



The Second Cup Ltd.

Audited Financial Statements
For the 52 week periods ended December 29, 2012 and December 31, 2011



March 5, 2013

Independent Auditor's Report

To the Shareholders of The Second Cup Ltd.

We have audited the accompanying financial statements of The Second Cup Ltd., which comprise the statements of financial position as at December 29, 2012 and December 31, 2011 and the statements of operations and comprehensive income (loss), statements of changes in equity and statements of cash flows for the two fifty-two week periods then ended, and the related notes, which comprise a summary of significant accounting policies and other explanatory information.

Management's responsibility for the financial statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with International Financial Reporting Standards, and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's responsibility

Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained in our audits is sufficient and appropriate to provide a basis for our audit opinion.

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"PwC" refers to PricewaterhouseCoopers LLP, an Ontario limited liability partnership.



Opinion

In our opinion, the financial statements present fairly, in all material respects, the financial position of The Second Cup Ltd. as at December 29, 2012 and December 31, 2011 and its financial performance and its cash flows for the fifty-two week periods then ended in accordance with International Financial Reporting Standards.

(Signed) “PricewaterhouseCoopers LLP”

Chartered Accountants, Licensed Public Accountants

The Second Cup Ltd.

Statements of Financial Position

As at December 29, 2012 and December 31, 2011

(Expressed in thousands of Canadian dollars)

	December 29, 2012	December 31, 2011
Assets		
Current assets		
Cash and cash equivalents (note 6)	\$ 3,880	\$ 5,465
Trade and other receivables (note 7)	4,616	5,338
Current portion of notes and leases receivable (note 9)	265	149
Inventories (note 8)	137	79
Prepaid expenses and other assets	695	194
	<u>9,593</u>	<u>11,225</u>
Non-current assets		
Notes and leases receivable (note 9)	741	469
Property and equipment (note 10)	3,544	3,478
Goodwill (note 11)	-	2,444
Intangible assets (note 12)	74,802	87,938
	<u>74,802</u>	<u>87,938</u>
Total assets	<u>\$ 88,680</u>	<u>\$ 105,554</u>
Liabilities		
Current liabilities		
Accounts payable and accrued liabilities (notes 14 and 27)	\$ 3,313	\$ 4,093
Current portion of other long-term liabilities (note 19)	189	166
Provisions (note 15)	365	447
Income tax payable	318	1,509
Gift card liability	4,560	4,353
Deposits from franchise partners	1,904	1,457
	<u>10,649</u>	<u>12,025</u>
Non-current liabilities		
Deferred income taxes (note 17)	9,190	10,183
Other long-term liabilities (note 19)	421	392
Provisions (note 15)	683	341
Fair value of derivative interest rate swap (note 18)	96	302
Term loan (note 18)	10,941	10,909
	<u>10,941</u>	<u>10,909</u>
Total liabilities	<u>31,980</u>	<u>34,152</u>
Shareholders' equity (note 1)	<u>56,700</u>	<u>71,402</u>
Total liabilities and shareholders' equity	<u>\$ 88,680</u>	<u>\$ 105,554</u>

Contingencies, commitments and guarantees (note 20) and subsequent event (note 29)

See accompanying notes to financial statements.

Approved by the Directors February 28, 2013

Michael Rosicki, Director

James Anas, Director

The Second Cup Ltd.

Statements of Operations and Comprehensive Income (Loss)
For the years ended December 29, 2012 and December 31, 2011
(Expressed in thousands of Canadian dollars, except per share amounts)

	2012	2011
Revenue		
Royalty	\$ 14,927	\$ 15,631
Sale of goods	4,698	3,006
Services	6,721	6,364
	<u>26,346</u>	<u>25,001</u>
Cost of goods sold	<u>3,523</u>	<u>2,223</u>
Gross profit	22,823	22,778
Operating expenses (note 22)	15,779	13,176
Impairment of goodwill and trademarks (note 13)	15,294	-
	<u>31,073</u>	<u>13,176</u>
Operating (loss) income	(8,250)	9,602
Interest income	(61)	(67)
Interest expense (note 18)	564	782
Net interest expense	<u>503</u>	<u>715</u>
(Loss) income before income taxes	<u>(8,753)</u>	<u>8,887</u>
Income taxes (recovery) (note 16)		
Current	1,644	1,527
Deferred	(993)	(5,941)
	<u>651</u>	<u>(4,414)</u>
Net (loss) income for the year	(9,404)	13,301
Other comprehensive income	<u>-</u>	<u>-</u>
Comprehensive (loss) income	<u>\$ (9,404)</u>	<u>\$ 13,301</u>
Basic and diluted (loss) earnings per share (note 21)	<u>\$ (0.95)</u>	<u>\$ 1.34</u>

See accompanying notes to financial statements.

The Second Cup Ltd.

Statements of Changes in Shareholders' Equity

(Expressed in thousands of Canadian dollars)

	Share Capital (see below *)	Contributed Surplus	(Deficit) Retained Earnings	Total
Balance - December 31, 2010	\$ <u>89,972</u>	\$ <u>160</u>	\$ <u>(27,575)</u>	\$ <u>62,557</u>
Reduction in share capital	(88,972)	61,397	27,575	-
Net income for the year	-	-	13,301	13,301
Dividends to shareholders	<u>-</u>	<u>-</u>	<u>(4,456)</u>	<u>(4,456)</u>
Balance - December 31, 2011	\$ <u>1,000</u>	\$ <u>61,557</u>	\$ <u>8,845</u>	\$ <u>71,402</u>
Net loss for the year	-	-	(9,404)	(9,404)
Dividends to shareholders	<u>-</u>	<u>-</u>	<u>(5,298)</u>	<u>(5,298)</u>
Balance - December 29, 2012	\$ <u>1,000</u>	\$ <u>61,557</u>	\$ <u>(5,857)</u>	\$ <u>56,700</u>

* Prior to the conversion from an income trust structure to a public corporation ("Conversion") Share Capital was referred to as Income Fund Units (notes 1 and 5)

See accompanying notes to financial statements.

The Second Cup Ltd.

Statements of Cash Flows

For the years ended December 29, 2012 and December 31, 2011

(Expressed in thousands of Canadian dollars)

	2012	2011
Cash provided by (used in)		
Operating activities		
Net (loss) income for the year	\$ (9,404)	\$ 13,301
Items not involving cash		
Amortization of deferred financing charges (note 3(m))	82	72
Amortization of intangible assets (note 3(i))	451	392
Amortization of leasehold inducements (note 3(l))	(35)	(3)
Amortization of property and equipment (note 3(g))	716	440
Amortization of provisions (note 3(k))	(89)	(112)
Deferred income taxes	(993)	(5,941)
Impairment of property and equipment	362	130
Impairment of goodwill	2,444	-
Impairment of trademarks	12,850	-
Loss on disposal of property and equipment	70	36
Movement in fair value of derivative interest rate swap	(206)	(29)
Income taxes	(1,191)	1,584
Leasehold inducement	61	406
Changes in non-cash working capital (note 24)	32	(1,971)
	<u>5,150</u>	<u>8,305</u>
Investing activities		
Investment in notes and leases receivable	-	(50)
Proceeds from disposal of assets held for sale	-	313
Proceeds from disposal of property and equipment	350	49
Proceeds from repayment of leases receivable	36	6
Proceeds from repayment of notes receivable	185	91
Purchase of assets held for sale	-	(291)
Purchase of property and equipment	(1,758)	(2,731)
Purchase of software	(180)	(312)
	<u>(1,367)</u>	<u>(2,925)</u>
Financing activities		
Deferred financing charges	(50)	-
Distributions paid to unitholders	-	(759)
Dividends paid to shareholders	(5,298)	(4,456)
Payments on long-term lease	(2)	(12)
Repayment of note payable	(18)	(101)
	<u>(5,368)</u>	<u>(5,328)</u>
(Decrease) increase in cash and cash equivalents during the year	<u>(1,585)</u>	<u>52</u>
Cash and cash equivalents - Beginning of year	<u>5,465</u>	<u>5,413</u>
Cash and cash equivalents - End of year	<u>\$ 3,880</u>	<u>\$ 5,465</u>

See accompanying notes to financial statements.

The Second Cup Ltd.

Notes to the Financial Statements

For the years ended December 29, 2012 and December 31, 2011

(Expressed in thousands of Canadian dollars, except per share amounts)

1. Organization and Nature of Business

The Second Cup Ltd. (“Second Cup” or “the Company”) is Canada’s largest specialty coffee café franchisor (as measured by the number of cafés) with 360 cafés operating under the trade name Second Cup™ in Canada, of which ten are Company operated and the balance are operated by franchise partners who are selected and trained to retail Second Cup’s product offering.

Second Cup owns the trademarks, trade names, operating procedures and systems and other intellectual property used in connection with the operation of Second Cup cafés only in Canada, excluding the Territory of Nunavut.

Second Cup is incorporated and domiciled in Canada. The address of its registered office is 6303 Airport Road, 2nd Floor, Mississauga, Ontario, L4V 1R8. The Company’s website is www.secondcup.com.

Second Cup’s fiscal year follows the method implemented by many retail entities, such that each quarter will consist of 13 weeks and will end on the Saturday closest to the calendar quarter end. The fiscal year is made up of 52 or 53 week periods ending on the last Saturday of December.

Prior to January 1, 2011, Second Cup Income Fund (the “Fund”) was an unincorporated open-ended trust established under the laws of the Province of Ontario. An unlimited number of units could have been issued pursuant to the Fund’s declaration of trust. Units were redeemable by the holder at any time, subject to certain limitations.

The common shares of the Company are listed on the Toronto Stock Exchange under the symbol “SCU”.

Conversion of the Fund

At the annual and special meeting of unitholders held on June 2, 2010, unitholders of the Fund approved the conversion from an income trust structure to a public corporation (“Conversion”). The Conversion was completed on January 1, 2011. Under the plan of arrangement, unitholders of the Fund received, for each unit of the Fund held, one common share of Second Cup. As a result of this Conversion, the Fund was dissolved with its assets and liabilities assumed by Second Cup. The common shares of Second Cup commenced trading on the Toronto Stock Exchange on January 4, 2011 under the symbol “SCU.”

The exchange of the units of the Fund into shares of the Company was recorded at the carrying values of the Fund’s assets and liabilities on January 1, 2011 in accordance with the continuity of interest method of accounting, as the Company is considered to be a continuation of the Fund.

As a result of the Conversion, unitholders’ capital of \$89,972 was reclassified to share capital. Included as part of the Conversion was a reduction in the stated capital from \$89,972 to \$1,000, resulting in a reduction of the deficit by \$25,575 and an increase in contributed surplus of \$61,397. The Conversion and the associated reduction in share capital were approved by court orders dated June 11, 2010 and December 17, 2010.

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2. Basis of Preparation

The financial statements of Second Cup have been prepared in accordance with International Financial Reporting Standards (“IFRS”) and International Financial Reporting Interpretation Committee (“IFRIC”) interpretations.

The preparation of financial statements in accordance with IFRS requires the use of certain critical accounting estimates. It also requires management to exercise its judgement in the process of applying the Company’s accounting policies. The areas involving a higher degree of judgement or complexity, or areas where assumptions and estimates are significant to the financial statements are disclosed in note 4.

The accounting policies applied in the financial statements are based on IFRS effective for the fiscal year ended December 29, 2012, as issued and outstanding as of February 28, 2013, the date the Board of Directors approved the financial statements.

3. Summary of Significant Accounting Policies

a. Basis of measurement

The financial statements have been prepared under the historical cost convention, except for certain financial instruments that are measured at fair values, as explained in the accounting policies below. Historical cost is generally based on the fair value of the consideration given in exchange for assets.

b. Segmented information

Second Cup operates within Canada, which is considered to be its sole operating segment. As a franchisor, Second Cup opens, acquires, closes and refranchises individual café locations in the normal course of business.

c. Cash and cash equivalents

Cash and cash equivalents include cash on hand, deposits held with banks and other short-term highly liquid investments with original maturities of three months or less.

d. Financial instruments

Financial assets and liabilities are recognized when the Company becomes a party to the contractual provisions of the instrument. Financial assets are derecognized when the rights to receive cash flows from the assets have expired or have been transferred and the Company has transferred substantially all risks and rewards of ownership.

Financial assets and liabilities are offset and the net amount reported in the Statements of Financial Position when there is a legally enforceable right to offset the recognized amounts and there is an intention to settle on a net basis, or realize the asset and settle the liability simultaneously.

At initial recognition, the Company classifies its financial instruments in the following categories depending on the purpose for which the instruments were acquired:

(i) *Financial assets and liabilities at fair value through profit or loss (“FVTPL”)*: A financial asset or liability is classified in this category if acquired principally for the purpose of selling or repurchasing in the short-term. Derivatives are also included in this category unless they are designated as hedges. The only

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instruments held by the Company classified in this category are interest rate swaps (see (v) below). The Company fair values the swap at the end of each quarter with the change in fair value accounted through profit or loss.

Financial instruments in this category are recognized initially and subsequently at fair value. Transaction costs are expensed in the Statements of Operations and Comprehensive Income (Loss). Gains and losses arising from changes in fair value are presented in the Statements of Operations and Comprehensive Income (Loss) within other gains and losses in the year in which they arise. Financial assets and liabilities at FVTPL are classified as current, except for the portion expected to be realized or paid beyond 12 months of the Statements of Financial Position dates, which is classified as non-current.

(ii) Loans and receivables: Loans and receivables are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market. The Company's loans and receivables comprise trade receivables, notes receivable and cash and cash equivalents, and are included in current assets due to their short-term nature, except for the portion expected to be realized beyond 12 months of the Statements of Financial Position dates. Loans and receivables are initially recognized at the amount expected to be received, less, when material, a discount to reduce the loans and receivables to fair value. Subsequently, loans and receivables are measured at amortized cost using the effective interest method less a provision for impairment, if necessary.

(iii) Leases: The Company has entered into lease agreements with some franchise partners relating to point of sale systems ("POS"). The lease term is for the major part of the economic life of the POS although the Company does not transfer title. The Company recognizes leases as finance type leases and records a lease receivable at an amount equal to the net investment in the lease. The Company's leases receivable are included in current assets due to their short-term nature, except for the portion expected to be realized beyond 12 months of the Statements of Financial Position dates. Leases receivable are initially recognized at the amount expected to be received, less, when material, a discount to reduce the leases receivable to fair value. Subsequently, leases receivable are measured at amortized cost using the effective interest method less a provision for impairment.

(iv) Financial liabilities at amortized cost: Financial liabilities at amortized cost include trade payables, deposits from franchise partners, gift card liability, bank debt and long-term debt. Trade payables are initially recognized at the amount required to be paid less, when material, a discount to reduce the payables to fair value. Subsequently, trade payables are measured at amortized cost using the effective interest method.

The sale process of a new café requires a deposit from a franchise partner at the outset, including an amount for franchise fees, which is recognized as revenue when the café opens. Deposits from franchise partners are applied against the cost of constructing a new café or the renovation of an existing café. Gift card liability represents liabilities related to unused balances on Second Cup's reloadable payment card ("Second Cup Café Card") net of estimated breakage. These balances are included as sales from franchised cafés, or as revenue of Company operated cafés at the time the customer redeems the amount in a café for products or services. Breakage represents management's estimate of balances outstanding relating to gift cards that may never be redeemed. Bank debt and long-term debt are recognized initially at fair value, net of any transaction costs incurred and, subsequently, at amortized cost using the effective interest method.

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Financial liabilities are classified as current liabilities if payment is due within 12 months. Otherwise, they are presented as non-current liabilities.

(v) Derivative financial instruments: The Company uses derivatives in the form of interest rate swaps to manage risks related to its variable rate debt. All derivatives have been classified as FVTPL, are included on the Statements of Financial Position within other liabilities and are classified as current or non-current based on the contractual terms specific to the instrument.

Gains and losses on remeasurement are included in interest income (expense).

(vi) Classification as debt or equity: Debt and equity instruments issued by the Company are classified as either financial liabilities or as equity in accordance with the substance of the contractual arrangements and the definitions of a financial liability and an equity instrument.

e. Impairment of financial assets

At each reporting date, the Company assesses whether there is objective evidence that a financial asset is impaired.

The criteria used to determine if objective evidence of an impairment loss include:

- a) significant financial difficulty of the borrower/lessee;
- b) delinquencies in interest or principal payments; and
- c) it becomes probable that the borrower/lessee will enter bankruptcy or other financial reorganization.

If such evidence exists, the Company recognizes an impairment loss, as follows:

(i) Financial assets carried at amortized cost: The loss is the difference between the amortized cost of the loan or receivable and the present value of the estimated future cash flows, discounted using the instrument's effective interest rate. The carrying value of the asset is reduced by this amount either directly or indirectly through the use of an allowance account.

Notes receivable and leases receivable are assessed for impairment quarterly on an individual basis based on the ability of the debtor/lessee to make the required payments and the value of the security. When there is no longer reasonable assurance that a note receivable or lease receivable will be collected, its carrying value is reduced and an impairment charge is recorded in the year.

Impairment losses on financial assets carried at amortized cost are reversed in subsequent years if the amount of the loss decreases and the decrease can be related objectively to an event's occurring after the impairment was recognized. Impairment losses on available-for-sale equity instruments are not reversed.

f. Inventories

Inventories are stated at the lower of cost and net realizable value, with cost being determined on a first-in, first-out ("FIFO") method. Net realizable value is the estimated selling price less applicable selling expenses. If carrying value exceeds net realizable amount, a writedown is recognized. The writedown may be reversed in a subsequent year if the circumstances that caused it no longer exist.

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g. Property and equipment

Property and equipment are stated at cost less accumulated amortization net of any impairment losses. Cost includes expenditures that are directly attributable to the acquisition of the asset. Subsequent costs are included in the asset's carrying value or recognized as a separate asset, as appropriate, only when it is probable that future economic benefits associated with the item will flow to the Company and the cost can be measured reliably. The carrying value of a replaced asset is derecognized when replaced. Repairs and maintenance costs are charged to the Statements of Operations and Comprehensive Income (Loss) during the year in which they are incurred.

Amortization is calculated using the straight-line basis at the following rates, which are based on the expected useful lives of the asset:

Leasehold improvements	lesser of 10 years and the remaining term of the lease
Equipment, furniture, fixtures and other	3 to 7 years
Computer hardware	3 years

Property and equipment are reviewed for impairment annually or at any time if an indicator of impairment exists (refer to note 3(j)).

h. Goodwill

Goodwill represents the excess of the cost of acquisition over the fair values of assets, liabilities and contingent liabilities acquired. Goodwill is carried at cost less accumulated impairment losses.

Goodwill is reviewed for impairment annually or at any time if an indicator of impairment exists (refer to note 3(j)).

i. Intangible assets

Intangible assets consist of trademarks, franchise rights and software, which are amortized or assessed for impairment (refer to note 3(j)) as follows:

(i) Trademarks

Trademarks consist of trade names, operating procedures and systems and other intellectual property used in connection with the operation of the Second Cup cafés in Canada and are recorded at the historical cost less impairment writedowns. The trademark is an indefinite life intangible asset that is tested annually for impairment.

Management believes the trademarks related to Second Cup are very well established in the marketplace and will continue to provide benefits indefinitely into the future.

(ii) Franchise rights

As a result of the acquisition of Second Cup in 2009, franchise rights were recognized as an intangible asset. The franchise rights intangible asset is based on the net present value of the discounted future net cash flows expected from the existing franchise partners of Second Cup as at the date of acquisition, including royalties and franchise fees.

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(iii) Software

Purchased software costs are recorded at cost and are amortized commencing when the asset is available for use.

Amortization is calculated using the straight-line basis at the following rates, which are based on the expected useful lives of the assets:

Franchise rights	average remaining term of the existing franchise agreement
Software	3 to 7 years

j. Impairment of non-financial assets

Property and equipment and intangible assets are tested for impairment when events or changes in circumstances indicate the carrying value may not be recoverable. Long-lived assets that are not amortized are subject to an annual impairment test or any time an impairment indicator exists.

For the purpose of measuring recoverable amounts, assets are grouped at the lowest levels for which there are separately identifiable cash inflows (cash generating units or “CGUs”). The recoverable amount of each particular CGU is the higher of an asset’s fair value less costs to sell and value in use. For the purposes of the impairment test, the Company estimates the fair value less costs to sell of the individual cash generating units.

The impairment analysis involves comparing the carrying value of the CGUs with their estimated recoverable amounts based on fair value less costs to sell values. Management considers a number of factors in estimating the recoverable value of each CGU. These factors are included in the discounted cash flow estimates. Each of these valuation methods use estimates and assumptions that are sensitive to change and require judgement. These key judgements include estimates of discount rates, forecast growth in system sales and other estimates impacting future cash flows. Changes in these estimates and assumptions may have a significant impact on recoverable amounts. Costs to sell are estimated based on the most recent transactions in the retail and franchise business.

An impairment loss is recognized for the amount by which the asset’s carrying value exceeds its recoverable amount. Impairment losses for CGUs reduce first the carrying value of any goodwill allocated to that CGU. Any remaining impairment loss is charged pro rata to the other intangible assets in the CGU.

The Company evaluates impairment losses, other than goodwill impairment, for potential reversals when events or circumstances warrant such consideration.

k. Provisions

Provisions are recognized when the Company has a present legal or constructive obligation as a result of past events; it is more likely than not that an outflow of resources will be required to settle the obligation; and the amount can be reliably estimated. Provisions are measured at management’s best estimate of the expenditure required to settle the obligation at the end of the reporting period and are discounted to present value where the effect is material. The Company performs evaluations to identify onerous contracts and, where applicable, records provisions for such contracts.

(i) Headlease liabilities

On June 27, 2009, Second Cup Trade-Marks Limited Partnership, on behalf of the Fund, completed the acquisition of all of the outstanding shares of Second Cup. Headlease liabilities represent the provision for lease guarantees provided by Second Cup for franchised operations at the date of acquisition, June 27, 2009. The liability was recorded at estimated fair value based on the net present value of the future estimated

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negative cash flows when Second Cup is required to cover rental arrears of its franchise partners, to terminate unfavourable leases or to cover shortfalls if a location is sublet to a third party. This liability is amortized over the average remaining length of these existing lease agreements.

(ii) Café lease agreements

The Company café lease liability is based on the net present value of the difference between the market related rental rates and the contract lease rates paid by Second Cup from the date of the acquisition until the end of each respective lease agreement. The café lease agreement liability is amortized over the average remaining length of these Company café leases.

l. Other long-term liabilities

(i) Deferred revenue

The Company has entered into several supply agreement contracts and receives an allowance from the supplier in consideration for achieving certain volume commitments over the term of the supply agreement. Deferred revenue is amortized over the term of the supply agreement based on the proportion of volume commitments met during the fiscal year. In addition, the Company defers construction administration fees received at the commencement of a new franchise term until the café renovation is completed.

(ii) Leasehold inducement

Leasehold inducements are amortized to rent expense on a straight-line basis over the term of the lease.

m. Deferred financing charges

Deferred financing charges represent costs associated with the Company's term loan, and are offset against the term loan and expensed to the Statements of Operations and Comprehensive Income (Loss) using the effective interest rate method.

n. Income taxes

Income tax comprises current and deferred income taxes. Income taxes are recognized in the Statements of Operations and Comprehensive Income (Loss) except to the extent that it relates to items recognized directly in equity, in which case the income tax is also recognized directly in equity.

Current income taxes are the expected taxes payable on the taxable income for the year, using tax rates enacted, or substantively enacted, at the end of the reporting period, and any adjustment to tax payable in respect of previous years.

Deferred income taxes are recognized in respect of temporary differences arising between the tax bases of assets and liabilities and their carrying values in the financial statements. Deferred income taxes are determined on a non-discounted basis using tax rates and laws that have been enacted or substantively enacted at the Statements of Financial Position dates and are expected to apply when the deferred income tax asset or liability is settled. Deferred income tax assets are recognized to the extent that it is probable that future taxable profit will be available against which the deductible temporary differences can be utilized.

Deferred income tax assets and liabilities are presented as non-current.

Prior to its Conversion in 2011, the Fund was an unincorporated open-ended trust and was not subject to income taxes to the extent that its taxable income was distributed to unitholders. As a result of new tax legislation substantively enacted on June 12, 2007, the Fund would have paid a tax on distributions declared

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subsequent to January 1, 2011. As a result of this legislation, the Fund had provided for the future income tax effect of existing temporary differences between the accounting and tax bases of assets and liabilities that were expected to reverse subsequent to January 1, 2011. On January 1, 2011, the Fund completed its conversion to a corporation. Second Cup is now subject to corporate income tax.

o. Advertising and co-operative fund assets and liabilities

Second Cup manages an advertising and co-operative fund (the “Co-op Fund”) established to collect and administer funds contributed for use in advertising and promotional programs, national training programs and, among other things, initiatives designed to increase sales and enhance the reputation of the Second Cup brand. Contributions to the Co-op Fund are required to be made from both franchised and Company-owned and operated cafés and are based on a percentage of café sales. The revenue, expenses and cash flows of the Co-op Fund are not included in the Company’s Statements of Operations and Comprehensive Income (Loss) and Cash Flows because the contributions to this fund are segregated and designated for a specific purpose. The assets and liabilities of the Co-op Fund are included in the assets and liabilities of the Company.

p. Gift card liability

Second Cup has a gift card program that allows customers to prepay for future purchases by reloading a dollar value onto their gift cards through cash or credit/debit card in the cafés or online through credit cards, when and as needed. The purpose of the gift card program is to expand the Second Cup brand through increased exposure as well as to increase sales. Gift card liability represents liabilities related to unused balances on the Second Cup Café Card net of estimated breakage. These balances are included as sales from franchised cafés, or as revenue of Company operated cafés, at the time the customer redeems the amount in a café for products or services. Breakage represents management’s estimates of balances outstanding relating to gift cards that may never be redeemed. This breakage factor is estimated based on historical redemption patterns and is reviewed quarterly by management. Breakage income is recognized by the Co-op Fund.

q. Revenue recognition

Revenue is recognized when it is probable the economic benefits will flow to the Company and delivery has occurred, the sales price is fixed or determinable, and collectability is reasonably assured. Revenue is measured at the fair value of the consideration received or receivable. Revenue is reduced for estimated customer returns, rebates and other similar allowances.

Royalty revenue from franchised cafés is recognized as the products are sold as reported by the franchise partner.

Revenue from the sale of goods from Company operated cafés, from the sale of products through wholesale and e-commerce channels are recognized as the products are sold to customers.

Services revenue includes initial franchise fees, renewal fees, transfer fees earned on the sale of cafés from one franchise partner to another, construction administration fees, product licencing revenue, purchasing coordination fees and other ancillary fees (IT support and training fees).

Initial franchise fees are recognized as income when the café commences operations, renewal fees are recognized at the commencement of a new franchise term, café resale fees are recognized when title transfers on the sale of a café between franchise partners and construction administration fees are recognized on the completion of a café renovation and re-opening. All fees are recognized as revenue after the franchise

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agreement has been signed and the Company has performed substantially all services and met all material conditions required by the franchise agreement.

For Second Cup branded products sold by third parties, product licencing revenue is recognized when goods are shipped from the distributor.

Purchasing coordination fees are derived from purchases made by franchise partners from approved suppliers and are recognized as the services are rendered or goods delivered and all significant conditions have been met.

r. Cost of goods sold

Cost of goods sold represents the product cost of goods sold in corporate cafés and through retail and wholesale channels plus the cost of direct labour to prepare and deliver the goods to the customers in the cafés.

s. Operating leases

Operating lease payments are recognized as rent expense on a straight-line basis over the lease term. Leasehold inducements are amortized to rent expense on a straight-line basis over the lease term. For the purposes of determining the lease term, the Company considers option periods for which failure to renew the lease impose an economic penalty on the Company of such an amount that the renewal appears to be reasonably assured at the inception of the lease.

t. Long-term incentive plan and Directors deferred share unit plan

In December 2009, Second Cup implemented a long-term incentive plan ("LTIP"), as described in note 27. Under IFRS 2, Share-based Payment, the fair value of each tranche of the grants is amortized over their respective vesting period using the graded amortization method. Compensation expense is measured at the grant date at fair value and recognized over the service period based on the vesting period and is adjusted for any changes in fair value of the Company's share price. Shares granted under the LTIP vest over a three-year period and are paid out in cash on December 15 of each year. In terms of the LTIP, any dividends paid by the Company during the vesting period will be accrued based on the total number of shares granted.

In January 2011, the Company implemented a Directors deferred share unit plan ("DSUP"), as described in note 27. Compensation expense is measured at the grant date (beginning of year) at fair value vesting on the last day of the year in which the shares are granted and is adjusted for any changes in fair value of the Company's share price. Shares granted under the DSUP vest on the last day of the year in which they are granted and are paid out in cash on the termination of the director. In terms of the DSUP, any dividends paid by the Company during the vesting period will be accrued based on the total number of shares granted.

u. Earnings per share

Basic earnings per share ("EPS") is calculated by dividing the net income (loss) for the year attributable to equity owners of the Company by the weighted average number of common shares outstanding during the year.

Diluted EPS is calculated by adjusting the weighted average number of common shares outstanding for dilutive instruments. The number of shares included with respect to options, warrants and similar instruments is computed using the treasury stock method.

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v. Related parties

For the purposes of these financial statements, a party is considered related to the Company if such party or the Company has the ability to, directly or indirectly, control or exercise significant influence over the other entity's financial and operating decisions, or if the Company and such party are subject to common influence. Related parties may be individuals or other entities. All transactions with related parties are recorded at fair value.

w. Dividends

Dividends on common shares are recognized in the Company's financial statements in the period in which the dividends are approved by the Board of Directors.

x. Future changes in accounting policies

IFRS 9, Financial Instruments ("IFRS 9"), was issued in November 2009 and addresses classification and measurement of financial assets. It replaces the multiple category and measurement models in International Accounting Standard 39, Financial Instruments: Recognition and Measurement ("IAS 39"), for debt instruments with a new mixed measurement model having only two categories: amortized cost and FVTPL. IFRS 9 also replaces the models for measuring equity instruments. Such instruments are either recognized at FVTPL or at fair value through other comprehensive income. Where equity instruments are measured at fair value through other comprehensive income, dividends are recognized in profit or loss to the extent that they do not clearly represent a return of investment; however, other gains and losses (including impairments) associated with such instruments remain in accumulated comprehensive income indefinitely.

Requirements for financial liabilities were added to IFRS 9 in October 2010 and they largely carried forward existing requirements in IAS 39, except that fair value changes due to credit risk for liabilities designated at FVTPL are generally recorded in other comprehensive income.

IFRS 13, Fair Value Measurement ("IFRS 13"), is a comprehensive standard for fair value measurement and disclosure for use across all IFRS. The new standard clarifies that fair value is the price that would be received to sell an asset, or paid to transfer a liability in an orderly transaction between market participants, at the measurement date. Under existing IFRS, guidance on measuring and disclosing fair value is dispersed among the specific standards requiring fair value measurements and does not always reflect a clear measurement basis or consistent disclosures.

IFRS 9 and IFRS 13 are effective for annual periods beginning on or after January 1, 2015 and January 1, 2013, respectively, with earlier adoption permitted. The Company will adopt IFRS 13, effective January 1, 2013, but does not expect it to have a significant impact. The Company has not yet assessed the impact of IFRS 9 or determined whether it will early adopt the standard.

4. Critical Accounting Estimates

The preparation of financial statements requires management to use judgement in applying its accounting policies and estimates and assumptions about the future. Estimates and other judgements are continuously evaluated and are based on management's experience and other factors, including expectations about future events that are believed to be reasonable under the circumstances. Estimates and underlying assumptions are reviewed on an ongoing basis. Revisions to accounting estimates are recognized in the year in which the estimates are revised and in any future years affected.

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The following discusses the most significant accounting judgements and estimates that the Company has made in the preparation of the financial statements:

Impairment analysis

Impairment analysis is an area involving management judgement requiring assessment as to whether the carrying value of assets is recoverable. Fair value less cost to sell is determined by estimating the net present value of future cash flows derived from such assets using cash flow projections that have been discounted at an appropriate rate. In calculating the net present value of the future cash flows, certain assumptions are required to be made in respect of highly uncertain matters including:

- a) Growth in total revenue
- b) Growth in cash flows, calculated as adjusted operating profit before depreciation and amortization,
- c) Long term growth rates
- d) Selection of discount rates to reflect the risks involved

Management has estimated cash flows based on market participant assumptions and expected future operations.

The discount rate is based upon a weighted average cost of capital derived from the benchmark analysis from similar retail or franchise businesses in Canada and the United States.

Changing the assumptions selected by management, in particular, the discount rate and the growth rate assumptions used in the cash flow projections, could significantly affect the impairment evaluations and, hence, results.

The Company's impairment test includes the key assumptions related to sensitivity in the cash flow projections. Further details are provided in note 13 to the financial statements.

Recoverable amount and CGUs

A CGU is defined as the smallest identifiable group of assets that generates cash inflows that are largely independent of the cash inflows from other assets or group of assets.

Goodwill is not amortized but tested for impairment at least once a year or more frequently when there is an indication that it may be impaired.

An impairment test is performed at the level of each CGU within each operating segment. This allocation is reviewed if the Company changes the level at which it monitors goodwill or changes in operating segments.

An impairment loss is recognized when the carrying value of the assets and liabilities of the franchise business CGU is higher than its recoverable amount. The recoverable amount of the franchise business CGU was estimated based on fair value less costs to sell. Fair value less costs to sell is the best estimate of the amount obtainable from the sale of a CGU in an arm's length transaction between knowledgeable, willing parties, less costs to sell. This estimate is determined on December 29, 2012.

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Deferred income taxes

The timing of reversal of timing differences and the expected income allocation to various tax jurisdictions within Canada affect the effective income tax rate used to compute the deferred income tax asset. Management estimates the reversals and income allocation based on historical and budgeted operating results and income tax laws existing at the Statements of Financial Position dates. In addition, management occasionally estimates the current or future deductibility of certain expenditures, affecting current or deferred income tax balances and expenses.

Fair value of derivative

Second Cup's derivative consists of an interest rate swap used to economically hedge exposure to variable cash flows associated with interest payments on the Company's borrowings. Management estimates the fair value of this derivative as the present value of expected future cash flows to be received or paid, based on available market data, which includes market yields and counterparty credit spreads.

Estimated useful lives

Management estimates the useful lives of property and equipment based on the period during which the assets are expected to be available-for-use. The amounts and timing of recorded expenses for amortization of property and equipment for any year are affected by these estimated useful lives. The estimates are reviewed at least annually and are updated if expectations change as a result of physical wear and tear, technical or commercial obsolescence and legal or other limits to use. It is possible that changes in these factors may cause significant changes in the estimated useful lives of the Company's property and equipment in the future.

Provisions

Second Cup has lease commitments since it acts as the head tenant on café leases. In cases where the lease contract specifies a termination fee due to the landlord or a fee is negotiated with the landlord upon termination, the Company records the expense at the time written notice is given or agreed to by the landlord. When ceasing operations under operating leases where the landlord does not allow the Company to prematurely exit the lease, but allows for subleasing, the Company estimates the fair value of sublease income in calculating the provision to the end of the lease term.

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5. Share Capital

Second Cup is authorized to issue an unlimited number of common shares.

	Income Fund Units		Share Capital	
	#	\$	#	\$
Balance January 1, 2010	9,903,045	89,972	-	-
Balance December 31, 2010	9,903,045	89,972	-	-
Conversion January 1, 2011	(9,903,045)	(89,972)	9,903,045	89,972
Reduction in stated capital January 1, 2011	-	-	-	(88,972)
Balance December 31, 2011	-	-	9,903,045	1,000

At the annual and special meeting of unitholders held June 2, 2010, the unitholders approved the Conversion to be undertaken on January 1, 2011. Included as part of the Conversion was a reduction in the stated capital from \$89,972 to \$1,000, resulting in a reduction of the deficit by \$27,575 and an increase in contributed surplus of \$61,397. The Conversion and the associated reduction in share capital were approved by court orders dated June 11, 2010 and December 17, 2010.

6. Cash and Cash Equivalents

	2012	2011
Cash	\$ 2,836	\$ 3,040
Cash equivalents	<u>1,044</u>	<u>2,425</u>
Cash and cash equivalents	<u>\$ 3,880</u>	<u>\$ 5,465</u>
Interest rate per annum	1.10%	1.10%

The cash equivalent represents short-term savings with maturity of less than three months since December 29.

7. Trade and Other Receivables

	2012	2011
Trade and other receivables	\$ 4,839	\$ 5,449
Less: Allowance for doubtful accounts	<u>(223)</u>	<u>(111)</u>
Trade and other receivables - net	<u>\$ 4,616</u>	<u>\$ 5,338</u>

The Company wrote-off \$78 (2011 - \$5), recovered \$91 (2011 - \$192) and increased the allowance for doubtful accounts \$281 (2011 - \$234) on trade and other receivables.

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Notes to the Financial Statements

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8. Inventories

	2012	2011
Merchandise held for resale	\$ 131	\$ 67
Supplies	24	12
	<u>155</u>	<u>79</u>
Less: Provision for obsolete inventory	<u>(18)</u>	<u>-</u>
	<u>\$ 137</u>	<u>\$ 79</u>

9. Notes and Leases Receivable

	2012	2011
Notes and leases receivable due in 1 year	\$ 341	\$ 162
Notes and leases receivable due after 1 year, but before 5 years	797	543
Notes and leases receivable due after 5 years	57	50
	<u>1,195</u>	<u>755</u>
Less: Allowance for doubtful accounts due in 1 year	(76)	(13)
Less: Allowance for doubtful accounts due after 1 year	<u>(113)</u>	<u>(124)</u>
	1,006	618
Less: Current portion	<u>265</u>	<u>149</u>
Notes and leases receivable - net	<u>\$ 741</u>	<u>\$ 469</u>

The Company entered into lease agreements with some franchise partners relating to POS. These leases bear interest at 8%. These were accounted for as finance leases totalling \$209 (2011 - \$74). The Company owns title to all POS. During 2012, the Company received proceeds from the repayment of leases receivable of \$36 (2011 - \$6).

In 2012 the Company did not provide financing to any franchise partners to assist them to purchase certain equipment, furniture and fixtures (2011 - \$50). The Company received proceeds from the repayment of notes receivable of \$185 (2011 - \$91) related to previous agreements. The Company settled \$741 (2011 - \$437) of trade receivables in return for notes receivable during the year. The Company received repayments totalling \$225 (2011 - \$22) from capitalized trade receivables. In addition, the Company wrote-off \$114 (2011 - \$nil), recovered \$24 (2011 - \$nil) and increased the allowance for doubtful accounts \$190 (2011 - \$137) on notes and leases receivable.

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10. Property and Equipment

	Leasehold improvements	Equipment, furniture, fixtures and other	Computer hardware	Total
Net carrying value				
As at December 31, 2010				
Cost	\$ 589	\$ 1,257	\$ 168	\$ 2,014
Accumulated amortization	<u>(247)</u>	<u>(171)</u>	<u>(105)</u>	<u>(523)</u>
As at December 31, 2010	342	1,086	63	1,491
Additions	664	1,959	108	2,731
Disposals - original cost	(25)	(107)	-	(132)
Disposals - accumulated amortization	1	24	-	25
Capitalized to lease	-	(67)	-	(67)
Impairment charge	(81)	(49)	-	(130)
Amortization	<u>(104)</u>	<u>(282)</u>	<u>(54)</u>	<u>(440)</u>
As at December 31, 2011	<u>\$ 797</u>	<u>\$ 2,564</u>	<u>\$ 117</u>	<u>\$ 3,478</u>
Cost	\$ 1,228	\$ 3,042	\$ 276	\$ 4,546
Accumulated amortization	<u>(431)</u>	<u>(478)</u>	<u>(159)</u>	<u>(1,068)</u>
As at December 31, 2011	<u>\$ 797</u>	<u>\$ 2,564</u>	<u>\$ 117</u>	<u>\$ 3,478</u>
Net carrying value				
As at December 31, 2011				
Cost	\$ 1,228	\$ 3,042	\$ 276	\$ 4,546
Accumulated amortization	<u>(431)</u>	<u>(478)</u>	<u>(159)</u>	<u>(1,068)</u>
As at December 31, 2011	797	2,564	117	3,478
Additions	851	857	50	1,758
Disposals - original cost	(177)	(297)	-	(474)
Disposals - accumulated amortization	20	34	-	54
Capitalized to lease	-	(194)	-	(194)
Impairment charge	(345)	(17)	-	(362)
Amortization	<u>(200)</u>	<u>(446)</u>	<u>(70)</u>	<u>(716)</u>
As at December 29, 2012	<u>\$ 946</u>	<u>\$ 2,501</u>	<u>\$ 97</u>	<u>\$ 3,544</u>
Cost	\$ 1,902	\$ 3,408	\$ 326	\$ 5,636
Accumulated amortization	<u>(956)</u>	<u>(907)</u>	<u>(229)</u>	<u>(2,092)</u>
As at December 29, 2012	<u>\$ 946</u>	<u>\$ 2,501</u>	<u>\$ 97</u>	<u>\$ 3,544</u>

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11. Goodwill

	2012	2011
Opening balance	\$ 2,444	\$ 2,444
Impairment charge	<u>(2,444)</u>	<u>-</u>
Closing balance	<u>\$ -</u>	<u>\$ 2,444</u>

The Company determined goodwill was impaired and recognized an impairment charge of \$2,444. There were no additions or disposals during the reporting periods (note 13).

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12. Intangible Assets

	Trademarks	Franchise rights	Software	Total
Net carrying value				
As at December 31, 2010				
Cost	\$ 86,905	\$ 1,331	\$ 312	\$ 88,548
Accumulated amortization	-	(424)	(99)	(523)
As at December 31, 2010	86,905	907	213	88,025
Additions (acquired)	-	-	312	312
Disposals - original cost	-	-	(43)	(43)
Disposals - accumulated amortization	-	-	43	43
Capitalized to lease	-	-	(7)	(7)
Amortization	-	(283)	(109)	(392)
As at December 31, 2011	\$ 86,905	\$ 624	\$ 409	\$ 87,938
Cost	\$ 86,905	\$ 1,331	\$ 574	\$ 88,810
Accumulated amortization	-	(707)	(165)	(872)
As at December 31, 2011	\$ 86,905	\$ 624	\$ 409	\$ 87,938
Net carrying value				
As at December 31, 2011				
Cost	\$ 86,905	\$ 1,331	\$ 574	\$ 88,810
Accumulated amortization	-	(707)	(165)	(872)
As at December 31, 2011	86,905	624	409	87,938
Additions (acquired)	-	-	180	180
Capitalized to lease	-	-	(15)	(15)
Impairment charge	(12,850)	-	-	(12,850)
Amortization	-	(283)	(168)	(451)
As at December 29, 2012	\$ 74,055	\$ 341	\$ 406	\$ 74,802
Cost	\$ 74,055	\$ 1,331	\$ 739	\$ 76,125
Accumulated amortization	-	(990)	(333)	(1,323)
As at December 29, 2012	\$ 74,055	\$ 341	\$ 406	\$ 74,802

Management concluded trademarks were impaired and recognized an impairment charge of \$12,850 (note 13).

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13. Impairment of assets

During the accounting periods presented, the Company had two CGUs - corporate cafés and franchise business.

Goodwill of \$2,444 as well as the Trademark of \$86,905 were allocated fully to the franchise business CGU. The CGUs recoverable amount has been determined using fair value less costs to sell.

Key assumptions

The discounted cash flow uses estimates and assumptions that are sensitive to change and require judgement. These key judgements include estimates of discount rates, forecast growth in system sales and other estimates impacting future cash flows. Changes in these estimates and assumptions may have a significant impact on recoverable amounts. General market uncertainty and the recessionary operating environment for the Company and other similar retail entities were also factors taken into account in the analysis. The changes in the market growth rates reflect the current general economic pressures now impacting the national economy.

These calculations use cash flow projections based on financial forecasts covering a five-year period. Cash flows beyond the five-year period are extrapolated using the estimated growth rates stated below. The following are key assumptions used in the fair value less costs to sell calculation:

Forecast same café sales growth	-2% to 4%
Forecast revenue growth	-2% to 8%
Average growth rate used to extrapolate cash flows beyond the budget period	2%
Discount rate	11.5%

The valuation of two corporate cafés based on revenue growth and future cash flows indicated an impairment of \$362. The Company wrote down leasehold improvements and property and equipment to their estimated recoverable amounts for both cafés.

The valuation of the franchise business CGU based on the forecasted cash flows and using an 11.5% discount rate indicates impairment. The Company recognized an impairment charge of \$2,444 to goodwill and \$12,850 to trademarks.

The effect of a change in management's key assumptions is reflected below:

Sensitivity

Key assumption	Low growth	High growth
Revenue growth	-2% to 2%	1% to 8%
Discount rate	11.0%	13.0%
Effect on fair value less cost to sell of CGU	(\$1,796)	\$5,749
Impact on impairment loss	Additional impairment loss of \$1,796	No impairment

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14. Accounts Payable and Accrued Liabilities

Accounts payable and accrued liabilities consist of:

	2012	2011
Accounts payable - trade	\$ 1,280	\$ 1,157
Accrued salaries, wages and benefits	577	1,126
Sales tax payable	235	134
Accrued liabilities	<u>1,221</u>	<u>1,676</u>
	<u>\$ 3,313</u>	<u>\$ 4,093</u>

15. Provisions

	Headlease Liabilities	Legal	Total
As at December 31, 2010	\$ 955	\$ 50	\$ 1,005
Provisions charged during the year	132	9	141
Provisions utilized during the year	<u>(299)</u>	<u>(59)</u>	<u>(358)</u>
As at December 31, 2011	788	-	788
Less: Current portion	<u>447</u>	<u>-</u>	<u>447</u>
Provisions	<u>\$ 341</u>	<u>\$ -</u>	<u>\$ 341</u>
As at December 31, 2011	\$ 788	\$ -	\$ 788
Provisions charged during the year	689	-	689
Provisions utilized during the year	<u>(429)</u>	<u>-</u>	<u>(429)</u>
As at December 29, 2012	1,048	-	1,048
Less: Current portion	<u>365</u>	<u>-</u>	<u>365</u>
Provisions	<u>\$ 683</u>	<u>\$ -</u>	<u>\$ 683</u>

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16. Income Taxes

Income tax expense is recognized based on management's best estimate of the weighted average annual income tax rate expected for the full financial year. The Ontario 2012 budget was substantively enacted on June 20, 2012, freezing corporate tax cuts with the effect that the income tax rate would remain at 11.5% until the province can achieve a balanced budget. Previously, the corporate income tax rate was slated to decrease to 10.0% by 2014. The impact of the income tax rate change is estimated to result in an increase in income tax of \$480 and has been recognized in the Statements of Operations and Comprehensive Income (Loss).

Under Canadian generally accepted accounting principles, income trusts were not subject to income taxes to the extent that their taxable income was distributed to unitholders. Under IAS 12 the rate to apply in 2010 was the highest marginal tax rate, which was estimated to be 46.41%. After the Conversion the tax rate is estimated to be 28.16%. The benefit of the rate reduction in 2011 due to the Conversion was \$7,462. As a result of the Conversion, Second Cup recognized certain deferred income tax assets and liabilities that were not previously recognized, resulting in a net charge of \$519 in 2011.

Income tax expense (recovery), as reported differs from the amount that would be computed by applying the combined Canadian federal and provincial statutory income tax rates to income before income taxes. The reasons for the differences are as follows:

	2012	2011
(Loss) income before income taxes	\$ (8,753)	\$ 8,887
Combined Canadian federal and provincial tax rates	<u>26.50%</u>	<u>28.16%</u>
Tax (recovery) provision at statutory rate	(2,320)	2,503
Increased (reduced) by following differences		
Change in income tax rates	480	(7,462)
Deferred income tax assets and liabilities not previously recognized	-	519
Non-deductible permanent differences - impairment of goodwill and trademarks	2,350	-
Non-deductible permanent differences - other	13	9
Other	<u>128</u>	<u>17</u>
Income tax expense (recovery)	<u>\$ 651</u>	<u>\$ (4,414)</u>

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17. Deferred Income Taxes

The analysis of deferred income tax assets and liabilities is as follows:

	2012	2011
Deferred income tax assets		
Deferred tax asset to be recovered after more than 12 months	\$ (133)	\$ (234)
Deferred income tax asset to be recovered within 12 months	(361)	(237)
	<u>(494)</u>	<u>(471)</u>
Deferred income tax liabilities		
Deferred income tax liability to be recovered after more than 12 months	<u>9,684</u>	<u>10,654</u>
Deferred income tax liabilities - net	\$ <u>9,190</u>	\$ <u>10,183</u>
Beginning of year	\$ 10,183	\$ 16,124
Income tax expense due to change in Ontario tax rates	480	-
Income tax (recovery)	<u>(1,473)</u>	<u>(5,941)</u>
End of year	\$ <u>9,190</u>	\$ <u>10,183</u>

The movement in deferred income tax assets and liabilities during the year is as follows:

	Property and equipment	Trademarks	Intangible assets	Other	Total
As at December 31, 2010	\$ (3,165)	\$ 19,419	\$ -	\$ (130)	\$ 16,124
Charged (credited) to the income statement	<u>4,312</u>	<u>(10,070)</u>	<u>158</u>	<u>(341)</u>	<u>(5,941)</u>
As at December 31, 2011	1,147	9,349	158	(471)	10,183
Charged (credited) to the income statement	<u>391</u>	<u>(1,294)</u>	<u>(68)</u>	<u>(22)</u>	<u>(993)</u>
As at December 29, 2012	\$ <u>1,538</u>	\$ <u>8,055</u>	\$ <u>90</u>	\$ <u>(493)</u>	\$ <u>9,190</u>

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18. Term Loan and Operating Facility

On June 12, 2012, the Company renegotiated its term loan and operating credit facilities, including an extension of the maturity of the credit facilities, to May 31, 2015 and a decrease in interest rates. The revised credit facilities comprise an \$11,000 non-revolving term credit facility, fully drawn, and an undrawn \$2,000 revolving credit facility. As a result of the refinancing, the Company capitalized loan extension fees of \$50. The term credit facilities are collateralized by substantially all the assets of the Company.

The \$11,000 non-revolving term credit facility bears interest at the bankers' acceptance rate plus 2.75% (December 31, 2011 - 3.50%). As at December 29, 2012, the full amount of the \$11,000 non-revolving term credit facility was drawn.

The \$2,000 operating credit facility bears interest at the bankers' acceptance rate plus 2.75% (December 31, 2011 - 3.50%). As at December 29, 2012, no advances had been drawn on this facility.

The Company has an interest rate swap agreement with a notional value of \$11,000 maturing on April 1, 2013, which fixes the interest rate on the Company's non-revolving credit facility at 3.04% per annum plus the margin noted above, which results in a fixed effective interest rate of 5.79% (December 31, 2011 - 6.54%). As at December 29, 2012, the estimated fair value of this contract is a \$96 liability to the Company (December 31, 2011 - \$302) which is recorded as a liability on the Company's Statements of Financial Position and the fair value movement of the interest rate swap has been recorded as a non-cash credit to income on the Company's Statements of Operations and Comprehensive Income (Loss).

Pursuant to the terms of the Company's operating loan and term loan, the Company is subject to certain financial and other customary covenants, including requirements to maintain a ratio of senior debt to EBITDA and to maintain a trailing four-quarter fixed charge coverage ratio. During the years ended December 29, 2012 and December 31, 2011, the Company was in compliance with all financial and other covenants of the Company's operating loan and term loan.

In accordance with IFRS 7, Financial Instruments: Disclosures ("IFRS 7"), the term loan is presented net of transaction costs. Transaction costs are amortized to the Statements of Operations and Comprehensive Income (Loss) using the effective interest method.

	2012	2011
Face value of long-term debt	\$ 11,000	\$ 11,000
Unamortized transaction costs	<u>(59)</u>	<u>(91)</u>
	<u>\$ 10,941</u>	<u>\$ 10,909</u>

At maturity on May 31, 2015, the Statements of Financial Position value of the term loan will be equal to the face value.

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Interest expense consists of the following:

	2012	2011
Interest on term loan	\$ 480	\$ 525
Interest on derivative interest rate swap	192	192
Movement in fair value of derivative interest rate swap	(206)	(29)
Amortization of deferred financing charges	82	72
Other interest expense	16	22
	<u>564</u>	<u>782</u>
	\$	\$

19. Other Long-term Liabilities

	2012	2011
Deferred revenue (i)	\$ 181	\$ 135
Promissory note payable	-	18
Leasehold inducement (note 3(l))	429	403
Other	-	2
	<u>610</u>	<u>558</u>
	\$	\$
Less: Current portion	<u>189</u>	<u>166</u>
	<u>421</u>	<u>392</u>
	\$	\$

(i) Deferred revenue on purchasing co-ordination fees and new term fees will be earned as follows: 2013 - \$150, 2014 - \$11, 2016 - \$20.

20. Contingencies, Commitments and Guarantees

Second Cup has lease commitments for Company-operated cafés and also acts as the head tenant on leases, which it in turn subleases to franchise partners. To the extent that the Company may be required to make rent payments due to headlease commitments, a provision has been recognized (note 15). The Company's lease commitments at December 29, 2012 are as follows:

	Headlease commitments	Sublease to franchisees	Net
December 31, 2013	\$ 19,246	\$ 17,867	\$ 1,379
December 31, 2014	18,346	17,121	1,225
December 31, 2015	16,710	15,474	1,236
December 31, 2016	14,676	13,430	1,246
December 31, 2017	12,667	11,501	1,166
Thereafter	<u>35,706</u>	<u>31,647</u>	<u>4,059</u>
	<u>117,351</u>	<u>107,040</u>	<u>10,311</u>
	\$	\$	\$

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Total occupancy and lease costs expensed in the year are as follows:

	2012		2011
Company head office and franchise café locations	\$ 1,614	\$	882
Company operated cafés	<u>885</u>		<u>504</u>
	<u>\$ 2,499</u>	\$	<u>1,386</u>

Second Cup is involved in litigation and other claims arising in the normal course of business. Management must use its judgement to determine whether or not a claim has any merit, the amount of the claims and whether to record a provision, which is dependent on the potential success of the claim. Second Cup believes it will not incur any significant loss or expense with such claims. However, there can be no assurance that unforeseen circumstances will not result in significant costs. The outcome of these actions is not determinable at this time, and adjustments, if any, will be recorded in the period of settlement.

Second Cup has a contract with a third party company to purchase and roast the coffee that is sold in all Second Cup cafés by franchise partners. In terms of this supply agreement, Second Cup has guaranteed a minimum volume of coffee purchases of \$4,421 (2011 - \$9,462). The coffee purchase commitment represents purchase commitments made up to the end of December 2013.

Second Cup has entered into a marketing agreement with a third party through 2014 and has committed to spend \$200 per year on advertising placed in various media offered by the third party over the term of the agreement.

21. Basic and Diluted Earnings (Loss) Per Share

Earnings (loss) per share are based on the weighted average number of shares outstanding during the year. Basic and diluted earnings (loss) per share are determined as follows:

	2012		2011
Net (loss) income	\$ (9,404)	\$	13,301
Weighted average number of shares issued and outstanding	<u>9,903,045</u>		<u>9,903,045</u>
Basic and diluted (loss) earnings per share	<u>\$ (0.95)</u>	\$	<u>1.34</u>

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22. Operating Expenses

Expenses by nature

	2012	2011
Head office		
Salaries, wages and benefits	\$ 6,540	\$ 7,311
Occupancy and lease costs	1,614	882
Travel and franchise partner meetings	1,010	888
Head office overheads	992	833
Professional fees	632	476
Legal costs	518	394
Amortization of property and equipment	506	289
Research and innovation	476	-
Amortization of intangible assets	451	392
Bad debt expense	422	257
Advertising and franchise development	304	263
Inventory markdowns	287	23
	<u>13,752</u>	<u>12,008</u>
Company cafés		
Lease costs	885	504
Impairment of property and equipment	362	130
Other operating expenses	350	253
Amortization of property and equipment	210	151
Advertising and local marketing	150	94
Loss on disposal of property and equipment	70	36
	<u>2,027</u>	<u>1,168</u>
Operating expenses	<u>\$ 15,779</u>	<u>\$ 13,176</u>

Salaries, wages and employee benefits

	2012	2011
Salaries and wages	\$ 5,868	\$ 6,245
Employee benefits	705	651
Directors' compensation	373	291
Severance costs	139	687
LTIP	130	93
Recovery from Co-op Fund	(675)	(656)
	<u>6,540</u>	<u>7,311</u>
Total head office	<u>\$ 6,540</u>	<u>\$ 7,311</u>

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23. Compensation of Key Management

Key management is defined as the senior management team and the Board of Directors.

	2012	2011
Salaries and short-term employee benefits	\$ 2,106	\$ 2,083
Severance costs	-	687
Stock-based compensation - LTIP (note 27)	130	93
Stock-based compensation - DSUP (note 27)	40	89
Pension costs - defined contribution plans	33	29
	<hr/>	<hr/>
Total compensation	\$ 2,309	\$ 2,981

24. Supplementary Cash Flow Information

Changes in non-cash working capital are as follows:

	2012	2011
Trade and other receivables	\$ 722	\$ 505
Notes and leases receivable	(400)	(278)
Inventories	(58)	(30)
Prepaid expenses and other assets	(501)	167
Accounts payable and accrued liabilities	(780)	(2,350)
Provisions	349	(105)
Other long-term liabilities	46	(75)
Gift card liability	207	186
Deposits from franchise partners	447	9
	<hr/>	<hr/>
	\$ 32	\$ (1,971)
Supplementary information		
Interest paid	\$ 689	\$ 739
Income taxes paid (recovered)	\$ 2,835	\$ (57)

25. Management of Capital

The capital structure of the Company consists of \$10,941 (2011 - \$10,909) in long-term debt and \$56,700 (2011 - \$71,402) in shareholders' equity, which comprises issued shares and accumulated earnings, less accumulated cash dividends.

The Company's objectives relating to the management of its capital structure are to:

- a) safeguard its ability to continue as a going concern;
- b) maintain financial flexibility in order to preserve its ability to meet financial obligations;
- c) maintain a capital structure that provides financing options to the Company when the need arises to access capital;

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- d) ensure it has sufficient cash and cash equivalents to pay declared dividends to its shareholders; and
- e) deploy capital to provide an adequate return to its shareholders.

The Company's primary uses of capital are to finance increases in non-cash working capital and capital expenditures.

The Company determines the appropriate level of long-term debt in the context of its cash flows and overall business risks. The Company has historically generated sufficient cash flows to pay quarterly dividends to its shareholders. In order to maintain or modify the capital structure, Second Cup may adjust the amount of dividends paid to its shareholders. The current level of capital is considered adequate in the context of current operations.

Under the term loan and operating facility, the Company is required to comply with a number of covenants and restrictions, including the requirements to meet certain financial ratios. These financial ratios include a senior leverage ratio and a fixed charge coverage ratio. To date, the Company has complied with these ratios.

There were no changes in the Company's approach to capital management during the year.

26. Financial Instruments and Financial Risk Management

Financial Instruments

The Company's financial instruments consist of cash and cash equivalents, trade and other receivables, notes receivable, accounts payable and accrued liabilities, gift card liability, other long-term liabilities, dividends payable to shareholders, term loan, the derivative interest rate swap and deposits from franchise partners.

Categories of financial instruments

The Company has designated each of its significant categories of financial instruments outstanding as follows:

	2012	2011
Financial assets		
Cash and cash equivalents	\$ 3,880	\$ 5,465
Loans and receivables		
Trade and other receivables	4,616	5,338
Leases receivable	245	71
Notes receivable	761	547
Financial liabilities		
FVTPL		
Derivative interest rate swap	96	302
Other financial liabilities		
Accounts payable and accrued liabilities	3,313	4,093
Gift card liability	4,560	4,353
Promissory note payable and other long-term liabilities	-	20
Term loan	10,941	10,909

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Financial liabilities designated as at FVTPL

	2012	2011
Opening fair value	\$ 302	\$ 331
Additions during the year	-	-
Realized during the year	-	-
Change in value	<u>(206)</u>	<u>(29)</u>
Closing fair value	\$ <u>96</u>	\$ <u>302</u>

Fair value of financial instruments

The fair values of cash and cash equivalents, trade and other receivables, accounts payable and accrued liabilities and gift card liability approximate their carrying values due to their short-term maturity. The fair value of notes receivable approximates their carrying value as the interest charged is considered to be based on market rates.

The fair value of the Company's term loan approximates its carrying value less transaction costs due to the floating interest rate of the term loan.

IFRS 7 requires financial instruments that are measured subsequent to initial recognition at fair value to be grouped in Levels 1 to 3 in the fair value hierarchy, based on the degree to which the fair value is observable. The three levels of the fair value hierarchy are:

- Level 1 - inputs derived from quoted prices (unadjusted) in active markets for identical assets or liabilities;
- Level 2 - inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly (i.e., as prices) or indirectly (i.e., derived from prices); and
- Level 3 - fair value derived from valuation techniques that include inputs for the asset or liability that are not based on observable market data (unobservable inputs).

The fair value for the derivative interest rate swap, classified as a Level 2, was derived using a discounted cash flow model that considers various observable inputs including time to maturity, forward interest rates and credit spreads.

As at December 31, 2011	Level 1	Level 2	Level 3
Derivative interest rate swap	<u>-</u>	<u>(302)</u>	<u>-</u>
	\$ <u>-</u>	\$ <u>(302)</u>	\$ <u>-</u>

The Second Cup Ltd.

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As at December 29, 2012	Level 1	Level 2	Level 3
Derivative interest rate swap	-	(96)	-
	\$ -	\$ (96)	\$ -

There were no transfers between Level 1 and Level 2 in the year.

The Company's financial instruments are exposed to credit risk, liquidity risk and interest rate risk.

Credit Risk

The Company's financial instruments exposed to credit risk include cash and cash equivalents, trade and other receivables, leases receivable and notes receivable. The Company places its cash with institutions of high creditworthiness. The Company's trade and other receivables, leases receivable and notes receivable primarily comprise amounts due from franchise partners. Based on experience, management believes its trade and other receivables, leases receivable and notes receivable credit risk exposure is limited. Credit risk from trade and other receivables, leases receivable and notes receivable is minimized as a result of the review and evaluation of franchise partner account balances beyond a particular age, and management accounts for a specific bad debt provision when the expected recovery is less than the actual accounts receivable. The provision relating to past due trade and other receivables as at December 29, 2012 was \$223 (December 31, 2011 - \$111). The provision relating to past due leases receivable and notes receivable as at December 29, 2012 was \$189 (December 31, 2011 - \$137).

The maturities of the Company's trade and other receivables as at December 29, 2012 are as follows:

	Maturing in the next 90 days	Maturing between 90 days and less than a year	Maturing between 1 year and less than 2 years	Maturing after 2 years	Total
Total	\$ 4,613	\$ 3	\$ -	\$ -	\$ 4,616

The creditworthiness of new franchise partners is reviewed during the application process. A new franchise partner requires a minimum 30% of their investment in unencumbered cash, written confirmation of financing for the remaining 70% from their bank and a deposit of \$100 to accompany the signed franchise agreement.

The maturities of the Company's notes and leases receivable as at December 29, 2012 are as follows:

	Maturing in the next 90 days	Maturing between 90 days and less than a year	Maturing between 1 year and less than 2 years	Maturing after 2 years	Total
Total	\$ 70	\$ 195	\$ 229	\$ 512	\$ 1,006

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Liquidity Risk

Liquidity risk is the risk the Company will encounter difficulty in meeting obligations as they come due associated with its financial liabilities. The Company manages liquidity risk through regular monitoring of dividends, forecast and actual cash flows, and also the management of its capital structure and senior leverage ratios as outlined in note 18. The Company's main source of income is royalty receipts from its franchise partners.

The contractual maturities of the Company's financial liabilities as at December 29, 2012 are as follows:

	Maturing in the next 90 days	Maturing between 90 days and less than a year	Maturing between 1 year and less than 2 years	Maturing after 2 years	Total
Accounts payable and accrued liabilities	\$ 2,873	\$ 367	\$ 73	\$ -	\$ 3,313
Gift card liability	4,560	-	-	-	4,560
Derivative interest rate swap	84	-	-	-	84
Term loan	<u>76</u>	<u>334</u>	<u>445</u>	<u>11,188</u>	<u>12,043</u>
Total	<u>\$ 7,593</u>	<u>\$ 701</u>	<u>\$ 518</u>	<u>\$ 11,188</u>	<u>\$ 20,000</u>

Interest Rate Risk

Interest rate risk is the risk the fair value of future cash flows of a financial instrument will fluctuate because of changes in market interest rates.

The Company is exposed to interest rate risk on its cash and cash equivalents and term loan, which earn and bear interest at floating rates. The Company entered into an interest rate swap agreement to minimize risk.

Interest expense on the long-term debt is adjusted to include the payments made or received under the interest rate swap agreement. The interest rate swap agreement is recognized in the Statements of Financial Position at its estimated fair value. During the year ended December 29, 2012, the Company recorded a net interest recovery of \$206 on the Statements of Operations and Comprehensive Income (Loss) relating to the interest rate swap (2011 - recovery of \$29).

Sensitivity Analysis

IFRS 7 requires disclosure of a sensitivity analysis to illustrate the sensitivity of the Company's financial position and performance to changes in market variables such as interest rates as a result of changes in the fair value of cash flows associated with the Company's financial instruments. The sensitivity analysis provided discloses the effect on net loss as at December 29, 2012, assuming that a reasonably possible change in the relevant risk variable has occurred as at December 29, 2012.

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The following table shows the Company's exposure to interest rate risk and the pre-tax effects on net loss for the year ended December 29, 2012 of a 1% change in interest rates management believes is reasonably possible:

		Pre-tax effects on net income - increase (decrease)	
	Carrying amount of liability	1% decrease in interest rates	1% increase in interest rates
Term loan	\$ 11,000	\$ (110)	\$ 110
Interest rate swap agreement	96	110	(110)
		<u>\$ -</u>	<u>\$ -</u>

27. Long-term Incentive Plan and Directors Deferred Share Unit Plan

Shares granted under the LTIP vest over a three-year period and are paid out in cash on December 15 of each year. Shares are granted based on the weighted average price of the Company's shares for the 20 trading days prior to the grant date. The fair value of the shares outstanding is determined based on the market value of the underlying shares of the Company.

A summary of the status of the Company's LTIP is presented below:

	Notional shares	Fair value
Notional shares outstanding as at December 31, 2010	77,083	\$ 445
Shares forfeited	(14,680)	(90)
Shares paid out	(6,263)	(50)
Shares granted in lieu of dividends	3,872	25
Shares granted on December 23, 2011	28,751	180
Change in fair value		<u>(92)</u>
Notional shares outstanding as at December 31, 2011	<u>88,763</u>	<u>\$ 418</u>
Expensed in current year		<u>\$ 93</u>

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	Notional shares		Fair value
Notional shares outstanding as at December 31, 2011	88,763	\$	418
Shares forfeited	(3,723)		(19)
Shares paid out	(32,682)		(175)
Shares granted in lieu of dividends	6,205		41
Change in fair value			(9)
	<u>58,563</u>	<u>\$</u>	<u>256</u>
Notional shares outstanding as at December 29, 2012			
Expensed in current year		\$	<u>130</u>

Shares granted under the DSUP vest on the last day of the year in which they are granted and are paid out in cash on the termination of the director. Shares are granted based on the weighted average price of the Company's shares for the five trading days prior to the grant date. The fair value of the shares outstanding is determined based on the market value of the underlying shares of the Company.

A summary of the status of the Company's DSUP is presented below:

	Notional shares		Fair value
Notional shares outstanding as at December 31, 2010	-	\$	-
Deferred share units granted	19,727		155
Shares granted in lieu of dividends	1,221		8
Shares forfeited	(4,367)		(34)
Shares paid out	(2,183)		(17)
Change in fair value			(23)
	<u>14,398</u>	<u>\$</u>	<u>89</u>
Notional shares outstanding as at December 31, 2011			
Expensed in current year		\$	<u>89</u>

	Notional shares		Fair value
Notional shares outstanding as at December 31, 2011	14,398	\$	89
Deferred share units granted	9,018		55
Shares granted in lieu of dividends	1,760		12
Change in fair value			(27)
	<u>25,176</u>	<u>\$</u>	<u>129</u>
Notional shares outstanding as at December 29, 2012			
Expensed in current year		\$	<u>40</u>

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28. Segmented Reporting

The Company's business is classified as one operating segment that is reported in a manner consistent with the internal reporting provided to the chief operating decision maker. The Company is structured as a franchisor with all of its operating revenues derived in Canada. Operating revenues comprise the sale of goods from Company-operated cafés and the sale of goods through ancillary channels, royalties and other service fees. Management is organized based on the Company's operations as a whole rather than the specific revenue streams.

29. Subsequent Event

On February 28, 2013, the Board of Directors of Second Cup approved a quarterly dividend of \$0.085 per common share, payable on March 28, 2013 to shareholders of record at the close of business on March 15, 2013.