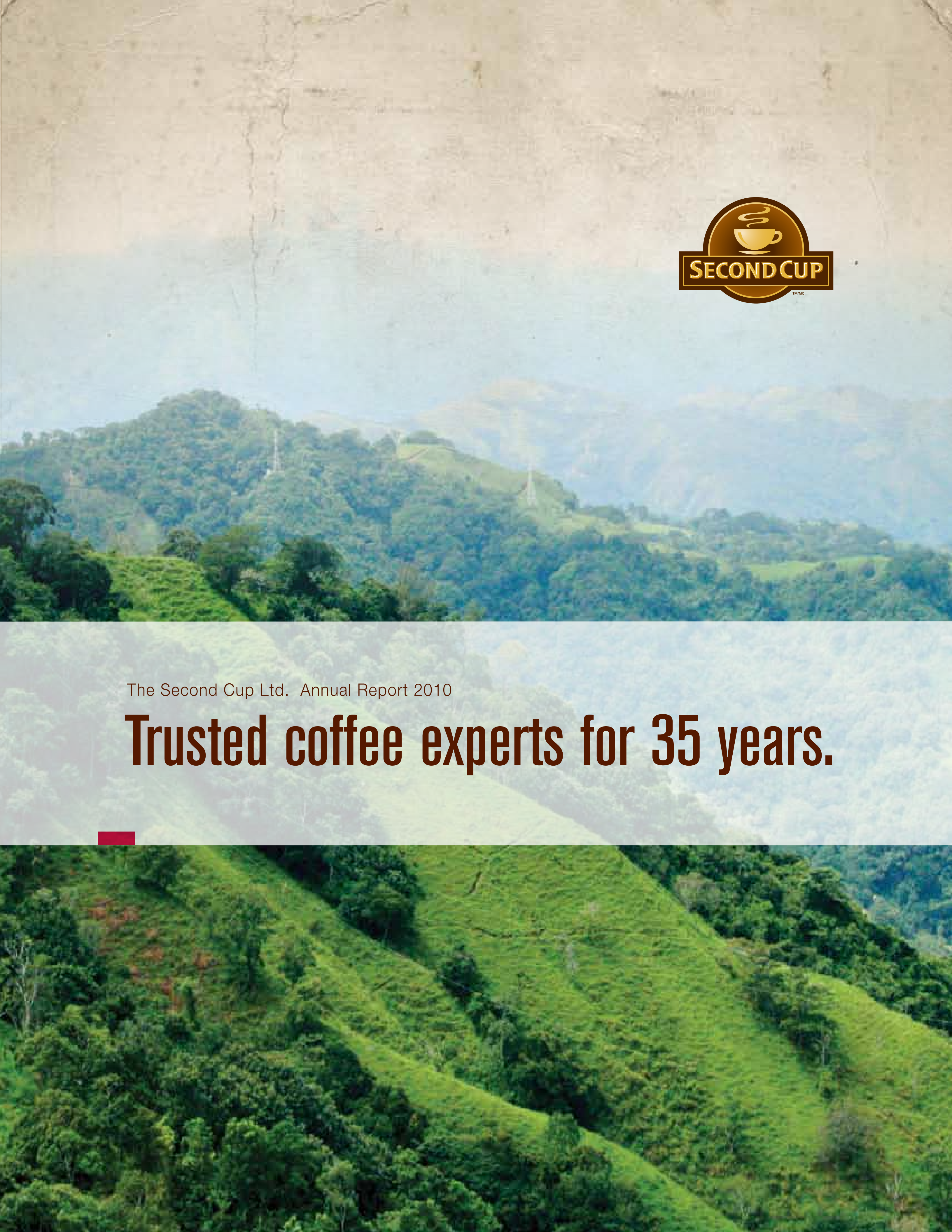


The Second Cup Ltd. Annual Report 2010

# Trusted coffee experts for 35 years.

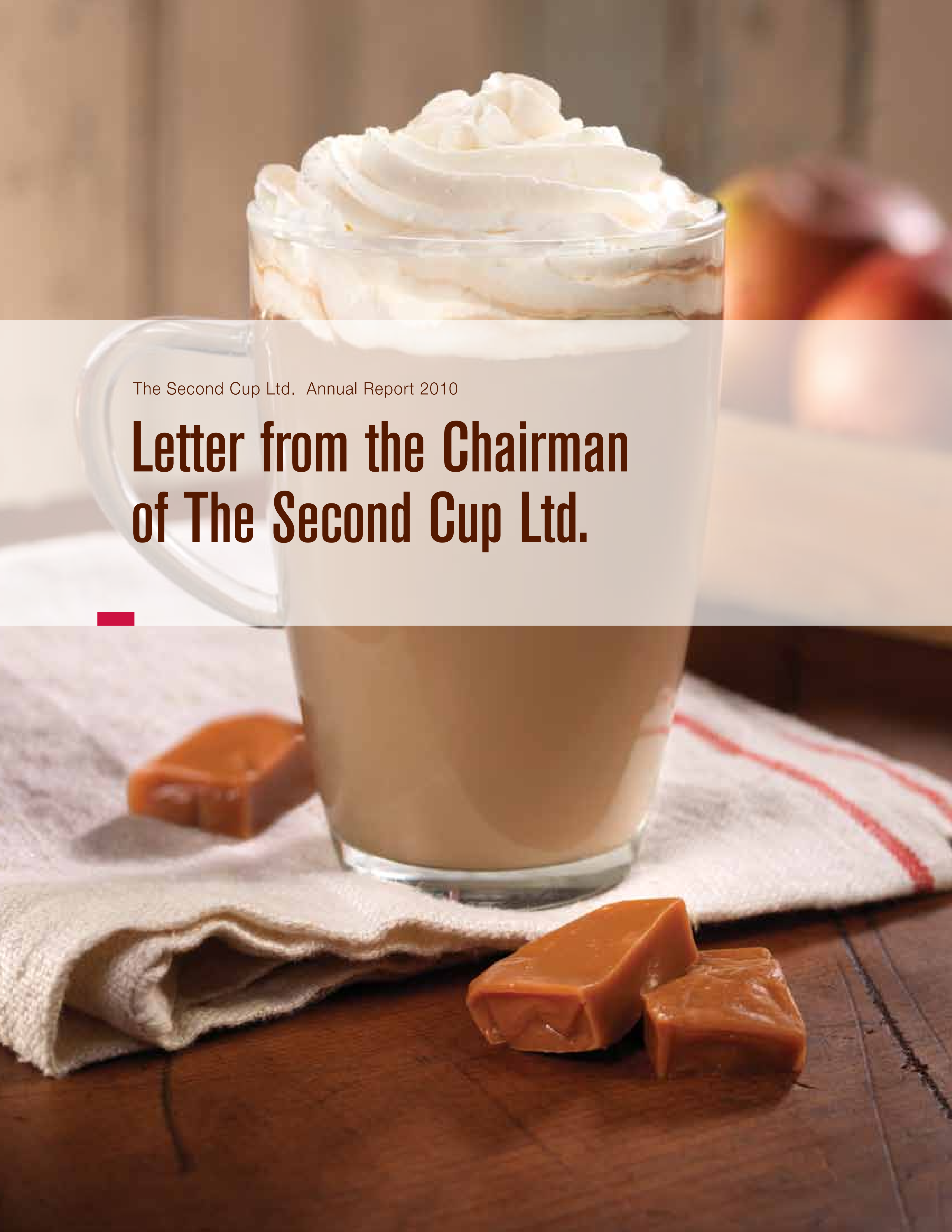
The Second Cup Ltd. Annual Report 2010

# We're the coffee company that cares.

# Contents

The Second Cup Ltd. Annual Report 2010

# Letter from the Chairman of The Second Cup Ltd.



**Michael Rosicki, Chairman**

On behalf of the Board of Directors of The Second Cup Ltd. ("Second Cup"), I am pleased to present our Annual Report for the fiscal year ended December 31, 2010. All amounts are expressed in thousands of dollars, except units, unless otherwise indicated.

Following the successful conversion to a corporation, the objective of Second Cup's dividend policy is to achieve a payout ratio of 75% to 85% of net earnings, on a normalized basis.

## HIGHLIGHTS

We are pleased to report that Second Cup Income Fund (the "Fund") completed the previously announced plan of arrangement pursuant to which the Fund's income trust structure has been converted into a dividend paying publicly traded corporation named The Second Cup Ltd. The conversion of the Fund to a corporate structure was approved by a majority of unitholders at the annual and special meeting of the unitholders of the Fund held on June 2, 2010. Effective January 1, 2011, unitholders of the Fund received, for each unit of the Fund held, one common share of Second Cup. The common shares of Second Cup commenced trading on the Toronto Stock Exchange on January 4, 2011 under the symbol "SCU".

The 2010 results represent the first year that the Fund included Second Cup for a full year, subsequent to the acquisition of Second Cup in June 2009. As a result, the earnings for 2010 are not directly comparable to 2009. Normalized net earnings per unit for the year were $1.00 compared to $1.09 in 2009, reflecting a decline of 8.9% (excluding the future income tax recovery in 2009 and 2010 and the transaction and conversion costs in 2009 and 2010, respectively).

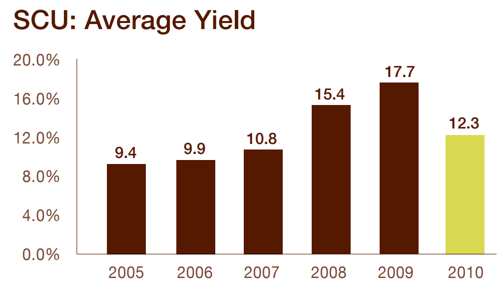
## DISTRIBUTABLE CASH

Distributable cash for the year was $11,200, or $1.14 per unit compared to $9,680, or $0.98 per unit in

2009. This increase is primarily due to the changes in non-cash working capital. Changes in non-cash working capital are primarily due to the timing of vendor payments and receipts of royalties. Excluding the impact of changes in non-cash working capital, distributable cash would have been $9,899, or $1.00 per unit, compared to $10,514, or $1.07 per unit for 2009, a decrease of 5.8%.

## DIVIDENDS

During 2010 we paid out 91.7% (2009 89.6%) of our distributable cash (excluding changes in non-cash working capital) and we continued to offer our shareholders a high yield, which averaged 12.3% in 2010. The Second Cup Board of Directors has approved a current dividend policy whereby Second Cup will pay a quarterly dividend at an initial rate of $0.15 per common share. The dividend policy was developed to continue to pay out a substantial portion of earnings while retaining a sufficient amount to adequately fund organic growth initiatives. The objective of the dividend policy post conversion is to reflect a payout ratio of approximately 75% to 85% of net earnings per share, on a normalized basis.




In closing, we would like to take this opportunity to thank our shareholders for their continued support, the talented Second Cup management team, my fellow directors, and most importantly, our network of very capable franchise partners and their associates, who by delivering a superior customer experience everyday, will ensure that Second Cup optimizes every opportunity to achieve stronger sales and earnings results for 2011 and beyond.

Our smooth and creamy lattes are carefully crafted, made with hand-steamed milk and hand-tamped espresso shots.

Michael Rosicki
Chairman, The Second Cup Ltd.
on behalf of the Board of Directors
April 8, 2011

Guests can feel good knowing our espresso beans are Rainforest Alliance Certified to help improve the lives, land and livelihood of coffee-growing communities.

All 24 of our brewed coffees are made from 100% arabica, shade grown coffees that are fairly traded and grown under best practices.

Frrrozen Hot Chocolate™ is one of Second Cup's most popular summer drinks made simply from high quality chocolates, milk and ice.

The Second Cup Ltd. Annual Report 2010

# Letter from the President & CEO of The Second Cup Ltd.

**Stacey Mowbray, President & CEO**

I am pleased to share with you our financial results for 2010 and our growth plans for 2011.

Second Cup is Canada's largest specialty coffee franchisor with 349 cafés across the country. Our focus in 2010 was to grow transactions for the long-term health of the brand and the success of our franchise partners. We are satisfied that we improved the previous trend line and succeeded in maintaining same store sales for the year in a highly competitive category, one that continues to grow in importance.

## We are confident in the strength of the Second Cup brand and proud of our unique position as the coffee company that cares.

### 2010 HIGHLIGHTS

Our focus in 2010 was on growing the number of guests and the frequency of their visits. We did this through various marketing efforts, including frequency cards for a 75 cent brewed coffee offer. We also completely re-launched our fruit chillers and supported the launch with a special Happy Hour offer throughout the summer. We celebrated our 35th birthday as a Canadian company with the launch of Blend 35 and trial offers around our Rainforest Alliance and Fair Trade coffees for 75 cents in the fourth quarter. Once again, we took very marginal price increases in 2010.

To support our continued focus on quality and innovation within coffee, we appointed Patrick Russell as our Coffee Expert, responsible for product development, quality control and in café best practices. Patrick demonstrated his expertise and knowledge by winning the Canadian Cup Tasters Championship in 2010 and will represent Canada in the world competition in 2011.

During 2010 we opened 13 new cafés resulting in net café growth of five units. We also renovated 33 cafés throughout the year. The number of cafés directly impacts our sales volume, royalty fee income and the size of the advertising fund. Our goal is to continue to increase the net number of cafés and ensure each of our cafés enhances Second Cup's brand and profitability.

## 2011 OUTLOOK

The Second Cup business continues to operate in a highly competitive market place and a challenging consumer environment. Our goal is to return to growth in 2011 with positive same café sales and the addition of net new cafés. The focus will be on driving new traffic into our cafés through external messaging, sampling and product news. Inside the café, our focus will be on maintaining operating excellence and promoting the brand's quality credentials.

We are very proud to announce that as of April, 80% of our coffee portfolio is now certified as Rainforest Alliance, Fair Trade or Organic. Certifications by renowned organizations like Rainforest Alliance and Transfair are important to 50% of premium coffee drinkers and we are proud to be a leader in this area. In addition, during 2011 we will launch a number of new products including a selection of super premium teas and new specialty cold drinks, including a frozen white hot chocolate to complement our popular frozen hot chocolate. Promotions to attract new guests like our popular $2.75 Latte Tuesday will also play a role in 2011.

Stacey Mowbray, President & CEO of Second Cup, visited one of our partner farms in Panama earlier this year.

In 2011, we expect to open 25 to 30 new cafés and to close 5 to 10 cafés that have below average profitability. We also plan to renovate approximately 30 cafés across Canada.

Second Cup began in 1975 as a company that cared about providing guests with a quality cup of coffee in a comfortable setting. Over the years we've maintained that commitment to caring and built a strong, stable company that cares about our guests, our growers, our franchise partners, our employees and our environment. It's more than a mission statement or brand positioning. It's what makes Second Cup truly unique and truly Canadian.

We value our unique relationships with our coffee growing estates and partners, our many local food partners and our franchise partners. On behalf of the Second Cup management team, I would like to thank all of our franchisees and employees for their dedication and commitment to growing the Second Cup brand by being the coffee company that cares for our guests.

Stacey Mowbray

Stacey Mowbray
President & CEO, The Second Cup Ltd.
April 8, 2011

After a full day of picking, bushels of coffee cherries are hand sorted, weighed, and washed in pure water to meet exacting standards.

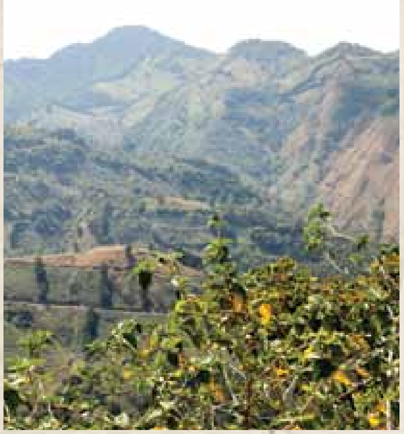
Rainforest Alliance Certified

Fair Trade Certified

OCIA Certified Organic

Trusted COFFEE EXPERT

Patrick Russell, a Coffee Expert for Second Cup since 1996, won the 2010 Canadian Cup Tasters Championship and is one of 8 people in Canada licensed as a Certified Quality Grader of coffee.



Coffee farms and estates cover the beautiful mountainsides in Costa Rica, which is renowned for producing the world's finest gourmet coffee, including La Minita Tarazu, a defect-free, hand sorted coffee exclusive to Second Cup for over 20 years.

The Second Cup Ltd. Annual Report 2010

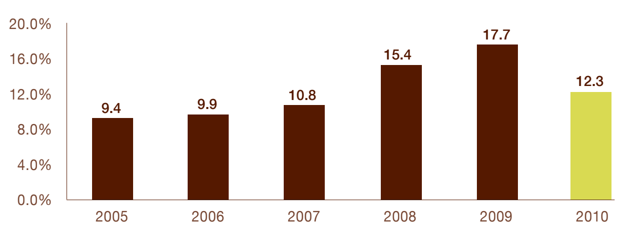
# The best coffee is grown under the best practices.

# Financial Highlights

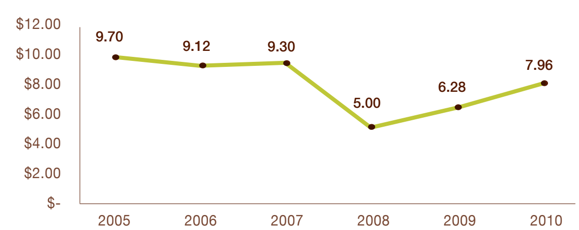
(in thousands of dollars, except number of cafés and per unit amounts)

| | Three Months Ended December 31 2010 | Three Months Ended December 31 2009 | Year Ended December 31 2010 | Year Ended December 31 2009 |
|---|---|---|---|---|
| System sales of cafés[1,4] | $52,921 | $53,234 | $190,197 | $190,406 |
| Number of cafés – end of period[1] | 349 | 344 | 349 | 344 |
| Same café sales growth[1,4] | (1.5%) | (1.3%) | 0.0% | (3.2%) |
| Total revenue[3] | $6,490 | $7,300 | $25,171 | $19,504 |
| Normalized earnings before items noted below[2] | $2,858 | $3,008 | $9,833 | $10,800 |
| Conversion costs[3] | $248 | - | $563 | - |
| Transaction costs[3] | - | - | - | $480 |
| Non-cash future income tax recovery[3] | ($33) | ($1,111) | ($33) | ($1,144) |
| Net earnings for the period | $2,643 | $4,119 | $9,303 | $11,464 |
| Normalized earnings per unit before conversion costs, transaction costs and non-cash future income tax recovery[4] | $0.29 | $0.31 | $1.00 | $1.09 |
| Basic and diluted earnings per unit | $0.27 | $0.42 | $0.94 | $1.16 |
| Distributable cash per unit excluding changes in non-cash working capital[4] | $0.27 | $0.31 | $1.00 | $1.07 |
| Distributable cash per unit[4] | $0.37 | $0.28 | $1.14 | $0.98 |
| Distributions declared per unit | $0.23 | $0.23 | $0.92 | $0.95 |
| Payout ratio excluding changes in non-cash working capital[4,5] | 84.1% | 73.1% | 91.7% | 89.6% |
| Payout ratio[4,6] | 62.0% | 83.6% | 81.0% | 97.4% |

**SCU: Average Yield**




**Stock Price** (December 31)




1 "System sales of cafés", "Number of cafés – end of period" and "Same café sales growth" refer to active cafés in the Royalty Pool for periods prior to June 28, 2009, and refer to all cafés for all subsequent periods.
2 "Normalized earnings before items noted below" is a non-GAAP measure and represents the earnings, before conversion costs, transaction costs and non-cash future income tax recovery of the consolidated Fund and its wholly owned subsidiaries, including Second Cup since June 27, 2009, which are consolidated with the statements of Second Cup for reporting purposes in accordance with GAAP.
3 "Total revenue", "Conversion costs", "Transaction costs" and "Non-cash future income tax recovery" represent the combined amounts of the consolidated Fund and its wholly owned subsidiary, MarksLP, which was, prior to June 28, 2009, consolidated with the statements of Second Cup for reporting purposes in accordance with GAAP. Prior to June 28, 2009, the Fund had accounted for the earnings of MarksLP on an equity accounted basis in its consolidated financial statements, in accordance with AcG-15 relating to variable interest entities ("VIEs").
4 "System sales of cafés", "Same café sales growth", "Normalized earnings per unit before conversion costs, transaction costs and non-cash future income tax expense recovery", "Distributable cash per unit excluding changes in non-cash working capital", "Distributable cash per unit", "Payout ratio excluding changes in non-cash working capital" and "Payout ratio" are non-GAAP measures.
5 "Payout ratio excluding changes in non-cash working capital" is calculated as "Distributions declared per unit" as a percentage of "Distributable cash per unit excluding changes in non-cash working capital
6 "Payout ratio" is calculated as "Distributions declared per unit" as a percentage of "Distributable cash per unit".

# 80% of our coffee is certified by world-renowned organizations.

# Management's Discussion and Analysis

The following is a discussion of the results of operations and financial condition of Second Cup Income Fund (the "Fund") for the year ended December 31, 2010 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. 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 dollars, unless otherwise indicated. This Management's Discussion and Analysis ("MD&A") has been prepared as of March 8, 2011.

## OVERVIEW AND BUSINESS OF THE FUND

The Fund was created as a limited purpose trust to use the proceeds of an initial public offering to indirectly acquire the trademarks and other intellectual property and associated rights used by Second Cup cafés in all provinces and territories of Canada, excluding the territory of Nunavut, (the "Second Cup Marks").

At the annual and special meeting of unitholders held on June 2, 2010, the unitholders approved the proposed conversion from an income trust structure to a public corporation ("Conversion"). The Conversion was completed on January 1, 2011. Under the plan of arrangement, unitholders of the Fund received, for each unit of the Fund held, one common share of The Second Cup Ltd. ("New Second Cup"). As a result of this Conversion, the Fund was dissolved with its assets and liabilities assumed by New Second Cup. The common shares of New Second Cup commenced trading on the Toronto Stock Exchange on January 4, 2011 under the symbol "SCU". The Fund's fiscal year ends December 31, 2010.

The Fund was an unincorporated open-ended trust established under the laws of the Province of Ontario. On June 27, 2009, the Fund, through its investment in Second Cup Trade-Marks Limited Partnership ("MarksLP") acquired all the outstanding shares of The Second Cup Ltd. ("Second Cup" or "the Company"). Refer to the notes below for further details. On August 21, 2009, the Fund changed its name from Second Cup Royalty Income Fund to Second Cup Income Fund. The Fund, through its investment in MarksLP, owned the trademarks, trade names, operating procedures and systems and other intellectual property ("Second Cup Marks" or "Marks") used in connection with the operation of Second Cup cafés in Canada, excluding the territory of Nunavut and, through the License and Royalty Agreement (the "Agreement") with Second Cup, the taking of actions to exploit the use of the Second Cup Marks and the collection of the royalty payable under the Agreement. New Second Cup is Canada's largest specialty coffee café franchisor (as measured by the number of cafés) with 349 cafés operating under the trade name Second Cup™ in Canada, of which five are Company operated and the balance are operated by franchise partners who are selected and trained to retail the Fund's product offering.

An unlimited number of units could have been issued pursuant to the Fund's declaration of trust. Units were redeemable by the holder at any time, subject to certain limitations. Income tax obligations related to distributions by the Fund were the responsibility of the unitholders.

The Fund's earnings were comprised of the consolidated financial results of the Fund, Marks LP and Second Cup. Under the structure of the Fund, income generated by MarksLP and the Fund was not subject to income tax until the new rules regarding the taxation of income trusts came into effect in 2011.

As at December 31, 2010, the Fund had 9,903,045 units outstanding.

## BASIS OF PRESENTATION

The audited consolidated financial statements include the accounts of the Fund and its wholly owned subsidiaries MarksLP, Second Cup GP Trust ("GP Trust"), Second Cup GP Inc. ("GP Inc.") and Second Cup.

Prior to June 27, 2009, MarksLP was consolidated with Second Cup in accordance with Accounting Guideline 15 (AcG-15) relating to variable interest entities ("VIEs") and was accounted for in the consolidated financial statements of the Fund as an equity investment because the Fund, despite having 100% ownership of MarksLP, was not deemed to be the primary beneficiary of MarksLP. At June 27, 2009, as a result of the acquisition of Second Cup, the Fund acquired control of the consolidated company of Second Cup, which includes Second Cup and MarksLP. The purchase price allocation for the acquisition of Second Cup as disclosed in Note 1 of the consolidated financial statements includes the assets and liabilities of Second Cup and MarksLP. The purchase price for the acquisition is deemed to be the carrying value of the Fund's equity investment in MarksLP plus the consideration of one dollar paid on closing. From the date of acquisition of Second Cup, the financial results of Second Cup and MarksLP were incorporated in the consolidated financial statements of the Fund on a full consolidation basis.

The audited consolidated financial statements have been prepared in accordance with Canadian generally accepted accounting principles.

Second Cup operates within Canada which is considered to be its sole operating segment. As a franchisor, Second Cup opens, acquires, closes and refranchises individual café locations in the normal course of business. Café closures in geographical areas where existing or new cafés continue to serve the same customer base are not reported as discontinued operations.

### Acquisition of Second Cup

On June 27, 2009, MarksLP, on behalf of the Fund, completed the acquisition of all the outstanding shares of Second Cup for total consideration of one dollar cash paid on closing, plus transaction costs incurred of $480. The transaction costs were expensed in the second quarter of 2009 by MarksLP.

The acquisition has been accounted for using the purchase method and the operating results are included in the Consolidated Statements of Operations and Comprehensive Income from the effective date of June 28, 2009. Previously, the results of MarksLP were consolidated with Second Cup in accordance with Accounting Guideline 15 ("AcG-15") and the Fund equity accounted for its 100% interest in the units of MarksLP. The result of this transaction is that the Fund now controls and is required to consolidate both MarksLP and Second Cup. Consequently, the purchase accounting equation treats the transaction as an acquisition of control of both Second Cup and MarksLP.

The acquisition accounting as noted below has been determined based on the fair values of assets acquired and liabilities assumed, as well as a valuation of intangible assets acquired and the fair value of certain lease obligations assumed.

The purchase price allocation of the net assets based on their fair values is as follows:

| | MarksLP | Second Cup |
|---|---|---|
| Fair value of net assets acquired: | | |
| Cash | | $ 2,966 |
| Accounts receivable | | 2,134 |
| Other assets | | 424 |
| Property and equipment | | 1,171 |
| Franchise rights | | 1,331 |
| Accounts payable and accrued liabilities | | (6,943) |
| Deposits from franchise partners | | (1,493) |
| Lease payable | | (32) |
| Café lease agreements | | (149) |
| Headlease liabilities | | (606) |
| Fair value of net assets acquired | | (1,197) |
| Less: | | |
| Settlement of pre-existing liability | | 1,568 |
| Redemption of Fund units** | | (321) |
| Consideration (one dollar) | | - |
| Goodwill arising on Second Cup acquisition | | $ 2,444 |
| Cash | $ 100 | |
| Trademark | 86,905 | |
| Accounts payable and accrued liabilities | (176) | |
| | 86,829 | |
| Less: | | |
| Settlement of pre-existing liability | (1,568) | |
| Consideration arising from deemed acquisition of MarksLP*** | 88,397 | - |
| Goodwill* | | $ 2,444 |

*Goodwill represents the difference between the purchase price and the net fair value of the identifiable assets and liabilities.

**As part of the acquisition of Second Cup, the Fund acquired 63,914 Fund units that were held by Second Cup. The fair value of the Fund units held by Second Cup as at June 27, 2009 was $321. In accordance with Emerging Issues Committee Abstract ("EIC") 138, these Fund units are treated as a repurchase of units. As a result, Income Fund Units are carried at cost and shown as a deduction from accumulated earnings in the Consolidated Statements of Unitholders' Equity.

***Represents carrying value of the Fund's equity investment in MarksLP at June 27, 2009.

## FINANCIAL HIGHLIGHTS

The following table sets out selected pro forma and non-GAAP financial information and other data of the Fund and its wholly owned subsidiaries, and should be read in conjunction with the audited consolidated financial statements of the Fund.

| | Three Months Ended December 31 | | Year Ended December 31 | |
|---|---|---|---|---|
| **(in thousands of dollars, except number of cafés and per unit amounts)** | **2010** | **2009** | **2010** | **2009** |
| System sales of cafés[1,4] | $52,921 | $53,234 | $190,197 | $190,406 |
| Number of cafés – end of period[1] | 349 | 344 | 349 | 344 |
| Same café sales growth[1,4] | (1.5%) | (1.3%) | 0.0% | (3.2%) |
| Total revenue[3] | $6,490 | $7,300 | $25,171 | $19,504 |
| Earnings before items noted below[2] | $2,858 | $3,008 | $9,833 | $10,800 |
| Conversion costs[3] | $248 | - | $563 | - |
| Transaction costs[3] | - | - | - | $480 |
| Non-cash future income tax recovery[3] | ($33) | ($1,111) | ($33) | ($1,144) |
| Net earnings for the period | $2,643 | $4,119 | $9,303 | $11,464 |
| Earnings per unit before conversion costs, transaction costs and non-cash future income tax recovery[4] | $0.2888 | $0.3057 | $0.9971 | $1.0941 |
| Basic and diluted earnings per unit | $0.2671 | $0.4186 | $0.9433 | $1.1614 |
| Distributable cash per unit excluding changes in non-cash working capital[4] | $0.2740 | $0.3147 | $1.0037 | $1.0651 |
| Distributable cash per unit[4] | $0.3716 | $0.2750 | $1.1357 | $0.9806 |
| Distributions declared per unit | $0.2300 | $0.2300 | $0.9200 | $0.9547 |
| Payout ratio excluding changes in non-cash working capital[4,5] | 84.1% | 73.1% | 91.7% | 89.6% |
| Payout ratio[4,6] | 62.0% | 83.6% | 81.0% | 97.4% |

1 "System sales of cafés", "Number of cafés – end of period" and "Same café sales growth" refer to active cafés in the Royalty Pool for periods prior to June 28, 2009, and refer to all cafés for all subsequent periods.
2 "Earnings before items noted below" is a non-GAAP measure and represents the earnings, before conversion costs, transaction costs and non-cash future income tax recovery of the consolidated Fund and its wholly owned subsidiaries, including Second Cup since June 27, 2009, which are consolidated with the statements of Second Cup for reporting purposes in accordance with GAAP.
3 "Total revenue", "Conversion costs", "Transaction costs" and "Non-cash future income tax recovery" represent the combined amounts of the consolidated Fund and its wholly owned subsidiary, MarksLP, which was, prior to June 28, 2009, consolidated with the statements of Second Cup for reporting purposes in accordance with GAAP. Prior to June 28, 2009, the Fund had accounted for the earnings of MarksLP on an equity accounted basis in its consolidated financial statements, in accordance with AcG-15 relating to variable interest entities ("VIEs").
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6 "Payout ratio" is calculated as "Distributions declared per unit" as a percentage of "Distributable cash per unit".

## SYSTEM SALES

### *Overview of System Sales*

System sales comprise the gross revenue reported to Second Cup by franchise partners of Second Cup cafés and by cafés owned by Second Cup. Sales are reported by franchise partners to Second Cup on a weekly basis without audit or other form of independent assurance. Second Cup's substantiation of sales reported by its franchise partners is through analytical and financial reviews performed by management, on-site visits and analyses of raw materials purchased by the cafés from vendors.

Increases in system sales result from the addition of new cafés and same café sales growth. System sales 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, disposable consumer income, consumer confidence, recessionary and inflationary trends, job security and unemployment, equity market levels, consumer credit availability and competitive activities. 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 franchise partners.

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 a renewal of a lease for a particular location is not available or when an alternative suitable location for the franchise partner is required.

*Overview of System Sales – prior to June 28, 2009*

The indirect source of revenue for the Fund was royalty income collected by MarksLP from Second Cup. Royalty income was equal to 6.5% of system sales of Second Cup cafés in the Royalty Pool. MarksLP used the royalty revenue to make distributions to the Fund. As a result, same café sales growth was a key performance indicator for the Fund.

Increases in system sales resulted from the addition of new cafés to the Royalty Pool and same café sales growth. System sales were also affected by the permanent closure of Second Cup cafés already included in the Royalty Pool. Cafés were closed when they ceased to be viable or, occasionally, when a renewal of a lease for a particular location was not available or when an alternative suitable location for the franchise partner was required. Under the Agreement, Second Cup was required to make a monthly make-whole payment to MarksLP to compensate the Fund for the loss of monthly royalty revenue on closed cafés until future Royalty Pool adjustment dates.

After the acquisition of Second Cup referred to above, the Agreement was amended as follows:

- There is no longer a vend-in process for new cafés added to the Royalty Pool;
- Second Cup is no longer required to make the monthly make-whole payments to MarksLP described above; and
- Second Cup makes royalty payments to MarksLP on all operating Second Cup cafés in Canada and the Royalty Pool concept described above is no longer applicable.

*Analysis of System Sales and Same Café Sales Growth*

System sales for the three months ended December 31, 2010 (the "Quarter") were $52,921, compared to $53,234 for the same quarter for 2009. The decrease was mainly the result of lower same café sales in the Quarter of 1.5%.

System sales for 2010 were $190,197, compared to $190,406, including $91,466 for the Royalty Pool in the first two quarters for 2009.

The fourth Quarter of 2010 witnessed a decline in same café sales of 1.5% compared to the prior year's decline of 1.3% in the fourth quarter. Same café transactions increased by 1.0% in the Quarter. There were several marketing initiatives built around Second Cup's 35th anniversary to drive sales. The six week promotion centred around $0.75 medium coffee offers on newly certified coffees (Rainforest Alliance, Organic and Fair Trade) delivered via newspaper and direct mail. Transaction growth during this six week period was 3.9%. Western Canada continues to experience negative same café sales growth. The core Toronto market showed solid growth in both sales and transactions.

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

*Seasonality of System Sales*

The Fund operates on a 12-period accounting basis. The following table shows the percentage of annual system sales achieved, on average, in each fiscal reporting quarter over the last three fiscal years:

| % of Annual System Sales | 2008 | 2009 | 2010 | Average |
|---|---|---|---|---|
| First quarter | 24.0 | 23.6 | 23.8 | 23.8 |
| Second quarter | 24.9 | 24.4 | 24.4 | 24.6 |
| Third quarter | 24.0 | 24.0 | 24.0 | 24.0 |
| Fourth quarter | 27.1 | 28.0 | 27.8 | 27.6 |
| | 100.0 | 100.0 | 100.0 | 100.0 |

The Fund's business is seasonal with revenues and operating income generally lower in the first quarter of the fiscal year due in part to post-holiday consumer spending patterns. Historically, results have been higher in the fourth quarter, which include the holiday sales periods of November and December. Because of this seasonality, the results for any quarter are not necessarily indicative of what may be achieved for any other quarter or for the full fiscal year.

## CAFÉ NETWORK

During the Quarter, six cafés were renovated (2009 – five); there were five café openings (2009 – six) and one café was closed (2009 – eight), with 349 cafés open at December 31, 2010. In 2010, 33 cafés (2009 – 25) have been renovated; there were 13 openings (2009 – 13) and eight closures (2009 – 30) for 2010 resulting in net café growth of five units. The number of cafés directly impacts sales, royalties and advertising. Second Cup focuses on increasing the net amount of cafés and management's decision to close unprofitable Company operated cafés is designed to improve the overall earnings of the Fund.

## INCOME, OPERATING EXPENSES, INCOME TAXES AND NET EARNINGS

### Fourth Quarter

*Analysis of revenues*

Revenues for the Quarter were $6,490 (2009 – $7,300) and consisted of royalties, revenue from Company operated cafés and other income.

Royalties for the Quarter were $4,397 (2009 – $4,396). Excluding sales from Company operated cafés, the effective royalty rate was 8.4% (2009 – 8.5%).

Revenues from Company operated cafés were $729 compared to $1,217 for the same quarter in 2009. Second Cup ended the Quarter with five (2009 – seven) Company operated cafés.

Other income for the Quarter was $1,364 (2009 – $1,687). Other income includes: initial franchise fees, which are recognized as income when the new cafés are opened; renewal fees, which are recognized when an existing franchise partner enters into a new franchise agreement; transfer fees earned on the sale of cafés from one franchise partner to another; purchasing coordination fees earned; and other income earned by Second Cup on the sale of its coffee through alternate channels. The $323 reduction in other income is mainly due to higher coffee prices, not all of which were passed onto the franchise partners, thereby impacting purchasing coordination fees.

*Operating, administrative and corporate café operating expenses*

Operating and administrative expenses include the general overhead expenses of Second Cup, as well as the public entity costs. Operating costs and administrative expenses decreased to $2,612 from $2,834 in the Quarter, mainly as a result of Second Cup recovering monies previously written off as unrecoverable. In addition, the operating costs and expenses of Company operated cafés, amounted to $700 (2009 - $1,061) in the Quarter due to the reduction in the number of Company operated cafés. The Fund also recorded amortization of $38 (2009 - $53) on property and equipment, amortization of $18 (2009 - $22) on software and amortization of $71 (2009 - $85) on franchise rights in the Quarter.

*Other Income and Expenses*

The Fund incurred interest expense of $180 (2009 - $178) and $48 (2009 - $54) in amortization of financing charges relating to the term loan. The Fund also recorded a non-cash credit of $118 (2009 - $57) for the movement in the fair value of the derivative interest rate swap which fixes the interest rate on the Fund's term loan. The Fund earned other net interest income of $3 (2009 - $nil) in the Quarter. During the Quarter, the Fund recorded a loss of $64 (2009 - $62) on the disposal of Company operated cafés. The Fund incurred $248 in expenses related to its conversion from an income trust structure to a public corporation.

*Income Taxes*

The Fund recorded a non-cash future income tax recovery in the Quarter of $33 (2009 - $1,111), mainly due to timing.

*Net Earnings*

The Fund's net earnings for the Quarter were $2,643 or $0.2671 per unit, compared to $4,119 or $0.4186 per unit in 2009. Excluding the non-cash future income tax recovery of $33 and Conversion costs of $248, net earnings for the Quarter would have been $2,858 or $0.2888 per unit. Excluding the non-cash future income tax recovery of $1,111, net earnings for the comparable 2009 quarter were $3,008 or $0.3057 per unit.

**Year ended December 31, 2010**

Prior to the acquisition of Second Cup on June 27, 2009, the Fund's source of revenue was royalty income collected by MarksLP from Second Cup. Royalty income was equal to 6.5% of system sales of Second Cup cafés in the royalty pool. After the Acquisition, the Fund's revenues are made up of royalties and other franchise fees, revenue from Company-operated cafés and other income. The Fund's expenses also include the general overhead expenses of Second Cup. Therefore, the year end financial results for 2010 are not directly comparable to last year.

*Analysis of revenues*

Revenues for the year were $25,171 compared to $14,079 in 2009. Revenue for 2009 includes royalty revenues from franchise partners, revenue from Company-operated cafés and other income after the acquisition date of June 27, 2009 and earnings and interest from the Fund's equity accounted investment in MarksLP of $5,425 earned prior to the acquisition date. Royalties for the year were $15,874 (2009 - $8,241 from the acquisition date). Excluding sales from Company operated cafés, the effective royalty rate was 8.5% (2009 – 8.5%).

Revenues from Company operated cafés were $3,388 (2009 - $2,819 from the acquisition date) for the year. Second Cup ended the year with five (2009 – seven) Company operated cafés.

Other income for the year was $5,909 (2009 - $3,019 from the acquisition date). Other income includes: initial franchise fees, which are recognized as income when the new cafés are opened; renewal fees, which are recognized when an existing franchise partner enters into a new franchise agreement; transfer fees earned on the sale of cafés from one franchise partner 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.

*Operating, Administrative and Corporate Café Operating Expenses*

Operating and administrative expenses include the general overhead expenses of Second Cup, as well as professional fees and public entity costs. Operating costs and administrative expenses increased from $5,415 in 2009 to $10,642 in 2010, mainly as a result of the acquisition and consolidation of Second Cup. In addition, the operating costs and expenses of Company operated cafés, amounting to $3,258, (2009 - $2,730) are now included. Year to date, the Fund recorded amortization of $142 (2009 - $88) on property and equipment, amortization of $63 (2009 - $38) on software and amortization of $283 (2009 - $141) on franchise rights.

*Other Income and Expenses*

The Fund incurred interest expense of $718 (2009 - $708) and $185 (2009 - $150) in amortization of financing charges relating to the term loan. The Fund also recorded a non-cash charge of $33 (2009 – credit of $114) for the movement in the fair value of the derivative interest rate swap, which fixes the interest rate on the Fund's term loan. The Fund incurred other interest expense of $5 (2009 – income of $1). The Company recorded a loss of $92 (2009 - $76) on the disposal of Company owned cafés. The Fund incurred $563 in expenses related to its Conversion as discussed above.

*Income Taxes*

The Fund recorded a non-cash future income tax recovery of $33 in 2010 related to timing differences. A future income tax recovery of $1,144 was recorded in 2009 related to changes in future tax rates. In addition in 2009, an income tax recovery related to prior years of $150 was recorded, including $103 included in the equity accounted income of MarksLP.

*Net Earnings*

The Fund's net earnings for the year were $9,303, or $0.9433 per unit, compared to $11,464 or $1.1614 per unit in 2009. Excluding the non-cash future income tax recovery of $33 and Conversion costs of $563, net earnings for the year would have been $9,833 or $0.9971 per unit. Excluding the transaction costs of $480 and the non-cash future income tax recovery of $1,144, net earnings for 2009 would have been $10,800 or $1.0941 per unit. Prior to the Acquisition, the Fund's indirect source of revenue was royalty income collected by MarksLP from Second Cup. Royalty income was equal to 6.5% of system sales of Second Cup cafés in the royalty pool. As a result, same café sales growth was the key performance indicator for the Fund. Following the Acquisition, the Fund's quarterly net earnings will also fluctuate based on items that include but are not limited to the seasonality of system sales; the timing of initial franchise fees, renewal fees and transfer fees; the timing of purchasing coordination fees; operating and administrative expenses; and opening and closing of cafés.

*Contributed Surplus*

During 2010, the Fund recorded a gain of $160 from the sale of 63,914 treasury units that were held by Second Cup on June 27, 2009. The gain has been recorded as contributed surplus in the Consolidated Statements of Unitholders' Equity.

## SELECTED QUARTERLY INFORMATION

A discussion of the Fund's previous interim results can be found in the Fund's quarterly MD&A reports available at www.sedar.com.

| (in thousands of dollars, except number cafés and per unit amounts) | Q4 2010[2,3] | Q3 2010[2] | Q2 2010[2] | Q1 2010 |
|---|---|---|---|---|
| System sales of cafés[1] | $52,921 | $45,583 | $46,353 | $45,340 |
| Same café sales growth[1] | (1.5%) | 0.3% | 0.2% | 1.1% |
| Number of cafés at end of period[1] | 349 | 345 | 342 | 342 |
| Net earnings for the period | $2,643 | $2,642 | $2,103 | $1,915 |
| Diluted earnings per unit | $0.2671 | $0.2682 | $0.2135 | $0.1944 |
| Distributable cash per unit | $0.3716 | $0.2074 | $0.1928 | $0.3635 |
| Distributable cash per unit excluding non-cash changes in working capital | $0.2740 | $0.2877 | $0.2460 | $0.1960 |
| Distributions declared per unit | $0.2300 | $0.2300 | $0.2300 | $0.2300 |

| | Q4 2009[3] | Q3 2009 | Q2 2009[2] | Q1 2009 |
|---|---|---|---|---|
| System sales of cafés[1] | $53,234 | $45,706 | $46,474 | $44,992 |
| Same café sales growth[1] | (1.3%) | (4.5%) | (4.7%) | (3.0%) |
| Number of cafés at end of period[1] | 344 | 346 | 350 | 350 |
| Net earnings for the period | $4,119 | $2,478 | $2,314 | $ 2,553 |
| Diluted earnings per unit | $0.4186 | $0.2519 | $0.2337 | $0.2578 |
| Distributable cash per unit | $0.2750 | $0.2016 | $0.2704 | $0.2436 |
| Distributable cash per unit excluding non-cash changes in working capital | $0.3147 | $0.2593 | $0.2341 | $0.2574 |
| Distributions declared per unit | $0.2300 | $0.2300 | $0.2300 | $0.2647 |

[1] "System sales of cafés", "Same café sales growth" and "Number of cafés at end of period" refer to active cafés in the Royalty Pool for periods prior to June 28, 2009, and refer to all cafés for all subsequent periods.

[2] Results for the fourth quarter of 2010 include conversion costs of $248, third quarter $3 and second quarter $312 relating to the conversion to a public corporation from an income trust structure. Results for the second quarter of 2009 include transaction costs of $480 relating to the acquisition of Second Cup and a recovery of current income taxes of prior years of $103.

[3] The Fund's fourth quarter system sales are higher than other quarters due to the seasonality of the business (see "Seasonality of System Sales" above).

## DISTRIBUTIONS

During the Quarter, the Fund declared aggregate distributions of $2,266 or $0.23001 per unit, compared to $2,264 or $0.23001 per unit, respectively, in the comparable 2009 quarter.

Distributions for the year to date were as follows:

| Period | Payment Date | Amount/unit |
|---|---|---|
| January 2010 | February 26, 2010 | $0.07667 |
| February 2010 | March 26, 2010 | $0.07667 |
| March 2010 | April 30, 2010 | $0.07667 |
| **Total – First quarter 2010** | | $0.23001 |
| April 2010 | May 31, 2010 | $0.07667 |
| May 2010 | June 30, 2010 | $0.07667 |
| June 2010 | July 30, 2010 | $0.07667 |
| **Total – Second quarter 2010** | | $0.23001 |
| July 2010 | August 31, 2010 | $0.07667 |
| August 2010 | September 30, 2010 | $0.07667 |
| September 2010 | October 29, 2010 | $0.07667 |
| **Total – Third quarter 2010** | | $0.23001 |
| October 2010 | November 30, 2010 | $0.07667 |
| November 2010 | December 31, 2010 | $0.07667 |
| December 2010 | January 31, 2011 | $0.07667 |
| **Total – Fourth quarter 2010** | | $0.23001 |
| **Total – Year to date 2010** | | $0.92004 |

New Second Cup implemented a dividend policy for 2011 whereby it will initially pay a quarterly dividend of $0.15 per common share. The first quarterly dividend is anticipated to be declared in respect of the quarter ended April 2, 2011 and is expected to be paid on May 30, 2011 to shareholders of record at the close of business on May 16, 2011. The dividend policy was developed to continue to pay out a substantial portion of earnings while retaining a sufficient amount to adequately fund organic growth initiatives. The objective of the dividend policy is to reflect a payout ratio of approximately 75% to 85% of net earnings per share, on a normalized basis. The determination to declare and make payable dividends from New Second Cup is at the discretion of the Board of Directors of New Second Cup ("Directors") and until declared payable, New Second Cup has no requirement to pay cash dividends to shareholders. Taking into account current economic conditions and their impact on the profitability of New Second Cup, the Directors will continually review the level of dividends paid by New Second Cup and there can be no assurance that the amount of the dividend will remain at the current level.

## DISTRIBUTABLE CASH

Prior to the Conversion and in common with other income trusts in Canada, management believed distributable cash was an appropriate measure of performance of the Fund as the amount of cash available to pay distributions to unitholders was determined with reference to distributable cash. Management believed, in addition to net income, distributable cash was a useful supplemental measure in evaluating the Fund's performance as it provided investors with an indication of cash available for distributions. Investors are cautioned, however, that distributable cash should not be construed as an alternative to the consolidated statements of cash flows as a measure of liquidity and cash flows. The method of calculating distributable cash for the purposes of this MD&A may differ from that used by other issuers and, accordingly, distributable cash in this MD&A may not be comparable to distributable cash used by other issuers (see "Non-GAAP Terms").

For the purposes of this MD&A, distributable cash is based on cash flows from operating activities, the GAAP measure reported in the Fund's Consolidated Statements of Cash Flows. Prior to the acquisition of Second Cup, the cash flow from operating activities of the Fund was adjusted to include cash flow from operating activities of its wholly owned subsidiary, MarksLP.

| | **Three months ended December 31, 2010** | **Three months ended December 31, 2009** |
|---|---|---|
| Cash flow from operating activities of the Fund | $3,677 | $2,706 |
| Distributable cash for the Fund | $3,677 | $2,706 |
| Number of units outstanding (weighted) | 9,895,108 | 9,839,131 |
| Distributable cash per unit | $0.3716 | $0.2750 |
| Distributions paid | $2,279 | $2,264 |
| Distributions declared | $2,279 | $2,264 |
| Distributions declared per unit | $0.2300 | $0.2300 |

Distributable cash for the Quarter was $3,677, or $0.3716 per unit compared to $2,706, or $0.2750 per unit in the fourth quarter of 2009. This increase is primarily due to the changes in non-cash working capital, which for the Quarter decreased by $966 compared to an increase of $390 for the Fund and MarksLP in the comparable 2009 quarter. Changes in non-cash working capital are primarily due to the timing of payments. Excluding the impact of changes in non-cash working capital, distributable cash would have been $2,711, or $0.2740 per unit, compared to $3,096, or $0.3147 per unit for the fourth quarter of 2009, a decrease of 12.9%.

| | **Year ended December 31, 2010** | **Year ended December 31, 2009** |
|---|---|---|
| Cash flow from operating activities of the Fund | $11,200 | $9,879 |
| Add (deduct): | | |
| Cash flow from operating activities of MarksLP | - | 5,501 |
| Distributions paid to Fund by MarksLP | - | (5,700) |
| Distributable cash for the Fund | $11,200 | $9,680 |
| Number of units outstanding (weighted) | 9,862,054 | 9,871,088 |
| Distributable cash per unit | $1.1357 | $0.9806 |
| Distributions paid | $9,077 | $9,595 |
| Distributions declared | $9,077 | $9,425 |
| Distributions declared per unit | $0.9200 | $0.9547 |

Distributable cash for the year was $11,200, or $1.1357 per unit compared to $9,680, or $0.9806 per unit in 2009. This increase is primarily due to the changes in non-cash working capital, which on a year to date basis decreased by $1,301 for the Fund compared to an increase of $910 for the Fund and a decrease of $76 for MarksLP up to the acquisition date in 2009. Changes in non-cash working capital are primarily due to the timing of payments. Excluding the impact of changes in non-cash working capital, distributable cash would have been $9,899, or $1.0037 per unit, compared to $10,514, or $1.0651 per unit for 2009, a decrease of 5.8%.

## LIQUIDITY AND CAPITAL RESOURCES

Prior to the Conversion, the Fund was required, if declared, to remit distributions in arrears to unitholders, on the last business day of each month. The Fund's distribution policy was 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 the Fund's income. Following the Conversion, dividends will be paid quarterly.

The primary source of liquidity for the Fund was the revenue of Second Cup. Second Cup collects royalties based on franchise partner system sales, franchise fees and other amounts from its franchise partners and also generates revenues from its Company operated cafés. The performance of Second Cup franchise partners and Company operated cafés could impact the ability of the Fund to declare and pay distributions to its unitholders. For a more detailed discussion of the risks and uncertainties affecting the Fund's liquidity see "Risks and Uncertainties" below.

**Fourth quarter**

Cash generated by operating activities was $3,677 for the Quarter compared to $2,706 for the same quarter last year. The increase is the result of lower increases in working capital compared to 2009 with the exception of prepaid expenses and sundry assets. Prepaid expenses include charges for the convention to be held in January and prepayment of annual polling fees for the purchase of point of sale systems ("POS") discussed below.

During the Quarter, cash utilized by investing activities was $1,335 (2009 - $22). Second Cup spent $1,162 (2009 - $25) to purchase property and equipment including $785 for the purchase of POS. In January 2011, the Board of Directors approved a plan whereby Second Cup will purchase new POS systems to be distributed to approximately 317 cafés. The franchise partners will pay a monthly fee to cover the support and maintenance of the system. It is expected that the project will be completed by the end of 2011 and the total capital investment is budgeted at $2,100 in 2011. The new POS will provide additional timely sales data to franchise partners and New Second Cup, which will assist in evaluating our marketing initiatives in the future. The Company spent $145 (2009 - $12) on software including $95 related to POS. In addition, Second Cup opened a new Company operated café in Calgary, provided financing to renovate a café, renovated a Company operated café in Toronto and upgraded head office computer equipment. Second Cup realized proceeds of $170 (2009 - $15) on the sale of café assets. The Company also invested in a note receivable for the renovated café totalling $185 to be repaid over seven years at a 6.5% interest rate. For all notes receivable, the Company owns title to the assets as security until the final payment has been collected. Second Cup collected $37 during the Quarter relating to a note receivable from a previous franchise partner.

Financing activities resulted in cash usage of $1,995 (2009 - $2,272). The Fund paid distributions to unitholders of $2,279 (2009 - $2,264) during the Quarter. In the Quarter, the Fund incurred $87 (2009 - $5) in financing charges related to the lender's consent to the Conversion discussed above and $3 (2009 - $3) in payments on a long-term lease. The Fund received proceeds of $399 from the sale of treasury units. The Fund also repaid $25 on a note payable to a landlord.

**Year ended December 31, 2010**

The Fund generated cash from operations of $11,200 in 2010 compared to $9,879 in 2009. The increase of $1,321 is mainly due to decreases in non-cash working capital. Accounts payable and accrued liabilities increased $2,423 which includes $1,026 for POS and licensing discussed above.

Cash utilized by investing activities was $1,671. In 2009, the Fund generated $3,345 from investing activities which included $3,066 of cash acquired on the acquisition of Second Cup. Second Cup spent $1,420 (2009 - $38) to purchase property and equipment including POS discussed above. Software purchases totalled $186 (2009 - $16) as discussed above. Second Cup received proceeds of $295 (2009 - $333) from the sale of Company owned café assets. Second Cup invested $435 in notes receivable including $185 in a note receivable to renovate a café and two small promissory notes totalling $29 which provides financing to purchase certain equipment. As discussed above, Second Cup owns title to the assets as security until the final payment has been collected. The promissory notes bear interest at rates varying from 0% to 8%. During 2010, Second Cup settled the early termination of a café lease with a landlord. The café was leased jointly with a third party and after Second Cup paid its 50% obligation to the landlord, the Company issued a promissory note for $200 to the landlord for the third party's 50% share. The Company then took back a promissory note for $221 from the third party secured by a general security agreement as collateral. The Company has collected $75 on the promissory notes.

Financing activities resulted in cash usage of $8,678 in 2010, compared to $9,864 in 2009. The Fund incurred $102 in financing charges related to the extension of the term loan to April 1, 2013 plus an additional $87 related to the lender's consent to the Conversion discussed above. In 2009, the Fund capitalized $263 of loan origination, legal and advisory fees in financing charges related to the extension of the term loan to January 1, 2011. As noted above in the previous paragraph, the Fund settled a lawsuit with a previous landlord by agreeing to a $200 note payable bearing interest at 5% maturing February 2012. The Fund repaid $81 during the course of the year. The Fund paid distributions to unitholders of $9,077 (2009 - $9,595). The decrease in distributions paid was due mainly to a decrease in the monthly distributions declared in 2009, effective with the distribution for the month of March as determined by the Trustees of the Fund. The Fund made payments of $12 (2009 - $6) on a long-term lease. The Fund received proceeds of $481 from the sale of 63,914 treasury units that were held by Second Cup on June 27, 2009.

The Fund had cash and cash equivalents balances of $5,413 at December 31, 2010 (December 31, 2009 - $4,562).

New Second Cup continues to believe it has sufficient financial resources to pay operating expenses, capital expenditures, liabilities, and dividends when declared and due.

*Term Loan, Operating Credit Facility and Interest Rate Swap*

On March 31, 2010, the Fund renegotiated its term loan and operating credit facilities including an extension of the credit facilities to April 1, 2013. The revised $13,000 credit facilities are comprised of an $11,000 non-revolving term credit facility, fully drawn, and an undrawn $2,000 revolving credit facility. As a result of the refinancing, the Fund capitalized $102 of loan extension fees. The Fund capitalized an additional $87 of fees related to the lender's consent to the Conversion discussed above. The term credit facilities are collateralized by substantially all the assets of the Fund.

The $11,000 non-revolving term credit facility bears interest at prime plus 2.50% or bankers' acceptance rate plus 3.50%. At December 31, 2010, the full amount of the $11,000 non-revolving term credit facility was drawn with an effective interest rate of 6.54% after taking into consideration the interest rate swap described below.

The $2,000 operating credit facility bears interest at prime plus 2.50% or bankers' acceptance rate plus 3.50%. At December 31, 2010, no advances had been drawn on this facility.

An interest rate swap agreement was entered into by the Fund maturing April 1, 2013, which fixes the interest rate on the Fund's non-revolving credit facility at 3.04% per annum plus the variable margin noted above, which results in a fixed effective interest rate of 6.54%. At December 31, 2010, the estimated fair value of this contract is a $331 liability to the Fund (2009 - $298) and is recorded as a liability on the Fund's Consolidated Balance Sheet and the fair value movement of the interest rate swap has been recorded as a non-cash charge or credit to earnings on the Fund's Consolidated Statement of Operations and Comprehensive Income.

Pursuant to the terms of the Fund's operating loan and term loan, the Fund is subject to certain financial and other customary covenants, including requirements to maintain a ratio of senior debt to EBITDA and to maintain a trailing four quarter fixed charge coverage ratio. As at December 31, 2010, the Fund was in compliance with all financial and other covenants of the Fund's operating loan and term loan.

## OFF-BALANCE SHEET ARRANGEMENTS

Second Cup has lease commitments for Company operated cafés and also acts as the head tenant on leases, which it, in turn, subleases to franchise partners. The Fund's lease commitments at December 31, 2010 are as follows:

| | Headlease commitments | Sublease to franchisees | Net |
|---|---|---|---|
| December 31, 2011 | $ 17,610 | $ 16,971 | $ 639 |
| December 31, 2012 | 16,115 | 15,616 | 499 |
| December 31, 2013 | 14,819 | 14,433 | 386 |
| December 31, 2014 | 13,517 | 13,121 | 396 |
| December 31, 2015 | 11,834 | 11,433 | 401 |
| Thereafter | 31,215 | 30,129 | 1,086 |
| | $ 105,110 | $ 101,703 | $ 3,407 |

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

New Second Cup guarantees a minimum volume of coffee purchases for franchise partners with a supplier. The minimum commitment for coffee purchases amounts to $3,628 (2009 - $2,633) over the next six months. In order to fulfill its commitments in terms of the supply agreement, the supplier has entered into a $US forward exchange contract amounting to $7,733 (2009 - $2,633) for green coffee purchases over the next 12 months. New Second Cup does not expect the liability, if any, relating to a shortfall of coffee purchases by franchise partners to be significant

## RELATED PARTY TRANSACTIONS AND BALANCES

The Fund had a service agreement with a company controlled by a unitholder to provide management and administrative services. The total cost recovery in 2010 was $250 (2009 - $95). The Fund had an outstanding payable of $1 (2009 - $15) which arose as a result of the related party paying for certain reimbursable general and administrative expenses of the Fund less the unpaid balance of the service agreement noted above.

## INTERNATIONAL FINANCIAL REPORTING STANDARDS (IFRS)

The Accounting Standards Board (the “AcSB”) has set January 1, 2011, as the date that IFRS will replace current Canadian GAAP for publicly accountable enterprises, which includes Canadian reporting issuers. Financial reporting under IFRS differs from Canadian GAAP in a number of respects, some of which are significant. IFRS on the date of adoption also is expected to differ from current IFRS due to new IFRS standards and pronouncements that are expected to be issued before the changeover date. New Second Cup will prepare its financial statements in accordance with IFRS for periods commencing as of January 1, 2011.

The following information is presented pursuant to the October 2008 recommendations of the Canadian Performance Reporting Board relating to pre-2011 communications about IFRS conversion and to comply with Canadian Securities Administrators Staff Notice 52-320, Disclosure of Expected Changes in Accounting Policies Relating to Changeover to IFRS. This information is provided to allow investors and others to obtain a better understanding of Second Cup’s IFRS changeover plan and the resulting possible effects on, for example, New Second Cup’s financial statements and operating performance measures. Readers are cautioned, however, that it may not be appropriate to use such information for any other purpose. This information also reflects New Second Cup’s most recent assumptions and expectations; circumstances may arise, such as changes in IFRS, regulations or economic conditions, which could change these assumptions or expectations.

### Progress toward completion of IFRS changeover plan

Summarized below is a description of the Fund’s progress toward completion of selected key activities of its IFRS changeover plan as of December 31, 2010. At this time, the Fund has determined the preliminary impact that the future adoption of IFRS will have on its consolidated financial statements and operating performance measures, however, the analysis is not complete and will be finalized in first quarter of fiscal 2011. It is also expected that the changeover to IFRS will impact internal controls over financial reporting, disclosure controls and procedures, and IT systems and processes.

| | SELECTED KEY ACTIVITIES | MILESTONES/ DEADLINES | PROGRESS TO DATE |
|---|---|---|---|
| **Financial statement preparation** | Identify relevant differences between IFRS and Second Cup's accounting policies and practices and design and implement solutions.<br><br>Evaluate and select one-time and ongoing accounting policy alternatives.<br><br>Benchmark findings with peer companies.<br><br>Prepare financial statements and related note disclosures to comply with IFRS.<br><br>Quantify the effects of changeover to IFRS. | Assessment and quantification of the significant effects of the changeover substantially completed by the end of fiscal 2010.<br><br>Final selection of accounting policy alternatives by the changeover date (Jan. 1, 2011). | Have established the scope of the project by identifying which IFRS statements are applicable to the Fund and have identified the potential differences between Canadian GAAP and IFRS.<br><br>The Fund has received approval of IFRS 1 accounting policy alternatives from the Fund's Audit Committee. |
| **Training and communication** | Establish IFRS project team.<br><br>Engage subject matter experts to assist in the transition. | Establish IFRS project team by first quarter 2009. | The Fund has formally established an IFRS project team consisting of members of its finance group and is led by the Fund's Chief Financial Officer. |
| | Provide training to the IFRS project team, management and the Trustees and relevant committees thereof, including the Audit Committee. | Timely training provided to align with work under changeover – training completed by the third quarter 2010. | Training for the IFRS project team has been completed. Training for the Trustees and the Audit Committee is ongoing. |
| | Communicate progress of changeover plan to internal and external stakeholders. | Communicate effects of changeover in time for creation of 2011 budget (fourth quarter of 2010). | Periodic internal and external communications about the Fund's progress is ongoing. |

| | SELECTED KEY ACTIVITIES | MILESTONES/ DEADLINES | PROGRESS TO DATE |
|---|---|---|---|
| **IT systems** | Identify and address IFRS differences that require changes to financial systems. | Changes to significant systems completed in time for the first quarter of 2010. | Based on the results of the Fund's review of the potential differences between IFRS and Canadian GAAP that may impact the Fund, to date no significant changes to the Fund's accounting package will be required. |
| **Contractual arrangements and compensation** | Identify impact of changeover on contractual arrangements, including customer and supplier agreements, financial covenants and employee compensation plans.<br><br>Make any required changes to arrangements and plans. | Changes completed by the fourth Quarter of 2010. | The Fund has reviewed IFRS differences with potential impact on contractual arrangements and compensation plan. The Fund has determined that no significant changes to its suppliers' and compensation agreements are required at this time. |
| **Internal control over financial reporting (ICFR)** | Revise existing internal control processes and procedures to address significant changes to existing accounting policies and practices during 2010.<br><br>Design and implement internal controls with respect to one-time change over adjustments and related communications. | Changes completed by the fourth Quarter of 2010.<br><br>Conduct management evaluation of new or revised controls throughout 2010 and 2011.<br><br>Update Chief Executive Officer/Chief Financial Officer certification process by the first quarter of 2011. | Monitoring design of solutions to address IFRS differences to permit concurrent design or revision, testing of automated controls if required, and implementation of necessary internal controls. |
| **Disclosure controls and procedures (DC&P)** | For changes to accounting policies and practices identified, assess the DC&P design and effectiveness implications. | See ICFR deadlines above. | MD&A disclosures have begun.<br><br>Project team meets monthly to track progress. |

### Changes in Accounting Policies

The International Accounting Standard Board ("IASB"), at its discretion, may issue new accounting standards during the conversion period, and as a result, the final impact of IFRS on New Second Cup's financial statements will only be measured once all the IFRS applicable at the conversion date are definitively known. Consequently, New Second Cup's analysis and estimates of changes and policy decisions have been made based on New Second Cup's current expectations regarding the accounting standards that New Second Cup anticipates will be effective at the time of transition. The future impacts of IFRS will also depend on the particular circumstances prevailing in those years. See the section entitled "Forward-Looking Information".

### Significant GAAP differences

Outlined below are the significant differences between Canadian GAAP and IFRS applicable to New Second Cup. The list and comments should not be regarded as a complete list of estimated changes that will result from transition to IFRS and are intended to highlight those areas New Second Cup currently believes to be most significant. New Second Cup is currently analyzing the impact of these differences.

### First-Time Adoption of International Financial Reporting Standards

New Second Cup's adoption of IFRS will require the application of IFRS 1, *First-Time Adoption of International Financial Reporting Standards* ("IFRS 1"), which provides guidance for an entity's initial adoption of IFRS. IFRS 1 generally requires that an entity apply all IFRS effective at the end of its first IFRS reporting period retrospectively. However, IFRS 1 does include certain mandatory exceptions and limited optional exemptions in specified areas of certain standards from this general requirement. The following are the significant optional exemptions available under IFRS 1 that New Second Cup expects to apply in preparing its first financial statements under IFRS.

| | |
|---|---|
| **Business Combinations** | New Second Cup has elected to not restate any Business Combinations that have occurred prior to January 1, 2010. |
| **Deemed Costs** | New Second Cup has not elected to measure its property and equipment at fair value and use fair value as the deemed cost for the same. |
| **Designation of previously accounted for financial assets or liabilities** | New Second Cup has not elected to designate, on January 1, 2010, any financial assets or liabilities, other than those mandatorily required to be classified as such, as "At fair value through profit and loss" per the requirements of IAS 39 *Financial Instruments: Recognition and Measurement*. |

### Financial Instruments: Debt versus Equity Classification

*Differences from existing Canadian GAAP:* IAS 32, *Financial Instruments: Presentation* ("IAS 32") requires a financial instrument which gives the holder the right to put the instrument back to the issuer for cash to be classified as a financial liability, unless certain criteria are met to allow for classification as equity. Canadian GAAP requires liability classification for such instruments in more limited circumstances than IAS 32.

*Expected Impact:* The Fund has analyzed the impact of this section on the classification of its Unitholders' Equity and determined that the Fund's units will qualify to be classified as equity under IFRS. In addition the Fund converted to a public corporation as of January 1, 2011, as such this issue is not applicable to 2011 and future reporting periods.

**Impairment of Indefinite Life Intangibles and Goodwill**

*Differences from existing Canadian GAAP:* International Accounting Standard 36, *Impairment of Assets* ("IAS 36"), requires that assets be tested for impairment at the level of cash generating units (including goodwill), which is the lowest level of assets that generate largely independent cash inflows. Under IFRS goodwill is always tested at the cash generating unit. Under Canadian GAAP goodwill is tested for impairment purposes with other assets and liabilities that are grouped at the lowest level for which identifiable cash flows are largely independent of the cash flows of other assets and liabilities.

Additionally, IFRS uses a one-step approach for both testing for and measurement of impairment, with cash generating unit's carrying values compared directly with the higher of fair value less costs to sell and value in use (which uses discounted future cash flows). Canadian GAAP however, uses a two-step approach to impairment testing of goodwill: first comparing carrying value of the reporting unit with the fair value of the reporting unit to determine whether impairment exists; and then measuring any impairment by comparing implied fair value of the goodwill and its carrying amount. The implied fair value of the goodwill is determined based on the value that would be ascribed to goodwill if the reporting unit were acquired in a current business combination at the date of the impairment test. Second Cup does not expect the difference in methodologies to result in additional asset impairments upon transition to IFRS.

However, with the exception of goodwill, any impairment losses may potentially be offset by the requirement under IAS 36 to reverse any previous impairment losses where circumstances have changed. Canadian GAAP prohibits reversal of impairment losses.

*Expected impact:* New Second Cup's impairment testing for goodwill and trademarks under IFRS as at January 1, 2010 is in progress and New Second Cup does not expect any material impact, if any, on its opening balance sheet.

**Provisions and Contingencies**

*Differences from existing Canadian GAAP:* IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* ("IAS 37"), requires an entity to recognize a provision when there is a probable outflow of resources and the amount can be estimated reliably. Canadian GAAP requires recognition of a provision if it is likely that a future event will confirm that a liability has been incurred and can be reasonably estimated. The probable limit for recognition of provisions, under IFRS, is a lower threshold than under Canadian GAAP.

Additionally, IAS 37 requires an entity to recognize a provision when a contract becomes onerous, that is, when it has a contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it. The unavoidable costs under a contract reflect the least net cost of exiting from the contract, which is the lower of the cost of fulfilling it and any compensation or penalties arising from failure to fulfill it. If an entity has a contract that is onerous, the present obligation under the contract shall be recognized and measured as a provision. Canadian GAAP only requires the recognition of such a liability in certain situations (e.g. for operating leases that the entity has ceased to use). This difference could result in recognition of an obligation under IFRS that was not previously recognized under Canadian GAAP.

*Expected impact:* New Second Cup is in the process of reviewing its significant contracts at January 1, 2010 including its commitments under the Headlease liabilities. Based on preliminary analysis, New Second Cup does not expect any material additional liabilities to be recognized as at January 1, 2010.

### Income Taxes

*Differences from existing Canadian GAAP:* IAS 12, *Income Taxes* ("IAS 12"), while being similar to the existing Canadian standard, any significant adjustments to balances resulting from the adoption of IFRS would have a corresponding effect on future income tax balances. Any impact will depend primarily on other adjustments made upon transition to IFRS.

*Expected impact:* New Second Cup is currently analyzing the impact of income tax adjustments, if any, and the effect of converting to a corporation in conjunction with its obligation to report under IFRS in 2011.

## MANAGEMENT OF CAPITAL

The capital structure of the Fund consists of long-term debt and unitholders' equity, which is comprised of issued units and accumulated earnings, less accumulated cash distributions.

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

- safeguard its ability to continue as a going concern;
- ensure it has sufficient cash and cash equivalents to pay declared distributions to its unitholders;
- maintain a capital structure that provides financing options to the Fund when the need arises to access capital;
- maintain financial flexibility in order to preserve its ability to meet financial obligations; and
- deploy capital to provide an adequate return to its unitholders.

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

The Fund determines the appropriate level of long-term debt in the context of its cash flow and overall business risks. The Fund has historically generated sufficient cash flow to pay monthly distributions to its unitholders. In order to maintain or modify the capital structure, New Second Cup may adjust the amount of dividends paid to its shareholders.

Under the term loan and operating facility, the Fund is required to comply with a number of covenants and restrictions, including the requirements to meet certain financial ratios. These financial ratios include a senior leverage ratio and ratios pertaining to earnings before interest, depreciation, taxes and amortization. To date, the Fund has complied with these ratios.

New Second Cup is subject to Canadian corporate income taxes beginning in 2011.

There were no changes in the Fund's approach to capital management during 2010.

The following table provides a summary of certain information with respect to the Fund's capital structure and consolidated financial position as at the dates indicated.

| | December 31, 2010 | December 31, 2009 |
|---|---|---|
| Cash and cash equivalents | $ (5,413) | $ (4,562) |
| Term loan | 10,837 | 10,841 |
| Net debt | 5,424 | 6,279 |
| Unitholders' equity | 70,045 | 69,338 |
| Total capitalization | $ 75,469 | $ 75,617 |

## OUTSTANDING UNIT AND SHARE DATA

| | As at December 31, 2010 | As at December 31, 2009 |
|---|---|---|
| Fund - units issued | 9,903,045 | 9,903,045 |
| Less: Units owned by Second Cup | - | 63,914 |
| Net Fund units issued | 9,903,045 | 9,839,131 |
| - amount | $ 89,972 | $ 89,972 |

## EVALUATION OF DISCLOSURE CONTROLS AND PROCEDURES

Multilateral Instrument 52-109 ("MI 52-109") requires the Fund's Chief Executive Officer ("CEO") and Chief Financial Officer ("CFO") to make certain certifications related to the information contained in the Fund's annual filings. Specifically, the CEO and CFO must acknowledge they are responsible for establishing and maintaining disclosure controls and procedures and internal control over financial reporting for the Fund. In addition, in respect of:

**(a) Disclosure Controls and Procedures**

The CEO and CFO must certify they have designed the disclosure controls and procedures, or caused them to be designed under their supervision, to provide reasonable assurance that material information relating to the Fund, including its consolidated subsidiaries, is made known to them in a timely manner and that information required under securities legislation is recorded, processed, summarized and reported in a timely manner.

As at December 31, 2010, the Fund's management, under the supervision of, and with the participation of, the CEO and CFO evaluated the design of the disclosure controls and procedures. Based on this evaluation, the CEO and CFO have concluded that as at December 31, 2010, the Fund's disclosure controls and procedures were appropriately designed.

Consistent with the concept of reasonable assurance, the Fund recognizes that the relative cost of maintaining these controls and procedures should not exceed their expected benefits. As such, the Fund's disclosure controls and procedures can only provide reasonable, and not absolute, assurance that the objectives of such controls and procedures are met.

**(b) Internal Controls over Financial Reporting**

The CEO and CFO must certify they have designed such internal controls over financial reporting, or caused them to be designed under their supervision to provide reasonable assurance regarding the reliability of financial reporting and the preparation of consolidated financial statements for external purposes in accordance with GAAP.

As at December 31, 2010, the Fund's management, under the supervision of, and with the participation of, the CEO and CFO evaluated the design of the controls over financial reporting. No material weaknesses in the design of these controls over financial reporting were identified. Based on this evaluation, the CEO and CFO have concluded that as at December 31, 2010, the Fund's controls over financial reporting were appropriately designed.

Consistent with the concept of reasonable assurance, the Fund recognizes that the relative cost of maintaining these controls should not exceed their expected benefits. As such, the Fund's internal controls over financial reporting can only provide reasonable, and not absolute, assurance that the objectives of such controls are met.

During the twelve months ended December 31, 2010, there has been no change in the Fund's internal control over financial reporting that has materially affected, or is reasonably likely to materially affect, the Fund's internal control over financial reporting.

## CRITICAL ACCOUNTING ESTIMATES

The preparation of the Fund's consolidated 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 the disclosure of contingent liabilities at the date of the consolidated financial statements.

*Intangible Assets*

Intangible assets consist of goodwill, trademarks, software and franchise rights. Goodwill is recorded at cost and represents the excess of the costs of investments and businesses acquired over the fair value of the net assets acquired. The trademarks are recorded at their historical carrying value. Software costs are recorded at cost and are amortized on a straight-line basis over their expected lives ranging from three to seven years commencing when the asset is available for use. The franchise rights intangible asset is based on the net present value of the discounted future net cash flows expected from the existing franchise partners of Second Cup. The net future cash flows are based on royalties and franchise fees less the head office expenses and relevant contributory changes of Second Cup. The franchise right is amortized over the average remaining length of the existing franchise agreements of Second Cup.

Management of the Fund reviews the carrying value of the intangible assets at least annually for impairment.

*Other Long-term Liabilities*

Headlease liabilities represent the provision for lease guarantees for franchised operations. When Second Cup opens new franchised café locations, the lease for the café is typically held in the name of Second Cup. The liability is recorded at estimated fair value based on the net present value of the future estimated negative cash flows when Second Cup is required to cover rental arrears of its franchise partners, to terminate unfavourable leases or to cover shortfalls if a location is sublet to a third party. This liability is amortized over the average remaining length of these existing lease agreements.

*Café Lease Agreements*

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

*Note Payable*

The Fund settled a lawsuit with a previous landlord by agreeing to a $200 note payable bearing interest at 5% maturing February 2012. The Fund repaid $81 during the course of the year. The maturity of the note payable subsequent to December 31, 2010 is as follows: 2011 - $102 and 2012 - $17.

*Contingent Liabilities*

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

Second Cup has guaranteed a minimum volume of coffee purchases from franchise partners with a supplier. The minimum commitment for coffee purchases amounts to $3,628 (2009 - $2,633) over the next six months. In order to fulfill its commitments in terms of the supply agreement, the supplier has entered into a $US forward exchange contract amounting to $7,733 (2009 - $2,633) for green coffee purchases over the next 12 months. The Company does not expect the liability, if any, relating to a shortfall of coffee purchases by franchise partners to be significant.

*Future Income Taxes*

The Fund follows the asset and liability method of accounting for income taxes. Future income tax assets are recognized only to the extent that management determines it is more likely than not that the future income tax assets will be realized. On January 1, 2011, the Fund completed its conversion to a corporation, therefore New Second Cup will be subject to corporate income tax.

## RISKS AND UNCERTAINTIES

The performance of New 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 the Second Cup café network 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 adversely affect the ability of New Second Cup to pay dividends.

Growth of the café network depends on New Second Cup's ability to secure and build desirable locations and find high calibre, qualified franchise partners to operate them. Adverse credit markets, such as those currently being experienced, may affect the ability of franchise partners to obtain new credit or refinance existing credit on economically reasonable terms.

New Second Cup faces competition for café locations and franchise partners from its competitors and from franchisors and operators of other businesses. The success of Second Cup franchise partners is significantly influenced by the location of their cafés. There can be no assurance that current Second Cup café locations will continue to be attractive, or that additional café sites can be located and secured as demographic patterns change. Also, there is no guarantee that the property leases in respect of the Second Cup cafés will be renewed or suitable alternative locations will be obtained and, in such event, one or several cafés could be closed. It is possible that the current locations or economic conditions where Second Cup cafés are located could decline in the future, resulting in potentially reduced sales in those locations, which will have an adverse effect on System Sales. There is no assurance that future sites will produce the same results as past sites. There is also no assurance that a franchise partner will continue to pay its rental obligations in a timely manner which could result in New Second Cup being obligated to pay the rental obligations pursuant to its head lease commitment which would adversely affect the profitability of New Second Cup's business.

A shortage in supply or an increase in the price of premium quality coffee beans could adversely affect New Second Cup. New Second Cup has no material long-term 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 New Second Cup will continue to supply coffee beans at competitive prices.

The Canadian specialty coffee industry is also affected by changes in discretionary spending patterns, which are in turn dependent on consumer confidence, disposable consumer income and general economic conditions. Factors such as a change in general economic conditions, recessionary or inflationary trends, job security and unemployment, equity market levels, consumer credit availability and overall consumer confidence levels may affect their business. The specialty coffee industry is also affected by demographic trends and traffic and weather patterns as well as the type, number and location of competing cafés.

New Second Cup's business could be adversely affected by increased concerns about food safety in general or other unusual events.

As a Franchisor, New Second Cup guarantees the lease of its franchise partners for most of its franchised cafés.

Changes in government regulations and other regulatory developments (such as smoking by-laws) could have an adverse impact on system sales and royalties.

The loss of key personnel and/or a shortage of experienced management and hourly employees could have an adverse impact on New Second Cup's operations and cafés.

A more detailed discussion of the risks and uncertainties affecting New Second Cup is set out in the New Second Cup's Annual Information Form, which is available at www.sedar.com.

## SUBSEQUENT EVENTS

On January 1, 2011, the Fund completed the previously announced plan of arrangement pursuant to which the Fund's income trust structure was converted into a dividend paying publicly traded corporation named The Second Cup Ltd. The common shares of Second Cup commenced trading on the Toronto Stock Exchange on January 4, 2011 under the symbol "SCU".

Subsequent to year end New Second Cup committed to capital expenditures on POS of $2,100.

## OUTLOOK

The information contained in this "Outlook" is forward-looking information. Please see "Forward-looking Information" below for a discussion of the risks and uncertainties in connection with forward-looking information.

The Second Cup business continues to operate in a highly competitive market place and a challenging consumer environment. For 2011, management is targeting to regain growth with positive same café sales, and the addition of net new cafés. The focus will be on driving traffic into cafés through external messaging, sampling and product news. In café, the focus will be on operating excellence, training and promotion of the brand's quality credentials as the "Trusted Coffee Expert".

In terms of 2011 network expansion, New Second Cup expects: (1) to open 25 to 30 new cafés in Canada; (2) to close five to 10 cafés during 2011, the majority of which have sales below the average performance of its cafés; and (3) approximately 30 cafés will be renovated.

## FORWARD-LOOKING INFORMATION

Certain statements in this MD&A may constitute forward-looking information within the meaning of applicable securities legislation. Forwardlooking 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 New Second Cup's control, that may cause New Second Cup's actual results, performance or achievements, or those of Second Cup cafés, or industry results to be materially different from any future results, performance or achievements expressed or implied by 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 franchise partners; the location of Second Cup cafés; the closure of Second Cup cafés; loss of key personnel; compliance with government regulations; potential litigation; the ability to exploit and protect the Second Cup Marks; changing consumer preferences and discretionary spending patterns including, but not restricted to, the impact of weather and economic conditions on such patterns; reporting of system sales by franchise partners; and the results of operations and financial condition of New Second Cup. The foregoing list of factors is not exhaustive, and investors should refer to the risks described under “Risks and Uncertainties” above and in New Second Cup’s Annual Information Form, which is available at www.sedar.com.

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 and, as a result, the forward-looking information may prove to be incorrect.

As these forward-looking statements are made as of the date of this MD&A, New Second Cup 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.

## 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”, “system sales of cafés in the royalty pool”, “same café sales growth”, “earnings per unit before conversion costs, transaction costs and non-cash future income tax recovery”, “distributable cash per unit excluding changes in non-cash working capital”, “distributable cash per unit” 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 all cafés in Canada. New Second Cup believes they are useful measures as they provide an indication of the top-line sales on which the royalty that is New Second Cup’s direct source of income is based. Distributable cash is presented in reference to the Fund’s distribution policy. The Fund believed distributable cash was a useful measure as it provided investors with an indication of cash available for distribution. Management believed, in addition to net income, distributable cash was a useful supplemental measure in evaluating the Fund’s performance as it provided 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 Consolidated Statements 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.

Additional information relating to New Second Cup, including New Second Cup’s Annual Information Form, is on SEDAR at www.sedar.com.

The Second Cup Ltd. (formerly Second Cup Income Fund)

# Audited Consolidated Financial Statements

For the years ended December 31, 2010 and 2009

PRICEWATERHOUSECOOPERS

**PricewaterhouseCoopers LLP**
**Chartered Accountants**
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March 8, 2011

## Independent Auditor's Report

**To the Shareholders of**
**The Second Cup Ltd.**
(formerly Second Cup Income Fund)

We have audited the accompanying consolidated financial statements of The Second Cup Ltd. (formerly Second Cup Income Fund) and its subsidiaries, which comprise the consolidated balance sheets as at December 31, 2010 and 2009 and the consolidated statements of operations and comprehensive income, unitholders' equity and cash flows for the years then ended, and the related notes including a summary of significant accounting policies.

**Management's responsibility for the consolidated financial statements**
Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with Canadian generally accepted accounting principles, and for such internal control as management determines is necessary to enable the preparation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

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

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

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

**Opinion**
In our opinion, the consolidated financial statements present fairly, in all material respects, the financial position of The Second Cup Ltd. (formerly Second Cup Income Fund) and its subsidiaries as at December 31, 2010 and 2009 and the results of its operations and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

PricewaterhouseCoopers LLP

**Chartered Accountants, Licensed Public Accountants**

"PricewaterhouseCoopers" refers to PricewaterhouseCoopers LLP, an Ontario limited liability partnership, which is a member firm of PricewaterhouseCoopers International Limited, each member firm of which is a separate legal entity.

The Second Cup Ltd. (formerly Second Cup Income Fund)

# Consolidated Balance Sheets

## As at December 31, 2010 and 2009

(Expressed in thousands of dollars)

| | 2010 | 2009 |
|---|---|---|
| **ASSETS** | | |
| Current assets | | |
| Cash and cash equivalents (note 4) | **$ 5,413** | $ 4,562 |
| Accounts receivable | **5,843** | 4,558 |
| Current portion of notes receivable (note 6) | **100** | - |
| Inventories (note 5) | **49** | 83 |
| Prepaid expenses and other assets | **361** | 92 |
| Income taxes recoverable | **75** | 53 |
| | **11,841** | 9,348 |
| Notes receivable (note 6) | **260** | - |
| Property and equipment (note 7) | **1,491** | 600 |
| Goodwill and intangibles (notes 1 and 2(g) and 8) | **90,469** | 90,629 |
| | **$ 104,061** | $ 100,577 |
| **LIABILITIES** | | |
| Current liabilities | | |
| Accounts payable and accrued liabilities | **$ 7,020** | $ 4,597 |
| Current portion of other long-term liabilities (note 10) | **304** | 72 |
| Gift card liability (note 2(m)) | **4,167** | 3,992 |
| Distributions payable to unitholders | **759** | 759 |
| Deposits from franchise partners | **1,448** | 1,375 |
| | **13,698** | 10,795 |
| Future income taxes (note 11) | **8,663** | 8,696 |
| Other long-term liabilities (notes 1, 2(h) and 10) | **487** | 609 |
| Fair value of derivative interest rate swap (note 12) | **331** | 298 |
| Term loan (note 12) | **10,837** | 10,841 |
| | **34,016** | 31,239 |
| **UNITHOLDERS' EQUITY** | **70,045** | 69,338 |
| | **$ 104,061** | $ 100,577 |

Contingencies, Commitments and Guarantees (note 13)
Subsequent events (note 21)
See accompanying notes to consolidated financial statements.

Approved by the Directors

Raymond Guyatt, Director James Anas, Director

The Second Cup Ltd. (formerly Second Cup Income Fund)

# Consolidated Statements of Operations and Comprehensive Income

## For the years ended December 31, 2010 and 2009

(Expressed in thousands of dollars, except per unit amounts)

| | 2010 | 2009 |
|---|---|---|
| **Revenue** | | |
| Royalty revenue (note 2(d)) | **$ 15,874** | $ 8,241 |
| Revenue from Company operated cafés (note 2(d)) | **3,388** | 2,819 |
| Other income (note 2(d)) | **5,909** | 3,019 |
| Earnings from equity accounted investment (note 9) | **-** | 5,425 |
| | **25,171** | 19,504 |
| **Operating Expenses** | | |
| Operating and administrative expenses | **10,642** | 5,415 |
| Expenses of Company operated cafés | **3,258** | 2,730 |
| Amortization of property and equipment | **142** | 88 |
| Amortization of intangibles | **346** | 179 |
| | **14,388** | 8,412 |
| Operating income | **10,783** | 11,092 |
| **Other expenses** | | |
| Loss on disposal of property and equipment | **92** | 76 |
| Conversion costs | **563** | - |
| Interest expense - net (note 12) | **941** | 743 |
| | **1,596** | 819 |
| Earnings before income taxes | **9,187** | 10,273 |
| **Income tax recovery** | | |
| Current | **(83)** | (47) |
| Future (note 11) | **(33)** | (1,144) |
| | **(116)** | (1,191) |
| Net earnings for the year | **9,303** | 11,464 |
| Other comprehensive income | **-** | - |
| Comprehensive income | **9,303** | 11,464 |
| Basic and diluted earnings per unit (note 15) | **$ 0.9433** | $ 1.1614 |

See accompanying notes to consolidated financial statements.

The Second Cup Ltd. (formerly Second Cup Income Fund)

# Consolidated Statements of Unitholders' Equity

(Expressed in thousands of dollars)

| | Income Fund Units | Contributed Surplus | Accumulated Unitholders' Earnings | Accumulated Distributions | Total |
|---|---|---|---|---|---|
| **Balance - December 31, 2008** | $ 89,800 | $ - | $ 19,628 | $ (41,980) | $ 67,448 |
| Units issued January, 2009 | 172 | - | - | - | 172 |
| Treasury units (note 1) | - | - | (321) | - | (321) |
| Net earnings for the year | - | - | 11,464 | - | 11,464 |
| Distributions to unitholders | - | - | - | (9,425) | (9,425) |
| **Balance - December 31, 2009** | $ 89,972 | $ - | $ 30,771 | $ (51,405) | $ 69,338 |
| Treasury units (note 1) | - | - | 321 | - | 321 |
| Net earnings for the year | - | - | 9,303 | - | 9,303 |
| Gain on disposal of treasury units (note 14) | - | 160 | - | - | 160 |
| Distributions to unitholders | - | - | - | (9,077) | (9,077) |
| | 89,972 | 160 | 40,395 | (60,482) | 70,045 |
| Accumulated other comprehensive income | - | - | - | - | - |
| **Balance - December 31, 2010** | $ 89,972 | $ 160 | $ 40,395 | $ (60,482) | $ 70,045 |

See accompanying notes to consolidated financial statements.

The Second Cup Ltd. (formerly Second Cup Income Fund)

# Consolidated Statements of Cash Flows

## For the years ended December 31, 2010 and 2009

(Expressed in thousands of dollars)

| | 2010 | 2009 |
|---|---|---|
| **CASH PROVIDED BY** (used in) | | |
| Operating activities | | |
| Net earnings for the year | $ 9,303 | $ 11,464 |
| Items not involving cash | | |
| Earnings from equity accounted investment | - | (5,425) |
| Amortization of other long-term liabilities | (169) | (185) |
| Amortization of property and equipment | 142 | 88 |
| Amortization of franchise rights | 283 | 141 |
| Amortization of software | 63 | 38 |
| Loss on disposal of property and equipment | 92 | 76 |
| Amortization of deferred financing charges | 185 | 150 |
| Movement in fair value of derivative interest rate swap | 33 | (114) |
| Future income taxes | (33) | (1,144) |
| Distributions received from investment (note 9) | - | 5,700 |
| Changes in non-cash working capital (note 16) | 1,301 | (910) |
| | 11,200 | 9,879 |
| Investing activities | | |
| Cash acquired on acquisition of Second Cup (note 1) | - | 3,066 |
| Purchase of property and equipment | (1,420) | (38) |
| Purchase of software | (186) | (16) |
| Proceeds from disposal of property and equipment | 295 | 333 |
| Investment in notes and leases receivable | (435) | - |
| Proceeds from repayment of note receivable | 75 | - |
| | (1,671) | 3,345 |
| Financing activities | | |
| Distributions paid to unitholders | (9,077) | (9,595) |
| Payments on long-term lease | (12) | (6) |
| Issuance of note payable | 200 | - |
| Repayment of note payable | (81) | - |
| Proceeds from disposal of treasury units | 481 | - |
| Deferred financing charges | (189) | (263) |
| | (8,678) | (9,864) |
| Increase in cash and cash equivalents during the year | 851 | 3,360 |
| Cash and cash equivalents - Beginning of year | 4,562 | 1,202 |
| Cash and cash equivalents - End of year | $ 5,413 | $ 4,562 |

See accompanying notes to consolidated financial statements.

The Second Cup Ltd. (formerly Second Cup Income Fund)

# Notes to Consolidated Financial Statements

December 31, 2010 and 2009

(Expressed in thousands of dollars, except units and per unit amounts)

## 1. ORGANIZATION AND NATURE OF BUSINESS

Prior to January 1, 2011, Second Cup Income Fund (the “Fund”) was an unincorporated open-ended trust established under the laws of the Province of Ontario. An unlimited number of units could have been issued pursuant to the Fund’s declaration of trust. Units were redeemable by the holder at any time, subject to certain limitations. Income tax obligations related to distributions by the Fund were the responsibility of the unitholders. On August 21, 2009, the Fund changed its name from Second Cup Royalty Income Fund to Second Cup Income Fund.

*Conversion of Second Cup Income Fund*

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

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

New Second Cup is a specialty coffee franchisor and retailer with 349 cafés operating under the trade name Second Cup™ in Canada of which five are Company operated. The cafés are predominantly operated by franchise partners who are selected and trained to retail Second Cup’s product offering.

*2009 Acquisition of The Second Cup Ltd.*

On June 27, 2009, Second Cup Trade-Marks Limited Partnership (“MarksLP”), on behalf of the Fund, completed the acquisition of all the outstanding shares of The Second Cup Ltd. (Second Cup” or “the Company”) for total consideration of one dollar cash paid on closing, plus transaction costs incurred of approximately $480. The transaction costs were expensed by MarksLP.

The acquisition has been accounted for using the purchase method and the operating results are included in the Consolidated Statements of Operations and Comprehensive Income from the effective date of June 28, 2009. Previously, the results of MarksLP were consolidated with Second Cup in accordance with Accounting Guideline 15 (“AcG-15”) and the Fund equity accounted for its 100% interest in the units of MarksLP (refer to note 2(a)). The result of this transaction is that the Fund now controls and is required to consolidate both MarksLP and Second Cup. Consequently, the purchase accounting equation treats the transaction as an acquisition of control of both Second Cup and MarksLP.

The acquisition accounting as noted below has been determined based on the fair values of assets acquired and liabilities assumed, as well as a valuation of intangible assets acquired and the fair value of certain lease obligations assumed.

The purchase price allocation of the net assets based on their fair values is as follows:

| | MarksLP | Second Cup |
|---|---|---|
| Fair value of net assets acquired: | | |
| Cash | | $ 2,966 |
| Accounts receivable | | 2,134 |
| Other assets | | 424 |
| Property and equipment | | 1,171 |
| Franchise rights (note 2(g)) | | 1,331 |
| Accounts payable and accrued liabilities | | (6,943) |
| Deposits from franchise partners | | (1,493) |
| Lease payable | | (32) |
| Café lease agreements (note 2(h)) | | (149) |
| Headlease liabilities (note 2(h)) | | (606) |
| Fair value of net assets acquired | | (1,197) |
| Less: | | |
| Settlement of pre-existing liability | | 1,568 |
| Acquisition of Fund units** | | (321) |
| Consideration (one dollar) | | - |
| Goodwill arising on Second Cup acquisition | | $ 2,444 |
| Cash | $ 100 | |
| Trademark | 86,905 | |
| Accounts payable and accrued liabilities | (176) | |
| | 86,829 | |
| Less: | | |
| Settlement of pre-existing liability | (1,568) | |
| Consideration arising from deemed acquisition of MarksLP*** | 88,397 | - |
| Goodwill* | | $ 2,444 |

*Goodwill represents the difference between the purchase price and the net fair value of the identifiable assets and liabilities of the acquired entities.
**As part of the acquisition of Second Cup, the Fund acquired 63,914 Fund units that were held by Second Cup. The fair value of the Fund units held by Second Cup as at June 27, 2009 was $321. In accordance with Emerging Issues Committee Abstract ("EIC") 138, these Fund units are treated as a repurchase of units. As a result, the Fund units are carried at cost and shown as a deduction from accumulated unitholders' earnings in the Consolidated Statements of Unitholders' Equity.
***Represents carrying value of the Fund's equity investment in MarksLP at June 27, 2009.

## 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

*(a) Basis of presentation*
These consolidated financial statements include the accounts of the Fund and its wholly-owned subsidiaries MarksLP, Second Cup GP Trust ("GP Trust"), Second Cup GP Inc. ("GP Inc.") and Second Cup.

Prior to June 27, 2009, MarksLP was consolidated with Second Cup in accordance with AcG-15 relating to variable interest entities ("VIEs") and was accounted for in the consolidated financial statements of the Fund as an equity investment because the Fund, despite having 100% ownership of MarksLP, was not deemed to be the primary beneficiary of MarksLP. On June 27, 2009, as a result of the acquisition of Second Cup, the Fund acquired control of the consolidated company of Second Cup, which includes Second Cup and MarksLP. The purchase price allocation for the acquisition of Second Cup as disclosed in note 1 of the consolidated financial statements includes the assets and liabilities of Second Cup and MarksLP. The purchase price for the acquisition is deemed to be the carrying value of the Fund's equity investment in MarksLP plus the consideration of one dollar paid on closing. From the date of acquisition of Second Cup, the financial results of Second Cup and MarksLP are consolidated.

These consolidated financial statements have been prepared in accordance with Canadian generally accepted accounting principles.

Second Cup operates within Canada which is considered to be its sole operating segment. As a franchisor, Second Cup opens, acquires, closes and refranchises individual café locations in the normal course of business. Café closures in geographical areas where existing or new cafés continue to serve the same customer base are not reported as discontinued operations.

*(b) Use of estimates*

The preparation of consolidated financial statements in conformity with Canadian generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the amounts of revenues and expenses for the reporting periods. Actual results could differ from those estimates. The carrying values of accounts receivable, long-lived assets, trademarks and goodwill and accounting for estimates of provisions for liabilities are the more significant areas requiring management judgment and estimates.

*(c) Cash and cash equivalents*

Deposits in bank 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 value.

*(d) Revenue recognition*

Royalty revenue from franchised cafés is recognized as the products are sold as reported by the franchise partner. Franchise fees are recognized as income when the agreement has been signed and all material conditions have been met. Other income includes initial franchise fees, café resale fees, renewal fees, construction administration fees and purchasing co-ordination fees, which are recognized as income once all significant conditions have been met. Amounts received from long term purchasing coordination fees are deferred and recognized as revenue based on the length of the term. 50% of renewal fees received in advance of completing a renovation are deferred and recognized as revenue upon completion, which is generally on café re-opening. Revenue from Company operated cafés is recognized as the products are sold to customers. Interest income on promissory notes is recognized when earned on an accrual basis.

*(e) Inventories*

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

*(f) Notes receivable*

Notes receivable are recorded at fair value and are assessed for impairment on an individual basis based on the ability of the debtor to make the required payments and the value of the security. When there is no longer reasonable assurance that a note receivable will be collected, its carrying amount is reduced and an impairment charge is recorded in the period.

*(g) Goodwill and intangibles*

Intangible assets consist primarily of trademarks, goodwill, franchise rights and software which are amortized or assessed for impairment as follows.

Goodwill

Goodwill represents the excess of the cost of investments in businesses acquired over the fair value of the net assets acquired by the Fund. Goodwill is not amortized, but is tested for impairment based on fair value on an annual basis as well as when events or changes in circumstances indicate that the carrying value may not be recoverable. The goodwill impairment test requires a comparison of the estimated fair value of the Fund to the carrying value that is recorded on the Fund's consolidated balance sheets.

The current estimated fair value of the Fund is based on discounted cash flows. The valuation approaches use key judgments and assumptions that are sensitive to change, which include appropriate system sales growth rates, café openings and closures, the contribution from corporate cafés and weighted average costs of capital ("WACC"). When developing these key judgments and assumptions, the Fund considers economic, operational and market conditions that could impact the estimated fair value of the Fund. However, estimates are inherently uncertain and represent only management's reasonable expectations regarding future developments. These estimates and the key judgments and assumptions upon which the estimates are based will, in all likelihood, differ in some respects from actual future results. For example, should a significant or prolonged deterioration in economic conditions occur, key judgments and assumptions could be impacted. Generally, a moderate decline in estimated operating income or an increase in WACC or a decline in market conditions could result in an additional indication of impairment.

During its annual review of the carrying value of Goodwill, the Fund performed the first step of its goodwill impairment test in accordance with CICA Handbook Section 3064. Management determined that as of December 31, 2010, the estimated fair value of the Fund exceeded its carrying value and that goodwill was not impaired.

Trademarks

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

The impairment test performed by management of the Fund involved comparing the estimated fair value of the trademark with its carrying value. Management of the Fund considered a number of factors in estimating fair value of the trademark. These included discounted cash flow estimates, comparison of the unitholders' equity to the Fund's market capitalization, capitalized cash flow methods and earnings multiples. Each of these valuation approaches use estimates and assumptions that are sensitive to change and require management judgment. These key judgments include estimates of discount rates, forecast growth in system sales, market multiples, other estimates impacting future cash flows and control premiums. Changes in these estimates and assumptions may have a significant impact on fair value. General market uncertainty and the recessionary operating environment for the Fund and other similar retail entities were also factors taken into account in the analysis. An increase in the discount rate used in the analysis reflects the current volatility of the Fund's units and market conditions. The changes in the market growth rates reflect the current general economic pressures now impacting the national economy.

Management of the Fund concluded the estimated fair value of its trademark exceeded its carrying value as of December 31, 2010 and that the trademark was not impaired.

Franchise rights

As a result of the acquisition of Second Cup, franchise rights were recognized as an intangible asset in the consolidated financial statements of the Fund. The franchise rights intangible asset is based on the net present value of the discounted future net cash flows expected from the existing franchise partners of Second Cup. At the date of acquisition the net future cash flows were based on royalties and franchise fees less the head office expenses and relevant contributory charges of Second Cup. The franchise rights are amortized over the average remaining length of the existing franchise agreements of Second Cup.

Software

Software costs are recorded at cost and are amortized on a straight-line basis over their expected lives ranging from three to seven years commencing when the asset is available for use.

*(h) Other long-term liabilities*

Headlease liabilities

Headlease liabilities represent the provision for lease guarantees provided by Second Cup for franchised operations at the date of acquisition, June 27, 2009. The liability was recorded at estimated fair value based on the net present value of the future estimated negative cash flows when Second Cup is required to cover rental arrears of its franchise partners, to terminate unfavourable leases or to cover shortfalls if a location is sublet to a third party. This liability is amortized over the average remaining length of these existing lease agreements.

### Café lease agreements

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

### *(i) Property and equipment*

Property 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:

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

The Fund evaluates the operating and financial performance of its property and equipment for potential impairment in accordance with CICA Section 3063, Impairment of Long-Lived Assets. If an asset is determined to be impaired, the asset is written down to its fair value. The Fund reviews the fair value of long-lived assets when events or changes in circumstances indicate that the carrying value may not be recoverable.

### *(j) Deferred financing charges*

Deferred financing charges represent costs associated with the Fund's term loan, and are offset against the term loan.

### *(k) Future income taxes*

Prior to June 12, 2007, pursuant to the Income Tax Act as previously enacted, the Fund was not subject to income tax to the extent that its taxable income was distributed to unitholders. As a result of new tax legislation proposed by the Minister of Finance (Canada) on October 31, 2006 and substantively enacted on June 12, 2007, the Fund will pay a tax on distributions declared subsequent to January 1, 2011 at substantively enacted income tax rates. As a result of this change, as further explained in note 11, the Fund has provided for the future tax effect of existing temporary differences between the accounting and tax bases of assets and liabilities that are expected to reverse subsequent to January 1, 2011. In 2011, income taxes payable will reduce net earnings of the Fund. On January 1, 2011, the Fund completed its conversion to a corporation, therefore New Second Cup will be subject to corporate income tax.

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

### *(l) Advertising and cooperative fund assets and liabilities*

Second Cup manages an advertising and cooperative fund (the "Coop Fund") established to collect and administer funds contributed for use in advertising and promotional programs, national training programs and, among other things, initiatives designed to increase sales and enhance the reputation of the Second Cup brand. Contributions to the Coop Fund are required to be made from both franchised and Company owned and operated cafés and are based on a percentage of café sales. The Fund accounts for the Coop Fund in accordance with CICA Accounting Guideline 2, Franchise Fee Revenue ("AcG-2"). The revenue, expenses, and cash flows of the Coop Fund are not included in the Fund's Consolidated Statements of Operations and Cash Flows because the contributions to this fund are segregated and designated for a specific purpose. At the year-end, if the Coop Fund is in a deficit position then the deficit amount is not recognized as an asset and is shown as an expense of the Fund. At the year-end, if the Coop Fund is in a surplus position, then the surplus amount is recognized as a liability of the Fund. As at December 31, 2010, the Coop Fund was in a net surplus position of $400 (2009 - $97) and is included as part of accrued liabilities.

*(m) Gift card liability*
Gift card liability represents $4,167 of liabilities related to unused balances on Second Cup's reloadable payment card ("Second Cup Café Card") net of estimated breakage. These balances are included as sales from franchised cafés, or as revenue of Company operated cafés, at the time the customer redeems the amount in a café for products or services. Breakage represents management's estimates of balances outstanding relating to gift cards that may never be redeemed. This breakage factor is estimated based on historical experience and other factors, is reviewed regularly by management and is recorded in the Coop Fund.

*(n) Operating leases*
Operating 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 Fund considers option periods for which failure to renew the lease impose an economic penalty on the Fund of such an amount that the renewal appears to be reasonably assured at the inception of the lease.

*(o) Financial instruments*
The Fund's financial instruments consist of cash and cash equivalents, accounts receivable, notes receivable, accounts payable and accrued liabilities, deposits from franchise partners, distributions payable to unitholders, term loan and the derivative interest rate swap.

Financial assets are classified as either available-for-sale, held-for-trading, held-to-maturity or loans and receivables. Financial liabilities are classified as either held-for-trading or cost/amortized cost. Financial assets held-to-maturity, loans and receivables and financial liabilities other than those held-for-trading are measured at amortized cost. All derivative instruments must be classified as held-for-trading. All other financial assets and derivatives are measured at fair value. Transaction costs associated with long-term debt are included in the carrying value of the long-term debt and are amortized using the effective interest rate method.

*(p) Long-term incentive plan*
In December 2009, the Fund implemented a long-term incentive plan ("LTIP") as described in Note 19. The Fund accounts for its grants under this plan in accordance with CICA Section 3870 Stock-Based Compensation and Other Stock-Based Payments. Compensation expense is measured at the grant date at fair value and recognized over the service period, based on the vesting period applicable and is adjusted for any changes in market value of the Fund's unit price.

## 3. FUTURE ACCOUNTING STANDARDS

International Financial Reporting Standards
In February 2008, the Canadian Accounting Standards Board ("AcSB") confirmed that Canadian public entities will have to adopt International Financial Reporting Standards ("IFRS") effective for fiscal years beginning on or after January 1, 2011 (the "changeover date"). New Second Cup will issue financial statements in accordance with IFRS commencing in the first quarter ended March 31, 2011, with comparative information. The impact of the adoption of IFRS on the financial statements of New Second Cup will not be material. New Second Cup has developed its convergence plan in order to transition its financial statement reporting, presentation and disclosure to IFRS in time to meet the January 1, 2011 deadline. New Second Cup continues the process of evaluating the potential impact of IFRS on its financial statements. The process will be ongoing as new standards and recommendations are issued by the International Accounting Standards Board and AcSB. New Second Cup will adopt IFRS on January 1, 2011.

## 4. CASH AND CASH EQUIVALENTS

| | **2010** | **2009** |
|---|---|---|
| Cash | $ 4,413 | $ 3,662 |
| Cashable guaranteed investment certificate | 1,000 | 900 |
| | $ 5,413 | $ 4,562 |

The guaranteed investment certificate is a 30 day cashable GIC. The effective interest rate earned during the year was 0.52% (2009 – 0.65%).

### 5. INVENTORIES

| | 2010 | 2009 |
|---|---|---|
| Merchandise held for resale | $ 39 | $ 66 |
| Supplies | 10 | 17 |
| | $ 49 | $ 83 |

### 6. NOTES RECEIVABLE

| | 2010 | 2009 |
|---|---|---|
| Notes receivable, bearing interest at rates varying from 0% to 8% | $ 360 | $ - |
| Less current portion | 100 | - |
| | $ 260 | $ - |
| Notes receivable due as of: | | |
| December 31, 2011 | $ 100 | $ - |
| December 31, 2012 | 89 | - |
| December 31, 2013 | 69 | - |
| December 31, 2014 | 27 | - |
| December 31, 2015 | 27 | - |
| Thereafter | 48 | - |
| | $ 360 | $ - |

During 2010, the Fund settled the early termination of a café lease with a landlord. The café was leased jointly with a third party and after the Company paid its 50% obligation to the landlord, the Company issued a promissory note to the landlord for the third party's 50% share (note 10). The company took back a promissory note from the third party secured by a general security agreement. The Company also agreed to finance three franchise partners to enable them to purchase certain equipment, furniture and fixtures all of which are owned by the Company as the underlying security. Title will be transferred to the franchise partner after collecting full payment on the receivable.

### 7. PROPERTY AND EQUIPMENT

| | 2010 | | |
|---|---|---|---|
| | Cost | Accumulated amortization | Net |
| Leasehold improvements | $ 1,357 | $ 1,015 | $ 342 |
| Equipment, furniture, fixtures and other | 1,909 | 823 | 1,086 |
| Computer hardware | 785 | 722 | 63 |
| | $ 4,051 | $ 2,560 | $ 1,491 |

| | 2009 | | |
|---|---|---|---|
| | Cost | Accumulated amortization | Net |
| Leasehold improvements | $ 1,212 | $ 968 | $ 244 |
| Equipment, furniture, fixtures and other | 1,192 | 882 | 310 |
| Computer hardware | 736 | 690 | 46 |
| | $ 3,140 | $ 2,540 | $ 600 |

## 8. GOODWILL AND INTANGIBLES

| | 2010 | | |
|---|---|---|---|
| | Cost | Accumulated amortization | Net |
| Trademarks 2(g) | $ 86,905 | $ - | $ 86,905 |
| Goodwill 2(g) | 2,444 | - | 2,444 |
| Franchise rights 2(g) | 1,331 | 424 | 907 |
| Software 2(g) | 985 | 772 | 213 |
| | $ 91,665 | $ 1,196 | $ 90,469 |

| | 2009 | | |
|---|---|---|---|
| | Cost | Accumulated amortization | Net |
| Trademarks 2(g) | $ 86,905 | $ - | $ 86,905 |
| Goodwill 2(g) | 2,444 | - | 2,444 |
| Franchise rights 2(g) | 1,331 | 141 | 1,190 |
| Software 2(g) | 799 | 709 | 90 |
| | $ 91,479 | $ 850 | $ 90,629 |

## 9. EQUITY ACCOUNTED INVESTMENT

The following table details the changes in the equity accounted investment, MarksLP. As described in note 1 as part of the Fund's acquisition of Second Cup, the Fund was deemed to have acquired control of MarksLP on June 27, 2009. At this date, the Fund began consolidating MarksLP.

| | 2010 | 2009 |
|---|---|---|
| Opening balance | $ - | $ 88,500 |
| Income in equity earnings from MarksLP | - | 5,425 |
| Distributions received from MarksLP | - | (5,700) |
| Additional investment in MarksLP | - | 172 |
| Consolidation of MarksLP with the Fund (notes 1 and 2(a)) | - | (88,397) |
| Closing balance | $ - | $ - |

The total equity accounted investment is summarized below:

| | 2010 | 2009 |
|---|---|---|
| Cumulative equity in earnings of MarksLP and predecessor company | $ - | $ 40,424 |
| Cumulative distributions received from MarksLP and predecessor company | - | (19,500) |
| Impairment recorded in 2008 | - | (24,349) |
| Investment in MarksLP | - | 91,822 |
| Consolidation of MarksLP with the Fund | - | (88,397) |
| | $ - | $ - |

## 10. OTHER LONG-TERM LIABILITIES

| | 2010 | 2009 |
|---|---|---|
| Headlease liabilities (note 2(h)) | $ 352 | $ 504 |
| Café lease agreements (note 2(h)) | 49 | 66 |
| Promissory note payable(note 2(h) (i) | 119 | - |
| Deferred revenue (note 2(d)) (ii) | 210 | 85 |
| Unearned interest revenue (note 2(d)) (iii) | 47 | - |
| Other | 14 | 26 |
| | 791 | 681 |
| Less current portion | 304 | 72 |
| | $ 487 | $ 609 |

(i) The promissory note payable bearing interest at 5% is payable in blended monthly payments of $9, maturing February 1, 2012 with principal payments due as follows: 2011 - $102 and 2012 - $17 (note 6).
(ii) Deferred revenue on purchasing co-ordination fees and new term fees will be earned as follows: 2011 - $174, 2012 - $15, 2013 - $14, 2014 - $7.
(iii) Unearned interest revenue on notes will be earned as follows: 2011 - $16, 2012 - $12, 2013 - $7, 2014 - $5, 2015 - $4 and thereafter - $3.

## 11. INCOME TAXES

Future income taxes are recorded as the difference between the accounting values of the Fund balance sheet assets and liabilities and the income tax cost basis of these assets and liabilities based on substantively enacted tax laws and rates for differences that are expected to reverse after January 1, 2011.

For the year ended December 31, 2010, the Fund recognized a future income tax recovery amounting to $33 (2009 – $1,144) arising primarily from a change in the temporary income tax differences expected to exist on January 1, 2011 at the tax rate applicable to New Second Cup.

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 differences are as follows:

| | 2010 | 2009 |
|---|---|---|
| Earnings before income taxes | $ 9,187 | $ 10,273 |
| Combined Canadian federal and provincial tax rates | 46.41% | 46.41% |
| Tax provision at statutory rate | 4,264 | 4,768 |
| Reduced by following differences: | | |
| Income distributed or accrued to unitholders not subject to tax in the Fund | (3,844) | (4,109) |
| Change in tax rates | (33) | (1,144) |
| Benefits derived from timing differences | (713) | (850) |
| Non-deductible permanent differences | 219 | 191 |
| Other | (9) | (47) |
| Income tax (recovery) | $ (116) | $ (1,191) |

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

| | 2010 | 2009 |
|---|---|---|
| Trademarks | (8,733) | (8,745) |
| Other | 70 | 49 |
| Net future income tax (liability) | $ (8,663) | $ (8,696) |
| Classified as Long-term liabilities | (8,663) | (8,696) |
| | $ (8,663) | $ (8,696) |

Second Cup has taxable income of $132, which is offset by the non-capital losses carry forward from prior years. The remaining non-capital loss balance of $2,497 is available for carry forward with expiry dates between December 2028 and December 2029. Management expects that the non-capital loss will become available after Conversion.

**12. TERM LOAN AND OPERATING FACILITY**

On March 31, 2010, the Fund renegotiated its term loan and operating credit facilities including an extension of the maturity of the credit facilities to April 1, 2013. The revised $13,000 credit facilities are comprised of an $11,000 non-revolving term credit facility, fully drawn, and an undrawn $2,000 revolving credit facility. As a result of the refinancing, the Fund capitalized $102 (2009 - $263) of loan extension fees. The Fund capitalized an additional $87 of fees related to the lender's consent to the Conversion discussed above. The term credit facilities are collateralized by substantially all the assets of the Fund.

The $11,000 non-revolving term credit facility bears interest at prime plus 2.50% or bankers' acceptance rate plus 3.50%. At December 31, 2010, the full amount of the $11,000 non-revolving term credit facility was drawn with an effective interest rate of 6.54% after taking into consideration the interest rate swap described below.

The $2,000 operating credit facility bears interest at prime plus 2.50% or bankers' acceptance rate plus 3.50%. At December 31, 2010, no advances had been drawn on this facility.

An interest rate swap agreement has been entered into by the Fund maturing April 1, 2013, which fixes the interest rate on the Fund's non-revolving credit facility at 3.04% per annum plus the variable margin noted above, which results in a fixed effective interest rate of 6.54%. At December 31, 2010, the estimated fair value of this contract is a $331 liability to the Fund (2009 - $298) and is recorded as a liability on the Fund's Consolidated Balance Sheet and the fair value movement of the interest rate swap has been recorded as a non-cash charge to earnings on the Fund's Consolidated Statement of Operations and Comprehensive Income.

Pursuant to the terms of the Fund's operating loan and term loan, the Fund is subject to certain financial and other customary covenants, including requirements to maintain a ratio of senior debt to EBITDA and to maintain a trailing four quarter fixed charge coverage ratio. During the year ended December 31, 2010, the Fund was in compliance with all financial and other covenants of the Fund's operating loan and term loan.

In accordance with CICA Handbook Section 3855, Financial Instruments – Recognition and Measurement, the term loan is presented net of transaction costs. Transaction costs are amortized to the Consolidated Statements of Operations and Comprehensive Income using the effective interest method.

| | **2010** | **2009** |
|---|---|---|
| Face value of long-term loan | $ 11,000 | $ 11,000 |
| Unamortized transaction costs | (163) | (159) |
| | $ 10,837 | $ 10,841 |

At maturity, April 1, 2013, the balance sheet value of the term loan will be equal to the face value.

Interest expense consists of the following:

| | **2010** | **2009** |
|---|---|---|
| Interest on term loan | $ 471 | $ 436 |
| Interest on derivative interest rate swap | 247 | 272 |
| Movement in fair value of derivative interest rate swap | 33 | (114) |
| Amortization of deferred financing charges | 185 | 150 |
| Other interest expense - net | 17 | 5 |
| Interest income on short-term deposits | (12) | (6) |
| | $ 941 | $ 743 |

## 13. CONTINGENCIES, COMMITMENTS AND GUARANTEES

Second Cup has lease commitments for Company operated cafés and also acts as the head tenant on leases, which it, in turn, subleases to franchise partners. The Fund's lease commitments at December 31, 2010 are as follows:

| | Headlease commitments | Sublease to franchisees | Net |
|---|---|---|---|
| December 31, 2011 | $ 17,610 | $ 16,971 | $ 639 |
| December 31, 2012 | 16,115 | 15,616 | 499 |
| December 31, 2013 | 14,819 | 14,433 | 386 |
| December 31, 2014 | 13,517 | 13,121 | 396 |
| December 31, 2015 | 11,834 | 11,433 | 401 |
| Thereafter | 31,215 | 30,129 | 1,086 |
| | $ 105,110 | $ 101,703 | $ 3,407 |

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

Second Cup has guaranteed a minimum volume of coffee purchases for franchise partners with a supplier. The minimum commitment for coffee purchases amounts to $3,628 (2009 - $2,633) over the next six months. In order to fulfill its commitments in terms of the supply agreement, the supplier has entered into a $US forward exchange contract amounting to $7,733 (2009 - $2,633) for green coffee purchases over the next 12 months. Second Cup does not expect the liability, if any, relating to a shortfall of coffee purchases by franchise partners to be significant.

## 14. 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.

| | Number of units | Net proceeds |
|---|---|---|
| Balance, December 31, 2008 | 9,884,733 | $ 89,800 |
| Issued January, 2009 | 18,312 | 172 |
| Balance, December 31, 2009 and 2010 | 9,903,045 | $ 89,972 |

On June 27, 2009 the Fund acquired 63,914 Fund units that were held by Second Cup (note 1). During 2010, the Fund sold 63,914 units and recorded a gain of $160 on the disposal of Fund treasury units which has been recorded as contributed surplus in the Consolidated Statements of Unitholders' Equity.

## 15. BASIC AND DILUTED EARNINGS PER UNIT

Earnings per unit are based on the weighted average number of units outstanding during the period. Basic and diluted earnings per unit are determined as follows:

| | 2010 | 2009 |
|---|---|---|
| Net earnings | $ 9,303 | $ 11,464 |
| Weighted average number of units issued and outstanding | 9,862,054 | 9,871,088 |
| Basic and diluted earnings per unit | $ 0.9433 | $ 1.1614 |

## 16. SUPPLEMENTARY CASH FLOW INFORMATION

Changes in non-cash working capital items (net of effects of acquisition of Second Cup)

| | 2010 | 2009 |
|---|---|---|
| Accounts receivable | $ (1,285) | $ (2,424) |
| Inventories | 34 | 71 |
| Prepaid expenses and other assets | (269) | 107 |
| Income taxes recoverable | (22) | 64 |
| Accounts payable and accrued liabilities | 2,423 | 56 |
| Deferred revenue | 125 | - |
| Unearned interest revenue | 47 | - |
| Gift card liability | 175 | 1,334 |
| Deposits from franchise partners | 73 | (118) |
| | $ 1,301 | $ (910) |
| Supplementary information | | |
| Interest paid | $ 739 | $ 599 |
| Income taxes recovered | $ (69) | $ (55) |

## 17. MANAGEMENT OF CAPITAL

The capital structure of the Fund consists of $10,837 long-term debt and $70,093 unitholders' equity, which is comprised of issued units and accumulated earnings, less accumulated cash distributions.

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

1. safeguard its ability to continue as a going concern;
2. ensure it has sufficient cash and cash equivalents to pay distributions to its unitholders;
3. maintain a capital structure that provides financing options to the Fund when the need arises to access capital;
4. maintain financial flexibility in order to preserve its ability to meet financial obligations; and
5. deploy capital to provide an adequate return to its unitholders.

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

The Fund determines the appropriate level of long-term debt in the context of its cash flow and overall business risks. The Fund has historically generated sufficient cash flow to pay monthly distributions to its unitholders. The current level of capital is considered adequate in the context of current operations.

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

New Second Cup will become subject to Canadian corporate income taxes beginning in 2011.

There were no changes in the Fund's approach to capital management during the period.

## 18. FINANCIAL INSTRUMENTS AND FINANCIAL RISK MANAGEMENT

### Financial Instruments

The Fund's financial instruments consist of cash and cash equivalents, accounts receivable, notes receivable, accounts payable and accrued liabilities, gift card liability, other long-term liabilities, distributions payable to unitholders, term loan, and the derivative interest rate swap.

The Fund has designated each of its significant categories of financial instruments outstanding as at December 31, 2010 as follows:

| | |
|---|---|
| Cash and cash equivalents | Held-for-trading |
| Accounts receivable | Loans and receivables |
| Notes receivable | Held-to-maturity |
| Accounts payable and accrued liabilities | Other liabilities |
| Gift card liability | Other liabilities |
| Other long-term liabilities | Other liabilities |
| Distributions payable to unitholders | Other liabilities |
| Derivative interest rate swap | Held-for-trading |
| Term loan | Other liabilities |

Financial assets are classified as either available-for-sale, held-for-trading, held-to-maturity or loans and receivables. Financial liabilities are classified as either held-for-trading or cost/amortized cost or other liabilities. Financial assets held-to-maturity, loans and receivables and financial liabilities other than those held-for-trading are measured at amortized cost. All derivative instruments must be classified as held-for-trading. All other financial assets and derivatives are measured at fair value. Transaction costs associated with long-term debt are included in the carrying value of the long-term debt and are amortized using the effective interest rate method.

The fair values of cash and cash equivalents, accounts receivable, accounts payable and accrued liabilities, gift card liability, other long-term liabilities and distributions payable to unitholders approximate their carrying amounts due to their short-term maturity. The fair value of notes receivable approximates their carrying value based on the ability of the debtor to make the required payments and the value of the security.

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

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

### Credit Risk

The Fund's financial instruments exposed to credit risk include cash and accounts receivable. The Fund places its cash with institutions of high creditworthiness. The Fund's accounts receivable primarily comprise amounts due from franchise partners. Based on experience, management believes that its accounts receivable credit risk exposure is limited. Credit risk from accounts receivable is minimized as a result of the review and evaluation of franchise partner account balances beyond a particular age, and management accounts for a specific bad debt provision when the expected recovery is less than the actual accounts receivable. The provision relating to past due accounts receivables at December 31, 2010 was $74 (2009 - $116).

The maturities of the Fund's notes receivable as at December 31, 2010 are as follows:

| | **Maturing in the next 90 days** | **Maturing between 90 days and less than a year** | **Maturing between 1 year and less than 2 years** | **Maturing after 2 years** | **Total** |
|---|---|---|---|---|---|
| Total | $29 | $71 | $89 | $171 | $360 |

### Liquidity Risk

Liquidity risk is the risk that the Fund will encounter difficulty in meeting obligations as they come due associated with its financial liabilities. The Fund manages liquidity risk through regular monitoring of distribution levels, forecast and actual cash flows, and also the management of its capital structure and senior leverage ratios as outlined in note 17. The Fund's main source of income is royalty receipts from its franchise partners.

The contractual maturities of the Fund's financial liabilities as at December 31, 2010 are as follows:

| | Maturing in the next 90 days | Maturing between 90 days and less than a year | Maturing between 1 year and less than 2 years | Maturing after 2 years | Total |
|---|---|---|---|---|---|
| Accounts payable and accrued liabilities | $ 4,993 | $ 1,510 | $ 163 | $ 354 | $ 7,020 |
| Gift card liability | 4,167 | - | - | - | 4,167 |
| Distributions payable to unitholders | 759 | - | - | - | 759 |
| Derivative interest rate swap | - | - | - | 331 | 331 |
| Term loan | - | - | - | 11,000 | 11,000 |
| Total | $ 9,919 | $ 1,510 | $ 163 | $ 11,685 | $ 23,277 |

### Interest Rate Risk

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

The Fund is exposed to interest rate risk on its cash and cash equivalents and term loan, which earn and bear interest at floating rates.

Interest expense on the long-term debt is adjusted to include the payments made or received under the interest rate swap agreement. The interest rate swap agreement is recognized in the consolidated balance sheet at its estimated fair value. During the year ended December 31, 2010, the Fund recorded a net interest expense of $33 on the consolidated statements of operations and comprehensive income relating to the interest rate swap (2009 – gain of $114).

### Sensitivity Analysis

CICA Handbook Section 3862, Financial Instruments – Disclosures, requires disclosure of a sensitivity analysis to illustrate the sensitivity of the Fund's financial position and performance to changes in market variables such as interest rates as a result of changes in the fair value of cash flows associated with the Fund's financial instruments. The sensitivity analysis provided discloses the effect on net earnings at December 31, 2010, assuming that a reasonably possible change in the relevant risk variable has occurred at December 31, 2010.

The following table shows the Fund's exposure to interest rate risk and the pre-tax effects on net income for the year ended December 31, 2010 of a 1% change in interest rates management believes is reasonably possible:

| | Pre-tax effects on net income – increase (decrease) | | |
|---|---|---|---|
| | Carrying amount of liability | 1% decrease in interest rates | 1% increase in interest rates |
| Term loan | $ 11,000 | $ (110) | $ 110 |
| Interest rate swap agreement | 331 | 110 | (110) |
| | | $ - | $ - |

In September 2009, the CICA amended Section 3862, Financial Instruments – Disclosures, to enhance disclosures about fair value measurements, including the relative reliability of the inputs used in those measurements and their classifications within a hierarchy that prioritizes the inputs to fair value measurement. The three levels of the fair value hierarchy are:

- Level 1 – Unadjusted quoted prices in active markets for identical assets or liabilities
- Level 2 – Inputs other than quoted prices that are observable for the asset or liability either directly or indirectly; and
- Level 3 – Inputs that are not based on observable market data

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

## 19. LONG-TERM INCENTIVE PLAN

In December 2009, the Fund implemented a long-term incentive plan ("LTIP"). The Fund accounts for its grants under this plan in accordance with CICA Section 3870 Stock-Based Compensation and Other Stock Based Payments. Compensation expense is measured at the grant date at fair value and recognized over the service period, based on the vesting period and is adjusted for any changes in market value of the Fund's unit price. In terms of the LTIP any distributions made by the Fund during the vesting period will be accrued based on the total number of units granted.

After January 1, 2011, the Fund units were converted to shares in the ratio of 1:1 as disclosed within the LTIP agreement.

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

| | Notional Units | Grant amount |
|---|---|---|
| Notional units outstanding at beginning of year | 41,391 | $ 260 |
| Units Granted in lieu of distributions | 6,268 | 44 |
| Units Granted on December 23, 2010 | 29,424 | 234 |
| Change in fair value | | 76 |
| Notional units outstanding at end of year | 77,083 | $ 614 |
| Amount expensed in current year | | $ 165 |

Units granted under the LTIP vest over a three year period, and are paid out in cash on December 15th of each year. Units are granted based on the weighted average price of the Fund units for the 20 trading days prior to the grant date.

## 20. RELATED PARTY TRANSACTIONS AND BALANCES

The Fund had a service agreement with a company controlled by a unitholder to provide management and administrative services. The total cost recovery in 2010 was $250 (2009 - $95). The Fund had an outstanding payable of $1 (2009 - $15) which arose as a result of the related party paying for certain reimbursable general and administrative expenses of the Fund less the unpaid balance of the service agreement noted above.

## 21. SUBSEQUENT EVENTS

On January 1, 2011, the Fund completed the previously announced plan of arrangement pursuant to which the Fund's income trust structure was converted into a dividend paying publicly traded corporation named The Second Cup Ltd. The common shares of Second Cup commenced trading on the Toronto Stock Exchange on January 4, 2011 under the symbol "SCU".

Subsequent to year end New Second Cup committed to capital expenditures on point of sale systems ("POS") of $2,100.

## 22. COMPARATIVE FIGURES

Certain comparative figures have been reclassified to conform to the financial statement presentation adopted in the current year.

The Second Cup Ltd. (formerly Second Cup Income Fund)

# Shareholder Information

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**THE SECOND CUP LTD.**
**Board of Directors**

Michael Rosicki (1) (2)
Chairman

James Anas
Bryna Goldberg (1) (2)
Raymond Guyatt (1)
Edward McDermott (2)

**Committees of the Board**
(1) Audit Committee
(2) Governance/Human Resources/ Compensation Committee

**Registrar and Transfer Agent**
Computershare Trust Company of Canada

**Auditors**
PricewaterhouseCoopers LLP

**Market Information**
Shares Listed: Toronto Stock Exchange
Symbol: SCU

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**THE SECOND CUP LTD.**
**Senior Management Team**

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Robert Masson, Chief Financial Officer
Ian Baskerville, Vice President, Legal Affairs
Kimberly Clark, Vice President, Marketing
Rita Toporowski, Vice President, Corporate Planning & Development
Wayne Vanderhorst, Vice President, Franchise Development


SECOND CUP

The Second Cup Ltd. (formerly Second Cup Income Fund)

Annual Report 2010

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