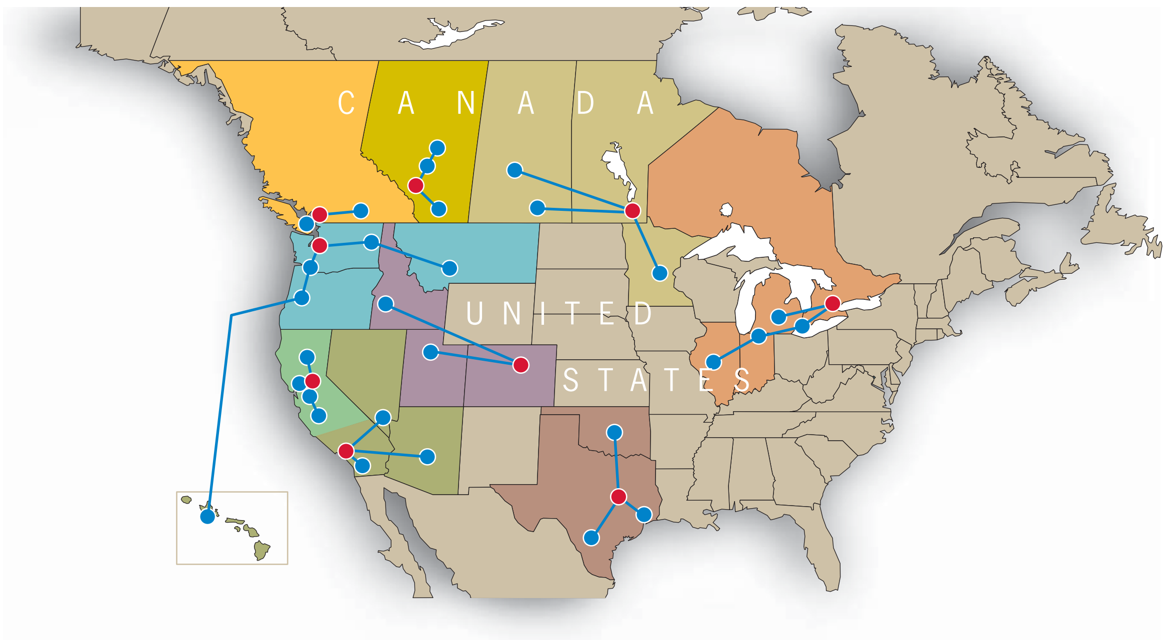
Hardwoods Distribution Income Fund

2005

Annual Report to Unitholders

About the Fund :: Hardwoods Distribution Income Fund is an unincorporated, open-ended, limited purpose trust. The Fund was launched on March 23, 2004 with the completion of an initial public offering (IPO) of 14.4 million trust units at $10 per unit. Net proceeds of the IPO were used to acquire an 80% interest in the hardwood lumber and sheet goods distribution business ("Hardwoods" or the "Business") from the previous owners.

Hardwoods Distribution Income Fund units trade on the Toronto Stock Exchange under the symbol HWD.UN. The Fund's performance depends on the performance of the Business.



About the Business :: Hardwoods has been providing quality lumber, hardwood plywood and specialty products to customers for over 45 years. Today, we are one of the largest distributors of hardwood lumber and sheet goods in North America, operating a network of 38 distribution centres organized into nine regional clusters.

Contents:

To Our Unitholders:

For Hardwoods, 2005 was a year of consolidating the double-digit sales growth we achieved in 2004 and ensuring we have the employee depth to support and build on the new level of sales going forward. We added new employees, enhanced employee training, adjusted remuneration, and reorganized our management team to ensure we have the right people in the right places. We also pursued our growth strategy, opening two new branches and expanding another in the Midwest, and expanding one of our warehouses in the busy California market.

Revenue, before considering the impact of foreign exchange, was on par with last year, demonstrating that 2004's strong sales results were not an anomaly. However, when expressed in Canadian dollars, sales were lower compared to 2004 as a result of the 6.9% year-over-year increase in the value of the Canadian dollar. Approximately two-thirds of our sales are generated in the United States in US dollars.

Due to our investment in personnel to support growth, costs were significantly higher in 2005, contributing to weaker EBITDA and distributable cash results when compared to 2004. Concerns about the impact of a higher distribution payout ratio led the Trustees to exercise the Fund's subordination feature in January 2006, suspending fourth quarter distributions on Class B ownership units in subsidiaries of the Fund, and returning annualized distributions to our public unitholders to the IPO level of $1.02 per unit. This initiative has provided greater distribution stability for our public unitholders by lowering our payout ratio to a more conservative level. The Fund's subordination feature stays in place until EBITDA and distributable cash tests established at the time of the IPO have been met.

High-Value, Niche Products

On the product front, we continued to differentiate our line-up in 2005 with a focus on high-value, niche products that deliver strong margins to Hardwoods. We further developed our import supply line, increasing our volumes of hardwood lumber from the Baltic countries, Africa, and South America. We also increased the volume of Dragon Ply™ brand hardwood plywood that we import by over 50%. Custom-made for us in China, Dragon Ply™ is a highly consistent, attractively priced product that has been well received by our traditional industrial sales base and is penetrating into OEM markets. Our product selection was rewarded with stable year-over-year gross margin performance in 2005.

Outlook

Moving forward, before considering the impact of foreign exchange, we anticipate a return to modest underlying sales growth in 2006.

Demand for hardwood products is expected to remain solid, supported by continuing strong economic conditions and Hardwoods' high degree of customer diversification. With over 2,500 different customers touching many areas of the economy, demand for our products typically remains balanced through a range of economic conditions. Sales are also expected to benefit as our two new branches build up to normal operating performance.

It is important to note that the first quarter, like the fourth quarter, is a seasonally slower period for our business. We expect that cash distributions could exceed cash available for distribution during this period, with catch-up expected to occur during the stronger second and third quarters. Foreign exchange also remains a concern for us and could offset sales gains made during the year if the Canadian dollar continues to strengthen.

Focused on Performance

Operationally, our focus will be on distribution centre performance as we work to achieve appropriate sales and cost levels in every region. We closed a centre in Albuquerque, New Mexico in January 2006 because of limited growth potential. At the same time, we will continue to expand our business in faster growing markets like California and the US Midwest. In March, we will move our Southern California hub centre to a new 130,000 square foot centre, adding 50,000 square feet of space to the operation.

Following a year of consolidating sales growth, and investing in our people and facilities, our intention is to move the Fund forward to the next level of performance.

I look forward to reporting to you on our progress in 2006, and on behalf of the Board of Trustees, thank you for your continued confidence in Hardwoods.

Maurice Paquette

Maurice E. Paquette
President and Chief Executive Officer

Terry M. Holland
Chairman of the Board of Trustees

Management's Discussion and Analysis of Financial Condition and Results

March 8, 2006

This management's discussion and analysis ("MD&A") should be read in conjunction with the audited consolidated financial statements and accompanying notes ("Audited Financial Statements") of Hardwoods Distribution Income Fund for the periods January 1, 2005 to December 31, 2005 and from March 23, 2004 to December 31, 2004. Results are reported in Canadian dollars unless otherwise stated, and have been prepared in accordance with Canadian generally accepted accounting principles ("GAAP").

The year ended December 31, 2005 is the first full fiscal year of the Fund. The Fund was created on March 23, 2004. As such, the prior period comparative information in the Audited Financial Statements is for the period from commencement of operations on March 23, 2004, to December 31, 2004. Accordingly results for 2005 and 2004 are not comparable. In order to enhance the usefulness of this MD&A, certain financial and operating results are compared to the unaudited pro forma results for the year ended December 31, 2004, which includes the results of the predecessor companies for the period from January 1 to March 23, 2004. Results of the predecessor companies have been prepared on a pro forma basis adjusted to reflect the new financial structure of the Fund. This information is for reference purposes only, and is not intended to represent a comprehensive comparison of the consolidated financial results or what the results would have been if the Fund had been created and operational at January 1, 2004.

About the Fund

The Fund is an unincorporated, open-ended limited purpose trust formed under the laws of the Province of British Columbia by a declaration of trust dated January 30, 2004. The Fund was launched on March 23, 2004 with the completion of an initial public offering ("IPO") of 14,410,000 trust Voting Units ("Class A Units"). Net IPO proceeds of $133.5 million, together with drawings on credit facilities totaling $31.7 million, were used to acquire an 80% interest in the hardwood lumber and sheet goods distribution business ("Hardwoods" or the "Business") from the previous owners.

The owners of the predecessor companies have retained a 20% interest in the Business in the form of Special Voting Units of the Fund and Class B Limited Partnership units of the Fund's operating subsidiaries ("Class B Units"), which together are exchangeable into Class A Units provided that the Fund achieves certain objectives. Distributions by the operating subsidiaries to the previous owners are subject to subordination arrangements until at least March 31, 2006. As at December 31, 2005, the following units of the Fund were issued and outstanding:

Class A Units	14,410,000
Special Voting Units	3,602,500

Hardwoods Distribution Income Fund Class A Units trade on the Toronto Stock Exchange under the symbol HWD.UN. The Fund's performance depends on the performance of the Business.

About our Business and Industry

Hardwoods is one of North America's largest distributors of high-grade hardwood lumber and specialty sheet goods to the cabinet, moulding, millwork, furniture and specialty wood products industries. At December 31, 2005 we operated from 39 distribution facilities organized into nine geographic regions throughout North America. In a highly fragmented but stable industry, we match products supplied from hundreds of mills to over 2,500 manufacturing customers.

Our product mix includes higher grades of hardwood lumber, as well as sheet goods, consisting primarily of hardwood plywood, as well as non-structural sheet goods such as medium density fiberboard, particleboard and melamine-coated stock. Our sheet goods are a key complementary product line as they are used by many purchasers of hardwood lumber in the manufacture of their end products.

Approximately 95% of the hardwood lumber distributed in North America is harvested from North American hardwood forests, located principally in the eastern United States. Imported hardwood lumber is largely limited to specialty species that generally do not compete with domestic hardwood lumber. Sheet goods are generally produced in North America by large manufacturers using domestic hardwoods and other materials, although imported hardwood plywood volumes have been increasing. Both domestic and imported hardwood lumber and plywood are distributed principally by third parties such as us. Historically, balanced supply and demand conditions have resulted in a stable pricing environment for hardwood lumber and hardwood plywood. Prices have generally kept pace with inflation over the long term.

The hardwood distribution industry is highly fragmented. While there are a number of hardwood distributors that operate from multiple locations, most are small, privately held companies serving discrete local markets. The competitive environment faced by small distributors, together with the desire of many owners for liquidity, provides an opportunity for industry consolidation.

Overview and Outlook

North American demand for hardwood products remained robust through the first three quarters of 2005, with a return to the normal seasonal slowdown in the fourth quarter.

Revenue, before considering the impact of foreign exchange, was on par with the previous year's record-breaking levels, indicating that Hardwoods was successful in consolidating the sales growth achieved in 2004 on a pro forma basis. The Fund increased sales by over 14% between 2003 and 2004 – more than double the normal rate of growth.

When expressed in Canadian dollars, sales on a pro forma basis were 4.7% lower compared to 2004, reflecting the 6.9% year-over-year increase in the value of the Canadian dollar. Approximately two-thirds of Hardwoods' sales are generated in the United States in US dollars. Accordingly, a higher Canadian dollar has a negative impact on revenue when we translate US sales to Canadian dollars for reporting purposes. The net earnings impact is significantly less due to our natural hedges and foreign exchange contracts. While the majority of our sales are in US dollars, most of the products we purchase and many of our operating costs are also in US dollars. In addition, we maintain a program to mitigate the potential impact of foreign exchange fluctuations on Canadian dollar distributions by the Fund by entering into monthly forward foreign exchange contracts. Further discussion of our foreign currency contracts can be found under Financial Instruments on page 14 of this report.

Selling and administrative costs were higher in 2005, reflecting significant investments in personnel improvements in support of our growth. On a network-wide basis, we hired 35 new employees, made salary adjustments within our existing workforce to retain key employees, enhanced our employee training programs, and reorganized our management team to ensure we have the right people in the right places.

From a distribution centre perspective, we achieved our goal of increasing our presence in the US Midwest with the opening of a 40,000 square foot centre in Minnesota and a 15,000 square foot centre in Illinois late in the third quarter, as well as the expansion of an existing facility in Indiana during the second quarter. In California, we expanded a warehouse in San Diego by 70% to capture additional sales in that market.

Our business is now better structured to support sales at the current level, and we have an appropriate foundation in place to help us continue to build on these sales.

The combination of increased costs and lower sales contributed to a 13.9% decline in EBITDA and a reduced pace of distributable cash generated in 2005. The weaker results contributed to the Board's decision to exercise the Fund's subordination feature as described on page 12.

Moving forward, our focus will be to capture sales growth while holding costs steady. Demand for hardwood products is expected to remain stable and in line with general economic trends, and we anticipate a return to modest sales growth in 2006. The first quarter, like the fourth quarter, is a seasonally slower period for our business. We expect demand levels in the first quarter of 2006 to be below second and third quarter levels, and cash distributions could exceed cash available for distribution during this period. A strengthening Canadian dollar could also effectively undermine sales growth when expressed in Canadian dollars.

Operationally, we will continue to fine-tune our distribution centre network in 2006 to ensure an appropriate return on investment. In January 2006, we closed a centre in Albuquerque, New Mexico as a result of limited growth potential. A centre in Bozeman, Montana, is expected to relocate to a new facility following a fire that occurred there March 1, 2006. The Bozeman centre represents less than 1% of total revenue, and Hardwoods carries commercial insurance which is expected to mitigate losses that arise from the fire. In March, we will further increase capacity in the Southern California market when we move our hub centre from its current 80,000 square foot centre to a new 130,000 square foot facility. Our growth strategy continues to focus on the promising Midwest and California markets where we are reviewing opportunities for new branches. Given the fragmented nature of the industry, we will also consider acquisition opportunities with the potential to broaden and strengthen our market position.

Results of Operations

Year ended December 31, 2005 and December 31, 2004

Selected Unaudited Consolidated Financial Information
(in thousands of Canadian dollars)

	For the year ended December 31 2005	For the year ended December 31 2004 (1)
Total sales	$ 355,775	$ 373,458
Sales in the US (US$)	*200,079*	*196,614*
Sales in Canada	*113,359*	*117,605*
Gross profit	66,387	69,825
Gross margin %	*18.7%*	*18.7%*
Selling and administrative expenses	43,480	42,742
Gain on realized foreign currency contracts	(677)	(306)
Earnings before interest, taxes, depreciation and amortization and non-controlling interest ("EBITDA")	$ 23,584	$ 27,389
Add (Deduct):		
Amortization	(2,181)	(2,406)
Interest	(2,114)	(1,652)
Mark-to-market gain on unrealized foreign currency contracts	142	2,511
Non-controlling interest	(3,886)	(5,168)
Income taxes	(2,194)	(2,831)
Net earnings for the period	$ 13,351	17,843
Basic and fully diluted earnings per Class A Unit	$ 0.927	1.238
Average Canadian dollar/U.S. dollar exchange rate	$ 1.2116	1.3013

(1) Financial results for the period January 1, 2004 to March 22, 2004 are of predecessor companies and have been adjusted on a pro forma basis to reflect the Fund's capital structure and the acquisition of the Hardwoods Group of Companies by the Fund. Significant pro forma adjustments related to changes in amortization, interest, non-controlling interest and income tax expenses. The pro forma results of the predecessor companies from the period January 1, 2004 to March 22, 2004 have been combined with the results of the Fund for the period March 23, 2004 to December 31, 2004.

Non-GAAP Measures – EBITDA and Distributable Cash

References to "EBITDA" are to earnings before interest, income taxes, depreciation and amortization and the non-controlling interest in earnings. We believe that, in addition to net income or loss, EBITDA is a useful supplemental measure of financial performance and of cash available for distribution prior to debt service, changes in working capital, capital expenditures and income taxes.

EBITDA is not an earnings measure recognized by generally accepted accounting principles in Canada ("GAAP") and does not have a standardized meaning prescribed by GAAP. Investors are cautioned that EBITDA should not replace net income or loss (as determined in accordance with GAAP) as an indicator of our performance, or to cash flows from operating, investing and financing activities or as a measure of our liquidity and cash flows. Our method of calculating EBITDA may differ from the methods used by other issuers. Therefore, our EBITDA may not be comparable to similar measures presented by other issuers.

Distributable Cash of the Fund is a non-GAAP measure generally used by Canadian open-ended income funds as an indicator of financial performance. We define Distributable Cash as net earnings before depreciation, amortization, future income taxes, non-controlling interest, gains or losses on the sale of property, plant and equipment, and unrealized mark-to-market adjustments on foreign exchange hedge contracts, and after capital expenditures and contributions to any reserves that the Board of Trustees deem to be reasonable and necessary for the operation of the Fund.

Our Distributable Cash may differ from similar computations as reported by other similar entities and, accordingly, may not be comparable to distributable cash as reported by such entities. We believe that our Distributable Cash is a useful supplemental measure that may assist prospective investors in assessing the return on their investment in Class A Units.

Sales

Sales for the year ended December 31, 2005 were $355.8 million, down 4.7% from $373.5 million in 2004. This difference in year-over-year sales was due entirely to the strengthening value of the Canadian dollar. During 2005, the average exchange rate for the Canadian dollar was 6.9% higher than during the same period in 2004. Had exchange rates remained consistent with 2004 levels, revenue for the 2005 year would have been $373.7 million.

Sales in the United States, as measured in US dollars, increased by 1.8% in 2005. Sales from our Canadian business, as measured in Canadian dollars, declined by 3.6% in 2005. The lower sales pace in Canada is largely attributed to the strengthening Canadian dollar. In Canada Hardwoods Canadian business buys the majority of our product from the United States in US dollars, and a stronger Canadian dollar reduces the Canadian dollar purchase price that we pay to purchase from mills in the United States. When this product is resold to our Canadian customers, it is also at a lower Canadian dollar equivalent selling price. Accordingly, sales revenues in Canada are effectively reduced.

Gross Profit

For the year ended December 31, 2005, we reported gross profit of $66.4 million. This was 4.9% lower than gross profit of $69.8 million we achieved in 2004. Our gross margin percentage remained steady at 18.7% of sales. Accordingly, the 4.9% decrease in gross profit is consistent with our decrease in sales.

Selling and Administrative Expenses

Selling and administrative expenses were $43.5 million in 2005, up $0.8 million or 1.7% from $42.7 million in 2004. The impact of the increased costs was partially offset by the strengthening value of the Canadian dollar, which reduced our US dollar expenses when translated to Canadian dollars for reporting purposes.

As a percentage of sales, our selling and administrative expenses were 12.2% in 2005, compared to 11.4% in 2004. Had our selling and administrative expenses as a percentage of sales been held at 2004 levels, our 2005 costs would have been $40.6 million, or $3.0 million lower. The higher costs relative to sales experienced in 2005 was due to a variety of factors. Additional employees were hired to consolidate prior year sales gains and to position Hardwoods for future sales growth. Competitive pressure on salaries, higher benefit expenses, and higher than normal moving costs to relocate a number of managers to new markets were also factors. In addition, a one-time $0.5 million severance expense was incurred relating to the departure of a long-term employee.

Gain on Realized Foreign Currency Contracts

The Fund realized gains of $0.7 million on foreign currency contracts which matured in 2005, compared to $0.3 million in 2004. The higher gains on realized foreign currency contracts reflects the continued strengthening of the Canadian dollar in 2005. The terms of our foreign currency contracts and the Fund's use of currency derivatives to mitigate the economic impact of fluctuations between the Canadian and United States dollar is described under Financial Instruments on page 14 of this report.

EBITDA

EBITDA for the year was $23.6 million, compared to $27.4 million in 2004. The $3.8 million decrease in EBITDA was primarily due to the $3.4 million decrease in gross profit and the $0.8 million increase in selling and administrative expenses, partly offset by a $0.4 million increase in gains on realized foreign currency contracts.

Other Income

The mark-to-market valuation of our unrealized foreign currency contracts resulted in an income gain of $0.1 million for the period January 1, 2005 to December 31, 2005. We continue to monitor our foreign currency contract policy to mitigate the impact of foreign exchange fluctuations on Canadian dollar distributions generated by our U.S. operations. Further discussion of our foreign currency contracts can be found under Financial Instruments on page 14 of this report.

Net Earnings

Net earnings in 2005 decreased $4.4 million to $13.4 million, from $17.8 million for the twelve months ended December 31, 2004. The decrease in net earnings primarily reflects the $3.8 million decrease in EBITDA and the $2.4 million lower mark-to-market gains on unrealized foreign currency contracts, partly offset by a $1.3 million decrease in non-controlling interest and $0.6 million decrease in income taxes as the result of lower earnings in 2005.

Results of Operations

Three months ended December 31, 2005 and December 31, 2004

Selected Unaudited Consolidated Financial Information
(in thousands of Canadian dollars)

	For the three months ended December 31 2005	For the three months ended December 31 2004
Total sales	$ 84,130	$ 93,730
Sales in the US (US$)	*49,150*	*51,715*
Sales in Canada	*26,420*	*30,499*
Gross profit	15,456	17,003
Gross margin %	*18.4%*	*18.1%*
Selling and administrative expenses	11,009	10,842
Gain on realized foreign currency contracts	(259)	(261)
Earnings before interest, taxes, depreciation and amortization and non-controlling interest ("EBITDA")	$ 4,706	$ 6,422
Add (Deduct):		
Amortization	(524)	(598)
Interest	(595)	(499)
Mark-to-market gain on unrealized foreign currency contracts	(399)	1,660
Non-controlling interest	(637)	(1,397)
Income taxes	(181)	(20)
Net earnings for the period	$ 2,370	5,568
Basic and fully diluted earnings per Class A Unit	$ 0.164	0.386
Average Canadian dollar/U.S. dollar exchange rate	$ 1.1732	1.2235

Sales

For the three months ended December 31, 2005, sales were $84.1 million, down 10.2% from $93.7 million during the fourth quarter of 2004. A stronger Canadian dollar accounted for 2.5% of the sales decrease, and lower underlying sales activity for the remainder. As described in our third quarter report to unitholders, the fourth quarter is traditionally a seasonally slower sales period for Hardwoods. In 2004, fourth quarter sales were unusually strong with very little in the way of a seasonal slowdown. In 2005, sales returned to a more traditional pattern of seasonal demand, and as a consequence fourth quarter sales did not match 2004 levels. Sales in the United States, as measured in US dollars, were 5.0% lower in the quarter, and sales in Canada, measured in Canadian dollars, were down by 13.4%.

Gross Profit

Gross profit for the three months ended December 31, 2005 was $15.5 million, a decrease of $1.5 million, or 9.1%, from $17.0 million in the fourth quarter of 2004. The change in gross profit reflects lower sales, partly offset by an improved gross margin percentage of 18.4% in the quarter compared to 18.1% during the fourth quarter of 2004.

Selling and Administrative Expenses

Selling and administrative expenses increased $0.2 million to $11.0 million in the fourth quarter, from $10.8 million during the same period in 2004. Higher employment costs and a fourth quarter increase in bad debts contributed to the increase. This was partially offset by a reduced employee bonus expense as a result of decreased profits, as well as the positive impact of a stronger Canadian dollar on U.S. operating costs.

EBITDA

EBITDA decreased to $4.7 million in the fourth quarter of 2005, down $1.7 million from $6.4 million during the same period in 2004. The decrease in EBITDA primarily reflects lower sales, combined with slightly higher selling and administrative expenses.

Other Income

For the three months ended December 31, 2005, the mark-to-market valuation of our outstanding foreign currency contracts provided a loss of $0.4 million, compared to a gain of $1.7 million in 2004. Further discussion of our foreign currency contracts can be found under Financial Instruments on page 14 of this report.

Net Earnings

Fourth quarter net earnings were $2.4 million, compared to $5.6 million during the same period in 2004. The $3.2 million decrease in net earnings primarily reflects the $1.7 million decrease in EBITDA, a $2.1 million decrease in mark-to-market gains on unrealized foreign currency contracts, and a $0.2 million increase in income taxes. This was partly offset by a $0.8 million reduction in non controlling interest as a result of lower profits in the quarter.

Quarterly Financial Information

(in thousands of dollars)

	3 months ended Dec 31 2005	3 months ended Sep 30 2005	3 months ended Jun 30 2005	3 months ended Mar 31 2005	3 months ended Dec 31 2004	3 months ended Sep 30 2004	The period Mar 23, 2004 to Jun 30, 2004
Total sales	$ 84,130	$ 94,766	$ 91,852	$ 85,027	$ 93,730	$ 97,040	$ 99,125
Net earnings	$ 2,370	$ 4,597	$ 3,442	$ 2,942	$ 5,568	$ 4,351	$ 4,684
Basic and fully diluted earnings per Class A Unit	$ 0.164	$ 0.319	$ 0.239	$ 0.204	$ 0.386	$ 0.302	$ 0.325

The table above provides selected quarterly financial information for the seven completed fiscal quarters from commencement of operations of the Fund to December 31, 2005. This information is unaudited, but reflects all adjustments of a normal, recurring nature which are, in our opinion, necessary to present a fair statement of the results of operations for the periods presented. Quarter-to-quarter comparisons of our financial results are not necessarily meaningful and should not be relied upon as an indication of future performance. Historically, the first quarter and fourth quarter have been seasonally slower periods for the business. In addition, net earnings reported in each quarter will be impacted by changes to the foreign exchange rate of the Canadian and US dollar and mark-to-market gains or losses on unrealized foreign currency contracts, which are described under Financial Instruments on page 14 of this report.

Liquidity

Distributable Cash and Cash Distributions
Selected Unaudited Consolidated Financial Information
(in thousands of dollars except per unit amounts)

	For the Year Ended Dec 31 2005	For the Period Mar 23, 2004 to Dec 31 2004	For the 3 Months Ended Dec 31 2005	For the 3 Months Ended Dec 31 2004
Net cash provided by operating activities	$ 13,011	$ 3,854	$ 7,053	$ 9,488
Increase (decrease) in non-cash operating working capital	7,058	15,059	(3,196)	(3,646)
Cash flow from operations before changes in non-cash operating working capital	20,069	18,913	3,857	5,842
Capital expenditures	(1,356)	(1,006)	(533)	(197)
Distributable cash	$ 18,713	$ 17,907	$ 3,324	$ 5,645
Distributions relating to the period:				
Class A Units	15,497 (1)	11,802	3,825 (1)	3,891
Class B Units	3,065 (2)	3,205	– (2)	1,214
	$ 18,562	$ 15,007	$ 3,825	$ 5,105
Outstanding units and per unit amounts:				
Class A Units outstanding	14,410,000	14,410,000	14,410,000	14,410,000
Class B Units outstanding	3,602,500	3,602,500	3,602,500	3,602,500
Total Units outstanding	18,012,500	18,012,500	18,012,500	18,012,500
Distributable Cash per Unit	$ 1.039	$ 0.994	$ 0.185	$ 0.313
Distributions relating to the period:				
Class A Units	$ 1.075 (1)	$ 0.819	$ 0.265 (1)	$ 0.270
Class B Units	$ 0.851 (2)	$ 0.890	$ – (2)	$ 0.337
Total Units	$ 1.031	$ 0.833	$ 0.212	$ 0.283
Payout ratio (3)	99.2%	83.8%	115.1%	90.4%

(1) Includes the cash distribution which relates to December 2005 operations of the Fund. The cash distribution of $0.08542 per Class A Unit related to December 2005 operations of the Fund was declared on January 10, 2006, to be paid on January 31, 2006 to unitholders of record as of January 20, 2006. As this distribution was not declared until after Fund's balance sheet date of December 31, 2005, it has not been reflected in the audited financial statements of the Fund for the year ended December 31, 2005.

(2) On January 10, 2006, Hardwoods Specialty Products LP and Hardwoods Specialty Products US LP, partnerships in which the Fund owns an 80% interest, announced that, effective immediately, quarterly distributions were suspended on the subordinated units, represented by the Class B LP and Class B US LP units. The Class B LP units and Class B US LP units represent a 20% interest in the combined business of Hardwoods, which is subordinated to the Fund's ownership interest in the business. Accordingly, no distributions were declared payable in the fourth quarter of 2005 related to the non-controlling interests and no liability for distributions payable to the non-controlling interests is reflected in the December 31, 2005 balance sheet.

(3) Payout ratio measures the ratio of distributions relating to the period to distributable cash in the period. Comparative distributable cash and payout ratio figures have been restated to conform with presentation adopted in the current year as a result of the suspension of quarterly distributions on the Class B Units.

We pay distributions to Class A Unitholders at the end of the month following the month in which the cash is earned. Distributions may also be made quarterly to Class B Unitholders in an amount equivalent on an after tax per unit basis to distributions made to Class A Unitholders, pursuant to the terms of a subordination agreement as outlined in the Fund's Annual Information Form dated March 20, 2006.

At the end of the fourth quarter of 2005, Hardwoods Specialty Products LP and Hardwoods Specialty Products US LP, partnerships in which the Fund owns an 80% interest, suspended quarterly distributions on the subordinated units, represented by the Class B LP and Class B US LP units. The Class B LP units and Class B US LP units represent a 20% interest in the combined business of Hardwoods, which is subordinated to the Fund's ownership interest in the business. The quarterly distributions which were suspended and not declared to Class B Units related to the fourth quarter of 2005 were $1.0 million. The subordination feature allows for this $1.0 million in suspended distributions to be made up to the Class B unitholders during 2006 under certain circumstances. In addition, monthly distributions to Class A public unitholders cannot be increased above the IPO level of $0.08542 per unit during any month in which a suspension of distributions has been in effect for Class B unitholders in a preceding twelve month period. The Fund's subordination feature is designed to stay in place until the EBITDA and distributable cash tests established at the time of the IPO are met. The terms of these EBITDA and distributable cash tests are described in note 6 to the accompanying financial statements of the Fund.

In 2005, the Fund and its subsidiaries generated distributable cash available to Class A and Class B Units of $18.7 million, or $1.039 per unit. Distributions relating to the period were $15.5 million to Class A Units ($1.075 per Class A Unit) and $3.1 million to Class B Units ($0.851 per Class B Unit). This represents an overall payout ratio of 99.2% for the year. For the seasonally slow fourth quarter, the Fund and is subsidiaries generated distributable cash available to Class A and Class B Units of $3.3 million, or $0.185 per unit. Distributions relating to the fourth quarter were $3.8 million to Class A Units ($0.265 per Class A Unit), and no distributions were declared to Class B Units, for an overall payout ratio of 115.1% for the period. At December 31, 2005, the overall payout ratio since the Fund's inception was 91.7%. The income tax characterization of distributions paid to unitholders in 2005 was approximately 43% fully taxable distributions, 26% dividends, and 31% return of capital.

Capital Expenditures

Capital expenditures were $0.5 million in the fourth quarter, and $1.4 million for the year. Included in these amounts was $0.2 million in expansion capital expenditures associated with opening two new branches in the third quarter.

In the second quarter of 2005, Hardwoods sold and leased-back for a ten year period the only land and building owned by the Fund or any of its subsidiaries. Net cash proceeds of $2.2 million were received and a gain on sale realized of $0.9 million. In accordance with Canadian generally accepted accounting principles, the $0.9 million gain has been treated as a deferred gain and is being amortized in proportion to the rental payments over the term of the lease.

As Hardwoods now leases all of its buildings and contracts out all freight delivery services, the Business has minimal capital requirements. Our capital expenditures are principally comprised of replacement of forklifts, furniture and fixtures, leasehold improvements, and computer equipment. We estimate our maintenance capital expenditures will be approximately $1.2 million annually. Additional capital expenditures may be incurred for new branch openings or to support acquisition opportunities that arise.

Revolving Credit Facilities

We have independent credit facilities in each of Canada and the US. In Canada, the term of our three-year operating line extends to March 23, 2007 and comprises a maximum facility of $22.0 million. The balance outstanding on the Canadian operating line as at December 31, 2005 was $13.2 million. In the

US, the term of our three-year operating line extends to March 31, 2007, and as at December 31, 2005 had a balance outstanding of $33.0 million (US $28.4 million). In December 2005 the US operating line facility was increased from US $30.0 million to US $35.0 million. We believe that our operating lines in both Canada and the U.S. are sufficient to meet our current working capital requirements.

Contractual Obligations

The table below sets forth other remaining contractual obligations of the Fund as at December 31, 2005, due in the years indicated, which relate to operating leases on various premises:

(in thousands of Canadian dollars)

Total	2006	2007	2008	2009	2010	2011 and thereafter
$ 25,741	$ 5,858	$ 5,565	$ 5,067	$ 4,219	$ 2,364	$ 2,668

The above contractual obligations include the rental payments required under the sale-leaseback transaction described under Capital Expenditures on page 12 of this report, as well as the lease commitments associated with the two new branch locations opened in Minnesota and Illinois during the third quarter of 2005.

Off-Balance Sheet Arrangements

The Fund has no off balance sheet arrangements. The foreign currency contracts discussed under Financial Instruments on page 14 of this report are marked-to-market at the end of each quarter, with the fair value recorded on the balance sheet.

Critical Accounting Estimates

The preparation of financial statements in accordance with Canadian generally accepted accounting principles requires that we make estimates and assumptions that can have a material impact on our results of operations as reported on a periodic basis. We base our estimates and assumptions on past experience and other factors that are deemed reasonable under the circumstances. Actual results could differ from these estimates. The critical estimates used in preparing our financial statements are:

Accounts Receivable Provision: Due to the nature of our business and the credit terms we provide to our customers, we anticipate that a certain portion of required customer payments will not be made, and we maintain an allowance for these doubtful accounts. The allowance is based on our estimate of the potential of recovering our accounts receivable, and incorporates current and expected collection trends.

Valuation of Inventories: We anticipate that the net realizable value of our inventory could be affected by market shifts or damage to our products. Our inventory is valued at the lower of cost and net realizable value.

All significant accounting policies have been included in note 2 to the financial statements.

Related Party Transactions

Related parties refers to affiliates of the previous owners of the Business who have retained a 20% interest in Hardwoods through ownership of Class B Hardwoods LP units and Class B Hardwoods USLP units, respectively. For the three months ended December 31, 2005, sales of $0.4 million were made to related parties, and the subsidiaries of the Fund purchased $0.4 million from related parties. For the year ended December 31, 2005, sales of $2.0 million were made to related parties, and the subsidiaries of the Fund purchased $0.6 million from related parties. These sales and purchases took place at prevailing market prices. Subsidiaries of the Fund also paid $31,704 in the fourth quarter and $122,384 in the year ended December 31, 2005 to related parties under the terms of an agreement to provide transitional services for management information systems.

Financial Instruments

The Fund uses currency derivatives to manage its exposure to fluctuations in exchange rates between the Canadian dollar and the United States dollar. The foreign currency contracts are recognized in the balance sheet and measured at their fair value, with changes in fair value recognized currently in the statement of operations. At December 31, 2005, the Fund had 28 monthly foreign currency contracts to exchange US$675,000 into approximately $878,000, reflecting an exchange rate of Cdn$1.30 to US$1.00, each month until April 2008. The fair value of the remaining 28 monthly contracts has been reflected in the financial statements.

On February 23, 2006 a subsidiary of the Fund entered into additional monthly foreign currency contracts which require the subsidiary to exchange, beginning in May 2008, US $675,000 into approximately Canadian $760,000 each month until April 2009, reflecting an exchange rate of $1.1255.

Based on the Fund's current monthly distribution of $0.08542 per unit to public unitholders, during the term of the monthly foreign currency contracts the principal value of the monthly foreign currency contracts is sufficient to fully cover the amount of expected US dollar denominated distributable cash which is necessary to be converted to Canadian dollars to pay current distributions to Class A Unitholders.

Disclosure Controls and Procedures

The Fund's management is responsible for establishing and maintaining disclosure controls and procedures to provide reasonable assurance that material information related to the Fund, including its consolidated subsidiaries, is made known to senior management, including the Chief Executive Officer (CEO) and the Chief Financial Officer (CFO), by others within those entities on a timely basis so that appropriate decisions can be made regarding public disclosure. The CEO and CFO have evaluated the effectiveness of the Fund's disclosure controls and procedures and have concluded that they are effective as of December 31, 2005.

Forward-looking Statements

This MD&A may contain forward-looking statements, which reflect our expectations regarding the future growth, results of operations, performance and business prospects, and opportunities of the Fund. Forward-looking statements contain such words as "anticipate", "believe", "continue", "could", "expects", "intend", "may", "plans" or similar expressions suggesting future conditions or events. Such forward-looking statements reflect our current beliefs and are based on information currently available to us. Forward-looking statements involve significant risks and uncertainties. A number of factors could cause actual results to differ materially from results discussed in the forward-looking statements, including the effects, as well as changes in: national and local business conditions; political or economic instability in local markets; competition; consumer preferences, spending patterns and demographic trends; legislation and governmental regulation. Although the forward-looking statements contained in this MD&A are based on what we believe to be reasonable assumptions, we cannot assure readers that actual results will be consistent with these forward-looking statements.

Additional Information

Additional information relating to the Fund, including all public filings, are available on SEDAR (www.sedar.com) and our website (www.hardwoods-inc.com).

Management's Statement of Responsibilities

The accompanying consolidated financial statements are the responsibility of management and have been reviewed and approved by the Boards of Directors and the Trustees. The consolidated financial statements have been prepared by management, in accordance with Canadian generally accepted accounting principles and, where appropriate, reflect management's best estimates and judgements. Management has also prepared financial and all other information in the annual report and has ensured that this information is consistent with the consolidated financial statements.

The Fund maintains appropriate systems of internal control, policies and procedures, which provide management with reasonable assurance that assets are safeguarded and the financial records are reliable and form a proper basis for preparation of financial statements.

The Boards of Directors and the Trustees ensure that management fulfills its responsibilities for financial reporting and internal control through an Audit Committee. This committee reviews the consolidated financial statements and is comprised of independent Trustees. The auditors have full and direct access to the Audit Committee.

The consolidated financial statements have been independently audited by KPMG LLP, in accordance with Canadian generally accepted auditing standards. Their report below expresses their opinion on the consolidated financial statements of the Fund.

Maurice Paquette

Maurice E. Paquette
President and Chief Executive Officer

Auditors' Report to the Unitholders

We have audited the consolidated balance sheet of Hardwoods Distribution Income Fund (the "Fund") as at December 31, 2005 and 2004 and the consolidated statements of operations and retained earnings and cash flows for the year ended December 31, 2005 and the period from March 23, 2004 to December 31, 2004. These financial statements are the responsibility of the Fund's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the Fund as at December 31, 2005 and 2004 and the results of its operations and its cash flows for the year ended December 31, 2005 and the period from March 23, 2004 to December 31, 2004 in accordance with Canadian generally accepted accounting principles.

KPMG LLP

Chartered Accountants

Vancouver, Canada
February 10, 2006, except as to note 4
which is as of February 23, 2006

Consolidated Balance Sheets

(Expressed in thousands of Canadian dollars)

	December 31 2005	December 31 2004
Assets		
Current assets:		
Cash and cash equivalents	$ 2,203	$ –
Accounts receivable	46,166	45,283
Income tax receivable	86	401
Inventory	47,666	42,499
Prepaid expenses	1,222	627
	97,343	88,810
Long-term receivables	2,634	1,787
Property, plant and equipment (note 3)	3,519	4,687
Deferred financing costs, net	77	142
Foreign currency contracts (note 4)	2,653	2,511
Other intangible assets	12,103	13,293
Goodwill	96,340	98,283
	$ 214,669	$ 209,513
Liabilities and Unitholders' Equity		
Current liabilities:		
Bank indebtedness (note 5)	$ 46,925	$ 39,058
Accounts payable and accrued liabilities	9,231	7,897
Distributions payable to Unitholders	–	1,297
Distributions payable to non-controlling interests	–	981
	56,156	49,233
Deferred gain on sale-leaseback of land and building	804	-
Non-controlling interests (note 6)	32,047	32,123
Future income taxes (note 8)	1,364	545
Unitholders' equity:		
Fund Units (note 7)	133,454	133,454
Retained earnings	1,886	2,801
Cumulative foreign currency translation account	(11,042)	(8,643)
	124,298	127,612
	$ 214,669	$ 209,513

Commitments (note 10)
Contingencies (note 15)
Subsequent events (notes 4, 6 and 16)

See accompanying notes to consolidated financial statements.

Approved on behalf of the Trustees:

Lawrence I. Bell, Trustee **Terry M. Holland**, Trustee

Consolidated Statements of Operations and Retained Earnings

(Expressed in thousands of Canadian dollars)

	Year ended December 31 2005	Period from March 23, 2004 to December 31, 2004
Sales	$ 355,775	$ 289,895
Cost of sales	289,388	236,040
Gross profit	66,387	53,855
Expenses (income):		
Selling and administrative	43,480	32,428
Amortization:		
Plant and equipment	1,236	1,040
Deferred financing costs	64	50
Other intangible assets	938	735
Deferred gain on sale-leaseback of land and building	(57)	–
Interest	2,114	1,252
Realized gain on foreign currency contracts	(677)	(306)
Mark-to-market gain on unrealized foreign currency contracts (note 4)	(142)	(2,511)
	46,956	32,688
Earnings before non-controlling interests and income taxes	19,431	21,167
Non-controlling interests (note 6)	3,886	4,233
Earnings before income taxes	15,545	16,934
Income taxes (note 8)	2,194	2,331
Net earnings for the period	13,351	14,603
Retained earnings, beginning of period	2,801	–
Distributions declared to Unitholders	(14,266)	(11,802)
Retained earnings, end of period	$ 1,886	$ 2,801
Basic and diluted earnings per Unit	$ 0.93	$ 1.01
Weighted average number of Units outstanding	14,410,000	14,410,000

See accompanying notes to consolidated financial statements.

Consolidated Statements of Cash Flows

(Expressed in thousands of Canadian dollars)

	Year ended December 31 2005	Period from March 23, 2004 to December 31, 2004
Cash flows provided by (used in) operating activities:		
Net earnings for the period	$ 13,351	$ 14,603
Items not involving cash:		
Amortization	2,181	1,825
Gain on sale of property, plant and equipment	(26)	(22)
Mark-to-market gain on unrealized foreign currency contracts	(142)	(2,511)
Non-controlling interests	3,886	4,233
Future income taxes (note 8)	819	785
	20,069	18,913
Change in non-cash operating working capital (note 9)	(7,058)	(15,059)
Net cash provided by operating activities	13,011	3,854
Cash flows provided by (used in) investing activities:		
Business acquisition (note 1)	–	(165,137)
Additions to property, plant and equipment	(1,356)	(1,006)
Proceeds on disposal of property, plant and equipment	2,150	53
Increase in long-term receivables, net	(972)	200
Net cash used in investing activities	(178)	(165,890)
Cash flows provided by (used in) financing activities:		
Net proceeds from the issuance of Units	–	133,454
Increase in bank indebtedness	8,996	41,515
Increase in deferred financing fees	–	(204)
Distributions paid to Unitholders	(15,563)	(10,505)
Distributions paid to non-controlling interests	(4,063)	(2,224)
Net cash provided by (used in) financing activities	(10,630)	162,036
Increase in cash	2,203	–
Cash, beginning of period	-	–
Cash, end of period	$ 2,203	$ –
Supplementary information (cash amounts):		
Interest paid	$ 2,114	$ 1,252
Income taxes paid	946	2,100

See accompanying notes to consolidated financial statements.

Notes to Consolidated Financial Statements

(Tabular amounts expressed in thousands of Canadian dollars)

Year ended December 31, 2005
Period from March 23, 2004 to December 31, 2004

1. Nature of operations and business acquisition:

Hardwoods Distribution Income Fund (the "Fund") is an unincorporated, open ended, limited purpose trust established under the laws of the Province of British Columbia on January 30, 2004 by a Declaration of Trust. The Fund commenced operations on March 23, 2004 when it completed an initial public offering (the "Offering") of Units and acquired (the "Acquisition") an 80% interest in a hardwood lumber and sheet goods distribution business in North America (the "Business") from affiliates of Sauder Industries Limited ("SIL"). The Fund holds, indirectly, 80% of the outstanding limited partnership units of Hardwoods Specialty Products LP ("Hardwoods LP") and Hardwoods Specialty Products US LP ("Hardwoods USLP"), limited partnerships established under the laws of the Province of Manitoba and the state of Delaware, respectively.

On March 23, 2004, the Fund issued 14,410,000 Units at $10 per Unit pursuant to the Offering. Net proceeds from the Offering were $133,454,000, after deducting expenses of the Offering of $10,646,000.

Also on March 23, 2004, the Fund used the net proceeds from the Offering, together with funds from two new credit facilities (note 5), to acquire an 80% interest in Hardwoods LP and Hardwoods USLP for total consideration of approximately $165,137,000. The acquisition of the Fund's interest in Hardwoods LP and Hardwoods USLP was completed through a series of transactions and has been accounted for using the purchase method.

The fair value of the net assets acquired is as follows:

Net working capital	$	73,658
Property, plant and equipment		5,094
Goodwill		104,580
Other intangible assets		15,000
Future income taxes		267
Non-controlling interests		(33,462)
Consideration, being cash from the Offering and new credit facilities	$	165,137

The results of operations of Hardwoods LP and Hardwoods USLP have been included in the Fund's consolidated financial statements from March 23, 2004, being the date of acquisition.

2. Significant accounting policies:

These consolidated financial statements have been prepared in accordance with Canadian generally accepted accounting principles.

(a) Basis of presentation:

These consolidated financial statements include the accounts of the Fund and its 80% owned subsidiaries Hardwoods LP and Hardwoods USLP and other wholly owned subsidiaries. All significant intercompany balances and transactions have been eliminated on consolidation.

2. Significant accounting policies (continued)

(b) Cash and cash equivalents:

The Fund considers deposits in banks, certificates of deposits and short-term investments with original maturities of three months or less when acquired as cash and cash equivalents.

(c) Accounts receivable:

Accounts receivable includes trade accounts receivable net of allowances for doubtful accounts plus the current portion of housing loans receivable from employees related to their relocation.

(d) Inventory:

Inventory is valued at the lower of weighted average cost and net realizable value.

(e) Long-term receivables:

Long-term receivables are non-interest bearing housing loans receivable from employees related to their relocation. The housing loans are secured by a deed of trust or mortgage depending upon the jurisdiction.

(f) Property, plant and equipment:

Property, plant and equipment are stated at cost. Amortization is provided at straight-line rates sufficient to amortize the cost of the assets over their estimated useful lives as follows:

Assets	Estimated useful life
Buildings	20 years
Machinery and equipment	5 to 10 years
Automobiles	3 years
Mobile equipment	7 to 10 years
Leasehold improvements	Over the term of the lease

(g) Deferred financing costs:

Financing costs incurred to obtain credit facilities are deferred and amortized on a straight-line basis over the term of the related debt.

(h) Other intangible assets:

Other intangible assets represent customer relationships acquired in the business combination and are recorded at cost less accumulated amortization. Amortization is provided for on a straight-line basis over 15 years.

(i) Goodwill:

Goodwill is recorded at cost and is not amortized. Management reviews the carrying value of goodwill for impairment annually, or more frequently if events or changes in circumstances indicate that the asset may be impaired. Any excess of carrying value over fair value will be charged to income in the period in which the impairment is determined. To December 31, 2005, no impairment in goodwill has been determined to have occurred. Goodwill related to the Fund's United States operations is translated into Canadian dollars at the exchange rate in effect at the balance sheet date.

(j) Impairment of long-lived assets:

Long-lived assets, including property, plant and equipment and other intangible assets, are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets is measured by a comparison of the carrying amount of an asset to estimated undiscounted future cash flows expected to be generated by the asset. If the carrying amount for the asset exceeds its estimated future cash flows an impairment charge is recognized by the amount the asset exceeds its fair value.

(k) Sales-leaseback of land and building:

During the year ended December 31, 2005, a subsidiary of the Fund sold a building and related land and leased back the facilities. The gain on the sale has been deferred and is amortized in proportion to the rental payments over the lease term.

(l) Income taxes:

Incorporated subsidiaries of the Fund use the asset and liability method of accounting for income taxes. Under the asset and liability method, future income tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Future tax assets and liabilities are measured using enacted or substantively enacted 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 tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the substantive enactment date. The amount of future income tax assets recognized is limited to the amount that is more likely than not to be realized.

As the Fund allocates all of its net earnings to Unitholders and deducts these amounts in computing its taxable income, Unitholders, rather than the Fund, will generally be liable for any income tax obligations. Accordingly, no provision for income taxes has been made in respect of the Fund itself.

(m) Revenue recognition:

Revenue from the sale of hardwood lumber and sheet goods is recognized at the time of delivery, which is when title and the risks and rewards of ownership transfers to the customer.

(n) Translation of foreign currencies:

The accounts of the Fund's self-sustaining foreign operations are translated into Canadian dollars using the current rate method. Assets and liabilities are translated at the exchange rate in effect at the balance sheet date and revenue and expenses are translated at average exchange rates for the period. Gains or losses arising from the translation of the financial statements of the self-sustaining foreign operations are deferred in the cumulative foreign currency translation account in Unitholders' equity.

Foreign monetary assets and liabilities of the Canadian operations have been translated into Canadian dollars using the rate of exchange in effect at the balance sheet date. Revenue and expenses of the Canadian operations denominated in foreign currencies are translated at the average exchange rates for the period. Exchange gains or losses arising from translation of these foreign monetary balances and transactions are reflected in earnings.

(o) Foreign currency contracts:

The Fund uses currency derivatives to manage its exposure to fluctuations in exchange rates between the Canadian and the United States dollar. The foreign currency contracts are recognized in the balance sheet and measured at fair value, with changes in fair value recognized currently in the statement of operations.

(p) Earnings per Unit:

Basic earnings per Unit is calculated by dividing net earnings by the weighted average number of Units outstanding during the reporting period. Diluted earnings per Unit is calculated by application of the if-converted method for convertible securities (being exchangeable Units held by the non-controlling interest). As the conversion of convertible securities would not have a dilutive effect on earnings per Unit, diluted and basic earnings per Unit are the same amount.

(q) Use of estimates:

The preparation of financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting period. Areas requiring significant management estimates include the valuation and impairment analysis of goodwill and other intangible assets, the determination of the allowance for doubtful accounts, future income taxes and amounts of accrued liabilities. Actual amounts may differ from the estimates applied in the preparation of these financial statements.

(r) Comparative Figures:

Certain comparative figures have been restated to conform to the current year's financial statement presentation.

3. Property, plant and equipment:

December 31, 2005		Cost		Accumulated amortization		Net book value
Machinery and equipment	$	1,919	$	743	$	1,176
Mobile equipment		2,922		1,021		1,901
Leasehold improvements		715		273		442
	$	5,556	$	2,037	$	3,519

December 31, 2004		Cost		Accumulated amortization		Net book value
Buildings	$	491	$	34	$	457
Machinery and equipment		1,283		344		939
Automobiles		11		9		2
Mobile equipment		2,454		463		1,991
Leasehold improvements		669		140		529
		4,908		990		3,918
Land		769		–		769
	$	5,677	$	990	$	4,687

4. Foreign currency contracts:

In order to manage the Fund's exposure to exchange rate fluctuations on United States dollar denominated distributable cash, a subsidiary of the Fund has entered into foreign currency contracts to exchange US$675,000 each month for approximately $878,000 until April 2008, reflecting an exchange rate of $1.30. The remaining 28 monthly foreign currency contracts at December 31, 2005 are recognized in the balance sheet and measured at fair value, which at December 31, 2005 represented an asset of $2,653,000.

On February 23, 2006, a subsidiary of the Fund entered into additional monthly foreign currency contracts which require the subsidiary to exchange, beginning in May 2008, US$675,000 into approximately $760,000 each month until April 2009, reflecting an exchange rate of $1.1255.

5. Bank indebtedness:

		December 31, 2005		December 31, 2004
Checks issued in excess of funds on deposit	$	753	$	1,186
Credit facility, Hardwoods LP		13,201		14,000
Credit facility, Hardwoods USLP (2005-US$28,350; 2004-US$19,860)		32,971		23,872
	$	46,925	$	39,058

Bank indebtedness consists of checks issued in excess of funds on deposit and advances under operating lines of credit available to Hardwoods LP and Hardwoods USLP. Hardwoods LP has a revolving credit facility of up to an aggregate amount of $22,000,000 and Hardwoods USLP has a revolving credit facility of up to an aggregate amount of $40,705,000 (US$35,000,000) (less the net exposure under the foreign currency contracts facility as described in note 4, as determined by the lender from time to time).

The Hardwoods LP credit facility is secured by a first security interest in all of the present and after acquired property of Hardwoods LP and its operating subsidiaries, and by the Hardwoods LP Units held indirectly by the Fund. The Hardwoods USLP credit facility and the foreign currency contract arrangements are secured by a first security interest in all of the present and after acquired property of Hardwoods USLP and by the Hardwoods USLP Units held indirectly by the Fund.

Each facility is a demand loan with a revolving three-year term expiring on March 23, 2007. The credit facilities are repayable without any prepayment penalties and bear interest at a floating rate based on the Canadian dollar or US dollar prime rate (as the case may be), LIBOR or bankers acceptance rates plus, in each case, an applicable margin. Letters of credit are also available under the credit facilities. The rates vary with the ratio of total debt for borrowed money, capital leases and letters of credit (as adjusted for certain items) to earnings before interest, taxes, depreciation and amortization, as defined in the credit agreements. Commitment fees and standby charges are payable.

The average annual interest rates payable for the year ended December 31, 2005 were 5.0% and 4.9% (period from March 23, 2004 to December 31, 2004 were 5.2% and 3.6%) for the Hardwoods LP and Hardwoods USLP credit facilities, respectively.

6. Non-controlling interests:

	Year ended December 31, 2005	Period from March 23, 2004 to December 31, 2004
Balance, beginning of the period	$ 32,123	$ –
Retained interest in Hardwoods LP and Hardwoods USLP	–	33,462
Interest in earnings for the period	3,886	4,233
Distributions declared to non-controlling interests	(3,066)	(3,205)
Foreign currency translation adjustment of non-controlling interest in Hardwoods USLP and other	(896)	(2,367)
Balance, end of the period	$ 32,047	$ 32,123

The previous owners of the Business (note 1) have retained a 20% interest in Hardwoods LP and Hardwoods USLP through ownership of Class B Hardwoods LP units ("Class B LP Units") and Class B Hardwoods USLP units ("Class B USLP Units"), respectively. The Fund owns an indirect 80% interest in Hardwoods LP and Hardwoods USLP through ownership of all Class A Hardwoods LP units ("Class A LP Units") and Class A Hardwoods USLP units ("Class A USLP Units"), respectively.

The Class A LP Units and Class B LP Units and the Class A USLP Units and Class B USLP Units, respectively, have economic and voting rights that are equivalent in all material respects except distributions on the Class B LP Units and Class B USLP Units are subject to the subordination arrangements described below until the date (the "Subordination End Date") on which:

- the consolidated Adjusted EBITDA, as defined in the Subordination Agreement dated March 23, 2004, of the Fund for the 12 month period ending on the last day of the month immediately preceding such date is at least $21,300,000; and

6. Non-controlling interests (continued)

- cash distributions of at least $29,540,000 ($2.05 per Unit) have been paid on the Units and a combined amount of cash advances or distributions of at least $7,385,000 has been paid on the Class B LP Units and Class B USLP Units, being $2.05 per combined Class B LP and Class B USLP Units (as adjusted for issuances, redemptions and repurchases of Units, LP Units and USLP Units subsequently and by converting the cash distributions or advances by Hardwoods USLP on the USLP Units at the rate of exchange used by the Fund to convert funds received by it in US dollars into Canadian dollars) for the 24 month period ending on the last day of the month immediately preceding such date.

The Subordination End Date had not occurred at December 31, 2005.

Distributions are to be made monthly on the Class A LP Units and Class A USLP Units equal to at least $0.0854 per Unit to the extent cash is available to make cash distributions and as determined by the board of directors of the general partners. Distributions on the Class B LP Units and Class B USLP Units will be subordinated and will be made quarterly in a combined amount for one Class B LP Unit and one Class B USLP Unit equal, on a pro rated basis, to the combined amount distributed on one Class A LP Unit and one Class A USLP Unit during such fiscal quarter, only after the distributions have been made on the Class A LP Units and Class A USLP Units and to the extent cash is available to make such distributions.

In January 2006, distributions on the Class B LP Units and the Class B USLP Units were suspended in accordance with the terms of the subordination arrangements. Under certain circumstances, the suspended distributions relating to the three months ended December 31, 2005 of $1.0 million may be declared and paid to the Class B LP Units and the Class B USLP Units in the twelve months following December 31, 2005. Monthly distributions by the Fund cannot exceed $0.08542 per Unit during any month in which suspended distributions exist on Class B LP Units and Class B USLP Units in a preceding twelve-month period.

After the Subordination End Date, the holders of the Class B LP Units and Class B USLP Units will generally be entitled to effectively exchange all or a portion of their Class B LP Units and Class B USLP Units together for up to 3,602,500 Units of the Fund, representing 20% of the issued and outstanding Units of the Fund on a fully diluted basis. In the event the Fund enters into an agreement in respect of an acquisition or a take-over bid of the Fund, the holders of the Class B LP Units and Class B USLP Units will be entitled to exchange such units for Units of the Fund.

7. Fund Units:

An unlimited number of Units and Special Voting Units may be created and issued pursuant to the Declaration of Trust. Each Unit is transferable and represents an equal undivided beneficial interest in any distributions from the Fund, whether of net income, net realized capital gains or other amounts and in the net assets of the Fund in the event of a termination or winding up of the Fund. The Special Voting Units are not entitled to any beneficial interest in any distribution from the Fund or in the net assets of the Fund in the event of a termination or winding up of the Fund. Each Unit, or Special Voting Unit, entitles the holder thereof to one vote at all meetings of voting Unitholders.

On March 23, 2004, the Fund issued 14,410,000 Units at a price of $10 per Unit pursuant to the Offering. Net proceeds from the Offering were $133,454,000 after deducting expenses of the Offering of $10,646,000. The holders of the Class B Units of Hardwoods LP and Hardwoods USLP were issued 3,602,500 Special Voting Units of the Fund, the value of which is included in non-controlling interests (note 6). Such Special Voting Units are to be cancelled on the exchange of Class B Units of Hardwoods LP and Hardwoods USLP for Units of the Fund.

8. Income taxes:

	Year ended December 31, 2005	Period from March 23, 2004 to December 31, 2004
Current	$ 1,323	$ 1,546
Future	871	785
	$ 2,194	$ 2,331

Income tax expense differs from that calculated by applying U.S. federal and state statutory income tax rates in effect in the jurisdiction in which a subsidiary of the Fund is subject to tax of 39.4% (period from March 23, 2004 to December 31, 2004 – 39.0%) to earnings before income taxes for the following reasons:

	Year ended December 31, 2005	Period from March 23, 2004 to December 31, 2004
Earnings before income tax	$ 15,545	$ 16,934
Computed tax expenses at statutory rate	6,125	6,604
Income of Fund distributed directly to Unitholders	(3,801)	(3,232)
Income and deductions not subject to tax	(250)	(783)
Deductible state taxes	(67)	(94)
Other	187	(164)
Income tax expense	$ 2,194	$ 2,331

The tax effect of temporary differences that give rise to significant portions of the future income tax assets and liabilities at December 31, 2005 is as follows:

	December 31, 2005	December 31, 2004
Future income tax assets:		
Accrued liabilities	$ 196	$ 103
Deferred gain on sale-leaseback of land and building	253	–
Inventory	410	451
Accounts receivable	45	–
Property, plant and equipment	35	–
	939	554
Future income tax liabilities:		
Property, plant and equipment	–	(3)
Goodwill	(2,200)	(1,096)
Prepaid expenses	(103)	–
	(2,303)	(1,099)
Net future income tax liability	$ (1,364)	$ (545)

Certain of the Fund's operations are not subject to income taxes because the income is allocated to the Unitholders and taxes are the responsibility of the Unitholders. At December 31, 2005, the tax bases exceeds the reported amounts of the Fund's consolidated assets and liabilities for entities that are not subject to income taxes by $5,025,000 (2004-$8,107,000).

9. Changes in non-cash operating working capital:

	Year ended December 31, 2005	Period from March 23, 2004 to December 31, 2004
Accounts receivable	$ (1,918)	$ 759
Income taxes receivable	314	(401)
Inventory	(6,371)	(6,902)
Prepaid expenses	(625)	(392)
Accounts payable and accrued liabilities	1,542	(8,123)
	$ (7,058)	$ (15,059)

10. Commitments:

(a) The Fund's subsidiaries are obligated under various operating leases that require minimum rental payments in each of the next five years as follows:

2006	$ 5,858
2007	5,565
2008	5,067
2009	4,219
2010	2,364
	23,073
Thereafter	2,668
	$ 25,741

(b) At December 31, 2005, the Fund's subsidiaries were committed in the amount of $151,702 (US$130,411) (2004 - $172,000; US $143,161) under letters of credit.

11. Segment disclosure:

Information about geographic areas is as follows:

		Year ended December 31, 2005		Period from March 23, 2004 to December 31, 2004
Revenue from external customers:				
Canada	$	113,359	$	91,337
United States		242,416		198,558
	$	355,775	$	289,895

		December 31, 2005		December 31, 2004
Property, plant and equipment:				
Canada	$	1,559	$	1,635
United States		1,960		3,052
	$	3,519	$	4,687
Goodwill:				
Canada	$	42,043	$	42,043
United States		54,297		56,240
	$	96,340	$	98,283

12. Financial instruments:

(a) Fair values of financial instruments:

The carrying value of cash and cash equivalents, trade accounts receivable, accounts payable and accrued liabilities and distributions payable approximate their fair value due to the relatively short period to maturity of the instruments. The fair value of long-term receivables is not expected to differ materially from the carrying value. The carrying value of the credit facilities approximate their fair values due to the existence of floating market based interest rates. The foreign currency contracts are carried at market values.

(b) Credit risk:

The Fund is exposed to credit risk in the event they are unable to collect in full amounts receivable from its customers. The Fund employs established credit approval practices and engages credit attorneys when appropriate to mitigate the credit risk. It is the Fund's policy to secure credit terms with customers whenever possible by registering security interests in the assets of the customer and by obtaining personal guarantees. No single customer represents a concentration of credit risk to the Fund.

(c) Counterparty risk:

Changes in the exchange rates and interest rates will result in market gains and losses on the foreign currency contracts entered into by the Fund. Furthermore, the Fund may be exposed to losses should the counterparty to its foreign currency contracts fail to fulfill its obligations. The Fund has sought to minimize potential counter party losses by transacting with high credit quality institutions.

13. Pensions:

Hardwoods USLP maintains a defined contribution 401 (k) retirement savings plan (the "USLP Plan"). The assets of the USLP Plan are held and related investment transactions are executed by the Plan's Trustee, ING National Trust, and, accordingly, are not reflected in these consolidated financial statements. During the year ended December 31, 2005, Hardwoods USLP contributed and expensed $400,329 (US$330,414) (period from March 23, 2004 to December 31, 2004 $243,766 (US$188,004)) in relation to the USLP Plan.

Hardwoods LP does not maintain a pension plan. Hardwoods LP does, however, administer a group registered retirement savings plan ("LP Plan") that has a matching component whereby Hardwoods LP makes contributions to the LP Plan which match contributions made by employees up to a certain level. The assets of the LP Plan are held and related investment transactions are executed by LP Plan's Trustee, Sun Life Financial Trust Inc., and, accordingly, are not reflected in these consolidated financial statements. During the year ended December 31, 2005, Hardwoods LP contributed and expensed $266,450 (period from March 23, 2004 to December 31, 2004 - $144,015) in relation to the LP Plan.

14. Related party transactions:

For the year ended December 31, 2005, sales of $2,046,323 (period from March 23, 2004 to December 31, 2004 - $1,158,593) were made to affiliates of SIL, and the Fund made purchases of $586,549 (period from March 23, 2004 to December 31, 2004 - $439,033) from affiliates of SIL. All these sales and purchases took place at prevailing market prices.

During the year ended December 31, 2005, the Fund paid $122,384 (period from March 23, 2004 to December 31, 2004 - $64,544) to affiliates of SIL under the terms of an agreement to provide transitional services for management information systems. This cost is included in the selling and administrative expense in the statement of operations.

15. Contingencies:

The Fund and its subsidiaries are subject to legal proceedings that arise in the ordinary course of its business. Management is of the opinion, based upon information presently available, that it is unlikely that any liability, to the extent not provided for through insurance or otherwise, would be material in relation to the Fund's consolidated financial statements.

16. Subsequent events:

On January 10, 2006 the Fund declared a cash distribution of $0.08542 per Unit to holders of its Units related to the month of December 2005. The Fund's policy is to pay cash distributions at the end of the month that follows the month when the cash was earned. The cash distribution was paid on January 31, 2006 to holders of record at the close of business on January 20, 2006. Although this cash distribution relates to cash generated in December 2005, because this cash distribution was declared and became payable after the end of the 2005 fiscal year it is not reflected as a liability or distributions to Unitholders in the December 31, 2005 consolidated financial statements.

Also on January 10, 2006, Hardwoods LP and Hardwoods USLP announced that, effective immediately, quarterly distributions were suspended on the subordinated units, represented by the Class B LP and Class B USLP units. Accordingly, no distributions were declared payable in the fourth quarter of 2005 related to the non-controlling interests and no liability for distributions payable to the non-controlling interests is reflected in the December 31, 2005 balance sheet.

The Beauty of Hardwood

People love hardwood and find many different ways to bring it into their lives. Whether in furniture, kitchen cabinets, doors and mouldings, or custom interior millwork, people place a higher value on products crafted from real wood. It’s a preference that doesn't change with the whims of fashion.

Demand for hardwood has remained remarkably stable decade after decade, in part because hardwood has no real substitute. There’s a warmth to the look and touch of hardwood that no other material can match.

Unitholder Information

Trustees

Directors

Officers

Maurice E. Paquette

President and
Chief Executive Officer

Robert J. Brown

Chief Financial Officer

Daniel A. Besen

Vice President and Group Manager,
California Region

Garry W. Warner

Vice President and Group Manager,
Western Canada Region

Head Office

#306 - 9440 202nd Street
Langley, BC Canada V1M 4A6

Telephone: 604 881 1999

Facsimile: 604 881 1995

www.hardwoods-inc.com

Auditors

KPMG LLP
Vancouver, British Columbia

Listings

The Toronto Stock Exchange
Trading under **HWD.UN**

Transfer Agent

Computershare Investor
Services Inc.

Investor Relations

Rob Brown
Chief Financial Officer

Telephone: 604 881 1990

Email: robbrown@hardwoods-inc.com

Annual General Meeting

The Annual General Meeting
of Hardwoods Distribution
Income Fund will be held at
The Fairmont Waterfront Hotel,
900 Canada Place Way,
Vancouver, BC
at 1:30pm
Monday, May 15, 2006.