SECOND QUARTER REPORT

FOR THE 13-WEEK PERIOD ENDED SEPTEMBER 30, 2006

Perseverance can unleash potentially endless value.

Indigo

Books & Music Inc.

www.indigo.ca

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Management's Discussion and Analysis

The following discussion and analysis for the second quarter of fiscal 2007 is prepared as at November 2, 2006 and is based primarily on the unaudited interim consolidated financial statements of Indigo Books & Music Inc. (the "Company" or "Indigo") for the 13-week periods ended September 30, 2006 and October 1, 2005. It should be read in conjunction with the unaudited interim consolidated financial statements and notes contained in this Quarterly Report, the audited annual consolidated financial statements and accompanying notes for the year ended April 1, 2006, and the Management's Discussion and Analysis ("MD&A") included in the Company's fiscal 2006 Annual Report. The Annual Report and additional information about the Company, including the Annual Information Form, can be found on SEDAR at www.sedar.com.

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.

Overview

Indigo is the nation's largest book retailer, operating stores in all 10 provinces and one territory in Canada and offering online sales through its *www.chapters.indigo.ca* web site. As at September 30, 2006, the Company operated 86 superstores under the banners *Chapters*, *Indigo* and the *World's Biggest Bookstore*, and 159 small format stores, under the banners *Coles*, *Indigo*, *Indigospirit*, *SmithBooks* and *The Book Company*. During the second quarter of fiscal 2007, the Company closed one small format store. The Company also has a 50% interest in Calendar Club of Canada Limited Partnership, which operates seasonal kiosks and year-round stores in shopping malls across Canada.

In October 2005, Indigo incorporated a separate registered charity under the name Indigo Love of Reading Fund (the "Fund"). The Fund provides new books and learning materials to high-needs elementary schools across the country through donations from Indigo, its customers, suppliers and employees.

As at November 2, 2006, the number of common shares outstanding was 24,376,218 with a book value of $195.8 million. The number of common shares reserved for issuance under the employee stock option plan is 2,157,232. As at September 30, 2006, there were 1,705,101 stock options outstanding with 691,327 of them exercisable.

Results of Operations

Revenue Decline Attributed to Lack of Blockbuster Titles

Total consolidated revenues for the 13-week period ended September 30, 2006 decreased $4.5 million or 2.4% to $182.2 million from $186.7 million for the period ended October 1, 2005. For the quarter, comparable store sales showed a decrease of 1.2% in superstores and a 3.0% decrease in small format stores. The Company operated four fewer small format stores compared to the same period last year. Online sales decreased 9.8% to $17.5 million compared to $19.4 million last year. Revenues from other sources increased 7.0% to $4.6 million, due to the continued growth in sales of the Company's loyalty card program.

The decline in revenues was largely due to two factors. The largest factor was the July 2005 release of *Harry Potter and the Half-Blood Prince* which boosted sales in the year ago period. There was no blockbuster title of this nature released during the current quarter. In July 2006, the Company implemented a new warehouse management application system to manage the flow of goods through its centralized distribution centre. As a result of this implementation, certain stores experienced delays in receiving stock during the quarter which also reduced sales.

Excluding sales from *Harry Potter*, comparable store sales were up 1.5% in superstores, 1.0% in small format stores and online sales were up 11.5% over the same quarter last year.

On a year-to-date basis, total consolidated revenues increased $1.7 million or 0.5%, from $350.8 million last year to $352.6 million this year. Year-to-date comparable store sales, excluding sales from *Harry Potter*, were up 2.9% for superstores and 2.7% for small format stores.

Revenues by channel are highlighted below:

(millions of dollars)	**13-week period ended September 30, 2006**	13-week period ended October 1, 2005	% increase	Comparable store sales % increase	Comparable store sales % increase (normalized for *Harry Potter*)
Superstores	**128.5**	129.0	(0.4)	(1.2)	1.5
Small format stores	**31.6**	34.0	(7.1)	(3.0)	1.0
Online (including store kiosks)	**17.5**	19.4	(9.8)	N/A	N/A
Other	**4.6**	4.3	7.0	N/A	N/A
	182.2	186.7	(2.4)	(1.6)	1.4

Comparable store sales are defined as sales generated by stores that have been open for more than 12 months. It is a key performance indicator for the Company as this measure excludes sales fluctuations due to store closings, permanent relocation and chain expansion. A reconciliation between total revenues and comparable store sales is provided below:

	Superstores		Small format stores	
(millions of dollars)	**13-week period ended September 30, 2006**	13-week period ended October 1, 2005	**13-week period ended September 30, 2006**	13-week period ended October 1, 2005
Total revenues	**128.5**	129.0	**31.6**	34.0
Adjustments for stores not in both fiscal periods	**(3.6)**	(2.6)	**(1.3)**	(2.7)
Comparable store sales	**124.9**	126.4	**30.3**	31.3
Harry Potter comparable sales	**–**	(3.3)	**–**	(1.2)
Comparable store sales (excluding *Harry Potter*)	**124.9**	123.1	**30.3**	30.0

Operating Costs Lower than Last Year

Operating costs (including cost of product, purchasing, selling and administration expenses) as a percent of sales decreased 0.9% to 95.7% this quarter from 96.6% in the same quarter last year. The majority of this reduction was driven by more efficient use of the Company's distribution centre which resulted in improvement in cost of goods sold in the period when the products were sold. The Company receives better pricing on products that are received centrally into its distribution centre than it does on products that are shipped directly to its stores.

Due to the implementation of the new warehouse management application system, the Company has taken steps to reduce the flow of goods through the distribution centre by routing more goods direct to the stores for the holiday season. This may negatively impact the Company's overall margin during the third quarter. Additionally, the Company is delaying the processing of some returns until the fourth quarter which has resulted in higher inventory and accounts payable levels in the current quarter. This delay is anticipated to have the same impact on inventory and accounts payable levels in the third quarter.

Selling and administration expense as a percent of sales was unchanged compared to the same period last year. As a result of an internal lease audit, the Company received a $1.6 million property tax settlement from a landlord during the current quarter. This was offset by increased store labour, selling and administrative expenses and the expenses associated with the new warehouse management system implementation mentioned above.

On a year-to-date basis, operating costs as a percent of sales declined 1.1% from 98.2% last year to 97.1% this year. Overall operating costs decreased $2.0 million to $342.4 million this year from $344.4 million last year.

Operating Earnings Improved Versus Last Year

Operating earnings, defined as revenues less cost of product, purchasing, selling and administration, were $7.8 million for the 13-week period ended September 30, 2006, a $1.4 million improvement over $6.4 million recorded for the same period last year. Year-to-date, operating earnings improved $3.8 million from $6.4 million last year to $10.2 million this year.

Increased Amortization Costs due to Ongoing Capital Improvements

Amortization for the 13-week period ended September 30, 2006 increased $1.0 million to $7.8 million, compared to $6.8 million for the 13-week period ended October 1, 2005. On a year-to-date basis, amortization increased by $1.5 million to $15.2 million compared to $13.7 million last year. Capital expenditures in the current quarter totalled $6.1 million, and included $2.3 million in store construction, renovations and store equipment, and $3.8 million in technology-related projects. Of the $6.1 million in capital expenditures, $0.7 million was financed through capital leases. Year-to-date in fiscal 2007, the Company spent $11.1 million on capital expenditures including $3.2 million in store construction and $7.9 million in technology-related projects.

Interest Expense Continued to Decline

Interest expense decreased $0.3 million to $0.9 million from $1.2 million in the same quarter last year. The decline was due to the ongoing reduction in total debt outstanding for the Company. On a year-to-date basis, interest expense decreased $0.6 million to $1.8 million this year from $2.4 million last year.

Fiscal 2006 Fourth Quarter Income Taxes Recovered

The federal budget passed in June of 2006 eliminated the federal Large Corporation Tax retroactively back to January 1, 2006. The Company had recognized $0.1 million in large corporation tax expense payable during its fourth quarter of fiscal 2006. As a result of the elimination of this tax in June 2006, the Company reversed the $0.1 million outstanding tax payable and recognized this $0.1 million into income during the first quarter.

Fiscal 2006 Non-Cash Adjustment to Restructuring Provision in Second Quarter

During the second quarter of fiscal 2006, the Company sublet part of an overlapping store that was previously identified for closure under its restructuring provision. Upon completion of the sublet transaction during the second quarter last year, the Company reduced its restructuring provision and recognized $2.8 million into income. There was no recovery of restructuring costs in the current fiscal quarter.

Net Loss Recorded for the Current Fiscal Quarter

Net loss for the second quarter was $1.0 million or $0.04 net loss per common share, compared to net earnings of $1.1 million or $0.04 net earnings per common share last year. The decline in net earnings was primarily due to the recovery of restructuring costs last year and the increase in amortization expense in the current year, as noted above. Year-to-date, net loss improved $0.2 million to $6.8 million this year from $7.0 million last year.

Seasonality and Second Quarter Results

Indigo's business is highly seasonal and follows quarterly sales and profit (loss) fluctuation patterns, which are similar to those of other retailers that are highly dependent on the December holiday sales season. A disproportionate amount of revenues and profits are earned in the third quarter. As a result, quarterly performance is not necessarily indicative of the Company's performance for the rest of the year. The following table sets out revenues, net earnings (loss), and basic and diluted earnings (loss) per share for the preceding eight fiscal quarters.

	Fiscal quarters							
(thousands of dollars, except per share data)	**Q2 Fiscal 2007**	Q1 Fiscal 2007	Q4 Fiscal 2006	Q3 Fiscal 2006	Q2 Fiscal 2006	Q1 Fiscal 2006	Q4 Fiscal 2005	Q3 Fiscal 2005
Revenues	**182,205**	170,351	189,263	309,518	186,657	164,178	176,533	286,585
Net earnings (loss)	**(976)**	(5,791)	(7,415)	39,761	1,081	(8,090)	(3,865)	34,332
Basic earnings (loss) per share	**$(0.04)**	$(0.24)	$(0.31)	$1.65	$0.04	$(0.34)	$(0.16)	$1.43
Diluted earnings (loss) per share	**$(0.04)**	$(0.24)	$(0.31)	$1.61	$0.04	$(0.34)	$(0.16)	$1.42

Overview of Consolidated Balance Sheets

Total Assets

Total assets at September 30, 2006 increased by $7.6 million compared to total assets at October 1, 2005. The increase in assets was primarily due to higher inventories of $11.5 million. Inventories increased due to the new warehouse management system implementation described above and earlier receipts of Calendar Club products compared to the same period last year. The increase in total assets was partially offset by lower net capital assets of $1.9 million and lower accounts receivable of $1.0 million. The decline in capital assets was partially due to the net closure of four small format stores over the past 12 months.

Other changes in total assets included an $8.2 million decrease in goodwill, which was offset by an $8.2 million increase in future tax assets due to the increased likelihood of utilizing the tax loss carryforwards. During the business combination in fiscal 2002, the Company did not recognize the acquired tax loss carryforwards as future tax assets as it was not certain the Company could use the losses. As the Company used a portion of the acquired unused tax losses in fiscal 2006, the $8.2 million tax benefit associated with the use of these losses was applied to reduce goodwill.

On a fiscal year-to-date basis, total assets increased $22.6 million compared to April 1, 2006. The increase in total assets was primarily due to an increase in inventories and partially offset by decreases in net capital assets and prepaid expenses. Year-to-date inventories increased $31.1 million in preparation for the third quarter holiday season and the delay in processing some returns, as noted above. Year-to-date, net capital assets decreased $4.2 million due to the net closure of five small format stores since the beginning of the current fiscal year. Prepaid expenses decreased $4.7 million year-to-date, as the Company had prepaid some occupancy expenses for April 2006 at year end.

Total Liabilities

Total liabilities at September 30, 2006 were $20.2 million lower than total liabilities at October 1, 2005, a continued improvement over last year. This was primarily due to a $38.2 million reduction in total debt (including bank indebtedness and long-term debt), which was partially offset by a $15.6 million increase in accounts payable and accrued liabilities. The reduction in total debt was attributable to the $12.0 million principal repayment the Company made on its existing long-term debt in December 2005 and a $32.2 million reduction in the balance outstanding on its operating line at quarter end. The two remaining payments on the Company's outstanding bank term-debt are due in December 2006 and July 2007. The July 2007 payment was reclassified from long-term debt to current portion of long-term debt during the quarter which is reflected in the $14.0 million increase in the current portion of long-term debt over the same period last year. Accounts payable and accrued liabilities increased $15.6 million compared to last fiscal year to finance the increased investment in inventories, and to account for strong gift card sales which are recorded as liabilities until they are redeemed.

On a year-to-date basis, total liabilities increased $28.1 million compared to April 1, 2006, as the Company used its short-term operating line of credit and accounts payable to finance higher inventories as noted above. Bank indebtedness and accounts payable and accrued liabilities increased $25.7 million year-to-date. Long-term accrued liabilities decreased $3.7 million as a result of amortization of the deferred rent liability.

Shareholders' Equity

Shareholders' equity at September 30, 2006 improved by $27.8 million compared to October 1, 2005, primarily due to net earnings of $25.6 million in the last four quarters. Share capital increased $1.5 million due to the exercise of employee stock options. Contributed surplus increased by $0.9 million due to the expensing of employee stock options and directors' deferred stock units, and was offset by a $0.2 million reduction due to the exercise of employee stock options. Year-to-date, $0.3 million was recorded for stock option expenses and $0.2 million was recorded for directors' deferred stock units.

Working Capital and Leverage

The Company historically has been in a negative working capital position at the end of the second quarter as it relies on a short-term operating line of credit and accounts payable as two of the primary vehicles to fund the business. Working capital improved from negative $22.6 million at the end of the second quarter last year, to negative $16.9 million at the end of the current quarter. Working capital was positive at $0.3 million at the end of the last fiscal year.

The Company's leverage position (defined as Total Liabilities to Total Shareholders' Equity) improved to 2.8:1 at the end of the current quarter from 3.9:1 last year due to the reduction in total debt and the increase in shareholders' equity, as described above. Consistent with the seasonality of the Company's operating results, the leverage position has weakened from 2.4:1 at April 1, 2006 due to the year-to-date net loss and the increase in total liabilities.

Overview of Consolidated Statements of Cash Flows

Cash and cash equivalents increased $0.2 million during the second quarter of fiscal 2007, compared to a decrease of $0.8 million last year. Year-to-date, cash and cash equivalents increased $0.2 million.

Cash Flows Used in Operating Activities

The Company used cash flow of $0.7 million in the second quarter towards operations. The primary uses of cash during the current quarter were a net loss of $1.0 million and a $28.9 million increased investment in inventories. The primary sources of cash were a growth in outstanding accounts payable and accrued liabilities of $18.3 million to finance the increased inventories, a $2.8 million reduction in prepaid expenses, and amortization of $7.8 million.

In the second quarter of last year, the Company generated $3.3 million in cash flow from operations. The primary sources of cash were net earnings of $1.1 million, an increase in accounts payable and accrued liabilities of $6.2 million and amortization of $6.8 million. The primary use of cash was an increased investment in inventories of $12.1 million, which is normal for this time of year in anticipation of the December holiday season.

On a year-to-date basis, the Company used $13.1 million in cash flow towards operations. The primary uses of cash were net loss of $6.8 million and an increased investment in inventories of $31.1 million. The primary sources of cash were amortization of $15.2 million, a reduction in prepaid expenses of $4.6 million and growth in accounts payable and accrued liabilities of $3.2 million.

For the 26-week period ended October 1, 2005, the Company used $10.9 million in cash flow towards operations. The primary uses of cash were the year-to-date net loss of $7.0 million and a $26.6 million increased investment in inventories. The primary sources of cash were amortization of $13.7 million, a $3.0 million reduction in accounts receivable and increased accounts payable and accrued liabilities of $5.8 million.

Cash Flows Used in Investing Activities

In the second quarter, net cash flows used in investing activities were $5.4 million compared to $4.1 million in the same quarter last year. During the current quarter, the Company spent $5.4 million on capital projects including $2.3 million in store renovations and equipment and $3.1 million in technology-related projects.

During the same quarter last year, the Company spent $4.1 million on capital projects including $1.3 million for store renovations and equipment and $2.8 million for technology-related projects.

On a year-to-date basis, net cash flows used in investing activities were $8.3 million compared to $5.8 million last year. Capital expenditures included $3.2 million in store renovations and equipment and $5.1 million in technology-related projects.

For the 26-week period ended October 1, 2005, the Company used cash flows of $5.8 million in investing activities. Capital expenditures during the first half of fiscal 2006 included $2.0 million in store renovations and equipment and $3.8 million in technology-related projects.

Cash Flows Provided by Financing Activities

In the second quarter, the Company generated $6.3 million in cash flow towards financing activities. The $6.4 million in cash received from short-term borrowings and $0.7 million in cash generated from share issuance was partially offset by the $0.8 million used to reduce outstanding term debt. In the same period last year, the Company used $0.5 million in cash flow to repay long-term debt and generated $0.5 million in cash from short-term borrowings and share issuances.

On a year-to-date basis, net cash flows generated from financing activities were $21.6 million compared to $13.6 million last year. The primary source of cash flow came from increased borrowings under the operating line which was used to fund the investment in inventory in advance of the December holiday season.

Liquidity and Capital Resources

The Company has a highly seasonal business which generates the majority of its revenues and cash flows during the December holiday season. Indigo has minimal accounts receivable, as its customers pay largely by cash or credit card, and it purchases products on trade terms with the right to return a significant portion of its products. As a result, the Company historically has been a net borrower in the first, second and fourth quarters, and has repaid all of its outstanding debt owing on its credit line during the third quarter.

Indigo's main sources of capital are cash flow generated from operations, a revolving line of credit and long-term debt. Based on current operating levels, management expects cash flow generated from operations along with the available borrowing capacity under the Company's credit facility to be sufficient to meet its working capital needs and debt service requirement for the current fiscal year. Indigo also has the ability to reduce capital spending to fund debt requirements if necessary, however, a long-term decline in capital expenditures may negatively impact revenue and profit growth.

Accounting Policies

Critical Accounting Estimates

The discussion and analysis of Indigo's operations and financial condition are based upon the unaudited interim consolidated financial statements, which have been prepared in accordance with Canadian generally accepted accounting principles. The preparation of these consolidated financial statements requires the Company to estimate the effect of several variables that are inherently uncertain. These estimates and assumptions can affect the reported amounts of assets, liabilities, revenues and expenses. Indigo bases its estimates on historical experience and other assumptions which the Company believes to be reasonable under the circumstances. The Company also evaluates its estimates on an ongoing basis. The significant accounting policies of the Company are described in Note 2 to the consolidated financial statements in the fiscal 2006 Annual Report, and the Company's critical accounting estimates are disclosed in the MD&A section of its fiscal 2006 Annual Report.

In the second quarter of fiscal 2007, there were no significant changes to the inventory obsolescence provision and the method of determination is consistent with that used in previous periods. There were also no material changes to the provision for future tax assets, gift cards, and restructuring costs. The Company continually monitors the redemption patterns on its outstanding gift cards. During the quarter, the Company reduced the breakage rate assumption (% of cards that will not be redeemed) based on recent redemption pattern experienced up to the end of the second quarter. This change in assumption did not have a material impact on the recorded liability for unredeemed gift cards.

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 2006 Annual Report.

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.

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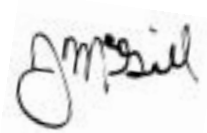
NOTICE OF NO AUDITOR REVIEW OF INTERIM FINANCIAL STATEMENTS

Under National Instrument 51-102, Part 4, subsection 4.3(3)(a), if an auditor has not performed a review of the interim financial statements, they must be accompanied by a notice indicating that the financial statements have not been reviewed by an auditor.

The accompanying unaudited interim financial statements of the Company have been prepared by and are the responsibility of the Company's management.

The Company's independent auditor has not performed a review of these financial statements.

Heather Reisman
Chair & Chief Executive Officer



Jim McGill
Chief Financial Officer

Dated as of the 2nd day of November, 2006.

Consolidated Balance Sheets

(Unaudited)

(thousands of dollars)	**As at September 30, 2006**	As at October 1, 2005	As at April 1, 2006
ASSETS			
Current			
Cash and cash equivalents	**6,177**	7,013	5,983
Accounts receivable	**5,891**	6,863	5,937
Inventories	**245,740**	234,201	214,598
Income taxes recoverable	**444**	340	156
Prepaid expenses	**4,594**	4,723	9,301
Future tax assets	**9,014**	10,723	9,014
Total current assets	**271,860**	263,863	244,989
Capital assets, net	**81,803**	83,694	85,959
Future tax assets	**19,750**	9,807	19,750
Goodwill	**39,999**	48,233	39,999
Deferred financing charges, net of accumulated amortization of $761 (October 1, 2005 – $496; April 1, 2006 – $606)	**251**	516	406
Total assets	**413,663**	406,113	391,103
LIABILITIES AND SHAREHOLDERS' EQUITY			
Current			
Bank indebtedness	**35,176**	67,328	12,728
Accounts payable and accrued liabilities	**215,540**	197,401	208,590
Deferred revenue	**10,392**	8,057	9,032
Current portion of long-term debt	**27,674**	13,657	14,300
Total current liabilities	**288,782**	286,443	244,650
Long-term accrued liabilities	**9,139**	11,665	12,859
Long-term debt	**5,655**	25,699	17,938
Total liabilities	**303,576**	323,807	275,447
Shareholders' equity			
Share capital (note 5)	**195,775**	194,245	194,861
Contributed surplus (notes 5 and 6)	**1,620**	948	1,336
Deficit	**(87,308)**	(112,887)	(80,541)
Total shareholders' equity	**110,087**	82,306	115,656
Total liabilities and shareholders' equity	**413,663**	406,113	391,103

See accompanying notes

Consolidated Statements of Earnings (Loss)

(Unaudited)

(thousands of dollars, except per share data)	**13-week period ended September 30, 2006**	13-week period ended October 1, 2005	**26-week period ended September 30, 2006**	26-week period ended October 1, 2005
Revenues	**182,205**	186,657	**352,556**	350,835
Cost of product, purchasing, selling and administration	**174,444**	180,241	**342,391**	344,412
	7,761	6,416	**10,165**	6,423
Amortization of capital assets	**7,751**	6,849	**15,140**	13,659
Amortization of pre-opening store costs	**49**	–	**100**	–
	7,800	6,849	**15,240**	13,659
Loss before the undernoted items	**(39)**	(433)	**(5,075)**	(7,236)
Recovery of restructuring costs (note 8)	**–**	(2,759)	**–**	(2,759)
Interest on long-term debt and financing charges	**141**	350	**400**	697
Interest on bank indebtedness	**796**	805	**1,382**	1,655
Earnings (loss) before income taxes	**(976)**	1,171	**(6,857)**	(6,829)
Income tax expense	**–**	90	**(90)**	180
Net earnings (loss) for the period	**(976)**	1,081	**(6,767)**	(7,009)
Net earnings (loss) per common share (note 4)				
Basic	**$(0.04)**	$0.04	**$(0.28)**	$(0.29)
Diluted	**$(0.04)**	$0.04	**$(0.28)**	$(0.29)
Weighted average number of common shares outstanding	**24,279**	24,121	**24,255**	24,103

See accompanying notes

Consolidated Statements of Deficit

(Unaudited)

(thousands of dollars)	**26-week period ended September 30, 2006**	26-week period ended October 1, 2005
Deficit, beginning of period	**(80,541)**	(105,878)
Net loss for the period	**(6,767)**	(7,009)
Deficit, end of period	**(87,308)**	(112,887)

Consolidated Statements of Cash Flows

(Unaudited)

(thousands of dollars)	**13-week period ended September 30, 2006**	13-week period ended October 1, 2005	**26-week period ended September 30, 2006**	26-week period ended October 1, 2005
CASH FLOWS FROM OPERATING ACTIVITIES				
Net earnings (loss) for the period	**(976)**	1,081	**(6,767)**	(7,009)
Add (deduct) items not affecting cash				
Amortization	**7,800**	6,849	**15,240**	13,659
Benefit plan credits	**–**	–	**–**	(376)
Stock-based compensation (note 6)	**143**	67	**278**	128
Directors' compensation (note 5)	**75**	66	**151**	135
Loss on disposal of capital assets	**12**	23	**21**	23
Amortization of deferred financing charges	**78**	78	**155**	156
Net change in non-cash working capital balances related to operations				
Accounts receivable	**(519)**	659	**46**	3,016
Inventories	**(28,924)**	(12,141)	**(31,142)**	(26,558)
Prepaid expenses	**2,780**	156	**4,607**	(427)
Income taxes recoverable	**(198)**	25	**(288)**	115
Deferred revenue	**742**	234	**1,360**	426
Accounts payable and accrued liabilities	**18,298**	6,225	**3,230**	5,818
Cash flows provided by (used in) operating activities	**(689)**	3,322	**(13,109)**	(10,894)
CASH FLOWS FROM INVESTING ACTIVITIES				
Purchase of capital assets	**(5,412)**	(4,142)	**(8,337)**	(5,794)
Proceeds from sale of capital assets	**2**	–	**59**	–
Cash flows used in investing activities	**(5,410)**	(4,142)	**(8,278)**	(5,794)
CASH FLOWS FROM FINANCING ACTIVITIES				
Increase in bank indebtedness	**6,418**	351	**22,448**	14,360
Repayment of long-term debt	**(820)**	(486)	**(1,636)**	(943)
Proceeds from share issuance (note 5)	**674**	134	**769**	184
Cash flows provided by (used in) financing activities	**6,272**	(1)	**21,581**	13,601
Net increase (decrease) in cash and cash equivalents during the period	**173**	(821)	**194**	(3,087)
Cash and cash equivalents, beginning of period	**6,004**	7,834	**5,983**	10,100
Cash and cash equivalents, end of period	**6,177**	7,013	**6,177**	7,013

See accompanying notes

Notes to the Interim Consolidated Financial Statements

September 30, 2006

(Unaudited)

1. DISCLOSURE

These unaudited interim consolidated financial statements do not contain all disclosures required by Canadian generally accepted accounting principles for audited annual consolidated financial statements and accordingly, these financial statements should be read in conjunction with the most recently prepared audited annual consolidated financial statements for the 52-week period ended April 1, 2006. Results of operations for the 13 and 26-week periods ended September 30, 2006 and October 1, 2005 and the balances at these dates are unaudited.

2. SEASONALITY OF OPERATIONS

The business of Indigo Books & Music Inc. (the "Company" or "Indigo") follows a seasonal pattern, with sales of merchandise being highest in the third fiscal quarter due to consumer holiday buying patterns. As a result, a disproportionate portion of total annual revenues are typically earned in the third fiscal quarter. Therefore, the results of operations for the 13 and 26-week periods ended September 30, 2006 and October 1, 2005 are not indicative of the results of other periods.

3. ACCOUNTING POLICIES

These financial statements follow the same accounting policies and methods of their application as the most recent annual audited financial statements for the 52-week period ended April 1, 2006.

4. EARNINGS (LOSS) PER SHARE

Earnings (loss) per share is calculated based on the weighted average number of common shares outstanding during the period. In calculating diluted earnings per share amounts under the treasury stock method, the numerator remains unchanged from the basic earnings per share calculations as the assumed exercise of the Company's stock options do not result in an adjustment to earnings.

The Company's stock options were anti-dilutive for the 13-week period ended September 30, 2006 and for the 26-week periods ended September 30, 2006 and October 1, 2005 as the Company recorded net losses in these periods.

For this reason, the stock options were not included in the diluted loss per share calculations.

The reconciliation of the denominator in calculating diluted earnings per share amount for the 13-week period ended October 1, 2005 is as follows:

(in thousands)	13-week period ended October 1, 2005
Weighted average number of common shares outstanding, basic	24,121
Effect of dilutive securities	
– Stock options	426
Weighted average number of common shares outstanding, diluted	24,547

5. SHARE CAPITAL

Share capital consists of the following:

	26-week period ended September 30, 2006		26-week period ended October 1, 2005		52-week period ended April 1, 2006	
	Number of shares	**Amount $ (thousands)**	Number of shares	Amount $ (thousands)	Number of shares	Amount $ (thousands)
Balance, beginning of period	**24,225,918**	**194,861**	24,081,352	193,974	24,081,352	193,974
Issued during the period						
Directors' deferred stock units converted	–	–	18,066	87	18,066	87
Options exercised	**148,300**	**914**	32,600	184	126,500	800
Balance, end of period	**24,374,218**	**195,775**	24,132,018	194,245	24,225,918	194,861

On October 31, 2002, the Company established a Directors' Deferred Stock Unit Plan. Under the Plan, Directors receive their annual retainer fees and other Board-related compensation in the form of deferred stock units ("DSUs"). The Company issued 4,366 DSUs with a value of $0.1 million during the 13-week period ended September 30, 2006. The value of the outstanding DSUs as at September 30, 2006 was $0.8 million and was recorded in contributed surplus.

During the second quarter of fiscal 2006, the Company issued 18,066 shares in exchange for Directors' DSUs when a Board member retired.

6. STOCK-BASED COMPENSATION

As at September 30, 2006, 1,705,101 stock options were outstanding with exercise prices ranging from $4.29 to $63.53. Of these outstanding stock options, 691,327 were exercisable. As at October 1, 2005, there were 1,790,483 options outstanding of which 506,921 were exercisable.

Effective March 30, 2003, the Company elected to adopt the new recommendations issued by the Canadian Institute of Chartered Accountants ("CICA") relating to stock-based compensation on a prospective basis. In accordance with the new standard, the Company changed its method of accounting for stock options from the intrinsic value method to the fair value method, which estimates the fair value of the stock options granted on the date of grant and expenses this value over the vesting period. During the 26-week period ended September 30, 2006, $0.3 million was recognized as an expense with the offset recorded in contributed surplus. Any consideration paid by employees on exercise of stock options is credited to share capital, with a corresponding reduction to contributed surplus.

The fair value of the employee stock options is estimated at the date of grant using the Black-Scholes option pricing model with the following assumptions during the periods presented:

	13-week period ended September 30, 2006	13-week period ended October 1, 2005
Risk-free interest rate	**5.5%**	4.3%
Expected volatility	**36.6%**	21.6%
Expected time until exercise	**4 years**	4 years
Expected dividend yield	**0.0%**	0.0%

On a pro forma basis, if the Company had used the fair value method of accounting for stock options issued before March 29, 2003, the Company's net loss would have increased to the amounts listed below. The pro forma impact of accounting for these options at fair value will continue to be disclosed until the last of these options vest in 2008.

(thousands of dollars, except per share data)	13-week period ended September 30, 2006	26-week period ended September 30, 2006
Net loss – reported	**(976)**	**(6,767)**
Net loss – pro forma	**(1,059)**	**(6,932)**
Basic net loss per common share – reported	**$(0.04)**	**$(0.28)**
Basic net loss per common share – pro forma	**$(0.04)**	**$(0.29)**
Diluted net loss per common share – reported	**$(0.04)**	**$(0.28)**
Diluted net loss per common share – pro forma	**$(0.04)**	**$(0.29)**

7. FINANCIAL INSTRUMENTS

The Company uses derivative financial instruments to manage the risks of its foreign currency and interest rate exposures. The Company enters into foreign currency derivative contracts to hedge future purchases of U.S. dollar denominated goods and services. The Company also uses interest rate swap agreements to manage the fixed and floating interest rate mix of the Company's total debt portfolio. Counterparty credit risk is considered to be negligible as the Company only deals with highly rated financial institutions.

The fair value of financial instruments is the estimated amount the Company would receive or pay to terminate the contracts at the reporting date. Such fair value estimates are not necessarily indicative of the amounts the Company might receive or pay in actual market transactions. 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:

(i) The fair values of cash and cash equivalents, accounts receivable, income taxes recoverable, income taxes payable, bank indebtedness and accounts payable and accrued liabilities approximate their carrying values given their short-term maturities;

(ii) The fair values of long-term debt 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;

(iii) 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 was $0.2 million in favour of the Company as at September 30, 2006; and

(iv) The fair values of foreign currency derivative contracts represent an approximation of the amounts that the Company would have paid to or received from counterparties to unwind its position prior to maturity. The fair value of the foreign exchange derivative contracts was $0.1 million in favour of the counterparty as at September 30, 2006.

8. RESTRUCTURING COSTS

In fiscal 2002, the Company recorded a $40.3 million restructuring charge as a result of the merger between Chapters Inc. and Old Indigo. As of the end of fiscal 2005, the Company had approximately $6.5 million of restructuring costs that were unpaid and had been included in accounts payable and accrued liabilities. This provision of $6.5 million included estimates for rent subsidies, legal fees, commissions and disposal costs for stores that were identified for closure in the current fiscal year.

During the second quarter of fiscal 2006, the Company sublet part of an overlapping store that was previously identified for closure under its restructuring provision. When the Company performed its assessment of restructuring costs at the end of fiscal 2005, the sublet was not considered reasonably assured; therefore, the restructuring provision was not adjusted to reflect the potential sublet income. Upon completion of the sublet transaction during that quarter, the Company reduced its restructuring provision and recognized $2.8 million into income.

9. CONSOLIDATED STATEMENTS OF CASH FLOWS

Supplemental cash flow information:

(thousands of dollars)	13-week period ended September 30, 2006	13-week period ended October 1, 2005	26-week period ended September 30, 2006	26-week period ended October 1, 2005
Interest paid	**1,113**	1,074	**1,773**	2,229
Income taxes paid	**198**	65	**198**	65

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