SECOND QUARTER REPORT

FOR THE 13-WEEK PERIOD ENDED SEPTEMBER 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") is the nation's largest book retailer, operating stores in all ten provinces in Canada. As at September 29, 2001, the Company operated 92 book superstores including 76 *Chapters*, 15 *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 owns a 69.6% interest in Chapters Online Inc. ("Chapters Online"), a leading e-commerce retailer, which sells books, video, CDs and DVDs through its Web site *chapters.indigo.ca*.

Subsequent to the end of the second quarter, on October 26, 2001 the Company acquired all of the outstanding shares of Chapters Online not already owned by the Company on the basis of one common share of the Company for every 7.14 common shares of Chapters Online. The transaction will result in the Company issuing 758,566 common shares to the minority shareholders of Chapters Online valued at $4.6 million.

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

Results of Operations

Total consolidated revenues in the second quarter increased 1.2% to $155.9 million from $154.1 million in the second quarter last year. The sales increase was primarily attributable to the addition of 20 superstores, offset by sales decreases from closing 24 traditional format stores and lower sales at Chapters Online. On a year-to-date basis, total consolidated revenues were $291.2 million as compared to $290.9 million on a year-to-date basis last year.

Consolidated earnings before interest, taxes, restructuring charges and amortization for the second quarter was $1.0 million compared to a loss of $2.9 million in the second quarter last year. This represents a reduction in operating losses of $3.9 million or 135% in the quarter. On a year-to-date basis, consolidated losses before interest, taxes, restructuring charges and amortization were $0.7 million as compared to $15.9 million on a year-to-date basis last year, a reduction in operating losses of $15.2 million.

The consolidated net loss for the second quarter was $31.3 million ($2.49 per share) as compared to a net loss of $7.8 million ($0.68 per share) in the second quarter last year. This loss includes restructuring and other charges of $21.2 million ($1.69 per share) relating to store closures and other costs associated with the amalgamation. 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 financing charges.

Of the total restructuring charges, approximately $8.6 million are cash charges of which $2.7 million have been paid. The balance of approximately $12.5 million relates to non-cash transactions. It is anticipated that further store closures will occur and other costs related to the acquisition will be incurred.

Excluding the restructuring and other charges, the net loss for the second quarter was $10.1 million ($0.80 per share) as compared to a net loss of $7.8 million ($0.68 per share) in the second quarter last year, an increase of $2.3 million ($0.13 per share) or 29%.

The consolidated net loss on a year-to-date basis was $38.2 million ($3.08 per share) as compared to a net loss of $20.5 million ($1.90 per share) on a year-to-date basis last year. Excluding the restructuring and other charges, the net loss on a year-to-date basis was $17.0 million ($1.37 per share) as compared to a net loss of $20.5 million ($1.80 per share) on a year-to-date basis last year. This represents a reduction in the net loss of $3.5 million ($0.43 per share).

The weighted average number of shares outstanding for the quarter was 12.6 million as compared to 11.4 million in the second quarter last year. This is a result of the issuance of shares relating to the acquisition of Old Indigo, employee stock purchase plan and the exercise of stock options.

On a year-to-date basis, the weighted average number of shares outstanding was 12.4 million as compared to 11.4 million last year.

Retail

During the second quarter, management continued to focus its attention on improving the in-stock position of best-sellers and core titles while clearing old and slow-moving inventory.

Retail sales in the second quarter were $149.0 million as compared to $141.3 million in the second quarter of last year, an increase of $7.7 million or 5.5%. Operating earnings fell to $2.3 million in the second quarter from $5.6 million in the second quarter last year a decrease of $3.3 million. The decrease in operating earnings was primarily attributable to increased occupancy and labour costs offset by improvements in gross margins.

Retail sales on a year-to-date basis were $274.9 million as compared to $265.5 million last year on a year-to-date basis, an increase of $9.4 million or 3.5%. Operating earnings on a year-to-date basis were $2.0 million as compared to $2.1 million on a year-to-date basis last year.

Superstores

In the second quarter, revenues at the 92 Chapters and Indigo superstores, including the World's Biggest Bookstore, grew to $104.5 million, a 12.5% increase compared to revenue of $92.9 million in the second quarter last year. The growth in revenue was generated by the operation of 20 additional superstores as compared to the second quarter last year. Comparative store sales declined 3.1% during the quarter.

Year-to-date revenues increased $15.4 million to $191.7 million as compared to last year. This growth in revenue is also attributable to the operation of a larger superstore portfolio.

Traditional Stores

Total traditional store revenues declined to $37.4 million in the second quarter, a decrease of $3.8 million or 9.3% in comparison to $41.2 million in the second quarter last year. The decline in revenue was the result of operating 24 fewer traditional bookstores or approximately 10% less stores as compared to the second quarter last year. The comparative store sales decrease of 0.7% during the quarter was a significant improvement over the 5.3% decline in the second quarter last year. During the second quarter the Company closed 8 traditional stores bringing the total number of stores to 190. This compares to 214 traditional stores as at the end of the second quarter last year.

Year-to-date revenues decreased $5.6 million to $73.1 million as compared to last year. Comparative store sales increased 1.3% on a year-to-date basis, a significant improvement over the 5.6% 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 $7.2 million in the second quarter as compared to $7.2 million in the second quarter last year. On a year-to-date basis, sales were $10.1 million as compared to $10.5 million during the same period last year.

Chapters Online

Revenues in the second quarter were $6.9 million as compared to $12.7 million in the second quarter last year, a decrease of $5.9 million or 46%. The decline was attributable to far less aggressive marketing and promotional activities during the second quarter of this year as compared to the second quarter last year. Operating losses were reduced by $7.2 million to $1.3 million as a result of restructuring activities undertaken over the previous two quarters.

During the second quarter, Chapters Online launched a redesigned Web site which significantly enhanced the customer shopping experience. The new site, along with further service enhancements, will allow Chapters Online to expand its customer base and improve revenue growth.

On a year-to-date basis, revenues were $16.2 million as compared to $25.4 million on a year-to-date basis last year, a $9.2 million decrease. Operating losses were reduced by $15.3 million on a year-to-date basis to $2.7 million, a significant improvement over last year's performance

Overview of Consolidated Statements of Financial Position

Total assets increased by $101.6 million as compared to the fiscal year ended March 31, 2001. The net increase was primarily due to a normal seasonal increase in inventory and an increase due to the operating of 20 additional superstores at the end of the quarter of $61.7 million and an increase in goodwill of $46.5 million as a result of the acquisition of Old Indigo.

Total liabilities increased by $133.7 million compared to the fiscal year ended March 31, 2001. The net increase was primarily due to $14.5 million increase in bank indebtedness, a $42.8 million increase in accounts payable and accrued liabilities, and a $76.6 million increase in long-term debt and convertible debentures.

Share capital increased by $4.2 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.

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.

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. This amount has been included as part of the restructuring charges taken in the quarter.

Overview of Consolidated Statements of Cash Flows

Cash increased by $1.0 million in the second quarter as compared to a $4.3 million decrease in the same period last year. The net increase in cash in the quarter was a result of cash used in operations of $1.6 million, net purchases of capital assets of $4.6 million and an increase in cash from financing activities of $7.1 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 $39.1 million and finance fees of $3.8 million.

Of the cash used in operations, changes in non-cash working capital provided for an increase in cash of $9.2 million. This increase primarily relates to a seasonal increase in inventory of $21.4 million offset by an increase in accounts payable and accruals of $30.4 million.

On a year-to-date basis, cash decreased by $10.1 million as compared to a $26.4 million decrease in the same period last year. The net decrease in cash was a result of cash used in operations of $32.8 million, net purchases of capital assets of $4.7 million, proceeds on the sale of short-term investments of $3.9 million and an increase in cash from financing activities of $23.6 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 $22.7 million and finance fees of $3.8 million.

Of the cash used in operations on a year-to-date basis, changes in non-cash working capital provided for a decrease in cash of $18.3 million. This decrease primarily relates to a seasonal increase in inventory of $34.6 million offset by an increase in accounts payable and accruals of $17.6 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 should 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.

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 September 29, 2001 and September 30, 2000 are unaudited

	As at September 29, 2001 $ (thousands)	As at September 30, 2000 $ (thousands)	As at March 31, 2001 $ (thousands)
Assets			
Cash	**$ 1,329**	$ 2,551	$ 11,394
Short-term investments	**–**	16,067	3,850
Accounts receivable	**13,484**	12,578	11,547
Inventories	**255,687**	280,378	193,977
Income taxes receivable	**4,845**	6,669	5,353
Prepaid expenses	**5,211**	5,869	4,863
Future income tax assets	**2,921**	925	5,281
Total current assets	**283,477**	325,037	236,265
Capital assets, net	**137,139**	142,031	138,842
Future income taxes assets	**11,714**	5,974	5,402
Deferred pension charges	**–**	26	–
Goodwill, net of accumulated amortization of $5,404 (2001 – $4,735) (note 4)	**54,333**	1,426	8,301
Deferred charges, net of accumulated amortization of $117	**3,733**	–	–
Total assets	**490,396**	474,494	388,810
Liabilities and shareholders' equity			
Bank indebtedness (note 7)	**67,089**	79,200	52,605
Accounts payable and accrued liabilities (note 9)	**225,782**	182,078	182,942
Deferred revenue	**6,089**	6,584	5,272
Current portion long-term debt (note 7)	**20,000**	–	–
Total current liabilities	**318,960**	267,862	240,819
Accrued benefit obligations	**1,666**	–	1,166
Long-term debt (note 7)	**84,000**	54,000	54,000
Convertible debentures (notes 4 and 8)	**26,629**	–	–
Non-controlling interest	**127**	7,752	1,716
Total liabilities	**431,382**	329,614	297,701
Shareholders' equity			
Share capital (note 4)	**149,004**	132,243	144,775
Equity portion of convertible notes (notes 4 and 8)	**1,903**	–	–
Retained earnings (deficit)	**(91,893)**	12,637	(53,666)
Total shareholders' equity	**59,014**	144,880	91,109
Total liabilities and shareholders' equity	**$ 490,396**	$ 474,494	$ 388,810

See accompanying notes

Consolidated Statements of Retained Earnings

Unaudited

	26-week period ended September 29, 2001 $ (thousands)	26-week period ended September 30, 2000 $ (thousands)
Opening balance	**(53,666)**	33,129
Net loss for the period	**(38,227)**	(20,492)
Closing balance	**(91,893)**	12,637

See accompanying notes

Consolidated Statements of Earnings

Unaudited

	13-week period ended September 29, 2001 $ (thousands*)	13-week period ended September 30, 2000 $ (thousands*)	**26-week period ended September 29, 2001 $ (thousands*)**	26-week period ended September 30, 2000 $ (thousands*)
Revenue				
Superstores	**$ 104,461**	$ 92,868	**$ 191,694**	$ 176,274
Traditional bookstores	**37,374**	41,202	**73,107**	78,683
Internet	**6,876**	12,754	**16,232**	25,434
Other	**7,159**	7,231	**10,122**	10,544
	55,870	154,055	**291,155**	290,935
Cost of product, purchasing, selling and administration	**154,852**	156,996	**291,830**	306,835
	1,018	(2,941)	**(675)**	(15,900)
Amortization of capital assets	**7,801**	6,789	**15,102**	13,331
Amortization of pre-opening store costs	**190**	328	**385**	675
Amortization of goodwill	**250**	134	**500**	268
Loss before the undernoted items	**(7,223)**	(10,192)	**(16,662)**	(30,174)
Restructuring charges (note 9)	**21,152**	–	**21,152**	–
Interest on long-term debt and financing charges	**2,011**	978	**2,989**	1,956
Interest on current debt	**1,503**	1,148	**2,665**	1,890
Loss before income tax recovery and non-controlling interest	**(31,889)**	(12,318)	**(43,468)**	(34,020)
Income tax expense (recovery)	**150**	(1,057)	**(3,652)**	(6,279)
Loss before non-controlling interest	**(32,039)**	(11,261)	**(39,816)**	(27,741)
Non-controlling interest	**(769)**	(3,483)	**(1,589)**	(7,249)
Net loss for the period	**$ (31,270)**	$ (7,778)	**$ (38,227)**	$ (20,492)
Basic net loss per common share	**$ (2.49)**	$ (0.68)	**$ (3.08)**	$ (1.80)
Diluted net loss per common share	**$ (2.49)**	$ (0.68)	**$ (3.08)**	$ (1.80)
Weighted average common shares outstanding	**12,561**	11,375	**12,421**	11,367

See accompanying notes

* Except per share data

Consolidated Statements of Cash Flows

Unaudited

	13-week period ended September 29, 2001 $ (thousands)	13-week period ended September 30, 2000 $ (thousands)	**26-week period ended September 29, 2001 $ (thousands)**	26-week period ended September 30, 2000 $ (thousands)
Cash flows from operating activities				
Net loss for the period	**$ (31,270)**	$ (7,778)	**$ (38,227)**	$ (20,492)
Add (deduct) items not affecting cash:				
Amortization	**8,241**	7,251	**15,987**	14,274
Future income taxes	**–**	(2,007)	**(3,952)**	(4,183)
Non-controlling interest	**(769)**	(3,483)	**(1,589)**	(7,249)
Accrued benefit obligations	**250**	75	**500**	150
Accrued interest on convertible notes	**348**	–	**348**	–
Financing charges	**117**	–	**117**	–
Write-down of capital assets	**12,297**	–	**12,297**	–
	(10,786)	(5,942)	**(14,519)**	(17,500)
Net change in non-cash working capital related to operations	**9,198**	(5,189)	**(18,272)**	(14,533)
Cash used in operating activities	**(1,588)**	(11,131)	**(32,791)**	(32,033)
Cash flows from investing activities				
Decrease in short-term investments	**–**	8,933	**3,850**	8,933
Purchase of capital assets, net	**(4,591)**	(7,039)	**(4,693)**	(13,471)
Cash provided by (used in) investing activities	**(4,591)**	1,894	**(843)**	(4,538)
Cash flows from financing activities				
Increase (decrease) in bank indebtedness	**(39,091)**	4,698	**(22,663)**	9,988
Proceeds on issuance of common shares	**82**	199	**82**	199
Repayment of long-term debt (note 7)	**(54,000)**	–	**(54,000)**	–
Proceeds on issuance of long-term debt (note 7)	**104,000**	–	**104,000**	–
Financing fees	**(3,850)**	–	**(3,850)**	–
Cash provided by financing activities	**7,141**	4,897	**23,569**	10,187
Net increase (decrease) in cash during the period	**962**	(4,340)	**(10,065)**	(26,384)
Cash, beginning of period	**367**	6,891	**11,394**	28,935
Cash, end of period	**$ 1,329**	$ 2,551	**$ 1,329**	$ 2,551

See accompanying notes

Notes to the Interim Consolidated Financial Statements

September 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") 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 and 26 weeks ended September 29, 2001 and September 30, 2000 are not indicative of the earnings for the other quarters.

3. ACCOUNTING POLICIES

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 the 2002 fiscal year, the Company retroactively adopted the new recommendations of the Canadian Institute of Chartered Accountants relating to loss per share. Pursuant to the new recommendations, basic loss per share is determined by dividing the net loss attributable to common shareholders by the weighted average number of common shares outstanding during the period. Diluted 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.

The adoption of the new recommendations has not impacted the basic and diluted loss per share presented in the current and comparative period due to its anti-dilutive effect.

The weighted average number of shares used in the computation of both basic and diluted loss per share is summarized below:

	(thousands)
13 weeks ended September 29, 2001	**12,561**
13 weeks ended September 30, 2000	11,375
26 weeks ended September 29, 2001	**12,421**
26 weeks ended September 30, 2000	11,367
52 weeks ended March 31, 2001	11,527

(b) Goodwill

During the second quarter of the 2002 fiscal year, 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 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

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 acquired		
Current assets	$	27,483
Capital assets		21,003
		48,486
Liabilities assumed		
Current liabilities		56,837
Convertible notes		26,281
		83,118
Net identifiable liabilities assumed		34,632
Goodwill		46,532
Purchase Price		11,900
The purchase price consists of:		
Common shares		4,147
Equity component of convertible notes and options		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.

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 September 29, 2001		
	Retail	**Online**	**Total**
	$ (thousands)	**$ (thousands)**	**$ (thousands)**
Segment loss			
Revenue	**$ 148,994**	**$ 6,876**	**$ 155,870**
Earnings (loss) before interest, income taxes and amortization	**2,295**	**(1,277)**	**1,018**
Amortization	**6,933**	**1,308**	**8,241**
Interest expense (income)	**3,570**	**(56)**	**3,514**
Segment loss before income taxes	**(8,208)**	**(2,529)**	**(10,737)**
Segment loss	**$ (8,358)**	**$ (2,529)**	**$ (10,887)**
Reconciliation of segment loss			
Segment loss			**(10,887)**
Restructuring charges			**21,152**
Non-controlling interest			**769**
Net loss			**$ (31,270)**

	13-week period ended September 30, 2000		
	Retail	Online	Total
	$ (thousands)	$ (thousands)	$ (thousands)
Segment loss			
Revenue	$ 141,301	$ 12,754	$ 154,055
Earnings (loss) before interest, income taxes and amortization	5,585	(8,526)	(2,941)
Amortization	6,249	1,002	7,251
Interest expense (income)	2,443	(317)	2,126
Segment loss before income taxes	(3,107)	(9,211)	(12,318)
Segment loss	$ (2,050)	$ (9,211)	(11,261)
Reconciliation of segment loss			
Segment loss			(11,261)
Non-controlling interest			3,483
Net loss			$ (7,778)

	26-week period ended September 29, 2001		
	Retail	Online	Total
	$ (thousands)	$ (thousands)	$ (thousands)
Segment loss			
Revenue	$ 274,923	$ 16,232	$291,155
Income (loss) before interest, income taxes and amortization	2,026	(2,701)	(675)
Amortization	13,372	2,615	15,987
Interest expense (income)	5,744	(90)	5,654
Segment loss before income taxes	(17,090)	(5,226)	(22,316)
Segment loss	$ (13,438)	$ (5,226)	$ (18,664)
Reconciliation of segment loss			
Segment loss			(18,664)
Restructuring charges			21,152
Non-controlling interest			1,589
Net loss			$ (38,227)
Segment assets			
Segment goodwill	$ 54,333	$ –	$ 54,333
Segment total assets	485,363	9,027	494,390
Goodwill on business combination	46,532	–	46,532
Capital expenditures, net	4,721	(28)	4,693
Reconciliation of segment assets			
Segment total assets			494,390
Intercompany receivables and investment in Chapters Online			(3,994)
			$ 490,396

	26-week period ended September 30, 2000		
	Retail	Online	Total
	$ (thousands)	$ (thousands)	$ (thousands)
Segment loss			
Revenue	$ 265,501	$ 25,434	$ 290,935
Income (loss) before interest, income taxes and amortization	2,129	(18,029)	(15,900)
Amortization	12,292	1,982	14,274
Interest expense (income)	4,706	(860)	3,846
Segment loss before income taxes	(14,869)	(19,151)	(34,020)
Segment loss	$ (8,590)	$ (19,151)	$ (27,741)
Reconciliation of segment loss			
Segment loss			(27,741)
Non-controlling interest			7,249
Net loss			$ (20,492)
Segment assets			
Segment goodwill	$ 1,088	$ 338	$ 1,426
Segment total assets	459,546	39,448	498,994
Capital expenditures, net	11,412	2,059	13,471
Reconciliation of segment assets			
Segment total assets			498,994
Intercompany receivables and investment in Chapters Online			(24,500)
			$ 474,494

6. SHARE CAPITAL

Outstanding share data as at September 29, 2001

12,822,000 common shares issued and outstanding (12,281,236 as at June 30, 2001)

Employees' Stock Plan (Options and Share Grants)

642,983 options outstanding, of which 510,756 are exercisable under the Plan (596,992 options outstanding, 494,384 exercisable, as at June 30, 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:

- 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 September 29, 2001 $67.4 million (March 31, 2001 – $42.7 million) was drawn against this facility.
- 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.

- 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 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.

8. CONVERTIBLE DEBENTURE

Upon acquisition 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 13-week period ended September 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 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 second 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, 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 $26.2 million.

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 September 29, 2001 was $2.3 million in favour of counterparties.

11. SUBSEQUENT EVENTS

On October 26, 2001, the Company acquired all of the outstanding shares of Chapters Online Inc. ("Chapters Online") not already owned by the Company on the basis of one common share of the Company for every 7.14 common shares of Chapters Online. The transaction will result in the Company issuing 756,566 common shares to the minority shareholders of Chapters Online valued at $4.6 million. The acquisition of Chapters Online will be accounted for using the purchase method of accounting.

12. CONSOLIDATED STATEMENTS OF CASH FLOWS

Supplemental cash flow information

	13-week period ended September 29, 2001 $ (thousands)	13-week period ended September 30, 2000 $ (thousands)	**26-week period ended September 29, 2001 $ (thousands)**	26-week period ended September 30, 2000 $ (thousands)
Interest paid	**$ 3,067**	$ 2,708	**$ 5,224**	$ 5,336
Income taxes paid	**–**	–	**–**	–

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