THIRD QUARTER REPORT

FOR THE 13-WEEK PERIOD ENDED DECEMBER 29, 2001

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

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Management's Discussion and Analysis

Overview

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 December 29, 2001, the Company operated 93 book superstores including 77 *Chapters*, 16 *Indigo* superstores and the *World's Biggest Bookstore*, and 190 traditional bookstores, under the banners *Coles*, *SmithBooks*, *Classic Books*, *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 pursuant to which the Company issued 528,268 common shares valued at $4.2 million. 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 has been changed from CHP to IDG.

The Company also operates *www.chapters.indigo.ca*, a leading e-commerce retail destination, which sells books, video, CDs and DVDs.

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 $5.5 million pursuant to which the Company issued 750,193 common shares valued at approximately $4.5 million. 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.

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 13 weeks ended December 29, 2001 and the 13 weeks ended December 30, 2000. It should be read in conjunction with the consolidated financial statements and notes contained in this Third Quarter Report.

Some 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 in the third quarter increased 10.6% to $273.9 million from $247.6 million in the third quarter last year. The sales increase was primarily attributable to the addition of 16 superstores, offset by sales decreases from closing 27 traditional format stores and lower sales at Chapters Online. On a year-to-date basis, total consolidated revenues were $565.0 million as compared to $538.5 million on a year-to-date basis last year.

Consolidated earnings before interest, taxes, amortization, restructuring charges and non-controlling interest ("operating earnings") for the third quarter was $34.9 million compared to earnings of $27.2 million in the third quarter last year. This represents an increase in operating earnings of $7.7 million or 28.3% in the quarter. On a year-to-date basis, consolidated earnings before interest, taxes, amortization, restructuring charges and non-controlling interest was $34.2 million as compared to $11.3 million on a year-to-date basis last year, an increase in earnings of $22.9 million or 203%.

The consolidated net income for the third quarter was $18.8 million ($1.41 per share) as compared to a net income of $9.0 million ($0.79 per share) in the third quarter last year a $9.8 million or a 109% improvement. The consolidated net loss on a year-to-date basis was $19.4 million ($1.53 per share) as compared to a net loss of $11.5 million ($1.01 per share) on a year-to-date basis last year.

Excluding restructuring charges, the net income on a year-to-date basis was $1.7 million ($0.13 per share) as compared to a net loss of $11.5 million ($1.01 per share) on a year-to-date basis last year. This represents an increase of $13.2 million ($1.14 per share).

Restructuring and other costs of $21.2 million relate to store closures and other costs associated with the amalgamation between the Company and Old Indigo. The charges are comprised of $12.3 million in capital asset write-downs, $4.5 million relating to store closings, $1.7 million relating to relocation and other costs associated with the acquisition and $2.7 million in finance charges.

Of the total restructuring charges, approximately $8.6 million are cash charges of which $3.0 million have been paid. The balance of approximately $12.5 million relates to non-cash transactions.

Income tax expenses were $4.1 million as compared to $11.1 million in the third quarter of last year. The reduction was due to the fact that income tax benefits were not recognized in the second quarter ended September 29, 2001 due to cumulative losses in previous periods. Income tax benefits recognized in the 26-week period ended September 30, 2000 amounted to $6.3 million as compared to $3.7 million for the 26-week period ended September 29, 2001.

Pursuant to a Consent Order issued by the Commissioner of Competition regarding the merger of the Company and Old Indigo, the Company agreed to offer for sale 13 superstores and 10 traditional stores. Subsequent to the completion of the quarter, no divestitures were completed by Indigo or by the trustee appointed pursuant to the Consent Order to effect the sale of the relevant assets. As a result, the relevant assets have reverted to Indigo. Therefore it is anticipated that further store closures will occur and other costs related to the acquisition will be incurred.

The weighted average number of shares outstanding for the quarter was 13.3 million as compared to 11.4 million in the third quarter last year. On a year-to-date basis, the weighted average number of shares outstanding was 12.7 million as compared to 11.4 million last year. The increase is a result of the issuance of shares relating to the acquisition of Old Indigo, the acquisition of the non-controlling interest in Chapters Online, employee stock purchase plan and the exercise of stock options.

Retail

Retail sales in the third quarter were $263.5 million as compared to $232.1 million in the third quarter of last year, an increase of $31.4 million or 13.5%. Earnings before interest, taxes, amortization and restructuring charges increased to $35.0 million in the third quarter from $33.3 million in the third quarter last year an increase of $1.7 million or 5.1%. The increase, as compared to last year, can be attributed to improved gross margin dollars, reduced warehousing and distribution costs offset by higher occupancy and labour costs due to the expansion of the superstore portfolio.

Retail sales on a year-to-date basis were $538.4 million as compared to $497.6 million last year an increase of $40.8 million or 8.2%. On a year-to-date basis, earnings before interest, taxes, amortization and restructuring charges were $37.0 million as compared to $35.4 million last year.

Superstores

In the third quarter, revenues at the Chapters and Indigo superstores, including the World's Biggest Bookstore, grew to $176.1 million, a 26.0% increase compared to revenue of $139.8 million in the third quarter last year. The growth in revenue was generated by the operation of 16 additional superstores as compared to the third quarter last year and positive performance on a comparable store basis. Comparative store sales increased 1.9% during the quarter as compared to 1.3% in the same period last year. Comparable store sales in the key month of December increased 5.7%.

Year-to-date revenues increased $51.7 million to $367.8 million as compared to last year. This growth in revenue is also primarily attributable to the operation of a larger superstore portfolio.

Traditional Stores

Total traditional store revenues declined to $72.4 million in the third quarter, a decrease of $5.3 million or 6.8% in comparison to $77.7 million in the third quarter last year. The decline in revenue was the result of operating 27 fewer traditional bookstores or approximately 12% fewer stores as compared to the third quarter last year. The comparative store sales increase of 3.9% during the quarter was a significant improvement over the 0.4% decline in the third quarter last year. The total number of stores as at the end of the quarter was 190 as compared to 217 stores last year. Comparable store sales in the key month of December increased 4.3%.

Year-to-date revenues decreased $10.8 million to $145.5 million as compared to last year. Comparative store sales increased 2.5% on a year-to-date basis, a significant improvement over the 3.1% decrease during the same period 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 Campus Bookstore joint venture were $15.0 million in the third quarter as compared to $14.6 million in the third quarter last year. On a year-to-date basis, sales were the same as last year at $25.1 million.

Online

Revenues in the third quarter were $10.4 million as compared to $15.5 million in the third quarter last year, a decrease of $5.1 million or 32.9%. The decline was attributable to less aggressive marketing, discounting and promotional activities during the third quarter of this year as compared to the third quarter last year. Losses before interest, taxes, amortization and restructuring charges were reduced by $5.9 million to $71,000 primarily due to significant reductions in operating costs as a result of restructuring activities undertaken over the previous three quarters.

On a year-to-date basis, revenues were $26.6 million as compared to $40.9 million on a year-to-date basis last year, a $14.3 million decrease. Losses before interest, taxes, amortization and restructuring charges were reduced by $21.2 million on a year-to-date basis to $2.8 million, a significant improvement over last year's performance.

Overview of Consolidated Statements of Financial Position

Total assets increased by $138.3 million as compared to the fiscal year ended March 31, 2001. The net increase was primarily due to an increase in inventory of $76.3 million, as a result of operating 16 additional superstores at the end of the quarter. Goodwill increased $51.0 million as a result of the acquisition of Old Indigo and the acquisition of the non-controlling interest in Chapters Online.

Total liabilities increased by $147.0 million compared to the fiscal year ended March 31, 2001. The net increase was primarily due to a $52.6 million decrease in bank indebtedness, a $122.6 million increase in accounts payable and accrued liabilities and a $77.1 million increase in long-term debt and convertible debentures.

Share capital increased by $8.8 million as compared to the fiscal year ended March 31, 2001 primarily as a result of issuing shares as part of the acquisition of Old Indigo and acquisition of the non-controlling interest in Chapters Online.

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. Subsequent to the end of the third quarter $20 million of the long-term debt was repaid in accordance with the credit agreement.

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

Overview of Consolidated Statements of Cash Flows

Cash increased by $24.0 million in the third quarter as compared to a $13.9 million increase in the same period last year. The net increase in cash in the quarter was a result of cash provided by operations of $93.8 million, net purchases of capital assets of $2.7 million and a decrease in bank indebtedness of $67.1 million.

Of the cash provided by operations, changes in non-cash working capital provided for an increase in cash of $70.1 million. This increase primarily relates to an increase in inventory of $14.6 million offset by an increase in accounts payable and accruals of $79.0 million and other items amounting to $5.7 million.

On a year-to-date basis, cash increased by $13.9 million as compared to a $12.5 million decrease in the same period last year. The net increase in cash was a result of cash provided by operations of $61.0 million, net purchases of capital assets of $7.4 million, proceeds on the sale of short-term investments of $3.8 million and an decrease in cash from financing activities of $43.5 million.

The financing activities included the new financing arrangements, which resulted in a net increase in long-term debt of $50.0 million offset by a decrease in bank indebtedness of $89.8 million and financing fees of $3.9 million.

Of the cash used in operations on a year-to-date basis, changes in non-cash working capital provided for an increase in cash of $43.9 million. This increase primarily relates to an increase in inventory of $49.1 million offset by an increase in accounts payable and accruals of $96.7 million and an increase in accounts receivable and other miscellaneous items of $3.7 million.

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 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 approximately $10.0 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.

On January 25, 2002, the Company's Board of Directors approved an offering of subscription rights to the Company's existing common shareholders. Shareholders will receive one right for each common share held by them. Four rights will entitle the holder thereof to one common share of the Company at an exercise price of $3.50 per share. Net proceeds, assuming exercise of 100% of the rights, are expected to be approximately $14.6 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.

Risks and Uncertainties

The risks and uncertainties faced by the Company are substantially the same as those disclosed in the Management's Discussion and Analysis section of its fiscal 2001 Annual Report, except for the impact that the tragic events of September 11, 2001 may have on consumer confidence and spending, which is not known to any degree of certainty. Traditionally, retail businesses are highly susceptible to downturns in consumer confidence in the economy. A decline in consumer spending could have an adverse impact on the Company's financial condition.

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 and its subsidiaries.

Consolidated Statements of Financial Position

Figures as at December 29, 2001 and December 30, 2000 are unaudited

	As at December 29, 2001 $ (thousands)	As at December 30, 2000 $ (thousands)	As at March 31, 2001 $ (thousands)
Assets			
Cash	**$ 25,322**	$ 16,474	$ 11,394
Short term investments	**–**	–	3,850
Accounts receivable	**16,526**	19,729	11,547
Inventories	**270,255**	297,129	193,977
Income taxes receivable	**4,695**	–	5,353
Prepaid expenses	**4,624**	4,551	4,863
Future income tax assets	**2,921**	925	5,281
Total current assets	**324,343**	338,808	236,265
Capital assets, net	**132,249**	140,206	138,842
Future income taxes assets	**7,762**	9,060	5,402
Goodwill, net of accumulated amortization of $5,653 (2001 – $5,137) (note 4)	**59,331**	1,292	8,301
Deferred financing charges, net of accumulated amortization of $467	**3,383**	–	–
Total assets	**527,068**	489,366	388,810
Liabilities and shareholders' equity			
Bank indebtedness (note 7)	**–**	–	52,605
Accounts payable and accrued liabilities (note 9)	**305,530**	262,457	182,942
Income taxes payable	**–**	8,170	–
Deferred revenue	**6,137**	5,318	5,272
Current portion long-term debt (note 7)	**20,000**	–	–
Total current liabilities	**331,667**	275,945	240,819
Accrued benefit obligations	**1,916**	49	1,166
Long-term debt (note 7)	**84,000**	54,000	54,000
Convertible debentures (notes 4 and 8)	**27,133**	–	–
Non-controlling interest	**–**	5,477	1,716
Total liabilities	**444,716**	335,471	297,701
Shareholders' equity			
Share capital (note 4 and 6)	**153,543**	132,262	144,775
Equity portion of convertible debentures (notes 4 and 8)	**1,903**	–	–
Retained earnings (deficit)	**(73,094)**	21,633	(53,666)
Total shareholders' equity	**82,352**	153,895	91,109
Total liabilities and shareholders' equity	**$ 527,068**	$ 489,366	$ 388,810

See accompanying notes

Consolidated Statements of Retained Earnings

Unaudited

	39-week period ended December 29, 2001 $ (thousands)	39-week period ended December 30, 2000 $ (thousands)
Opening balance	**$ (53,666)**	$ 33,129
Net loss for the period	**(19,428)**	(11,496)
Ending balance	**$ (73,094)**	$ 21,633

See accompanying notes

Consolidated Statements of Earnings

Unaudited

	13-week period ended December 29, 2001 $ (thousands)*	13-week period ended December 30, 2000 $ (thousands)*	**39-week period ended December 29, 2001 $ (thousands)***	39-week period ended December 30, 2000 $ (thousands)*
Revenue				
Superstores	**$ 176,142**	$ 139,838	**$ 367,836**	$ 316,112
Traditional bookstores	**72,394**	77,661	**145,501**	156,344
Internet	**10,386**	15,481	**26,618**	40,915
Other	**14,969**	14,570	**25,091**	25,114
	273,891	247,550	**565,046**	538,485
Cost of product, purchasing, selling and administration	**238,967**	220,302	**530,797**	527,137
	34,924	27,248	**34,249**	11,348
Amortization of capital assets	**7,636**	6,836	**22,738**	20,167
Amortization of pre-opening store costs	**58**	157	**443**	832
Amortization of goodwill	**249**	134	**749**	402
Income (loss) before the undernoted items	**26,981**	20,121	**10,319**	(10,053)
Restructuring charges (note 9)	**–**	–	**21,152**	–
Interest on long-term debt and financing charges	**2,246**	978	**5,235**	2,934
Interest on current debt	**1,961**	1,370	**4,626**	3,260
Income (loss) before income tax recovery and non-controlling interest	**22,774**	17,773	**(20,694)**	(16,247)
Income tax expense	**4,102**	11,052	**450**	4,773
Income (loss) before non-controlling interest	**18,672**	6,721	**(21,144)**	(21,020)
Non-controlling interest	**(127)**	(2,275)	**(1,716)**	(9,524)
Net income (loss) for the period	**$ 18,799**	$ 8,996	**$ (19,428)**	$ (11,496)
Basic net income (loss) per common share	**$ 1.41**	$ 0.79	**$ (1.53)**	$ (1.01)
Diluted net income (loss) per common share	**$ 1.27**	$ 0.79	**$ (1.53)**	$ (1.01)
Weighted average common shares outstanding				
Basic	**13,341**	11,375	**12,728**	11,369
Diluted	**15,090**	11,379	**12,728**	11,369

See accompanying notes
*except per share data

Consolidated Statements of Cash Flows

Unaudited

	13-week period ended December 29, 2001 $ (thousands)	13-week period ended December 30, 2000 $ (thousands)	**39-week period ended December 29, 2001 $ (thousands)**	39-week period ended December 30, 2000 $ (thousands)
Cash flows from operating activities				
Net income (loss) for the period	**$ 18,799**	$ 8,996	**$ (19,428)**	$ (11,496)
Add (deduct) items not affecting cash:				
Amortization	**7,943**	7,127	**23,930**	21,401
Future income taxes	**(3,952)**	(3,086)	**–**	(7,269)
Non-controlling interest	**(127)**	(2,275)	**(1,716)**	(9,524)
Accrued benefit obligations	**250**	75	**750**	225
Accrued interest on convertible notes	**504**	–	**852**	–
Financing charges	**350**	–	**467**	–
Write-down of capital assets	**–**	–	**12,297**	–
	23,767	10,837	**17,152**	(6,663)
Net change in non-cash working capital balances related to operations	**70,061**	71,211	**43,885**	56,678
Cash provided by operating activities	**93,828**	82,048	**61,037**	50,015
Cash flows from investing activities				
Decrease in short-term investments	**–**	16,067	**3,850**	
Purchase of capital assets, net	**(2,746)**	(5,011)	**(7,439)**	(18,482)
Cash provided by (used in) investing activities	**(2,746)**	11,056	**(3,589)**	6,518
Cash flows from financing activities				
Decrease in bank indebtedness	**(67,089)**	(79,200)	**(89,752)**	(69,212)
Proceeds on issuance of common shares	**–**	19	**82**	218
Repayment of long-term debt (note 7)	**–**	–	**(54,000)**	–
Proceeds on issuance of long-term debt (note 7)	**–**	–	**104,000**	–
Financing fees	**–**	–	**(3,850)**	–
Cash used in financing activities	**(67,089)**	(79,181)	**(43,520)**	(68,994)
Net increase (decrease) in cash during the period	**23,993**	13,923	**13,928**	(12,461)
Cash, beginning of period	**1,329**	2,551	**11,394**	28,935
Cash, end of period	**$ 25,322**	$ 16,474	**$ 25,322**	$ 16,474

See accompanying notes

Notes to the Interim Consolidated Financial Statements

December 29, 2001
Unaudited

1. DISCLOSURE

These interim financial statements do not contain all disclosures required by Canadian generally accepted accounting principles for annual financial statements and accordingly, the financial statements should be read in conjunction with the most recently prepared annual financial statements for the 52-week period ended March 31, 2001.

2. SEASONALITY OF OPERATIONS

The business of Indigo Books & Music Inc. (the "Company"or "Indigo") follows a seasonal pattern, with sales of merchandise being higher in the third quarter due to consumer holiday buying patterns. As a result, a disproportionate portion of total annual revenues is typically earned in the third quarter. Therefore, the earnings for the 13 weeks ended December 29, 2001 and December 30, 2000 are not indicative of the earnings for the other quarters.

3. ACCOUNTING POLICIES AND ADOPTION OF NEW ACCOUNTING STANDARDS

These interim financial statements follow the same accounting policies and the method of application, thereof, as the most recently prepared annual financial statements for the 52-week period ended March 31, 2001 except as follows:

Adoption of New Accounting Standards

(a) 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 income (loss) per share. Pursuant to the new recommendations, basic income (loss) per share is determined by dividing the net income (loss) attributable to common shareholders by the weighted average number of common shares outstanding during the period. Fully diluted income (loss) per share is 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. Basic earnings per share were not impacted by the change.

Earnings per share for the 13-week period ended December 29, 2001 and December 30, 2000 is summarized as follows:

	13-week period ended December 29, 2001 $ (thousands)*			13-week period ended December 30, 2000 $ (thousands)*		
	Income	**Shares**	**Per share amount**	Income	Shares	Per share amount
Basic earnings per share						
Income available to common shareholders	**$ 18,799**	**13,341**	**$ 1.41**	$ 8,996	11,375	$ 0.79
Effect of dilutive securities						
Employee options	**–**	**–**		–	4	
Convertible debentures	**299**	**1,749**		–	–	
Diluted earnings per share	**$ 19,098**	**15,090**	**$ 1.27**	$ 8,966	11,379	$ 0.79

*except per share amounts

Options to purchase 431,143 common shares were outstanding during the 13 weeks ended December 29, 2001 (December 30, 2001 – 957,355) but were not included in the computation of diluted earnings per share due to the fact that the options' exercise price was greater than the average market price of the common shares during the period.

The impact of the new recommendations was to increase the diluted earnings per share for the 13 weeks ended December 30, 2000 from $0.74 to $0.79.

The adoption of the new recommendations has not impacted the basic and diluted loss per share for the 39-week period ended December 29, 2001 and December 30, 2000 due to its anti-dilutive effect. The weighted average number of shares outstanding used in both basic and diluted loss per share for the 39-week period ended December 29, 2001 was 12,278,000 (December 30, 2000 – 11,369,000). The weighted average number of shares outstanding used in both basic and diluted loss per share for the 52-week period ended March 31, 2001 was 11,527,000.

(b) 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 Company will not be adopting the new recommendations relating to goodwill and other intangible assets until the first quarter of

the 2003 fiscal year. The new recommendations require that, in periods prior to adoption, goodwill and intangible assets with a deemed indefinite life arising from acquisitions completed after June 30, 2001 are not amortized, but tested for impairment annually, or more frequently if changes in circumstances indicate a potential impairment. In accordance with the new recommendations, goodwill arising prior to July 1, 2001 continues to be amortized over its useful life on a straight line basis over a 5 to 10 year period, and goodwill arising from the current year acquisition (note 4) will not be amortized.

(c) Financing Costs

Financing costs are deferred and amortized over the term of the respective indebtedness. The unamortized balance of financing costs is included in deferred charges.

4. ACQUISITION

(a) 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 $4.15 million. 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 has been 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)
Assets	
Current assets	$ 27,483
Capital assets	21,003
Goodwill	46,532
	95,018
Liabilities	
Current liabilities	56,837
Convertible debentures	26,281
	83,118
	11,900
Funded by	
Common shares	4,147
Equity component of convertible debentures	1,903
Transaction costs	5,850
	$ 11,900

The above purchase price allocation is based on estimated fair values of assets and liabilities; thus, the allocation of the purchase price may be subject to refinement. In addition transaction costs are subject to actual receipt and recognition. Transaction costs have been included in accrued liabilities as they remain unpaid as of the end of the period. The $46.5 million of goodwill was assigned to the retail segment and will not be amortized.

(b) Chapters Online Inc.

On October 27, 2001 the Company acquired all of the outstanding shares of Chapters Online Inc. ("Chapters Online") not already owned by the Company. The aggregate purchase price was $5.5 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 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.

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)
Assets	
Current assets	$ 1,190
Capital assets	1,784
Goodwill	5,250
	8,224
Liabilities	
Current liabilities	2,685
	5,539
Funded by	
Common shares	4,539
Transaction costs	1,000
	$ 5,539

The above purchase price allocation is based on estimated fair values of assets and liabilities; thus, the allocation of the purchase price may be subject to refinement. In addition transaction costs are subject to actual receipt and recognition. Transaction costs have been included in accrued liabilities as they remain unpaid as of the end of the period. The $5.3 million of goodwill was assigned to the Chapters Online segment and will not be amortized.

5. SEGMENTED INFORMATION

The Company has two reportable segments. The two segments consist of Indigo Retail, which operates a chain of retail bookstores across Canada and Chapters Online, an e-commerce retailer selling books and other products.

	13-week period ended December 29, 2001		
	Retail $ (thousands)	Online $ (thousands)	Total $ (thousands)
Segment income (loss)			
Revenue	$ 263,505	$ 10,386	$ 273,891
Earnings (loss) before interest, income taxes, amortization and non-controlling interest	34,995	(71)	34,924
Amortization	6,635	1,308	7,943
Interest expense (income) and financing fees	4,209	(2)	4,207
Segment income (loss) before income taxes and non-controlling interest	24,151	(1,377)	22,774
Segment income (loss) before non-controlling interest	$ 20,049	$ (1,377)	$ 18,672
Reconciliation of segment income			
Segment income (loss) before non-controlling interest			18,672
Non-controlling interest			127
Net income			$ 18,799

	13-week period ended December 30, 2000		
	Retail $ (thousands)	Online $ (thousands)	Total $ (thousands)
Segment income (loss)			
Revenue	$ 232,069	$ 15,481	$ 247,550
Earnings (loss) before interest, income taxes, amortization and non-controlling interest	33,264	(6,016)	27,248
Amortization	6,100	1,027	7,127
Interest expense (income) and financing fees	2,550	(202)	2,348
Segment income (loss) before income taxes and non-controlling interest	24,614	(6,841)	17,773
Segment income (loss) before non-controlling interest	$ 13,987	$ (7,266)	$ 6,721
Reconciliation of segment income			
Segment income (loss) before non-controlling interest			6,721
Non-controlling interest			2,275
Net income			$ 8,996

	39-week period ended December 29, 2001		
	Retail	Online	Total
	$ (thousands)	$ (thousands)	$ (thousands)
Segment income (loss)			
Revenue	$ 538,428	$ 26,618	$ 565,046
Earnings (loss) before interest, income taxes, amortization, restructuring charges and non-controlling interest	37,021	(2,772)	34,249
Amortization	20,007	3,923	23,930
Interest expense (income) and financing fees	9,953	(92)	9,861
Segment income (loss) before income taxes, restructuring charges and non-controlling interest	7,061	(6,603)	458
Segment income (loss) before restructuring charges and non-controlling interest	$ 6,611	$ (6,603)	$ 8
Reconciliation of segment loss			
Segment income (loss) before restructuring charges and non-controlling interest			8
Restructuring charges			(21,152)
Non-controlling interest			1,716
Net loss			$ (19,428)
Segment assets			
Segment goodwill	$ 54,081	$ 5,250	$ 59,331
Segment total assets	522,240	8,323	530,563
Goodwill on business combination	45,532	5,250	51,782
Capital expenditures, net	7,468	(29)	7,439
Reconciliation of segment assets			
Segment total assets			530,563
Intercompany receivables and investment in Chapters Online			(3,495)
			$ 527,068

	39-week period ended December 30, 2000		
	Retail	Online	Total
	$ (thousands)	$ (thousands)	$ (thousands)
Segment income (loss)			
Revenue	$ 497,570	$ 40,915	$ 538,485
Earnings (loss) before interest, income taxes, amortization, restructuring charges and non-controlling interest	35,397	(24,049)	11,348
Amortization	18,393	3,008	21,401
Interest expense (income) and financing fees	7,256	(1,062)	6,194
Segment income (loss) before income taxes and non-controlling interest	9,748	(25,995)	(16,247)
Segment income (loss) before non-controlling interest	$ 5,400	$ (26,420)	$ (21,020)
Reconciliation of segment loss			
Segment income (loss) before non-controlling interest			(21,020)
Non-controlling interest			9,524
Net loss			$ (11,496)
Segment assets			
Segment goodwill	$ 988	$ 304	$ 1,292
Segment total assets	459,579	30,390	489,969
Capital expenditures, net	16,324	2,158	18,482
Reconciliation of segment assets			
Segment total assets			489,969
Intercompany receivables and investment in Chapters Online			(603)
			$ 489,366

6. SHARE CAPITAL

Outstanding share data as at December 29, 2001

13,571,925 common shares issued and outstanding (12,822,000 as at September 29, 2001; 12,281,000 as at March 31, 2001)

Employees' Stock Plan (Options and Share Grants)

431,143 options outstanding, of which 262,285 are exercisable under the Plan (642,983 options outstanding, 510,756 exercisable, as at September 29, 2001; 764,179 options outstanding, 530,679 exercisable, as at March 31, 2001).

7. BANK INDEBTEDNESS AND LONG-TERM DEBT

During the second quarter of fiscal 2002 the Company re-negotiated its credit agreement with its bank and repaid the $54 million in Senior Secured Notes.

The amended and restated credit agreement provides for:

(i) Revolving line of credit of up to $75 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 credit shall be repaid in full and cancelled on May 31, 2004. As at December 29, 2001 the Company has outstanding letters of credit totaling $1,969,000 (March 31, 2001 – $984,000).

(ii) Long-term debt of $50 million bearing interest at the same rates as the revolving line of credit. The facility is to be repaid as follows: $14 million on December 31, 2002, $14 million on December 31, 2003 and $22 million on May 31, 2004.

(iii) Long-term debt of $54 million bearing interest at the bank's prime rate plus 4.5% per annum. The facility is to be repaid as follows: $20 million was paid on December 31, 2001, $17 million on December 31, 2002 and $17 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.

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 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 million is 5.02% and 5.19% on the remaining notional amount of $50 million. The contracts expire on December 31, 2003 and April 30, 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 million. The fixed interest rate is 3.14% and the contracts expire on December 1, 2003. The Company has 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.

8. CONVERTIBLE DEBENTURE

Upon acquisition of Old Indigo by the Company, the Old Indigo Series I and II subordinated convertible notes in the amount of $10 million and $20 million became convertible into common shares of the Company at conversion price and for a number of shares 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 4). 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.

9. RESTRUCTURING CHARGES

Restructuring charges for the 39-week period ended December 29, 2001 consist of the following:

	$ (thousands)
Write-down of capital assets	$ 12,297
Provision for store closing and other costs	4,497
Relocation and other costs as a result of the acquisition	1,691
Finance fee	2,667
	$ 21,152

The finance fee relates to a payment made by the company to the previous Senior Secured Note holders in order to repay the debt before maturity, as part of the refinancing arrangements undertaken by the Company. The entire amount has been paid as of the end of the third quarter of fiscal 2002 and no further costs relating to the refinancing will be incurred.

It is anticipated that further store closures will occur and other costs related to the acquisition will be incurred, however, such costs cannot be estimated at this time. The estimates relating to the home office relocation costs are preliminary and are subject to refinement in the remainder of the fiscal year.

10. FINANCIAL INSTRUMENTS

The fair value of financial instruments are 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, bank indebtedness, accounts payable and accrued liabilities approximate their carrying values given their short-term maturities.

The fair values 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 $26.3 million as at December 29, 2001.

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 December 29, 2001 was $2.9 million in favour of counterparties.

11. SUBSEQUENT EVENTS

(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 and resulted in net proceeds of approximately $10.0 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) Pursuant to a Consent Order issued by the Commissioner of Competition regarding the merger of the Company and Old Indigo, the Company agreed to offer for sale 13 superstores and 10 traditional stores. No divestitures were completed by Indigo or by the trustee appointed pursuant to the Consent Order to effect the sale of the relevant assets. As a result, the relevant assets have reverted to Indigo.

(iii) On January 25, 2002 the Company's Board of Directors approved an offering of subscription rights to the Company's existing common shareholders. Shareholders will receive one right for each common share held by them. Four rights will entitle the holder thereof to one common share of the Company at an exercise price of $3.50 per share. Net proceeds, assuming exercise of 100% of the rights, are expected to be approximately $14.6 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. The Company expects that the proposed rights offering will be completed shortly after the end of the company's current fiscal year ending March 30, 2002. The offering is subject to necessary securities, regulatory and Toronto Stock Exchange approvals.

12. CONSOLIDATED STATEMENTS OF CASH FLOWS

Supplemental cash flow information

	13-week period ended December 29, 2001 $ (thousands)	13-week period ended December 30, 2000 $ (thousands)	**39-week period ended December 29, 2001 $ (thousands)**	39-week period ended December 30, 2000 $ (thousands)
Interest paid	**3,632**	2,270	**8,856**	7,606
Income taxes paid	**24**	159	**24**	159

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