ANNUAL REPORT

FOR THE 52-WEEK PERIOD ENDED MARCH 30, 2002

experience the world of Indigo

imagination energy tenacity

respect vision creativity victory

dedication risk integrity spirit

awareness caring inspiration

Indigo

Books & Music Inc.

www.indigo.ca

The Indigo Mission

The book-lover's r*etailer of choice

To provide book-lovers, culture makers, information and entertainment seekers with the most inspiring, richly stocked and inviting r*etail environments in the world; and to provide shareholders and employees with a meaningful return on their investment in this enterprise.

Indigo operates under the following banners: *Indigo Books, Music & More*; *Chapters*; *Coles*; *The World's Biggest Bookstore* and *chapters.indigo.ca*. The Company employs 6,693 people across the country.

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Report of the Chair

Dear Shareholders,

I am pleased to have this opportunity to report on our Company's performance over the past year. Fiscal 2002 was a challenging and very rewarding year for this Company. To be sure, the most significant event was the bringing together of the two key participants in the industry, Indigo Books & Music and Chapters.

The Indigo/Chapters Merger

In June 2001 we were given permission by the Competition Bureau to merge Indigo and Chapters. We set to work immediately on bringing together what was essentially not two, but five separate operating companies: Indigo, Chapters, Pegasus Distribution, Chapters Online and Indigo Online. Our vision was, and remains, one of being a fully integrated bricks and clicks retailer.

The senior management team put significant energy into effectively integrating and streamlining the organization and ensuring that we communicated fully with everyone affected by job changes whether staying with the company or being transitioned out. Following the organization changes, and for several months thereafter, all our employees received weekly newsletters on business plans, operating principles, targets, people changes and monthly results – a practice that was well received and helped to lower the levels of concern that naturally accompany any merger. In addition, managers from across the country were brought together on a number of occasions to discuss issues and opportunities and put faces to new names. This, together with a day-in and day-out emphasis on sharing our vision and goals for the business, resulted in a very successful merger process.

Today, we are one company and proud of this accomplishment which we considered to be the top priority for the year. Indigo Books & Music Inc. is the umbrella trademark under which we operate our five brands: Indigo Books Music & More; Chapters; Coles; The World's Biggest Bookstore, and chapters.indigo.ca. The new structure has paved the way for better service for our customers, significant operating efficiencies, greater career opportunities for our employees and an overall healthier book industry in Canada.

I would note that the restructuring process also included repatriating the 30% of Chapters Online which we did not own, thereby providing the company with organizational flexibility and financial advantages.

Retail Operations

With the major merger activities largely completed by the middle of the second quarter, our focus turned to preparing all our stores for the important Fall and Holiday seasons.

Three major initiatives grabbed the lion's share of our effort during the summer months: liquidating over $25 million of non-productive inventory from the old Pegasus warehouse, re-establishing supplier relationships which had been badly strained under previous Chapters management, and upgrading the inventories and merchandising standards in the Chapters and Coles stores.

By the end of August all of our stores were in an excellent position for the Back to School rush. And then… September 11th. This cataclysmic world event was keenly felt by our business. From early September through to early November, sales dropped well below budget and directly impacted both our sales and profitability targets. Fortunately however, we emerged as one of the retailers of choice for consumers during the all-important Christmas period. From mid-November through Boxing Day and then to the end of our fiscal year, we enjoyed our best store performance to-date. Comparative store sales during that period were up 4.2% in our large format Indigo and Chapters stores and 4.1% in our small format Coles stores – a heartening confirmation of our value to consumers and an endorsement of the tremendous effort which everyone in the company had put forth in the previous months.

On a year-over-year basis sales in our superstores increased 19% to $486 million, primarily attributable to operating an additional 13 superstores. Sales in our Coles division declined by 6% to $184 million, attributable to our closing 17 underperforming stores. Comparative store sales in our Coles division were 3.7%, marking the first time in several years that Coles experienced a positive sales trend.

To achieve these results in a year which was marked by major change and upheaval is very satisfying.

Online Operations

We began this year with two online operations, Chapters.ca and Indigo.ca. At Chapters.ca alone, losses in the previous year totalled $38.8 million. Our short-term focus was on merging, eliminating operating losses completely, and "living to fight another day". We were successful in achieving this goal but in the process gave up our number 1 position. Sales in online declined by 32% to $34.7 million.

Once we had stabilized this operation, we began developing a much stronger and economically sound strategy which we believe allows us to regain a leadership position. As I write this letter, sales are increasing steadily and, notwithstanding Amazon's increased presence, we have a strong view that over time our multi-channel strategy will emerge as the one most valued by consumers.

Real Estate

We began the year with superstore overcapacity in a few key markets. Early in the year we identified 10 stores that should be closed. A few of these had been designated for sale under a government order issued at the time we were given permission to merge. We were therefore not able to address these locations until the outcome of the government mandated sale process was known. As it turned out, all stores in the disposition package reverted to us. Over the course of the year, we were successful in ending our lease obligations on five of the 10 stores earmarked for closure. The closing of these five stores resulted in a restructuring charge of $3.0 million in cash costs and a non-cash write-down of assets of $9.5 million. Consistent with our objectives we are enjoying strong sales and productivity increases in neighbouring stores.

The balance of the stores earmarked for closure are currently being marketed and by the end of fiscal 2004 we expect to have fully eliminated all non-performing stores from our portfolio.

Other Activity

Over the course of the year we also completed a number of other initiatives which we had identified as critical to strengthening our company. These included: completing two successful Rights Offerings which raised $24.2 million of new capital for the company, refinancing our operating line of credit and long-term loan facilities, launching a new prototype for Coles, and working with our suppliers to help rebuild the damage which had been caused to them in past years. This latter effort has been particularly satisfying and we look forward to continuing to play a meaningful role in the strengthening of the publishing community in this country.

We also implemented The Balanced Scorecard approach to target setting, strategy development and measurement. In embracing this approach, we were fortunate to have Robert Kaplan, Marvin Bower Professor at Harvard Business School and the originator of this set of concepts, as our active guide and counsellor. I have long been a proponent of Bob's work and we have, as a company, made a major commitment to having these ideas directly influence our culture and approach to operating.

In all, it was a highly productive year and it ended with all key indicators moving in the right direction. We now have a strong foundation upon which to build – our employees are engaged, energized and focused on moving the company boldly forward; the senior management team has forged strong and supportive working relationships allowing us to focus attention on major end-to-end process improvements; and we are continually communicating with our customers to ensure we respond to emerging needs or concerns.

Unquestionably, there remains a great deal to do to fully leverage the opportunity before us. With the "heavy lifting" of merging, restructuring, and inventory improvement behind us, we can now work on repairing several other fundamental aspects of our company and then move toward industry-leading innovation and financial performance. I often say within the company that we have a strong leadership position but one which will only be sustained if we continue to work at being the best we can be. And this we intend to do.

Looking Forward

As I write this letter, we are almost through the first quarter of fiscal 2003. Last year seems like ancient history and it won't be long before we start thinking about what we need to do for next year. But let me back up a bit.

Strategic Planning

Supply Chain Redesign

Late in the fourth quarter we undertook an intensive strategic planning effort. We identified seven major initiatives for 2003/04, with the single most significant initiative being the redesign of our supply chain from end-to-end. Our analysis confirms that there are huge efficiencies to be gained, as well as major improvements in customer service available to us, if we streamline our core processes and enable them with high impact technology/information.

We have set very specific improvement targets for each of the supply chain variables and I look forward to reporting on these in next year's Report to you.

Additional Initiatives

In addition to our work on the supply chain, we intend to:

(i) expand our gift program, which has proven to be very successful and adds to our margin base;
(ii) implement a highly advanced Enterprise Information System;
(iii) mitigate our commitments on the remaining stores identified for closing;
(iv) launch a major training and development initiative;
(v) re-establish a leadership position in our online business by linking our "bricks & clicks" and significantly enhance service levels and functionality; and
(vi) refurbish 20 Chapters stores and 15 Coles stores.

In total it is an ambitious program but we feel confident in the organization's ability to achieve these objectives and the performance targets which have been set.

In a world such as the one we face today, it is hard to know what events may occur. We feel however that we are in the right business, at the right time. At the end of the day our business is one of entertainment, education and stress reduction. Our goal is to add a little joy to our customers' lives each time they choose to interact with us. It is hard to imagine a more relevant business.

We are now 12 months into what I originally indicated would be a 24-month turnaround. Our forward-looking 24-month target is to achieve performance on key indicators fully consistent with the leading performers in our industry. We feel this is a demanding but appropriate goal. From there we intend to break out of the pack and become the leader in our industry. Bold goals – but the entire team feels the opportunity is here to achieve them.

I want to thank the shareholders who have stayed with us during the first phase of this transition period and welcome new shareholders. Mostly I want to take this opportunity to say thank you to each and every employee in our Company. You put out tremendous effort this past year – and you did so with grace. Rest assured, the best is yet to come.

See you here next year when I look forward to reporting on our progress once again.

Heather Reisman

Heather Reisman
Chair & Chief Executive Officer

Management's Responsibility for Financial Reporting

Management of Indigo Books & Music Inc. ("Indigo") is responsible for the preparation and integrity of the financial statements as well as the information contained in this report. The following financial statements of Indigo have been prepared in accordance with Canadian generally accepted accounting principles, which involve management's best estimates and judgments based on available information.

Indigo's accounting procedures and related systems of internal control are designed to provide reasonable assurance that its assets are safeguarded and its financial records are reliable. In recognizing that the Company is responsible for both the integrity and objectivity of the financial statements, Management is satisfied that the financial statements have been prepared according to and within reasonable limits of materiality and that the financial information throughout this report is consistent with these financial statements.

Ernst & Young LLP, Chartered Accountants, serve as Indigo's auditors. The Board of Directors of Indigo, along with the management team, have reviewed and approved the financial statements and information contained within this report. Ernst & Young's report on the accompanying financial statements follows. Their report outlines the extent of their examination as well as an opinion on the statements.

Heather Reisman
Chair and Chief Executive Officer

Ian Young
Chief Financial Officer

Management's Discussion and Analysis of Financial Condition and Results

52 Weeks Ended March 30, 2002, Compared to 52 Weeks Ended March 31, 2001

Indigo Books & Music Inc. (the "Company" or "Indigo") is the nation's largest book retailer, operating stores in all ten provinces in Canada. As at March 30, 2002, the Company operated 90 superstores including 73 *Chapters*, 16 *Indigo* superstores and the *World's Biggest Bookstore*, and 187 traditional bookstores, under the banners *Coles*, *SmithBooks*, *LibrairieSmith* and *The Book Company*. The Company also has a 51% interest in Chapters Campus Bookstores Company which operates 6 university and college bookstores.

On August 14, 2001, the Company acquired all of the issued and outstanding shares of Indigo Books & Music, Inc. ("Old Indigo"). The aggregate purchase price was $11.9 million, satisfied as to $4.1 million by the issuance of 528,268 common shares. In addition, the corporate name of the Company was changed from Chapters Inc. to Indigo Books & Music Inc. and the Company's trading symbol on the Toronto Stock Exchange was changed from CHP to IDG.

On October 27, 2001 the Company acquired all of the issued and outstanding shares of Chapters Online Inc. ("Chapters Online") not already owned by the Company. The aggregate purchase price was $4.8 million, satisfied as to $4.5 million by the issuance of 750,193 common shares. Chapters Online became a wholly owned subsidiary of Indigo, and is in the process of being dissolved. Immediately following the acquisition, Chapters Online's business was incorporated into Indigo's business. Pursuant to this transaction, Chapters Online filed Articles of Continuance in Ontario on November 5, 2001. Indigo's Internet business combines the businesses of Chapters Online and Indigo Online Inc., and is integrated into the overall business of Indigo.

On January 14, 2002 the Company successfully completed an offering of 3,395,074 common shares of the Company at $3.00 per share. The issue, which was completed by way of an offering of subscription rights to all holders of common shares of the Company, was fully subscribed and resulted in net proceeds of $9.9 million being received by the Company, which was used to fund working capital in connection with the repayment of $20.0 million in long-term debt on December 31, 2001.

Discussion and Analysis

The following discussion and analysis of the consolidated financial position and results of operations is based primarily on the consolidated financial statements of the Company for the 52 weeks ended March 30, 2002 and March 31, 2001. It should be read in conjunction with the consolidated financial statements and notes contained in this Annual Report.

Certain financial measures discussed in the following discussion and analysis are not necessarily defined by Canadian generally accepted accounting principles and may not be comparable to similar measures presented by other companies.

Results of Operations

Total consolidated revenues increased 7.2% to $735.7 million from $686.5 million last year. The sales increase was primarily attributable to operating an additional 13 superstores, offset by a sales decrease as a result of operating 17 fewer traditional format stores and lower sales at Chapters Online.

Consolidated earnings before interest, taxes, amortization, restructuring charges, takeover costs and non-controlling interest was $37.0 million compared to a loss of $43.3 million last year. This represents an improvement of $80.3 million, over last year.

The consolidated net loss for the year was $47.9 million ($3.03 per share) as compared to a net loss of $84.5 million ($6.24 per share) last year, a $36.6 million or a 43.3% improvement.

Excluding restructuring and take-over costs, net losses were $7.6 million ($0.48 per share) as compared to a net loss of $54.5 million ($4.02 per share) last year. This represents an improvement of $46.9 million ($3.54 per share).

Restructuring and take-over costs of $40.3 million relate to store closures and other costs associated with the amalgamation between the Company and Old Indigo and Chapters Online. Restructuring and take-over costs amounted to $30.0 million last year. The restructuring and take-over costs are comprised of $24.0 million in capital asset write downs, $11.9 million relating to store closings, $1.7 million relating to relocation and other costs associated with the acquisition and $2.7 million in refinancing charges. Of the total restructuring and take-over costs, approximately $15.9 million are cash charges, of which $6.1 million have been paid. The balance of approximately $24.4 million relates to non-cash transactions.

Income tax expenses were $600,000 as compared to an income tax recovery of $12.7 million last year. The decrease was due to the fact that income tax benefits were not recognized in fiscal 2002 due to cumulative losses in previous periods in accordance with Canadian generally accepted accounting principles.

The weighted average number of shares outstanding for the year were 15.8 million as compared to 13.5 million last year. The increase is a result of the issuance of shares relating to the acquisitions of Old Indigo, the non-controlling interest in Chapters Online, employee stock purchase plan and the subscription rights offering.

The Company's revenues, comparable store sales, store openings, store closings, number of stores and square footage at the fiscal year end are set forth below:

	52-week period ended March 30, 2002	52-week period ended March 31, 2001	52-week period ended April 1, 2000
Revenue (thousands of dollars)			
Superstores	$ 485,767	$ 408,849	$ 376,307
Traditional Bookstores	183,792	195,199	217,771
Other Retail	31,394	29,995	27,450
Indigo Distribution Centre	–	1,345	67
Indigo Online	34,731	51,091	38,714
	$ 735,684	$ 686,479	$ 660,309
Comparable Store Sales			
Superstores	1.1%	(1.6%)	(3.1%)
Traditional Bookstores	3.7%	(3.0%)	(4.0%)
Stores Opened			
Superstores (opened and acquired)	16	7	16
Traditional Bookstores	0	7	0
Campus Bookstores	0	2	3
	16	16	19
Stores Closed			
Superstores	3	0	0
Traditional Bookstores	17	34	30
	20	34	30
Number of Stores Open at Year-End			
Superstores	90	77	70
Traditional Bookstores	187	204	231
Campus Bookstores	6	6	4
	283	287	305
Selling Square Footage at Year-End (in thousands)			
Superstores	2,164	1,883	1,751
Traditional Bookstores	496	536	604
Campus Bookstores	38	38	35
	2,698	2,457	2,390

Retail

Sales were $701.0 million as compared to $635.4 million last year, an increase of $65.6 million or 10.3%. Earnings before interest, taxes, amortization and restructuring and take-over costs increased to $38.9 million from a loss of $10.2 million last year, an increase of $49.1 million. The increase, as compared to last year, can be attributed to improved gross margin dollars and reduced warehousing and distribution costs offset by higher occupancy and labour costs due to the additional 13 superstores.

Superstores

Revenues at the Chapters and Indigo superstores, including the World's Biggest Bookstore, grew to $485.8 million, an 18.8% increase compared to revenue of $408.9 million last year. The growth in revenue was generated by the operation of 16 additional superstores offset by the closure of 3 such stores, as compared to last year and positive performance on a comparable store basis. Comparative store sales increased 1.1% during the period as compared to a decline of 1.6% last year.

Traditional Stores

Total traditional store revenues declined to $183.8 million, a decrease of $11.4 million or 5.8% in comparison to $195.2 million last year. The decline in revenue was the result of operating 17 fewer traditional bookstores or approximately 8% less stores as compared to the last year. The comparative store sales increase of 3.7% during the year was a significant improvement over the 3.0% decline last year. The total number of traditional stores as at the end of the year was 187 as compared to 204 stores last year.

Other Retail

Other revenues generated from the sale of the Company's loyalty cards, as well as the Company's proportionate share of revenues from the Calendar Club and Campus Bookstores joint ventures, were $31.4 million as compared to $30.0 million last year.

Online

Revenues were $34.7 million as compared to $51.1 million last year, a decrease of $16.4 million or 32.1%. The decline was attributable to less aggressive marketing, discounting and promotional activities during the year as compared to last year. Losses before interest, taxes, amortization and restructuring charges were reduced by $31.2 million to $1.9 million due to significant reductions in operating costs as a result of restructuring activities undertaken during the year.

Interest Expense

Interest expense during the year increased by $6.9 million. This was due to a higher average level of bank indebtedness and an increase in long-term borrowings.

Seasonality

The company's business is highly seasonal and follows quarterly sales and profit (loss) fluctuation patterns, which are similar to other retailers. The following table sets forth revenues and net earnings (loss) for the preceding twenty fiscal quarters from the retail operations only.

Retail Revenues and Net Earnings (Loss) for the Fiscal Quarter Ended On About:

(thousands of dollars)	June 30	September 30	December 31	March 31
Fiscal 2002 Revenue	**$ 125,929**	**$ 148,994**	**$ 263,505**	**$ 162,525**
Net Earnings (Loss)	**(5,080)**	**(8,358)**	**20,049**	**(8,880)**
Fiscal 2001 Revenue	$ 123,943	$ 140,993	$ 231,478	$ 137,629
Net Earnings (Loss)	(3,773)	444	17,930	(8,755)
Fiscal 2000 Revenue	$ 118,683	$ 141,720	$ 222,526	$ 138,599
Net Earnings (Loss)	(4,274)	(1,339)	15,801	472
Fiscal 1999 Revenue	$ 100,692	$ 120,970	$ 210,073	$ 144,103
Net Earnings (Loss)	(3,281)	(1,639)	17,066	527
Fiscal 1998 Revenue	$ 80,467	$ 93,383	$ 176,931	$ 105,830
Net Earnings (Loss)	(3,449)	(2,143)	14,912	(900)

Overview of Consolidated Statements of Financial Position

Total assets increased by $51.0 million as compared to the fiscal year ended March 31, 2001. The net increase was primarily due to an increase in inventory of $29.5 million as a result of operating 13 additional superstores at the end of the year, an increase in goodwill of $56.3 million as a result of the acquisition of Old Indigo and the acquisition of the non-controlling interest in Chapters Online. These increases were offset by a reduction in net capital assets of $23.8 million, primarily due to restructuring activities in the year and a reduction in cash balances of $10.7 million.

Total liabilities increased by $78.3 million as compared to the fiscal year ended March 31, 2001. The net increase was primarily due to a $4.6 million increase in bank indebtedness, a $15.8 million increase in accounts payable and accrued liabilities and a $58.1 million increase in long-term debt and convertible debentures.

Primarily as a result of issuing shares as part of the acquisition of Old Indigo, acquisition of the non-controlling interest in Chapters Online, and issuance of shares by way of an offering of subscription rights, share capital increased by $18.7 million as compared to the fiscal year ended March 31, 2001.

Financing Activities

In August 2001, the Company re-negotiated its financing arrangements. The amended and restated credit agreement provides for revolving line of credit of up to $75 million and long-term debt of $104 million, of which $54 million was used to repay the Senior Secured Notes on August 14, 2001. During the year, $20 million of the long-term debt was repaid in accordance with the credit agreement.

As part of the refinancing arrangements undertaken by the Company, a refinancing fee of $2.7 million was paid to the previous Senior Secured Note holders in order to repay the debt before maturity.

Overview of Consolidated Statements of Cash Flows

Cash decreased by $10.7 million in the year as compared to a $17.5 million decrease last year. The net decrease in cash in the year was a result of cash used by operations of $2.6 million, cash used in investing activities of $11.5 million and cash provided by financing activities of $3.4 million.

Of the cash used by operations, changes in non-cash working capital decreased cash by $11.3 million. This decrease primarily relates to an increase in inventory of $7.5 million, a net decrease in accounts payable and accruals of $4.4 million, offset by other items amounting to $0.6 million.

Net cash used in investing activities consisted of capital expenditures of $9.6 million and outflows relating to the acquisition of Old Indigo and Chapters Online of $5.7 million, offset by a decrease of short-term investments $3.8 million.

The Company obtained its financing through a combination of bank financing and an equity issue. During the year, the Company obtained bank financing of $104.0 million and repaid $74.0 million of long-term debt. In addition, the Company decreased its bank indebtedness by $32.5 million, paid $4.2 million relating to its refinancing and issued $10.0 million in equity by way of a rights offering and shares issued through its Employee Stock Purchase Plan.

Liquidity and Capital Reserves

Based on current operating levels, management believes that cash flow generated from operations and its available borrowing capacity from time to time under the Company's credit facility is expected to be sufficient to meet its working capital needs and debt service requirements.

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

On April 19, 2002, the Company successfully completed an offering of 4,243,841 common shares of the Company at $3.50 per share. The issue which was completed by way of an offering of subscription rights to all holders of common shares of the Company, was fully subscribed and resulted in net proceeds of $14.3 million and will be used to provide the Company with capital to further reduce overall levels of indebtedness. Proceeds will also be used to cover certain costs associated with the restructuring of stores previously offered for sale and initiatives to improve merchandising and logistics information systems.

Risks and Uncertainties

Superstore Operations

The success of the Company's superstore operations will depend on, among other things, the current and anticipated number of competing stores in a particular market and on the ability of the Company to increase the overall profitability of the chain by increasing sales on an absolute and comparative basis, managing inventory levels and focusing on cost containment efforts.

Traditional Bookstore Operations

The Company's traditional bookstores are highly dependent upon conditions in the mall retailing industry, including overall mall traffic and the impact caused by the increasing number of book superstores operating in the Canadian market. The Company will continue to close under-performing stores upon lease expiry to increase the overall profitability of this division.

Internet Operations

The success of Online operations will be dependent upon growing consumer acceptance of electronic commerce and the cost of acquiring and retaining the loyalty of customers. In addition, electronic retailing is a highly competitive business, as barriers to entry are low.

Leases

The average unexpired lease term of the Company's traditional bookstores is approximately 2.5 years. As these leases come up for renewal, the Company attempts to renew the lease for a term which coincides with the opening of a book superstore in the immediate vicinity. As a result, the traditional bookstore portfolio is susceptible to volatility in the market for shopping mall space. With an average unexpired lease term of 7.6 years, the Company's superstore rental expense is expected to remain stable.

Competition

The retail bookselling business is highly competitive. Specialty bookstores, independents, other book superstores, regional multi-store operators, supermarkets, drug stores, warehouse clubs, mail order clubs, Internet booksellers, mass merchandisers and other retailers offering books are also a source of competition for the Company.

Economic Environment

Traditionally, retail businesses are highly susceptible to downturns in consumer confidence in the economy. A decline in consumer spending could have an adverse effect on the Company's financial condition. However, management believes that the general economic environment will remain positive, and provide opportunities for growth in 2002.

Cautionary Statement Regarding Forward-Looking Statements

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

Auditors' Report

To the Shareholders of Indigo Books & Music Inc.

We have audited the consolidated balance sheets of Indigo Books & Music Inc. as at March 30, 2002 and March 31, 2001 and the consolidated statements of loss, deficit and cash flows for the 52-week periods then ended. These financial statements are the responsibility of the Company'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 Company as at March 30, 2002 and March 31, 2001 and the results of its operations and its cash flows for the 52-week periods then ended in accordance with Canadian generally accepted accounting principles.

Ernst + Young LLP

Chartered Accountants
Toronto, Canada,
May 15, 2002

Consolidated Balance Sheets

(thousands of dollars)	As at March 30, 2002	As at March 31, 2001
ASSETS (note 5)		
Current		
Cash and cash equivalents	**677**	11,394
Short-term investments	**–**	3,850
Accounts receivable	**12,817**	11,547
Inventories (note 12)	**223,467**	193,977
Income taxes receivable	**4,950**	5,353
Prepaid expenses	**4,338**	4,863
Future income tax assets (note 4)	**6,538**	5,281
Total current assets	**252,787**	236,265
Capital assets, net (note 3)	**115,041**	138,842
Future income tax assets (note 4)	**4,145**	5,402
Goodwill, net of accumulated amortization of $5,991 (March 31, 2001 – $4,904) (notes 8, 9 and 10)	**64,570**	8,301
Deferred financing fees, net of accumulated amortization of $886	**3,289**	–
	439,832	388,810
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current		
Bank indebtedness (note 5)	**57,254**	52,605
Accounts payable and accrued liabilities (note 13)	**198,746**	182,942
Deferred revenue	**6,625**	5,272
Current portion of long-term debt (note 5)	**31,000**	–
Total current liabilities	**293,625**	240,819
Accrued benefit obligations (note 6)	**1,306**	1,166
Long-term debt (note 5)	**53,000**	54,000
Convertible debentures (notes 9 and 11)	**28,071**	–
Non-controlling interest	**–**	1,716
Total liabilities	**376,002**	297,701
Commitments and contingencies (note 17)		
Shareholders' equity		
Share capital (note 7)	**163,505**	144,775
Equity portion of convertible notes (notes 9 and 11)	**1,903**	–
Deficit	**(101,578)**	(53,666)
Total shareholders' equity	**63,830**	91,109
	439,832	388,810

See accompanying notes

On behalf of the Board:

Heather M. Reisman
Director

Nigel S. Wright
Director

Consolidated Statements of Loss

(thousands of dollars*)	52-week period ended March 30, 2002	52-week period ended March 31, 2001
Revenue	**735,684**	686,479
Cost of product, purchasing, selling and administration (note 12)	**698,660**	729,800
	37,024	(43,321)
Amortization of capital assets	**29,839**	28,143
Amortization of pre-opening store costs	**452**	1,033
Amortization of goodwill	**1,087**	516
	31,378	29,692
Earning (loss) before the under noted items	**5,646**	(73,013)
Restructuring and take-over costs (note 13)	**40,316**	29,966
Interest on long-term debt and financing charges (note 5)	**7,576**	3,910
Interest on bank indebtedness	**6,782**	3,586
Loss before income taxes and non-controlling interest	**(49,028)**	(110,475)
Income tax expense (benefit) (note 4)	**600**	(12,718)
Loss before non-controlling interest	**(49,628)**	(97,757)
Non-controlling interest	**(1,716)**	(13,285)
Net loss for the period	**(47,912)**	(84,472)
Net loss per common share		
Basic	**$(3.03)**	$(6.24)
Diluted	**$(3.03)**	$(6.24)
Weighted average number of common shares outstanding (note 7)		
Basic	**15,787**	13,546
Diluted	**15,787**	13,546

*Except per share data

See accompanying notes

Consolidated Statements of Deficit

(thousands of dollars)	**52-week period ended March 30, 2002**	52-week period ended March 31, 2001
Retained earnings (deficit), beginning of period	**(53,666)**	33,129
Adjustment relating to change in accounting policy (note 2)	–	(576)
Net loss for the period	**(47,912)**	(84,472)
Dividends paid	–	(1,747)
Deficit, end of period	**(101,578)**	(53,666)

See accompanying notes

Consolidated Statements of Cash Flows

(thousands of dollars)	52-week period ended March 30, 2002	52-week period ended March 31, 2001
CASH FLOWS FROM OPERATING ACTIVITIES		
Net loss for the period	**(47,912)**	(84,472)
Add (deduct) items not affecting cash		
Amortization	**31,378**	29,692
Future income taxes	**–**	(7,967)
Loss on disposal of capital assets	**76**	316
Benefit plan expense	**140**	766
Accrued interest on convertible notes	**1,790**	–
Non-controlling interest	**(1,716)**	(13,285)
Financing fees	**886**	–
Write-down of capital assets (note 13)	**24,052**	–
Write-down of goodwill (note 13)	**–**	377
	8,694	(74,573)
Net change in non-cash working capital balances (note 16(a))	**(11,268)**	74,068
Cash flows used in operating activities	**(2,574)**	(505)
CASH FLOWS FROM INVESTING ACTIVITIES		
Acquisitions net of cash acquired (notes 9 and 10)	**(5,736)**	–
Decrease in short-term investments	**3,850**	21,150
Purchase of capital assets	**(9,632)**	(25,125)
Proceeds on disposal of capital assets	**4**	62
Cash flows used in investing activities	**(11,514)**	(3,913)
CASH FLOWS FROM FINANCING ACTIVITIES		
Decrease in bank indebtedness	**(32,498)**	(16,607)
Proceeds from share issuance	**10,044**	5,231
Repayment of long-term debt (note 5)	**(74,000)**	–
Proceeds from issuance of long-term debt (note 5)	**104,000**	–
Financing fees	**(4,175)**	–
Dividends paid	**–**	(1,747)
Cash flows from (used in) financing activities	**3,371**	(13,123)
Net decrease in cash and cash equivalents during the period	**(10,717)**	(17,541)
Cash and cash equivalents, beginning of period	**11,394**	28,935
Cash and cash equivalents, end of period	**677**	11,394

See accompanying notes

Notes to Consolidated Financial Statements

March 30, 2002

1. NATURE OF OPERATIONS

Indigo Books & Music Inc. (the "Company" or "Indigo") was formed as a result of an amalgamation of Chapters Inc. and Indigo Books & Music, Inc. under the laws of the Province of Ontario, pursuant to a certificate of Amalgamation dated August 16, 2001. The Company operates a chain of retail bookstores across Canada including 90 (March 31, 2001 – 77) superstores under the *Chapters*, *Indigo*, and *World's Biggest Bookstore* names, as well as 187 (March 31, 2001 – 204) traditional bookstores under the *Coles*, *SmithBooks*, *LibrairieSmith,* and *The Book Company* names. Effective October 27, 2001, the Company holds a 100% (March 31, 2001 – 69.6%) interest in Chapters Online Inc. ("Chapters Online"), an e-commerce retailer *(note 10)*. Immediately following the acquisition, Chapters Online's business was incorporated into Indigo's Internet business and together are integrated into the overall business of Indigo. The Company also has 6 (March 31, 2001 – 6) university and college bookstores through Chapters Campus Bookstores Company, a joint partnership with Barnes & Noble College Bookstore Canadian Division.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of consolidation

These consolidated financial statements have been prepared in accordance with Canadian generally accepted accounting principles and include the accounts of the Company and its subsidiary companies. All significant intercompany balances and transactions have been eliminated.

Inventories

Inventories are valued, using the retail inventory method, at the lower of cost and net realizable value less a normal profit margin.

Prepaid expenses

Prepaid expenses include pre-opening store costs. All costs associated with the opening of new stores are deferred and amortized over the respective store's first twelve months of operations.

Capital assets

Capital assets are recorded at cost and amortized over their estimated useful lives on a straight-line basis over the following periods:

Furniture, fixtures and equipment	5 – 10 years
Computer equipment and development costs	3 – 5 years
Leasehold improvements	over the term of the lease to a maximum of ten years

Employee future benefits

For the period ended March 31, 2001, the Company adopted, on a retroactive basis without restatement, the method of accounting for employee future benefits required by The Canadian Institute of Chartered Accountants' recommendations in Section 3461, Employee Future Benefits. The effect of adopting the new recommendations was to decrease the March 31, 2001 opening retained earnings by $0.6 million.

The cost of pensions and other retirement benefits earned by employees is determined using the projected benefit method prorated on service and management's best estimate of expected plan investment performance, salary escalation, future cost trends and retirement ages of employees. The discount rate used to determine the accrued benefit obligation is determined by reference to market interest rates at the measurement date on high-quality debt instruments with cash flows that match the timing and amount of expected benefit payments. For purposes of calculating the expected return on plan assets, those assets are valued at fair value. The excess of the net actuarial gain (loss) arising after April 2, 2000 over 10% of the greater of the benefit obligation and the fair value of plan assets is amortized over the average remaining service life of active employees.

Deferred financing fees

Financing costs are deferred and amortized over the term of the respective indebtedness.

Deferred revenue

For an annual fee, the Company offers customers loyalty cards that entitle the cardholder to receive discounts on purchases. Each card is issued with a twelve-month expiry period. The fee revenue related to the issuance of a card is deferred and amortized into earnings over the expiry period, based upon historical volumes.

Income taxes

The Company follows the liability method of tax allocation for accounting for income taxes. Under the liability method of tax allocation, future tax assets and liabilities are determined based on differences between the financial reporting and tax bases of assets and liabilities and are measured using the substantively enacted tax rates and laws that will be in effect when the differences are expected to reverse.

Goodwill

Goodwill represents the excess of the cost over the value assigned to the net identifiable assets acquired at the date of acquisition.

During the second quarter of fiscal 2002, the Company adopted the new recommendations of The Canadian Institute of Chartered Accountants relating to business combinations. The new recommendations relating to business combinations require that purchase method be used for all business combinations initiated after June 30, 2001, and also include guidance on the initial recognition and measurement of goodwill and other intangible assets arising from business combinations completed after June 30, 2001. The Company will not be adopting the new recommendations relating to goodwill and other intangible assets. The Company will test for goodwill impairment using the two-step process. The first step is a screen for potential impairment, if any. The Company will complete the first step of the required transitional impairment test at the end of the second quarter of fiscal 2003. If required, the second step of the transitional impairment test will be completed by the end of the fourth quarter of fiscal 2003. Any impairment charge resulting from these transitional impairment tests will be reflected as the cumulative effect of a change in accounting policy in the first quarter of 2003. The Company has not yet determined what the effect of these tests will be on the earnings and financial position of the Company. Prior to the adoption of the new recommendations goodwill arising prior to July 1, 2001 continues to be amortized over its useful life, a 5 to 10 year period, on a straight-line basis and goodwill arising subsequent to July 1, 2001 (notes 9 and 10) is not amortized.

Joint ventures

The accounts of the Company reflect its proportionate interest in retail activities conducted through joint ventures.

Stock-based compensation plan

The Company has an employee stock option plan, which is discussed in note 7. No compensation expense is recognized when stock options are issued to employees. Any consideration paid by employees on the exercise of stock options or purchase of stock is credited to share capital.

Cash and cash equivalents

Cash and cash equivalents consist of cash on hand, balances with banks and highly liquid investments that are readily convertible to cash with less than three months to maturity at the date of acquisition.

Short-term investments

Short-term investments consist of investments with a maturity date of ninety days or greater at the date of acquisition and are recorded at the lower of cost and market value. As at March 30, 2002 there were no short-term investments outstanding. As at March 31, 2001, short-term investments consisted of a discount note with an interest rate of 5.64% due April 4, 2001.

Use of estimates

The preparation of financial statements in accordance with Canadian generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenue and expenses during the reporting period. Actual results may differ from those estimates.

Revenue recognition

The Company recognizes revenue for product sales when title passes to the customers.

Earnings (loss) per share

During the first quarter of fiscal 2002, the Company retroactively adopted the new recommendations of The Canadian Institute of Chartered Accountants relating to earnings (loss) per share. Pursuant to the new recommendations, basic earnings (loss) per share is determined by dividing the net earnings (loss) attributable to common shareholders by the weighted average number of common shares outstanding during the period. Diluted earnings (loss) per share is calculated in accordance with the treasury stock method and is based on the weighted average number of common shares and dilutive common share equivalents outstanding during the period. The adoption of the new recommendations has not impacted the basic and diluted earnings (loss) per share presented in the current and comparative periods. Basic and diluted earnings per share have been adjusted retroactively for all periods presented to account for the completion of the Company's rights offering on January 14, 2002 and April 19, 2002 (note 21).

3. CAPITAL ASSETS

Capital assets consist of the following:

(thousands of dollars)	March 30, 2002 Cost	March 30, 2002 Accumulated amortization	March 31, 2001 Cost	March 31, 2001 Accumulated amortization
Furniture, fixtures and equipment	111,775	48,476	105,881	38,476
Computer equipment and development costs	40,753	33,235	52,707	34,519
Leasehold improvements	84,937	40,713	89,784	36,535
	237,465	122,424	248,372	109,530
Less accumulated amortization	122,424		109,530	
Net book value	115,041		138,842	

4. INCOME TAXES

Future income taxes reflect the net tax effect of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. Significant components of the Company's future tax assets and liabilities are as follows

(thousands of dollars)	March 30, 2002	March 31, 2001
Current future tax assets		
Deferred contract fee	339	542
Reserves and allowances	6,211	4,930
Current future tax liabilities		
Pre-opening costs	(12)	(191)
Net current future tax assets	6,538	5,281

(thousands of dollars)	March 30, 2002	March 31, 2001
Non-current future tax assets		
Tax loss carryforwards	54,244	40,403
Share issue costs	2,067	712
Book amortization in excess of CEC deduction	805	485
Accrued benefit obligations	466	505
Book amortization in excess of capital cost allowance	16,767	–
Non-current future tax assets before valuation allowance	74,349	42,105
Valuation allowance	(70,204)	(29,569)
	4,145	12,536
Non-current future tax liabilities		
Capital cost allowance in excess of book amortization	–	(7,134)
Net non-current future tax assets	4,145	5,402

Significant components of the income tax expense (benefit) attributable to continuing operations are as follows:

(thousands of dollars)	52-week period ended March 30, 2002	52-week period ended March 31, 2001
Current income tax expense (benefit)	600	(4,914)
Future income tax expense (benefit) relating to origination and reversal of temporary differences	(45,743)	(2,165)
Increase in valuation allowance	40,635	–
Future income tax benefit resulting from recognition of loss carryforwards	–	(6,525)
Adjustment to future income tax assets resulting from reduction in substantively enacted tax rates	5,108	886
Total income tax expense (benefit)	600	(12,718)

The reconciliation of income taxes attributable to continuing operations computed at the statutory income tax rates to income tax benefit is:

(thousands of dollars)	52-week period ended March 30, 2002	52-week period ended March 31, 2001
Tax at combined federal and provincial tax rates	(20,910)	(47,837)
Tax effect of expenses not deductible for income tax purposes	125	4,300
Benefit of current year income tax losses not recognized	1,681	28,231
Benefit of current year temporary differences not recognized	13,981	–
Large Corporations Tax	600	355
Reduction in income tax benefits resulting from substantively enacted tax rate reductions	5,108	2,034
Other, net	15	199
	600	(12,718)

As at March 30, 2002 the Company has combined non-capital loss carryforwards of $171,911,000 (March 31, 2001 – $111,858,000) for income tax purposes that expire as follows if not utilized:

(thousands of dollars)	March 30, 2002	March 31, 2001
2006	48,629	35,359
2007	95,759	76,499
2008	21,942	–
2009	5,581	–
	171,911	111,858

For consolidated financial statements reporting purposes, a future tax asset of $nil (March 31, 2001 – $10,834,000) has been recognized in respect of these carryforwards.

5. BANK INDEBTEDNESS AND LONG-TERM DEBT

In August 2001, the Company re-negotiated its credit agreement with its bank and repaid the $54.0 million of Senior Secured Notes (the "Notes"). The Company had issued the Notes at a fixed rate of 7.24%. Interest on these Notes was payable on a quarterly basis. The Notes were to mature and were repayable on May 31, 2004. The Notes were collateralized by a general security agreement and a general assignment of book debts.

The amended and restated credit agreement provides for:

(i) A revolving line of credit of up to $75.0 million, based on defined levels of inventory and accounts receivable bearing interest, at the Company's option, at either the bank's prime rate or the bankers acceptance rate plus 0.5% to 3.5% depending on certain financial ratios. The revolving line of credit shall be repaid in full and cancelled on May 31, 2004. As at March 30, 2002, $67.4 million was drawn against this facility;

(ii) Long-term debt of $50.0 million bearing interest at the same rates as the revolving line of credit. The facility is to be repaid as follows; $14.0 million on December 31, 2002, $14.0 million on December 31, 2003, and $22.0 million on May 31, 2004; and

(iii) Long-term debt of $34.0 million bearing interest at the bank's prime rate plus 4.5% per annum. The facility is to be repaid as follows; $17.0 million on December 31, 2002,and $17.0 million on December 31, 2003.

The revolving line of credit and long-term debt are collateralized by first-ranking security over all the property and assets of the Company, and are dependent upon the continued compliance with certain financial covenants.

On September 5, 2001, the Company entered into interest rate derivative agreements involving the exchange of prime rate floating interest rates for fixed interest rates on a notional amount of $84.0 million. There are reductions in the notional amounts of the derivative agreements that coincide with principal repayments of the underlying long-term debt. The fixed interest rate on a notional amount of $34.0 million is 5.02%, and 5.19% on the remaining notional amount of $50.0 million. The contracts expire on December 31, 2003 and May 31, 2004, respectively. The Company has therefore used the floating rates of interest up to September 5, 2001, at which time the fixed interest rates under the derivative agreement have been used to calculate interest expense on the respective debt.

On November 8, 2001, the Company entered into interest rate derivative agreements involving the exchange of prime rate floating interest rates for fixed interest rates on a notional amount of $40.0 million. The fixed interest rate is 3.14% and the contracts expire on December 1, 2003. The Company used the floating rates of interest up to November 8, 2001, at which time the fixed interest rates under the derivative agreement have been used to calculate interest expense on the respective debt.

As at March 30, 2002, the Company has outstanding letters of credit totaling $1.5 million (March 31, 2001 – $1.0 million).

As at March 31, 2001, the Company had, with a major Canadian chartered bank, a demand operating line of credit of up to $80.0 million, calculated monthly, based on defined levels of and collateralized by inventories and accounts receivable. This obligation bore interest, at the Company's option, at the bank's prime rate or banker's acceptance rate plus a 1% stamping fee. The bank's prime rate at March 31, 2001, was 6.75%. As at March 31, 2001, $42.7 million was drawn against this facility.

6. ACCRUED BENEFIT OBLIGATIONS

The Company uses actuarial reports prepared by independent actuaries for funding and accounting purposes. The significant actuarial assumptions adopted in measuring the Company's accrued benefit obligations are as follows:

(thousands of dollars)	March 30, 2002	March 31, 2001
Accrued benefit obligations, beginning of period	**9,761**	8,765
Current service cost	**1,164**	1,152
Interest on accrued benefits	**704**	665
Benefits paid	**(762)**	(821)
Experience gain (loss)	**(492)**	–
Balance, end of period	**10,375**	9,761
Fair value of plan assets, beginning of period	**8,595**	8,365
Employee contributions	**1,109**	484
Interest on plan assets	**619**	567
Benefits paid	**(762)**	(821)
Experience gain (loss)	**(558)**	–
Fair value of plan assets, end of period	**9,003**	8,595
Funded status – plan deficit	**1,372**	1,166
Unamortized experience gain (loss)	**(66)**	–
Accrued benefit obligations	**1,306**	1,166

The following is a summary of the significant weighted average actuarial assumptions used in measuring the Company's accrued benefit obligations:

	March 30, 2002	March 31, 2001
Weighted average assumptions		
Discount rate	**7.00%**	7.00%
Expected long-term rate of return on plan assets	**7.00%**	7.00%
Rate of compensation increase	**4.50%**	4.50%

The Company's net benefit plan expense is as follows:

(thousands of dollars)	March 30, 2002	March 31, 2001
Current service cost	**55**	668
Interest on accrued benefits	**704**	665
Interest on plan assets	**(619)**	(567)
Net benefit plan expense	**140**	766

7. SHARE CAPITAL

Share capital consists of the following:

(thousands of dollars)	March 30, 2002	March 31, 2001
Authorized		
Unlimited Class A preference shares, voting, convertible into common shares on a one-for-one basis at the option of the shareholder		
Unlimited common shares, voting		
Issued		
16,976,754 common shares (March 31, 2001 – 12,281,236)	**163,505**	144,775

Common shares issued:

	March 30, 2002		March 31, 2001	
	Number of shares	Amount $ (thousands)	Number of shares	Amount $ (thousands)
Balance, beginning of period	**12,281,236**	**144,775**	11,358,429	132,044
Issued during the period				
Issued for cash (net of expenses and future income taxes) (i)	**3,395,074**	**9,920**	–	–
Employee Stock Purchase Plan (ii)	**21,983**	**124**	29,576	293
Options exercised (iii)	**–**	**–**	400,836	4,881
Issued on acquisition (notes 8, 9 and 10)	**1,278,461**	**8,686**	491,803	7,500
Issued to directors for cash	**–**	**–**	592	57
	4,695,518	**18,730**	922,807	12,731
Balance, end of period	**16,976,754**	**163,505**	12,281,236	144,775

(i) On January 14, 2002, the Company successfully completed an offering of 3,395,074 common shares of the Company at $3.00 per share. The issue which was completed by way of an offering of subscription rights to all holders of common shares of the Company, was fully subscribed, resulted in net proceeds of $9.9 million, and was used to fund working capital in connection with the repayment of $20.0 million in long-term debt on December 31, 2001.

(ii) The Company had an Employee Stock Purchase Plan that allowed employees, other than senior management and directors, to purchase up to 10% of their salary in common shares at a 15% discount price from the lesser of the fair market value at the opening or closing price of each six-month period. This plan was discontinued on January 24, 2002.

(iii) On August 26, 1996, the Company established an employee stock option plan (the "Plan") for its directors and key employees. The number of common shares reserved for issuance under the Plan is 1,728,500. One quarter of the options granted are exercisable on the date of issue with the remainder exercisable in equal installments on the anniversary date for the next three years.

Under the Stock Option Plan Agreement, in the event of an offer to purchase shares of the Company which, if accepted, would result in the offeror exercising control of the Company, the Board of Directors could authorize certain non-vested options to become exercisable during the period that the offer is open for acceptance. On December 11, 2000, Trilogy Retail Enterprises L.P. ("Trilogy") issued an offer to purchase 4,888,000 common shares of the Company, which would have resulted in Trilogy exercising control of the Company, if accepted. As a result of the offer, the Board of Directors authorized that all options with an exercise price of $16.80 or less became exercisable during the period that the offer was open for acceptance.

A summary of the status of the Plan and changes during the period is presented below:

	March 30, 2002		March 31, 2001	
	Number #	Weighted Average exercise price $	Number #	Weighted Average exercise price $
Outstanding options, beginning of period	764,179	22.60	1,011,204	21.21
Granted	130,941	47.56	248,000	12.07
Exercised	–	–	(400,836)	12.18
Cancelled	(512,487)	22.83	(94,189)	24.37
Outstanding options, end of period	382,633	30.83	764,179	22.60
Options exercisable, end of period	265,040		530,670	

Options outstanding and exercisable

	March 30, 2002				
	Outstanding			Exercisable	
Range of exercise prices $	Number #	Weighted average exercise price $	Weighted average remaining contractual life years	Number #	Weighted average exercise price $
9.63-17.60	130,284	15.48	0.8	105,252	16.46
21.92-27.85	2,275	25.13	3.0	569	25.13
28.00-34.06	177,478	30.21	0.8	141,070	29.96
34.56-42.84	23,107	42.49	3.0	5,777	42.49
44.05-96.39	49,489	68.27	3.0	12,372	68.27
9.63-96.39	382,633	30.83	1.2	265,040	26.65

8. ACQUISITION OF MINORITY SHARE IN PEGASUS WHOLESALE INC. ("PEGASUS")

Effective January 14, 2001, the Company entered into a share purchase agreement (the "Agreement") to acquire the outstanding 15% non-controlling interest in Pegasus. Under the terms of the Agreement, the Company issued subscription receipts having an aggregate redemption price of $7.5 million. The subscription receipts were subsequently converted into 491,803 common shares of the Company. The acquisition has been accounted for using the purchase method of accounting. The allocation of the purchase price is based on the fair value of the net identifiable assets acquired of Pegasus.

The total cost of the acquisition was allocated to the net assets acquired on the basis of their fair values as follows:

(thousands of dollars)	
Current assets	13,014
Capital assets	2,484
Goodwill	7,500
Current liabilities	(10,488)
Note payable	(4,515)
	7,995
Funded by	
Issuance of subscription receipts	7,500
Restructuring costs	495
	7,995

Restructuring costs are comprised of termination and severance costs. No further restructuring costs relating to Pegasus are anticipated.

9. ACQUISITION OF INDIGO BOOKS & MUSIC, INC.

On August 14, 2001 ("date of acquisition"), the Company acquired all of the issued and outstanding shares of Indigo Books & Music, Inc. ("Old Indigo"). The aggregate purchase price was $11.9 million pursuant to which the Company issued 528,268 common shares valued at $4.1 million and 97,908 options to purchase common share in exchange for all of Old Indigo's Class A shares, Series I Convertible Preference Shares and options and warrants to purchase common shares outstanding. The value of the 528,268 common shares issued was determined based on the average market price of the Company's common shares over a reasonable period before and after the date the terms of the business combination were agreed and announced. The results of Old Indigo's operations have been included in the consolidated financial statements since the date of acquisition. In addition, the corporate name of the Company was changed from Chapters Inc. to Indigo Books & Music Inc. and the Company's trading symbol on the Toronto Stock Exchange was changed from CHP to IDG.

The acquisition was accounted for using the purchase method. The following table summarizes the fair value of the assets acquired, liabilities assumed and the composition of the purchase price as at the date of acquisition:

(thousands of dollars)	
Current assets	22,383
Capital assets	20,530
Goodwill	52,856
Current liabilities	(57,588)
Convertible notes	(26,281)
	11,900
Funded by	
Issuance of common shares	4,147
Equity component of convertible notes and options	1,903
Transaction costs	5,850
	11,900

The $52.9 million of goodwill was assigned to the Retail segment and will not be amortized. All of the transaction costs have been paid.

10. ACQUISITION OF CHAPTERS ONLINE INC.

On October 27, 2001, the Company acquired all of the outstanding shares of Chapters Online not already owned by the Company. The aggregate purchase price was $4.8 million pursuant to which the Company issued 750,193 common shares valued at $4.5 million. The value of the 750,193 common shares was determined based on the average market price of the Company's common shares over a reasonable period before and after the date the terms of the business combination were agreed and announced. Chapters Online became a wholly owned subsidiary of Indigo, and is in the process of being wound up.

The acquisition was accounted for using the purchase method. The following table summarizes the fair value of the assets acquired, liabilities assumed and the composition of the purchase price as at the date of acquisition:

(thousands of dollars)	
Current assets	1,190
Capital assets	1,784
Goodwill	4,500
Current liabilities	(2,685)
	4,789
Funded by	
Common shares	4,539
Transaction costs	250
	4,789

The $4.5 million of goodwill was assigned to the Chapters Online segment and will not be amortized. All of the transaction costs have been paid.

11. CONVERTIBLE DEBENTURES

Upon acquisition of Old Indigo by the Company, the Old Indigo Series I and II subordinated convertible notes in the amount of $10.0 million and $20.0 million became convertible into common shares of the Company on the basis of one common share of the Company for each $18.93 of principal and interest owing.

The Series I notes bear interest at 8% per annum and mature on June 30, 2005. The Series II notes bear interest at prime plus 2% per annum and mature on June 30, 2005.

At the date of acquisition, the fair value of the subordinated convertible notes was allocated between a liability and equity component (note 9). The recorded amount of the liability component will be accreted to its face value over the remaining term of the notes as interest expense. The holder's conversion option is treated as a separate element within equity.

12. COST OF PRODUCT

The cost of product, purchasing, selling and administration includes the following amounts:

(thousands of dollars)	52-week period ended March 30, 2002	52-week period ended March 31, 2001
Provision for future markdowns	**2,876**	24,722
Inventory shrink	**23,988**	28,600
	26,864	53,322

The provision for future markdowns reflects the required clearance of slow moving, non-returnable inventory and a provision for damaged stock. Inventory shrink recorded reflects the actual experience during the period.

13. RESTRUCTURING AND TAKE-OVER COSTS

(a) Restructuring charges for the period ended March 30, 2002 consist of the following:

(thousands of dollars)	
Write-down of capital assets	**24,052**
Provision for store closing and other costs	**11,906**
Relocation and other costs as a result of acquisition	**1,691**
Refinancing fee	**2,667**
	40,316

As at March 30, 2002, approximately $9.75 million of the provision for store closing, relocation and other costs remain unpaid and have been included in accounts payable and accrued liabilities.

(b) Restructuring and take-over costs for the period ended March 31, 2001, consisted of the following:

(thousands of dollars)	
Restructuring	**13,554**
Take-over costs	**16,412**
	29,966

During fiscal 2001, the operations of the Company were evaluated and as a result the Company restructured its distribution operations, online operations and senior executive management team. Restructuring costs are comprised of approximately $11.1 million relating to employee termination and severance costs, a $0.4 million write down of goodwill related to the closure of the gardencrazy.com Web site, and $2.0 million related to other costs including professional fees.

Take-over costs are comprised of $8.8 million of investment advisory, legal and other professional fees associated with the take-over bid by Trilogy, and break-up fees in the amount of $7.6 million consisting of fees paid, as part of an acquisition offer made by Future Shop Ltd. for 100% of the outstanding shares of the Company. The agreement called for a fee to be paid by the Company in the event that the offer was not accepted. As at March 30, 2002, all break-up fees have been paid and no further cost will be incurred.

14. JOINT VENTURES

In August 1999, the Company formed a joint venture with Barnes & Noble College Bookstore Canadian Division to manage its Campus Bookstore division. Under the terms of the agreement, the Company contributed assets at a net book value of $4.6 million, consisting primarily of inventory, in return for a promissory note of $2.1 million and a 51% equity interest in the newly formed company, Chapters Campus Bookstores Company.

In addition, the Company participates in a joint venture through a 50% equity ownership in the Calendar Club of Canada Limited Partnership to sell calendars through temporary kiosks during the Christmas season.

The following amounts represent the total assets and liabilities of the Company's joint ventures in which the Company participates and its proportionate share of the assets, liabilities, revenue and expenses and cash flows therein:

	Total		Proportionate share	
(thousands of dollars)	**2002**	2001	**2002**	2001
Current assets	**13,882**	10,564	**7,029**	5,340
Long-term assets	**1,872**	1,622	**942**	819
Current liabilities	**3,646**	5,897	**1,855**	2,972
Revenue	**40,826**	37,393	**20,606**	18,885
Expenses	**35,111**	35,793	**17,691**	18,090
Net income	**5,715**	1,600	**2,915**	795
Cash flows provided by (used in)				
Operating activities	**8,281**	2,296	**4,177**	1,152
Financing activities	**(506)**	(896)	**(253)**	(457)
Investing activities	**(632)**	(2,817)	**(316)**	(1,411)
Net cash flow	**7,143**	(1,417)	**3,608**	(716)

15. SEGMENT INFORMATION

The Company has two reportable segments: Indigo Retail and Chapters Online. Indigo Retail operates a chain of retail bookstores across Canada including superstores, traditional and college bookstores. Chapters Online is an e-commerce retailer, selling books and other products through the Internet Web site *www.chapters.indigo.ca*. Prior to fiscal 2002, the Company also had, as a reportable segment, Pegasus, a national wholesaler of books and other retail products. Beginning in fiscal 2002, Pegasus no longer continued to meet the criteria as a reportable segment, accordingly, the segments reported have been restated to conform to the new operating structure.

The accounting policies of the segments are the same as those described in the summary of significant accounting policies. The Company evaluates performance based on profit or loss from operations. The Company's reportable segments are strategic business units that offer different products through different channels. They are managed separately because each business requires different technology and market strategies. All of the Company's assets are located in Canada.

(thousands of dollars)	52-week period ended March 30, 2002		
	Retail	Online	Total
Revenue	700,953	34,731	735,684
Earnings (loss) before interest, amortization, income taxes, restructuring charges and non-controlling interest	38,900	(1,876)	37,024
Amortization	26,119	5,259	31,378
Interest expense (income)	14,450	(92)	14,358
Segment loss before income taxes, restructuring charges and non-controlling interest	(1,669)	(7,043)	(8,712)
Segment loss before restructuring charges and non-controlling interest	(2,269)	(7,043)	(9,312)
Segment assets	427,108	5,674	432,782
Capital expenditures	9,560	72	9,632
Goodwill on business combinations	52,856	4,500	57,356

Reconciliation – segment loss

Segment loss before restructuring charges and non-controlling interest	(9,312)
Restructuring charges and take-over costs	(40,316)
Non-controlling interest	1,716
Net loss	(47,912)

Reconciliation – segment assets

(thousands of dollars)	March 30, 2002		
	Retail	Online	Total
Cash and cash equivalents	220	457	677
Accounts receivable	12,265	552	12,817
Inventories	223,467	–	223,467
Prepaid expenses	4,173	165	4,338
Capital assets	115,041	–	115,041
Intercompany receivables	3,633	–	3,633
Other	68,309	4,500	72,809
	427,108	5,674	432,782
Future income tax assets			10,683
Intercompany receivables			(3,633)
			439,832

(thousands of dollars)	52-week period ended March 31, 2001 Retail	Online	Total
Revenue	670,756	51,091	721,847
Inter-segment revenue	(35,368)	–	(35,368)
Revenue from external customers	635,388	51,091	686,479
Earnings (loss) before interest, amortization, income taxes, restructuring charges and non-controlling interest	(10,186)	(33,135)	(43,321)
Amortization	24,842	4,850	29,692
Interest expense (income)	8,732	(1,236)	7,496
Segment loss before income taxes, restructuring charges and non-controlling interest	(43,764)	(36,745)	(80,509)
Segment loss before restructuring charges and Non-controlling interest	(31,046)	(36,745)	(67,791)
Segment assets	422,186	18,835	441,021
Capital expenditures	22,897	2,228	25,125
Goodwill on business combination	7,500	–	7,500

Reconciliation – segment loss

Segment loss before restructuring charges and non-controlling interest	(67,791)
Restructuring and take-over costs	(29,966)
Non-controlling interest	13,285
	(84,472)

Reconciliation – segment assets

(thousands of dollars)	March 31, 2001 Retail	Online	Total
Cash and cash equivalents and short-term investments	7,718	7,526	15,244
Accounts receivable	10,831	716	11,547
Inventories	192,643	1,334	193,977
Prepaid expenses	4,493	370	4,863
Capital assets	129,953	8,889	138,842
Intercompany receivables and investments in subsidiaries	62,894	–	62,894
Other	13,654	–	13,654
	422,186	18,835	441,021
Future income tax assets			10,683
Intercompany receivables and investments in subsidiaries			(62,894)
			388,810

16. CONSOLIDATED STATEMENTS OF CASH FLOWS

(a) The net change in non-cash working capital balances related to operations consists of the following:

(thousands of dollars)	March 30, 2002	March 31, 2001
Accounts receivable	(1,251)	3,667
Inventories	(7,467)	75,339
Prepaid expenses	375	243
Income taxes receivable	403	(1,481)
Deferred revenue	1,028	(902)
Accounts payable and accrued liabilities	(4,356)	(2,808)
	(11,268)	74,068

(b) Supplemental cash flow information:

(thousands of dollars)	March 30, 2002	March 31, 2001
Interest paid	12,435	8,763
Income taxes paid	916	–

(c) The Company entered into the following non-cash transactions:

(i) During the period ended March 30, 2002, the Company issued 528,268 common shares valued at $4.1 million with respect to the acquisition of Old Indigo (note 9) and 750,193 common shares valued at $4.5 million with respect to the acquisition of all of the outstanding shares of Chapters Online (note 10).

(ii) During the period ended March 31, 2001, the Company issued 491,803 common shares valued at $7.5 million with respect to the acquisition of Pegasus (note 8).

17. COMMITMENTS AND CONTINGENCIES

(a) Operating leases

The Company has operating lease commitments in respect of its stores, support office premises and certain equipment. The leases expire at various dates between 2003 and 2016 and are subject to renewal options in certain cases. Annual store rentals consist of a base amount together with additional payments based on store sales. The base rentals payable under present leases are as follows:

(thousands of dollars)	
2003	59,960
2004	57,198
2005	53,827
2006	52,432
2007	51,052
Thereafter	206,681
	481,150

(b) Legal claims

In the normal course of business, the Company becomes involved in various claims and litigation. While the final outcome of such claims and litigation pending as at March 30, 2002 cannot be predicted with certainty, it is the opinion of management that the resolution of any such claims would not have had a material adverse effect on the Company's financial position.

18. FINANCIAL INSTRUMENTS

The fair value of financial instruments is the estimated amount the Company would receive or pay to terminate the contracts at the reporting date. The following methods and assumptions were used to estimate the fair value of each type of financial instrument by reference to various market value data and other valuation techniques, as appropriate.

The fair value of cash and cash equivalents, short-term investments, accounts receivable, income taxes receivable, bank indebtedness and accounts payable and accrued liabilities approximate their carrying values given their short-term maturities.

The fair value of long-term debt and convertible debentures are estimated based on the discounted cash payments of the debt at the Company's estimated incremental borrowing rates for debt of the same remaining maturities. The fair value of the long-term debt approximates its carrying value. The fair value of the convertible debentures is approximately $27.3 million as at March 30, 2002.

The fair values of interest rate derivatives are estimated by discounting cash payments of the derivatives at market rates for derivatives of the same remaining maturities. At this time, the Company does not intend to terminate the interest rate swap agreement and therefore does not anticipate any impact on earnings arising from the differences between book value and fair value. The fair value of the interest rate swap agreements as at March 30, 2002 was $0.7 million in favour of the counterparties.

19. RELATED PARTY TRANSACTIONS

As at March 30, 2002, the Company has outstanding convertible debentures with related parties in the amount of $34.6 million including accrued interest (March 31, 2001 – $nil). During the 52-week period ended March 30, 2002, interest expense related to the convertible debentures amounted to $1.8 million (March 31, 2001 – $nil).

20. SUBSEQUENT EVENTS

On April 19, 2002, the Company completed an offering of 4,243,841 common shares of the Company at $3.50 per share. The issue which was completed by way of an offering of subscription rights to all holders of common shares of the Company, was fully subscribed and resulted in net proceeds of $14.3 million and will be used to provide the Company with capital to further reduce overall levels of indebtedness. Proceeds will also be used to cover certain costs associated with the restructuring of stores previously offered for sale and with initiatives to improve merchandising and logistics information systems.

Since (a) the exercise price of the offering was less than the fair market value of the shares at issuance, and (b) the offering was available to all existing shareholders, the offering contains a bonus element that is considered to be similar to a stock dividend. As a result, basic and diluted earnings per share have been adjusted retroactively for the bonus element for all periods presented.

Corporate Governance Policies

A presentation of Indigo's corporate governance policies is included in the Management Information Circular which is mailed to all shareholders. If you would like to receive a copy of this information, please contact Investor Relations at Indigo.

Executive Management and Board of Directors

EXECUTIVE MANAGEMENT

Doug Caldwell
Chief Technology Officer

Susan Croft
Senior Vice President, Human Resources

Michael Gagnier
President, Retail & Online

Deirdre Horgan
Vice President, Marketing

Heather Reisman
Chair & Chief Executive Officer

Kathy Weston
Executive Vice President, Procurement

Ian Young
Chief Financial Officer

BOARD OF DIRECTORS

Jonathan Deitcher
Vice President & Director
RBC Dominion Securities

James Hall
Senior Vice President, Investment and Chief Investment Officer
Working Ventures Canadian Fund Inc.

Senator Michael Kirby
Senator
The Senate of Canada

Robert Lantos
President
Serendipity Point Films

Jack Lawrence
Chairman
Lawrence & Company Inc.

Heather Reisman
Chair & Chief Executive Officer
Indigo Books & Music Inc.

Gerald Schwartz
Chairman, President & CEO
Onex Corporation

Lawrence Tanenbaum
President
Kilmer Van Nostrand Co. Limited

Nigel Wright
Vice President
Onex Corporation

Summary of Financial Information

For the years ended (millions of dollars except per share)	March 30, 2002	March 31, 2001	April 1, 2000	April 3, 1999	March 28, 1998
SELECT INCOME STATEMENT INFORMATION					
Revenue					
Superstores	**485.8**	408.9	376.3	296.9	166.7
Traditional Bookstores	**183.8**	195.2	217.8	253.2	278.8
Internet	**34.7**	51.1	38.7	2.0	–
Other	**31.4**	31.3	27.5	25.7	11.1
Total Revenues	**735.7**	686.5	660.3	577.9	456.6
EBITDA	**37.0**	(43.3)	(8.9)	41.3	32.9
EBIT	**5.6**	(73.0)	(34.5)	23.3	19.0
Restructuring and take-over costs	**40.3**	30.0	–	–	–
Dilution gain on sale of Chapters Online Inc. & Pegasus Wholesale	**–**	–	41.1	–	–
Earnings per weighted average shares outstanding	**(3.52)**	(7.33)	1.54	1.00	0.90
SELECT BALANCE SHEET INFORMATION					
Working capital	**(40.8)**	(4.6)	88.3	9.4	53.6
Total assets	**439.8**	388.8	495.3	351.8	219.4
Long-term debt	**112.1**	54.0	54.0	–	11.1
Shareholders' equity	**63.8**	91.1	165.2	115.2	104.4
Long-term debt / (long-term debt + equity)	**0.64:1**	0.37:1	0.25:1	–	0.10:1
Weighted average number of shares outstanding	**13,629,541**	11,526,705	11,133,222	10,295,450	9,326,203
Common shares outstanding at end of period	**16,976,754**	12,281,236	11,358,429	10,310,583	10,284,672
STORE OPERATING STATISTICS					
Number of stores at end of period					
Superstores	**90**	77	70	54	29
Traditional Bookstores	**187**	204	231	261	305
Campus Bookstores	**6**	6	4	1	1
Selling square footage at end of period (in thousands)					
Superstores	**2,164**	1,883	1,751	1,484	833
Traditional bookstores	**496**	536	604	721	842
Campus bookstores	**38**	38	35	28	28
Comparable store sales growth					
Superstores	**1.1%**	(1.6%)	(3.1%)	3.9%	*
Traditional Bookstores	**3.7%**	(3.0%)	(4.0%)	0.7%	(3.4%)
Sales per selling square foot					
Superstores	**233**	229	244	258	*
Traditional Bookstores	**358**	352	358	339	323

*Insufficient number of superstores for a meaningful comparison

Investor Information

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STOCK LISTING

Toronto Stock Exchange

TRADING SYMBOL

IDG (formerly CHP)

TRANSFER AGENT AND REGISTRAR

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ANNUAL MEETING

The Annual Meeting represents an opportunity for shareholders to review and participate in the management of their Company as well as meet with its directors and officers.

Indigo's Annual Meeting will be held on August 28, 2002 at 8:00 a.m. at the Toronto Stock Exchange Conference Centre, 130 King Street West, Toronto, Ontario, Canada.

Shareholders are encouraged to attend and guests are welcome.

Une traduction française de ce document est disponible sur demande.

Our Guiding Principles

- We believe that great companies are built over time through the efforts of talented, committed people. We will take the time to build this Company consistent with our beliefs and guiding principles, knowing that the result will be a great and lasting enterprise with the potential for sustained success.
- Quality matters in everything we do. We are always striving to be the very best we know how to be, understanding that in the process we will make some mistakes. From the latter will likely come our best learning.
- Serving and satisfying customers will be our hallmark in all our stores. It is our number one priority. Everyone working with our Company needs to understand how the implications of their actions affect customer satisfaction.
- We believe that in the Information Era the only sustainable competitive advantage is people, therefore everything else can be duplicated. People and organization development are also our priorities. All of our actions will reinforce our belief in the importance and value of our people.
- Profitability and value enhancement are essential to long-term success and must be the focus, in an appropriate manner, at all levels of our organization.
- All those who create value should feel fairly rewarded for their contribution – employees, suppliers and investors.
- We have a responsibility to be respectful of, and to add value to, the communities in which we operate.