



Second Cup Royalty Income Fund  
TSX: SCU.UN

2005 ANNUAL REPORT  
FOR THE YEAR ENDED DECEMBER 31, 2005

# TABLE OF CONTENTS

Letter From the Chairman of Second Cup Royalty Income Fund	2
Letter From the President of The Second Cup Ltd.	3

## Second Cup Royalty Income Fund

Management Discussion And Analysis	4
Auditors' Report	17
Consolidated Balance Sheets	18
Consolidated Statements Of Earnings	19
Consolidated Statements Of Unitholders' Equity	20
Consolidated Statements Of Cash Flows	21
Notes To Consolidated Financial Statements	22
Unitholder Information	61

## The Second Cup Ltd.

Management Discussion And Analysis	29
Auditors' Report	43
Consolidated Balance Sheets	44
Consolidated Statements Of Earnings	45
Consolidated Statements Of Cash Flows	47
Notes To Consolidated Financial Statements	48

## Second Cup Royalty Income Fund

### LETTER FROM THE CHAIRMAN

On behalf of the Trustees of Second Cup Royalty Income Fund (the “Fund”), I am pleased to present the 2005 Annual Report of the Fund. As the Fund’s initial public offering was on December 2, 2004, this is the Fund’s second annual report and covers its first full fiscal year, for the period from January 1, 2005 to December 31, 2005.

The Fund owns the Second Cup trade-marks, which it licences to The Second Cup Ltd. (“Second Cup”). Second Cup franchises and operates Second Cup cafés across Canada using these trade-marks and pays a royalty to the Fund of 6.5% of the system sales of Second Cup cafés included in the royalty pool. The initial royalty pool consisted of 351 cafés and was adjusted on January 1, 2006 to include eligible cafés opened since the determination of the initial royalty pool, less those cafés included in the royalty pool at the inception of the Fund but subsequently closed, resulting in an increase in the royalty pool to 352 Second Cup cafés as at January 1, 2006.

During 2005, the cafés in the royalty pool realized same café sales growth of 4.6%. This followed same café sales growth of 5.8% experienced by Second Cup’s café network for the 40-week period ended January 1, 2005. This is a solid performance by Second Cup, particularly after having experienced a number of specific challenges that affected the food services industry in 2002 and 2003. Based on the results to date, Second Cup continues to believe that it will be able to achieve positive same café sales growth in the range of 3% to 5% for 2006. Actual performance for the first quarter of 2006 was 6.4%, exceeding this range. This favourable growth was due in part to the mild winter in the Ontario market and the change in the timing of Easter.

During its first full fiscal year, the Fund achieved positive distributable cash of \$1.0688 per unit, of which 93.4% was distributed to unitholders during the year. A significant portion of the remaining distributable cash will be invested in restructuring the Fund in order to eliminate income tax expenses going forward.

Since its creation in December of 2004, the Fund has owned the Second Cup trade-marks through intermediary corporate subsidiaries. This structure subjects these subsidiaries to income tax which, in turn, reduces the cash available for distribution to the Fund’s unitholders. The Fund proposes to modify the current structure of the Fund by replacing the intermediary corporations with a trust and a limited partnership. The Board believes that the proposed reorganization, which has been adopted by a number of other income trusts, will provide the Fund with a “flow through” structure that will maximize the cash available for distribution by eliminating income taxes paid by the Fund. The reorganization would be conditional on obtaining a number of regulatory and third party approvals, including a favourable tax ruling from Canada Revenue Agency. It is anticipated that the tax savings expected over the next few years through this reorganization will more than offset the costs of the restructuring.

The proposed structure is explained in more detail in the Information Circular being delivered in conjunction with this Annual Report to all unitholders of the Fund. From a unitholder’s perspective, the reorganization will not result in a change to the number, type and ownership of outstanding units of the Fund. In addition, there will be no impact on the daily operations of the Fund.

In closing, we look forward to 2006 being another successful year with growing royalty income. In addition, we would like to thank you, our unitholders, for your continued support of the Second Cup Royalty Income Fund and the Second Cup café operators who deliver those special café moments to their guests.



David R. Bloom  
Chairman, Second Cup Royalty Income Fund  
on behalf of the Board of Trustees  
April 13, 2006

# Second Cup Royalty Income Fund

## LETTER FROM THE PRESIDENT

On behalf of The Second Cup Ltd. (“Second Cup”), our management team and our employees, I am pleased to present financial results for Second Cup for the 52-weeks ended December 31, 2005, included in the 2005 Annual Report of the Second Cup Royalty Income Fund (the “Fund”).

As highlighted by the Fund’s Chairman, David Bloom, we are pleased to report healthy same café sales growth by Second Cup of 4.6% for the 52-week period ended December 31, 2005. This follows the achievement of same café sales growth of 5.8% for the 40-week period ended January 1, 2005, and marks eight consecutive quarters of positive same café sales growth for Second Cup. Since 1994, Second Cup has experienced average annual same café sales growth of 3.8%, a testament to the brand’s stability and health. For 2006, we expect to deliver on same café sales growth in the range of 3% to 5%.

During 2005, our team made significant accomplishments that we believe will drive same café sales growth and, accordingly, add value to the Fund’s investment in the Second Cup brand.

In late 2005, we launched the Second Cup Café Card (“Café Card”) across Canada. The Café Card is a reloadable payment card that is not only redeemable at participating Second Cup cafés but also at popular restaurant brands, including Harvey’s, Swiss Chalet, Kelsey’s, Milestone’s and Montana’s Cookhouse. We intend to feature the Café Card significantly in our promotions for 2006, which we believe will help build loyalty and enhance sales growth throughout the chain.

We also significantly strengthened our café development teams during 2005 through the addition of dedicated real estate, franchising and construction resources. These resources are vital for ongoing success in modernizing Second Cup’s café network and adding new cafés to our portfolio. With a majority of the brand’s cafés due for renewal in the next four to five years, we are in a position to effect significant change to our brand proposition and image in a relatively short period of time. History has shown that renovated cafés achieve same café sales growth in excess of the average of the chain. During 2006, we expect to modernize 20 cafés and open 15 to 20 new cafés across Canada.

We firmly believe the key to Second Cup’s future success lies in consistently delivering a relaxing café environment that allows our guests to feel personally rewarded by our premium products and guest service. With this in mind, we will be spending considerable resources on one of our main imperatives this year — the training and development of our franchise system and café support staff. By raising the skill set of the people who are key to the success of their cafés, we expect each of them will be able to convert their Second Cup café into an “oasis” for their guests.

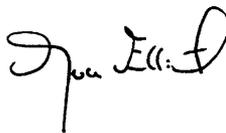
We are also going to expand our merchandise offerings to include exciting new seasonal products that build on the success of our 2005 holiday line-up. We believe that, by offering a line-up of seasonally aligned merchandise throughout the year, we can accelerate sales growth in this category.

Continuing our efforts to increase sales of our non-beverage products, our promotional strategies for 2006 will feature complementary pairings of a feature beverage with the above-mentioned merchandise and new seasonal food offerings. We will also be adding to our current offerings of snack foods and impulse items, as well as expanding our sandwich program in 2006.

During 2006, we will also be rolling out a new menu board system to our cafés. Tests have shown that the new menu boards are more approachable and guest friendly, which we expect will lead to increased sales of our premium espresso-based beverages, blender drinks, and food items.

We look forward to delivering on these and other strategic initiatives and hope to share in the positive performance of the Fund through our ownership position in the Fund. We thank you, for your trust and support as we strive to “Make Second Cup a Second Home” for our guests.

On behalf of The Second Cup Ltd.,



J. Bruce Elliot,  
President,  
The Second Cup Ltd.  
April 13, 2006

# 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, 2005 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. Since the Fund was created on October 22, 2004, results of operations and financial condition for the prior period are not directly comparable. This Management's Discussion and Analysis ("MD&A") has been prepared as of March 7, 2006.

### **CHANGE IN ACCOUNTING POLICIES INCLUDING INITIAL ADOPTION**

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

Effective January 1, 2005 the Fund adopted Accounting Guideline 15 ("AcG-15"), a new 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 has 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. In the prior fiscal year, the Fund consolidated the financial results of MarksCo. The Fund now reflects its investment in MarksCo as an equity-accounted investment.

The adoption of this new pronouncement effective January 1, 2005 resulted in MarksCo no longer being consolidated by the Fund. For comparability, this change has been applied retroactively and prior year amounts have been restated to exclude the results of MarksCo. Refer to the Fund's consolidated financial statements for a summary of the effect on the financial statements due to this change. Readers are advised that this is an accounting change only and does not have an impact on the cash flows and legal rights and obligations of the Fund, Second Cup and MarksCo.

#### **Implicit Variable Interests Under AcG-15, EIC 157**

Effective November 2005, the Emerging Issues Committee of the CICA issued for adoption "Implicit Variable Interests Under AcG-15" (EIC 157). This abstract provides additional guidance with respect to the implementation of AcG-15 and implicit variable interests. The Fund has adopted this guidance, with no additional accounting changes to those made with the adoption of AcG-15. As a result of issuing this guidance, the Emerging Issues Committee will not be proceeding with the adoption of Draft Abstract D48, "Sales of Future Revenues" (EIC D48), which the Fund had disclosed in its interim Management's Discussion and Analysis as an abstract that, if adopted, might have impacted the original accounting treatment used by Second Cup to record the sale of the Second Cup Marks.

**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 has decided not to early adopt this standard in 2006 and is reviewing Section 3855 to determine the impact this standard will have on the accounting for the Fund's financial instruments.

**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 has decided not to early adopt this standard in 2006 and is reviewing Section 3865 to determine the impact this standard will have on the Fund's financial statements.

**Comprehensive Income, CICA Handbook Section 1530**

Section 1530 introduces new standards for reporting and display 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 has decided not to early adopt this standard in 2006 and is reviewing Section 1530 to determine the impact this standard will have on the Fund's financial statements.

**OVERVIEW AND BUSINESS OF THE FUND**

The Fund, through its indirect wholly-owned subsidiary, MarksCo, acquired the Canadian trade-marks and certain other intellectual property and associated rights used by Second Cup in connection with the operation of Second Cup cafés in Canada (excluding the territory of Nunavut) (the "Second Cup Marks" or the "Marks"). The Fund, indirectly through MarksCo, then licensed to Second Cup the Second Cup Marks for use in its cafés in return for payment of a royalty of 6.5% of system sales of a certain number of Second Cup cafés in Canada (the "Royalty Pool"). 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. At the inception of the Fund, the system sales of 351 cafés were included for purposes of determining the royalty. Units of the Fund are traded on the Toronto Stock Exchange under the symbol "SCU.UN".

As at December 31, 2005, the Fund has 9,582,760 units outstanding, of which 15% were owned by Second Cup.

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.

## 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, 2005	PERIOD ENDED DECEMBER 31, 2004 <sup>(1)</sup>
Number of active cafés in Royalty Pool - end of period (352 cafés post the January 1, 2006 adjustment)	343	349
Same café sales growth	4.6%	6.8%
System sales of cafés in the Royalty Pool	\$ 177,527	\$ 16,610
Interest income from MarksCo	9,487	780
Net earnings for the period	10,036	784
Basic and fully diluted earnings per unit	\$ 1.0473	\$ 0.0818
Distributable cash	10,242	808
Distributable cash per unit	\$ 1.0688	\$ 0.0842
Distributions declared	9,583	787
Distributions declared per unit	\$ 1.0000	\$ 0.0821
	AS AT DECEMBER 31, 2005	AS AT DECEMBER 31, 2004
Total assets	\$ 88,350	\$ 87,826
Total long-term liabilities	-	-

(1) For the period October 22, 2004 (date of commencement of the Fund) to December 31, 2004.

### 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. Furthermore, audits are performed at random by Second Cup's internal audit team on cafés throughout the Second Cup network.

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 in to 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.

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

System sales for the year were \$177,527 and same café sales growth was 4.6% for the same period. System sales and same café sales growth were impacted by a number of factors.

- System sales growth benefited from a price increase implemented in the first quarter of 2005. The increase was applied to certain product offerings and accounted for approximately 3.0% of the same café sales growth for the year.
- Second Cup experienced a strong finish to the holiday season with same café sales growth of just under 10% for the month of December 2005 and 5.6% for the fourth quarter. This was driven by a number of Second Cup initiatives, such as a new holiday merchandise line, the launch of the reloadable Second Cup Café Card and an increased focus on serving guests better.
- System sales also benefited from an improvement in sales mix, driven by stronger premium beverage sales. In particular, based on sales mix information reported by franchisees, the cold blender drinks category experienced an increase in sales mix from an estimated 4.4% of system sales in calendar year 2004 to an estimated 5.7% of system sales in 2005, with strong growth achieved during the summer of 2005.
- System sales and same café sales growth were impacted by the temporary closure of a high-volume café situated in a major Toronto-area retail centre. The café was closed during the second half of the year due to a major mall renovation. This adversely impacted system sales by approximately 0.3% on an annualized basis. The café was reopened prior to the end of the year.

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.

#### **Analysis of Royalty Pool and Café Network**

As at December 31, 2005, eight cafés from the initial Royalty Pool had been permanently closed, three of which were closed during the fourth quarter of 2005. Average annualized system sales of the eight closed cafés were below the average of all Royalty Pool cafés and totalled approximately \$2.9 million 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 closed since the inception of the Fund. The loss of the royalty revenues from these cafés was more than offset by future royalty income from nine cafés added to the Royalty Pool on January 1, 2006 (see "Adjustment to the Royalty Pool" below).

Four cafés were opened by Second Cup in 2004 subsequent to the determination of the initial Royalty Pool on September 12, 2004. In addition, two cafés were opened in 2005, prior to the cut-off date for inclusion in the Royalty Pool at the next adjustment date. These six cafés were added to the Royalty Pool on January 1, 2006 (see "Adjustment to the Royalty Pool" below). In addition, Second Cup renewed the leases of three existing cafés which were originally not included in the Royalty Pool on September 12, 2004 due to the imminent expiry of their leases. With the extension of these leases, Second Cup added these cafés to the Royalty Pool on January 1, 2006 (see "Adjustment to the Royalty Pool" below).

An additional four cafés were opened in 2005 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, 2007 adjustment date, along with any cafés opened in 2006 prior to the cut-off date for the January 1, 2007 adjustment.

Historically, renovated cafés typically experience above average café sales growth. As a result, café modernization is a significant ongoing initiative for Second Cup. The Company renovated 15 cafés included in the Royalty Pool in 2005.

#### Operating Expenses and Income Taxes

(IN THOUSANDS OF DOLLARS)	YEAR ENDED DECEMBER 31, 2005	PERIOD ENDED DECEMBER 31, 2004
General and administrative expenses	\$ 301	\$ 100
Income taxes		
Current	12	2
Future	-	-
Total income tax expense	\$ 12	\$ 2

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 2005 were \$301 (2004 - \$100). This excludes general and administrative expenses of MarksCo of \$348 (2004 - \$76) and amortization expense of MarksCo of \$93 (2004 - \$7). Total operating expenses of both the Fund and MarksCo remain in line with management's expectations.

As a result of the change in accounting policy described above, the Fund recorded after-tax income of \$862 during the year (2004 - \$106) from its equity-accounted investment in MarksCo, a wholly-owned subsidiary of the Fund. This represents the net earnings of MarksCo during the period.

During the year, the Fund incurred an income tax expense of \$12 (2004 - \$2). This excludes income tax expenses of MarksCo of \$241 (2004 - \$61), comprised of current tax expense of \$128 (2004 - \$44) and future tax expense of \$113 (2004 - \$17). After taking into account distributions declared of \$9,583 (2004 - \$787), which are not subject to tax in the Fund, and the impact of additional provisions recorded in 2005 for prior year tax expenses, the overall income tax expense reflects the annual expected effective tax rate of 23.1% applicable to the Fund's wholly-owned subsidiaries.

#### FOURTH QUARTER OPERATING RESULTS

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

System sales for the fourth quarter of 2005 were \$49,774 and same café sales growth was 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 a price increase implemented in the first quarter of 2005. The increase was applied to certain product offerings and accounted for approximately 3.0% of the same café sales growth for the fourth quarter.
- Second Cup experienced a strong finish to the holiday season with same café sales growth of just under 10% for the month of December 2005. This was driven by a number of Second Cup initiatives, such as a new holiday merchandise line, the launch of the reloadable Second Cup Café Card and an increased focus on serving guests better.

- Second Cup's reloadable payment card, the "Second Cup Café Card", was rolled out across its major Canadian markets during the fourth quarter. During the holiday periods of November and December alone, over \$2 million was loaded on to the cards.
- System sales and same café sales growth were impacted by the temporary closure of a high-volume café situated in a major Toronto-area retail centre. The café was closed for most of the quarter due to a major mall renovation. This adversely impacted system sales by approximately 0.6% during the quarter. The café was reopened prior to the end of the year.

#### **Analysis of Royalty Pool and Café Network**

During the fourth quarter, three cafés in the Royalty Pool were closed. Average annualized system sales totalled approximately \$1.3 million for the three cafés. In accordance with the Agreement, Second Cup made monthly make-whole payments to the Fund related to sales of the cafés closed since the inception of the Fund. The loss of future royalty revenues from these cafés was more than offset by future royalty income from cafés added to the Royalty Pool on January 1, 2006 (see "Adjustment to the Royalty Pool" below).

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

Total operating expenses of the Fund in the fourth quarter of 2005 were \$80 (2004 - \$100). This excludes general and administrative expenses of MarksCo of \$65 (2004 - \$76) and amortization expense of MarksCo of \$24 (2004 - \$7). Operating results for the fourth quarter are not directly comparable to prior year figures as the Fund and its subsidiaries were established during the fourth quarter of 2004. Total operating expenses of both the Fund and MarksCo remain in line with management's expectations.

As a result of the change in accounting policy described above, the Fund recorded after-tax income of \$495 during the quarter (2004 - \$106) from its equity-accounted investment in MarksCo, a wholly-owned subsidiary of the Fund. This represents the net earnings of MarksCo during the period.

During the quarter, the Fund incurred an income tax expense of \$2 (2004 - \$2). This excludes income tax expenses of MarksCo of \$150 (2004 - \$61), comprised of current tax expense of \$121 (2004 - \$44) and future tax expense of \$29 (2004 - \$17). After taking into account distributions declared of \$2,397 (2004 - \$787), which are not subject to tax in the Fund, the overall income tax expense reflects the annual expected effective tax rate of 23.1% applicable to the Fund's wholly-owned subsidiaries.

#### **DISTRIBUTIONS AND DISTRIBUTABLE CASH**

During 2005, the Fund declared distributions of \$0.0833 per unit for each month, with the exception of the distributions for June and December, which were each declared at \$0.0835 per unit to ensure total distributions by the Fund for the year were \$1.00, in line with the indicated annualized yield of 10.0% on the initial public offering of \$10.00 per unit.

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, 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.

(IN THOUSANDS OF DOLLARS EXCEPT PER UNIT AMOUNTS)	YEAR ENDED DECEMBER 31, 2005	PERIOD ENDED DECEMBER 31, 2004
Net earnings for the Fund	\$ 10,036	\$ 784
Add:		
Future income tax expense of the Fund and MarksCo	113	17
Amortization expense MarksCo	93	7
Distributable cash for the Fund	<u>\$ 10,242</u>	<u>\$ 808</u>
Distributable cash per unit	<u>\$ 1.0688</u>	<u>\$ 0.0842</u>
Distributions declared	<u>\$ 9,583</u>	<u>\$ 787</u>
Distributions declared per unit	<u>\$ 1.0000</u>	<u>\$ 0.0821</u>

#### Tax Treatment of Distributions

Of the \$1.00 in distributions declared per unit during the year, 16.8% or \$0.1682 per unit represents a tax deferred return of capital and 83.2% or \$0.8318 per unit is taxable as income from property. For the period ended December 31, 2004, 56.9% or \$0.0467 per unit represented a tax deferred return of capital and 43.1% or \$0.0354 per unit was taxable as income from property. The tax treatment of distributions for 2004 was unusual as the Fund was created in 2004. Based on the timing of the Fund's establishment compared to the commencement of the Agreement, the Fund was entitled to a higher than normal tax deduction, allowing for a larger tax deferral on distributions paid in 2004.

#### 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 2005	Q3 2005	Q2 2005	Q1 2005	2004 <sup>(1)</sup>
Total number of cafés in Royalty Pool at end of period	351 <sup>(2)</sup>	351	351	351	351
Number of active cafés in Royalty Pool at end of period	343 <sup>(2)</sup>	346	348	349	349
Same café sales growth	5.6%	4.6%	4.6%	3.3%	6.8%
System sales of Royalty Pool Cafés	\$ 49,774	\$ 43,727	\$ 43,590	\$ 40,436	\$ 16,610
Net earnings for the period	2,804	2,464	2,479	2,289	784
Basic and fully diluted earnings per unit	\$ 0.2927	\$ 0.2570	\$ 0.2587	\$ 0.2389	\$ 0.0818
Distributable cash per unit	\$ 0.2981	\$ 0.2624	\$ 0.2617	\$ 0.2466	\$ 0.0842
Distributions declared per unit	\$ 0.2501	\$ 0.2499	\$ 0.2501	\$ 0.2499	\$ 0.0821

(1) For the period October 22, 2004 (date of commencement of the Fund) to December 31, 2004.

(2) Subsequent to the end of the quarter, the Royalty Pool was adjusted (see "Adjustment to the Royalty Pool"). As at January 1, 2006, the total number of cafés and number of active cafés in the Royalty Pool was 352.

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). In addition, the results for the period ended

December 31, 2004 are not comparable to results of other quarters as the Fund was not operational for an entire quarter in 2004.

## **LIQUIDITY AND CAPITAL RESOURCES**

The Fund had cash and cash equivalent balances of \$209 at December 31, 2005 (2004 - nil). This excludes cash and cash equivalent amounts held by MarksCo of \$317 (2004 - \$3,449).

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, 2005, the Fund generated cash from operations of \$9,204. The Fund also received \$575 in dividends from MarksCo, and paid distributions to unitholders of \$9,570 during the year. For the period ended December 31, 2004, the Fund did not generate any cash from operations as all cash transactions relating to the Fund's operations for the brief period following the IPO were made by MarksCo, the results of which are not included in the Fund's consolidated statement of cash flows.

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

The Fund 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 "Adjustment to the Royalty Pool" below. As per 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 2005 and does not have any plans for capital expenditures in 2006.

The Fund has guaranteed a term credit agreement entered into by MarksCo and maturing on December 2, 2007. The credit facilities total \$12.0 million and are comprised of an \$11.0 million non-revolving term credit facility and a \$1.0 million operating credit facility. As at December 31, 2005, the \$1.0 million operating line of credit was unused and the \$11.0 million 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, with reference to MarksCo's primary asset, the Second Cup Marks. 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 compared to the IPO unit price, actual and forecast royalty income from Second Cup and actual and forecast distributable cash of the Fund. The Fund reviewed the Second Cup Marks as at December 31, 2005 and concluded there was no impairment in its investment in MarksCo.

## **RELATED PARTY TRANSACTIONS AND BALANCES**

During the year, interest income of \$9,487 (2004 - \$780) was earned from MarksCo, of which \$806 is receivable at December 31, 2005 (2004 - \$780). In addition, during the year, dividend income of \$575 (2004 - nil) was received from MarksCo.

Included in accounts payable and accrued liabilities is an amount of \$26 (2004 - nil) 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.

## **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.

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).

#### **ADJUSTMENT TO THE ROYALTY POOL**

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. 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.

On January 1, 2006, nine Second Cup cafés were added to the Royalty Pool, of which three cafés were operational at the Fund's inception, but had been excluded from the initial Royalty Pool due to uncertainty as to their future operational status. These locations have now secured long-term lease commitments, making them suitable for inclusion in the Royalty Pool. The system sales of these nine cafés added to the Royalty Pool has been estimated at \$4.06 million annually. These were offset by \$2.91 million 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.

As a result of this adjustment to the Royalty Pool, the Fund expects to make a payment of \$685 to Second Cup and expects to satisfy this obligation by the issuance of units. On January 1, 2006 the Fund issued 55,316 units representing 80% of this payment based on forecast net system sales. After a full year of performance of the new cafés, the Fund expects to issue additional units to satisfy the remaining obligation.

#### **SUBSEQUENT EVENTS**

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.

On January 31, 2006, the Fund paid the declared distribution for December 2005 of \$800, or \$0.0835 per Unit to holders of record at the close of business on December 31, 2005. On February 28, 2006, the Fund paid distributions of \$798 or \$0.0833 per Unit to holders of record at the close of business on February 24, 2006.

#### **OUTSTANDING UNIT AND SHARE DATA**

	<b>AS AT DECEMBER 31, 2005</b>	<b>AS AT DECEMBER 31, 2004</b>
Fund - units issued	9,582,760	9,582,760
- amount	<u>\$ 9,582,760</u>	<u>\$ 9,582,760</u>

At December 31, 2004 and 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.

#### **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, 2005, 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 (including with respect to Second Cup if it would be material to the Fund) would have been made known to such management.

#### **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 2005, Second Cup made significant progress in implementing its previously announced strategies, aimed at increasing same café sales growth and expanding the number of Second Cup cafés across Canada. This is evidenced by same café sales growth of 4.6% for the year, following the achievement of 5.8% same café sales growth in the 40-week period ended January 1, 2005. Subject to healthy economic conditions continuing across the Company’s primary markets, the Company expects to achieve same café sales growth of approximately 3% to 5% for the 2006 fiscal year.

To this end, the Company has a number of ongoing initiatives aimed at strengthening the long-term success of Second Cup and its franchise partners:

- In October 2005, Second Cup completed the rollout of the Second Cup Café Card across its major Canadian markets. The card allows customers to load a dollar amount on the card at a café and redeem it not only for their daily purchases at participating cafés, but also at Cara Operations Limited restaurant brands including Harvey's, Swiss Chalet, Kelsey's, Milestone's and Montana's. During the Holiday periods of November and December alone, over \$2 million was loaded on to the cards. The Company intends to benefit from a full year of the Café Card program by featuring it in many of the promotions and themes planned for 2006, allowing the Company significant opportunity for sales growth.
- As part of its commitment to focus on premium products, Second Cup launched its reformulated latte in the fourth quarter of 2005. The new recipe was launched with significant print advertising and media coverage in the fourth quarter of 2005 and consumer reception has been positive. The Company intends to build on this success by launching a number of new premium beverages during 2006.
- In an effort to raise sales of non-beverage product categories, the Company's promotional strategies for 2006 will feature complementary pairings of seasonal foods and merchandise combined with a featured premium beverage. Second Cup will also be selectively adding to its offerings of ready-to-serve beverages, seasonal merchandise and snack food items, including an expanded sandwich program in select cafés.
- During 2006, Second Cup will also be investing significantly in revamping the training and development it offers to its franchisees and café support staff. This will include an emphasis on leveraging technology in delivering knowledge across the Second Cup café network. The increased focus on training and development is expected to raise overall business capabilities and generate long-term value for the Company and its partners.

The Company is projecting moderate price increases on select product offerings later in 2006. The level of price increases will be dependent on various competitive factors and is not expected to reach the level experienced in 2005.

The Company completed the renovation of 15 existing cafés and opened six new cafés in Canada during 2005. Newly-renovated cafés typically experience above-average same café sales growth and the company has in excess of 70 cafés due for renovation in the next three years. Accordingly, development of the Second Cup café network has been and continues to be a strategic initiative for the Company.

To that end, the Company expects to renovate and modernize approximately 20 cafés during 2006. In terms of network expansion, Second Cup expects to open approximately 15 to 20 new cafés in Canada during the 2006 fiscal year. However, as part of its ongoing efforts to raise the Company's competitive position, Second Cup also expects to permanently close 12 to 15 cafés during 2006, the majority of which have sales below the average performance of cafés in the Royalty Pool.

Overall, based on the Second Cup initiatives outlined above and others, the anticipated economic environment and market conditions affecting the specialty coffee industry, the Fund expects a successful year in 2006.

#### **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 upon 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 “Risk and Uncertainties” above.

Although the forward-looking information contained in this MD&A is based upon 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 2006 and that inflation will remain relatively low. The Fund has also assumed that interest rates will gradually increase in 2006 and that demand for specialty coffee will be comparable with demand in 2005.

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” 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, 2005

March 7, 2006

## 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, 2005 and 2004 and the consolidated statements of earnings, unitholders' equity and cash flows for the year ended December 31, 2005 and for the period from October 22, 2004, date of commencement, to December 31, 2004. These financial statements are the responsibility of the Fund's management. Our responsibility is to express an opinion on these financial statements based on our 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, 2005 and 2004 and the results of its operations and its cash flows for the year ended December 31, 2005 and for the period from October 22, 2004, date of commencement, to December 31, 2004 in accordance with Canadian generally accepted accounting principles.

*PricewaterhouseCoopers LLP*

Chartered Accountants

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, 2005	DECEMBER 31, 2004
<b>Assets</b>		
<b>CURRENT ASSETS</b>		
Cash and cash equivalents	\$ 209	\$ -
Interest receivable from Second Cup Trade-Marks Inc. (note 9)	806	780
Income taxes recoverable	2	-
	<hr/>	<hr/>
	1,017	780
 Note receivable from Second Cup Trade-Marks Inc. (note 9)	 78,246	 78,246
 Investment in Second Cup Trade-Marks Inc. (note 7)	 9,087	 8,800
	<hr/>	<hr/>
	\$ 88,350	\$ 87,826
	<hr/>	<hr/>
<b>Liabilities</b>		
<b>CURRENT LIABILITIES</b>		
Accounts payable and accrued liabilities (note 9)	\$ 161	\$ 100
Distributions payable to unitholders	800	787
Income taxes payable	-	2
	<hr/>	<hr/>
	961	889
 <b>UNITHOLDERS' EQUITY</b>	 87,389	 86,937
	<hr/>	<hr/>
	\$ 88,350	\$ 87,826
	<hr/>	<hr/>

Change in accounting standard (note 2)

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, 2005</b>	<b>FOR THE PERIOD FROM OCTOBER 22, 2004 (DATE OF COMMENCEMENT) TO DECEMBER 31, 2004</b>
Interest income from Second Cup Trade-Marks Inc. (note 9)	\$ 9,487	\$ 780
General and administrative expenses	(301)	(100)
Earnings from equity-accounted investment (note 7)	862	106
Earnings before income taxes	<u>10,048</u>	<u>786</u>
Income taxes (note 6)		
Current	12	2
Future	-	-
	<u>12</u>	<u>2</u>
<b>NET EARNINGS</b>	<u>\$ 10,036</u>	<u>\$ 784</u>
<b>BASIC AND FULLY DILUTED EARNINGS PER UNIT</b>	<u>\$ 1.0473</u>	<u>\$ 0.0818</u>

Change in accounting standard (note 2)  
See accompanying notes to consolidated financial statements.

## Second Cup Royalty Income Fund

### CONSOLIDATED STATEMENTS OF UNITHOLDERS' EQUITY

(EXPRESSED IN THOUSANDS OF DOLLARS)

	CAPITAL	UNITHOLDERS' EARNINGS	ACCUMULATED DISTRIBUTIONS	REFUNDABLE TAXES	TOTAL
<b>BALANCE - OCTOBER 22, 2004</b>					
(date of commencement)	\$ -	\$ -	\$ -	\$ -	\$ -
Issuance of trust units	95,827	-	-	-	95,827
Issuance costs	(8,887)	-	-	-	(8,887)
Net earnings	-	784	-	-	784
Distributions to unitholders	-	-	(787)	-	(787)
<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

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, 2005</b>	<b>FOR THE PERIOD FROM OCTOBER 22, 2004 (DATE OF COMMENCEMENT) TO DECEMBER 31, 2004</b>
<b>Cash provided by (used in)</b>		
<b>OPERATING ACTIVITIES</b>		
Net earnings for the period	\$ 10,036	\$ 784
Item not involving cash		
Earnings from equity-accounted investment (note 7)	(862)	(106)
Change in non-cash working capital items (note 13)	30	(678)
	<hr/> 9,204	<hr/> -
<b>INVESTING ACTIVITIES</b>		
Acquisition of Second Cup Marks (note 3)	-	(86,940)
	<hr/> -	<hr/> (86,940)
<b>FINANCING ACTIVITIES</b>		
Issuance of trust units (note 3)	-	95,827
Cost of issuing trust units (note 3)	-	(8,887)
Dividends from equity-accounted investment (note 7)	575	-
Distributions to unitholders	(9,570)	-
	<hr/> (8,995)	<hr/> 86,940
<b>INCREASE IN CASH AND CASH EQUIVALENTS DURING THE PERIOD</b>	209	-
<b>CASH AND CASH EQUIVALENTS - BEGINNING OF PERIOD</b>	-	-
	<hr/> -	<hr/> -
<b>CASH AND CASH EQUIVALENTS - END OF PERIOD</b>	<b>\$ 209</b>	<b>\$ -</b>
	<hr/> <b>\$ 209</b>	<hr/> <b>\$ -</b>
<b>SUPPLEMENTARY CASH FLOW INFORMATION:</b>		
Interest paid	\$ -	\$ -
	<hr/> -	<hr/> -
Income taxes paid	\$ 16	\$ -
	<hr/> 16	<hr/> -

See accompanying notes to consolidated financial statements.

# Second Cup Royalty Income Fund

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

DECEMBER 31, 2005 AND DECEMBER 31, 2004

(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 obligations of the unitholders.

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 (see note 2 below). Second Cup is Canada’s leading franchisor of specialty coffee cafés.

### 2. CHANGE IN ACCOUNTING STANDARD

Effective January 1, 2005, the Fund adopted Accounting Guideline 15 (“AcG-15”), a new pronouncement of The Canadian Institute of Chartered Accountants 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 has determined that its wholly-owned indirect subsidiary, MarksCo, is a variable interest entity. MarksCo owns the Second Cup trademarks and, through the Licence and Royalty Agreement, has licensed the trademarks to Second Cup, 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 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. Previously, the Fund consolidated MarksCo. The Fund now reflects its investment in MarksCo as an equity-accounted investment.

The adoption of this new pronouncement has resulted in the financial results of MarksCo no longer being consolidated by the Fund. Instead, the financial results of MarksCo are consolidated with the financial results of Second Cup. This change has been applied retroactively and prior year amounts have been restated to exclude results of MarksCo. The effect on the consolidated balance sheet of the Fund at December 31, 2004 was an elimination of the trademark of \$115.4 million and related tax liability of \$17.7 million, long-term debt of \$11.0 million, and deferred financing charges of \$0.2 million, and an increase in the notes receivable and investment in MarksCo of \$86.9 million. As a result of the Fund accounting for MarksCo as an equity-accounted investment, the consolidated financial statements of the Fund include the income and expenses of MarksCo on a net basis as a separate income statement line item. Accordingly, the Fund’s consolidated earnings consist of interest income from MarksCo and the equity-accounted earnings of MarksCo, with dividends received from MarksCo being accounted for as a reduction in the investment in MarksCo.

## Second Cup Royalty Income Fund

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

DECEMBER 31, 2005 AND DECEMBER 31, 2004

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

#### 3. INITIAL PUBLIC OFFERING AND ACQUISITION OF SECOND CUP MARKS

On December 2, 2004, the Fund used the proceeds from an offering of units under a prospectus dated November 23, 2004, to subscribe for common shares and notes of AcquisitionCo, a newly created subsidiary of the Fund, which in turn used the proceeds to acquire MarksCo from Cara Operations Limited. At the time the interest in MarksCo was acquired, its primary asset was the Second Cup Marks.

#### 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 (see note 2). 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 AcG-15 (see note 2 above). AcG-15 requires consolidation of VIE's 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. The Fund has evaluated its interests in its wholly-owned subsidiary, MarksCo, and determined that Second Cup is the primary beneficiary at December 31, 2005 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.

## Second Cup Royalty Income Fund

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

DECEMBER 31, 2005 AND DECEMBER 31, 2004

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

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

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

#### **5. 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.

	YEAR ENDED DECEMBER 31, 2005	PERIOD ENDED DECEMBER 31, 2004
System sales reported by cafés in the Royalty Pool	\$ 177,527	\$ 16,610

## Second Cup Royalty Income Fund

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

DECEMBER 31, 2005 AND DECEMBER 31, 2004

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

#### 6. 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 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:

	FOR THE YEAR ENDED DECEMBER 31, 2005	FOR THE PERIOD ENDED DECEMBER 31, 2004
Earnings before income taxes	\$ 10,048	\$ 786
Combined Canadian federal and provincial tax rates	23.11%	36.12%
Tax provision at statutory rate	\$ 2,321	\$ 284
Reduced by following permanent differences:		
Income distributed or accrued to Unitholders not subject to tax in the fund	(2,110)	(243)
Earnings from equity-accounted investment	(199)	(39)
Provision for income taxes	\$ 12	\$ 2

As a result of a clarification of the tax status of the Fund's subsidiaries, the effective tax rate applicable to the Fund's subsidiary has changed from 36.12% to 23.11%.

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

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

	YEAR ENDED DECEMBER 31, 2005	PERIOD ENDED DECEMBER 31, 2004
Opening balance	\$ 8,800	\$ 8,694
Equity in earnings for the period	862	106
Dividends received during the period	(575)	-
	\$ 9,087	\$ 8,800

## Second Cup Royalty Income Fund

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

DECEMBER 31, 2005 AND DECEMBER 31, 2004

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

	AS AT DECEMBER 31, 2005	AS AT DECEMBER 31, 2004
Common shares	\$ 8,694	\$ 8,694
Cumulative equity in earnings	968	106
Cumulative dividends received	(575)	-
	<u>\$ 9,087</u>	<u>\$ 8,800</u>

#### 8. 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.

Weighted average units outstanding:

	AS AT DECEMBER 31, 2005	AS AT DECEMBER 31, 2004
Fund units	<u>9,582,760</u>	<u>9,582,760</u>

Subsequent to December 31, 2005, the Fund issued an additional 55,316 units (see note 12 below).

#### 9. RELATED PARTY TRANSACTIONS AND BALANCES

During the year, interest income of \$9,487 (2004 - \$780) was earned on the \$78,246 note receivable from MarksCo, of which \$806 is receivable at December 31, 2005 (2004 - \$780). In addition, during the year, dividend income of \$575 (2004 - nil) was received from MarksCo.

Included in accounts payable and accrued liabilities is an amount of \$26 (2004 - nil) 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.

#### 10. GUARANTEE

The Fund has guaranteed a term credit agreement entered into by MarksCo and maturing on December 2, 2007. The credit facilities total \$12.0 million and are comprised of an \$11.0 million non-revolving term credit facility, which was

## Second Cup Royalty Income Fund

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

DECEMBER 31, 2005 AND DECEMBER 31, 2004

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

fully utilized as at December 31, 2005, and a \$1.0 million operating credit facility, which was unused as at December 31, 2005.

#### 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

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. In return for adding cafés to the Royalty Pool, Second Cup is entitled to be paid an amount which 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.

On January 1, 2006, nine Second Cup cafés were added to the Royalty Pool, of which three cafés were operational at the Fund's inception, but had been excluded from the initial Royalty Pool due to uncertainty as to their future operational status. These locations have now secured long-term lease commitments, making them suitable for inclusion in the Royalty Pool. The system sales of these nine cafés added to the Royalty Pool has been estimated at \$4.06 million annually. These were offset by \$2.91 million 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.

As a result of this adjustment to the Royalty Pool, the Fund expects to make a payment of \$685 to Second Cup and expects to satisfy this obligation by the issuance of units. On January 1, 2006, the Fund issued 55,316 units representing 80% of this payment based on forecast net system sales. After a full year of performance of the new cafés, the Fund expects to issue additional units to satisfy the remaining obligation.

## Second Cup Royalty Income Fund

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

DECEMBER 31, 2005 AND DECEMBER 31, 2004

(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:

	FOR THE YEAR ENDED DECEMBER 31, 2005	FOR THE PERIOD ENDED DECEMBER 31, 2004
Interest receivable from MarksCo	\$ (26)	\$ (780)
Income taxes recoverable	(2)	-
Accounts payable and accrued liabilities	61	100
Income taxes payable	(2)	2
Refundable taxes	(1)	-
	\$ 30	\$ (678)

#### 14. PRIOR YEAR COMPARATIVES

Prior year comparatives have been restated to conform with current year's presentation.

## 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 period ended December 31, 2005. The consolidated financial statements of Second Cup are prepared in accordance with Canadian generally accepted accounting principles ("GAAP"). All amounts are presented in thousands of Canadian dollars, unless otherwise indicated. The financial results for the 52-week period ended December 31, 2005 are not directly comparable to those of the 40-week period ended January 1, 2005 due to the different number of weeks in the periods and due to seasonal fluctuations in the business as described further in "Financial Highlights - Overview of system sales" below. This Management's Discussion and Analysis ("MD&A") has been prepared as of March 7, 2006.

#### **BASIS OF PRESENTATION**

This MD&A and the financial information contained herein are those of The Second Cup Ltd. ("Second Cup"), incorporated on November 17, 2004, and its predecessor corporation ("Old Second Cup" or the "Predecessor Corporation") of the same name. The Predecessor Corporation was subsequently amalgamated and changed its name to Second Cup Trade-Marks Inc. ("MarksCo"). As discussed below, MarksCo, while a wholly-owned subsidiary of Second Cup Royalty Income Fund ("the Fund"), is consolidated in the financial statements of Second Cup.

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

The net proceeds of the Fund's initial public offering were used by the Fund to indirectly acquire all of the issued and outstanding share capital of MarksCo on December 2, 2004. At this time, Second Cup also acquired 1.4 million units of the Fund (the "Units") for an aggregate cash cost of \$14.4 million. This represented a 15% interest in the Fund as at the IPO date.

#### **CHANGES IN ACCOUNTING POLICIES INCLUDING INITIAL ADOPTION**

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

Effective January 2, 2005, Second Cup adopted Accounting Guideline 15 ("AcG-15"), a new 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 has identified two significant VIEs related to it.

#### *Second Cup Trade-Marks Inc. (MarksCo)*

MarksCo, an indirect wholly-owned subsidiary of the Fund, is a variable interest entity that owns the Second Cup Marks and, through the Agreement, has licensed 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. Previously, the Fund consolidated the financial results of MarksCo.

The adoption of this new pronouncement effective January 2, 2005 resulted in the financial results of MarksCo being consolidated by the Company. This change has been applied retroactively and prior year amounts have been restated to include the results of MarksCo. Refer to the Company's consolidated financial statements for the year ended December 31, 2005 for a summary of the effect on the consolidated financial statements of this change. Readers are advised that this is an accounting change only and does not have an impact on the cash flows and legal rights and obligations of Second Cup, the Fund or MarksCo.

#### *Franchise entities*

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

#### **Implicit Variable Interests Under AcG-15, EIC 157**

Effective November 2005, the Emerging Issues Committee of the CICA issued for adoption "Implicit Variable Interests Under AcG-15" (EIC 157). This abstract provides additional guidance with respect to the implementation of AcG-15 and implicit variable interests. The Fund has adopted this guidance, with no additional accounting changes to those made with the adoption of AcG-15. As a result of issuing this guidance, the Emerging Issues Committee will not be proceeding with the adoption of Draft Abstract D48, "Sales of Future Revenues" (EIC D48), which the Fund had disclosed in its interim Management's Discussion and Analysis as an abstract that, if adopted, might have impacted the original accounting treatment used by Second Cup to record the sale of the Second Cup Marks.

#### **Determining Whether an Arrangement Contains a Lease, EIC 150**

An entity may enter into certain arrangements comprising a transaction or a series of related transactions that does not take the legal form of a lease but conveys a right to use a tangible asset (e.g., an item of property, plant or equipment) in return for a payment or series of payments. EIC 150 provides guidance for determining whether such arrangements are, or contain, leases that are within the scope of Section 3065 - Leases. The Company has adopted this new guidance effective January 2, 2005. No adjustment has been made in the consolidated financial statements of Second Cup as a result of the adoption of this policy.

#### **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 has decided not to early adopt this standard in 2006 and is reviewing Section 3855 to determine the impact this standard will have on the accounting for the Company's financial instruments.

#### **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 Company has decided not to early adopt this standard in 2006 and is reviewing Section 3865 to determine the impact this standard will have on the Company's financial statements.

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

Section 1530 introduces new standards for reporting and display 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 has decided not to early adopt this standard in 2006 and is reviewing Section 1530 to determine the impact this standard will have on the Company's financial statements.

#### **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, commencing December 2, 2004, Second Cup also pays a royalty to MarksCo equal to 6.5% of system sales of cafés in the Royalty Pool, pursuant to the Licence and Royalty Agreement. At the time the Agreement was entered into, 351 cafés were included in the Royalty Pool.

Due to the changes in accounting policy noted above, 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) has typically been added approximately every five years. It should be noted that prior to entering into the transactions discussed above, Second Cup's fiscal year ended on the Saturday closest to March 31. As a result, the Company experienced a 40-week fiscal period ended January 1, 2005, compared to the most recent 52-week fiscal year ended December 31, 2005.

MarksCo's business is the ownership of the Second Cup Marks. MarksCo uses the royalty revenue earned on the licensing 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)	52 WEEKS ENDED DECEMBER 31, 2005	40 WEEKS ENDED JANUARY 1, 2005
Number of cafés in Canada - end of period	359	369
System sales - Canadian operations	\$ 184,005	\$ 140,848
Same café sales growth	4.6%	5.8%
Total revenue	33,664	21,860
Operating costs and administrative expenses	21,877	13,401
Investment income	1,437	118
Interest expense - net	10,035	651
Net earnings for the period	\$ 842	\$ 4,579

	AS AT DECEMBER 31, 2005	AS AT JANUARY 1, 2005
Total assets	\$ 116,965	\$ 116,835
Total long-term liabilities	\$ 99,778	\$ 99,566

### Overview of system sales

System sales comprise the gross revenue reported to Second Cup by franchisees of Second Cup cafés (328 as at December 31, 2005), including Cara under its Master Franchise Agreement, and by company-owned cafés (31 as at December 31, 2005), which include two that are operated by franchisees.

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. Furthermore, audits are performed at random by Cara's internal audit team on cafés throughout the Second Cup network.

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

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

the lowest average system sales quarter for the year and the final quarter, which includes the holiday sales periods of November and December, generally constitutes the highest average system sales quarter of the fiscal year.

#### **Analysis of system sales**

System sales for the 52-week period ended December 31, 2005 were \$184,005, compared to \$140,848 for the 40-week period ended January 1, 2005. Same café sales growth for the 52-week period ended December 31, 2005 was 4.6%, compared to same café sales growth of 5.8% for the 40-week period ended January 1, 2005. System sales and same café sales growth were impacted by a number of factors:

- System sales growth benefited from a price increase implemented in the first quarter of 2005. The increase was applied to certain product offerings and accounted for approximately 3.0% of the same café sales growth for the year.
- Second Cup experienced a strong finish to the holiday season with same café sales growth of just under 10% for the month of December 2005 and 5.6% for the fourth quarter. This was driven by a number of Second Cup initiatives, such as a new holiday merchandise line, the launch of the reloadable Second Cup Café Card and an increased focus on serving our guests better.
- System sales also benefited from an improvement in sales mix, driven by stronger premium beverage sales. In particular, based on sales mix information reported by franchisees, the cold blender drinks category experienced an increase in sales mix from an estimated 4.4% of system sales in calendar year 2004 to an estimated 5.7% of system sales in 2005, with strong growth achieved during the summer of 2005.
- System sales and same café sales growth were impacted by the temporary closure of a high-volume café situated in a major Toronto-area retail centre. The café was closed during the second half of the year due to a major mall renovation. This adversely impacted system sales by approximately 0.3% on an annualized basis. The café was reopened prior to the end of the year.
- System wide sales were negatively impacted by a reduction in the number of cafés open during the year (364 for 2005 compared to 374 in the prior period).

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

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

Revenues for the 52-week period ended December 31, 2005 were \$33,664, compared to \$21,860 for the 40-week period ended January 1, 2005. Revenues increased on a comparative basis due mainly to the increased number of cafés operated corporately in the period as discussed further below. Royalty expense as a percentage of system wide sales decreased slightly from 8.1% of total system wide sales for the 40-week period ended January 1, 2005 to 8.0% for the 52-week period ended December 31, 2005 as a result of Second Cup operating more company-owned cafés during the quarter. Excluding sales from company-owned cafés during the period, the effective royalty rate was 8.6% for the current and prior fiscal years.

Sales from company-owned cafés were \$13,466 for the year, versus \$7,261 for the 40-week period ended January 1, 2005. Second Cup operated, on average, 28 company-owned cafés during the year versus 23 in the prior fiscal year. Second Cup ended the period with 31 company-owned cafés (two of which were operated by franchisees), compared to 31 company-owned cafés (three of which were operated by franchisees) as at January 1, 2005.

Other income increased to \$5,447 for the year versus \$3,169 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. The majority of the increase in other income reflects a

full 52 weeks of activities in 2005 versus a comparative period of 40 weeks. Additionally, as a result of improvements made to its supply chain distribution arrangements, the distribution costs to the franchised café network were reduced and purchasing coordination fees earned by the Company were higher and, accordingly, accounted for a large portion of the increase in other income reported in the year.

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

Operating costs and administrative expenses, including expenses of MarksCo of \$348 (\$76 in the prior period), were \$21,877 for the year ended December 31, 2005 versus \$13,401 for the 40-week period ended January 1, 2005. The increase in operating expenses for the period was due mainly to increased costs related to operating company-owned cafés, which rose due to Second Cup operating more company-owned cafés in the period, as discussed in “ - Analysis of revenues from Canadian operations” above.

Amortization of property, plant and equipment amounted to \$591 for the year versus \$424 for the prior year. Again, on a comparative basis, the expense was higher as the Company operated a higher number of company-owned cafés during the year, compared to the prior period. Amortization of the deferred financing charges on the MarksCo term loan amounted to \$93 for the year versus \$7 for the prior year. This is due to the timing of the IPO and related MarksCo term loan in the prior year.

During the year, investment income of \$1,437 was recognized on the 1.4 million units of the Fund held by Second Cup, representing 15% of total outstanding units of the Fund as at December 31, 2005. This is significantly higher than the income of \$118 recorded in the prior year due to the fact that the Fund was not established until late in the prior period.

For the 52-weeks ending December 31, 2005, interest expense of \$9,461 was incurred on the note payable by MarksCo to a subsidiary of the Fund. An additional interest expense of \$574 was incurred due to the bank term loan payable by MarksCo. The comparable expenses for the prior fiscal year (\$806 and \$51) were significantly lower due to the fact that the Fund was not established until late in the prior fiscal year.

Second Cup sold the assets and liabilities of its international operations to Cara in connection with a series of transactions associated with the Fund's IPO in 2004. For the 40-week period ended January 1, 2005, these operations contributed a loss of \$179 before income taxes. With the sale of these operations to Cara in 2004, there was no comparable income or expense in 2005.

Income tax expense for the year was \$799 versus \$2,632 for the previous fiscal year. This represents 31.9% of earnings before income taxes and non-controlling interest in the current period versus 36.0% for the 40-week period ended January 1, 2005. The decrease in the effective income tax rate from the prior year is mainly due to the consolidation of MarksCo, which has a lower effective tax rate than Second Cup. In addition, the rate declined due to a tax provision taken in the prior period as discussed in “Critical Accounting Estimates” below.

Non-controlling interest of \$864 was recorded in the period compared to an amount of \$105 for the prior year. This reflects the earnings of MarksCo attributable to the Fund, which owns 100% of MarksCo. Refer to the change in accounting standard described in “Changes in Accounting Policies Including Initial Adoption” above.

Net earnings for Second Cup were \$842 for the year ended December 31, 2005 versus \$4,579 for the 40-week period ended January 1, 2005.

#### **FOURTH QUARTER OPERATING RESULTS**

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

System sales for the fourth quarter of 2005 were \$61,560 and same café sales growth was 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 a price increase implemented in the first quarter of 2005. The increase was applied to certain product offerings and accounted for approximately 3.0% of the same café sales growth for the fourth quarter.
- Second Cup experienced a strong finish to the holiday season with same café sales growth of just under 10% for the month of December 2005. This was driven by a number of Second Cup initiatives, such as a new holiday merchandise line, the launch of the reloadable Second Cup Café Card and an increased focus on serving our guests better.
- Second Cup's reloadable payment card, the "Second Cup Café Card", was rolled out across its major Canadian markets during the fourth quarter. During the holiday periods of November and December alone, over \$2 million was loaded on to the cards.
- System sales and same café sales growth were impacted by the temporary closure of a high-volume café situated in a major Toronto-area retail centre. The café was closed for most of the quarter due to a major mall renovation. This adversely impacted system sales by approximately 0.6% during the quarter. The café was reopened prior to the end of the year.

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

Revenues for the 16-week period ended December 31, 2005 were \$10,967, compared to \$9,567 for the 16-week period ended January 1, 2005. Revenues increased due to the higher number of cafés operated corporately in the period. Royalty expense as a percentage of system wide sales was constant at 8.1% of total system wide sales for the current and comparative quarter. Excluding sales from company-owned cafés, the effective royalty rate was 8.7% for the quarter ended December 31, 2005 and 8.6% for the comparative quarter.

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

Operating costs and administrative expenses, including expenses of MarksCo of \$65 (\$76 in the prior period) were \$7,127 for the quarter ended December 31, 2005 and \$5,985 for the comparative period. The increase in operating expenses for the period was due mainly to an increase in the number of company-owned cafés.

Amortization of property, plant and equipment amounted to \$202 in the current period versus \$172 for the prior year. Again, the expense was higher as the Company operated a higher number of company-owned cafés during 2005 compared to the prior period. Amortization of the deferred financing charges on the MarksCo term loan amounted to \$24 for the quarter versus \$7 for the prior year. This is due to the timing of the IPO and related MarksCo term loan in the comparative period.

During the quarter, investment income of \$442 was recognized on the units of the Fund held by Second Cup, significantly higher than the \$118 recorded in the prior year due to the fact that the Fund was not established until late in the prior period.

For the 16-weeks ending December 31, 2005, interest expense of \$2,911 was incurred on the note payable by MarksCo to the Fund. In addition, interest expense of \$170 was incurred on the MarksCo term loan during the period. The comparable expense for the fourth quarter of 2004 (\$806 and \$51, respectively) were significantly lower due to the timing of the Fund's establishment in 2004.

Second Cup sold the assets and liabilities of its international operations to Cara in connection with a series of transactions associated with the Fund's IPO in 2004. For the 16-week period ended January 1, 2005, these operations contributed a loss of \$80 before income taxes. With the sale of these operations to Cara in 2004, there was no comparable income or expense in 2005.

Income tax expense for the quarter was \$311 versus \$1,003 for the comparative period. This represents 32.1% of earnings before income taxes and non-controlling interest in the current period versus 38.3% for the comparative period. The decrease in the effective income tax rate from the prior year is mainly due to the consolidation of MarksCo, which has a lower effective tax rate than Second Cup.

Non-controlling interest of \$540 was recorded in the period compared to an amount of \$105 for the prior period. This reflects the earnings of MarksCo attributable to the Fund, which owns 100% of MarksCo. Refer to the change in accounting standard described in “Changes in Accounting Policies Including Initial Adoption” above.

Net earnings for Second Cup were \$119 for the quarter ended December 31, 2005 versus \$1,583 for the quarter ended January 1, 2005.

### 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)	2005				2004 <sup>(1)</sup>			
	Q4 <sup>(2)</sup>	Q3	Q2	Q1	Q4 <sup>(2)</sup>	Q3	Q2	Q1
Number of cafés in Canada at end of period	359	360	365	368	369	372	378	372
Same café sales growth	5.6%	4.3%	4.1%	3.2%	5.2%	6.2%	5.6%	3.2%
System sales - Canada	\$ 61,560	\$ 41,127	\$ 41,719	\$ 39,599	\$ 59,890	\$ 40,071	\$ 40,887	\$ 39,227
Net earnings for the period	\$ 119	\$ 267	\$ 256	\$ 200	\$ 1,583	\$ 1,224	\$ 1,772	\$ 1,491

(1) This consolidated information is of The Second Cup Ltd., incorporated on November 17, 2004, and its predecessor corporation of the same name. For 2004, the predecessor corporation had a fiscal period of 52 weeks ending the Saturday closest to March 31. In addition, the predecessor corporation had a shortened 40-week fiscal period ending January 1, 2005 as a result of the IPO of the Fund. The historical information presented above has been modified to conform with the present corporation’s fiscal period of 52 weeks ending the Saturday closest to January 1.

(2) 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 2004 and 2005 represents the 16 weeks ending January 1, 2005 and December 31, 2005 respectively.

The Company’s fourth quarter system sales are significantly higher than other quarters due to the seasonality of the business (see “Financial Highlights - Seasonality” above) as well as the fact that the fourth quarter consists of 16 weeks of activity, while all other quarters consist of 12 weeks of activity.

The net earnings of the Company were significantly lower throughout 2005 compared to 2004 due to the creation of the Fund, which indirectly collects a royalty from Second Cup through its subsidiary, MarksCo.

### LIQUIDITY AND CAPITAL RESOURCES

Second Cup’s parent company provides group treasury functions for Second Cup on an ongoing basis. As a result, surplus cash generated from Second Cup’s operations and changes in working capital will be advanced to the parent company on a routine basis. See “Related Party Transactions” below.

Cash generated by operating activities was \$208 for the year ended December 31, 2005, compared to \$7,891 for the 40-week period ended January 1, 2005. The reduction in cash from operating activities is mainly a result of the establishment of the Fund and the resulting royalty payable by Second Cup to MarksCo and interest expense from MarksCo to the Fund. In addition, a \$3,500 payment was 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, working capital was impacted by changes in accounts receivable and accrued liabilities which were mainly due to the launch of the Café Card program and other timing differences.

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 of corporate cafés. During the year, investing activities used \$1,352 of cash, as the Company invested in the opening of new cafés, four of which were in the

fourth quarter and were not sold prior to the end of the year. In the prior year, investing activities also included the acquisition of the Second Cup Marks by MarksCo and Second Cup's initial investment in the Fund as part of the Fund's IPO.

During the year, financing activities used cash of \$2,496, compared to cash generated of \$93,486 in the prior year. Current year activities reflect advances of \$1,886 to related parties, primarily by Second Cup to its parent company as part of group treasury functions. In addition, current year activities include payment of \$575 in dividends by MarksCo to its parent company. Prior year activities included repayment by Second Cup's parent company of \$7,445 in advances made previously. Prior year activities also included a number of non-recurring transactions related to the Fund's IPO, including a reorganization of Second Cup's share capital, and issuance by MarksCo of notes and capital shares.

MarksCo has \$12.0 million of credit facilities, which have 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 31, 2005, and a \$1.0 million operating credit facility, which was unused as at December 31, 2005. Certain covenants must be maintained by MarksCo for existing credit facilities to be in good standing, all of which were met as at December 31, 2005. 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					
	2006	2007	2008	2009	2010	AFTER 2010
Minimum lease obligation	15,069	13,421	11,487	9,530	7,065	18,397
Less: Sublease to franchisees	13,582	12,153	10,375	8,443	6,105	13,152
Net lease obligations	1,487	1,268	1,112	1,087	960	5,245

Cash held in trust on behalf of franchisees for marketing, advertising and other co-operative expenditures as at December 31, 2005 amounted to \$1,554, versus \$1,434 as at January 1, 2005, and is not recorded on Second Cup's consolidated balance sheet.

An interest rate swap agreement entered into by MarksCo maturing December 2, 2007, fixes the interest rate on MarksCo's non-revolving credit facility at 5.34% per annum. As at December 31, 2005, the fair value of this contract is a \$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 52-week period ended December 31, 2005, the Company incurred expenses of \$327 (\$1,769 for the 40-week period ended January 1, 2005) for rent and other shared services provided by its parent, Cara. These costs are included in the Company's operating costs and administrative expenses and are net of an administrative charge of \$400 (nil for the 40-week period ended January 1, 2005) charged by Second Cup to Cara for the management of the International operations, which are owned by Cara.

In addition, Second Cup has a master franchise agreement with Cara. Under this agreement, Cara operates 38 Second Cup locations. System sales and royalties earned from these locations for the 52-week period ended December 31, 2005 amounted to \$6,336 and \$317, respectively, compared to amounts of \$4,952 and \$251 for the 40-week period ended January 1, 2005.

In the prior year, there were specific advances due from Cara that bore interest at 3% per annum and were due on demand. The Company earned interest of \$179 for the 40-week period ended January 1, 2005 from these advances. The amounts were repaid during 2004. At December 31, 2005, the Company had an outstanding receivable of \$1,860 (January 1, 2005 - nil) from the parent arising primarily from cash balances held by Cara as part of group treasury functions. This amount is non-interest bearing and is due on demand.

Second Cup earned investment income of \$1,437 during the year (\$118 for the period ended January 1, 2005) on its investment in units of the Fund.

### **MarksCo**

For the 52-week period ended December 31, 2005, interest expense of \$9,461 (\$806 for the 40-week period ended January 1, 2005) was due to the Fund on the MarksCo notes, of which \$806 was payable as at December 31, 2005 and January 1, 2005. In addition, during the period ended December 31, 2005, dividends of \$575 were declared by MarksCo to the Fund (nil for the period ended January 1, 2005).

At December 31, 2005, MarksCo had an outstanding receivable of \$26 due from the Fund (nil at January 1, 2005). 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.

## **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 31, 2005.

**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 the intangible assets at least annually for impairment. Management believes that no impairment of goodwill exists as at December 31, 2005.

**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. It is management's opinion 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. In the prior year, a provision was taken for potential income tax liabilities of Second Cup that are currently under review by the Canada Revenue Agency.

**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 and cash equivalents, 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 value of Second Cup's investment in the Fund is \$13,943. 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 and cash equivalents, accounts receivable and advances to related parties. The Company places its cash and cash equivalents 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 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 caliber, qualified franchisees to operate them.
- A shortage in supply or an increase in the price of premium quality coffee beans could adversely affect Second Cup. Second Cup has no long-term or written contracts with coffee bean suppliers and relies upon historical relationships to ensure availability. While there are a number of coffee bean suppliers, there can be no assurance that coffee bean suppliers that have relationships with Second Cup will continue to supply coffee beans at competitive prices.
- The specialty coffee industry is also affected by changes in discretionary spending patterns, demographic trends, and traffic and weather patterns as well as the type, number and location of competing cafés.
- Second Cup's business could be adversely affected by reduced consumer confidence and increased concerns about food safety in general, or other unusual events.
- 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).

#### **ADJUSTMENT TO THE ROYALTY POOL**

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. 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.

On January 1, 2006, nine Second Cup cafés were added to the Royalty Pool, of which three cafés were operational at the Fund's inception, but had been excluded from the initial Royalty Pool due to uncertainty as to their future operational status. These locations have now secured long-term lease commitments, making them suitable for inclusion in the Royalty Pool. The system sales of these nine cafés added to the Royalty Pool has been estimated at \$4.06 million annually. These were offset by \$2.91 million 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.

As a result of this adjustment to the Royalty Pool, the Fund expects to make a payment of \$685 to Second Cup and expects to satisfy this obligation by the issuance of units. On January 1, 2006 the Fund issued 55,316 units representing 80% of this payment based on forecast net system sales. After a full year of performance of the new cafés, the Fund expects to issue additional units to satisfy the remaining obligation.

## **SUBSEQUENT EVENTS**

On January 1, 2006, an additional 55,316 units were issued to Second Cup by the Fund (see “Adjustment to the Royalty Pool” above). As a result of this adjustment, Second Cup’s ownership share in the Fund increased to 1,492,730 Units, representing approximately 15.5% of the issued and outstanding Units of the Fund.

## **OUTLOOK**

During 2005, Second Cup made significant progress in implementing its previously announced strategies, aimed at increasing same café sales growth and expanding the number of Second Cup cafés across Canada. This is evidenced by same café sales growth of 4.6% for the year, following the achievement of 5.8% same café sales growth in the 40-week period ended January 1, 2005. Subject to healthy economic conditions continuing across the Company’s primary markets, the Company expects to achieve same café sales growth of approximately 3% to 5% for the 2006 fiscal year. To this end, the Company has a number of ongoing initiatives aimed at strengthening the long-term success of Second Cup and its franchise partners:

- In October 2005, Second Cup completed the rollout of the Second Cup Café Card across its major Canadian markets. The card allows customers to load a dollar amount on the card at a café and redeem it not only for their daily purchases at participating cafés, but also at Cara Operations Limited restaurant brands including Harvey’s, Swiss Chalet, Kelsey’s, Milestone’s and Montana’s. During the Holiday periods of November and December alone, over \$2 million was loaded on to the cards. The Company intends to benefit from a full year of the Café Card program by featuring it in many of the promotions and themes planned for 2006, allowing the Company significant opportunity for sales growth.
- As part of its commitment to focus on premium products, Second Cup launched its reformulated latte in the fourth quarter of 2005. The new recipe was launched with significant print advertising and media coverage in the fourth quarter of 2005 and consumer reception has been positive. The Company intends to build on this success by launching a number of new premium beverages during 2006.
- In an effort to raise sales of non-beverage product categories, the Company’s promotional strategies for 2006 will feature complementary pairings of seasonal foods and merchandise combined with a featured premium beverage. Second Cup will also be selectively adding to its offerings of ready-to-serve beverages, seasonal merchandise and snack food items, including an expanded sandwich program in select cafés.
- During 2006, Second Cup will also be investing significantly in revamping the training and development it offers to its franchisees and café support staff. This will include an emphasis on leveraging technology in delivering knowledge across the Second Cup café network. The increased focus on training and development is expected to raise overall business capabilities and generate long-term value for the Company and its partners.

The Company is projecting moderate price increases on select product offerings later in 2006. The level of price increases will be dependent on various competitive factors and is not expected to reach the level experienced in 2005.

The Company completed the renovation of 15 existing cafés and opened six new cafés in Canada during 2005. Newly-renovated cafés typically experience above-average same café sales growth and the company has in excess of 70 cafés due for renovation in the next three years. Accordingly, development of the Second Cup café network has been and continues to be a strategic initiative for the Company.

To that end, the Company expects to renovate and modernize approximately 20 cafés during 2006. In terms of network expansion, Second Cup expects to open approximately 15 to 20 new cafés in Canada during the 2006 fiscal year. However, as part of its ongoing efforts to raise the Company’s competitive position, Second Cup also expects to permanently close 12 to 15 cafés during 2006, the majority of which have sales below the average performance of all Second Cup cafés.

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 2006.

#### **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, 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 “Risk and Uncertainties”.

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 2006 and that inflation will remain relatively low. The Company has also assumed that interest rates will gradually increase in 2006 and that demand for specialty coffee will be comparable with demand in 2005.

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.

## CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2005

March 7, 2006

### AUDITORS' REPORT

**To the Directors of The Second Cup Ltd.**

We have audited the consolidated balance sheets of **The Second Cup Ltd.** as at December 31, 2005 and January 1, 2005 and the consolidated statements of earnings and deficit and cash flows for the 52-week period ended December 31, 2005 and for the 40-week period ended January 1, 2005. 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 31, 2005 and January 1, 2005 and the results of its operations and its cash flows for the 52-week period ended December 31, 2005 and for the 40-week period ended January 1, 2005 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 31, 2005	JANUARY 1, 2005 (AS RESTATED, NOTE 3)
<b>Assets</b>		
<b>CURRENT ASSETS</b>		
Cash and cash equivalents	\$ 625	\$ 4,265
Accounts receivable	2,830	1,898
Inventories (note 5)	272	238
Future income taxes (note 13)	138	231
Prepaid expenses and sundry assets	255	284
Due from related parties (note 16)	1,886	-
Income taxes recoverable	207	-
	<hr/> 6,213	<hr/> 6,916
Deferred financing charges (note 6)	178	235
Property, plant and equipment (note 7)	3,220	2,393
Investment in Second Cup Royalty Income Fund (notes 8 and 16)	14,374	14,374
Trademarks	88,019	88,019
Goodwill	4,898	4,898
Future income taxes (note 13)	63	-
	<hr/> \$ 116,965	<hr/> \$ 116,835
<b>Liabilities</b>		
<b>CURRENT LIABILITIES</b>		
Accounts payable and accrued liabilities	\$ 5,702	\$ 3,871
Interest payable to Second Cup Royalty Income Fund (note 16)	806	806
Deposits from franchisees	782	266
Income taxes payable	-	3,554
	<hr/> 7,290	<hr/> 8,497
MarksCo term loan (notes 10 and 16)	11,000	11,000
MarksCo note payable to the Fund (notes 11 and 16)	78,246	78,246
Future income taxes (note 13)	10,532	10,320
	<hr/> 107,068	<hr/> 108,063
Non-controlling interest in MarksCo Inc. (note 9)	1,413	1,130
	<hr/> 108,481	<hr/> 109,193
<b>SHAREHOLDERS' EQUITY</b>		
Capital stock (note 12)	19,724	19,724
Deficit	(11,240)	(12,082)
	<hr/> 8,484	<hr/> 7,642
	<hr/> \$ 116,965	<hr/> \$ 116,835
Change in accounting standard (note 3)		
Contingencies, contracts and guarantees (note 15)		
See accompanying notes to consolidated financial statements.		

**APPROVED BY THE BOARD OF DIRECTORS**

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

(Signed) Michael Forsayeth  
 \_\_\_\_\_  
 Director

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

	<b>52 WEEKS ENDED DECEMBER 31, 2005</b>	<b>40 WEEKS ENDED JANUARY 1, 2005</b>
<b>SYSTEM SALES</b> - Canada (note 16)	\$ 184,005	\$ 140,848
<b>REVENUE</b>		
Royalty revenue (note 16)	\$ 14,751	\$ 11,430
Revenue from Company-owned cafés	13,466	7,261
Other income (note 16)	5,447	3,169
	<u>33,664</u>	<u>21,860</u>
<b>EXPENSES</b>		
Operating costs and administrative expenses (note 16)	21,877	13,401
Amortization of property, plant and equipment	591	424
Amortization of deferred financing charges	93	7
MarksCo interest expense on notes due to Fund (notes 11 and 16)	9,461	806
MarksCo interest expense on term loan (notes 10 and 16)	574	51
	<u>32,596</u>	<u>14,689</u>
	1,068	7,171
Other interest income (note 16)	-	206
Investment income (notes 8 and 16)	1,437	118
International operations - net	-	(179)
	<u>2,505</u>	<u>7,316</u>
<b>EARNINGS BEFORE INCOME TAXES AND NON-CONTROLLING INTEREST</b>	<b>2,505</b>	<b>7,316</b>
Income taxes (note 13)		
Current	556	2,557
Future	243	75
	<u>799</u>	<u>2,632</u>
<b>EARNINGS BEFORE NON-CONTROLLING INTEREST</b>	<b>1,706</b>	<b>4,684</b>
Non-controlling interest in MarksCo (note 9)	864	105
	<u>842</u>	<u>4,579</u>
<b>NET EARNINGS</b>	<b>\$ 842</b>	<b>\$ 4,579</b>

Change in accounting standard (note 3)  
See accompanying notes to consolidated financial statements.

The Second Cup Ltd.

CONSOLIDATED STATEMENTS OF DEFICIT

(EXPRESSED IN THOUSANDS OF DOLLARS)

	52 WEEKS ENDED DECEMBER 31, 2005	40 WEEKS ENDED JANUARY 1, 2005
<b>DEFICIT - BEGINNING OF PERIOD</b>	\$ (12,082)	\$ (45,930)
Reorganization (note 2)	-	41,463
Change in accounting standard (note 3)	-	(12,194)
Net earnings	842	4,579
<b>DEFICIT - END OF PERIOD</b>	<u>\$ (11,240)</u>	<u>\$ (12,082)</u>

See accompanying notes to consolidated financial statements.

The Second Cup Ltd.

CONSOLIDATED STATEMENTS OF CASH FLOWS

(EXPRESSED IN THOUSANDS OF DOLLARS)

	52 WEEKS ENDED DECEMBER 31, 2005	40 WEEKS ENDED JANUARY 1, 2005
<b>Cash provided by (used in)</b>		
<b>OPERATING ACTIVITIES</b>		
Net earnings for the period	\$ 842	\$ 4,579
Items not involving cash		
Non-controlling interest	864	105
Amortization expense	684	431
Future income taxes	242	75
(Gain) loss on disposal of property, plant and equipment	(67)	4
(Decrease) increase in non-cash working capital (note 17)	(2,357)	2,697
	208	7,891
<b>INVESTING ACTIVITIES</b>		
Purchase of property, plant and equipment	(1,960)	(1,509)
Proceeds from disposal of property, plant and equipment	608	281
Purchase of investment in Second Cup Royalty Income Fund	-	(14,374)
Acquisition of Second Cup Marks	-	(83,440)
	(1,352)	(99,042)
<b>FINANCING ACTIVITIES</b>		
Advances to related parties - net (note 16)	(1,886)	7,445
Dividends paid to non-controlling interest (notes 9 and 16)	(575)	-
Deferred financing charges	(35)	-
Issuance of capital stock	-	19,724
Reorganization (note 2)	-	6,511
Repayment of capital stock	-	(27,134)
Issuance of MarksCo notes	-	78,246
Issuance of MarksCo capital stock	-	8,694
	(2,496)	93,486
<b>(DECREASE) INCREASE IN CASH AND CASH EQUIVALENTS DURING THE PERIOD</b>	(3,640)	2,335
<b>CASH AND CASH EQUIVALENTS - BEGINNING OF PERIOD</b>	4,265	1,930
<b>CASH AND CASH EQUIVALENTS - END OF PERIOD</b>	\$ 625	\$ 4,265

Change in accounting standard (note 3)

See accompanying notes to consolidated financial statements.

# The Second Cup Ltd.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

DECEMBER 31, 2005 AND JANUARY 1, 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 359 cafés in Canada as of December 31, 2005, of which 31 are Company-owned (January 1, 2005 - 369 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 of brewed coffee, espresso-based beverages, blender drinks, whole beans, baked goods and coffee-related merchandise.

Second Cup Trade-Marks Inc. ("MarksCo") is a wholly-owned subsidiary of the Second Cup Royalty Income Fund (the "Fund"). The business of MarksCo is the ownership of the Second Cup trademarks and, through the Licence and Royalty Agreement (the "Agreement") with Second Cup, the taking of actions to exploit the use of the Second Cup trade-marks and the collection of the royalty payable under the Agreement. As discussed in note 3 below, MarksCo, while a wholly-owned subsidiary of the Fund, is consolidated in these financial statements.

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

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

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

In connection with this series of transactions, the Fund filed a prospectus on November 23, 2004. The net proceeds of the offering were used to acquire the issued and outstanding share capital of MarksCo on December 2, 2004. At this time Second Cup also acquired 1,437,414 units in the Fund for an aggregate cash cost of \$14,374. This represented a 15% interest in the Fund. Second Cup agreed not to sell, without the consent of the Fund or the underwriters, any of these initial units acquired for a period of two years following their initial acquisition, except in certain limited circumstances.

As mentioned above, Second Cup acquired the Canadian Assets on November 26, 2004 in exchange for cash consideration of \$5,350. Since the Canadian Assets were acquired from another entity, which at the time was under

# The Second Cup Ltd.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

DECEMBER 31, 2005 AND JANUARY 1, 2005

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

common control, the acquired assets are recorded in these consolidated financial statements at their historical carrying amounts as follows:

Cash	\$ 207
Accounts receivable	1,528
Prepaid expenses	446
Inventories	274
Amount due from Cara	167
Property, plant and equipment	2,352
Goodwill <sup>(i)</sup>	4,898
Accounts payable and accrued liabilities	(4,522)
Net assets acquired	<u>\$ 5,350</u>

(i) Prior to the reorganization, goodwill was carried at an amount of \$8,149 in the Predecessor Corporation. As a result of the transfer of the assets, an external valuation was prepared that indicated that the remaining goodwill had a fair value of \$4,898. Accordingly, the Predecessor Corporation recorded the change in valuation as a reorganization charge to retained earnings.

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

Predecessor Corporation deficit <sup>(i)</sup>	\$ 3,979
Predecessor Corporation share capital	37,678
Income tax adjustment - net	(194)
	<u>\$ 41,463</u>

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

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

	40 WEEKS ENDED JANUARY 1, 2005
Revenue	\$ 143
Loss before taxation	\$ (179)

# The Second Cup Ltd.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

DECEMBER 31, 2005 AND JANUARY 1, 2005

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

### 3. CHANGE IN ACCOUNTING STANDARD

Effective January 2, 2005, the Fund adopted Accounting Guideline 15 (“AcG-15”), a new pronouncement of The Canadian Institute of Chartered Accountants 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 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 variable interest entity, that owns the Second Cup Marks. MarksCo has, through the Agreement, licensed these trademarks to Second Cup, 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 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 results of MarksCo. Previously, the Fund consolidated the financial results of MarksCo.

The adoption of this new pronouncement has resulted in MarksCo being consolidated by the Company. This change has been applied retroactively and prior year amounts have been restated to include the results of MarksCo. The effect on the consolidated balance sheet at January 1, 2005 was the inclusion of a trademark of \$88.0 million, related tax liability of \$10.2 million, deferred financing fees of \$0.2 million, notes payable to the Fund of \$78.2 million, term loan of \$11.0 million, and non-controlling interests of \$1.1 million, an increase in net working capital of \$0.1 million and deficit of \$12.2 million. As a result of the Company consolidating MarksCo, the consolidated financial statements eliminate 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 owned completely by the Fund.

As a result of a clarification of the tax status and applicable tax rates of MarksCo, the value of the trademark and the related future income tax liability have been revised from previously disclosed amounts to reflect a more favourable effective tax rate. This resulted in a decrease in the trademark and related tax liability of \$3.1 million.

#### **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.

### 4. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

#### **a. Consolidation**

These consolidated financial statements include the accounts of the Company and MarksCo, a wholly-owned subsidiary of the Fund. All intercompany accounts and transactions have been eliminated on consolidation. These consolidated financial statements have been prepared in accordance with Canadian generally accepted accounting principles.

# The Second Cup Ltd.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

DECEMBER 31, 2005 AND JANUARY 1, 2005

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

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

### **b. Fiscal year**

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

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

### **c. Use of estimates**

The preparation of these consolidated financial statements 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. Master franchise fees are recognized as income when the agreement has been signed and all material conditions have been met. Other income includes purchasing co-ordination fees, café resale fees, new term fees, construction administration fees and initial franchise fees, which are recognized as income once all significant conditions have been met.

### **f. Cash and cash equivalents**

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

### **g. 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.

### **h. Investment in the Fund**

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

### **i. Variable interest entities**

On January 2, 2005, the Company adopted the requirements of AcG-15 (see note 2 above). AcG-15 requires consolidation of VIE's 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 subsidiary of the Fund, and determined that the Company is the primary beneficiary at December 31, 2005 and should consolidate MarksCo.

# The Second Cup Ltd.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

DECEMBER 31, 2005 AND JANUARY 1, 2005

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

### **j. Trademarks**

Trademarks, trade names, operating procedures and systems and other intellectual property used in connection with the operation of the Second Cup cafés in Canada (collectively the “Second Cup Marks”) are recorded at the historical cost to Second Cup. 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.

### **k. Goodwill**

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

### **l. Property, plant and equipment**

Property, plant and equipment 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:

Lease 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

### **m. Impairment of long-lived assets**

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

### **n. Deferred financing charges**

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

### **o. 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.

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

Accounts payable and accrued liabilities include \$1,733 and \$1,073 of liabilities related to unredeemed gift certificates and unused balances on Second Cup Café Cards at December 31, 2005 and January 1, 2005 respectively.

# The Second Cup Ltd.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

DECEMBER 31, 2005 AND JANUARY 1, 2005

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

### q. 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.

### r. 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 balance sheet at fair value. Changes in fair value are recorded as an income or expense in the statement of earnings.

### s. Financial instruments

#### *Fair values*

The Company's financial instruments consist of cash and cash equivalents, 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 value of Second Cup's investment in the Fund is \$13,943 (January 1, 2005 - \$17,062). 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 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 and cash equivalents, accounts receivable and advances to related parties. The Company places its cash and cash equivalents with institutions of high creditworthiness. The Company's accounts receivable primarily comprise amounts due from franchises and management believes that its accounts receivable credit risk exposure is limited. Advances to related parties are also believed to have limited risk exposure based on the creditworthiness of the parent company and the Fund.

## 5. INVENTORIES

	DECEMBER 31, 2005	JANUARY 1, 2005
Merchandise held for resale	\$ 217	\$ 186
Supplies	55	52
	<hr/>	<hr/>
	\$ 272	\$ 238

The Second Cup Ltd.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

DECEMBER 31, 2005 AND JANUARY 1, 2005

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

**6. DEFERRED CHARGES**

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

	DECEMBER 31, 2005	JANUARY 1, 2005
Cost	\$ 277	\$ 242
Accumulated Amortization	99	7
Net	<u>\$ 178</u>	<u>\$ 235</u>

Amortization of deferred charges for the fiscal period ended December 31, 2005 was \$93 (period ended January 1, 2005 - \$7).

**7. PROPERTY, PLANT AND EQUIPMENT**

	DECEMBER 31, 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
	<u>\$ 7,008</u>	<u>\$ 3,788</u>	<u>\$ 3,220</u>
	JANUARY 1, 2005		
	COST	ACCUMULATED AMORTIZATION	NET
Leasehold improvements	\$ 2,654	\$ 1,293	\$ 1,361
Equipment, furniture, fixtures and other	1,898	904	994
Computer software and hardware	1,145	1,107	38
	<u>\$ 5,697</u>	<u>\$ 3,304</u>	<u>\$ 2,393</u>

Amortization of property, plant and equipment for the fiscal period ended December 31, 2005 was \$591 (period ended January 1, 2005 - \$424).

# The Second Cup Ltd.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

DECEMBER 31, 2005 AND JANUARY 1, 2005

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

### 8. INVESTMENT IN SECOND CUP ROYALTY INCOME FUND

The Company's investment in Second Cup Royalty Income Fund consists of ownership of 1,437,414 Fund units as at December 31, 2005 and January 1, 2005.

	DECEMBER 31, 2005	JANUARY 1, 2005
Units of the Fund	\$ 14,374	\$ 14,374
Income earned on investment during the period thus ended	\$ 1,437	\$ 118

The value of this investment based on the closing trading price on the Toronto Stock Exchange as at December 31, 2005 was \$13,943 (January 1, 2005 - \$17,062).

### 9. MARKSCO: NON-CONTROLLING INTEREST

	52 WEEKS ENDED DECEMBER 31, 2005	40 WEEKS ENDED JANUARY 1, 2005
Balance - beginning of period	\$ 1,130	\$ 1,025
Earnings: non-controlling interest	864	105
Less:		
Dividends paid to non-controlling interest	(575)	-
Change in refundable taxes	(6)	-
	\$ 1,413	\$ 1,130

### 10. MARKSCO: 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. The credit facilities total \$12.0 million and are comprised of an \$11.0 million non-revolving term credit facility, and a \$1.0 million operating credit facility.

The \$11.0 million non-revolving credit facility bears interest at prime or base rate plus 0.75% or LIBOR advances or banker's acceptances plus 1.75%. At December 31, 2005, the full amount of the \$11.0 million non-revolving credit facility was drawn with an effective interest rate of 5.34% after taking into consideration the interest rate swap described below.

The \$1.0 million operating credit facility bears interest at prime or base rate plus 0.50% or LIBOR advances or banker's acceptance plus 1.50%. At December 31, 2005, no advances had been drawn on this facility.

On December 2, 2004, MarksCo entered into an interest rate swap agreement to fix the interest rate on the \$11.0 million non-revolving credit facility loan at 3.59% plus the variable margin noted above until December 2, 2007. The differential the Company would receive to hypothetically terminate or exchange its interest rate swap contract in the prevailing market conditions net of accrued interest is estimated at \$97.

# The Second Cup Ltd.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

DECEMBER 31, 2005 AND JANUARY 1, 2005

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

### 11. MARKSCO: NOTE PAYABLE TO SECOND CUP ROYALTY INCOME FUND

The note payable to the Fund of \$78,246 bears interest at 12.125% and matures December 2, 2014. During the year, interest of \$9,461 was accrued and paid under this note (period ended January 1, 2005 - \$806).

### 12. CAPITAL STOCK

#### AUTHORIZED

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

#### ISSUED COMMON SHARES

	NUMBER OF SHARES (THOUSANDS)		AMOUNT
Balance as at March 27, 2004	9,760	\$	64,812
Return of capital	-		(27,134)
Reorganization	(9,760)		(37,678)
Issuance of new share capital	19,724		19,724
Balance as at January 1, 2005	19,724	\$	19,724
Balance as at December 31, 2005	19,724	\$	19,724

### 13. INCOME TAXES

	52 WEEKS ENDED DECEMBER 31, 2005		40 WEEKS ENDED JANUARY 1, 2005
Earnings before income taxes and non-controlling interest	\$ 2,505	\$	7,316
Combined Canadian statutory income tax rates	35.14%		35.52%
Income taxes at combined statutory income tax rates	880		2,599
Expenses not deductible for income tax purposes	40		33
Difference in income tax rates applicable to MarksCo	(133)		-
Other	12		-
Income tax expense	\$ 799	\$	2,632

# The Second Cup Ltd.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

DECEMBER 31, 2005 AND JANUARY 1, 2005

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

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

	DECEMBER 31, 2005	JANUARY 1, 2005
Property, plant and equipment	\$ 53	\$ -
Provisions and accrued expenses	96	231
Goodwill	(178)	(130)
Deferred financing charges	9	1
Second Cup Marks	(10,311)	(10,191)
Net future income tax liability	<u>\$ (10,331)</u>	<u>\$ (10,089)</u>
Classified as		
Current asset	\$ 138	\$ 231
Long-term asset	63	-
Long-term liability	(10,532)	(10,320)
	<u>\$ (10,331)</u>	<u>\$ (10,089)</u>

### 14. CASH HELD IN TRUST

Cash held in trust on behalf of franchisees for marketing, advertising and other co-operative expenditures at December 31, 2005 amounted to \$1,554 (January 1, 2005 - \$1,434) and is not recorded on the Company's consolidated balance sheets.

### 15. CONTINGENCIES, COMMITMENTS AND GUARANTEES

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

	LEASE COMMITMENTS	SUBLEASE TO FRANCHISEES	NET
2006	\$ 15,069	\$ 13,582	\$ 1,487
2007	13,421	12,153	1,268
2008	11,487	10,375	1,112
2009	9,530	8,443	1,087
2010	7,065	6,105	960
Thereafter	18,397	13,152	5,245
	<u>\$ 74,969</u>	<u>\$ 63,810</u>	<u>\$ 11,159</u>

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

## The Second Cup Ltd.

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

DECEMBER 31, 2005 AND JANUARY 1, 2005

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

required to make a payment of \$454 at December 31, 2005. This amount decreases over the remaining life of the contract. In addition, the Company would be required to make a payment based on the earnings of the key supplier under the contract and may be required to fulfill certain outstanding purchase obligations that the supplier may enter into from time to time. The Company would take steps to ensure there was an orderly transition to a new supplier. At this time, management is of the view that the likelihood of any such payment is remote.

The Company is involved in litigation 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. It is management's opinion 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.

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

#### 16. RELATED PARTY TRANSACTIONS AND BALANCES

##### Second Cup

For the 52-week period ended December 31, 2005, the Company incurred expenses of \$327 (\$1,769 for the 40-week period ended January 1, 2005) for rent and other shared services provided by its 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 \$400 (nil for the 40-week period ended January 1, 2005) charged by Second Cup to Cara for the management of the International operations, which are owned by Cara.

In addition, Second Cup has a master franchise agreement with Cara. Under this agreement, Cara operates 38 Second Cup locations. System sales and royalties earned from these locations for the 52-week period ended December 31, 2005 amounted to \$6,336 and \$317, respectively, compared to amounts of \$4,952 and \$251 for the 40-week period ended January 1, 2005.

In the prior year, there were specific advances due from Cara that bore interest at 3% per annum and were due on demand. The Company earned interest of \$179 for the 40-week period ended January 1, 2005 from these advances. The amounts were repaid during 2004. At December 31, 2005, the Company had an outstanding receivable of \$1,860 (January 1, 2005 - nil) from the parent arising primarily from cash balances held by Cara as part of group treasury functions. This amount is non-interest bearing and is due on demand.

Second Cup earned investment income of \$1,437 during the year (\$118 for the period ended January 1, 2005) on its investment in units of the Fund.

##### MarksCo

For the 52-week period ended December 31, 2005, interest expense of \$9,461 (\$806 for the 40-week period ended January 1, 2005) was due to the Fund on the MarksCo notes, of which \$806 was payable as at December 31, 2005 and

# The Second Cup Ltd.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

DECEMBER 31, 2005 AND JANUARY 1, 2005

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

January 1, 2005. In addition, during the period ended December 31, 2005, dividends of \$575 were declared by MarksCo to the Fund (nil for the period ended January 1, 2005).

At December 31, 2005, MarksCo had an outstanding receivable of \$26 due from the Fund (nil at January 1, 2005). 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.

### 17. SUPPLEMENTARY CASH FLOW INFORMATION

Changes in non-cash working capital items:

	52 WEEKS ENDED DECEMBER 31, 2005	40 WEEKS ENDED JANUARY 1, 2005
Accounts receivable	\$ (932)	\$ 3
Inventories	(34)	(78)
Prepaid expenses and sundry assets	29	(44)
Income taxes recoverable	(207)	-
Accounts payable and accrued liabilities	1,831	1,774
Interest payable to the Fund	-	806
Deposits	516	(196)
Income taxes payable	(3,554)	432
Refundable taxes (see note 9)	(6)	-
	<hr/>	<hr/>
	\$ (2,357)	\$ 2,697
Supplementary information:		
Interest paid	\$ 10,044	\$ 27
Income taxes paid	\$ 4,454	\$ 2,436

### 18. SUBSEQUENT EVENT

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. In return for adding cafés to the Royalty Pool, Second Cup is entitled to be paid an amount which 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.

On January 1, 2006, nine Second Cup cafés were added to the Royalty Pool, of which three cafés were operational at the Fund's inception, but had been excluded from the initial Royalty Pool due to uncertainty as to their future

The Second Cup Ltd.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

DECEMBER 31, 2005 AND JANUARY 1, 2005

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

operational status. These locations have now secured long-term lease commitments, making them suitable for inclusion in the Royalty Pool. The system sales of these nine cafés added to the Royalty Pool has been estimated at \$4.06 million annually. These were offset by \$2.91 million 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.

As a result of this adjustment to the Royalty Pool, the Fund expects to make a payment of \$685 to Second Cup and expects to satisfy this obligation by the issuance of units. On January 1, 2006, the Fund issued 55,316 units representing 80% of this payment based on forecast net system sales. After a full year of performance of the new cafés, the Fund expects to issue additional units to satisfy the remaining obligation.

### 19. PRIOR YEAR COMPARATIVES

Prior year comparatives have been restated to conform with current year's presentation.

# Second Cup Royalty Income Fund

## UNITHOLDER INFORMATION

### **CORPORATE HEAD OFFICE**

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

### **MAILING ADDRESS**

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

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

#### **Board of Trustees**

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

### **SECOND CUP TRADE-MARKS INC.**

#### **Board of Directors**

David Bloom<sup>(2)</sup>  
Chairman  
  
Michael Rosicki<sup>(2)</sup>  
Raymond Guyatt<sup>(2)</sup>  
Gabriel Tsampalieros  
J. Bruce Elliot

#### **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

### **Investor Enquiries**

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### **Website:**

[www.secondcupincomefund.com](http://www.secondcupincomefund.com)