



# Simplify, Innovate, Grow



**Loblaw**<sup>®</sup>

C O M P A N I E S   L I M I T E D

2006 Financial Report

## Financial Highlights

For the years ended December 30, 2006 and December 31, 2005 (\$ millions except where otherwise indicated)	2006 (52 weeks)	2005 (52 weeks)
<b>Operating Results</b>		
Sales <sup>(3)</sup>	\$ 28,640	\$ 27,627
Sales excluding the impact of VIEs <sup>(2) (3)</sup>	28,257	27,212
Adjusted EBITDA <sup>(2)</sup>	1,892	2,132
Operating income	289	1,401
Adjusted operating income <sup>(2)</sup>	1,326	1,600
Interest expense	259	252
Net (loss) earnings	(219)	746
<b>Cash Flow</b>		
Cash flows from operating activities	1,180	1,489
Free cash flow <sup>(2)</sup>	70	103
Capital investment	937	1,156
<b>Per Common Share (\$)</b>		
Basic net (loss) earnings	(.80)	2.72
Adjusted basic net earnings <sup>(2)</sup>	2.72	3.35
Dividend rate at year end	.84	.84
Cash flows from operating activities	4.31	5.43
Book value	19.85	21.48
Market price at year end	48.79	56.37
<b>Financial Ratios</b>		
Adjusted EBITDA margin <sup>(2)</sup>	6.7%	7.8%
Operating margin	1.0%	5.1%
Adjusted operating margin <sup>(2)</sup>	4.7%	5.9%
Return on average total assets <sup>(2)</sup>	2.3%	11.2%
Return on average shareholders' equity	(3.9%)	13.2%
Interest coverage	1.0:1	5.1:1
Net debt <sup>(2)</sup> to equity	.72:1	.66:1
<b>Operating Statistics</b>		
Retail square footage (in millions)	49.7	48.5
Average corporate store size (square feet)	57,400	56,100
Corporate stores sales per average square foot (\$)	585	579
Same-store sales growth	.8%	.2%
Number of corporate stores	672	670
Number of franchised stores	405	402

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As part of our fresh thinking, we are now introducing additional information on our website [loblaw.ca](http://loblaw.ca).

The Annual Report consists of the 2006 Annual Summary and the 2006 Financial Report.

(1) For financial definitions and ratios refer to the Glossary of Terms on page 80.

(2) See Non-GAAP Financial Measures on page 40.

(3) During 2006, the Company implemented Emerging Issues Committee Abstract 156, "Accounting by a Vendor for Consideration Given to a Customer (Including a Reseller of the Vendor's Products)" on a retroactive basis. Accordingly certain sales incentives paid to independent franchisees, associates and independent accounts for the prior year have been reclassified between sales and cost of sales, selling and administrative expenses. For a further discussion, see the Accounting Standards Implemented in 2006 section in the Management's Discussion and Analysis of this Financial Report.

## Management's Discussion and Analysis

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## Management's Discussion and Analysis

The following Management's Discussion and Analysis ("MD&A") for Loblaw Companies Limited and its subsidiaries (collectively, the "Company" or "Loblaw") should be read in conjunction with the consolidated financial statements and the accompanying notes on pages 45 to 77 of this Financial Report. The consolidated financial statements and the accompanying notes have been prepared in accordance with Canadian generally accepted accounting principles ("GAAP") and are reported in Canadian dollars. The consolidated financial statements include the accounts of the Company and its subsidiaries and variable interest entities ("VIEs") that the Company is required to consolidate in accordance with Accounting Guideline 15, "*Consolidation of Variable Interest Entities*", ("AcG 15"). A glossary of terms used throughout this Financial Report can be found on page 80. The information in this MD&A is current to March 13, 2007, unless otherwise noted.

### 1. Forward-Looking Statements

This Annual Report, including the Annual Summary and this MD&A, contains forward-looking statements which reflect management's expectations and are contained in discussions regarding the Company's objectives, plans, goals, aspirations, strategies, potential future growth, results of operations, performance and business prospects and opportunities. Forward-looking statements are typically, though not always, identified by words or phrases such as "anticipates", "expects", "believes", "estimates", "intends" and other similar expressions.

These forward-looking statements are not guarantees, but only predictions. Although the Company believes that these statements are based on information and assumptions which are current, reasonable and complete, these statements are necessarily subject to a number of factors that could cause actual results to vary significantly from the estimates, projections and intentions. Such differences may be caused by factors which include, but are not limited to, changes in consumer spending and preferences, heightened competition including new competitors and expansion of current competitors, changes in the Company's or its competitors' pricing strategies, the ability to realize anticipated cost savings and efficiencies, including those resulting from restructuring, inventory liquidation and other cost reduction and simplification initiatives, the ability to execute restructuring plans, implement strategies and introduce innovative products successfully and in a timely manner, changes in the markets for the inventory intended for liquidation and changes in the expected realizable value and costs associated with the liquidation, unanticipated, increased or decreased costs associated with the announced initiatives, including those related to compensation costs, the Company's relationship with its employees, results of labour negotiations including the terms of future collective bargaining agreements, changes to the regulatory environment in which the Company operates now or in the future, changes in the Company's tax liabilities, either through changes in tax laws or future assessments, performance of third-party service providers, public health events, the ability of the Company to attract and retain key executives and supply and quality control issues with vendors. The calculation of the goodwill impairment charge described in this MD&A involves the estimation of several variables, including but not limited to market multiples, projected future sales and earnings, capital investment, discount rates, terminal growth rates and the fair values of those assets and liabilities being valued. The Company cautions that this list of factors is not exhaustive.

The assumptions applied in making the forward-looking statements contained in this Annual Report, including this MD&A include the following: economic conditions do not materially change from those expected, patterns of consumer spending are reasonably consistent with historical trends, no new significant competitors enter our market nor does any existing competitor unexpectedly significantly increase its presence, neither the Company's nor its competitors' pricing strategies change materially, the Company successfully offers new and innovative products and executes its strategies as planned, anticipated cost savings and efficiencies are realized as planned, continuing future restructuring activities are effectively executed in a timely manner, costs associated with the liquidation of inventory are not higher or lower than expected, the Company's assumptions regarding average compensation costs and average years of service for employees affected by the simplification initiatives are materially correct, the Company does not significantly change its approach to its current restructuring activities, there is no material amount of excess inventory in the Company's supply chain, there are no material work stoppages and the performance of third-party service providers is in accordance with expectations.

These estimates and assumptions may change in the future due to uncertain competitive and economic market conditions or changes in business strategies. This list of factors and other risks and uncertainties are discussed in the Company's materials filed with the Canadian securities regulatory authorities from time to time, including the Risks and Risk Management section of this MD&A.

Potential investors and other readers are urged to consider these factors carefully in evaluating these forward-looking statements and are cautioned not to place undue reliance on them. The forward-looking statements included in this Annual Report, including this MD&A are made only as of the filing date of this Annual Report and the Company disclaims any obligation or intention to publicly update these forward-looking statements to reflect new information, future events or otherwise. In light of these risks, uncertainties and assumptions, the forward-looking events contained in these forward-looking statements may or may not occur. The Company cannot assure that projected results or events will be achieved.

## 2. Overview

Loblaw, a subsidiary of George Weston Limited, is Canada's largest food distributor and a leading provider of general merchandise, drugstore and financial products and services. Through its various operating banners, including 672 corporate stores and 405 franchised stores, Loblaw is committed to providing Canadians across the country with a one-stop destination in meeting their food and everyday household needs. For 50 years, the Company has supplied the Canadian market with innovative products and services through a portfolio of store formats across Canada.

Corporate owned store banners include *Atlantic Superstore*, *Dominion* (in Newfoundland and Labrador), *Extra Foods*, *Loblaws*, *Maxi*, *Maxi & Cie*, *Provigo*, the *Real Canadian Superstore* and *Zehrs* and wholesale outlets operating as *Cash & Carry*, *Presto* and *The Real Canadian Wholesale Club*. The Company's franchised and associated stores operate under the trade names *Atlantic SaveEasy*, *Fortinos*, *no frills*, *SuperValu*, *Valu-mart* and *Your Independent Grocer*. The store network is supported by 26 Company-operated and 2 third-party warehouse facilities located across Canada as well as temporary storage facilities when required.

The Company offers a strong control label program, including the *President's Choice*, *no name* and *Joe Fresh Style* brands. In addition, the Company makes available to consumers *President's Choice Financial* services and products, including the *President's Choice Financial MasterCard*<sup>®</sup>, and *PC Financial* auto, home, travel and pet insurance, *PC Mobile* phone service, as well as a loyalty program known as *PC points*.

The Company competes in the retail industry in Canada, which is a changing and competitive market. Consumer needs drive industry changes, which are impacted by changing demographic and economic trends such as changes in disposable income, ethnic diversity, nutritional awareness and time availability. Over the past several years, consumers have demanded more choice, value and convenience. Customer satisfaction is central to the success of the Company's business.

The Company competes with non-traditional competitors as well as traditional supermarkets. Recent industry changes have seen the expansion of non-traditional competitors, such as mass merchandisers, warehouse clubs, drugstores, limited assortment stores, discount stores, convenience stores and specialty stores, all of which continue to increase their offerings of products typically associated with traditional supermarkets. Over the past several years, there has been an increase in the number of retail outlets that traditionally exclusively featured food, general merchandise or drugstore items that now offer a selection of these items, resulting in what is commonly referred to in the industry as "channel blurring". This evolution of the retail landscape presents a number of issues for traditional grocers: the need to reposition conventional supermarkets to either expand or, conversely, better focus their offerings; the reality of lower prices offered by discount retailers; and the need to reduce operating and labour costs in order to maintain earnings in light of lower prices and increased competition.

## Management's Discussion and Analysis

Since the beginning of 2005 and throughout 2006, the financial performance of the Company has been uncharacteristically poor. 2006 was a year of challenge and change for the Company as it evolves through its continued transformation into a company that will be truly competitive over the long term. The past year saw a number of significant changes in the operations of the Company, including the change in senior leadership. Galen G. Weston was appointed Executive Chairman of the Company's Board of Directors (the "Board"), Mark Foote became President and Chief Merchandising Officer and Allan L. Leighton joined the Board as Deputy Chairman. Early in 2007, Dalton Philips joined the Company as Chief Operating Officer and William M. Wells will be joining the Company as Chief Financial Officer, effective April 2007. A 100 Day Review of the Company commenced in the latter half of 2006 which focused on key drivers of the business such as fresh food presentation, maximizing employee engagement, the performance of retailing basics and customer satisfaction. The results of this review provided key inputs into management's future business priorities and vision for the organization.

### 3. Vision and Strategies

#### Vision

Loblaw's vision is to maximize the return on its assets under the three main principles of, "Simplify, Innovate, Grow" in addition to its "Formula for Growth". The Company strives to be consumer focused, cost effective and agile. While accepting prudent operating risks, Loblaw seeks long term, stable growth supported by a strong balance sheet, with the goal of providing sustainable superior returns to its shareholders through a combination of common share price appreciation and dividends.

#### Strategies

Under the principles of Simplify, Innovate, Grow, the Company employs various operating and financial strategies which guide the Company over the long term and represent a philosophy for the way in which it conducts its business.

Loblaw is simplifying the organization by more clearly defining accountabilities, eliminating duplication and establishing consistent, simple and efficient processes. A less complex organizational structure and a short list of key performance indicators are expected to lead to more focus on customers and store operations.

Innovation is one of the many strengths of Loblaw, most clearly exhibited by its control label offerings. The Company supports innovation based on the belief that providing consumers with new products and convenient services at competitive prices and stimulating shopping environments is critical to its success.

The new management team developed its Formula for Growth to define priorities for a three year renewal plan. In order to provide an integrated offering of food, general merchandise and drugstore, the Company's Formula for Growth focuses on the following:

- best format: truly distinctive formats meeting customers' different needs;
- fresh first: best fresh food offering;
- control label advantage: leading in the development of unique, high quality control label products and services;
- *Joe Fresh Style*: ensuring great style at an affordable price;
- health, home and wholesome: making healthy living affordable;
- priced right: providing best value;
- always available: best in-stock positions; and
- friendly colleagues motivated to serve.

The Company's long term operating strategies are consistent with its Formula for Growth and continue to be as follows:

- using the cash flow generated in the business to invest in its future;
- owning its real estate, where possible, to maximize flexibility for product and business opportunities in the future;
- using a multi-format approach to maximize market share over the longer term;
- focusing on food but serving the consumer's everyday household needs;



- creating customer loyalty and enhancing price competitiveness through a superior control label program;
- implementing and executing plans and programs flawlessly; and
- constantly striving to improve the Company's value proposition.

The Company's long term financial strategies are as follows:

- maintaining a strong balance sheet;
- minimizing the risks and costs of its operating and financing activities; and
- maintaining liquidity and access to capital markets.

The table below summarizes the Company's strategic imperatives and the activities undertaken in 2006 to progress these imperatives.

Strategic Imperative	Progress in 2006
Simplify	<ul style="list-style-type: none"> <li>• Continued efforts to restructure the supply chain which proved to be more complex and costly than originally anticipated. By year end, the supply chain stabilized and delivered improved service levels.</li> <li>• Planned and developed organizational transition, focused on redesigned processes and a leaner administrative structure.</li> <li>• Identified key performance indicators to be further developed and implemented in 2007.</li> </ul>
Innovate	<ul style="list-style-type: none"> <li>• Launched <i>Joe Fresh Style</i> apparel for adults in April 2006 with positive consumer response.</li> <li>• Developed and distributed a record six issues of the <i>Insider's Report</i> to a total of over ten million homes in Canada, keeping customers informed about exciting new products and services.</li> <li>• Over 2,000 new control label products launched.</li> </ul>
Grow	<ul style="list-style-type: none"> <li>• Commenced the 100 Day Review of key drivers of the business.</li> <li>• Established the first phase of Positive Action Groups, teams made up of employees from every functional area across the business, dedicated to producing meaningful action on individual strategic issues including optimization of the <i>Real Canadian Superstore</i>, fresh perception measurement, groundwork for Maple Leaf Gardens great food store, Credit For Value, on-shelf availability measurement, and an employee survey tool.</li> <li>• Continued major product development, to be refined as needed.</li> <li>• Reached a labour agreement in Ontario which will allow store conversions.</li> </ul>

### Board Commitment

The Company's Board and senior management meet annually to review the strategic imperatives. These strategic imperatives, which generally span a three to five year timeframe, target specific issues in response to the Company's performance and changes in consumer needs and the competitive retail landscape.

### 4. Key Performance Indicators

As a result of the priorities established under the new management's Formula for Growth and following the 100 Day Review, the Company has identified and is developing specific key performance indicators to measure the progress of short and long term strategies. These key performance indicators will measure format same-store sales, fresh perception, penetration of control label sales, *Joe Fresh Style* percentage share of total general merchandise sales; specific comparative sales for Health and Beauty, *Natural Value* and *President's Choice* Organics, index pricing targets, targeted on-shelf availability and employee satisfaction. In 2007, targets will be implemented across the Company that will enable management to assess progress made on each imperative as well as the effectiveness of implementation of the Company's strategy. The Company believes that if it successfully implements and executes its various strategic imperatives in support of its long term operating and financial strategies, it will be well positioned to pursue its vision of providing sustainable superior returns to its shareholders.

## Management's Discussion and Analysis

Additional key financial performance indicators are set out below:

### Key Financial Performance Indicators

	2006 (52 weeks)	2005 <sup>(2)</sup> (52 weeks)
Sales growth	3.7%	6.1%
Sales growth excluding the impact of VIEs <sup>(1)</sup>	3.8%	4.5%
Basic net earnings per common share decline	(129.4%)	(22.9%)
Adjusted basic net earnings per common share <sup>(1)</sup> decline	(18.8%)	(3.7%)
Net debt <sup>(1)</sup> to equity ratio	.72:1	.66:1
Free cash flow <sup>(1)</sup> (\$ millions)	\$ 70	\$ 103
Return on average shareholders' equity	(3.9%)	13.2%

(1) See Non-GAAP Financial Measures on page 40.

(2) During 2006, the Company implemented Emerging Issues Committee Abstract 156, "Accounting by a Vendor for Consideration Given to a Customer (Including a Reseller of the Vendor's Products)" on a retroactive basis. Accordingly certain sales incentives paid to independent franchisees, associates and independent accounts for the prior years have been reclassified between sales and cost of sales, selling and administrative expenses. For a further discussion, see the Accounting Standards Implemented in 2006 section included in this MD&A.

By effectively implementing the Formula for Growth, management aspires to achieve on average 5% sales growth, 10% adjusted net earnings<sup>(1)</sup> growth and \$250 million of free cash flow<sup>(1)</sup>.

## 5. Financial Performance

Basic net loss per common share for 2006 was \$0.80, a decrease of \$3.52 when compared to basic net earnings per common share of \$2.72 last year. Basic net loss per common share was impacted in 2006 by the following:

- a charge of \$2.92 per common share related to non-cash goodwill impairment;
- a charge of 20 cents per common share related to the Ontario collective labour agreement;
- a charge of 16 cents per common share related to inventory liquidation;
- a charge of 17 cents per common share for the net effect of stock-based compensation and the associated equity forwards;
- a charge of 11 cents per common share related to restructuring and other charges;
- a charge of 3 cents per common share related to a departure entitlement payment;
- income of 6 cents per common share related to the adjustment to future income tax balances resulting from changes in the Canadian federal and certain provincial statutory income tax rates; and
- income of 1 cent per common share related to the consolidation of VIEs.

After adjusting for the above-noted items, adjusted basic net earnings per common share<sup>(1)</sup> were \$2.72 for 2006 compared to \$3.35 in 2005, a decline of 18.8%, which for 2005 excluded the impact of the following:

- a charge of 22 cents per common share for the net effect of stock-based compensation and the associated equity forwards;
- a charge of 20 cents per common share related to restructuring and other charges;
- a charge of 10 cents per common share for Goods and Services Tax ("GST") and provincial sales taxes ("PST");
- a charge of 7 cents per common share for direct costs associated with supply chain disruptions;



- a charge of 1 cent per common share related to the adjustment to future income tax balances resulting from changes in statutory income tax rates; and
- a charge of 3 cents per common share related to the consolidation of VIEs.

Results for 2006 were affected by the short term costs associated with one of the largest transformations in the Company's history. The need for this transformative process was driven by the Company's recent uncharacteristically poor financial performance, its assessment of a fast-changing retail environment and a strategic review of processes, structure and key drivers of its operations.

This strategic review highlighted both core strengths and issues to be addressed. The core strengths include a strong market share, control label products and a strong store network. A number of issues facing the business included unacceptable levels of on-shelf availability, the need to strengthen price positioning, insufficiently distinctive formats, a complex organizational structure with inconsistent procedures and standards which lacked clear accountabilities and insufficient focus on the customer. In response to these findings, the Company embarked on planning and developing an organizational transition which focuses on redesigning processes, a leaner administrative structure and a comprehensive strategy designed to fortify its competitive position and maintain its leadership role in meeting the food and everyday household needs of Canadian consumers. In pursuit of this strategy, the Company is refocusing the business around the three principles of Simplify, Innovate, Grow and took decisive action in 2006 to initiate tangible change. Additional steps taken in 2006 include the negotiation of a new four-year collective agreement with members of certain Ontario locals of the United Food and Commercial Workers union ("UFCW"), the liquidation of certain general merchandise inventory and the closure of certain underperforming stores.

Changes in 2005 included the restructuring of its supply chain network, the reorganizations involving its merchandising, procurement and operations groups, the establishment of a new National Head Office and Store Support Centre in Brampton, Ontario, which opened in 2005, and the relocation of general merchandise operations from Calgary, Alberta to the new National Head Office.

During 2005, the Company encountered challenges during the execution of planned changes to its systems, supply chain and general merchandise areas, including certain supply chain systems conversions which were initiated as part of the creation of a national information technology platform and the start-up of a new third-party owned and operated general merchandise warehouse and distribution centre for eastern Canada which handles general merchandise and certain drugstore products, primarily health and beauty care products. These challenges disrupted the flow of inventory to the Company's stores and caused the Company to incur additional operating costs and reduced overall sales as product availability impacted consumers at the store level.

During 2006, the Company continued to feel the effects from these changes. However, progress continued to be made in reducing the impact of the supply chain disruptions as follows:

- the third-party owned and operated general merchandise warehouse and distribution centre for eastern Canada posted slight productivity improvements and achieved improved service levels;
- six additional systems conversions were completed during the year with minimal disruption to continuing operations as part of the move to a national systems platform;
- food service levels continued at expected levels during 2006 and service levels for drugstore improved; and
- service levels for general merchandise showed signs of stability and improvement, and while slower than anticipated, progress has been made.

## 5.1 Results of Operations

### Sales and Sales Growth Excluding the Impact of VIEs<sup>(1)</sup>

(\$ millions except where otherwise indicated)	2006 (52 weeks)	2005 <sup>(2)</sup> (52 weeks)
Total sales	<b>\$ 28,640</b>	\$ 27,627
Less: Sales attributable to the consolidation of VIEs	<b>383</b>	415
Sales excluding the impact of VIEs <sup>(1)</sup>	<b>\$ 28,257</b>	\$ 27,212
Total sales growth	<b>3.7%</b>	6.1%
Less: Impact on sales growth attributable to the consolidation of VIEs	<b>(.1%)</b>	1.6%
Sales growth excluding the impact of VIEs <sup>(1)</sup>	<b>3.8%</b>	4.5%

(1) See Non-GAAP Financial Measures on page 40.

(2) During 2006, the Company implemented Emerging Issues Committee Abstract 156, "Accounting by a Vendor for Consideration Given to a Customer (Including a Reseller of the Vendor's Products)" on a retroactive basis. Accordingly certain sales incentives paid to independent franchisees, associates and independent accounts for the prior years have been reclassified between sales and cost of sales, selling and administrative expenses. For a further discussion, see the Accounting Standards Implemented in 2006 section included in this MD&A.

### Sales

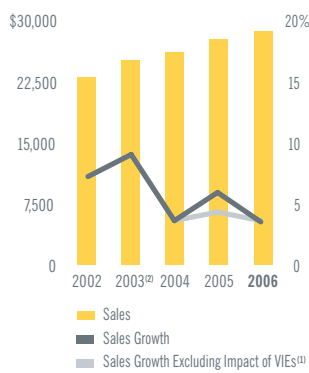
Full year sales in 2006 increased 3.7% to \$28.6 billion from \$27.6 billion last year, including a decrease of 0.1% or \$32 million in sales relating to the consolidation of certain independent franchisees as required by AcG 15. In 2006, sales excluding the impact of VIEs<sup>(1)</sup>, increased by \$1 billion or 3.8% over last year.

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

- food, general merchandise and drugstore sales posted gains over the prior year across all regions of the country;
- significant sales growth from the *Real Canadian Superstore* program in Ontario;
- same-store sales growth of approximately 0.8% compared to 0.2% in 2005;
- a decline in tobacco sales negatively impacted sales and same-store sales by approximately 1.2%;

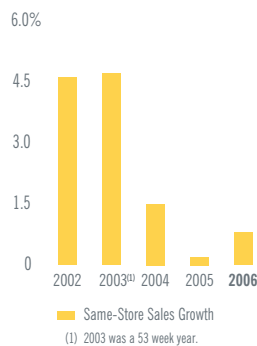
**Sales and Sales Growth**

(\$ millions)



(1) See Non-GAAP Financial Measures on page 40.  
(2) 2003 was a 53 week year.

**Same-Store Sales Growth**



(1) 2003 was a 53 week year.

- national food price inflation as measured by “The Consumer Price Index for Food Purchased from Stores” (“CPI”) was approximately 2.3% for the year compared to approximately 2.0% for 2005, with variances by region; the Company’s calculation of food price inflation, which considers Company-specific product mix and pricing strategy, was reasonably consistent with that of CPI;
- an increase in net retail square footage of 1.2 million square feet or 2.5% due to the net effect of the opening of 37 new corporate and franchised stores and the closure of 33 stores inclusive of stores which underwent conversions and major expansions;
- sales per corporate store increased to \$33 million in 2006 from \$32 million in 2005 reflecting the introduction of larger stores which are expected to become ultimately more productive; and
- sales per average square foot of corporate stores of \$585 in 2006 increased from \$579 in 2005 as a result of an increase in sales which outpaced the increase in net retail square footage.

Sales of control label products for 2006 amounted to \$6.2 billion compared to \$5.9 billion in 2005. Control label penetration, which is measured as control label retail sales as a percentage of total retail sales, was 22.9% for 2006, compared to 22.4% for 2005.

The Company introduced over 2,000 new control label products in 2006, including 1,400 new general merchandise products.

The Company’s control label program, which includes *President’s Choice*, *PC*, *President’s Choice Organics*, *President’s Choice Blue Menu*, *President’s Choice Mini Chefs*, *no name*, *Joe Fresh Style*, *Club Pack*, *President’s Choice GREEN*, *EXACT*, *Teddy’s Choice* and *Life@Home*, provides additional sales growth potential.

Loblaws expects that the following initiatives, coupled with continued focus on value-for-money, promotions and advertising where appropriate, will generate continued sales growth over the next few years:

- focus on on-shelf availability of product through an enhancement of customer focus and supply chain, and stronger store processes;
- restoring innovation as a competitive advantage both for control label products as well as unique environments in each retail format;
- refining three distinctive retail formats: Superstore, Great Food and Hard Discount, and making the *Real Canadian Superstore* the key platform for growth;
- increasing the number of stores carrying the *Joe Fresh Style* apparel offering;
- emphasizing a fresh first focus by raising presentation and quality standards; and
- training of employees to ensure they are focused on meeting customer needs.

Operating Income, Adjusted Operating Income<sup>(1)</sup>, Adjusted EBITDA<sup>(1)</sup> and Margins<sup>(1)</sup>

(\$ millions except where otherwise indicated)	2006 (52 weeks)	2005 (52 weeks)	Change
Operating income	\$ 289	\$ 1,401	(79%)
Adjusted operating income <sup>(1)</sup>	\$ 1,326	\$ 1,600	(17%)
Adjusted EBITDA <sup>(1)</sup>	\$ 1,892	\$ 2,132	(11%)
Operating margin	1.0%	5.1%	
Adjusted operating margin <sup>(1)</sup>	4.7%	5.9%	
Adjusted EBITDA margin <sup>(1)</sup>	6.7%	7.8%	

(1) See Non-GAAP Financial Measures on page 40.

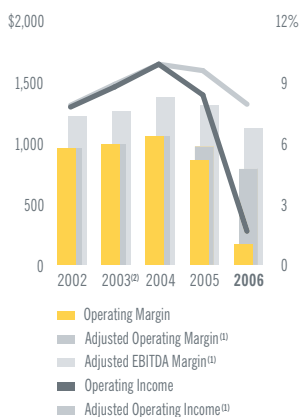
### Operating Income

Operating income for 2006 decreased \$1.1 billion, or 79%, to \$289 million resulting in a decline in operating margin to 1.0% in 2006 from 5.1% in 2005. Operating income in both 2006 and 2005 was adversely affected by a number of specific items as outlined below:

- A non-cash goodwill impairment charge of \$800 million related to the goodwill established on the acquisition of Provigo Inc. in 1998 was recorded in 2006. The determination that the fair value of goodwill was less than its carrying value resulted from a decline in market multiples, both from an industry and Company perspective, and a reduction of fair value as determined using the discounted cash flow methodology, incorporating both current Company and market assumptions, which in combination resulted in the goodwill impairment. This non-cash goodwill impairment charge recorded in 2006 is expected to be adjusted if necessary in the first half of 2007. The Company expects no income tax deduction from this charge. A further discussion regarding the non-cash goodwill impairment charge can be found in the Critical Accounting Estimates section of this MD&A.
- During 2006, members of certain Ontario locals of the UFCW ratified a new four-year collective agreement which enables the Company to convert 44 stores in Ontario to the *Real Canadian Superstore* banner or food stores with equivalent labour economics, and the flexibility to invest in additional store labour where appropriate. As a result of securing this agreement, the Company recognized a one-time charge of \$84 million in 2006, including a \$36 million amount due to a multi-employer pension plan and a payment of \$38 million which was due upon ratification. The Company expects this agreement to generate future economic benefits and to provide increased operating efficiencies, on a store by store basis, in a critical era of intensifying competition.
- As part of management's review of inventory levels, certain excess inventory, primarily general merchandise, was identified. Management's decision to proceed with the liquidation of this inventory resulted in a \$68 million charge in 2006 reflecting the write-down of inventory to expected net recoverable values net of the associated costs of facilitating the disposition incurred to date. In addition, higher than normal mark downs in the range of \$15 million to \$20 million were taken in order to clear some of this excess inventory through stores particularly in the last quarter of the year.
- A \$12 million charge relating to the departure of John A. Lederer from the position of President and Director of the Company was recorded in 2006. An additional \$10 million was paid pursuant to various incentive plans, the majority of which was previously accrued.
- A charge of \$37 million (2005 – \$43 million) was recorded in 2006 for the net effect of stock-based compensation and the associated equity forwards.
- Income of \$8 million (2005 – nil) from the consolidation of VIEs was recognized in 2006.

**Operating Income and Margins**

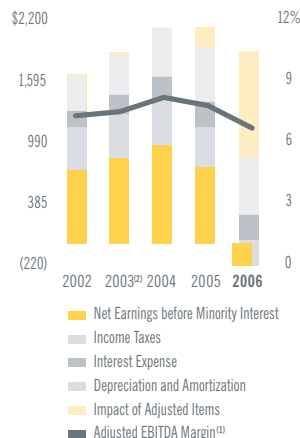
(\$ millions)



(1) See Non-GAAP Financial Measures on page 40.  
(2) 2003 was a 53 week year.

**Analysis of Adjusted EBITDA and Margin<sup>(1)</sup>**

(\$ millions)



(1) See Non-GAAP Financial Measures on page 40.  
(2) 2003 was a 53 week year.

Included in restructuring and other charges of \$44 million (2005 – \$86 million) within operating income were the following:

- As part of its assessment of store operations, management of the Company approved and communicated a plan in 2006 to close 19 underperforming Quebec stores, mainly within the *Provigo* banner, and 8 stores in the Atlantic region. This resulted in a charge in 2006 of \$29 million for fixed asset impairment and other costs arising from these store closures and employee termination costs. In addition, as a result of the loss of tobacco sales following the decision by a major tobacco supplier to sell directly to certain customers of the Company, a review of the impact on the Cash & Carry and wholesale club network was undertaken. In 2006, management approved and communicated a formal plan to close 24 wholesale outlets which were impacted most significantly by this change. This initiative resulted in a charge of \$6 million in 2006 for fixed asset impairment and other costs arising from these closures and employee termination costs. These closures are expected to be completed during 2007.
- A charge of \$8 million (2005 – \$62 million) was recorded in 2006 relating to the plan approved in 2005 concerning the restructuring of the supply chain operations, including the closure of six distribution centres and the relocation of certain activities to new distribution centres.
- A charge of \$1 million (2005 – \$24 million) related to the reorganization of the merchandising, procurement and operations groups, the establishment of a National Head Office and Store Support Centre and the relocation of the general merchandise operations from Calgary, Alberta to Brampton, Ontario, was recorded in 2006, all of which were approved in 2005.

A summary of restructuring and other charges is included in the table below:

(\$ millions)	Costs Recognized 2006 (52 weeks)	Costs Recognized 2005 (52 weeks)	Total Expected Costs	Total Expected Costs Remaining
Store operations	\$ 35	\$ —	\$ 54	\$ 19
Supply chain network	8	62	90	20
Office move and reorganization of the operation support functions	1	24	25	—
<b>Total restructuring and other charges</b>	<b>\$ 44</b>	<b>\$ 86</b>	<b>\$ 169</b>	<b>\$ 39</b>

Details regarding the nature of the above charges are described in Note 4 to the consolidated financial statements.

Additional items specific to 2005 included in operating income in that year are:

- A charge of \$40 million related to potential liabilities for GST and PST which was not appropriately charged and remitted; and
- Approximately \$30 million of direct costs associated with the supply chain disruptions experienced during the last two quarters of 2005.

After adjusting for the above noted items, adjusted operating income<sup>(1)</sup> was \$1.3 billion in 2006 compared to \$1.6 billion in 2005.

Adjusted operating margin<sup>(1)</sup> was 4.7% in 2006 compared to 5.9% in 2005. Adjusted EBITDA margin<sup>(1)</sup> decreased to 6.7% from 7.8% in 2005. The \$274 million decline in adjusted operating income<sup>(1)</sup> and the significant decline in adjusted operating margin<sup>(1)</sup> for 2006 over 2005 was due to a variety of factors as discussed below.

Early in 2006, operating income was adversely impacted by the effects of product supply issues, resulting from the implementation challenges arising from the 2005 conversions, and delays in program activities resulted in foregone sales and lost cost leverage on fixed components of operating and administrative expenses. The Company's supply chain performance in the areas of general merchandise and drugstore was not at acceptable levels. Therefore, management early in the year was focused on improving service levels and ensuring product availability at the store level to support merchandising programs. By the end of 2006, the supply chain had stabilized and delivered improved service levels.

(1) See Non-GAAP Financial Measures on page 40.

Throughout 2006, the continued investments in lower food prices to drive sales growth had a negative impact on operating income. Aggregate gross margin percentage softened as a result of this pricing investment, higher general merchandise mark downs, primarily in the fourth quarter, and higher inventory shrink, partially offset by improvements in buying synergies and improved mix of food, general merchandise and drugstore. Higher information technology investments in addition to store and distribution centre operational costs, principally labour, were incurred in order to stabilize the flow of product to the stores. Short term costs of additional third-party locations for storage of inventory were also absorbed.

A fixed asset impairment charge of \$27 million was recorded in 2006 due in part to a decision to suspend plans for a number of sites scheduled for future development.

As mentioned previously, the new management team is refocusing the business through three principles: Simplify, Innovate, Grow, and has developed a Formula for Growth as a framework for a three year renewal plan. Business priorities for 2007 to return the Company to higher profitability include the following:

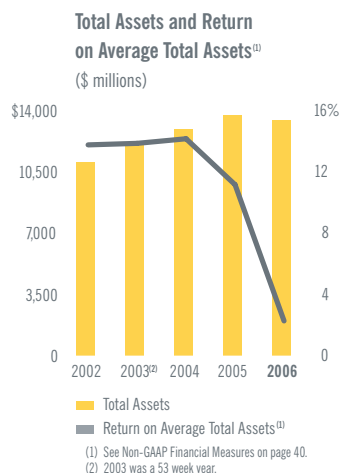
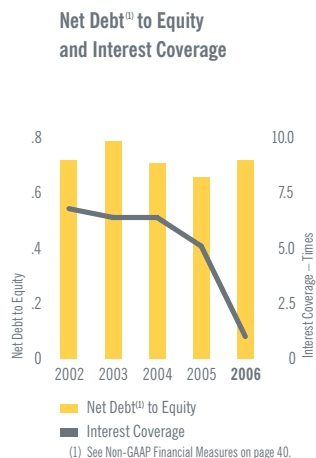
- simplifying the organization by more clearly defining accountabilities, eliminating duplication and establishing consistent, simple and efficient processes;
- restoring innovation as a competitive advantage; and
- focusing on retailing basics in the areas of store operations, supply chain and information technology including on-shelf availability and major investments in price to obtain maximum Credit For Value.

Early in 2007, the Company approved and announced the restructuring of its merchandising and store operations into more streamlined functions. Costs of this restructuring including severance, retention and other costs are expected to be in the range of \$150 million to \$200 million, the substantial portion to be recorded in the first half of 2007. The Company is also assessing the loss of drugstore-related operating income in 2007 arising from recently enacted legislative changes late in 2006 by the Ontario government, as more fully explained in the Operating Risks and Risk Management section of this MD&A.

### Interest Expense

Interest expense consists primarily of interest on short and long term debt, the amortization of deferred financing costs, interest on financial derivative instruments net of interest income earned on short term investments and interest capitalized to fixed assets. In 2006, total interest expense increased \$7 million, or 2.8%, to \$259 million from \$252 million in 2005.

Interest on long term debt was \$284 million compared to \$290 million in 2005. The 2006 weighted average fixed interest rate on long term debt (excluding capital lease obligations) was 6.7% (2005 – 6.7%) and the weighted average term to maturity was 17 years (2005 – 17 years).





Interest on financial derivative instruments includes the net effect of the Company's interest rate swaps, cross currency basis swaps and equity forwards, and amounted to a charge of \$7 million in 2006 (2005 – income of \$6 million). The change in interest on financial derivative instruments was due mainly to an increase in Canadian short term interest rates. Net short term interest income in 2006 was consistent with last year's level at \$11 million.

During 2006, \$21 million (2005 – \$21 million) of interest incurred on debt related to real estate properties under development was capitalized to fixed assets.

#### Analysis of Long Term Financing Costs

(\$ millions except where otherwise indicated)	2006 (52 weeks)	2005 (52 weeks)
Total long term debt at year end (including portion due within one year)	\$ 4,239	\$ 4,355
Interest on long term debt	\$ 284	\$ 290
Weighted average fixed interest rate on long term debt (excluding capital lease obligations)	6.7%	6.7%

#### Income Taxes

The Company's 2006 effective income tax rate increased to 826.7% from 34.8% in 2005. The increase was mainly the result of the non-deductible goodwill impairment charge, which accounted for 796.8% of the change over last year. The effective income tax rate before the impact of the non-deductible goodwill impairment charge as calculated in Note 8 to the consolidated financial statements decreased to 29.9% in 2006 mainly as a result of:

- a change in the proportion of taxable income earned across different tax jurisdictions; and
- a \$16 million reduction to the future income tax expense recognized as a result of the reduction in the Canadian federal and certain provincial statutory income tax rates, the cumulative effect of which was included in the consolidated financial statements at the time of substantive enactment.

#### Net Earnings

In 2006, net earnings decreased \$965 million to a net loss of \$219 million from net earnings of \$746 million in 2005 and basic net earnings per common share decreased \$3.52 to a basic net loss per common share of 80 cents from basic net earnings per common share of \$2.72 in 2005 due to the factors described in the preceding sections.

## 5.2 Financial Condition

#### Financial Ratios

The net debt<sup>(1)</sup> to equity ratio continued to be within the Company's internal guideline of less than 1:1. The 2006 net debt<sup>(1)</sup> to equity ratio was .72:1 compared to the 2005 ratio of .66:1. The non-cash goodwill impairment charge negatively impacted the net debt<sup>(1)</sup> to equity ratio by .10:1 as a result of an \$800 million reduction to equity.

Cash flows from operating activities cover a large portion of the Company's funding requirements and in 2006 exceeded the capital investment program. In 2006, funding requirements resulted primarily from the capital investment program and dividends paid on the Company's common shares.

(1) See Non-GAAP Financial Measures on page 40.

## Management's Discussion and Analysis

In 2006, shareholders' equity decreased \$445 million, or 7.6%, to \$5.4 billion. The significant decline in operating income resulted in an interest coverage ratio of 1.0 times in 2006 compared to 5.1 times in 2005. The goodwill impairment charge is a significant non-cash item in operating income, which adversely impacted the interest coverage ratio by approximately 3.1 times.

At year end, the working capital position increased over the prior year. The 2006 return on average total assets<sup>(1)</sup> was 2.3% compared to 11.2% in 2005. The 2006 return on average shareholders' equity was (3.9)% compared to the 2005 return of 13.2%. Both 2006 returns were negatively impacted by the incremental costs and charges incurred in 2006 as outlined previously. The five year average return on shareholders' equity was 12.5% (2005 – 17.3%).

### Common Share Dividends

The declaration and payment of dividends are at the discretion of the Board. The Company's dividend policy is to maintain a dividend payment equal to approximately 20% to 25% of the prior year's adjusted basic net earnings per common share<sup>(1)</sup>, giving consideration to the year end cash position, future cash flow requirements and investment opportunities. Currently, there is no restriction that would prevent the Company from paying dividends at historical levels. The Company intends to maintain the current dividend level in 2007 putting annualized dividends above the historical range. During 2006, the Board declared quarterly dividends of 21 cents per common share. The annualized dividend per common share of 84 cents is equal to 25.1% of the 2005 adjusted basic net earnings per common share<sup>(1)</sup>, which is consistent with the Company's dividend policy. Subsequent to year end, the Board declared a quarterly dividend of 21 cents per common share, payable April 1, 2007.

### Outstanding Share Capital

The Company's outstanding share capital is comprised of common shares. An unlimited number of common shares is authorized and 274,173,564 common shares were issued and outstanding at year end. Further information on the Company's outstanding share capital is provided in Note 18 to the consolidated financial statements.

At year end, a total of 4,084,646 stock options were outstanding and represented 1.5% of the Company's issued and outstanding common shares, which was within the Company's guideline of 5%. Further information on the Company's stock-based compensation is provided in Note 19 to the consolidated financial statements.

## 6. Liquidity and Capital Resources

### 6.1 Cash Flows

#### Major Cash Flow Components

(\$ millions)	2006 (52 weeks)	2005 (52 weeks)	Change
Cash flows from (used in):			
Operating activities	\$ 1,180	\$ 1,489	\$ (309)
Investing activities	\$ (1,308)	\$ (903)	\$ (405)
Financing activities	\$ (120)	\$ (208)	\$ 88

### Cash Flows from Operating Activities

2006 cash flows from operating activities decreased to \$1.2 billion compared to \$1.5 billion in 2005. The change in cash flows from operating activities for the year is mainly due to the decrease in operating income.

### Cash Flows used in Investing Activities

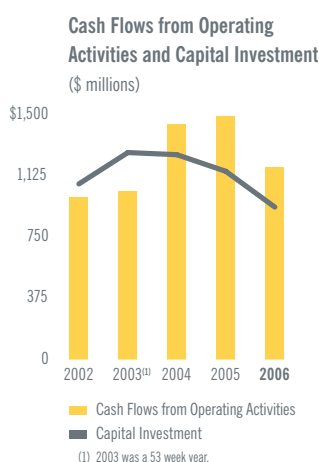
2006 cash flows used in investing activities were \$1.3 billion compared to \$0.9 billion in 2005. During 2005, proceeds were received from the sale of a portfolio of third-party long term loans receivable as described in the Related Party Transactions section of this MD&A. In addition, capital expenditures declined \$219 million and the longer term to maturity profile of the Company's short term investments portfolio resulted in a shift to short term investments from cash and cash equivalents.

Capital investment amounted to \$0.9 billion (2005 – \$1.2 billion) for the year as the Company continued to maintain and renew its asset base and invest for growth. Approximately 79% (2005 – 82%) of the capital investment was for new stores, renovations or expansions. The continued capital investment activity benefited all regions in varying degrees and strengthened the existing store base. Some of the new, larger stores replaced older, smaller, less efficient stores that did not offer the broad range of products and services demanded by today's consumer. The remaining 21% (2005 – 18%) of the capital investment was for the warehouse and distribution network, information systems and other infrastructure required to support store growth. Levels of capital investment in 2007 are expected to be lower than in previous years as a result of the Company's desire to fully prove store format economics before building new stores.

The 2006 corporate and franchised store capital investment program, which includes the impact of store openings and closures, resulted in an increase in net retail square footage of 2.5% over 2005. During 2006, 37 (2005 – 69) new corporate and franchised stores were opened and 147 (2005 – 77) underwent renovation or minor expansion. The 37 new stores, net of 33 (2005 – 57) store closures, added 1.2 million square feet of retail space (2005 – 2.8 million). The 2006 average corporate store size increased 2.3% to 57,400 square feet (2005 – 56,100) and the average franchised store size increased 1.1% to 27,400 square feet (2005 – 27,100).

At year end 2006, the Company had committed approximately \$153 million (2005 – \$264 million) with respect to capital investment projects such as the construction, expansion and renovation of buildings and the purchase of real property.

During 2006, the Company also generated \$99 million (2005 – \$109 million) from fixed asset sales.



## Management's Discussion and Analysis

### Capital Investment and Store Activity

	2006 (52 weeks)	2005 (52 weeks)	Change
Capital investment (\$ millions)	\$ 937	\$ 1,156	\$ (219)
Retail square footage (in millions)	49.7	48.5	2.5%
Average store size (sq. ft.)			
Corporate	57,400	56,100	2.3%
Franchised	27,400	27,100	1.1%

### Cash Flows used in Financing Activities

Cash flows used in financing activities decreased to \$120 million in 2006 compared to \$208 million in 2005 mainly due to the 2006 fourth quarter dividend payment occurring after year end.

During the second quarter of 2006, the Company repaid its \$125 million of 8.70% Series 1996 Provigo Inc. Debenture as it matured.

During 2005, the Company's 2003 Base Shelf Prospectus expired and a new Base Shelf Prospectus was filed allowing for the issue of up to \$1.0 billion of aggregate Medium Term Notes ("MTN"), all of which remains available.

The Company intends to renew its Normal Course Issuer Bid ("NCIB") to purchase on the Toronto Stock Exchange or enter into equity derivatives to purchase up to 5% of its common shares outstanding. No shares were purchased for cancellation in 2006 under the NCIB (2005 – 226,100).

### 6.2 Sources of Liquidity

The Company can obtain its short term financing through a combination of cash generated from operating activities, cash, cash equivalents, short term investments, bank indebtedness and its commercial paper program. The Company's cash, cash equivalents and short term investments, as well as \$845 million in uncommitted operating lines of credit extended by several banks, support its \$1.2 billion commercial paper program. The Company's commercial paper borrowings generally mature less than three months from the date of issuance although the terms can be up to 364 days.

Securitization of credit card receivables provides *President's Choice Bank* ("PC Bank"), a wholly owned subsidiary of the Company, with an additional source of funds for the operation of its business. Under PC Bank's securitization program, a portion of the total interest in the credit card receivables is sold to independent trusts. In 2006, PC Bank restructured its credit card securitization program and Eagle Credit Card Trust ("Eagle"), a previously established independent trust, issued \$500 million of five year senior notes and subordinated notes due 2011 at a weighted average rate of 4.5%. The restructuring of the portfolio yielded a nominal net loss. PC Bank securitized an aggregate \$240 million of credit card receivables during 2006 (2005 – \$225 million). Information on PC Bank's credit card receivables and securitization is provided in Notes 1 and 11 to the consolidated financial statements and in the Off-Balance Sheet Arrangements section of this MD&A.

The Company obtains its long term financing through its MTN program. The Company plans to refinance existing long term debt as it matures.

In the normal course of business, the Company establishes standby letters of credit used in connection with certain obligations related to the financing program for its independent franchisees, securitization of *PC Bank's* credit card receivables, real estate transactions and benefit programs. At year end, the aggregate gross potential liability related to the Company's standby letters of credit was approximately \$333 million (2005 – \$276 million) against which the Company had \$371 million (2005 – \$316 million) in credit facilities available to draw on.

It is the intention of the Company to enter into a committed credit facility expected to be extended by several banks in the amount of \$500 million for general corporate purposes and to support the Company's commercial paper program.

The Company has the following sources from which it can fund its 2007 cash requirements:

- cash flows generated from operating activities;
- cash, cash equivalents, and short term investments;
- commercial paper program;
- MTN program; and
- additional credit card receivable securitizations from future growth in the *PC Bank* credit card operations.

During the third quarter of 2006, the Company's MTN and debentures were downgraded by Dominion Bond Rating Service ("DBRS") to "A" from "A (high)" and the commercial paper rating was confirmed at "R-1 (low)". In both cases, the trend was changed to "stable" from "negative". During the fourth quarter of 2006, the Company's long term corporate credit and commercial paper ratings were downgraded by Standard & Poor's ("S&P") to "A-" from "A" and to "A-1 (low)" from "A-1 (mid)", respectively. The Company was removed from CreditWatch with negative implications and the outlook was changed to "stable".

Subsequent to year end, DBRS placed the Company's MTN and debentures Under Review with Negative Implications and at the same time, confirmed the Company's commercial paper rating at its current level with a "stable" trend; and S&P placed the Company's long term corporate credit and commercial paper ratings on CreditWatch with negative implications. Although a further rating decline will increase borrowing costs, the Company anticipates no difficulty in obtaining external financing based on past experience and the expectation of stable market conditions.

The Company's current credit ratings are outlined in the table below:

Credit Ratings (Canadian Standards)

	Dominion Bond Rating Service	Standard & Poor's
Commercial paper	R-1 (low)	A-1 (low)
Medium term notes	A	A-
Other notes and debentures	A	A-

The rating organizations listed above base their credit ratings on quantitative and qualitative considerations. These credit ratings are intended to give an indication of the risk that the Company will not fulfill its obligations in a timely manner.

### 6.3 Contractual Obligations

The following illustrates certain of the Company's significant contractual obligations and discusses other obligations as at December 30, 2006:

#### Summary of Contractual Obligations

(\$ millions)	Payments due by year						Total
	2007	2008	2009	2010	2011	Thereafter	
Long term debt (including capital lease obligations)	\$ 27	\$ 420	\$ 148	\$ 319	\$ 369	\$ 2,956	\$ 4,239
Operating leases <sup>(1)</sup>	190	178	156	134	114	720	1,492
Contracts for purchases of real property and capital investment projects <sup>(2)</sup>	145	4	4				153
Purchase obligations <sup>(3)</sup>	735	660	562	562	561	358	3,438
<b>Total contractual obligations</b>	<b>\$ 1,097</b>	<b>\$ 1,262</b>	<b>\$ 870</b>	<b>\$ 1,015</b>	<b>\$ 1,044</b>	<b>\$ 4,034</b>	<b>\$ 9,322</b>

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

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

(3) These include material contractual obligations to purchase goods or services where the contract prescribes fixed or minimum volumes to be purchased or payments to be made within a fixed period of time for a set or variable price. These are estimates of anticipated financial commitments and the amount of actual payments may vary. The purchase obligations do not include purchase orders issued in the ordinary course of business for goods which are meant for resale, nor do they include any contracts which may be terminated on relatively short notice or with insignificant cost or liability to the Company. Also excluded are purchase obligations related to commodities or commodity-like goods for which a market for resale exists. The Company believes such excluded contracts do not have a material impact on its liquidity.

At year end, the Company had other long term liabilities which included accrued benefit plan liability, future income taxes liability and stock-based compensation liability. These long term liabilities have not been included in the table for the following reasons:

- future payments of accrued benefit plan liability, principally post-retirement benefits, depend on when and if retirees submit claims;
- future payments of income taxes depend on the levels of taxable earnings and income tax rates;
- future payments of the share appreciation value on employee stock options depend on whether employees exercise their stock options, the market price of the Company's common shares on the exercise date and the manner in which they exercise those stock options; and
- future payments of restricted share units depend on the market price of the Company's common shares.

### 6.4 Off-Balance Sheet Arrangements

In the normal course of business, the Company enters into the following off-balance sheet arrangements:

- standby letters of credit used in connection with certain obligations mainly related to real estate transactions, and benefit programs, the aggregate gross potential liability of which is approximately \$221 million (2005 – \$143 million);
- guarantees;
- the securitization of a portion of PC Bank's credit card receivables through independent trusts;
- a standby letter of credit to an independent funding trust which provides loans to the Company's independent franchisees for their purchase of inventory and fixed assets; and
- financial derivative instruments in the form of interest rate swaps.



## Guarantees

The Company has entered into various guarantee agreements including standby letters of credit in relation to the securitization of *PC Bank's* credit card receivables and in relation to third-party financing made available to the Company's independent franchisees and obligations to indemnify third parties in connection with leases, business dispositions and other transactions in the normal course of the Company's business. For a detailed description of the Company's guarantees, see Note 21 to the consolidated financial statements.

## Securitization of Credit Card Receivables

The Company, through its wholly owned subsidiary *PC Bank*, securitizes credit card receivables through an independent trust administered by a major Canadian chartered bank and through Eagle, also an independent trust. In these securitizations, *PC Bank* sells a portion of its credit card receivables to the trusts in exchange for cash. The trusts fund these purchases by issuing debt securities in the form of asset-backed commercial paper ("ABCP") and asset-backed term notes respectively, to third-party investors. The securitizations are accounted for as asset sales only when *PC Bank* transfers control of the transferred assets and receives consideration other than beneficial interests in the transferred assets. All transactions between the trusts and *PC Bank* have been, and are expected to continue to be, accounted for as sales as contemplated by Canadian GAAP, specifically Accounting Guideline ("AcG") 12, "*Transfers of Receivables*". As *PC Bank* does not control or exercise any measure of influence over the trusts, the financial results of the trusts have not been included in the Company's consolidated financial statements.

When *PC Bank* sells credit card receivables to the trusts, it no longer has access to the receivables but continues to maintain credit card customer account relationships and servicing obligations. *PC Bank* does not receive a servicing fee from the trusts for its servicing obligations and accordingly, a servicing obligation is recorded. When a sale occurs, *PC Bank* retains rights to future cash flows after obligations to the investors in the trusts have been met, which is considered to be a retained interest. The ABCP issuing trust's recourse to *PC Bank's* assets is limited to *PC Bank's* retained interests and is further supported through a standby letter of credit provided by a major Canadian chartered bank for 9% (2005 – 9%) of the securitized amount. This standby letter of credit could be drawn upon in the event of a major decline in the income flow from or in the value of the securitized credit card receivables. The Company has agreed to reimburse the issuing bank for any amount drawn on the standby letter of credit. The Company believes that the likelihood of this occurrence is remote. The subordinated notes issued by Eagle provide credit support to those notes which are more senior. The carrying value of the retained interests is periodically reviewed and when a decline in value is identified that is other than temporary, the carrying value is written down to fair value.

As at December 30, 2006, the total amount of securitized credit card receivables outstanding which *PC Bank* continues to service was \$1.25 billion (2005 – \$1.01 billion) and the associated retained interests amounted to \$5 million (2005 – \$5 million). The standby letter of credit supporting a portion of these securitized receivables amounted to approximately \$68 million (2005 – \$91 million). During 2006, *PC Bank* received income of \$116 million (2005 – \$106 million) in securitization revenue from the independent trusts relating to the securitized credit card receivables. In the absence of securitization, the Company would be required to raise alternative financing by issuing debt or equity instruments. Further disclosure regarding this arrangement is provided in Notes 11 and 21 to the consolidated financial statements.

## Independent Funding Trust

Independent franchisees of the Company may obtain financing through a structure involving independent trusts which were created to provide loans to the independent franchisees to facilitate their purchase of inventory and fixed assets, consisting mainly of fixturing and equipment. These trusts are administered by a major Canadian chartered bank. The independent funding trust within the structure finances its activities through the issuance of ABCP to third-party investors. The total amount of loans issued to the Company's independent franchisees outstanding as of December 30, 2006 was \$419 million (2005 – \$420 million) including \$124 million (2005 – \$126 million) of loans payable of VIEs consolidated by the Company in 2006. Based on a formula, the Company has agreed to provide credit enhancement in the form of a standby letter of credit for the benefit of the independent funding trust equal to approximately 10% of the principal amount of the loans outstanding at any point in time, \$44 million (2005 – \$42 million) as of December 30, 2006. This credit enhancement allows the independent funding trust to provide favourable financing terms to the Company's independent franchisees. In the event that

## Management's Discussion and Analysis

an independent franchisee defaults on its loan and the Company has not, within a specified time period, assumed the loan or the default is not otherwise remedied, the independent funding trust may assign the loan to the Company and draw upon this standby letter of credit. The Company has agreed to reimburse the issuing bank for any amount drawn on the standby letter of credit. No amount has ever been drawn on the standby letter of credit. The Company believes it would be able to fully recover from the independent franchisee any amounts it had reimbursed to the issuing bank. Neither the independent funding trust nor the Company can voluntarily terminate the agreement prior to December 2009, and following that date only upon six months' prior notice. Automatic termination of the agreement can only occur if specific, predetermined events occur and are not remedied within the time periods required including a credit rating downgrade of the Company below a long term credit rating of A (low) issued by DBRS. If the arrangement is terminated, the independent franchisees would be required to replace the loans provided by the independent funding trust with alternative financing. The Company is under no contractual obligation to provide funding to independent franchisees under such circumstances. In accordance with Canadian GAAP, the financial statements of the independent funding trust are not consolidated with those of the Company.

### Financial Derivative Instruments

The Company uses off-balance sheet financial derivative instruments to manage its exposure to changes in interest rates. For a detailed description of the Company's off-balance sheet financial derivative instruments and the related accounting policies, see Notes 1 and 20 to the consolidated financial statements.

## 7. Selected Consolidated Annual Information

The following is a summary of selected consolidated annual information extracted from the Company's audited consolidated financial statements. This information was prepared in accordance with Canadian GAAP and is reported in Canadian dollars. The analysis of the data contained in the table focuses on the trends affecting the financial condition and results of operations over the latest two year period.

### Selected Consolidated Annual Information

(\$ millions except where otherwise indicated)	2006 (52 weeks)	2005 <sup>(2)</sup> (52 weeks)	2004 <sup>(2)</sup> (52 weeks)
Sales	<b>\$ 28,640</b>	\$ 27,627	\$ 26,030
Sales excluding the impact of VIEs <sup>(1)</sup>	<b>28,257</b>	27,212	26,030
Net (loss) earnings	<b>(219)</b>	746	968
Net (loss) earnings per common share (\$)			
Basic	<b>(.80)</b>	2.72	3.53
Adjusted basic <sup>(1)</sup>	<b>2.72</b>	3.35	3.48
Diluted	<b>(.80)</b>	2.71	3.51
Total assets	<b>13,486</b>	13,761	12,949
Long term debt (excluding amount due within one year)	<b>4,212</b>	4,194	3,935
Dividends declared per common share (\$)	<b>.84</b>	.84	.76

(1) See Non-GAAP financial measures on page 40.

(2) During 2006, the Company implemented Emerging Issues Committee Abstract 156, "Accounting by a Vendor for Consideration Given to a Customer (Including a Reseller of the Vendor's Products)" on a retroactive basis. Accordingly certain sales incentives paid to independent franchisees, associates and independent accounts for the prior years have been reclassified between sales and cost of sales, selling and administrative expenses. For a further discussion, see the Accounting Standards Implemented in 2006 section included in this MD&A.

The Company has been undergoing a significant amount of change over the past two years. As discussed previously, a number of significant changes in the operations of the Company occurred in 2006, including the change in senior leadership. The new management team commenced a review of the Company in the latter half of 2006 which focused on key drivers of the business such as fresh food presentation, the value propositions of the Company's banners, maximizing employee engagement, the performance of retailing basics and customer satisfaction. The Company also continued to feel the effects in 2006 of certain of its 2005 initiatives which included restructuring of the supply chain operations, supply chain systems conversions which were initiated as part of the creation of a national information technology platform, the reorganization of its merchandising, procurement and operations groups and the move of personnel to the Store Support Centre in Brampton, Ontario.

Sales in 2006 increased 3.7% to \$28.6 billion from \$27.6 billion in 2005. Excluding the impact of VIEs, sales were \$28.3 billion or 3.8% higher than 2005. Same-store sales increased 0.8% in 2006 and 0.2% in 2005. National food price inflation as measured by CPI was approximately 2.3% for 2006 compared to approximately 2.0% for 2005. The Company's calculation of food price inflation, which considers Company-specific product mix and pricing strategy, was reasonably consistent with that of CPI. Sales and same-store sales in 2006 were adversely impacted by a decrease in tobacco sales caused by a general market decline and the loss of tobacco sales through its wholesale club network due to the decision of a major tobacco supplier to sell directly to certain customers of the Company. In 2005, and to a lesser extent 2006, sales and same-store sales were also adversely impacted as the flow of inventory to the Company's stores was disrupted by the effects of systems conversions and the start-up of a third-party warehouse.

Sales were also influenced by a number of other factors, including changes in net retail square footage, expansion into new services and/or departments and the activities of competitors. Over the past two years, an average of \$1.0 billion annually in capital was invested, resulting in an increase in net retail square footage of approximately 4.0 million square feet or 8.8%.

Corporate store sales per average square foot decreased from \$592 in 2004 to \$585 in 2006.

The amount of new net retail square footage and the timing of the store openings and closures within any given year may vary. The increase in weighted average net retail square footage was 4.5% in 2006 and 7.5% in 2005.

In pursuit of improving its value proposition, Loblaw has invested in pricing in specific markets by adopting everyday low pricing strategies. Consistent with its strategy of focusing on food but serving the consumer's everyday household needs, the Company has expanded its general merchandise and drugstore offerings over this period and the retail sales growth realized in those categories continued to surpass retail sales growth of food. Competitor activity varied by market. During the past two years, unprecedented levels of retail square footage, mainly associated with food offerings, have been introduced into certain markets, resulting in pressure on prices and customer retention.

Full year 2006 net earnings decreased \$965 million to a net loss of \$219 million and basic net earnings per common share decreased \$3.52 to a basic net loss per common share of 80 cents. This decline included a decrease of 79.4% in operating income and a 2.8% increase in interest expense. The effective income tax rate increased to 826.7% in 2006 from 34.8% in 2005.

In 2005, net earnings decreased \$222 million or 22.9% and basic net earnings per common share decreased 81 cents or 22.9% from 2004. The decrease was due to a decrease in operating income of 15.2% over 2004 and a 5.4% increase in interest expense. The effective income tax rate increased to 34.8% in 2005 from 31.5% in 2004.

## Management's Discussion and Analysis

Operating income for the full year 2006 was lower than in 2005 as a result of recording a non-cash goodwill impairment charge. The ongoing transformative changes and certain other charges outlined previously in the Results of Operations section of this MD&A have resulted in lower operating income for the year for both 2006 and 2005 when compared to the prior year. Over the two year period, net interest expense increased, primarily due to the increase in Canadian short term borrowing rates and the decrease in net interest income due to the maturity of interest rate swaps during this period. The 2006 increase in the effective income tax rate was mainly the result of the non-deductible goodwill impairment charge.

Adjusted basic net earnings per common share<sup>(1)</sup> decreased 18.8% to \$2.72 in 2006 from \$3.35 in 2005 and decreased 3.7% to \$3.35 in 2005 from \$3.48 in 2004.

Total assets of the Company decreased in 2006 as a result of the non-cash goodwill impairment charge. Fixed assets have grown as a result of the capital investment program. Inventory at the end of 2006 remained relatively flat to 2005 but was still greater than that of two years ago due to an investment in general merchandise. Inventory turns of general merchandise categories are lower than those of food categories, resulting in higher aggregate levels of investment in general merchandise inventory as that business developed. A substantial portion of credit card receivables is sold to independent trusts and the unsecuritized balance net of the allowance for credit losses increased by \$156 million since 2004. Cash flows from operating activities have covered a large portion of the funding requirements for the Company. While the Company issued long term debt net of amounts retired in 2005, long term debt was repaid in 2006. In addition, long term debt increased in 2005 as a result of consolidating the long term debt of VIEs pursuant to AcG 15.

Dividends declared per common share have been consistent with the Company's policy of maintaining a dividend payment equal to approximately 20% to 25% of the prior year's adjusted basic net earnings per common share<sup>(1)</sup>, although dividends in 2006 were slightly in excess of that range.

During the two year period ended December 30, 2006, the Company implemented several new accounting standards issued by the Canadian Institute of Chartered Accountants ("CICA"). The new accounting standards implemented in 2006 and the resulting impact on the financial position and results of operations are outlined in the Accounting Standards Implemented in 2006 section of this MD&A. The following standards were implemented in 2005:

- AcG 15, "*Consolidation of Variable Interest Entities*";
- EIC Abstract 150, "*Determining Whether an Arrangement Contains a Lease*"; and
- EIC Abstract 154, "*Accounting for Pre-Existing Relationships Between the Parties of a Business Combination*".

## 8. Quarterly Results of Operations

### 8.1 Results by Quarter

The 52 week reporting cycle followed by the Company is divided into four quarters of 12 weeks each except for the third quarter which is 16 weeks in duration. The following is a summary of selected consolidated financial information derived from the Company's unaudited interim consolidated financial statements for each of the eight most recently completed quarters. This information was prepared in accordance with Canadian GAAP and is reported in Canadian dollars.

## Summary of Quarterly Results

(unaudited)

(\$ millions except where otherwise indicated)	2006					2005				
	First Quarter	Second Quarter	Third Quarter	Fourth Quarter	Total (audited)	First Quarter	Second Quarter	Third Quarter	Fourth Quarter	Total (audited)
Sales <sup>(1)</sup>	\$6,147	\$6,699	\$9,010	\$6,784	\$28,640	\$6,060	\$6,405	\$8,610	\$6,552	\$27,627
Net (loss) earnings	140	194	203	(756)	(219)	142	211	192	201	746
Net (loss) earnings per common share										
Basic (\$)	\$ .51	\$ .71	\$ .74	\$ (2.76)	\$ (.80)	\$ .52	\$ .77	\$ .70	\$ .73	\$ 2.72
Diluted (\$)	\$ .51	\$ .71	\$ .74	\$ (2.76)	\$ (.80)	\$ .52	\$ .76	\$ .70	\$ .73	\$ 2.71

(1) During 2006, the Company implemented Emerging Issues Committee Abstract 156, "Accounting by a Vendor for Consideration Given to a Customer (Including a Reseller of the Vendor's Products)" on a retroactive basis. Accordingly certain sales incentives paid to independent franchisees, associates and independent accounts for the prior year have been reclassified between sales and cost of sales, selling and administrative expenses. For a further discussion, see the Accounting Standards Implemented in 2006 section included in this MD&A.

Sales growth in 2006 was impacted by various factors. Sales growth during the last two quarters of 2006 continued to be negatively impacted by the loss in tobacco sales as discussed previously. Sales and same-store sales in the fourth quarter were higher by approximately 2.0% excluding the loss in tobacco sales. Tobacco sales are not a large earnings contributor. Quarterly same-store sales growth for 2006 improved during the year from a decline of 2.5% in the first quarter to an increase of approximately 1.3% in the fourth quarter. Overall national food price inflation, as measured by CPI, during 2006 was approximately 2.3%. The adverse effects of the 2005 systems conversions and the start-up of the third-party warehouse continued into 2006. Early in 2006, service levels for general merchandise were below expected running rates but improved throughout 2006 with increasing stability. Net retail square footage increased by 1.2 million square feet in 2006 and was more heavily weighted over the last two quarters.

Fluctuations in quarterly net earnings in 2006 reflect the impact of a number of specific charges outlined previously resulting from the ongoing transformative changes. Softening sales in the first quarter of 2006, from continued product supply issues and deliberate delays in program activities, resulted in lost leverage on the fixed components in administrative and operating expenses. In the second, third and fourth quarters, higher store and distribution centre operational costs were incurred to stabilize the flow of product to the stores and additional storage costs were absorbed to quicken the supply chain stabilization process. Fourth quarter performance reflects the adverse impact on operating income of the following:

- Higher inventory shrink of approximately \$35 million and higher store labour costs of approximately \$20 million;
- An investment of approximately 0.5% in food pricing, resulting in an impact of approximately \$30 million;
- Higher general merchandise mark downs in the range of \$15 million to \$20 million to clear inventory through retail stores;
- A fixed asset impairment charge of \$24 million due in part to a decision to suspend plans for a number of sites scheduled for future development; and
- Incremental supply chain costs and information technology investments of approximately \$15 million.

Investments in the form of lower food prices continue to be made in specific markets in support of the Company's business strategy to grow sales levels.

## Management's Discussion and Analysis

Interest expense, relative to 2005, increased marginally in the first half of 2006, but was reasonably consistent with 2005 in the second half of 2006.

The change in the effective income tax rate for 2006 over 2005 was primarily due to the non-cash goodwill impairment charge which is not deductible for income tax, the change in the proportion of taxable income earned across different tax jurisdictions, and a reduction to future income tax expense resulting from a reduction in statutory income tax rates.

During 2006, the Company did not purchase common shares for cancellation pursuant to its NCIB (2005 – 226,100).

### 8.2 Fourth Quarter Results

The following is a summary of selected consolidated information for the fourth quarter of 2006. This information was prepared in accordance with Canadian GAAP and is reported in Canadian dollars. The analysis of the data contained in the table focuses on the results of operations and changes in the financial condition and cash flows in the fourth quarter.

#### Selected Consolidated Information for the Fourth Quarter

(unaudited)

(\$ millions except where otherwise indicated)	2006 (12 weeks)	2005 (12 weeks)
Sales <sup>(2)</sup>	<b>\$ 6,784</b>	\$ 6,552
Sales excluding the impact of VIEs <sup>(1)(2)</sup>	<b>6,692</b>	6,454
Operating (loss) income	<b>(695)</b>	394
Adjusted operating income <sup>(1)</sup>	<b>286</b>	441
Interest expense	<b>60</b>	61
Income taxes	<b>2</b>	132
Net (loss) earnings	<b>(756)</b>	201
Net (loss) earnings per common share (\$)		
Basic	<b>(2.76)</b>	.73
Adjusted basic <sup>(1)</sup>	<b>.58</b>	.94
Diluted	<b>(2.76)</b>	.73
Cash flows from (used in):		
Operating activities	<b>777</b>	830
Investing activities	<b>(409)</b>	(456)
Financing activities	<b>(267)</b>	(333)
Dividends declared per common share (\$)	<b>.21</b>	.21

(1) See Non-GAAP Financial Measures on page 40.

(2) During 2006, the Company implemented Emerging Issues Committee Abstract 156, "Accounting by a Vendor for Consideration Given to a Customer (Including a Reseller of the Vendor's Products)" on a retroactive basis. Accordingly certain sales incentives paid to independent franchisees, associates and independent accounts for the prior year have been reclassified between sales and cost of sales, selling and administrative expenses. For a further discussion, see the Accounting Standards Implemented in 2006 section included in this MD&A.

Sales for the fourth quarter of 2006 increased 3.5% or \$232 million to \$6.8 billion from \$6.6 billion reported in the fourth quarter of 2005, including a decrease of 0.2% related to the consolidation of certain independent franchisees.



## Sales and Sales Growth Excluding the Impact of VIEs<sup>(1)</sup>

(\$ millions except where otherwise indicated)	2006 (12 weeks)	2005 <sup>(2)</sup> (12 weeks)
Total sales	\$ 6,784	\$ 6,552
Less: Sales attributable to the consolidation of VIEs	92	98
Sales excluding the impact of VIEs	\$ 6,692	\$ 6,454
Total sales growth	3.5%	4.3%
Less: Impact on sales growth attributable to the consolidation of VIEs	(.2%)	1.6%
Sales growth excluding the impact of VIEs <sup>(1)</sup>	3.7%	2.7%

(1) See Non-GAAP Financial Measures on page 40.

(2) During 2006, the Company implemented Emerging Issues Committee Abstract 156, "Accounting by a Vendor for Consideration Given to a Customer (Including a Reseller of the Vendor's Products)" on a retroactive basis. Accordingly certain sales incentives paid to independent franchisees, associates and independent accounts for the prior years have been reclassified between sales and cost of sales, selling and administrative expenses. For a further discussion, see the Accounting Standards Implemented in 2006 section included in this MD&A.

Sales increases were realized across all regions of the country and in all areas of food, general merchandise and drugstore.

Fourth quarter same-store sales increased approximately 1.3% when compared to the same period last year. The growth in sales and same-store sales in the quarter is higher by approximately 2.0% excluding the loss in tobacco sales. During the fourth quarter of 2006, 8 new corporate and franchised stores were opened and 4 stores were closed, resulting in a net increase of 0.3 million square feet or 0.6%. The Company's calculation of food price inflation was consistent with the national food price inflation as measured by CPI of approximately 1.5% for the quarter.

During the fourth quarter of 2006, the business focused on on-shelf availability, targeted pricing investments and incremental marketing. The Company experienced some positive sales momentum particularly when the decrease in tobacco sales is excluded. A successful *Holiday Insider's Report* contributed to this improved sales performance.

Operating income for the fourth quarter of 2006 decreased \$1.1 billion from the fourth quarter of 2005 to an operating loss of \$695 million and operating margin declined to (10.2)% from 6.0% in the comparable period of 2005 due to the effects of the charges described below, all of which have been previously detailed in the Results of Operations section of this MD&A:

- A non-cash goodwill impairment charge of \$800 million related to the goodwill established on the acquisition of Provigo Inc. in 1998;
- A one-time charge of \$84 million in the fourth quarter related to the ratification of a new four-year collective agreement with members of certain Ontario locals of the UFCW;
- A charge of \$68 million in connection with the liquidation process for selected general merchandise inventory reflecting the expected inventory value through liquidation as well as the associated costs of facilitating the disposition incurred to date; and
- A charge of \$35 million recorded upon management's approval and announcement of its plans to close 19 underperforming stores in Quebec, mainly within the *Provigo* banner, 8 stores in the Atlantic region, and 24 wholesale outlets. These closures are expected to result in total costs of \$54 million.

(1) See Non-GAAP Financial Measures on page 40.

## Management's Discussion and Analysis

Adjusted operating income<sup>(1)</sup> in the fourth quarter of 2006 was \$286 million compared to \$441 million in 2005, resulting in adjusted operating margins<sup>(1)</sup> of 4.3% and 6.8% respectively. During the fourth quarter of 2006, the Company continued to incur higher than anticipated store and distribution centre operational costs, particularly in higher inventory shrinkage and labour of approximately \$35 million and approximately \$20 million, respectively. Investments in lower food prices continued into the fourth quarter with an approximate 0.5% investment in food pricing, which resulted in an adverse impact to operating income of approximately \$30 million when compared to the same period last year. As the Company continued to manage its inventory levels down to more desirable levels in store backrooms, outside storage and distribution centres, some success was realized in the fourth quarter from the focused clearance pricing of certain categories resulting in higher general merchandise mark downs in the range of \$15 million to \$20 million from the clearance of inventory through retail stores. Incremental supply chain costs and information technology investments of approximately \$15 million were also absorbed in the fourth quarter.

Adjusted EBITDA<sup>(1)</sup> and EBITDA margin<sup>(1)</sup> for the fourth quarter were \$414 million and 6.2%, respectively. For the comparable period of 2005, adjusted EBITDA<sup>(1)</sup> and EBITDA margin<sup>(1)</sup> were \$573 million and 8.9%, respectively.

Total interest expense for the fourth quarter was flat compared to that of last year for the same period.

The effective income tax rate for the fourth quarter of 2006 was negative 0.3% compared to 39.6% in 2005. This significant change in the effective income tax rate was due to the non-cash goodwill impairment recorded in the quarter which is not subject to income tax. In addition, the effective income tax rate was impacted by a change in the proportion of taxable income earned across different tax jurisdictions.

Net loss for the quarter was \$756 million, a decrease of \$957 million from the same period last year. Basic net loss per common share was \$2.76, a decrease of \$3.49 from a basic net earnings per common share of 73 cents in 2005. Adjusted basic net earnings per common share<sup>(1)</sup> decreased 36 cents or 38.3% to 58 cents in 2006 from 94 cents in 2005.

Fourth quarter cash flows from operating activities were \$777 million in 2006 compared to \$830 million in 2005. The decrease was mainly a result of lower net earnings before minority interest. Fourth quarter cash flows used in investing activities were \$409 million in 2006 compared to \$456 million in 2005. Capital investment for the fourth quarter amounted to \$261 million (2005 – \$335 million). Fourth quarter cash flows used in financing activities were \$267 million in 2006 compared to \$333 million in 2005.

### 9. Management's Certification of Disclosure Controls and Procedures

Management is responsible for designing disclosure controls and procedures to provide reasonable assurance that all material information relating to the Company and its subsidiaries, is gathered and reported to senior management on a timely basis so that appropriate decisions can be made regarding public disclosure. As required by Multilateral Instrument 52-109 (Certification of Disclosure in Issuers' Annual and Interim Filings) of the Canadian Securities Administrators, the Executive Chairman as chief executive officer and the Executive Vice President as chief financial officer have evaluated the effectiveness of such disclosure controls and procedures and have concluded that the Company's disclosure controls and procedures are effective as at December 30, 2006.

## **10. Risks and Risk Management**

### **10.1 Operating Risks and Risk Management**

Each year, the Company performs an Enterprise Risk Assessment (“ERA”) which identifies the key risks facing the Company and evaluates the risk management effectiveness for each of these risks. The assessment is primarily carried out through interviews with senior management, who assess the potential impact of risks and the likelihood that a negative impact will occur. The results of the ERA are used to prioritize risk management activities, allocate resources effectively and inform overall business direction. The Audit Committee receives a report on the ERA.

A description of the risks and risk management strategies identified by the ERA is included in the operational risks discussed below, any of which has the potential to negatively affect financial performance. The Company has operating and risk management strategies and insurance programs which help to mitigate the potential financial impact of these operating risks.

#### **Industry and Competitive Environment**

The retail industry in Canada is a changing and competitive market. Consumer needs drive industry changes, which are impacted by changing demographic and economic trends such as changes in disposable income, ethnic diversity, nutritional awareness and time availability. Customer satisfaction is central to the Company’s business. Over the past several years, consumers have demanded more choice, value and convenience. If the Company is ineffective in responding to these demands or ineffective in executing its strategies, its financial performance could be negatively impacted.

The Company monitors its market share and the markets in which it operates, and will adjust its operating strategies, which include, but are not limited to, closing underperforming stores, relocating stores or reformatting them under a different banner, reviewing pricing and adjusting product offerings and marketing programs. The Company’s control label program represents a significant competitive advantage because it enhances customer loyalty by offering superior value and provides some protection against national brand pricing strategies.

The Company faces increasing competition from many types of non-traditional competitors, such as mass merchandisers, warehouse clubs, drugstores, limited assortment stores, discount stores, convenience stores and specialty stores, all of which continue to increase their offerings of products typically associated with traditional supermarkets. The Company is also subject to competitive pressures from new entrants into the marketplace and from the expansion of existing competitors, particularly those expanding into the grocery market. These competitors may have extensive resources which will allow them to compete effectively with the Company in the long term. Increased competition could adversely affect the Company’s ability to achieve its objectives. The Company’s inability to compete effectively with its current or any future competitors could result in, among other things, lessening of market share and lower pricing in response to its competitors’ pricing activities. Accordingly, the Company’s competitive position and financial performance could be negatively impacted. The Company may not always achieve the expected cost savings and other benefits of its initiatives, which could negatively impact the Company’s financial performance.

#### **Change Management**

2006 was a year of significant change for the Company. The change in senior management will be followed by changes to the Company’s structures and business processes. While these changes are expected to bring benefits to the Company in the form of a more agile and consumer-focused business, success is dependent on management effectively implementing these changes. Ineffective change management may result in disruptions to the operations of the business or affect the ability of the Company to implement and achieve its strategic objectives, due to a lack of clear accountabilities, or cause employees to act in a manner which is inconsistent with Company objectives. Any of these events could negatively impact the Company’s performance.

### **Food Safety and Public Health**

The Company is subject to potential liabilities connected with its business operations, including potential exposures associated with product defects, food safety and product handling. Such liabilities may arise in relation to the storage, distribution and display of products and, with respect to the Company's control label products, in relation to the production, packaging and design of products.

A majority of the Company's sales are generated from food products and the Company could be vulnerable in the event of a significant outbreak of food-borne illness or increased public health concerns in connection with certain food products. Such an event could negatively affect the Company's financial performance. Procedures are in place to manage such events, should they occur. These procedures identify risks, provide clear communication to employees and consumers and are aimed at ensuring that potentially harmful products are expeditiously removed from inventory. The ability of these procedures to address such events is dependent on their successful execution. Food safety related liability exposures are insured by the Company's insurance program. In addition, the Company has food safety procedures and programs which address safe food handling and preparation standards. The Company endeavours to employ best practices for the storage and distribution of food products and also actively supports consumer awareness of safe food handling and consumption.

The Company strives to ensure its control label products have informative nutritional labelling so that today's health conscious consumer can make informed choices.

### **Information Technology**

In order to support the current and future requirements of the business in an efficient, cost effective and well-controlled manner, the Company is reliant on information technology systems. These have been assessed by management to need significant upgrading in order to act as an enabler for the business to achieve its operating objectives. These systems are essential in providing management with the appropriate information for decision making, including its key performance indicators. Change management risk and other associated risks will arise from the various information technology projects which will be undertaken to upgrade existing systems and introduce new systems to effectively manage the business going forward. Failure by the Company to appropriately invest in information technology or failure to implement information technology infrastructure in a timely or effective manner may negatively impact the Company's financial performance.

### **Labour**

A significant majority of the Company's store level and distribution centre workforce is unionized. Renegotiating collective agreements might result in work stoppages or slowdowns, which could negatively affect the Company's financial performance, depending on their nature and duration. The Company is willing to accept the short term costs of labour disruption in order to negotiate competitive labour costs and operating conditions for the longer term. Significant labour negotiations took place across the Company in 2006 as 87 collective agreements expired and 64 collective agreements were successfully negotiated which represented a combination of agreements expiring in 2006, those carried over from prior years, and those negotiated early. In 2007, 77 collective agreements affecting approximately 20,000 employees will expire, with the single largest agreement covering approximately 8,600 employees. The Company will also continue to negotiate the 57 collective agreements carried over from 2004, 2005 and 2006. The Company has good relations with its employees and unions and, although it is possible, does not anticipate any unusual difficulties in renegotiating these agreements.

Several of the Company's competitors operate in a non-union environment. These competitors may benefit from lower labour costs and more favourable operating efficiencies, making it more difficult for the Company to compete.

### **Employee Future Benefit Contributions**

While the Company's registered funded defined benefit pension plans are currently adequately funded and returns on pension plan assets are in line with expectations, there is no assurance that this will continue. An extended period of depressed capital markets and low interest rates could require the Company to make contributions to its registered funded defined benefit pension plans in excess of those currently contemplated, which in turn could have a negative effect on its financial performance.

During 2006, the Company contributed \$88 million (2005 – \$59 million) to its registered funded defined benefit pension plans. During 2007, the Company expects to contribute approximately \$75 million to these plans. This estimate may vary subject to actuarial valuations being completed, market performance and regulatory requirements. The Company also expects to make contributions in 2007 to defined contribution pension plans and multi-employer pension plans, as well as benefit payments to the beneficiaries of the unfunded defined benefit pension and other benefit plans.

### **Multi-Employer Pension Plans**

In addition to the Company-sponsored pension plans, the Company participates in various multi-employer pension plans, providing pension benefits in which approximately 41% (2005 – 40%) of employees of the Company and of its independent franchisees participate. The administration of these plans and the investment of their assets are legally controlled by a board of independent trustees generally consisting of an equal number of union and employer representatives. In some circumstances, Loblaw may have a representative on the board of trustees of these multi-employer pension plans. The Company's responsibility to make contributions to these plans is limited by the amounts established pursuant to its collective agreements. Pension cost for these plans is recognized as contributions are due.

Subsequent to year end, the Company was served with an action brought by certain beneficiaries of a multi-employer pension plan in the Superior Court of Ontario. In their claim against the employers and the trustees of the multi-employer pension plan, the plaintiffs claim that assets of the multi-employer pension plan have been mismanaged. The Company is one of the employers affected by the action. One billion dollars of damages are claimed in the action against a total of 17 defendants. In addition, the plaintiffs are seeking to have a representative defendant appointed for the employers of all the members of the multi-employer pension plan. The action is framed as a representative action on behalf of all of the beneficiaries of the multi-employer pension plan. The action is at a very early stage and the Company intends to vigorously defend it. Statements of Defence have not yet been filed.

During 2006, the trustees of a multi-employer pension plan (including an employee who was appointed by the Company) were charged under the Pension Benefits Act (Ontario) by the Superintendent of Financial Services with failure to administer various investments made by the trustees in a manner consistent with the legislation. It is not anticipated that the trial relating to these charges will be scheduled before February, 2008.

### **Third-Party Service Providers**

Certain aspects of the Company's business are significantly affected by third parties. While appropriate contractual arrangements are put in place with these third parties, the Company has no direct influence over how such third parties are managed. It is possible that negative events affecting these third parties could in turn negatively impact the Company's operations and its financial performance.

A large portion of the Company's case-ready meat products are produced by a third party which operates facilities dedicated to Loblaw. The Company's control label products, which are among the most recognized brands in Canada, are manufactured under contract by third-party vendors. In order to preserve the brands' equity, these vendors are held to high standards of quality. The Company also uses third-party logistic services including those in connection with a dedicated warehouse and distribution centre in Pickering, Ontario and third-party common carriers. Any disruption in these services could interrupt the delivery of merchandise to the stores and therefore could negatively impact sales.

*President's Choice Financial* banking services are provided by a major Canadian chartered bank. *PC Bank* uses third-party service providers to process credit card transactions, operate call centres and monitor credit and fraud for the *President's Choice Financial MasterCard*®. In order to minimize operating risk, *PC Bank* and the Company actively manage and monitor their relationships with all third-party service providers. *PC Bank* has developed a vendor management policy, approved by its Board of Directors, and has established a vendor management team that provides its Board with regular reports on vendor management and risk assessment. *PC Financial* home and auto insurance products are provided by companies within the Aviva Canada group, the Canadian subsidiary of a major international property and casualty insurance provider.

### Real Estate

The availability and conditions affecting the acquisition and development of real estate properties may impact the Company's ability to execute its planned real estate program on schedule and, therefore, its ability to achieve its sales targets. Real estate development plans may be contingent on successful negotiation of labour agreements with respect to same-site expansion or redevelopment. As the Company continues to offer general merchandise, on-time execution of the real estate program becomes increasingly important due to significantly longer lead times required for ordering this merchandise. Delays in execution could lead to inventory management issues. The Company maintains a significant portfolio of owned retail real estate and, whenever practical, pursues a strategy of purchasing sites for future store locations. This enhances the Company's operating flexibility by allowing the Company to introduce new departments and services that could be precluded under operating leases. At year end 2006, the Company owned 72% (2005 – 72%) of its corporate store square footage.

### Seasonality

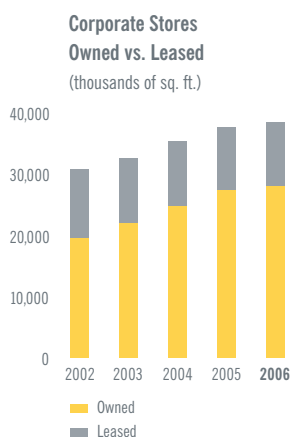
The Company's operations as they relate to food, specifically inventory levels, sales volume and product mix, are impacted to some degree by certain holiday periods in the year. Certain general merchandise items are subject to more seasonal fluctuations. As the Company expands and redefines its general merchandise offerings, its operating results may be subject to more seasonal fluctuations.

### Excess Inventory

As the Company continues to offer general merchandise, it is possible that certain merchandising programs will result in excess inventory that cannot be sold profitably through the Company's stores. Excess inventory may result in mark downs, shrink or the need to liquidate the inventory, all of which may negatively impact the Company's financial performance. In addition, the Company's current inventory management infrastructure, including its information technology systems, is not efficient in its tracking of inventory through all stages of the supply chain. The Company has implemented procedures and information technology workarounds which provide management with the ability to adequately detect and quantify excess and obsolete inventory. The Company expects to implement new systems in this area to address this risk.

### Employee Development and Retention

Effective employee development and succession planning are essential to sustaining the growth and success of the Company. The Company continues to focus on the development of employees at all levels and across all regions. The degree to which the Company is not effective



in developing its employees and establishing appropriate succession planning processes could lead to a lack of requisite knowledge, skills and experience which could, in turn, affect its ability to execute its strategies, efficiently run its operations and meet its goals for financial performance.

The tight labour market in Western Canada has created unique challenges to effectively operate stores and distribution centres, thereby affecting the Company's ability to meet its business objectives. The Company has implemented targeted programs to attract the appropriate calibre of employee in a very competitive environment.

The Company has announced a reorganization of some of its functions and an associated reduction of between 800 and 1,000 store support and regional office employees. These actions, if not properly executed, will impact the Company's ability to execute its strategies going forward. These actions will require the Company to address employee engagement in the process and ensure that key employees remain empowered to effectively execute the Company's strategies.

### **Utility and Fuel Prices**

The Company is a significant consumer of electricity, other utilities and fuel. Unanticipated cost increases in these items could negatively affect the Company's financial performance. The Company has entered into contracts with suppliers to fix the price of a portion of its future variable costs associated with electricity and natural gas, and financial contracts to fix a portion of variable costs associated with heating oil requirements for 2007.

### **Insurance**

The Company limits its exposure to risk through a combination of appropriate levels of self-insurance and the purchase of various insurance coverages, including an integrated insurance program. The Company's insurance program is based on various lines and limits of coverage which provides the appropriate level of retained and insured risks. Insurance is arranged on a multi-year basis with reliable, financially stable insurance companies as rated by A.M. Best Company, Inc. The Company combines comprehensive risk management programs and the active management of claims handling and litigation processes by using internal professionals and external technical expertise to manage the risk it retains.

### **Environmental, Health and Safety**

The Company has environmental, health and workplace safety programs in place and has established policies and procedures aimed at ensuring compliance with applicable legislative requirements. To this end, the Company employs environmental risk assessments and audits using internal and external resources together with employee awareness programs throughout its operating locations. The Company endeavours to be socially and environmentally responsible, and recognizes that the competitive pressures for economic growth and cost efficiency must be integrated with sound environmental stewardship and ecological considerations. Environmental protection requirements do not and are not expected to have a material effect on the Company's financial performance.

The Environmental, Health and Safety Committee of the Board receives regular reporting from management, addressing current and potential future issues, identifying new regulatory concerns and related communication efforts. The Company's dedicated Environmental Affairs staff work closely with the operations to help ensure that corporate requirements are met.

### **Ethical Business Conduct**

Any failure of the Company to adhere to its policies, the law or ethical business practices could significantly affect its reputation and brands and could, therefore, negatively impact the Company's financial performance. The Company has adopted a Code of Business Conduct which employees and directors of the Company are required to acknowledge and agree to on a regular basis. The Company has in place an Ethics and Business Conduct Committee which monitors compliance with the Code of Business Conduct and determines how the Company can best ensure it is conducting its business in an ethical manner. The Company has also adopted a Vendor Code of Conduct which outlines its ethical expectations to its vendor community in a number of areas, including social responsibility.



### **Legal, Taxation and Accounting**

Changes to any of the laws, rules, regulations or policies related to the Company's business including the production, processing, preparation, distribution, packaging and labelling of its products could have an adverse impact on its financial and operational performance. In the course of complying with such changes, the Company may incur significant costs. Failure by the Company to fully comply with applicable laws, rules, regulations and policies may subject it to civil or regulatory actions or proceedings, including fines, assessments, injunctions, recalls or seizures, which may have an adverse effect on the Company's financial results.

During 2006, the Government of Ontario passed a new law which prohibits the receipt of rebates paid by manufacturers to pharmacies in respect of interchangeable products and products listed in Ontario's Formulary. Pharmacies are permitted to accept only limited defined professional allowances to be used in compliance with a new Code of Conduct. As a result of this recently enacted legislation, drugstore-related operating income could decrease although the Company is attempting to mitigate some of the impact of these changes. It is possible that similar legislation could be implemented in other provinces which could have a further negative impact.

There can be no assurance that the tax laws and regulations in the jurisdictions affecting the Company will not be changed in a manner which could adversely affect the Company. New accounting pronouncements introduced by appropriate authoritative bodies may also impact the Company's financial results.

### **Holding Company Structure**

Loblaw Companies Limited is a holding company. As such, it does not carry on business directly but does so through its subsidiaries. It has no major source of income or assets of its own, other than the interests it has in its subsidiaries, which are all separate legal entities. Loblaw Companies Limited is therefore financially dependent on dividends and other distributions it receives from its subsidiaries.

## **10.2 Financial Risks and Risk Management**

In the normal course of business, the Company is exposed to financial risks that have the potential to negatively affect its financial performance including financial risks related to changes in foreign currency exchange rates, interest rates and the market price of the Company's common shares. These risks and the actions taken to minimize them are discussed below. The Company is also exposed to credit risk on certain of its financial instruments.

### **Financial Derivative Instruments**

The Company uses over-the-counter financial derivative instruments, specifically cross currency basis swaps, interest rate swaps and equity forwards, to minimize the risks and costs associated with its financing activities and its stock-based compensation plans. The Company maintains treasury centres that operate under policies and guidelines approved by the Board covering funding, investing, equity, foreign currency exchange and interest rate management. The Company's policies and guidelines prevent it from using any financial derivative instrument for trading or speculative purposes. See Notes 1 and 20 to the consolidated financial statements for additional information on the Company's financial derivative instruments.

### **Foreign Currency Exchange Rate**

The Company enters into cross currency basis swaps to manage its current and anticipated exposure to fluctuations in foreign currency exchange rates. The Company's cross currency basis swaps are transactions in which floating interest payments and principal in United States dollars are exchanged against the receipt of floating interest payments and principal in Canadian dollars. These cross currency basis swaps limit the Company's exposure against foreign currency exchange rate fluctuations on a portion of its United States dollar denominated assets, principally cash, cash equivalents and short term investments.

### **Interest Rate**

The Company enters into interest rate swaps to manage its current and anticipated exposure to fluctuations in interest rates and market liquidity. Interest rate swaps are transactions in which the Company exchanges interest flows with a counterparty on a specified notional amount for a predetermined period based on agreed upon fixed and floating interest rates. Notional amounts are not exchanged. The Company monitors market conditions and the impact of interest rate fluctuations on its fixed and floating interest rate exposure mix on an ongoing basis.

### **Common Share Market Price**

The Company enters into equity forwards to manage its exposure to fluctuations in its stock-based compensation cost as a result of changes in the market price of its common shares. These equity forwards change in value as the market price of the underlying common shares changes, which results in a partial offset to fluctuations in the Company's stock-based compensation costs. The partial offset between the Company's stock-based compensation costs and the equity forwards exists as long as the market price of the Company's common shares exceeds the exercise price of employee stock options. As at year end 2006, 4,068,646 stock options had exercise prices which were greater than the market price of the Company's common shares at year end.

### **Counterparty**

Over-the-counter financial derivative instruments are subject to counterparty risk. Counterparty risk arises from the possibility that market changes may affect a counterparty's position unfavourably and that the counterparty defaults on its obligations to the Company. The Company has sought to minimize potential counterparty risk and losses by conducting transactions for its derivative agreements with counterparties that have at minimum a long term "A" credit rating from a recognized credit rating agency and by placing risk adjusted limits on its exposure to any single counterparty for its financial derivative agreements. The Company has internal policies, controls and reporting processes, which require ongoing assessment and corrective action, if necessary, with respect to its derivative transactions. In addition, principal amounts on cross currency basis swaps and equity forwards are each netted by agreement and there is no exposure to loss of the original notional principal amounts on the interest rate swaps and equity forwards.

### **Credit**

The Company's exposure to credit risk relates to the Company's cash equivalents and short term investments, *PC Bank's* credit card receivables and accounts receivable from independent franchisees, associates and independent accounts.

Credit risk associated with the Company's cash equivalents and short term investments results from the possibility that a counterparty may default on the repayment of a security. This risk is mitigated by the established policies and guidelines that require issuers of permissible investments to have at minimum a long term "A" credit rating from a recognized credit rating agency and that specify minimum and maximum exposures to specific issuers.

*PC Bank* manages the *President's Choice Financial MasterCard®*. *PC Bank* grants credit to its customers on *President's Choice Financial MasterCard®* with the intention of increasing the loyalty of those customers and the Company's profitability. Credit risk results from the potential for loss due to those customers defaulting on their payment obligations. In order to minimize the associated credit risk, *PC Bank* employs stringent credit scoring techniques, actively monitors the credit card portfolio and reviews techniques and technology that can improve the effectiveness of its collection process. In addition, these receivables are dispersed among a large, diversified group of credit card customers.

The Company also has accounts receivable from its independent franchisees, associates and independent accounts, mainly as a result of sales to these customers. The Company actively monitors the balances on an ongoing basis and collects funds from its independent franchisees on a frequent basis in accordance with terms specified in the applicable agreements.

## 11. Related Party Transactions

The Company's majority shareholder, George Weston Limited and its affiliates ("Weston"), other than the Company, are related parties. It is the Company's policy to conduct all transactions and settle all balances with related parties on market terms and conditions.

Related party transactions include:

**Inventory Purchases** Purchases of inventory from related parties for resale in the distribution network represented approximately 3% (2005 – 3%) of the cost of sales, selling and administrative expenses.

**Cost Sharing Agreements** Weston has entered into certain contracts with third parties for administrative and corporate services, including telecommunication services and information technology related matters on behalf of the Company. Through cost sharing agreements that have been established between the Company and Weston concerning these costs, the Company has agreed to be responsible to Weston for its proportionate share of the costs incurred on its behalf. Payments by the Company pursuant to these cost sharing agreements were approximately \$25 million (2005 – \$22 million).

**Real Estate Matters** The Company leases certain properties from an affiliate of Weston, namely office space for approximately \$4 million (2005 – \$4 million). During 2006, the Company purchased from an affiliate of Weston a property designated for future development for consideration of \$8 million, which was prepaid in accordance with a former ground lease between the parties.

**Borrowings/Lendings** The Company, from time to time, may borrow from or may lend to Weston on a short term basis at commercial paper rates. There were no such amounts outstanding as at year end.

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

**Management Agreements** The Company, through Glenhuron Bank Limited ("Glenhuron"), a wholly owned subsidiary of the Company, manages certain United States cash, cash equivalents and short term investments for wholly owned non-Canadian subsidiaries of Weston. Management fees are based on market rates and included in interest expense.

**Sale of Loan Portfolio** During 2005, Glenhuron sold a portfolio of third-party long term loans receivable to a wholly owned subsidiary of Weston. The loans in this portfolio were originally acquired from third-party financial institutions in 2001. This transaction was undertaken by Glenhuron as part of its overall ongoing management of its investment portfolio.

The amount of the cash consideration of U.S.\$106 million was based on a fair market value of the loan portfolio and was approximately equal to carrying value. An independent review of the valuation analysis has been obtained by the Company to ensure that Glenhuron's methodology used in arriving at fair market value was reasonable. As at the date of sale, the current portion of this loan portfolio of U.S.\$13 million was included in accounts receivable and the long term portion of U.S.\$93 million was included in other assets.

Glenhuron has entered into an agreement with a subsidiary of Weston for the administration of the loan portfolio.

## 12. Critical Accounting Estimates

The preparation of financial statements in accordance with Canadian GAAP requires management to make estimates and assumptions that affect the reported amounts and disclosures made in the consolidated financial statements and accompanying notes.

Management continually evaluates the estimates and assumptions it uses. These estimates and assumptions are based on management's historical experience, best knowledge of current events and conditions and activities that the Company may undertake in the future. Actual results could differ from these estimates.

The estimates and assumptions described in this section depend upon subjective or complex judgments about matters that may be uncertain and changes in these estimates and assumptions could materially impact the consolidated financial statements.

## 12.1 Inventories

Certain retail store inventories are stated at the lower of cost and estimated net realizable value less normal gross profit margin. Significant estimation or judgment is required in the determination of (i) discount factors used to convert inventory to cost after a physical count at retail has been completed and (ii) estimated inventory losses, or shrinkage, occurring between the last physical inventory count and the balance sheet date.

Inventories counted at retail are converted to cost by applying a discount factor to retail selling prices. This discount factor is determined at a category or department level, is calculated in relation to historical gross margins and is reviewed on a regular basis for reasonableness. Inventory shrinkage, which is calculated as a percentage of sales, is evaluated throughout the year and provides for estimated inventory shortages from the last physical count to the balance sheet date. To the extent that actual losses experienced vary from those estimated, both inventories and operating income may be impacted.

During 2006, the Company decided to proceed with the liquidation of certain inventory, consisting primarily of general merchandise. A charge of \$68 million was recorded in 2006 in connection with this liquidation process. Significant estimation or judgment was required in the determination of what is considered excess inventory, estimated recovery values and discounted cost of retail store inventories.

Changes or differences in these estimates may result in changes to inventories on the consolidated balance sheet and a charge or credit to operating income in the consolidated statement of earnings.

## 12.2 Employee Future Benefits

The cost and accrued benefit plan obligations of the Company's defined benefit pension plans and other benefit plans are accrued based on actuarial valuations which are dependent on assumptions determined by management. These assumptions include the discount rate, the expected long term rate of return on plan assets, the expected growth rate of health care costs, the rate of compensation increase, retirement ages and mortality rates. These assumptions are reviewed annually by management and the Company's actuaries.

The discount rate, the expected long term rate of return on plan assets and the expected growth rate in health care costs are the three most significant assumptions.

The discount rates are based on market interest rates, as at the Company's measurement date of September 30 on a portfolio of Corporate AA bonds with terms to maturity that, on average, match the terms of the accrued benefit plan obligations. The discount rates used to determine the 2006 net cost for defined benefit pension and other benefit plans were 5.25% and 5.2%, respectively, on a weighted average basis, compared to 6.25% and 6.1%, respectively, in 2005. The discount rates used to determine the net 2007 defined benefit pension and other benefit plans costs decreased to 5.0% and 5.0%, respectively and as a result, the Company expects an increase in these costs in 2007.

The expected long term rate of return on plan assets is based on current market conditions, the asset mix, the active management of defined benefit pension plan assets and on historical returns. The Company's defined benefit pension plan assets had a 10 year annualized return of 9.0% as at the 2006 measurement date. The actual annual returns within this 10 year period varied with market conditions. The Company has assumed a 7.75% expected long term rate of return on plan assets in calculating its defined benefit pension plans cost for 2007.

The expected growth rate in health care costs for 2006 was based on external data and the Company's historical trends for health care costs, and in 2007 initial growth rates will be relatively consistent with that of 2006.

Since the three key assumptions discussed above are forward-looking and long term in nature, they are subject to uncertainty and actual results may differ. In accordance with Canadian GAAP, differences between actual experience and the assumptions, as well as the impact of changes in the assumptions, are accumulated as unamortized net actuarial gains or losses and amortized over future periods, affecting the recognized cost of defined benefit pension plans and other benefit plans and the accrued benefit plan obligation in future periods. While the Company believes that its assumptions are appropriate, significant differences in actual experience or significant changes in the Company's assumptions may materially affect its defined benefit pension plans and other benefit plans accrued benefit plan obligations and future cost.

Additional information regarding the Company's pension and other benefit plans, including a sensitivity analysis for changes in key assumptions, is provided in Note 15 to the consolidated financial statements and in the Employee Future Benefit Contributions discussion in the Operating Risks and Risk Management section of this MD&A.

### 12.3 Goodwill

Goodwill is not amortized and is assessed for impairment at the reporting unit level at least annually. Any potential goodwill impairment is identified by comparing the fair value of a reporting unit to its carrying value. If the fair value of the reporting unit exceeds its carrying value, goodwill is considered not to be impaired. If the carrying value of the reporting unit exceeds its fair value, a more detailed goodwill impairment assessment must be undertaken. A goodwill impairment charge is recognized to the extent that, at the reporting unit level, the carrying value of goodwill exceeds the implied fair value.

The Company determines the fair value using a discounted cash flow model corroborated by other valuation techniques such as market multiples. The process of determining these fair values requires management to make estimates and assumptions including, but not limited to projected future sales, earnings and capital investment, discount rates and terminal growth rates. Projected future sales, earnings and capital investment are consistent with strategic plans presented to the Company's Board. Discount rates are based on an industry weighted average cost of capital. These estimates and assumptions are subject to change in the future due to uncertain competitive and economic market conditions or changes in business strategies.

In 2006, the Company performed the annual goodwill impairment test and it was determined that the carrying value of the goodwill established on the acquisition of Provigo Inc. in 1998 exceeded its respective fair value. As a result, the Company recorded in operating income a non-cash goodwill impairment charge of \$800 million relating to this goodwill, which was within its previously disclosed range of \$600 million to \$900 million. The Company expects no income tax deduction from this non-cash goodwill impairment charge. The determination that the fair value of goodwill was less than its carrying value resulted from a decline in market multiples, both from an industry and Company perspective, and a reduction of fair value as determined using the discounted cash flow methodology, incorporating both current Company and market assumptions, which in combination resulted in the goodwill impairment. This non-cash goodwill impairment charge is expected to be adjusted if necessary in the first half of 2007 and may result in a charge or credit to operating income in the consolidated statement of earnings and in the carrying value of goodwill on the balance sheet.

### 12.4 Income Taxes

Future income tax assets and liabilities are recognized for the future income tax consequences attributable to temporary differences between the financial statement carrying values of assets and liabilities and their respective income tax bases. Future income tax assets or liabilities are measured using enacted or substantively enacted income tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The calculation of current and future income taxes requires management to make estimates and assumptions and to exercise judgment regarding the financial statement carrying values of assets and liabilities which are subject to accounting estimates inherent in those balances, the interpretation of income tax legislation across various jurisdictions, expectations about future operating results and the timing of reversal of temporary differences and possible audits of tax filings by the

regulatory authorities. Management believes it has adequately provided for income taxes based on current available information. Changes or differences in these estimates or assumptions may result in changes to the current or future income taxes on the consolidated balance sheet, a charge or credit to income tax expense in the consolidated statement of earnings and may result in cash payments or receipts.

## 12.5 Goods and Services Tax and Provincial Sales Taxes

During 2005, the Company recorded a charge relating to an audit and proposed assessment by the Canada Revenue Agency relating to GST on certain products sold on which GST was not appropriately charged and remitted. In light of this proposed assessment, the Company assessed and estimated the potential liabilities for GST and PST in other areas of its operations for various periods. Accordingly, a charge of \$40 million was recorded in operating income in 2005. Approximately \$1 million was paid in 2006 (2005 – \$15 million) and approximately \$24 million remains accrued as at December 30, 2006. The ultimate remaining amount paid will depend on the outcome of audits performed by or settlements reached with the various tax authorities, and therefore may differ from this estimate. Management will continue to assess the remaining accrual as progress towards resolution with the various tax authorities is made and will adjust the remaining accrual accordingly. Changes in this accrual may result in a charge or credit to operating income in the consolidated statement of earnings.

## 12.6 Fixed Assets

Fixed assets to be held and used are reviewed for impairment annually and when events or circumstances indicate that their carrying value exceeds the sum of the undiscounted cash flows expected from their use and eventual disposition. An impairment loss is measured as the amount by which the fixed assets carrying value exceeds the fair value. As discussed in notes 4 and 13 to the consolidated financial statements, the Company recorded fixed asset impairment and accelerated depreciation charges of \$32 million (2005 – \$7 million) and an additional \$27 million (2005 – \$14 million) was recorded in restructuring and other charges.

Factors that most significantly influence the impairment assessments and calculations are estimates of future cash flows. The Company uses its internal plans in estimating future cash flows. These plans reflect the Company's current best estimate of future cash flows but may change due to uncertain competitive and economic market conditions or changes in business strategies. Changes or differences in these estimates may result in changes to fixed assets on the consolidated balance sheet and a charge to operating income on the consolidated statement of earnings.

## 13. Accounting Standards

### 13.1 Accounting Standards Implemented in 2006

During the year, the Company implemented the following accounting standards issued by the CICA:

- Section 3831, "*Non-Monetary Transactions*", issued in June 2005, replaces Section 3830 of the same name. The revised standard addresses the measurement and disclosure of non-monetary transactions and defines when an exchange of assets is measured at fair value and when it is measured at the carrying amount. The criterion for the measurement of a non-monetary transaction at fair value is based on whether the non-monetary transaction has commercial substance rather than the culmination of the earnings process under Section 3830. The revised standard is applied to non-monetary transactions initiated in periods beginning after January 1, 2006. The adoption of these new recommendations, on a prospective basis, did not have a material impact on the Company's consolidated financial statements.
- EIC Abstract 156, "*Accounting by a Vendor for Consideration Given to a Customer (Including a Reseller of the Vendor's Products)*", ("EIC 156") issued in September 2005, addresses cash consideration, including sales incentives, given by a vendor to a customer. This consideration is presumed to be a reduction of the selling price of the vendor's products and should therefore be classified as a reduction of sales in the vendor's statement of earnings.

## Management's Discussion and Analysis

Prior to the implementation of EIC 156, the Company recorded certain sales incentives paid to independent franchisees, associates and independent accounts in cost of sales, selling and administrative expenses on the statement of earnings.

Accordingly, the implementation of EIC 156, on a retroactive basis, resulted in a reduction in both sales and cost of sales, selling and administrative expenses as follows:

	First Quarter (12 weeks)		Second Quarter (12 weeks)		Third Quarter (16 weeks)		Fourth Quarter (12 weeks)		Total (52 weeks)	
	2005	2004	2005	2004	2005	2004	2005	2004	2005	2004
	Sales as previously reported	\$ 6,124	\$ 5,677	\$ 6,436	\$ 6,069	\$ 8,653	\$ 8,134	\$ 6,588	\$ 6,329	\$27,801
Sales after reclassification	\$ 6,060	\$ 5,622	\$ 6,405	\$ 6,036	\$ 8,610	\$ 8,089	\$ 6,552	\$ 6,283	\$27,627	\$26,030
Reclassification between sales and cost of sales, selling and administrative expenses	\$ 64	\$ 55	\$ 31	\$ 33	\$ 43	\$ 45	\$ 36	\$ 46	\$ 174	\$ 179

As reclassifications, these changes did not impact net earnings. Operating margins, adjusted operating margins<sup>(1)</sup> and adjusted EBITDA margins<sup>(1)</sup> for 2005 have also been recalculated and updated, if applicable, as a result of the change in sales.

- EIC Abstract 157, "*Implicit Variable Interest under AcG-15*", issued in October 2005, provides new guidance and clarification to the recommendations in AcG-15, with respect to all implicit variable interests held by an enterprise or its related parties. The guidance addresses how implicit variable interests should be included in the assessment as to whether the entity is the primary beneficiary of the VIE. An implicit variable interest is an interest that indirectly absorbs or receives the variability of the entity. The adoption of these recommendations in the first quarter of 2006 did not have a material impact on the Company's consolidated financial statements.
- EIC Abstract 159, "*Conditional Asset Retirement Obligations*", issued in December 2005, provides guidance on the recognition and measurement of a conditional asset retirement obligation and further clarifies the requirements under Section 3110, "*Asset Requirement Obligations*" such that a conditional asset retirement obligation should be recognized at fair value when the obligation to perform the asset retirement activity is unconditional even though uncertainty exists about the timing and/or method of settlement. These recommendations were adopted retroactively for the second quarter of 2006 and did not have a material impact on the Company's consolidated financial statements.
- EIC Abstract 162, "*Stock-Based Compensation for Employees eligible to retire before the Vesting date*", issued in July 2006, requires that stock-based compensation granted to employees eligible to retire should be expensed at the time of grant. The Company's stock-based compensation plans do not continue to vest after retirement, and therefore the adoption of this abstract did not have an impact on the Company's consolidated financial statements.

### 13.2 Future Accounting Standards

The Company closely monitors new accounting standards to assess the impact, if any, on its consolidated financial statements. In 2007, the Company will be reviewing the implications of the following standards and implementing the recommendations as required:

- The Accounting Standards Board continues to work towards the transition from Canadian GAAP to International Financial Reporting Standards over a five-year period. After this transitional period, Canadian GAAP will cease to exist as a separate, distinct basis of financial reporting. The Company continues to closely monitor the changes resulting from this transition in preparation for the convergence.

Section 3855, "*Financial Instruments – Recognition and Measurement*", Section 3865, "*Hedges*", Section 1530, "*Comprehensive Income*", Section 3861, "*Financial Instruments – Disclosures and Presentation*", and Section 3251, "*Equity*", issued in April 2005:

- Section 3855, "*Financial Instruments – Recognition and Measurement*", establishes guidance for recognizing and measuring financial assets, financial liabilities and non-financial derivatives. The standard requires that financial instruments within scope, including derivatives, be included on the Company's balance sheet and measured, either at fair value or, in limited circumstances, at cost or



amortized cost. All financial instruments must be classified into a defined category, namely, held-to-maturity investments, held-for-trading financial assets or financial liabilities, loans and receivables, available-for-sale financial assets, and other financial liabilities. This classification will determine how each instrument is measured and how gains and losses are recognized. Held-for-trading financial assets and financial liabilities are measured at fair value with gains and losses recognized in net income. Financial assets held-to-maturity, loans and receivables and financial liabilities, other than those held-for-trading, are measured at amortized cost using the effective interest method of amortization. Available-for-sale financial assets are measured at fair value, with unrealized gains and losses, including changes in foreign exchange rates, being recognized in other comprehensive income, a new section of shareholders' equity. Investments in equity instruments classified as available-for-sale that do not have a quoted market price in an active market can be measured at cost. The recommendations further define derivatives to include non-financial derivatives and embedded derivatives which meet certain criteria. All derivatives must be classified as held-for-trading unless they are designated in a hedging relationship.

- Section 3865, "*Hedges*", replaces AcG 13, "*Hedging Relationships*" and the guidance formerly in Section 1650, "*Foreign Currency Translation*" will be replaced by Section 1651 of the same name, such that foreign exchange gains or losses on available-for-sale financial assets be accounted for in other comprehensive income instead of net earnings. The requirements for identification, designation and documentation of hedging relationships remain unchanged. The new guidance addresses the accounting treatment of qualifying hedging relationships and the necessary disclosures. The standard defines three specific hedging relationships, namely, fair value hedges, cash flow hedges, and hedges of a net investment in self-sustaining foreign operations, and defines how the accounting should be performed. Changes in the fair value of hedging derivatives in a fair value hedge are offset in the consolidated statement of earnings against the change in fair value of the asset, liability or cash flow being hedged. In cash flow hedges, the changes in fair value are recorded in other comprehensive income, a new section of shareholders' equity. To the extent the change in fair value of the derivative is not completely offset by the change in fair value of the item it is hedging, the ineffective portion of the hedging relationship is recorded immediately in the consolidated statement of earnings.
- Section 1530, "*Comprehensive Income*" introduces a statement of comprehensive income which will be included in interim and annual financial statements. Comprehensive income is comprised of net income and other comprehensive income, and represents the change in equity during a period from transactions and other events with non-owner sources. Other comprehensive income will include unrealized gains and losses on financial assets that are classified as available-for-sale and changes in fair value of the effective portion of cash flow hedges.
- Section 3861, "*Financial Instruments – Disclosure and Presentation*", replaces Section 3860 of the same name, and addresses the presentation and disclosure of financial instruments and non-financial derivatives. The main features of these new recommendations revise the requirements to provide accounting policy disclosures and provide new requirements for disclosure on fair value.
- Section 3251, "*Equity*", replaces Section 3250, "*Surplus*" and establishes standards for the presentation of equity and changes in equity during the reporting period and requires that an enterprise present separately equity components and changes in equity arising from i) net income; ii) other comprehensive income; iii) other changes in retained earnings; iv) changes in contributed surplus; v) changes in share capital; and vi) changes in reserves.

These standards are effective for interim and annual financial statements for fiscal years beginning on or after October 1, 2006.

Consequently, the Company will implement them in the first quarter of 2007. The transitional adjustments resulting from these standards will be recognized in the opening balances of retained earnings and other comprehensive income as appropriate. The impact on the consolidated balance sheet will include the recording of the fair value of the interest rate swaps designated in a cash flow hedge. We are determining the impact of these changes based on the transitional guidance within these sections. Prior periods will not be restated.

- Section 1506, "*Accounting Changes*", issued in July 2006 revises current standards on changes in accounting policy, estimates or errors. An entity is permitted to change an accounting policy only when it results in financial statements that provide reliable and more relevant information or results from a requirement under a primary source of Canadian GAAP. The guidance also addresses how to account for a change in accounting policy, estimate or corrections of errors, and establishes enhanced disclosures about their effects

on the financial statements. These recommendations are effective for fiscal years beginning on or after January 1, 2007. The Company will implement these recommendations as required on a prospective basis.

- Section 3862, "*Financial Instruments Disclosure*" and Section 3863, "*Financial Instruments Presentation*", both issued in December 2006, revise the current standards on financial instrument disclosure and presentation, and place an increased emphasis on disclosures regarding the risks associated with both recognized and unrecognized financial instruments and how these risks are managed. Section 3863 establishes standards for presentation of financial instruments and non-financial derivatives and provides additional guidance for classification of financial instruments, from the perspective of the issuer, between liabilities and equity. These recommendations are effective for fiscal years beginning on or after October 1, 2007 and therefore the Company will implement them in the first quarter of 2008.
- Section 1535, "*Capital Disclosures*", issued in December 2006, establishes guidelines for the disclosure of information regarding a company's capital and how it is managed. Enhanced disclosure with respect to the objectives, policies and processes for managing capital and quantitative disclosures about what a company regards as capital are required. These recommendations are effective for fiscal years beginning on or after October 1, 2007 and therefore the Company will implement them in the first quarter of 2008.
- EIC Abstract 163, "*Determining the variability to be considered in applying AcG-15*", issued in September 2006, addresses how to assess whether arrangements should be treated as variable interests or considered as creators of variability by a reporting enterprise in applying AcG-15. This abstract is effective for fiscal years beginning on or after January 1, 2007. The Company will implement these recommendations as required on a prospective basis. The Company does not expect the adoption of this abstract to have a material impact on the consolidated financial statements.

### 14. Outlook

Loblaw has a number of strengths at its core – strong market share and control label products and a strong store network under various store formats with the potential to meet the needs of all Canadians. But as the Company looks forward, it must transition this enterprise into a lean company that is ready and able to compete on all fronts. 2006 marked the beginning of this transition. The Company's main focus going forward is on simplifying its organizational structure, on retailing basics such as on-shelf availability and customer focus, on innovation as a competitive advantage and on executing the Company's growth strategy.

### 15. Non-GAAP Financial Measures

The Company reports its financial results in accordance with Canadian GAAP. However, the Company has included certain non-GAAP financial measures and ratios which it believes provide useful information to both management and readers of this Annual Report, including this Financial Report, in measuring the financial performance and financial condition of the Company for the reasons set out below. These measures do not have a standardized meaning prescribed by Canadian GAAP and, therefore, may not be comparable to similarly titled measures presented by other publicly traded companies, nor should they be construed as an alternative to other financial measures determined in accordance with Canadian GAAP. For the following tables, the annual non-GAAP financial measures for the years 2006 through to 2002, are for the 52 or 53 weeks ended or as at December 30, 2006; December 31, 2005; January 1, 2005; January 3, 2004; and December 28, 2002, respectively.

#### Sales and Sales Growth Excluding the Impact of VIEs

These financial measures exclude the impact on sales from the consolidation by the Company of certain independent franchisees which resulted from the implementation of AcG 15 retroactively without restatement effective January 2, 2005. This impact on sales is excluded because the Company believes this allows for a more effective analysis of the operating performance of the Company. Both the current and comparative measures reflect the retroactive implementation of EIC 156. A reconciliation of the financial measures to the Canadian GAAP financial measures is included in the table "Sales and Sales Growth Excluding the Impact of VIEs" on pages 8 and 25 of this MD&A.

### Adjusted Operating Income and Margin

The following table reconciles adjusted operating income to Canadian GAAP operating income reported in the consolidated statements of earnings for the twelve week periods ended December 30, 2006 and December 31, 2005 and the years ended as previously indicated. Items listed in the reconciliation below are excluded because the Company believes this allows for a more effective analysis of the operating performance of the Company. In addition, they affect the comparability of the financial results and could potentially distort the analysis of trends. The exclusion of these items does not imply they are non-recurring. Adjusted operating income and margin are useful to management in assessing the Company's performance and in making decisions regarding the ongoing operations of its business.

(\$ millions)	2006 (12 weeks)	2005 (12 weeks)	2006 (52 weeks)	2005 (52 weeks)	2004 (52 weeks)	2003 (53 weeks)	2002 (52 weeks)
Operating (loss) income	\$ (695)	\$ 394	\$ 289	\$ 1,401	\$ 1,652	\$ 1,467	\$ 1,303
Add (deduct) impact of the following:							
Goodwill impairment charge	800		800				
Ontario collective labour agreement	84		84				
Inventory liquidation	68		68				
Net effect of stock-based compensation and the associated equity forwards	(6)	27	37	43		(4)	14
Restructuring and other charges	35	6	44	86			
Departure entitlement charge			12				
Goods and Services Tax and provincial sales taxes				40			
Direct costs associated with supply chain disruptions		10		30			
VIEs		4	(8)				
The <i>Real Canadian Superstore</i> labour arrangement						25	
Adjusted operating income	\$ 286	\$ 441	\$ 1,326	\$ 1,600	\$ 1,652	\$ 1,488	\$ 1,317

Adjusted operating margin is calculated as adjusted operating income divided by sales excluding the impact of VIEs.

### Adjusted EBITDA and Margin

The following table reconciles adjusted earnings before interest, income taxes, depreciation and amortization ("EBITDA") to adjusted operating income which is reconciled to Canadian GAAP operating income reported in the consolidated statements of earnings, in the table above, for the twelve week periods ended December 30, 2006 and December 31, 2005 and the years ended as previously indicated. Adjusted EBITDA is useful to management in assessing the Company's performance of its ongoing operations and its ability to generate cash flows to fund its cash requirements, including the Company's capital investment program.

(\$ millions)	2006 (12 weeks)	2005 (12 weeks)	2006 (52 weeks)	2005 (52 weeks)	2004 (52 weeks)	2003 (53 weeks)	2002 (52 weeks)
Adjusting operating income	\$ 286	\$ 441	\$ 1,326	\$ 1,600	\$ 1,652	\$ 1,488	\$ 1,317
Add (deduct) impact of the following:							
Depreciation and amortization	133	140	590	558	473	393	354
VIE depreciation and amortization	(5)	(8)	(24)	(26)			
Adjusted EBITDA	\$ 414	\$ 573	\$ 1,892	\$ 2,132	\$ 2,125	\$ 1,881	\$ 1,671

## Management's Discussion and Analysis

Adjusted EBITDA margin is calculated as adjusted EBITDA divided by sales excluding the impact of VIEs.

### Adjusted Net Earnings

Adjusted net earnings can be reconciled to Canadian GAAP net earnings reported in the consolidated statements of earnings by excluding the net earnings impact associated with the items included in the adjusted basic net earnings per common share table below. Adjusted net earnings is useful to management in assessing the Company's performance and in making decisions regarding the ongoing operations of its business. Certain items are excluded from the comparable GAAP measure because the Company believes this allows for a more effective analysis of the operating performance of the Company. In addition, they affect the comparability of the financial results and could potentially distort the analysis of trends. The exclusion of these items does not imply they are non-recurring.

### Adjusted Basic Net Earnings per Common Share

The following table reconciles adjusted basic net earnings per common share to Canadian GAAP basic net earnings per common share measures reported in the consolidated statements of earnings for the twelve week periods ended December 30, 2006 and December 31, 2005 and the years ended as previously indicated. Items listed in the reconciliation below are excluded because the Company believes this allows for a more effective analysis of the operating performance of the Company. In addition, they affect the comparability of the financial results and could potentially distort the analysis of trends. The exclusion of these items does not imply they are non-recurring. Adjusted basic net earnings per common share is useful to management in assessing the Company's performance and in making decisions regarding the ongoing operations of its business.

	2006 (12 weeks)	2005 (12 weeks)	2006 (52 weeks)	2005 (52 weeks)	2004 (52 weeks)	2003 (53 weeks)	2002 (52 weeks)
Basic net (loss) earnings per common share	\$ (2.76)	\$ .73	\$ (.80)	\$ 2.72	\$ 3.53	\$ 3.07	\$ 2.64
Add (deduct) impact of the following:							
Goodwill impairment charge	2.92		2.92				
Ontario collective labour agreement	.20		.20				
Inventory liquidation	.16		.16				
Net effect of stock-based compensation and the associated equity forwards	(.02)	.15	.17	.22		(.06)	.04
Restructuring and other charges	.09	.01	.11	.20			
Departure entitlement charge			.03				
Changes in statutory income tax rates		.01	(.06)	.01		.03	
Goods and Services Tax and provincial sales taxes				.10			
Direct costs associated with supply chain disruptions		.02		.07			
VIEs	(.01)	.02	(.01)	.03			
Resolution of certain income tax matters					(.05)		
The <i>Real Canadian Superstore</i> labour arrangement						.06	
Adjusted basic net earnings per common share	\$ 0.58	\$ .94	\$ 2.72	\$ 3.35	\$ 3.48	\$ 3.10	\$ 2.68

### Net Debt

The following table reconciles net debt used in the net debt to equity ratio to Canadian GAAP measures reported in the consolidated balance sheets as at the years ended as previously indicated. The Company calculates net debt as the sum of long term debt and short term debt less cash, cash equivalents and short term investments. The net debt to equity ratio is useful in assessing the amount of leverage employed.

(\$ millions)	2006	2005	2004	2003	2002
Bank indebtedness	\$ 1	\$ 30	\$ 28	\$ 38	\$ —
Commercial paper	647	436	473	603	533
Long term debt due within one year	27	161	216	106	106
Long term debt	4,212	4,194	3,935	3,956	3,420
Less: Cash and cash equivalents	669	916	549	618	823
Short term investments	327	4	275	378	304
Net debt	\$3,891	\$3,901	\$3,828	\$3,707	\$2,932

### Free Cash Flow

The following table reconciles free cash flow to Canadian GAAP measures reported in the consolidated cash flow statements as at the years ended as previously indicated. The Company calculates free cash flow as cash flows from operating activities less fixed asset purchases and dividends. The Company believes free cash flow is a useful measure of the Company's cash available for additional funding requirements.

(\$ millions)	2006	2005	2004	2003	2002
Cash flows from operating activities	\$ 1,180	\$ 1,489	\$ 1,443	\$ 1,032	\$ 998
Less: Fixed asset purchases	937	1,156	1,258	1,271	1,079
Dividends	173	230	209	198	127
Free cash flow	\$ 70	\$ 103	\$ (24)	\$ (437)	\$ (208)

### Total Assets

The following table reconciles total assets used in the return on average total assets to Canadian GAAP measures reported in the consolidated balance sheets as at the years ended as previously indicated. The Company believes the return on average total assets ratio is useful in assessing the performance of its operating assets and therefore excludes cash, cash equivalents and short term investments from the total assets used in the ratio.

(\$ millions)	2006	2005	2004	2003	2002
Total assets	\$ 13,486	\$ 13,761	\$ 12,949	\$ 12,113	\$ 11,047
Less: Cash and cash equivalents	669	916	549	618	823
Short term investments	327	4	275	378	304
Total assets	\$ 12,490	\$ 12,841	\$ 12,125	\$ 11,117	\$ 9,920

## 16. Additional Information

Additional information about the Company, including its Annual Information Form and other disclosure documents, has been filed electronically with various securities regulators in Canada through the System for Electronic Document Analysis and Retrieval (SEDAR) and is available online at [www.sedar.com](http://www.sedar.com) and with the Office of the Superintendent of Financial Institutions (OSFI) as the primary regulator for the Company's subsidiary, *President's Choice Bank*.

March 13, 2007  
Toronto, Canada

## Financial Results

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## Management's Statement of Responsibility for Financial Reporting

The management of Loblaw Companies Limited is responsible for the preparation, presentation and integrity of the accompanying consolidated financial statements, Management's Discussion and Analysis and all other information in the Annual Report. This responsibility includes the selection and consistent application of appropriate accounting principles and methods in addition to making the judgments and estimates necessary to prepare the consolidated financial statements in accordance with Canadian generally accepted accounting principles. It also includes ensuring that the financial information presented elsewhere in the Annual Report is consistent with that in the consolidated financial statements.

To provide reasonable assurance that assets are safeguarded and that relevant and reliable financial information is produced, management is required to design a system of internal controls and certify as to the design effectiveness of internal controls over financial reporting. Internal auditors, who are employees of the Company, review and evaluate internal controls on management's behalf. KPMG LLP, whose report follows, were appointed as independent auditors by a vote of the Company's shareholders to audit the consolidated financial statements.

The Board of Directors, acting through an Audit Committee comprised solely of directors who are independent of the Company, is responsible for determining that management fulfills its responsibilities in the preparation of the consolidated financial statements and the financial control of operations. The Audit Committee recommends the independent auditors for appointment by the shareholders. The Audit Committee meets regularly with senior and financial management, internal auditors and the independent auditors to discuss internal controls, auditing activities and financial reporting matters. The independent auditors and internal auditors have unrestricted access to the Audit Committee. These consolidated financial statements and Management's Discussion and Analysis have been approved by the Board of Directors for inclusion in the Annual Report based on the review and recommendation of the Audit Committee.

Toronto, Canada

March 13, 2007



**Galen G. Weston**

Executive Chairman



**Mark Foote**

President and Chief Merchandising Officer



**Richard P. Mavrinc**

Executive Vice President

## Independent Auditors' Report

To the Shareholders of Loblaw Companies Limited:

We have audited the consolidated balance sheets of Loblaw Companies Limited as at December 30, 2006 and December 31, 2005 and the consolidated statements of earnings, retained earnings and cash flow for the 52 week years then ended. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated 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 consolidated financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall consolidated financial statement presentation.

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the Company as at December 30, 2006 and December 31, 2005 and the results of its operations and its cash flow for the years then ended in accordance with Canadian generally accepted accounting principles.



Toronto, Canada

March 13, 2007



Chartered Accountants



## Consolidated Statements of Earnings

For the years ended December 30, 2006 and December 31, 2005 (\$ millions except where otherwise indicated)	2006 (52 weeks)	2005 (52 weeks)
<b>Sales</b> (note 2)	\$ 28,640	\$ 27,627
<b>Operating Expenses</b>		
Cost of sales, selling and administrative expenses (note 2)	26,917	25,542
Depreciation and amortization	590	558
Goodwill impairment (note 3)	800	—
Restructuring and other charges (note 4)	44	86
Goods and Services Tax and provincial sales taxes (note 5)	—	40
	<b>28,351</b>	<b>26,226</b>
<b>Operating Income</b>	<b>289</b>	<b>1,401</b>
Interest Expense (note 7)	259	252
<b>Earnings before Income Taxes</b>	<b>30</b>	<b>1,149</b>
Income Taxes (note 8)	248	400
<b>Net (Loss) Earnings before Minority Interest</b>	<b>(218)</b>	<b>749</b>
Minority Interest	1	3
<b>Net (Loss) Earnings</b>	<b>\$ (219)</b>	<b>\$ 746</b>
<b>Net (Loss) Earnings per Common Share</b> (\$) (note 9)		
Basic	\$ (.80)	\$ 2.72
Diluted	\$ (.80)	\$ 2.71

See accompanying notes to the consolidated financial statements.

## Consolidated Statements of Retained Earnings

For the years ended December 30, 2006 and December 31, 2005 (\$ millions except where otherwise indicated)	2006 (52 weeks)	2005 (52 weeks)
<b>Retained Earnings, Beginning of Year</b>	\$ 4,694	\$ 4,193
Net (loss) earnings	(219)	746
Premium on common shares purchased for cancellation (note 18)	—	(15)
Dividends declared per common share — 84¢ (2005 — 84¢)	(230)	(230)
<b>Retained Earnings, End of Year</b>	<b>\$ 4,245</b>	<b>\$ 4,694</b>

See accompanying notes to the consolidated financial statements.

## Consolidated Balance Sheets

As at December 30, 2006 and December 31, 2005

(\$ millions)

	2006	2005
<b>Assets</b>		
<b>Current Assets</b>		
Cash and cash equivalents (note 10)	\$ 669	\$ 916
Short term investments (note 10)	327	4
Accounts receivable (note 11)	728	656
Inventories (note 12)	2,037	2,020
Income taxes	63	3
Future income taxes (note 8)	85	72
Prepaid expenses and other assets	39	30
<b>Total Current Assets</b>	<b>3,948</b>	<b>3,701</b>
Fixed Assets (note 13)	8,055	7,785
Goodwill (note 3)	794	1,587
Other Assets (note 14)	689	688
<b>Total Assets</b>	<b>\$ 13,486</b>	<b>\$ 13,761</b>
<b>Liabilities</b>		
<b>Current Liabilities</b>		
Bank indebtedness	\$ 1	\$ 30
Commercial paper	647	436
Accounts payable and accrued liabilities	2,598	2,535
Long term debt due within one year (note 16)	27	161
<b>Total Current Liabilities</b>	<b>3,273</b>	<b>3,162</b>
Long Term Debt (note 16)	4,212	4,194
Future Income Taxes (note 8)	234	237
Other Liabilities (note 17)	314	271
Minority Interest	12	11
<b>Total Liabilities</b>	<b>8,045</b>	<b>7,875</b>
<b>Shareholders' Equity</b>		
Common Share Capital (note 18)	1,196	1,192
Retained Earnings	4,245	4,694
<b>Total Shareholders' Equity</b>	<b>5,441</b>	<b>5,886</b>
<b>Total Liabilities and Shareholders' Equity</b>	<b>\$ 13,486</b>	<b>\$ 13,761</b>

See accompanying notes to the consolidated financial statements.

Approved on Behalf of the Board



**Galen G. Weston**  
Director



**Thomas C. O'Neill**  
Director

## Consolidated Cash Flow Statements

For the years ended December 30, 2006 and December 31, 2005

(\$ millions)

	2006 (52 weeks)	2005 (52 weeks)
<b>Operating Activities</b>		
Net (loss) earnings before minority interest	\$ (218)	\$ 749
Depreciation and amortization	590	558
Goodwill impairment (note 3)	800	—
Restructuring and other charges (note 4)	44	86
Goods and Services Tax and provincial sales taxes (note 5)	—	40
Future income taxes	(18)	90
Change in non-cash working capital	(69)	(51)
Other	51	17
<b>Cash Flows from Operating Activities</b>	<b>1,180</b>	<b>1,489</b>
<b>Investing Activities</b>		
Fixed asset purchases	(937)	(1,156)
Short term investments	(323)	271
Proceeds from fixed asset sales	99	109
Credit card receivables, after securitization (note 11)	(82)	(84)
Franchise investments and other receivables	(18)	53
Other	(47)	(96)
<b>Cash Flows used in Investing Activities</b>	<b>(1,308)</b>	<b>(903)</b>
<b>Financing Activities</b>		
Bank indebtedness	(29)	(17)
Commercial paper	211	(37)
Long term debt (note 16)		
Issued	29	333
Retired	(162)	(240)
Common share capital		
Issued (notes 18 and 19)	4	1
Retired (note 18)	—	(16)
Dividends	(173)	(230)
Other	—	(2)
<b>Cash Flows used in Financing Activities</b>	<b>(120)</b>	<b>(208)</b>
Effect of foreign currency exchange rate changes		
on cash and cash equivalents (note 10)	1	(31)
Initial impact of variable interest entities (note 2)	—	20
<b>Change in Cash and Cash Equivalents</b>	<b>(247)</b>	<b>367</b>
Cash and Cash Equivalents, Beginning of Year	916	549
<b>Cash and Cash Equivalents, End of Year</b>	<b>\$ 669</b>	<b>\$ 916</b>

See accompanying notes to the consolidated financial statements.

## Notes to the Consolidated Financial Statements

For the years ended December 30, 2006 and December 31, 2005  
(\$ millions except where otherwise indicated)

### Note 1. Summary of Significant Accounting Policies

The consolidated financial statements were prepared in accordance with Canadian generally accepted accounting principles (“GAAP”) and are reported in Canadian dollars.

**Basis of Consolidation** The consolidated financial statements include the accounts of Loblaw Companies Limited and its subsidiaries, collectively referred to as the “Company” or “Loblaw”. The Company’s interest in the voting share capital of its subsidiaries is 100%. The Company also consolidates variable interest entities (“VIEs”) that are subject to control on a basis other than through ownership of a majority of voting interest (see Note 2).

**Fiscal Year** The fiscal year of the Company ends on the Saturday closest to December 31. As a result, the Company’s fiscal year is usually 52 weeks in duration but includes a 53rd week every 5 to 6 years. The years ended December 30, 2006 and December 31, 2005 each contained 52 weeks.

**Revenue Recognition** Sales include revenues, net of estimated returns, from customers through corporate stores operated by the Company and independent franchisee stores that are consolidated by the Company pursuant to Accounting Guideline 15, “*Consolidation of Variable Interest Entities*”, (“AcG 15”). In addition, sales include sales to and service fees from associated stores and independent account customers and franchised stores excluding VIE stores. The Company recognizes revenue at the time the sale is made to its customers.

**(Loss) Earnings per Share (“EPS”)** Basic EPS is calculated by dividing the net (loss) earnings available to common shareholders by the weighted average number of common shares outstanding during the year. Diluted EPS is calculated using the treasury stock method, which assumes that all outstanding stock options with an exercise price below the average market price during the year are exercised and the assumed proceeds are used to purchase the Company’s common shares at the average market price during the year.

**Cash, Cash Equivalents and Bank Indebtedness** Cash balances which the Company has the ability and intent to offset are used to reduce reported bank indebtedness. Cash equivalents are highly liquid investments with a maturity of 90 days or less.

**Short Term Investments** Short term investments are carried at the lower of cost or quoted market value and consist primarily of United States government securities, commercial paper and bank deposits.

**Credit Card Receivables** The Company, through *President’s Choice Bank* (“PC Bank”), a wholly owned subsidiary of the Company, has credit card receivables that are stated net of an allowance for credit losses. Credit card receivables, if contractually past due, are not classified as impaired but are fully written off on the earlier of when payments are contractually 180 days in arrears or when the likelihood of collection is considered remote. Interest income on credit card receivables is recorded on an accrual basis and is recognized in operating income.

**Allowance for Credit Losses** PC Bank maintains an allowance for probable credit losses on aggregate exposures for which losses cannot be determined on an item-by-item basis. The allowance is based upon a statistical analysis of past performance, the level of allowance already in place and management’s judgment. The allowance for credit losses is deducted from the credit card receivables balance. The net credit loss experience for the year is recognized in operating income.

**Securitization** PC Bank securitizes credit card receivables through the sale of a portion of the total interest in these receivables to independent trusts and does not exercise any control over the trusts’ management, administration or assets. The credit card receivables are removed from the consolidated balance sheet when PC Bank has surrendered control and are considered sold for accounting purposes pursuant to Accounting Guideline 12, “*Transfers of Receivables*”. When PC Bank sells credit card receivables in a securitization transaction, it has a retained interest in the securitized receivables represented by the rights to future cash flows after obligations to

investors have been met. Although *PC* Bank remains responsible for servicing all credit card receivables, it does not receive additional compensation for servicing those credit card receivables sold to the trusts and accordingly a service liability is recorded. Gains or losses on the sale of these receivables depends, in part, on the previous carrying amount of receivables involved in the securitization, allocated between the receivables sold and the retained interest, based on their relative fair values at the date of securitization. When quoted market values are not available, the fair values are determined using management's best estimate of the net present value of expected future cash flows using key assumptions for monthly payment rates, weighted average life, expected annual credit losses and discount rates. Any gain or loss on a sale is recognized in operating income at the time of the securitization. The carrying value of retained interests is periodically reviewed and when a decline in value is identified that is other than temporary, the carrying value is written down to fair value.

**Vendor Allowances** The Company receives allowances from certain of its vendors whose products it purchases for resale. These allowances are received for a variety of buying and/or merchandising activities, including vendor programs such as volume purchase allowances, purchase discounts, listing fees and exclusivity allowances. Consideration received from a vendor is a reduction in the cost of the vendor's products or services and is recognized as a reduction in the cost of sales, selling and administrative expenses and the related inventory when recognized in the consolidated statement of earnings and the consolidated balance sheet. Certain exceptions apply if the consideration is a payment for assets or services delivered to the vendor or for reimbursement of selling costs incurred to promote the vendor's products, provided that certain conditions are met.

**Inventories** Retail store inventories are stated at the lower of cost and estimated net realizable value less normal gross profit margin. Distribution centre inventories and seasonal general merchandise inventories are stated at the lower of cost and estimated net realizable value. Cost is determined substantially using the first-in, first-out method.

**Fixed Assets** Fixed assets are recorded at cost including capitalized interest. Depreciation commences when the assets are put into use and is recognized on a straight-line basis to depreciate the cost of these assets over their estimated useful lives. Estimated useful lives range from 20 to 40 years for buildings, 10 years for building improvements and from 3 to 10 years for equipment and fixtures. Leasehold improvements are depreciated over their estimated useful lives and may include renewal options when an improvement is made after inception of the lease to a maximum of 25 years, which approximates economic life. Equipment under capital leases is depreciated over the term of the lease.

Fixed assets are reviewed for impairment when events or changes in circumstances indicate that the carrying value exceeds the sum of the undiscounted future cash flows expected from use and eventual disposal. These events or changes in circumstances include a commitment to close a store or distribution centre or to relocate or convert a store. Fixed assets are also reviewed for impairment annually. For purposes of annually reviewing store assets for impairment, asset groups are reviewed at their lowest level for which identifiable cash flows are largely independent of cash flows of other assets and liabilities. Therefore, store net cash flows are grouped together by primary market areas, where cash flows are largely dependent on each other. Primary markets are regional areas where a number of store formats operate within close proximity to one another. If an indicator of impairment exists, such as sustained negative operating cash flows of the respective asset group, then an estimate of undiscounted future cash flows of each such store within this group is prepared and compared to its carrying value. For purposes of annually reviewing distribution centre assets for impairment, distribution centre net cash flows are grouped with the respective net cash flows of the stores they service. An impairment in the store network serviced by the distribution centre would indicate an impairment in the distribution centre assets as well. If these assets are determined to be impaired, the impairment loss is measured as the excess of the carrying value over fair value. In addition, the carrying value of fixed assets is evaluated whenever events or changes in circumstances indicate that the carrying value of fixed assets may not be recoverable. These events or changes in circumstances include a commitment to close a store or distribution centre or to relocate or convert a store where the carrying value of its assets is greater than the expected undiscounted future cash flows.

**Deferred Charges** Debt issue costs associated with long term debt are deferred and amortized on a straight-line basis over the term of the respective debt issues. Other deferred charges are amortized over the related assets' estimated useful lives, to a maximum of 15 years.

**Goodwill** Goodwill represents the excess of the purchase price of a business acquired over the fair value of the underlying net assets acquired at the date of acquisition. Goodwill is not amortized and its carrying value is tested at least annually for impairment. Any impairment in the carrying value of goodwill is recognized in operating income. Additional disclosure regarding the results of the 2006 annual goodwill impairment test is provided in Note 3.

**Financial Derivative Instruments** The Company uses financial derivative agreements in the form of cross currency basis swaps, interest rate swaps and equity forwards to manage its current and anticipated exposure to fluctuations in foreign currency exchange rates, interest rates and the market price of the Company's common shares. The Company does not enter into financial derivative agreements for trading or speculative purposes.

The Company formally identifies, designates and documents the relationships between hedging instruments and hedged items including cross currency basis swaps and interest rate swaps as cash flow hedges against its exposure to fluctuations in the foreign currency exchange rate and variable interest rates on a portion of its United States dollar denominated assets, principally cash equivalents and short term investments; and interest rate swaps as a cash flow hedge of the variable interest rate exposure on commercial paper. Effectiveness tests are performed to evaluate hedge effectiveness at inception and on an ongoing basis, both retrospectively and prospectively.

Realized and unrealized foreign currency exchange rate adjustments on cross currency basis swaps are offset by realized and unrealized foreign currency exchange rate adjustments on a portion of the Company's United States dollar denominated assets and are recognized in operating income. The cumulative unrealized foreign currency exchange rate receivable or payable is recorded in other assets or other liabilities, respectively. The exchange of interest payments on the cross currency basis swaps and interest rate swaps is recognized on an accrual basis in interest expense. Unrealized gains or losses on the interest rate swaps designated within an effective hedging relationship are not recognized.

Financial derivative instruments not designated within an effective hedging relationship are measured at fair value with changes in fair value recorded in interest expense.

Equity forwards are used to manage exposure to fluctuations in the Company's stock-based compensation cost because they change in value as the market price of the underlying common shares changes. The market price adjustments on the equity forwards are recognized in operating income as gains or losses and the cumulative unrealized gains or losses are recorded in other assets or other liabilities, respectively. Interest on the equity forwards is recognized on an accrual basis in interest expense.

**Foreign Currency Translation** Assets and liabilities denominated in foreign currencies are translated into Canadian dollars at the foreign currency exchange rate in effect at the balance sheet date. Exchange gains or losses arising from the translation of these balances denominated in foreign currencies are recognized in operating income. Revenues and expenses denominated in foreign currencies are translated into Canadian dollars at the average foreign currency exchange rate for the year.

**Income Taxes** The asset and liability method of accounting is used for income taxes. Under the asset and liability method, future income tax assets and liabilities are recognized for the future income tax consequences attributable to temporary differences between the financial statement carrying values of existing assets and liabilities and their respective income tax bases. Future income tax assets and liabilities are measured using enacted or substantively enacted income tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on future income tax assets and liabilities of a change in income tax rates is recognized in income tax expense when enacted or substantively enacted. Future income tax assets are evaluated and a valuation allowance, if required, is recorded against any future income tax asset if it is more likely than not that the asset will not be realized.

**Employee Future Benefits** The Company sponsors a number of pension plans including registered funded defined benefit pension plans, defined contribution pension plans and supplemental unfunded arrangements providing pension benefits in excess of statutory limits. The Company also offers certain employee post-retirement and post-employment benefit plans and a long term disability benefit plan. Post-retirement and post-employment benefit plans are not funded, are mainly non-contributory and include health care, life insurance and dental benefits. The Company also contributes to various multi-employer pension plans which provide pension benefits.

*Defined Benefit Plans* The cost and accrued benefit plan obligations of the Company's defined benefit pension plans and other benefit plans, including post-retirement, post-employment and long term disability benefits, are accrued based on actuarial valuations. The actuarial valuations are determined using the projected benefit method prorated on service and management's best estimate of the expected long term rate of return on plan assets, rate of compensation increase, retirement ages of employees and expected growth rate of health care costs. Actuarial valuations are performed using a September 30 measurement date for accounting purposes. Market values used to value benefit plan assets are as at the measurement date. The discount rate used to value the accrued benefit plan obligation is based on market interest rates as at the measurement date, assuming a portfolio of Corporate AA bonds with terms to maturity that, on average, match the terms of the accrued benefit plan obligation.

Past service costs arising from plan amendments are amortized over the expected average remaining service period of the active employees. The unamortized net actuarial gain or loss that exceeds 10% of the greater of the accrued benefit plan obligation or the fair value of the benefit plan assets at the beginning of the year is amortized over the expected average remaining service period of the active employees for defined benefit pension and post-retirement benefit plans. The unamortized net actuarial gain or loss for post-employment and long term disability benefits is amortized over periods not exceeding three years. The expected average remaining service period of the active employees covered by the defined benefit pension plans ranges from 6 to 17 years, with a weighted average of 13 years. The expected average remaining service period of the employees covered by the post-retirement benefit plans ranges from 6 to 22 years, with a weighted average of 18 years.

The accrued benefit plan asset or liability represents the cumulative difference between the cost and the funding contributions and is recorded in other assets and other liabilities.

*Defined Contribution and Multi-Employer Pension Plans* The costs of pension benefits for defined contribution pension plans and multi-employer pension plans are expensed as contributions are due.

**Stock Option Plan** The Company recognizes a compensation cost in operating income and a liability related to employee stock options that allow for settlement in shares or in the share appreciation value in cash at the option of the employee, using the intrinsic value method. Under the intrinsic value method, the stock-based compensation liability is the amount by which the market price of the common shares exceeds the exercise price of the stock options. A year-over-year change in the stock-based compensation liability is recognized in operating income on a prescribed vesting basis.

The Company accounts for stock options issued prior to December 30, 2001 that will be settled by issuing common shares as capital transactions. Consideration paid by employees on the exercise of this type of stock option is credited to common share capital. This type of option was last issued in 2001 and represents approximately 1.0% of all options outstanding at year end.

**Restricted Share Unit ("RSU") Plan** The Company recognizes a compensation cost in operating income for each RSU granted equal to the market value of a Loblaw common share at the date on which RSUs are awarded to each participant prorated over the performance period and adjusts for changes in the market value until the end of the performance date. The cumulative effect of the change in market value is recognized in operating income in the period of change.



**Employee Share Ownership Plan** The Company maintains an Employee Share Ownership Plan which allows employees to acquire the Company's common shares through regular payroll deductions of up to 5% of their gross regular earnings. The Company contributes an additional 25% of each employee's contribution to the plan, which is recognized in operating income as a compensation cost when the contribution is made.

**Deferred Share Units** Members of the Company's Board of Directors may elect annually to receive all or a portion of their annual retainer(s) and fees in the form of deferred share units, which are accounted for using the intrinsic value method. Under the intrinsic value method, the deferred share unit compensation liability is the amount by which the market price of the common shares exceeds the initial value of the deferred share unit. The year-over-year change in the deferred share unit compensation liability is recognized in operating income.

**Use of Estimates and Assumptions** The preparation of the consolidated financial statements requires management to make estimates and assumptions that affect the reported amounts and disclosures made in the consolidated financial statements and accompanying notes. These estimates and assumptions are based on management's historical experience, best knowledge of current events and conditions and activities that may be undertaken in the future. Actual results could differ from these estimates.

Certain estimates, such as those related to valuation of inventories, goodwill, income taxes, Goods and Services Tax and provincial sales taxes, fixed assets and employee future benefits, depend upon subjective or complex judgments about matters that may be uncertain, and changes in those estimates could materially impact the consolidated financial statements.

**Comparative Information** Certain prior year's information was reclassified to conform with current year's presentation.

## **Note 2. Implementation of New Accounting Standards**

### **Accounting Standards Implemented in 2006**

Effective January 1, 2006, the Company implemented Emerging Issues Committee Abstract 156, "*Accounting by a Vendor for Consideration Given to a Customer (Including a Reseller of the Vendor's Products)*", ("EIC 156") issued by the Canadian Institute of Chartered Accountants in September 2005. EIC 156 addresses cash consideration, including sales incentives, given by a vendor to a customer. This consideration is presumed to be a reduction of the selling price of the vendor's products and should therefore be classified as a reduction of sales in the vendor's statement of earnings.

Prior to the implementation of EIC 156, the Company recorded certain sales incentives paid to independent franchisees, associates and independent accounts in cost of sales, selling and administrative expenses on the consolidated statements of earnings. Accordingly, the implementation of EIC 156, on a retroactive basis, resulted in a reduction in both sales and cost of sales, selling and administrative expenses of \$174 for 2005. As reclassifications, these changes did not impact net earnings.

### **Accounting Standards Implemented in 2005**

Effective January 2, 2005, the Company implemented AcG 15, retroactively without restatement of prior periods and as a result, the Company consolidates entities in which it has control through ownership of a majority of the voting interests as well as all VIEs for which it is the primary beneficiary.

AcG 15 defines a variable interest entity as an entity that either does not have sufficient equity at risk to finance its activities without subordinated financial support or where the holders of the equity at risk lack the characteristics of a controlling financial interest. AcG 15 requires the primary beneficiary to consolidate VIEs and considers an entity to be the primary beneficiary of a VIE if it holds variable interests that expose it to a majority of the VIE's expected losses or that entitle it to receive a majority of the VIE's expected residual returns or both.

Upon implementation of AcG 15, the Company identified the following significant VIEs:

**Independent Franchisees** The Company enters into various forms of franchise agreements that generally require the independent franchisee to purchase inventory from the Company and pay certain fees in exchange for services provided by the Company and for the right to use certain trademarks and licences owned by the Company. Independent franchisees generally lease the land and building from the Company, and when eligible, may obtain financing through a structure involving independent trusts to facilitate the purchase of the majority of their inventory and fixed assets, consisting mainly of fixturing and equipment. These trusts are administered by a major Canadian chartered bank. Under the terms of certain franchise agreements, the Company may also lease equipment to independent franchisees. Independent franchisees may also obtain financing through operating lines of credit with traditional financial institutions or through issuing preferred shares or notes payable to the Company. The Company monitors the financial condition of its independent franchisees and provides for estimated losses or write-downs on its accounts and notes receivable or investments when appropriate. Upon implementation of AcG 15, the Company determined that 121 of its independent franchise stores met the criteria for VIEs that require consolidation by the Company pursuant to AcG 15.

As at year end 2006, 123 (2005 – 123) of the Company's independent franchise stores met the criteria for a VIE and were consolidated pursuant to AcG 15.

**Warehouse and Distribution Agreement** The Company has entered into a warehouse and distribution agreement with a third party to provide to the Company distribution and warehousing services from a dedicated facility. The Company has no equity interest in this third party; however, the terms of the agreement with the third party are such that the Company has determined that the third party meets the criteria for a VIE that requires consolidation by the Company. As a result of the fee structure agreed to with this third party, the impact of the consolidation of the warehouse and distribution entity was not material.

Accordingly, the Company has included the results of these independent franchisees and this third-party entity that provides distribution and warehousing services in its consolidated financial statements effective January 2, 2005.

An after-tax, one-time charge of \$29 (net of income taxes of \$12) was recorded upon implementation and resulted mainly from delaying the recognition of vendor monies to when the related inventories of the independent franchisees are sold to their customers, the excess of the independent franchisees' accumulated losses over the allowance for doubtful accounts previously recorded by the Company and the reversal of initial franchise fees initially recognized upon the sale of franchises to third parties.

**Independent Trust** The Company has also identified that it holds a variable interest, by way of a standby letter of credit, in an independent trust which is used to securitize credit card receivables for *PC* Bank. In these securitizations, *PC* Bank sells a portion of its credit card receivables to the independent trust in exchange for cash. Although this independent trust has been identified as a VIE, it was determined that the Company is not the primary beneficiary and therefore this VIE is not subject to consolidation by the Company. The Company's maximum exposure to loss as a result of its involvement with this independent trust is disclosed in Notes 11 and 21.

The consolidation of these VIEs by the Company does not result in any change to its tax, legal or credit risks, nor does it result in the Company assuming any obligations of these third parties.

### Note 3. Goodwill

Goodwill is assessed for impairment at the reporting unit level at least annually. Any potential goodwill impairment is identified by comparing the fair value of a reporting unit to its carrying value. If the fair value of the reporting unit exceeds its carrying value, goodwill is considered not to be impaired. If the carrying value of the reporting unit exceeds its fair value, a more detailed goodwill impairment assessment must be undertaken. A goodwill impairment charge is recognized to the extent that, at the reporting unit level, the carrying value of goodwill exceeds the implied fair value.

The Company determines the fair value using a discounted cash flow model corroborated by other valuation techniques such as market multiples. The process of determining these fair values requires management to make estimates and assumptions including, but not limited to projected future sales, earnings and capital investment, discount rates and terminal growth rates. Projected future sales, earnings and capital investment are consistent with strategic plans presented to the Company's Board of Directors. Discount rates are based on an industry weighted average cost of capital. These estimates and assumptions are subject to change in the future due to uncertain competitive and economic market conditions or changes in business strategies.

In 2006, the Company performed the annual goodwill impairment test and it was determined that the carrying value of the goodwill established on the acquisition of Provigo Inc. in 1998 exceeded its respective fair value. As a result, the Company recorded in operating income a non-cash goodwill impairment charge of \$800 relating to this goodwill. The Company expects no income tax deduction from this non-cash goodwill impairment charge. The determination that the fair value of goodwill was less than its carrying value resulted from a decline in market multiples, both from an industry and Company perspective, and a reduction of fair value as determined using the discounted cash flow methodology, incorporating both current Company and market assumptions, which in combination resulted in the goodwill impairment. This non-cash goodwill impairment charge is expected to be adjusted if necessary in the first half of 2007 and may result in a charge or credit to operating income in the consolidated statement of earnings and in the carrying value of goodwill on the balance sheet.

In the normal course of business, the Company may acquire from time to time franchisee stores and convert them to corporate stores. In 2006, the Company acquired 7 franchisee businesses (2005 – 7 franchisee businesses). The acquisitions were accounted for using the purchase method of accounting with the results of the business acquired included in the consolidated financial statements from the date of acquisition. The fair value of the net assets acquired consisted of fixed assets of \$2 (2005 – nominal), other assets principally inventory of \$2 (2005 – \$3) and goodwill of \$7 (2005 – \$3) for cash consideration of \$9 (2005 – \$5), net of accounts receivable due from the franchisees of \$2 (2005 – \$1).

The consolidated balance sheet as at year end 2006 includes \$4 (2005 – \$4) of goodwill of independent franchisees that were consolidated by the Company pursuant to the requirements of AcG 15.

During 2005, the Company reduced goodwill by \$41 due to the resolution of certain income tax matters previously accrued for as part of the Provigo Inc. purchase equation.

The following table discloses the changes in goodwill over 2006 and 2005.

	2006	2005
Balance, beginning of year	\$ 1,587	\$ 1,621
Goodwill acquired	7	7
Goodwill impairment	(800)	—
Other adjustments	—	(41)
Balance, end of year	\$ 794	\$ 1,587

#### **Note 4. Restructuring and Other Charges**

##### **Store Operations**

During 2006, the Company completed assessments of its store operations, and approved and communicated plans to restructure certain of its store operations. The total restructuring cost under these plans is estimated to be approximately \$54. Of the \$54 total estimated costs, approximately \$10 is attributable to employee termination benefits which include severance resulting from the termination of employees, \$25 to fixed asset impairment and accelerated depreciation of assets relating to these restructuring activities and \$19 to site closing and other costs including lease obligations. In 2006, the Company recognized \$35 of these restructuring costs, which are composed of \$9 for employee termination benefits, \$25 for fixed asset impairment and accelerated depreciation and \$1 for other costs directly associated with those initiatives. The components of the store operations restructuring plan are described below.

As part of a review of the Quebec store operations, the Company approved and communicated a plan in 2006 to close 19 underperforming stores, mainly within the *Provigo* banner. This initiative is expected to be completed during 2007 and the total restructuring cost under this initiative is estimated to be approximately \$40, of which \$28 was recognized in 2006.

Based on the Company's review of the impact on the Cash & Carry and wholesale club network of the loss in tobacco sales following the decision by a major tobacco supplier to sell directly to certain customers of the Company, the Company approved and communicated a plan in 2006 to close 24 wholesale outlets which were impacted most significantly by this change. This initiative is expected to be completed during 2007 and the total restructuring cost under this initiative is estimated to be approximately \$10, of which \$6 was recognized in 2006.

As part of a review of the Atlantic store operations, the Company approved and communicated a plan in 2006 to close 8 stores in the Atlantic region. This initiative is expected to be completed during 2007 and the total restructuring cost under this initiative is estimated to be approximately \$4, of which \$1 was recognized in 2006.

##### **Supply Chain Network**

During 2005, the Company approved a comprehensive plan to restructure its supply chain operations nationally. The restructuring plan is now expected to be completed by the first quarter of 2009 and the total restructuring cost under this plan is estimated to be approximately \$90. Of the \$90 total estimated cost, approximately \$57 is attributable to employee termination benefits which include severance and additional pension costs resulting from the termination of employees, \$13 to fixed asset impairment and accelerated depreciation of assets relating to this restructuring activity and \$20 to site closing and other costs directly attributable to the restructuring plan. In 2006, the Company recognized \$8 (2005 – \$62) of restructuring costs resulting from this plan which is composed of \$4 (2005 – \$45) for employee termination benefits resulting from planned involuntary terminations, \$2 (2005 – \$11) for fixed asset impairment and accelerated depreciation and \$2 (2005 – \$6) for other costs directly associated with those initiatives.

##### **Office Move and Reorganization of the Operation Support Functions**

During 2005, the Company consolidated several administrative and operating offices from across southern Ontario into a new National Head Office and Store Support Centre in Brampton, Ontario and reorganized the merchandising, procurement and operations groups which included the transfer of the general merchandise operations from Calgary, Alberta to the new office. Of the expected \$25 of costs related to these initiatives, \$24 were recognized in 2005 and \$1 was recognized in 2006.

The following table provides a summary of the costs recognized and cash payments made, as well as the corresponding net liability as at December 30, 2006 and December 31, 2005:

	Employee Termination Benefits	Site Closing Costs and Other	Total Net Liability	Fixed Asset Impairment and Accelerated Depreciation	2006 Total	2005 Total
Net liability, beginning of year	\$ 41	\$ —	\$ 41	\$ —	\$ —	\$ —
Costs recognized:						
Store operations	9	1	10	25	35	—
Supply chain network	4	2	6	2	8	62
Office move and reorganization of the operation support functions	—	1	1	—	1	24
	\$ 13	\$ 4	\$ 17	\$ 27	\$ 44	\$ 86
Cash payments:						
Store operations	\$ —	\$ 1	\$ 1		\$ 1	\$ —
Supply chain network	4	2	6		6	13
Office move and reorganization of the operation support functions	1	1	2		2	18
	\$ 5	\$ 4	\$ 9		\$ 9	\$ 31
Charges against other assets <sup>(1)</sup>	\$ 9	\$ —	\$ 9		\$ 9	\$ —
Net liability, end of year	\$ 40	\$ —	\$ 40		\$ 40	\$ 41
Recorded in the consolidated balance sheet as follows:						
Other assets <sup>(1)</sup> (note 15)	\$ —		\$ —		\$ —	\$ 9
Accounts payable and accrued liabilities	19		19		19	7
Other liabilities (note 17)	21		21		21	25
Net liability, end of year	\$ 40		\$ 40		\$ 40	\$ 41

(1) Represents defined benefit pension plan cost applied to other assets. Charges against other assets relates to the contractual termination benefits cost recognized in 2005 which reduced the accrued benefit plan asset.

## Note 5. Goods and Services Tax (“GST”) and Provincial Sales Taxes (“PST”)

During 2005, the Company recorded a charge relating to an audit and proposed assessment by the Canada Revenue Agency relating to GST on certain products sold on which GST was not appropriately charged and remitted. In light of this proposed assessment, the Company assessed and estimated the potential liabilities for GST and PST in other areas of its operations for various periods. Accordingly, a charge of \$40 was recorded in operating income in 2005. Approximately \$1 was paid in 2006 (2005 – \$15) and approximately \$24 remains accrued as at December 30, 2006. The ultimate remaining amount to be paid will depend on the outcome of audits performed by, or settlements reached with the various tax authorities and therefore may differ from this estimate. Management will continue to assess the remaining accrual as progress towards resolution with the various tax authorities is made and will adjust the remaining accrual accordingly.

**Note 6. Collective Agreement**

During 2006, members of certain Ontario locals of the United Food and Commercial Workers union ratified a new four-year collective agreement. The new agreement enables the Company to convert 44 stores in Ontario to the *Real Canadian Superstore* banner or food stores with equivalent labour economics, and the flexibility to invest in additional store labour where appropriate. As a result of securing this agreement, the Company recognized a one-time charge of \$84 in operating income, including a \$36 amount due to a multi-employer pension plan and a payment of \$38 which was due upon ratification.

**Note 7. Interest Expense**

	2006	2005
Interest on long term debt	\$ 284	\$ 290
Interest expense (income) on financial derivative instruments	7	(6)
Net short term interest	(11)	(11)
Capitalized to fixed assets	(21)	(21)
Interest expense	\$ 259	\$ 252

Net interest paid in 2006 was \$278 (2005 – \$263).

**Note 8. Income Taxes**

The effective income tax rate in the consolidated statements of earnings is reported at a rate different than the weighted average basic Canadian federal and provincial statutory income tax rate for the following reasons:

	2006	2005
Weighted average basic Canadian federal and provincial statutory income tax rate	33.7%	34.4%
Net (decrease) increase resulting from:		
Earnings in jurisdictions taxed at rates different from the Canadian statutory income tax rates	(0.6)	0.5
Non-taxable amounts	(1.1)	(0.7)
Large corporation tax	–	0.5
Statutory income tax rate changes on future income tax balances	(2.1)	0.3
Successful resolution of certain income tax matters from a previous year and other	–	(0.2)
Effective income tax rate before impact of non-deductible goodwill impairment charge	29.9%	34.8%
Non-deductible goodwill impairment charge	796.8	–
Effective income tax rate	826.7%	34.8%

Net income taxes paid in 2006 were \$325 (2005 – \$387).

The cumulative effects of changes in Canadian federal and certain provincial statutory income tax rates on future income tax assets and liabilities are included in the consolidated financial statements at the time of substantive enactment. Accordingly, in 2006 a \$16 reduction to future income tax expense was recognized as a result of the reduction in the Canadian federal and certain provincial statutory income tax rates, compared to a \$3 charge to future income tax expense in 2005 as a result of statutory income tax rate changes in certain provinces.

The income tax effects of temporary differences that gave rise to significant portions of the future income tax assets (liabilities) were as follows:

	2006	2005
Accounts payable and accrued liabilities	\$ 55	\$ 55
Other liabilities	117	86
Fixed assets	(278)	(278)
Other assets	(103)	(64)
Losses carried forward (expiring 2026)	20	6
Other	40	30
<b>Net future income tax liabilities</b>	<b>\$ (149)</b>	<b>\$ (165)</b>
	2006	2005
Recorded in the consolidated balance sheets as follows:		
Current future income tax assets	\$ 85	\$ 72
Non-current future income tax liabilities	(234)	(237)
<b>Net future income tax liabilities</b>	<b>\$ (149)</b>	<b>\$ (165)</b>

**Note 9. Basic and Diluted Net (Loss) Earnings per Common Share** (\$, except where otherwise indicated)

	2006	2005
Net (loss) earnings (\$ millions)	\$ (219)	\$ 746
Weighted average common shares outstanding (in millions)	274.1	274.2
Dilutive effect of stock-based compensation (in millions)	.2	.8
Diluted weighted average common shares outstanding (in millions)	274.3	275.0
Basic net (loss) earnings per common share	\$ (.80)	\$ 2.72
Dilutive effect of stock-based compensation per common share	–	(.01)
<b>Diluted net (loss) earnings per common share</b>	<b>\$ (.80)</b>	<b>\$ 2.71</b>

Stock options outstanding with an exercise price greater than the market price of the Company's common shares at December 30, 2006 were not recognized in the computation of diluted net (loss) earnings per common share. Accordingly, for 2006, 4,027,406 (2005 – 2,254,639) stock options, with a weighted average exercise price of \$61.55 (2005 – \$69.58) per common share, were excluded from the computation of diluted net (loss) earnings per common share.



**Note 10. Cash, Cash Equivalents and Short Term Investments**

At year end, the Company had \$864 (2005 – \$837) in cash, cash equivalents and short term investments held by Glenhuron Bank Limited (“Glenhuron”), a wholly owned subsidiary of the Company in Barbados. The \$40 (2005 – \$27) of income from cash, cash equivalents and short term investments was recognized in net short term interest.

The Company recognized an unrealized foreign currency exchange gain of \$2 (2005 – \$31 loss) as a result of translating its United States dollar denominated cash, cash equivalents and short term investments, of which \$1 income (2005 – \$31 loss) related to cash and cash equivalents. The resulting gain or loss on cash, cash equivalents and short term investments is offset in operating income by the unrealized foreign currency exchange gain on the cross currency basis swaps. A cumulative unrealized foreign currency exchange receivable of \$165 (2005 – \$168) relating to these swaps is recorded in other assets on the balance sheet.

**Note 11. Credit Card Receivables**

The Company, through *PC* Bank, securitizes credit card receivables through the sale of a portion of the total interest in these receivables to independent trusts and does not exercise any control over the trusts’ management, administration or assets. When *PC* Bank sells credit card receivables in a securitization transaction, it has a retained interest in the securitized receivables represented by the right to future cash flows after obligations to investors have been met. Although *PC* Bank remains responsible for servicing all credit card receivables, it does not receive additional compensation for servicing those credit card receivables sold to the trusts.

During 2006, \$240 (2005 – \$225) of credit card receivables were securitized through the sale of a portion of the total interest in these receivables to independent trusts, yielding a nominal net loss (2005 – nominal net loss) on the initial sale inclusive of nil (2005 – \$1) servicing liability. Servicing liabilities expensed during the year were \$14 (2005 – \$13) and the fair value at year end of recognized servicing liabilities was \$8 (2005 – \$8). The trusts’ recourse to *PC* Bank’s assets is limited to *PC* Bank’s retained interests and is further supported by the Company through a standby letter of credit for 9% (2005 – 9%) on a portion of the securitized amount.

	2006	2005
Credit card receivables	\$ 1,571	\$ 1,257
Amount securitized	(1,250)	(1,010)
Net credit card receivables	\$ 321	\$ 247
Net credit loss experience	\$ 9	\$ 5

The net credit loss experience of \$9 (2005 – \$5) includes \$45 (2005 – \$33) of credit losses on the total portfolio of credit card receivables net of credit losses of \$36 (2005 – \$28) relating to securitized credit card receivables. The following table displays the sensitivity of the current fair value of retained interests to an immediate 10% and 20% adverse change in the 2006 key economic assumptions. The sensitivity analysis provided in the table is hypothetical and should be used with caution. The sensitivities of each key assumption have been calculated independently of any changes in other key assumptions. Actual experience may result in changes in a number of key assumptions simultaneously. Changes in one factor may result in changes in another, which could amplify or reduce the impact of such assumptions.

	2006	Change in Assumptions	
		10%	20%
Carrying value of retained interests	\$ 5		
Payment rate (monthly)	44.0%		
Weighted average life (years)	.7		
Expected credit losses (annual)	3.14%	\$ (.7)	\$ (1.4)
Discount rate applied to residual cash flows (annual)	14.83%	\$ (2.4)	\$ (4.9)

The details on the cash flows from securitization are as follows:

	2006	2005
Proceeds from new securitizations	\$ 240	\$ 225
Net cash flows received on retained interests	\$ 116	\$ 106

In 2006, *PC Bank* restructured its credit card securitization program. Eagle Credit Card Trust (“Eagle”), a previously established independent trust, issued \$500 of five year senior notes and subordinated notes due 2011 at a weighted average rate of 4.5% to finance the purchase of credit card receivables previously securitized by *PC Bank* through an independent trust. The subordinated notes provide credit support to those notes which are more senior. *PC Bank* will continue to service the credit card receivables on behalf of Eagle, but will not receive any fee for its servicing obligations and has a retained interest in the securitized receivables represented by the right to future cash flows after obligations to investors have been met. In accordance with Canadian GAAP, the financial statements of Eagle are not consolidated with those of the Company. The restructuring of the portfolio yielded a nominal net loss.

## Note 12. Inventory Liquidation

As part of the Company’s review of inventory levels, certain excess inventory, primarily general merchandise, was identified.

The Company recognized a charge of \$68 in operating income as a result of its decision to proceed with the liquidation of this inventory, reflecting the write-down of inventory to recovery values and the associated costs of facilitating the disposition incurred to date. Additional costs are to be recognized as appropriate criteria are met.

**Note 13. Fixed Assets**

	2006			2005		
	Cost	Accumulated Depreciation	Net Book Value	Cost	Accumulated Depreciation	Net Book Value
Properties held for development	\$ 500		\$ 500	\$ 442		\$ 442
Properties under development	226		226	231		231
Land	1,699		1,699	1,629		1,629
Buildings	4,955	\$ 1,012	3,943	4,579	\$ 835	3,744
Equipment and fixtures	3,788	2,475	1,313	3,589	2,207	1,382
Building and leasehold improvements	611	269	342	647	290	357
	<b>11,779</b>	<b>3,756</b>	<b>8,023</b>	11,117	3,332	7,785
Capital leases – buildings and equipment	129	97	32	95	95	–
	<b>\$ 11,908</b>	<b>\$ 3,853</b>	<b>\$ 8,055</b>	\$ 11,212	\$ 3,427	\$ 7,785

Fixed asset impairment and accelerated depreciation charges of \$32 (2005 – \$7) were recognized in operating income. An additional \$27 (2005 – \$14) was recognized in restructuring and other charges in 2006 (see Note 4). The fair values were determined using quoted market prices where available, independent offers to purchase where available or prices for similar assets.

**Note 14. Other Assets**

	2006	2005
Franchise investments and other receivables	\$ 195	\$ 194
Accrued benefit plan asset (note 15)	182	139
Unrealized equity forwards receivable (note 20)	–	30
Unrealized cross currency basis swaps receivable (notes 10 and 20)	165	168
Deferred charges and other	147	157
	<b>\$ 689</b>	<b>\$ 688</b>

## **Note 15. Employee Future Benefits**

### **Pension and Other Benefit Plans**

The Company sponsors a number of pension plans, including registered funded defined benefit pension plans, defined contribution pension plans and supplemental unfunded arrangements providing pension benefits in excess of statutory limits. Certain obligations of the Company to these supplemental pension arrangements are secured by a standby letter of credit issued by a major Canadian chartered bank. The Company's defined benefit pension plans are predominantly non-contributory and these benefits are, in general, based on career average earnings.

A new national defined contribution pension plan for salaried employees was introduced by the Company during 2006. All eligible salaried employees were given the option to join this new plan and convert their past accrued pension benefits or to remain in their existing defined benefit pension plans. All new salaried employees will participate only in the new national defined contribution pension plan.

The Company also offers certain employee post-retirement and post-employment benefit plans and a long term disability benefit plan. Post-retirement and post-employment benefit plans are not funded, are mainly non-contributory and include health care, life insurance and dental benefits. Employees eligible for post-retirement benefits are those who retire at certain retirement ages and employees eligible for post-employment benefits are those on long term disability leave. The majority of post-retirement health care plans for current and future retirees include a limit on the total benefits payable by the Company.

The Company also contributes to various multi-employer pension plans that provide pension benefits.

The accrued benefit plan obligations and the fair value of the benefit plan assets were determined using a September 30 measurement date for accounting purposes.

### **Funding of Pension and Other Benefit Plans**

The most recent actuarial valuations of the defined benefit pension plans for funding purposes ("funding valuations") are to be performed as at December 31, 2006 for all plans, except two plans which were as at December 31, 2004. The Company is required to file funding valuations at least every three years; accordingly, the next required funding valuations for the above mentioned plans will be performed no later than December 31, 2009 and 2007, respectively.

Total cash payments made by the Company during 2006, consisting of contributions to funded defined benefit pension plans, defined contribution pension plans, multi-employer pension plans, long term disability benefit plan and benefits paid directly to beneficiaries of the unfunded defined benefit pension plans and unfunded other benefit plans, were \$166 (2005 – \$134). The Company has accrued \$36 relating to a one-time contribution to a multi-employer pension plan (see Note 6).

During 2007, the Company expects to contribute approximately \$75 to its registered funded defined benefit pension plans. This estimate may vary subject to the completion of actuarial valuations, market performance and regulatory requirements. The Company also expects to make contributions in 2007 to defined contribution pension plans and multi-employer pension plans as well as benefit payments directly to beneficiaries of the unfunded defined benefit pension plans and unfunded other benefit plans.

**Pension and Other Benefit Plans Status**

Information on the Company's defined benefit pension plans and other benefit plans, in aggregate, was as follows:

	2006			2005		
	Pension Benefit Plans	Other Benefit Plans <sup>(1)</sup>	Total	Pension Benefit Plans	Other Benefit Plans <sup>(1)</sup>	Total
<b>Benefit Plan Assets</b>						
Fair value, beginning of year	\$ 944	\$ 42	\$ 986	\$ 838	\$ 35	\$ 873
Actual return (loss) on plan assets	74	(1)	73	98	2	100
Employer contributions	90	21	111	61	22	83
Employee contributions	2	—	2	2	—	2
Benefits paid	(58)	(18)	(76)	(53)	(17)	(70)
Other	—	—	—	(2)	—	(2)
Fair value, end of year	\$ 1,052	\$ 44	\$ 1,096	\$ 944	\$ 42	\$ 986
<b>Accrued Benefit Plan Obligations</b>						
Balance, beginning of year	\$ 1,155	\$ 243	\$ 1,398	\$ 937	\$ 181	\$ 1,118
Current service cost	50	9	59	37	4	41
Interest cost	62	13	75	60	11	71
Benefits paid	(58)	(18)	(76)	(53)	(17)	(70)
Actuarial loss	55	61	116	173	64	237
Past service costs	—	—	—	—	2	2
Contractual termination benefits <sup>(2)</sup>	—	—	—	9	—	9
Curtailment gain <sup>(3)</sup>	—	—	—	(6)	(2)	(8)
Other	(2)	—	(2)	(2)	—	(2)
Balance, end of year	\$ 1,262	\$ 308	\$ 1,570	\$ 1,155	\$ 243	\$ 1,398
<b>Deficit of Plan Assets Versus Plan Obligations</b>						
Unamortized past service costs	\$ (210)	\$ (264)	\$ (474)	\$ (211)	\$ (201)	\$ (412)
Unamortized net actuarial loss	5	(7)	(2)	6	(7)	(1)
	313	172	485	271	128	399
Net accrued benefit plan asset (liability)	\$ 108	\$ (99)	\$ 9	\$ 66	\$ (80)	\$ (14)
Recorded in the consolidated balance sheets as follows:						
Other assets (note 14)	\$ 145	\$ 37	\$ 182	\$ 102	\$ 37	\$ 139
Other liabilities (note 17)	(37)	(136)	(173)	(36)	(117)	(153)
Net accrued benefit plan asset (liability)	\$ 108	\$ (99)	\$ 9	\$ 66	\$ (80)	\$ (14)

(1) Other benefit plans include post-retirement, post-employment and long term disability benefit plans.

(2) Contractual termination benefits resulted from the 2005 plan to restructure the supply chain operations nationally and were recorded in restructuring and other charges in 2005 (see Note 4).

(3) Certain defined benefit pension plans and other benefit plans affected by the 2005 plan to restructure the supply chain operations nationally were remeasured as at March 31, 2005 and costs subsequent to April 1, 2005 were determined using a discount rate of 5.75%. This resulted in a nominal impact to 2005 net earnings and curtailment gains which were offset against unamortized net actuarial losses for those plans.

### Funded Status of Plans in a Deficit

Included in the accrued benefit plan obligations and the fair value of benefit plan assets at year end are the following amounts in respect of plans with accrued benefit plan obligations in excess of benefit plan assets:

	2006		2005	
	Pension Benefit Plans	Other Benefit Plans	Pension Benefit Plans	Other Benefit Plans
Fair Value of Benefit Plan Assets	\$ 1,052	\$ 44	\$ 944	\$ —
Accrued Benefit Plan Obligations	1,262	308	1,155	202
Deficit of Plan Assets versus Plan Obligations	\$ 210	\$ 264	\$ 211	\$ 202

### Asset Allocations

The benefit plan assets are held in trust and at September 30 consisted of the following asset categories:

Percentage of Plan Assets	2006		2005	
	Pension Benefit Plans	Other Benefit Plans	Pension Benefit Plans	Other Benefit Plans
Asset Category				
Equity securities	63%	—%	64%	—%
Debt securities	36%	93%	34%	99%
Cash and cash equivalents	1%	7%	2%	1%
Total	100%	100%	100%	100%

Pension benefit plan assets include securities issued by the Company's majority shareholder, George Weston Limited ("Weston") having a fair value of \$3 (2005 – \$4) as at September 30. Other benefit plan assets do not include any Weston or Loblaw securities.

**Pension and Other Benefit Plans Cost**

The total net cost for the Company's benefit plans and multi-employer pension plans was as follows:

	2006		2005	
	Pension Benefit Plans	Other Benefit Plans	Pension Benefit Plans	Other Benefit Plans
Current service cost, net of employee contributions	\$ 48	\$ 9	\$ 35	\$ 4
Interest cost on plan obligations	62	13	60	11
Actual (return) loss on plan assets	(74)	1	(98)	(2)
Actuarial loss	55	61	173	64
Past service costs	—	—	—	2
Contractual termination benefits <sup>(1)</sup>	—	—	9	—
Defined benefit plan cost, before adjustments to recognize the long term nature of employee future benefit costs	91	84	179	79
(Shortfall) excess of actual return over expected return on plan assets	(1)	(4)	30	—
Shortfall of amortized net actuarial loss over actual actuarial loss on accrued benefit obligation	(43)	(40)	(170)	(59)
Excess (shortfall) of amortized past service costs over actual past service costs	1	—	—	(2)
Net defined benefit plan cost	48	40	39	18
Defined contribution plan cost	6	—	6	—
Multi-employer pension plan cost <sup>(2)</sup>	85	—	45	—
Net benefit plan cost	\$ 139	\$ 40	\$ 90	\$ 18
Recognized in the consolidated statements of earnings as follows:				
Pension and other benefit plan costs	\$ 139	\$ 40	\$ 81	\$ 18
Restructuring and other charges <sup>(1)</sup>	—	—	9	—
Net benefit plan cost	\$ 139	\$ 40	\$ 90	\$ 18

(1) Contractual termination benefits resulted from the 2005 plan to restructure the supply chain operations nationally and were recorded in restructuring and other charges in 2005 (see Note 4).

(2) Included in 2006 is a \$36 amount due relating to a one-time contribution to a multi-employer pension plan (see Note 6).



## Plan Assumptions

The significant annual weighted average actuarial assumptions used in calculating the Company's accrued benefit plan obligations as at the measurement date of September 30 and the net defined benefit plan cost for the year were as follows:

	2006		2005	
	Pension Benefit Plans	Other Benefit Plans	Pension Benefit Plans	Other Benefit Plans
Accrued Benefit Plan Obligations				
Discount rate	5.0%	5.0%	5.25%	5.2%
Rate of compensation increase	3.5%		3.5%	
Net Defined Benefit Plan Cost				
Discount rate <sup>(1)</sup>	5.25%	5.2%	6.25%	6.1%
Expected long term rate of return on plan assets	8.0%	5.0%	8.0%	5.5%
Rate of compensation increase	3.5%		3.5%	

(1) Certain defined benefit pension plans and other benefit plans affected by the 2005 plan to restructure the supply chain operations nationally were remeasured as at March 31, 2005 and costs subsequent to April 1, 2005 were determined using a discount rate of 5.75%. This resulted in a nominal impact to 2005 net earnings and curtailment gains which were offset against unamortized net actuarial losses for those plans.

The growth rate of health care costs, primarily drug and other medical costs for other benefit plans, was estimated at 10.0% (2005 – 10.0%) and is assumed to gradually decrease to 5.0% by 2014 (2005 – 5.0% by 2013), remaining at that level thereafter.

**Sensitivity of Key Assumptions**

The following table outlines the key assumptions for 2006 and the sensitivity of a 1% change in each of these assumptions on the accrued benefit plan obligations and on the benefit plan cost for defined benefit pension plans and other benefit plans. The table reflects the impact on the current service and interest cost components for the discount rate and expected growth rate of health care costs assumptions.

The sensitivity analysis provided in the table is hypothetical and should be used with caution. The sensitivities of each key assumption have been calculated independently of any changes in other key assumptions. Actual experience may result in changes in a number of key assumptions simultaneously. Changes in one factor may result in changes in another, which could amplify or reduce the impact of such assumptions.

	Pension Benefit Plans		Other Benefit Plans	
	Accrued Benefit Plan Obligations	Benefit Plan Cost <sup>(1)</sup>	Accrued Benefit Plan Obligations	Benefit Plan Cost <sup>(1)</sup>
Expected long term rate of return on plan assets		8.0%		5.0%
Impact of: 1% increase	n/a	\$ (9)	n/a	\$ —
1% decrease	n/a	\$ 9	n/a	\$ —
Discount rate	5.0%	5.25%	5.0%	5.2%
Impact of: 1% increase	\$ (173)	\$ (10)	\$ (38)	\$ (2)
1% decrease	\$ 201	\$ 10	\$ 45	\$ 2
Expected growth rate of health care costs <sup>(2)</sup>			10.0%	10.0%
Impact of: 1% increase	n/a	n/a	\$ 35	\$ 4
1% decrease	n/a	n/a	\$ (30)	\$ (3)

n/a – not applicable

(1) Discount rate and expected growth rate of health care costs sensitivity is for current service and interest costs only.

(2) Gradually decreasing to 5.0% by 2014 for the accrued benefit plan obligation and the benefit plan cost, and remaining at that level thereafter.

## Note 16. Long Term Debt

	2006	2005
<b>Provigo Inc. Debentures</b>		
Series 1996, 8.70%, due 2006 (i)	\$ —	\$ 125
Other	—	1
<b>Loblaw Companies Limited Notes</b>		
6.00%, due 2008	390	390
5.75%, due 2009	125	125
7.10%, due 2010	300	300
6.50%, due 2011	350	350
5.40%, due 2013	200	200
6.00%, due 2014	100	100
7.10%, due 2016	300	300
6.65%, due 2027	100	100
6.45%, due 2028	200	200
6.50%, due 2029	175	175
11.40%, due 2031		
— principal	151	151
— effect of coupon repurchase	(34)	(26)
6.85%, due 2032	200	200
6.54%, due 2033	200	200
8.75%, due 2033	200	200
6.05%, due 2034	200	200
6.15%, due 2035	200	200
5.90%, due 2036 (i)	300	300
6.45%, due 2039	200	200
7.00%, due 2040	150	150
5.86%, due 2043	55	55
Other at a weighted average interest rate of 8.69%, due 2007 to 2043	21	33
VIE loans payable and capital leases (ii)	156	126
<b>Total long term debt</b>	<b>4,239</b>	<b>4,355</b>
<b>Less amount due within one year</b>	<b>27</b>	<b>161</b>
	<b>\$ 4,212</b>	<b>\$ 4,194</b>

The five year schedule of repayment of long term debt, inclusive of VIE and other debt, based on maturity is as follows: 2007 – \$27; 2008 – \$420; 2009 – \$148; 2010 – \$319; 2011 – \$369.

(i) During 2006, the Company repaid its \$125 of 8.70% Series 1996 Provigo Inc. Debenture as it matured. During 2005, the Company issued \$300 of 5.90% Medium Term Notes (“MTN”) due 2036 and \$200 of 6.95% MTN matured and was repaid.

(ii) Pursuant to the requirements of AcG 15, the consolidated balance sheet as at December 30, 2006 includes \$156 (2005 – \$126) of loans payable and capital lease obligations of VIEs consolidated by the Company, \$23 (2005 – \$23) of which is due within one year.

## Notes to the Consolidated Financial Statements

The loans payable of \$124 (2005 – \$126) represent financing obtained by eligible independent franchisees through a structure involving independent trusts to facilitate the purchase of the majority of their inventory and fixed assets, consisting mainly of fixturing and equipment. The loans payable, which have an average term to maturity of 8 years (2005 – 7 years), are due and payable on demand under certain predetermined circumstances and are secured through a general security agreement made by the independent franchisees in favour of the independent funding trust. Interest is charged on a floating rate basis and prepayment of the loans may be made without penalty. The independent funding trust within the structure finances its activities through the issuance of short term asset-backed notes to third-party investors. As disclosed in Note 21, a standby letter of credit has been provided by a major Canadian chartered bank for the benefit of the independent funding trust equal to approximately 10% of the total principal amount of the loans outstanding at any point in time. The Company has agreed to reimburse the issuing bank for any amount drawn on the standby letter of credit.

In the event of a default by an independent franchisee the independent funding trust may assign the loan to the Company and draw upon the standby letter of credit. No amount has ever been drawn on the standby letter of credit.

Capital lease obligations of \$32 (2005 – nil) are included in the consolidated balance sheet as at year end. The capital lease obligations are related to equipment of the third-party VIE that provides distribution and warehousing services. The amount due within one year is \$4 (2005 – nil).

### Note 17. Other Liabilities

	2006	2005
Accrued benefit plan liability (note 15)	\$ 173	\$ 153
Stock-based compensation (note 19)	17	13
Unrealized equity forwards payable (note 20)	13	—
Restructuring and other charges (note 4)	21	25
Goods and Services Tax and provincial sales tax (note 5)	14	16
Other	76	64
	<b>\$ 314</b>	<b>\$ 271</b>

### Note 18. Common Share Capital (authorized – unlimited)

The changes in the common shares issued and outstanding during the year were as follows:

	2006		2005	
	Number of Common Shares	Common Share Capital	Number of Common Shares	Common Share Capital
Issued and outstanding, beginning of year	274,054,814	\$ 1,192	274,255,914	\$ 1,192
Issued for stock options exercised (note 19)	118,750	4	25,000	1
Purchased for cancellation	—	—	(226,100)	(1)
Issued and outstanding, end of year	<b>274,173,564</b>	<b>\$ 1,196</b>	274,054,814	\$ 1,192
Weighted average outstanding	<b>274,066,885</b>		274,183,823	

**Normal Course Issuer Bids (“NCIB”)** During 2006, the Company purchased for cancellation nil of its common shares (2005 – 226,100 for \$16).

The Company intends to renew its NCIB to purchase on the Toronto Stock Exchange or enter into equity forwards to purchase up to 5% of its common shares outstanding. The Company, in accordance with the rules and by-laws of the Toronto Stock Exchange, may purchase its shares at the then market price of such shares.

**Note 19. Stock-Based Compensation** (\$, except where otherwise indicated)

The Company maintains various types of stock-based compensation plans, which are described below.

The Company’s net stock-based compensation cost recognized in operating income related to its stock option plan and the associated equity forwards and the restricted share unit plan was as follows:

(\$ millions)	2006	2005
Stock option plan income	\$ (11)	\$ (35)
Equity forwards loss <small>(note 20)</small>	32	71
Restricted share unit plan expense	16	7
Net stock-based compensation cost	\$ 37	\$ 43

**Stock Option Plan** The Company maintains a stock option plan for certain employees. Under this plan, the Company may grant options for up to 20.4 million common shares; however, the Company has set a guideline which limits the number of stock option grants to a maximum of 5% of outstanding common shares at any time. Stock options have up to a seven-year term, vest 20% cumulatively on each anniversary date of the grant and are exercisable at the designated common share price, which is 100% of the market price of the Company’s common shares on the last trading day prior to the effective date of the grant. Each stock option is exercisable into one common share of the Company at the price specified in the terms of the option, or option holders may elect to receive in cash the share appreciation value equal to the excess of the market price at the date of exercise over the specified option price.

During 2006, the Company granted 189,354 (2005 – 2,247,627) stock options with a weighted average exercise price of \$55.30 (2005 – \$69.73) per common share under its existing stock option plan, which allows for settlement in shares or in the share appreciation value in cash at the option of the employee.

In 2006, the share appreciation value of \$11 million (2005 – \$41 million) was paid on the exercise of 815,403 (2005 – 1,135,221) stock options. The Company issued 118,750 (2005 – 25,000) common shares on the exercise of stock options and received cash consideration of \$4 million (2005 – \$0.9 million) for which it had recorded a stock-based compensation liability of \$0.1 million (2005 – \$1 million).

At year end, a total of 4,084,646 (2005 – 5,305,422) stock options were outstanding, and represented approximately 1.5% (2005 – 1.9%) of the Company’s issued and outstanding common shares, which was within the Company’s guideline of 5%. Of the 4,084,646 (2005 – 5,305,422) outstanding options, 4,043,406 (2005 – 5,151,682) relate to stock option grants that allow for settlement in shares or in the share appreciation value in cash at the option of the employee and 41,240 (2005 – 153,740) relate to stock option grants, issued prior to December 30, 2001 that will be settled by issuing common shares.

## Notes to the Consolidated Financial Statements

A summary of the status of the Company's stock option plan and activity was as follows:

	2006		2005	
	Options (number of shares)	Weighted Average Exercise Price/Share	Options (number of shares)	Weighted Average Exercise Price/Share
Outstanding options, beginning of year	5,305,422	\$ 56.98	4,365,958	\$ 45.04
Granted	189,354	\$ 55.30	2,247,627	\$ 69.73
Exercised	(934,153)	\$ 35.18	(1,160,221)	\$ 36.41
Forfeited/cancelled	(475,977)	\$ 61.56	(147,942)	\$ 59.49
Outstanding options, end of year	4,084,646	\$ 61.36	5,305,422	\$ 56.98
Options exercisable, end of year	1,544,232	\$ 57.37	1,701,050	\$ 43.25

Range of Exercise Prices	2006 Outstanding Options			2006 Exercisable Options	
	Number of Options Outstanding	Weighted Average Remaining Contractual Life (years)	Weighted Average Exercise Price/Share	Number of Exercisable Options	Weighted Average Exercise Price/Share
\$ 43.80 – \$ 49.05	157,240	1	\$ 48.67	157,240	\$ 48.67
\$ 53.60 – \$ 55.50	1,928,006	3	\$ 53.83	976,113	\$ 53.70
\$ 61.95 – \$ 72.95	1,999,400	5	\$ 69.61	410,879	\$ 69.41

**Restricted Share Unit (“RSU”) Plan** The Company has adopted a RSU plan for certain senior employees. The RSUs entitle employees to a cash payment after the end of each performance period, of up to 3 years, following the date of award. The RSU payment will be an amount equal to the weighted average price of a Loblaw common share on the last three trading days preceding the end of the performance period for the RSUs multiplied by the number of RSUs held by the employee.

During 2006, the Company granted 691,001 (2005 – 393,335) RSUs to 238 (2005 – 236) employees, 211,526 (2005 – 10,151) RSUs were cancelled and 112,707 (2005 – nil) were paid out. At year end, a total of 749,952 (2005 – 383,184) RSUs were outstanding.

**Employee Share Ownership Plan (“ESOP”)** The Company maintains an ESOP which allows employees to acquire the Company's common shares through regular payroll deductions of up to 5% of their gross regular earnings. The Company contributes an additional 25% (2005 – 25%) of each employee's contribution to the plan. The ESOP is administered through a trust which purchases the Company's common shares on the open market on behalf of employees. A compensation cost of \$6 million (2005 – \$5 million) related to this plan was recognized in operating income.

**Deferred Share Units (“DSUs”) Plan** Members of the Company's Board of Directors may elect annually to receive all or a portion of their annual retainer(s) and fees in the form of DSUs, the value of which is determined by the market price of the Company's common shares at the time the director's annual retainer(s) or fees are earned. Upon termination of Board service, the common shares due to the director, as represented by the DSUs, will be purchased on the open market on the director's behalf. At year end, 44,397 (2005 – 36,666) DSUs were outstanding. The year-over-year change in the deferred share units liability was minimal and was recognized in operating income.

## Note 20. Financial Instruments

A summary of the Company's outstanding financial derivative instruments is as follows:

	Notional Amounts Maturing						2006	2005
	2007	2008	2009	2010	2011	Thereafter	Total	Total
Cross currency basis swaps	\$ 76	\$ 140	\$ 31	\$ 174	\$ 95	\$ 544	\$ 1,060	\$ 1,036
Interest rate swaps (receive)/pay		\$ 240	\$ 140	\$ 50	\$ 200	\$ (150)	\$ 480	\$ 437
Equity forwards				\$ 120	\$ 34	\$ 93	\$ 247	\$ 240

**Cross Currency Basis Swaps** The Company enters into cross currency basis swaps to hedge its exposure to fluctuations in the foreign currency exchange rate on a portion of its United States dollar denominated assets, principally cash, cash equivalents and short term investments.

The Company entered into cross currency basis swaps to exchange United States dollars for \$1.1 billion (2005 – \$1.0 billion) Canadian dollars, which mature by 2016. Currency adjustments receivable or payable arising from these swaps are settled in cash on maturity. At year end, a cumulative unrealized foreign currency exchange rate receivable of \$165 (2005 – \$168) was recorded in other assets.

**Interest Rate Swaps** The Company enters into interest rate swaps to hedge a portion of its exposure to fluctuations in interest rates. The Company's interest rate swaps convert a net notional \$480 (2005 – \$437) of its floating rate investments to average fixed rate investments at 4.73% (2005 – 4.76%), which mature by 2013.

**Equity Forwards (\$)** The Company enters into equity forwards to manage its exposure to fluctuations in its stock-based compensation cost as a result of changes in the market price of its common shares. At year end 2006, the Company had cumulative equity forwards to buy 4.8 million (2005 – 4.8 million) of its common shares at a cumulative average forward price of \$51.43 (2005 – \$50.02) including \$6.56 (2005 – \$5.15) per common share of interest expense net of dividends that has been recognized in net earnings and will be paid at termination. The equity forwards allow for settlement in cash, common shares or net settlement. The Company has included a cumulative unrealized market loss of \$13 million (2005 – gain of \$30 million) in other liabilities (2005 – other assets) relating to these equity forwards.

**Fair Value of Financial Instruments** The fair value of a financial instrument is the estimated amount that the Company would receive or pay to terminate the instrument agreement at the reporting date. The following methods and assumptions were used to estimate the fair value of each type of financial instrument by reference to various market value data and other valuation techniques as appropriate.

The fair values of cash, cash equivalents, short term investments, accounts receivable, bank indebtedness, commercial paper, accounts payable and accrued liabilities approximated their carrying values given their short term maturities.

The fair value of the cross currency basis swaps was estimated based on the market spot exchange rates and forward interest rates and approximated their carrying value.

The fair value of long term debt issues was estimated based on the discounted cash flows of the debt at the Company's estimated incremental borrowing rates for debt of the same remaining maturities.

The fair value of the interest rate swaps was estimated by discounting net cash flows of the swaps at market and forward interest rates for swaps of the same remaining maturities.



The fair value of the equity forwards, which approximated carrying value, was estimated by multiplying the number of the Company's common shares outstanding under the equity forwards by the difference between the market price of its common shares and the average forward price of the outstanding forwards at year end.

	2006		2005	
	Carrying Value	Estimated Fair Value	Carrying Value	Estimated Fair Value
Long term debt liability	\$ 4,239	\$ 4,798	\$ 4,355	\$ 5,027
Interest rate swaps net liability	\$ —	\$ (15)	\$ —	\$ (11)

**Counterparty Risk** The Company may be exposed to losses should any counterparty to its financial derivative agreements fail to fulfill its obligations. The Company has sought to minimize potential counterparty risk and losses by conducting transactions for its derivative agreements with counterparties that have at minimum a long term A credit rating from a recognized credit agency and by placing risk adjusted limits on its exposure to any single counterparty for its financial derivative agreements. The Company has internal policies, controls and reporting processes which require ongoing assessment and corrective action, if necessary, with respect to its derivative transactions. In addition, principal amounts on cross currency basis swaps and equity forwards are each netted by agreement and there is no exposure to loss of the original notional principal amounts on the interest rate swaps and equity forwards.

**Credit Risk** The Company's exposure to credit risk relates to the Company's cash equivalents and short term investments, *PC Bank's* credit card receivables and accounts receivable from franchisees, associates and independent accounts.

Credit risk associated with the Company's cash equivalents and short term investments results from the possibility that a counterparty may default on the repayment of a security. This risk is mitigated by established policies and guidelines that require issuers of permissible investments to have at minimum a long term A credit rating from a recognized credit rating agency and that specify minimum and maximum exposures to specific issuers.

Credit risk from *PC Bank's* credit card receivables and receivables from franchisees, associates and independents results from the possibility that customers may default on their payment obligation. *PC Bank* manages the credit card receivable risk by employing stringent credit scoring techniques and actively monitoring the credit card portfolio and reviewing techniques and technology that can improve the effectiveness of the collection process. In addition, these receivables are dispersed among a large, diversified group of credit card customers. Accounts receivable from franchisees, associates and independent accounts are actively monitored on an ongoing basis and settled on a frequent basis in accordance with the terms specified in the applicable agreements.

## Note 21. Contingencies, Commitments and Guarantees

The Company is involved in and potentially subject to various claims by third parties arising out of the normal course and conduct of its business including, but not limited to, product liability, labour and employment, regulatory and environmental claims. In addition, the Company is involved in and potentially subject to regular audits from federal and provincial tax authorities relating to income, capital and commodity taxes and as a result of these audits may receive assessments and reassessments.

Although such matters cannot be predicted with certainty, management currently considers the Company's exposure to such claims and litigation, to the extent not covered by the Company's insurance policies or otherwise provided for, not to be material to these consolidated financial statements.

There are various operating leases that have been committed to. Future minimum lease payments relating to these operating leases are as follows:

	Payments due by year						2006 Total	2005 Total
	2007	2008	2009	2010	2011	Thereafter to 2049		
Operating lease payments	\$ 190	\$ 178	\$ 156	\$ 134	\$ 114	\$ 720	\$ 1,492	\$ 1,637
Expected sub-lease income	(40)	(34)	(30)	(24)	(17)	(43)	(188)	(203)
Net operating lease payments	\$ 150	\$ 144	\$ 126	\$ 110	\$ 97	\$ 677	\$ 1,304	\$ 1,434

At year end, the Company has committed approximately \$153 (2005 – \$264) with respect to capital investment projects such as the construction, expansion and renovation of buildings and the purchase of real property.

The Company establishes standby letters of credit used in connection with certain obligations mainly related to real estate transactions and benefit programs. The aggregate gross potential liability related to these standby letters of credit is approximately \$221 (2005 – \$143). Other standby letters of credit related to the financing program for the Company's independent franchisees and securitization of PC Bank's credit card receivables have been identified as guarantees and are discussed further in the Guarantees section below.

**Guarantees** The Company has provided to third parties the following significant guarantees as defined pursuant to Accounting Guideline 14, "Disclosure of Guarantees":

**Standby Letters of Credit** A standby letter of credit for the benefit of an independent trust with respect to the credit card receivables securitization program of PC Bank has been issued by a major Canadian chartered bank. This standby letter of credit could be drawn upon in the event of a major decline in the income flow from or in the value of the securitized credit card receivables. The Company has agreed to reimburse the issuing bank for any amount drawn on the standby letter of credit. The Company believes that the likelihood of this occurrence is remote. The aggregate gross potential liability under this arrangement, which represents 9% (2005 – 9%) on a portion of the securitized credit card receivables amount, is approximately \$68 (2005 – \$91) (see Note 11).

A standby letter of credit has been issued by a major Canadian chartered bank in the amount of \$44 (2005 – \$42) for the benefit of an independent funding trust which provides loans to the Company's franchisees for their purchase of inventory and fixed assets, mainly fixturing and equipment. The amount of the standby letter of credit is equal to approximately 10% of the principal amount of the loans outstanding at any point in time. In the event that an independent franchisee defaults on its loan and the Company has not, within a specified time period, assumed the loan or the default is not otherwise remedied, the independent funding trust may assign the loan to the Company and draw upon this standby letter of credit. The Company has agreed to reimburse the issuing bank for any amount drawn on the standby letter of credit.

**Lease Obligations** In connection with historical dispositions of certain of its assets, the Company has assigned leases to third parties. The Company remains contingently liable for these lease obligations in the event any of the assignees are in default of their lease obligations. The estimated amount for minimum rent, which does not include other lease related expenses such as property tax and common area maintenance charges, is \$111 (2005 – \$138).

**Indemnification Provisions** The Company from time to time enters into agreements in the normal course of its business, such as service and outsourcing arrangements and leases, in connection with business or asset acquisitions or dispositions. These agreements by their nature may provide for indemnification of counterparties. These indemnification provisions may be in connection with breaches of representation and warranty or with future claims for certain liabilities, including liabilities related to tax and environmental matters. The terms of these indemnification provisions vary in duration and may extend for an unlimited period of time. Given the nature of such indemnification provisions, the Company is unable to reasonably estimate its total maximum potential liability as certain indemnification provisions do not provide for a maximum potential amount and the amounts are dependent on the outcome of future contingent events, the nature and likelihood of which cannot be determined at this time. Historically, the Company has not made any significant payments in connection with these indemnification provisions.

**Legal Proceedings** Subsequent to year end, the Company was served with an action brought by certain beneficiaries of a multi-employer pension plan in the Superior Court of Ontario. In their claim against the employers and the trustees of the multi-employer pension plan, the plaintiffs claim that assets of the multi-employer pension plan have been mismanaged. The Company is one of the employers affected by the action. One billion dollars of damages are claimed in the action against a total of 17 defendants. In addition, the plaintiffs are seeking to have a representative defendant appointed for the employers of all the members of the multi-employer pension plan. The action is framed as a representative action on behalf of all the beneficiaries of the multi-employer pension plan. The action is at a very early stage and the Company intends to vigorously defend it. Statements of Defence have not yet been filed.

## Note 22. Related Party Transactions

The Company's majority shareholder, George Weston Limited and its affiliates ("Weston"), other than the Company, are related parties. It is the Company's policy to conduct all transactions and settle all balances with related parties on market terms and conditions. Related party transactions include:

**Inventory Purchases** Purchases of inventory from related parties for resale in the distribution network represented approximately 3% (2005 – 3%) of the cost of sales, selling and administrative expenses. The intercompany payable relating to this inventory, outstanding at year end, is recorded in accounts payable and accrued liabilities.

**Cost Sharing Agreements** Weston has entered into certain contracts with third parties for administrative and corporate services, including telecommunication services and information technology related matters on behalf of the Company. Through cost sharing agreements that have been established between the Company and Weston concerning these costs, the Company has agreed to be responsible to Weston for its proportionate share of the costs incurred on its behalf. Payments by the Company pursuant to these cost sharing agreements were approximately \$25 (2005 – \$22).

**Real Estate Matters** The Company leases certain properties from an affiliate of Weston, namely office space for approximately \$4 (2005 – \$4). During 2006, the Company purchased from an affiliate of Weston a property designated for future development for consideration of \$8, which was prepaid in accordance with a former ground lease between the parties.

**Borrowings/Lendings** The Company, from time to time, may borrow from or may lend to Weston on a short term basis at commercial paper rates. There were no such amounts outstanding as at year end.

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

**Management Agreements** The Company, through Glenhuron, manages certain United States cash, cash equivalents and short term investments for wholly owned non-Canadian subsidiaries of Weston. Management fees are based on market rates and included in interest expense.

**Sale of Loan Portfolio** During 2005, Glenhuron sold a portfolio of third-party long term loans receivable to a wholly owned subsidiary of Weston. The loans in this portfolio were originally acquired from third-party financial institutions in 2001. This transaction was undertaken by Glenhuron as part of its overall ongoing management of its investment portfolio.

The amount of the cash consideration of U.S. \$106 was based on a fair market value of the loan portfolio and was approximately equal to carrying value. An independent review of the valuation analysis has been obtained by the Company to ensure that Glenhuron's methodology used in arriving at fair market value was reasonable. As at the date of sale, the current portion of this loan portfolio of U.S. \$13 was included in accounts receivable and the long term portion of U.S. \$93 was included in other assets.

Glenhuron has entered into an agreement with a subsidiary of Weston for the administration of the loan portfolio.

### **Note 23. Subsequent Event**

Subsequent to year end, the Company approved and announced the restructuring of its merchandising and store operations into more streamlined functions. Costs of this restructuring including severance, retention and other costs are expected to be in the range of \$150 to \$200, the substantial portion to be recorded in the first half of 2007.

### **Note 24. Other Information**

**Segment Information** The only reportable operating segment is merchandising, which includes primarily food as well as general merchandise and drugstore products and services. All sales to external parties were generated in Canada and all fixed assets and goodwill were attributable to Canadian operations.

## Five Year Summary<sup>(1)</sup>

Year <sup>(2)</sup> (\$ millions except where otherwise indicated)	2006	2005	2004	2003	2002
<b>Operating Results</b>					
Sales <sup>(4)</sup>	28,640	27,627	26,030	25,066	22,953
Sales excluding the impact of VIEs <sup>(3)(4)</sup>	28,257	27,212	26,030	25,066	22,953
Adjusted EBITDA <sup>(3)</sup>	1,892	2,132	2,125	1,881	1,671
Operating income	289	1,401	1,652	1,467	1,303
Adjusted operating income <sup>(3)</sup>	1,326	1,600	1,652	1,488	1,317
Interest expense	259	252	239	196	161
Net (loss) earnings	(219)	746	968	845	728
<b>Financial Position</b>					
Working capital	675	539	290	356	320
Fixed assets	8,055	7,785	7,113	6,390	5,557
Goodwill	794	1,587	1,621	1,607	1,599
Total assets	13,486	13,761	12,949	12,113	11,047
Net debt <sup>(3)</sup>	3,891	3,901	3,828	3,707	2,932
Shareholders' equity	5,441	5,886	5,414	4,690	4,082
<b>Cash Flow</b>					
Cash flows from operating activities	1,180	1,489	1,443	1,032	998
Free cash flow <sup>(3)</sup>	70	103	(24)	(437)	(208)
Capital investment	937	1,156	1,258	1,271	1,079
<b>Per Common Share (\$)</b>					
Basic net (loss) earnings	(.80)	2.72	3.53	3.07	2.64
Adjusted basic net earnings <sup>(3)</sup>	2.72	3.35	3.48	3.10	2.68
Dividend rate at year end	.84	.84	.76	.60	.48
Cash flows from operating activities	4.31	5.43	5.26	3.75	3.61
Capital investment	3.42	4.22	4.59	4.62	3.91
Book value	19.85	21.48	19.74	17.07	14.79
Market price at year end	48.79	56.37	72.02	67.85	54.00
<b>Financial Ratios</b>					
Adjusted EBITDA margin (%) <sup>(3)</sup>	6.7	7.8	8.2	7.5	7.3
Operating margin (%)	1.0	5.1	6.3	5.9	5.7
Adjusted operating margin (%) <sup>(3)</sup>	4.7	5.9	6.3	5.9	5.7
Return on average total assets (%) <sup>(3)</sup>	2.3	11.2	14.2	13.9	13.8
Return on average shareholders' equity (%)	(3.9)	13.2	19.2	19.3	19.0
Interest coverage	1.0	5.1	6.4	6.4	6.8
Net debt <sup>(3)</sup> to equity	.72	.66	.71	.79	.72
Cash flows from operating activities to net debt <sup>(3)</sup>	.30	.38	.38	.28	.34
Price/net earnings ratio at year end	(61.0)	20.7	20.4	22.1	20.5
Market/book ratio at year end	2.5	2.6	3.6	4.0	3.7

(1) For financial definitions and ratios refer to the Glossary of Terms on page 80.

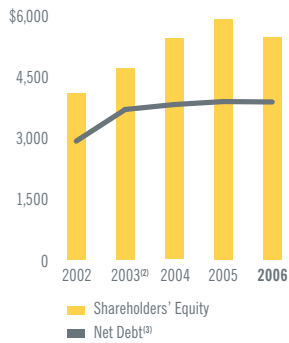
(2) 2003 was a 53 week year.

(3) See Non-GAAP Financial Measures on page 40.

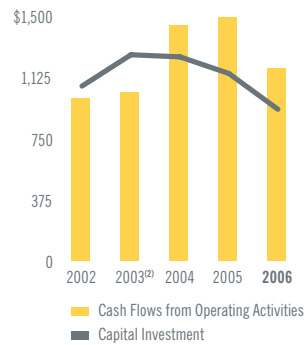
(4) During 2006, the Company implemented Emerging Issues Committee Abstract 156, "Accounting by a Vendor for Consideration Given to a Customer (Including a Reseller of the Vendor's Products)" on a retroactive basis. Accordingly certain sales incentives paid to independent franchisees, associates and independent accounts for prior years have been reclassified between sales and cost of sales, selling and administrative expenses. For a further discussion, see the Accounting Standards Implemented in 2006 section in the Management's Discussion and Analysis of this Financial Report.

(5) Certain prior years' information was reclassified to conform with current year's presentation.

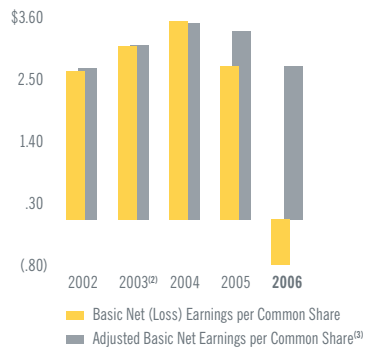
**Shareholders' Equity and Net Debt<sup>(2)</sup>**  
(\$ millions)



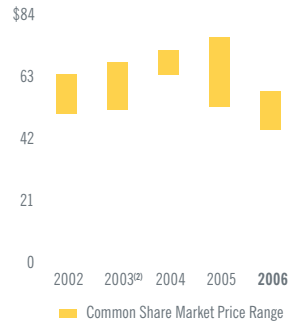
**Cash Flows from Operating Activities and Capital Investment**  
(\$ millions)



**Basic Net (Loss) Earnings and Adjusted Basic Net Earnings per Common Share<sup>(2)</sup>**  
(\$)



**Common Share Market Price Range**  
(\$)



## Glossary of Terms

Term	Definition	Term	Definition
<b>Adjusted basic net earnings per common share</b>	Basic net earnings per common share adjusted for items that affect the comparability of the financial results and are not a result of ongoing operations (see Non-GAAP Financial Measures on page 40).	<b>Major expansion</b>	Expansion of a store that results in an increase in square footage that is greater than 25% of the square footage of the store prior to the expansion.
<b>Adjusted EBITDA</b>	Adjusted operating income before depreciation and amortization (see Non-GAAP Financial Measures on page 40).	<b>Market/book ratio at year end</b>	Market price per common share at year end divided by book value per common share at year end.
<b>Adjusted EBITDA margin</b>	Adjusted EBITDA divided by sales excluding the impact of VIEs (see Non-GAAP Financial Measures on page 40).	<b>Minor expansion</b>	Expansion of a store that results in an increase in square footage that is less than or equal to 25% of the square footage of the store prior to the expansion.
<b>Adjusted net earnings</b>	Net earnings adjusted for items that affect the comparability of the financial results and are not a result of ongoing operations (see Non-GAAP Financial Measures on page 40).	<b>Net debt</b>	Bank indebtedness, commercial paper, long term debt due within one year, long term debt and debt equivalents less cash, cash equivalents and short term investments (see Non-GAAP Financial Measures on page 40).
<b>Adjusted operating income</b>	Operating income adjusted for items that affect the comparability of the financial results and are not a result of ongoing operations (see Non-GAAP Financial Measures on page 40).	<b>Net debt to equity</b>	Net debt divided by total shareholders' equity.
<b>Adjusted operating margin</b>	Adjusted operating income divided by sales excluding the impact of VIEs (see Non-GAAP Financial Measures on page 40).	<b>New store</b>	A newly constructed store, conversion or major expansion.
<b>Annual Report</b>	For 2006, the Annual Report consists of the Annual Summary and the Financial Report.	<b>Operating income</b>	Earnings before interest expense and income taxes.
<b>Basic net (loss) earnings per common share</b>	Net (loss) earnings available to common shareholders divided by the weighted average number of common shares outstanding during the year.	<b>Operating margin</b>	Operating income divided by sales.
<b>Book value per common share</b>	Shareholders' equity divided by the number of common shares outstanding at year end.	<b>Price/net (loss) earnings ratio at year end</b>	Market price per common share at year end divided by basic net (loss) earnings per common share for the year.
<b>Capital investment</b>	Fixed asset purchases.	<b>Renovation</b>	A capital investment in a store resulting in no change to the store square footage.
<b>Capital investment per common share</b>	Capital investment divided by the weighted average number of common shares outstanding during the year.	<b>Retail sales</b>	Combined sales of stores owned by the Company and those owned by the Company's independent franchisees.
<b>Cash flows from operating activities per common share</b>	Cash flows from operating activities divided by the weighted average number of common shares outstanding during the year.	<b>Retail square footage</b>	Retail square footage includes corporate and independent franchised stores.
<b>Cash flows from operating activities to net debt</b>	Cash flows from operating activities divided by net debt.	<b>Return on average total assets</b>	Operating income divided by average total assets excluding cash, cash equivalents and short term investments (see Non-GAAP Financial Measures on page 40).
<b>Control label</b>	A brand and associated trademark that is owned by the Company for use in connection with its own products and services.	<b>Return on average shareholders' equity</b>	Net (loss) earnings available to common shareholders divided by average total common shareholders' equity.
<b>Conversion</b>	A store that changes from one Company banner to another Company banner.	<b>Sales excluding the impact of VIEs</b>	Total sales less sales attributable to the consolidation of VIEs pursuant to AcG 15 (see Non-GAAP Financial Measures on page 40).
<b>Corporate stores sales per average square foot</b>	Sales by corporate stores divided by the average corporate stores' square footage at year end.	<b>Same-store sales</b>	Retail sales from the same physical location for stores in operation in that location in both periods being compared but excluding sales from a store that has undergone a conversion or major expansion in the period.
<b>Diluted net (loss) earnings per common share</b>	Net (loss) earnings available to common shareholders divided by the weighted average number of common shares outstanding during the period minus the dilutive impact of outstanding stock option grants at period end.	<b>Variable interest entity ("VIE")</b>	An entity that either does not have sufficient equity at risk to finance its activities without subordinated financial support or where the holders of the equity at risk lack the characteristics of a controlling financial interest (see Note 2 to the consolidated financial statements).
<b>Dividend rate per common share at year end</b>	Dividend per common share declared in the fourth quarter multiplied by four.	<b>Weighted average common shares outstanding</b>	The number of common shares outstanding determined by relating the portion of time within the year the common shares were outstanding to the total time in that year.
<b>Free cash flow</b>	Cash flows from operating activities less fixed asset purchases and dividends (see Non-GAAP Financial Measures on page 40).	<b>Working capital</b>	Total current assets less total current liabilities.
<b>Gross margin</b>	Sales less cost of sales and inventory shrinkage divided by sales.	<b>Year</b>	A fiscal year ends on the Saturday closest to December 31, usually 52 weeks in duration, but includes 53 weeks every 5 to 6 years. The year ended January 3, 2004 contained 53 weeks.
<b>Interest coverage</b>	Operating income divided by interest expense adding back interest capitalized to fixed assets.		



## Shareholder and Corporate Information

### National Head Office and Store Support Centre

Loblaw Companies Limited  
1 President's Choice Circle  
Brampton, Canada  
L6Y 5S5  
Tel: (905) 459-2500  
Fax: (905) 861-2206  
Internet: www.loblaw.ca

### Stock Exchange Listing and Symbol

The Company's common shares are listed on the Toronto Stock Exchange and trade under the symbol "L".

### Common Shares

63% of the Company's common shares are owned beneficially by W. Galen Weston and George Weston Limited.

At year end 2006 there were 274,173,564 common shares issued and outstanding, 5,696 registered common shareholders and 100,744,229 common shares available for public trading.

The average daily trading volume of the Company's common shares for 2006 was 382,410.

### Trademarks

Loblaw Companies Limited and its subsidiaries own a number of trademarks. Several subsidiaries are licensees of additional trademarks. These trademarks are the exclusive property of Loblaw Companies Limited or the licensor and where used in this report are in italics.

### Common Dividend Policy

It is the Company's policy to maintain a dividend payment equal to approximately 20% to 25% of the prior year's adjusted basic net earnings per common share.<sup>(1)</sup>

### Common Dividend Dates

The declaration and payment of quarterly dividends are made subject to approval by the Board of Directors. The anticipated record and payment dates for 2007 are:

Record Date	Payment Date
March 15	April 1
June 15	July 1
Sept. 15	Oct. 1
Dec. 15	Dec. 30

### Normal Course Issuer Bid

The Company has a Normal Course Issuer Bid on the Toronto Stock Exchange.

### Investor Relations

Shareholders, security analysts and investment professionals should direct their requests to Mr. Geoffrey H. Wilson, Senior Vice President, Financial Services and Investor Relations at the Company's National Head Office or by e-mail at [investor@loblaw.ca](mailto:investor@loblaw.ca)

### Value of Common Shares

For capital gains purposes, the valuation day (December 22, 1971) cost base for the Company is \$0.958 per common share. The value on February 22, 1994 was \$7.67 per common share.

### Registrar and Transfer Agent

Computershare Investor Services Inc.  
100 University Avenue  
Toronto, Canada  
M5J 2Y1  
Tel: (416) 263-9200  
Toll free: 1-800-663-9097  
Fax: (416) 263-9394  
Toll free fax: 1-888-453-0330

To change your address, eliminate multiple mailings, or for other shareholder account inquiries, please contact Computershare Investor Services Inc.

### Independent Auditors

KPMG LLP  
Chartered Accountants  
Toronto, Canada

### Annual and Special Meeting

Loblaw Companies Limited Annual and Special Meeting of Shareholders will be held on Tuesday, May 1, 2007 at 11:00 a.m. at Maple Leaf Gardens, 60 Carlton Street, Toronto, Canada.

Additional financial information has been filed electronically with various securities regulators in Canada through the System for Electronic Document Analysis and Retrieval (SEDAR) and with the Office of the Superintendent of Financial Institutions (OSFI) as the primary regulator for the Company's subsidiary, President's Choice Bank. The Company holds an analyst call shortly following the release of its quarterly results. These calls are archived in the Investor Zone section of the Company's website.

Ce rapport est disponible en français.

This Financial Report was printed in Canada on Husky Offset, manufactured elemental chlorine-free, at a mill independently certified as meeting the procurement provisions of the Sustainable Forestry Initiative® (SFI) standard.

(1) See Non-GAAP Financial Measures on page 40.

**Loblaws**<sup>®</sup>

COMPANIES LIMITED

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