

Interim Consolidated Financial Statements of

STERLING SHOES INCOME FUND

September 30, 2007

(Unaudited – expressed in thousands of dollars)

STERLING SHOES INCOME FUND

Consolidated Balance Sheets

(Unaudited - expressed in thousands of dollars, except per unit and number of unit figures.)

	As at September 30, 2007	As at December 31, 2006
ASSETS		
CURRENT		
Cash	\$ -	\$ 2,845
Accounts receivable	826	465
Inventory	32,563	18,640
Prepaid expenses and deposits	962	625
	<u>34,351</u>	<u>22,575</u>
LEASEHOLDS AND EQUIPMENT [note 3]	16,234	13,283
GOODWILL	828	828
INTANGIBLE ASSETS [note 4]	49,041	49,041
	<u>\$ 100,454</u>	<u>\$ 85,727</u>

LIABILITIES AND UNITHOLDERS' EQUITY

CURRENT		
Bank indebtedness [note 5]	\$ 4,873	\$ -
Accounts payable and accrued liabilities	21,818	13,895
Distributions payable	1,116	4,218
	<u>27,807</u>	<u>18,113</u>
FUTURE INCOME TAXES [notes 2 and 11]	7,724	-
TERM LOAN [note 5]	7,932	5,000
DEFERRED LEASE INDUCEMENTS	1,577	1,535
NON-CONTROLLING INTEREST [note 6]	11,113	12,231
UNITHOLDERS' EQUITY	44,302	48,848
	<u>\$ 100,454</u>	<u>\$ 85,727</u>

COMMITMENTS [note 8]

SUBSEQUENT EVENT [note 13]

On behalf of the Board of Trustees

(signed) Rick Mahler
Trustee

(signed) Jeremy Horwitz
Trustee

See accompanying notes

STERLING SHOES INCOME FUND
Consolidated Statements of Income and Comprehensive Income

(Unaudited - expressed in thousands of dollars, except per unit and number of unit figures.)

	Three-month period ended		Nine-month period ended	
	Sept 30, 2007	Sept 30, 2006	Sept 30, 2007	Sept 30, 2006
SALES	\$ 30,483	\$ 26,968	\$ 82,675	\$ 71,173
COST OF SALES	13,315	11,308	35,870	31,541
GROSS MARGIN	17,168	15,660	46,805	39,632
EXPENSES				
Store and selling	10,566	8,895	29,774	24,291
General and administrative [note 10]	1,643	1,483	5,194	4,144
	12,209	10,378	34,968	28,435
Income before interest, amortization and non-controlling interest	4,959	5,282	11,837	11,197
Interest expense	194	90	488	233
(Gain) Loss on disposal of leaseholds and equipment	-	-	(5)	43
Amortization of leaseholds and equipment	716	687	2,121	1,888
Amortization of deferred financing costs	0	9	-	27
INCOME BEFORE NON-CONTROLLING INTEREST AND TAXES	4,049	4,497	9,233	9,006
Future income taxes [notes 2 and 11]	-	-	7,724	-
INCOME BEFORE NON-CONTROLLING INTEREST	4,049	4,497	1,509	9,006
NON-CONTROLLING INTEREST [note 6]	815	904	317	1,814
NET INCOME AND COMPREHENSIVE INCOME	\$ 3,234	\$ 3,594	\$ 1,192	\$ 7,192
Basic and diluted net income per unit	\$ 0.61	\$ 0.68	\$ 0.22	\$ 1.35
Basic weighted average number of units outstanding	5,313,488	5,313,488	5,313,488	5,313,488
Diluted weighted average number of units outstanding	6,641,860	6,641,860	6,641,860	6,641,860

See accompanying notes

STERLING SHOES INCOME FUND
Consolidated Statements of Unitholders' Equity

(Unaudited - expressed in thousands of dollars, except per unit and number of unit figures.)

	Fund Units [note 7]	Cumulative earnings	Cumulative distributions	Total
Balance, July 12, 2005	\$ -	-	-	\$ -
Issuance of units on initial public offering	53,135	-	-	53,135
Issuance costs	(5,288)	-	-	(5,288)
Net income for the 173-day period	-	3,549	-	3,549
Distributions declared during the 173-day period	-	-	(3,537)	(3,537)
BALANCE, December 31, 2005	\$ 47,847	3,549	(3,537)	\$ 47,859
Net income	-	1,668	-	1,668
Distributions declared	-	-	(1,428)	(1,428)
BALANCE, March 31, 2006	\$ 47,847	5,216	(4,965)	\$ 48,098
Net income	-	1,930	-	1,930
Distributions declared	-	-	(1,592)	(1,592)
BALANCE, June 30, 2006	\$ 47,847	7,146	(6,557)	\$ 48,436
Net income for the period	-	3,594	-	3,594
Distributions declared	-	-	(1,674)	(1,674)
BALANCE, September 30, 2006	\$ 47,847	10,740	(8,231)	\$ 50,356
Net income for the period	-	2,822	-	2,822
Distributions declared	-	-	(4,330)	(4,330)
BALANCE, December 31, 2006	\$ 47,847	13,562	(12,561)	\$ 48,848
Net income for the period	-	1,807	-	1,807
Distributions declared	-	-	(1,913)	(1,913)
BALANCE, March 31, 2007	\$ 47,847	15,369	(14,474)	\$ 48,742
Net income (loss) for the period	-	(3,849)	-	(3,849)
Distributions declared	-	-	(1,913)	(1,913)
BALANCE, June 30, 2007	\$ 47,847	11,520	(16,386)	\$ 42,981
Net income (loss) for the period	-	3,234	-	3,234
Distributions declared	-	-	(1,913)	(1,913)
BALANCE, September 30, 2007	\$ 47,847	14,754	(18,299)	\$ 44,302

See accompanying notes

STERLING SHOES INCOME FUND
Consolidated Statement of Cash Flows

(Unaudited - expressed in thousands of dollars, except per unit and number of unit figures.)

	Three-month period ended		Nine-month period ended	
	Sept 30, 2007	Sept 30, 2006	Sept 30, 2007	Sept 30, 2006
OPERATING ACTIVITIES				
Net Income (Loss)	\$ 3,234	\$ 3,594	\$ 1,192	\$ 7,192
Items not involving cash				
Future income taxes	-	-	7,724	-
Amortization of leaseholds and equipment	716	687	2,121	1,888
Amortization of deferred financing costs	0	9	0	27
Amortization of deferred lease inducements	(85)	(86)	(238)	(265)
Loss on disposal of leaseholds and equipment	-	-	-	43
Non-controlling interest	815	904	317	1,814
	<u>4,681</u>	<u>5,107</u>	<u>11,116</u>	<u>10,700</u>
Change in non-cash working capital balances related to operations				
Accounts receivable	(31)	(328)	(359)	(398)
Inventory	(6,260)	(5,431)	(13,923)	(8,491)
Prepaid expenses and deposits	(85)	(380)	(337)	(534)
Accounts payable and accrued liabilities	6,053	3,743	7,924	5,211
	<u>(324)</u>	<u>(2,396)</u>	<u>(6,696)</u>	<u>(4,212)</u>
Cash provided by operating activities	<u>4,357</u>	<u>2,711</u>	<u>4,420</u>	<u>6,488</u>
INVESTING ACTIVITIES				
Acquisition of leaseholds and equipment	(1,479)	(2,156)	(5,078)	(5,174)
Proceeds from disposal of assets	-	-	5	0
Lease inducements received	110	159	278	237
Cash used in investing activities	<u>(1,369)</u>	<u>(1,997)</u>	<u>(4,795)</u>	<u>(4,937)</u>
FINANCING ACTIVITIES				
Capital expenditure loan [note 5]	-	-	2,932	-
Operating loan [note 5]	(597)	1,358	4,873	1,525
Payment of distributions	(2,391)	(2,072)	(10,275)	(6,786)
Cash used in financing activities	<u>(2,988)</u>	<u>(713)</u>	<u>(2,470)</u>	<u>(5,261)</u>
CASH OUTFLOW DURING THE PERIOD	0	(0)	(2,845)	(3,710)
CASH, BEGINNING OF PERIOD	-	-	2,845	3,710
CASH, END OF PERIOD	\$ 0	\$ (0)	\$ (0)	\$ 0
Supplemental cash flow information				
Interest paid	\$ 194	\$ 90	\$ 488	\$ 233

See accompanying notes

STERLING SHOES INCOME FUND

Notes to Interim Consolidated Financial Statements

September 30, 2007

(Unaudited – expressed in thousands of dollars, unless otherwise specified and except for per unit and per share amounts.)

1. ORGANIZATION AND NATURE OF OPERATIONS

Sterling Shoes Income Fund (the “Fund”) is an unincorporated, open-ended, limited-purpose trust established under the laws of the Province of British Columbia pursuant to the declaration of trust dated May 31, 2005 (the “Declaration of Trust”). The Fund commenced operations on July 12, 2005.

The Fund operates retail stores in five provinces in shopping malls, high-streets and strip malls, principally in Western Canada. The Fund is a leading retailer offering a broad selection of private label and national brand name shoes and accessories through six separate retail banners: Sterling, Joneve, Shoe Warehouse, Freedmans, Gia and Sterling Outlet. The Fund holds, indirectly, an 80% interest in Sterling Shoes Limited Partnership (“Sterling Shoes LP”), a partnership established under the laws of the Province of Manitoba.

2. SIGNIFICANT ACCOUNTING POLICIES

(a) *Basis of presentation*

These unaudited interim consolidated financial statements and accompanying notes (“Interim Financial Statements”) have been prepared in accordance with Canadian generally accepted accounting principles (“GAAP”) for interim financial statements. These Interim Financial Statements include the accounts of the Fund, and its 80% interest in Sterling Shoes LP. All material intercompany transactions have been eliminated upon consolidation.

(b) *Measurement uncertainty*

The preparation of the financial statements in accordance with GAAP requires management to make estimates and assumptions that affect the reported amount of assets and liabilities and disclosure of contingencies at the date of the financial statements and the reported amount of revenues and expenses during the period. Areas requiring significant management estimates include the valuation of inventory, the valuation of goodwill and intangible assets, the recorded amounts of accrued liabilities and the useful life of leaseholds and equipment. Actual results could differ from these estimates.

(c) *Cash*

Cash consists of cash on hand and bank balances.

(d) *Inventory*

Inventory, all of which is finished goods, is valued using the retail method at the lower of estimated average cost and net realizable value. The net realizable value is derived from the anticipated selling price after adjustments for markdowns and obsolescence, less a normal profit margin. Inventory write-downs are included in cost of sales.

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Incentives received from suppliers are treated as a reduction in the prices of the suppliers' products and are accounted for as a reduction in the related inventory.

In June 2007, the Canadian Institute of Chartered Accountants ("CICA") issued CICA Handbook Section 3031 – "Inventories", which replaces Section 3030 of the same title. The new standard has been developed based on International Financial Reporting Standards ("IFRS"). The standard was revised to provide more extensive guidance than Section 3030, to facilitate the CICA's move towards IFRS, and to reduce the number of alternatives for the measurement of inventories.

This Section applies to interim and annual financial statements for fiscal years beginning on or after January 1, 2008. The Fund will apply this section to opening inventory for fiscal 2008. Opening retained earnings as at January 1, 2008 will be adjusted for the difference on adoption of the new standard (prior periods will not restated).

As noted above, under "Critical Accounting Estimates", the Fund currently values its inventory at the lower of average cost and net realizable value less a normal profit margin, using the retail method. Management estimates the net realizable value less a normal profit margin, taking into consideration current and expected selling prices, sales patterns for the inventory, recent product introductions and the level of inventory on hand.

Section 3031 allows for the measurement of inventories at the lower of cost and net realizable value, however, it excludes from the definition of net realizable value the ability to maintain a normal profit margin and notes that the retail method is only an acceptable technique for measuring the cost of inventories, if the results approximate cost.

The Fund believes that the adoption of the new standard will have a material impact on the Fund's valuation of its inventory, which will increase. The Fund is currently evaluating the impact of this change in methodology. The impact of this change is not reasonably estimable at this time.

(e) *Leaseholds and equipment*

Leaseholds and equipment are recorded at cost. Amortization is provided on a straight-line basis over the following estimated useful lives of the assets:

Furniture and equipment	10 years
Computer equipment and software.....	5 years
Leasehold improvements	initial term of the lease

Amortization is reduced to one-half the normal rate in the year of acquisition.

Leaseholds and equipment are reviewed for impairment whenever changes in circumstances indicate that the carrying amount of an asset may not be recoverable from expected undiscounted future cash flows from their expected use and eventual disposition. If such assets are considered impaired, the impairment to be recognized is measured as the amount by which the carrying amount of the assets exceeds their fair value.

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(f) *Goodwill*

Goodwill is recorded at cost and is not amortized. Goodwill is reviewed for impairment at least annually, or whenever events or changes in circumstances indicate that the carrying amount may be impaired. If goodwill is considered to be impaired, the impairment to be recognized is measured as the amount by which the carrying amount of the goodwill exceeds fair value.

(g) *Intangible assets*

Identifiable intangible assets, including store banners and private label brand names, are carried at cost. These assets have been determined by management to have indefinite lives and are therefore not being amortized. These assets are reviewed at least annually for impairment or whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable from its expected use and eventual disposition.

If such assets are considered to be impaired, the impairment to be recognized is measured as the amount by which the carrying amount of the assets exceeds fair value.

(h) *Deferred lease inducements*

Deferred lease inducements consist of lease incentive amounts received from landlords and rent-free lease periods. These lease inducements are amortized over the life of the initial lease term as a reduction of store and selling expenses.

(i) *Revenue recognition*

Revenue is recognized at the point of sale, net of a provision for sales returns.

(j) *Foreign currency translation*

Monetary assets and liabilities denominated in foreign currencies are translated to the Canadian dollar equivalent at the rate of exchange at the balance sheet date. Purchases transacted in foreign currencies are translated to the Canadian dollar equivalent at the rate of exchange in effect at the time of the transaction. Foreign currency gains and losses are included in the results of operations in the period in which they occur.

(k) *Income taxes and Future income taxes*

As the Fund will allocate all of its taxable income and taxable capital gains to unitholders (the “Unitholders”), the Fund itself will not be subject to income taxes.

In June 2007 the Government of Canada substantially enacted new legislation to tax distributions of publicly traded income trusts, commencing in 2011. As a result, the Fund is now required to recognize the future income tax assets and liabilities expected to arise when the tax on distributions becomes applicable.

Future income tax assets and liabilities are determined based on the difference between the tax basis of the Fund’s assets and liabilities and the amounts reported in the financial

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statements. Future tax assets or liabilities are calculated using the tax rates for the periods in which the differences are expected to be settled. Future tax assets are recognized to the extent that they are considered more likely than not to be realized.

(l) *Net income per Unit*

Basic net income per Unit of the Fund (a “Unit”) is calculated by dividing net income by the weighted average number of Units outstanding during the reporting period. Diluted net income per Unit is calculated by dividing the income before non-controlling interest by the sum of the weighted average number of Units outstanding used in the basic net income per Unit calculation and the number of Units that would be issued assuming conversion of all Subordinated Exchangeable Class D LP units (“Class D LP units”) (note 6), being the only dilutive securities.

(m) *Long-term incentive plan*

Under the terms of a long-term incentive plan (“LTIP”) 10% to 25% of distributable cash in excess of an established threshold is allocated as between: (i) cash awards to participants who already hold significant ownership positions; and (ii) monies to be used by the plan trustee to purchase units of the Fund for other participants. The cost is accrued in the period when distributable cash exceeds the thresholds established by the LTIP and amortized to general and administrative expenses over the vesting period of the applicable employee award.

As at September 30, 2007, the Fund has recorded a liability of \$881 (2006 - \$594) in respect of the LTIP. During the three and nine month periods ended September 30, 2007 the Fund recorded compensation expense of \$206 (2006 - \$324) and \$793 (2006 - \$587), respectively.

(n) *Derivative financial instruments*

Derivative financial instruments are utilized by the Fund in the management of its foreign currency exposures. The Fund’s policy is not to utilize derivative financial instruments for trading or speculative purposes.

The Fund formally documents all relationships between hedging instruments and hedged items, as well as its risk management objectives and strategies for undertaking various hedge transactions. This process includes linking all derivatives to forecasted transactions. The Fund also formally assesses, both at the hedge’s inception and on an ongoing basis, whether the derivatives that are used in hedging transactions are highly effective in offsetting changes in cash flows of hedged items.

When the Fund discontinues its designation of a hedging relationship, or when a hedging relationship is no longer effective, hedge accounting is discontinued. When the Fund discontinues hedge accounting, the derivative financial instrument is recorded on the consolidated balance sheet at fair value. Gains and losses that had previously been

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deferred are carried forward for recognition in the statement of income and statement of other comprehensive income in the same period that the hedged items are recognized. The Fund has decided not to use hedge accounting.

(o) *Financial Instruments*

Under the new standards, financial assets and financial liabilities are initially recognized at fair value and their subsequent measurement is dependent on their classification as described below. Their classification depends on the purpose, for which the financial instruments were acquired or issued, their characteristics and the Fund's designation of such instruments. The standards require that all financial assets be classified either as held-for-trading ("HFT"), available-for-sale ("AFS"), held-to-maturity ("HTM"), or loans and receivables. The standards require that all financial assets, including all derivatives, be measured at fair value with the exception of loans and receivables, debt securities classified as HTM, and AFS financial assets that do not have quoted market prices in an active market. Settlement date accounting continues to be used for all financial assets, except changes in fair value between the trade date and settlement date are reflected in interest and other expenses, net for HFT financial assets, while changes in fair value between trade date and settlement date are reflected in other comprehensive income ("OCI") for AFS financial assets.

The following is a summary of the accounting model the Fund has elected to apply to each of its significant categories of financial instruments outstanding as of January 1, 2007:

Cash and cash equivalents	Designated as held-for-trading
Accounts receivable	Loans and receivables
Accounts payable and accrued liabilities	Other liabilities
Bank indebtedness	Other liabilities
Long-term debt	Other liabilities

Held-for-trading – HFT financial assets are financial assets typically acquired for resale prior to maturity. They are measured at fair value at the balance sheet date. Interest earned, interest accrued, gains and losses realized on disposal and unrealized gains and losses from market fluctuations are included in interest and other expenses, net.

Financial liabilities designated at fair value ("FVO") are those non-derivative financial liabilities that the Fund elects to designate on initial recognition as instruments that it will measure at fair value through interest and other expenses, net. These are accounted for in the same manner as HFT financial assets. The Fund has not designated any non-derivative financial liabilities as FVO.

Held-to-maturity – HTM financial assets are non-derivative financial assets with fixed or determinable payments and a fixed maturity, other than loans and receivables that an

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entity has the positive intention and ability to hold to maturity. These financial assets are measured at amortized cost.

Available-for-sale – AFS financial assets are those non-derivative financial assets that are designated as AFS, or that are not classified as loans and receivables, HTM investments or HFT. AFS financial assets are carried at fair value with unrealized gains and losses included in OCI until realized when the cumulative gain or loss is transferred to interest and other expenses, net. The Company has not designated any financial assets as AFS.

Loans and receivables – Loans and receivables are accounted for at amortized cost.

Other liabilities – Other liabilities (“OL”), are recorded at amortized cost and include all liabilities, other than derivatives or liabilities to which the FVO has been applied.

(p) *Cash Flow Statements – Disclosure for HB 1540.55*

Amendments to CICA 1540, Cash Flow Statements, require entities to disclose total cash distributions on financial instruments classified as equity in accordance with a contractual agreement and the extent to which total cash distributions are non-discretionary. This disclosure requirement is effective for interim and annual financial statements for fiscal periods ending on or after March 31, 2007. The determination to declare and make payable distributions from the Fund are at the discretion of the board of Trustees of the Fund and, until declared payable by the Board of Trustees of the Fund, the Fund has no contractual requirement to pay cash distributions to unitholders’ of the Fund. During the three-month and nine-month periods ended September 30, 2007, \$1.9 million and \$5.7 million (2006 - \$1.7 million and \$4.7 million) in cash distributions were declared payable by the Board of Trustees of the Fund and paid to unitholders, respectively.

3. LEASEHOLDS AND EQUIPMENT

	September 30, 2007			December 31, 2006		
	Cost	Accumulated Depreciation	Net Book Value	Cost	Accumulated Depreciation	Net Book Value
Leasehold improvements	\$ 10,266	\$ (2,830)	\$ 7,436	\$ 7,810	\$ (1,763)	\$ 6,047
Furniture and equipment	8,970	(1,935)	7,036	7,317	(1,154)	6,163
Computer equipment and software	2,465	(702)	1,763	1,502	(429)	1,073
	\$ 21,701	\$ (5,467)	\$ 16,234	\$ 16,629	\$ (3,346)	\$ 13,283

STERLING SHOES INCOME FUND

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4. INTANGIBLE ASSETS

	Sept 30, 2007	December 31, 2006
Store banners	\$ 29,516	\$ 29,516
Private label brand names	19,525	19,525
	\$ 49,041	\$ 49,041

These intangible assets have no basis for tax purposes.

5. OPERATING LOAN AND TERM LOAN

	Sept 30, 2007	December 31, 2006
Term loan #1	\$ 5,000	\$ 5,000
Operating loan	4,873	-
Term loan #2	2,932	-
	\$ 12,805	\$ 5,000
Less current portion	(4,873)	-
Long-term portion	\$ 7,932	\$ 5,000

The Fund has utilized a \$5,000, 3-year committed non-revolving loan (the “Term Loan #1”) due on July 11, 2008. Term Loan #1 was made available to fund the purchase of assets from Inc. Advances bear interest at the lender’s prime rate plus 0.25% to 0.75% or at the banker’s acceptance rate plus 1.50% to 2.00%, based on the ratio of debt to earnings before interest, taxes, depreciation and amortization, calculated on a quarterly basis. Term Loan #1 is secured by a general security agreement covering all assets of Sterling Shoes LP.

The Fund has utilized \$4,873 of an available \$12,500, 3-year committed revolving loan (the “Operating Loan”). The Operating Loan is available for working capital requirements, capital expenditures and for general corporate purposes. Interest, terms and security are the same as Term Loan #1.

The Fund has utilized \$2,932 of an available a \$10,000, 3-year committed non-revolving loan (“Term Loan #2”). Term Loan #2 is available for future funding of new store facilities. Interest, terms and security are the same as Term Loan #1.

Subsequent to September 30, 2007 the Fund closed an offering of \$25 million of convertible unsecured subordinated debentures. Net proceeds from the offering will be used to repay existing indebtedness and the balance will be used to fund new store expansion projects and for general corporate purposes. See also, Note 13: Subsequent Event.

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6. NON-CONTROLLING INTEREST (“NCI”)

	NCI	Cumulative Income	Cumulative Distribution	Total
Balance, December 31, 2005	\$ 11,962	\$ 887	\$ (884)	\$ 11,965
NCI in income of Sterling Shoes LP for the period		416	-	416
Distributions declared in respect of the NCI		-	(357)	(357)
Balance, March 31, 2006	\$ 11,962	\$ 1,303	\$ (1,241)	\$ 12,023
NCI in income of Sterling Shoes LP for the period		495	-	495
Distributions declared in respect of the NCI		-	(397)	(397)
Balance, June 30, 2006	\$ 11,962	\$ 1,798	\$ (1,638)	\$ 12,121
NCI in income of Sterling Shoes LP for the period		902	-	902
Distributions declared in respect of the NCI		-	(418)	(418)
Balance, September 30, 2006	\$ 11,962	\$ 2,699	\$ (2,057)	\$ 12,604
NCI in income of Sterling Shoes LP for the period		709	-	709
Distributions declared in respect of the NCI		-	(1,082)	(1,082)
Balance, December 31, 2006	\$ 11,962	\$ 3,408	\$ (3,139)	\$ 12,231
NCI in income of Sterling Shoes LP for the period		462	-	462
Distributions declared in respect of the NCI		-	(480)	(480)
Balance, March 31, 2007	\$ 11,962	\$ 3,870	\$ (3,618)	\$ 12,214
NCI in (loss) of Sterling Shoes LP for the period		(960)	-	(960)
Distributions declared in respect of the NCI		-	(478)	(478)
Balance, June 30, 2007	\$ 11,962	\$ 2,910	\$ (4,097)	\$ 10,775
NCI in (loss) of Sterling Shoes LP for the period		816	-	816
Distributions declared in respect of the NCI		-	(478)	(478)
Balance, September 30, 2007	\$ 11,962	\$ 3,727	\$ (4,575)	\$ 11,113

The shareholders of Inc have retained a 20% interest in Sterling Shoes LP through ownership of 100% of the issued and outstanding Class D LP units and Class B LP units.

The Class C LP units (all of which are owned indirectly by the Fund) and the Class D LP units (collectively, the “LP Units”) have economic and voting rights that are equivalent in all material respects, except that distributions on the Class D LP units are subordinated to distributions on the Class A LP units and Class C LP units, such that distributions will only be paid on the Class D LP units at the end of a fiscal quarter to the extent that Sterling Shoes LP has paid average monthly distributions on the Class C LP units to enable the Fund to make distributions of at least \$0.0896 per Unit to holders of Units during that quarter, along with priority Class A LP unit distributions, and any deficiency in such distributions during the preceding 12 months has been satisfied.

Subject to subordination, distributions are to be made monthly on the outstanding LP Units of Sterling Shoes LP. Generally, distributions on the Class D LP units will be made quarterly on a prorated basis to the amount distributed on the outstanding LP Units during such fiscal quarter, only after the distributions have been made on the other outstanding LP Units and to the extent that cash is available to make such distributions.

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Class D LP units will automatically become freely exchangeable for Units on a one-for-one basis on (and the distribution subordination provisions will only apply until) the date (the “Subordination End Date”) that is the earlier of:

1. December 31, 2007, if the Fund’s consolidated earnings before interest, depreciation and amortization (“EBITDA”) for the fiscal year then ended is at least \$9.545 million (the “EBITDA Target”), and cash distributions of at least \$5.712 million (\$1.075 per Unit) have been paid on the Units, and cash advances or distributions of at least \$1.428 million (effectively \$1.075 per Unit) have been paid to Inc, as the holder of the Class D LP Units (the “Distribution Target”) for each of the fiscal years ended December 31, 2007 and 2006, and
2. the last day of any fiscal year of the Fund following December 31, 2007 in respect of which the Fund’s consolidated EBITDA is at least the EBITDA Target and cash distributions at least equal to the Distribution Target have been made for such fiscal year.

As noted above, the distributions on the Class D LP units are not economically equivalent to those on the Class C LP units owned by the Fund, as a result of the subordination of distributions on Class D LP units. As a result, the Class D LP units have been classified as non-controlling interests.

7. FUND UNITS

An unlimited number of 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. Each Unit entitles the holder thereof to one vote at all meetings of voting Unitholders.

On July 12, 2005, the Fund issued 5,313,488 Units at a price of \$10 per Unit pursuant to the Offering. Net proceeds from the Offering were \$47,847 after deducting expenses of the Offering of \$5,288. The holders of the Class D LP units were issued 1,328,372 special voting units (“Special Voting Units”) of the Fund, representing the number of Units such Class D LP units are in certain circumstances exchangeable for. 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. Such Special Voting Units are to be cancelled on the exchange of the Class D LP units for Units of the Fund.

The Units are redeemable at any time on demand by the holders thereof, subject to the terms and conditions as outlined in the prospectus of the Fund dated June 30, 2005. The total amount payable by the Fund in respect of those Units and all other Units tendered for redemption in the same calendar month shall not exceed \$50, provided that the Trustees of the Fund may, in their sole discretion, waive this limitation in respect of all Units tendered for redemption in any calendar month.

STERLING SHOES INCOME FUND

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(Unaudited – expressed in thousands of dollars, unless otherwise specified and except for per unit and per share amounts.)

8. COMMITMENTS

(a) *Minimum rental commitments*

The Fund has the following minimum rental commitments for premises, excluding percentage rent adjustments and operating expense assessments over the remainder of this year and the next four fiscal years:

2007	\$	3,326
2008		12,332
2009		11,206
2010		9,320
2011		8,026
		<hr/>
	\$	44,210

Certain of the operating leases provide for additional annual rentals based on store sales.

(b) *Letters of credit*

The Fund had letters of credit outstanding on September 30, 2007 securing inventory commitments totaling \$422. The last of these letters of credit expire December 31, 2007.

9. FINANCIAL INSTRUMENTS

(a) *Fair value*

Financial instruments consist of cash, accounts receivable, operating loan, accounts payable, foreign exchange contracts, distributions payable, the Term Loans and the Operating Loan. The fair values of all financial instruments, except the Term Loan #1, are considered to approximate their carrying values due to their short term nature. The fair value of the Term Loans are considered to approximate the carrying values as they bear interest at floating rates.

(b) *Interest rate risk*

The Fund is subject to the risks associated with fluctuating interest rates on its credit facilities.

(c) *Foreign exchange risk*

During the three and nine-month periods ended September 30, 2007, approximately 37% and 34% (2006: 43% and 34%, respectively) of product purchases were denominated in US dollars, respectively. From time to time, the Fund enters into contracts to manage the foreign exchange risk associated with anticipated purchases in US dollars. The Fund

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does not hold or issue financial instruments for trading or speculative purposes. At September 30, 2007 there were no foreign exchange contracts outstanding.

(d) *Secured loan*

A loan of \$38,597 has been made to Inc by SS Holdings Trust (the “Trust”) (all the trust units of which are owned by the Fund), secured, in turn, by Class A LP units (with a par value of \$38,597) issued by Sterling Shoes LP to Inc.

The secured loan and the Class A LP units, which have the attributes of a liability, are presented net in the consolidated balance sheet of the Fund as this reflects the entities’ cash flows and the intention for settlement of the financial instruments, as well as the associated risks related to the cash flows.

10. RELATED PARTY TRANSACTIONS

(a) The Fund leases its head office location from a company controlled by the shareholders of Inc, who have a non-controlling interest in the Fund (see Note 6). Rent expense recognized on this lease was \$53 and \$158 for the three-month and nine-month periods ended September 30, 2007, (2006 - \$53 and \$158), respectively and is included in general and administrative expenses in the statement of income.

(b) The Fund purchased equipment from a company in which a Board member has an interest, for \$137 and \$464 during the three-month and nine-month periods ended September 30, 2007, (2006 - \$355 and \$544), respectively.

These transactions arose during the normal course of business and have been recorded at the exchange amount, which is the amount agreed upon by the related parties.

11. FUTURE INCOME TAXES

The temporary differences comprising the future income tax liability are estimated as follows:

	<u>Sept 30, 2007</u>	
Future income tax liability:		
Intangible Asset - store banners	\$	4,649
Intangible asset - private label brand names		3,075
Expected reversal of temporary differences prior to 2011		-
	\$	<u>7,724</u>

Based on a current estimate of the income tax liability at the beginning of 2011, the Fund recognized a future income tax liability and corresponding non-cash future tax charge to net income in the second quarter of 2007. This non-cash charge relates to the Fund’s intangible assets and is based on temporary differences between the accounting and tax basis of the Fund’s assets and liabilities expected to reverse after January 1, 2011.

STERLING SHOES INCOME FUND

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12. SEGMENTED INFORMATION

The Fund operates in one industry segment; that being the retail footwear business, offering a broad selection of private label and brand name shoes and accessories.

13. SUBSEQUENT EVENT

On October 3, 2007 the Fund closed an offering of \$25 million of convertible unsecured subordinated debentures (the “Debentures”) at a price of \$1,000 per debenture. The Debentures bear interest at an annual rate of 6.5% payable semi-annually in arrears on October 31 and April 30 in each year commencing April 30, 2008. The maturity date for the Debentures is October 31, 2012.