Second Cup Royalty Income Fund
TSX: SCU.UN

2004 ANNUAL REPORT

FOR THE YEAR ENDED DECEMBER 31, 2004

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Second Cup Royalty Income Fund

The Second Cup Ltd.

Second Cup Royalty Income Fund

MANAGEMENT'S DISCUSSION AND ANALYSIS

The following is a discussion of the results of operations and financial condition of Second Cup Royalty Income Fund (the "Fund") for the 30-day period following the initial public offering of the Fund on December 2, 2004 and should be read in conjunction with the consolidated Financial Statements of the Fund and accompanying notes. The consolidated Financial Statements of the Fund are prepared in accordance with Canadian generally accepted accounting principles ("GAAP"). All amounts are presented in thousands of Canadian dollars, unless otherwise indicated. Since this is the first year of operations of the Fund, comparisons of results of operations and financial condition for prior periods are not available.

This Management's Discussion and Analysis ("MD&A") has been prepared as of March 7,2005.

FORWARD-LOOKING INFORMATION

Certain statements in this MD&A may constitute forward-looking statements. Forward-looking statements include words such as ''may'', ''will'', ''should'', ''expect'', ''anticipate'', ''believe'', ''plan'', ''intend'' and other similar words. These statements reflect current expectations regarding future events and operating performance and speak only as of the date of this MD&A. These forward-looking statements should not be read as guarantees of future performance or results and will not necessarily be accurate indications of whether or not those results will be achieved. Forward looking statements are subject to known and unknown risks, uncertainties and other factors that may cause the Fund's actual results, performance or achievements, or those of Second Cup Trade-Marks Inc. ("MarksCo"), The Second Cup Ltd. ("Second Cup"), Second Cup cafés, or industry results to be materially different from any future results, performance or achievements expressed or implied by those forward looking statements. The following are some of the factors that could cause actual results to differ materially from those expressed in or underlying those forward looking statements: competition; availability of premium quality coffee beans; the ability to attract qualified franchisees; the location of Second Cup cafés; the ability to exploit and protect the Second Cup trade-marks and other intellectual property rights owned by MarksCo and used in connection with the operation of Second Cup cafés in Canada; changing consumer preferences and discretionary spending patterns; reporting of gross revenue by franchisees; and the results of operations and financial condition of Second Cup. The foregoing list of factors is not exhaustive, and prospective investors should refer to the risks described below under "Risks and Uncertainties". Although the forward looking statements contained in this MD&A are based upon what management believes are reasonable assumptions, there can be no assurance that actual results will be consistent with these forward looking statements. As these forward looking statements are made as of the date of this MD&A, the Fund assumes no obligation to update or revise them to reflect new events or circumstances.

NON-GAAP TERMS

In addition to using financial measures prescribed by GAAP, non-GAAP financial measures and other terms are used in this MD&A. These terms include "same café sales", "distributable cash" and "EBITDA" (earnings before interest, taxes, depreciation and amortization). These terms are not financial measures recognized by GAAP and do not have any standardized meaning prescribed by GAAP and therefore may not be comparable to similar terms and measures presented by other similar issuers. These non-GAAP measures and terms are intended to provide additional information on the Fund's performance and should not be considered in isolation or as a substitute for measures of performance prepared in accordance with GAAP.

Distributable cash is presented in reference to the Fund's distribution policy. The Fund believes that distributable cash is a useful measure as it provides investors with an indication of cash available for distribution. References to EBITDA are to earnings determined in accordance with GAAP applicable to the financial statements before amounts for interest, taxes and depreciation and amortization are included in the earnings. Management believes that, in addition to net income, EBITDA is a useful supplemental measure in evaluating the Fund's performance as it provides investors with an indication of cash available for debt service, working capital needs and capital expenditures. Investors are cautioned, however, that distributable cash and EBITDA should not be construed as an alternative to the statement of cash flows as a measure of liquidity and cash flows. The method of calculating distributable cash and EBITDA for the purposes of this MD&A may differ from that used by other issuers and, accordingly, distributable cash and EBITDA in this MD&A may not be comparable to distributable cash and EBITDA used by other issuers.

OVERVIEW AND BUSINESS OF THE FUND

The Fund was established on October 22, 2004 and was created as a limited purpose trust to invest in notes and common shares of 1636433 Ontario Inc. ("Acquisition Co"), which in turn invested in notes and common shares of MarksCo. On December 2, 2004, the Fund completed an initial public offering of 9,582,760 units (the "Units") at $10.00 per Unit for aggregate proceeds of $95.8 million before expenses of the offering of $8.9 million. The Units are traded on the Toronto Stock Exchange under the symbol "SCU.UN".

The Fund, through its indirect wholly-owned subsidiary, MarksCo, acquired the Canadian trade-marks and certain other intellectual property and associated rights used by Second Cup in connection with the operation of Second Cup cafés in Canada (excluding the territory of Nunavut) (the "Second Cup Marks"). The Fund, indirectly through MarksCo, then licensed to Second Cup the Second Cup Marks for use in its cafés in return for payment of a royalty of 6.5% of system sales of a certain number of Second Cup cafés in Canada (the "Royalty Pool Cafés"). The pool of Second Cup cafés from which royalties to the Fund, indirectly through MarksCo, are generated is adjusted annually on January 1 of each year, commencing January 1, 2006, to include new cafés which, on November 1 of the previous year, had been open for at least 60 consecutive days. MarksCo pays Second Cup for the additional royalty revenue, after deducting the system sales from cafés that permanently closed during the previous reporting period, according to a formula designed to be accretive to Unitholders and specified in the Licence and Royalty Agreement. At the inception of the Fund, the system sales of 351 cafés were included for purposes of determining the royalty.

At the Fund's inception and as at December 31, 2004, Second Cup owned 15% of the Units on a fully diluted basis.

MarksCo, Acquisition Co, and the Fund's fiscal year ends are December 31, whereas Second Cup's fiscal year end is the Saturday closest to December 31.

SELECTED FINANCIAL INFORMATION

The following tables set out selected financial information and other data of the Fund, which should be read in conjunction with the consolidated Financial Statements of the Fund.

(IN THOUSANDS OF DOLLARS EXCEPT PER UNIT AMOUNTS)	FROM THE DATE OF INCEPTION OF THE FUND TO DEC 31, 2004
System sales of Royalty Pool Cafés	$ 16,610
Royalty income	1,080
Net earnings for the period	784
Basic and fully diluted earnings per Unit	$ 0.0818
Distributions declared	787
Distributions declared per Unit	$ 0.0821
	AS AT DECEMBER 31, 2004
Total assets	$ 120,313
Total long-term liabilities	28,667

Analysis of System Sales, New Café Openings and Closures

System sales of the Royalty Pool Cafés during the period from December 2 to December 31, 2004 were $16,610 and same café sales growth was 6.8%. The holiday period, generally considered to be the months of November and December in the retail industry, constitute slightly higher sales months than the rest of the year. On average, approximately 9% to 10% of annual system sales per month are generated in the months of November and December. While December is typically the highest system sales month, Second Cup, with renewed holiday merchandising programs, experienced a very strong final few weeks of the holiday season. The success of this program was a large factor in the achievement of same café sales growth of 6.8%. This same café sales growth performance is substantially better than the comparable periods in the last two years.

In late December, Second Cup did not renew the franchise agreements with two separate food service operators, resulting in the permanent closure of two of the Royalty Pool Cafés. Annualized system sales for these two locations were below the average of all the Royalty Pool Cafés and amounted to $660 in total. In accordance with the Licence and Royalty Agreement, Second Cup will make a "make-whole" payment of $4 per month to the Fund as a result of the closures, commencing in January 2005.

Second Cup has opened four new cafés subsequent to September 12, 2004, the date of determination of the initial Royalty Pool Cafés. These cafés are expected to be vended in as Royalty Pool Cafés on January 1, 2006, the first adjustment date under the License and Royalty Agreement.

Management is not aware of any reliable third party comparable data on the trends affecting the Canadian specialty coffee market during December 2004 or the performance of Second Cup's competitors in the Canadian market during this period.

Operating and Tax Expenses

(IN THOUSANDS OF DOLLARS)	FROM THE DATE OF INCEPTION OF THE FUND TO DEC 31, 2004
General and administrative	$ 176
Interest on term loan	51
Amortization of deferred financing fees	7
Total Operating Expenses	$ 234
Income taxes	
Current	$ 46
Future	17
	63

Operating expenses of the Fund are limited to general and administrative expenses for the administration of the Fund itself, interest on MarksCo's term loan, and amortization of deferred financing fees associated with the term loan. General and administrative expenses consist primarily of professional fees, public entity costs, insurance premiums, and directors and trustees fees. Expenses in the month were generally higher than what would normally be expected due to the disproportionate amount of costs associated with normal year-end related activities, including preparation of audited financial statements relative to the short 30 day operating period of the Fund.

During the period the Fund incurred an income tax expense of $63, of which $46 represents a current liability and the balance a future income tax liability. After taking into account distributions of $787 which are not subject to tax in the Fund, the overall income tax expense reflects the Fund's expected effective tax rate of 36%.

DISTRIBUTIONS AND DISTRIBUTABLE CASH

(IN THOUSANDS OF DOLLARS EXCEPT PER UNIT AMOUNTS)	FROM THE DATE OF INCEPTION OF THE FUND TO DEC 31, 2004
Net earnings for the period	$ 784
Add:	
Amortization of deferred financing fees	7
Future income taxes	17
Distributable cash	$ 808
Distributable cash per Unit	$ 0.0842
Distributions declared per Unit	$ 0.0821

The distributable cash for the period was $808, or $0.0842 per Unit. This reflects the impact of higher than average royalties earned from the strong system sales the cafés typically enjoy during the holiday season. Accordingly, net earnings for the Fund for the period were $784, or $0.0818 per Unit, and the Fund declared and, subsequent to the year-end, paid its projected distribution to Unitholders of $787, or $0.0821 per Unit.

LIQUIDITY AND CAPITAL RESOURCES

	PAYMENTS DUE BY PERIOD (IN THOUSANDS OF DOLLARS)				
	TOTAL	LESS THAN 1 YEAR	1-3 YEARS	4-5 YEARS	AFTER 5 YEARS
Long Term Debt	$11,000	-	$11,000	-	-

The Fund's distribution policy is to make cash distributions to Unitholders from the distributable cash generated by the Fund, and to make such distributions in equal amounts to Unitholders on a monthly basis in order to smooth out any seasonal fluctuations in royalty income.

The Fund, through its indirect wholly-owned subsidiary, MarksCo, receives monthly royalty payments in arrears from Second Cup on the 21st day of the following month. The Fund, in turn, is required to remit distributions to Unitholders in arrears, at each month end.

In December, MarksCo entered into a term credit agreement maturing on December 2, 2007 to partially finance the purchase of the Second Cup Marks and to finance any seasonal working capital fluctuations. The credit facilities total $12.0 million and comprise an $11.0 million non-revolving term credit facility and a $1.0 million operating credit facility.

The $11.0 million non-revolving term credit facility bears interest at the prime or base rate plus 0.75%, or at LIBOR advances or bankers acceptances rates plus 1.75%. At December 31, 2004, the full amount of the $11.0 million non-revolving term credit facility was drawn with an effective interest rate of 5.34% after taking into consideration the interest rate swap described below. The non-revolving term credit facilities contain financial and other customary covenants, including requirements to maintain a ratio of senior debt to EBITDA of less than 1.25:1.0 and to maintain trailing four quarter EBITDA in excess of $9 million. At December 31, 2004 MarksCo was in compliance with these covenants.

The $1.0 million operating credit facility bears interest at the prime or base rate plus 0.50%, or at LIBOR advances or bankers acceptance rates plus 1.50%.

On December 2, 2004, MarksCo entered into an interest rate swap agreement to fix the interest rate on the $11.0 million non-revolving term credit facility loan, resulting in an effective interest rate of 5.34% until December 2, 2007. On December 31, 2004, this financial instrument had a nominal market value.

The Fund does not have any plans for capital expenditures in 2005. As at December 31, 2004, 100% of the Fund's $1.0 million operating line of credit was available.

OFF-BALANCE SHEET ARRANGEMENTS

The Fund does not have any off-balance sheet arrangements other than the interest rate swap discussed above under "Liquidity and Capital Resources".

RELATED PARTY TRANSACTIONS

Included in accounts payable and accrued liability is an amount of $103 due to Second Cup. This amount is non-interest bearing, is due on demand and arose primarily as a result of Second Cup paying for certain general and administrative fees and providing accounting and bookkeeping services.

CRITICAL ACCOUNTING ESTIMATES

Revenue recognition

Revenue of the Fund comprises the royalty of 6.5% of system sales of the Royalty Pool Cafés, including any "make-whole" payments under the Licence and Royalty Agreement, made by Second Cup for use of the Second Cup Marks in Canada. The revenue is received on or before the 21st day of the following calendar month and is recognized on an accrual basis. Second Cup is required to make "make-whole" payments for Royalty Pool Cafés that are permanently closed within a reporting period. These payments are calculated as 6.5% of a permanently closed café's annual gross revenue for the first 52 weeks that the café was included in the royalty pool. If the permanently closed café was included in the royalty pool for less than 52 weeks, an appropriate adjustment is made to annualize the initial revenues.

Intangible assets

Intangible assets, consisting of the Second Cup Marks, are recorded at cost. Management of MarksCo reviews the carrying value of the intangible assets at least annually for impairment. The review is based on a number of factors including the Unit price throughout the fiscal year compared to the initial public offering Unit price and distributable cash compared to the level as set out in the MD&A. Management concluded that as at December 31, 2004 there was no impairment of these assets.

Future Income Taxes

The Fund follows the asset and liability method of accounting for income taxes. Future income tax assets are recognized only to the extent that management determines it is more likely than not that the future income tax assets will be realized.

CHANGES IN ACCOUNTING POLICIES INCLUDING INITIAL ADOPTION

Consolidation of Variable Interest Entities ("VIEs"), AcG-15

In June 2003, the CICA issued a new accounting guideline which requires the consolidation of VIEs by the primary beneficiary. The primary beneficiary is the enterprise that will absorb or receive the majority of the VIE's expected losses, expected residual returns, or both. Revisions to this guideline were published by the CICA in August 2004 to harmonize with the U.S. VIE accounting standard. A VIE is an entity where (a) its equity investment at risk is insufficient to permit the entity to finance its activities without additional subordinated support from others and/or where certain essential characteristics of a controlling financial interest are not met, and (b) it does not meet specified exemption criteria. This guideline is effective for the Fund's first quarter commencing January 1, 2005. Adoption of AcG-15 is a change in accounting policy accounted for in accordance with Section 1506 - Accounting Changes and applied retroactively except that restatement of prior period financial statements is encouraged, but not required. At this time the Fund is undertaking a review to determine the impact that this new standard may have on the Fund's financial statements.

FINANCIAL INSTRUMENTS

The Fund's financial instruments consist of cash, royalty receivable, accounts payable and accrued liabilities, income taxes payable and distributions payable to Unitholders, dividends payable, MarksCo's term loan and an interest rate swap. Unless otherwise noted in this MD&A, it is management's opinion that the Fund is not exposed to significant interest or credit risks arising from financial instruments. Management estimates that the fair vale of these financial instruments approximate their carrying values, unless otherwise noted in this MD&A.

RISKS AND UNCERTAINTIES

The performance of the Fund is dependent upon the royalties paid to MarksCo by Second Cup on the system sales of Royalty Pool Cafés. This is considered to be a key attribute of the Fund and a fund with this structure is commonly referred to as a "top line" fund. The distributions to Unitholders are a function of the system sales of the Royalty Pool Cafés less the Fund's expenses and are therefore not determined by the profitability of Second Cup or the individual Second Cup cafés. The success of the Fund is determined primarily by the ability of Second Cup to maintain and increase the system sales of Royalty Pool Cafés and to add new cafés to the royalty pool on an accretive basis.

System sales of Royalty Pool Cafés are affected by various external factors that can affect the specialty coffee industry as a whole. Potential risks include the following;

- The specialty coffee industry is characterized by intense competition with respect to price, location, coffee and food quality and numerous factors affecting discretionary consumer spending. Competitors include national and regional chains, all restaurants and food service outlets which serve coffee, and supermarkets that compete in the whole bean segment. If Second Cup cafés are unable to successfully compete in the Canadian specialty coffee industry, system sales may be adversely affected which, in turn, may reduce the amount of the royalty paid to MarksCo and adversely affect the ability of the Fund to pay distributions.
- Second Cup faces intense competition for high profile retail locations and qualified franchisees, both from specialty coffee chains and competitors from other industries. Growth of the café network depends upon Second Cup's ability to secure and build desirable locations and find high caliber, qualified franchisees to operate them.
- A shortage in supply or an increase in the price of premium quality coffee beans could adversely affect Second Cup. Second Cup has no long term or written contracts with coffee bean suppliers and relies upon historical relationships to ensure availability. While there are a number of coffee bean suppliers, there can be no assurance that coffee bean suppliers that have relationships with Second Cup will continue to supply coffee beans at competitive prices.
- The specialty coffee industry is also affected by changes in discretionary spending patterns, demographic trends, and traffic and weather patterns as well as the type, number and location of competing cafés.
- Second Cup's business could be adversely affected by reduced consumer confidence and increased concerns about food safety in general, or other unusual events such as the power outage that occurred in Toronto and other cities in August of 2003.
- Changes in government regulations and other regulatory developments (such as smoking by-laws) could have an adverse impact on system sales and the royalty.
- The loss of key personnel and/or a shortage of experienced management and hourly employees could have an adverse impact on Second Cup's operations and cafés.

A more detailed discussion of the risks and uncertainties affecting the Fund is set out in the prospectus dated November 23, 2004 and in the Fund's Annual Information Form, which are or will be available at www.sedar.com.

SUBSEQUENT EVENTS

On January 31, 2005, the Fund paid the declared distribution for December 31, 2004 of $787, or $0.0821 per Unit to holders of record at the close of business on December 31, 2004. On February 28, 2005, the Fund paid distributions of $798 or $0.0833 per Unit to holders of record at the close of business on February 24, 2005.

OUTSTANDING UNIT AND SHARE DATA

The following table outlines the ownership structure of the Fund and its wholly-owned subsidiaries, Acquisition Co and MarksCo:

	2004 ISSUED	2004 AMOUNT
Fund		
Units issued	9,582,760(1)	$ 95,827,760
Acquisition Co		
Common shares issued to the Fund	8,694,039	8,694,039
MarksCo		
Common shares issued to Acquisition Co	8,694,039	8,694,039

(1) Second Cup owns 1,437,414 Units, representing 15% of the issued and outstanding Units.

OUTLOOK

The Fund's "top line" structure means that its success and growth depends primarily on Second Cup's ability to maintain and increase the overall system sales of Royalty Pool Cafés. Growth in overall system sales is dependent upon same café sales growth, and adding net new cafés to the café network.

During 2005, Second Cup intends to continue to focus on growing same café sales and expanding the number of new Second Cup cafés across Canada. Same café sales growth is expected to be accomplished by continuing to focus on operational excellence and by:

- Increasing marketing and development programs centered on espresso-based beverages and blender drinks, which carry a higher average price than Second Cup's other beverage offerings.
- Modernizing and renovating the café network. During 2005, Second Cup expects to renovate and modernize 15 to 20 cafés.
- Introducing new products, including expanding Second Cup's complimentary offerings such as snack foods and impulse items.
- Increasing prices of certain product offerings.

Second Cup is also positioning itself for successful new café growth in Canada. To facilitate this growth, Second Cup is augmenting its administrative resources in real estate, franchising and construction.

Overall, based on the Second Cup initiatives outlined above and others, the anticipated economic environment and market conditions affecting the specialty coffee industry, the Fund expects a successful year for 2005.

Second Cup Royalty Income Fund

CONSOLIDATED FINANCIAL STATEMENTS

March 7, 2005

AUDITORS' REPORT

To the Trustees of Second Cup Royalty Income Fund

We have audited the consolidated balance sheet of Second Cup Royalty Income Fund (the Fund) as at December 31, 2004 and the consolidated statements of earnings, unitholders' equity and cash flows for the period from October 22, 2004, date of commencement, to December 31, 2004. These financial statements are the responsibility of the Fund's management. Our responsibility is to express an opinion on these financial statements based on our audit.

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

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the Fund as at December 31, 2004 and the results of its operations and its cash flows for the period from October 22, 2004, date of commencement, to December 31, 2004 in accordance with Canadian generally accepted accounting principles.

PricewaterhouseCoopers LLP

Chartered Accountants
Toronto, Canada

Second Cup Royalty Income Fund

CONSOLIDATED BALANCE SHEET

AS AT DECEMBER 31, 2004

Assets

CURRENT ASSETS	
Cash and cash equivalents	$ 3,449,205
Prepaid expenses	114,423
Royalty receivable	1,155,705
	$ 4,719,333
Deferred charges	235,411
Trademark (note 2)	115,358,314
	$ 120,313,058

Liabilities

CURRENT LIABILITIES	
Accounts payable and accrued liabilities (note 8)	$ 365,971
Income taxes payable	3,556,113
Distributions payable	786,745
	$ 4,708,829
Term bank loan (note 6)	
	11,000,000
Future income taxes (note 5)	17,667,000
	$ 33,375,829
Unitholders' Equity	86,937,229
	$ 120,313,058

See accompanying notes to consolidated financial statements.

APPROVED BY THE TRUSTEES

(Signed) David Bloom — Trustee

(Signed) Raymond Guyatt — Trustee

Second Cup Royalty Income Fund

CONSOLIDATED STATEMENT OF EARNINGS

FOR THE PERIOD FROM OCTOBER 22, 2004, DATE OF COMMENCEMENT, TO DECEMBER 31, 2004

SYSTEM SALES - Royalty Pooled Cafés	$	16,610,357
REVENUE		
Royalty income	$	1,080,098
EXPENSES		
General and administrative (note 8)	$	176,111
Amortization of deferred charges		6,726
Interest on term loan		50,679
	$	233,516
EARNINGS BEFORE INCOME TAXES	$	846,582
INCOME TAXES (note 5)		
Current	$	46,000
Future		17,000
	$	63,000
NET EARNINGS FOR THE PERIOD	$	783,582
BASIC AND DILUTED EARNINGS PER TRUST UNIT (9,582,760 units)	$	0.0818

See accompanying notes to consolidated financial statements.

Second Cup Royalty Income Fund

CONSOLIDATED STATEMENT OF UNITHOLDERS' EQUITY

FOR THE PERIOD FROM OCTOBER 22, 2004, DATE OF COMMENCEMENT, TO DECEMBER 31, 2004

	CAPITAL	UNITHOLDERS' EARNINGS	ACCUMULATED DISTRIBUTIONS	TOTAL
BALANCE - BEGINNING OF PERIOD	$ -	$ -	$ -	$ -
Issuance of trust units (notes 1 and 7)	95,827,600	-	-	95,827,600
Issuance costs (notes 1 and 7)	(8,887,208)	-	-	(8,887,208)
Net earnings for the period	-	783,582	-	783,582
Distributions (note 4)	-	-	(786,745)	(786,745)
BALANCE - END OF PERIOD	$ 86,940,392	$ 783,582	$ (786,745)	$ 86,937,229

See accompanying notes to consolidated financial statements.

Second Cup Royalty Income Fund

CONSOLIDATED STATEMENT OF CASH FLOWS

FOR THE PERIOD FROM OCTOBER 22, 2004, DATE OF COMMENCEMENT, TO DECEMBER 31, 2004

Cash provided by (used in)

OPERATING ACTIVITIES	
Net earnings for the period	$ 783,582
Amortization of deferred charges	6,726
Future income taxes	17,000
Change in non-cash working capital items	
Prepaid expenses	(114,369)
Royalty receivable	(1,155,705)
Accounts payable and accrued liabilities	365,971
Income taxes payable	46,000
	$ (50,795)
INVESTING ACTIVITIES	
Acquisition of Second Cup Marks - net of cash acquired (note 2)	$ (83,440,392)
FINANCING ACTIVITIES	
Issuance of trust units (note 1)	$ 95,827,600
Cost of issuing trust units (note 1)	(8,887,208)
	$ 86,940,392
INCREASE IN CASH AND CASH EQUIVALENTS DURING THE PERIOD	$ 3,449,205
CASH AND CASH EQUIVALENTS - BEGINNING OF PERIOD	-
CASH AND CASH EQUIVALENTS - END OF PERIOD	$ 3,449,205

See accompanying notes to consolidated financial statements.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

DECEMBER 31, 2004

1. THE FUND

Second Cup Royalty Income Fund (the Fund) is an open-ended trust established under the laws of the Province of Ontario. An unlimited number of units may be issued pursuant to the declaration of trust. Units are redeemable by the holder at any time. The Fund issued ten initial units on October 22, 2004 for cash proceeds of $100. These initial units were redeemed prior to the Fund commencing operations on December 2, 2004. Income tax obligations related to distributions by the Fund are obligations of the unitholders.

On December 2, 2004 the Fund completed an initial public offering of 9,582,760 units at $10.00 per unit pursuant to a prospectus for aggregate proceeds of $95,827,600 before issuance costs of $8,887,208.

As discussed below, the Fund, on December 2, 2004 used the net proceeds from the initial public offering of trust units, to indirectly acquire the successor, by amalgamation, to The Second Cup Ltd. (MarksCo), (subsequently this company changed its name to Second Cup Trade-Marks Inc.) whose primary asset at that time was the trademarks and associated rights (the Second Cup Marks) used by Second Cup cafés in Canada. MarksCo, prior to its acquisition, had granted to a subsidiary of Cara Operations Limited (Cara), referred to herein as The Second Cup Ltd. (Second Cup or New Second Cup), a licence, under the License and Royalty Agreement (the Agreement), to use the Second Cup Marks in all provinces and territories of Canada (except Nunavut) for a period of 99 years for a royalty payable by Second Cup to MarksCo equal to 6.5% of the system sales reported from certain specifically identified Second Cup cafés in Canada (Royalty Pooled Cafés).

The number of cafés in the Royalty Pooled Cafés will be adjusted annually on January 1 of each year (the adjustment date), to include Second Cup cafés, which on November 1 of the previous year had been open for at least 60 days and were not previously included in the Royalty Pooled Cafés. Thereafter, the gross revenue of the additional Second Cup cafés will be added to the revenue of the original Royalty Pooled Cafés for the purposes of calculating the royalty payment. Payment to Second Cup for these new cafés can be made at MarksCo's election by: (i) the issuance of new trust units based on the then market price; or (ii) in cash. The first such adjustment will be made on January 1, 2006.

According to the terms of the Agreement, Second Cup is required to remit Make-Whole Payments (as part of royalty payments) for Royalty Pooled Cafés that become permanently closed during a reporting period. These payments are calculated as 6.5% of the permanently closed café's system sales for the first 52 weeks that the café was included in the Royalty Pooled Café. If the permanently closed café was included in the Royalty Pooled Cafés for less than 52 weeks, an appropriate adjustment is made to annualize the initial revenues. One-twelfth of the Make-Whole Payment will be paid every month for the remainder of the year in which the permanent closure occurred, up to the next adjustment date (pro-rated for partial months). However, the Make-Whole Payments can be reduced, or eliminated, by royalty payments from the addition of new Royalty Pooled Cafés.

2. INITIAL PUBLIC OFFERING AND ACQUISITION OF SECOND CUP MARKS

On December 2, 2004, the Fund used the proceeds from an offering of units under a prospectus dated November 23, 2004, to subscribe for common shares and notes of 1636433 Ontario Inc. (AcquisitionCo), a newly created subsidiary of the Fund, which in turn used the proceeds to acquire from Cara all of the issued and outstanding shares of MarksCo. At the time the interest in MarksCo was acquired, its primary asset was the Second Cup Marks. The acquisition, which was accounted for as a purchase, comprises the following:

Cash	$ 3,500,000
Prepaid expenses	54
Deferred charges	242,137
Trademark	115,358,314
	$ 119,100,505
Income taxes payable	(3,510,113)
Term bank loan	(11,000,000)
Future income taxes	(17,650,000)
Net assets acquired	$ 86,940,392

3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

a. Basis of presentation

These consolidated financial statements include the accounts of the Fund and its wholly owned subsidiaries, AcquisitionCo and MarksCo. These consolidated financial statements have been prepared in accordance with Canadian generally accepted accounting principles. All significant intercompany transactions have been eliminated.

b. Revenue recognition

Revenue comprises royalty income equal to 6.5% of system sales from the Royalty Pooled Cafés, including any Make-Whole Payments under the Agreement. The revenue is received on or before the 21st day of the following calendar month and is recognized on an accrual basis. Second Cup recognizes revenue from corporate and franchised cafés when services are rendered and collection is reasonably assured.

c. Cash and cash equivalents

Deposits in banks and short-term investments with original maturities of three months or less are considered cash and cash equivalents. Cash equivalents are carried at cost, which approximates fair market value.

d. Deferred charges

Deferred charges represent costs associated with the term bank loan and are being amortized over the term of the debt.

e. Trademarks

Trademarks, trade names, operating procedures and systems and other intellectual property used in connection with the operation of the Second Cup cafés in Canada (collectively the Second Cup Marks) are recorded at cost. The trustees of the Fund review the carrying value of the trademarks at least annually for impairment taking into consideration any events or circumstances that might have impaired the carrying value. If there is an impairment, trademarks are written down to their estimated fair value.

f. Future income taxes

Future income taxes are calculated using the asset and liability method of tax accounting. Temporary differences arising from the differences between the tax basis of an asset or liability and its carrying amount on the consolidated balance sheet are used to calculate future income tax assets or liabilities. Future income tax assets or liabilities are calculated using the substantially enacted tax rates anticipated to apply in the periods that the temporary differences are expected to reverse.

g. Earnings per trust unit

The earnings per unit are based on the weighted average number of units outstanding during the period. Diluted earnings per unit are calculated to reflect the dilutive effect, if any, of any other outstanding equity investments.

h. Distribution to unitholders

The amount of cash to be distributed annually to unitholders is determined with reference to distributable cash, which is calculated as net earnings adjusted for future income taxes and amortization of deferred charges.

Distributions to unitholders are intended to be made monthly in arrears based on estimated annualized distributable cash less cash redemptions of units, if any, and subject to the Fund retaining such reasonable working capital reserves as may be considered appropriate by the trustees of the Fund.

i. Use of estimates

Preparation of the consolidated financial statements in conformity with Canadian generally accepted accounting principles requires the trustees to make estimates and assumptions that affect the reported amounts in the consolidated financial statements and accompanying notes. Actual results could differ from those estimates.

j. Derivative instruments

The Fund uses a swap contract to manage its exposure to movements in interest rates on its variable interest term loan.

The Fund has adopted Accounting Guideline 13, Hedging Relationships (AcG 13) issued by The Canadian Institute of Chartered Accountants that establishes the criteria for applying hedge accounting for derivative instruments. Derivatives, that have been designated, and function effectively as hedges in accordance with AcG 13 are accounted for using hedge accounting principles. These principles require that the realized current period income or expense generated by the swap contracts are recognized as adjustments to interest expenses.

Derivatives that do not qualify for hedge accounting are recorded in the consolidated balance sheet at fair value. Changes in fair value are recorded as an income or expense in the consolidated statement of earnings.

k. Financial instruments

The Fund's financial instruments consist of cash, royalty receivable, accounts payable and accrued liabilities, income taxes payable and distributions payable to the unitholders. It is the trustees' opinion that the Fund is not exposed to significant interest or credit risk arising from these financial instruments. The trustees of the Fund estimate that the fair values of these financial instruments approximate their carrying values.

The Fund also has an interest rate swap contract that is a derivative financial instrument. The fair value of the swap contract is estimated to be nominal at December 31, 2004.

4. DISTRIBUTION TO UNITHOLDERS

Distributable cash is not a defined term under Canadian generally accepted accounting principles but is determined as earnings before future income taxes.

Net earnings for the period	$	783,582
Amortization of deferred charges		6,726
Future income taxes		17,000
Distributable cash	$	807,308
Distributable cash per unit (9,582,760 units)	$	0.0842
Distributable cash declared per unit (9,582,760 units) [1]	$	0.0821

(1) This distribution was paid on January 31, 2005.

5. FUTURE INCOME TAXES

The net future income tax liability of $17,667,000 relates to the difference between the accounting value and the tax basis of the trademark.

The reconciliation of the Fund's tax charge to statutory rates is as follows:

Combined Canadian statutory rate		36.12%
Tax provision at statutory rates	$	305,785
Income accrued to unitholders not subject to tax in the Fund		(242,785)
Income tax provision	$	63,000

6. TERM LOAN

On December 2, 2004, MarksCo, a subsidiary of the Fund, as borrower, and the Fund and AcquisitionCo, as guarantors, entered into a term credit agreement maturing on December 2, 2007. The credit facilities total $12.0 million and are comprised of an $11.0 million non-revolving term credit facility, and a $1.0 million operating credit facility.

The $11.0 million non-revolving credit facility bears interest at prime or base rate plus 0.75% or LIBOR advances or banker's acceptances plus 1.75%. At December 31, 2004, the full amount of the $11.0 million non-revolving credit facility was drawn with an effective interest rate of 5.34% after taking into consideration the interest rate swap described below.

The $1.0 million operating credit facility bears interest at prime or base rate plus 0.50% or LIBOR advances or banker's acceptance plus 1.50%. At December 31, 2004, no advances had been drawn on this facility.

The term credit facilities contain common and restrictive and financial covenants including maintenance of a leverage ratio and minimum EBITDA. The term credit facilities are collateralized by substantially all the assets of the Fund, including the Agreement pursuant to which the New Second Cup has provided a general security agreement.

On December 2, 2004, MarksCo entered into an interest rate swap agreement to fix the interest rate on the $11.0 million non-revolving credit facility loan at 3.59% plus the variable margin noted above until December 2, 2007. On December 31, 2004, this financial instrument had a nominal market value.

7. UNITHOLDERS' EQUITY TRUST UNITS

The declaration of trust provides that an unlimited number of units may be issued. Each unit is transferable, and represents an equal undivided beneficial interest in any distribution of the Fund and in the net assets of the Fund. All units have equal rights and privileges. Each unit entitles the holder thereof to participate equally in allocations and distributions and to one vote at all meetings of unitholders for each whole unit held. The units are not subject to future calls or assessments. Units are redeemable at any time at the option of the unitholder at amounts related to market prices at the time, subject to a maximum of $50,000 in cash redemptions by the Fund in any one month. The limitation may be waived at the discretion of the trustees of the Fund.

On December 2, 2004, the Fund issued 9,582,760 units at $10 per unit pursuant to a public underwriting. Expenses of the offering amounted to $8,887,208.

8. RELATED PARTY TRANSACTIONS AND BALANCES

Included in accounts payable and accrued liabilities is an amount of $102,504 due to Second Cup. This amount is non-interest bearing and is due on demand and arose as a result of Second Cup paying for certain general and administrative fees and providing accounting and bookkeeping services.

9. ECONOMIC DEPENDENCE

All of the Fund's revenue is derived from royalties payable by Second Cup as described in note 3(b).

The Second Cup Ltd.

MANAGEMENT'S DISCUSSION AND ANALYSIS

The following is a discussion of the results of operations and financial condition of The Second Cup Ltd. ("Second Cup") for the 40-week period ended January 1, 2005. The consolidated Financial Statements of Second Cup are prepared in accordance with Canadian generally accepted accounting principles ("GAAP"). All amounts are presented in thousands of Canadian dollars, unless otherwise indicated. The financial results for the 40-week period ended January 1, 2005 are not directly comparable to those of the 52-week period ended March 27, 2004 due to the different number of weeks in the periods and due to seasonal fluctuations in the business as described further in "System Wide Sales – Overview of system wide sales" below.

This Management's Discussion and Analysis ("MD&A") has been prepared as of March 7, 2005.

FORWARD-LOOKING INFORMATION

Certain statements in this MD&A may constitute forward-looking statements. Forward-looking statements include words such as "may", "will", "should", "expect", "anticipate", "believe", "plan", "intend" and other similar words. These statements reflect current expectations regarding future events and operating performance and speak only as of the date of this MD&A. These forward-looking statements should not be read as guarantees of future performance or results and will not necessarily be accurate indications of whether or not those results will be achieved. Forward looking statements are subject to known and unknown risks, uncertainties and other factors that may cause Second Cup's actual results, performance or achievements, or those of Second Cup cafés, or industry results to be materially different from any future results, performance or achievements expressed or implied by those forward looking statements. The following are some of the factors that could cause actual results to differ materially from those expressed in or underlying those forward looking statements: competition; availability of premium quality coffee beans; the ability to attract qualified franchisees; the location of Second Cup cafés; the ability to exploit and protect the Second Cup trade-marks and other intellectual property rights owned by Second Cup Trade-Marks Inc. and used in connection with the operation of Second Cup cafés in Canada; changing consumer preferences and discretionary spending patterns; reporting of gross revenue by franchisees; and the results of operations and financial condition of Second Cup. The foregoing list of factors is not exhaustive, and prospective investors should refer to the risks described below under "Risks and Uncertainties". Although the forward looking statements contained in this MD&A are based upon what management believes are reasonable assumptions, there can be no assurance that actual results will be consistent with these forward looking statements. As these forward looking statements are made as of the date of this MD&A, Second Cup assumes no obligation to update or revise them to reflect new events or circumstances.

NON-GAAP TERMS

In addition to using financial measures prescribed by GAAP, non-GAAP financial measures and other terms are used in this MD&A. These terms include "same café sales" and "EBITDA" (earnings before interest, taxes, depreciation and amortization). These terms are not financial measures recognized by GAAP and do not have any standardized meaning prescribed by GAAP and therefore may not be comparable to similar terms and measures presented by other similar issuers. These non-GAAP measures and terms are intended to provide additional information on Second Cup's performance and should not be considered in isolation or as a substitute for measures of performance prepared in accordance with GAAP.

References to EBITDA are to earnings determined in accordance with GAAP applicable to the financial statements before amounts for interest, taxes and depreciation and amortization are included in the earnings. Management believes that, in addition to net income, EBITDA is a useful supplemental measure in evaluating Second Cup's performance as it provides investors with an indication of cash available for debt service, working capital needs and capital expenditures. Investors are cautioned, however, that EBITDA should not be construed as an alternative to the statement of cash flows as a measure of liquidity and cash flows. The method of calculating EBITDA for the purposes of this MD&A may differ from that used by other issuers and, accordingly, EBITDA in this MD&A may not be comparable to EBITDA used by other issuers.

BASIS OF PRESENTATION

This MD&A and the financial information contained herein are those of The Second Cup Ltd. ("Second Cup"), incorporated on November 17, 2004, and its predecessor corporation ("Old Second Cup" or the "Predecessor Corporation") of the same name. As described below, the Predecessor Corporation was subsequently amalgamated and changed its name to Second Cup Trade-Marks Inc. ("MarksCo").

In connection with a series of transactions associated with the initial public offering of Second Cup Royalty Income Fund ("the Fund"), which was completed on December 2, 2004, Second Cup acquired substantially all of the assets and liabilities relating to Old Second Cup's Canadian business other than the Second Cup Canadian trade-marks and certain other intellectual property and associated rights used in connection with the operation of Second Cup cafés in Canada (the "Second Cup Marks"). The assets and liabilities of Old Second Cup's international business were acquired by Second Cup's parent company, Cara Operations Limited ("Cara"). As a result, the primary remaining asset of the Predecessor Corporation was the Second Cup Marks. As part of these transactions, Old Second Cup was also amalgamated with one of its shareholders and a wholly-owned subsidiary to form MarksCo and a licence and royalty agreement (the "Licence and Royalty Agreement") was entered into under which MarksCo agreed to license the use of the Second Cup Marks to Second Cup in all provinces and territories of Canada, excluding the territory of Nunavut, for a period of 99 years. In exchange for this licence, Second Cup agreed to pay MarksCo a royalty equal to 6.5% of system sales of a certain number of Second Cup cafés in Canada (the "Royalty Pool Cafés"). Note 2 to the Consolidated Financial Statements of Second Cup provides further details pertaining to the basis of presentation, including the treatment of the series of transactions undertaken by the Predecessor Corporation prior to its indirect acquisition by the Fund.

The net proceeds of the Fund's initial public offering were used by the Fund to indirectly acquire all of the issued and outstanding share capital of MarksCo on December 2, 2004. At this time Second Cup also acquired 1.4 million units of the Fund (the "Units") for an aggregate cash cost of $14.3 million. This represents an approximate 15% interest in the Fund. At January 1, 2005, the fair market value of this investment was $17.0 million.

OVERVIEW AND BUSINESS OF SECOND CUP

Second Cup franchises, owns and operates the second largest specialty coffee café chain in Canada, as measured by number of cafés. Second Cup's revenues are derived from royalties from franchisees, initial and renewal franchise fees, administration fees, sales from company owned cafés, coordination fees, and other sources of revenue. The amount of revenue can be affected by a number of factors, principally system wide sales, the number of new cafés opened, the number of franchise agreements renewed and sales of company owned cafés.

Operating costs and administrative expenses include the compensation, general and administrative costs associated with the operations of Second Cup in providing services to the company owned and franchised Second Cup cafés, costs of maintaining and enhancing the Second Cup brand, costs associated with developing, researching and marketing new products, and costs associated with the establishment of new Second Cup cafés and the renewal of existing Second Cup cafés. Operating costs also include the operating costs of company owned cafés. As described in "Basis of Presentation" above, commencing December 2, 2004, Second Cup also pays a royalty to MarksCo equal to 6.5% of system sales of the Royalty Pool Cafés, pursuant to the Licence and Royalty Agreement. At the time the Licence and Royalty Agreement was entered into, 351 cafés were included as Royalty Pool Cafés.

Second Cup's fiscal year is comprised of 13 periods of four weeks each, ending on the Saturday closest to December 31. To accommodate this year-end, an additional week (i.e., a 53rd week) has typically been added approximately every five years. It should be noted that prior to entering into the transactions discussed above, Second Cup's fiscal year ended on the Saturday closest to March 31.

SYSTEM WIDE SALES

The following table sets out system wide sales reported by Second Cup cafés in Canada to Second Cup for the periods indicated below:

(IN THOUSANDS OF DOLLARS)	40 WEEKS ENDED JANUARY 1, 2005	52 WEEKS ENDED MARCH 27, 2004
Franchisee Owned Operations	$ 133,586	$ 164,860
Company Owned Operations	7,262	7,645
System Wide Sales	$ 140,848	$ 172,505

Overview of system wide sales

System wide sales comprise the gross revenue reported to Second Cup by franchisees of 338 Second Cup cafés, including Cara under its Master Franchise Agreement, and by 31 company owned cafés, which include three that are operated by franchisees, as at January 1, 2005.

Sales are reported by franchisees to Second Cup on a weekly basis without audit or other form of independent assurance. Second Cup verifies sales reported by its franchisees through analytical reviews performed by management that consist of historical and year-to-date comparisons of individual café performance and performance within the network, and by comparing purchases of raw materials by café, as provided by suppliers, against reported sales. Furthermore, audits are performed at random by Cara's internal audit team on cafés throughout the Second Cup network.

Increases in system wide sales result from the addition of new cafés to the Second Cup café network and same café sales growth. Sales increases from existing cafés are primarily dependent upon pricing, product and marketing initiatives undertaken by Second Cup, maintaining operational excellence within the café network and general market conditions. The primary factors that influence the number of cafés added to the Second Cup café network include the availability and cost of high quality locations, competition from other specialty coffee retailers and other businesses for prime locations and the availability of qualified franchisees.

System wide sales are also affected by the permanent closure of Second Cup cafés. Cafés are closed when they cease to be viable or, occasionally, when it is not possible to renew a lease for a particular location or to find an alternative suitable location for the franchisee.

System wide sales are minimally affected by seasonal fluctuations. For instance, the four-week holiday periods of November and December account for approximately 8.5% and 9.0%, respectively, of system wide sales for Second Cup's fiscal year, whereas other periods account for between 7.0% and 7.9% of system wide sales.

Analysis of system wide sales

System wide sales for the 40-week period ended January 1, 2005 were $140.8 million, compared to $172.5 million for the 52-week period ended March 27, 2004. Same café sales growth for the 40-week period ended January 1, 2005 was 5.8% over the same 40-week period in the prior year. The growth in same café sales was, in part, due to a pricing increase that Second Cup implemented on certain beverages, representing an estimated 1.0% to 1.5% of the increase in the period; an increase in sales at locations that were detrimentally impacted by the outbreak of Severe Acute Respiratory Syndrome ("SARS") in the prior period, estimated to account for 1.5% to 2.0% of the increase in the period (based on the sales of Ontario hospital cafés alone); the introduction of the "$2.00 Tuesdays" promotions; and a general increase in the efficiency of café operations. Sales in the prior period were also impacted by the power outage that occurred in the Greater Toronto Area in August 2003. During the 40-week period ended January 1, 2005, Second Cup opened seven new cafés and closed 19 cafés. The closures were part of an ongoing process to eliminate under-performing locations and maintain a modern portfolio of cafés. As at January 1, 2005 there were 369 cafés in Canada, compared to 381 cafés at March 27, 2004.

SELECTED FINANCIAL INFORMATION

The following tables set out selected financial information and other data of Second Cup, which should be read in conjunction with the consolidated Financial Statements of Second Cup.

(IN THOUSANDS OF DOLLARS)	40 WEEKS ENDED JANUARY 1, 2005	52 WEEKS ENDED MARCH 27, 2004
System wide sales – Canadian operations	$ 140,848	$ 172,505
Income Statement Data		
Revenue from Canadian operations:		
Royalty revenue from franchised cafés	$ 11,430	$ 13,985
Revenue from company owned cafés	7,262	7,645
Other income	3,169	4,231
	$ 21,861	$ 25,861
Operating costs and administrative expenses of Canadian operations	13,326	15,330
Royalty expense	1,105	-
Amortization of property plant and equipment	424	460
Investment income	(118)	-
Interest income	(206)	(208)
Restructuring costs and other unusual expenses	-	378
International operations	179	399
Earnings before income taxes	$ 7,151	$ 9,502
Income taxes	2,572	3,778
Net earnings for the period	$ 4,579	$ 5,724

(IN THOUSANDS OF DOLLARS)	AS AT JANUARY 1, 2005	AS AT MARCH 27, 2004
Balance Sheet Data		
Total assets	$ 26,222	$ 23,163
Total long-term liabilities	131	-

RESULTS OF CANADIAN OPERATIONS

Analysis of revenues from Canadian operations

Revenues for the 40-week period ended January 1, 2005 were $21.9 million, compared to $25.9 million for the 52-week period ended March 27, 2004. As a percentage of total system wide sales, royalties collected from franchised cafés remained consistent with the 52-week period ended March 27, 2004, at 8.1%. Excluding sales from company-owned cafés during the period, the effective royalty rate, calculated by taking royalty revenue divided by total franchised system wide sales including sales of cafés operated by Cara under a master franchise agreement, was 8.6% for the period versus 8.5% for the 52-week period ended March 27, 2004.

Sales from company-owned cafés was $7.3 million for the period, versus $7.6 million for the 52-week period ended March 27, 2004. Second Cup operated, on average, 23 company-owned cafés during the period versus 19 in the 52-week period ended March 27, 2004. Second Cup ended the period with 31 company-owned cafés (three of which were operated by franchisees), compared to 26 company-owned cafés (six of which were operated by franchisees) as at March 27, 2004.

Other income includes initial franchise fees, which are recognized as income on new cafés when they are opened, renewal fees, which are recognized when an existing franchisee enters into a new franchise agreement, transfer fees earned on the sale of cafés from one franchisee to another, construction administration fees, purchasing coordination fees earned from suppliers and rebate income earned by Second Cup on the sale of its coffee to alternate channels.

Analysis of net earnings

Operating costs and administrative expenses were $13.3 million for the 40-week period ended January 1, 2005 versus $15.3 million for the 52-week period ended March 27, 2004. Included in operating costs and administrative expenses for the 52-week period ended March 27, 2004 is a non-recurring charge of $0.7 million relating to costs incurred by Second Cup due to the insolvency of a construction management company used by Second Cup to manage its construction requirements. Operating and administrative expenses include costs related to operating company-owned cafés, which increased as a percentage of overall costs due to Second Cup operating, on average, 23 company-owned cafés in the 40-week period ended January 1, 2005 versus 19 in the 52-week period ended March 27, 2004. Operating and administrative expenses also include Shared Service costs paid to Cara of $2.1 million in the 40-week period ended January 1, 2004 versus $0.3 million in the 52-week period ended March 27, 2004. These costs are further explained in "Related Party Transactions" below.

Royalty expense of $1.1 million was accrued related to the 6.5% royalty owing to MarksCo for use of the Second Cup Marks. The royalty was based on the system sales of Royalty Pool Cafés for the period from December 2, 2004 to January 1, 2005, which amounted to $16.6 million of total system wide sales.

Amortization expense amounted to $0.4 million for the 40-week period ended January 1, 2005 versus $0.5 million for the 52-week period ended March 27, 2004.

The Fund declared distributions of $0.0821 per Unit for the period from December 2 to December 31, 2004 for holders of record on December 31, 2004. Investment income of $0.1 million was recognized to record the income earned on the 1.4 million Units of the Fund held by Second Cup as at December 31, 2004.

Interest income of $0.2 million was earned in the year versus $0.2 million for the 52-week period ended March 27, 2004. The vast majority of this interest income was earned on funds advanced to Cara as described in "Related Party Transactions" below.

Restructuring costs in the prior year related primarily to the elimination of redundant office space, work force reduction costs and other related reorganization costs as a result of the acquisition of Old Second Cup by Cara, which was completed in February 2002.

As described in "Basis of Presentation" above, Old Second Cup sold the assets and liabilities of its international operations to Cara in connection with a series of transactions associated with the Fund's initial public offering. For the 40-week period ended January 1, 2005, these operations contributed a loss of $0.2 million before income taxes versus a loss of $0.4 million before income taxes for the 52-week period ended March 27, 2004. International operations expenses include an allocation of overhead expenses of Second Cup amounting to $0.3 million for the 40-week period ended January 1, 2005 versus $0.4 million for the 52-week period ended March 27, 2004. This allocation relates to costs associated with the supervision of international cafés by designated individuals at Second Cup, the benefit derived from the use of products and initiatives developed by Second Cup's Canadian operations, services relating to the review and approval of café design, and other general costs related to the development of the international brand.

Income tax expense in the period was $2.6 million versus $3.8 million in the 52-week period ended March 27, 2004, or 36.0% of earnings before income taxes in the current period versus 39.7% for the 52-week period ended March 27, 2004. The decrease from the prior year is mainly due to a provision taken in the prior period as discussed in "Critical Accounting Estimates" below.

Net earnings for Second Cup were $4.6 million for the 40-week period ended January 1, 2005 versus $5.7 million for the 52-week period ended March 27, 2004.

LIQUIDITY AND CAPITAL RESOURCES

Cash provided by operating activities increased to $7.9 million for the 40-week period ended January 1, 2005 compared to $4.0 million for the 52-week period ended March 27, 2004. The change in cash provided by operating activities is mainly attributable to there being a decrease in non-cash working capital of $2.9 million in the current period compared to an increase of $2.1 million in the 52-week period ended March 27, 2004. The decrease in non-cash working capital of $2.9 million in the current period was principally due to an increase in current liabilities resulting from the $1.2 million royalty payable to the Fund and an increase in trade and other payables due to the timing of payments and seasonality of the business as described in "System Wide Sales – Overview of system wide sales". In the prior year the increase in non-cash working capital primarily due to a decrease in deposits received from franchisees.

Cash used in investing activities in the period related primarily to the purchase of 1.4 million Units of the Fund for $14.4 million as described in "Basis of Presentation" above. Also included in investing activities is $1.5 million related to the acquisition of existing franchised cafés, the addition of new company owned cafés and the renovation of existing company owned cafés, net of $0.3 million of proceeds received on the sale of corporate cafés.

Cash provided by financing activities of $6.5 million in the period relate entirely to the transactions described in "Basis of Presentation" above and in Note 2 of the Consolidated Financial Statements of Second Cup.

OFF-BALANCE SHEET ARRANGEMENTS

Second Cup has lease commitments for company owned cafés. In addition, Second Cup is a sublessor under the head lease for all franchised cafés, other than locations franchised to certain corporate franchises and certain hospitals and universities. Should franchisees fail to meet their obligations under the terms of their respective subleases, Second Cup would become liable for the obligations under the related head leases. In the event that a franchisee fails to meet its obligations under the terms of its sublease, Second Cup would take steps to terminate the existing franchise agreement and either operate the location as a company owned café or refranchise the location.

The following table sets out anticipated net lease obligations for Second Cup.

						PAYMENTS DUE BY PERIOD
(IN THOUSANDS OF DOLLARS)	2005	2006	2007	2008	2009	AFTER 2009
Minimum lease obligations	$ 14,800	$ 13,148	$ 11,339	$ 9,400	$ 7,531	$ 14,512
Less: Sublease to franchisees	13,295	11,885	10,316	8,515	6,743	12,909
Net lease obligations	$ 1,505	$ 1,263	$ 1,023	$ 885	$ 788	$ 1,603

Cash held in trust on behalf of franchisees for marketing, advertising and other co-operative expenditures as at January 1, 2005 amounted to $1.4 million versus $0.7 million as at March 27, 2004, and $0.5 million as at March 29, 2003, and is not recorded on Second Cup's consolidated balance sheet.

RELATED PARTY TRANSACTIONS

Second Cup has entered into related party transactions with Cara. These transactions are entered into in the normal course of business and are measured at the exchange amount, which is the amount of consideration established and agreed to by the related parties. Significant related party transactions include:

- Payments of royalties to Second Cup on the sales of cafés operated by Cara under the Master Franchise Agreement entered into with Second Cup in 1996. For the 40-week period ended January 1, 2005, these payments amounted to $0.3 million versus $0.3 million for the 52-week period ended March 27, 2004.

- Second Cup's offices are located at Cara's head office in Mississauga, Ontario, for which Second Cup pays rent to Cara. Furthermore, Cara provides services to Second Cup ("Shared Services") related to office services, payroll and other administrative functions. In 2004, the Shared Services provided by Cara were expanded to include real estate, construction, franchising, human resources, accounting and information technology services. For the 40-week period ended January 1, 2005 the consideration charged for these services amounted to $2.1 million versus $0.3 million for the 52 week period ended March 27, 2004.

- Second Cup has advanced funds to Cara in the form of promissory notes bearing interest at 3.0% per annum, which are due on demand. Second Cup earned interest of $0.2 million for the 40-week period ended January 1, 2005 from these advances versus $0.2 million for the 52-week period ended March 27, 2004. The amounts were repaid during the period. At January 1, 2005, Second Cup had an outstanding receivable of $1,204,666 from Cara arising from Cara holding surplus cash balances. These amounts are non-interest bearing and are due on demand.
- Royalty expense of $1.1 million was accrued related to the 6.5% royalty owing to MarksCo for use of the Second Cup Marks for the period from December 2, 2004 to January 1, 2005. This amount was paid on January 21, 2005.
- Investment income of $0.1 million was recognized in the period to record the income earned on the 1.4 million Units of the Fund held by Second Cup as at December 31, 2004. This amount was received on January 31, 2005.

CRITICAL ACCOUNTING ESTIMATES

The preparation of Second Cup's financial statements requires management to make estimates and assumptions that affect income and expenses during the reporting periods, in addition to the reported amounts of assets and liabilities and disclosure of contingent liabilities at the date of the financial statements.

Intangible assets

Intangible assets, consisting of goodwill, are recorded at cost. Goodwill represents the excess of costs of investments and businesses acquired over the fair value of the net assets acquired. Management of Second Cup reviews the carrying value of the intangible assets at least annually for impairment. Management believes that no impairment of goodwill exists as at January 1, 2005.

Contingent liabilities

Second Cup is involved in litigation and other claims arising in the normal course of business. Management must use its judgment to determine whether or not a claim has any merit, the amount of the claims and whether to record a provision, which is dependent upon the potential success of the claim. Management does not believe that any liability that may arise from current claims will have a material adverse impact on the financial position of Second Cup.

Future Income Taxes

Second Cup follows the asset and liability method of accounting for income taxes. Future income tax assets are recognized only to the extent that management determines it is more likely than not that the future income tax assets will be realized. In the prior year, a provision was taken for potential income tax liabilities that are currently under review by the Canada Revenue Agency.

Allowance for doubtful debts

Second Cup has recorded a provision for accounts receivable resulting from the potential risk that the receivable will not be collected. Management continually monitors past due accounts to assess the likelihood of collections to estimate the required provision.

CHANGES IN ACCOUNTING POLICIES INCLUDING INITIAL ADOPTION

Consolidation of Variable Interest Entities ("VIEs"), AcG-15

In June 2003, the Canadian Institute of Chartered Accountants ("CICA") issued a new accounting guideline which requires the consolidation of VIEs by the primary beneficiary. The primary beneficiary is the enterprise that will absorb or receive the majority of the VIE's expected losses, expected residual returns, or both. Revisions to this guideline were published by the CICA in August 2004 to harmonize with the U.S. VIE accounting standard. A VIE is an entity where (a) its equity investment at risk is insufficient to permit the entity to finance its activities without additional subordinated support from others and/or where certain essential characteristics of a controlling financial interest are not met, and (b) it does not meet specified exemption criteria. This guideline is effective for Second Cup's first quarter commencing January 2, 2005. Adoption of AcG-15 is a change in accounting policy accounted for in accordance with Section 1506 - Accounting Changes and applied retroactively except that restatement of prior period financial statements is encouraged, but not required. At this time Second Cup is undertaking a review to determine the impact that this new standard may have on its financial statements.

Asset Retirement Obligations, CICA Handbook Section 3110

Second Cup has adopted the provisions of Handbook Section 3110, Asset Retirement Obligations, which was adopted by Old Second Cup effective March 28, 2004 and which establishes standards for the recognition, measurement and disclosure of liabilities for asset retirement obligations and the associated asset retirement cost. The standard applies to legal obligations associated with the retirement of tangible long-lived assets and applies to obligations for both lessors and lessees in connection with the leased assets. No adjustment has been made in the financial statements as a result of the adoption of the provisions of Section 3110.

Determining Whether an Arrangement Contains a Lease, EIC 150

An entity may enter into certain arrangements comprising a transaction or a series of related transactions that does not take the legal form of a lease but conveys a right to use a tangible asset (e.g., an item of property, plant or equipment) in return for a payment or series of payments. EIC 150 provides guidance for determining whether such arrangements are, or contain, leases that are within the scope of Section 3065 - Leases. The EIC is applicable to: (a) arrangements agreed to, or committed to if earlier, after the beginning of an entity's next reporting period beginning after December 9, 2004; (b) arrangements modified after the beginning of an entity's next reporting period beginning after December 9, 2004; and (c) arrangements acquired in business combinations initiated after the beginning of an entity's next reporting period beginning after December 9, 2004. This new standard will be adopted by Second Cup on January 2, 2005 and is not expected to have a significant impact on its financial statements.

FINANCIAL INSTRUMENTS

Second Cup's financial instruments consist of cash and cash equivalents, accounts receivable, advances, bank indebtedness, accounts payable and accrued liabilities. The fair values of these instruments approximate their carrying amounts due to their short-term maturity. The fair value of advances due from Cara cannot be determined due to the uncertainty of the timing of cash payments.

Second Cup's financial instruments exposed to credit risk include cash and cash equivalents and accounts receivable. Second Cup places its cash and cash equivalents with institutions of high creditworthiness. Accounts receivable primarily comprise amounts due from franchisees and management believes that its accounts receivable credit risk exposure is limited.

RISKS AND UNCERTAINTIES

The performance of Second Cup is primarily dependent upon its ability to maintain and increase the sales of existing cafés, add new profitable cafés to the network and redevelop and modernize cafés as their leases come due.

The performance of Second Cup and its cafés is affected by various external factors that can affect the specialty coffee industry as a whole. Potential risks include the following:

- The specialty coffee industry is characterized by intense competition with respect to price, location, coffee and food quality and numerous factors affecting discretionary consumer spending. Competitors include national and regional chains, all restaurants and food service outlets which serve coffee, and supermarkets that compete in the whole bean segment. If Second Cup cafés are unable to successfully compete in the Canadian specialty coffee industry, system wide sales may decrease.

- Second Cup faces intense competition for high profile retail locations and qualified franchisees, both from specialty coffee chains and competitors from other industries. Growth of the café network depends upon Second Cup's ability to secure and build desirable locations and find high caliber, qualified franchisees to operate them.
- A shortage in supply or an increase in the price of premium quality coffee beans could adversely affect Second Cup. Second Cup has no long term or written contracts with coffee bean suppliers and relies upon historical relationships to ensure availability. While there are a number of coffee bean suppliers, there can be no assurance that coffee bean suppliers that have relationships with Second Cup will continue to supply coffee beans at competitive prices.
- The specialty coffee industry is also affected by changes in discretionary spending patterns, demographic trends, and traffic and weather patterns as well as the type, number and location of competing cafés.
- Second Cup's business could be adversely affected by reduced consumer confidence and increased concerns about food safety in general, or other unusual events such as the power outage that occurred in Toronto and other cities in August of 2003.
- Changes in government regulations and other regulatory developments (such as smoking by-laws) could have an adverse impact on system wide sales.
- The loss of key personnel and/or a shortage of experienced management and hourly employees could have an adverse impact on Second Cup's operations and cafés.

OUTLOOK

Management intends to continue to focus on growing same café sales and expanding the number of new Second Cup cafés across Canada. Same café sales growth is expected to be accomplished by continuing to focus on operational excellence and by:

- Increasing marketing and development programs centered on espresso-based beverages and blender drinks, which carry a higher average price than Second Cup's other beverage offerings.
- Modernizing and renovating the café network. During 2005, Second Cup expects to renovate and modernize 15 to 20 cafés.
- Introducing new products, including expanding complimentary offerings such as snack foods and impulse items.
- Increasing prices of certain product offerings.

Second Cup is also positioning itself for successful new café growth in Canada. To facilitate this growth, Second Cup is augmenting its administrative resources in real estate, franchising and construction.

Management believes that franchise revenues, sales from company-owned cafés and revenues from other sources, coupled with the receipt of distributions from the Fund arising from Units held by Second Cup, will provide Second Cup with the ability to generate cash sufficient to pay the royalty to MarksCo under the Licence and Royalty Agreement and to continue to manage the operations and growth of the business. Second Cup anticipates using cash flow from operations to fund its working capital.

Capital expenditures of Second Cup will be limited since Second Cup anticipates being able to grow through franchising. Furthermore, management believes that new company-owned cafés will be franchised within three to 15 months of being developed and anticipates franchising several of its existing company-owned cafés, which it expects will generate additional cash flow. Capital expenditure requirements for head office improvements and equipment are not expected to be material.

Overall, based on the Second Cup initiatives outlined above and others, the anticipated economic environment and market conditions affecting the specialty coffee industry, management expects a successful year for 2005.

The Second Cup Ltd.
CONSOLIDATED FINANCIAL STATEMENTS

March 7, 2005

Auditors' Report

To the Directors of The Second Cup Ltd.

We have audited the consolidated balance sheets of The Second Cup Ltd. as at January 1, 2005 and March 27, 2004 and the consolidated statements of earnings and retained earnings (deficit) and cash flows for the 40-week period ended January 1, 2005 and the year ended March 27, 2004. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the Company as at January 1, 2005 and March 27, 2004 and the results of its operations and its cash flows for the 40-week period ended January 1, 2005 and the year ended March 27, 2004 in accordance with Canadian generally accepted accounting principles.

PricewaterhouseCoopers LLP

Chartered Accountants
Toronto, Canada

The Second Cup Ltd.

CONSOLIDATED BALANCE SHEETS

		JANUARY 1, 2005 (NOTE 2)		MARCH 27, 2004 (NOTE 2)
Assets				
CURRENT ASSETS				
Cash and cash equivalents	$	815,919	$	1,930,235
Accounts receivable (note 12)		1,898,346		1,900,871
Inventories (note 4)		237,971		160,065
Future income taxes (note 9)		231,000		318,981
Prepaid expenses and sundry assets		169,470		240,281
Due from parent (note 12)		1,204,666		-
Current assets - International operations		-		10,500
	$	4,557,372	$	4,560,933
Property, plant and equipment (note 5)		2,392,800		1,593,749
Advances due from parent (note 12)		-		8,650,000
Investment (note 2)		14,374,140		-
Future income taxes (note 9)		-		209,000
Goodwill (note 2)		4,897,912		8,149,028
	$	26,222,224	$	23,162,710
Liabilities				
CURRENT LIABILITIES				
Accounts payable and accrued liabilities	$	4,411,411	$	3,300,250
Royalty payable (note 12)		1,182,013		-
Deposits		662,175		462,727
Income taxes payable		-		452,135
Current liabilities - International operations		-		65,035
	$	6,255,599	$	4,280,147
Future income taxes (note 9)		130,500		-
	$	6,386,099	$	4,280,147
Shareholders' Equity				
Capital stock (note 6)	$	19,724,141	$	64,812,338
Retained earnings (deficit)		111,984		(45,929,775)
	$	19,836,125	$	18,882,563
	$	26,222,224	$	23,162,710

Contingencies, commitments and guarantees (note 11)

See accompanying notes to consolidated financial statements.

APPROVED BY THE BOARD OF DIRECTORS

(Signed) Gabriel Tsampalieros
Director

(Signed) Michael Forsayeth
Director

The Second Cup Ltd.

CONSOLIDATED STATEMENTS OF EARNINGS AND RETAINED EARNINGS (DEFICIT)

	40 WEEKS ENDED JANUARY 1, 2005 (NOTE 2)	52 WEEKS ENDED MARCH 27, 2004 (NOTE 2)
SYSTEM WIDE SALES - Canada (note 12)	$ 140,847,550	$ 172,505,112
REVENUE		
Royalty revenue (note 12)	$ 11,429,620	$ 13,984,809
Revenue from Company-owned cafés	7,261,531	7,644,718
Other income	3,168,899	4,230,851
	$ 21,860,050	$ 25,860,378
EXPENSES		
Operating costs and administrative expenses (note 12)	13,324,795	15,330,218
Royalty expense (note 12)	1,104,686	-
Amortization of property, plant and equipment	424,474	459,518
Investment income (note 12)	(118,012)	-
Interest income - net (note 7)	(206,107)	(207,690)
Restructuring and reorganization expenses (note 8)	-	378,448
International operations - net (note 2)	179,305	398,722
	$ 14,709,141	$ 16,359,216
EARNINGS BEFORE INCOME TAXES	$ 7,150,909	$ 9,501,162
INCOME TAXES (note 9)	2,571,713	3,778,392
NET EARNINGS FOR THE PERIOD	$ 4,579,196	$ 5,722,770
DEFICIT - BEGINNING OF PERIOD	(45,929,775)	(51,652,545)
REORGANIZATION (note 2)	41,462,563	-
Retained earnings (deficit) - End of period	$ 111,984	$ (45,929,775)

See accompanying notes to consolidated financial statements

The Second Cup Ltd.

CONSOLIDATED STATEMENTS OF CASH FLOWS

	40 WEEKS ENDED JANUARY 1, 2005 (NOTE 2)	52 WEEKS ENDED MARCH 27, 2004 (NOTE 2)
Cash provided by (used in)		
OPERATING ACTIVITIES		
Net earnings for the period	$ 4,579,196	$ 5,722,770
Items not involving cash		
Amortization of property, plant and equipment	424,474	459,518
Future income taxes	57,981	188,791
Loss (gain) on disposal of property, plant and equipment	3,960	(314,362)
	$ 5,065,611	$ 6,056,717
Decrease (increase) in non-cash working capital (note 13)	2,875,917	(2,092,864)
	$ 7,941,528	$ 3,963,853
INVESTING ACTIVITIES		
Purchase of property, plant and equipment	$ (1,508,964)	$ (1,133,129)
Proceeds from disposal of property, plant and equipment	281,479	1,276,858
Purchase of investment (note 2)	(14,374,140)	-
	$ (15,601,625)	$ 143,729
FINANCING ACTIVITIES		
Issuance of capital stock	$ 19,724,141	$ -
Reorganization (note 2)	6,510,766	-
Repayment of capital stock	(27,134,460)	-
Advances to parent company - net	7,445,334	(4,250,000)
	$ 6,545,781	$ (4,250,000)
DECREASE IN CASH AND CASH EQUIVALENTS DURING THE PERIOD	$ (1,114,316)	$ (142,418)
CASH AND CASH EQUIVALENTS - BEGINNING OF PERIOD	1,930,235	2,072,653
CASH AND CASH EQUIVALENTS - END OF PERIOD	$ 815,919	$ 1,930,235

Supplemental information (note 13)

The Second Cup Ltd.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

JANUARY 1, 2005 AND MARCH 27, 2004

1. NATURE OF OPERATIONS

The Second Cup Ltd. is a specialty coffee retailer with 369 (2004 - 372) cafés in Canada as of January 1, 2005, of which 31 (2004 - 26) are Company-owned. The cafés are predominantly operated by franchisees who are selected and trained to retail the Company's product offering of brewed coffee, espresso-based beverages, blender drinks, whole beans, baked goods and coffee-related merchandise.

2. BASIS OF PRESENTATION AND REORGANIZATION RELATED TO INITIAL PUBLIC OFFERING

These consolidated financial statements are those of The Second Cup Ltd. (New Second Cup or the Company), incorporated on November 17, 2004, and its predecessor corporation (Old Second Cup or the Predecessor Corporation) of the same name. The Predecessor Corporation subsequently amalgamated and changed its name to Second Cup Trade-Marks Inc.

In connection with a series of transactions associated with the initial public offering of The Second Cup Royalty Income Fund (the Fund) outlined in the prospectus filed on November 23, 2004, New Second Cup acquired substantially all of the assets and liabilities relating to Old Second Cup's Canadian business (Canadian Assets). The assets and liabilities of Old Second Cup's International business (International Assets) were acquired by its parent company, Cara Operations Limited (Cara). As a result, the primary remaining asset of the Predecessor Corporation was the Second Cup Canadian trademarks, excluding those related to Nunavut. Also, New Second Cup entered into a Licence and Royalty Agreement (the Agreement) with Second Cup Trade-Marks Inc. to use the Second Cup trademarks in exchange for a royalty payment of 6.5% of system sales pertaining to certain specifically identified cafés in Canada (Royalty Pooled Cafés).

Following this series of transactions, Second Cup Royalty Income Fund (the Fund) filed a prospectus on November 23, 2004. The net proceeds of the offering were used to acquire the issued and outstanding share capital of the Second Cup Trade-Marks Inc. on December 2, 2004. At this time New Second Cup also acquired 1,437,414 units in the Fund for an aggregate cash cost of $14,374,140. This represents an approximate 15% interest in the Fund. At January 1, 2005, the fair market value of this investment was $17,062,104. New Second Cup has agreed not to sell, without the consent of the Fund or the underwriters, any of these initial units acquired for a period of two years following their initial acquisition, except in certain limited circumstances.

As mentioned above, New Second Cup acquired the Canadian Assets on November 26, 2004 in exchange for cash consideration of $5,350,000. Since the Canadian Assets were acquired from another entity, which at the time was under common control, the acquired assets are recorded in these consolidated financial statements at their carrying amounts as follows:

Cash	$ 207,073
Accounts receivable	1,528,349
Prepaid expenses	446,243
Inventories	273,905
Amount due from Cara	167,327
Property, plant and equipment	2,352,088
Goodwill (1)	4,897,912
Accounts payable and accrued liabilities	(4,522,897)
Net assets acquired	$ 5,350,000

(1) Prior to the reorganization, goodwill was carried at an amount of $8,149,028 in the Predecessor Corporation. As a result of the transfer of the assets, an external valuation was prepared that indicated that the remaining goodwill had a fair value of $4,897,912. Accordingly, the Predecessor Corporation recorded the change in valuation as a reorganization charge to retained earnings.

These consolidated financial statements have been prepared as if the Company had always owned the Canadian Assets, and the comparative amounts shown are those of the Predecessor Corporation. The series of transactions effected by the Predecessor Corporation to transfer its International Assets and other related transactions, including the transfer of certain obligations associated with the reorganization and initial public offering, have been shown as a net charge to retained earnings and is comprised as follows:

Predecessor Corporation deficit (1)	$ 3,979,399
Predecessor Corporation share capital (note 6)	37,677,878
Income tax adjustments - net	(194,714)
	$ 41,462,563

(1) Represents net liabilities of the Predecessor Corporation not acquired by New Second Cup, includes $3,251,116 of goodwill, which was not acquired in the transaction described above.

Earnings related to International operations have been reflected in these consolidated financial statements as a net charge in the consolidated statements of earnings. Salient information related to activities up to their transfer is as follows:

	PERIOD ENDED DECEMBER 2, 2004	YEAR ENDED MARCH 27, 2004
System wide sales	$ 2,152,099	$ 947,721
Revenue	142,642	143,360
Loss before taxation	(179,305)	(398,722)

3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

a. Consolidation

These consolidated financial statements include the accounts of the Company and its subsidiary. All intercompany accounts and transactions have been eliminated on consolidation.

These consolidated financial statements have been prepared in accordance with Canadian generally accepted accounting principles and disclosures applicable to private companies. When public company disclosure provides additional meaningful information, management has incorporated such disclosure in these consolidated financial statements.

The Company opens and closes individual café locations in the normal course of business. Café closures in geographical areas where existing or new cafés continue to serve the same customer base are not reported as discontinued operations.

b. Fiscal year

The Company's fiscal year is made up of 52 or 53-week periods ending on the Saturday closest to December 31. Previously the Company's fiscal year-end was the Saturday closest to March 31.

A summary of significant accounting policies followed in the preparation of these consolidated financial statements is as follows:

c. Use of estimates

The preparation of these consolidated financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent liabilities at the date of the consolidated financial statements and the amounts of revenues and expenses for the reported periods. Actual results may differ from those estimates.

d. System wide sales

System wide sales include gross revenue of all Company-owned and franchised cafés based on information reported by café operators. Gross revenue is self-assessed by each outlet on a weekly basis and submitted to the Company.

e. Revenue recognition

Royalty revenue from franchised cafés is recognized as earned. Master franchise fees are recognized as income when the agreement has been signed and all material conditions have been met. Other income includes purchasing co-ordination fees, café resale fees, new term fees, construction administration fees and initial franchise fees, which are recognized as income when the café has opened.

f. Royalty expense

Royalty expense represents 6.5% of system sales for the Royalty Pooled Cafés, including any Make-Whole payments pursuant to the Agreement. The amounts are paid on or before the twenty-first day of the following calendar month and are recognized on an accrual basis.

g. Cash and cash equivalents

Cash and cash equivalents consist of cash on hand, balances with banks and investments in short-term money market instruments. Investments in short-term money market instruments are recorded at the lower of cost and estimated market value and consist substantially of highly liquid investments.

h. Inventories

Inventories are valued at the lower of cost and net realizable value, with cost being determined substantially on a first-in, first-out basis.

i. Investment

Investments over which the company does not exercise significant influence are accounted for using the cost method. An impairment would be recognized when there is an impairment in value that is other than temporary. Distributions received in excess of its pro rata share of income are considered, for accounting purposes, to be a return of capital.

j. Goodwill

Goodwill represents the excess of the cost of investments in subsidiaries and businesses acquired over the fair value of the net assets acquired. Goodwill is no longer amortized, but is tested for impairment at least annually or when events or changes in circumstances indicate that the carrying value may not be recoverable. The measurement of possible impairment is based on fair value.

k. Property, plant and equipment

Property, plant and equipment are recorded at cost. Amortization is calculated using the straight-line basis at the following rates, which are based on the expected useful life of the asset:

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

l. Impairment of long-lived assets

An impairment charge is recognized for long-lived assets, including intangible assets with definite lives, when an event or change in circumstances causes an asset's carrying value to exceed the total undiscounted cash flows expected from their use and eventual disposition. The impairment loss is calculated as the difference between the fair value of the assets and their carrying value.

m. Foreign currency translation

Revenue and expenses have been translated at the average exchange rates in effect during the period. Monetary assets and liabilities are translated at the exchange rates in effect at the consolidated balance sheet date. Exchange gains and losses are reflected in the consolidated statements of earnings.

n. Future income taxes

Future income taxes are provided on the asset and liability method whereby future income tax assets are recognized for deductible temporary differences and operating loss carry-forwards, and future income tax liabilities are recognized for taxable temporary differences. Temporary differences are the differences between the amounts of assets and liabilities recorded for income tax and financial reporting purposes. Future income tax assets are recognized only to the extent that management determines that it is more likely than not that the future income tax assets will be realized. Future income tax assets and liabilities are adjusted for the effects of changes in tax laws and rates on the date of enactment or substantive enactment.

o. Financial instruments

The Company's financial instruments consist of cash and cash equivalents, accounts receivable, advances, accounts payable and accrued liabilities and royalties payable. The fair values of these instruments approximate their carrying amounts due to their short-term maturity. The fair values of the advances due from parent cannot be determined due to the uncertainty of the timing of cash payments.

The Company's financial instruments exposed to credit risk include cash and cash equivalents and accounts receivable. The Company places its cash and cash equivalents with institutions of high creditworthiness. The Company's accounts receivable primarily comprise amounts due from franchises and management believes that its accounts receivable credit risk exposure is limited.

4. INVENTORIES

	JANUARY 1, 2005	MARCH 27, 2004
Merchandise held for resale	$ 186,337	$ 125,279
Supplies	51,634	34,786
	$ 237,971	$ 160,065

5. PROPERTY, PLANT AND EQUIPMENT

JANUARY 1, 2005

	COST	ACCUMULATED AMORTIZATION	NET
Leasehold improvements	$ 2,654,176	$ 1,293,092	$ 1,361,084
Equipment, furniture, fixtures and other	1,898,279	904,147	994,132
Computer software and hardware	1,144,152	1,106,568	37,584
	$ 5,696,607	$ 3,303,807	$ 2,392,800

MARCH 27, 2004

	COST	ACCUMULATED AMORTIZATION	NET
Leasehold improvements	$ 1,950,903	$ 1,068,215	$ 882,688
Equipment, furniture, fixtures and other	1,411,656	754,766	656,890
Computer software and hardware	1,137,772	1,083,601	54,171
	$ 4,500,331	$ 2,906,582	$ 1,593,749

Amortization of property, plant and equipment for the fiscal period ended January 1, 2005 was $424,474 (March 27, 2004 - $459,518).

6. CAPITAL STOCK

AUTHORIZED

An unlimited number of common shares and an unlimited number of preference shares issuable in one or more series

ISSUED COMMON SHARES	NUMBER OF SHARES	AMOUNT
Balance at March 27, 2004 and March 29, 2003	9,760,274	$ 64,812,338
Return of capital	-	(27,134,460)
Reorganization (note 2)	(9,760,274)	(37,677,878)
Issuance of new share capital	19,724,141	19,724,141
Balance at January 1, 2005	19,724,141	$ 19,724,141

The Predecessor Corporation retained share capital in the amount of $27,134,460. The details of the reorganization related to the initial public offering are set out in note 2. The Company issued 19,724,141 common shares for cash consideration of $19,724,141.

7. NET INTEREST EXPENSE - NET

	PERIOD ENDED JANUARY 1, 2005	YEAR ENDED MARCH 27, 2004
Interest income	$ (209,052)	$ (213,073)
Interest expense	2,945	5,383
	$ (206,107)	$ (207,690)

8. RESTRUCTURING AND REORGANIZATION EXPENSES

Restructuring and reorganization expenses are comprised of the following:

	PERIOD ENDED JANUARY 1, 2005	YEAR ENDED MARCH 27, 2004
Workforce reduction [a]	$ -	$ 268,876
Other reorganization [b]	-	109,572
	$ -	$ 378,448

a. Workforce reduction costs are charged as expenses in the period the liability is incurred. These amounts comprise charges in respect of employee severance and other employee-related costs for employee positions made redundant following the acquisition of the Company by Cara.

b. Other reorganization costs relate to relocation costs, employee retention agreements, integration with Cara and other reorganization expenses resulting from the acquisition by Cara, which were charged to income as incurred.

9. INCOME TAXES

	PERIOD ENDED JANUARY 1, 2005	YEAR ENDED MARCH 27, 2004
Combined Canadian statutory income tax rates	35.52%	37.19%
Income taxes at combined Canadian statutory rates	$ 2,540,002	$ 3,533,482
Expenses not deductible for tax purposes	31,710	25,206
Other	-	219,704
	$ 2,571,712	$ 3,778,392

The significant components of future income tax assets and liabilities are as follows:

	PERIOD ENDED JANUARY 1, 2005	YEAR ENDED MARCH 27, 2004
Property, plant and equipment	$ -	$ 191,000
Provisions and accrued expenses	231,000	318,981
Goodwill	(130,500)	-
Other	-	18,000
Net future income tax asset	$ 100,500	$ 527,981
Classified as		
Current	$ 231,000	$ 318,981
Long-term	(130,500)	209,000
	$ 100,500	$ 527,981

10. CASH HELD IN TRUST

Cash held in trust on behalf of franchisees for marketing, advertising and other co-operative expenditures at January 1, 2005 amounted to $1,433,908 (March 27, 2004 - $680,256) and is not recorded on the Company's consolidated balance sheets.

11. CONTINGENCIES, COMMITMENTS AND GUARANTEES

The Company has lease commitments for Company-owned cafés and its head office premises. The Company also acts as the head tenant on leases, which it in turn subleases to franchisees. The Company's lease commitments at January 1, 2005 are as follows:

	LEASE COMMITMENTS	SUBLEASE TO FRANCHISEES	NET
2005	$ 14,800,222	$ 13,295,431	$ 1,504,791
2006	13,148,325	11,884,572	1,263,753
2007	11,339,096	10,315,938	1,023,158
2008	9,400,098	8,515,339	884,759
2009	7,531,468	6,743,357	788,111
Thereafter	14,512,233	12,908,778	1,603,455
	$ 70,731,442	$ 63,663,415	$ 7,068,027

The Company has a long-term contract with a key supplier; the Company has no future minimum purchase requirements under the terms of this contract. In the event that this contract is terminated, then the Company would be required to make a payment of $713,558 at January 1, 2005. This amount decreases over the remaining life of the contract. In addition, the Company would be required to make a payment based on the earnings of the key supplier under the contract and may be required to fulfill certain outstanding purchase obligations that the supplier may enter into from time to time. The Company would take steps to ensure that there was an orderly transition to a new supplier. At this time, management is of the view that the likelihood of any such payment is remote.

The Company is involved in litigation with former franchisees and others in the ordinary course of business. It is management's opinion that the resolution of known claims should not have a material adverse impact on the consolidated financial statements of the Company. 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.

Prior to December 2, 2004, the Company was a guarantor of, and had pledged substantially all of its assets as collateral for, the indebtedness of Cara. As a result of entering into the Agreement, substantially all of the Company's assets have been pledged under a general security agreement as collateral for commitments under the Agreement.

12. RELATED PARTY TRANSACTIONS AND BALANCES

a. Since 1996, the Company has a master franchise agreement with its parent, Cara. Cara operates 38 locations (2004 - 38) under this agreement, and system sales and royalties earned from these locations amounted to $4,951,537 (2004 - $5,841,296) and $250,554 (2004 - $292,065), respectively, for the 40-week period ended January 1, 2005.

b. In the prior year, advances due from the parent, Cara, of $8,650,000 bore interest at 3% per annum and were due on demand. The Company earned interest of $179,162 for the 40-week period ended January 1, 2005 from these advances. The amounts have been repaid during the period. At January 1, 2005, the Company had an outstanding receivable of $1,204,666 from the parent arising from the parent holding surplus cash balances. These amounts are non-interest bearing and are due on demand.

c. Since the Company relocated its corporate offices to Cara's premises in October 2002 through to March 29, 2003, Cara charged the Company an annualized expense of $300,000 for rent and other shared services provided by Cara. As a result of increased integration between Cara and the Company for the fiscal year beginning March 28, 2004, the annual charge was increased. The charge to the Company for the period ended January 1, 2005 was $1,769,231.

d. During the period, the Company incurred a royalty expense of $1,182,013 pursuant to the Agreement, as described in note 2. This amount was paid on January 21, 2005.

e. The Company recorded a distribution receivable from the Fund of $118,012 during the period. This amount was received on January 31, 2005.

f. Included in accounts receivable is an amount of $102,504 due from the Fund arising from expenses paid on behalf of the Fund and a fee charged for the provision of accounting and bookkeeping services. These amounts are non-interest bearing and are due on demand.

13. CASH FLOW INFORMATION

	PERIOD ENDED JANUARY 1, 2005	YEAR ENDED MARCH 27, 2004
Interest paid	$ 26,945	$ 5,383
Income taxes paid	2,435,971	3,438,175

Non-cash working capital items related to operations:

	PERIOD ENDED JANUARY 1, 2005	YEAR ENDED MARCH 27, 2004
Accounts receivable	$ 2,525	$ 123,012
Inventories	(77,906)	19,980
Prepaid expenses	70,811	(50,585)
Accounts payable and accrued liabilities	1,111,161	(741,986)
Deposits	199,448	(1,761,544)
Income taxes	387,865	257,724
Royalty payable	1,182,013	-
Other	-	60,535
	$ 2,875,917	$ (2,092,864)

Second Cup Royalty Income Fund

UNITHOLDER INFORMATION

CORPORATE HEAD OFFICE

Second Cup Trade-Marks Inc.
6303 Airport Road
Mississauga, Ontario
Canada L4V 1R8

MAILING ADDRESS

Second Cup Royalty Income Fund
6303 Airport Road
Mississauga, Ontario
Canada L4V 1R8

Committees of the Board

(1) Audit Committee
(2) Governance Committee

Registrar and Transfer Agent

Computershare Trust Company of Canada

Auditors

PricewaterhouseCoopers LLP

Market Information

Units Listed:
Toronto Stock Exchange
Symbol: **SCU.UN**

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