FIRST QUARTER REPORT

FOR THE 13-WEEK PERIOD ENDED JULY 3, 2010

"I believe that imagination is stronger than knowledge. That myth is more potent than history. That dreams are more powerful than facts. That hope always triumphs over experience. That laughter is the only cure for grief. And I believe that love is stronger than death."

– Robert Fulghum

Indigo

Books & Music Inc.

www.indigo.ca

Table of Contents

Management's Discussion and Analysis

The following Management's Discussion and Analysis ("MD&A") is prepared as at August 9, 2010 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 July 3, 2010 and June 27, 2009. 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 3, 2010, and Management's Discussion and Analysis ("MD&A") included in the Company's fiscal 2010 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 Canada'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* website. As at July 3, 2010, the Company operated 96 superstores under the banners *Chapters*, *Indigo* and the *World's Biggest Bookstore*, 149 small format stores under the banners *Coles*, *Indigo*, *Indigospirit*, *SmithBooks* and *The Book Company* and one new concept store under the banner *Pistachio*. During the first quarter of fiscal 2011, the Company opened no new superstores and no new small format stores. The Company closed one small format store during the first quarter of fiscal 2011. The Company has a 50% interest in Calendar Club of Canada Limited Partnership ("Calendar Club"), which operates seasonal kiosks and year-round stores in shopping malls across Canada.

In February 2009, Indigo launched *Shortcovers* (*www.shortcovers.com*), a new digital destination offering online and mobile service that provides instant access to books, articles and blogs. In December 2009, Indigo transferred the net assets of *Shortcovers* into a new company, Kobo Inc. ("Kobo"). The *Shortcovers* website was renamed to *www.kobobooks.com*. Indigo owns 57.7% of Kobo's outstanding common shares.

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

The weighted average number of common shares outstanding for the first quarter of fiscal 2011 was 24,742,761 as compared to 24,526,991 last year.

As at August 9, 2010, the number of outstanding common shares was 24,736,815 with a book value of $198.6 million. The number of common shares reserved for issuance under the employee stock option plan is 2,223,192. As at July 3, 2010, there were 1,814,542 stock options outstanding of which 861,542 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 and may not be comparable to that of other retailers.

(millions of dollars)	**13-week period ended July 3, 2010**	**% Revenues**	13-week period ended June 27, 2009	% Revenues
Revenues	**204.3**	**100.0**	193.6	100.0
Cost of sales	**117.8**	**57.7**	107.8	55.7
Cost of operations	**64.6**	**31.6**	63.0	32.6
Selling and administrative expenses	**22.6**	**11.1**	18.8	9.7
EBITDA[1]	**(0.7)**	**(0.3)**	4.0	2.1

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

Revenue Increase Driven by New Store Openings and eReader Sales

Total consolidated revenues for the 13-week period ended July 3, 2010 increased $10.7 million or 5.5% to $204.3 million from $193.6 million for the period ended June 27, 2009. The increase was driven by new superstores which were not open in the first quarter of last year, growth in the sales of gift, toys and paper products, and the sale of Kobo eReaders.

Comparable store sales for the fiscal year increased 1.5% in superstores primarily due to growth in the sales of gift, toys and paper products and eReaders, and decreased 0.7% in small format stores primarily due to lower trade book sales. Comparable store sales are defined as sales generated by stores that have been open for more than 12 months on a 52-week basis. 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 remained flat at $19.1 million for the 13-week period ended July 3, 2010 compared to the same period last year. Revenues from other sources include revenues generated through corporate sales, revenues from the sale of loyalty cards, the Company's proportionate revenues generated through Calendar Club, gift card breakage, and revenues from Kobo and Pistachio.

Revenues from other sources increased $5.3 million over last year to $11.9 million primarily as a result of Kobo eBook and eReader sales.

Revenues by channel are highlighted below:

(millions of dollars)	**13-week period ended July 3, 2010**	13-week period ended June 27, 2009	% increase	Comparable store sales % increase
Superstores	**142.9**	136.6	4.6	1.5
Small format stores	**30.4**	31.3	(2.9)	(0.7)
Online (including store kiosks)	**19.1**	19.1	–	N/A
Other	**11.9**	6.6	80.3	N/A
	204.3	193.6	5.5	1.1

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

	Superstores		Small format stores	
(millions of dollars)	**13-week period ended July 3, 2010**	13-week period ended June 27, 2009	**13-week period ended July 3, 2010**	13-week period ended June 27, 2009
Total revenues	**142.9**	136.6	**30.4**	31.3
Adjustments for stores not in both fiscal periods	**(6.9)**	(2.6)	**(0.7)**	(1.4)
Comparable store sales	**136.0**	134.0	**29.7**	29.9

Cost of Sales (as a Percent of Revenues) Increased Compared to Last Year

Cost of sales includes the landed cost of goods sold, online shipping costs, inventory shrink and damage provision, less all vendor support programs. In absolute dollar terms, cost of sales increased $10.0 million to $117.8 million. The increase was primarily driven by the cost of goods sold associated with the sales of Kobo eReaders and sales from new stores.

As a percent of total revenues, cost of sales increased 2.0% to 57.7% in the first quarter of fiscal 2011, compared to 55.7% last year. The increase in cost of sales percentage was driven by Kobo eReaders, which have minimal margin and higher sales discounts compared to last year. The increase in sales discounts resulted in a reduction to revenues, causing cost of sales percentage to increase.

Cost of Operations (as a Percent of Revenues) Improved from Last Year
Cost of operations includes all store, online, distribution centre and Calendar Club costs. As a percent of total revenues, cost of operations decreased by 1.0% in the first quarter as compared to the same period last year. The Company saw growth in total revenues while minimizing the impact of increased costs arising from new superstores. Cost of operations increased $1.6 million primarily due to an increase in occupancy and labour costs. Occupancy costs increased $1.1 million primarily due to the operation of five additional superstores compared to last year. Labour costs increased $0.9 million compared to last year as a result of higher minimum wage rates in most provinces and the opening of new superstores as mentioned above. These increases were partially offset by a decrease of $0.2 million in Pistachio expenses as the Company operated one fewer store compared to last year.

Selling and Administrative Expenses Increased due to Expenses Related to Kobo and Strategic Projects
Selling and administrative expenses include all marketing, head office and Kobo costs. In absolute dollar terms, these expenses increased $3.8 million compared to last year. As a percent of total revenues, selling and administrative expenses increased by 1.4% in the first quarter as compared to the same period last year.

The Company recorded $2.6 million more in operating expenses for Kobo and strategic projects this year compared to the same period last year. In the first quarter, expenses related to the operation of Kobo totalled $3.2 million compared to $0.8 million spent by Indigo on digital initiatives last year. Marketing expenses increased by $1.0 million compared to last year as the result of an increased number of promotional campaigns.

EBITDA Decreased as a Percent of Revenues
EBITDA, defined as earnings before interest, taxes, depreciation, amortization, non-controlling interest and non-recurring items decreased $4.7 million to a loss of $0.7 million for the 13-week period ended July 3, 2010, compared to earnings of $4.0 million for the 13-week period ended June 27, 2009. As discussed above, the decrease in EBITDA was primarily due to increases in cost of sales, cost of operations and selling and administrative expenses, offset by the increase in total revenues. EBITDA as a percent of revenues decreased to a loss of 0.3% this quarter from earnings of 2.1% in the same quarter last year.

Depreciation and Amortization Increased versus Last Year
Depreciation and amortization for the 13-week period ended July 3, 2010 increased by $0.1 million to $6.9 million compared to $6.8 million last year. Capital expenditures in the current quarter totalled $8.1 million and included $3.8 million on store construction, renovations and equipment, $3.5 million on intangible assets (primarily application software and internal development costs), and $0.8 million on technology equipment. Of the $0.8 million expenditure in technology equipment, $0.3 million was financed through capital leases.

Net Interest Income Recorded
The Company recognized net interest income of less than $0.1 million in the first quarter of this year compared to net interest expense of less than $0.1 million in the same period last year. The Company nets interest income received against interest expense paid on capital leases. The interest income received was higher this year due to an increase in market interest rates and a stronger cash position.

Income Tax Recovery Decreased from Last Year
The Company recognized income tax recovery of $0.4 million in the first quarter compared to $0.5 million in the same period last year. The Company did not book any income tax recovery on the portion of operating losses incurred by Kobo, as Kobo is a separate company this year and has not demonstrated that it can more likely than not utilize its tax loss carryforwards based on expected future earnings. In addition, the estimated annual effective tax rate is lower this year compared to last year, leading to lower income tax recovery in the first quarter. The estimated annual effective tax rate is lower because the Company has a larger deferred credit that will reduce income tax expense this year compared to last year. The deferred credit represents the difference between the net cash consideration paid and the value of the future tax asset recorded from the purchase of tax losses from a related company.

Non-Controlling Interest
As the majority shareholder of Kobo, the Company fully consolidates its results in its unaudited interim consolidated financial statements. The Company records a non-controlling interest to its Consolidated Statements of Loss and Comprehensive Loss to reflect the portion of Kobo's income or loss that is attributable to the minority shareholders of Kobo. For the quarter ended July 3, 2010, the Company recorded $1.9 million in non-controlling interest for the portion of Kobo losses attributable to the minority shareholders.

Net Loss Recorded for the Current Fiscal Quarter

The Company recognized a net loss of $5.3 million for the quarter or $0.21 net loss per common share, compared to a net loss of $2.3 million or $0.09 net loss per common share last year. The increase in net loss was primarily due to the decrease in EBITDA, as described above.

Seasonality and First Quarter Results

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

	Fiscal quarters							
(thousands of dollars, except per share data)	**Q1 Fiscal 2011**	Q4 Fiscal 2010	Q3 Fiscal 2010	Q2 Fiscal 2010	Q1 Fiscal 2010	Q4 Fiscal 2009	Q3 Fiscal 2009	Q2 Fiscal 2009
Revenues	**204,286**	228,191	340,195	206,990	193,551	214,522	330,014	205,261
Net earnings (loss)	**(5,308)**	497	34,530	2,200	(2,304)	1,917	26,770	3,188
Basic earnings (loss) per share	**$ (0.21)**	$ 0.02	$ 1.41	$ 0.09	$ (0.09)	$ 0.08	$ 1.09	$ 0.13
Diluted earnings (loss) per share	**$ (0.21)**	$ 0.02	$ 1.38	$ 0.09	$ (0.09)	$ 0.08	$ 1.07	$ 0.13

Overview of Consolidated Balance Sheets

Total Assets

As at July 3, 2010, total assets were $53.8 million greater than total assets at June 27, 2009. The increase in assets was primarily due to increases in the Company's cash and cash equivalents (including restricted cash, as described in notes 3 and 9 to the unaudited interim consolidated financial statements), inventories, intangible assets, property, plant and equipment and future tax assets. Cash and cash equivalents (including restricted cash) increased $16.0 million primarily due to increased sales and the consolidation of $6.1 million of Kobo's cash and cash equivalents. Intangible assets increased by $7.2 million primarily due to expenditures for technology-related projects. Property, plant and equipment increased by $6.9 million primarily due to the opening of new superstores throughout last fiscal year. The Company's inventory position increased $15.6 million mainly due to new superstores and the expansion of the gift, paper and toy businesses. Future tax assets increased by $4.8 million compared to last year as the result of acquiring tax loss carryforwards from a related company.

On a fiscal year-to-date basis, total assets decreased $15.9 million compared to April 3, 2010. The decrease in total assets was primarily due to a decrease in cash and cash equivalents (including restricted cash), offset by increases in accounts receivable and intangible assets. Cash and cash equivalents (including restricted cash) decreased by $18.4 million while accounts receivable increased by $2.4 million and intangible assets increased by $1.1 million compared to April 3, 2010. The decrease in cash and cash equivalents (including restricted cash) is consistent with the seasonal nature of the business. Accounts receivable increased due to Kobo's sales of eReaders to other resellers.

Total Liabilities

As at July 3, 2010, total liabilities were $24.1 million higher than total liabilities at June 27, 2009. The increase in liabilities was primarily due to a $26.3 million increase in accounts payable and current and long-term accrued liabilities. The increase in accounts payable is consistent with the increase in the Company's inventory position, as noted above. The deferred credit, which arose from the Company's purchase of tax losses and is recorded as part of accounts payable and current accrued liabilities, increased by $8.6 million from last year. Deferred revenue also increased by $2.4 million as a result of growth in the Company's loyalty card program. These increases were partially offset by a decrease of $1.7 million in long-term debt as the Company made payments on its capital lease obligations. Dividends payable also decreased by $2.5 million compared to last year due to the timing of the dividend payments.

On a fiscal year-to-date basis, total liabilities decreased $6.3 million compared to April 3, 2010. The decrease in total liabilities was mainly due to reductions in accounts payable and current and long-term accrued liabilities of $7.9 million and was partially offset by the increase of $2.0 million in deferred revenue.

Non-Controlling Interest

As the majority shareholder of Kobo, the Company fully consolidates its results in its unaudited interim consolidated financial statements. The Company records a non-controlling interest to its Consolidated Balance Sheets to reflect the portion of Kobo's equity that is attributable to the minority shareholders of Kobo. For the quarter ended July 3, 2010, the Company recorded $5.2 million in non-controlling interest. On a fiscal year-to-date basis, the value of the non-controlling interest decreased $1.7 million compared to April 3, 2010 due to Kobo's year-to-date net loss.

Shareholders' Equity

Shareholders' equity at July 3, 2010 increased $24.5 million compared to June 27, 2009. The increase in shareholders' equity was primarily due to net earnings of $31.9 million in the last four quarters offset by $10.1 million of dividend payments. Share capital increased $2.1 million mainly due to employees exercising their stock options and contributed surplus increased $0.9 million due to the expensing of employee stock options and Director's deferred stock units.

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. The Company relies on cash and accounts payable as 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 $94.3 million as at July 3, 2010, compared to $82.4 million as at June 27, 2009 and $106.4 million at the end of fiscal 2010.

The Company's leverage position (defined as Total Liabilities to Total Shareholders' Equity) remained stable at 1.0:1 at the end of the current quarter compared to last year and as at April 3, 2010.

Overview of Consolidated Statements of Cash Flows

Cash and cash equivalents decreased $19.2 million during the first quarter of fiscal 2011 compared to a decrease of $22.6 million last year. The $19.2 million decrease was driven by cash flows used in operating activities of $8.1 million, cash flows used in investing activities of $8.5 million, cash flows used in financing activities of $3.6 million and the effect of foreign currency exchange rate changes on cash and cash equivalents of $1.1 million.

Cash Flows Used in Operating Activities

Cash flows used in operating activities were $8.1 million in the first quarter of fiscal 2011. This was a reduction of $7.3 million over the same period last year, when cash flows used in operating activities were $15.4 million. Cash flows for the current quarter were primarily used to reduce the Company's accounts payable and accrued liabilities by $7.9 million.

Cash Flows Used in Investing Activities

In the first quarter, net cash flows used in investing activities were $8.5 million compared to $6.4 million used in the same quarter last year. In the current quarter, the Company spent $3.8 million in store construction, renovations and equipment, $3.5 million on intangible assets and $0.5 million in technology-related products. During the first quarter last year, the Company spent $2.6 million in store construction, renovations and equipment, $3.2 million on intangible assets and $0.6 million in technology-related products. The change in restricted cash for the first quarter of this year was $0.8 million and primarily represents cash pledged as collateral for letter of credit obligations issued to support the Company's purchases of offshore merchandise.

Cash Flows Used in Financing Activities

Net cash flows used in financing activities were $3.6 million during the first quarter compared to $0.7 million in the same period last year. The increase in cash flows used by financing activities was driven by $2.7 million of dividends paid in the first quarter of the current fiscal year. No dividends were paid in the first quarter of last year.

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 flows generated from operations and long-term debt. Indigo invests its cash in highly liquid assets. The Company does not invest in asset-backed commercial paper.

Based on the Company's liquidity position and cash flow forecast, the Board of Directors approved a 10% increase in the Company's quarterly cash dividend to $0.11 per common share or $0.44 per common share annually, starting in the current quarter. Based on current operating levels, management expects cash flow generated from operations to be sufficient to meet its working capital needs, debt service requirements and dividend payments for fiscal 2011. In addition, Indigo has the ability to reduce capital spending to fund debt requirements if necessary; however a long-term decline in capital expenditures may negatively impact revenues and profit growth. Future declaration of quarterly dividends and the establishment of future record and payment dates are subject to the final determination of the Company's Board of Directors. Dividends may be reduced or eliminated if required to maintain appropriate capital resources.

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 flows. 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 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. Methods used to calculate critical accounting estimates are consistent with prior periods. The significant accounting policies of the Company are described in Note 2 of the consolidated financial statements in the fiscal 2010 Annual Report, and the Company's critical accounting estimates are disclosed in the MD&A section of its fiscal 2010 Annual Report.

In the first quarter of fiscal 2011, 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 future tax assets or management's assessment of impairment of long-lived assets, intangibles and goodwill. Furthermore, the method of determining gift card breakage is consistent with that used in previous periods.

New Accounting Pronouncements

The following accounting standards will be adopted by the Company in the future.

Financial Instruments – Recognition and Measurement

In April 2009, the CICA amended Section 3855, "Financial Instruments – Recognition and Measurement," to provide guidance on when an embedded prepayment option is separated from its host debt instrument. The amendment is effective for interim and annual financial statements relating to fiscal years beginning on or after January 1, 2011, with early adoption permitted. The amendment does not have an impact on Indigo's results of operations, financial position or disclosures. The Company plans to adopt the new amendment for fiscal 2012.

Business Combinations

Section 1582 of the CICA Handbook, "Business Combinations", replaces the existing Section 1581, "Business Combinations." The CICA also issued Section 1601, "Consolidated Financial Statements" and Section 1602, "Non-Controlling Interests", which replaces Section 1600, "Consolidated Financial Statements." These new sections are based on the International Accounting Standards Board's ("IASB") International Financial Reporting Standard 3, "Business Combinations" and will replace the existing guidance on business combinations and consolidated financial statements.

The objective of the new standards is to harmonize Canadian accounting for business combinations with the international and U.S. accounting standards. The three new standards have to be adopted concurrently and will apply to interim and annual consolidated financial statements relating to fiscal years beginning on or after January 1, 2011. Assets and liabilities that arose from business combinations whose acquisition dates preceded the application of the new standards will not be adjusted upon application of these new standards. Section 1602 should be applied retrospectively except for certain items. The Company plans to adopt the new accounting standards for fiscal 2012. Adoption of the new standards will have no retrospective impact on Indigo's results of operations, financial position or disclosures.

International Financial Reporting Standards

In February 2008, the Canadian Accounting Standards Board confirmed its plan to converge with International Financial Reporting Standards ("IFRS"). An opening statement of financial position in accordance with IFRS will be prepared as at April 4, 2010 ("transition date"), to facilitate the changeover to IFRS. However, the Company will continue to report its fiscal 2011 and comparative fiscal 2010 results in accordance with Canadian GAAP. The Company will prepare and report interim and annual consolidated financial statements according to IFRS starting fiscal 2012, with fiscal 2011 comparatives also in accordance with IFRS, after the changeover date of April 3, 2011.

A detailed description of the Company's IFRS project structure and status was included as part of the "New Accounting Pronouncements" section on page 20 of the MD&A included in the Company's 2010 Annual Report. The IFRS conversion project is progressing according to plan and no significant changes have been made to the project structure or timelines.

The Company will be implementing a new stock option accounting software program which is capable of maintaining records in both Canadian GAAP and IFRS. For testing purposes, the new software will be run in tandem with the Company's existing accounting system. The Company also continues to perform testing over its existing IT system's capability to capture data necessary for IFRS reporting. To date, no significant issues have been noted. Testing of the IT system will continue throughout the IFRS conversion process as new impacts are identified.

The Company is currently assessing the quantitative impact of the transitional adjustments which will result from the implementation of IFRS. Preliminary indication as to the impact of certain standards, elections and exemptions was provided in the 2010 MD&A included in the Company's 2010 Annual Report. As further impacts are determined throughout the year, updates to this information will be provided.

The Company has identified one new IFRS impact during the current quarter relating to cash-settled share-based compensation awards. Under Canadian GAAP, these awards are measured by reference to market value of the related shares. However, under IFRS, fair value of these awards is measured using a valuation model. This measurement difference will result in a transition adjustment on the IFRS opening balance sheet. The transition adjustment is expected to increase liabilities and decrease retained earnings on the IFRS opening balance sheet.

The information above is provided to allow investors and others to obtain a better understanding of our IFRS changeover plan and the resulting possible effects on, for example, our consolidated financial statements and operating performance measures. Readers are cautioned, however, that it may not be appropriate to use such information for any other purpose. This information also reflects our most recent assumptions and expectations; circumstances may arise, such as changes in IFRS, regulations or economic conditions, which could change these assumptions or expectations.

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 2010 Annual Report.

Disclosure Controls & Procedures

Management is responsible for establishing and maintaining a system of disclosure controls and procedures to provide reasonable assurance that all material information relating to the Company is gathered and reported on a timely basis to senior management, including the Chief Executive Officer (CEO) and Chief Financial Officer (CFO), so that appropriate decisions can be made by them regarding public disclosure.

Internal Controls over Financial Reporting

Management is also responsible for establishing and maintaining adequate internal control 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.

All internal control systems, no matter how well designed, have inherent limitations. Therefore, even those systems determined to be effective can provide only reasonable assurance with respect to consolidated financial statement preparation and presentation. Additionally, management is necessarily required to use judgment in evaluating controls and procedures.

Changes in Internal Control over Financial Reporting

Management has also evaluated whether there were changes in the Company's internal control over financial reporting that occurred during the period beginning on April 4, 2010 and ended on July 3, 2010 that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting, and has determined that no material changes occurred during this period.

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 on a 52-week basis. 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, amortization and non-controlling interest. The method of calculating EBITDA is consistent with that used in prior periods.

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

(millions of dollars)	**13-week period ended July 3, 2010**	13-week period ended June 27, 2009
EBITDA	**(0.7)**	4.0
Depreciation of property, plant and equipment	**4.5**	4.9
Amortization of intangible assets	**2.4**	1.8
Interest on long-term debt and financing charges	**0.1**	0.1
Interest income on cash and cash equivalents	**(0.1)**	0.0
Loss before income taxes and non-controlling interest	**(7.6)**	(2.8)

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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 consolidated 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 Operating Officer & Chief Financial Officer

Dated as of the 9th day of August, 2010.

Consolidated Balance Sheets

(Unaudited)

(thousands of dollars)	**As at July 3, 2010**	As at June 27, 2007	As at April 3, 2010
ASSETS			
Current			
Cash and cash equivalents	**84,314**	69,165	103,489
Restricted cash (note 9)	**1,196**	363	409
Accounts receivable	**10,827**	7,910	8,455
Inventories (note 7)	**223,836**	208,208	224,406
Income taxes recoverable	**899**	–	899
Prepaid expenses	**5,948**	5,631	6,771
Future tax assets	**7,036**	6,717	6,615
Total current assets	**334,056**	297,994	351,044
Property, plant and equipment	**77,470**	70,597	77,478
Future tax assets	**40,894**	36,422	40,894
Intangible assets	**24,861**	17,612	23,794
Goodwill	**26,632**	27,523	26,632
Total assets	**503,913**	450,148	519,842
LIABILITIES AND SHAREHOLDERS' EQUITY			
Current			
Accounts payable and accrued liabilities (notes 8 and 10)	**223,418**	197,859	229,920
Deferred revenue	**14,849**	12,434	12,882
Dividends payable	**–**	2,453	–
Income taxes payable	**–**	344	–
Current portion of long-term debt (notes 8 and 9)	**1,460**	2,538	1,863
Total current liabilities	**239,727**	215,628	244,665
Long-term accrued liabilities (note 8)	**6,841**	6,123	8,203
Long-term debt (notes 8 and 9)	**1,198**	1,868	1,174
Total liabilities	**247,766**	223,619	254,042
Non-controlling interest	**5,160**	–	6,831
Shareholders' equity			
Share capital (note 5)	**198,561**	196,508	198,635
Contributed surplus (note 6)	**4,936**	4,044	4,670
Retained earnings	**47,490**	25,977	55,664
Total shareholders' equity	**250,987**	226,529	258,969
Total liabilities and shareholders' equity	**503,913**	450,148	519,842

See accompanying notes

On behalf of the Board:

Heather M. Reisman, Director

Michael Kirby, Director

Consolidated Statements of Loss and Comprehensive Loss

(Unaudited)

(thousands of dollars, except per share data)	**13-week period ended July 3, 2010**	13-week period ended June 27, 2009
Revenues	**204,286**	193,551
Cost of sales, operations, selling and administration (note 7)	**205,014**	189,592
	(728)	3,959
Depereciation of property, plant and equipment	**4,505**	4,912
Amortization of intangible assets	**2,412**	1,841
	6,917	6,753
Loss before the undernoted items	**(7,645)**	(2,794)
Interest on long-term debt and financing charges	**33**	57
Interest income on cash and cash equivalents	**(80)**	(11)
Loss before income taxes and non-controlling interest	**(7,598)**	(2,840)
Income tax recovery	**(421)**	(536)
Loss before non-controlling interest	**(7,177)**	(2,304)
Non-controlling interest	**(1,869)**	–
Net loss and comprehensive loss for the period	**(5,308)**	(2,304)
Net loss per common share (note 4)		
Basic	**$ (0.21)**	$ (0.09)
Diluted	**$ (0.21)**	$ (0.09)

See accompanying notes

Consolidated Statements of Retained Earnings

(Unaudited)

(thousands of dollars)	**13-week period ended July 3, 2010**	13-week period ended June 27, 2009)
Retained earnings, beginning of period	**55,664**	30,734
Net loss for the period	**(5,308)**	(2,304)
Shares repurchase excess (note 5)	**(144)**	–
Dividends paid	**(2,722)**	(2,453)
Retained earnings, end of period	**47,490**	25,977

See accompanying notes

Consolidated Statements of Cash Flows

(Unaudited)

(thousands of dollars)	**13-week period ended July 3, 2010**	13-week period ended June 27, 2009
CASH FLOWS FROM OPERATING ACTIVITIES		
Net loss	**(5,308)**	(2,304)
Add (deduct) items not affecting cash		
Depreciation of property, plant and equipment	**4,505**	4,912
Amortization of intangible assets	**2,412**	1,841
Stock-based compensation (note 6)	**175**	243
Directors' stock-based compensation (note 6)	**112**	125
Future tax assets	**(421)**	(536)
Loss on disposal of capital assets	**67**	8
Non-controlling interest	**(1,869)**	–
Other	**(926)**	105
Net change in non-cash working capital balances related to operations		
Accounts receivable	**(2,372)**	1,980
Inventories	**570**	13,559
Prepaid expenses	**823**	(513)
Deferred revenue	**1,967**	822
Accounts payable and accrued liabilities	**(7,864)**	(35,672)
Cash flows used in operating activities	**(8,129)**	(15,430)
CASH FLOWS FROM INVESTING ACTIVITIES		
Change in restricted cash	**(787)**	5
Purchase of property, plant and equipment	**(4,277)**	(3,238)
Addition of intangible assets	**(3,479)**	(3,154)
Cash flows used in investing activities	**(8,543)**	(6,387)
CASH FLOWS FROM FINANCING ACTIVITIES		
Repayment of long-term debt	**(666)**	(742)
Proceeds from share issuances (note 5)	**74**	28
Repurchase of common shares (note 5)	**(313)**	–
Dividends paid	**(2,722)**	–
Cash flows used in financing activities	**(3,627)**	(714)
Effect of foreign currency exchange rate changes on cash and cash equivalents	**1,124**	(105)
Net decrease in cash and cash equivalents during the period	**(19,175)**	(22,636)
Cash and cash equivalents, beginning of period	**103,489**	91,801
Cash and cash equivalents, end of period	**84,314**	69,165

See accompanying notes

Notes to the Interim Consolidated Financial Statements

July 3, 2010
(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 53-week period ended April 3, 2010. Results of operations for the 13-week periods ended July 3, 2010 and June 27, 2009 and the balances as 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 July 3, 2010 and June 27, 2009 are not indicative of the results of other periods.

3. ACCOUNTING POLICIES

Except as indicated below, these unaudited interim consolidated financial statements follow the same accounting policies and methods of their application as the most recent audited annual consolidated financial statements for the 53-week period ended April 3, 2010.

Restricted cash

Cash is considered to be restricted when it is subject to contingent rights of a third-party customer, vendor, or government agency.

New Accounting Pronouncements

Financial Instruments – Recognition and Measurement

In April 2009, the CICA amended Section 3855, "Financial Instruments – Recognition and Measurement," to provide guidance on when an embedded prepayment option is separated from its host debt instrument. The amendment is effective for interim and annual financial statements relating to fiscal years beginning on or after January 1, 2011, with early adoption permitted. The amendment does not have an impact on Indigo's results of operations, financial position or disclosures. The Company plans to adopt the new amendment for fiscal 2012.

Business Combinations

Section 1582 of the CICA Handbook, "Business Combinations", replaces the existing Section 1581, "Business Combinations." The CICA also issued Section 1601, "Consolidated Financial Statements" and Section 1602, "Non-Controlling Interests", which replaces Section 1600, "Consolidated Financial Statements." These new sections are based on the International Accounting Standards Board's ("IASB") International Financial Reporting Standard 3, "Business Combinations" and will replace the existing guidance on business combinations and consolidated financial statements.

The objective of the new standards is to harmonize Canadian accounting for business combinations with the international and U.S. accounting standards. The three new standards have to be adopted concurrently and will apply to interim and annual consolidated financial statements relating to fiscal years beginning on or after January 1, 2011. Assets and liabilities that arose from business combinations whose acquisition dates preceded the application of the new standards will not be adjusted upon application of these new standards. Section 1602 should be applied retrospectively except for certain items. The Company plans to adopt the new accounting standards for fiscal 2012. Adoption of the new standards will have no retrospective impact on Indigo's results of operations, financial position or disclosures.

International Financial Reporting Standards ("IFRS")

In February 2008, the Canadian Accounting Standards Board confirmed its plan to converge with IFRS. The Company must prepare interim and annual financial statements in accordance with IFRS for fiscal years beginning on or after January 1, 2011. The Company's launch of its IFRS conversion project began in 2008 when it established an internal project team and engaged an external consultant to conduct a preliminary diagnosis and scoping exercise. To date, the project team has completed a detailed assessment of each standard, including identifying the differences between the Company's current policies and those under IFRS, and determined the financial implications that will result from the adoption of these new standards. The team, with the assistance of its external consultant, has prepared a sample of the Company's historical financial statements using IFRS.

Project plans are being developed to address the information technology and data system impacts, disclosure controls and procedures and internal controls over financial reporting.

The Company continues to monitor and assess the impact of evolving differences between Canadian GAAP and IFRS, since the IASB is expected to continue issuing new accounting standards during the transition period. As a result, the final impact of IFRS on the Company's consolidated financial statements can only be measured once all the applicable IFRS at the conversion date are known.

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 July 3, 2010 and June 27, 2009 diluted loss per share calculations.

5. SHARE CAPITAL

Share capital consists of the following:

	13-week period ended July 3, 2010		13-week period ended June 27, 2009		52-week period ended April 3, 2010	
	Number of shares	**Amount $ (thousands)**	Number of shares	Amount $ (thousands)	Number of shares	Amount $ (thousands)
Balance, beginning of period	**24,742,915**	**198,635**	24,526,272	196,471	24,526,272	196,471
Issued during the period						
Directors' deferred stock units converted	–	–	–	–	5,000	70
Options exercised	**10,000**	**95**	4,200	37	245,156	2,362
Repurchase of common shares	**(21,000)**	**(169)**	–	–	(33,513)	(268)
Balance, end of period	**24,731,915**	**198,561**	24,530,472	196,508	24,742,915	198,635

On October 27, 2009, the Company announced its intent to make a normal course issuer bid ("NCIB"), subject to final acceptance of its notice of intention by the Toronto Stock Exchange. The Toronto Stock Exchange approved the NCIB on October 27, 2009. Under the NCIB, Indigo may purchase up to 1,227,229 of its common shares, representing approximately 5% of its total outstanding common shares. Daily purchases will be limited to 2,571 common shares, other than block purchase exemptions. During the 13-week period ended July 3, 2010, the Company repurchased 21,000 common shares (2009 – nil) at an average price of $14.89 per share for a total cash consideration of $0.3 million under the NCIB. The repurchased shares were cancelled and returned to treasury. The cash consideration exceeded the carrying value of the shares repurchased by $0.1 million and the amount was charged to retained earnings.

6. STOCK-BASED COMPENSATION

As at July 3, 2010, 1,814,542 stock options were outstanding with exercise prices ranging from $4.45 to $16.75. Of these outstanding stock options, 861,542 were exercisable. As at June 27, 2009, there were 2,019,919 stock options outstanding of which 846,731 were exercisable.

The Company uses the fair value method of accounting for stock options, which estimates the fair value of the stock options granted on the date of grant and expenses this value over the vesting period. There were no stock options granted during the 13-week period ended July 3, 2010 (2009 – $1.7 million).

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 weighted average assumptions during the periods presented:

	13-week period ended June 27, 2009
Risk-free interest rate	2.3%
Expected volatility	41.6%
Expected time until exercise	5.9 years
Expected dividend yield	3.1%

On October 31, 2002, the Company established a Directors' Deferred Stock Unit Plan ("DSU Plan"). Under the DSU Plan, Directors receive their annual retainer fees and other Board-related compensation in the form of deferred stock units ("DSUs"). The number of shares reserved for issuance under this plan is 250,000. The Company issued 9,620 DSUs with a value of $0.1 million during the 13-week period ended July 3, 2010 (2009 – $0.1 million). The fair value of the outstanding DSUs as at July 3, 2010 was $2.1 million (2009 – $1.7 million) and was recorded in contributed surplus.

As part of the Kobo transaction in fiscal 2010, the Company entered into agreements to allow one Indigo Director and one Kobo Director to purchase shares of Kobo. These agreements allow for the purchase of up to 200,000 Kobo shares directly from Indigo. The agreements may only be exercised upon fulfillment of specified performance conditions. As at July 3, 2010, the performance conditions have not been met and, as such, no amount has been recorded relating to these agreements.

The effect of stock-based compensation transactions on contributed surplus is presented below:

(thousands of dollars)	**13-week period ended July 3, 2010**	13-week period ended June 27, 2009
Balance, beginning of period	**4,670**	3,685
Options expensed	**175**	243
DSUs expensed	**112**	125
Options exercised	**(21)**	(9)
Balance, end of period	**4,936**	4,044

7. INVENTORIES

The cost of inventories recognized as an expense for the 13-week period ended July 3, 2010 was $116.3 million (2009 – $108.1 million). The amount of inventory write-downs as a result of net realizable value lower than cost was $0.5 million for the first quarter (2009 – $0.2 million), and there were no reversals of inventory write-downs that were recognized in prior periods. The amount of inventory with net realizable value equal to cost was $1.1 million as at July 3, 2010 (2009 – $1.4 million).

8. FINANCIAL RISK MANAGEMENT

The Company's activities expose it to a variety of financial risks, including risks related to foreign exchange, interest rate, credit and liquidity.

Foreign exchange risk

The Company's foreign exchange risk is largely limited to currency fluctuations between the Canadian and U.S. dollar. Decreases in the value of the Canadian dollar relative to the U.S. dollar affect less than 10% of the Company's total cost of purchases and could negatively impact the Company's net earnings. Additionally, the Company's overall U.S. dollar exposure is immaterial. The Company does not use foreign currency derivative contracts to hedge its foreign exchange risk.

The strategic partnerships entered into by Kobo are anticipated to result in sales to American, European, Asian and Australian customers. Therefore, foreign exchange risk is expected to increase as Kobo expands its operations. Kobo is in the start-up phase of operations and its current impact on foreign exchange risk is not significant.

Interest rate risk

The Company's interest rate risk is limited to the fluctuation of floating rates on its cash and cash equivalents. The Company does not use any interest rate swaps to fix the interest rate on its cash and cash equivalents.

Credit risk

The Company's credit risk is considered to be negligible as the Company only deals with highly rated financial institutions. In addition, the Company has minimal accounts receivable as its customers pay mainly by cash or credit card. The maximum exposure to credit risk at the reporting date is equal to the carrying value of the accounts receivable.

Liquidity risk

The Company manages liquidity risk by maintaining available financial assets in excess of financial obligations due at any point in time.

Current and long-term liabilities

The contractual maturities of the Company's current and long-term liabilities as at July 3, 2010 are as follows:

(thousands of dollars)	Payments due in the next 90 days	Payments due between 90 days and less than a year	Payments due after 1 year	Total
Accounts payable and accrued liabilities	169,453	49,844	4,121	223,418
Current portion of long-term debt	–	1,460	–	1,460
Long-term debt	–	–	1,198	1,198
Long-term accrued liabilities	–	–	6,841	6,841
Total	169,453	51,304	12,160	232,917

Long-term accrued liabilities include deferred rent and the Long Term Performance and Retention Incentive Program.

9. CAPITAL DISCLOSURES

The Company's objectives when managing capital are to safeguard the entity's ability to continue as a going concern while maintaining adequate financial flexibility to invest in new business opportunities that will provide attractive returns to shareholders. The primary activities engaged by the Company to generate attractive returns include the construction and related leasehold improvements of new and relocated stores, the development of new business

concepts, and investment in information technology and distribution capacity to support the expansion of the store and online network. The Company's main sources of capital are cash flows generated from operations and long-term debt. This cash flow is used to fund its capital expenditures, working capital needs, debt service requirements, and dividend distribution to shareholders. There were no changes to these objectives during the first quarter of fiscal 2011.

As at July 3, 2010, the Company recorded $1.2 million (2009 – $0.4 million) of restricted cash. This restricted cash balance primarily represents cash pledged as collateral for letter of credit obligations issued to support the Company's purchases of offshore merchandise.

The Company monitors its capital structure principally through measuring its total debt to shareholders' equity ratio and ensures its ability to service its debt obligation by tracking its interest and other fixed charge coverage ratios. Total debt is defined as the total long-term debt (including the current portion).

The following table summarizes selected capital structure information for the Company:

(thousands of dollars)	**13-week period ended July 3, 2010**	13-week period ended June 27, 2009
Current portion of long-term debt	**1,460**	2,538
Long-term debt	**1,198**	1,868
Total debt	**2,658**	4,406
Shareholders' equity	**250,987**	226,529
Total debt : Shareholders' equity	**0.01:1**	0.02:1

10. ACCOUNTS PAYABLE AND ACCRUED LIABILITIES

(thousands of dollars)	**July 3, 2010**	June 27, 2009	April 3, 2010
Accounts payable and accrued liabilities	**173,013**	158,401	179,159
Provision for unredeemed gift cards	**37,460**	35,070	37,816
Deferred credit	**12,945**	4,388	12,945
Total	**223,418**	197,859	229,920

11. CONSOLIDATED STATEMENTS OF CASH FLOWS

Supplemental cash flow information:

(thousands of dollars)	**13-week period ended July 3, 2010**	13-week period ended June 27, 2009
Interest paid (received)	**(50)**	62
Assets acquired under capital lease	**287**	142

12. RELATED PARTY TRANSACTIONS

The Company is the controlling shareholder of Kobo as at July 3, 2010. During the quarter, the Company earned commission revenue from Kobo for referring Indigo customers to *www.kobobooks.com*, provided back office management services to Kobo and purchased inventory from Kobo. All related party transactions were recorded at the exchange amount and included as part of "Cost of sales, operations, selling and administration" in the Consolidated Statements of Loss and Comprehensive Loss. The net amount of these transactions in the first quarter was $3.9 million paid by Indigo (2009 – nil).

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