



HARDWOODS DISTRIBUTION INC.

2011

Second Quarter

Report To Shareholders



Company Overview

Hardwoods Distribution Inc. (“HDI”) is a publicly traded company that holds, indirectly, a 100% ownership interest in Hardwoods Specialty Products LP and Hardwoods Specialty Products US LP (collectively, “Hardwoods” or the “Business”). Formerly the Hardwoods Distribution Income Fund (the “Fund”), HDI was formed by the Fund in order to convert from an income trust structure to a corporation. The Fund was converted to a corporation by way of a plan of arrangement effective July 1, 2011.

Pursuant to the conversion, all outstanding units of the Fund held by unitholders were exchanged for common shares of Hardwoods Distribution Inc. on a one-for-one basis. All of the Class B limited partner units in the Fund’s operating subsidiaries, which represented a 20% equity interest in Hardwoods and were held by the former owners of the Business, were exchanged for common shares of Hardwoods Distribution Inc. on the basis of 0.3793 common shares per Class B limited partner unit. As a result of these arrangements, Hardwoods Distribution Inc. owns 100% of Hardwoods, whereas previously the Fund owned 80% of the Business. The Fund has been wound up into HDI. Hardwoods Distribution Inc. is listed on the Toronto Stock Exchange and trades under the symbol HWD.

HDI’s results are based upon the performance of Hardwoods, one of North America’s largest wholesale distributors of hardwoods lumber and related sheet good products, operating a network of 26 distribution centres in the US and Canada.



About the Business

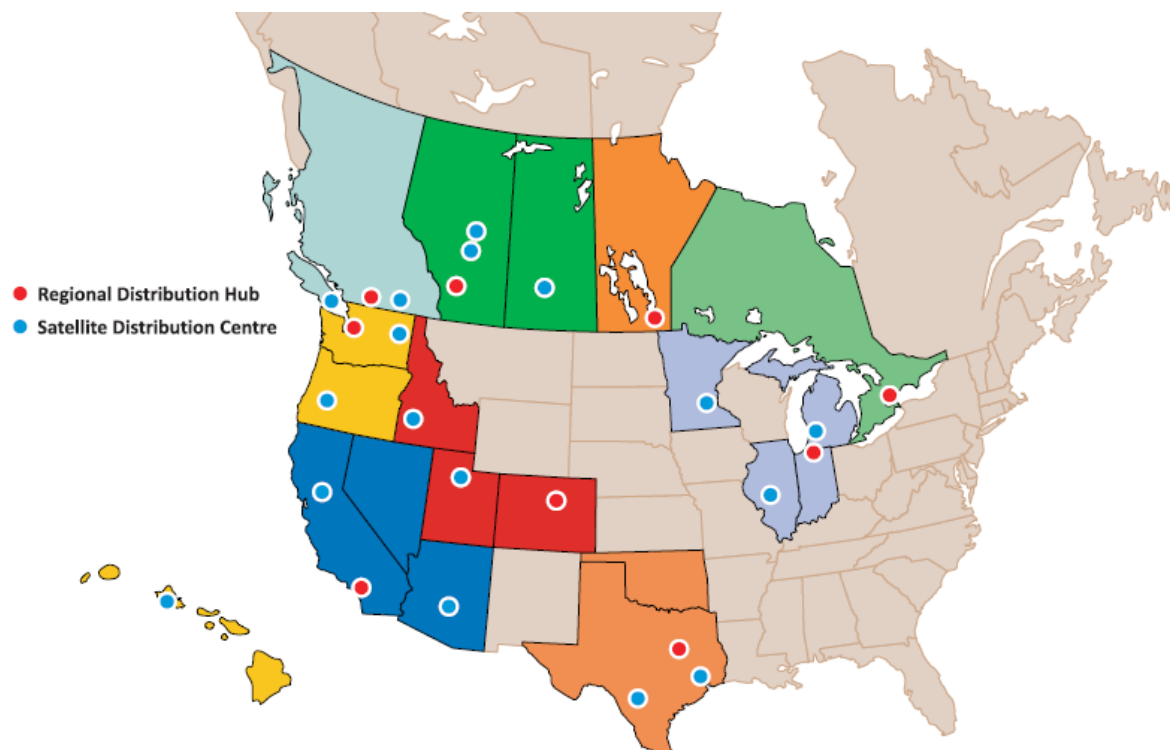
Hardwoods has been in business for over 50 years. We sell quality lumber, hardwood plywood and specialty products to cabinet makers, custom millworkers, furniture makers and other industrial customers that manufacture products made from hardwood. Demand for products made from hardwood comes from multiple sectors of the North American economy, including new home construction, renovation, non-residential construction, and institutional markets.

There is warmth to the look and touch of hardwoods that no other material can match, and people place a high value on products crafted from real wood. Hardwood products are a part of our daily lives in the homes we live in (cabinets, mouldings, custom finishing, and home furniture) and places we visit (furniture, cabinetry, and 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).

Our role in the industry is to provide the critical link between mills that manufacture large volumes of hardwood lumber and sheet goods, and industrial customers that require smaller quantities of many different hardwood products for their own manufacturing processes. We provide a means for hundreds of hardwood mills to get their product to thousands of small-to-mid-sized industrial manufacturers. We add value to our suppliers by buying their product in volume and paying them promptly, effectively acting as their third-party sales force. We add value for our customers by providing them with the materials they need on a just-in-time basis, in smaller quantities and offering a wider range of product selection than the customer would be able to purchase directly from an individual mill. We also provide an important source of financing for our customers by allowing them to buy material from us on approved credit.



We are one of the largest distributors of hardwood lumber and sheet goods in North America. We are larger than most of our suppliers, customers, and direct competitors. 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.



As shown in the map above, we operate 26 distribution centres organized into nine regions, providing geographic coverage in 14 states and 5 provinces across the US and Canada. To maximize inventory management, we operate utilizing a hub-and-spoke distribution system. Our major hub distribution centres hold the bulk of our inventory, and make regular truck transfers to replenish stock in satellite distribution centres that are located in smaller markets. We operate using a low capital expenditure model. We lease all of our facilities, utilize third-party freight providers for all our product shipping needs, and focus strictly on wholesale distribution.

The North American economy recently experienced a significant economic downturn, particularly in housing and construction, which are key markets for the hardwoods products that we distribute. This reduction in hardwood demand reduced our sales and financial performance in 2008 and 2009. A partial recovery in our sales and earnings was achieved in 2010 and in the first six months of 2011, despite the fact that current levels of housing and construction activity in North America are low relative to expected longer-term population and housing trends. We believe when a sustained economic recovery takes hold prospects for our industry are attractive.

To Our Shareholders

We are pleased to present financial results for the Hardwoods Distribution Income Fund (the “Fund”) for the three and six month periods ended June 30, 2011. During these periods, the Fund held an 80% interest in the Business.

Corporate Conversion

Subsequent to the end of the second quarter, the Fund was converted to a publicly traded corporation named Hardwoods Distribution Inc. (“HDI”). As part of that process, Unitholders of the Fund exchanged their units for common shares of Hardwoods Distribution Inc. on a one-for-one basis. Concurrently, HDI acquired the remaining 20% interest in the Business that the Fund did not previously own, and the Fund was wound up into HDI. Hardwoods Distribution Inc. now owns 100% of the Business, and trades on the Toronto Stock Exchange under the symbol HWD.

Financial Performance

Our sales results continued to strengthen during the three and six months ended June 30, 2011 as we implemented our market-expansion strategy. The addition of experienced sales reps in targeted markets, our increased emphasis on the commercial and institutional markets, and successful leveraging of our import program were key factors in the 8.6% and 8.0% year-over-year increase in sales for the second quarter and first six months of 2011 respectively.

We view these gains as significant given the negative impact of a stronger Canadian dollar and continued weakness in the US residential construction market. While new housing starts increased to a seasonally adjusted rate of 629,000 units in June according the US Census Bureau, this is still roughly half the 1.2 million homes per year that economists say must be built to reflect a long term sustainable housing market. Lumber product pricing also remained flat, although we were able to capitalize on slightly stronger prices for sheet goods with increased volumes of imported products.

Our higher sales translated into stronger bottom-line results compared to the same period last year. Second-quarter gross profit increased by 8.2% to \$10.1 million, EBITDA was up 6.5% to \$2.5 million, profit for the period improved 1.1% to \$1.5 million, and we achieved Distributable Cash of 13 cents per unit compared to 11.7 cents per unit in the second quarter last year. This was despite a slight reduction in gross margin percentage and an increase in operating expense. Our

margins continued to be constrained by a combination of weak market demand and strong competition, but remained in line with our expectations for this point in the market cycle.

The higher operating costs reflect increased staffing to support sales growth and non-recurring expenses related to our recent conversion to a corporation. The increase in six-month operating costs also reflects the absence of a one-time \$0.3 million recovery from a lawsuit settlement that helped our 2010 first half results. Factoring out the impact of these unusual items, our second quarter and year-to-date Distributable Cash performance would have improved by 25% in both periods. Based on this performance, our Board of Directors has declared a quarterly dividend of \$0.02 per share to be paid on October 31, 2011 to shareholders of record on October 20, 2011.

Enhanced Financing Arrangements

The second quarter also brought the successful renewal of our \$25 million US revolving credit facility for an additional four-year term under more favourable terms, including improved borrowing rates, a more flexible covenant and an enhanced calculation of the borrowing base under the facility.

Looking Ahead

Overall, we are pleased with our achievements and confident in our ability to continue generating improving results going forward, although we caution that market conditions remain challenging. Housing starts remain near historical lows in the US and are expected to moderate this year in Canada. Market competition also remains intense and our results could continue to be negatively affected by the stronger Canadian dollar. We intend to maintain tight control of our business through 2011.

Longer term, we recognize that current levels of housing and construction activity in North America are low relative to expected longer-term population and housing trends. We believe that when a sustained economic recovery takes hold, prospects for our industry will become increasingly attractive. We intend to participate fully in the recovery with both a strong market position and a stable financial position.



Lance R. Blanco
President and Chief Executive Officer

Management's Discussion and Analysis

This management's discussion and analysis ("MD&A") has been prepared by Hardwoods Distribution Inc. ("HDI"), formerly Hardwoods Distribution Income Fund (the "Fund"), as of August 8, 2011. All financial results discussed in this MD&A are those of the Fund. References to future actions or decisions to be taken by the Fund subsequent to its conversion to a corporation should be read as future actions or decisions to be taken by HDI. This MD&A covers the Fund's unaudited interim condensed consolidated financial statements as at and for the three and six-month periods ended June 30, 2011 ("Interim Financial Statements"). As well, it provides an update to the MD&A section contained in the Fund's 2010 Annual Report. The information below should be read in conjunction with the Interim Financial Statements, and the audited consolidated financial statements and accompanying notes of the Fund for the years ended December 31, 2010 and 2009 ("Audited Financial Statements"). Results are reported in Canadian dollars unless otherwise stated, and have been prepared in accordance with International Financial Reporting Standards ("IFRS") applicable to the preparation of interim financial statements, including IAS 34 "Interim Financial Reporting" and IFRS 1 "First Time Adoption of IFRS." For comparative purposes all financial amounts related to the quarters ended March 31, 2010 and June 30, 2010, and for the year ended December 31, 2010, have been restated in accordance with IFRS. All other periods remain unchanged from the numbers originally reported under Canadian generally accepted accounting principles. For additional information, readers should also refer to our Annual Information Form and other information filed on www.sedar.com.

This MD&A includes the following sections:

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Certain statements in this MD&A contain forward-looking information within the meaning of applicable securities laws in Canada (“forward-looking information”). The words “anticipates”, “believes”, “budgets”, “could”, “estimates”, “expects”, “forecasts”, “intends”, “may”, “might”, “plans”, “projects”, “schedule”, “should”, “will”, “would” and similar expressions are often intended to identify forward-looking information, although not all forward-looking information contains these identifying words.

The forward-looking information in this MD&A includes, but is not limited to: our belief that when a sustained economic recovery takes hold prospects for our industry are attractive; our perspective that market competition remains intense and that our results could continue to be negatively affected by the stronger Canadian dollar; our intention to participate fully in any economic recovery with both a strong market position and a stable financial position; that we expect to achieve continued performance improvements in 2011 as we implement our market expansion strategy; our expectation that operating expenses will continue to trend somewhat higher in 2011 as our strategies are implemented and we support increased sales activity; that overall our priorities for the balance of the year remain unchanged with continued focus on executing the strategy while tightly managing the business; that our debt management strategy is to roll and renew (as opposed to repay and retire) our revolving credit facilities in Canada and the US when they expire in August 2012 and May 2015, respectively; that we do not intend to restrict future dividends in order to fully extinguish our bank debt obligations upon their maturity; that the amount of bank debt that will actually be drawn on our available revolving credit facilities will depend upon the seasonal and cyclical needs of the business, and the cash generating capacity of HDI going forward; that when making future dividend decisions for HDI, we will consider the amount of financial leverage, and therefore bank debt, we believe is appropriate given existing and expected market conditions and available business opportunities; and that we do not target a specific financial leverage amount.

The forecasts and projections that make up the forward-looking information are based on assumptions which include, but are not limited to: there are no material exchange rate fluctuations between the Canadian and US dollar that affect our performance; the general state of

the economy does not worsen; we do not lose any key personnel; there are no decreases in the supply of, demand for, or market values of hardwood lumber or sheet goods that harm our business; we do not incur material losses related to credit provided to our customers; our products are not subjected to negative trade outcomes; we are able to sustain our level of sales and EBITDA margins; we are able to grow our business long term and to manage our growth; there is no new competition in our markets that leads to reduced revenues and profitability; we do not become subject to more stringent regulations; importation of products manufactured with hardwood lumber or sheet goods does not increase and replace products manufactured in North America; our management information systems upon which we are dependent are not impaired; our insurance is sufficient to cover losses that may occur as a result of our operations; and, the financial condition and results of operations of our business upon which we are dependent is not impaired.

The forward-looking information is subject to risks, uncertainties and other factors that could cause actual results to differ materially from historical results or results anticipated by the forward-looking information. The factors which could cause results to differ from current expectations include, but are not limited to: exchange rate fluctuations between the Canadian and US dollar could affect our performance; our results are dependent upon the general state of the economy; we depend on key personnel, the loss of which could harm our business; decreases in the supply of, demand for, or market values of hardwood lumber or sheet goods could harm our business; we may incur losses related to credit provided to our customers; our products may be subject to negative trade outcomes; we may not be able to sustain our level of sales or EBITDA margins; we may be unable to grow our business long term to manage any growth; competition in our markets may lead to reduced revenues and profitability; we may become subject to more stringent regulations; importation of products manufactured with hardwood lumber or sheet goods may increase, and replace products manufactured in North America; we are dependent upon our management information systems; our insurance may be insufficient to cover losses that may occur as a result of our operations; we are dependent upon the financial condition and results of operations of our business; our credit facilities affect our liquidity, contain restrictions on our ability to borrow funds, and impose restrictions on distributions that can be made by our operating limited partnerships; our future growth may be restricted by the payout of substantially all of our operating cash flow; and, other risks described in our Annual Information Form and this MD&A.

All forward-looking information in this MD&A is qualified in its entirety by this cautionary statement and, except as may be required by law, we undertake no obligation to revise or update any forward-looking information as a result of new information, future events or otherwise after the date hereof.

In this MD&A, references to “EBITDA” are to earnings before interest, income taxes, depreciation and amortization, where interest is defined as net finance costs as per the Fund’s consolidated statement of comprehensive income. In addition to profit 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.

References to “Distributable Cash” are to net cash provided by operating activities, before changes in non-cash operating working capital and cash income taxes, less capital expenditures, principle payments on finance lease obligation, and contributions to any reserves that the Boards of Directors of our operating entities determine to be reasonable and necessary for the operation of the businesses owned by these entities.

We believe that, in addition to net income or loss, our EBITDA and our Distributable Cash are each a useful supplemental measure of operating performance that may assist investors in assessing their investment in the Fund. Neither EBITDA nor Distributable Cash are earnings measures recognized by IFRS and they do not have a standardized meaning prescribed by IFRS. Investors are cautioned that EBITDA should not replace profit or loss (as determined in accordance with IFRS) as an indicator of our performance, nor should Distributable Cash replace cash flows from operating, investing and financing activities or as a measure of our liquidity and cash flows. Our method of calculating EBITDA and Distributable Cash may differ from the methods used by other issuers. Therefore, our EBITDA and Distributable Cash may not be comparable to similar measures presented by other issuers. For a reconciliation between EBITDA and profit or loss as determined in accordance with IFRS, please refer to the discussion of Results of Operations described in section 3.0 of this report. For a reconciliation between Distributable Cash and net cash provided by operating activities as determined in accordance with IFRS, please refer to the discussion of Distributable Cash and Cash Distributions described in section 4.1 of this report.

We believe that this MD&A has been prepared in all material respects in accordance with recommendations issued by the Canadian Institute of Chartered Accountants (the “CICA”) with respect to “Standardized Distributable Cash in Income Trusts and Other Flow Through Entities”

and National Policy 41-201 of the Canadian Securities Administrators “Income Trusts and Other Indirect Offerings” (collectively, the “Interpretive Guidance”). The Interpretive Guidance provides guidance on standardized preparation and disclosure of distributable cash for income trusts (“Standardized Distributable Cash”). The CICA calculation of Standardized Distributable Cash, which is also a non- IFRS measure, is defined, for the purposes of the Fund, as the periodic cash provided by operating activities as reported in the IFRS financial statements, including the effects of changes in non-cash working capital, less total capital expenditures. For a summary of our Standardized Distributable Cash, please refer to section 4.2 of this report. For reconciliation between Standardized Distributable Cash and our Distributable Cash, please see section 4.2.

1.0 Background

1.1 About the Fund

Until June 30, 2011, the Fund was 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 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 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 were exchangeable into Class A Units provided that the Fund achieved certain objectives. Distributions by the Fund’s operating subsidiaries to the previous owners were subject to subordination arrangements until certain financial tests established at the time of the IPO and described in the Audited Financial Statements were met. As at June 30, 2011, the following units of the Fund were issued and outstanding:

Units	14,604,085
Special Voting Units	3,602,500

Prior to the Fund’s conversion to a corporation discussed in section 1.2 of this report, Hardwoods Distribution Income Fund units traded on the Toronto Stock Exchange under the symbol HWD.UN. The Fund’s performance depended upon the performance of the Business.

1.2 Conversion to Hardwoods Distribution Inc.

Effective July 1, 2011 the Fund converted to a newly formed corporation, Hardwoods Distribution Inc. Pursuant to the conversion, all outstanding units of the Fund held by unitholders were exchanged for common shares of Hardwoods Distribution Inc. on a one-for-one basis. All of the Class B limited partner units in the Fund's operating subsidiaries, which represented a 20% equity interest in Hardwoods and were held by the former owners of the Business, were exchanged for common shares of Hardwoods Distribution Inc. on the basis of 0.3793 common shares per Class B limited partner unit. As a result of these arrangements, Hardwoods Distribution Inc. owns 100% of Hardwoods, whereas previously the Fund owned 80% of the Business, and the Fund has been wound up into HDI. There are 15,970,513 shares of HDI issued and outstanding as at August 8, 2011. Hardwoods Distribution Inc. is listed on the Toronto Stock Exchange and trades under the symbol HWD. Hardwoods Distribution Inc.'s performance depends upon the performance of the Business.

1.3 About our Business and Industry

Serving customers for over 50 years, 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 June 30, 2011 we operated 26 distribution facilities organized into nine geographic regions covering 14 states and 5 provinces throughout North America. To maximize inventory management, we utilize a hub and spoke distribution system, with major hub distribution centres holding the bulk of our inventory and making regular truck transfers to replenish stock in satellite distribution centres that are located in smaller markets. We operate using a low capital expenditure model. We lease all of our facilities and utilize third-party freight providers for all our product shipping needs.

Approximately 40% of our product mix is made up of high-grade hardwood lumber. The balance is made up of sheet goods and other specialty products, including hardwood plywood, and including non-structural sheet goods such as medium-density fiberboard, particleboard and melamine-coated stock. Our sheet goods and lumber are complementary product lines that are key products used by our industrial customers in the manufacture of their end-use products.

Our role in the industry is to provide the critical link between mills that manufacture large volumes of hardwood lumber and sheet goods, and industrial customers that require smaller quantities of many different hardwood products for their own manufacturing processes. We provide a means for hundreds of hardwood mills to get their product to thousands of small-to-

mid-sized industrial manufacturers. We add value to our suppliers by buying their product in volume and paying them promptly, effectively acting as their third-party sales force. We add value for our customers by providing them with the materials they need on a just-in-time basis, in smaller quantities and offering a wider range of product selection than the customer would be able to purchase directly from an individual mill. We also provide an important source of financing for our customers by allowing them to buy material from us on approved credit.

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 at least 50% of our products are used 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, and is milled by hundreds of small mills. 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. More recently, global economic conditions and weaker US housing markets have resulted in supply/demand imbalances and greater variability in product pricing.

The North American economy is currently experiencing a sluggish recovery after a significant economic downturn in housing and construction, which are key markets for the hardwood products that we distribute. However, current levels of housing and construction activity in North America are low relative to expected longer-term population and housing trends, and we believe that when a sustained economic recovery takes hold, prospects for our industry are attractive.

2.0 Overview and Outlook

We achieved continued revenue growth in the second quarter and first half of 2011. In the three and six month periods ended June 30, 2011 sales increased 8.6% and 8.0% respectively, compared to the same periods in 2010, even after taking the negative sales impact of a stronger Canadian dollar into account. Without the exchange impact, our underlying sales improved by 12.7% for the second quarter and by 11.8% for the first half of 2011, with all nine of our geographic regions achieving year-over-year sales gains. This is the fifth consecutive quarter in which we have improved our sales performance compared to the same quarter in the previous year.

Significantly, we achieved these gains in an environment of continued weak market demand. According to the US Census Bureau, the seasonally adjusted annual rate of US residential housing starts was just 629,000 units in at the end of the second quarter, a very low level by historical standards. The recovery in other sectors of the economy also remains slow and hardwood lumber prices have been generally flat through the first half of the year.

Competition among hardwood distributors has also continued to place pressure on pricing and gross profit margins. Our gross margin percentage was 17.8% and 17.6% for the second quarter and first half of 2011 respectively, compared to 17.9% and 17.8% during the same periods last year. As we anticipated, operating expenses increased with one-time costs for our conversion to a corporation and increased investment in support of higher sales adding to our operating expenses. Six-month operating costs also reflect the absence of a one-time \$0.3 million recovery from a lawsuit settlement that helped reduce our 2010 first half expense results.

Despite these challenges, our bottom line results improved in the second quarter with EBITDA up 6.5%, profit increasing by 1.1% and Distributable Cash up 12.7% for the three month period ended June 30, 2011, compared to the same period in the preceding year. After normalizing for the non-recurring expenses, our second quarter and year-to-date Distributable Cash performance would have improved by 25% in both periods, as demonstrated in the following table.

Selected Unaudited Consolidated Financial Information
(in thousands of dollars)

	3 months ended June 30, 2011	3 months ended June 30, 2010	6 months ended June 30, 2011	6 months ended June 30, 2010
Distributable Cash as reported	\$ 2,373	\$ 2,105	\$ 2,910	\$ 3,097
Add (deduct):				
Corporate conversion expenses	271	-	571	-
Proceeds received from litigation settlement	-	-	-	(320)
Adjusted Distributable Cash	<u>\$ 2,644</u>	<u>\$ 2,105</u>	<u>\$ 3,481</u>	<u>\$ 2,777</u>

Based on our improving performance, the Board of Directors has announced a quarterly dividend of \$0.02 per share, payable on October 31, 2011 to shareholders of record on October 31, 2011.

A significant factor in our improving results and our ability to institute a quarterly dividend continues to be our market expansion strategies, comprising:

End-Market Diversification: We are increasing our emphasis on the commercial and institutional construction markets to help offset the slower recovery in the residential construction market. During the second quarter, we continued to build our presence in the commercial and institutional markets with a dedicated sales force and an expanded roster of products.

Leveraging Import Products: We were successful in increasing sales volumes of high-quality imported sheet goods, as well as selling more of our higher-margin specialty products such as EchoWood and O2 Bamboo brands during the second quarter. In total, second quarter import sales grew by 31% compared to the second quarter of 2010. We intend to continue seeking out new products and introducing our import line to a broader range of customers through the balance of 2011.

Focusing on High-Potential Geographic Markets: We made further progress on plans to increase market share in three densely populated geographies where hardwood demand is significant, but where we currently hold a relatively small market share. This is a longer-term component of our strategy, and could eventually include acquisitions in some markets.

To ensure we have the appropriate financing in place, in the second quarter of 2011 we renewed our US\$25 million credit facility in the United States, securing a new four year term under more favourable terms. This, together with our Canadian credit facility, gives us significant unused borrowing capacity to support our market expansion strategies.

Overall, we are pleased with our second quarter achievements and confident in our ability to continue generating improving results going forward, although we caution that market conditions remain challenging.

While US residential construction activity has improved slightly from a year ago, the pace of new housing starts remains at historically low levels. Industrial and commercial construction markets are faring better, but here too, the pace of recovery is slow.

In Canada, industry forecasts continue to call for a slight dip in Canadian housing starts in 2011 compared to 2010. The stronger Canadian dollar is also having a negative impact on the competitiveness of Canadian manufacturers selling finished products into the US, while also reducing HDI's own selling prices for US-sourced lumber and panels.

Despite these challenges, we expect to achieve continued performance improvements in 2011 as we implement our market expansion strategy. Operating expenses are expected to continue trending somewhat higher in 2011 as these strategies are implemented and we support increased sales activity.

Overall, our priorities for the balance of the year remain unchanged with continued focus on executing the strategy while tightly managing the business.

3.0 Results of Operations

3.1 Three Months Ended June 30, 2011 and June 30, 2010

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

	For the three months Ended June 30, 2011	For the three months Ended June 30, 2010
Total sales	\$ 56,718	\$ 52,206
<i>Sales in the US (US\$)</i>	35,450	30,353
<i>Sales in Canada</i>	22,370	20,978
Gross profit	10,085	9,323
<i>Gross profit %</i>	17.8%	17.9%
Operating expenses	(7,762)	(7,252)
Profit from operating activities	2,323	2,071
Add: Depreciation	219	316
Earnings before interest, taxes, depreciation and amortization and non-controlling interest (“EBITDA”)	\$ 2,542	\$ 2,387
Add (deduct):		
Depreciation	(219)	(316)
Net finance income (cost)	(47)	297
Income tax expense	(765)	(873)
Profit for the period	\$ 1,511	\$ 1,495
Basic and fully diluted profit per Class A Unit	\$ 0.10	\$ 0.10
Average Canadian dollar exchange rate for one US dollar	0.968	1.028

Sales

For the three months ended June 30, 2011, total sales increased to \$56.7 million, up 8.6% from \$52.2 million during the same period in 2010. The 8.6% increase in total sales reflects a 12.7% improvement in underlying sales activity, less a 4.1% reduction due to the negative impact of a stronger Canadian dollar on foreign exchange conversion of our US-based sales.

All nine of our operating regions posted year-over-year sales growth to contribute to the 12.7% improvement in underlying sales. Our shift to a market-expansion strategy, including our increased focus on end-market diversification, continued leveraging of our import program, and the selective addition of qualified sales representatives to our staff, contributed to our improved sales performance. Second quarter sales growth was strongest at our US operations, where sales (as measured in US dollars) increased by 16.8%. Sales in Canada, a market which has seen more stable ongoing demand for hardwoods throughout the recent economic downturn, increased by a more modest 6.6%.

Gross Profit

Gross profit for the three months ended June 30, 2011 was \$10.1 million, an increase of \$0.8 million from the \$9.3 million reported in the same period in 2010. The improvement in gross

profit reflects the higher sales, partially offset by a decrease in gross profit as a percentage of sales to 17.8% in the second quarter of 2011, compared to 17.9% in the same period in 2010. We view a gross profit margin of 17.8% as appropriate given competitive conditions at this point in the business cycle. Under normal market conditions, we target a gross profit margin of 18% to 19%.

Operating Expenses

Operating expenses were \$7.8 million in the second quarter of 2011, compared to \$7.3 million during the same period last year, an increase of \$0.5 million. This increase includes \$0.3 million in expenses associated with completion of the conversion of the Fund to a corporation and \$0.5 million in higher people costs to support our sales growth. These cost increases were partially offset by a \$0.3 million positive foreign exchange impact of a stronger Canadian dollar on the conversion of S&A expenses at our US operations. As a percentage of sales, second quarter 2011 operating expenses were 13.7% of sales, compared to 13.9% in 2010.

EBITDA

For the three months ended June 30, 2011, we recorded EBITDA of \$2.5 million, compared to \$2.4 million during the same period in 2010. The increase in EBITDA reflects the \$0.8 million increase in gross profit driven by higher sales, partially offset by the \$0.6 million increase in operating expenses before depreciation.

Net Finance Income (Cost)

For the three months ended June 30, 2011, net finance cost was \$47,000, compared to net finance income of \$0.3 million in the three months ended June 30, 2010. The increase in net finance cost is primarily due to changes in the fair value of the non-controlling interest (“NCI”) liability. The fair value of the NCI decreased by \$28,000 in the second quarter of 2011, compared to a decrease of \$0.3 million in the same period in 2010. In accordance with the accounting policies adopted under IFRS, the NCI is recorded at fair value at each reporting date, with the change in the fair value being recorded in profit and loss during the reporting period. There is no impact on cash flows related to these fair value adjustments.

Income Tax Expense

An income tax expense of \$0.8 million was recorded in the second quarter of 2011, compared to \$0.9 million in the same period in 2010. The income tax expense in both periods primarily reflects the use of future tax assets to offset taxable income generated during the period.

Profit for the Period

Profit for the three months ended June 30, 2011 was \$1.5 million, compared to profit of \$1.5 million in the same period in 2010. The \$0.1 million increase in EBITDA, the \$0.1 million decrease in depreciation, and the \$0.1 million decrease in income tax expense in 2011 were offset by a \$0.3 million increase in net finance costs.

3.2 Six Months Ended June 30, 2011 and June 30, 2010

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

	For the six months Ended June 30, 2011	For the six months Ended June 30, 2010
Total sales	\$ 108,748	\$ 100,704
<i>Sales in the US (US\$)</i>	<i>67,290</i>	<i>58,056</i>
<i>Sales in Canada</i>	<i>43,012</i>	<i>40,663</i>
Gross profit	19,184	17,952
<i>Gross profit %</i>	<i>17.6%</i>	<i>17.8%</i>
Operating expenses	(16,534)	(14,971)
Profit from operating activities	2,650	2,981
Add: Depreciation	450	646
Earnings before interest, taxes, depreciation and amortization and non-controlling interest ("EBITDA")	\$ 3,100	\$ 3,627
Add (deduct):		
Depreciation	(450)	(646)
Net finance income (cost)	(782)	171
Income tax expense	(1,058)	(1,088)
Profit for the period	\$ 810	\$ 2,064
Basic and fully diluted profit per Class A Unit	\$ 0.06	\$ 0.14
Average Canadian dollar exchange rate for one US dollar	0.977	1.034

Sales

For the six months ended June 30, 2011, total sales increased to \$108.7 million, from \$100.7 million in the first half of 2010. The 8.0% increase reflects an 11.8% increase in underlying sales activity as a result of strategy implementation (discussed in section 2.0 of this report) and stronger prices for sheet goods, partially offset by a 3.8% decrease in sales due to the negative impact of a stronger Canadian dollar. First-half sales activity at our US operations, as measured in US dollars, increased 15.9% year-over-year. Sales in Canada were up by a more

modest 5.8%, reflecting the negative impact of the stronger Canadian dollar on product prices and on demand from Canadian manufacturing customers exporting to the US.

Gross Profit

First-half gross profit increased to \$19.2 million, from \$18.0 million in the first six months of 2010. The increase in gross profit reflects higher sales, partially offset by slightly lower gross profit margins. As a percentage of sales, gross profit was 17.6% in the first half of 2011, compared to 17.8% during the same period in 2010.

Operating Expenses

Operating expenses increased \$1.5 million to \$16.5 million in the first six months of 2011, from \$15.0 million during the same period in 2010. The increase in operating expenses in the most recent period reflects a \$1.4 million increase in personnel costs to support higher sales, \$0.6 million in costs related to our conversion to a corporation, and a \$0.3 million litigation expense recovery that was received in the first six months of 2010 and was not repeated in the 2011 period. These cost increases were partially offset by \$0.3 million reduction in premises expenses due to fewer branches, sublets, and favourable lease rate renewals, and a \$0.5 million reduction attributable to the positive impact of the stronger Canadian dollar on the conversion of expenses at our US operations. As a percentage of sales, first-half operating expenses were 15.2% of sales, compared to 14.9% in 2010.

EBITDA

For the six months ended June 30, 2011, we recorded EBITDA of \$3.1 million, compared to \$3.6 million during the same period in 2010. The \$0.5 million decrease in EBITDA reflects the \$1.7 million increase in operating expenses before depreciation, partially offset by the \$1.2 million increase in gross profit.

Net Finance Income (Cost)

Net finance cost was \$0.8 million for the six months ended June 30, 2011, compared to net finance income of \$0.2 million in the same period in 2010. The \$1.0 million increase in net finance expense was primarily due to \$0.8 million in changes in the fair value of the non-controlling interest liability. The fair value of the NCI increased by \$0.5 million in the first half of 2011, compared to a decrease of \$0.3 million in the same period in 2010. In accordance with the accounting policies adopted under IFRS the non-controlling interest is recorded at fair value at each reporting date, with the change in fair value being recorded in profit or loss during the reporting period. There is no impact on cash flows related to these fair value adjustments.

Previously under Canadian GAAP the non-controlling interest was allocated its share of profit or loss.

Income Tax Expense

An income tax expense of \$1.1 million was recorded in the first six months of 2011 as well as in the same period in 2010. The income tax expense in both periods primarily reflects the use of future tax assets to offset taxable income generated during the period.

Profit for the Period

Profit for the six months ended June 30, 2011 was \$0.8 million, compared to profit of \$2.1 million in 2010. The \$1.3 million reduction in profit primarily reflects the \$0.5 million decrease in EBITDA and the \$1.0 million increase in net finance expense, partially offset by a \$0.2 million decrease in depreciation expense.

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)

	Three months ended June 30, <u>2011</u>	Three months ended June 30, <u>2010</u>	Six months ended June 30, <u>2011</u>	Six months ended June 30, <u>2010</u>
Net cash provided by (used in) operating activities	\$ (2,862)	\$ (3,318)	(2,034)	\$ (6,897)
Increase (decrease) in non-cash operating working capital and income taxes paid / received	5,498	5,638	5,417	10,435
	<u>2,636</u>	<u>2,320</u>	<u>3,383</u>	<u>3,538</u>
Principal repayments on finance lease obligation	(175)	(192)	(343)	(387)
Capital expenditures	(88)	(23)	(130)	(54)
Distributable Cash	<u>\$ 2,373</u>	<u>\$ 2,105</u>	<u>\$ 2,910</u>	<u>\$ 3,097</u>
Distributions relating to the period:				
Class A Units	\$ -	\$ -	\$ -	\$ -
Class B Units ⁽¹⁾	-	-	-	-
Total Units	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>
Weighted average outstanding units and per unit amounts:				
Class A Units outstanding	14,604,085	14,410,000	14,563,972	14,410,000
Class B Units outstanding	3,602,500	3,602,500	3,602,500	3,602,500
Total Units outstanding	<u>18,206,585</u>	<u>18,012,500</u>	<u>18,166,472</u>	<u>18,012,500</u>
Distributable Cash per Total Units	\$ 0.130	\$ 0.117	\$ 0.160	\$ 0.172
Distributions relating to the period:				
Class A Units	\$ -	\$ -	\$ -	\$ -
Class B Units ⁽¹⁾	\$ -	\$ -	\$ -	\$ -
Total Units	\$ -	\$ -	\$ -	\$ -
Payout ratio ⁽²⁾	0.0%	0.0%	0.0%	0.0%
March 23, 2004 to June 30, <u>2011</u>				
Cumulative since inception:				
Distributable Cash	82,545 ⁽³⁾			
Distributions relating to the period	66,754			
Payout ratio ⁽²⁾	80.9%			

¹ On January 10, 2006, Hardwoods Specialty Products LP and Hardwoods Specialty Products US LP, limited partnerships in each of which the Fund owns an 80% interest, announced that quarterly distributions were suspended on 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 Hardwoods Specialty Products LP and Hardwoods Specialty Products US LP, respectively. No distributions are to be paid on the Class B LP units and Class B US LP units unless distributions in stipulated minimum amounts are paid on the units in the limited partnerships held by the Fund, and in certain other circumstances. Accordingly, no distributions have been declared since the third quarter of 2005 to the non-controlling interests. No liability for distributions payable to the non-controlling interests is reflected in the June 30, 2011 balance sheet.

² Payout ratio measures the ratio of distributions by the Fund relating to the period to Distributable Cash for the period.

³ Information for Q1 2010, Q2 2010, Q1 2011, and Q2 2011 are in accordance with IFRS. All other periods are in accordance with Canadian GAAP.

During the three months ended June 30, 2011, the Fund and its subsidiaries generated total Distributable Cash available to Class A and Class B Unitholders of \$2.4 million, or \$0.130 per unit. During the six months June 30, 2011 the Fund and its subsidiaries generated total Distributable Cash available to Class A and Class B Unitholders of \$2.9 million, or \$0.160 per unit. No distributions were made during either period.

On November 3, 2008, the Trustees of the Fund suspended monthly cash distributions until such time as market conditions strengthened and the Fund's financial performance stabilized. Since its initial public offering on March 23, 2004, the Fund has paid \$66.8 million in distributions,

representing 80.9% of Distributable Cash generated since its inception. More recently, in the last four quarters the Fund has generated \$4.0 million in Distributable Cash. Based on this performance, our Board of Directors has declared a quarterly dividend of \$0.02 per HDI share to be paid on October 31, 2011 to shareholders of record on October 20, 2011.

4.2 Standardized Distributable Cash and Cash Distributions

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

	Three months ended June 30, <u>2011</u>	Three months ended June 30, <u>2010</u>	Six months ended June 30, <u>2011</u>	Six months ended June 30, <u>2010</u>
Net cash provided by (used in) operating activities	\$ (2,862)	\$ (3,318)	\$ (2,034)	\$ (6,897)
Capital expenditures	(88)	(23)	(130)	(54)
Standardized Distributable Cash	<u>\$ (2,950)</u>	<u>\$ (3,341)</u>	<u>\$ (2,164)</u>	<u>\$ (6,951)</u>
Distributions relating to the period:				
Class A Units	\$ -	\$ -	\$ -	\$ -
Class B Units ⁽¹⁾	-	-	-	-
Total Units	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>
Weighted average outstanding units and per unit amounts:				
Class A Units outstanding	14,604,085	14,410,000	14,563,972	14,410,000
Class B Units outstanding	<u>3,602,500</u>	<u>3,602,500</u>	<u>3,602,500</u>	<u>3,602,500</u>
Total Units outstanding	<u>18,206,585</u>	<u>18,012,500</u>	<u>18,166,472</u>	<u>18,012,500</u>
Standardized Distributable Cash per Total Units	\$ (0.162)	\$ (0.185)	\$ (0.119)	\$ (0.386)
Distributions per Total Units	\$ -	\$ -	\$ -	\$ -
Standardized payout ratio ⁽²⁾	0.0%	0.0%	0.0%	0.0%
March 23, 2004 to June 30, <u>2011</u>				
Cumulative since inception:				
Standardized Distributable Cash	87,965 ⁽³⁾			
Distributions relating to the period	66,754			
Standardized Payout ratio ⁽²⁾	75.9%			

¹ On January 10, 2006, Hardwoods Specialty Products LP and Hardwoods Specialty Products US LP, limited partnerships in each of which the Fund owns an 80% interest, announced that quarterly distributions were suspended on 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 Hardwoods Specialty Products LP and Hardwoods Specialty Products US LP, respectively. No distributions are to be paid on the Class B LP units and Class B US LP units unless distributions in stipulated minimum amounts are paid on the units in the limited partnerships held by the Fund, and in certain other circumstances. Accordingly, no distributions have been declared since the third quarter of 2005 to the non-controlling interests. No liability for distributions payable to the non-controlling interests is reflected in the June 30, 2011 balance sheet.

² Payout ratio measures the ratio of distributions by the Fund relating to the period to Standardized Distributable Cash for the period.

³ Information for Q1 2010, Q2 2010, Q1 2011, and Q2 2011 are in accordance with IFRS. All other periods are in accordance with Canadian GAAP.

In addition to our Distributable Cash, the Interpretive Guidance also recommends disclosure of Standardized Distributable Cash. This is provided in the table above. We believe that the calculation of Standardized Distributable Cash distorts the Fund's quarter-to-quarter distributable cash and payout ratios, as our non-cash operating working capital fluctuates significantly as a result of the seasonality of our business and significant changes in market demand for our products. The board of directors of our operating entities looks beyond quarter-to-quarter

fluctuations in working capital when making decisions regarding monthly distributions. The definition of Standardized Distributable Cash also does not include principle payments on finance lease obligations, which in the case of the Fund is monthly auto lease expense. As a result, we believe that our historical measure of Distributable Cash is a better measure for determining our operating performance.

The table below reconciles Standardized Distributable Cash to our Distributable Cash.

Selected Unaudited Consolidated Financial Information
(in thousands of dollars)

	Three months ended June 30, <u>2011</u>	Three months ended June 30, <u>2010</u>	Six months ended June 30, <u>2011</u>	Six months ended June 30, <u>2010</u>
Standardized Distributable Cash	\$ (2,950)	\$ (3,341)	\$ (2,164)	\$ (6,951)
Increase in non-cash operating working capital and income taxes paid / received	5,498	5,638	5,417	10,435
Principal repayments on finance lease obligation	<u>(175)</u>	<u>(192)</u>	<u>(343)</u>	<u>(387)</u>
Distributable Cash	<u>\$ 2,373</u>	<u>\$ 2,105</u>	<u>\$ 2,910</u>	<u>\$ 3,097</u>

4.3 Working Capital

Our business requires an ongoing investment in working capital, comprised of accounts receivable, income taxes recoverable, inventory, and prepaid expenses, partially offset by short-term credit provided by suppliers in the form of accounts payable and accrued liabilities. Our investment in working capital fluctuates from quarter-to-quarter based on factors such as seasonal sales demand, strategic purchasing decisions taken by management, and the timing of collections from customers and payments made to our suppliers. Historically the first and fourth quarters are seasonally slower periods for construction activity and therefore demand for hardwood products decreases. As a result, sales and working capital requirements may be lower in these quarters. A summary of changes in our non-cash operating working capital during the three and six months ended June 30, 2011 and 2010 is provided below.

(in thousands of Canadian dollars)

Source (use) of funds	Three months ended June 30, <u>2011</u>	Three months ended June <u>30, 2010</u>	Six months ended June <u>30, 2011</u>	Six months ended June <u>30, 2010</u>
Accounts receivable	\$ (2,769)	\$ (938)	\$ (8,269)	\$ (6,235)
Income taxes (paid) received	(54)	293	1,742	234
Inventory	(2,510)	(4,798)	(1,702)	(5,286)
Prepaid expenses	47	(186)	190	(11)
Accounts payable and accrued liabilities	(230)	85	2,674	1,052
Provisions	18	(94)	(52)	(189)
Increase in non-cash operating working capital	<u>\$ (5,498)</u>	<u>\$ (5,638)</u>	<u>\$ (5,417)</u>	<u>\$ (10,435)</u>

Continued compliance with financial covenants under our credit facilities is important to ensure that we maintain adequate availability of financing to meet our working capital requirements. The terms of our revolving credit facilities are addressed in section 4.6 of this report.

4.4 Capital Expenditures and Productive Capacity

Our capital expenditures are typically low as we lease all of our buildings and contract out all freight delivery services. Capital expenditures are principally for the replacement of forklifts, furniture and fixtures, leasehold improvements and computer equipment. Between 2007 and 2010 we closed a total of 10 branch locations in response to weak economic conditions. These closures have freed up additional forklift capacity and reduced our need to purchase replacement forklift equipment. We also generally decreased our discretionary cash outlays for capital items during this period as we shifted our focus to cost reduction and cash conservation. As a result, our total capital expenditures amounted to just \$74,000 in 2010, and were \$130,000 in the first half of 2011. The Fund's subsidiaries also lease automobiles for the use of its outside sales representatives and certain managers. For the six months ended June 30, 2011 principle payments on automobile finance lease obligation was \$0.3 million (2010 - \$0.4 million). Despite the reduced spending on capital expenditures, we believe we have made sufficient expenditures to sustain productive capacity of our business as it relates to our needs for property, plant and equipment.

In addition to maintaining the productive capacity of our property, plant and equipment, we also manage the productive capacity of our business in terms of: (1) available distribution infrastructure; and (2) maintenance of a skilled work force.

Available distribution infrastructure refers to the physical capacity of the distribution network maintained by our business, and may be measured in terms of the number and total square footage of distribution centres in operation. Since the Fund's IPO in March 2004, we have made a number of adjustments to our distribution network, including opening, closing, and relocating some of our distribution facilities. In response to the lengthy market downturn, we downsized our distribution infrastructure, closing a total of ten branches between 2007 and 2010. We believe these reductions are appropriate to better match our productive capacity to current market demand.

Selected Unaudited Consolidated Financial Information

	June 30, <u>2011</u>	December 31, <u>2010</u>	December 31, <u>2009</u>	December 31, <u>2008</u>	December 31, <u>2007</u>	December 31, <u>2006</u>
Number of distribution centres in operation	26	26	27	29	36	36
Total square footage of distribution centres	0.9 million s.f.	0.9 million s.f.	1.0 million s.f.	1.1 million s.f.	1.3 million s.f.	1.3 million s.f.

Maintenance of a skilled workforce is also important to managing the productive capacity of our business. Our staffing levels reflect decisions regarding our distribution network and our expectations for sales demand, based upon prevalent economic conditions. Trends in our workforce capacity, as measured in terms of number of employees and average annual sales dollars per employee, are summarized below. Although the productive capacity of our human capital is difficult to measure directly, we believe the productive capacity of our business in terms of our human capital relative to available market demand, as measured by sales, has been largely sustained. As at June 30, 2011, we have added 18 additional employees in the last 18 months to support our sales expansion efforts.

Selected Unaudited Consolidated Financial Information

	June 30, <u>2011</u>	December 31, <u>2010</u>	December 31, <u>2009</u>	December 31, <u>2008</u>	December 31, <u>2007</u>	December 31, <u>2006</u>
Number of employees	177	172	159	190	236	252
Annual sales per employee (\$ millions)	1.2 ⁽¹⁾	1.2	1.2	1.3	1.4	1.4

⁽¹⁾ Six months sales to June, 2011 annualized, divided by number of employees

4.5 Utilization of Distributable Cash

Selected Unaudited Consolidated Financial Information (in thousands of dollars)

	Three months ended June 30, <u>2011</u>	Three months ended June 30, <u>2010</u>	Six months ended June 30, <u>2011</u>	Six months ended June 30, <u>2010</u>
Distributable Cash	\$ 2,373	\$ 2,105	\$ 2,910	\$ 3,097
Cash Distributions paid in the period	-	-	-	-
Distributable Cash retained	<u>\$ 2,373</u>	<u>\$ 2,105</u>	<u>\$ 2,910</u>	<u>\$ 3,097</u>
Increase in non-cash operating working capital and income taxes paid / received	(5,498)	(5,638)	(5,417)	(10,435)
Decrease in long-term receivables	108	270	154	433
Proceeds from disposal of property, plant and equipment	49	87	98	106
Increase in bank indebtedness, net of cash	<u>\$ (2,968)</u>	<u>\$ (3,176)</u>	<u>\$ (2,255)</u>	<u>\$ (6,799)</u>

Our utilization of Distributable Cash and its relation to working capital use and bank line financing are summarized in the preceding table.

For the three months ended June 30, 2011, the Fund generated Distributable Cash of \$2.4 million and paid no cash distributions. We increased our investment in non-cash operating working capital and income taxes by \$5.5 million, primarily as a result of additional inventory and accounts receivable to support our higher sales in the second quarter. We generated \$0.2 million in cash from reducing our investment in long-term receivables and from realizing proceeds from the sale of property, plant and equipment. Combined, these actions increased our bank indebtedness (net of cash) by \$3.0 million in the second quarter of 2011.

For the six months ended June 30, 2011 the Fund generated Distributable Cash of \$2.9 million and made no cash distributions during the period. We increased our non-cash operating working

capital by \$5.4 million, decreased our investment in long-term receivables by \$0.2 million, and realized \$0.1 million in cash from disposal of property, plant and equipment. Taking these factors together, the Fund increased its bank indebtedness (net of cash) by \$2.3 million in the first six months of 2011.

4.6 Revolving Credit Facilities and Debt Management Strategy

Selected Unaudited Consolidated Financial Information (in thousands of dollars)

	<u>As at June 30, 2011</u>	<u>As at December 31, 2010</u>
Cash and cash equivalents	\$ (29)	\$ (43)
Bank indebtedness	8,886	6,745
Net Debt	\$ 8,857	\$ 6,702
Fund unit liability	144,588	144,366
Net deficit attributable to Unitholders	(83,764)	(83,557)
Total Capitalization	\$ 69,681	\$ 67,511
Net debt to total capitalization	12.7%	9.9%

The Fund considers its capital to be bank indebtedness (net of cash) and the Fund unit liability, less the net deficit attributable to Unitholders. As discussed previously in section 4.5 of this report, we increased our net debt by \$2.3 million during the six months ended June 30, 2011. The impact of a stronger Canadian dollar (as at June 30, 2011 compared to December 31, 2010) on the conversion of our US dollar bank line reduced our debt by a \$0.1 million. Combined, the Fund's net debt balance increased by \$2.2 million to \$8.9 million at June 30, 2011, from \$6.7 million at December 31, 2010. Overall net debt compared to total capitalization stood at 12.7% as of June 30, 2011, compared to 9.9% at December 31, 2010.

We have independent credit facilities in both Canada and the U.S. These facilities may be drawn down to meet short-term financing requirements such as fluctuations in non-cash working capital, and in the case of the Canadian credit facility to also make capital contributions to the Fund's US operating subsidiary. The amount made available under our Canadian and US revolving credit facilities is, from time-to-time, limited to the extent of the value of certain accounts receivable and inventories held by subsidiaries of the Fund. Credit facilities also require ongoing compliance with certain credit ratios. A summary of our credit facilities at June 30, 2011 is provided in the following table. In the second quarter of 2011 we renewed our US credit facility which provides our US operating subsidiary with committed revolving credit extending to May 26, 2015.

Selected Unaudited Consolidated Financial Information (in thousands of dollars)

	Canadian Credit Facility	US Credit Facility
Maximum borrowings under credit facility	\$15 million	\$24.1 million (US\$25 million)
Credit facility expiry date	August 7, 2012	May 26, 2015
Available to borrow	\$14.1 million	\$ 22.5 million (US\$23.3 million)
Credit facility borrowings	<u>\$ 0.0 million</u>	<u>\$ 7.1 million (US\$ 7.4 million)</u>
Unused credit facility available	<u><u>\$14.1 million</u></u>	<u><u>\$ 15.4 million (US\$ 15.9 million)</u></u>
Financial covenants:		
a. (EBITDA - Cash Taxes - Capital Expenditures) / Interest ⁽¹⁾		
Covenant minimum	1.1	
Covenant actual	11.4	
b. Fixed charge coverage ratio of 1.0 to 1 (EBITDA less cash taxes less capital expenditure, divided by interest plus distributions)		Covenant does not apply when the unused credit facility available exceeds US\$2.5million, which it did as at June 30, 2011

¹ EBITDA and Interest calculated on a trailing twelve month basis in accordance with the terms of the Canadian credit facility.

The principal terms of the credit facilities of Hardwoods LP and Hardwoods US LP are available at www.sedar.com.

The terms of the agreements with our lenders provide that distributions cannot be made to our unitholders in the event that our subsidiaries are not compliant with their financial covenants. As shown in the preceding table, our operating subsidiaries were compliant with all required credit ratios as at June 30, 2011, and accordingly there were no restrictions on distributions arising from non-compliance with financial covenants.

Our debt management strategy is to roll and renew (as opposed to repay and retire) our revolving credit facilities in Canada and the US when they expire in August 2012 and May 2015, respectively. We do not intend to restrict future dividends in order to fully extinguish our bank debt obligations upon their maturity. The amount of bank debt that will actually be drawn on our available revolving credit facilities will depend upon the seasonal and cyclical needs of the business, and the cash generating capacity of HDI going forward. When making future dividend decisions for HDI, we will consider the amount of financial leverage, and therefore bank debt, we believe is appropriate given existing and expected market conditions and available business opportunities. We do not target a specific financial leverage amount.

4.7 Contractual Obligations

The table below sets forth our contractual obligations as at June 30, 2011. These obligations relate to leases on various premises and automobiles, and become due in the fiscal years indicated.

(in thousands of Canadian dollars)

	Total	2011	2012	2013	2014	2015	2016 and thereafter
\$	15,476	\$ 2,717	\$ 4,647	\$ 3,651	\$ 2,755	\$ 1,416	\$ 290

4.8 Off-Balance Sheet Arrangements

The Fund has no off-balance sheet arrangements.

5.0 Related Party Transactions

Related parties refers to affiliates of the previous owners of the Business who retained a 20% interest in Hardwoods through ownership of Class B Hardwoods LP units and Class B Hardwoods USLP units, respectively. For the three months ended June 30, 2011, sales of \$0.1 million were made to related parties, and the subsidiaries of the Fund purchased \$41,000 from related parties. For the six months ended June 30, 2011, sales of \$0.1 million were made to related parties, and the subsidiaries of the Fund purchased \$67,000 from related parties. These sales and purchases took place at prevailing market prices.

6.0 Critical Accounting Estimates and Adoption of Changes in Accounting Policies

6.1 Critical Accounting Estimates

The preparation of financial statements in accordance with IFRS 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.

Deferred income Taxes: We are required to make estimates and assumptions regarding future business results, as well as the amount and timing of certain future discretionary tax deductions available to the Fund. These estimates and assumptions can have a material impact upon the amount of deferred income tax assets and liabilities that we recognize.

Fair Value of Non-Controlling Interest: We are required to estimate the fair value of the non-controlling interest liability at each reporting date. Estimating the value of the non-controlling interest requires significant judgment, and we consider, amongst other things, the value of Fund Units as traded on the Toronto Stock Exchange, and the relative economic interests of non-controlling interests compared with Fund Units, including the terms of the subordination arrangements with the non-controlling interest which are more fully described in the notes to the Interim Financial Statements. As the changes in fair value determined at each reporting date are recorded in profit or loss for the period, our estimates of fair value may have a material impact upon our reported profit or loss.

6.2 Adoption of New Accounting Standards

Effective January 1, 2011 Canadian publicly listed entities were required to prepare their financial statements in accordance with IFRS. Due to the requirement to present comparative financial information, the effective transition date is January 1, 2010. The three-month period ended March 31, 2011 was the Fund's first reporting period under IFRS. Full disclosure of the Fund's accounting policies in accordance with IFRS can be found in Notes 2 and 3 to those financial statements. Those financial statements also include reconciliations of the previously disclosed comparative periods financial statements prepared in accordance with Canadian generally accepted accounting principles to IFRS as set out in Note 20 to those financial statements.

We note that the standard-setting bodies that determine IFRS have significant ongoing projects that could impact the IFRS accounting policies that we have selected. The impact of any new IFRS standards or interpretations will be evaluated as they are drafted and published. New standards and interpretations that have been identified but have yet to be adopted are:

IFRS 9 - Financial Instruments

In November 2009, the IASB issued IFRS 9 - *Financial Instruments*, which is the first step in its project to replace IAS 39 - *Financial Instruments: Recognition and Measurement*. IFRS 9 establishes the measurement and classification of financial assets. Under IFRS 9, financial assets are measured either at fair value through earnings or at amortized cost if certain conditions are met. The effective date of this standard is January 1, 2013, but early adoption is permitted. HDI will apply this standard to its financial statements beginning on January 1, 2013. HDI is currently evaluating the impact of IFRS 9 on its financial statements.

IFRS 10 – Consolidated Financial Statements

In May 2011, the IASB issued IFRS 10 – *Consolidated Financial Statements*. The objective of IFRS 10 is to establish principles for the presentation and preparation of consolidated financial statements when an entity controls one or more other entities. The effective date of this standard is January 1, 2013, but early adoption is permitted. HDI will apply this standard to its financial statements beginning on January 1, 2013. The adoption of IFRS 10 is not expected to have a significant impact on HDI's consolidated financial statements.

IFRS 12 – Disclosure of Interests in Other Entities

In May 2011, the IASB issued IFRS 12 – *Disclosure of Interests in Other Entities*. The objective of IFRS 12 is to require the disclosure of information that enables users of financial statements to evaluate the nature of, and risks associated with, its interests in other entities and the effects of those interests on its financial position, financial performance and cash flows. The effective date of this standard is January 1, 2013, but early adoption is permitted. HDI will apply this standard to its financial statements beginning on January 1, 2013. HDI is currently evaluating the impact of IFRS 13 on its financial statements.

IFRS 13 – Fair Value Measurement

In May 2011, the IASB issued IFRS 13 – *Fair Value Measurement*. The objective of IFRS 13 is to define fair value, set out in a single IFRS framework for measuring fair value, and establish disclosure requirements regarding fair value measurements. The effective date of this standard is January 1, 2013, but early adoption is permitted. HDI will apply this standard to its financial statements beginning on January 1, 2013. HDI is currently evaluating the impact of IFRS 13 on its financial statements.

7.0 Risks and Uncertainties

We are exposed to a number of risks and uncertainties in the normal course of business that could have a negative effect on our financial condition or results of operations. We identified significant risks that we were aware of in our Annual Information Form dated March 24, 2010, and in our Information Circular and Proxy Statement dated April 15, 2011 relating to the proposed plan of arrangement to convert the Fund to a corporate structure, which are available to readers at www.sedar.com.

8.0 Internal Control Over Financial Reporting

Our management is responsible for establishing and maintaining adequate internal control over financial reporting. Any system of internal control over financial reporting, no matter how well designed, has inherent limitations. Therefore, even those systems determined to be effective can provide only reasonable assurance with respect to financial statement preparation and presentation. There have been no changes in our internal control over financial reporting during the quarter ended June 30, 2011 that have materially affected, or are reasonably likely to materially affect, internal control over financial reporting.

9.0 Quarterly Financial Information

(in thousands of dollars)	Q2 <u>2011</u>		Q1 <u>2011</u>		Q4 <u>2010⁽¹⁾</u>		Q3 <u>2010⁽¹⁾</u>		Q2 <u>2010</u>		Q1 <u>2010</u>		Q4 <u>2009⁽¹⁾</u>		Q3 <u>2009⁽¹⁾</u>	
Total sales	\$	56,718	\$	52,030	\$	46,392	\$	50,559	\$	52,206	\$	48,498	\$	41,577	\$	46,435
Net earnings	\$	1,511	\$	(701)	\$	(543)	\$	263	\$	1,495	\$	569	\$	(544)	\$	(11,072)
Basic and fully diluted earnings (loss) per Class A Unit	\$	0.10	\$	(0.05)	\$	(0.04)	\$	0.02	\$	0.10	\$	0.04	\$	(0.04)	\$	(0.77)
EBITDA	\$	2,542	\$	558	\$	(317)	\$	1,391	\$	2,387	\$	1,240	\$	(2,421)	\$	543
Distributable Cash	\$	2,373	\$	537	\$	(199)	\$	1,259	\$	2,105	\$	992	\$	(505)	\$	230
Total distributions to Class A and Class B Units	\$	-	\$	-	\$	-	\$	-	\$	-	\$	-	\$	-	\$	-
Payout ratio		0.0%		0.0%		0.0%		0.0%		0.0%		0.0%		0.0%		0.0%

¹ Information for 2009, and the third and fourth quarters of 2010, is presented in accordance with Canadian GAAP and has not been restated in accordance with IFRS.

The preceding table provides selected quarterly financial information for our eight most recently completed fiscal quarters. 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 an indication of future performance. Historically, the first and fourth quarters 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 and write-downs, in the carrying value of deferred income tax assets (which occurred in the three months ended September 30, 2009), and changes in the fair value of the non-controlling interest liability.

HARDWOODS DISTRIBUTION INCOME FUND

Unaudited Condensed Consolidated Interim Statement of Financial Position
(Expressed in thousands of Canadian dollars)

	Note	June 30, 2011	December 31, 2010
Assets			
Current assets:			
Cash		\$ 29	\$ 43
Accounts receivable	6	34,366	26,656
Income taxes recoverable		8	1,820
Inventories	7	28,595	27,441
Prepaid expenses		566	768
Total current assets		63,564	56,728
Non-current assets:			
Long-term receivables	6	1,326	1,515
Property, plant and equipment	8	2,517	2,444
Deferred income taxes		14,202	15,463
Total non-current assets		18,045	19,422
Total assets		\$ 81,609	\$ 76,150

Liabilities

Current liabilities:			
Bank indebtedness	9	\$ 8,886	\$ 6,745
Accounts payable and accrued liabilities		5,672	3,098
Income taxes payable		20	41
Provisions	10	428	301
Finance lease obligation	11	824	733
Total current liabilities		15,830	10,918
Non-current liabilities:			
Provisions	10	49	240
Finance lease obligation	11	726	722
Non-controlling interests	12	3,744	3,197
Long term incentive plan liability	13(b)	436	264
Fund Units	13(a)	144,588	144,366
Total non-current liabilities		149,543	148,789
Total liabilities		165,373	159,707

Net Deficit Attributable to Unitholders

Deficit		(80,810)	(81,620)
Accumulated other comprehensive loss		(2,954)	(1,937)
Net deficit attributable to unitholders		(83,764)	(83,557)
Total net deficit attributable to unitholders and liabilities		\$ 81,609	\$ 76,150

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

Approved on behalf of the Trustees:

(Signed) GRAHAM M. WILSON Trustee

(Signed) TERRY M. HOLLAND Trustee

HARDWOODS DISTRIBUTION INCOME FUND

Unaudited Condensed Consolidated Statement of Comprehensive Income (Loss)
(Expressed in thousands of Canadian dollars)

Three and six month periods ended June 30, 2011 and 2010

	Note	Three months ended June 30, 2011	Three months ended June 30, 2010	Six months ended June 30, 2011	Six months ended June 30, 2010
Sales		\$ 56,718	\$ 52,206	\$ 108,748	\$ 100,704
Cost of sales		(46,633)	(42,883)	(89,564)	(82,752)
Gross profit		10,085	9,323	19,184	17,952
Operating expenses:					
Selling and distribution		(5,960)	(5,600)	(12,427)	(11,867)
Administration		(1,531)	(1,652)	(3,536)	(3,424)
Other		(271)	-	(571)	320
		(7,762)	(7,252)	(16,534)	(14,971)
Profit from operating activities		2,323	2,071	2,650	2,981
Finance expense	15	(210)	(252)	(1,049)	(458)
Finance income	15	163	549	267	629
Net finance costs		(47)	297	(782)	171
Profit before income taxes		2,276	2,368	1,868	3,152
Income tax expense:					
Current	14	(22)	(108)	(35)	(134)
Deferred	14	(743)	(765)	(1,023)	(954)
		(765)	(873)	(1,058)	(1,088)
Profit for the period		1,511	1,495	810	2,064
Other comprehensive income (loss):					
Exchange differences translating foreign operations		(316)	1,710	(1,017)	466
Total comprehensive income (loss) for the period		\$ 1,195	\$ 3,205	\$ (207)	\$ 2,530
Basic and diluted profit per Unit		\$ 0.10	\$ 0.10	\$ 0.06	\$ 0.14

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

HARDWOODS DISTRIBUTION INCOME FUND

Unaudited Condensed Consolidated Statement of Changes in Net Deficit Attributable to Unitholders
(Expressed in thousands of Canadian dollars)

Three and six month periods ended June 30, 2011 and 2010

	Accumulated other comprehensive income- translation reserve	Deficit	Total net assets (deficit) attributable to unitholders
Balance at January 1, 2010	\$ -	\$ (82,557)	\$ (82,557)
Profit for the period	-	2,064	2,064
Translation of foreign operations	466	-	466
Balance at June 30, 2010	\$ 466	\$ (80,493)	\$ (80,027)
Balance at January 1, 2011	(1,937)	(81,620)	(83,557)
Profit for the period	-	810	810
Translation of foreign operations	(1,017)	-	(1,017)
Balance at June 30, 2011	\$ (2,954)	\$ (80,810)	\$ (83,764)

The accompanying notes are an integral part of the condensed consolidated interim financial statements.

HARDWOODS DISTRIBUTION INCOME FUND

Unaudited Condensed Consolidated Statement of Cash Flows
(Expressed in thousands of Canadian dollars)

Three and six month periods ended June 30, 2011 and 2010

	Note	Three months ended June 30, 2011	Three months ended June 30, 2010	Six months ended June 30, 2011	Six months ended June 30, 2010
Cash flows from operating activities:					
Profit for the period		\$ 1,511	\$ 1,495	\$ 810	\$ 2,064
Adjustments for:					
Depreciation	8	219	316	450	646
Gain on sale of property, plant and equipment	8	(26)	(49)	(59)	(51)
Non-cash employee incentive program		142	-	394	-
Income tax expense		765	873	1,058	1,088
Net finance costs		47	(297)	782	(171)
Interest received		130	166	258	299
Interest paid		(152)	(184)	(310)	(337)
		2,636	2,320	3,383	3,538
Changes in non-cash working capital:					
Accounts receivable		(2,769)	(938)	(8,269)	(6,235)
Inventories		(2,510)	(4,798)	(1,702)	(5,286)
Prepaid expenses		47	(186)	190	(11)
Provisions		18	(94)	(52)	(189)
Accounts payable and accrued liabilities		(230)	85	2,674	1,052
		(5,444)	(5,931)	(7,159)	(10,669)
Income taxes paid		(54)	(2)	(54)	(61)
Income tax refunds received		-	295	1,796	295
Net cash used in operating activities		(2,862)	(3,318)	(2,034)	(6,897)
Cash flow from financing activities:					
Increase in bank indebtedness		2,809	3,097	2,241	6,452
Principle payments on finance lease obligation		(175)	(192)	(343)	(387)
Net cash provided by financing activities		2,634	2,905	1,898	6,065
Cash flow from investing activities:					
Additions to property, plant and equipment		(88)	(23)	(130)	(54)
Proceeds on disposal of property, plant and equipment		49	87	98	106
Payments received on long-term receivables		108	270	154	433
Net cash provided by investing activities		69	334	122	485
Decrease in cash		(159)	(79)	(14)	(347)
Cash, beginning of period		188	195	43	463
Cash, end of period		\$ 29	\$ 116	\$ 29	\$ 116

The accompanying notes are an integral part of the condensed consolidated interim financial statements.

HARDWOODS DISTRIBUTION INCOME FUND

Notes to Unaudited Condensed Consolidated Interim Financial Statements
(Tabular amounts expressed in thousands of Canadian dollars)

Three and six month periods ended June 30, 2011 and 2010

1. Nature of operations and subsequent events:

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 principal and head office of the Fund is located in Langley, British Columbia. 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.

On May 19, 2011, Unitholders of the Fund approved the reorganization of the Fund into a corporate structure. The conversion was completed by way of a plan of arrangement under the Canada Business Corporations Act (the "Arrangement"). Pursuant to the Arrangement holders of Fund Units received common shares ("Common Shares") of the newly created corporation, Hardwoods Distribution Inc. (the "Corporation"), on a one-for-one basis. Concurrently with the Arrangement, holders of the Special Voting Units of the Fund and corresponding Class B limited partner units of Hardwoods Specialty Products LP and Hardwoods Specialty Products US LP (together the "Exchangeable Units") directly or indirectly exchanged each Exchangeable Unit for 0.3793 Common Shares of the Corporation. Upon completion of the Arrangement, the Corporation holds all the assets previously held by the Fund and wholly owns Hardwoods Specialty Products LP and Hardwoods Specialty Products US LP. The Arrangement will result in the Corporation having 15,970,513 Common Shares issued and outstanding after closing. On July 1, 2011 the Arrangement was completed in accordance with the terms described above.

On August 8, 2011 Hardwoods Distribution Inc. declared a cash dividend of \$0.02 per common share to shareholders of record as of October 20, 2011. The dividend is to be paid to shareholders on October 31, 2011.

2. Basis of preparation:

(a) Statement of compliance:

These condensed consolidated interim financial statements are prepared in accordance with IAS 34, Interim Financial Reporting and thus do not include all of the information required for full annual financial statements. These are the Fund's second condensed consolidated interim financial statements prepared for part of the period covered by the first IFRS annual financial statements and IFRS 1, First Time Adoption of International Financial Reporting Standards ("IFRS 1"), has been applied as of the Fund's transition date of January 1, 2010.

The preparation of these condensed consolidated interim financial statements resulted in changes to the accounting policies adopted by the Fund in its most recent annual financial statements, which were prepared under Canadian generally accepted accounting principals ("GAAP") as issued by the Canadian Institute of Chartered Accountants. An explanation of how the transition to IFRS has affected the reported financial position and financial performance of the Fund is explained in note 20 to these condensed consolidated interim financial statements and note 20 to the Fund's unaudited condensed consolidated interim financial statement for the three month period ended March 31, 2011.

HARDWOODS DISTRIBUTION INCOME FUND

Notes to Unaudited Condensed Consolidated Interim Financial Statements
(Tabular amounts expressed in thousands of Canadian dollars)

Three and six month periods ended June 30, 2011 and 2010

2. Basis of preparation (continued):

(a) Statement of compliance (continued):

These condensed consolidated interim financial statements were authorized for issue by the Board of Directors on August 8, 2011.

(b) Basis of measurement:

These condensed consolidated interim financial statements have been prepared on the historical cost basis, except for the non-controlling interest's exchangeable units liability which is recorded in the statement of financial position at its estimated fair value.

(c) Functional and presentation currency:

These condensed consolidated interim financial statements are presented in Canadian dollars, which is the Fund's functional currency. All financial information presented in the financial statements, with the exception of per unit amounts, has been rounded to the nearest thousand.

(d) Use of estimates and judgment:

The preparation of financial statements in accordance with IFRS requires management to make judgments, estimates and assumptions that affect the application of accounting policies and the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting period. Actual amounts may differ from the estimates applied in the preparation of these financial statements.

Estimates and underlying assumptions are reviewed on an ongoing basis. Revisions to accounting estimates are recognized in the period in which the estimates are revised and in any future periods affected.

Information about significant areas of estimation uncertainty and critical judgments in applying policies that have the most significant effect on the amounts recognized in the condensed consolidated interim financial statements is included in the following notes:

- Note 6 – the determination of the allowance for doubtful accounts;
- Note 10 – the determination of provisions and contingencies
- Note 11 – the determination of finance lease obligations
- Note 12 – the valuation of the non-controlling interest exchangeable units; and
- Note 14 – the valuation of deferred income taxes and utilization of tax loss carry forwards.

3. Significant accounting policies:

The significant accounting policies that have been used in the preparation of these condensed consolidated interim financial statements are summarized in note 3 to the first interim condensed consolidated interim financial statements of the Fund for the three month period ended March 31, 2011. Accordingly, these statements should be read in conjunction with the condensed consolidated interim financial statements for the period ended March 31, 2011.

HARDWOODS DISTRIBUTION INCOME FUND

Notes to Unaudited Condensed Consolidated Interim Financial Statements
(Tabular amounts expressed in thousands of Canadian dollars)

Three and six month periods ended June 30, 2011 and 2010

3. Significant accounting policies (continued):

New standards and interpretations yet to be adopted:

IFRS 9 - Financial Instruments

In November 2009, the IASB issued IFRS 9 - *Financial Instruments*, which is the first step in its project to replace IAS 39 - *Financial Instruments: Recognition and Measurement*. IFRS 9 establishes the measurement and classification of financial assets. Under IFRS 9, financial assets are measured either at fair value through earnings or at amortized cost if certain conditions are met. The effective date of this standard is January 1, 2013, but early adoption is permitted. The Fund will apply this standard to its financial statements beginning on January 1, 2013. The Fund is currently evaluating the impact of IFRS 9 on its financial statements.

IFRS 10 – Consolidated Financial Statements

In May 2011, the IASB issued IFRS 10 – *Consolidated Financial Statements*. The objective of IFRS 10 is to establish principles for the presentation and preparation of consolidated financial statements when an entity controls one or more other entities. The effective date of this standard is January 1, 2013, but early adoption is permitted. The Fund will apply this standard to its financial statements beginning on January 1, 2013. The adoption of IFRS 10 is not expected to have a significant impact on the Fund's consolidated financial statements.

IFRS 12 – Disclosure of Interests in Other Entities

In May 2011, the IASB issued IFRS 12 – *Disclosure of Interests in Other Entities*. The objective of IFRS 12 is to require the disclosure of information that enables users of financial statements to evaluate the nature of, and risks associated with, its interests in other entities and the effects of those interests on its financial position, financial performance and cash flows. The effective date of this standard is January 1, 2013, but early adoption is permitted. The Fund will apply this standard to its financial statements beginning on January 1, 2013. The Fund is currently evaluating the impact of IFRS 13 on its financial statements..

IFRS 13 – Fair Value Measurement

In May 2011, the IASB issued IFRS 13 – *Fair Value Measurement*. The objective of IFRS 13 is to define fair value, set out in a single IFRS framework for measuring fair value, and establish disclosure requirements regarding fair value measurements. The effective date of this standard is January 1, 2013, but early adoption is permitted. The Fund will apply this standard to its financial statements beginning on January 1, 2013. The Fund is currently evaluating the impact of IFRS 13 on its financial statements.

HARDWOODS DISTRIBUTION INCOME FUND

Notes to Unaudited Condensed Consolidated Interim Financial Statements
(Tabular amounts expressed in thousands of Canadian dollars)

Three and six month periods ended June 30, 2011 and 2010

4. Capital management:

The Fund's policy is to maintain a strong capital base so as to maintain investor, creditor and market confidence and to sustain future development of the business. The Fund considers its capital to be bank indebtedness (net of cash) and the Fund unit liability, less the net deficit attributable to Unitholders. The Fund's capitalization is as follows:

	June 30, 2011	December 31, 2010
Cash and cash equivalents	\$ (29)	\$ (43)
Bank indebtedness	8,886	6,745
Fund unit liability	144,588	144,366
Net deficit attributable to unitholders	(83,764)	(83,557)
Total capitalization	\$ 69,681	\$ 67,511

The terms of the Fund's US and Canadian credit facilities are described in note 9. The terms of the agreements with the Fund's lenders provide that distributions cannot be made to its unitholders in the event that its subsidiaries did not meet the foregoing earnings and cash flow tests as well as certain additional credit ratios. The Fund's operating subsidiaries were compliant with all required credit ratios under the US and Canadian credit facilities as at June 30, 2011, and accordingly there were no restrictions on distributions arising from compliance with financial covenants.

Distributions are one of the ways the Fund manages its capital. Distributions of the Fund's available cash are made to the maximum extent possible, subject to reasonable reserves established by the Trustees of the Fund. Distributions are made by the Fund having given consideration to a variety of factors including the outlook for the business, financial leverage, and the ratio of distributions to available cash of the Fund. There were no changes in the Fund's approach to capital management during the period ended June 30, 2011. On November 3, 2008, the Trustees of the Fund suspended further monthly distributions until such time as market conditions and the Fund's generation of cash has improved.

HARDWOODS DISTRIBUTION INCOME FUND

Notes to Unaudited Condensed Consolidated Interim Financial Statements
(Tabular amounts expressed in thousands of Canadian dollars)

Three and six month periods ended June 30, 2011 and 2010

5. Financial instruments:

Financial instrument assets include cash and cash equivalents, which are designated as fair value through profit and loss, and current and long-term receivables which are designated as loans and receivables and measured at amortized cost. Financial instrument liabilities include bank indebtedness, accounts payable, accrued liabilities, finance lease obligation and the Fund unit liability. All financial liabilities are designated as other liabilities and are measured at amortized cost. There are no financial instruments classified as available-for-sale or held-to-maturity.

Fair values of financial instruments

The carrying values of cash and cash equivalents, accounts receivable, income tax recoverable, and accounts payable accrued liabilities approximate their fair values due to the relatively short period to maturity of the instruments. The fair value of long-term receivables and finance lease obligations are not expected to differ materially from their respective carrying values, given the interest rates being charged. The carrying values of the credit facilities approximate their fair values due to the existence of floating market based interest rates. The fair value of these non-derivative financial assets and liabilities has been estimated based on the present value of future cash flows, discounted at a market rate of interest at the reporting date.

The fair value of the Fund unit liability at June 30 is \$40.0 million (December 31, 2010 - \$34.0 million) based on the quoted market price of the Fund units at each respective reporting date.

Derivative financial instruments

The Fund's non-controlling interest exchangeable Unit liability (note 12) is recorded at fair value each reporting period.

HARDWOODS DISTRIBUTION INCOME FUND

Notes to Unaudited Condensed Consolidated Interim Financial Statements
(Tabular amounts expressed in thousands of Canadian dollars)

Three and six month periods ended June 30, 2011 and 2010

6. Accounts receivable:

The following is a breakdown of the Fund's current and long term receivables and represents the Fund's principal exposure to credit risk.

	June 30, 2011	December 31, 2010
Trade accounts receivable - Canada	\$ 14,186	\$ 10,555
Trade accounts receivable - United States	22,696	17,726
Sundry receivable	146	200
Current portion of long-term receivables	494	413
	<u>37,522</u>	<u>28,894</u>
Less:		
Allowance for credit loss	3,156	2,238
	<u>\$ 34,366</u>	<u>\$ 26,656</u>
Long-term receivables:		
Employee housing loans	\$ 354	\$ 375
Customer notes	1,025	1,088
Security deposits	441	465
	<u>1,820</u>	<u>1,928</u>
Less:		
Current portion, included in accounts receivable	494	413
	<u>\$ 1,326</u>	<u>\$ 1,515</u>

The aging of the Fund's trade receivables is:

	June 30, 2011	December 31, 2010
Current	\$ 24,408	\$ 16,791
Past due 31 - 60 days	6,385	5,460
Past due 61 - 90 days	2,164	2,059
Past due 90+ days	3,925	3,971
	<u>\$ 36,882</u>	<u>\$ 28,281</u>

HARDWOODS DISTRIBUTION INCOME FUND

Notes to Unaudited Condensed Consolidated Interim Financial Statements
(Tabular amounts expressed in thousands of Canadian dollars)

Three and six month periods ended June 30, 2011 and 2010

6. Accounts receivable (continued):

The Fund determines its allowance for doubtful accounts based on its best estimate of the net recoverable amount by customer account. Accounts that are considered uncollectable are written off. The total allowance at June 30, 2011 was \$3.2 million (December 31, 2010 - \$2.2 million). The amount of the allowance is considered sufficient based on the past experience of the business, the security the Fund has in place for past due accounts and management's regular review and assessment of customer accounts and credit risk.

Bad debt expense, net of recoveries, for the three month period ended June 30, 2011 was \$0.3 million which equates to 0.5% of sales (three month period ended June 30, 2010 – \$0.2 million, being 0.5% of sales). For the six months ended June 30, 2011 net bad debt expense was \$0.8 million (six month period ended June 30, 2010 - \$0.8 million), being 0.7% of sales.

7. Inventories:

	June 30, 2011	December 31, 2010
Lumber	\$ 9,735	\$ 9,868
Sheet goods	13,909	13,270
Specialty	2,349	2,307
Goods in-transit	2,602	1,996
	\$ 28,595	\$ 27,441

Inventory related expenses are included in the consolidated statement of comprehensive income as follows:

	Three months ended June 30, 2011	Three months ended June 30, 2010	Six months ended June 30, 2011	Six months ended June 30, 2010
Inventory write-downs	\$ 168	\$ 204	\$ 363	\$ 454
Cost of inventory sold	\$ 44,740	\$ 42,319	\$ 85,961	\$ 79,527
Other cost of sales	1,893	1,564	3,603	3,225
Total cost of sales	46,633	42,883	89,564	82,752

HARDWOODS DISTRIBUTION INCOME FUND

Notes to Unaudited Condensed Consolidated Interim Financial Statements
(Tabular amounts expressed in thousands of Canadian dollars)

Three and six month periods ended June 30, 2011 and 2010

8. Property, plant and equipment:

	Leased vehicles	Machinery and equipment	Mobile equipment	Leasehold improvements	Total
Cost					
Balance at January 1, 2010	\$ 2,456	\$ 2,095	\$ 3,225	\$ 786	\$ 8,562
Additions	1,476	61	-	13	1,550
Disposals	(1,416)	(137)	(134)	(2)	(1,689)
Adjustments:					
Foreign currency translation	(82)	(63)	(112)	(12)	(269)
Balance at December 31, 2010	2,434	1,956	2,979	785	8,154
Additions	556	84	-	37	677
Disposals	(413)	(2)	(37)	-	(452)
Adjustments:					
Foreign currency translation	(45)	(33)	(58)	(7)	(143)
Balance at June 30, 2011	\$ 2,532	\$ 2,005	\$ 2,884	\$ 815	\$ 8,236
Accumulated depreciation					
Balance at January 1, 2010	\$ 1,180	\$ 1,685	\$ 2,394	\$ 736	\$ 5,995
Depreciation during period	706	189	205	37	1,137
Disposals	(974)	(133)	(133)	(2)	(1,242)
Adjustments:					
Foreign currency translation	(31)	(53)	(85)	(11)	(180)
Balance at December 31, 2010	881	1,688	2,381	760	5,710
Depreciation during period	336	67	38	9	450
Disposals	(305)	(2)	(36)	-	(343)
Adjustments:					
Foreign currency translation	(14)	(29)	(48)	(7)	(98)
Depreciation June 30, 2011	\$ 898	\$ 1,724	\$ 2,325	\$ 762	\$ 5,719
Net book value:					
December 31, 2010	\$ 1,553	\$ 268	\$ 598	\$ 25	\$ 2,444
June 30, 2011	1,634	281	549	53	2,517

Additions to leased vehicles were financed by long-term lease obligation (note 11).

Depreciation of property, plant and equipment is included in the statement of comprehensive income as follows:

	Three months ended June 30, 2011	Three months ended June 30, 2010	Six months ended June 30, 2011	Six months ended June 30, 2010
Selling and distribution Administration	\$ 210 9	\$ 285 31	\$ 434 16	\$ 575 71
	\$ 219	\$ 316	\$ 450	\$ 646

HARDWOODS DISTRIBUTION INCOME FUND

Notes to Unaudited Condensed Consolidated Interim Financial Statements
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8. Property, plant and equipment (continued):

Gains on disposal of property, plant and equipment are included in the statement of comprehensive income as follows:

	Three months ended June 30, 2011	Three months ended June 30, 2010	Six months ended June 30, 2011	Six months ended June 30, 2010
Selling and distribution Administration	\$ 26 -	\$ 48 -	\$ 59 -	\$ 51 -
	\$ 26	\$ 48	\$ 59	\$ 51

9. Bank indebtedness:

	June 30, 2011	December 31, 2010
Checks issued in excess of funds on deposit	\$ 1,840	\$ 282
Credit facility, Hardwoods LP	-	548
Credit facility, Hardwoods USLP (June 30, 2011 - US\$7,424; December 31, 2010 - US\$6,162)	7,161	6,129
Deferred finance fees	(115)	(214)
	\$ 8,886	\$ 6,745

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 (the "Credit Facilities").

Each of the Credit Facilities is separate, is not guaranteed by the other partnership, and does not contain cross default provisions to the other Credit Facility. The Credit Facility made available to Hardwoods LP 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 LP Units held by a subsidiary of the Fund and SIL. The Credit Facility made available to Hardwoods USLP is secured by a first security interest in all of the present and after acquired property of Hardwoods USLP and by the USLP Units held by a subsidiary of the Fund and by SIL.

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9. Bank indebtedness (continued):

The Hardwoods LP Credit Facility has a three year term, provides financing up to \$15.0 million and has a maturity date of August 7, 2012. The Hardwoods USLP credit facility was renewed on May 26, 2011 and provides financing of up to US\$25.0 million and has a maturity date of May 26, 2015. Each facility is payable in full at maturity. The Hardwoods LP Credit Facility is a revolving credit facility which Hardwoods LP may terminate subject to prepayment penalties of \$225,000 if terminated in the first 12 months of the credit facility term, \$150,000 if repaid in the second 12 months of the credit facility term, and \$75,000 thereafter if repaid prior to the maturity date of the credit facility. The Hardwoods USLP Credit Facility may be terminated by Hardwoods USLP without prepayment penalties. The Credit Facilities bear interest at a floating rate based on the Canadian or US 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 on customary terms for facilities of this nature. The Credit Facilities' rates vary with the ratio of EBITDA minus capital expenditures and cash taxes, divided by interest. Fees and standby charges usual for borrowings of this nature were and are payable.

The amount made available under the Credit Facility to Hardwoods LP from time to time is limited to the extent of 85% of the book value of accounts receivable and the lesser of 60% of the book value or 85% of appraised value of inventories with the amount based on inventories not to exceed 60% of the total amount to be available. Certain identified accounts receivable and inventories are excluded from the calculation of the amount available under the Credit Facility. Hardwoods LP is required to maintain a fixed charge coverage ratio (calculated as the ratio of EBITDA less cash taxes less capital expenditures, divided by interest) of not less than 1.1 to 1. At June 30, 2011, the Hardwoods LP credit facility had \$14.1 million of additional borrowing capacity.

The amount to be made available under the Credit Facility to Hardwoods USLP from time to time is limited to the extent of 85% of the book value of certain accounts receivable and 55% of the book value of inventories (with certain accounts receivable and inventory being excluded). Hardwoods USLP is required to maintain a fixed charge coverage ratio (calculated as EBITDA less cash taxes less capital expenditures, divided by interest plus distributions) of 1.0 to 1. This covenant of the Hardwoods USLP Credit Facility does not need to be met however when the unused availability under the credit facility is in excess of US\$2.5 million. At June 30, 2011, the Hardwoods USLP credit facility had unused availability of \$15.3 million (US\$15.9 million).

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10. Provisions:

	Legal	Onerous contracts	Total
Balance at January 1, 2010	\$ 203	\$ 656	\$ 859
Provisions made during the period	150	-	150
Provisions used during the period	(53)	(415)	(468)
Adjustments during the period	-	-	-
Balance at December 31, 2010	300	241	541
Provisions made during the period	44	-	44
Provisions used during the period	-	(104)	(104)
Adjustments during the period	(4)	-	(4)
Balance at June 30, 2011	\$ 340	\$ 137	\$ 477
Non-current	\$ -	\$ 49	\$ 49
Current	340	88	428
	\$ 340	\$ 137	\$ 477

Legal

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

Onerous contracts

Due to the closure of some branches before the expiry of the lease the Fund has a legal obligation to pay the monthly lease until the expiry date. The Fund has mitigated the obligation by sub-leasing the properties. The Fund has made provision for the net lease in the case that the sub-lease does not cover the entire obligation. The full expense was recognized in profit/loss in the period of the branch closure and subsequently the related liability is being reduced over the life of the obligation as cash payments are made. The liability is measured at the present value of the expected net cost of the remaining term of the contract.

Decommissioning

The Fund and its subsidiaries are not obligated in any material way for decommissioning or site restoration.

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11. Leases:

(a) Finance leases as lessee:

Subsidiaries of the Fund lease vehicles with terms ranging from 18 to 50 months. Hardwoods LP guarantees a residual value under the terms of the leases in Canada, and any difference between the amount realized and the guaranteed residual value is either paid to or paid by Hardwoods LP. In the US the lease payments cover the full capitalized cost over the term of the lease, and any proceeds from the sale of the vehicle are paid to Hardwoods USLP. The Fund and its subsidiaries have determined that these vehicle leases are considered finance leases and are recorded on the statement of financial position.

Finance lease liabilities are payable as follows:

Minimum lease payments due	Within one year	One to five years	Total
June 30, 2011:			
Future minimum lease payments	\$ 750	\$ 696	\$ 1,446
Interest	74	30	104
<u>Present value of minimum payments</u>	<u>\$ 824</u>	<u>\$ 726</u>	<u>\$ 1,550</u>

The present value of the lease payments is calculated using the interest rate implicit in the lease.

(b) Operating leases as lessee:

At June 30, 2011 the Fund's subsidiaries are obligated under various operating leases, mainly building leases that require future minimum rental payments as follows:

Minimum lease payments due	Within one year	One to five years	After five years	Total
Minimum lease payments due	\$ 4,136	\$ 9,644	\$ -	\$ 13,780
Minimum sublease revenue receivable	210	17	-	227

Minimum lease payments are recognized as an expense while sublease payments are recognized as a reduction to selling and distribution costs on the statement of comprehensive income as follows:

	Three months ended June 30, 2011	Three months ended June 30, 2010	Six months ended June 30, 2011	Six months ended June 30, 2010
Minimum lease payment expense	\$ 1,034	\$ 1,213	\$ 2,071	\$ 2,475
Sublease payments received	(173)	(60)	(360)	(130)

The Fund's operating lease agreements do not contain any contingent rent clauses. Some operating building lease agreements contain renewal options but none contains any restrictions regarding distributions, further leasing or additional debt. Renewal options are reviewed regularly by management.

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12. Non-controlling interests:

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.

As described in note 1 to these financial statements the non-controlling interest exchanged its Class B LP Units and Class B USLP Units for common shares of Hardwoods Distribution Inc. effective July 1, 2011. Prior to July 1, 2011, 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 U.S. 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 June 30, 2011.

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;

HARDWOODS DISTRIBUTION INCOME FUND

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12. Non-controlling interests (continued):

- 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 June 30, 2011, the amount of such deficiency was \$15.0 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 June 30, 2011, the amount of such deficiency was nil; and
 - 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.

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12. Non-controlling interests (continued):

For accounting purposes, the non-controlling interest exchangeable Units, being the Class B LP Units and the Class B USLP Units, are considered a liability as the Units to be issued by the Fund in an exchange are themselves a puttable financial instrument. The non-controlling interest exchangeable Units include an embedded derivative, being the ability of the non-controlling interest to convert the exchangeable Units to full participating Fund Units, subject to the conditions noted in the preceding paragraphs. The Fund has chosen not to separate the embedded derivative and is instead recording the non-controlling interest exchangeable unit liability at its estimated fair value as at the reporting date.

The fair value of the non-controlling interest exchangeable unit liability is estimated to be as follows:

	June 30, 2011	December 31, 2010
Non-controlling interest exchangeable unit liability	\$ 3,744	\$ 3,197

Changes in the fair value of the above noted liability are recorded in the statement of comprehensive income as part of net finance expense (note 15).

13. Fund Units:

(a) An unlimited number of Units and Special Voting Units may be created and issued pursuant to the Fund's 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. Units of the Fund are redeemable at the holders' option for amounts based on the market price of the Units at the time of redemption, subject to a maximum of \$50,000 in cash redemptions by the Fund in any particular month. 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. Proceeds from the Offering were \$144.1 million and expenses of the Offering of \$10.6 million were expensed at the time of the transaction. The holders of the Class B Units of Hardwoods LP and Hardwoods USLP were issued 3,602,500 Special Voting Units of the Fund, which are to be cancelled on the exchange of Class B Units of Hardwoods LP and Hardwoods USLP for Units of the Fund.

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13. Fund Units (continued):

The Fund Units are classified as a liability under IFRS in accordance with IAS 32, Financial Instruments: Presentation. This classification is a result of the Units being puttable instruments as the holder has the option to redeem the Units for amounts based on the market prices at the time of redemption and the Units have a contractual obligation requiring delivery of income to the unitholders. The Fund has recorded the liability at the fair value of the Units at the inception of the liability, being \$144.1 million and has recorded the amounts subsequent to initial recognition on an amortized cost basis. Direct expenses associated with the initial issuance of the Fund Units, totaling \$10.6 million, were expensed as a financing cost at the date of issuance. Subsequent issuances of Fund units have been recorded at the fair value of the Units at the date of issuance.

A continuity of the Fund Unit liability is as follows:

	Units	Total
Balance at January 1, 2010	14,410,000	\$ 144,100
Issued pursuant to long term incentive plan	113,858	266
Balance at December 31, 2010	14,523,858	144,366
Issued pursuant to long term incentive plan	80,227	222
Balance at June 30, 2011	14,604,085	\$ 144,588

The income linked distribution stream arising from the Units is not considered to be an embedded derivative by the Fund as it is considered a non-financial variable specific to one of the parties to the contract and thus does not meet the criteria for a derivative.

(b) Long Term Incentive Plan:

At the Annual General Meeting held on May 20, 2010, the Unitholders approved a long term incentive plan ("LTIP") which authorized the issuance of a maximum of 850,000 LTIP Units to qualified trustees, directors, officers, employees and consultants to align the interests of such persons with the interests of Unitholders. Terms of the Fund's LTIP are described in the Fund's most recent annual financial statements dated December 31, 2010.

In accordance with the IFRS 2, Share-based Payment, the Fund is required to classify its Restricted Units and Performance Units as cash settled awards as they convert into Units of the Fund which are redeemable at the holder's option. The amount of compensation cost is measured each period end based on the current market price of the Fund's Units and the expense is recognized each period during the requisite service period based on the estimated number of awards that are expected to vest and in the case of Performance Units, based on the estimated number of Units to be issued provided that the performance conditions are considered probable of achievement.

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13. Fund Units (continued):

(b) Long Term Incentive Plan (continued):

A continuity of the LTIP Units outstanding is as follows:

	Performance Units	Restricted Units
Balance at January 1, 2010	-	-
LTIP Units issued during the period	160,452	341,571
LTIP Units settled by exchange for free-trading Fund Units	-	(113,858)
Balance at December 31, 2010	160,452	227,713
LTIP Units issued during the period	24,631	105,900
LTIP Units settled by exchange for free-trading Fund Units	(80,227)	-
Balance at June 30, 2011	104,856	333,613

Restricted and Performance Units vest over a three year period from the grant dates. As of June 30, 2011, 80,227 Performance Units became fully vested and were settled by the issuance of Fund Units with a fair value of \$0.2 million.

A non-cash compensation expense and associated long-term incentive plan amount of \$141,986 was recorded for the three month period ended June 30, 2011 (six month period ended June 30, 2011 - \$394,432) (2010 - nil).

A continuity of the LTIP liability is as follows:

Balance at January 1, 2010	\$	-
Compensation expense		530
Transfer to Fund Unit liability on issuance of Fund Units		(266)
Balance at December 31, 2010		264
Compensation expense		394
Transfer to Fund Unit liability on issuance of Fund Units		(222)
Balance at June 30, 2011	\$	436

14. Income taxes:

Income tax expense is recognized based on management's best estimate of the annual income tax rates expected for the full financial year applied to the pre-tax income earned in Canada and the United States for the interim period. The Fund's consolidated effective tax rate is affected by changes in the fair value of the non-controlling interest which results in no current or deferred taxes attributable to unitholders and other non deductible expenses of the Fund.

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15. Finance income and expense:

	Note	Three months ended June 30, 2011	Three months ended June 30, 2010	Six months ended June 30, 2011	Six months ended June 30, 2010
Finance expense:					
Interest on bank indebtedness	9	\$ 110	\$ 184	\$ 246	\$ 326
Amortization of deferred finance cost	9	54	44	98	89
Accretion of finance lease obligation	11	24	24	48	43
Change in fair value of non-controlling interest	12	-	-	547	-
Foreign exchange losses		22	-	110	-
Total finance expense		210	252	1,049	458
Finance income:					
Imputed interest on employee loans receivable	6	4	5	8	12
Interest on trade receivables and customer notes	6	131	166	259	299
Change in fair value of non-controlling interest	12	28	273	-	273
Foreign exchange gain		-	105	-	45
Total finance income		163	549	267	629
Net finance costs (income)		\$ 47	\$ (297)	\$ 782	\$ (171)

16. Segment reporting:

Information about geographic areas is as follows:

	Three months ended June 30, 2011	Three months ended June 30, 2010	Six months ended June 30, 2011	Six months ended June 30, 2010
Revenue from external customers:				
Canada	\$ 22,371	\$ 20,978	\$ 43,013	\$ 40,663
United States	34,347	31,228	65,735	60,041
	\$ 56,718	\$ 52,206	\$ 108,748	\$ 100,704

	June 30, 2011	December 31, 2010
Non-current assets:		
Canada	\$ 8,004	\$ 8,340
United States	10,041	11,082
	\$ 18,045	\$ 19,422

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17. Employee remuneration:

(a) Employee benefits expense:

Expenses recognized for employee benefits are analyzed below.

	Three months ended June 30, 2011	Three months ended June 30, 2010	Six months ended June 30, 2011	Six months ended June 30, 2010
Wages, salaries, and benefits	\$ 3,735	\$ 3,546	\$ 8,082	\$ 7,296
Pensions - defined contribution plans	118	105	244	229
LTIP Unit compensation	142	-	394	-
	<u>\$ 3,995</u>	<u>\$ 3,651</u>	<u>\$ 8,720</u>	<u>\$ 7,525</u>

Employee benefit expenses are included in the consolidated statement of comprehensive income as follows:

	Three months ended June 30, 2011	Three months ended June 30, 2010	Six months ended June 30, 2011	Six months ended June 30, 2010
Selling and distribution	\$ 3,276	\$ 3,139	\$ 6,763	\$ 6,075
Administration	719	512	1,957	1,450
	<u>\$ 3,995</u>	<u>\$ 3,651</u>	<u>\$ 8,720</u>	<u>\$ 7,525</u>

(b) 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 condensed consolidated interim financial statements

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 condensed consolidated interim financial statements.

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17. Employee remuneration (continued):

(b) Pensions (continued):

Pension expenses are included in the consolidated statement of comprehensive income as follows:

	Three months ended June 30, 2011	Three months ended June 30, 2010	Six months ended June 30, 2011	Six months ended June 30, 2010
USLP Plan	\$ 56	\$ 52	\$ 114	\$ 112
LP Plan	62	53	130	92

18. Related party transactions:

The Fund's related parties include its non-controlling Class B unit holder, key management, and post-employment benefit plan for the employee's of the Fund's subsidiaries.

(a) Transactions with non-controlling interest:

For the three month period ended June 30, 2011, sales of \$71,517 (three month period ended June 30, 2010 - \$138,696) were made to affiliates of SIL, and the Fund's subsidiaries made purchases of \$40,925 (three month period ended June 30, 2010 - \$16,854) from affiliates of SIL. For the six months ended June 30, 2011, sales of \$126,651 (six month period ended June 30, 2010 - \$266,558) were made to affiliates of SIL, and the Fund's subsidiaries made purchases of \$67,315 (six month period ended June 30, 2010 - \$44,329) from affiliates of SIL. All these sales and purchases took place at prevailing market prices.

(b) Transactions with key management personnel:

Key management of the Fund includes members of the Board of Directors, the President, Chief Financial Officer, and regional Vice Presidents. Key management personnel remuneration includes the following expenses:

	Three months ended June 30, 2011	Three months ended June 30, 2010	Six months ended June 30, 2011	Six months ended June 30, 2010
Short-term employee benefits:				
Salaries and benefits including bonuses	\$ 279	\$ 377	\$ 591	\$ 758
Company car	8	15	17	29
LTIP Unit compensation	50	-	138	-
Total remuneration	\$ 337	\$ 392	\$ 746	\$ 787

The Fund offers housing loans to employees required to relocate. Key management had no loans outstanding at either June 30, 2011 or December 31, 2010.

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18. Related party transactions (continued):

(b) Transactions with key management personnel (continued):

During the three month period ended June 30, 2011, the Fund paid \$0.1 million (three month period ended June 30, 2010 - \$0.1 million) to former key management personnel under the term of non-compete and consulting arrangements. During the six month period ended June 30, 2011, the Fund paid \$0.2 million (six month period ended June 30, 2010 - \$0.1 million) under these arrangements with former key management personnel.

(c) Transactions with post-employment benefit plans:

The defined contribution plan referred to in note 17(b) is a related party to the Fund. The Fund's transactions with the pension plan include contributions paid to the plan, which are disclosed in note 17(b). A subsidiary of the Fund paid US\$3,000 during 2011 for administration of the plan. The Fund has not entered into other transactions with the pension plan, neither has it any outstanding balances at either June 30, 2011 or December 31, 2010.

19. Seasonality:

The Fund is subject to seasonal influences. Historically the first and fourth quarters are seasonally slower periods for construction activity and therefore demand for hardwood products.

20. Explanation of transition to IFRS:

As stated in note 2(a), these are the Fund's second condensed consolidated interim financial statement prepared in accordance with IAS 34.

The accounting policies set out in note 3 of the Fund's condensed consolidated interim financial statements for the three month period ended March 31, 2011 have been consistently applied in preparing the interim financial statements for the three and six month periods ended June 30, 2011, the comparative periods ended June 30, 2010 and the year ended December 31, 2010 and in the preparation of an opening IFRS statement of financial position at January 1, 2010 (the Fund's date of transition).

Adjustments on transition to IFRS

In preparing its opening IFRS statement of financial position, the Fund has adjusted amounts reported previously in financial statements prepared in accordance with previous Canadian GAAP. An explanation of how the transition from previous Canadian GAAP to IFRS has affected the Fund's financial position and financial performance is set out in the following tables and the accompanying notes thereto. Reconciliation of the consolidated IFRS statements of financial position at January 1, 2010 and December 31, 2010 and the consolidated statement of comprehensive income for the year ended December 31, 2010 can be found in the Fund's condensed consolidated interim financial statements for the three month period ended March 31, 2011.

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20. Explanation of transition to IFRS (continued):

Reconciliation of Condensed Consolidated Statement of Financial Position at June 30, 2010:

	Note	Canadian GAAP	Effect of transition to IFRS	IFRS
Assets				
Current assets:				
Cash		\$ 116	\$ -	\$ 116
Accounts receivable		31,839	-	31,839
Income taxes recoverable		1,933	-	1,933
Inventories		29,501	-	29,501
Prepaid expenses		894	-	894
Total current assets		64,283	-	64,283
Non-current assets:				
Long-term receivables		1,783	-	1,783
Property, plant and equipment	e	1,031	1,636	2,667
Deferred financing costs	h	307	(307)	-
Deferred income taxes	i	16,735	(166)	16,569
Total non-current assets		19,856	1,163	21,018
Total assets		\$ 84,139	\$ 1,163	\$ 85,302
Liabilities				
Current liabilities:				
Bank indebtedness	h	\$ 11,638	\$ (307)	\$ 11,331
Accounts payable and accrued liabilities	g	5,930	(755)	5,175
Income taxes payable	g	-	85	85
Provisions	g	-	312	312
Finance lease obligation	e	-	737	737
Total current liabilities		17,568	72	17,640
Non-current liabilities:				
Deferred gain	d	382	(382)	-
Provisions	g	-	361	361
Finance lease obligation	e	-	768	768
Non-controlling interests	c	9,487	(7,027)	2,460
Fund Units	b	-	144,100	144,100
Total non-current liabilities		9,869	137,820	147,689
Total liabilities		27,437	137,892	165,329
Net Assets (Deficit) Attributable to Unitholders				
Fund Units	b	133,454	(133,454)	-
Deficit	k	(58,962)	(21,531)	(80,493)
Accumulated other comprehensive income (loss)	a	(17,790)	18,256	466
Total net assets (deficit) attributable to unitholders		56,702	(136,729)	(80,027)
Total net assets (deficit) and liabilities		\$ 84,139	\$ 1,163	\$ 85,302

HARDWOODS DISTRIBUTION INCOME FUND

Notes to Unaudited Condensed Consolidated Interim Financial Statements
(Tabular amounts expressed in thousands of Canadian dollars)

Three and six month periods ended June 30, 2011 and 2010

20. Explanation of transition to IFRS (continued):

Reconciliation of Condensed Consolidated Statement of Comprehensive Income for the three month period ended June 30, 2010:

	Note	Canadian GAAP	Effect of transition to IFRS	IFRS
Sales		\$ 52,206	\$ -	\$ 52,206
Cost of sales		(42,883)	-	(42,883)
Gross profit		9,323	-	9,323
Expenses:				
Selling and distribution	e,f	-	(5,600)	(5,600)
Administration	f,j	-	(1,652)	(1,652)
Other	f	-	-	-
Sales and administration	f	(6,949)	6,949	-
Depreciation	f	(136)	136	-
Deferred financing costs	f	(44)	44	-
Amortization of deferred gain	d	19	(19)	-
Interest	f	(186)	186	-
Foreign exchange gains	f	101	(101)	-
		(7,195)	(57)	(7,252)
Finance expense	e,f	-	(252)	(252)
Finance income	c,f	-	549	549
Net finance expense		-	297	297
Non-controlling interest	c	(426)	426	-
Profit before income taxes		1,702	666	2,368
Income tax expense				
Current	i	(108)	-	(108)
Deferred	i	(772)	(7)	(765)
		(880)	(7)	(873)
Profit for the period		822	673	1,495
Other comprehensive income:				
Exchange differences translating foreign operations		1,132	578	1,710
Total comprehensive profit for the period		\$ 1,954	\$ 1,251	\$ 3,205
Basic and diluted profit per Unit		\$ 0.06	\$ 0.05	\$ 0.10

HARDWOODS DISTRIBUTION INCOME FUND

Notes to Unaudited Condensed Consolidated Interim Financial Statements
(Tabular amounts expressed in thousands of Canadian dollars)

Three and six month periods ended June 30, 2011 and 2010

20. Explanation of transition to IFRS (continued):

Reconciliation of Condensed Consolidated Statement of Comprehensive Income for the six month period ended June 30, 2010:

	Note	Canadian GAAP	Effect of transition to IFRS	IFRS
Sales		\$ 100,704	\$ -	\$ 100,704
Cost of sales		(82,752)	-	(82,752)
Gross profit		17,952	-	17,952
Expenses:				
Selling and distribution	e,f	-	(11,867)	(11,867)
Administration	f,j	-	(3,424)	(3,424)
Other	f	-	320	320
Sales and administration	f	(14,409)	14,409	-
Depreciation	f	(292)	292	-
Deferred financing costs	f	(89)	89	-
Amortization of deferred gain	d	38	(38)	-
Interest	f	(331)	331	-
Foreign exchange gains (losses)	f	44	(44)	-
		(15,039)	68	(14,971)
Finance expense	e,f	-	(458)	(458)
Finance income	c,f	-	629	629
Net finance expense		-	171	171
Non-controlling interest	c	(583)	583	-
Profit before income taxes		2,330	822	3,152
Income tax expense				
Current	i	(134)	-	(134)
Deferred	i	(960)	(6)	(954)
		(1,094)	(6)	(1,088)
Profit for the period		1,236	828	2,064
Other comprehensive gain:				
Exchange differences translating foreign operations		308	158	466
Total comprehensive profit for the period		\$ 1,544	\$ 986	\$ 2,530
Basic and diluted profit per Unit		\$ 0.09	\$ 0.05	\$ 0.14

HARDWOODS DISTRIBUTION INCOME FUND

Notes to Unaudited Condensed Consolidated Interim Financial Statements
(Tabular amounts expressed in thousands of Canadian dollars)

Three and six month periods ended June 30, 2011 and 2010

20. Explanation of transition to IFRS (continued):

Notes to the reconciliation of net assets

(a) IFRS-1 “First-time Adoption of International Financial Reporting Standards (“IFRS 1”):

IFRS 1 generally requires that first-time adopters retrospectively apply all effective IFRS standards and interpretations in effect as at the reporting date. IFRS-1 also provides for certain optional exemptions and certain mandatory exceptions to this general principle. The Fund has made the following elections under IFRS-1:

- (i) The Fund has elected under IFRS 1 not to apply IFRS 3 Business Combinations (“IFRS 3”) retrospectively to business combinations that occurred prior to January 1, 2010 (the date of transition to IFRS). Accordingly, the Fund has continued with the same accounting treatment of previous business combinations under Canadian GAAP.
- (ii) The Fund has elected under IFRS 1 not to apply IAS 21 The Effects of Changes in Foreign Exchange Rates to the cumulative translation differences that arose prior to the date of transition to IFRS. The cumulative translation differences that existed for foreign subsidiaries at the date of transition to IFRS have been deemed to be nil and the amount recorded at December 31, 2009 under Canadian GAAP was transferred to deficit. Gains or loss on a subsequent disposal of foreign operations will exclude translation differences that arose before the date of transition to IFRS.

The effect of this election is to increase deficit and decrease accumulated other comprehensive loss by \$18.1 million at January 1, 2010, June 30, 2010, and December 31, 2010 as compared to amounts reported under previous Canadian GAAP.

- (b) Previously under Canadian GAAP, the Fund’s Units were classified as equity instruments. In Accordance with IAS 32, Financial Instruments: Presentation, the Fund Units are classified as a long-term liability as the Units are considered puttable financial instruments as the holder has the option to redeem the Units for amounts related to market prices at the time of the redemption and the Units impose an obligation requiring delivery of income to the unitholders. Certain exceptions provided in IAS 32 allow some puttable instruments to be classified as equity under IFRS, however these conditions are much more restrictive than previous Canadian GAAP. The Fund does not meet the exceptions in IAS 32 for equity presentation, as the Fund has a contractual obligation to distribute its taxable income to unitholders on an annual basis.

The Fund has made the following two accounting policy elections with respect to these units:

- (i) it has not separated the income distribution stream as an embedded derivative as it is considered to be dependent on a non-financial variable specific to a party to the contract, and
- (ii) it has elected to treat the distribution stream based on income as a floating rate financial instrument.

HARDWOODS DISTRIBUTION INCOME FUND

Notes to Unaudited Condensed Consolidated Interim Financial Statements
(Tabular amounts expressed in thousands of Canadian dollars)

Three and six month periods ended June 30, 2011 and 2010

20. Explanation of transition to IFRS (continued):

Notes to the reconciliation of net assets (continued)

(b) (continued):

As a result the Fund has recorded the liability at the cash amount originally exchanged for the Units, being \$144.4 million. The effect of classification of the Fund Units as a long-term liability is to reduce Unitholders' equity and increase long-term liabilities by \$144.4 million at June 30, 2010, and December 31, 2010 as compared to amounts reported under previous Canadian GAAP. The Fund has transferred \$10.6 million of related unit issuance costs previously netted against the Unitholders' equity balance to deficit as a financing cost expensed prior to the IFRS adoption date.

Consistent with the classification of the Fund units as a liability, distributions paid to Unitholder's are considered a financing cost in the statement of comprehensive income. As no distributions were paid during the six month period ended June 30, 2010, there is no impact to the comparative statement of comprehensive income. As the Fund units are treated as a floating rate liability, any changes in the distributions based on changes to income levels are expensed in the period in which they occur.

(c) The Fund's non-controlling interest is in the form of exchangeable Class B units that, under certain conditions, can be converted into units of the Fund, as described in note 12 to these financial statements. In accordance with IAS 32, if the instruments to be received on exchange are themselves puttable instruments, or instruments that impose an obligation to deliver a pro rata share of the net assets of the entity on liquidation, the exchangeable instruments are themselves considered a financial liability. As the Fund's units are themselves considered a liability, the non-controlling interest's exchangeable units are also considered a liability. As the non-controlling interest was previously presented in the statement of financial position as a liability there is no difference in classification arising from the transition to IFRS.

HARDWOODS DISTRIBUTION INCOME FUND

Notes to Unaudited Condensed Consolidated Interim Financial Statements
(Tabular amounts expressed in thousands of Canadian dollars)

Three and six month periods ended June 30, 2011 and 2010

20. Explanation of transition to IFRS (continued):

Notes to the reconciliation of net assets (continued)

(c) (continued):

As described in note 12, the non-controlling interest's exchangeable units are measured at fair value at each financial statement date and the difference is recorded as a gain or loss in the net finance cost section of the consolidated statement of comprehensive income. The impact resulting from the change in measurement of the non-controlling interest is as follows:

	Three months ended June 30, 2010	Six months ended June 30, 2010
Consolidated statement of comprehensive income		
Decrease in non-controlling interest share of net income	\$ 426	\$ 583
Increase in finance income (expense)	273	273
Increase in comprehensive income	\$ 699	\$ 856
Consolidated statement of financial position		
	June 30, 2010	December 31, 2010
Decrease in non-controlling interest	\$ (7,027)	\$ (5,547)
Decrease in deficit	\$ 7,027	\$ 5,547

HARDWOODS DISTRIBUTION INCOME FUND

Notes to Unaudited Condensed Consolidated Interim Financial Statements
(Tabular amounts expressed in thousands of Canadian dollars)

Three and six month periods ended June 30, 2011 and 2010

20. Explanation of transition to IFRS (continued):

Notes to the reconciliation of net assets (continued)

- (d) During the year ended December 31, 2005, a subsidiary of the Fund sold a building and related land to an unrelated third party and subsequently leased back the facilities. Canadian GAAP required the gain on the sale to be deferred and it was amortized in proportion to the rental payments until the changeover to IFRS. IFRS requires the gain on the sale to be recognized in income when the sale is made at fair market value and the leaseback is classified as an operating lease. The Fund has determined that under IFRS the gain on sale would have been recognized in its entirety in 2005.

The impact arising from the transition to IFRS is summarized as follows:

	Three months ended June 30, 2010	Six months ended June 30, 2010
Consolidated statement of comprehensive income		
Decrease in other income	\$ (19)	\$ (38)
Decrease in deferred income tax expense	6	11
Decrease in comprehensive income	\$ (13)	\$ (27)
Consolidated statement of financial position		
	June 30, 2010	December 31, 2010
Decrease in deferred gain on sale leaseback	\$ (382)	\$ (320)
Reduction in deferred income tax asset	102	101
Decrease in deficit	\$ 280	\$ 219

HARDWOODS DISTRIBUTION INCOME FUND

Notes to Unaudited Condensed Consolidated Interim Financial Statements
(Tabular amounts expressed in thousands of Canadian dollars)

Three and six month periods ended June 30, 2011 and 2010

20. Explanation of transition to IFRS (continued):

Notes to the reconciliation of net assets

- (e) Under previous Canadian GAAP, leases of automobiles used by the Fund's sales people were considered operating leases. Upon assessment of IAS 17 Leases, the Fund has concluded that the automobile leases are finance leases, primarily because the gains or losses from the fluctuation in the fair value of the automobiles residual values accrue to the Fund and its subsidiaries as a result of a residual value guarantee included in the lease agreement.

The effect of this change in classification has resulted in the Fund's subsidiaries recording a finance lease obligation and increasing its property, plant and equipment to reflect the depreciated value of the automobiles. Furthermore, the statement of comprehensive income now includes depreciation expense related to the automobiles and finance costs related to the lease obligation, as compared to an operating lease expense which had been previously recorded as a selling and distribution expense.

The impact arising from the change is summarized as follows:

	Three months ended June 30, 2010	Six months ended June 30, 2010
Consolidated statement of comprehensive income		
Increase (decrease) in selling and distribution:		
Decrease in operating lease expense	\$ 215	\$ 444
Increase in depreciation expense	(180)	(354)
Decrease in gain on leased autos	(24)	(42)
Decrease in expense related to leased autos	11	48
Increase in finance costs	(24)	(43)
(Increase) decrease in deferred income tax expense	-	(6)
Increase (decrease) in comprehensive income	(13)	\$ (1)
	June 30, 2010	December 31, 2010
Consolidated statement of financial position		
Increase in property, plant and equipment	\$ 1,636	\$ 1,553
Increase in capital lease obligation:		
Current portion	737	733
Long-term portion	768	722
Decrease in deferred tax asset	(64)	(30)
Increase in payable for leased auto asset	3	-
Decrease in deficit	64	68

HARDWOODS DISTRIBUTION INCOME FUND

Notes to Unaudited Condensed Consolidated Interim Financial Statements
(Tabular amounts expressed in thousands of Canadian dollars)

Three and six month periods ended June 30, 2011 and 2010

20. Explanation of transition to IFRS (continued):

Notes to the reconciliation of net assets

- (f) Management has elected to present the Consolidated Statement of Comprehensive Income according to the expenses functional classification. Previously under GAAP, the sales and administrative expenses were presented together. Under IFRS, these categories have been separated and expenses such as employee expenses and benefits (note 17) and amortization (note 8) have been allocated between these functional categories.
- (g) In accordance with IAS 37, Provisions, *Contingent Liabilities and Contingent Assets*, management of the Fund reviewed its assessments relating to provisions for legal proceedings based on the probability-weighted average of the possible outcomes. There is no change to provisions at June 30, 2010 or December 31, 2010.

Other provisions and income taxes payable that were previously included in accounts payable and accrued liabilities have been separately disclosed on the IFRS statement of financial position. The impact of these reclassifications is as follows:

	June 30, 2010	December 31, 2010
Consolidated statement of financial position		
Decrease in accounts payable and accrued liabilities	\$ (758)	\$ (582)
Reclassified to provisions:		
Current portion	312	301
Long-term portion	361	240
Reclassified to income taxes payable	85	41

- (h) In accordance with IAS 32, deferred finance costs that were directly incurred in attaining revolving credit facilities by subsidiaries of the Fund are to be netted against the associated bank indebtedness. Under previous Canadian GAAP, such charges were shown as a long-term asset. This reclassification has no impact on the Fund's deficit.

HARDWOODS DISTRIBUTION INCOME FUND

Notes to Unaudited Condensed Consolidated Interim Financial Statements
(Tabular amounts expressed in thousands of Canadian dollars)

Three and six month periods ended June 30, 2011 and 2010

20. Explanation of transition to IFRS (continued):

Notes to the reconciliation of net assets

- (i) The above changes increased (decreased) the deferred tax asset as follows based on a tax rate of 39.4% in the US and 26% in Canada:

	Note	June 30, 2010	December 31, 2010
Decrease to the deferred tax asset arising from:			
Elimination of deferred gain on sale lease-back financing charges	d	102	101
Recognition of finance lease obligation and corresponding adjustment to property, plant and equipment	e	64	30
Decrease in deferred tax asset		\$ (166)	\$ (131)

- (j) In accordance with IFRS 2, Share-based Payment, the Fund is required to classify its Restricted Units and Performance Units, issued under the Fund's LTIP, as a liability as compared to equity (contributed surplus) under previous Canadian GAAP. In addition, unlike Canadian GAAP, the LTIP liability is measured each period end based on the current market price of the Fund's units.

There was no impact arising from the transition to IFRS during the three or six month periods ending June 30, 2010.

- (k) The above noted changes decreased (increased) deficit (each net of related tax) as follows:

	Note	June 30, 2010	December 31, 2010
Reclassification of cumulative currency differences	a	\$ (18,098)	\$ (18,098)
Unit issue costs	b	(10,646)	(10,646)
Fair value non-controlling interest	c	7,027	5,547
Deferred gain on sale leaseback	d	280	219
Finance leases	f	64	68
LTIP compensation	j	-	(134)
CTA on adjustment items		(158)	(666)
Increase in deficit		(21,531)	(22,378)

HARDWOODS DISTRIBUTION INCOME FUND

Notes to Unaudited Condensed Consolidated Interim Financial Statements
(Tabular amounts expressed in thousands of Canadian dollars)

Three and six month periods ended June 30, 2011 and 2010

20. Explanation of transition to IFRS (continued):

- (l) The following table is a reconciliation of the change in classification of cash flows arising from the transition to IFRS for the periods ended June 30, 2010:

	Canadian GAAP	Effect of transition to IFRS	IFRS
Three months ended June 30, 2010			
Net cash used in operating activities	\$ (3,443)	\$ 125	\$ (3,318)
Net cash provided by financing activities	3,099	(194)	2,905
Net cash provided by investing activities	265	69	334
Six months ended June 30, 2010			
Net cash used in operating activities	\$ (7,228)	\$ 331	\$ (6,897)
Net cash provided by financing activities	6,454	(389)	6,065
Net cash provided by investing activities	427	58	485

The adjustments to the cash flow classification arise as a result of the presentation of the Fund's automobile leases as finance leases. In accordance with the Fund's lease classification, the principle repayments on the automobile leases are presented as a financing activity.

Shareholder Information

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Director

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President, Krystal Financial Corp.

Graham M. Wilson
President, Grawil Consultants Inc.

E. Lawrence Sauder
Chair and CEO, Sauder Industries

William Sauder
Executive VP, Sauder Industries

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