by Canadian generally accepted accounting principles for audited annual consolidated financial statements and accordingly, these financial statements should be read in conjunction with the most recently prepared audited annual consolidated financial statements for the 52-week period ended March 28, 2009. Results of operations for the 13 and 26-week periods ended September 26, 2009 and September 27, 2008 and the balances at these dates are unaudited.

## 2. SEASONALITY OF OPERATIONS

The business of Indigo Books & Music Inc. (the “Company” or “Indigo”) follows a seasonal pattern, with sales of merchandise being highest in the third fiscal quarter due to consumer holiday buying patterns. As a result, a disproportionate portion of total annual revenues are typically earned in the third fiscal quarter. Therefore, the results of operations for the 13 and 26-week periods ended September 26, 2009 and September 27, 2008 are not indicative of the results of other periods.

## 3. ACCOUNTING POLICIES

These unaudited interim consolidated financial statements follow the same accounting policies and methods of their application as the most recent audited annual consolidated financial statements for the 52-week period ended March 28, 2009.

### New Accounting Pronouncements

#### **Business combinations**

Section 1582 of the Canadian Institute of Chartered Accountants (“CICA”) Handbook, “Business Combinations”, replaces the existing Section 1580, “Business Combinations.” The CICA also issued Section 1601, “Consolidated Financial Statements” and Section 1602, “Non-Controlling Interests”, which

replaces Section 1600, “Consolidated Financial Statements.” These new sections are based on the International Accounting Standards Board’s (“IASB”) International Financial Reporting Standard 3, “Business Combinations” and will replace the existing guidance on business combinations and consolidated financial statements. The objective of the new standards is to harmonize Canadian accounting for business combinations with the international and U.S. accounting standards. The three new standards have to be adopted concurrently and will apply to interim and annual consolidated financial statements relating to fiscal years beginning on or after January 1, 2011. Assets and liabilities that arose from business combinations whose acquisition dates preceded the application of the new standards will not be adjusted upon application of these new standards. Section 1602 should be applied retrospectively except for certain items. The Company is currently assessing whether it will apply the new accounting standards at the beginning of its fiscal 2012 year or elect to early adopt.

#### **International financial reporting standards**

In February 2008, the Canadian Accounting Standards Board confirmed its plan to converge with International Financial Reporting Standards (“IFRS”). The Company must prepare interim and annual financial statements in accordance with IFRS for fiscal years beginning on or after January 1, 2011. The Company’s launch of its IFRS conversion project began in 2008 where it engaged an external consultant to conduct a preliminary diagnosis and scoping exercise. To date, a project team has been established to complete a detailed assessment of each standard, including identifying the differences between the Company’s current policies and those under IFRS, and determining the financial implications that result from the adoption of these new standards. The team, with the assistance of its external consultant, has prepared a sample of the Company’s historical financial statements using IFRS. Project plans are also being developed to address the information technology and data system impacts, disclosure controls and procedures and internal controls over financial reporting.

The Company continues to monitor and assess the impact of evolving differences between Canadian GAAP and IFRS, since the IASB is expected to continue issuing new accounting standards during the transition period. As a result, the final impact of IFRS on the Company’s consolidated financial statements can only be measured once all the applicable IFRS at the conversion date are known.

#### 4. EARNINGS (LOSS) PER SHARE

Earnings (loss) per share is calculated based on the weighted average number of common shares outstanding during the period. In calculating diluted earnings per share amounts under the treasury stock method, the numerator remains unchanged from the basic earnings per share calculations as the assumed exercise of the Company's stock options and Director's deferred stock units ("DSUs") do not result in an adjustment to net earnings. The reconciliation of the denominator in calculating diluted earnings per share amount for the 13 and 26-week periods ending September 26, 2009 and September 27, 2008 is as follows:

(in thousands)	13-week period ended September 26, 2009	13-week period ended September 27, 2008	26-week period ended September 26, 2009	26-week period ended September 27, 2008
Weighted average number of common shares outstanding, basic	24,539	24,743	24,533	24,689
Effect of dilutive securities				
– Stock options	332	414	332	396
– Deferred stock units	184	151	184	151
Weighted average number of common shares outstanding, diluted	25,055	25,308	25,049	25,236

#### 5. SHARE CAPITAL

Share capital consists of the following:

	26-week period ended September 26, 2009		26-week period ended September 27, 2008		52-week period ended March 28, 2009		13-week period ended September 26, 2009
	Number of shares	Amount \$ (thousands)	Number of shares	Amount \$ (thousands)	Number of shares	Amount \$ (thousands)	
<b>Balance, beginning of period</b>	<b>24,526,272</b>	<b>196,471</b>	24,843,147	198,938	24,843,147	198,938	
Issued during the period							
Options exercised	18,300	167	37,550	378	39,750	390	
Repurchase of common shares	–	–	(179,565)	(1,439)	(356,625)	(2,857)	
<b>Balance, end of period</b>	<b>24,544,572</b>	<b>196,638</b>	24,701,132	197,877	24,526,272	196,471	

On May 6, 2008, the Company announced its intent to make a normal course issuer bid ("NCIB"), subject to final acceptance of its notice of intention by the Toronto Stock Exchange. The Toronto Stock Exchange approved the NCIB on May 8, 2008. Under the NCIB, Indigo was allowed to purchase up to 1,242,157 of its common shares, representing approximately 5% of its total outstanding

common shares. Daily purchases were limited to 2,905 common shares, other than block purchase exceptions. During the 26-week period ended September 27, 2008, the Company repurchased 179,565 common shares at an average price of \$14.65 per share for total cash consideration of \$2.6 million. The repurchased shares were cancelled and returned to treasury. The cash consideration exceeded the carrying value of the shares repurchased by \$1.2 million and the amount was charged to retained earnings. The NCIB expired on May 10, 2009 and no shares were repurchased in the 26-week period ended September 26, 2009.

#### 6. STOCK-BASED COMPENSATION

As at September 26, 2009, 2,020,719 stock options were outstanding with exercise prices ranging from \$4.45 to \$63.53. Of these outstanding stock options, 896,419 were exercisable. As at September 27, 2008, there were 1,537,052 stock options outstanding of which 673,864 were exercisable.

The Company uses the fair value method of accounting for stock options, which estimates the fair value of the stock options granted on the date of grant and expenses this value over the vesting period. During the 13-week period ended September 26, 2009, the Company issued stock options and \$0.3 million was recognized as an expense with the offset recorded in contributed surplus. Any consideration paid by employees on exercise of stock options is credited to share capital with a corresponding reduction to contributed surplus.

The fair value of the employee stock options is estimated at the date of grant using the Black-Scholes option pricing model with the following assumptions during the period presented:

Risk-free interest rate	2.1%
Expected volatility	42.6%
Expected time until exercise	5.9 years
Expected dividend yield	3.2%

The Company did not issue any stock options to employees during the 13-week period ended September 27, 2008.

On October 31, 2002, the Company established a Director's Deferred Stock Unit Plan. Under the Plan, Directors receive their annual retainer fees and other Board-related compensation in the form of DSUs. The Company issued 8,087

DSUs with a value of \$0.1 million during the 13-week period ended September 26, 2009. The value of the outstanding DSUs as at September 26, 2009 was \$2.0 million and was recorded in contributed surplus.

## 7. GOODWILL AND INTANGIBLE ASSETS

Section 3064 of the CICA Handbook, “Goodwill and Intangible Assets”, replaces the existing Section 3062, “Goodwill and Other Intangible Assets” and Section 3450, “Research and Development Costs”. In conjunction with the issuance of this new standard, the CICA has amended Section 1000, “Financial Statement Concepts”. These changes clarify the criteria for asset recognition for an internally developed intangible asset and reinforce the distinction between costs that should be expensed and those that should be capitalized. This standard was applied retrospectively by the Company in fiscal 2009. Upon adoption of this standard, the Company reclassified the net carrying value of its application software and internal development costs from property, plant and equipment to intangible assets. The resulting adjustments that were recorded in the Company’s consolidated financial statements are summarized below:

### Consolidated balance sheets

Increase (decrease)

(thousands of dollars)	As at September 27, 2008
Property, plant and equipment	(12,069)
Intangible assets	12,069

### Consolidated statements of earnings (loss)

Increase (decrease)

(thousands of dollars)	13-week period ended September 27, 2008	26-week period ended September 27, 2008
Amortization of property, plant and equipment	(1,289)	(2,600)
Amortization of intangible assets	1,289	2,600

## 8. INVENTORIES

The cost of inventories recognized as an expense for the 13 and 26-week period ended September 26, 2009 was \$114.6 million and \$222.6 million, respectively. The amount of inventory write-downs as a result of net realizable value lower than cost was \$0.5 million for the period, and there were no reversals of inventory write-downs that were recognized in prior periods. The amount of inventory with net realizable value equal to cost was \$1.5 million as at September 26, 2009. The full value of the inventories was pledged as security under the Company’s credit agreement with its bank.

## 9. FINANCIAL RISK MANAGEMENT

The Company’s activities expose it to a variety of financial risks, including risks related to foreign exchange, interest rate, credit and liquidity.

### Foreign exchange risk

The Company’s foreign exchange risk is largely limited to currency fluctuations between the Canadian and US dollar. Decreases in the value of the Canadian dollar relative to the US dollar affect less than 10% of the Company’s total cost of purchases and could negatively impact the Company’s net earnings. The Company does not use foreign currency derivative contracts to hedge its foreign exchange risk.

### Interest rate risk

The Company’s interest rate risk is limited to the fluctuation of floating rates on its outstanding operating line. The Company did not use its operating line during the quarter and does not use any interest rate swaps to fix the interest rate on its operating line.

### Credit risk

The Company’s credit risk is considered to be negligible as the Company only deals with highly rated financial institutions. In addition, the Company has minimal accounts receivable as its customers pay mainly by cash or credit card. The maximum exposure to credit risk at the reporting date is equal to the carrying value of the accounts receivable.

## Liquidity risk

The Company manages liquidity risk by maintaining available financial assets in excess of financial obligations due at any point in time.

## Current liabilities and long-term liabilities

The contractual maturities of the Company's current and long-term liabilities as at September 26, 2009 are as follows:

(thousands of dollars)	Payments due in the next 90 days	Payments due between 90 days and less than a year	Payments due after 1 year	Total
Accounts payable and accrued liabilities	162,813	81,171	3,289	247,273
Current portion of long-term debt	—	2,408	—	2,408
Long-term debt	—	—	1,827	1,827
Long-term accrued liabilities	—	—	6,296	6,296
<b>Total</b>	<b>162,813</b>	<b>83,579</b>	<b>11,412</b>	<b>257,804</b>

## 10. CAPITAL DISCLOSURES

The Company's objectives when managing capital are to safeguard the entity's ability to continue as a going concern while maintaining adequate financial flexibility to invest in new business opportunities that will provide attractive returns to shareholders. The primary activities engaged by the Company to generate attractive returns include the construction and related leasehold improvements of new and relocated stores, the development of new business concepts, and investment in information technology and distribution capacity to support the expansion of the store and online network. The Company's main sources of capital are cash flows generated from operations, a revolving line of credit and long-term debt. This cash flow is used to fund its capital expenditures, working capital needs, debt service requirements, and dividend distribution to shareholders. There were no changes to these objectives during the 13 and 26-week period ended September 26, 2009.

The Company monitors its capital structure principally through measuring its total debt to shareholders' equity ratio and ensures its ability to service its debt obligation by tracking its interest and other fixed charge coverage ratios. Total debt is defined as the total of bank indebtedness and long-term debt (including the current portion). The Company has certain debt covenants and is in compliance with those covenants.

The following table summarizes selected capital structure information for the Company for the periods indicated:

(thousands of dollars)	26-week period ended September 26, 2009	26-week period ended September 27, 2008
Current portion of long-term debt	2,408	2,589
Long-term debt	1,827	2,302
<b>Total debt</b>	<b>4,235</b>	<b>4,891</b>
Shareholders' equity	226,712	203,963
<b>Total debt : Shareholders' equity</b>	<b>0.02:1</b>	<b>0.02:1</b>

## 11. CONSOLIDATED STATEMENTS OF CASH FLOWS

Supplemental cash flow information:

(thousands of dollars)	13-week period ended September 26, 2009	13-week period ended September 27, 2008	26-week period ended September 26, 2009	26-week period ended September 27, 2008
Interest paid (received)	(34)	(330)	28	(605)
Income taxes paid	1,210	—	1,210	—
Assets acquired under capital lease	591	101	733	1,135

## 12. SUBSEQUENT EVENT

The Company had a revolving line of credit with a borrowing capacity of \$30.0 million. On October 15, 2009, the revolving line of credit expired and was not renewed by the Company.

# Investor Information

## Support Office

468 King Street West  
Suite 500  
Toronto, Ontario  
Canada M5V 1L8  
Telephone (416) 364-4499  
Fax (416) 364-0355  
[www.chapters.indigo.ca/ir](http://www.chapters.indigo.ca/ir)

## Investor Contact

Jim McGill  
Chief Financial Officer  
Telephone (416) 640-4856

## Media Contact

Janet Eger  
Director, Public Relations  
Telephone (416) 342-8561

## Stock Listing

Toronto Stock Exchange

## Trading Symbol

IDG

## Transfer Agent and Registrar

CIBC Mellon Trust Company  
P.O. Box 7010  
Adelaide Street Postal Station  
Toronto, Ontario  
Canada M5C 2W9  
Telephone (Toll Free) 1-800-387-0825  
(Toronto) (416) 643-5500

## Auditors

Ernst & Young LLP  
Ernst & Young Tower  
Toronto-Dominion Centre  
Toronto, Ontario  
Canada M5K 1J7

