FIRST QUARTER REPORT

FOR THE 13-WEEK PERIOD ENDED JUNE 30, 2007

Adjust your sails and you will catch the wind.

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 July 30, 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 June 30, 2007 and July 1, 2006. 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 March 31, 2007, and Management's Discussion and Analysis ("MD&A") included in the Company's fiscal 2007 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.

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 June 30, 2007, 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 first quarter of fiscal 2008, the Company opened 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 material to high-needs elementary schools across the country through donations from Indigo, its customers, suppliers and employees.

As at July 30, 2007, the number of common shares outstanding was 24,651,554 with a book value of $197.6 million. The number of common shares reserved for issuance under the employee stock option plan is 2,215,155. As at June 30, 2007, there were 1,341,546 stock options outstanding of which 626,152 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 June 30, 2007**	**% Revenues**	13-week period ended July 1, 2006	% Revenues
Revenues	**184.9**	**100.0%**	170.4	100.0%
Cost of sales	**105.4**	**57.0%**	96.9	56.9%
Cost of operations	**59.7**	**32.3%**	56.7	33.3%
Selling and administrative expenses	**14.6**	**7.9%**	14.4	8.5%
EBITDA[1]	**5.2**	**2.8%**	2.4	1.4%

[1] Earnings before interest, taxes, depreciation and amortization. Also see "Non-GAAP Financial Measures".

Revenue Growth Achieved in All Sales Channels

Total consolidated revenues for the 13-week period ended June 30, 2007 increased $14.5 million or 8.5% to $184.9 million from $170.4 million for the period ended July 1, 2006. The increase in revenues was largely attributable to strong comparable store growth in superstores and small format stores, as well as the online channel. The Company operated two additional large format stores and one less small format store compared to the same period last year.

Comparable store sales for the quarter increased 6.1% in superstores and 6.0% in small format stores over the same quarter last year. 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.

Online sales experienced strong growth during the first quarter, increasing $3.2 million or 19.6% to $19.5 million for the 13-week period ended June 30, 2007 from $16.3 million in the same period last year. The pending release of *Harry Potter and the Deathly Hallows* materially increased customer traffic to the online web site during the quarter, positively impacting sales of other products in the period.

Revenues from other sources include revenues generated through corporate sales, revenues from the sale of loyalty cards, the Company's proportionate revenue generated through Calendar Club, and gift card breakage. Revenues from other sources increased $1.5 million or 34.1% from $4.4 million in the first quarter last year to $5.9 million this year, driven by the continued growth in sales of the Company's loyalty card program and an increase in gift card breakage.

Revenues by channel are highlighted below:

(millions of dollars)	**13-week period ended June 30, 2007**	13-week period ended July 1, 2006	% increase	Comparable store sales % increase
Superstores	**129.1**	120.4	7.2	6.1
Small format stores	**30.4**	29.3	3.8	6.0
Online (including store kiosks)	**19.5**	16.3	19.6	N/A
Other	**5.9**	4.4	34.1	N/A
	184.9	170.4	8.5	6.1

A reconciliation between total revenues and comparable store sales is provided below:

	Superstores		Small format stores	
(millions of dollars)	**13-week period ended June 30, 2007**	13-week period ended July 1, 2006	**13-week period ended June 30, 2007**	13-week period ended July 1, 2006
Total revenues	**129.1**	120.4	**30.4**	29.3
Adjustments for stores not in both fiscal periods	**(3.7)**	(2.2)	**(1.9)**	(2.4)
Comparable store sales	**125.4**	118.2	**28.5**	26.9

Cost of Sales Increased in First Quarter

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 increased 0.1% to 57.0% in the first quarter, compared to 56.9% in the same period last year. The increase in cost of sales was driven by an increase in online shipping costs and less volume flowing through the Company's distribution centre than in the same quarter a year ago. 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. In the first quarter, the Company implemented a new process that manages the flow of products from suppliers, and more products were sent direct-to-store during the implementation, thus negatively impacting cost of sales.

Cost of Operations (as a Percent of Revenues) Improved over Last Year

Cost of operations includes all store, online, distribution centre and calendar club costs. Costs of operations increased $3.0 million primarily due to increased volume and higher minimum wage rates in most provinces. As a percent of total

revenues, cost of operations improved by 1.0% to 32.3% of sales compared to 33.3% of sales in the first quarter last year.

Selling and Administrative Expenses Increased Slightly over Same Period Last Year

Selling and administrative expenses include all marketing and head office costs. Selling and administration expenses increased $0.2 million compared to the same quarter last year. The increase was the result of investments in marketing and information technology, which were largely offset by a favourable settlement of a trademark dispute and gains realized on foreign exchange. As a percent of total revenues, selling and administrative expenses decreased from 8.5% last year to 7.9% this year.

EBITDA Strengthened by 1.4% over Last Year

EBITDA, defined as earnings before interest, taxes, depreciation and amortization, increased $2.8 million to $5.2 million for the 13-week period ended June 30, 2007, compared to $2.4 million for the 13-week period ended July 1, 2006. The improvement in EBITDA was the result of strong quarterly sales, and reduced cost of operations and selling and administrative expenses as a percent of total revenues, as explained above.

Increased Amortization Costs Resulting from Ongoing Capital Investment

Amortization for the 13-week period ended June 30, 2007 increased $0.3 million to $7.7 million, compared to $7.4 million for the 13-week period ended July 1, 2006. Capital expenditures in the current quarter totalled $3.7 million, and included $1.6 million on store construction, renovations and equipment, and $2.1 million on technology-related projects. Of the $3.7 million in capital expenditures, $0.8 million was financed through capital leases.

Interest Expense Continued to Decline

Interest expense decreased $0.5 million to $0.3 million from $0.8 million in the same quarter last year. The decline was due to the continued reduction in total debt outstanding for the Company.

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 of fiscal 2007.

Net Loss Recorded for the Current Fiscal Quarter

Net loss for the first quarter was $2.8 million or $0.12 net loss per common share, compared to a net loss of $5.8 million or $0.24 net loss per common share last year. The reduction in net loss was primarily due to strong operating results, as noted above.

Other Comprehensive Loss

The Company adopted new accounting standards related to financial instruments on April 1, 2007, as explained in the section of the MD&A entitled Accounting Standards Adopted in Fiscal 2008 and in Note 3 to the financial statements.

The Company has a hedging program in place whereby it enters into foreign currency contracts to mitigate the risk of fluctuations in the cost of product it purchases in US dollars. At the end of the quarter, the Company valued its outstanding foreign currency contracts resulting in the recognition of a $1.4 million other comprehensive loss and a $1.4 million derivative liability. This $1.4 million represents the cost to terminate the outstanding contracts at quarter end. This amount will fluctuate from quarter to quarter with movements in the exchange rate between the US and Canadian dollar, with the expiration of existing contracts, and with the addition of new contracts. The Company currently has no plans to terminate any of its outstanding contracts.

Seasonality and First 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.

(thousands of dollars, except per share data)	Fiscal quarters							
	Q1 Fiscal 2008	Q4 Fiscal 2007	Q3 Fiscal 2007	Q2 Fiscal 2007	Q1 Fiscal 2007	Q4 Fiscal 2006	Q3 Fiscal 2006	Q2 Fiscal 2006
Revenues	**184,917**	201,896	320,491	182,305	170,351	190,119	309,868	187,157
Net earnings (loss)	**(2,840)**	(4,206)	40,977	(976)	(5,791)	(7,415)	39,761	1,081
Basic earnings (loss) per share	**$ (0.12)**	$ (0.17)	$ 1.68	$ (0.04)	$ (0.24)	$ (0.31)	$ 1.65	$ 0.04
Diluted earnings (loss) per share	**$ (0.12)**	$ (0.17)	$ 1.62	$ (0.04)	$ (0.24)	$ (0.31)	$ 1.61	$ 0.04

Overview of Consolidated Balance Sheets

Total Assets

As at June 30, 2007, total assets were $13.2 million less than total assets at July 1, 2006. The decrease in assets was primarily due to decreases in the Company's prepaid expenses and inventory position, and a reduction in net capital assets. Prepaid expenses decreased $2.3 million compared to last year, as the Company had prepaid some occupancy expenses last year for July 2006. Inventories were lower by $2.5 million. Net capital assets declined by $11.2 million as the Company did not spend as much on capital additions ($22.3 million) over the past 12 months relative to the capital asset amortization ($30.9 million). In addition, the Company wrote-off capital assets relating to an online order management project and a product database system at the end of fiscal 2007 in the amount of $2.4 million. The decrease in total assets was partially offset by increased accounts receivable of $2.0 million.

Other changes in total assets included a $12.5 million decrease in goodwill, which was offset by a $12.5 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 2007, the $12.5 million tax benefit associated with the use of these losses was applied to reduce goodwill.

On a fiscal year-to-date basis, total assets decreased $22.3 million compared to March 31, 2007. The decrease in total assets was primarily due to reductions in cash and cash equivalents, accounts receivable, inventory position, and net capital assets. Cash and cash equivalents and accounts receivable decreased by $9.2 million compared to March 31, 2007. Inventories decreased $9.7 million fiscal year-to-date, as the Company completed the processing of returns that were delayed at fiscal year-end due to the implementation of the new warehouse management system. Net capital assets decreased $3.9 million compared to March 31, 2007 due to capital asset amortization of $7.6 million, partially offset by net capital additions of $3.7 million. The Company opened one small format store in the first quarter of fiscal 2008.

Total Liabilities

Total liabilities as at June 30, 2007 were $47.9 million less than total liabilities at July 1, 2006. The decrease in total liabilities was primarily due to a $41.9 million decrease in total debt (including bank indebtedness and long-term debt) and a $10.2 million reduction in accounts payable and accrued liabilities. The decrease in total debt was partially attributable to a $12.0 million principal repayment the Company made on its long-term debt in December 2006. In addition, during the first quarter of fiscal 2008, the Company renegotiated its credit agreement with its bank. As part of the refinancing, the Company repaid $13.0 million of long-term debt that was outstanding under the old agreement. Total debt was further reduced by a decrease in the operating line of credit of $16.2 million. The reduction in accounts payable is consistent with the Company's lower inventory position, as noted above. The decrease in total liabilities was partially offset by increased deferred revenue of $2.8 million due to the growth in the Company's loyalty card program.

On a year-to-date basis, total liabilities decreased $18.4 million compared to March 31, 2007. The decrease in total liabilities was mostly due to reductions in accounts payable and accrued liabilities of $21.1 million, partially offset by increased deferred revenue of $1.8 million and the recognition of $1.4 million in derivative liabilities in the first quarter of fiscal 2008, as described in Note 3 of the consolidated financial statements.

Shareholders' Equity

Shareholders' equity at June 30, 2007 increased $34.7 million compared to July 1, 2006. The improvement was primarily due to net earnings of $33.0 million in the last four quarters. Share capital increased $2.6 million due to the exercising 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 $0.4 million reduction due to the exercise of employee stock options. Year-to-date, $0.1 million was recorded for stock option expenses and $0.1 million was recorded for Directors' deferred stock units in contributed surplus.

In accordance with the new accounting standards on financial instruments, the Company recognized a $1.4 million accumulated other comprehensive loss as part of shareholders' equity, as described in the Financial Instruments section of the MD&A and in Notes 3 and 8 of the consolidated financial statements.

Working Capital and Leverage

The Company's working capital position usually declines from the end of its fiscal year until the third fiscal quarter due to the seasonal nature of the business, as it relies on a short-term operating line of credit and accounts payable as two of the primary vehicles to fund the business before generating a disproportionate amount of cash during the December holiday season. The Company reported working capital of $26.9 million as at June 30, 2007 compared to $28.8 million at the end of fiscal 2007, consistent with the historical trend.

The Company's leverage position (defined as Total Liabilities to Total Shareholders' Equity) improved to 1.6:1 at the end of the current quarter from 2.5:1 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 1.7:1 at March 31, 2007.

Overview of Consolidated Statements of Cash Flows

Cash and cash equivalents decreased $6.8 million during the first quarter of fiscal 2008, and remained unchanged in the same quarter last year.

Cash Flows Used in Operating Activities

The Company generated negative cash flow from operating activities of $2.5 million during the quarter. This was an improvement of $9.9 million over the year ago period when cash flow generated from operating activities was negative $12.4 million. The primary reasons for the improvement in cash flow year over year were a $9.7 million reduction in the Company's investment in inventory and a reduction in the net loss from $5.8 million last year to $2.4 million this year.

Cash Flows Used in Investing Activities

Net cash flows used in investing activities remained unchanged at $2.9 million in the first quarter of fiscal 2008 compared to the same quarter last year. The Company spent $2.9 million on capital projects in the current quarter, including $1.6 million in store renovations and equipment and $1.3 million in technology-related projects. During the same quarter last year, the Company spent $2.9 million on capital projects including $0.9 million for store construction, renovations and equipment and $2.0 million for technology-related projects.

Cash Flows Used in Financing Activities

Net cash flows used in financing activities were $1.4 million during the current quarter compared to a $15.3 million source of cash in the same period last year. The change in cash flows between the two years was primarily due to the $13.0 million repayment of long-term debt the Company made on its previous credit agreement in the first quarter of fiscal 2008.

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. Indigo's main sources of capital are cash flow generated from operations, a revolving line of credit and long-term debt. In the first quarter of fiscal 2008, the Company refinanced its debt and reduced the borrowing capacity against the line of credit to $60.0 million as the Company is forecasting lower borrowing needs.

Based on current operating levels, management expects cash flow generated from operations along with the available borrowing capacity under the Company's new credit facility to be sufficient to meet its working capital needs and debt service requirements for the next 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.

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 Indigo'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.

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 ("GAAP"). 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 of the consolidated financial statements in the fiscal 2007 Annual Report, and the Company's critical accounting estimates are disclosed in the MD&A section of its fiscal 2007 Annual Report.

In the first quarter of fiscal 2008, there were no significant changes to the provisions for slow-moving and damaged products and for gift and paper products that have been marked down. There were also no material changes to the provision for future tax assets, restructuring costs and goodwill. Furthermore, the method of determining gift card breakage is consistent with that used in previous periods.

Accounting Standards Adopted in Fiscal 2008

Financial Instruments

The Canadian Institute of Chartered Accountants ("CICA") issued new standards relating to financial instruments: Comprehensive Income; Financial Instruments – Recognition and Measurement; Financial Instruments – Disclosure and Presentation; and Hedges. These new standards have been created to harmonize with International Accounting Standards. These new standards were adopted by the Company as of April 1, 2007.

These standards set out the recognition and measurement criteria for financial assets, financial liabilities and derivatives. In addition, they provide guidance on the basis of presentation for gains and losses on financial instruments. Based on the classification on the balance sheet, the gains or losses associated with these financial instruments can be recorded in the consolidated statements of earnings or the new financial statement called statements of comprehensive income/(loss). For a more detailed description on the adoption of these new standards by the Company and its associated financial impact, see Note 3 of the consolidated financial statements in this Quarterly Report.

Accounting Changes

In July 2006, the Accounting Standards Board issued a replacement of the CICA Handbook Section 1506, Accounting Changes. The new standard allows for voluntary changes in accounting policy only when they result in the financial statements providing reliable and more relevant information, requires changes in accounting policy to be applied retrospectively unless doing so is impracticable, requires prior period errors to be corrected retrospectively and calls for enhanced disclosures about the effects of changes in accounting policies, estimates and errors on the financial statements. It also requires disclosure of information relevant to assessing the possible impact that the application of a new GAAP standard will have on the Company's financial statements in the period of initial application. The impact that the adoption of this section will have on the Company's financial position and results of operations will depend on the nature of the future accounting changes. The Company has determined that the adoption of this section, effective April 1, 2007, did not have a material impact on its financial statements.

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 2007 Annual Report.

Internal Controls over Financial Reporting

Management is responsible for the design of internal controls over financial reporting to provide reasonable assurance regarding the reliability of financial reporting and the preparation of consolidated financial statements for external purposes in accordance with Canadian generally accepted accounting principles.

For the quarter ended June 30, 2007, there were no material changes in internal controls over financial reporting that has materially affected, or is reasonably likely to materially affect, the Company's internal controls over financial reporting.

The Company implemented a new warehouse management software application in July of 2006. Subsequent to the implementation of this application, management identified the need for improvement to the access and change controls within the application. Management has and continues to take steps to address these controls issues and has in place a number of compensating controls to mitigate the risk of an error in its financial reporting. Management expects to fully resolve these issues by the end of this fiscal year.

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.

Non-GAAP Financial Measures

The Company prepares its consolidated financial statements in accordance with Canadian generally accepted accounting principles. In order to provide additional insight into the business, the Company has also provided non-GAAP data, including comparable store sales and EBITDA, in the discussion and analysis section above. Neither measure has a standardized meaning prescribed by GAAP, and is therefore specific to Indigo and may not be comparable to similar measures presented by other companies.

Comparable stores sales and EBITDA are key indicators used by the Company to measure performance against internal targets and prior period results. Both measures are commonly used by financial analysts and investors to compare Indigo to other retailers. 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. EBITDA is defined as earnings before interest, taxes, depreciation and amortization.

A reconciliation between comparable store sales and revenue (the most comparable GAAP measure) was included earlier in this report. A reconciliation between EBITDA and earnings before income taxes (the most comparable GAAP measure) is provided below:

(millions of dollars)	**13-week period ended June 30, 2007**	13-week period ended July 1, 2006
EBITDA	**5.2**	2.4
Amortization of capital assets	**7.6**	7.4
Amortization of pre-opening store costs	**0.1**	0.1
Interest on long-term debt and financing charges	**0.2**	0.2
Interest on bank indebtedness	**0.1**	0.6
Loss before income taxes	**(2.8)**	(5.9)

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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 30th day of July, 2007.

Consolidated Balance Sheets

(Unaudited)

(thousands of dollars)	**As at June 30, 2007**	As at July 1, 2006	As at March 31, 2007
ASSETS			
Current			
Cash and cash equivalents	**6,870**	6,004	13,639
Accounts receivable	**7,417**	5,372	9,848
Inventories	**214,313**	216,816	224,059
Income taxes recoverable	**194**	246	194
Prepaid expenses	**5,085**	7,423	4,578
Future tax assets	**9,205**	9,014	9,205
Total current assets	**243,084**	244,875	261,523
Capital assets, net	**72,303**	83,505	76,186
Future tax assets	**32,035**	19,750	32,035
Goodwill	**27,523**	39,999	27,523
Total assets	**374,945**	388,129	397,267
LIABILITIES AND SHAREHOLDERS' EQUITY			
Current			
Bank indebtedness	**12,520**	28,758	–
Accounts payable and accrued liabilities	**187,207**	196,642	206,542
Deferred revenue	**12,431**	9,650	10,621
Derivative liabilities (note 3)	**1,400**	–	–
Current portion of long-term debt (note 7)	**2,661**	14,270	15,562
Total current liabilities	**216,219**	249,320	232,725
Long-term accrued liabilities	**9,009**	9,739	10,807
Long-term debt	**4,861**	18,899	4,928
Total liabilities	**230,089**	277,958	248,460
Shareholders' equity			
Share capital (note 5)	**197,622**	194,979	197,592
Contributed surplus (notes 5 and 6)	**1,994**	1,524	1,752
Deficit	**(53,396)**	(86,332)	(50,537)
Accumulated other comprehensive loss (note 8)	**(1,364)**	–	–
Total shareholders' equity	**144,856**	110,171	148,807
Total liabilities and shareholders' equity	**374,945**	388,129	397,267

See accompanying notes

Consolidated Statements of Earnings

(Unaudited)

(thousands of dollars, except per share data)	**13-week period ended June 30, 2007**	13-week period ended July 1, 2006
Revenues	**184,917**	170,351
Cost of sales, operations, selling and administration	**179,764**	167,947
	5,153	2,404
Amortization of capital assets	**7,610**	7,389
Amortization of pre-opening store costs	**54**	51
	7,664	7,440
Loss before the undernoted items	**(2,511)**	(5,036)
Interest on long-term debt and financing charges	**247**	259
Interest on bank indebtedness	**82**	586
Loss before income taxes	**(2,840)**	(5,881)
Income tax recovery	**–**	(90)
Net loss for the period	**(2,840)**	(5,791)
Net loss per common share (note 4)		
Basic	**$ (0.12)**	$ (0.24)
Diluted	**$ (0.12)**	$ (0.24)
Weighted average number of common shares outstanding	**24,648**	24,231

See accompanying notes

Consolidated Statements of Deficit

(Unaudited)

(thousands of dollars)	**13-week period ended June 30, 2007**	13-week period ended July 1, 2006
Deficit, beginning of period, as reported	**(50,537)**	(80,541)
Transitional adjustment on adoption of new accounting policies (note 3)	**(19)**	–
Deficit, beginning of period, as restated	**(50,556)**	(80,541)
Net loss for the period	**(2,840)**	(5,791)
Deficit, end of period	**(53,396)**	(86,332)

See accompanying notes

Consolidated Statements of Cash Flows

(Unaudited)

(thousands of dollars)	**13-week period ended June 30, 2007**	13-week period ended July 1, 2006
CASH FLOWS FROM OPERATING ACTIVITIES		
Net loss for the period	**(2,840)**	(5,791)
Add (deduct) items not affecting cash		
Amortization	**7,664**	7,440
Stock-based compensation (note 6)	**140**	135
Directors' compensation (note 5)	**110**	76
Loss on disposal of capital assets	**–**	9
Amortization and write-off of deferred financing charges	**139**	77
Other	**17**	–
Net change in non-cash working capital balances related to operations		
Accounts receivable	**2,431**	565
Inventories	**9,746**	(2,218)
Prepaid expenses	**(561)**	1,827
Income taxes recoverable	**–**	(90)
Deferred revenue	**1,810**	618
Accounts payable and accrued liabilities	**(21,133)**	(15,068)
Cash flows used in operating activities	**(2,477)**	(12,420)
CASH FLOWS FROM INVESTING ACTIVITIES		
Purchase of capital assets	**(2,939)**	(2,925)
Proceeds from sale of capital assets	**–**	57
Cash flows used in investing activities	**(2,939)**	(2,868)
CASH FLOWS FROM FINANCING ACTIVITIES		
Increase in bank indebtedness	**12,520**	16,030
Repayment of long-term debt (note 7)	**(13,895)**	(816)
Proceeds from share issuances (note 5)	**22**	95
Cash flows used in financing activities	**(1,353)**	15,309
Net increase (decrease) in cash and cash equivalents during the period	**(6,769)**	21
Cash and cash equivalents, beginning of period	**13,639**	5,983
Cash and cash equivalents, end of period	**6,870**	6,004

See accompanying notes

Consolidated Statements of Comprehensive Loss

(Unaudited)

(thousands of dollars)	**13-week period ended June 30, 2007**	13-week period ended July 1, 2006
Net loss	**(2,840)**	(5,791)
Other comprehensive loss, net of taxes		
Losses on derivatives designated as cash flow hedges (net of tax – $nil)	**(1,364)**	–
Reclassification to earnings of losses on derivatives designated as cash flow hedges prior to April 1, 2007 (net of tax – $nil)	**(144)**	–
Other comprehensive loss, net of taxes	**(1,508)**	–
Comprehensive loss	**(4,348)**	(5,791)

See accompanying notes

Notes to the Interim Consolidated Financial Statements

June 30, 2007

(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 March 31, 2007. Results of operations for the 13-week periods ended June 30, 2007 and July 1, 2006 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-week periods ended June 30, 2007 and July 1, 2006 are not indicative of the results of other periods.

3. CHANGES IN ACCOUNTING POLICIES

These consolidated 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 March 31, 2007, except as noted below.

Financial Instruments, Comprehensive Income and Hedges

The Canadian Institute of Chartered Accountants ("CICA") issued new standards relating to financial instruments: Financial Instruments – Recognition and Measurement; Financial Instruments – Disclosure and Presentation; Comprehensive Income; and Hedges. These new standards were adopted by the Company as of April 1, 2007.

Financial Instruments

Section 3855 of the CICA Handbook, "Financial Instruments – Recognition and Measurement", describes the standards for recognizing and measuring financial

assets, financial liabilities and derivatives. The new standard requires the Company to revalue certain of its financial assets and liabilities, including derivatives designated in qualifying hedging relationships and embedded derivatives in certain contracts, at fair value on the initial date of implementation and at each subsequent financial reporting date.

This standard also requires the Company to classify financial assets and liabilities according to their characteristics and management's intentions for the purposes of ongoing measurement. Classification for financial assets include:

a) held for trading – measured at fair value with changes in fair value recorded in net earnings;
b) held to maturity – recorded at amortized cost using the effective interest rate method, with gains and losses recognized in net earnings in the period that the asset is de-recognized or impaired;
c) available for sale – measured at fair value with changes in fair value recognized in other comprehensive income for the current period until realized through de-recognition or impairment; and
d) loans and receivables – recorded at amortized cost using the effective interest rate method, with gains and losses recognized in net earnings in the period that the asset is de-recognized or impaired.

Classification for financial liabilities include:

a) held for trading – measured at fair value with changes in fair value recorded in net earnings; and
b) other – measured at amortized cost using the effective interest rate method, with gains and losses recognized in net earnings in the period that the liability is de-recognized.

In accordance with the new standards, the Company's financial assets and liabilities are generally classified and measured as follows:

Asset/Liability	**Category**	**Measurement**
Cash and cash equivalents	Held for trading	Fair value
Accounts receivable	Loans and receivables	Amortized cost
Bank indebtedness	Other liabilities	Amortized cost
Accounts payable	Other liabilities	Amortized cost
Other accrued liabilities	Other liabilities	Amortized cost
Long-term debt	Other liabilities	Amortized cost

Other balance sheet accounts, such as inventories, prepaid expenses, future income taxes, capital assets, goodwill, deferred financing charges and deferred revenue are not within the scope of the new accounting standards as they are not financial instruments.

Embedded derivatives are required to be separated and measured at fair values if certain criteria are met. Management reviewed these contracts and determined that the Company does not currently have any significant embedded derivatives in these contracts that require separate accounting and disclosure.

Comprehensive Income

Section 1530 of the CICA Handbook, "Comprehensive Income", establishes standards for reporting and display of comprehensive income and defines other comprehensive income to include revenues, expenses, gains and losses that, in accordance with primary sources of generally accepted accounting principles, are recognized in comprehensive income, but excluded from net earnings. The Company has chosen to report a new financial statement entitled "Consolidated Statements of Comprehensive Loss" for changes in the fair value of certain of these financial assets and liabilities (i.e., the effective portion of changes in the fair value of a derivative designated in a cash flow hedging relationship). The "accumulated other comprehensive loss" (i.e., the portion of comprehensive income not already included in net earnings) is being presented as a separate line in shareholders' equity.

Hedges

Section 3865 of the CICA Handbook, "Hedges", describes when and how hedge accounting may be applied. It replaces Accounting Guideline 13, "Hedging Relationships", which was adopted by the Company in April 2004. The Company uses derivative financial instruments to manage the risks of its foreign currency and interest rate exposures. The Company enters into foreign currency option contracts to hedge future purchases of US dollar denominated goods and services. The fair value of these contracts is included in derivative liabilities. The changes in fair value of these contracts are included in other comprehensive income/loss to the extent the hedges continue to be effective. When the inventory is sold, the corresponding gain or loss deferred in accumulated other comprehensive income/loss is re-classed to cost of sales, operations, selling and administration. To the extent the change in fair value of the derivative is not completely offset by the change in fair value of the hedged item, the ineffective portion of the hedging relationship is recorded immediately in net earnings. For the quarter ended

June 30, 2007, the Company recorded a loss of $53,000 in cost of sales, operations, selling and administration representing the amount of hedge ineffectiveness.

Management estimates that the cost of goods sold for the remaining nine months of the fiscal year would be $1.4 million dollars lower had the Company not entered into foreign currency contracts to manage the risk of its foreign currency exposure. This estimate assumes exchange rates remain constant at the closing exchange rate for the quarter for the remainder of the fiscal year. The maximum length of time over which the Company is hedging its exposure to future cash flow variability for anticipated transactions is one year.

4. LOSS PER SHARE

Loss per share is calculated based on the weighted average number of common shares outstanding during the period. The Company's stock options and Director's deferred stock units ("DSUs") were anti-dilutive and therefore, were not included in the June 30, 2007 and July 1, 2006 diluted loss per share calculations.

5. SHARE CAPITAL

Share capital consists of the following:

	13-week period ended June 30, 2007		13-week period ended July 1, 2006		52-week period ended March 31, 2007	
	Number of shares	**Amount $ (thousands)**	Number of shares	Amount $ (thousands)	Number of shares	Amount $ (thousands)
Balance, beginning of period	**24,647,554**	**197,592**	24,225,918	194,861	24,225,918	194,861
Issued during the period						
Options exercised	**4,000**	**30**	17,200	118	421,636	2,731
Balance, end of period	**24,651,554**	**197,622**	24,243,118	194,979	24,647,554	197,592

On October 31, 2002, the Company established a Director's Deferred Stock Unit Plan. Under the Plan, Director's receive their annual retainer fees and other Board-related compensation in the form of DSUs. The Company issued 6,607 DSUs with a value of $0.1 million during the 13-week period ended June 30, 2007. The value of the outstanding DSUs as at June 30, 2007 was $1.1 million and was recorded into contributed surplus.

6. STOCK-BASED COMPENSATION

As at June 30, 2007, 1,341,546 stock options were outstanding with exercise prices ranging from $4.29 to $63.53. Of these outstanding stock options, 626,152 were exercisable. As at July 1, 2006, there were 1,821,688 options outstanding of which 619,786 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 13-week period ended June 30, 2007, $0.1 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 June 30, 2007	13-week period ended July 1, 2006
Risk-free interest rate	**4.1%**	4.7%
Expected volatility	**18.2%**	34.4%
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.

Pro Forma Earnings (thousands of dollars, except per share data)	**13-week period ended June 30, 2007**	13-week period ended July 1, 2006
Net loss – reported	**(2,840)**	(5,791)
Net loss – pro forma	**(2,922)**	(5,873)
Basic net loss per common share – reported	**$ (0.12)**	$ (0.24)
Basic net loss per common share – pro forma	**$ (0.12)**	$ (0.24)
Diluted net loss per common share – reported	**$ (0.12)**	$ (0.24)
Diluted net loss per common share – pro forma	**$ (0.12)**	$ (0.24)

7. DEFERRED FINANCING CHARGES

On April 11, 2007, the Company renegotiated its credit agreement with its bank. The new credit agreement provides the Company with a revolving line of credit of up to $60.0 million. As part of the refinancing, the Company repaid $13.0 million of long-term debt that was outstanding under the old agreement, and wrote-off $0.1 million in deferred financing charges associated with the old agreement. The Company incurred $0.1 million of deferred financing charges associated with the new agreement and it has been netted with long-term debt in the consolidated balance sheets. The repayment was originally due in July 2007. As a result of the long-term debt repayment, the Company also terminated the interest rate swap associated with the long-term debt and recognized $0.1 million into earnings in April 2007.

8. ACCUMULATED OTHER COMPREHENSIVE LOSS

Changes in accumulated other comprehensive loss during the period are presented as follows:

(thousands of dollars)	**13-week period ended June 30, 2007**
Adjusted opening balance due to adoption of new accounting policies – financial instruments	**144**
Other comprehensive loss for the period	**(1,508)**
Balance, end of period	**(1,364)**

9. CONSOLIDATED STATEMENTS OF CASH FLOWS

Supplemental cash flow information:

(thousands of dollars)	**13-week period ended June 30, 2007**	13-week period ended July 1, 2006
Interest paid	**287**	660
Assets acquired under capital lease	**788**	2,076

10. 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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