THIRD QUARTER REPORT

FOR THE 13-WEEK PERIOD ENDED DECEMBER 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 is prepared as at January 31, 2007 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 December 30, 2006 and December 31, 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 December 30, 2006, the Company operated 88 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 third quarter of fiscal 2007, the Company opened two large format stores and one small format store, which was offset by the closure of 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 January 31, 2007, the number of common shares outstanding was 24,439,918 with a book value of $196.2 million. The number of common shares reserved for issuance under the employee stock option plan is 2,157,232. As at December 30, 2006, there were 1,639,882 stock options outstanding of which 685,528 of them were exercisable.

Results of Operations

The following table summarizes the consolidated statement of operations for the periods indicated. The classification of financial information presented below is specific to Indigo Books & Music Inc., and may not be comparable to that of other retailers.

(millions of dollars)	**13-week period ended December 30, 2006**	**% Revenues**	13-week period ended December 31, 2005	% Revenues	**39-week period ended December 30, 2006**	**% Revenues**	39-week period ended December 31, 2005	% Revenues
Revenues	**320.5**	**100.0%**	309.9	100.0%	**673.1**	**100.0%**	661.7	100.0%
Cost of sales	**177.7**	**55.5%**	174.8	56.4%	**378.4**	**56.2%**	382.6	57.8%
Net margin	**142.8**	**44.5%**	135.1	43.6%	**294.7**	**43.8%**	279.1	42.2%
Cost of operations	**73.0**	**22.8%**	69.7	22.5%	**187.4**	**27.8%**	179.0	27.1%
Operating contribution	**69.9**	**21.8%**	65.4	21.1%	**107.3**	**15.9%**	100.1	15.1%
Selling and administrative expenses	**18.6**	**5.8%**	17.1	5.5%	**45.9**	**6.8%**	45.4	6.9%
Operating earnings	**51.2**	**16.0%**	48.3	15.6%	**61.4**	**9.1%**	54.7	8.3%

Improvement in Revenue driven by Strong Holiday Season

Total consolidated revenues for the 13-week period ended December 30, 2006 increased $10.6 million or 3.4% to $320.5 million from $309.9 million for the period ended December 31, 2005. Comparable store sales for the quarter increased 2.5% in superstores and 0.6% in small format stores over the same quarter last year. The increase in revenues was largely due to higher customer traffic and an increase in the number of customer purchases, offset by a reduction in the average retail price of items sold. In particular, the price of U.S. published books has dropped 6% year over year due to the strength of the Canadian dollar. The Company operated two additional large format stores and seven fewer small format stores compared to the same period last year.

Online sales experienced strong growth during the third quarter, largely due to pricing decreases implemented at the end of the second quarter and the introduction of toys in the fall of 2006, which benefited holiday sales. Online sales grew 17.7% to $28.6 million compared to $24.3 million in the same period last year.

Revenues from other sources increased 6.9% from $21.8 million in the third quarter last year to $23.3 million for the current quarter. Other revenues were driven by the sustained growth in sales of the Company's loyalty card program.

On a year-to-date basis, total consolidated revenues increased $11.4 million or 1.7%, from $661.7 million last year to $673.1 million this year. Year-to-date comparable store sales were up 1.9% for superstores and 0.6% for small format stores. Excluding sales from *Harry Potter and the Half-Blood Prince*, year-to-date comparable store sales were up 2.7% for superstores and 1.6% for small format stores.

Revenues by channel are highlighted below:

(millions of dollars)	**13-week period ended December 30, 2006**	13-week period ended December 31, 2005	% increase (decrease)	Comparable store sales % increase
Superstores	**206.5**	199.2	3.7	2.5
Small format stores	**62.1**	64.6	(3.9)	0.6
Online (including store kiosks)	**28.6**	24.3	17.7	N/A
Other	**23.3**	21.8	6.9	N/A
	320.5	309.9	3.4	2.0

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 December 30, 2006**	13-week period ended December 31, 2005	**13-week period ended December 30, 2006**	13-week period ended December 31, 2005
Total revenues	**206.5**	199.2	**62.1**	64.6
Adjustments for stores not in both fiscal periods	**(5.2)**	(2.7)	**(3.5)**	(6.3)
Comparable store sales	**201.3**	196.5	**58.6**	58.3

Cost of Sales Improved due to Enhanced Vendor Support

Cost of sales includes the landed cost of goods sold, online shipping costs, inventory shrink and damage, less all vendor support programs. As a percent of total revenues, cost of sales decreased 0.9% to 55.5% in the third quarter, compared to 56.4% in the same period last year. The improvement in cost of sales was driven by greater vendor support and lower shrink. These improvements were partially offset by an increase in the cost of goods sold. As noted in the last quarterly report, the implementation of the new warehouse management application system at the distribution centre required more goods to be routed directly to stores during the holiday season. This negatively impacted the Company's margin, as the Company incurred higher prices on products that were shipped directly to stores.

On a year-to-date basis, cost of sales as a percent of total revenues decreased 1.6% from 57.8% last year to 56.2% this year.

Cost of Operations Increased over Last Year

Cost of operations includes all store, online, distribution centre and calendar club costs. Costs of operations increased by 0.3% to 22.8% of sales compared to 22.5% of sales in the same quarter last year. The increase was due to three main factors: higher labour costs in the distribution centre due to the warehouse management system conversion; higher wages in Alberta; and a new holiday bag and gift wrap program introduced in the retail stores.

On a year-to-date basis, cost of operations as a percent of total revenue increased 0.7% from 27.1% last year to 27.8% this year.

Selling and Administrative Expenses Increased in Third Quarter

Selling and administrative expenses include all marketing and head office costs. Selling and administration expenses increased by 0.3% to 5.8% of sales in the third quarter compared to 5.5% of sales last year. This was primarily due to spending on information technology, foreign exchange loss and increased donation expense to the Indigo Love of Reading Fund. On a year-to-date basis, selling and administrative expenses remained relatively stable, measuring 6.8% of sales compared to 6.9% of sales for the same period last year.

Continued Growth in Operating Earnings

Operating earnings, defined as revenues less cost of sales, operations, and selling and administration expenses, increased $2.9 million to $51.2 million for the 13-week period ended December 30, 2006, compared to $48.3 million for the 13-week period ended December 31, 2005. The increase in quarterly earnings was primarily due to strong holiday sales, higher vendor support, and reduced inventory shrink as explained above. Year-to-date, operating earnings improved $6.7 million from $54.7 million last year to $61.4 million this year.

Increased Amortization Costs due to Ongoing Capital Improvements

Amortization for the 13-week period ended December 30, 2006 increased $0.6 million to $7.9 million, compared to $7.3 million for the 13-week period ended December 31, 2005. On a year-to-date basis, amortization increased by $2.2 million to $23.1 million compared to $20.9 million last year. Capital expenditures in the current quarter totalled $8.4 million, and included $6.4 million on store construction, renovations and equipment, and $2.0 million on technology-related projects. Of the $8.4 million in capital expenditures, $0.1 million was financed through capital leases. Year-to-date in fiscal 2007, the Company spent $19.5 million on capital expenditures including $9.6 million in store construction, renovations and equipment, and $9.9 million in technology-related projects.

The Company began work on a new online order management system in fiscal 2006. Upon review in the third quarter, the Company decided not to continue with the implementation due to unplanned scope and cost increases. As a result, the Company wrote off $1.6 million of assets associated with this project.

Interest Expense Continued to Decline

Interest expense decreased $0.5 million to $0.7 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 $1.0 million to $2.5 million this year from $3.5 million last year.

Fiscal 2006 Fourth Quarter Income Taxes Recovered

The federal budget passed in June 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 earnings 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 earnings. There was no recovery of restructuring costs in the current fiscal year.

Net Earnings Recorded for the Current Fiscal Quarter

Net earnings for the third quarter were $41.0 million or $1.68 net earnings per common share, compared to net earnings of $39.8 million or $1.65 net earnings per common share last year. The gain in net earnings was primarily due to strong operating results, offset by the capital assets write-off in the current quarter, as noted above. Year-to-date, net earnings improved $1.4 million to $34.2 million this year from $32.8 million last year.

Seasonality and Third Quarter Results

Indigo's business is highly seasonal and follows quarterly revenues and earnings (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 earnings 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)	**Q3 Fiscal 2007**	Q2 Fiscal 2007	Q1 Fiscal 2007	Q4 Fiscal 2006	Q3 Fiscal 2006	Q2 Fiscal 2006	Q1 Fiscal 2006	Q4 Fiscal 2005
Revenues	**320,491**	182,305	170,351	190,119	309,868	187,157	164,678	176,383
Net earnings (loss)	**40,977**	(976)	(5,791)	(7,415)	39,761	1,081	(8,090)	(3,865)
Basic earnings (loss) per share	**$1.68**	$(0.04)	$(0.24)	$(0.31)	$1.65	$0.04	$(0.34)	$(0.16)
Diluted earnings (loss) per share	**$1.62**	$(0.04)	$(0.24)	$(0.31)	$1.61	$0.04	$(0.34)	$(0.16)

Overview of Consolidated Balance Sheets

Total Assets

As at December 30, 2006, total assets were $31.1 million greater than total assets at December 31, 2005. The increase in assets was primarily due to increases in the Company's cash and cash equivalents and inventory positions. Cash and cash equivalents increased $18.8 million due to improved holiday sales compared to last year. Inventories were higher by $17.1 million. As described in the second quarter, the Company has delayed the processing of some inventory returns until the fourth quarter due to the implementation of a new warehouse management system. The increase in total assets was partially offset by lower net capital assets of $6.2 million. The decline in capital assets was primarily due to the net closure of seven small format stores over the past 12 months, and the capital assets write-off relating to the online order management system described above.

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 losses could be used. Since 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 $101.4 million compared to April 1, 2006. The increase in total assets was primarily due to higher cash and cash equivalents and inventories, partially offset by a reduction in net capital assets and prepaid expenses. Cash and cash equivalents and accounts receivable increased $77.8 million compared to April 1, 2006, due to strong sales generated during the holiday season. Inventories increased $34.0 million fiscal year-to-date, due to the cyclical nature of the business with holiday season falling in the third quarter. Net capital assets decreased $5.4 million year-to-date due to the net closure of five small format stores since the beginning of the current fiscal year. Prepaid expenses decreased $5.1 million compared to April 1, 2006, as the Company had prepaid some occupancy expenses for April 2006 at year end.

Total Liabilities

As at December 30, 2006, total liabilities were $2.2 million higher than total liabilities at December 31, 2005. Total debt (including bank indebtedness and long-term debt) decreased $10.3 million compared to last year, as the Company made a $12.0 million principal repayment on its existing long-term debt in December 2006. The final payment on the Company's outstanding bank term debt is due in July 2007. The reduction in total debt was fully offset by an $11.1 million increase in accounts payable and accrued liabilities compared to the same period last year. Accounts payable were used to finance the increased investment in inventories, and accrued liabilities increased as a result of strong gift card sales which are recorded as a liability until they are redeemed.

On a year-to-date basis, total liabilities increased $65.4 million compared to April 1, 2006. The increase in liabilities was primarily due to increased accounts payable and accrued liabilities of $88.7 million fiscal year-to-date, which were used to finance inventories to support the holiday season. The increase in total liabilities was partially offset by a reduction in total debt of $24.3 million because the Company paid off the balance on its short-term operating line of credit and made a $12.0 million repayment on its existing term debt. Long-term accrued liabilities decreased $4.2 million as a result of amortization of the deferred rent liability.

Shareholders' Equity

Shareholders' equity at December 30, 2006 increased $29.0 million compared to December 31, 2005. The improvement was primarily due to net earnings of $26.8 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 $0.3 million reduction due to the exercise of employee stock options. Year-to-date, $0.4 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 since it relies on a short-term operating line of credit and accounts payable as two of the primary vehicles to fund the business. At the end of the third fiscal quarter, the working capital position is usually positive due to cash received from holiday season sales. Working capital improved from $5.2 million at the end of the third quarter last year, to $24.9 million at the end of the current quarter. Working capital was positive $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 2.2:1 at the end of the current quarter from 2.8:1 last year due to the reduction in total debt and the increase in shareholders' equity, as described above. The Company's leverage position has also improved from 2.4:1 at April 1, 2006.

Overview of Consolidated Statements of Cash Flows

Cash and cash equivalents increased $70.5 million during the third quarter of fiscal 2007, compared to an increase of $50.8 million last year. Year-to-date, cash and cash equivalents increased $70.7 million.

Cash Flows from Operating Activities

The Company generated cash flow of $126.4 million from operations in the third quarter. The primary sources of cash were net earnings of $41.0 million, amortization of $7.9 million, and growth in outstanding accounts payable and accrued liabilities of $85.5 million due to timing of payments for product purchases for sale in the December holiday season. The primary use of cash was a $7.2 million increase in accounts receivable as a result of higher credit card receivables associated with holiday sales.

In the third quarter of last year, the Company generated $137.6 million in cash flow from operations. The primary sources of cash were net earnings of $39.8 million, amortization of $7.3 million, and an increase in accounts payable and accrued liabilities of $90.0 million. The primary use of cash was an increase in accounts receivable of $5.4 million.

On a year-to-date basis, the Company generated $113.3 million in cash flow from operations. The primary sources of cash were net earnings of $34.2 million, amortization of $23.1 million, and an increase in accounts payable and accrued liabilities of $88.7 million. The primary uses of cash were an increase in accounts receivable of $7.1 million and an increased investment in inventories of $34.0 million.

For the 39-week period ended December 31, 2005, the Company generated $126.8 million in cash flow from operations. The primary sources of cash were year-to-date net earnings of $32.8 million, amortization of $20.9 million, and growth in outstanding accounts payable and accrued liabilities of $95.8 million. The primary use of cash was a $23.9 million increased investment in inventories.

Cash Flows Used in Investing Activities

In the third quarter, net cash flows used in investing activities were $8.3 million compared to $7.3 million in the same quarter last year. During the current quarter, the Company spent $8.3 million on capital projects including $6.4 million in store construction, renovations and equipment and $1.9 million in technology-related projects.

During the same quarter last year, the Company spent $7.3 million on capital projects including $4.7 million for store construction, renovations and equipment and $2.6 million for technology-related projects.

On a year-to-date basis, net cash flows used in investing activities were $16.6 million compared to $13.1 million last year. Capital expenditures included $9.6 million in store construction, renovations and equipment and $7.0 million in technology-related projects.

For the 39-week period ended December 31, 2005, the Company used cash flows of $13.1 million in investing activities. Capital expenditures during the first three quarters of fiscal 2006 included $6.7 million in store construction, renovations and equipment and $6.4 million in technology-related projects.

Cash Flows Used in Financing Activities

Net cash flows used in financing activities were $47.6 million during the quarter compared to $79.5 million in the same period last year. In the third quarter of this fiscal year, the Company paid the outstanding balance of $35.2 million owing on its short-term operating line of credit, and made a $12.8 million repayment of principal on its long-term debt. The Company also received $0.4 million from the exercise of employee stock options. In the same period last year, the Company used $79.9 million in cash flow from financing activities to repay total debt and generated $0.4 million in cash from share issuances.

On a year-to-date basis, net cash flows used in financing activities were $26.0 million compared to $65.9 million last year. The primary uses of these cash flows were to repay the Company's operating line of credit and long-term debt, as described above.

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 earnings 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 third 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 and restructuring costs.

Effective in the third quarter of fiscal 2007, the Company changed its accounting policy relating to gift cards. This policy change was made based on the Company's review of the gift card accounting clarifications provided by the Securities and Exchange Commission ("SEC") and the introduction of legislation by the Ontario government banning gift card expiry dates and excessive service charges. The Company sells gift cards to its customers and recognizes the revenue as the gift cards are redeemed. The Company also recognizes income from unredeemed gift cards (gift card breakage) if the likelihood of the gift card being redeemed by the customer is considered to be remote. Based on historical information, the likelihood of a gift card remaining unredeemed is reasonably certain 24 months after the gift card is issued. The Company now determines its average gift card breakage rate based on redemption rates for all gift cards more than two years old. Once the breakage rate is determined, the resulting income is recognized over a 24-month period, commencing when the gift cards are sold, based on historical redemption patterns.

In addition, the Company has reclassified gift card breakage from "Cost of sales, operations, selling and administration" to "Revenues" in the consolidated statements of earnings. In the third quarter of fiscal 2007, the Company recorded $0.5 million in gift card breakage compared to $0.4 million in the same quarter last year. There was no material impact to the Company's net earnings and net earnings per share in prior periods as a result of this change in accounting policy.

Risks and Uncertainties

The risks and uncertainties faced by the Company are substantially the same as those disclosed in the MD&A 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 31st day of January, 2007.

Consolidated Balance Sheets

(Unaudited)

(thousands of dollars)	**As at December 30, 2006**	As at December 31, 2005	As at April 1, 2006
ASSETS			
Current			
Cash and cash equivalents	**76,655**	57,824	5,983
Accounts receivable	**13,054**	12,283	5,937
Inventories	**248,596**	231,532	214,598
Income taxes recoverable	**444**	246	156
Prepaid expenses	**4,229**	3,524	9,301
Future tax assets	**9,014**	10,723	9,014
Total current assets	**351,992**	316,132	244,989
Capital assets, net	**80,570**	86,747	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 $834 (December 31, 2005 – $567; April 1, 2006 – $606)	**178**	445	406
Total assets	**492,489**	461,364	391,103
LIABILITIES AND SHAREHOLDERS' EQUITY			
Current			
Bank indebtedness	**–**	–	12,728
Accounts payable and accrued liabilities (note 8)	**301,493**	287,946	208,590
Deferred revenue	**10,014**	8,713	9,032
Current portion of long-term debt	**15,551**	14,278	14,300
Total current liabilities	**327,058**	310,937	244,650
Long-term accrued liabilities	**8,667**	11,066	12,859
Long-term debt	**5,135**	16,707	17,938
Total liabilities	**340,860**	338,710	275,447
Shareholders' equity			
Share capital (note 5)	**196,201**	194,667	194,861
Contributed surplus (notes 5 and 6)	**1,759**	1,113	1,336
Deficit	**(46,331)**	(73,126)	(80,541)
Total shareholders' equity	**151,629**	122,654	115,656
Total liabilities and shareholders' equity	**492,489**	461,364	391,103

See accompanying notes

Consolidated Statements of Earnings

(Unaudited)

(thousands of dollars, except per share data)	**13-week period ended December 30, 2006**	13-week period ended December 31, 2005	**39-week period ended December 30, 2006**	39-week period ended December 31, 2005
Revenues	**320,491**	309,868	**673,147**	661,703
Cost of sales, operations, selling and administration	**269,287**	261,569	**611,778**	606,981
	51,204	48,299	**61,369**	54,722
Amortization of capital assets	**7,843**	7,254	**22,983**	20,913
Capital assets write-off (note 9)	**1,639**	–	**1,639**	–
Amortization of pre-opening store costs	**51**	–	**151**	–
	9,533	7,254	**24,773**	20,913
Earnings before the undernoted items	**41,671**	41,045	**36,596**	33,809
Recovery of restructuring costs (note 8)	**–**	–	**–**	(2,759)
Interest on long-term debt and financing charges	**437**	365	**837**	1,062
Interest on bank indebtedness	**257**	829	**1,639**	2,484
Earnings before income taxes	**40,977**	39,851	**34,120**	33,022
Income tax expense (recovery)	**–**	90	**(90)**	270
Net earnings for the period	**40,977**	39,761	**34,210**	32,752
Net earnings per common share (note 4)				
Basic	**$1.68**	$1.65	**$1.41**	$1.36
Diluted	**$1.62**	$1.61	**$1.36**	$1.33

See accompanying notes

Consolidated Statements of Deficit

(Unaudited)

(thousands of dollars)	**39-week period ended December 30, 2006**	39-week period ended December 31, 2005
Deficit, beginning of period	**(80,541)**	(105,878)
Net earnings for the period	**34,210**	32,752
Deficit, end of period	**(46,331)**	(73,126)

Consolidated Statements of Cash Flows

(Unaudited)

(thousands of dollars)	**13-week period ended December 30, 2006**	13-week period ended December 31, 2005	**39-week period ended December 30, 2006**	39-week period ended December 31, 2005
CASH FLOWS FROM OPERATING ACTIVITIES				
Net earnings for the period	**40,977**	39,761	**34,210**	32,752
Add (deduct) items not affecting cash				
Amortization	**7,894**	7,254	**23,134**	20,913
Benefit plan credits	**–**	–	**–**	(376)
Stock-based compensation (note 6)	**142**	99	**420**	227
Directors' compensation (note 5)	**68**	66	**219**	201
Loss on disposal of capital assets	**187**	1,273	**208**	1,296
Write-down of capital assets (note 9)	**1,639**	–	**1,639**	–
Amortization of deferred financing charges	**73**	71	**228**	227
Net change in non-cash working capital balances related to operations				
Accounts receivable	**(7,163)**	(5,420)	**(7,117)**	(2,404)
Inventories	**(2,856)**	2,669	**(33,998)**	(23,889)
Prepaid expenses	**314**	1,176	**4,921**	749
Income taxes recoverable	**–**	94	**(288)**	209
Deferred revenue	**(378)**	656	**982**	1,082
Accounts payable and accrued liabilities	**85,482**	89,946	**88,712**	95,764
Cash flows from operating activities	**126,379**	137,645	**113,270**	126,751
CASH FLOWS FROM INVESTING ACTIVITIES				
Purchase of capital assets	**(8,330)**	(7,314)	**(16,667)**	(13,108)
Proceeds from sale of capital assets	**8**	–	**67**	–
Cash flows used in investing activities	**(8,322)**	(7,314)	**(16,600)**	(13,108)
CASH FLOWS FROM FINANCING ACTIVITIES				
Decrease in bank indebtedness	**(35,176)**	(67,328)	**(12,728)**	(52,968)
Repayment of long-term debt	**(12,758)**	(12,614)	**(14,394)**	(13,557)
Proceeds from share issuance (note 5)	**355**	422	**1,124**	606
Cash flows used in financing activities	**(47,579)**	(79,520)	**(25,998)**	(65,919)
Net increase in cash and cash equivalents during the period	**70,478**	50,811	**70,672**	47,724
Cash and cash equivalents, beginning of period	**6,177**	7,013	**5,983**	10,100
Cash and cash equivalents, end of period	**76,655**	57,824	**76,655**	57,824

See accompanying notes

Notes to the Interim Consolidated Financial Statements

December 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 39-week periods ended December 30, 2006 and December 31, 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 39-week periods ended December 30, 2006 and December 31, 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, except for the following:

Gift Cards

Effective in the third quarter of fiscal 2007, the Company changed its accounting policy relating to gift cards. This policy change was made based on the Company's review of the gift card accounting clarifications provided by the Securities and Exchange Commission ("SEC") and the introduction of legislation by the Ontario government banning gift card expiry dates and excessive service charges. The Company sells gift cards to its customers and recognizes the revenue as the gift cards are redeemed. The Company also recognizes income from unredeemed gift cards (gift card breakage) if the likelihood of the gift card being redeemed by the customer is considered to be remote. Based on historical information, the likelihood of a gift card remaining unredeemed is reasonably certain 24 months after the gift card is issued. The Company now determines its average gift card breakage rate based on redemption rates for all gift cards more than two years old. Once the breakage rate is determined, the resulting income is recognized over a 24-month period, commencing when the gift cards are sold, based on historical redemption patterns.

In addition, the Company has reclassified gift card breakage from "Cost of sales, operations, selling and administration" to "Revenues" in the consolidated statements of earnings. In the third quarter of fiscal 2007, the Company recorded $0.5 million in gift card breakage compared to $0.4 million in the same quarter last year. There was no material impact to the Company's net earnings and net earnings per share in prior periods as a result of this change in accounting policy.

4. EARNINGS PER SHARE

Earnings 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 reconciliation of the denominator in calculating diluted earnings per share amounts is as follows:

(in thousands)	**13-week period ended December 30, 2006**	13-week period ended December 31, 2005	**39-week period ended December 30, 2006**	39-week period ended December 31, 2005
Weighted average number of common shares outstanding, basic	**24,403**	24,138	**24,304**	24,109
Effect of dilutive securities – Stock options	**871**	484	**871**	484
Weighted average number of common shares outstanding, diluted	**25,274**	24,622	**25,175**	24,593

5. SHARE CAPITAL

Share capital consists of the following:

	39-week period ended December 30, 2006		39-week period ended December 31, 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	**209,200**	**1,340**	79,000	606	126,500	800
Balance, end of period	**24,435,118**	**196,201**	24,178,418	194,667	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 4,470 DSUs with a value of $0.1 million during the 13-week period ended December 30, 2006. The value of the outstanding DSUs as at December 30, 2006 was $0.9 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 December 30, 2006, 1,639,882 stock options were outstanding with exercise prices ranging from $4.29 to $63.53. Of these outstanding stock options, 685,528 were exercisable. As at December 31, 2005, there were 1,736,913 options outstanding of which 487,051 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 39-week period ended December 30, 2006, $0.4 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 period presented:

	13-week period ended December 30, 2006
Risk-free interest rate	**5.8%**
Expected volatility	**36.9%**
Expected time until exercise	**4 years**
Expected dividend yield	**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 earnings would have decreased 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 December 30, 2006**	**39-week period ended December 30, 2006**
Net earnings – reported	**40,977**	**34,210**
Net earnings – pro forma	**40,895**	**33,964**
Basic net earnings per common share – reported	**$1.68**	**$1.41**
Basic net earnings per common share – pro forma	**$1.68**	**$1.40**
Diluted net earnings per common share – reported	**$1.62**	**$1.36**
Diluted net earnings per common share – pro forma	**$1.62**	**$1.35**

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, 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 $0.1 million in favour of the Company as at December 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 $0.3 million in favour of the Company as at December 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 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 the quarter, the Company reduced its restructuring provision and recognized $2.8 million into income.

9. CAPITAL ASSETS WRITE-OFF

The Company began work on a new online order management system in fiscal 2006. Upon review in the third quarter, the Company decided not to continue with the implementation due to unplanned scope and cost increases. As a result, the Company wrote off $1.6 million of assets associated with this project.

10. CONSOLIDATED STATEMENTS OF CASH FLOWS

Supplemental cash flow information:

(thousands of dollars)	**13-week period ended December 30, 2006**	13-week period ended December 31, 2005	**39-week period ended December 30, 2006**	39-week period ended December 31, 2005
Interest paid	**838**	1,170	**1,951**	3,399
Income taxes paid	**–**	–	**–**	65

11. COMPARATIVE CONSOLIDATED FINANCIAL STATEMENTS

The comparative consolidated financial statements have been reclassified from statements previously presented to conform to the presentation of the current year consolidated financial statements.

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