

# **PET VALU**™

## **Better Pet Nutrition**

**PET VALU, INC.**

**ANNUAL REPORT 2005**

(prepared in accordance with Accounting Principles Generally Accepted in the United States of America)  
(in U.S. dollars)

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Markham, Ontario  
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## Company Profile

The first PET VALU store was opened in Ontario, Canada in 1976 by Geoff and Carole Holt. By 1977, there were three stores in the Toronto area. Ten years later, the company had over 75 locations and began to franchise existing stores. In 1993, with more than 120 stores, the company went public on the Toronto Stock Exchange ("TSX"). The TSX stock symbol for Pet Valu Canada Inc., Pet Valu, Inc.'s publicly traded Canadian operating subsidiary, is PVC. In 1995, the company opened its first U.S. store in Bowie, Maryland.

Pet Valu, Inc. is a specialty retailer and wholesaler of pet food and pet-related supplies. As of December 31, 2005, it had 351 stores located in Ontario, Manitoba, Maryland, Virginia, Pennsylvania, New Jersey and Delaware. The Canadian stores operate under the names PET VALU®, PET VALU BETTER PET NUTRITION® and PAULMAC'S PET FOOD®, and together comprise the largest retail operation in Canada dedicated to the sale of food and supplies for dogs, cats, caged birds, wild birds, fish, reptiles and small animals. Pet Valu, Inc. offers over 7,000 products, including national and premium brands of pet foods, private label pet foods and pet supplies, purchased from over 200 suppliers in 10 countries. The products are purchased, warehoused and distributed to all franchised and corporate stores through Peton Distributors Inc., a wholly owned subsidiary of Pet Valu Canada Inc.

Our philosophy is to provide pet owners with a wide selection of better quality pet foods and pet-related supply products than can generally be found at grocery stores and mass merchandisers. We offer friendly customer service and good value in conveniently located stores. Stores typically range in size from 1,200 to 2,500 square feet and are located in or near neighbourhood shopping plazas. Our franchisees and staff are knowledgeable about the needs of pets. We encourage them to sharpen their expertise with informational articles in our in-house publication, the FOCUS.

## President's Message

Dear Shareholder:

2005 marked another year of progress for Pet Valu as net income before non-comparable items increased by 70% from US\$3.78 million to US\$6.42 million, and earnings per share before non-comparable items improved by 70% to US\$0.86 (Cdn. \$1.04).

The increase of US\$3.52 million in stated 2005 earnings was partly due to a non-cash tax recovery resulting from the further realization of Pet Valu's net operating loss carryforward applicable to U.S. operations. This non-cash adjustment reflects an expectation of the likelihood of future use of these losses against future taxable income of the U.S. operations. After giving effect to this adjustment, there remains approximately US\$7.7 million of net operating tax loss carryforwards that have not been recognized.

It is also relevant to note that a reserve has been taken in relation to accrued expenses chargeable but not charged to Canadian franchisees in relation to their Promotion Fund. The level of expenditures through the Promotion Fund has increased over the past few years as a result of the expanded development and marketing of new private label products. This is not expected to abate in 2006. While this spike in expenditures is not expected to normalize or provide an opportunity for a retraction of the reserve in the near future, it is expected that, over time, Promotion Fund costs will normalize and retraction may be possible.

The financial direction being pursued by the Company involves several objectives. A decrease in debt servicing costs will be pursued through both reductions in levels of long term debt and the replacement of high coupon fixed rate debt with lower coupon debt. Cash flows are expected to support the development of infrastructure and systems improvements that are necessary to ensure best practices applicable over the coming decade, in addition to moderate levels of store expansion during 2006. Liquidity for shareholders will be sought through improvements to EPS.

Progressively, as Pet Valu's financial position improves and its infrastructure reflects next-decade practices, we will also be able to consider a new array of opportunities if and when they present themselves including horizontal and/or vertical business combinations as well as more aggressive levels of expansion.

I would like to thank Pet Valu's employees, franchisees, and customers for helping to make 2005 a great year for Pet Valu and I am looking forward to the Company's continued success in the years to come.

Yours truly



Geoffrey F. Holt  
Chief Executive Officer



## Management's Discussion & Analysis

For purposes of this discussion, "Pet Valu" or the "Company" refers to Pet Valu, Inc. and its subsidiaries.

This Management's Discussion and Analysis ("MD&A") section of the Annual Report contains commentary from the Company's management regarding strategy, operating results, and financial condition.

This MD&A should be read in conjunction with the Consolidated Financial Statements and Notes to the Consolidated Financial Statements for the 2005 fiscal year – the 52-week period ended December 31, 2005. The 2004 fiscal year refers to the 52-week period ended January 1, 2005 and the 2003 fiscal year refers to the 53-week period ended January 3, 2004. Unless otherwise indicated, all amounts are expressed in U.S. dollars. References to Canadian dollars shall be noted by using the International Monetary symbol for Canadian dollars, namely "C\$".

This MD&A is current as of March 17, 2006. Additional information relating to the Company, including Pet Valu Canada Inc.'s Annual Information Form, is available on-line at [www.sedar.com](http://www.sedar.com).

### Cautionary Statement Regarding Forward-Looking Information

Certain information in the President's Message, this MD&A and in other public announcements by the Company is forward-looking and is subject to important risks and uncertainties. Forward-looking information includes information concerning the Company's future financial performance, business strategy, plans, goals, and objectives. Factors which could cause actual results or events to differ materially from current expectations include, among other things: the ability of the Company to successfully implement its strategic initiatives and whether such strategic initiatives will yield the expected benefits; competitive conditions in the businesses in which the Company participates; changes in consumer spending; the outcome of legal proceedings as they arise; general economic conditions and normal business uncertainty; customer preferences towards product offerings; adverse climate changes; the occurrence of a pandemic or other catastrophic event which could create shortages of labour; products or services required to operate the business profitably; fluctuations in foreign currency exchange rates; changes in the Company's relationship with its merchandise and service suppliers; interest rate fluctuations and other changes in borrowing costs; and changes in laws, rules and regulations applicable to the Company or the markets in which the Company operates.

While the Company believes that its forecasts and assumptions are reasonable, results or events predicted in this forward-looking information may differ materially from actual results or events.

### Overview

The Company's principal business is that of a specialty retailer and wholesaler of food and supplies for dogs, cats, birds, fish, reptiles, and small animals and a franchisor of pet food and pet-related supply outlets. The Company was founded in 1976 with the opening of its first retail outlet in Ontario, Canada. Canadian operations have grown through "greenfield" store development and through the acquisition of smaller chains. In 1995, the Company entered the U.S. market by opening its first retail outlet in the state of Maryland. At the end of fiscal 2005, there were 285 stores in operation in Canada and 66 stores operating in the U.S. Of the 285 Canadian stores, 217 stores were franchised and 68 were company-owned. In the U.S., 62 of the 66 stores were company-owned and four were franchised. PET VALU stores are located in Ontario, Manitoba, Pennsylvania, Delaware, New Jersey, Maryland and Virginia.

The Company classifies its operations into two geographical operating segments, Canadian operations and U.S. operations. Canadian stores are operated by, or franchised through, Pet Valu Canada Inc. or one of Pet Valu Canada Inc.'s Ontario subsidiaries, Paulmac's Pet Food Inc. ("Paulmac's"). U.S. stores are operated by, or franchised through, Pet Valu, Inc.'s U.S. operating subsidiary, Pet Valu International Inc.

### Products and Services

PET VALU and PAULMAC'S stores offer a wide range of pet food and pet-related supply products. In addition to national and premium brands of pet food and supplies, they carry a broad selection of private label dog, cat and other pet foods marketed under trademarks owned by either Pet Valu Canada Inc. or Paulmac's. All company-owned and franchise stores also offer customers a large variety of non-food products, such as rawhide products, collars, leashes, flea and tick products, pet cages and carriers, dog and cat toys, and other pet-related accessories. These products include both brand name and private label brands. Additional pet food and pet-related supply products, not regularly carried by stores, are available by special order.

In Canada, some PET VALU and most PAULMAC'S stores sell fish, birds, reptiles, and/or small animals and some offer grooming services. All stores in Canada and the U.S. carry a range of wild bird products and none sell dogs or cats.

The Company has ongoing programs to identify higher quality, differentiated merchandise brands as well as private label offerings. Among the private label food products developed and introduced in recent years are the Company's PERFORMATRIN ULTRA line of products. These products take a wellness-focused approach to pet nutrition by using fresh, whole food and other functionally beneficial ingredients, such as anti-oxidants, probiotics and prebiotics. In addition to private label branded products, the Company has also introduced in recent years into its stores third party brands of specialized natural and wellness-focused products, which are not typically offered for sale by mass merchandisers and grocery retailers. Through

the introduction of these private label and specialty food offerings as well as unique pet-related supply products, reflecting higher tiers of product quality, the Company seeks to differentiate itself from many of its principal competitors in the sale of pet food and supplies.

### **Warehousing and Distribution**

The Company purchases, warehouses, and distributes pet food and pet-related supplies for and to all company-owned and franchise stores in Canada and the U.S. There are eight leased and two owned distribution facilities in Canada and two leased distribution facilities in the U.S. Total space under lease in these facilities is approximately 484,000 square feet. Most of these facilities are located regionally to support local small box store delivery logistics. Distribution services in both countries are provided by a fleet of company-owned and leased vehicles and supplemented by outside carriers and short-term rentals. Distribution services include delivery of merchandise to company-owned and franchise stores, as well as pick up of merchandise from some vendors to improve the utilization of the fleet.

### **Franchising**

In Canada, Company revenues in relation to franchise operations are generated from fees and gains on the sale of franchises, from ongoing merchandise sales to franchisees, and from royalty and other income from franchise operations. Franchisees purchase the majority of their inventory requirements from the Company. In Canada, PET VALU franchises are sold on a turnkey basis and the price of a franchise includes leasehold improvements, equipment, merchandise inventory, goodwill where applicable, franchise fees, and a site development fee. Franchisees pay a royalty as a percentage of gross sales or imputed gross sales and percentage rent equal to the amount by which a fixed percentage of gross sales or imputed gross sales exceeds the base rent payable by the franchisee under the sublease. They are also responsible, generally, for the costs of operating the business, including rent, employee wages and benefits, and other costs. Transfer fees are charged on the sale of existing franchises to new franchisees. The purchase price of a PAULMAC's franchise includes similar items. PAULMAC's franchisees pay a weekly royalty as a percentage of gross sales and are responsible, generally, for the costs of operating the business, including rent, employee wages and benefits, and other costs. PET VALU franchisees in Canada and PAULMAC's franchisees sign a franchise agreement and, generally, a lease or sublease.

Under the U.S. franchising system, as distinct from the Canadian franchise program, the Company retains ownership of all inventories and records as revenue the full amount of store sales at the retail level. As well, the franchisee does not sublet the premises; instead, Pet Valu International Inc. pays the rent and normal operating expenses. U.S. franchisees purchase the store equipment and are responsible for certain store operating costs, including labour, for which they receive an allowance from the Company. In addition, U.S. franchisees are paid a royalty based on merchandise sales and compliance with operational standards. Royalties and store operating cost allowances paid by the Company to U.S. franchisees are recorded by the Company as store operating expenses. The Company is not currently offering new PET VALU franchises in the U.S. nor PAULMAC'S franchises in Canada.

### **Key Accomplishments**

During fiscal 2005, the Company pursued key priorities intended to improve results from operations, liquidity, capital resources and cash flow.

#### **Reniching project**

During the last two fiscal years, the Company continued to pursue a long-term objective of shifting its product offering to higher-margin, high-quality pet products, which include pet specialty brands and private label products featuring a wellness focused approach to pet nutrition. Initiatives implemented to achieve this objective included the refinement and testing of marketing strategies, a shift in the in-store presentations, and the introduction of new pet foods in the wellness focused categories. While this component of our reniching may result in temporary same store sales declines, it is also expected to improve operating profits and enhance the image of the Company as a specialty retailer. The other key component of the Company's reniching project involves the development of revised or new store location and store image strategies reflecting changes in consumer traffic patterns, shopping centre developments, and competitive dynamics between mass merchandiser's and specialty stores. This resulted in certain store closures in Canada and certain store openings in the U.S. during fiscal 2005.

During fiscal 2005, the Company commenced rebranding efforts with the introduction of its new PET VALU BETTER PET NUTRITION trademark, now used in addition to the PET VALU trademark and name. This new mark, together with the expected gradual elimination of the "discount" image in association with the PET VALU business, highlight efforts to transform the Company's image from discount retailer to purveyor of higher quality products.

#### **U.S. Expansion**

During fiscal 2005, the Company continued to pursue profitable expansion in the U.S. markets in which it operates, resulting in the opening of six new stores in the states of Pennsylvania and New Jersey. The Company will continue to pursue a modest level of expansion in fiscal 2006.

#### **Debenture issuance**

On September 30, 2004, the Company completed a C\$15 million financing ("Penfund Financing") with Penfund Mezzanine Limited Partnership II ("Penfund"). The Penfund Financing involved the issuance of a five-year 12.5% secured subordinated

debenture and share purchase warrants with a term of five years to purchase up to 924,200 exchangeable shares of Pet Valu Canada Inc. The proceeds of the debenture issue were used to make early repayment of debentures otherwise due in March 2005. In fiscal 2005, upon cancellation of certain conversion rights held by the holders of certain 8.5% convertible debentures, warrants issued as part of the Penfund Financing to purchase up to 47,256 exchangeable shares were cancelled.

#### **Litigation settlement**

During fiscal 2004, Pet Valu, Inc. and certain of its affiliates settled a litigation matter ("Bedford Litigation") between them as plaintiffs and Bedford Capital Corporation ("Bedford") and others as defendants. Pursuant to the terms of the settlement, 3,843,750 voting warrants and 890,345 preferred shares of PVUS Holdings Inc. (a subsidiary of Pet Valu Canada Inc.) held by the defendants were surrendered for cancellation. Bedford also surrendered for cancellation the one share of special voting stock of Pet Valu, Inc. which it had held as trustee for the holders of the voting warrants and pursuant to which it had cast the votes associated with those warrants. Certain monitoring agreements were cancelled, thereby releasing the Company from any obligation to pay certain past and future fees under those agreements. At the same time, the Company used certain proceeds of the Penfund Financing to repay in full to the defendants the principal amount and accrued interest owing under certain debentures held by the defendants in the principal amount of U.S. \$10.24 million, thereby extinguishing the indebtedness owing under those debentures. As well, an agreement among certain shareholders of the Company (namely, Holtcorp Inc., Wildcat Wilderness Holdings Inc., Bedford and Euro Credit Investments Ltd.) to vote for the continuous election of four nominees of Bedford, one nominee of Euro Credit and four nominees of Holtcorp as directors of Pet Valu, Inc., Pet Valu International Inc. and Pet Valu Canada Inc. was terminated. The amount of C\$200,000 was paid to certain of the defendants to defray certain of their expenses. Finally, the amount of C\$150,000 was paid to the Company's Chief Executive Officer as a reimbursement of legal costs incurred by him in the defense of the third party claims brought against him and certain other former and current directors of the Company by certain of the defendants in the Bedford Litigation. The Chief Executive Officer had used his own personal resources to pay for the defense not only of the third party claims brought against himself but also those brought against other current and former directors, namely, Breena Holt, Carole Holt, Tony Iordanis, and David Wheat. The payment was necessary to achieve a settlement of the third party claims, and a resolution of the third party claims was necessary to achieve an overall settlement of the Bedford Litigation, a settlement believed by the Company's then board of directors to be in the Company's best interest.

#### **Credit extension**

In November of 2004, the Company announced the extension of its existing credit facility with its bank, Bank of Montreal. The term of the credit facility was extended to July 2006 on essentially the same terms as the original agreement.

#### **Overall Performance**

The Company reported net income of \$7.3 million for fiscal 2005, which included a future income tax recovery of \$1.2 million related to the recognition of U.S. net operating loss ("NOL") carryforwards. Net income before non-comparable items was \$6.4 million, which represented an improvement of \$2.6 million over fiscal 2004 results. Net income in fiscal 2004 was \$3.7 million, which included a future income tax recovery of \$0.3 million related to the recognition of U.S. NOL carryforwards, a gain on foreign exchange of \$0.1 million related to U.S. dollar denominated debentures issued by the Canadian operations, and litigation related costs of \$0.6 million. Net income before non-comparable items for fiscal 2004 was \$3.8 million.

The increase in net income before non-comparable items was primarily due to improvements in blended gross profit margins. Blended gross profit margins increased as a result of a shift to higher margin products, and a strengthening of the Canadian dollar, which increased margins on products purchased in U.S. dollars for sale in the Canadian operations in Canadian dollars. For a more in depth discussion of revenues, gross profit and expenses, please refer to the section of this MD&A entitled "Results of Operations".

Cash flow from current operations was sufficient to meet all of the Company's debt obligations during the year. There were no acquisitions during fiscal 2005 that required funding. Acquisitions of certain property and equipment were funded through vendor leasing programs. In Canada, as part of regular operations, franchises were repurchased and sold on an on-going basis. Cash flow required to support the cost of repurchasing franchise store assets was partially offset by cash received from the sale of Company-owned store assets to new franchisees. Store expansion in the U.S. resulted in the opening of six new stores. As the typical size of a store in the U.S. is 2,500 square feet, the amount of funding required to set up equipment and fill the store with inventory is not significant.

The Company anticipates that cash flow from current operations along with availability from its bank operating line will be sufficient to meet debt servicing obligations for fiscal 2006. Future expansion will be funded through operating cash flow. The Company anticipates that it will continue to generate positive cash flow for the foreseeable future.

The Company's financial condition improved in fiscal 2005 due to increased cash flow. The Company's capital structure remained similar to prior years with a highly leveraged balance sheet. A C\$15 million debenture and warrant financing (namely, the Penfund Financing) was completed in fiscal 2004, the proceeds of which were used to make early repayment of debentures otherwise due in fiscal 2005. There was no additional debt issued other than capital leases for capital asset additions and notes payable to former franchisees for franchise repurchases. All subordinated debt is denominated in Canadian dollars. Therefore, the strengthening of the Canadian dollar against the U.S. dollar resulted in an increase in the U.S. dollar value of the Canadian dollar debt.

In general terms, competition in pet food and pet-related supply retailing continued to increase in 2005. Mass merchants appear to have increased their share of the cat and dog food markets at the expense of grocery and pet specialty retailers. Pet product superstores and pet food specialty stores also continued to expand. The Company expects continued increases in competition and plans to address these challenges by employing strategies focused on its key competitive strengths in customer service, convenience, and expanded private label, specialty and wellness focused products, focusing on front line staff training to enhance its customer service, and increasing its efforts to source new products.

Subordinated debentures of Pet Valu Canada Inc. in the principal amount of C\$15,054,788 will mature on July 24, 2006. The Company is finalizing arrangements to retire these debentures in due course.

### **Selected Annual Information**

The Company's financial information is prepared using U.S. generally accepted accounting principles ("GAAP"). The reporting currency is U.S. dollars. The functional currency is U.S. dollars for the U.S. operations and Canadian dollars for the Canadian operations. As the Canadian operations comprise the majority of the consolidated operations, the foreign currency exchange rate between the Canadian and U.S. dollars may have a material effect on the consolidated U.S. dollar results.

### **Three year summary**

(expressed in thousands of U.S. dollars except for number of stores and per share amounts)

(Unless otherwise noted, 2005 and 2004 results reflect a 52-week period while 2003 results reflect a 53-week period.)

	<u>Dec 31, 2005</u>	<u>Jan 1, 2005</u>	<u>Jan 3, 2004</u>
Number of Stores			
Company owned	130	120	121
Franchised	221	232	233
Total number of stores	<u>351</u>	<u>352</u>	<u>354</u>
System-wide sales *	171,751	162,456	156,387
Sales and revenue	134,406	128,212	123,868
EBITDA **	14,101	9,766	10,011
EBITDA before non-comparable items	14,682	10,435	8,530
Depreciation	1,769	1,529	1,421
Net interest expense	3,902	3,572	3,640
Net income	7,254	3,733	6,236
Net income before non-comparable items ***	6,416	3,784	2,335
Net income per share –basic	0.97	0.50	0.83
Net income per share –diluted	0.84	0.45	0.73
Cash flow provided by operating activities	10,589	4,087	543
Financing position			
Working capital (deficit) – non cash	(2,368)	6,969	1,754
Total assets	54,609	51,425	47,563
Long-term liabilities	19,451	31,587	27,959
Shareholders' equity (deficit)	4,083	(3,028)	(7,365)
Minority interest	-	1,118	2,009

\* System-wide sales represent retail sales to customers through company-owned and franchise stores.

\*\* Earnings before interest, taxes, depreciation and amortization of goodwill is not a recognized measure under GAAP. As this measure does not have a standardized meaning prescribed by GAAP, the Company's method of calculating EBITDA may differ from other companies. Management believes EBITDA is a useful supplemental measure as it provides investors with an indication of cash available prior to debt service, capital expenditures and income taxes.

\*\*\* Net income before non-comparable items is not a recognized measure under GAAP. As this measure does not have a standardized meaning prescribed by GAAP, the Company's method of calculating net income before non-comparable items may differ from other companies. Management believes net income before non-comparable items is a useful supplemental measure as it provides investors with a measure that can be used to compare year over year net income without the effects of non-recurring or non-operational activities.

Non-comparable items include (1) foreign exchange gains on long term monetary items, (2) future income tax recovery relating to the NOL carryforwards of the U.S. operations, (3) loss on extinguishment of debt, (4) litigation costs and (5) allowance for promotion fund deficit. For a more in depth discussion of non-comparable items, please refer to the section of this MD&A entitled "Results of Operations".

Net income before non-comparable items increased by \$2.6 million or 70%. The improvement in net income before non-comparable items was a result of an increase in blended gross profit margins. Blended gross profit margins increased as a



on foreign exchange from these debentures. The gain or loss is disclosed separately in the Consolidated Statement of Operations. Up to September 30, 2004, the Company had recognized a gain on foreign exchange as the Canadian dollar had strengthened slightly from its year-end level. These debentures were repaid on September 30, 2004 from the proceeds of a C\$15 million financing completed that day (namely, the Penfund Financing).

The Company reduced the valuation allowance relating to the NOL carryforwards for tax purposes of the U.S. operations in both fiscal 2005 and 2004. The result of the reduction in the valuation allowance is a future tax recovery of \$1.2 million in fiscal 2005 and \$0.3 million in fiscal 2004.

The Company and its franchisees make contributions to the Canadian promotion fund, which is used for marketing and advertising activities. As of the end of fiscal 2005, the Company determined that the deficit balance of the promotion fund was unlikely to be recovered in the next fiscal year due to the magnitude of the promotion fund deficit and the Company's assessment of its future promotional plans. Therefore, an allowance of \$0.6 million was provided.

The Company does not have a significant exposure to seasonal fluctuations among its product lines. Traditionally, fourth quarter earnings tend to be stronger due to higher store sales and increased margins, particularly in the month of December.

## **Results of Operations**

### **Impact of a strengthening of the Canadian dollar versus the U.S. dollar**

The Company is comprised of various Canadian and U.S. subsidiaries. Generally, the country in which the subsidiary operates will determine the functional currency. The reporting currency for the consolidated financial statements is U.S. dollars. Therefore, the statement of operations for each subsidiary whose functional currency is not U.S. dollars is converted to U.S. dollars at the end of the period using the year-to-date average foreign currency exchange rate. During fiscal 2003, 2004 and 2005, the Canadian dollar strengthened significantly. The result of this strengthening was that each line item in the statements of operations of subsidiaries using Canadian dollars as their functional currency increased in U.S. dollar value by 7% in fiscal 2005, 8% in fiscal 2004, and 12% in fiscal 2003. This effect was somewhat offset when the results of operations of subsidiaries which use the U.S. dollar as their functional currency were consolidated with the results of operations of the Canadian subsidiaries. In all areas of the following analysis, the change in the foreign currency exchange rate will have the effect of increasing fiscal 2005 dollar amounts as compared to those of fiscal 2004 and fiscal 2004 dollar amounts as compared to those of fiscal 2003.

### **Non-comparable items**

Non-comparable items are non-recurring non-operational items incurred by the Company during the year. Non-comparable items include litigation costs, gains or losses on foreign exchange, loss on debt extinguishment, allowance for promotion fund deficit and tax recovery of NOLs. Litigation costs are primarily legal and financial advisory costs related to the Bedford Litigation (as previously defined). Gains or losses on foreign exchange relate to certain debentures denominated in U.S. dollars and issued by a Canadian subsidiary, Pet Valu Canada Inc. These debentures were repaid on September 30, 2004. The loss on debt extinguishment is related to the loss resulting from the repayment of the aforesaid debentures on September 30, 2004 and is arrived at by computing the difference between the book value of the debentures at the time of repayment and the amount repaid. The allowance for promotion fund deficit relates to management's estimate of the amount of promotion fund deficit that will not be recovered in the near term. The future tax recovery of NOLs relates to the recognition of the recoverability of a part of the income tax NOLs arising from the U.S. operations.

## **Comparison of Fiscal 2005 to Fiscal 2004**

### **Store Operations**

During fiscal 2005, there was a net increase of five stores in the U.S. and a net decrease of six stores in Canada. Store operations are evaluated on an on-going basis with openings and closings resulting from shifts in demographics, quality of locations, population growth, and competition. The stores that were closed in fiscal 2005 were identified by an evaluation of criteria such as cash flow contribution and the Company's ability to negotiate favourable lease termination arrangements. The Company believes that the Canadian markets in which the Company operates are highly competitive, mature markets where growth is limited to normal population changes, inflation, changes in per pet spending, and consolidation within the industry itself.

In fiscal 2005, there were an average of 3.6 fewer stores in operation during the year, 4.4 fewer in Canada offset by 0.8 more in the U.S. The decrease resulted from the closure of Canadian stores in the first half of the year offset by U.S. store openings in the last quarter of the year. This decrease contributed to lower sales and revenue for fiscal 2005 in the Canadian operations.

### **System-wide sales**

System-wide sales represent retail sales to customers through company-owned and franchise stores. During fiscal 2005, system-wide sales increased by \$9.3 million or 5.7% from the prior year to \$171.8 million. The change in foreign exchange rates resulted in an increase in system-wide sales from the prior year of \$9.3 million. Before the effects of the change in foreign exchange rates, the system-wide sales in the Canadian operations decreased by \$0.9 million or 0.7%. The system-wide sales in the U.S. operations increased by \$0.9 million or 2.9%.

Comparable store sales represent a year-over-year comparison of the same group of stores that were open during both years of comparison. A store becomes comparable one year after its first full month of operation. Comparable store sales decreased by 0.6% in Canada and increased by 2.5% in the U.S. In Canada, increases in competition, maturity of markets, demographic shifts, and the persistent unseasonably hot weather during the summer contributed to the decrease in sales. In the U.S., increases in competition, and the effects of the Company's shift towards a more profitable upscale product offering held sales growth to a modest level.

### **Sales and revenue**

Sales and revenue represent retail sales through company-owned stores in Canada and the U.S., retail sales through franchise stores in the U.S., merchandise sales to franchisees in Canada, initial and continuing franchise fees in both countries, and wholesale sales to third parties. The Company's sales and revenue increased by \$6.2 million or 4.8% in fiscal 2005 as compared to fiscal 2004. In fiscal 2005, the change in foreign exchange rates resulted in an increase in sales and revenue of \$6.9 million. Before the effects of the change in foreign exchange rates, the sales and revenue in the Canadian operations decreased by \$1.7 million or 1.8%. The sales and revenue in the U.S. operations increased by \$1.0 million or 3.0%. A reduction in the average number of stores in operation contributed to the decrease in sales and revenue in Canada. In the U.S., an increase in the average number of stores in operation and an increase in the comparable store sales contributed to the increase in sales and revenue.

In fiscal 2005, total merchandise sales through company-owned stores increased by \$2.5 million to \$53.0 million, accounting for an increase of 1.8% in consolidated sales and revenue. In fiscal 2005, the change in foreign exchange rates resulted in an increase of \$1.5 million in merchandise sales through company-owned stores. Before the effects of the change in foreign exchange rates, the merchandise sales through company-owned stores in the Canadian operations decreased by \$0.6 million or 3.1%. In the U.S. operations, merchandise sales through company-owned stores increased by \$1.7 million or 5.5%. The decrease in merchandise sales through company-owned stores in fiscal 2005 in Canada was due to a decrease in the average number of company-owned stores. The increase in fiscal 2005 in the U.S. was primarily due to an increase in the average number of company-owned stores and the increase in comparable store sales.

Merchandise revenue from franchisees includes (1) merchandise sales at U.S. franchise stores; and (2) merchandise sold to Canadian franchisees together with related franchise distribution charges, royalty revenue and percentage rent revenue. Total merchandise revenue from franchise stores increased by \$3.5 million to \$79.2 million, accounting for a 2.7% increase in consolidated sales and revenue. In fiscal 2005, the change in foreign exchange rates resulted in an increase of \$5.3 million in merchandise revenue from franchise stores. Before the effects of the change in foreign exchange rates, the merchandise revenue from franchise stores in the Canadian operations decreased by \$1.1 million or 1.5%. In the U.S. operations, merchandise revenue from franchise stores decreased by \$0.7 million or 24.3%. A reduction of two franchises during the year in the U.S. operation and a decrease of 1.3% in the average number of franchise stores open in the Canadian operation contributed to the decrease in merchandise revenue from franchisees.

Initial fees and gains on the sale of franchises in fiscal 2005 of \$1.1 million was \$0.2 million greater than the prior year.

Wholesale revenue in fiscal 2005 of \$0.9 million increased by \$0.1 million as compared to the prior year.

### **Gross profit**

Gross profit on sales and revenue increased by \$5.0 million or 15.6% in 2005 as compared to the previous year. In fiscal 2005, the change in foreign exchange rates resulted in an increase in gross profit of \$1.9 million. Before the effects of the change in foreign exchange rates, gross profit in the Canadian operations increased by \$2.9 million or 13.0%. In the U.S. operations, gross profit increased by \$0.3 million or 2.6%.

Blended gross profit margins increased to 27.8% in fiscal 2005, as compared to 25.2% in fiscal 2004. Blended gross profit margins in the U.S. stores increased by 1.3% over the prior year. Canadian company-owned stores achieved an increase in blended gross profit margins of 0.7%.

### **Store operating expenses**

Store operating expenses increased by \$1.3 million or 10.2% in fiscal 2005 as compared to fiscal 2004. In fiscal 2005, the change in foreign exchange rates resulted in an increase of \$0.4 million in store operating expenses. Before the effects of the change in foreign exchange rates, store operating expenses in the Canadian operations increased by \$0.9 million or 17.0%. In the U.S. operations, store operating expenses were consistent with the prior year. On a per store basis, store operating costs increased by 21.7% in Canada and decreased by 0.8% in the U.S. An allowance for promotion fund deficit of \$0.6 million (11% of store operating expenses), increased minimum wages in Ontario and increased costs related to the store point of sale systems contributed to the increase in store operating expenses in Canada. In the U.S., decreases in insurance costs and advertising contributed to the decrease in store operating expenses.

### **General and administrative expenses**

General and administrative expenses decreased by \$0.3 million or 2.6% in fiscal 2005 as compared to fiscal 2004. In fiscal 2005, the change in foreign exchange rates resulted in an increase of \$0.7 million in general and administrative expenses. Before the effects of the change in foreign exchange rates, general and administrative expenses in the Canadian operations decreased by \$1.0 million. In the U.S. operations, general and administrative expenses were consistent with the prior year.

Included in the general and administrative costs of the Canadian operations, in fiscal 2004, were \$0.6 million of non-recurring legal and consulting costs relating to the Bedford Litigation, which was settled during fiscal 2004.

### **Net interest expense**

Net interest expense increased by \$0.3 million or 9.2% in fiscal 2005 as compared to fiscal 2004. In fiscal 2005, the change in foreign exchange rates resulted in an increase of \$0.3 million in net interest expense. Before the effects of the change in foreign exchange rates, net interest expense in the Canadian operations increased by \$0.1 million or 3.5%. In the U.S. operations, net interest expense decreased by \$0.1 million.

### **Net income**

Net income for fiscal 2005 was \$7.3 million as compared to \$3.7 million in fiscal 2004. Net income before non-comparable items for fiscal 2005 was \$6.4 million as compared to \$3.8 million in fiscal 2004. Net income before non-comparable items increased in both U.S. and Canadian operations. The fiscal 2005 net income before non-comparable items for the U.S. operations was \$1.9 million as compared to \$1.6 million in fiscal 2004. The increase was primarily due to improvements in sales and gross profit margins. Canadian operations' net income before non-comparable items for fiscal 2005 was \$4.5 million as compared to \$2.2 million in fiscal 2004. The increase in Canadian operations' net income for fiscal 2004 was due to improved blended gross profit margins.

## **Comparison of Fiscal 2004 to Fiscal 2003**

### **Store Operations**

During fiscal 2004, there was a net decrease of two stores in the U.S. and no net change in the number of stores in Canada.

In fiscal 2004, there were an average of 7.6 fewer stores in operation during the year resulting from the closure of stores in second half of fiscal 2003.

### **System-wide sales**

During fiscal 2004, system-wide sales increased by \$6.1 million or 3.9% from the prior year to \$162.5 million. The change in foreign exchange rates resulted in an increase in system-wide sales from the prior year of \$9.2 million. Before the effects of the change in foreign exchange rates, the system-wide sales in the Canadian operations decreased by \$1.5 million or 1.3%. The system-wide sales in the U.S. operations decreased by \$1.5 million or 4.4%. One fewer week of sales in fiscal 2004 as compared to fiscal 2003 and a reduction in the number of stores in operation contributed to the decrease in system-wide sales in both operations.

Excluding the extra week of sales in fiscal 2003, comparable store sales increased by 1.0% in Canada and 1.5% in the U.S. The modest sales growth reflected the increase in competition, maturity of markets, demographic shifts and the effects of the Company's shift towards a more profitable upscale product offering.

### **Sales and revenue**

The Company's sales and revenue increased by \$4.3 million or 3.5% in fiscal 2004 as compared to fiscal 2003. In fiscal 2004, the change in foreign exchange rates resulted in an increase in sales and revenue of \$6.9 million. Before the effects of the change in foreign exchange rates, the sales and revenue in the Canadian operations decreased by \$1.0 million or 1.2%. The sales and revenue in the U.S. operations decreased by \$1.5 million or 4.4%. One fewer week of sales in fiscal 2004 as compared to fiscal 2003 and a reduction in the average number of stores in operation contributed to the decrease in sales and revenue in both operations.

In fiscal 2004, total merchandise sales through company-owned stores increased by \$2.5 million to \$50.5 million, accounting for an increase of 2.0% in consolidated sales and revenue. In fiscal 2004, the change in foreign exchange rates resulted in an increase of \$1.5 million in merchandise sales through company-owned stores. Before the effects of the change in foreign exchange rates, the merchandise sales through company-owned stores in the Canadian operations increased by \$1.5 million or 8.4%. In the U.S. operations, merchandise sales through company-owned stores decreased by \$0.5 million or 1.6%. The increase in merchandise sales through company-owned stores in fiscal 2004 in Canada was due to an increase in the average number of company-owned stores. The decrease in fiscal 2004 in the U.S. was primarily due to one fewer week of sales in fiscal 2004 as compared to fiscal 2003.

In fiscal 2004, total merchandise revenue from franchise stores increased by \$1.9 million to \$75.7 million, accounting for a 1.5% increase in consolidated sales and revenue. In fiscal 2004, the change in foreign exchange rates resulted in an increase of \$5.3 million in merchandise revenue from franchise stores. Before the effects of the change in foreign exchange rates, the merchandise revenue from franchise stores in the Canadian operations decreased by \$2.3 million or 3.3%. In the U.S. operations, merchandise revenue from franchise stores decreased by \$1.0 million or 26.4%. One fewer week of sales in fiscal 2004 as compared to fiscal 2003 and a reduction of one franchise in the U.S. operation contributed to the decrease in merchandise revenue from franchisees.

Initial fees and gains on the sale of franchises in fiscal 2004 of \$0.9 million was consistent with the prior year.

Wholesale revenue in fiscal 2004 of \$0.8 million decreased by \$0.1 million as compared to the prior year.

**Gross profit**

Gross profit on sales and revenue increased by \$2.7 million or 9.0% in 2004 as compared to the previous year. In fiscal 2004, the change in foreign exchange rates resulted in an increase in gross profit of \$1.6 million. Before the effects of the change in foreign exchange rates, gross profit in the Canadian operations increased by \$1.7 million or 8.9%. In the U.S. operations, gross profit decreased by \$0.6 million or 6.0%. The decrease in gross profit in the U.S. operations was the result of fewer stores in operation during the year and one fewer week of sales in 2004.

Blended gross profit margins increased to 25.2% in fiscal 2004, as compared to 24.0% in fiscal 2003. Blended gross profit margins in the U.S. stores increased by 0.8% over the prior year. Canadian company-owned stores achieved an increase in blended gross profit margins of 1.2%. Similarly, gross profit earned by Canadian franchisees on merchandise purchased from the Company increased by 1.5% in total.

**Store operating expenses**

Store operating expenses increased by \$0.3 million or 2.2% in fiscal 2004 as compared to fiscal 2003. In fiscal 2004, the change in foreign exchange rates resulted in an increase of \$0.4 million in store operating expenses. Before the effects of the change in foreign exchange rates, store operating expenses in the Canadian operations increased by \$0.5 million or 12.8%. In the U.S. operations, store operating expenses decreased by \$0.6 million or 7.2%. In the U.S., total store operating expenses decreased overall due to the closure of stores during the year. On a per store basis, store operating costs increased by 7.0% in Canada and by 1.2% in the U.S. Increased advertising contributed to the increase in per store operating expenses in Canada. In Canada, the expenses increased overall due to franchise repurchases and the increased costs per store.

**General and administrative expenses**

General and administrative expenses increased by \$0.8 million or 7.3% in fiscal 2004 as compared to fiscal 2003. In fiscal 2004, the change in foreign exchange rates resulted in an increase of \$0.8 million in general and administrative expenses. Before the effects of the change in foreign exchange rates, general and administrative expenses in the Canadian operations increased by \$0.2 million. In the U.S. operations, general and administrative expenses decreased by \$0.2 million. Included in the general and administrative costs of the Canadian operations were \$0.6 million of non-recurring legal and consulting costs relating to the Bedford Litigation, which was settled during fiscal 2004, and to recapitalization, as compared to \$0.5 million in the prior year. Excluding these non-comparable costs, general and administrative expenses in the Canadian operations were consistent with the prior year.

**Net interest expense**

Net interest expense in fiscal 2004 was consistent with the prior year at \$3.6 million. In fiscal 2004, the change in foreign exchange rates resulted in an increase of \$0.3 million in net interest expense. Before the effects of the change in foreign exchange rates, net interest expense in the Canadian operations decreased by \$0.2 million or 6.6%. In the U.S. operations, net interest expense decreased by \$0.1 million or 55%. Decreases in interest expense resulted primarily from lower utilization of the bank operating line.

**Net income**

Net income for fiscal 2004 was \$3.7 million as compared to \$6.2 million in fiscal 2003. Net income before non-comparable items for fiscal 2004 was \$3.8 million as compared to \$2.3 million in fiscal 2003. Net income before non-comparable items increased in both U.S. and Canadian operations. The fiscal 2004 net income before non-comparable items for the U.S. operations was \$1.6 million as compared to \$1.4 million in fiscal 2003. The increase was primarily due to improvements in gross profit margins. Canadian operations net income before non-comparable items for fiscal 2004 was \$2.2 million as compared to \$1.0 million in fiscal 2003. The increase in Canadian operations net income for fiscal 2004 was due to improved blended gross profit margins.

**Liquidity and Financial Position**

At the end of fiscal 2005, the Company had a non-cash working capital deficit of \$2.4 million, which was \$9.3 million less than the non-cash working capital of \$6.9 million at the end of fiscal 2004 and \$4.2 million less than the fiscal 2003 non-cash working capital of \$1.8 million. The reclassification from long-term to current of subordinated debentures in the amount of \$12.9 million as of December 31, 2005 as compared to \$3.0 million at the end of fiscal 2004 contributed to the decrease in non-cash working capital. Subordinated debentures of Pet Valu Canada Inc. in the principal amount of C\$15,054,788 will mature on July 24, 2006. The Company is finalizing arrangements to retire these debentures in due course. No additional working capital requirements are expected in fiscal 2006; however, as store locations are added in the future, inventory requirements may increase.

Merchandise accounts payable leveraging (trade payables as a percentage of inventory) increased to 21.8% as of December 31, 2005, as compared to 19.3% as of January 1, 2005 and 18.1% as of January 3, 2004. The Company maintains a relatively low level of leveraging due to efforts to realize increased vendor discounts and allowances.

Total assets increased by \$3.2 million to \$54.6 million at December 31, 2005, as compared to \$51.4 million at the end of fiscal 2004 and \$47.6 million at the end of fiscal 2003. The change in foreign exchange rates resulted in an increase of \$1.4 million in total assets from fiscal 2004 to fiscal 2005 and an increase of \$2.7 million in total assets from fiscal 2003 to fiscal 2004. Before

the effects of the change in foreign exchange rates, total assets increased due to increased cash, inventory and the deferred charges which arose from the Penfund Financing.

Cash provided by operating activities in fiscal 2005 was \$10.6 million as compared to \$4.1 million in fiscal 2004. The increase was primarily due to increased gross profit and changes in working capital. Changes in working capital provided \$3.0 million of cash in fiscal 2005 as compared to a net use of \$0.8 million of cash in fiscal 2004. Increases in gross profit led to increased net income which contributed an additional \$3.5 million to cash provided by operating activities.

Net cash used in investing activities for fiscal 2005 increased by \$0.5 million to \$1.1 million as compared to \$0.6 million used in fiscal 2004. An increase in purchases of property and equipment and the repurchase of a franchise resulting in repurchased goodwill contributed to the increase in the use of cash for investing activities. The purchases of property and equipment consisted mainly of replacements for automotive and computer equipment. Franchise repurchases also resulted in purchases of property and equipment including store equipment, leaseholds and goodwill.

Net cash used in financing activities in fiscal 2005 was \$7.8 million as compared to \$3.5 million of cash used in financing activities in fiscal 2004. In both years, cash was used to make scheduled principal repayments of long-term debt and reduce the amount of funds borrowed under the bank operating facility. In fiscal 2005, the Company repaid \$3.0 million of Pet Valu Canada Inc. debentures and redeemed \$1.1 million of Pet Valu Canada Inc. Class A preferred shares. In fiscal 2004, the Company issued debentures in the amount of C\$15 million (US\$11.8 million) and repaid debentures in the amount of \$10.2 million providing a net \$1.6 million of cash from financing activities.

There were no acquisitions during fiscal 2005 that required funding. Acquisitions of certain property and equipment were funded through vendor leasing programs. In Canada, as part of regular operations, franchises were repurchased and sold on an on-going basis. Cash flow required to support the cost of repurchasing franchise store assets was partially offset by cash received from the sale of Company-owned store assets to new franchisees. Store expansion in the U.S. resulted in the opening of six new stores. As the typical size of a store in the U.S. is 2,500 square feet, the amount of funding required to set up equipment and fill the store with inventory is not significant.

The Company anticipates that cash flow from current operations along with availability from its operating line will be sufficient to meet debt servicing obligations for fiscal 2006. Future expansion will be funded through operating cash flow. The Company anticipates that it will continue to generate positive cash flow for the foreseeable future.

The Company has certain debt obligations that will mature in fiscal 2006. The Company is finalizing arrangements to retire these debentures in due course. The Company also has certain debt obligations that will mature in fiscal 2009.

### **Table of contractual obligations**

(amounts stated in thousands of US dollars)

Contractual obligations, including payments due for each of the next five years and thereafter, are shown in the following table:

	Total	2006	2007	2008	2009	2010	2011 & thereafter
Long-term debt (excluding capital lease obligations)	\$ 725	\$ 217	\$ 149	\$ 136	\$ 113	\$ 110	\$ -
Capital lease obligations	1,183	408	318	245	155	52	5
Operating leases	51,694	13,559	11,371	8,680	6,311	3,867	7,906
Subordinated debentures	29,024	12,945	-	-	16,079	-	-
<b>Total contractual obligations</b>	<b>\$ 82,626</b>	<b>\$ 27,129</b>	<b>\$ 11,838</b>	<b>\$ 9,061</b>	<b>\$ 22,658</b>	<b>\$ 4,029</b>	<b>\$ 7,911</b>

Included in operating leases are lease payments for store, warehouse and office facilities. The Company generally sublets store locations to its franchisees. Lease payments by franchisees offset the total operating lease payments of the Company. At the end of fiscal 2005, the total amounts assumed by franchisees for the next 5 years and thereafter was \$27.0 million.

### **Capital Resources**

On November 14, 2000, the Company completed a banking arrangement with Bank of Montreal for a senior line of credit. The facility was a floating rate loan restricted by borrowing base calculations and certain general covenants. The total borrowing capability before borrowing base calculations was C\$18.0 million.

In fiscal 2004, the Company entered into an agreement with Bank of Montreal to extend the terms of the senior line of credit. Pursuant to this agreement, the term of the agreement was extended to July 13, 2006 on substantially the same terms as the original agreement.

In anticipation of the expiry of this facility, the Company has commenced discussions with its bank to renew the facility for a further term. While it is expected that a senior line of credit satisfactory to the Company will be obtained to renew or replace the expiring one in a timely fashion, there can be no assurances in this regard.

At the end of fiscal 2005, the Company had utilized C\$2.2 million of the senior line of credit as compared to C\$3.2 million at the end of fiscal 2004 and C\$10.6 million at the end of fiscal 2003. Pursuant to its banking agreement, in addition to the borrowing

base restrictions, the Company must also comply with certain general covenants which include, among other things, minimum debt service ratios and a minimum consolidated tangible net worth calculation as defined. The Company is in compliance with these covenants.

On September 30, 2004, the Company completed the Penfund Financing which involved the issuance of a five-year 12.5% secured subordinated debenture and share purchase warrants with a term of five years to purchase up to 924,200 exchangeable shares of Pet Valu Canada Inc. The proceeds of the Penfund Financing were used to make early payment of debentures otherwise due in March 2005. In fiscal 2005, upon cancellation of certain conversion rights held by the holders of certain 8.5% convertible debentures, warrants issued as part of the Penfund Financing to purchase up to 47,256 exchangeable shares were cancelled.

In fiscal 2005, the Company repaid \$0.8 million of 7% convertible debentures of Pet Valu Canada Inc. and \$2.2 million of 8.5% convertible debentures of Pet Valu Canada Inc. Among the 8.5% debentures repaid were a C\$1,122,100 debenture held by Holtcorp Inc. and a C\$400,000 debenture held by the Taff VeCa Trust. Holtcorp Inc. and the Taff VeCa Trust are controlled by Geoffrey Holt, a director and the Chief Executive Officer of the Company.

In fiscal 2005, the Company redeemed \$1.1 million of Class A convertible preferred shares of Pet Valu Canada Inc.

The Company does not have any commitments with respect to future capital expenditures. Replacement of existing capital assets will occur as required. Additions of furniture and fixtures are normally financed through internal cash flow. Additions of tractors, trailers, warehouse material handling equipment, and some computer and office equipment may be financed through vendor leasing programs.

### **Off-Balance Sheet Arrangements**

#### **Debt guarantees**

During fiscal 1999, the Company offered a franchise financing program in the U.S. pursuant to which the Company guaranteed loans from financial institutions to qualifying franchisees of up to \$130,000 per franchise. Pursuant to that program, the Company withheld an amount equal to the monthly payments due to the financial institution from amounts due to the franchisee and remitted it directly to the financial institution. The loans were secured by the value of the store equipment owned by the franchisee and a personal guarantee of the franchisee. The interest rate was determined by the financial institution based on prevailing market rates. At December 31, 2005, there were no franchisees participating in the financing program as compared to two U.S. franchisees at January 1, 2005. Total loans guaranteed were nil and \$58,143 at December 31, 2005 and January 1, 2005, respectively. The interest rates on the outstanding loans ranged from 15% to 16%. The financing program has not been offered since fiscal 1999.

The Company does not have any contingent liabilities.

### **Risks and Uncertainties**

The Company is exposed to a number of risks in the normal course of its business that have the potential to affect operating performance. Exposure to certain risks is an integral part of carrying on business.

#### **Competition**

The Company's stores compete with four main types of competitors: (i) grocery product retailers; (ii) pet food specialty stores; (iii) pet product superstores; and (iv) pet shops.

Grocery product retailers including grocery stores, mass merchandisers, warehouse clubs, and convenience retailers (such as some convenience stores, discount stores, drug stores, and hardware general merchandise stores) are competitors primarily for the sale of pet food; pet shops are competitors primarily with respect to pet-related supplies; and pet food specialty stores and pet product superstores are competitors with respect to all product categories in varying degrees.

The Company's stores compete with these groups by seeking to offer products at competitive prices as well as higher margin, high quality products including private label and natural and wellness focused products, and by seeking to provide a convenient, friendly, service-oriented shopping environment in which customers may discuss their pets and obtain product information and advice about the care of their pets from knowledgeable staff. The Company believes that this kind of environment provides it with a competitive advantage by engendering a level of customer loyalty that facilitates repeat sales of its products.

In general terms, competition in pet food and pet-related supply retailing continued to increase in 2005. Mass merchants appear to have increased their share of the cat and dog food markets at the expense of grocery and pet specialty retailers. Pet product superstores and pet food specialty stores also continued to expand. The Company expects continued increases in competition and plans to address these challenges by employing strategies focused on its key competitive strengths in customer service, convenience, and expanded private label, specialty and wellness focused products, focusing on front line staff training to enhance its customer service, and increasing its efforts to source new products.

**Dependence on Key Personnel**

The success of the Company is dependent to a significant degree upon the expertise and experience of its senior management, most of whom have been with the Company for many years. The Company's continued success could depend on its ability to retain current management or hire comparable replacement personnel.

**Reliance on Suppliers, Product Lines and Current Distribution Arrangements**

The Company purchases significant amounts of its merchandise from certain key suppliers. A termination or interruption in the flow of merchandise from any of these vendors or any other significant suppliers of pet food or pet-related supplies offered by the Company could have an adverse impact on the Company.

**Risks Associated with Foreign Operations**

The Company does not have operations outside Canada or the U.S. However, it does purchase certain of its goods for resale from foreign suppliers in foreign currencies. The foreign exchange rate at the time of purchase is included in the calculation of the cost of the product. There are, therefore, the usual risks associated with exchange rate fluctuations. The Company does not feel that purchases of this type are sufficient in magnitude to warrant hedging of currency rates.

The Company's merchandise purchases include products that are subject to various laws and rules, including those administered by the Food and Drug Administration in the U.S. and the Canadian Food Inspection Agency in Canada. These agencies are empowered to act to prevent the importing of goods for various reasons within their mandate. Broad import restrictions could negatively impact the ability of the Company to source products demanded by its customers. For example, import and export controls on animal protein ingredients of pet products pursuant to events such as the discovery of bovine spongiform encephalopathy in cattle or the H5 virus in poultry could disrupt the supply of products available for the Company to sell, or affect the price of brand name products or the raw material ingredients for its private label products.

**Leases**

The Company leases space for most of the company-owned and franchise stores, as well as the majority of warehouse and office facilities. The terms of the leases vary by location. In the event of unreasonable rent increases upon renewal of store leases or an inability to secure renewals, relocation costs are minimized due to store sizes. With respect to warehouse and office facilities, the Company expects that it will be in a position to find adequate facilities in the event that it is unable to reach satisfactory extensions of lease terms at current locations.

**Environmental Matters**

As an owner, occupier, and lessor of property, the Company is subject to various laws relating to environmental matters. Under such laws an owner, occupier, or lessor could be liable for the costs of removal and remediation of certain contaminants with respect to the properties it owns, occupies, or leases. These risks are believed to be limited.

**Litigation**

The Company's wholly owned subsidiary, Paulmac's, is currently defending a motor vehicle claim where the amount claimed for damages totals C\$3,600,000 and the limit of insurance coverage is C\$2,000,000. Moreover, the plaintiffs make a claim for punitive damages and there is no insurance coverage for punitive damages. While the outcome of this litigation is not certain, the Company believes that there are substantive defences to this claim.

Pet Valu, Inc. and its affiliates (other than Paulmac's) have, both before and after this claim, and Paulmac's has, since its acquisition by Pet Valu Canada Inc., maintained automobile insurance coverage limits which have been, and are, well in excess of the above limit and which have been, and are, adequate in the view of management to cover future risks similar to the above.

From time to time, the Company is named as a defendant in legal proceedings arising from its normal business activities. Although the amount of any liability that could arise with respect to currently pending actions cannot be estimated, in the opinion of the Company, any such liability is not likely to have a material adverse effect on its financial position, operating results or liquidity.

**Seasonality**

The Company does not have a significant exposure to seasonal fluctuations among its product lines. Traditionally, fourth quarter earnings tend to be stronger due to higher store sales and increased margins, particularly in the month of December.

**Inflation**

The results of operations and financial condition are presented based upon historical cost. While it is difficult to accurately measure the impact of inflation, the Company believes that the effects of inflation on its operations have been immaterial over the last three years.

**Market risks**

The Company does not engage in financial transactions for trading or speculative purposes.

**Interest rate risk**

The Company believes that debt subject to variable interest rates is at an acceptable level and that any current obligations affected by minor fluctuations in rates can be met by current operations.

**Expansion Plans**

The Company's continued expansion depends, to a significant degree, on the ability of its stores to maintain sales and margins and the Company's ability to open new stores. The Company's growth also depends on several other factors, including its ability to obtain favourable store sites, to compete in existing and new geographic markets, and to secure or generate adequate financial resources.

**Other Risks**

Additional risks include: the ability of the Company to successfully implement its strategic initiatives and whether such strategic initiatives will yield the expected benefits; changes in consumer spending; general economic conditions and normal business uncertainty; customer preferences toward product offerings; adverse climate changes; the occurrence of a pandemic or other catastrophic event which could create shortages of labour, products or services required to operate the business profitably; and changes in the laws, rules and regulations applicable to the Company or the markets in which the Company operates. Although most of these risks are beyond the Company's control, with respect to the risk of a pandemic, the Company is currently preparing a comprehensive contingency plan.

**Critical accounting estimates**

The preparation of financial statements requires the Company to estimate the effect of various matters that are inherently uncertain as of the date of the financial statements. Each of these required estimates varies in regard to the level of judgment involved and its potential impact on the Company's reported financial results. Estimates are deemed critical when a different estimate could have reasonably been used or where changes in the estimate are reasonably likely to occur from period to period, and would materially impact the Company's financial condition, changes in financial condition or results of operations. The Company's significant accounting policies are discussed in Note 1 of the Notes to Consolidated Financial Statements; critical estimates inherent in these accounting policies are discussed in the following paragraphs.

**Allowance for doubtful accounts**

The Company records an allowance for doubtful accounts to reflect management's best estimate of losses inherent in its franchise accounts receivable as of the balance sheet date. This allowance is established through a charge to operating expenses and represents amounts of current and past due franchise account receivable balances and notes receivable balances which management estimates may not be collected. The Company calculates the allowance for doubtful accounts using a model that considers the current condition of the franchisee. The Company's calculation is then reviewed by management to assess whether, based on economic events, additional analyses are required to appropriately estimate losses. Management believes that the allowance for doubtful accounts is adequate to cover anticipated potential losses in the franchise accounts receivables; however, significant deterioration in the condition of the franchisees, or in the overall health of the economy, could materially change these expectations.

**Allowance for promotion fund deficit**

Pet Valu Canada Inc. maintains a promotion fund, which is used to offset marketing and advertising activities performed by Pet Valu Canada Inc. When the promotion fund is in a deficit position, the balance is included in other receivables. An allowance for the promotion fund is recorded to reflect management's best estimate of losses inherent in the deficit balance of the promotion fund as of the balance sheet date. This allowance is established through a charge to the provision and represents amounts which management estimates may not reverse. Management prepares an estimate of the amount of the deficit that will reverse in the near term through a review of the projected marketing and advertising activities and the expected funding. The Company calculates the allowance for promotion fund as the difference between the deficit balance and the amount which will reverse in the near term as estimated by management. For fiscal 2005, a provision of \$581,735 was charged to store operating expenses in respect of the promotion fund deficit. There was no allowance in fiscal 2004, at which time the promotion fund deficit was \$170,892.

**Inventory valuation**

All inventories are counted as close to year-end as possible without impacting operational activities including peak pre-Christmas sales activity. Inventories are valued at the lower of cost or market, with cost determined using the retail inventory method ("RIM") under the first-in, first-out ("FIFO") cost flow assumption. Inherent in the RIM calculation are certain significant management judgments and estimates, which impact the ending inventory valuation at cost as well as resulting gross margins. The methodologies utilized by the Company in its application of the RIM are consistent for all periods presented. Such methodologies include the development of cost-to-retail ratios and the groupings of homogeneous classes of merchandise. Management believes that the application of the Company's RIM and of FIFO provides an inventory valuation which reasonably approximates cost using a first in, first out assumption, and results in carrying inventory at the lower of cost or market.

**Vendor allowances**

The Company receives allowances and rebates from its vendors through a variety of programs and arrangements. Given the promotional nature of the Company's business, the allowances are generally intended to offset the Company's direct and indirect costs of promoting (including markdowns and product margins support), advertising and selling the vendors' products in its stores. Vendor allowances are recognized as a reduction of cost of goods sold when the purpose for which the vendor funds were intended to be used has been fulfilled. Accordingly, a reduction or increase in vendor allowances has an inverse impact on cost of sales.

**Income taxes**

Deferred income tax assets and liabilities are established for temporary differences between the financial reporting bases and the income tax bases of the Company's assets and liabilities at enacted tax rates expected to be in effect when such assets or liabilities are realized or settled. Deferred income tax assets are reduced by a valuation allowance if, in the judgment of the Company's management, it is more likely than not that such assets will not be realized. The Company's income tax NOL carryforwards in U.S. jurisdictions give rise to a deferred tax asset. The Company performs an evaluation of the deferred tax asset incorporating positive and negative evidence including the current and projected results of operations in the U.S. jurisdictions and based on these results a valuation allowance is recorded. In the event new circumstances make the future realization of these tax benefits more or less likely, the valuation allowance will be reduced or increased with the change either debited or credited to income, as required.

**Goodwill**

Goodwill represents the excess purchase price of acquired businesses over the fair value of the net assets acquired. Goodwill relates to the leveraged buyout of the Company in 1990, a business acquired in fiscal 1998 and the repurchase of franchises. An annual impairment test is performed for each reporting unit with goodwill recorded in the unit. The test compares the fair value of the reporting unit to its carrying amount. Based on the results of this test, the Company has determined that the value of its goodwill was not impaired as of December 31, 2005.

**Changes in Accounting Policies including Initial Adoption**

In 2004, the FASB issued SFAS No. 123(R), "Share Based Payment." This is effective for public companies that do not file as small business issuers as of the beginning of the first interim or annual reporting period that begins after June 15, 2005. All public companies must use either the modified prospective or the modified retrospective transition method. The Company adopted this pronouncement in the third quarter of 2005. The adoption of SFAS No. 123(R) has had no material effect on the Company's financial position, results of operations or cash flows.

**Outstanding Share Data**

The following table contains the number of outstanding voting or equity securities at the end of fiscal 2005 and 2004. Please refer to notes 10 and 11 of the fiscal 2005 financial statements for additional information.

	<u>December 31, 2005</u>	<u>January 1, 2005</u>
Common Stock of Pet Valu, Inc.	100	100
Special Voting Stock of Pet Valu, Inc.	-	-
Additional Special Voting Stock of Pet Valu, Inc.	9,626,274	9,626,274
Exchangeable Shares of Pet Valu Canada Inc.	7,501,158	7,496,418
Private Placement warrants issued March 7, 2000	-	-
Common Shares of Pet Valu Canada Inc. (held by Pet Valu, Inc.)	1	1
Non-voting securities convertible into Exchangeable Shares of Pet Valu Canada Inc.		
1,454,396 Class A Preferred Shares of Pet Valu Canada Inc.	-	167,488
7% debentures of Pet Valu Canada Inc. *	-	143,823
8.5% debentures of Pet Valu Canada Inc. **	672,727	1,150,533
Warrants of Pet Valu Canada Inc. listed on TSX	2,007,305	2,007,305
Warrants of Pet Valu Canada Inc. issued September 30, 2004 ***	876,944	924,200

\* Repayment of these debentures was completed in fiscal 2005.

\*\* Repayment of face value C\$2,627,934 of these debentures was completed in fiscal 2005.

\*\*\* Upon completion of the repayment of C\$2,627,934 of the 8.5% debentures, 47,256 warrants were cancelled.

**2006 Outlook**

The Company believes that it is well positioned as a specialty retailer in both the Canadian and U.S. markets. In Canada, the Company believes that it can maintain a dominant position in the Ontario and Manitoba markets. In the U.S., the Company believes that it has expansion opportunities with low capital cost requirements in both the short term and long term. In the short term, expansion is expected to be at a modest rate and will focus on the markets within the Company's logistical area of operations. The Company believes that current levels of cash flow will be sufficient to support its expansion plans and debt servicing obligations.

The Company successfully introduced several new private label and brand food products in various categories in fiscal 2005. The possibility exists that competitors will attempt to introduce the same or similar products, which may impact the Company's success with these products. To meet this challenge, the Company expects to introduce new brand and private label products in various categories in the current and future fiscal years.

The Company expects that manufacturers will implement cost increases for their products in both Canada and the U.S. The Company's gross profit margins could be adversely affected if retail price movement is restrained due to competitive pricing pressures.

The Company believes that most of its expenses will increase in fiscal 2006. The Province of Ontario announced annual increases in minimum wage levels effective in fiscal 2004 through 2007. These increases are not expected to significantly affect the Company's results. There will likely be upward pressure on utility rates in Ontario in fiscal 2006. The effect on the Company is not expected to be material. Energy prices are expected to continue to increase which could impact the costs of delivering products to the Company's markets as well as the manufacturers' costs to produce the products the Company sells.

In fiscal 2006, the Company's priorities include the continued pursuit of the reniching project, improved automation, and store expansion.

#### **Disclosure Controls and Procedures**

The Company has designed disclosure controls and procedures to provide reasonable assurance that material information related to the Company is included in the annual filings. In addition, the Chief Executive Officer and the Chief Financial Officer have evaluated the effectiveness of the disclosure controls and procedures as of the end of the filing period of December 31, 2005 and concluded that these controls are effective.

## Responsibility for Financial Reporting

These consolidated financial statements have been prepared by management in accordance with accounting principles generally accepted in the United States. Management is responsible for their integrity, objectivity and reliability and, where necessary, they reflect management's best estimates and judgements. All financial information in the annual report is consistent with the consolidated financial statements. Management is also responsible for the maintenance of financial and operating systems, which include effective controls, to provide reasonable assurance that the Company's assets are safeguarded and that reliable financial information is produced.

The Board of Directors is responsible for ensuring that management fulfills its responsibilities for financial reporting and internal control. The Board exercises these responsibilities through its Audit Committee. The Audit Committee meets with management and the independent auditors, Grant Thornton, to satisfy itself that management's responsibilities are properly discharged and to review and report to the Board on the consolidated financial statements.

In accordance with generally accepted auditing standards, the independent auditors conduct an examination each year in order to express a professional opinion on the consolidated financial statements.



Geoffrey F. A. Holt  
President and Chief Executive Officer



Dale Winkworth  
Vice-President, Finance and Chief Financial Officer

March 17, 2006

## Auditors' Report

To the Shareholders of Pet Valu, Inc.:

We have audited the consolidated balance sheets of Pet Valu, Inc. as at December 31, 2005 and January 1, 2005 and the consolidated statements of operations, shareholders' equity (deficit) and cash flows for the fiscal years then ended. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the consolidated financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the Company as at December 31, 2005 and January 1, 2005 and the results of its operations and its cash flows for the fiscal years then ended in accordance with accounting principles generally accepted in the United States of America.



Chartered Accountants  
Markham, Canada

March 3, 2006

**Consolidated Balance Sheets**

In accordance with accounting principles generally accepted in the United States of America  
(In U.S. dollars)

	December 31, 2005	January 1, 2005
<b>Assets</b>		
<b>Current assets</b>		
Cash	\$ 1,673,708	\$ 51,839
Accounts receivable	1,945,004	1,622,856
Other receivables (Note 3)	1,201,325	1,331,778
Inventories	23,803,567	22,365,496
Prepaid expenses	929,033	2,718,325
Deferred income tax assets (Note 13)	828,570	678,395
<b>Total current assets</b>	<b>30,381,207</b>	<b>28,768,689</b>
Notes receivable (Note 4) (Less allowances of \$37,833, 2004 - \$36,605)	66,379	167,446
Deferred charges (Note 1)	1,686,220	1,464,698
Property and equipment, net of accumulated depreciation and amortization (Note 5)	4,905,029	5,261,243
Goodwill (Note 1)	13,592,915	13,021,307
Deferred income taxes (Note 13)	3,977,741	2,742,104
<b>Total assets</b>	<b>\$ 54,609,491</b>	<b>\$ 51,425,487</b>
<b>Liabilities and Shareholders' Equity</b>		
<b>Current liabilities</b>		
Bank overdraft	\$ 1,559,421	\$ 3,710,327
Bank operating loans (Note 6)	1,862,419	2,691,935
Current portion of long-term debt including capital lease obligations (Note 7)	559,672	581,867
Current portion of deferred gain on warehouse sale (Note 5)	225,576	215,354
Trade accounts payable	5,201,056	4,311,514
Accrued liabilities (Note 8)	3,708,713	3,066,492
Accrued wages and benefits	2,459,436	2,405,662
Income taxes payable (Note 13)	2,602,198	1,747,247
Subordinated debentures (Note 9)	12,896,691	3,017,554
<b>Total current liabilities</b>	<b>31,075,182</b>	<b>21,747,952</b>
Deferred franchise revenue (Note 3)	20,039	104,897
Deferred gain on warehouse sale (Note 5)	605,419	804,034
Deferred rent payable	2,054,679	1,943,967
Long-term debt including capital lease obligations, less current maturities (Note 7)	1,203,785	1,406,017
Subordinated debentures (Note 9)	15,567,178	27,328,353
<b>Total liabilities</b>	<b>50,526,282</b>	<b>53,335,220</b>
Commitments and contingencies (Notes 6, 14 & 15)		
Minority interest in subsidiaries (Note 10)	-	1,118,388
<b>Shareholders' Equity (Deficit)</b>		
Capital stock (Notes 10 & 11)	963	963
Additional paid in capital	12,453,589	12,384,686
Accumulated deficit	(2,296,046)	(9,550,223)
Accumulated other comprehensive loss	(5,383,312)	(5,171,562)
Treasury stock – exchangeable shares, at cost	(691,985)	(691,985)
<b>Total shareholders' equity (deficit)</b>	<b>4,083,209</b>	<b>(3,028,121)</b>
<b>Total liabilities and shareholders' equity (deficit)</b>	<b>\$ 54,609,491</b>	<b>\$ 51,425,487</b>

The accompanying notes are an integral part of these consolidated financial statements.

Signed on behalf of the Board,

Director



Director



## Consolidated Statements of Operations

In accordance with accounting principles generally accepted in the United States of America  
(In U.S. dollars, except number of shares)

	Fiscal Years Ended	
	December 31, 2005	January 1, 2005
<b>Sales and revenue</b> (Note 3)	\$ 134,405,802	\$ 128,212,055
Cost of sales including occupancy costs	97,069,899	95,903,926
<b>Gross profit</b>	<b>37,335,903</b>	32,308,129
Store operating expenses excluding occupancy costs	14,057,272	12,757,603
General and administrative expenses	10,947,027	11,244,380
	<b>12,331,604</b>	8,306,146
Net interest expense (Note 12)	3,901,664	3,572,408
Loss on extinguishment of debt (Note 9e)	-	210,543
Gain on foreign exchange (Note 1)	-	(141,666)
Income before income taxes	8,429,940	4,664,861
Income taxes provision (Note 13)	1,175,763	932,100
<b>Net income</b>	<b>\$ 7,254,177</b>	\$ 3,732,761
Basic EPS (Note 2)	\$ 0.97	\$ 0.50
Diluted EPS (Note 2)	0.84	0.45
Weighted average number of common stock and exchangeable shares outstanding:		
Basic (Note 2)	7,497,586	7,496,418
Diluted (Note 2)	8,902,695	9,007,219

The accompanying notes are an integral part of these consolidated financial statements.

**Consolidated Statements of Shareholders' Equity (Deficit)**

In accordance with accounting principles generally accepted in the United States of America  
(In U.S. dollars)

	Special Voting Stock	Additional Special Voting Stock	Additional Paid-in Capital	Accumulated Deficit	Accumulated Other Comprehensive Income (Loss)	Treasury Stock	Total Shareholders' Equity (Deficit)	Comprehensive Income (Loss)
Balance – January 3, 2004	\$ 1	\$ 963	\$ 11,308,016	\$ (13,282,984)	\$ (4,698,574)	\$(691,985)	\$ (7,364,563)	
Cancellation of Special Voting Stock	(1)	-	-	-	-	-	(1)	
Cancellation of Class B Preferred Shares (Note 10)	-	-	890,353	-	-	-	890,353	
Income tax on cancellation of Warrants (Note 11)	-	-	(438,450)	-	-	-	(438,450)	
Issuance of Warrants (Note 11)	-	-	624,767	-	-	-	624,767	
Net Income	-	-	-	3,732,761	-	-	3,732,761	3,732,761
Foreign currency translation Adjustments	-	-	-	-	(472,988)	-	(472,988)	(472,988)
Balance – January 1, 2005	\$ -	\$ 963	\$ 12,384,686	\$ (9,550,223)	\$ (5,171,562)	\$(691,985)	\$ (3,028,121)	-
Comprehensive Income fiscal 2004								\$ 3,259,773
Stock-based compensation costs	-	-	57,637	-	-	-	57,637	
Cancellation of Tranche C warrants (Note 11)	-	-	(2)	-	-	-	(2)	
Issuance of Exchangeable Shares (Note 11)	-	-	11,268	-	-	-	11,268	
Net Income	-	-	-	7,254,177	-	-	7,254,177	7,254,177
Foreign currency translation Adjustments	-	-	-	-	(211,750)	-	(211,750)	(211,750)
<b>Balance – December 31, 2005</b>	<b>\$ -</b>	<b>\$ 963</b>	<b>\$ 12,453,589</b>	<b>\$ (2,296,046)</b>	<b>\$ (5,383,312)</b>	<b>\$(691,985)</b>	<b>\$ 4,083,209</b>	<b>-</b>
<b>Comprehensive Income fiscal 2005</b>								<b>\$ 7,042,427</b>

The accompanying notes are an integral part of these consolidated financial statements.

## Consolidated Statements of Cash Flows

In accordance with accounting principles generally accepted in the United States of America  
(In U.S. dollars)

	Fiscal Years Ended	
	December 31, 2005	January 1, 2005
<b>Operating activities</b>		
Net income	\$ 7,254,177	\$ 3,732,761
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	1,769,026	1,528,765
Deferred income taxes	(1,351,409)	(288,718)
Loss on disposal of property and equipment	20,552	29,979
Amortization of debenture discount	210,258	479,846
Loss on extinguishment of debt	-	206,293
Stock based compensation costs	55,326	-
Deferred charges	(111,685)	(508,515)
Deferred franchise revenue	901	(1,390)
Amortization of deferred gain on warehouse sale	(213,666)	(198,951)
Gain on foreign exchange	-	(141,665)
Changes in other operating assets and liabilities:		
(Increase) decrease in receivables	(97,903)	707,145
Increase in inventories	(808,098)	(537,938)
Decrease (increase) in prepaid expenses	1,802,578	(534,149)
Increase in trade accounts payable	746,193	324,535
Increase (decrease) in accrued liabilities	550,702	(865,960)
Increase in income taxes payable	761,841	154,862
<b>Net cash provided by operating activities</b>	<b>10,588,793</b>	<b>4,086,900</b>
<b>Investing activities</b>		
Purchases of property and equipment	(1,006,174)	(709,068)
Proceeds on disposal of property and equipment	47,929	65,698
Purchase of store goodwill	(141,771)	(20,753)
Notes and other receivables	16,680	70,140
<b>Net cash used in investing activities</b>	<b>(1,083,336)</b>	<b>(593,983)</b>
<b>Financing activities</b>		
Repayment of short-term financing	(884,804)	(5,612,600)
(Decrease) increase in bank overdraft	(2,185,139)	1,115,698
Repayment of capital lease obligation	(298,919)	(186,478)
Issuance of Exchangeable Shares	11,268	-
Repayment of note payable	(142,426)	(146,756)
Repayment of term loan financing	(175,929)	(201,761)
Redemption of Class A preferred shares	(1,118,388)	-
Tax on cancellation of warrants	(2)	-
Repayment of debentures	(2,969,782)	-
Issuance of 12.5% debentures	-	11,805,446
Repayment of 7.95% and 8.08% debentures	-	(10,234,872)
<b>Net cash used in financing activities</b>	<b>(7,764,121)</b>	<b>(3,461,323)</b>
Effect of exchange rate changes on cash	(119,467)	(46,238)
Net increase (decrease) in cash	1,621,869	(14,644)
<b>Cash – Beginning of fiscal year</b>	<b>51,839</b>	<b>66,483</b>
<b>Cash – End of fiscal year</b>	<b>\$ 1,673,708</b>	<b>\$ 51,839</b>

The accompanying notes are an integral part of these consolidated financial statements.

## Notes to Consolidated Financial Statements

For the fiscal years ended December 31, 2005 and January 1, 2005

In accordance with accounting principles generally accepted in the United States of America

(All amounts are expressed in U.S. dollars, unless otherwise indicated.)

(Canadian dollar reporting shall be cited as C\$)

### 1. Significant Accounting Policies

**Background** Pet Valu, Inc. was incorporated in Delaware, U.S.A. on February 28, 1996 and is a specialty retailer and wholesaler of pet food and pet-related supplies. The operations now carried on through Pet Valu, Inc. and its subsidiaries began in 1976 in Ontario, Canada and in 1995 in the U.S. As of December 31, 2005, Pet Valu, Inc. and its subsidiaries had 217 franchised and 68 company-owned stores in Ontario and Manitoba (Canada) and 4 franchised and 62 company-owned stores in Maryland, Virginia, Pennsylvania, Delaware and New Jersey (U.S.). These consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America ("U.S. GAAP").

**Principles of Consolidation** The consolidated financial statements include the accounts of Pet Valu, Inc., its subsidiaries, Pet Valu Canada Inc., Pet Valu International Inc. and Realty Management Systems Inc. and subsidiaries of Pet Valu Canada Inc., including Paulmac's Pet Food Inc., All Pet Enterprises Limited, and Peton Distributors Inc. (collectively, the "Company"). All significant intercompany transactions and balances are eliminated on consolidation. The Company considers third party holdings of preferred shares in a subsidiary to be a minority interest and accounted for under Accounting Research Bulletin No. 51 "Consolidated Financial Statements."

**Fiscal Year-end** The Company operates under a 52-week fiscal year ending on the Saturday nearest December 31. The consolidated financial statements for the year ended December 31, 2005 (fiscal 2005) and January 1, 2005 (fiscal 2004) each consisted of 52 weeks.

**Fair Value of Financial Instruments** The Company's financial instruments consist primarily of cash, trade accounts and other receivables, bank overdrafts, bank operating loans, trade accounts payable, accrued liabilities, accrued wages and benefits, term loans, supplier notes payable, other notes payable, and subordinated debentures. Except for the subordinated debentures, these balances, as presented in the financial statements, approximate their fair values. The subordinated debentures are not listed for trading on a stock exchange and are not actively traded. Accordingly, the fair value of these debentures is not readily determinable.

**Business and Credit Risk Concentration** Financial instruments which potentially subject the Company to concentrations of credit risk are cash and notes receivable. The Company's deposits are with various high quality financial institutions. The Company is dependent on key suppliers to provide sufficient quantities of inventory at competitive prices. The Company does not currently have any key suppliers who provide greater than 15% of the Company's inventory requirements.

To the extent that the assets securing bank overdrafts and bank operating loans and other activities are not denominated in the same currency, changes in foreign exchange rates can expose the Company to foreign currency risk.

The bank operating loans and certain notes are subject to variable interest rates. The Company does not engage in hedging and, therefore, is subject to interest rate risk.

**Use of Estimates** The presentation of financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the dates of the financial statements, as well as the reported amounts of revenues and expenses during the reported periods. Actual results could differ from those estimates.

**Inventories and Cost of Sales** Merchandise inventories are valued at the lower of cost or market. Cost is determined utilizing the retail method of accounting and includes certain distribution and buying costs relating to the processing of merchandise. Cost of sales includes the cost of merchandise, plus store occupancy costs and certain foreign currency transaction gains/losses. Foreign currency gains included in cost of sales were \$141,618 and \$199,073 in fiscal 2005 and 2004, respectively.

The Company accounts for vendor rebates and allowances using EITF No. 02-16, "Accounting by a Reseller for Cash Consideration Received from a Vendor by a Customer (Including a Reseller of the Vendor's Products)". EITF 02-16 provides guidance on how the cash consideration received by a customer from a vendor should be classified in the customer's statement of income. The Company includes vendor rebates in the cost of sale of inventory as appropriate when the purchases occur.

## 1. Significant Accounting Policies (Continued)

**Property and Equipment** Property and equipment are stated at cost. Additions and improvements are capitalized, while repairs and maintenance are charged to expense as incurred. The straight-line method of depreciation is used for financial reporting purposes. Estimated useful lives (or remaining lease life) are as follows:

Buildings	25 years
Furniture and fixtures	3 to 10 years
Automotive equipment	5 to 10 years
Leasehold improvements	Over the shorter of the useful life or the remaining term of the lease (not exceeding 11 years)
Internally-developed software	5 years

The Company accounts for internally-developed software according to Statement of Financial Position ("SOP") 98-1 "Accounting for the Costs of Computer Software Developed or Obtained for Internal Use." All capitalized software costs meet the characteristics of SOP 98-1. In particular, the software was internally developed or modified with the sole purpose of meeting the Company's internal requirements and neither at the time of development nor currently are there substantive plans to market the software externally.

**Long-Lived Assets** The Company accounts for long-lived assets using Statement of Financial Accounting Standards ("SFAS") No. 144, "Accounting for Impairment and Disposal of Long-lived Assets." SFAS No. 144 requires that long-lived assets and certain identifiable intangibles to be held and used by the Company be reviewed for possible impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. If changes in circumstances indicate that the carrying amount of an asset that an entity expects to hold and use may not be recoverable, future cash flows expected to result from the use of the asset and its disposition must be estimated. If the undiscounted value of the future cash flows is less than the carrying amount of the asset, impairment is recognized. Management has reviewed its property and equipment for impairment and believes that there has been no impairment of the Company's long-lived assets.

**Goodwill** The Company accounts for goodwill using SFAS No. 141 "Business Combination", and SFAS No. 142 "Goodwill and Intangible Assets". SFAS No. 141 requires the use of the purchase method of accounting for business combinations and prohibits the use of the pooling of interests method. SFAS No. 141 also refines the definition of intangible assets acquired in a purchase business combination.

Goodwill represents the excess purchase price of acquired businesses over the fair value of the net assets acquired. Goodwill as shown on the consolidated balance sheets of the Company, relates to the leveraged buyout of the Company in 1990, a business acquired in fiscal 1998 and the repurchase of franchises. In 2005, additions to goodwill amounted to \$141,771 (2004-\$20,753) in relation to the acquisition of franchises.

Impairment tests were performed as of December 31, 2005 and January 1, 2005. Based on the results of these tests, the Company determined that its goodwill was not impaired.

**Deferred Charges** Debt issuance costs relating to the debentures referred to in Note 9 are recorded as deferred charges and are amortized over the term of the debentures on a straight-line basis. As of December 31, 2005 and January 1, 2005, the unamortized balance was \$754,771 and \$619,943, respectively.

Deferred financing costs relating to the senior line of credit referred to in Note 6 are recorded as deferred charges and are amortized over the term of the credit agreement. As of December 31, 2005 and January 1, 2005 the unamortized balance was \$17,197 and \$66,556, respectively.

The Company has various lease agreements which include scheduled rent increases over the non-cancelable lease term. Rent expense for such leases is recognized on a straight-line basis over the related lease term. The excess of rent expense over the actual cash paid is recorded as deferred rent payable. The Company has entered into sublease arrangements with its Canadian franchisees and has recognized revenues on a straight-line basis resulting in deferred rents receivable, which are also included in deferred charges.

**Revenue Recognition** The Company recognizes revenue from retail sales through company-owned stores, wholesale sales to other retailers, and revenues from its franchise operations.

The Company has individual franchise agreements, which grant the individual franchisees the exclusive right to operate a franchise store. Initial site development fees, established business fees and franchise fees are collected in advance and recorded as income when the store commences operations as a franchise location. All initial fees are earned on the date of the store opening. On the sale of an existing company-owned store to a franchisee, costs relating to the sale of the store are charged to expense as incurred and proceeds (excluding fees) in excess of the net book value of store assets are recorded as a gain on the date of sale.

## 1. Significant Accounting Policies (Continued)

Ongoing revenue from Canadian franchise operations are comprised of royalties, percentage rents, franchise fees, fees for services, and wholesale merchandise sales. Royalties and percentage rents are based on the gross sales or imputed gross sales of the franchise and are recorded in income as earned. Franchise fees are non-refundable. Accordingly, revenue is recognized when the fees are collected. Fees for service are recognized when the service has been performed by the Company. Canadian franchisees purchase the majority of their inventory requirements from the Company. Accordingly, the Company recognizes revenue from the wholesale sale of merchandise to these franchisees.

Under the U.S. franchising system, the Company retains ownership of all inventories and recognizes revenue and records related expenses upon the sale of merchandise at the retail level. U.S. franchisees purchase the store equipment and are responsible for store operating costs, including labour for which they receive an allowance from the Company. In addition, U.S. franchisees are paid a royalty based on merchandise sales and compliance with operational standards. Royalties and store operating cost allowances paid by the Company to U.S. franchisees are recorded as store operating expenses.

**Stock-based Compensation Plans** The Company has stock-based compensation plans which are described in Note 11. On July 3, 2005, the Company adopted SFAS No. 123(R) "Stock Based Compensation". Under SFAS No. 123(R), the Company is required to use a fair value method for estimating the value of the stock options and to record compensation costs for any stock option outstanding for which the requisite service period has not yet been completed. The Company previously accounted for the plans under the Accounting Principles Board's Opinion No. 25, under which no compensation expense was recognized with respect to these plans. Any consideration paid upon exercise of options and the issue of shares is credited to share capital. Prior to July 3, 2005, if compensation cost for the options issued under the plans had been determined consistent with SFAS No. 123, "Accounting for Stock-Based Compensation," the Company's net income, basic EPS and diluted EPS would have been equal to the proforma amounts indicated below:

	Fiscal Years Ended	
	December 31, 2005	January 1, 2005
Net income applicable to holders of Common Stock and Exchangeable Shares – as reported	\$ 7,254,177	\$ 3,732,761
Add: stock-based employee compensation expenses included in reported net income, net of related tax effects	55,326	-
Deduct: total stock-based employee compensation expense determined under fair value based method for all awards net of related tax effects	(84,096)	(61,215)
<b>Pro forma net income</b>	<b>\$ 7,225,407</b>	<b>\$ 3,671,546</b>
Earnings per share:		
Basic EPS - as reported	0.97	0.50
- pro forma	0.96	0.49
Diluted EPS - as reported	0.84	0.45
- pro forma	0.83	0.44

**Income Taxes** The Company accounts for income taxes using SFAS No. 109, "Accounting for Income Taxes". SFAS No. 109 uses an asset and liability approach that requires the recognition of deferred tax assets and liabilities for the expected future, tax consequences of events that have been recognized in the Company's financial statements or tax returns as well as tax credit carryforwards and loss carryforwards. These deferred taxes are measured by applying enacted tax rates. Future tax benefits, such as loss carryforwards, are recognized to the extent that such benefits are more likely than not to be realized during the carryforward period.

**Foreign Currency Translation** Pursuant to SFAS No. 52, "Foreign Currency Translation", the functional currency of the Canadian operations is Canadian dollars, the functional currency of the U.S. operations is U.S. dollars, and the reporting currency for the consolidated operations is U.S. dollars. Accordingly, the assets and liabilities of the Company's Canadian operating subsidiary, Pet Valu Canada Inc., are recorded in the functional currency of Canadian dollars and are translated into the reporting currency at the rate of exchange as of the balance sheet date. Revenues and expenses are translated at the average rates of exchange for the period of operation. Gains and losses arising from the translation are deferred and classified as a foreign currency translation adjustment within shareholders' equity.

The Company recognizes foreign exchange gains or losses on outstanding debentures denominated in a currency other than the operating currency of the issuer when the foreign exchange rate changes. These gains or losses are disclosed separately in the Consolidated Statement of Operations. In fiscal 2005, there were no debentures outstanding that were denominated in a currency other than the operating currency of the issuer and therefore there were no related gains or losses. In fiscal 2004, the Company recognized a gain on foreign exchange of \$141,666. The gain arose from the 7.95% and 8.08% subordinated debentures denominated in U.S. dollars issued by Pet Valu Canada Inc. in March 2000 and repaid in September 2004.

## 1. Significant Accounting Policies (Continued)

**Store Pre-opening Costs** All costs associated with the opening of new stores are charged to expense as incurred.

**Advertising Costs** Advertising costs are charged to expense as incurred. Advertising expense was \$1,635,581 and \$1,012,195 in fiscal 2005 and 2004, respectively. The allowance for promotion fund deficit of \$581,735 was included in advertising expense for fiscal 2005. There was no allowance in fiscal 2004.

**Comparative Figures** Certain comparative figures have been reclassified in order to conform to current year presentation.

### Recent Accounting Pronouncements

In May 2005, FASB issued SFAS No. 154, "Accounting Changes and Error Corrections." SFAS No. 154 requires retrospective application to prior periods' financial statements of a voluntary change in accounting principle. SFAS No. 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. The adoption of SFAS No. 154 is not expected to have a material effect on the Company's financial position, results of operations or cash flows.

In October 2005, FASB issued FSP 13-1, "Accounting for Rental Costs Incurred During a Construction Period." FSP 13-1 requires rental costs incurred during a construction period associated with ground or building operating leases to not be capitalized and to be recognized as rental expense. FSP 13-1 applies to reporting periods beginning after December 15, 2005. The Company will adopt this pronouncement in the first quarter of 2006. The adoption of FSP 13-1 is not expected to have a material effect on the Company's financial position or results of operations or cash flows.

### Newly Adopted Accounting Policies

In 2004, the FASB issued SFAS No. 123(R), "Share Based Payment." This is effective for public companies that do not file as small business issuers as of the beginning of the first interim or annual reporting period that begins after June 15, 2005. All public companies must use either the modified prospective or the modified retrospective transition method. The Company adopted this pronouncement in the third quarter of 2005 using the modified prospective method. The adoption of SFAS No. 123 (R) has had no material effect on the Company's financial position, results of operations or cash flows.

### Supplemental Cash Flow Information

	Fiscal Years Ended	
	December 31, 2005	January 1, 2005
Interest paid	\$ 3,207,602	\$ 3,708,558
Income taxes paid	\$ 1,917,011	\$ 1,013,522
Income taxes refunded	\$ 98,513	\$ 9,713

Non-cash investing and financing activities:

Capital lease obligations of \$354,239 and \$527,260 were entered into during fiscal 2005 and 2004, respectively.

## 2. Net Earnings per Share

Basic earnings per share ("EPS") exclude potentially dilutive securities and are computed by dividing net income available to common shareholders by the weighted average number of common shares outstanding for the period. Diluted EPS is computed assuming the conversion or exercise of all dilutive securities such as preferred stock, options and warrants.

In order to reflect the economic substance of the Company's capital structure, the computation of basic EPS is based on the aggregate number of shares of common stock of Pet Valu, Inc. ("Common Stock") and exchangeable shares of its subsidiary, Pet Valu Canada Inc. ("Exchangeable Shares"), excluding treasury stock. Diluted EPS is based on the diluted effect of equity and debt instruments convertible into either Common Stock or Exchangeable Shares (see Note 10).

Basic EPS is calculated using a weighted average number of shares outstanding. In fiscal 2005 and fiscal 2004, the calculation of diluted EPS included certain stock options, warrants, preferred shares and convertible debt outstanding during the relevant period. Class A preferred shares of Pet Valu Canada were convertible into 167,488 Exchangeable Shares until their redemption date in fiscal 2005. The debt was convertible into 1,294,363 Exchangeable Shares. Debt convertible into 621,636 Exchangeable Shares were repaid in fiscal 2005. Stock options and warrants to purchase 3,559,849 Exchangeable Shares and/or Common Stock were outstanding on December 31, 2005 (January 1, 2005 – 3,629,745). The Company uses the treasury method to determine the number of Exchangeable Shares to be added to the denominator due to dilutive warrants and options.

Net income applicable to holders of Common Stock and Exchangeable Shares:  
(In U.S. dollars, except for number of shares)

	Fiscal Years Ended	
	December 31, 2005	January 1, 2005
Net income for the year	\$ 7,254,177	\$ 3,732,761
Net income applicable to holders of Common Stock and Exchangeable Shares		
Basic	\$ 7,254,177	\$ 3,732,761
Interest on 7% debenture	5,814	34,070
Interest on 8.5% debenture	183,101	262,013
Diluted	\$ 7,443,092	\$ 4,028,844
Basic EPS	\$ 0.97	\$ 0.50
Diluted EPS	\$ 0.84	\$ 0.45
Weighted average number of Common Stock and Exchangeable Shares outstanding:		
Basic	7,497,586	7,496,518
Effect of conversion of class A preferred shares	67,639	167,488
Effect of dilutive stock options outstanding	185,206	32,629
Effect of dilutive warrants outstanding	380,485	16,221
Effect of conversion of 7% debenture	22,918	143,830
Effect of conversion of 8.5% debenture	748,861	1,150,533
Diluted	8,902,695	9,007,219

### 3. Franchise Operations

Included in other receivables were net amounts due from franchisees of \$1,077,217 and \$1,143,897 as of December 31, 2005 and January 1, 2005, respectively. An amount due in respect of a deficit balance in the franchise promotion fund of \$170,892 was included in the net amount due from franchisees as of January 1, 2005.

Included in sales and revenue were the following amounts with respect to Canadian franchise operations:

	Fiscal Years Ended	
	December 31, 2005	January 1, 2005
Merchandise sales to franchisees	\$ 61,520,000	\$ 58,016,000
Distribution charges	5,149,000	4,836,000
Initial franchise fees	368,000	415,000
Gain on sale of company-owned stores	147,000	5,000
Franchise royalties and other revenues	10,547,000	10,432,000
	\$ 77,731,000	\$ 73,704,000

In fiscal 2005 and 2004, the Company earned initial franchise fees and gains on the sale of company-owned stores of \$51,791 and \$18,533 respectively, through its U.S. franchise operations. Retail sales of merchandise through U.S. franchise stores were \$2,202,629 and \$2,910,488 in fiscal 2005 and 2004, respectively, and were included in sales and revenue. Royalties and other fees paid to U.S. franchisees in the amount of \$482,419 for fiscal 2005 and \$628,086 for fiscal 2004 were included in store operating expenses excluding occupancy costs.

#### Promotion Fund

The Company's Canadian franchisees contribute a percentage of their weekly merchandise purchases to a promotion fund. This fund is used to offset marketing and advertising activities performed by the Company. Collections for this fund are made in accordance with the terms of applicable agreements made with each franchisee. The percentage of franchise merchandise purchases designated for the promotion fund is determined at the discretion of the Company, subject to certain restrictions contained in the franchise agreements.

A deficit balance in the promotion fund may occur when the cumulative cost of marketing and advertising activities exceed the cumulative franchise funding. These differences can be short-term in nature, caused by timing of marketing and advertising activities in a given year as compared to franchise funding for that year, or long-term as part of strategic uses of the fund. The promotion fund had a deficit balance of \$605,995 and \$170,892 at the end of fiscal 2005 and 2004, respectively. The Company has reviewed the marketing and advertising activities and the expected funding for the near term and concluded that due to the planned strategic uses of the fund, the deficit balance at the end of fiscal 2005 is not expected to reverse in the near term. Accordingly, the Company has recorded an allowance for the promotion fund deficit in the amount of \$605,995 at the end of fiscal 2005.

#### Guarantee of Debt

During fiscal 1999, the Company offered a franchise financing program in the U.S. whereby the Company guaranteed loans of up to \$130,000 to qualifying franchisees. The Company withheld an amount equal to the monthly payments due to the financial institution from amounts due to the franchisee and remitted it directly to the financial institution. The loans were secured by the value of the store equipment owned by the franchisee. The interest rate was determined by the financial institution based on prevailing market rates. As at December 31, 2005 there were no loans guaranteed under this program. At January 1, 2005, two U.S. franchisees were participating in the financing program. Total loans guaranteed were \$58,143. The interest rates on the outstanding loans ranged from 15% to 16%. The financing program has not been offered since fiscal 1999.

#### Bank Comfort Letters

On many occasions when requested by a lending institution, Pet Valu Canada Inc. has provided a comfort letter for the purpose of assisting franchisees in securing financing. In the comfort letter, Pet Valu Canada Inc. states that it will agree to purchase certain inventory and equipment necessary for the operation of the store at book value less 15% in the rare case where the lending institution is forced to realize on its security.

#### 4. Notes Receivable

Notes receivable included unsecured loans in the amount of \$102,855 and \$202,730 as of December 31, 2005 and January 1, 2005, respectively. The loans bore interest at a rate of prime plus 2% for Canadian franchisees (7.00% at December 31, 2005) and between 14 - 16% for U.S. franchisees. These notes were provided to various franchisees in connection with the purchase of their franchises and to provide working capital. The loans are for various terms not exceeding seven years.

#### 5. Property and Equipment

	December 31, 2005	January 1, 2005
Land	\$ 80,570	\$ 77,956
Buildings	996,590	964,255
Furniture and fixtures	13,024,053	11,645,712
Automotive equipment	2,785,748	2,969,324
Leasehold improvements	3,348,511	3,183,602
Internally-developed software	2,335,430	2,225,760
	<b>22,570,902</b>	21,066,609
Less: Accumulated depreciation and amortization	17,665,873	15,805,366
	<b>\$ 4,905,029</b>	\$ 5,261,243

During fiscal 2005 and 2004, the Company recorded depreciation and amortization expense related to property and equipment of \$1,774,180 and \$1,528,765 respectively.

In 1999, the Company sold and leased back five of its Canadian warehouses. The sale resulted in gross proceeds of \$6,972,010 and a deferred pre-tax gain of \$1,759,075. The deferred gain is being amortized into income over the term of the various leases.

#### 6. Bank Operating Loans

During fiscal 2000, the Company entered into an agreement with Bank of Montreal for a C\$18,000,000 senior line of credit, with borrowings denominated in either Canadian or U.S. dollars. In 2004, the Company entered into an agreement with the Bank of Montreal to extend the term of the 2000 credit agreement on substantially similar terms. The term of the facility will expire July 13, 2006. Borrowings under the facility are limited to the lesser of the loan ceiling of C\$18,000,000 and a borrowing base calculation related to inventories and franchise receivables. On December 31, 2005 the borrowings outstanding under the credit facility, the borrowing base calculation and the resulting availability were \$1,862,419 (2004-\$2,691,935), C\$14,862,442 (2004 - C\$15,614,528), and C\$12,696,449 (2004 - C\$12,378,822), respectively. Interest is calculated using the bank's prime rate plus 1.00% per annum. The interest rates at December 31, 2005 were 6.00% for Canadian dollar borrowings and 8.75% for U.S. dollar borrowings. In addition, a fee of 0.5% is charged on the unused portion of the credit facility.

The facility is collateralized by liens against all assets of the Company, subject to certain permitted encumbrances.

Pursuant to the above agreement, in addition to its borrowing base restrictions, the Company must comply with certain general covenants which include, among others, a minimum consolidated debt service ratio, a minimum total net worth calculation and a minimum debt service ratio for Pet Valu International Inc. The Company was in compliance with these covenants at December 31, 2005.

**7. Long-term Debt**

	December 31, 2005			January 1, 2005		
	Long-term	Current	Total	Long-term	Current	Total
Term loans	\$ 5,159	\$ 68,583	\$ 73,742	\$ 66,502	\$ 159,161	\$ 225,663
Supplier notes payable	441,969	110,492	552,461	545,487	109,097	654,584
Other notes payable	60,632	38,142	98,774	96,296	58,914	155,210
Capitalized lease obligations	696,025	342,455	1,038,480	697,732	254,695	952,427
<b>Total</b>	<b>\$ 1,203,785</b>	<b>\$ 559,672</b>	<b>\$ 1,763,457</b>	<b>\$ 1,406,017</b>	<b>\$ 581,867</b>	<b>\$ 1,987,884</b>

**Term Loans**

Term loans bear interest at rates ranging between 7.00% and 15.01%. The loans have maturities to May 2007 and are secured by certain store fixtures and equipment and a mortgage on certain property.

**Supplier Notes Payable**

During fiscal 2000, the Company entered into loan agreements with a certain supplier. These loans are payable in annual principal installments of C\$50,000 and US\$67,500, respectively and mature in 2010. The loans bear interest, payable monthly, at Canadian bank prime (5% at December 31, 2005) and U.S. prime (7.25% at December 31, 2005), respectively. Pursuant to the loan agreements, the Company must meet certain merchandise purchase targets. If the targets are not met, the principal repayments are accelerated based on a formula. All targets were met in fiscal 2005 and 2004.

**Other Notes Payable**

Other notes payable bear interest at annual rates ranging between 7.00% and 7.25%, have various maturity dates from 2006 to 2009, and are unsecured.

**Capital Lease Obligations**

The Company financed certain automotive equipment and computer and office equipment under capital leases with a capitalized cost included in property and equipment of \$1,616,998 and \$1,372,364 as at December 31, 2005 and January 1, 2005, respectively. Accumulated depreciation relating to these assets was \$592,545 and \$359,881 as at December 31, 2005 and January 1, 2005, respectively.

Future repayments are as follows:

	Term Loans	Supplier Notes Payable	Other Notes Payable	Capitalized Lease Obligations	Total
2006	\$ 68,583	\$ 110,492	\$ 38,142	\$ 408,468	\$ 625,685
2007	5,159	110,492	32,874	317,779	466,304
2008	-	110,492	25,310	244,531	380,333
2009	-	110,492	2,448	155,129	268,069
2010	-	110,493	-	52,187	162,680
2011	-	-	-	4,946	4,946
	\$ 73,742	\$ 552,461	\$ 98,774	\$ 1,183,040	\$ 1,908,017
Less: Interest	-	-	-	144,560	144,560
Current maturities	68,583	110,492	38,142	342,455	559,672
<b>Total</b>	<b>\$ 5,159</b>	<b>\$ 441,969</b>	<b>\$ 60,632</b>	<b>\$ 696,025</b>	<b>\$ 1,203,785</b>

**8. Accrued Liabilities**

	December 31, 2005	January 1, 2005
Accrued interest	\$ 354,925	\$ 126,174
Accrued rent, common area maintenance and realty taxes	905,347	770,664
Sales and use taxes	722,463	659,014
Supplies and services	1,725,978	1,510,640
	<b>\$ 3,708,713</b>	<b>\$ 3,066,492</b>

## 9. Subordinated Debentures

	December 31, 2005			January 1, 2005		
	Face Value (Converted from C\$)	Unamortized Discount	Net	Face Value (Converted from C\$)	Unamortized Discount	Net
8.5% subordinated (non-convertible)	\$ 12,944,787	\$ 48,096	\$ 12,896,691	\$ 12,524,781	\$ 126,431	\$ 12,398,350
8.5% subordinate (convertible)	3,181,427	-	3,181,427	5,264,505	-	5,264,505
7% subordinate (convertible)	-	-	-	831,253	-	831,253
12.5% subordinated (non-convertible)	12,897,678	511,927	12,385,751	12,479,201	627,402	11,851,799
	<b>\$ 29,023,892</b>	<b>\$ 560,023</b>	<b>\$ 28,463,869</b>	<b>\$ 31,099,740</b>	<b>\$ 753,833</b>	<b>\$ 30,345,907</b>
Balance Sheet Classification						
Current	12,944,787	48,096	12,896,691	3,017,554	-	3,017,554
Non-Current	16,079,105	511,927	15,567,178	28,082,186	753,833	27,328,353
	<b>\$ 29,023,892</b>	<b>\$ 560,023</b>	<b>\$ 28,463,869</b>	<b>\$ 31,099,740</b>	<b>\$ 753,833</b>	<b>\$ 30,345,907</b>

**(a) 8.5% Non-Convertible**

In fiscal 1996, Pet Valu Canada Inc. raised C\$15,054,788 through the sale of units to its subscribing Common and Exchangeable Shareholders (see Note 10). Each unit consisted of one C\$7.50 principal amount 8.5% non-convertible subordinated unsecured debenture of Pet Valu Canada Inc. due July 24, 2006 and one Exchangeable Share purchase warrant (see Note 11) of Pet Valu Canada Inc. The fair value of these warrants was allocated to shareholders' equity, resulting in a debenture discount of \$700,831 (C\$963,506), which is being amortized over the remaining term of the debentures. Amortization of \$79,269 (C\$96,034) and \$73,810 (C\$96,034) was included in net interest expense for fiscal 2005 and 2004, respectively. Interest is paid quarterly.

**(b) 8.5% Convertible**

In fiscal 1999, an agreement was completed creating new 8.5% convertible subordinated unsecured debentures of Pet Valu Canada Inc. in the amount of C\$6,327,934. These debentures replaced certain existing 7% convertible debentures and one non-convertible unsecured debenture together with a corresponding exchangeable share purchase warrant (see Note 11).

These debentures are convertible, at any time, into Exchangeable Shares at a conversion price of C\$5.50 per share and are repayable by Pet Valu Canada Inc. on the terms specified in the applicable debenture holder agreement. Debentures totaling C\$2,627,934, along with accrued interest thereon, were repaid in fiscal 2005. The balance of C\$3,700,000 is due in 2009. Interest on all these debentures is paid quarterly.

**(c) 7% Convertible**

Prior to repayment, 7% convertible subordinated unsecured debentures of Pet Valu Canada Inc. totaling C\$999,166 were convertible, at any time, into 1.0076 Exchangeable Shares at a conversion price of C\$7.00. Interest was paid quarterly. In fiscal 2005, Pet Valu Canada Inc. repaid C\$999,166 principal amount of 7% convertible debentures, along with accrued interest thereon.

**(d) 12.5% Non-Convertible**

In fiscal 2004, Pet Valu Canada Inc. issued to Penfund Mezzanine Limited Partnership II ("Penfund") a C\$15,000,000 secured subordinated debenture and share purchase warrants entitling Penfund to purchase up to 924,200 Exchangeable Shares. The fair value of these warrants at the time of issue was \$624,767 (C\$793,829), which was allocated to shareholders' equity and deducted as a debenture discount, which is being amortized over the five year term of the debenture. Amortization of \$131,049 (C\$158,765) and \$30,506 (C\$39,691) was included in net interest expense for fiscal 2005 and 2004, respectively. As a result of the repayment of C\$2,627,934 of the debentures referred to in Note 9(b), 47,256 of the warrants issued to Penfund referred to above were cancelled on March 31, 2005.

## 9. Subordinated Debentures (Continued)

### (e) 7.95% Non-Convertible and 8.08% Non-Convertible

In fiscal 2000, the Company completed a private placement transaction arranged by Bedford Capital Corporation ("Bedford"). The transaction converted an existing \$4,000,000 bridge loan and an existing preferred stock and warrant investment (see Notes 10 and 11) into the following:

- \$6,240,000 of 7.95% five-year non-convertible subordinated secured debentures of Pet Valu Canada Inc.;
- \$3,994,872 of 8.08% five-year non-convertible subordinated secured debentures of Pet Valu Canada Inc.;
- 3,843,750 voting warrants to purchase Common Stock or alternatively, Exchangeable Shares (see Note 11); and
- one share of Special Voting Stock of Pet Valu, Inc. with a par value of \$1, possessing a total number of votes equal to the number of outstanding corresponding warrants.

The debentures issued as a result of the private placement were secured by a charge on certain assets of Pet Valu Canada Inc. and Peton Distributors Inc.

In fiscal 2004, Pet Valu Canada Inc. repaid in full the 7.95% and 8.08% debentures including accrued interest of \$464,398 as part of a settlement of a litigation matter between Pet Valu Canada Inc. and certain affiliates as plaintiffs, and Bedford and others as defendants (the "Bedford Litigation"). The Company recognized a loss on debt extinguishment of \$210,543 which was arrived at by computing the difference between the book value of the debentures at the time of repayment and the amount paid. The 3,843,750 voting warrants referred to above were also cancelled in fiscal 2004 as part of the litigation settlement. The warrants were not listed for trading. The fair value of these warrants at the time of issue was \$2,412,177, which was allocated to shareholders' equity, and deducted as a debenture discount. The debenture discount was amortized over the remaining term of the debentures. Amortization of \$586,073 was included in net interest expense for fiscal 2004.

## 10. Capital Stock

### Authorized

1	Special Voting Stock with a par value of \$1.00.
9,626,274	Additional Special Voting Stock with a par value of \$0.0001 per share, possessing as a class a total number of votes equal to the number of outstanding Exchangeable Shares from time to time not owned by Pet Valu, Inc. or any of its subsidiaries.
100,000,000	Preferred Stock with 8% cumulative dividends, a par value of \$0.0624 per share, redeemable at the option of both the Company and the holder based on terms as defined.
20,000,000	Common Stock with a par value of \$0.0001 per share, possessing one vote per share.

### Issued and Outstanding

	December 31, 2005		January 1, 2005	
	Shares Issued and Outstanding	Amount	Shares Issued and Outstanding	Amount
Special Voting Stock	-	\$ -	-	\$ -
Additional Special Voting Stock	9,626,274	963	9,626,274	963
Common Stock	100	-	100	-
Additional paid-in capital		12,453,589		12,384,686
		<b>\$12,454,552</b>		<b>\$12,385,649</b>

In fiscal 2000, the Company reacquired the 100,000,000 shares of Preferred Stock and 1,000,000 warrants as part of a private placement arranged by Bedford (See Note 9e). The Preferred Stock is now held by one of Pet Valu Canada Inc.'s subsidiaries, PVUS Holdings Inc. and is eliminated on consolidation. The warrants were cancelled.

### Pet Valu Canada Inc. Shares

	December 31, 2005			January 1, 2005	
	Authorized	Issued	Outstanding	Pet Valu, Inc. Common Equivalent	Pet Valu, Inc. Common Equivalent
Common Shares, no par value	Unlimited	1	1	-	-
Exchangeable Shares, no par value	Unlimited	7,854,858	7,501,158	7,501,158	7,496,418
Class A Preferred Shares, no par value	7,000,000	-	-	-	167,488
Class B Preferred Shares, no par value	176,845	-	-	-	-
Class C Preferred Shares, no par value	1	-	-	-	-

**10. Capital Stock (Continued)**

Pet Valu Canada Inc. had one common share issued to Pet Valu, Inc. as of December 31, 2005 and January 1, 2005, which has been eliminated in consolidation.

**Exchangeable Shares**

Pet Valu, Inc. and Pet Valu Canada Inc. have an agreement under which the Exchangeable Shares have the right to dividends and can vote on an equivalent basis with the Common Stock and have exercise privileges which could result in the exchange of the Exchangeable Shares for Common Stock, at the option of the holder. The Exchangeable Shares vote in Pet Valu, Inc. through the Additional Special Voting Stock, which is held by CIBC Mellon Trust Company as trustee.

In order to reflect the economic substance of the Company's capital structure, the value of the Exchangeable Shares and equity instruments of Pet Valu Canada Inc. convertible into Exchangeable Shares have been included in shareholders' equity in the consolidated financial statements.

Pet Valu, Inc. held 353,700 Exchangeable Shares at December 31, 2005 and January 1, 2005, in treasury at cost, in anticipation of grants under certain warrants. No shares were repurchased in fiscal 2005 or fiscal 2004.

**Minority Interest in Subsidiaries**

	December 31, 2005	January 1, 2005
Pet Valu Canada Inc.: Class A preferred shares	\$ -	\$ 1,118,388
Other Subsidiary: Class B preferred shares	-	-
	<u>\$ -</u>	<u>\$ 1,118,388</u>

The Class A Preferred Shares were convertible into Exchangeable Shares at a conversion rate of one Exchangeable Share for every 8.6836 Class A Preferred Shares at the option of the holder under terms as defined. The Class A Preferred Shares were redeemable at the price of C\$1.00 per share, subject to certain restrictions, including covenants regarding bank indebtedness and compliance with the Business Corporations Act (Ontario). Redemption of the outstanding Class A Preferred Shares was completed in fiscal 2005. The holders of the Class A Preferred Shares had no voting rights and were not entitled to dividends.

The Class B preferred shares were cancelled in fiscal 2004 as part of the settlement of the Bedford Litigation. The Class B preferred shares were comprised of 890,345 non-voting, non-dividend bearing shares issued by a subsidiary. These shares were redeemable at the price of \$1.00 per share, subject to certain restrictions.

**11. Stock Options and Warrants**

The Company's Executive Stock Option Plan and Board Stock Option Plan (collectively, the "Plans") provide for the granting of options to purchase Exchangeable Shares to certain full-time employees and to members of the Company's Board of Directors. Required disclosure information with respect to these Plans has been combined due to the similarities of the Plans.

The Company has reserved 1,079,260 Exchangeable Shares for issuance pursuant to its Plans of which 403,660 are available for grant.

The weighted average fair value of the Common Stock and Exchangeable Share options granted in fiscal 2005 was \$1.54 (2004 - \$1.62) per share. The fair value of the Common Stock and Exchangeable Share options granted is estimated at the grant date using the Black-Scholes option-pricing model with the following assumptions:

	Fiscal years ended	
	December 31, 2005	January 1, 2005
Expected dividend rate	0%	0%
Expected volatility	70%	70%
Weighted average risk-free interest rate	4.5%	4.58%
Expected lives (years)	4 to 8	8 to 10

Pursuant to the terms of the Board Stock Option Plan, new board members receive options that vest and become exercisable at a rate of 2,000 per year of service on the Board. Such options expire three years after vesting. The Board Plan permits the board to grant additional options to existing directors as well.

Pursuant to the terms of the Executive Stock Option Plan, certain full time employees are eligible to receive options that may be granted from time to time by the Company. The option exercise period shall not exceed ten years.

As of December 31, 2005 there were 76,000 Board options vested and exercisable and 530,600 Executive options vested and exercisable with weighted average exercise prices of C\$1.67 and C\$2.99, respectively.

**11. Stock Options and Warrants (Continued)**

Information with respect to all options outstanding is as follows:  
(all amounts in Canadian dollars)

	Shares	Range of Exercise Prices	Weighted Average Exercise Price
Outstanding January 3, 2004	658,240	\$ 0.72 – 5.46	\$ 2.77
Granted	50,000	2.06	2.06
Exercised	-	-	-
Cancelled	(10,000)	0.72 – 5.46	2.53
Outstanding January 1, 2005	698,240	1.16 – 3.28	2.72
Granted	30,000	3.26	3.26
Exercised	(4,740)	2.80	2.80
Cancelled	(47,900)	1.16 - 3.28	2.29
Outstanding December 31, 2005	675,600	\$ 1.16 - 3.28	\$ 2.78

The weighted average remaining term of options outstanding at December 31, 2005 was 4.14 years.

The following table summarizes information about stock options outstanding at December 31, 2005:

Range of exercise price	Options Outstanding	Weighted Average Remaining Contractual Life(yrs)	Options outstanding Weighted Average Exercise Price	Options exercisable	Weighted Average Exercise Price
\$ 1.16 – 1.83	75,040	2.86	\$ 1.48	66,040	\$1.46
2.06	50,000	8.88	2.06	10,000	2.06
2.75	12,000	1.04	2.75	12,000	2.75
2.80	287,560	3.98	2.80	287,560	2.80
3.26	20,000	5.36	3.26	-	3.26
3.28	231,000	3.79	3.28	231,000	3.28
	675,600			606,600	

**Warrants**

In fiscal 2004, Pet Valu Canada Inc. issued share purchase warrants as part of a private placement financing entitling the holder to purchase up to 924,200 Exchangeable Shares of Pet Valu Canada Inc. The share purchase warrants were issued in three tranches, as follows: (1) 810,411 warrants exercisable at C\$2.00 ("Tranche A Warrants"), at the option of the holder; (2) 66,533 warrants exercisable at C\$5.50 ("Tranche B Warrants"), at the option of the holder; and (3) 47,256 warrants exercisable at C\$5.50 ("Tranche C Warrants"). Each warrant entitles the holder to purchase one Exchangeable Share. All warrants expire on September 30, 2009. The Tranche C Warrants were not automatically exercisable, but rather only became exercisable in certain circumstances, and were subject to cancellation if certain conversion rights held by unrelated third party investors were cancelled. The cancellation of said conversion rights was completed in fiscal 2005 and the Tranche C warrants were cancelled.

In fiscal 2004, the Company cancelled 3,843,750 voting warrants that were issued on March 7, 2000 as part of a private placement arranged by Bedford (see Note 9e). The warrants were cancelled as part of the settlement of the Bedford Litigation. These voting warrants had entitled the holders to purchase an aggregate of 3,843,750 shares of Common Stock or Exchangeable Shares at an exercise price of C\$4.00 per share, subject to certain events.

During fiscal 1996, Pet Valu Canada Inc. issued 2,007,305 warrants in connection with the 8.5% non-convertible subordinated unsecured debentures (see Note 9a). Each warrant entitles the holder to purchase one Exchangeable Share at a price equal to the greater of (i) C\$7.00; or (ii) the then current market price of an Exchangeable Share on the Toronto Stock Exchange less C\$7.00, at any time on or before July 24, 2006, subject to adjustment under certain events, as defined.

**12. Net Interest Expense**

Net interest expense is comprised of:

	Fiscal years ended	
	December 31, 2005	January 1, 2005
Interest on bank indebtedness	\$ 530,033	\$ 496,079
Amortization of financing costs	257,742	100,497
Interest on notes payable	56,956	70,130
Interest on debentures	2,902,706	2,232,160
Amortization of debenture discount	210,318	690,388
Interest income	(56,091)	(16,846)
Interest expense, net	\$ 3,901,664	\$ 3,572,408

### 13. Income Taxes

Provisions for federal, state and foreign income taxes in the consolidated statements of operations consist of the following components:

	December 31, 2005			Fiscal years ended		
	Current	Deferred	Total	Current	Deferred	January 1, 2005 Total
U.S. federal taxes	\$ (6,123)	\$ 663,590	\$ 657,467	\$ 36,118	\$ 836,585	\$ 872,703
U.S. state taxes	1,467	159,978	161,445	21,680	(11,442)	10,238
Non-U.S. taxes	2,616,371	(225,811)	2,390,560	1,157,191	41,738	1,198,929
Provision for income taxes before valuation allowance	2,611,715	597,757	3,209,472	1,214,989	866,881	2,081,870
Decrease in valuation allowance	-	(2,033,709)	(2,033,709)	-	(1,149,770)	(1,149,770)
<b>Provision for income taxes</b>	<b>\$ 2,611,715</b>	<b>\$ (1,435,952)</b>	<b>\$ 1,175,763</b>	<b>\$ 1,214,989</b>	<b>\$ (282,889)</b>	<b>\$ 932,100</b>

In assessing the Company's ability to realize future tax assets, management considers whether it is more likely than not that some portion or all of the future tax assets will not be realized. The realization of future tax assets is dependent upon the generation of future taxable income during the periods in which those temporary differences become deductible. The Company believes that there is sufficient positive evidence including the taxable income recorded in fiscal 2005 and 2004 and projected future taxable income to conclude that it is more likely than not that it will realize a portion of its future tax assets.

In fiscal 2005, the Company decreased its valuation allowance by \$2,033,709 (2004-\$1,149,770). Of this amount, \$823,568 (2004-\$825,143) represents net operating losses and other temporary differences utilized in the current year. The remaining decrease of \$1,210,141 (2004-\$324,627) is due to an increase in the amount of future tax assets recognized on loss carryforwards that, based on revised projections of future income in the U.S. operations, the Company has concluded are more likely than not to be realized.

The balance of the increase in the future tax assets relates to the Canadian operations.

The provision for income taxes differs from the amount computed by applying the U.S. federal income tax rate of 34% as a result of the following:

	Fiscal years ended			
	December 31, 2005		January 1, 2005	
	Dollars	Percent	Dollars	Percent
Computed expected income tax expense	\$ 2,867,205	34.0%	\$ 1,586,053	34.0%
Permanent differences:				
Foreign exchange	(36,278)	(0.4)%	(37,504)	(0.8)%
Debt discount amortization	37,983	0.5%	124,684	2.7%
State income taxes net of federal benefit	106,554	1.3%	6,757	0.1%
Foreign tax rate differential	138,801	1.6%	64,621	1.4%
Other, net	95,207	1.0%	337,259	7.2%
Valuation allowance	(2,033,709)	(24.1)%	(1,149,770)	(24.6)%
<b>Provision (benefit) for income taxes</b>	<b>\$ 1,175,763</b>	<b>13.9%</b>	<b>\$ 932,100</b>	<b>20.0%</b>

**13. Income Taxes (continued)**

The tax effects of temporary timing differences that give rise to significant portions of the deferred income tax assets and liabilities are as follows:

	December 31, 2005	January 1, 2005
Deferred tax assets:		
Loss carryforwards	\$ 10,660,438	\$ 10,699,551
Interest expense limitations – related party debt	315,091	1,032,381
Other items	1,793,237	1,661,590
Deferred tax assets before valuation allowance	12,768,766	13,393,522
Valuation allowance	(7,696,246)	(9,729,956)
Total deferred tax assets	5,072,520	3,663,566
Deferred tax liabilities:		
Intangible assets, net	(266,209)	(213,921)
Property, plant & equipment, net	-	(29,146)
Total deferred tax liabilities	(266,209)	(243,067)
Net deferred tax asset	\$ 4,806,311	\$ 3,420,499

Balance Sheet Classification	December 31, 2005	January 1, 2005
Current	\$ 828,570	\$ 678,395
Non-current	3,977,741	2,742,104
	\$ 4,806,311	\$ 3,420,499

At December 31, 2005, the Company has available U.S. federal and state net operating loss carryforwards of \$27,349,864 which can be carried forward through the years 2011-2025.

**14. Commitments****Leases**

The Company had rental obligations, excluding certain realty tax, maintenance and other expenses on its office, warehouse and store premises, of the following annual amounts as of December 31, 2005:

	Total	Assumed by Franchisees	Net	Equipment Operating Leases
2006	\$ 13,462,000	\$ 6,312,000	\$ 7,150,000	\$ 97,167
2007	11,322,000	5,527,000	5,795,000	48,583
2008	8,639,000	4,334,000	4,305,000	40,955
2009	6,293,000	3,099,000	3,194,000	18,405
2010	3,867,000	2,155,000	1,712,000	-
2011 and thereafter	7,906,000	5,584,000	2,322,000	-
	\$ 51,489,000	\$ 27,011,000	\$ 24,478,000	\$ 205,110

Rental expense for fiscal 2005 and 2004 was \$6,616,606 and \$6,244,694, respectively. This included contingent rents of \$16,850 and \$20,543. This is net of rent recoveries related to sublease arrangements with franchisees. In addition, total rent recovered from franchisees in fiscal 2005 and 2004 were \$6,169,127 and \$5,592,532, respectively. The Company is responsible for any lease obligations of the Company not met by franchisees. Store leases typically have an initial term of five years, with two five-year renewal options.

## 15. Contingencies

a) On October 1, 2004, the Company announced that it had settled the Bedford Litigation.

The Bedford Litigation arose out of a financing transaction which was completed in March of 2000 ("2000 Financing"). The 2000 Financing had involved, among other things, the issuance to various investors of \$10.24 million of debentures of Pet Valu Canada Inc. ("Bedford Debentures"), 3,843,750 voting warrants of Pet Valu, Inc. and Pet Valu Canada Inc. ("Voting Warrants") and 890,345 Class B preferred shares of PVUS Holdings Inc. with a redemption value of \$890,345 ("Class B Preferred Shares"), and the entering into of certain monitoring agreements between Pet Valu Canada Inc. and certain defendants involving annual payments in excess of \$100,000 ("Bedford Monitoring Agreements").

Pursuant to the terms of the settlement, all of the 3,843,750 Voting Warrants and 890,345 Class B Preferred Shares held by the defendants were surrendered for cancellation. Bedford also surrendered for cancellation the one share of special voting stock of Pet Valu, Inc. which it had held as trustee for the holders of the Voting Warrants and pursuant to which it had cast the votes associated with those warrants. The Bedford Monitoring Agreements were cancelled, thereby releasing the Company from any obligation to pay certain past and future fees under those agreements. At the same time, the Company used certain of the proceeds of a debenture and warrant financing (see Note 9(d)) to repay in full to the defendants the principal amount and accrued interest owing under the Bedford Debentures, thereby extinguishing the indebtedness owing under those debentures. An agreement among certain shareholders of the Company (namely, Holtcorp Inc., Wildcat Wilderness Holdings Inc., Bedford and Euro Credit Investments Ltd.) to vote for the continuous election of four nominees of Bedford, one nominee of Euro Credit and four nominees of Holtcorp as directors of Pet Valu Canada Inc., Pet Valu International Inc. and Pet Valu, Inc. was terminated. The amount of C\$200,000 was paid to certain of the defendants to defray certain of their expenses. Finally, the amount of C\$150,000 was paid to the Company's Chief Executive Officer as a reimbursement of legal costs incurred by him in the defense of the third party claims brought against him and certain other former and current directors of the Company by certain of the defendants in the Bedford Litigation.

b) From time to time, the Company is named as a defendant in legal actions arising from its normal business activities. Although the amount of any liability that could arise with respect to currently pending actions cannot be estimated, in the opinion of the Company, any such liability will not have a material adverse effect on its financial position, operating results or liquidity.

## 16. Employee Savings Plan

The Company maintains a defined contribution 401(K) and profit sharing plan which permits eligible employees who have completed one year of service and attained the age of 21 to make contributions by salary reduction of up to 15% of compensation. Under the plan, the Company makes mandatory matching contributions and discretionary profit sharing contributions. Matching contributions equal 50% of the first 6% of compensation that is contributed by each participating employee. Matching contributions vest at a rate of 20% per year, over the first 5 years of service. In connection with the required matching, the Company portion was \$78,533 and \$74,705 during fiscal 2005 and 2004, respectively. There have been no discretionary profit sharing contributions since the inception of the plan.

**17. Segmented Financial Information**

The Company operates exclusively in the pet product retail industry. The Company's reportable segments are based on geographic area. All intercompany revenues and expenses are eliminated in computing revenues and operating income. The accounting policies of the segments are the same as those described in Note 1 - Significant Accounting Policies.

Operating results and other financial data by segment for fiscal 2005 and 2004 were as follows:  
(in thousands of U.S. dollars)

	Fiscal years ended	
	December 31, 2005	January 1, 2005
<b>Sales and revenue to external customers</b>		
Canada	\$ 100,555	\$ 95,334
U.S.	33,851	32,878
<b>Total sales and revenue</b>	<b>\$ 134,406</b>	<b>\$ 128,212</b>
<b>Net interest expense</b>		
Canada	\$ 3,891	\$ 3,501
U.S.	11	71
<b>Total net interest expense</b>	<b>\$ 3,902</b>	<b>\$ 3,572</b>
<b>Net Income</b>		
Canada	\$ 4,622	\$ 2,352
U.S.	3,100	1,883
Intersegment elimination	(468)	(502)
<b>Total net income</b>	<b>\$ 7,254</b>	<b>\$ 3,733</b>
<b>Depreciation and amortization</b>		
Canada	\$ 1,412	\$ 1,163
U.S.	357	366
<b>Total depreciation and amortization</b>	<b>\$ 1,769</b>	<b>\$ 1,529</b>
<b>Purchases of property and equipment</b>		
Canada	\$ 653	\$ 525
U.S.	353	184
<b>Total purchases of property and equipment</b>	<b>\$ 1,006</b>	<b>\$ 709</b>

Total assets by segment were as follows:  
(in thousands of U.S. dollars)

	December 31, 2005	January 1, 2005
Canada	\$ 92,896	\$ 89,813
U.S.	13,296	10,119
Intersegment elimination	(51,583)	(48,507)
<b>Total assets</b>	<b>\$ 54,609</b>	<b>\$ 51,425</b>

## Corporate Directory

### Directors\*

C. Ian Ross<sup>2,3,4,5</sup>  
Director and Chairman.  
Chairman,  
World Heart Corporation

Geoffrey F. A. Holt<sup>3,4,5</sup>  
Director.  
President and  
Chief Executive Office  
Pet Valu, Inc. and  
Pet Valu International Inc.  
Chief Executive Officer,  
Pet Valu Canada Inc.

Gary Goertz<sup>1</sup>  
Director.  
Retired Executive

Breana L. Holt  
Director.  
Senior Director of  
Corporate Planning  
Pet Valu Canada Inc.

Tony Iordanis<sup>1</sup>  
Director.  
Executive Vice-President  
Picture Homes Millennium Inc.

Doug Lunau<sup>2</sup>  
Director.  
Retired Executive

Darryl Squires<sup>1,2</sup>  
Director.  
Partner, The Progeny Group

\* Term of office of all directors expires on the date of the annual meeting of stockholders of Pet Valu, Inc., namely, May 2, 2006. For information as to nominees for election on that date, please refer to Pet Valu, Inc.'s management information circular in respect of that meeting of stockholders

### Officers

Ed Casey<sup>4</sup>  
President and Chief Operating Officer  
Pet Valu Canada Inc.

David Stauble<sup>4</sup>  
President and Chief Operating Officer  
Peton Distributors Inc.

Angelo Intorre<sup>5</sup>  
Executive Vice-President  
Pet Valu International Inc.

John Turner<sup>4,5</sup>  
Senior Vice-President, Business Development  
Business Development

Michael Fitzgerald<sup>3,4,5</sup>  
Secretary and Vice-President, Senior Counsel

Dale Winkworth<sup>3,4,5</sup>  
Vice-President, Finance and Chief Financial Officer  
Pet Valu, Inc. and Pet Valu Canada Inc.  
Vice-President, Pet Valu International Inc.

Wayne Balsinger<sup>3,5</sup>  
Vice-President, Accounting, Pet Valu, Inc.  
Vice-President, Finance and Chief Financial Officer  
Pet Valu International Inc.

Jack Handa<sup>4</sup>  
Vice-President, Information Technology and  
Systems and Chief Information Officer

Carole Holt<sup>3,4,5</sup>  
Treasurer

John Fleming<sup>4,5</sup>  
Vice-President,  
Business Development

Christine A. Martin-Bevilacqua<sup>4</sup>  
Vice-President, Human Resources

Brian McKeown<sup>4,5</sup>  
Vice-President, Corporate Security  
and Loss Prevention

Denis McLaughlin<sup>4</sup>  
Vice-President, Merchandising Pet  
Nutrition

Phil Policelli<sup>4</sup>  
Vice-President,  
Warehousing and Distribution

Steve Rifle<sup>4</sup>  
Vice-President, Real Estate

Deborah Barook<sup>4</sup>  
Assistant Vice-President,  
Senior Associate Counsel

John Watson<sup>4</sup>  
Assistant Vice-President,  
Marketing and Sales Planning

Jim Young<sup>4</sup>  
Assistant Vice-President,  
Store Operations

1. Member of Audit Committee
2. Member of Corporate Governance and Compensation Committee
3. Officer of Pet Valu, Inc.
4. Officer of Pet Valu Canada Inc.
5. Officer of Pet Valu International Inc.

### Executive Offices

130 Royal Crest Court  
Markham, Ontario  
L3R 0A1  
905-946-1200  
Fax: 905-946-0658

U.S. Corporate Office

992 Old Eagle School Road  
Wayne, PA 19087  
610-225-0800  
Fax: 610-225-0822

### Annual Meeting

Pet Valu, Inc.  
The Toronto Board of Trade  
77 Adelaide Street West  
First Canadian Place  
Toronto, Ontario  
May 2, 2006 – 2:30 pm

**Stock Exchange Listing**  
Toronto

**Stock Trading Symbol**  
PVC

### Auditors

Grant Thornton LLP  
15 Allstate Parkway, Suite 200  
Markham, Ontario  
L3R 5B4

**Fiscal Year End**  
Saturday closest to  
December 31

**Transfer Agent and Registrar**  
CIBC Mellon Trust Company  
Toronto, Ontario