



Second Cup Royalty Income Fund  
TSX: SCU.UN

2006 ANNUAL REPORT  
FOR THE YEAR ENDED DECEMBER 31, 2006

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# Second Cup Royalty Income Fund

## LETTER FROM THE CHAIRMAN

On behalf of the Board of Trustees of the Second Cup Royalty Income Fund (the "Fund"), I am pleased to present our Annual Report for the fiscal year ended December 31, 2006.

The Fund indirectly owns the Second Cup trade-marks which it licenses to The Second Cup Ltd. ("Second Cup") in accordance with the terms of a licence and royalty agreement. Second Cup, in turn, franchises and operates cafés across Canada using these trade-marks and pays to the Fund a royalty of 6.5% of the total sales of cafés included in the Royalty Pool. As at January 1, 2007, there were 351 cafés in the Royalty Pool.

### HIGHLIGHTS

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 on same café sales growth, and adding net new cafés to the café network. Same café sales growth is of particular importance as it directly correlates to increased cash available for distribution, and is a key indicator of brand health and franchise profitability.

I am very pleased to announce that in 2006 the cafés in the Royalty Pool continued their strong same café sales performance, achieving growth of 6.2% following same café sales growth of 4.6% in 2005. The exceptional fourth quarter same café sales growth of 7.8% represented the eighth consecutive quarter of positive same café sales growth since the commencement of the Fund in December 2004. Since the inception of the Fund, same café sales growth has averaged 5.3%.

Excluding the costs of the reorganization (described below) and changes in non-cash working capital, distributable cash was \$1.1229 per unit representing a 5.1% increase over 2005.

### DISTRIBUTION INCREASES

In 2006, monthly distributions were increased by 4% which, annualized, represented an increase from \$1.00 per unit to \$1.0404 per unit. In March 2007 we were pleased to announce an additional increase of 5% to monthly distributions, resulting in an annualized distribution amount of \$1.0920 per unit.

### IMPLEMENTATION OF REORGANIZATION

I would also like to confirm that the previously announced reorganization of the Fund has now been completed. Since the creation of the Fund in December 2004, the Fund owned the Second Cup trade-marks through intermediary corporate subsidiaries. This structure subjected these subsidiaries to income tax which, in turn, reduced the cash available for distribution to the Fund's unitholders.

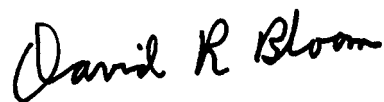
Under the new structure, implemented in April 2007, the subsidiary corporations have been replaced with a limited partnership which provides the Fund with a "flow-through" structure. This structure will maximize the cash available for distribution by eliminating income taxes payable by the Fund and its subsidiaries until the proposed income tax legislation on income funds becomes applicable in 2011. It is anticipated that the tax savings expected over the next few years resulting from this new structure will more than offset the costs of the restructuring.

### FEDERAL GOVERNMENT TAX ON INCOME FUNDS

On October 31, 2006, the Federal Department of Finance announced a proposed distribution tax on publicly traded income trusts effective in 2011. We are disappointed with the decision made by the Federal Department of Finance and the resulting impact it had on our unit value. These proposals are not expected to have an immediate impact on the Fund's tax treatment, or distribution policy or the tax treatment of distributions to unitholders. While we will continue to monitor developments with regards to this proposal, until legislation implementing the proposed changes has been finalized, the exact impact of changes to the Fund is unknown and no action will be taken at this time.

In closing, we would like to take this opportunity to thank our unitholders for their continued support, and the Second Cup café franchisees, operators and colleagues who, through their ongoing dedication to their guests and Second Cup, continue to deliver positive café sales growth.

We look forward to another successful year in 2007.



David Bloom  
Chairman, Second Cup Royalty Income Fund  
on behalf of the Board of Trustees  
April 11, 2007

# The Second Cup Ltd.

## LETTER FROM THE PRESIDENT

On behalf of The Second Cup Ltd. ("Second Cup"), our shareholder, management team and our colleagues, I am pleased to present the financial results for Second Cup for the fiscal year ended December 30, 2006 which are included in the 2006 Annual Report of the Second Cup Royalty Income Fund (the "Fund").

### HIGHLIGHTS

2006 was another successful year of sales growth for Second Cup. We achieved same café sales growth of 6.2%, surpassing management's targets for the year and representing Second Cup's best same café sales growth in almost 10 years. In the fourth quarter same café sales grew by an impressive 8.3% over the comparable period in 2005, closing off another highly successful holiday season for Second Cup. This also represented the 13<sup>th</sup> consecutive quarter of positive same café sales growth for Second Cup, a testament to the brand's stability and health.

Increasing and rejuvenating the network of Second Cup cafés has been and continues to be a key strategic initiative. During 2006 we opened 16 new cafés, surpassing the number of cafés opened in 2005. In addition, during the year Second Cup also increased and enhanced the resources in its café development departments, with the goal of continuing to further expand the café network in 2007 and beyond, and to achieve an accelerated schedule of renovation and renewal of the existing café base.

### A NEIGHBOURHOOD OASIS IS BORN

In 2005 we embarked on a rebranding effort, adjusting our internal focus from one that was based mainly on traditional operational drivers to one based on emotional attributes and touch points in-café. As a consequence, the concept of "Neighbourhood Oasis" was born. In an effort to deliver on this brand promise, in 2006 we finalized our new "Oasis" café design. Guest research has shown that this design delivers a relaxing café environment allowing our guests to feel personally rewarded by our premium products and guest service. Moving forward, all of our new cafés and renovated cafés will contain key elements of this new design.

Other initiatives completed in 2006 which align with our brand promise included:

- Introduction of an e-learning system for our front-line colleagues focussed on improving guest service.
- The introduction of new blender drinks made with real fruit ingredients;
- Enhanced marketing programs highlighting gifting opportunities within our five key promotional periods; and
- The expansion of our food program to compliment our premium beverages.

We believe each of these initiatives were positively received by our guests and led to increased sales growth during the year.

### A NEW OWNER, A SINGLE FOCUS

In November of 2006, Gabriel Tsampalieros, the former CEO of Cara Operations Limited became the sole owner of Second Cup. In purchasing all of the outstanding shares of Second Cup, Mr. Tsampalieros clearly demonstrated his belief, commitment and passion for the brand, a passion we believe will lead to continued success in the years to come.

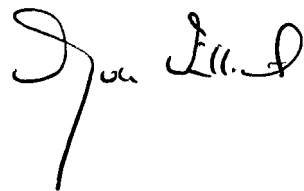
### OUTLOOK

Our 2007 promotional strategies continue to focus on increasing sales of our premium espresso-based beverages, blender drinks, food and merchandise offerings. We will also introduce products and beverages which will be free of trans fats and offer healthier food options to our guests. In addition, each program will leverage our guest-friendly, reloadable payment and gift card, the "Second Cup Café Card", to promote guest loyalty and drive café sales.

From a café network perspective, Second Cup will continue to invest in its café development resources, and expects to open 14 to 18 new cafés and renovate upwards of 30 existing cafés.

Subject to healthy economic conditions continuing across the company's primary markets, Second Cup believes it can achieve same café sales growth of approximately 3 to 5% for the 2007 fiscal year.

We look forward to delivering on these and other strategic initiatives aimed at increasing sales and expanding our café network. In closing, I would like to personally thank our franchisees and colleagues, whose hard work and ongoing dedication to our Brand are the key contributors to making Second Cup a "Second Home" with our guests and colleagues alike.



J. Bruce Elliot  
President,  
The Second Cup Ltd.  
April 11, 2007

# 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 year ended December 31, 2006 and should be read in conjunction with the audited consolidated financial statements of the Fund and accompanying notes, which are available at [www.sedar.com](http://www.sedar.com). 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. This Management's Discussion and Analysis ("MD&A") has been prepared as of March 6, 2007.

### **BASIS OF PRESENTATION**

Effective January 1, 2005 the Fund adopted Accounting Guideline 15 ("AcG-15"), a pronouncement of The Canadian Institute of Chartered Accountants ("CICA") related to variable interest entities ("VIEs"). A VIE is an entity where 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. AcG-15 outlines who should consolidate such entities.

The Fund determined that its wholly-owned indirect subsidiary, Second Cup Trade-Marks Inc. ("MarksCo"), is a variable interest entity. MarksCo owns the Second Cup Marks (as defined below) and, through a Licence and Royalty Agreement (the "Agreement"), has licensed the Marks to The Second Cup Ltd. ("Second Cup"), which operates the business activities associated with these Marks, in exchange for a royalty payment. The activities of MarksCo and Second Cup are closely related and, based on the guidance provided in AcG-15, it was determined that although MarksCo is owned by the Fund, Second Cup should consolidate the financial results of MarksCo. The Fund reflects its investment in MarksCo as an equity-accounted investment.

### **OVERVIEW AND BUSINESS OF THE FUND**

The Fund, through its indirect wholly-owned subsidiary, MarksCo, holds 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" or the "Marks"). The Fund, indirectly through MarksCo, has 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"). The Royalty Pool 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 of cafés that permanently closed during the previous reporting period, according to a formula designed to be accretive to unitholders and specified in the Agreement. Units of the Fund are traded on the Toronto Stock Exchange under the symbol "SCU.UN".

The fiscal year ends of the Fund and its wholly-owned subsidiaries are December 31, whereas Second Cup's fiscal year end is the Saturday closest to December 31.

As at December 31, 2006, the Fund has 9,638,076 units outstanding.

## FINANCIAL HIGHLIGHTS

The following tables set out selected financial information and other data of the Fund, excluding the results of MarksCo, and should be read in conjunction with the audited consolidated financial statements of the Fund.

(IN THOUSANDS OF DOLLARS EXCEPT CAFÉS AND PER UNIT AMOUNTS)	YEAR ENDED DECEMBER 31, 2006	YEAR ENDED DECEMBER 31, 2005
Number of cafés in Royalty Pool	352	351
Number of active cafés - end of period (351 cafés post the January 1, 2007 adjustment)	340	343
Same café sales growth	6.2%	4.6%
System sales of cafés in the Royalty Pool	\$ 189,287	\$ 177,527
Interest income from MarksCo	\$ 9,547	\$ 9,487
Net earnings for the year excluding reorganization costs and non-cash tax item <sup>(1)</sup>	\$ 10,630	\$ 10,036
Net earnings for the period	\$ 10,143	\$ 10,036
Basic earnings per unit excluding reorganization costs and non-cash tax item <sup>(1)</sup>	\$ 1.1029	\$ 1.0473
Basic earnings per unit	\$ 1.0524	\$ 1.0473
Diluted earnings per unit	\$ 1.0485	\$ 1.0473
Distributable cash per unit excluding reorganization costs and changes in non-cash working capital <sup>(2)</sup>	\$ 1.1229	\$ 1.0688
Distributable cash per unit <sup>(2)</sup>	\$ 1.0998	\$ 1.0558
Distributions declared per unit	\$ 1.0303	\$ 1.0000
	AS AT DECEMBER 31, 2006	AS AT DECEMBER 31, 2005
Total assets	\$ 89,198	\$ 88,350
Total long-term liabilities	-	-

(1) "Net earnings for the period excluding reorganization costs and non-cash item" and "Basic earnings per unit excluding reorganization costs and non-cash item" represent non-GAAP measures and are calculated by adding back to net earnings \$407 in costs incurred related to the reorganization and the \$80 non-cash income tax charge discussed below (see "- Operating Expenses and Income Taxes").

(2) "Distributable cash", "Distributable cash per unit" and "Distributable cash per unit excluding reorganization costs and changes in non-cash working capital" represent non-GAAP measures. "Distributable cash per unit excluding reorganization costs and changes in non-cash working capital" is calculated by taking the Distributable cash as calculated below (see "- Distributable Cash") and adding back \$407 (2005 - \$nil) in costs incurred related to the reorganization (see "- Operating Expenses and Income Taxes") and deducting \$184 (2005 - adding back \$126) related to changes in non-cash working capital balances of the Fund and MarksCo (see "- Distributable Cash").

### Overview of System Sales

The indirect source of revenue for the Fund is royalty income collected by MarksCo from Second Cup. Royalty income is equal to 6.5% of system sales of Second Cup cafés in the Royalty Pool. MarksCo uses the royalty revenue to pay interest and dividend income to the Fund. As a result, same café sales growth is a key performance indicator for the Fund.

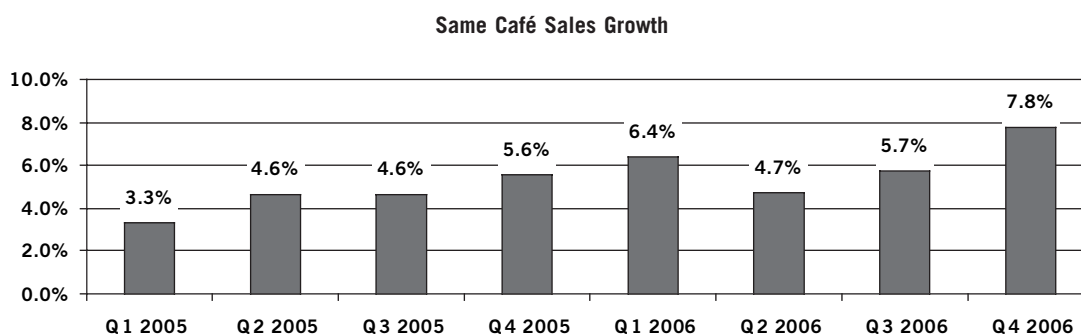
System sales comprise the gross revenue reported to Second Cup by franchisees of Second Cup cafés and by cafés owned by Second Cup that are included in the Royalty Pool. Sales are reported by franchisees to Second Cup on a weekly basis without audit or other form of independent assurance. Second Cup substantiates sales reported by its franchisees through analytical and financial reviews performed by management, on site visits, and analysis of raw material purchases by the cafés.

Increases in system sales result from the addition of new cafés to the Royalty Pool and same café sales growth. System sales increases from existing cafés are primarily dependent on pricing, product and marketing initiatives undertaken by Second Cup, maintaining operational excellence within the café network and general market conditions, including weather. The primary factors that influence the number of cafés added to the Second Cup café network, and subsequently vended into the Royalty Pool, 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 sales are also affected by the permanent closure of Second Cup cafés already included in the Royalty Pool. 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. Under the Agreement, Second Cup is required to make a monthly make-whole payment to MarksCo to compensate the Fund for the loss of monthly royalty revenue on closed cafés until the next Royalty Pool adjustment date.

### System Sales and Same Café Sales Growth

System sales for the year were \$189,287 and same café sales growth was 6.2% for the same period. The following chart depicts the same café sales growth by Second Cup cafés in the Royalty Pool for the past eight fiscal quarters.



Overall, system sales and same café sales growth benefited from an increase in average transaction size attributable to a number of operational and marketing initiatives launched by Second Cup in 2005 and 2006.

*Premium Beverages:* Second Cup rolled out a number of operational and product initiatives that management believes improved the customer experience and led to increased sales:

- Second Cup launched a new portfolio of blender drinks made with real fruit ingredients, a key differentiator that management believes resonates with Canadian consumers. These beverages are premium-priced, higher margin products which benefit same café sales performance.
- While not quantifiable, management believes that sales continue to benefit from the second quarter roll out of newly designed, customer-friendly menu-board systems to all cafés. These menu boards are segmented by consumer category and easier to read, improving the customer's shopping experience.
- In conjunction with the roll-out of new menu-boards mentioned above, Second Cup simplified its cup line-up for both hot and cold beverage offerings, providing a more positive customer experience and effectively moving customers up an order size and thereby positively impacting the average transaction size in café.

Overall, management believes the above changes were well-received by Second Cup's customers and franchise partners and generated positive media coverage and led to increased sales growth during 2006.

*Food:* Second Cup's food category continues to grow and complement its core premium beverage offerings. During the year, Second Cup continued to improve upon its basic food offerings, and expand its cold sandwich program, which is now offered at more than half of its cafés.

*Merchandise:* Following the success of the 2005 holiday merchandise program, one of Second Cup's initiatives in 2006 was to deliver more seasonal, premium merchandise offerings throughout the year. Although merchandise accounts for only a small proportion of total system sales, Second Cup believes this represents a significant opportunity to strengthen its brand position, and solidify its cafés as gifting destinations. As it did in 2005, Second Cup achieved same café sales results in the fourth quarter which outpaced the rest of the year, particularly indicative of a strong holiday merchandise program.

During the year Second Cup made a number of price increases across a variety of its product groups, specifically whole beans, food and beverages. In aggregate, the impact of these price increases on system sales is estimated at 1.0 to 1.5%. In mid-November, Second Cup also increased the prices of its brewed coffee and several of its espresso-based beverages. These increases ranged from approximately 5 to 35 cents per cup, and management estimates the annualized impact of the price increase to be approximately 2.5 to 3.5% on system sales.

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

#### **Seasonality of system sales**

The first quarter represents the lowest average system sales quarter for the year due to the seasonality of the business. The final quarter, which includes the holiday sales periods of November and December in the retail industry, generally constitutes the highest average system sales quarter of the fiscal year. The Fund's quarterly earnings will vary as a result of this seasonality in system sales.

#### **Royalty Pool and Café Network**

During the year, 12 cafés from the Royalty Pool were permanently closed, five of which were closed during the fourth quarter of 2006 bringing the number of active cafés in the Royalty Pool to 340 as at December 31, 2006. Average annualized system sales of the 12 closed cafés were below the average of all Royalty Pool cafés with the total system sales of the 12 cafés being approximately \$3,815 on an annualized basis. In accordance with the Agreement, Second Cup made monthly "make-whole" payments to the Fund related to sales of the cafés permanently closed. The loss of the royalty revenues from these cafés was more than offset by future royalty income from 11 cafés added to the Royalty Pool on January 1, 2007 (see "Adjustment to the Royalty Pool" below).

#### **Operating Expenses and Income Taxes**

<b>(IN THOUSANDS OF DOLLARS)</b>	<b>YEAR ENDED DECEMBER 31, 2006</b>	<b>YEAR ENDED DECEMBER 31, 2005</b>
General and administrative expenses	\$ 304	\$ 301
Reorganization expense	\$ 407	\$ -
Income taxes - current	\$ 12	\$ 12

Operating expenses of the Fund are limited to general and administrative expenses for the administration of the Fund on a consolidated basis. General and administrative expenses consist primarily of professional fees, public entity costs, insurance premiums, and trustee fees. Total operating expenses of the Fund in 2006 were \$304 (2005 - \$301). During the year the Fund incurred costs of \$407 related to the reorganization (see "Reorganization of the Fund").

The Fund recorded after-tax income of \$1,319 (2005 - \$862) during the year from its equity-accounted investment in MarksCo, an indirect wholly-owned subsidiary of the Fund. This represents the net earnings of MarksCo during the year. Net earnings of MarksCo benefited from an increase in royalty revenues of \$815 as a result of the increase in system sales of cafés in the Royalty Pool. General and administrative expenses of MarksCo were \$389 (2005 - \$348) and amortization expense of MarksCo was \$86 (2005 - \$93). MarksCo also incurred income tax expense of \$493 (2005 - \$241), comprised of current tax expense of \$306 (2005 - \$128) and future tax expense of \$107 (2005 - \$113).



MarksCo also recognized a reduction in its future income tax asset as a result of the federal government substantively enacting new legislation which will result in a reduction in federal income tax rates commencing 2008. This change resulted in an \$80 charge to future income taxes of MarksCo during 2006.

During the year, the Fund incurred an income tax expense of \$12 (2005 - \$12). Further, included in the earnings from the Fund's equity-accounted investment in MarksCo is a current income tax expense of \$306 and future income tax expense of \$187. Consequently, excluding the \$80 charge to future income taxes of MarksCo described above, total income tax expense included in the earnings of the Fund amounted to \$425. This income tax expense reflects the annual expected effective tax rate of 23% applicable to the taxable income of the Fund's wholly-owned subsidiary corporations.

Accordingly, net earnings of the Fund were \$10,143 or \$1.0524 cents per unit for the year, compared to \$10,036, or \$1.0473 cents per unit in 2005. Net earnings excluding the above mentioned reorganization costs and the non-cash tax charge were \$10,630, or \$1.1029 cents per unit.

### SELECTED QUARTERLY INFORMATION

A discussion on the Fund's previous quarterly results can be found in the Fund's quarterly Management's Discussion and Analysis reports available at [www.sedar.com](http://www.sedar.com).

(IN THOUSANDS OF DOLLARS EXCEPT

CAFÉS AND PER UNIT AMOUNTS)

	Q4 2006 <sup>(1),(2),(4)</sup>	Q3 2006 <sup>(2)</sup>	Q2 2006 <sup>(2),(3)</sup>	Q1 2006 <sup>(2)</sup>
Total number of cafés in Royalty Pool at end of period	352	352	352	352
Number of active cafés in Royalty Pool at end of period	340	345	348	350
Same café sales growth	7.8%	5.7%	4.7%	6.4%
System sales of cafés in the Royalty Pool	\$ 53,759	\$ 46,343	\$ 45,812	\$ 43,373
Net earnings for the period	3,111	2,627	2,160	2,245
Diluted earnings per unit	\$ 0.3216	\$ 0.2715	\$ 0.2233	\$ 0.2321
Distributable cash per unit	\$ 0.3091	\$ 0.2783	\$ 0.2409	\$ 0.2715
Distributions declared per unit	\$ 0.2601	\$ 0.2601	\$ 0.2601	\$ 0.2500
	Q4 2005 <sup>(1)</sup>	Q3 2005	Q2 2005	Q1 2005
Total number of cafés in Royalty Pool at end of period	351	351	351	351
Number of active cafés in Royalty Pool at end of period	343	346	348	349
Same café sales growth	5.6%	4.6%	4.6%	3.3%
System sales of Royalty Pool Cafés	\$ 49,774	\$ 43,727	\$ 43,590	\$ 40,436
Net earnings for the period	2,804	2,464	2,479	2,289
Fully diluted earnings per unit	\$ 0.2927	\$ 0.2570	\$ 0.2587	\$ 0.2389
Distributable cash per unit <sup>(5)</sup>	\$ 0.2825	\$ 0.2541	\$ 0.2224	\$ 0.2968
Distributions declared per unit	\$ 0.2501	\$ 0.2499	\$ 0.2501	\$ 0.2499

(1) The Fund's fourth quarter system sales are significantly higher than other quarters due to the seasonality of the business (see "Financial Highlights - Seasonality of system sales" above).

(2) Results for the quarters of 2006 are not directly comparable to results of comparable quarters as they include the impact of expenses related to the reorganization of the Fund (see "Reorganization of the Fund"). Details on expenses related to the reorganization are set out in the table below.

(3) Results for the second quarter of 2006 include a \$224 non-cash tax charge, resulting from a revaluation of MarksCo's future income tax assets as a result of reductions in federal income tax rates that were substantively enacted during the quarter. This resulted in a reduction in basic and fully diluted earnings per unit of \$0.0232. There was no impact to distributable cash per unit from this non-cash item.

(4) Upon the detailed annual review of the tax provision by management of MarksCo, it was deemed that the reductions in federal income tax rates that were substantively enacted in the second quarter reduced future income taxes by \$80, versus the original estimate of \$224. This resulted in a non-cash

tax recovery of \$144 being recognized in the fourth quarter of 2006. This recovery increased basic and fully diluted earnings per unit in the fourth quarter by \$0.0149. There was no impact to distributable cash per unit from this non-cash item.

Information pertaining to the expenses incurred related to the reorganization of the structure of the Fund is below. These costs are included in the quarterly net earnings and distributable cash amounts disclosed above.

	Q4 2006	Q3 2006	Q2 2006	Q1 2006
Expenses related to the reorganization				
- in thousands of dollars	\$ 40	\$ 10	\$ 164	\$ 193
- per unit	\$ 0.0041	\$ 0.0010	\$ 0.0171	\$ 0.0200

#### Fourth Quarter System Sales and Same Café Sales Growth

System sales for the fourth quarter of 2006 were \$53,759 (2005 - \$49,774) and same café sales growth was 7.8% (2005 - 5.6%) for the same period. System sales and same café sales growth were impacted by a number of factors:

- System sales growth benefited from various price increases implemented during the year as described above, and a price increase of 5 to 35 cents per cup on several of its espresso-based beverages and its brewed coffee beverages in mid-November 2006. Management estimates that the impact of the price increase made in mid-November, plus the smaller price increases made earlier in the year, positively impacted sales by approximately 3 to 4% in the quarter.
- Second Cup experienced another strong holiday season, driven by the continued success of its holiday merchandise program and sales of its reloadable payment card (the “Second Cup Café Card”). Activations and reloads on the Second Cup Café Card amounted to over \$3,000 during the holiday periods of November and December of 2006, representing an increase of more than 30% over the same period in the prior year. Activations and reload amounts are not recorded as a sale until such time as the customer redeems any amounts for the purchase of product in the future.
- System sales and same café sales growth continued to benefit from Second Cup’s continued focus on customer service, more effective marketing and advertising initiatives, and training initiatives implemented throughout the year.

#### Fourth Quarter Operating Expenses and Income Taxes

Total operating expenses of the Fund in the fourth quarter of 2006 were \$57 (2005 - \$80). Total operating expenses of the Fund were in line with management’s expectations. During the quarter the Fund incurred costs of \$40 related to the reorganization (see “Reorganization of the Fund”).

The Fund recorded after-tax income of \$805 during the quarter (2005 - \$495) from its equity-accounted investment in MarksCo, a wholly-owned subsidiary of the Fund. This represents the net earnings of MarksCo during the period. Net earnings of MarksCo included general and administrative expenses of \$123 (2005 - \$65) and amortization expense of \$17 (2005 - \$24). Income tax expenses of MarksCo were \$52 (2005 - \$150), comprised of current tax expense of \$168 (2005 - \$121) and future tax recovery of \$116 (2005 - expense of \$29). Following the detailed annual review of the annual income tax provision of MarksCo by management, a non-cash future income tax recovery of \$116 was recorded in the fourth quarter.

During the quarter, the Fund incurred an income tax expense of \$3 (2005 - \$2). After taking into account distributions declared of \$2,507 (2005 - \$2,397), which are not subject to tax in the Fund, the overall income tax expense reflects the annual expected effective tax rate of 23% applicable to the Fund’s wholly-owned subsidiary corporations.

Accordingly, net earnings of the Fund were \$3,111 or \$0.3228 cents per unit for the quarter, compared to \$2,804, or \$0.2927 cents per unit for the comparable quarter. Net earnings for the quarter excluding the above mentioned reorganization costs and the non-cash tax recovery were \$3,007, or \$0.3120 cents per unit.

## DISTRIBUTIONS

During the fourth quarter, the Fund declared total distributions of \$2,507 or \$0.2601 per unit, compared to total distributions declared in the fourth quarter of 2005 of \$2,397 or \$0.2501 per unit. On a per unit basis, this represents a 4.0% increase from the comparable period.

On a year-to-date basis, the Fund declared distributions of \$9,930 or \$1.0303 per unit, compared to total distributions declared in the comparable period in 2005 of \$9,583 or \$1.0000. On a per unit basis, this represents a 3.0% increase over the comparable year-to-date period.

Distributions for the year-to-date were as follows:

PERIOD	PAYMENT DATE	AMOUNT/UNIT
January 2006	February 28, 2006	\$ 0.0833
February 2006	March 31, 2006	\$ 0.0833
March 2006	April 28, 2006	\$ 0.0834
<i>Total - First Quarter 2006</i>		<u>\$ 0.2500</u>
April 2006	May 31, 2006	\$ 0.0867
May 2006	June 30, 2006	\$ 0.0867
June 2006	July 31, 2006	\$ 0.0867
<i>Total - Second Quarter 2006</i>		<u>\$ 0.2601</u>
July 2006	August 31, 2006	\$ 0.0867
August 2006	September 30, 2006	\$ 0.0867
September 2006	October 31, 2006	\$ 0.0867
<i>Total - Third Quarter 2006</i>		<u>\$ 0.2601</u>
October 2006	November 30, 2006	\$ 0.0867
November 2006	December 29, 2006	\$ 0.0867
December 2006	January 31, 2007	\$ 0.0867
<i>Total - Fourth Quarter 2006</i>		<u>\$ 0.2601</u>
<b>Total - Year-to-date</b>		<u><u>\$ 1.0303</u></u>

On January 31, 2007, the Fund paid the declared distribution for December 2006 of \$836, or \$0.0867 per Unit to holders of record at the close of business on December 31, 2006. On February 28, 2007, the Fund paid distributions for January 2007 of \$842 or \$0.0867 per unit to holders of record at the close of business on February 26, 2007.

On March 6, 2007, the Fund's Board of Trustees approved a 5% increase in the monthly unitholder distribution effective for the February 2007 distribution which will be paid on March 30, 2007 to holders of record at the close of business on March 28, 2007. The change will increase the monthly distribution rate from \$0.0867 to \$0.0910 per unit.

## DISTRIBUTABLE CASH

In common with other royalty income trusts in Canada, management believes distributable cash is an appropriate measure of performance of the Fund as the amount of cash available to pay distributions to unitholders is determined with reference to distributable cash. Management believes that, in addition to net income, distributable cash is a useful supplemental measure in evaluating the Fund's performance as it provides investors with an indication of cash available for distributions. Investors are cautioned, however, that distributable cash 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 for

the purposes of this MD&A may differ from that used by other issuers and, accordingly, distributable cash in this MD&A may not be comparable to distributable cash used by other issuers (see “Non-GAAP Terms”).

Commencing in the third quarter of 2006, the Fund has adjusted the way it presents distributable cash. Prior to the third quarter, distributable cash was presented as net earnings of the Fund before future income taxes and amortization expense of the Fund and MarksCo, an indirect wholly-owned subsidiary of the Fund accounted for as an equity investment in the Fund’s consolidated financial statements. For purposes of this MD&A, distributable cash is based on cash flows from operating activities, the GAAP measure reported in the Fund’s consolidated statement of cash flows. Cash flow from operating activities of the Fund is adjusted to include cash flow from operating activities of MarksCo.

	YEAR ENDED DECEMBER 31, 2006	YEAR ENDED DECEMBER 31, 2005
Cash flow from operating activities of the Fund	\$ 8,870	\$ 9,204
Add:		
Cash flow from operating activities of MarksCo	1,730	(2,587)
Income tax payment relating to Fund’s IPO	-	3,500
Distributable cash for the Fund	<u>\$ 10,600</u>	<u>\$ 10,117</u>
Distributable cash per unit	<u>\$ 1.0998</u>	<u>\$ 1.0558</u>
Distributions declared	<u>\$ 9,930</u>	<u>\$ 9,583</u>
Distributions declared per unit	<u>\$ 1.0303</u>	<u>\$ 1.0000</u>

Excluding \$407 of expenses related to the reorganization, distributable cash for the year-to-date would have been \$11,007, or \$1.1420 per unit as compared to \$1.0558 per unit for the comparable year. For the year ended December 31, 2006, non-cash working capital for the Fund decreased by \$46 and changes in non-cash working capital of MarksCo decreased by \$138 compared to a decrease of \$30 in the Fund and an increase of \$3,656 in MarksCo for the comparable period. Changes in non-cash working capital are primarily due to timing of payments from related parties and payments of income tax amounts. In 2004, an income tax liability amounting to \$3,500, incurred in connection with the transactions relating to the Fund’s IPO in 2004, was recorded and funded at the time of closing of the IPO. This income tax liability was paid in the first quarter of 2005 by MarksCo and is the primary reason for the increase in non-cash working capital of \$3,656 in the comparable period. As this liability was incurred in connection with the Fund’s IPO and is unrelated to the cash generated by operations during the period, it is excluded from the calculation of distributable cash for the year ended December 31, 2005. Excluding the impact of changes in non-cash working capital and the reorganization costs noted above, distributable cash would have been \$10,823 or \$1.1229 per unit compared to \$10,242 or \$1.0688 per unit, which represents a 5.1% increase in distributable cash per unit versus the comparable period.

#### **Tax Treatment of Distributions**

Of the \$1.0303 in distributions declared per unit during the year, 13.5% or \$0.1389 per unit represents a tax deferred return of capital, 11.9% or \$0.1224 per unit represented dividend income and 74.6% or \$0.7690 per unit is taxable as income from property. For the period ended December 31, 2005, 16.8% or \$0.1680 per unit represented a tax deferred return of capital, 6.5% or \$0.0648 represented dividend income and 76.7% or \$0.7672 per unit was taxable as income from property.

On October 31, 2006, the Federal Government announced its intention to tax distributions of certain income trusts, subject to certain exceptions, effective January 2011. This is discussed more fully below (see “Risks and Uncertainties”).

## **LIQUIDITY AND CAPITAL RESOURCES**

The Fund had cash and cash equivalent balances of \$320 at December 31, 2006 (2005 - \$209). This excludes cash and cash equivalent amounts held by MarksCo of \$802 (2005 - \$317).

The primary source of liquidity for the Fund is the Royalty payable to MarksCo by Second Cup. Second Cup collects royalties based on franchisee system sales, franchise fees and other amounts from its franchisees and also generates revenues from its company-owned cafés. The performance of Second Cup franchisees and company-owned cafés could impact the ability of Second Cup to pay the Royalty to MarksCo. For a more detailed discussion of the risks and uncertainties affecting the Fund's liquidity, refer to "Risks and Uncertainties" below.

For the year ended December 31, 2006, the Fund generated cash from operations of \$8,870 (2005 - \$9,204). The Fund also received \$1,135 (2005 - \$575) in dividends from MarksCo, and paid distributions to unitholders of \$9,894 (2005 - \$9,570) during the year.

The Fund receives monthly interest income payments in arrears from MarksCo on or about the 21st day of the following month, as well as dividend income as declared by MarksCo. Dividends are declared by MarksCo based on its earnings, cash on hand and future cash needs of the Fund.

In turn, the Fund is required to remit distributions to unitholders in arrears, on the last business day of each month. The Fund's distribution policy is to make cash distributions to unitholders from the distributable cash generated by the Fund and its wholly-owned subsidiaries, and to make such distributions in equal amounts to unitholders on a monthly basis in order to smooth out any seasonal fluctuations in the Fund's income.

Annually, commencing January 1, 2006, the Royalty Pool is adjusted to include new Second Cup cafés opened on or before September 2 of the prior year, and to exclude any Second Cup cafés that were in the Royalty Pool and permanently closed during the year. See "Adjustments to the Royalty Pool" below. In accordance with the Agreement, the Fund has the right to acquire the future royalty stream on the net system sales in return for payment of an amount calculated as 92.5% of the royalty revenue added to the Royalty Pool, divided by the yield of the Fund units over a 20-day trading period specified in the Agreement. The Fund also has the right to elect payment in cash or Fund units to Second Cup. For the January 1, 2006 adjustment to the Royalty Pool, the Fund elected to make payment to Second Cup in units of the Fund.

The Fund has no contractual or purchase obligations. The Fund did not have any capital expenditures in 2006 and does not have any plans for capital expenditures in 2007.

The Fund has guaranteed a term credit agreement entered into by MarksCo which matures on December 2, 2009. The credit facilities total \$12,000 and are comprised of an \$11,000 non-revolving term credit facility and a \$1,000 operating credit facility. As at December 31, 2006, the \$1,000 operating line of credit was unused and the \$11,000 non-revolving facility was fully utilized.

The Fund continues to believe it has sufficient financial resources to pay ongoing future distributions, operating expenses and income taxes.

## **OFF-BALANCE SHEET ARRANGEMENTS**

The Fund does not have any off-balance sheet arrangements.

## **CRITICAL ACCOUNTING ESTIMATES**

The Fund annually reviews the book value of its primary asset, its investment in the notes and common shares of MarksCo. The review is based on the distributable cash flow of the Fund, which is based on income from the Fund's investment in MarksCo. In turn, MarksCo's cash flows are based on the royalty income earned on licensing the Second Cup Marks to Second Cup. The review also considers the unit price of the Fund, actual and forecast royalty income

from Second Cup and actual and forecast distributable cash of the Fund. The Fund reviewed its investment in MarksCo as at December 31, 2006 and concluded there was no impairment.

#### **RELATED PARTY TRANSACTIONS AND BALANCES**

During the year, interest income of \$9,547 (2005 - \$9,487) was earned from MarksCo, of which \$811 is receivable at December 31, 2006 (2005 - \$806). In addition, during the year, dividend income of \$1,135 (2005 - \$575) was received from MarksCo.

Included in accounts payable and accrued liabilities is an amount of \$69 (2005 - \$26) due to MarksCo. This amount arose as a result of MarksCo paying for certain general and administrative expenses of the Fund. The amount is non-interest bearing and is due on demand.

#### **CHANGE IN CONTROL OF SECOND CUP**

In November, Mr. Gabriel Tsampalieros, the Executive Chairman of Second Cup and the former Chief Executive Officer of Cara Operations Ltd. ("Cara"), purchased all of the issued and outstanding shares of Second Cup from Cara through Dinecorp Hospitality Inc. ("DHI"), a corporation controlled by him. The transaction excluded the Fund units previously held by Second Cup which were transferred to Cara prior to the acquisition of Second Cup by DHI. In addition, DHI also purchased all the international Second Cup trade-marks held directly by Cara which were not transferred to the Fund in connection with the Fund's initial public offering in December 2004. Cara will continue to operate a number of Second Cup cafés as a franchisee under currently existing franchise agreements.

Mr. Tsampalieros has been actively involved with Second Cup for ten years, first as a Director of Second Cup since 1996, and then as its Executive Chairman since 2002 following Second Cup's acquisition by Cara. The purchase consideration was not disclosed.

#### **REORGANIZATION OF THE FUND**

The Fund has decided to restructure the manner in which the Fund holds its interest in the Second Cup Marks. Since the completion of its initial public offering in 2004, the Fund has owned the Second Cup Marks through its direct and indirect corporate subsidiaries, including MarksCo. These subsidiaries are subject to income tax which, in turn, reduces the cash that would otherwise be available for distribution to the Fund's unitholders. The Fund will modify the current organizational structure of the Fund by replacing the intermediary corporations with a newly formed trust and limited partnership. This will provide the Fund with a "flow-through" structure that would eliminate income tax expense currently being incurred by the Fund's corporate subsidiaries.

The reorganization of the Fund's structure was approved by unitholders of the Fund at a meeting held on May 10, 2006. The Fund has received a favourable Advance Income Tax Ruling from the Canada Revenue Agency with respect to the reorganization. MarksCo together with the Fund's advisors have determined that it remains in the best interests of the Fund and its unitholders to proceed with implementing the reorganization notwithstanding the proposed tax legislation regarding income trusts announced by the federal government on October 31, 2006. It is anticipated that the proposed reorganization will be implemented in the Fund's second quarter of 2007.

Expenses incurred by the Fund relating to the proposed reorganization were \$407 for the year (2005 - \$nil).

#### **FINANCIAL INSTRUMENTS**

##### **Fair values**

The Fund's financial instruments consist of cash and cash equivalents, notes and interest receivable from MarksCo, income taxes recoverable, accounts payable and accrued liabilities, income taxes payable and distributions payable to the unitholders. Aside from the notes receivable from MarksCo, the fair values of these instruments approximate their

carrying amounts due to their short-term maturity. Based on prevailing market interest rates and the creditworthiness of MarksCo, the fair value of the notes receivable from MarksCo approximate their carrying amounts.

#### **Credit risk**

The Fund's financial instruments exposed to credit risk include cash and cash equivalents and notes and interest receivable from MarksCo. The Fund places its cash and cash equivalents with institutions of high creditworthiness. The Fund believes the credit risk exposure on its notes and interest receivable from MarksCo is limited. This is based on the consistency of the royalty income collected by MarksCo, which is its sole source of cash for payment of interest on the notes receivable by the Fund.

#### **RISKS AND UNCERTAINTIES**

The performance of the Fund is dependent on 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 not directly a function of 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 that 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 on Second Cup's ability to secure and build desirable locations and find high calibre, 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 on 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.
- 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.

On October 31, 2006, the federal government announced proposed changes to income taxes, which if enacted, would significantly change the income tax treatment of most publicly traded income trusts and the distributions from these entities to their unitholders. The proposals were released in draft legislative form on December 21, 2006. Under the proposals, certain income earned by these entities will be taxed in a manner similar to income earned by a corporation

and distributions or allocations made by these entities to unitholders will be taxed similar to dividends from taxable Canadian corporations. The deemed dividends will be eligible for the proposed new enhanced dividend tax credit if paid or allocated to a resident of Canada. These proposals will generally be effective beginning in the 2011 taxation year for income trusts that were publicly traded prior to November 1, 2006, such as the Fund. The Fund is currently reviewing these proposals and the possible impact they will have on the Fund and its unitholders, and what, if any, steps to take in respect of the Fund. However, these proposals are not expected to have an immediate impact on the Fund's tax treatment, or distribution policy or the tax treatment of distributions to unitholders. Until final legislation implementing the proposed changes is introduced, the exact impact of changes to the Fund is unknown and no action, if any, will be taken. There can be no assurances that the Fund will be able to undertake any measures to minimize such impact.

A more detailed discussion of the risks and uncertainties affecting the Fund is set out in the Fund's Annual Information Form, which is available at [www.sedar.com](http://www.sedar.com).

#### **ADJUSTMENTS TO THE ROYALTY POOL**

Annually, commencing January 1, 2006, the Royalty Pool is adjusted to include Second Cup cafés that, on November 1 of the previous year, had been open for at least 60 days and which were not previously included in the Royalty Pool. At the same time, the Royalty Pool is adjusted to remove cafés that were permanently closed in the year. In return for adding cafés to the Royalty Pool, Second Cup is entitled to be paid an amount that may be satisfied by additional Fund units or cash, the form of payment being at the option of the Fund. The amount to be paid is calculated as 92.5% of the royalty revenue added to the Royalty Pool, divided by the yield of the Fund units over a 20-day trading period specified in the Agreement. Second Cup initially receives 80% of the amount based on forecast net system sales, with the balance received when the actual full year performance of the new cafés is known.

##### **January 1, 2006**

On January 1, 2006, nine Second Cup cafés were added to the Royalty Pool. At the time, the system sales of these nine cafés for the 2006 calendar year were forecasted to be \$4,055. These were offset by \$2,907 in actual system sales of eight cafés closed from the Royalty Pool since the Fund's inception. As a result of this adjustment, the total number of cafés in the Royalty Pool increased from 351 to 352.

On January 1, 2006, the Fund issued 55,316 units to MarksCo, which were then delivered to Second Cup, to satisfy 80% of the estimated total obligation to Second Cup resulting from the increase in the royalty revenue of the Royalty Pool. After a full year of performance of the new cafés, the Fund expects to issue additional units to satisfy the remaining obligation (see "January 1, 2007" below).

In conjunction with this adjustment to the Royalty Pool, the Fund (through its direct subsidiary) acquired a note of MarksCo in the amount of \$493 and common shares of MarksCo in the amount of \$55 for total cash consideration of \$548. The note issued by MarksCo to the Fund bears interest at 12.125% and matures January 1, 2016.

##### **January 1, 2007**

On January 1, 2007 the actual system sales of the nine cafés added to the Royalty Pool on January 1, 2006 were \$4,421 as compared to the original estimate of \$4,055. As a result, a final adjustment payment of \$356 was made by MarksCo to Second Cup, which MarksCo satisfied by delivering to Second Cup 35,903 additional units of the Fund that were issued to MarksCo by the Fund on January 1, 2007. In accordance with the licence and royalty agreement, MarksCo also made a cash payment of \$37 to Second Cup, representing the cash distributions that would have otherwise been earned by Second Cup on the 35,903 additional units above had they been issued on January 1, 2006. As a result of this adjustment, the number of outstanding units increased to 9,673,979.

Also on January 1, 2007, 11 Second Cup cafés were added to the Royalty Pool. The system sales of these 11 cafés added to the Royalty Pool has been estimated at \$4,555 annually. These were offset by \$3,815 in actual system sales of 12 cafés permanently closed. As a result of this adjustment, the total number of cafés in the Royalty Pool decreased from 352 to 351.



As a result of this adjustment to the Royalty Pool, the Fund, through its indirect wholly owned subsidiary MarksCo, made a payment of \$314 to Second Cup representing 80% of the obligation based on forecasted net system sales. This payment was satisfied by the Fund's issuance of 34,630 units to MarksCo, which were then delivered to Second Cup. After a full year of performance of the new cafés, the Fund expects to issue additional units to satisfy the remaining obligation.

An additional nine cafés were opened in 2006 subsequent to the cut-off date for inclusion in the Royalty Pool at the next adjustment date. These cafés are expected to be added to the Royalty Pool as at the January 1, 2008 adjustment date, along with any cafés opened in 2007 prior to the cut-off date for the January 1, 2008 adjustment.

#### OUTSTANDING UNIT AND SHARE DATA

	AS AT DECEMBER 31, 2006	AS AT DECEMBER 31, 2005
Fund - units issued	9,638,076	9,582,760
- amount	\$ 87,488	\$ 86,940

At December 31, 2005, Second Cup owned 1,437,414 units, representing 15.0% of the issued and outstanding units. On January 1, 2006, an additional 55,316 units were issued to Second Cup (see "Adjustment to the Royalty Pool" above). As a result of this adjustment, the number of outstanding units increased to 9,638,076 and Second Cup's ownership share increased to 1,492,730 units, representing approximately 15.5% of the issued and outstanding units. In November 2006, Second Cup transferred ownership of its 1,492,730 units to Cara as further described in "Change in Control of Second Cup" above. On January 1, 2007, 70,533 units were issued to Second Cup (see "Adjustment to the Royalty Pool" above) representing approximately 0.7% of the total issued and outstanding units of the Fund.

#### EVALUATION OF DISCLOSURE CONTROLS AND PROCEDURES

The Chief Executive Officer and the Chief Financial Officer of MarksCo, as administrator of the Fund, together with other management, have evaluated, as of December 31, 2006, the effectiveness of the Fund's disclosure controls and procedures within the meaning of Multilateral Instrument 52-109 Certification of Disclosure in Issuers' Annual and Interim Filings. They have concluded that the Fund's disclosure controls and procedures provide reasonable assurance that material information relating to the Fund would have been made known to such management. As well, the certifying officers are satisfied that the system of internal controls over financial reporting has been designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes. Management has not evaluated the effectiveness of internal controls over financial reporting.

#### NEW ACCOUNTING PRONOUNCEMENTS

##### Financial Instruments - Recognition and Measurement, CICA Handbook Section 3855

Section 3855 prescribes when a financial asset, financial liability, or non-financial derivative is to be recognized on the balance sheet and at what amount - sometimes using fair value; other times using cost-based measures. It also specifies how financial instrument gains and losses are to be presented.

Section 3855 applies to interim and annual financial statements relating to fiscal years beginning on or after October 1, 2006. The Fund will adopt this standard effective January 1, 2007 and does not expect the impact on the Fund's financial statements will be material.

##### Hedges, CICA Handbook Section 3865

Section 3865 is applicable whenever a company chooses to designate a hedging relationship for accounting purposes. It builds on existing Accounting Guideline AcG-13 - Hedging Relationships by specifying how hedge accounting is applied and what disclosures are necessary when it is applied.

Section 3865 applies for interim and annual financial statements relating to fiscal years beginning on or after October 1, 2006. The Fund will adopt this standard effective January 1, 2007 and does not expect the impact on the Fund's financial statements will be material.

#### **Comprehensive Income, CICA Handbook Section 1530**

Section 1530 introduces new standards for reporting and displaying of comprehensive income. Comprehensive income is the change in equity (net assets) of an enterprise during a reporting period from transactions and other events and circumstances from non-owner sources. It includes all changes in equity during a period except those resulting from investments by owners and distributions to owners.

Section 1530 applied to interim and annual financial statements relating to fiscal years beginning on or after October 1, 2006. Financial statements of prior periods are required to be restated for certain comprehensive income items. The Fund will adopt this standard effective January 1, 2007.

#### **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 on same café sales growth, and adding net new cafés to the café network.

During 2006, Second Cup made significant progress in implementing its previously announced strategies aimed at increasing same café sales growth. This is evidenced by the achievement of 6.2% same café sales growth for the year, following 4.6% same café sales growth for the year ended December 31, 2005. Second Cup has now achieved 13 consecutive quarters of positive same café sales dating back to the fourth quarter of 2003. Subject to healthy economic conditions continuing across the company's primary markets, Second Cup believes it can continue this trend and expects to achieve same café sales growth of approximately 3 to 5% for the 2007 fiscal year. To achieve this growth, Second Cup has planned a number of growth initiatives to strengthen the long-term success of the Second Cup brand and its franchisees:

- Second Cup will continue to develop and build neighbourhood cafés with a focus on expansion in key markets utilizing a disciplined and revitalized café development process, and the delivery of cost savings to franchisees in the build out of their new and renovated cafés.
- In an effort to drive loyalty among specialty coffee customers, the company's promotional strategies will focus on targeted branding initiatives leveraging its premium priced specialty beverages, food and merchandise innovations, and value added offers. Second Cup will also selectively enhance the nutritional quality of its grab and go food, and beverage offerings.
- Second Cup will continue to focus on its reloadable payment card introduced in late 2005. In 2006, the card has represented approximately 5% of system sales activity among cafés in the program. During the 2006 Holiday period of November and December alone, over \$3,000 was loaded on to the cards, an increase of over 30% versus the comparable period in 2005. Second Cup management believes that through the delivery of new and innovative initiatives in 2007, the card will continue to drive incremental sales growth and customer loyalty.
- Second Cup will continue to invest significantly in the training and development it offers its franchise partners and café sales associates. This will include a revitalized curriculum available through its Business School and its online learning programs that were launched in 2006, which keep cafes current on the fundamentals of business success at Second Cup. Simultaneously new values will be introduced to the organization which will help build a branded organizational culture and enable long-term value creation for the company and its partners.

In terms of network expansion, Second Cup expects to open 14 to 18 new cafés in Canada during the 2007 fiscal year. Second Cup also expects to close 8 to 12 cafés during 2007, the majority of which have sales below the average performance of cafés in the Royalty Pool. Furthermore, Second Cup expects that approximately 30 of its cafés will be

renovated during 2007. Accordingly, development of the Second Cup café network has been and continues to be a strategic initiative for the company.

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 looks forward to a successful year in 2007.

#### **FORWARD-LOOKING INFORMATION**

Certain statements in this MD&A may constitute forward-looking information within the meaning of applicable securities legislation. Forward-looking information can be identified by words such as “may”, “will”, “should”, “expect”, “anticipate”, “believe”, “plan”, “intend” and other similar words. Forward-looking information reflects current expectations regarding future events and operating performance and speaks only as of the date of this MD&A. It should not be read as a guarantee of future performance or results and will not necessarily be an accurate indication of whether or not those results will be achieved. Forward-looking information is based on a number of assumptions and is subject to known and unknown risks, uncertainties and other factors, many of which are beyond the Fund’s control, that may cause the Fund’s actual results, performance or achievements, or those of MarksCo, Second Cup, Second Cup cafés, or industry results to be materially different from any future results, performance or achievements expressed or implied by such forward-looking information. The following are some of the factors that could cause actual results to differ materially from those expressed in or underlying forward-looking information: 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 Marks; changing consumer preferences and discretionary spending patterns; reporting of system sales by franchisees; and the results of operations and financial condition of Second Cup. The foregoing list of factors is not exhaustive, and investors should refer to the risks described under “Risks and Uncertainties” above.

Although the forward-looking information contained in this MD&A is based on what management believes are reasonable assumptions, there can be no assurance that actual results will be consistent with this forward-looking information. Certain assumptions made in preparing forward-looking information include the assumption that the Canadian economy will remain stable or expand at a moderate pace in 2007 and that inflation will remain relatively low. The Fund has also assumed that interest rates will remain stable in 2007 and that demand for specialty coffee will be comparable with demand in 2006.

As these forward-looking statements are made as of the date of this MD&A, the Fund does not undertake to update any such forward-looking information whether as a result of new information, future events or otherwise. Additional information about these assumptions and risks and uncertainties is contained in the Fund’s filings with securities regulators. These filings are also available on the Fund’s website at [www.secondcupincomefund.com](http://www.secondcupincomefund.com).

#### **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 “system sales”, “same café sales growth”, “net earnings for the year excluding reorganization costs and non-cash tax”, “basic earnings per unit excluding reorganization costs and non-cash tax item”, “distributable cash per unit excluding reorganization costs and changes in non-cash working capital” and “distributable cash”. 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.

System sales and same café sales growth are presented in reference to the sales performance of the Royalty Pool Cafés. The Fund believes they are useful measures as they provide an indication of the top-line sales on which the royalty that is the Fund’s indirect source of income is based. Distributable cash is presented in reference to the Fund’s distribution

policy. The Fund believes distributable cash is a useful measure as it provides investors with an indication of cash available for distribution. Management believes, in addition to net income, distributable cash is a useful supplemental measure in evaluating the Fund's performance as it provides investors with an indication of cash available for distributions and working capital needs. Investors are cautioned, however, that distributable cash 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 for the purposes of this MD&A may differ from that used by other issuers and, accordingly, distributable cash in this MD&A may not be comparable to distributable cash used by other issuers. Distributable cash is determined as net earnings of the Fund before future income taxes and amortization expense of the Fund and MarksCo, a wholly-owned subsidiary of the Fund accounted for as an equity investment in the Fund's consolidated financial statements.

Second Cup Royalty Income Fund  
CONSOLIDATED FINANCIAL STATEMENTS  
DECEMBER 31, 2006



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March 6, 2007

## **Auditors' Report**

To the Unitholders of  
Second Cup Royalty Income Fund

We have audited the consolidated balance sheets of **Second Cup Royalty Income Fund** (the Fund) as at December 31, 2006 and 2005 and the consolidated statements of earnings, unitholders' equity and cash flows for the years then ended. These financial statements are the responsibility of the Fund's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the Fund as at December 31, 2006 and 2005 and the results of its operations and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

*PricewaterhouseCoopers LLP*

Chartered Accountants

PricewaterhouseCoopers refers to the Canadian firm of PricewaterhouseCoopers LLP and the other member firms of PricewaterhouseCoopers International Limited, each of which is a separate and independent legal entity.

Second Cup Royalty Income Fund  
**CONSOLIDATED BALANCE SHEETS**  
 (EXPRESSED IN THOUSANDS OF DOLLARS)

	DECEMBER 31, 2006	DECEMBER 31, 2005
<b>Assets</b>		
<b>CURRENT ASSETS</b>		
Cash and cash equivalents	\$ 320	\$ 209
Interest receivable from Second Cup Trade-Marks Inc. (note 9)	811	806
Income taxes recoverable	2	2
	<hr/>	<hr/>
	1,133	1,017
Notes receivable from Second Cup Trade-Marks Inc. (note 9)	78,739	78,246
Investment in Second Cup Trade-Marks Inc. (note 6)	9,326	9,087
	<hr/>	<hr/>
	\$ 89,198	\$ 88,350
	<hr/>	<hr/>
<b>Liabilities</b>		
<b>CURRENT LIABILITIES</b>		
Accounts payable and accrued liabilities (note 9)	\$ 211	\$ 161
Distributions payable to unitholders	836	800
	<hr/>	<hr/>
	1,047	961
<b>UNITHOLDERS' EQUITY</b>	<hr/>	<hr/>
	88,151	87,389
	<hr/>	<hr/>
	\$ 89,198	\$ 88,350
	<hr/>	<hr/>

Subsequent event (note 12)

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 STATEMENTS OF EARNINGS**  
**(EXPRESSED IN THOUSANDS OF DOLLARS, EXCEPT PER UNIT AMOUNTS)**

	<b>FOR THE YEAR ENDED DECEMBER 31, 2006</b>	<b>FOR THE YEAR ENDED DECEMBER 31, 2005</b>
Interest income from Second Cup Trade-Marks Inc. (note 9)	\$ 9,547	\$ 9,487
General and administrative expenses	(304)	(301)
Reorganization expense	(407)	-
Earnings from equity-accounted investment (note 6)	1,319	862
Earnings before income taxes	10,155	10,048
Income taxes - current (note 5)	12	12
Net earnings	<u>\$ 10,143</u>	<u>\$ 10,036</u>
Basic earnings per unit (note 8)	<u>\$ 1.0524</u>	<u>\$ 1.0473</u>
Diluted earnings per unit (note 8)	<u>\$ 1.0485</u>	<u>\$ 1.0473</u>

See accompanying notes to consolidated financial statements.

## Second Cup Royalty Income Fund

### CONSOLIDATED STATEMENTS OF UNITHOLDERS' EQUITY

(EXPRESSED IN THOUSANDS OF DOLLARS, EXCEPT PER UNIT AMOUNTS)

	CAPITAL	UNITHOLDERS' EARNINGS	ACCUMULATED DISTRIBUTIONS	REFUNDABLE TAXES	TOTAL
<b>BALANCE - DECEMBER 31, 2004</b>	\$ 86,940	\$ 784	\$ (787)	\$ -	\$ 86,937
Net earnings	-	10,036	-	-	10,036
Distributions to unitholders	-	-	(9,583)	-	(9,583)
Refundable taxes incurred	-	-	-	(207)	(207)
Recovery of refundable taxes	-	-	-	206	206
<b>BALANCE - DECEMBER 31, 2005</b>	\$ 86,940	\$ 10,820	\$ (10,370)	\$ (1)	\$ 87,389
Net earnings	-	10,143	-	-	10,143
Units issued January 1, 2006	548	-	-	-	548
Distributions to unitholders	-	-	(9,930)	-	(9,930)
Refundable taxes incurred	-	-	-	(371)	(371)
Recovery of refundable taxes	-	-	-	372	372
<b>BALANCE - DECEMBER 31, 2006</b>	\$ 87,488	\$ 20,963	\$ (20,300)	\$ -	\$ 88,151

See accompanying notes to consolidated financial statements.



Second Cup Royalty Income Fund  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**  
**(EXPRESSED IN THOUSANDS OF DOLLARS)**

	<b>FOR THE YEAR ENDED DECEMBER 31, 2006</b>	<b>FOR THE YEAR ENDED DECEMBER 31, 2005</b>
<b>Cash provided by (used in)</b>		
<b>OPERATING ACTIVITIES</b>		
Net earnings for the year	\$ 10,143	\$ 10,036
Item not involving cash		
Earnings from equity-accounted investment	(1,319)	(862)
Change in non-cash working capital items (note 13)	46	30
	<hr/> 8,870	<hr/> 9,204
<b>INVESTING ACTIVITIES</b>		
Investment in note receivable of Second Cup Trade-Marks Inc. (note 3)	(493)	-
Dividends from equity-accounted investment	1,135	575
Investment in common shares of Second Cup Trade-Marks Inc.	(55)	-
	<hr/> 587	<hr/> 575
<b>FINANCING ACTIVITIES</b>		
Issuance of units	548	-
Distributions paid to unitholders	(9,894)	(9,570)
	<hr/> (9,346)	<hr/> (9,570)
<b>INCREASE IN CASH AND CASH EQUIVALENTS DURING THE YEAR</b>	111	209
<b>CASH AND CASH EQUIVALENTS - BEGINNING OF YEAR</b>	209	-
	<hr/> \$ 320	<hr/> \$ 209
<b>CASH AND CASH EQUIVALENTS - END OF YEAR</b>		
<b>SUPPLEMENTARY CASH FLOW INFORMATION:</b>		
Income taxes paid	\$ 12	\$ 16

See accompanying notes to consolidated financial statements.

# Second Cup Royalty Income Fund

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

DECEMBER 31, 2006 AND DECEMBER 31, 2005

(ALL AMOUNTS EXPRESSED IN THOUSANDS OF DOLLARS, EXCEPT UNITS AND PER UNIT AMOUNTS)

### 1. ORGANIZATION AND NATURE OF BUSINESS

Second Cup Royalty Income Fund (the "Fund") is an unincorporated open-ended trust established under the laws of the Province of Ontario. The Fund was established to invest in Second Cup Trade-Marks Inc. ("MarksCo"), which owns the Second Cup trademarks used in Second Cup's specialty coffee cafés in Canada. The Fund's investment in MarksCo is held through 1636433 Ontario Inc. ("AcquisitionCo"), a wholly-owned subsidiary of the Fund. An unlimited number of units may be issued pursuant to the Fund's declaration of trust. Units are redeemable by the holder at any time, subject to certain limitations. Income tax obligations related to distributions by the Fund are currently the obligations of the unitholders.

On October 31, 2006, the Federal Government announced proposed plans to apply a tax on distributions from publicly traded income trusts. For existing income trusts the proposed changes, with certain restrictions around business growth, would not be applicable until the 2011 taxation year. If these changes are enacted as proposed, cash available for distributions to unitholders will be reduced commencing in 2011 by the amount of income tax paid or payable by the Fund.

The business of MarksCo is the ownership of the Second Cup trademarks and through the Licence and Royalty Agreement with The Second Cup Ltd. ("Second Cup"), the taking of actions to exploit the use of the Second Cup trademarks and the collection of the royalty payable under the Licence and Royalty Agreement. MarksCo is not consolidated with the Fund (note 4(e)). Second Cup is Canada's leading franchisor of specialty coffee cafés.

### 2. SYSTEM SALES

System sales include gross revenue of the pool of Second Cup cafés (Company-owned or franchised) on which Second Cup pays a royalty to MarksCo (the "Royalty Pool") based on information reported by café operators. Gross revenue is self-assessed by each café on a weekly basis and submitted to Second Cup.

	2006	2005
System sales reported by cafés in the Royalty Pool	\$ 189,287	\$ 177,527

### 3. JANUARY 1, 2006 ROYALTY POOL ADJUSTMENT

Annually, commencing January 1, 2006, the Royalty Pool is adjusted to include new Second Cup cafés which have been open for at least 60 days and which were not previously included in the Royalty Pool and to exclude any cafés that were in the Royalty Pool and permanently closed during the year. In return for adding cafés to the Royalty Pool, Second Cup is entitled to be paid an amount calculated as 92.5% of the estimated net additional royalty revenue added to the Royalty Pool, divided by the yield of the Fund units over a 20-day trading period specified in the Licence and Royalty Agreement. Second Cup initially receives 80% of the amount based on forecast net system sales, with the balance received when the actual full year performance of the new cafés is known. These amounts may be satisfied by additional Fund units or cash, the form of payment being at the option of the Fund.

On January 1, 2006, nine cafés were added to the Royalty Pool. The system sales of these nine cafés added to the Royalty Pool was estimated at the time to be \$4,055 annually. These were offset by \$2,907 in actual system sales of

## Second Cup Royalty Income Fund

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

DECEMBER 31, 2006 AND DECEMBER 31, 2005

(ALL AMOUNTS EXPRESSED IN THOUSANDS OF DOLLARS, EXCEPT UNITS AND PER UNIT AMOUNTS)

eight cafés closed from the Royalty Pool since the Fund's inception. As a result of this adjustment, the total number of cafés in the Royalty Pool increased from 351 to 352.

On January 1, 2006, the Fund issued 55,316 units to MarksCo, which were then delivered to Second Cup, to satisfy 80% of the estimated total obligation to Second Cup resulting from the increase in the royalty revenue of the Royalty Pool. After a full year of performance of the new cafés, the Fund expects to issue 35,903 additional units to satisfy the remaining obligation of MarksCo on or about January 1, 2007 (see note 12).

In conjunction with this adjustment to the Royalty Pool, the Fund (through its direct subsidiary) acquired a note of MarksCo in the amount of \$493 and common shares of MarksCo in the amount of \$55 for total cash consideration of \$548. The note issued by MarksCo to the Fund bears interest at 12.125% and matures January 1, 2016. The common shares have been accounted for in these consolidated financial statements as an increase in the Fund's investment in MarksCo (note 6).

#### 4. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

##### a. Basis of presentation

These consolidated financial statements include the accounts of the Fund and its wholly-owned subsidiary, AcquisitionCo. They do not include the accounts of MarksCo, a wholly-owned indirect subsidiary of the Fund (note 4(e)). 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 is comprised of interest income earned on notes receivable from MarksCo. Interest revenue is recognized and accrued when earned. Dividends earned and received from MarksCo are accounted for as a reduction in the equity-accounted investment in MarksCo.

##### 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. Future income taxes

Future income taxes are provided for 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.

##### e. Variable interest entities

On January 1, 2005, the Fund adopted the requirements of Accounting Guideline 15 ("AcG-15"). AcG-15 requires consolidation of VIEs by the primary beneficiary. The primary beneficiary is defined as the party that has exposure to the majority of the VIEs expected losses and/or residual returns. The Fund has evaluated its interests in its indirect

## Second Cup Royalty Income Fund

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

DECEMBER 31, 2006 AND DECEMBER 31, 2005

(ALL AMOUNTS EXPRESSED IN THOUSANDS OF DOLLARS, EXCEPT UNITS AND PER UNIT AMOUNTS)

wholly-owned subsidiary, MarksCo, and determined that Second Cup is the primary beneficiary and should consolidate MarksCo. The Fund has accounted for its investment in the common shares of MarksCo as an equity-accounted investment.

#### **f. Earnings per 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 using the treasury stock method.

#### **g. Distribution to unitholders**

Distributions are recorded when declared, made monthly in arrears and are subject to the Fund retaining such reasonable working capital reserves as may be considered appropriate by the trustees of the Fund.

#### **h. Use of estimates**

The 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.

#### **i. Financial instruments**

##### *Fair values*

The Fund's financial instruments consist of cash and cash equivalents, notes and interest receivable from MarksCo, income taxes recoverable, accounts payable and accrued liabilities and distributions payable to unitholders. Aside from the notes receivable from MarksCo, the fair values of these instruments approximate their carrying amounts due to their short-term maturity. Based on prevailing market interest rates and the creditworthiness of MarksCo, the fair value of the notes receivable from MarksCo approximate their carrying amounts.

##### *Credit risk*

The Fund's financial instruments exposed to credit risk include cash and cash equivalents and notes and interest receivable from MarksCo. The Fund places its cash and cash equivalents with institutions of high creditworthiness. The Fund believes the credit risk exposure on its notes and interest receivable from MarksCo is limited. This is based on the consistency of the royalty income collected by MarksCo, which is its sole source of cash for payment of interest on the notes receivable by the Fund.

#### **5. INCOME TAXES**

The Fund is not taxable on any income that is distributed to unitholders. The Fund's indirect subsidiaries are taxable on their income at Canadian statutory rates. Income tax expense as reported differs from the amount that would be

## Second Cup Royalty Income Fund

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

DECEMBER 31, 2006 AND DECEMBER 31, 2005

(ALL AMOUNTS EXPRESSED IN THOUSANDS OF DOLLARS, EXCEPT UNITS AND PER UNIT AMOUNTS)

computed by applying the combined federal and provincial statutory income tax rates to earnings before income taxes. The reasons for the difference are as follows:

	2006	2005
Earnings before income taxes	\$ 10,155	\$ 10,048
Combined Canadian federal and provincial tax rates	23.12%	23.11%
Tax provision at statutory rate	2,347	2,321
Reduced by following permanent differences:		
Income distributed or accrued to unitholders not subject to tax in the fund	(2,030)	(2,110)
Earnings from equity-accounted investment	(305)	(199)
Provision for income taxes	\$ 12	\$ 12

#### 6. INVESTMENT IN SECOND CUP TRADE-MARKS INC.

The Fund's equity investment in Second Cup Trade-Marks Inc. is as follows:

	2006	2005
Opening balance	\$ 9,087	\$ 8,800
Equity in earnings for the year	1,319	862
Dividends received during the year	(1,135)	(575)
Investment in common shares	55	-
	\$ 9,326	\$ 9,087
Common shares	\$ 8,749	\$ 8,694
Cumulative equity in earnings	2,287	968
Cumulative dividends received	(1,710)	(575)
	\$ 9,326	\$ 9,087

#### 7. INCOME FUND UNITS

The declaration of trust of the Fund 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 a price based on market value as defined in the trust agreement, subject to a maximum of \$50 in cash redemptions by the Fund in any one month. The limitation may be waived at the discretion of the trustees of the Fund.

## Second Cup Royalty Income Fund

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

DECEMBER 31, 2006 AND DECEMBER 31, 2005

(ALL AMOUNTS EXPRESSED IN THOUSANDS OF DOLLARS, EXCEPT UNITS AND PER UNIT AMOUNTS)

Weighted average units outstanding:

	NUMBER OF UNITS	NET PROCEEDS
Issued and outstanding as at December 31, 2005 and 2004	9,582,760	\$ 86,940
Issued on January 1, 2006 (note 3)	55,316	548
Fund units	<u>9,638,076</u>	<u>\$ 9,582,760</u>

Subsequent to December 31, 2006, the Fund issued an additional 70,533 units (note 12).

#### 8. BASIC AND DILUTED EARNINGS PER UNIT

Earnings per unit are based on the weighted average number of units outstanding during the year. Diluted earnings per unit are calculated to reflect the estimated dilutive impact of the additional units of the Fund to be issued to Second Cup on January 1, 2007 as final consideration for the increase in the Royalty Pool on January 1, 2006 (see note 3). Basic and diluted earnings per unit are determined as follows:

	2006	2005
Numerator for basic and diluted earnings per unit - net income	<u>\$ 10,143</u>	<u>\$ 10,036</u>
Denominator for basic earnings per unit: - weighted average number of units issued and outstanding	<u>9,638,076</u>	<u>9,582,760</u>
Denominator for diluted earnings per unit: - weighted average number of units issued and outstanding	9,638,076	9,582,760
- estimated impact of additional units to be issued on January 1, 2006 adjustment to Royalty Pool	<u>35,903</u>	<u>-</u>
Denominator for diluted earnings per unit	<u>9,673,979</u>	<u>9,582,760</u>
Basic earnings per unit	<u>\$ 1.0524</u>	<u>\$ 1.0473</u>
Diluted earnings per unit	<u>\$ 1.0485</u>	<u>\$ 1.0473</u>

#### 9. RELATED PARTY TRANSACTIONS AND BALANCES

During the year, interest income of \$9,547 (2005 - \$9,487) was earned on the \$78,739 (2005 - \$78,246) note receivable from MarksCo, of which \$811 is receivable at December 31, 2006 (2005 - \$806). In addition, during the year, dividend income of \$1,135 (2005 - \$575) was received from MarksCo.

## Second Cup Royalty Income Fund

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

DECEMBER 31, 2006 AND DECEMBER 31, 2005

(ALL AMOUNTS EXPRESSED IN THOUSANDS OF DOLLARS, EXCEPT UNITS AND PER UNIT AMOUNTS)

Included in accounts payable and accrued liabilities is an amount of \$69 (2005 - \$26) due to MarksCo. This amount arose as a result of MarksCo paying for certain general and administrative expenses of the Fund. The amount is non-interest bearing and is due on demand.

The notes receivables amount to \$78,739 and are due from MarksCo. The notes bear interest at 12.125% and mature as follows:

December 2, 2014	\$ 78,246
January 1, 2016	493
	<hr/>
	\$ 78,739

Interest only payments are receivable monthly in arrears.

#### 10. GUARANTEE

The Fund has guaranteed a term credit agreement entered into by MarksCo and maturing on December 2, 2009. The credit facilities total \$12,000 and are comprised of an \$11,000 non-revolving term credit facility, which was fully utilized as at December 31, 2006, and a \$1,000 operating credit facility, which was unused as at December 31, 2006.

#### 11. ECONOMIC DEPENDENCE

All of the Fund's income is indirectly derived from interest payable by MarksCo as described in note 4(b). In turn, all of MarksCo's income is derived from royalties payable by Second Cup to MarksCo under the Licence and Royalty Agreement as described in note 1.

#### 12. SUBSEQUENT EVENT

On January 1, 2007 the actual system sales of the nine cafés added to the Royalty Pool on January 1, 2006 (note 3) for the year ended December 31, 2006 were \$4,421 as compared to the original estimate of \$4,055. As a result, a final adjustment of \$356 was satisfied by MarksCo purchasing and delivering 35,903 additional units of the Fund to Second Cup. In accordance with the Licence and Royalty Agreement, MarksCo also made a cash payment of \$37 to Second Cup, representing the cash distributions that would have otherwise been earned by Second Cup on the 35,903 additional units above had they been issued on January 1, 2006.

Also, on January 1, 2007, 11 cafés were added to the Royalty Pool. The system sales of these 11 cafés added to the Royalty Pool has been estimated at \$4,555 for the 2007 calendar year. These were offset by \$3,815 in system sales of 12 cafés permanently closed from the Royalty Pool during the year. As a result of this adjustment to the Royalty Pool, the Fund, through MarksCo, was required to make a payment of \$314 to Second Cup, representing 80% of the obligation based on forecast system sales. On January 1, 2007, the Fund issued 34,630 units to MarksCo which were then delivered to Second Cup to satisfy this obligation. After a full year of performance of the new cafés, the Fund expects to issue additional units to satisfy the remaining obligation. As a result of this adjustment, the total number of cafés in the Royalty Pool decreased from 352 to 351.

## Second Cup Royalty Income Fund

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

DECEMBER 31, 2006 AND DECEMBER 31, 2005

(ALL AMOUNTS EXPRESSED IN THOUSANDS OF DOLLARS, EXCEPT UNITS AND PER UNIT AMOUNTS)

#### 13. SUPPLEMENTARY CASH FLOW INFORMATION

Changes in non-cash working capital items:

	2006		2005
Prepaid expenses	\$ -	\$	-
Interest receivable from Second Cup Trade-Marks Inc.	(5)		(26)
Accounts payable and accrued liabilities	50		61
Income taxes recoverable	-		(4)
Refundable taxes	1		(1)
	<u>\$ 46</u>	<u>\$</u>	<u>30</u>



# 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" or "the Company") for the 52-week fiscal year ended December 30, 2006. 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. This Management's Discussion and Analysis ("MD&A") has been prepared as of March 14, 2007.

### **BASIS OF PRESENTATION**

Effective January 2, 2005, the Company adopted Accounting Guideline 15 ("AcG-15"), a pronouncement of The Canadian Institute of Chartered Accountants ("CICA") related to variable interest entities ("VIEs"). A VIE is an entity where 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. AcG-15 outlines who should consolidate such entities.

The Company determined that MarksCo, an indirect wholly owned subsidiary of the Second Cup Royalty Income Fund (the "Fund"), is a variable interest entity that owns 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) (collectively, the "Second Cup Marks" or the "Marks") and, through the Agreement, has licenced them to the Company, which operates the business activities associated with these trademarks, in exchange for a royalty payment. The activities of MarksCo and Second Cup are closely related and with the guidance provided in AcG-15, it was determined that Second Cup should consolidate the financial results of MarksCo.

In connection with a series of transactions associated with the initial public ("IPO") offering of the Second Cup Royalty Income Fund (the "Fund"), which was completed on December 2, 2004, a licence and royalty agreement (the "Agreement") was entered into under which MarksCo agreed to licence 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").

### **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 is 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 cost of operating Company-owned cafés. As described in "Basis of Presentation"

above, Second Cup also pays a royalty to MarksCo equal to 6.5% of system sales of cafés in the Royalty Pool, pursuant to the Agreement.

As a result of the application of AcG-15, operating costs and administrative expenses disclosed in the Company's consolidated annual financial statements include expenses of MarksCo, a wholly owned subsidiary of the Fund.

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) is expected to be added approximately every five years.

MarksCo's business is the ownership of the Second Cup Marks. MarksCo uses the royalty revenue earned on the licencing of the Second Cup Marks to pay interest and dividends to a wholly owned subsidiary of the Fund. MarksCo's fiscal year ends December 31.

## FINANCIAL HIGHLIGHTS

The following tables set out selected consolidated financial information and other data of Second Cup, including the results of MarksCo, and should be read in conjunction with the audited consolidated financial statements of Second Cup.

(IN THOUSANDS OF DOLLARS, EXCEPT NUMBER OF CAFÉS)	2006	2005
Number of cafés in Canada - end of year	360	359
System sales - Canadian operations	\$ 193,098	\$ 184,005
Same café sales growth	6.2%	4.6%
Total revenue	\$ 33,707	\$ 33,664
Operating costs and administrative expenses	\$ 22,054	\$ 21,877
Investment income	\$ 1,150	\$ 1,437
Interest expense - net	\$ 10,106	\$ 10,035
Net earnings	\$ 340	\$ 842

	AS AT DECEMBER 30, 2006	AS AT DECEMBER 31, 2005
Total assets	\$ 102,604	\$ 116,965
Total long-term liabilities	\$ 99,839	\$ 99,778

## Overview of system sales

System sales comprise the gross revenue reported to Second Cup by franchisees of Second Cup cafés and by cafés owned by Second Cup. Sales are reported by franchisees to Second Cup on a weekly basis without audit or other form of independent assurance. Second Cup substantiates sales reported by its franchisees through analytical and financial reviews performed by management, on site visits, and analysis of raw material purchases by the cafés.

Increases in system 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 on pricing, product and marketing initiatives undertaken by Second Cup, maintaining operational excellence within the café network and general market conditions, including weather. 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 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.

### **Seasonality**

The first quarter represents the lowest average system sales quarter for the year due to the seasonality of the business. The final quarter, which includes the holiday sales periods of November and December in the retail industry, generally constitutes the highest average system sales quarter of the fiscal year. The Company's quarterly earnings will vary as a result of this seasonality in system sales.

### **Analysis of system sales**

System sales for the fiscal year ended December 30, 2006 were \$193,098 (2005 - \$184,005). Overall, system sales and same café sales growth benefited from an increase in average transaction size attributable to a number of operational and marketing initiatives launched by the Company in 2005 and 2006.

*Premium Beverages:* The Company rolled out a number of operational and product initiatives that management believes improved the customer experience and led to increased sales:

- The Company launched a new portfolio of blender drinks made with real fruit ingredients, a key differentiator that management believes resonates with Canadian consumers. These beverages are premium-priced, higher margin products which benefit same café sales performance.
- While not quantifiable, management believes that sales continue to benefit from the second quarter roll out of newly designed, customer-friendly menu-board systems to all cafés. These menu boards are segmented by consumer category and easier to read, improving the customer's shopping experience.
- In conjunction with the roll-out of new menu-boards mentioned above, the Company simplified its cup line-up for both hot and cold beverage offerings, providing a more positive customer experience and effectively moving customers up an order size and thereby positively impacting the average transaction size in café.

Overall, management believes the above changes were well-received by Second Cup's customers and franchise partners and generated positive media coverage and led to increased sales growth during 2006.

*Food:* The Company's food category continues to grow and complement its core premium beverage offerings. During the year, the Company continued to improve upon its basic food offerings, and expand its cold sandwich program, which is now offered at more than half of its cafés.

*Merchandise:* Following the success of the 2005 holiday merchandise program, one of the Company's strategic initiatives in 2006 was to deliver more seasonal, premium merchandise offerings throughout the year. Although merchandise accounts for only a small proportion of total system sales, the Company believes this represents a significant opportunity to strengthen its brand position, and solidify its cafés as gifting destinations. As it did in 2005, the Company achieved same café sales results in the fourth quarter which outpaced the rest of the year, particularly indicative of a strong holiday merchandise program.

During the year the Company made a number of price increases across a variety of its product groups, specifically whole beans, food and beverages. In aggregate, the impact of these price increases on system sales is estimated at 1.0 to 1.5%. In mid-November, the Company also increased the prices of its brewed coffee and several of its espresso-based beverages. These increases ranged from approximately 5 to 35 cents per cup, and management estimates the annualized impact of the price increase to be approximately 2.5 to 3.5% on system sales.

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

### **Analysis of revenues from Canadian operations**

Revenues for the fiscal year ended December 30, 2006 were \$33,707 (2005 - \$33,664). Revenues increased on a comparative basis due mainly to an increase in royalty revenue of \$775 during the year on higher system sales. This increase was offset by lower sales from Company-owned and operated cafés of \$12,526 as compared to \$13,466 in the prior year as discussed further below. Royalty income, as a percentage of system wide sales, was comparable to the prior fiscal year at 8.0% of total system wide sales. Excluding sales from Company-owned cafés during the year, the effective royalty rate was 8.6% for the current and prior fiscal years.

Sales from Company-owned cafés were \$12,526 for the year, versus \$13,466 for the comparable year. Second Cup operated, on average, 25 Company-owned cafés during the year versus 28 in the prior year. Second Cup ended the year with 24 Company-owned cafés, compared to 31 Company-owned cafés as at December 31, 2005 as a result of refranchising several of these cafés. In accordance with the Company's strategy to be a franchise-focussed business, the Company refranchises Company-owned locations from time to time.

Other income increased to \$5,655 for the year as compared to \$5,447 for the previous year. 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 and other income earned by Second Cup on the sale of its coffee through alternate channels.

### **Analysis of net earnings**

Operating costs and administrative expenses, including expenses of MarksCo of \$388 (2005 - \$348), were \$22,054 for the year ended December 31, 2005 versus \$21,877 for the comparable year. The reduction in costs related to operating Company-owned cafés, as a result of Second Cup operating less Company-owned cafés in the year as discussed in “- Analysis of revenues from Canadian operations” above, were offset mainly by increases in overhead costs related to the Company adding resources to its development departments in 2005 and 2006 and costs incurred to secure leases for sites that were opened during the year.

Amortization of capital assets amounted to \$500 for the year versus \$591 for the prior year. On a comparative basis, amortization expense was lower as a result of the Company operating fewer Company-owned cafés during the year as discussed above. Also included in expenses for the year is a charge of \$335 (2005 - \$nil) for the write-down on the book value of certain Company-owned cafés during the year. Amortization of the deferred financing charges on the MarksCo term loan amounted to \$86 for the year (2005 - \$93).

During the year, investment income of \$1,150 was earned on the units of the Fund compared to \$1,437 in the prior year. The decrease from the prior year is due to the Company holding units in the Fund for a shorter period of time as discussed in “Change in Control of Second Cup” below.

For the 2006 fiscal year, interest expense of \$9,521 was incurred on the note payable by MarksCo to a subsidiary of the Fund compared to \$9,461 in the prior year. An additional interest expense of \$585 was incurred due to the bank term loan payable by MarksCo, compared to \$574 in the prior year.

During the year the Company recorded an income tax expense of \$117, compared to \$799 in the prior year. The reduction in income taxes is mainly due to a reduction in federal income tax rates substantively enacted during the second quarter. This reduction in income tax rates resulted in recognition of a non-cash future income tax recovery of \$551. This recovery was partially offset by an \$80 non-cash future income tax charge on account of MarksCo's future income tax asset being revalued due to the same reduction in federal income tax rates. Excluding these non-cash items relating to the reduction in federal income tax rates, income tax expense for the year represents an effective rate of 33.1% of earnings before income taxes and non-controlling interest for the year versus 31.9% for the prior fiscal year.

Non-controlling interest of \$1,319 was recorded in the year compared to an amount of \$864 for the prior year. This reflects the earnings of MarksCo included in the Company's consolidated financial statements. MarksCo's higher

earnings resulted mainly from the increase in system sales and related royalty revenue resulting from the positive same café sales growth achieved over the last year, as well as the net additional system sales of the cafés vended in on January 1, 2006.

Accordingly, net earnings for Second Cup was \$340 for the 2006 fiscal year as compared to net earnings of \$842 for the comparable year.

### SELECTED QUARTERLY INFORMATION

A discussion on the Company's previous quarterly results since the Fund's inception can be found in the Company's quarterly Management's Discussion and Analysis reports available at [www.sedar.com](http://www.sedar.com).

(IN THOUSANDS OF DOLLARS EXCEPT CAFÉS)	2006				2005			
	Q4 <sup>(1)</sup>	Q3	Q2 <sup>(2)</sup>	Q1	Q4 <sup>(1)</sup>	Q3	Q2	Q1
Number of cafés in Canada at end of period	360	358	355	357	359	360	365	368
Same café sales growth	8.3%	4.8%	5.0%	5.8%	5.6%	4.3%	4.1%	3.2%
System sales	\$ 66,745	\$ 42,666	\$ 42,809	\$ 40,878	\$ 61,560	\$ 41,127	\$ 41,720	\$ 39,599
Net earnings (loss) for the period	\$ (434)	\$ 120	\$ 623	\$ 31	\$ 119	\$ 267	\$ 256	\$ 200

(1) The Company's fiscal year consists of three 12-week quarters and a fourth quarter consisting of 16 weeks. As such, the fourth quarter information presented for 2006 and 2005 represents the 16 weeks ending December 30, 2006 and December 31, 2005 respectively.

(2) The Company's earnings for the second quarter of 2006 originally included a future tax recovery of \$1,523 resulting from the reduction in federal income tax rates substantially enacted during that period. Upon the detailed annual review of the tax provision by the Company and its advisors, it was determined that the aforementioned reductions in federal income tax rates should have been recorded as a reduction in future income taxes of \$551, versus the original estimate of \$1,523. The Company has accordingly restated its second quarter earnings for the period from \$1,595 to \$623.

### Analysis of System Sales and Same Café Sales Growth

System sales for the fourth quarter of 2006 were \$66,745 (2005 - \$61,560) and same café sales growth was 8.3% for the same period (2005 - 5.6%). System sales and same café sales growth were impacted by a number of factors:

- System sales growth benefited from various price increases implemented during the year as described above, and a price increase of 5 to 35 cents per cup on several of its espresso-based beverages and its brewed coffee beverages in mid-November 2006. Management estimates that the impact of the price increase made in mid-November, plus the smaller price increases made earlier in the year, positively impacted sales by approximately 3 to 4% in the quarter.
- Second Cup experienced another strong holiday season, driven by the continued success of its holiday merchandise program and sales of its reloadable payment card (the "Second Cup Café Card"). Activations and reloads on the Second Cup Café Card amounted to over \$3,000 during the holiday periods of November and December of 2006, representing an increase of more than 30% over the same period in the prior year. Activations and reload amounts are not recorded as a sale until such time as the customer redeems any amounts for the purchase of product in the future.
- System sales and same café sales growth continued to benefit from the Company's continued focus on customer service, more effective marketing and advertising initiatives, and training initiatives implemented throughout the year.

### Analysis of revenues from Canadian operations

Revenues for the fourth quarter ended December 30, 2006 were \$10,857, compared to \$10,967 for the comparable period ended December 31, 2005. A decrease in sales from Company-owned cafés during the period was offset by increased royalty revenues on higher system sales and increased other income in the period. Other income increased mainly due to increased franchise fees as the company franchised seven cafés in the period compared to only one café in

the comparable period. Other income also increased as a result of an increase in transfer fees earned on the sale of franchised cafés from one franchisee to another, and on increased fees earned on the refranchising of Company-owned cafés in the period as compared to the comparable period.

#### **Analysis of net earnings**

Operating costs and administrative expenses, including expenses of MarksCo of \$126 (2005 - \$65) were \$7,421 for the fourth quarter ended December 30, 2006 and \$7,127 for the comparable period. The increase in operating expenses in the current period was due mainly to increases in overhead costs mainly as a result of the Company adding resources to its development department. This was offset partially by a decrease in costs related to the Company operating fewer Company-owned cafés in 2006 versus the comparable period.

Amortization of capital assets amounted to \$149 in the current period versus \$202 for the comparable period.

Amortization expense decreased in the period as the Company owned and operated fewer Company-owned cafés in the period versus the same period in 2005. In the current period, the Company also incurred a charge of \$335 for the write-down on the book value of certain Company-owned cafés during the year (2005 - \$nil). Amortization of the deferred financing charges on the MarksCo term loan amounted to \$22 for the quarter versus \$24 for the comparable period.

During the quarter, investment income of \$91 was recognized on the units of the Fund held by the Company, compared to \$442 for the comparable period. This decrease is due to the Company's transfer of its ownership in the units of the Fund in November 2006, as discussed above.

During the quarter, interest expense of \$2,930 (2005 - \$2,911) was incurred on the note payable by MarksCo to the Fund. In addition, interest expense of \$180 (2005 - \$170) was incurred on the MarksCo term loan during the quarter.

The Company recorded income tax expense of \$217 in the current quarter, compared to \$311 for the comparable quarter.

Accordingly, mainly as a result of the non-cash write-down and of the planned increased overhead costs discussed above, the Company incurred a net loss of \$434 for the quarter, as compared to net earnings of \$119 for the comparable period.

#### **LIQUIDITY AND CAPITAL RESOURCES**

Second Cup's former parent company, Cara, provided group treasury functions for Second Cup on an ongoing basis until December 30, 2006. As a result, surplus cash generated from Second Cup's operations and changes in working capital were advanced to Cara on a routine basis. See "Related Party Transactions" below.

Cash generated by operating activities was \$2,306 for the year ended December 30, 2006, compared to \$208 for the comparable year ended December 31, 2005. The increase in cash from operating activities is mainly the result of a \$3,500 payment made by MarksCo during the first quarter of 2005 to meet a tax liability arising from the transactions surrounding the Fund's IPO in 2004. Furthermore, in 2005, working capital was significantly impacted by changes in accounts receivable and accrued liabilities due mainly to the launch of the Café Card program and other timing differences.

During the year, investing activities resulted in a usage of cash amounting to \$589, as compared to \$1,352 for the comparable period. Investing activities include the acquisition of existing franchised cafés, the addition of new Company-owned cafés and the renovation of existing Company-owned cafés, offset by proceeds received on the sale and refranchising of Company-owned cafés. The Company received proceeds of \$1,818 on the sale and refranchising of Company-owned cafés to franchisees in the year, as compared to \$608 for the prior year. Furthermore, the Company purchased \$1,859 for capital assets related to the development and renovation of Company-owned cafés, compared to \$1,960 in the comparable year. On January 1, 2006, Second Cup also received 55,316 units of the Fund valued at \$548

(see “Royalty Pool Adjustments”), which were purchased by MarksCo from the Fund and delivered to Second Cup, compared to nil in the prior year.

During the year, financing activities resulted in a cash outflow of \$46, compared to a cash outflow of \$2,496 in the prior year. Current year activities reflect repayment by its former parent, Cara, of \$1,637 in funds previously advanced to them resulting from former group treasury functions performed by Cara, as compared to an advancement of funds to Cara amounting to \$1,860 in 2005. As part of the change in control discussed further below (see ~ “Change in Control of Second Cup”), Cara ceased to perform group treasury functions for Second Cup as at December 30, 2006. On January 1, 2006, MarksCo delivered units of the Fund valued at \$548 to Second Cup (see “Royalty Pool Adjustments”) and financed the purchase of these units by the issuance of \$55 in common shares of MarksCo and \$493 of notes payable to a subsidiary of the Fund. During the year, the Company also declared and paid a cash dividend of \$950 to Cara (2005 - \$nil). Dividends of \$1,135 were declared by MarksCo to the Fund (2005 - \$575).

MarksCo has \$12.0 million of credit facilities, the amount of which has not changed since the end of the previous fiscal year. These facilities include an \$11.0 million non-revolving term credit facility, which was fully utilized as at December 30, 2006, and a \$1.0 million operating credit facility, which was unused as at December 30, 2006. During the year, MarksCo amended the terms of the credit facilities to extend the maturity date on the \$11.0 non-revolving term credit facility to December 2, 2009. Certain covenants must be maintained by MarksCo for existing credit facilities to be in good standing, all of which were met as at December 30, 2006. In accordance with the terms of the credit facility, MarksCo is presently making interest-only payments on the non-revolving credit facility.

#### Payments due by period

The table below represents payments due by period by MarksCo, and relate to credit facilities that have been consolidated in the Company’s financial statements.

(IN THOUSANDS OF DOLLARS)	TOTAL	LESS THAN			
		1 YEAR	1 TO 3 YEARS	4 TO 5 YEARS	AFTER 5 YEARS
Term loan	\$ 11,000	-	\$ 11,000	-	-

#### 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 rebrand the location.

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

(IN THOUSANDS OF DOLLARS)	PAYMENTS DUE BY PERIOD					
	2007	2008	2009	2010	2011	AFTER 2011
Minimum lease obligation	14,945	13,147	11,029	8,620	7,166	19,396
Less: Sublease to franchisees	13,672	12,005	9,881	7,528	6,291	17,194
Net lease obligations	1,273	1,142	1,148	1,092	875	2,202

Cash held on behalf of franchisees for marketing, advertising and other co-operative expenditures as at December 30, 2006 amounted to \$61, versus \$1,554 as at December 31, 2005, and is not recorded on Second Cup’s consolidated balance sheet.

An interest rate swap agreement entered into by MarksCo, fixes the interest rate on MarksCo's non-revolving credit facility at 5.34% per annum until the maturity date of the swap being December 2, 2007. As at December 30, 2006, the estimated fair value of this contract is a \$72 (2005 - \$97) asset to MarksCo not recorded on the balance sheet. The Company does not have any other off-balance sheet arrangements.

## **RELATED PARTY TRANSACTIONS**

### **Second Cup**

For the period January 1, 2006 through November 13, 2006, the Company incurred expenses of \$281 (2005 - \$327) for rent and other shared services provided by its former parent, Cara. These costs are included in the Company's operating costs and administrative expenses for the respective periods and are net of an administrative charge of \$346 (2005 - \$400) charged by Second Cup to Cara for the management of international operations and trade-marks, which were owned by Cara until November 13, 2006 (see "Change in Control of Second Cup").

For the period November 14, 2006 through December 30, 2006, the Company charged an administrative fee of \$53 to its parent, DHI, for management of the international operations and trade-marks, which are owned by DHI. These charges are netted against the Company's operating costs and administrative expenses.

In addition, Second Cup has a master franchise agreement with its former parent, Cara, under which, Cara operates 25 Second Cup cafés (2005 - 38). For the period January 1, 2006 through November 13, 2006, system sales and royalties earned from these cafés amounted to \$5,755 and \$286, respectively, compared to amounts of \$6,336 and \$317, respectively, for the year ended December 31, 2005.

As at December 30, 2006, the Company had an outstanding receivable of \$53 from its parent DHI, arising from the administrative charge for management of the international operations and trade-marks as described above. This amount is non-interest bearing and is due on demand. As at December 30, 2006, the Company had an outstanding receivable of \$223 (2005 - \$1,860) from its former parent, Cara, arising primarily from cash balances held by Cara as part of group treasury functions.

Second Cup earned investment income of \$1,150 during the year (2005 - \$1,437) on its investment in units of the Fund.

During the year ended December 30, 2006, dividends of \$1,504 (2005 - \$nil) were paid by Second Cup to its former parent, Cara, satisfied by transferring 55,383 units of the Fund, and \$950 in cash. In accordance with GAAP, Second Cup recorded the transfer of units at an amount of \$554, being the book value of the units on the Company's consolidated financial statements at the time of the transaction.

Second Cup also transferred its remaining investment in the Fund, consisting of 1,437,347 units of the Fund, by way of a return of capital to Cara of \$12,950. In accordance with GAAP, this return of capital was recorded in the consolidated financial statements of the Company as a reduction in capital stock of \$12,950 and a credit to retained deficit of \$1,418, for a total amount of \$14,368, being the book value of the units.

### **MarksCo**

For the year ended December 30, 2006, interest expense of \$9,521 (2005 - \$9,461) was due to a subsidiary of the Fund on the MarksCo notes, of which \$785 was payable as at December 30, 2006 (2005 - \$806). In addition, during the year ended December 30, 2006, dividends of \$1,135 were declared by MarksCo to the Fund (2005 - \$575).

At December 30, 2006, MarksCo had an outstanding receivable of \$69 due from the Fund (2005 - \$26). This amount arose as a result of MarksCo paying for certain general and administrative expenses of the Fund. The amount is non-interest bearing and is due on demand.

## **CHANGE IN CONTROL OF SECOND CUP**

In November, Mr. Gabriel Tsampalieros, the Executive Chairman of the Company and the former Chief Executive Officer of Cara Operations Ltd. ("Cara"), purchased all of the issued and outstanding shares of the Company from Cara



through Dinecorp Hospitality Inc. (“DHI”), a corporation controlled by him. The transaction excluded the Fund units previously held by the Company which were transferred to Cara prior to the acquisition of Second Cup by DHI. In addition, DHI also purchased all the international Second Cup trade-marks held directly by Cara which were not transferred to the Fund in connection with the Fund’s initial public offering in December 2004. Cara will continue to operate a number of Second Cup cafés as a franchisee under currently existing franchise agreements.

Mr. Tsampalieros has been actively involved with the Company for ten years, first as a Director of Second Cup since 1996, and then as its Executive Chairman since 2002 following Second Cup’s acquisition by Cara. The purchase consideration was not disclosed.

## **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.

### **Trademarks**

The trademarks are recorded at their historical carrying value. Management reviews the carrying value of the trademarks at least annually for impairment. The review is based on a number of factors including the Fund’s unit price throughout the fiscal year, actual and forecast royalty income and actual and forecast distributable cash of the Fund. Management believes there has been no decline in the carrying value of the intangible assets as of December 30, 2006.

### **Goodwill**

Goodwill is recorded at cost and 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 Goodwill at least annually for impairment and believes that no impairment of goodwill exists as at December 30, 2006.

### **Contingent liabilities**

The Company 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 on the potential success of the claim. Management believes that the resolution of known claims should not have a material adverse impact on the financial position 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.

### **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.

### **Allowance for doubtful debts**

Second Cup records provisions for specific accounts receivable based on estimates that the receivable will not be collected. Management continually monitors past due accounts to assess the likelihood of collections to estimate the required provision.

## **FINANCIAL INSTRUMENTS**

### **Fair values**

The Company’s financial instruments consist of cash, accounts receivable, advances to related parties, income taxes recoverable, investment in the Fund, accounts payable and accrued liabilities, interest and notes payable to the Fund, income taxes payable, and the MarksCo term loan and related interest rate swap. The fair values of the advances to related parties cannot be determined due to the uncertainty of the timing of cash payments. Based on prevailing interest rates, fair values of the MarksCo term loan and related interest rate swap are estimated to approximate their current

carrying value. The fair values of all other financial instruments approximate their carrying amounts due to their short-term maturity.

#### **Credit risk**

The Company's financial instruments exposed to credit risk include cash, accounts receivable and advances to related parties. The Company places its cash 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. Advances to related parties are also believed to have limited risk exposure based on the creditworthiness of the parent company.

#### **RISKS AND UNCERTAINTIES**

The performance of Second Cup is primarily dependent on 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. System sales of Second Cup's café network 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 that 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 on Second Cup's ability to secure and build desirable locations and find high calibre, 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.
- 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.

A more detailed discussion of these and other risks and uncertainties affecting the Company and the Fund is set out in the Fund's Annual Information Form, which is available at [www.sedar.com](http://www.sedar.com).

#### **ADJUSTMENTS TO THE ROYALTY POOL**

Annually, on January 1 of each calendar year, the Royalty Pool is adjusted to include new Second Cup cafés opened on or before September 2 of the prior year, and to exclude any cafés that were in the Royalty Pool and permanently closed during the year. In return for adding cafés to the Royalty Pool, Second Cup is entitled to be paid an amount which may be satisfied by additional units of the Fund or cash, the form of payment being at the option of the Fund. The amount to be paid is calculated as 92.5% of the royalty revenue added to the Royalty Pool, divided by the yield of the Fund

units over a 20-day trading period specified in the Agreement. Second Cup initially receives 80% of the amount based on forecast net system sales, with the balance received when the actual full year performance of the new cafés is known.

#### **January 1, 2006**

On January 1, 2006, nine cafés were added to the Royalty Pool. At the time, the system sales of these nine cafés for the 2006 calendar year were forecasted to be \$4,055. These were offset by \$2,907 in actual system sales of eight cafés closed from the Royalty Pool since the Fund's inception. As a result of this adjustment, the total number of cafés in the Royalty Pool increased from 351 to 352.

On January 1, 2006, the Fund issued 55,316 units to MarksCo, which were then delivered to Second Cup, to satisfy 80% of the estimated total obligation to Second Cup resulting from the increase in the royalty revenue of the Royalty Pool. After a full year of performance of the new cafés, the Fund expects to issue additional units to satisfy the remaining obligation (see "January 1, 2007 Adjustment" below).

In conjunction with this adjustment to the Royalty Pool, the Fund (through its direct subsidiary) acquired a note of MarksCo in the amount of \$493 and common shares of MarksCo in the amount of \$55 for total cash consideration of \$548. The note issued by MarksCo to the Fund bears interest at 12.125% and matures January 1, 2016. The common shares have been accounted for in Second Cup's consolidated financial statements as an increase in the non-controlling interest.

#### **January 1, 2007**

On January 1, 2007, the actual system sales of the nine cafés added to the Royalty Pool on January 1, 2006 for the calendar year ended December 31, 2006 were \$4,421 as compared to the original estimate of \$4,055. As a result, a final adjustment of \$356 was satisfied by MarksCo purchasing and delivering 35,903 additional units of the Fund to Second Cup. In accordance with the Agreement, MarksCo also made a cash payment of \$37 to Second Cup, representing the cash distributions that would have otherwise been earned by Second Cup on the 35,903 additional units above had they been issued on January 1, 2006.

Also, on January 1, 2007, 11 cafés were added to the Royalty Pool. The system sales of these 11 cafés added to the Royalty Pool has been estimated at \$4,555 for the 2007 calendar year. These were offset by \$3,815 in system sales of 12 cafés permanently closed from the Royalty Pool during the year. As a result of this adjustment to the Royalty Pool, the Fund, through MarksCo, was required to make a payment of \$314 to Second Cup, representing 80% of the obligation based on forecast system sales. On January 1, 2007, the Fund issued 34,630 units to MarksCo which were then delivered to Second Cup to satisfy this obligation. After a full year of performance of the new cafés, the Fund expects to issue additional units to satisfy the remaining obligation. As a result of this adjustment, the total number of cafés in the Royalty Pool decreased from 352 to 351.

### **NEW ACCOUNTING PRONOUNCEMENTS**

#### **Financial Instruments - Recognition and Measurement, CICA Handbook Section 3855**

Section 3855 prescribes when a financial asset, financial liability, or non-financial derivative is to be recognized on the balance sheet and at what amount - sometimes using fair value; other times using cost-based measures. It also specifies how financial instrument gains and losses are to be presented.

Section 3855 applies to interim and annual financial statements relating to fiscal years beginning on or after October 1, 2006. The Company will adopt this standard effective December 31, 2006 and does not expect the impact on its financial statements will be material.

#### **Hedges, CICA Handbook Section 3865**

Section 3865 is applicable whenever a company chooses to designate a hedging relationship for accounting purposes. It builds on existing AcG-13 - Hedging Relationships by specifying how hedge accounting is applied and what disclosures are necessary when it is applied.

Section 3865 applies for interim and annual financial statements relating to fiscal years beginning on or after October 1, 2006. The Company will adopt this standard effective December 31, 2006 and does not expect the impact on its financial statements will be material.

#### **Comprehensive Income, CICA Handbook Section 1530**

Section 1530 introduces new standards for reporting and displaying of comprehensive income. Comprehensive income is the change in equity (net assets) of an enterprise during a reporting period from transactions and other events and circumstances from non-owner sources. It includes all changes in equity during a period except those resulting from investments by owners and distributions to owners.

Section 1530 applied to interim and annual financial statements relating to fiscal years beginning on or after October 1, 2006. Financial statements of prior periods are required to be restated for certain comprehensive income items. The Company will adopt this standard effective December 31, 2006 and does not expect the impact on its financial statements will be material.

#### **OUTLOOK**

During 2006, Second Cup made significant progress in implementing its previously announced strategies aimed at increasing same café sales growth. This is evidenced by the achievement of 6.2% same café sales growth for the year, following 4.6% same café sales growth for the year ended December 31, 2005. Second Cup has now achieved 13 consecutive quarters of positive same café sales dating back to the fourth quarter of 2003. Subject to healthy economic conditions continuing across the company's primary markets, Second Cup believes it can continue this trend and expects to achieve same café sales growth of approximately 3 to 5% for the 2007 fiscal year. To achieve this growth, Second Cup has planned a number of growth initiatives to strengthen the long-term success of the Second Cup brand and its franchisees:

- Second Cup will continue to develop and build neighbourhood cafés with a focus on expansion in key markets utilizing a disciplined and revitalized café development process, and the delivery of cost savings to franchisees in the build out of their new and renovated cafés.
- In an effort to drive loyalty among specialty coffee customers, the company's promotional strategies will focus on targeted branding initiatives leveraging its premium priced specialty beverages, food and merchandise innovations, and value added offers. Second Cup will also selectively enhance the nutritional quality of its grab and go food, and beverage offerings.
- Second Cup will continue to focus on its reloadable payment card introduced in late 2005. In 2006, the card has represented approximately 5% of system sales activity among cafés in the program. During the 2006 holiday period of November and December alone, over \$3,000 was loaded on to the cards, an increase of over 30% versus the comparable period in 2005. Second Cup management believes that through the delivery of new and innovative initiatives in 2007, the card will continue to drive incremental sales growth and customer loyalty.
- Second Cup will continue to invest significantly in the training and development it offers its franchise partners and café sales associates. This will include a revitalized curriculum available through its Business School and its online learning programs that were launched in 2006, which keep cafes current on the fundamentals of business success at Second Cup. Simultaneously new values will be introduced to the organization which will help build a branded organizational culture and enable long-term value creation for the company and its partners.

In terms of network expansion, Second Cup expects to open 14 to 18 new cafés in Canada during the 2007 fiscal year. Second Cup also expects to close 8 to 12 cafés during 2007, the majority of which have sales below the average performance of cafés in the Royalty Pool. Furthermore, Second Cup expects that approximately 30 of its cafés will be renovated during 2007. Accordingly, development of the Second Cup café network has been and continues to be a strategic initiative for the company.

Overall, based on the initiatives outlined above and others, the anticipated economic environment and market conditions affecting the specialty coffee industry, the Company expects a successful year in 2007.

#### **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 “system sales” and “same café sales growth”. 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.

System sales and same café sales growth are presented in reference to the sales performance of Second Cup cafés. The Company believes they are useful measures as they provide an indication of the top-line sales on which the Company’s royalty income is based.

#### **FORWARD-LOOKING INFORMATION**

Certain statements in this MD&A may constitute forward-looking information within the meaning of applicable securities legislation. Forward-looking information can be identified by words such as “may”, “will”, “should”, “expect”, “anticipate”, “believe”, “plan”, “intend” and other similar words. Forward-looking information reflects current expectations regarding future events and operating performance and speaks only as of the date of this MD&A. It should not be read as a guarantee of future performance or results and will not necessarily be an accurate indication of whether or not those results will be achieved. Forward-looking information is based on a number of assumptions and is subject to known and unknown risks, uncertainties and other factors, many of which are beyond the Company’s control, that may cause the Company’s actual results, performance or achievements, or those of MarksCo, the Fund, Second Cup cafés, or industry results to be materially different from any future results, performance or achievements expressed or implied by such forward-looking information. The following are some of the factors that could cause actual results to differ materially from those expressed in or underlying forward-looking information: 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 Marks; changing consumer preferences and discretionary spending patterns; reporting of system sales by franchisees; and the results of operations and financial condition of Second Cup. The foregoing list of factors is not exhaustive, and investors should refer to the risks described under “Risks and Uncertainties” above.

Although the forward-looking information contained in this MD&A is based on what management believes are reasonable assumptions, there can be no assurance that actual results will be consistent with this forward-looking information. Certain assumptions made in preparing forward-looking information include the assumption that the Canadian economy will remain stable or expand at a moderate pace in 2007 and that inflation will remain relatively low. The Company has also assumed that interest rates will remain stable in 2007 and that demand for specialty coffee will be comparable with demand in 2006.

As these forward-looking statements are made as of the date of this MD&A, the Company does not undertake to update any such forward-looking information whether as a result of new information, future events or otherwise. Additional information about these assumptions and risks and uncertainties is contained in the Fund’s filings with securities regulators. These filings are also available on the Fund’s website at [www.secondcupincomefund.com](http://www.secondcupincomefund.com).

The Second Cup Ltd.



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**Chartered Accountants**  
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March 14, 2007

## **Auditors' Report**

To the Shareholder of  
The Second Cup Ltd.

We have audited the consolidated balance sheets of **The Second Cup Ltd.** as at December 30, 2006 and December 31, 2005 and the consolidated statements of earnings, deficit and cash flows for the 52-week periods then ended. 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 December 30, 2006 and December 31, 2005 and the results of its operations and its cash flows for the 52-week periods then ended in accordance with Canadian generally accepted accounting principles.

*PricewaterhouseCoopers LLP*

Chartered Accountants

PricewaterhouseCoopers refers to the Canadian firm of PricewaterhouseCoopers LLP and the other member firms of PricewaterhouseCoopers International Limited, each of which is a separate and independent legal entity.

The Second Cup Ltd.  
**CONSOLIDATED BALANCE SHEETS**  
**(EXPRESSED IN THOUSANDS OF DOLLARS)**

	DECEMBER 30, 2006	DECEMBER 31, 2005
<b>Assets</b>		
<b>CURRENT ASSETS</b>		
Cash	\$ 2,296	\$ 625
Accounts receivable	3,364	2,830
Due from former parent (note 15)	223	1,860
Due from related parties (note 15)	122	26
Inventories (note 4)	208	272
Prepaid expenses and sundry assets	302	255
Income taxes recoverable	277	207
Future income taxes (note 11)	145	138
	<hr/>	<hr/>
	6,937	6,213
Deferred financing charges (note 5)	142	178
Capital assets (note 6)	2,570	3,220
Investment in Second Cup Royalty Income Fund (notes 7 and 15)	-	14,374
Trademarks	88,019	88,019
Goodwill	4,898	4,898
Future income taxes (note 11)	38	63
	<hr/>	<hr/>
	\$ 102,604	\$ 116,965
<b>Liabilities</b>		
<b>CURRENT LIABILITIES</b>		
Accounts payable and accrued liabilities (note 3(n))	\$ 6,173	\$ 5,702
Interest payable to Second Cup Royalty Income Fund (note 15)	785	806
Deposits from franchisees	1,196	782
	<hr/>	<hr/>
	8,154	7,290
Term loan (note 9)	11,000	11,000
Notes payable (note 10)	78,739	78,246
Future income taxes (note 11)	10,100	10,532
	<hr/>	<hr/>
	107,993	107,068
Non-controlling interest in MarksCo (note 8)	1,659	1,413
	<hr/>	<hr/>
	109,652	108,481
<b>SHAREHOLDER'S EQUITY</b>		
Capital stock (note 12)	3,724	19,724
Deficit	(10,772)	(11,240)
	<hr/>	<hr/>
	(7,048)	8,484
	<hr/>	<hr/>
	\$ 102,604	\$ 116,965
<hr/>		
Contingencies, commitments and guarantees (note 14)		
Subsequent event (note 18)		
See accompanying notes to consolidated financial statements.		

**APPROVED BY THE BOARD OF DIRECTORS**

(Signed) Gabriel Tsampalieros  
 \_\_\_\_\_  
 Director

(Signed) James Anas  
 \_\_\_\_\_  
 Director

The Second Cup Ltd.  
**CONSOLIDATED STATEMENTS OF EARNINGS**  
**(EXPRESSED IN THOUSANDS OF DOLLARS)**

	<b>FOR THE YEAR ENDED DECEMBER 30, 2006</b>	<b>FOR THE YEAR ENDED DECEMBER 30, 2005</b>
<b>SYSTEM SALES</b> - Canada	\$ 193,098	\$ 184,005
<b>REVENUE</b>		
Royalty revenue	\$ 15,526	\$ 14,751
Revenue from Company-owned cafés	12,526	13,466
Other income	5,655	5,447
	<u>33,707</u>	<u>33,664</u>
<b>EXPENSES</b>		
Operating costs and administrative expenses	22,054	21,877
Amortization of capital assets	500	591
Amortization of deferred financing charges	86	93
Writedown of capital assets	335	-
Interest expense on notes payable	9,521	9,461
Interest expense on term loan	585	574
	<u>33,081</u>	<u>32,596</u>
	626	1,068
Investment income (note 7)	<u>1,150</u>	<u>1,437</u>
<b>EARNINGS BEFORE INCOME TAXES AND NON-CONTROLLING INTEREST</b>	1,776	2,505
Income taxes		
Current	531	557
Future	(414)	242
	<u>117</u>	<u>799</u>
<b>EARNINGS BEFORE NON-CONTROLLING INTEREST</b>	1,659	1,706
Non-controlling interest in MarksCo (note 8)	<u>1,319</u>	<u>864</u>
<b>NET EARNINGS</b>	<u>\$ 340</u>	<u>\$ 842</u>

See accompanying notes to consolidated financial statements.



The Second Cup Ltd.

CONSOLIDATED STATEMENTS OF DEFICIT

(EXPRESSED IN THOUSANDS OF DOLLARS)

	FOR THE YEAR ENDED DECEMBER 30, 2006	FOR THE YEAR ENDED DECEMBER 31, 2005
<b>DEFICIT - BEGINNING OF YEAR</b>	\$ (11,240)	\$ (12,082)
Dividends paid (note 15)	(1,504)	-
Reduction of legal stated capital (note 12)	3,050	-
Transfer of investment (note 15)	(1,418)	-
Net earnings	340	842
<b>DEFICIT - END OF YEAR</b>	<u>\$ (10,772)</u>	<u>\$ (11,240)</u>

See accompanying notes to consolidated financial statements.

The Second Cup Ltd.

CONSOLIDATED STATEMENTS OF CASH FLOWS

(EXPRESSED IN THOUSANDS OF DOLLARS)

	FOR THE YEAR ENDED DECEMBER 30, 2006	FOR THE YEAR ENDED DECEMBER 31, 2005
Cash provided by (used in)		
<b>OPERATING ACTIVITIES</b>		
Net earnings	\$ 340	\$ 842
Items not involving cash		
Non-controlling interest	1,319	864
Amortization expense	586	684
Writedown of capital assets	335	-
Future income taxes	(414)	242
Gain on disposal of capital assets	(144)	(67)
	2,022	2,565
Increase (decrease) in non-cash working capital (note 16)	284	(2,357)
	2,306	208
<b>INVESTING ACTIVITIES</b>		
Purchase of capital assets	(1,859)	(1,960)
Proceeds from disposal of capital assets	1,818	608
Purchase of investments in the Fund (note 17)	(548)	-
	(589)	(1,352)
<b>FINANCING ACTIVITIES</b>		
Advances to related parties (note 15)	(96)	(26)
Advances from (to) former parent (note 15)	1,637	(1,860)
Issuance of common shares in MarksCo (note 8)	55	-
Issuance of notes payable (note 10)	493	-
Dividends paid (note 15)	(950)	-
Dividends paid to non-controlling interest (notes 8 and 15)	(1,135)	(575)
Deferred financing charges	(50)	(35)
	(46)	(2,496)
<b>INCREASE (DECREASE) IN CASH DURING THE YEAR</b>	1,671	(3,640)
<b>CASH - BEGINNING OF YEAR</b>	625	4,265
<b>CASH - END OF YEAR</b>	\$ 2,296	\$ 625

See accompanying notes to consolidated financial statements.

# The Second Cup Ltd.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

DECEMBER 30, 2006 AND DECEMBER 31, 2005

(ALL AMOUNTS EXPRESSED IN THOUSANDS OF DOLLARS, EXCEPT UNITS)

### 1. ORGANIZATION AND NATURE OF OPERATIONS

The Second Cup Ltd. (“Second Cup” or the “Company”) is a specialty coffee retailer with 360 cafés operating under the trade name Second Cup™ in Canada as of December 30, 2006, of which 24 are Company-owned (December 31, 2005 - 359 cafés, of which 31 were Company-owned). The cafés are predominantly operated by franchisees who are selected and trained to retail the Company’s product offering.

On November 14, 2006, the Company’s former parent, Cara Operations Limited (“Cara”), sold its investment in Second Cup, which consisted of all the issued and outstanding common shares of the Company, to Dinecorp Hospitality Inc. (“DHI”), a Canadian controlled private corporation.

Second Cup Trade-Marks Inc. (“MarksCo”) is a wholly owned indirect subsidiary of the Second Cup Royalty Income Fund (the “Fund”). The business of MarksCo is the ownership of 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) (collectively, the “Second Cup Marks”, or the “Marks”) and, through the Licence and Royalty Agreement (the “Agreement”) with Second Cup, the taking of actions to exploit the use of the Second Cup Marks and the collection of the royalty payable under the Agreement. As discussed in note 2 below, MarksCo, while a wholly owned subsidiary of the Fund, is consolidated in these financial statements.

### 2. BASIS OF PRESENTATION

Effective January 2, 2005, the Company adopted Accounting Guideline 15 (“AcG-15”), a new pronouncement of The Canadian Institute of Chartered Accountants relating to variable interest entities (“VIEs”). A VIE is an entity where 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. AcG-15 outlines who should consolidate such entities. The Company has identified two significant VIEs related to the Company.

#### **Second Cup Trade-Marks Inc.**

MarksCo, a wholly owned indirect subsidiary of the Fund, is a VIE that owns the Second Cup Marks. MarksCo has, through the Agreement, licenced these Marks to Second Cup, which operates the business activities associated with these Marks in exchange for a royalty payment. The activities of MarksCo and Second Cup are closely related and, based on the guidance provided in AcG-15, it was determined that although MarksCo is wholly owned by the Fund, Second Cup should consolidate the financial assets and results of MarksCo. As a result, the consolidated financial statements exclude the royalty expense paid to MarksCo, but include the interest expense and dividends declared by MarksCo, as well as other expenses of MarksCo. The non-controlling interest represents the equity of MarksCo, which is 100% owned by the Fund.

#### **Franchise entities**

The Company also possesses a variable interest in the franchise entities, which operate Second Cup’s franchised cafés. Based on guidance provided by AcG-15, it was determined that these franchise entities would not be required to be consolidated by Second Cup.

# The Second Cup Ltd.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

DECEMBER 30, 2006 AND DECEMBER 31, 2005

(ALL AMOUNTS EXPRESSED IN THOUSANDS OF DOLLARS, EXCEPT UNITS)

### 3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

#### a. Consolidation

These consolidated financial statements include the accounts of the Company and MarksCo, an indirect wholly owned subsidiary of the Fund and have been prepared in accordance with Canadian generally accepted accounting principles.

The Company opens, acquires 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.

#### c. Use of estimates

The preparation of consolidated financial statements in conformity with Canadian generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and 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 sales

System 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 the products are sold by the franchisee. 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, renewal fees, construction administration fees and initial franchise fees, which are recognized as income once all significant conditions have been met.

#### f. 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.

#### g. Investments

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.

#### h. VIEs

AcG-15 requires consolidation of VIEs by the primary beneficiary. The primary beneficiary is defined as the party that has exposure to the majority of the VIE's expected losses and/or residual returns. Second Cup has evaluated its interests in MarksCo, a wholly owned indirect subsidiary of the Fund, and determined that the Company is the primary beneficiary and should consolidate MarksCo.

# The Second Cup Ltd.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

DECEMBER 30, 2006 AND DECEMBER 31, 2005

(ALL AMOUNTS EXPRESSED IN THOUSANDS OF DOLLARS, EXCEPT UNITS)

### **i. 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 are recorded at the historical cost to MarksCo. The management of MarksCo reviews 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.

### **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 not 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 impairment is based on fair value.

### **k. Capital assets**

Capital assets are recorded at cost less accumulated amortization. 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

Capital assets are tested for impairment when events or changes in circumstances indicate that the carrying value may not be recoverable. The measurement of impairment is based on estimated fair value.

### **l. Deferred financing charges**

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

### **m. Future income taxes**

Future income taxes are provided for 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 substantive enactment.

### **n. Gift certificates and Café Cards**

Accounts payable and accrued liabilities include \$2,751 (2005 - \$1,733) of liabilities related to unredeemed gift certificates and unused balances on Second Cup's reloadable payment card ("Second Cup Café Card"). These balances are included as sales of franchised cafés, or as revenue of Company-owned cafés, at the time the customer redeems the amount in a café.

# The Second Cup Ltd.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

DECEMBER 30, 2006 AND DECEMBER 31, 2005

(ALL AMOUNTS EXPRESSED IN THOUSANDS OF DOLLARS, EXCEPT UNITS)

### **o. Operating leases**

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

### **p. Derivative instruments**

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

Derivatives that have been designated, and function effectively as hedges in accordance with Accounting Guideline 13, Hedging Relationships, are accounted for using hedge accounting principles. These principles require that the realized current period income or expense generated by the swap contracts is recognized as an adjustment to interest expense.

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

### **q. Financial instruments**

#### *Fair values*

The Company's financial instruments consist of cash, accounts receivable, advances to related parties and former parent, income taxes recoverable, investment in the Fund, accounts payable and accrued liabilities, interest and notes payable to the Fund, income taxes payable, deposits from franchisees and the MarksCo term loan and related interest rate swap. The fair value of Second Cup's investment in the Fund at December 30, 2006 was \$nil (2005 - \$13,943). The fair value of the advances to related parties cannot be determined due to the uncertainty of the timing of cash payments. Based on prevailing interest rates, fair values of the term loan and related interest rate swap are estimated to approximate their current carrying value. As at December 30, 2006, the fair value of the interest rate swap is \$72 (2005 - \$97). The fair values of all other financial instruments approximate their carrying amounts due to their short-term maturity.

#### *Credit risk*

The Company's financial instruments exposed to credit risk include cash, accounts receivable and advances to related parties. The Company places its cash with institutions of high creditworthiness. The Company's accounts receivable primarily comprise amounts due from franchisees and management believes that its accounts receivable credit risk exposure is limited. Advances to related and previously related parties are also believed to have limited risk exposure based on their creditworthiness.

## **4. INVENTORIES**

	2006		2005
Merchandise held for resale	\$ 161	\$	217
Supplies	47		55
	<hr/>		<hr/>
	\$ 208	\$	272

The Second Cup Ltd.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

DECEMBER 30, 2006 AND DECEMBER 31, 2005

(ALL AMOUNTS EXPRESSED IN THOUSANDS OF DOLLARS, EXCEPT UNITS)

**5. DEFERRED FINANCING CHARGES**

Deferred charges consist of deferred financing costs related to the MarksCo term loan.

	2006		2005
Cost	\$ 327	\$	277
Accumulated amortization	185		99
	\$ 142	\$	178

Amortization of deferred charges for the year ended December 30, 2006 was \$86 (2005 - \$93).

**6. CAPITAL ASSETS**

	2006		
	COST	ACCUMULATED AMORTIZATION	NET
Leasehold improvements	\$ 2,937	\$ 1,359	\$ 1,578
Equipment, furniture, fixtures and other	1,906	994	912
Computer software and hardware	1,234	1,154	80
	\$ 6,077	\$ 3,507	\$ 2,570

	2005		
	COST	ACCUMULATED AMORTIZATION	NET
Leasehold improvements	\$ 3,517	\$ 1,564	\$ 1,953
Equipment, furniture, fixtures and other	2,308	1,097	1,211
Computer software and hardware	1,183	1,127	56
	\$ 7,008	\$ 3,788	\$ 3,220

Amortization of capital assets for the year ended December 30, 2006 was \$500 (2005 - \$591).

**7. INVESTMENT IN SECOND CUP ROYALTY INCOME FUND**

	2006		2005
Investment in units of the Fund (2006 - nil, 2005 - 1,437,414 units)	\$ -	\$	14,374
Income earned on investment	\$ 1,150	\$	1,437

# The Second Cup Ltd.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

DECEMBER 30, 2006 AND DECEMBER 31, 2005

(ALL AMOUNTS EXPRESSED IN THOUSANDS OF DOLLARS, EXCEPT UNITS)

### 8. NON-CONTROLLING INTEREST IN MARKSCO

	2006	2005
Balance - Beginning of year	\$ 1,413	\$ 1,130
Earnings: non-controlling interest	1,319	864
Issuance of common shares (note 19)	55	-
Less:		
Dividends paid to non-controlling interest	(1,135)	(575)
Change in refundable taxes	7	(6)
Balance - End of year	<u>\$ 1,659</u>	<u>\$ 1,413</u>

### 9. TERM LOAN AND OPERATING FACILITY

On December 2, 2004, MarksCo, as borrower, and the Fund and a subsidiary of the Fund, as guarantors, entered into a term credit agreement maturing on December 2, 2007, which was subsequently extended to December 2, 2009. The \$12,000 credit facilities are comprised of an \$11,000 non-revolving term credit facility and a \$1,000 operating credit facility.

The \$11,000 non-revolving term credit facility bears interest at prime or base rate plus 0.75% or LIBOR advances or banker's acceptances plus 1.75%. At December 30, 2006, the full amount of the \$11,000 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 \$1,000 operating credit facility bears interest at prime or base rate plus 0.50% or LIBOR advances or banker's acceptances plus 1.50%. At December 30, 2006, no advances had been drawn on this facility.

The term credit facilities are collateralized by substantially all the assets of the MarksCo, including the Agreement, pursuant to which the Company 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 \$11,000 non-revolving term credit facility loan at 3.59% plus the variable margin noted above until December 2, 2007.

### 10. NOTES PAYABLE

The notes payable amount to \$78,739 (2005 - \$78,246) and are due by MarksCo to a subsidiary of the Fund, a related party. The notes bear interest at 12.125% and mature as follows:

December 2, 2014	\$ 78,246
January 1, 2016	493
	<u>\$ 78,739</u>

Interest only payments are due monthly in arrears.



The Second Cup Ltd.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

DECEMBER 30, 2006 AND DECEMBER 31, 2005

(ALL AMOUNTS EXPRESSED IN THOUSANDS OF DOLLARS, EXCEPT UNITS)

**11. INCOME TAXES**

	<b>2006</b>	<b>2005</b>
Earnings before income taxes and non-controlling interest	\$ 1,776	\$ 2,505
Combined Canadian statutory income tax rates	35.38%	35.14%
Income taxes at combined statutory income tax rates	628	880
Rate change on future income taxes	(551)	-
Difference in income tax rates applicable to MarksCo	(222)	(133)
Difference in statutory rate applicable to investment income earned	(52)	-
Expenses not deductible for income tax purposes	61	40
Permanent differences associated with Royalty Income Pool Adjustment (note 17)	320	-
Prior year tax recovery	(68)	-
Other	1	12
Income tax expense	<u>\$ 117</u>	<u>\$ 799</u>

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

	<b>2006</b>	<b>2005</b>
Capital assets	\$ 25	\$ 53
Provisions and accrued expenses	145	96
Goodwill	(240)	(178)
Deferred financing charges	13	9
Trademarks	(9,860)	(10,311)
Net future income tax liability	<u>\$ (9,917)</u>	<u>\$ (10,331)</u>
Classified as		
Current asset	\$ 145	\$ 138
Long-term asset	38	63
Long-term liability	(10,100)	(10,532)
	<u>\$ (9,917)</u>	<u>\$ (10,331)</u>

**12. CAPITAL STOCK**

**AUTHORIZED**

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

# The Second Cup Ltd.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

DECEMBER 30, 2006 AND DECEMBER 31, 2005

(ALL AMOUNTS EXPRESSED IN THOUSANDS OF DOLLARS, EXCEPT UNITS)

### ISSUED COMMON SHARES

	NUMBER OF SHARES		AMOUNT
Balance as at January 1, 2005 and December 31, 2005	19,724	\$	19,724
Reduction in legal stated capital	-		(3,050)
Return of capital	-		(12,950)
Balance as at December 30, 2006	19,724	\$	3,724

A return of capital of \$12,950 to its former parent, Cara, was effected on November 13, 2006 (see note 15). On November 13, 2006, the Company reduced its legal stated capital by \$3,050.

### 13. CASH HELD ON BEHALF OF FRANCHISEES

Cash held on behalf of franchisees for marketing, advertising and other co-operative expenditures at December 30, 2006 amounted to \$61 (2005 - \$1,554) and is not recorded on the Company's consolidated balance sheets.

### 14. CONTINGENCIES, COMMITMENTS AND GUARANTEES

The Company has lease commitments for Company-owned cafés. The Company also acts as the head tenant on leases, which, it in turn, subleases to franchisees. The Company's lease commitments at December 30, 2006 are as follows:

	LEASE COMMITMENTS	SUBLEASE TO FRANCHISEES	NET
2007	\$ 14,945	\$ 13,672	\$ 1,273
2008	13,147	12,005	1,142
2009	11,029	9,881	1,148
2010	8,620	7,528	1,092
2011	7,166	6,291	875
Thereafter	19,396	17,194	2,202
	\$ 74,303	\$ 66,571	\$ 7,732

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, the Company would be required to make a payment of \$195 at December 30, 2006. 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 there was an orderly transition to a new supplier. At this time, the Company views the likelihood of any such payment as remote.

## The Second Cup Ltd.

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

DECEMBER 30, 2006 AND DECEMBER 31, 2005

(ALL AMOUNTS EXPRESSED IN THOUSANDS OF DOLLARS, EXCEPT UNITS)

The Company 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 on the potential success of the claim. The Company believes that it will not incur any significant loss or expense with such claims. However, there can be no assurance that unforeseen circumstances will not result in significant costs. The outcome of these actions is not determinable at this time, and adjustments, if any, will be recorded in the period of settlement.

Substantially all of the Company's assets have been pledged under a general security agreement as collateral for commitments under the Agreement.

#### 15. RELATED PARTY TRANSACTIONS AND BALANCES

##### Second Cup

For the period January 1, 2006 through November 13, 2006, the Company incurred expenses of \$281 (2005 - \$327) for rent and other shared services provided by its former parent, Cara. These costs are included in the Company's operating costs and administrative expenses for the respective years and are net of an administrative charge of \$346 (2005 - \$400) charged by Second Cup to Cara for the management of international operations and trade marks, which were owned by Cara until November 13, 2006.

For the period November 14, 2006 through December 30, 2006, the Company charged an administrative fee of \$53 to its parent, DHI, for management of the international operations and trade marks, which are owned by DHI. These charges are netted against the Company's operating costs and administrative expenses.

In addition, Second Cup has a master franchise agreement with its former parent, Cara, under which, Cara operates 25 (2005 - 38) Second Cup cafés. For the period January 1, 2006 through November 13, 2006, system sales and royalties earned from these cafés amounted to \$5,755 and \$286, respectively, compared to amounts of \$6,336 and \$317, respectively, for the year ended December 31, 2005.

As at December 30, 2006, the Company had an outstanding receivable of \$53 from its parent, DHI, arising from the administrative charge for management of the international operations and trade marks as described above. This amount is non-interest bearing and is due on demand. As at December 30, 2006, the Company had an outstanding receivable of \$223 (2005 - \$1,860) from its former parent, Cara, arising primarily from cash balances held by Cara as part of group treasury functions.

Second Cup earned investment income of \$1,150 during the year (2005 - \$1,437) on its investment in units of the Fund.

During the year ended December 30, 2006, dividends of \$1,504 (2005 - \$nil) were paid by Second Cup to its former parent, Cara, satisfied by transferring 55,383 units of the Fund, and \$950 in cash. In accordance with GAAP, Second Cup recorded the transfer of units at an amount of \$554, being the book value of the units on the Company's consolidated financial statements at the time of the transaction.

Second Cup also transferred its remaining investment in the Fund, consisting of 1,437,347 units of the Fund, by way of a return of capital to its former parent, Cara, of \$12,950. The return of capital was recorded in the consolidated financial statements of the Company as a reduction in capital stock of \$12,950 and a charge to deficit of \$1,418, for a total amount of \$14,368, being the book value of the units at the time of the transaction.

# The Second Cup Ltd.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

DECEMBER 30, 2006 AND DECEMBER 31, 2005

(ALL AMOUNTS EXPRESSED IN THOUSANDS OF DOLLARS, EXCEPT UNITS)

### MarksCo

For the year ended December 30, 2006, interest expense of \$9,521 (2005 - \$9,461) was due to a subsidiary of the Fund on the MarksCo notes (note 10), of which \$785 was payable as at December 30, 2006 (2005 - \$806). In addition, during the year ended December 30, 2006, dividends of \$1,135 were declared by MarksCo to the Fund (2005 - \$575).

At December 30, 2006, MarksCo had an outstanding receivable of \$69 due from the Fund (2005 - \$26). This amount arose as a result of MarksCo paying for certain general and administrative expenses of the Fund. The amount is non-interest bearing and is due on demand.

### 16. SUPPLEMENTARY CASH FLOW INFORMATION

Changes in non-cash working capital items:

	2006	2005
Accounts receivable	\$ (534)	\$ (932)
Inventories	64	(34)
Prepaid expenses and sundry assets	(47)	29
Income taxes recoverable	(70)	(207)
Accounts payable and accrued liabilities	471	1,831
Interest payable to the Fund	(21)	-
Deposits from franchisees	414	516
Income taxes payable	-	(3,554)
Refundable income taxes	7	(6)
	<hr/>	<hr/>
	\$ 284	\$ (2,357)
Supplementary information:		
Interest paid	\$ 10,138	\$ 10,044
Income taxes paid	\$ 647	\$ 4,454

### 17. ROYALTY POOL ADJUSTMENT

Annually, on January 1 of each calendar year, the Royalty Pool is adjusted to include new Second Cup cafés that have been open for at least 60 days and which were not previously included in the Royalty Pool, and to exclude any Second Cup cafés that were in the Royalty Pool and permanently closed during the year. In return for adding cafés to the Royalty Pool, Second Cup is entitled to be paid an amount that may be satisfied by additional units of the Fund or cash, the form of payment being at the option of the Fund. The amount to be paid is calculated as 92.5% of the estimated net additional royalty revenue added to the Royalty Pool, divided by the yield of the Fund units over a 20-day trading period specified in the Agreement. Second Cup initially receives 80% of the amount based on forecast net system sales, with the balance received when the actual full year performance of the new cafés is known. These amounts may be satisfied by additional Fund units or cash, the form of payment being at the option of the Fund.

## The Second Cup Ltd.

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

DECEMBER 30, 2006 AND DECEMBER 31, 2005

(ALL AMOUNTS EXPRESSED IN THOUSANDS OF DOLLARS, EXCEPT UNITS)

On January 1, 2006, nine Second Cup cafés were added to the Royalty Pool. At the time, the system sales of these nine cafés for the 2006 calendar year were forecasted to be \$4,055 (note 18). These additional system sales were offset by \$2,907 in actual system sales of eight cafés closed from the Royalty Pool since the Fund's inception. As a result of this adjustment, the total number of cafés in the Royalty Pool increased from 351 to 352.

On January 1, 2006, the Fund issued 55,316 units to MarksCo, which were then delivered to Second Cup, to satisfy 80% of the estimated total obligation to Second Cup resulting from the increase in the royalty revenue of the Royalty Pool. MarksCo financed the purchase of these units by issuing notes amounting to \$493 and common shares of \$55 to a subsidiary of the Fund, for a total consideration of \$548. After a full year of performance of the new cafés, the Fund expects to issue 35,903 additional units to satisfy the remaining obligation of MarksCo on or about January 1, 2007 (note 18).

The note issued by MarksCo to a subsidiary of the Fund bears interest at 12.125% and matures January 1, 2016. The common shares have been accounted for in these consolidated financial statements as an increase in the non-controlling interest (note 8). Transactions between MarksCo and Second Cup relating to the Royalty Pool adjustments have been eliminated in these consolidated financial statements.

#### 18. SUBSEQUENT EVENT

On January 1, 2007, the actual system sales of the nine cafés added to the Royalty Pool on January 1, 2006 (see note 17) for the year ended December 30, 2006 were \$4,421 as compared to the original estimate of \$4,055. As a result, a final adjustment of \$356 was satisfied by MarksCo purchasing and delivering 35,903 additional units of the Fund to Second Cup. In accordance with the Licence and Royalty Agreement, MarksCo also made a cash payment of \$37 to Second Cup, representing the cash distributions that would have otherwise been earned by Second Cup on the 35,903 additional units above had they been issued on January 1, 2006.

Also, on January 1, 2007, 11 cafés were added to the Royalty Pool. The system sales of these 11 cafés added to the Royalty Pool have been estimated at \$4,555 annually. These were offset by \$3,815 in system sales of 12 cafés permanently closed from the Royalty Pool during the year. As a result of this adjustment to the Royalty Pool, the Fund, through MarksCo, was required to make a payment of \$314 to Second Cup, representing 80% of the obligation based on forecast system sales. On January 1, 2007, the Fund issued 34,630 units to MarksCo which were then delivered to Second Cup to satisfy this obligation. After a full year of performance of the new cafés, the Fund expects to issue additional units to satisfy the remaining obligation. As a result of this adjustment, the total number of cafés in the Royalty Pool decreased from 352 to 351.

# Second Cup Royalty Income Fund

## UNITHOLDER INFORMATION

### **CORPORATE HEAD OFFICE**

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Canada L4V 1R8

### **MAILING ADDRESS**

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Canada L4V 1R8

### **SECOND CUP ROYALTY INCOME FUND**

#### **Board of Trustees**

David Bloom<sup>(1)</sup>  
Raymond Guyatt<sup>(1)</sup>  
Michael Rosicki<sup>(1)</sup>

### **SECOND CUP GP INC.**

#### **Board of Directors**

David Bloom<sup>(2)</sup>  
Chairman

James Anas  
J. Bruce Elliot  
Raymond Guyatt<sup>(2)</sup>  
Gabriel Tsampalieros

#### **Committees of the Board**

<sup>(1)</sup> Audit Committee

<sup>(2)</sup> 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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