

Taking the RIGHT Steps

Hardwoods Distribution
Income Fund

2006

Annual Report
to Unitholders

HARDWOODS



About the Fund

Hardwoods Distribution Income Fund is an unincorporated, open-ended, limited purpose trust.

The Fund was launched on March 23, 2004 with the completion of an initial public offering (IPO) of 14.4 million trust units at \$10 per unit. Net proceeds of the IPO were used to acquire an 80% interest in the hardwood lumber and sheet goods distribution business (“Hardwoods” or the “Business”) from the previous owners.

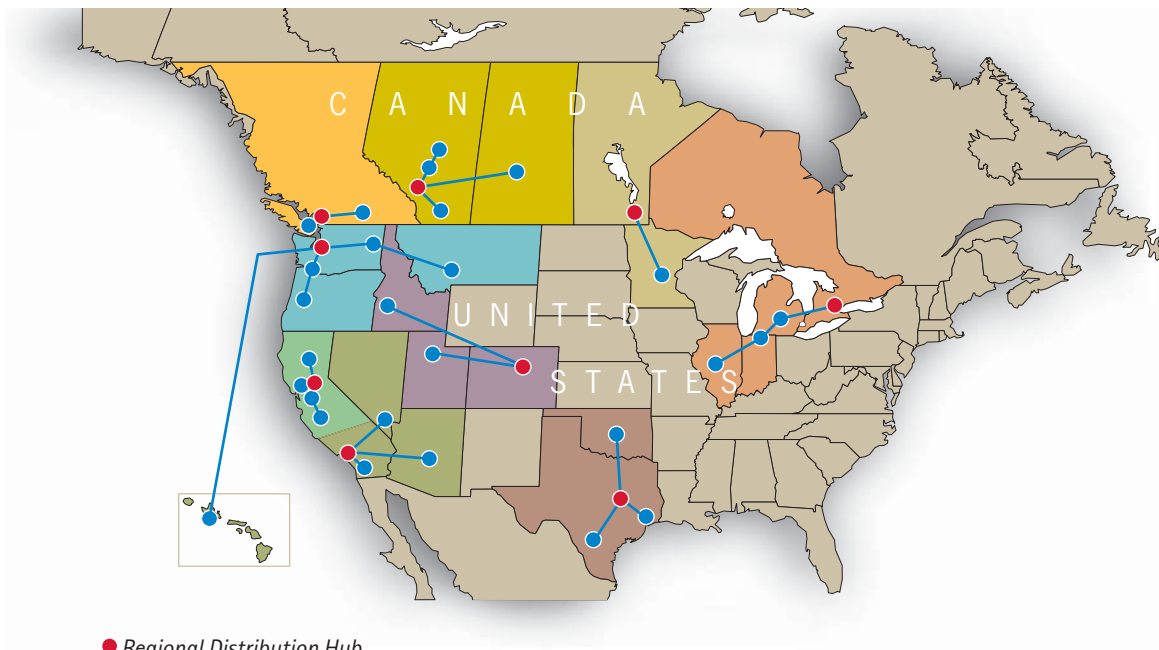
Hardwoods Distribution Income Fund units trade on the Toronto Stock Exchange under the symbol HWD.UN.

The Fund’s performance depends on the performance of the Business.

About the Business

Hardwoods has been providing quality lumber, hardwood plywood and specialty products to customers for over 45 years.

Today, we are one of the largest distributors of hardwood lumber and sheet goods in North America, operating a network of 36 distribution centres organized into nine regional clusters.



● Regional Distribution Hub

● Distribution Facilities



To Our Unitholders:

2006 was a year of taking the right steps in response to a number of business issues.

We came into the year having successfully completed much-needed investments in our distribution network. From adding new employees to opening two new branches and expanding others, we had built growth capacity into our business. While these steps were essential to support our future growth, they were completed just as market conditions became much more challenging.

According to the US Department of Commerce, housing starts in the United States fell by 12.9% in 2006 compared to 2005. The Canadian housing market performed better, but by year-end, it too showed signs of a slowdown. Simultaneously, we experienced a 10% decline in prices for many of our hardwood lumber species. In addition, the Canadian dollar, which has a significant impact on our business, climbed to a 28-year high.

These issues, combined with our own rising costs, put significant pressure on our ability to sustain profits and distributable cash in the first half of the year. This, in turn, contributed to a rising payout ratio and higher debt levels. We needed to take action, but we were mindful that it could not come at the expense of sales growth if we wanted to achieve longer-term success.

Our Trustees made the difficult decision to reduce monthly cash distributions to our public unitholders and to suspend distributions to our Class B unitholders.

Internally, we increased our emphasis on cost control and on disciplined selling, and we took decisive action on our distribution network. We closed underperforming distribution centres in Albuquerque, Regina and Windsor, while expanding in markets that show long-term promise, including Southern California, where we expanded a hub facility by 50%. We also continued to build our import product program, sourcing and introducing new products, appointing a full time representative in China and ultimately doubling our import volume during the year.

The results were encouraging. Despite the dramatic decline in US housing starts, our underlying sales grew by 6.7% in 2006, before considering the impact of changes in foreign exchange rates. Performance from our US operations was especially strong with sales in US dollars increasing by 11.7%, compared to 2005. These gains reflect the steps taken to promote growth, as well the market diversity of our business. We were also successful in halting the cost creep in our business, bringing selling and administrative expenses under control in the second half of the year.

I am pleased to report that we ended the year with a payout ratio of 79% – a more prudent result in the current market environment than the 91% payout ratio we were tracking midway through 2006. We also succeeded in strengthening our balance sheet. By year-end we had

lowered our debt-to-EBITDA ratio to 1.77 times and extended our Canadian and US credit facilities for an additional three years on more favourable terms.

We are pleased with this progress, but recognize that our work is not done. While our gross margins improved in the second half of 2006, our full-year gross margin average of 18.2% was below the 18.7% achieved in 2005. One of our key priorities in 2007 will be to return our gross margins to our target range of 18.5% or better.

We are also focused on continuing to grow our sales. Although the residential construction market has entered a weaker cycle, Hardwoods benefits from strong product, market and geographic diversification, and we see opportunities to continue expanding and diversifying our business.

Ultimately, we view our network of 36 distribution facilities as an adaptable “pipeline” for moving products – one that comes equipped with established logistical capabilities, and a large and proven sales force. During 2006, we demonstrated that we can use this pipeline to benefit from trends like the increasing importance of China in the supply chain. We will continue to seek out new opportunities that meet our objectives of profitably growing our business as we work to meet the needs of our customers.

Overall, we anticipate flat to moderate sales growth in 2007, which together with discipline on the gross profit margin and cost front, should enable us to generate increased distributable cash.

As we move forward, we are closely monitoring the federal government’s proposed changes to income trust taxation, which could come into effect for existing funds like ours beginning in 2011. As 70% of our business is based in the US and already taxed under US laws, we believe the impact may be less on our Fund than on income trusts with operations based primarily in Canada. We will continue to monitor this proposal and take appropriate action as required.

At the close of a challenging year, I want to thank our employees for the hard work that went into improving our business in 2006, and acknowledge the support and guidance of our directors and trustees as we took important strategic steps. Most of all I thank you, our investors, for your continued confidence in Hardwoods. We see a brighter future ahead for Hardwoods, and I look forward to reporting to you on our progress in 2007.



Maurice E. Paquette
President and Chief Executive Officer



Management's Discussion and Analysis

March 12, 2007

This management's discussion and analysis ("MD&A") should be read in conjunction with the audited consolidated financial statements and accompanying notes ("Audited Financial Statements") of Hardwoods Distribution Income Fund for the years ended December 31, 2006 and 2005. Results are reported in Canadian dollars unless otherwise stated, and have been prepared in accordance with Canadian generally accepted accounting principles ("GAAP").

This MD&A includes the following sections:

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This MD&A may contain forward-looking statements. Such statements involve known and unknown risks, uncertainties and other factors outside of our control that could cause actual results to differ materially from those expressed in the forward-looking statements. Hardwoods Distribution Income Fund does not assume responsibility for the accuracy or completeness of the forward-looking statements and does not undertake any obligation to publicly revise these forward-looking statements to reflect subsequent events or circumstances.

References to "EBITDA" are to earnings before interest, income taxes, depreciation and amortization, mark-to-market adjustments on foreign currency contracts, goodwill and other intangible assets impairments, and the non-controlling interest in earnings. We believe that, in addition to net income or loss, EBITDA is a useful supplemental measure of performance and cash available for distribution prior to debt service, changes in working capital, capital expenditures and income taxes.

EBITDA is not an earnings measure recognized by generally accepted accounting principles in Canada ("GAAP") and does not have a standardized meaning prescribed by GAAP. Investors are cautioned that EBITDA should not replace net income or loss (as determined in accordance with GAAP) as an indicator of our performance, or to cash flows from operating, investing and financing activities or as a measure of our liquidity and cash flows. Our method of calculating EBITDA may

differ from the methods used by other issuers. Therefore, our EBITDA may not be comparable to similar measures presented by other issuers. For a reconciliation between EBITDA and net income or loss as determined in accordance with GAAP, please refer to the discussion of Results of Operations described in section 3.0 of this report.

Distributable Cash of the Fund is a non-GAAP measure generally used by Canadian open-ended income funds as an indicator of financial performance. We define Distributable Cash as net earnings before depreciation, amortization, future income taxes, non-controlling interest, gains or losses on the sale of property, plant and equipment, mark-to-market adjustments on foreign currency contracts, and goodwill and other intangible assets impairments, and after capital expenditures and contributions to any reserves that the Board of Trustees deem to be reasonable and necessary for the operation of the Fund.

Our Distributable Cash may differ from similar computations as reported by other similar entities and, accordingly, may not be comparable to distributable cash as reported by such entities. We believe that Distributable Cash is a useful supplemental measure that may assist investors and prospective investors in assessing the return on their investment in Class A Units. For a reconciliation between Distributable Cash and net cash provided by operating activities as determined in accordance with GAAP, please refer to the discussion of Distributable Cash and Cash Distributions described in section 4.1 of this report.

Additional information related to the Fund, including all public filings, are available on SEDAR (www.sedar.com) and our website (www.hardwoods-inc.com).

1.0 BACKGROUND

1.1 About the Fund

The Fund is an unincorporated open-ended, limited purpose trust formed under the laws of the Province of British Columbia by a declaration of trust dated January 30, 2004. The Fund was launched on March 23, 2004 with the completion of an initial public offering (“IPO”) of 14,410,000 trust Voting Units (“Class A Units”). Net IPO proceeds of \$133.5 million, together with drawings on credit facilities totalling \$31.6 million, were used to acquire an 80% interest in the hardwood lumber and sheet goods distribution business (“Hardwoods” or the “Business”) from the previous owners.

The owners of the predecessor companies have retained a 20% interest in the Business in the form of Special Voting Units of the Fund and Class B Limited Partnership units of the Fund’s operating subsidiaries (“Class B Units”), which together are exchangeable into Class A Units provided that the Fund achieves certain objectives. Distributions by the Fund’s operating subsidiaries to the previous owners are subject to subordination arrangements until certain financial tests established at the time of the IPO and described in the Audited Financial Statements are met. As at December 31, 2006, the following units of the Fund were issued and outstanding:

Units	14,410,000
Special Voting Units	3,602,500

Hardwoods Distribution Income Fund units trade on the Toronto Stock Exchange under the symbol HWD.UN. The Fund’s performance depends on the performance of the Business.

1.2 About our Business and Industry

Hardwoods is one of North America’s largest distributors of high-grade hardwood lumber and specialty sheet goods to the cabinet, moulding, millwork, furniture and specialty wood products industries. At December 31, 2006 we operated 36 distribution facilities organized into nine geographic regions throughout North America. In a highly fragmented but stable industry, we match products supplied from hundreds of mills to over 2,500 manufacturing customers.

Approximately 55% of our product mix is made up of high-grade hardwood lumber. The balance is made up of sheet goods, consisting primarily of hardwood plywood,

and including non-structural sheet goods such as medium density fiberboard, particleboard and melamine-coated stock. Our sheet goods are a key complementary product line as they are used by many purchasers of hardwood lumber in the manufacture of their end products.

Our customer base manufactures a range of end-use products, such as cabinetry, furniture and custom millwork. These products in turn are sold into multiple sectors of the economy, including new home construction, renovation, non-residential construction and institutional markets. As a result of this diversity, it is difficult to determine with certainty what proportion of our products ends up in each sector of the economy. We estimate that approximately 40% to 50% of our products end up in new residential construction, in the form of cabinets, mouldings, custom finishing and home furniture. We believe the balance of our products end up in other sectors of the economy not associated with new residential construction, such as home renovations, finishing millwork for office buildings, restaurant and bar interiors, hotel lobbies, retail point-of-purchase displays, schools, hospitals, custom motor coaches, yacht interiors and other specialty areas.

Approximately 95% of the hardwood lumber distributed in North America is harvested from North American hardwood forests, located principally in the Eastern United States. Imported hardwood lumber is largely limited to specialty species that generally do not compete with domestic hardwood lumber. Sheet goods are generally produced in North America by large manufacturers using domestic hardwoods and other materials, although imported hardwood plywood volumes have been increasing. Both domestic and imported hardwood lumber and plywood are distributed principally by third parties such as us. Historically, balanced supply and demand conditions have resulted in a stable pricing environment for hardwood lumber and hardwood plywood. Prices have generally kept pace with inflation over the long term.

The hardwood distribution industry is highly fragmented. While there are a number of hardwood distributors that operate from multiple locations, most are small, privately held companies serving discrete local markets.

2.0 OVERVIEW AND OUTLOOK

2006 brought mixed market conditions with a steep 12.9% decline in US housing starts contrasting with continuing strength in Canadian residential construction markets, and robust North American renovation and commercial construction markets. Product prices were generally lower than in 2005, with approximately half of our hardwood lumber products experiencing a 10% decline in pricing.

Despite the more challenging market conditions, our 2006 sales increased by 6.7%, before considering the impact of changes in foreign exchange rates. The gains were led by our operations in the US which posted an 11.7% year-over-year increase in US dollar sales. This improvement reflects our diversification across multiple product and market segments, as well as the success of several strategic initiatives. In particular, we benefited from the addition of new import products to our product mix, the ramp up of our two new branches in Minneapolis and Illinois, and increased investment in personnel and working capital.

Strategically, we took decisive action to control costs, lower our payout ratio and reduce debt in 2006. Although sales and administrative (“S&A”) expenses were higher year-over-year, we were successful in stabilizing costs in the second half of 2006. This was achieved through better cost control and changes to our distribution network. We closed branches with limited growth prospects in Albuquerque, New Mexico and Regina, Saskatchewan. We also closed our Windsor, Ontario branch in the fourth quarter due to weakness in Southern Ontario’s economy.

Concurrently, we expanded in markets that offer long-term promise, such as Southern California, where we increased space at our hub facility by 50%. Although branch changes were a factor in a 3.8% year-over-year reduction in Canadian sales, we believe our distribution network is now more closely matched to the sales potential in each geographic region.

The Board's decision to lower monthly cash distributions helped us achieve a payout ratio of 79% for the year ended December 31, 2006. In the current market environment, this was more prudent than the 91% ratio we were tracking midway through the year. The reduction in distributions, together with better working capital management, resulted in a reduction of our debt-to-EBITDA ratio to a more conservative 1.77 times by the end of the year. We also extended our Canadian and US credit facilities for an additional three years on more favourable terms.

We are pleased with this progress, but recognize that there is more work to be done. Our gross margin dipped to 18.2% in 2006, from 18.7% in 2005. A key priority for us in 2007 will be to return gross margins to our target level of 18.5% or better. One of the ways we are working to achieve this objective is through continued development of our import product program. We more than doubled our import volume from China in 2006, and we expect to continue to fill our product pipeline with offshore products that offer cost benefits and other competitive advantages. We are also maintaining our focus on strict selling discipline, and careful management of inventory and working capital.

Although US housing starts are not expected to recover in the near term and the Canadian Housing and Mortgage Corporation forecasts a 7.4% decline in Canadian housing starts in 2007, we expect that sales will continue to be supported by our product, end-market and geographic diversification. Looking ahead, we anticipate flat to moderate sales growth and that this, combined with discipline on the gross profit margin and cost front, will result in an increase in the Fund's distributable cash in 2007.

We continue to monitor and assess the impact of the federal government's proposed taxation of income trusts. If passed into law, these changes will begin to affect our Fund in 2011. Overall, we anticipate that the proposed trust tax may have substantially less impact on our Fund than on other trusts that operate principally or exclusively in Canada. Approximately 70% of our business is conducted in the United States and is already subject to US taxation. We believe that we may be able to re-organize our business structure prior to 2011 such that our US source income will not be exposed to additional taxes associated with the proposed new Canadian trust tax. The remaining 30% of our earnings that are generated in Canada would be subject to tax at a rate of 31.5%. The proposed tax has not yet been finalized and passed into law, and accordingly all assessments are preliminary and are subject to change.

We continue to maintain an active hedging program to mitigate the potential impact of foreign exchange fluctuations on Canadian dollar distributions by the Fund. Foreign exchange fluctuations could negatively affect the Fund in 2007, although in recent months, we have benefited from a weakening Canadian dollar.

3.0 RESULTS OF OPERATIONS

3.1 Year Ended December 31, 2006 and December 31, 2005

*Selected Unaudited Consolidated Financial Information
(Expressed in thousands of Canadian dollars)*

	Year ended December 31 2006	Year ended December 31 2005
Total sales	\$ 362,528	\$ 355,775
<i>Sales in the US (US\$)</i>	223,509	200,079
<i>Sales in Canada</i>	109,024	113,359
Gross profit	66,042	66,387
<i>Gross profit %</i>	18.2%	18.7%
Selling and administrative expenses	45,559	43,480
Realized gain on foreign currency contracts	(1,338)	(677)
Earnings before interest, taxes, depreciation and amortization and non-controlling interest (“EBITDA”)	\$ 21,821	\$ 23,584
Add (deduct):		
Amortization	(2,100)	(2,181)
Interest	(3,127)	(2,114)
Mark-to-market adjustment on foreign currency contracts	(1,280)	142
Intangibles impairment	(326)	–
Goodwill impairment	(7,566)	–
Non-controlling interest	(1,484)	(3,886)
Income taxes	(2,301)	(2,194)
Net earnings for the period	\$ 3,637	\$ 13,351
Basic and fully diluted earnings per Class A Unit	\$ 0.252	\$ 0.927
Average Canadian dollar/US dollar exchange rate	1.1342	1.2116

Sales

Sales for the year ended December 31, 2006 were \$362.5 million, up 1.9% from \$355.8 million in 2005. During 2006, the Canadian dollar continued to strengthen, with the average exchange rate up 6.4% compared to 2005. Had exchange rates remained consistent with 2005 levels, our reported revenue for 2006 would have been \$17.3 million higher, at \$379.8 million.

Sales in the United States, as measured in U.S. dollars, increased by 11.7% in 2006. This was achieved despite the slowdown in the residential construction market. The higher sales pace in the U.S. reflects the continued positive impact of adding import products into our sales mix, increased sales from the two new branches opened late in 2005 in Minneapolis and Illinois, and general sales growth at our branch locations. All five of our operating regions in the U.S. either maintained or increased sales in 2006.

Sales from our Canadian business, as measured in Canadian dollars, declined by 3.8% year-over-year. This was largely due to the negative impact of a stronger Canadian dollar and weaker demand at our Windsor branch. A stronger Canadian dollar affects our Canadian business on two fronts. First, a stronger Canadian dollar reduces the purchase price we pay for products sourced from mills in the United States. When these products are resold to our Canadian customers, it is also at a lower Canadian dollar equivalent selling price, which effectively reduces our revenues in Canada. Second, a stronger Canadian dollar can affect the competitiveness of our Canadian customers who sell their products to customers in the US.

Gross Profit

For the year ended December 31, 2006, we reported gross profit of \$66.0 million, compared to \$66.4 million in 2005. Our gross profit percentage decreased to 18.2% in 2006, compared to 18.7% in 2005, resulting in the \$0.4 million reduction in gross profit. Restoring our gross profit percentage to our target rate of 18.5% or better in 2007 is a key priority.

Selling and Administrative Expenses

S&A expenses were \$45.6 million in 2006, up \$2.1 million or 4.8% from \$43.5 million in 2005. The three most significant areas of higher costs in 2006 related to personnel, bad debt, and premises expense. The increase in

personnel costs was driven by competitive wage pressures, as well as higher costs associated with delivery of our U.S. medical plan to employees. Increased bad debt expense reflected higher sales activity in 2006, as well as a return to more typical level of bad debt activity (approximately 0.6% of sales) following 2005's favourable collection trend. The third major area of cost increase, premises expense, primarily reflects rent increases in the ordinary course of business at our leased facility locations, and higher rent from expansion of our Riverside, California hub facility.

The benefit of a stronger Canadian dollar on the conversion of S&A expenses at our US operations partially offset these increases, reducing costs by \$2.3 million in 2006. As a percentage of sales, 2006 S&A expenses in 2006 were 12.6%, compared to 12.2% in 2005.

Realized Gain on Foreign Currency Contracts

The Fund realized gains of \$1.3 million on foreign currency contracts which matured in 2006, compared to \$0.7 million in 2005. This improvement was driven by the strengthening of the Canadian dollar in 2006. The terms of our foreign currency contracts and the Fund's use of currency derivatives to mitigate the economic impact of fluctuations between the Canadian and US dollar are described under Financial Instruments in section 5.0 of this report.

EBITDA

Full-year EBITDA was \$21.8 million, compared to \$23.6 million in 2005. The \$1.8 million decrease in EBITDA was due to the \$0.4 million decrease in gross profit and the \$2.1 million increase in S&A, partly offset by a \$0.7 million increase in realized gains on foreign currency contracts.

Interest Expense

Interest expense in 2006 was \$3.1 million, up \$1.0 million from \$2.1 million in 2005. The increase in interest expense reflects higher average advances under operating lines of credit available to subsidiaries of the Fund, as well as increases in market borrowing rates. Further discussion of our borrowing arrangements can be found under Revolving Credit Facilities in section 4.4 of this report.

Mark-To-Market Adjustment on Foreign Currency Contracts

For the 12 months ended December 31, 2006, the mark-to-market valuation of our outstanding foreign currency contracts created a loss of \$1.3 million, compared to a gain of \$0.1 million in the same period in 2005. As of December 31, 2006, the combined value of our foreign currency contracts continued to provide a net asset to the Fund with a fair value of \$1.4 million. We continue to monitor our foreign currency contract policy to mitigate the impact of foreign exchange fluctuations on Canadian dollar distributions generated by our U.S. operations. Further discussion of our foreign currency contracts can be found under Financial Instruments in section 5.0 of this report.

Goodwill and Intangibles Impairment

Under Canadian GAAP, goodwill and intangible assets are subject to an annual impairment test. When the Fund acquired its 80% indirect interest in Hardwoods, \$104.6 million was assigned as goodwill and \$15.0 million as intangible assets. In the fourth quarter of 2006, the Fund completed its annual impairment test and determined that the carrying value of goodwill exceeded the fair value of goodwill by \$7.6 million, while the carrying value of other intangibles exceeded the fair value of other intangibles by \$0.3 million. Consistent with our accounting policies, the excess of carrying value over fair value was charged to income in the fourth quarter when the impairment was identified. The \$7.9 million total impairment represents a non-cash charge, and consequently has no impact upon the Fund's distributable cash. The write-down of goodwill and intangibles relates solely to Hardwoods' Canadian operations. Approximately two-thirds of the \$7.9 million in impairment charges reflects the anticipated reduction to cash flows resulting from the federal government's intention to tax Canadian income trusts commencing in 2011. The remainder reflects our outlook for lower than previously anticipated Canadian revenue and cash flows. The Overview and Outlook section 2.0 of this report provides further

discussion of how we anticipate the Canadian government's proposed tax will impact upon the Fund. No impairment was identified in relation to our US operations.

Income Taxes

Income tax expense for 2006 was \$2.3 million, compared to \$2.2 million in 2005. Although earnings for tax purposes were lower in 2006 than in 2005, income taxes rose \$0.1 million due to an increase in estimated taxable income allocated to the Fund for 2006 by its US operating subsidiary. Although the Fund has an 80% indirect interest in its US operating subsidiary, in 2006 it was allocated 100% of the US operating subsidiaries' taxable income, reflecting the fact that no distributions were paid on the Class B Units for the year. Subordination of the Class B Units is described in section 4.1 of this report.

Net Earnings

Net earnings of \$3.6 million in 2006 declined by \$9.7 million from \$13.4 million in 2005. The decrease in net earnings primarily reflects the \$1.8 million decrease in EBITDA, the \$1.0 million increase in interest expense, the \$1.4 million negative mark-to-market adjustment on foreign currency contracts, the \$7.9 million impairment in goodwill and other intangible assets, and the \$0.1 million increase in income taxes. This was partially offset by a \$2.4 million reduction in non-controlling interest as the result of lower earnings in 2006.

3.2 Three Months ended December 31, 2006 and December 31, 2005

*Selected Unaudited Consolidated Financial Information
(Expressed in thousands of Canadian dollars)*

	3 months ended December 31 2006	3 months ended December 31 2005
Total sales	\$ 83,120	\$ 84,130
<i>Sales in the US (US\$)</i>	51,502	49,150
<i>Sales in Canada</i>	24,466	26,420
Gross profit	15,116	15,456
<i>Gross profit %</i>	18.2%	18.4%
Selling and administrative expenses	11,354	11,009
Realized gain on foreign currency contracts	(326)	(259)
Earnings before interest, taxes, depreciation and amortization and non-controlling interest ("EBITDA")	\$ 4,088	\$ 4,706
Add (deduct):		
Amortization	(527)	(524)
Interest	(664)	(595)
Mark-to-market adjustment on foreign currency contracts	(1,212)	(399)
Intangibles impairment	(326)	-
Goodwill impairment	(7,566)	-
Non-controlling interest	(1,242)	(637)
Income taxes	139	(181)
Net earnings for the period	\$ (4,826)	\$ 2,370
Basic and fully diluted earnings per Class A Unit	\$ (0.335)	\$ 0.164
Average Canadian dollar/US dollar exchange rate	1.1384	1.1732

Sales

For the three months ended December 31, 2006, we reported sales of \$83.1 million, down 1.2% from \$84.1 million in 2005. Underlying sales activity remained solid at our US operations, with sales as measured in US dollars, up 4.8% in the quarter. This was achieved despite multi-day, weather-related closures at some customer locations and at some Hardwoods branches in the Pacific Northwest and Rocky Mountain regions. Sales in Canada, as measured in Canadian dollars, were down 7.4% in the fourth quarter, primarily reflecting reduced sales contribution from the closed Windsor branch, as well as the negative impact of a stronger Canadian dollar.

Gross Profit

Gross profit for the three months ended December 31, 2006 was \$15.1 million, a decrease of \$0.4 million or 2.2%, from the \$15.5 million reported in 2005. The change in gross profit reflects the 1.2% decrease in sales, and a reduced gross profit percentage of 18.2%, compared to 18.4% during the fourth quarter of 2005. Some quarter-to-quarter variation in our gross profit percentage is considered normal for the business, with 18% to 19% representing a typical range. Over the longer term, gross profits are targeted to achieve 18.5% of sales or higher.

Selling and Administrative Expenses

S&A expenses increased \$0.3 million to \$11.4 million in the fourth quarter of 2006, from \$11.0 million during the same period in 2005. This increase reflects higher rent expense, partially offset by the benefits of the stronger Canadian dollar on the conversion of S&A expenses at our US operations.

EBITDA

EBITDA decreased to \$4.1 million in the fourth quarter of 2006, down \$0.6 million from \$4.7 million in 2005. The decrease in EBITDA primarily reflects a \$0.4 million decrease in gross profit combined with a \$0.3 million increase in S&A expenses.

Mark-To-Market Adjustment on Foreign Currency Contracts

For the three months ended December 31, 2006, the mark-to-market valuation of our outstanding foreign currency contracts created a loss of \$1.2 million, compared to a loss of \$0.4 million in the same period in 2005. Further discussion of our foreign currency contracts can be found under Financial Instruments in section 5.0 of this report.

Goodwill and Intangibles Impairment

As described previously in section 3.1 of this report, in the fourth quarter of 2006 the Fund completed its annual impairment test. This test determined that the carrying value of goodwill exceeded the fair value of goodwill by \$7.6 million, while the carrying value of other intangibles exceeded the fair value of other intangibles by \$0.3 million.

Net Earnings (Loss)

Net loss for the three-months ended December 31, 2006 was \$4.8 million, compared to net earnings of \$2.4 million in the comparative period in 2005. The \$7.2 million decrease in net earnings primarily reflects the \$0.6 million decrease in EBITDA, the \$0.8 million increase in mark-to-market adjustment losses on foreign currency contracts, and the \$7.9 million goodwill and other intangible assets impairment. These reductions to net earnings were partially offset by a \$0.3 million decrease in income taxes and a \$1.9 million reduction in non-controlling interest as a result of lower profits in the quarter.

4.0 LIQUIDITY AND CAPITAL RESOURCES

4.1 Distributable Cash and Cash Distributions

*Selected Unaudited Consolidated Financial Information
(in thousands of dollars except per unit amounts)*

	Year ended December 31 2006	Year ended December 31 2005	3 months ended December 31 2006	3 months ended December 31 2005
Net cash provided by operating activities	\$ 18,539	\$ 13,875	\$ 8,860	\$ 7,917
Increase (decrease) in non-cash operating working capital	(889)	6,194	(5,049)	(4,060)
Cash flow from operations before changes in non-cash operating working capital	17,650	20,069	3,811	3,857
Capital expenditures	(902)	(1,356)	(97)	(533)
Distributable cash	\$ 16,748	\$ 18,713	\$ 3,714	\$ 3,324
Distributions relating to the period:				
Class A Units	13,265 ⁽¹⁾	15,497	2,940 ⁽²⁾	3,825
Class B Units	– ⁽³⁾	3,065	– ⁽³⁾	–
	\$ 13,265	\$ 18,562	\$ 2,940	\$ 3,825
Outstanding units and per unit amounts				
Class A Units outstanding	14,410,000	14,410,000	14,410,000	14,410,000
Class B Units outstanding	3,602,500	3,602,500	3,602,500	3,602,500
Total Units outstanding	18,012,500	18,012,500	18,012,500	18,012,500
Distributable Cash per Total Units	\$ 0.930	\$ 1.039	\$ 0.206	\$ 0.185
Distributions relating to the period:				
Class A Units	\$ 0.921 ⁽¹⁾	\$ 1.075	\$ 0.204 ⁽²⁾	\$ 0.265
Class B Units	\$ – ⁽³⁾	\$ 0.851	\$ – ⁽³⁾	\$ –
Total Units	\$ 0.736	\$ 1.031	\$ 0.163	\$ 0.212
Payout Ratio ⁽⁴⁾	79.2%	99.2%	79.2%	115.1%

(1) Includes the cash distributions of \$0.08542 per Class A Unit per month which relate to the operations of the Fund for the months January through June 2006, and distributions of \$0.068 per Class A Unit per month which relate to the operations of the Fund for July through December 2006.

(2) Includes the cash distributions of \$0.068 per Class A Unit per month which relate to the operations of the Fund for October, November, and December 2006.

(3) On January 10, 2006, Hardwoods Specialty Products LP and Hardwoods Specialty Products US LP, partnerships in which the Fund owns an 80% interest, announced that quarterly distributions were suspended on the subordinated units, represented by the Class B LP and Class B US LP units. The Class B LP units and Class B US LP units represent a 20% interest in the combined business of Hardwoods, which is subordinated to the Fund's ownership interest in the business. Accordingly, no distributions were declared payable relating to the fourth quarter of 2005, and the first, second, third and fourth quarters of 2006 to the non-controlling interests and no current liability for distributions payable to the non-controlling interests is reflected in the December 31, 2006 balance sheet.

(4) Payout ratio measures the ratio of distributions relating to the period to distributable cash in the period. Comparative distributable cash and payout ratio figures have been restated to conform with presentation adopted in the year ended December 31, 2006 as a result of the suspension of quarterly distributions on the Class B Units.

We pay distributions on Class A Units at the end of the month following the month in which the cash is earned. Distributions may also be made quarterly on Class B Units in an amount equivalent on an after-tax per-unit basis to distributions made on Class A Units, pursuant to the terms of a subordination agreement as outlined in the Fund's Annual Information Form dated March 20, 2007.

The Fund's subordination feature is designed to stay in place until the EBITDA and distributable cash tests established at the time of the IPO are met. The terms of these EBITDA and distributable cash tests are described in note 7 to the accompanying financial statements of the Fund.

In 2006, the Fund and its subsidiaries generated total distributable cash available to Class A and Class B Unitholders of \$16.7 million, or \$0.930 per unit. Distributions relating to the period were \$13.3 million, or \$0.921 per unit, to our public unitholders (Class A Units). In accordance with the terms of a subordination feature in place with the previous owners (Class B Units), no distributions were made to the previous owners related to the year ended December 31, 2006. In the fourth quarter of

2006, the Fund and its subsidiaries generated total distributable cash available to Class A and Class B Unitholders of \$3.7 million, or \$0.206 per unit, and made distributions relating to the period of \$2.9 million, or \$0.204 per unit, to our public unitholders only (Class A Units). These distributions represent an overall payout ratio of 79% for the twelve months ended December 31, 2006, and 79% for the fourth quarter of 2006. The income tax characterization of distributions paid to unitholders in 2006 was 45.03% fully taxable distributions, 26.33% dividends, and 28.64% return of capital.

4.2 Capital Expenditures

Capital expenditures were \$0.1 million in the fourth quarter of 2006 and \$0.9 million for the year. Hardwoods leases all of its buildings and contracts out all freight delivery services. As a result, our capital requirements are minimal and principally include replacement of forklifts, furniture and fixtures, leasehold improvements and computer equipment.

4.3 Utilization of Distributable Cash

*Selected Unaudited Consolidated Financial Information
(in thousands of dollars except per unit amounts)*

	Year ended December 31 2006	Year ended December 31 2005	3 months ended December 31 2006	3 months ended December 31 2005
Distributable Cash	\$ 16,748	\$ 18,713	\$ 3,714	\$ 3,324
Cash Distributions paid in the period	(13,516)	(19,626)	(2,940)	(4,869)
Distributable Cash retained	\$ 3,232	\$ (913)	\$ 774	\$ (1,545)
Decrease (increase) in non-cash working capital	889	(6,194)	5,049	4,060
Decrease (increase) in long-term receivables	2,002	(1,836)	2,086	(1,087)
Decrease (increase) in deferred financing fees	(33)	–	(33)	–
Proceeds from disposal of property, plant and equipment	34	2,150	17	(15)
Decrease (increase) in bank indebtedness, net of cash	\$ 6,124	\$ (6,793)	\$ 7,893	\$ 1,413

Our utilization of distributable cash, and its relation to working capital use and bank line financing in the Business is summarized above.

For the year ended December 31, 2006, the Fund generated distributable cash of \$16.7 million, paid cash distributions of \$13.5 million and retained \$3.2 million of distributable cash. In the same period the Fund reduced its investment in non-cash operating working capital by \$0.9 million and decreased its investment in long-term receivables by \$2.0 million. The retained distributable cash, combined with the reduced non-cash working capital and long-term receivables investment, enabled the Fund to pay down its bank indebtedness (net of cash) by \$6.1 million in 2006. For the fourth quarter of 2006, the Fund generated distributable cash of \$3.7 million,

paid cash distributions of \$2.9 million, and retained \$0.8 million of distributable cash. Non-cash operating working capital fell by \$5.0 million in the fourth quarter, primarily due to a \$4.2 million reduction in accounts receivable, and long-term receivables were reduced by \$2.1 million. These factors contributed to the Fund reducing its bank indebtedness (net of cash) by \$7.9 million in the three-months ended December 31, 2006.

We believe that our credit facilities, combined with the retained portion of our distributable cash, are sufficient to meet our current working capital requirements. The terms of our revolving credit facilities are addressed on the following page.

4.4 Revolving Credit Facilities

*Selected Unaudited Consolidated Financial Information
(in thousands of dollars)*

	As at December 31 2006	As at December 31 2005
Cash and cash equivalents	\$ (594)	\$ (2,203)
Debt	39,152	46,925
Net debt	\$ 38,558	\$ 44,722
Unitholders' equity	\$ 113,310	\$ 124,298
Total capitalization	\$ 151,868	\$ 169,020
Net debt to total capitalization	25.4%	26.5%
Previous 12 months EBITDA	21,821	23,584
Net debt to previous 12 months EBITDA	1.77	1.90

In the fourth quarter of 2006, we renewed our independent credit facilities in Canada and the U.S. In Canada, the term of our operating line now extends to November 30, 2009 and comprises a maximum facility of \$22.0 million. The balance outstanding on the Canadian operating line as at December 31, 2006 was \$10.8 million. In the US, the term of our operating line now extends to March 31, 2010, comprises a maximum facility of US\$35 million, and as at December 31, 2006 had a balance outstanding of \$27.6 million (US \$23.7 million). The principal terms of the credit facilities available to Hardwoods LP and Hardwoods US LP are described in more detail in the Fund's Annual Information Form dated March 20, 2007.

The Fund's net debt at December 31, 2006 was \$38.6 million, compared to \$44.7 million at December 31, 2005. Overall net debt compared to total capitalization

stands at 25.4% as of December 31, 2006, down from 26.5% as of December 31, 2005. The ratio of net debt to EBITDA in the previous 12 months, an indicator of the Fund's financial leverage, decreased to 1.77 times as of December 31, 2006 from 1.90 times as of December 31, 2005. The maximum ratio of net debt to EBITDA allowed under the Fund's Canadian credit facility is 2.75 times at the end of any financial quarter up to and including September 30, 2007, and not more than 2.50 times at the end of any financial quarter ending thereafter. The maximum ratio of net debt to EBITDA allowed under the Fund's US credit facility is 2.85 times. The Fund's operating subsidiaries were fully compliant with these ratios as at December 31, 2006.

4.5 Contractual Obligations

The table below sets forth contractual obligations of the Fund as at December 31, 2006. These obligations relate to operating leases on various premises and automobiles and become due in the fiscal years indicated:

(in thousands of Canadian dollars)

2007	\$	7,459
2008		6,018
2009		4,659
2010		2,987
2011		1,085
2012 and thereafter		1,202
Total	\$	23,410

4.6 Off-Balance Sheet Arrangements

The Fund has no off balance sheet arrangements. The foreign currency contracts discussed under Financial Instruments in section 5.0 of this report are marked-to-market at the end of each quarter, with the fair value recorded on the balance sheet.

5.0 FINANCIAL INSTRUMENTS

The Fund uses currency contracts to assist in managing its exposure to fluctuations in exchange rates between the Canadian dollar and the United States dollar. The foreign currency contracts are recognized in the balance sheet and measured at their fair value, with changes in fair value recognized currently in the statement of operations. At December 31, 2006, a subsidiary of the Fund had entered into 16 monthly foreign currency contracts to exchange US\$675,000 into approximately Canadian \$878,000 each month until April 2008. This reflects an exchange rate of Cdn\$1.3001 to US\$1.00. This same subsidiary had an additional 12 monthly foreign currency contracts to exchange US\$675,000 into approximately Canadian \$760,000 each month from May 2008 until April 2009, reflecting an exchange rate of \$1.1255. This means that foreign currency contracts will provide approximately \$118,000 less per month beginning in May 2008 than they do currently. The fair value of the Fund's 16 remaining monthly currency contracts covering the

period January 2007 to April 2008 have been reflected in the financial statements and represent a current asset of \$1.1 million and a long-term asset of \$0.4 million at December 31, 2006. The fair value of the Fund's 12 monthly currency contracts covering the period May 2008 to April 2009 has been reflected in the financial statements and represents a long-term liability of \$0.1 million at December 31, 2006.

Based on a monthly distribution of \$0.068 per unit to public unitholders, the principal value of the Fund's current foreign currency contracts (through to April 2009) are sufficient to fully cover the estimated amount of US dollar denominated distributable cash that must be converted to Canadian dollars to pay distributions to Class A Unitholders.

6.0 RELATED PARTY TRANSACTIONS

Related parties refers to affiliates of the previous owners of the Business who have retained a 20% interest in Hardwoods through ownership of Class B Hardwoods LP units and Class B Hardwoods USLP units, respectively. For the year ended December 31, 2006, sales of \$1.1 million were made to related parties, and the subsidiaries of the Fund purchased \$78,000 from related parties. These sales and purchases took place at prevailing market prices. Subsidiaries of the Fund also paid \$108,000 to related parties to provide services for management information systems.

7.0 CRITICAL ACCOUNTING ESTIMATES AND NEW ACCOUNTING STANDARDS

7.1 Critical Accounting Estimates

The preparation of financial statements in accordance with Canadian generally accepted accounting principles requires that we make estimates and assumptions that can have a material impact on our results of operations as reported on a periodic basis. We base our estimates and assumptions on past experience and other factors that are deemed reasonable under the circumstances. Actual results could differ from these estimates. The critical estimates used in preparing our financial statements are:

Accounts Receivable Provision: Due to the nature of our business and the credit terms we provide to our customers, we anticipate that a certain portion of required customer payments will not be made, and we maintain an allowance for these doubtful accounts. The allowance is based on our estimate of the potential of recovering our accounts receivable, and incorporates current and expected collection trends.

Valuation of Inventories: We anticipate that the net realizable value of our inventory could be affected by market shifts or damage to our products. Our inventory is valued at the lower of cost and net realizable value.

Valuation of Other Intangible Assets and Goodwill: Other intangible assets represent customer relationships acquired at the time of our IPO, and are recorded at cost, less accumulated amortization. Amortization is provided for on a straight line basis over 15 years. Goodwill is recorded at cost and is not amortized. Management reviews the carrying value of goodwill and of other intangible assets annually, or more frequently if events or changes in circumstances indicate that an asset may be impaired. An excess of carrying value over fair value is charged to income in the period in which the impairment is determined.

All significant accounting policies have been included in note 2 to the financial statements.

7.2 New Accounting Standards

The Accounting Standards Board of the Canadian Institute of Chartered Accountants (“CICA”) issued Section 3855, Financial Instruments – Recognition and Measurement, Section 3861, Financial Instruments – Disclosure and Presentation, Section 3865, Hedges, and Section 1530, Comprehensive Income, all applicable to the Fund for annual or interim accounting periods beginning on January 1, 2007.

Section 3855 requires all financial assets, financial liabilities and non-financial derivatives to be recognized on the balance sheet and measured based on specified categories. Section 3861 identifies and details information to be disclosed in the financial statements

Section 3865 sets out when hedge accounting can be applied and builds on existing Canadian GAAP guidance by specifying how hedge accounting is applied and disclosed.

Section 1530 introduces new standards for the presentation and disclosure of the components of comprehensive income. Comprehensive income is defined as the change in net assets of an enterprise during a reporting period from transactions and other events and circumstances from non-owner sources.

The Fund is currently evaluating the full impact of the standards and will be required to present a new statement entitled “Comprehensive Income”.

The CICA also issued Section 1506, Accounting Changes, which revises the current standards on changes in accounting policy, estimates or errors as follows: voluntary changes in accounting policy are allowed only when they result in financial statements that provide reliable and more relevant information; changes in accounting policy are to be applied retrospectively unless doing so is impracticable; changes in estimates are to be recorded prospectively; and prior period adjustments are to be corrected retrospectively.

In addition, these standards call for enhanced disclosure about the effects of changes in accounting policies, estimates and errors on the financial statements.

These revised accounting standards are effective for the Fund from January 1, 2007. The impact of Section 1506 cannot be determined until such time as the Fund makes a change in accounting policy.

8.0 RISKS AND UNCERTAINTIES

The Fund is exposed to a number of risks and uncertainties in the normal course of business that could have a negative effect on the Fund’s financial condition or results of operations. We identified significant risks that we were aware of in our Annual Information Report dated March 20, 2007, which is available to readers at www.sedar.com.

As discussed in section 2.0 of this report, a number of economic measures in 2006 indicated that a slowdown is underway in the US and Canadian housing sectors. We are diversified geographically, by customer, and by the wide range of commercial and residential applications for hardwoods. However, significant erosion in levels

of activity in any of these areas, including levels of commercial and new home construction or renovation, could have a negative impact on demand for the hardwood products we sell. The risk of bad debts also increases if some of our customers prove unable to stay in business during a period of reduced hardwood demand. To address these heightened risks, we are prepared to take action by operating region to control costs in the event that we do experience a downturn in the economy that reduces demand for our hardwood products. Where possible, we have also proactively negotiated repayment plans and enhanced security on customer accounts deemed to be most at risk from a credit perspective.

On October 31, 2006, the Canadian Department of Finance announced the “Tax Fairness Plan” whereby the income tax rules applicable to publicly traded trusts and partnerships will be significantly modified. In particular, certain income of, and distributions made by, these entities will be taxed in a manner similar to a corporation. The application of these rules will be delayed to the 2011 taxation year with respect to trusts that were publicly traded prior to November 1, 2006, although the announcement suggested that this transitional relief could be lost under certain circumstances, including the “undue expansion” of an income trust. On December 15, 2006, the Canadian Department of Finance released guidance for income trusts and other flow-through entities that qualify for the four-year transitional relief. The guidance establishes objective tests for income trusts with respect to how much an income trust is permitted to grow without jeopardizing its transitional relief. In general, the Fund will be permitted to issue new equity over the next four years equal to its market capitalization as of the end of trading on October 31, 2006, subject to certain annual limits. Market capitalization, for these purposes, is to be measured in terms of the value of the Fund’s issued and outstanding publicly traded units. If these limits are exceeded, the Fund may lose its transitional relief and thereby become immediately subject to the proposed rules. On December 21, 2006, the Department of Finance

issued for public comment the draft legislation to implement these proposals. There is no assurance that the draft legislation will be enacted in the manner proposed or at all.

As previously described in section 2.0 of this report, the Fund is considering these announcements and the possible impact of the proposed rules to the Fund. The proposed rules, including the guidance released on December 15, 2006, may adversely affect the marketability of the Fund’s units and the ability of the Fund to undertake financings and acquisitions, and, at such time as the proposed rules apply to the Fund, the Distributable Cash of the Fund may be reduced.

9.0 DISCLOSURE CONTROLS AND PROCEDURES AND INTERNAL CONTROL OVER FINANCIAL REPORTING

The Fund’s management is responsible for establishing and maintaining disclosure controls and procedures to provide reasonable assurance that material information related to the Fund, including its consolidated subsidiaries, is made known to senior management, including the Chief Executive Officer (CEO) and the Chief Financial Officer (CFO), by others within those entities on a timely basis so that appropriate decisions can be made regarding public disclosure. The CEO and CFO have evaluated the Fund’s disclosure controls and procedures and have concluded that they are effective as of December 31, 2006.

The Fund’s management are also responsible for designing internal controls over financial reporting, or causing it to be designed under their supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with GAAP. As of December 31, 2006, the CEO and CFO have designed, or caused to be designed under their supervision, such internal controls over financial reporting. Additionally, the CEO and CFO have identified no changes in the Fund’s internal control over financial reporting that occurred during the Fund’s most recent interim period that has materially affected, or is reasonably likely to materially affect, the Fund’s internal control over financial reporting.

10.0 SELECTED FINANCIAL INFORMATION

10.1 Quarterly Financial Information

(in thousands of dollars except per Unit and ratio amounts)

	Q4 2006	Q3 2006	Q2 2006	Q1 2006	Q4 2005	Q3 2005	Q2 2005	Q1 2005
Total sales	83,120	90,974	95,054	93,380	84,130	94,766	91,852	85,027
Net earnings (loss)	(4,826)	2,656	3,939	1,868	2,370	4,597	3,442	2,942
Basic and fully diluted earnings (loss) per Class A Unit	(0.335)	0.184	0.273	0.130	0.164	0.319	0.239	0.204
EBITDA	4,088	6,727	6,427	4,579	4,706	6,679	6,691	5,508
Distributable cash	3,714	4,921	4,716	3,397	3,324	5,193	5,473	4,723
Total distributions to Class A and Class B Units	2,940	2,940	3,693	3,693	3,825	4,971	4,910	4,877
Payout ratio	79%	60%	78%	109%	115%	96%	90%	103%

The table above provides selected quarterly financial information for the eight most recently completed fiscal quarters of the Fund. This information is unaudited, but reflects all adjustments of a normal, recurring nature which are, in our opinion, necessary to present a fair statement of the results of operations for the periods presented. Quarter to quarter comparisons of our financial results are not necessarily meaningful and should not be relied upon as indication of future performance. Historically, the first quarter and fourth quarter have

been seasonally slower periods for our business. In addition, net earnings reported in each quarter may be impacted by changes to the foreign exchange rate of the Canadian and US dollar, write-downs in the carrying value of goodwill and other intangible assets (which occurred in the three months ended December 31, 2006), and gains or losses on foreign currency contracts which are described under Financial Instruments in section 5.0 of this report.

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10.2 Annual Financial Information

(in thousands of dollars except per Unit amounts)

	Year ended December 31 2006	Year ended December 31 2005	Period from March 23, 2004 to December 31 2004 ⁽¹⁾
Total sales	362,528	355,775	289,895
Net earnings	3,637	13,351	14,603
Basic and fully diluted earnings per Class A Unit	0.252	0.927	1.01
Total assets	198,404	214,669	209,513
Total long-term financial liabilities	37,372	34,215	32,668
Distributions per Unit relating to the period:			
Class A Units	0.921	1.075	0.819
Class B Units	–	0.851	0.890
Total Units	0.736	1.031	0.833

(1) The Fund commenced operations on March 23, 2004



Management's Statement of Responsibilities

The accompanying consolidated financial statements are the responsibility of management and have been reviewed and approved by the Boards of Directors and the Trustees. The consolidated financial statements have been prepared by management, in accordance with Canadian generally accepted accounting principles and, where appropriate, reflect management's best estimates and judgements. Management has also prepared financial and all other information in the annual report and has ensured that this information is consistent with the consolidated financial statements.

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The Fund maintains appropriate systems of internal control, policies and procedures, which provide management with reasonable assurance that assets are safeguarded and the financial records are reliable and form a proper basis for preparation of financial statements.

The Boards of Directors and the Trustees ensure that management fulfills its responsibilities for financial reporting and internal control through an Audit Committee. This committee reviews the consolidated financial statements and is comprised of independent Trustees. The auditors have full and direct access to the Audit Committee.

The consolidated financial statements have been independently audited by KPMG LLP, in accordance with Canadian generally accepted auditing standards. Their report herewith expresses their opinion on the consolidated financial statements of the Fund.

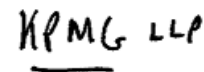

Maurice E. Paquette
President and Chief Executive Officer

Auditors' Report to the Unitholders

We have audited the consolidated balance sheets of Hardwoods Distribution Income Fund (the "Fund") as at December 31, 2006 and 2005 and the consolidated statements of earnings and retained earnings (deficit) and cash flows for the years then ended. These financial statements are the responsibility of the Fund's management. Our responsibility is to express an opinion on these 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 financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the 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 Fund as at December 31, 2006 and 2005 and the results of its operations and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.



Chartered Accountants
Vancouver, Canada

February 9, 2007

CONSOLIDATED BALANCE SHEETS

(Expressed in thousands of Canadian dollars)

	December 31 2006	December 31 2005
Assets		
Current assets:		
Cash and cash equivalents	\$ 594	\$ 2,203
Accounts receivable	43,767	46,166
Income taxes recoverable	596	86
Inventory	44,584	47,666
Prepaid expenses	1,098	1,222
Foreign currency contracts (note 5)	1,129	1,439
	91,768	98,782
Long-term receivables (note 3)	3,236	2,634
Property, plant and equipment (note 4)	3,219	3,519
Deferred financing costs	32	77
Foreign currency contracts (note 5)	385	1,214
Other intangible assets	10,878	12,103
Goodwill	88,886	96,340
	\$ 198,404	\$ 214,669
Liabilities and Unitholders' Equity		
Current liabilities:		
Bank indebtedness (note 6)	\$ 39,152	\$ 46,925
Accounts payable and accrued liabilities	7,590	9,231
Distributions payable to Unitholders	980	–
	47,722	56,156
Foreign currency contracts (note 5)	141	–
Deferred gain on sale-leaseback of land and building	719	804
Non-controlling interests (note 7)	33,859	32,047
Future income taxes (note 9)	2,653	1,364
Unitholders' equity:		
Fund Units (note 8)	133,454	133,454
Retained earnings (deficit)	(8,973)	1,886
Cumulative foreign currency translation account	(11,171)	(11,042)
	113,310	124,298
Commitments (note 11)		
Contingencies (note 16)		
	\$ 198,404	\$ 214,669

See accompanying notes to consolidated financial statements.

Approved on behalf of the Trustees:


Lawrence M Bell
Trustee


Terry M. Holland
Trustee

CONSOLIDATED STATEMENT OF EARNINGS AND RETAINED EARNINGS (DEFICIT)

(Expressed in thousands of Canadian dollars)

	Year Ended December 31 2006	Year Ended December 31 2005
Sales	\$ 362,528	\$ 355,775
Cost of sales	296,486	289,388
Gross profit	66,042	66,387
Expenses (income):		
Selling and administrative	45,559	43,480
Amortization:		
Plant and equipment	1,208	1,236
Deferred financing costs	77	64
Other intangible assets	899	938
Deferred gain on sale-leaseback of land and building	(84)	(57)
Interest	3,127	2,114
Foreign currency contracts	(58)	(819)
Intangibles impairment (note 2(g))	326	–
Goodwill impairment (note 2(h))	7,566	–
	58,620	46,956
Earnings before non-controlling interests and income taxes	7,422	19,431
Non-controlling interests (note 7)	1,484	3,886
Earnings before income taxes	5,938	15,545
Income taxes (note 9)	2,301	2,194
Net earnings for the year	3,637	13,351
Retained earnings, beginning of year	1,886	2,801
Distributions declared to Unitholders	(14,496)	(14,266)
Retained earnings (deficit), end of year	\$ (8,973)	\$ 1,886
Basic and diluted earnings per Unit	\$ 0.25	\$ 0.93
Weighted average number of Units outstanding	14,410,000	14,410,000

See accompanying notes to consolidated financial statements.

CONSOLIDATED STATEMENTS OF CASH FLOWS

(Expressed in thousands of Canadian dollars)

	Year Ended December 31 2006	Year Ended December 31 2005
Cash flows provided by (used in) operating activities:		
Net earnings for the year	\$ 3,637	\$ 13,351
Items not involving cash:		
Amortization	2,100	2,181
Gain on sale of property, plant and equipment	(32)	(26)
Mark-to-market adjustment on unrealized foreign currency contracts	1,280	(142)
Intangibles impairment (note 2(g))	326	–
Goodwill impairment (note 2(h))	7,566	–
Non-controlling interests	1,484	3,886
Future income taxes	1,289	819
	17,650	20,069
Change in non-cash operating working capital (note 10)	889	(6,194)
Net cash provided by operating activities	18,539	13,875
Cash flows provided by (used in) financing activities:		
Increase (decrease) in bank indebtedness	(7,733)	8,996
Increase in deferred financing fees	(33)	–
Distributions paid to Unitholders	(13,516)	(15,563)
Distributions paid to non-controlling interests	–	(4,063)
Net cash used in financing activities	(21,282)	(10,630)
Cash flows provided by (used in) investing activities:		
Additions to property, plant and equipment	(902)	(1,356)
Proceeds on disposal of property, plant and equipment	34	2,150
Decrease (increase) in long-term receivables, net	2,002	(1,836)
Net cash provided by (used in) investing activities	1,134	(1,042)
Increase (decrease) in cash	(1,609)	2,203
Cash, beginning of year	2,203	–
Cash, end of year	\$ 594	\$ 2,203
Supplemental information:		
Interest paid	\$ 3,127	\$ 2,114
Income taxes paid	1,572	946
Transfer of accounts receivable to long-term customer notes receivable, being a non-cash transaction	2,167	509

See accompanying notes to consolidated financial statements.



Notes to the Consolidated Financial Statements

(Tabular amounts expressed in thousands of Canadian dollars)

Years ended December 31, 2006 and 2005

1. Nature of operations and business acquisition:

Hardwoods Distribution Income Fund (the “Fund”) is an unincorporated, open-ended, limited purpose trust established under the laws of the Province of British Columbia on January 30, 2004 by a Declaration of Trust. The Fund commenced operations on March 23, 2004 when it completed an initial public offering (the “Offering”) of Units and acquired an 80% interest in a hardwood lumber and sheet goods distribution business in North America (the “Business”) from affiliates of Sauder Industries Limited (“SIL”). The Fund holds, indirectly, 80% of the outstanding limited partnership units of Hardwoods Specialty Products LP (“Hardwoods LP”) and Hardwoods Specialty Products US LP (“Hardwoods USLP”), limited partnerships established under the laws of the Province of Manitoba and the state of Delaware, respectively.

2. Significant accounting policies:

These consolidated financial statements have been prepared in accordance with Canadian generally accepted accounting principles.

(a) Basis of presentation:

These consolidated financial statements include the accounts of the Fund and its 80% owned subsidiaries Hardwoods LP and Hardwoods USLP, and other wholly owned subsidiaries. All significant intercompany balances and transactions have been eliminated on consolidation.

(b) Cash and cash equivalents:

The Fund considers deposits in banks, certificates of deposits and short-term investments with original maturities of three months or less when acquired as cash and cash equivalents.

(c) Accounts receivable:

Accounts receivable includes trade accounts receivable net of allowances for doubtful accounts plus the current portion of housing loans receivable from employees related to their relocation and customer notes receivable.

(d) Inventory:

Inventory is valued at the lower of weighted average cost and net realizable value.

(e) Property, plant and equipment:

Property, plant and equipment are stated at cost. Amortization is provided at straight-line rates sufficient to amortize the cost of the assets over their estimated useful lives as follows:

Assets	Estimated useful life
Machinery and equipment	5 to 10 years
Mobile equipment	7 to 10 years
Leasehold improvements	Over the term of the lease

(f) Deferred financing costs:

Financing costs incurred to obtain credit facilities are deferred and amortized on a straight-line basis over the term of the related debt.

(g) Other intangible assets:

Other intangible assets represent customer relationships acquired in the business combination (note 1) and are recorded at cost less accumulated amortization and any write-downs. Amortization is provided for on a straight-line basis over 15 years. Management reviews the carrying value of intangible assets for impairment annually, or more frequently if events or changes in circumstances indicate that the asset may be impaired. Any excess of carrying value over fair value is charged to income in the period in which the impairment is determined. During the fourth quarter ended December 31, 2006, management performed its annual impairment test and having determined that the carrying value of intangible assets exceeded their fair value, recorded an impairment of \$326,000.

(h) Goodwill:

Goodwill is recorded at cost less any write-downs and is not amortized. Management reviews the carrying value of goodwill for impairment annually, or more frequently if events or changes in circumstances indicate that the asset may be impaired. Any excess of carrying value over fair value is charged to income in the period in which the impairment is determined. During the fourth quarter ended December 31, 2006, management performed its annual impairment test and having determined that the carrying value of goodwill exceeded its fair value, recorded a goodwill impairment of \$7,566,000. The write-down of goodwill relates solely to the Fund's Canadian business, Hardwoods LP. The goodwill impairment in Hardwoods LP is largely due to the anticipated reduction to cash flows resulting from the Canadian federal government's intention to tax Canadian income trusts commencing in 2011, as well as lower than previously anticipated revenue and cash flows to be generated.

(i) Impairment of long-lived assets:

Long-lived assets, including property, plant and equipment and other intangible assets, are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets is measured by a comparison of the carrying amount of an asset to estimated undiscounted future cash flows expected to be generated by the asset. If the carrying amount for the asset exceeds its estimated future cash flows, an impairment charge is recognized by the amount that the carrying amount of the asset exceeds its fair value.

(j) Sales-leaseback of land and building:

During the year ended December 31, 2005, a subsidiary of the Fund sold a building and related land and leased back the facilities. The gain on the sale has been deferred and is amortized in proportion to the rental payments over the lease term.

(k) Income taxes:

Incorporated subsidiaries of the Fund use the asset and liability method of accounting for income taxes. Under the asset and liability method, future income tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Future tax assets and liabilities are measured using enacted or substantively enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on future tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the substantive enactment date. The amount of future income tax assets recognized is limited to the amount that is more likely than not to be realized.

As the Fund allocates all of its net earnings to Unitholders and deducts these amounts in computing its taxable income, Unitholders, rather than the Fund, will generally be liable for any income tax obligations. Accordingly, no provision for income taxes has been made in respect of the Fund itself.

(l) Revenue recognition:

Revenue from the sale of hardwood lumber and sheet goods is recognized at the time of delivery, which is when title and the risks and rewards of ownership transfer to the customer.

(m) Translation of foreign currencies:

The accounts of the Fund's self-sustaining foreign operations are translated into Canadian dollars using the current rate method. Assets and liabilities are translated at the exchange rate in effect at the balance sheet date and revenue and expenses are translated at average exchange rates for the period. Gains or losses arising from the translation of the financial statements of the self-sustaining foreign operations are deferred in the cumulative foreign currency translation account in Unitholders' equity.

2. Significant accounting policies (continued)

Foreign monetary assets and liabilities of the Canadian operations have been translated into Canadian dollars using the rate of exchange in effect at the balance sheet date. Revenue and expenses of the Canadian operations denominated in foreign currencies are translated at the average exchange rates for the period. Exchange gains or losses arising from translation of these foreign monetary balances and transactions are reflected in earnings.

(n) Foreign currency contracts:

The Fund uses currency derivatives to manage its exposure to fluctuations in exchange rates between the Canadian and the United States dollar. The foreign currency contracts are recognized in the balance sheet and measured at fair value, with changes in fair value recognized currently in the statement of operations.

(o) Earnings per Unit:

Basic earnings per Unit is calculated by dividing net earnings by the weighted average number of Units outstanding during the reporting period. Diluted earnings per Unit is calculated by application of the if-converted method for convertible securities (being exchangeable Units held by the non-controlling interest). As the conversion of convertible securities would not have a dilutive effect on earnings per Unit, diluted and basic earnings per Unit are the same amount.

(p) Use of estimates:

The preparation of financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting period. Areas requiring significant management estimates include the valuation and impairment analysis of goodwill and other intangible assets, the determination of the allowance for doubtful

accounts, future income taxes and amounts of accrued liabilities. Actual amounts may differ from the estimates applied in the preparation of these financial statements.

(q) Comparative figures:

Certain comparative figures have been restated to conform to the current year's financial statement presentation.

3. Long-term receivables:

	2006	2005
Employee housing loans	\$ 1,766	\$ 3,364
Customer notes	2,277	477
Security deposits	606	611
	4,649	4,452
Less: current portion	1,413	1,818
	\$ 3,236	\$ 2,634

Long-term receivables consist of non-interest bearing housing loans receivable from employees related to their relocation, interest bearing notes receivable from certain customers, and security deposits recoverable on leased premises. The housing loans are secured by a deed of trust or mortgage depending upon the jurisdiction. The customer notes receivable have various security arrangements and bear interest rates ranging from 8%-18%.

4. Property, plant and equipment:

December 31, 2006	Cost	Accumulated amortization	Net book value
Machinery and equipment	\$ 2,312	\$ 1,228	\$ 1,084
Mobile equipment	3,322	1,549	1,773
Leasehold improvements	765	403	362
	\$ 6,399	\$ 3,180	\$ 3,219

December 31, 2005	Cost	Accumulated amortization	Net book value
Machinery and equipment	\$ 1,919	\$ 743	\$ 1,176
Mobile equipment	2,922	1,021	1,901
Leasehold improvements	715	273	442
	\$ 5,556	\$ 2,037	\$ 3,519

5. Foreign currency contracts:

In order to manage the Fund's exposure to exchange rate fluctuations on United States dollar denominated distributable cash, at December 31, 2006 a subsidiary of the Fund had entered into 16 foreign currency contracts to exchange US\$675,000 each month for approximately \$878,000 until April 2008, reflecting an exchange rate of \$1.30. The subsidiary of the Fund also had an additional 12 monthly foreign currency contracts to exchange US\$675,000 into approximately \$760,000 each month from May 2008 until April 2009, reflecting an exchange rate of \$1.1255. The fair value of the Fund's 16 remaining monthly foreign currency contracts covering the period January 2007 to April 2008 represent a current asset of \$1,129,000 and a long-term asset of \$385,000 at December 31, 2006. The fair value of the Fund's 12 monthly currency contracts covering the period May 2008 to April 2009 represent a long-term liability of \$141,000 at December 31, 2006. The fair values were determined based on valuations obtained from the counter-party.

6. Bank indebtedness:

	2006	2005
Checks issued in excess of funds on deposit	\$ 797	\$ 753
Credit facility, Hardwoods LP	10,788	13,201
Credit facility, Hardwoods USLP (2006 - US\$23,655; 2005 - US\$28,350)	27,567	32,971
	\$ 39,152	\$ 46,925

Bank indebtedness consists of checks issued in excess of funds on deposit and advances under operating lines of credit available to Hardwoods LP and Hardwoods USLP. Hardwoods LP has a revolving credit facility of up to an aggregate amount of \$22,000,000 and Hardwoods USLP has a revolving credit facility of up to an aggregate amount of \$40,789,000 (US\$35,000,000), less the net exposure under the foreign currency contracts facility as described in note 5.

The Hardwoods LP credit facility was renegotiated in November 2006 and now expires November 30, 2009, and is secured by a first security interest in all of the present and after acquired property of Hardwoods LP and its operating subsidiaries, and by the Hardwoods LP Units held indirectly by the Fund. The Hardwoods USLP credit facility and the foreign currency contract arrangements were renegotiated in December 2006 and now expire March 31, 2010. They are secured by a first security interest in all of the present and after acquired property of Hardwoods USLP and by the Hardwoods USLP Units held indirectly by the Fund.

The credit facilities are repayable without any prepayment penalties and bear interest at a floating rate based on the Canadian dollar or US dollar prime rate (as the case may be), LIBOR or bankers acceptance rates plus, in each case, an applicable margin. Letters of credit are also available under the credit facilities. The rates vary with the ratio of total debt for borrowed money, capital leases and letters of credit (as adjusted for certain items) to earnings before interest, taxes, depreciation and amortization, as defined in the credit agreements. Commitment fees and standby charges are payable.

The average annual interest rates payable for the year ended December 31, 2006 were 6.6% and 7.2% (2005 - 5.0% and 4.9%) for the Hardwoods LP and Hardwoods USLP credit facilities, respectively.

7. Non-controlling interests:

	2006	2005
Balance, beginning of the year	\$ 32,047	\$ 32,123
Interest in earnings for the year	1,484	3,886
Distributions declared to non-controlling interests	-	(3,066)
Foreign currency translation adjustment of non-controlling interest in Hardwoods USLP and other	328	(896)
Balance, end of the year	\$ 33,859	\$ 32,047

The previous owners of the Business (note 1) have retained a 20% interest in Hardwoods LP and Hardwoods USLP through ownership of Class B Hardwoods LP units ("Class B LP Units") and Class B Hardwoods USLP units ("Class B USLP Units"), respectively. The Fund owns an indirect 80% interest in Hardwoods LP and Hardwoods USLP through ownership of all Class A Hardwoods LP units ("Class A LP Units") and Class A Hardwoods USLP units ("Class A USLP Units"), respectively.

7. Non-controlling interests (continued)

The Class A LP Units and Class B LP Units and the Class A USLP Units and Class B USLP Units, respectively, have economic and voting rights that are equivalent in all material respects except distributions on the Class B LP Units and Class B USLP Units are subject to the subordination arrangements described below until the date (the “Subordination End Date”) on which:

- the consolidated Adjusted EBITDA, as defined in the Subordination Agreement dated March 23, 2004, of the Fund for the 12 month period ending on the last day of the month immediately preceding such date is at least \$21,300,000; and
- cash distributions of at least \$29,540,000 (\$2.05 per Unit) have been paid on the Units and a combined amount of cash advances or distributions of at least \$7,385,000 has been paid on the Class B LP Units and Class B USLP Units, being \$2.05 per combined Class B LP and Class B USLP Units (as adjusted for issuances, redemptions and repurchases of Units, LP Units and USLP Units subsequently and by converting the cash distributions or advances by Hardwoods USLP on the USLP Units at the rate of exchange used by the Fund to convert funds received by it in US dollars into Canadian dollars) for the 24 month period ending on the last day of the month immediately preceding such date.

The Subordinated End Date had not occurred at December 31, 2006.

Prior to the Subordination End Date, advances and distributions on the LP Units and the USLP Units will be made in the following order of priority:

- At the end of each month, cash advances or distributions will be made to the holders of Class A LP Units and Class A USLP Units in a combined amount that is sufficient to provide available cash to the Fund to enable the Fund to make cash distributions upon the Units for such month at least equal to \$0.08542 per Unit or, if there is insufficient available cash to make distributions or advances in such amount, such lesser amount as is available as determined by the board of directors of the general partners;
- At the end of each fiscal quarter of Hardwoods LP and Hardwoods USLP, including the fiscal quarter ending on the fiscal year end, available cash of Hardwoods LP and Hardwoods USLP will be advanced or distributed in the following order of priority:
 - First, in payment of the monthly cash advance or distribution to the holders of Class A LP Units and Class A USLP Units as described above, for the month then ended;

- Second, to the holders of Class A LP Units and Class A USLP Units, to the extent that the combined monthly cash advances or distributions in respect of the 12 month period then ended (and not, for greater certainty, in any previous 12 month period) on Class A LP Units and Class A USLP Units were not made or were made in amounts less than a combined amount at least equal to \$1.025 per Unit, the amount of any such deficiency. As of December 31, 2006, the amount of such deficiency was \$1.5 million;
- Third, to the holders of Class B LP Units and Class B USLP Units in a combined amount for one Class B LP Unit and one Class B USLP Unit equal, on a pro-rated basis, to the combined amount advanced or distributed on one Class A LP Unit and one Class A USLP Unit during such fiscal quarter or, if there is insufficient available cash to make advances or distributions in such amount, such lesser amount as is available;
- Fourth, to the holders of Class B LP Units and Class B USLP Units, to the extent only that combined advances or distributions in respect of any fiscal quarter(s) during the 12 month period then ended (and not, for greater certainty, in any previous 12 month period) on one Class B LP Unit and one Class B USLP Unit were not made, or were made in amounts less, on a pro-rated basis, that the combined amount advanced or distributed on one Class A LP Unit and one Class A USLP Unit during such 12 month period, the amount of such deficiency. As of December 31, 2006, the amount of such deficiency was \$3.3 million;
- Fifth, to the extent of any excess, to the holders of the Class A LP Units and Class B LP Units and Class A USLP Units and Class B USLP Units, respectively, so that the combined advances or distributions on one Class A LP Unit and one Class A USLP Unit are the same as the combined advances or distribution on one Class B LP Unit and one Class B USLP Unit in respect of the 12 month period then ended (and not, for greater certainty, any previous 12 month period).

After the Subordination End Date, the holders of the Class B LP Units and Class B USLP Units will generally be entitled to effectively exchange all or a portion of their Class B LP Units and Class B USLP Units together for up to 3,602,500 Units of the Fund, representing 20% of the issued and outstanding Units of the Fund on a fully diluted basis. In the event the Fund enters into an agreement in respect of an acquisition or a take-over bid of the Fund, the holders of the Class B LP Units and Class B USLP Units will be entitled to exchange such units for Units of the Fund.

8. Fund Units:

- (a) An unlimited number of Units and Special Voting Units may be created and issued pursuant to the Declaration of Trust. Each Unit is transferable and represents an equal undivided beneficial interest in any distributions from the Fund, whether of net income, net realized capital gains or other amounts and in the net assets of the Fund in the event of a termination or winding up of the Fund. The Special Voting Units are not entitled to any beneficial interest in any distribution from the Fund or in the net assets of the Fund in the event of a termination or winding up of the Fund. Each Unit, or Special Voting Unit, entitles the holder thereof to one vote at all meetings of voting Unitholders.

On March 23, 2004, the Fund issued 14,410,000 Units at a price of \$10 per Unit pursuant to the Offering. Net proceeds from the Offering were \$133,454,000 after deducting expenses of the Offering of \$10,646,000. The holders of the Class B Units of Hardwoods LP and Hardwoods USLP were issued 3,602,500 Special Voting Units of the Fund, the value of which is included in non-controlling interests (note 7). Such Special Voting Units are to be cancelled on the exchange of Class B Units of Hardwoods LP and Hardwoods USLP for Units of the Fund.

- (b) The Trustees of the Fund approved the adoption of a Unitholders Rights Plan (the "Rights Plan") dated December 12, 2006, that is intended to ensure fair treatment for all Unitholders in the event of a take-over bid or any other attempt to acquire a controlling interest in the Fund. Provisions of the Rights Plan include the limitation on Unitholder ownership at 20% of outstanding units in the absence of a take-over bid for all outstanding units and a requirement for a take-over bid to be open for a minimum of 60 days. At the effective date of the Rights Plan, beneficial owners of 20% or more of the units of the Fund (including holders of securities exchangeable for units of the Fund) are deemed to be "Grandfathered Persons" and are exempt from the definition of an "Acquiring Person" under the Rights Plan provided their beneficial interest in the outstanding units does not increase by more than 1.0% following December 12, 2006. The rights become exercisable only when a person or party acquires 20% or more of the Units, or in the case of a Grandfathered Person increases their beneficial interest in Units by more than 1.0%, each

without complying with certain provisions of the Rights Plan. Each right would entitle each holder of Units (other than the acquiring person or party) to purchase additional Units of the Fund at a 50 per cent discount to the market price at the time. Although the Rights Plan has been conditionally accepted by the Toronto Stock Exchange and took effect immediately, the Fund will ask its Unitholders to approve it at the next meeting of Unitholders. The Rights Plan will expire if Unitholder approval is not obtained within six months of December 12, 2006. If approved by Unitholders, it will continue in effect until the annual general meeting of Unitholders in 2010.

9. Income taxes:

	2006	2005
Current	\$ 1,054	\$ 1,323
Future	1,247	871
	\$ 2,301	\$ 2,194

Income tax expense differs from that calculated by applying U.S. federal and state statutory income tax rates in effect in the jurisdiction in which a subsidiary of the Fund is subject to tax of 39.4% (2005 - 39.4%) to earnings before income taxes for the following reasons:

	2006	2005
Earnings before income tax	\$ 5,938	\$ 15,545
Computed tax expenses at statutory rate	\$ 2,340	\$ 6,125
Income of Fund distributed directly to Unitholders	(763)	(3,801)
Income and deductions not subject to tax	(386)	(250)
Deductible state taxes	(8)	(67)
Other	275	187
Taxes paid as a result of Subordination Agreement	843	-
	\$ 2,301	\$ 2,194

Taxes paid as a result of Subordination Agreement represent additional taxes incurred by the Fund due to distributions having not been made to the non-controlling interests on a proportional basis.

9. Income taxes (continued)

The tax effect of temporary differences that give rise to significant portions of the future income tax assets and liabilities at December 31, 2006 is as follows:

	2006	2005
Future income tax assets:		
Accrued liabilities	\$ 21	\$ 196
Deferred gain on sale-leaseback of land and building	227	253
Inventory	453	410
Accounts receivable	272	45
Property, plant and equipment	-	35
	973	939
Future income tax liabilities:		
Property, plant and equipment	(69)	-
Goodwill	(3,466)	(2,200)
Prepaid expenses	(91)	(103)
	(3,626)	(2,303)
Net future income tax liability	\$ (2,653)	\$ (1,364)

On October 31, 2006, proposed legislation was announced by the Canadian federal government that would subject the Fund to tax on income of certain of the Fund's subsidiary operations that are currently not subject to tax in the Fund. The proposed taxation changes, if substantively enacted, would require recognition of future income tax assets and liabilities with a corresponding impact on future tax expense (recovery) when so enacted, based on the temporary differences expected to reverse after the date the taxation changes take effect. If substantively enacted in the form currently proposed, the Fund expects these taxation changes to take effect in 2011.

At December 31, 2006, the tax bases exceeds the reported amounts of the Fund's consolidated assets and liabilities for entities that are not subject to income taxes by \$7,628,000 (2005 – \$5,025,000).

10. Changes in non-cash operating working capital:

	2006	2005
Accounts receivable	\$ (122)	\$ (1,054)
Income taxes recoverable	(510)	314
Inventory	3,070	(6,371)
Prepaid expenses	123	(625)
Accounts payable and accrued liabilities	(1,672)	1,542
	\$ 889	\$ (6,194)

11. Commitments:

(a) The Fund's subsidiaries are obligated under various building and automobile operating leases that require minimum rental payments in each of the next five years as follows:

2007	\$ 7,459
2008	6,018
2009	4,659
2010	2,987
2011	1,085
	22,208
Thereafter	1,202
	\$ 23,410

(b) At December 31, 2006, the Fund's subsidiaries were committed in the amount of \$26,222 (US\$22,500) (2005 - \$151,702 (US\$130,411)) under letters of credit.

12. Segment disclosure:

Information about geographic areas is as follows:

	2006	2005
Revenue from external customers:		
Canada	\$109,024	\$ 113,359
United States	253,504	242,416
	\$362,528	\$ 355,775
Property, plant and equipment:		
Canada	\$ 1,156	\$ 1,559
United States	2,063	1,960
	\$ 3,219	\$ 3,519
Goodwill		
Canada	\$ 34,477	\$ 42,043
United States	54,409	54,297
	\$ 88,886	\$ 96,340

13. Financial instruments:

(a) Fair values of financial instruments:

The carrying values of cash and cash equivalents, trade accounts receivable, accounts payable and accrued liabilities and distributions payable approximate their fair values due to the relatively short period to maturity of the instruments. The fair value of long-term receivables is not expected to differ materially from the carrying value. The carrying values of the credit facilities approximate their fair values due to the existence of floating market based interest rates. The foreign currency contracts are carried at market values.

(b) Credit risk:

The Fund is exposed to credit risk in the event it is unable to collect in full amounts receivable from its customers. The Fund employs established credit approval practices and engages credit attorneys when appropriate to mitigate the credit risk. It is the Fund's policy to secure credit terms with customers whenever possible by registering security interests in the assets of the customer and by obtaining personal guarantees. Our largest individual customer balance amounted to 5.7% of accounts receivable and customer notes receivable at December 31, 2006.

(c) Counterparty risk:

Changes in the exchange rates and interest rates will result in market gains and losses on the foreign currency contracts entered into by the Fund. Furthermore, the Fund may be exposed to losses should the counterparty to its foreign currency contracts fail to fulfill its obligations. The Fund has sought to minimize potential counter party losses by transacting with high credit quality institutions.

14. Pensions:

Hardwoods USLP maintains a defined contribution 401 (k) retirement savings plan (the "USLP Plan"). The assets of the USLP Plan are held, and related investment transactions are executed, by the Plan's Trustee, ING National Trust, and, accordingly, are not reflected in these consolidated financial statements. During the year ended December 31, 2006, Hardwoods USLP contributed and expensed \$394,505 (US\$347,826) (2005 - 400,329 (US\$330,414)) in relation to the USLP Plan.

Hardwoods LP does not maintain a pension plan. Hardwoods LP does, however, administer a group registered retirement savings plan ("LP Plan") that has a matching component whereby Hardwoods LP makes contributions to the LP Plan which match contributions made by employees up to a certain level. The assets of the LP Plan are held, and related investment transactions are executed, by LP Plan's Trustee, Sun Life Financial Trust Inc., and, accordingly, are not reflected in these consolidated financial statements. During the year ended December 31, 2006, Hardwoods LP contributed and expensed \$266,153 (2005 - \$266,450) in relation to the LP Plan.

15. Related party transactions:

For the year ended December 31, 2006, sales of \$1,141,799 (2005 - \$2,046,323) were made to affiliates of SIL, and the Fund made purchases of \$77,932 (2005 - \$586,549) from affiliates of SIL. All these sales and purchases took place at prevailing market prices.

During the year ended December 31, 2006, the Fund expensed \$108,000 (2005 - \$122,384) for management information systems services provided by affiliates of SIL. This cost is included in selling and administrative expense in the consolidated statement of earnings and retained earnings (deficit).

16. Contingencies:

The Fund and its subsidiaries are subject to legal proceedings that arise in the ordinary course of its business. Management is of the opinion, based upon information presently available, that it is unlikely that any liability, to the extent not provided for through insurance or otherwise, would be material in relation to the Fund's consolidated financial statements.

THE BEAUTY OF HARDWOOD

People love hardwood and find many different ways to bring it into their lives. Whether in furniture, kitchen cabinets, doors and mouldings, or custom interior millwork, people place a higher value on products crafted from real wood. It's a preference that doesn't change with the whims of fashion.

Demand for hardwood has remained remarkably stable decade after decade, in part because hardwood has no real substitute. There's a warmth to the look and touch of hardwood that no other material can match.





HARDWOODS



UNITHOLDER INFORMATION

Trustees

Lawrence I. Bell
Chair, British Columbia Hydro & Power Authority

Terry M. Holland
President, Krystal Financial Corp.

Graham M. Wilson
President, Grawil Consultants Inc.

Directors

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Chair, British Columbia Hydro & Power Authority

Terry M. Holland
President, Krystal Financial Corp.

Graham M. Wilson
President, Grawil Consultants Inc.

E. Lawrence Sauder
Vice Chair, Sauder Industries Limited

Richard N. McKerracher
President, Sauder Industries Limited

Officers

Maurice E. Paquette
President and Chief Executive Officer

Robert J. Brown
Vice President and Chief Financial Officer

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Rob Brown
Chief Financial Officer

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Annual General Meeting

The Annual General Meeting of Hardwoods Distribution Income Fund will be held at The Fairmont Waterfront Hotel, 900 Canada Place Way, Vancouver, BC Monday, May 14, 2007 at 1:30pm