



The Second Cup Ltd.

Unaudited Condensed Interim Financial Statements
For the 13 weeks ended March 29, 2014

Notice to Reader

The management of The Second Cup Ltd. (“Second Cup” or the “Company”) is responsible for the preparation of the accompanying condensed interim financial statements. The condensed interim financial statements have been prepared in accordance with International Financial Reporting Standards and are considered by management to present fairly the financial position, financial performance and cash flows of Second Cup.

These condensed interim financial statements have not been reviewed by an auditor. These condensed interim financial statements are unaudited and include all adjustments, consisting of normal and recurring items that management considers necessary for a fair presentation of the financial position, financial performance and cash flows.

(Signed)

Alix Box
President and Chief Executive Officer, The Second Cup Ltd.

(Signed)

Steve Boyack
Chief Financial Officer, The Second Cup Ltd.

May 8, 2014

The Second Cup Ltd.

Condensed Interim Statements of Financial Position

(Unaudited, expressed in thousands of Canadian dollars)

	March 29, 2014	December 28, 2013
ASSETS		
Current assets		
Cash and cash equivalents	\$ 5,415	\$ 6,501
Trade and other receivables	3,376	4,368
Notes and leases receivable	227	220
Inventories	92	123
Prepaid expenses and other assets	161	190
Income tax recoverable	361	-
	<u>9,632</u>	<u>11,402</u>
Non-current assets		
Notes and leases receivable	717	701
Property and equipment	3,551	3,507
Intangible assets	62,140	61,730
	<u>66,408</u>	<u>66,938</u>
Total assets	<u>\$ 76,040</u>	<u>\$ 77,340</u>
LIABILITIES		
Current liabilities		
Accounts payable and accrued liabilities	\$ 5,095	\$ 4,586
Provisions	966	847
Other liabilities	765	717
Income tax payable	-	138
Gift card liability	3,129	3,895
Deposits from franchise partners	1,109	878
	<u>11,064</u>	<u>11,061</u>
Non-current liabilities		
Provisions	812	1,380
Other liabilities	416	428
Long-term debt (note 4)	11,138	11,089
Deferred income taxes	7,432	7,418
	<u>19,808</u>	<u>20,315</u>
Total liabilities	<u>30,862</u>	<u>31,376</u>
SHAREHOLDERS' EQUITY	<u>45,178</u>	<u>45,964</u>
Total liabilities and shareholders' equity	<u>\$ 76,040</u>	<u>\$ 77,340</u>

Contingencies, commitments and guarantees (note 10) and subsequent event (note 12).
See accompanying notes to the unaudited condensed interim financial statements.

Approved by the Directors May 8, 2014

Michael Bregman, Director

Rael Merson, Director

The Second Cup Ltd.

Condensed Interim Statements of Income and Comprehensive Income (Unaudited, expressed in thousands of Canadian dollars, except per share amounts)

	13 weeks ended March 29, 2014	13 weeks ended March 30, 2013
Revenue		
Royalties	\$ 3,195	\$ 3,497
Sale of goods	2,789	1,289
Services and other	1,628	1,460
	<u>7,612</u>	<u>6,246</u>
Cost of goods sold	<u>1,878</u>	<u>967</u>
Gross profit	5,734	5,279
Operating expenses (note 5)	<u>5,508</u>	<u>4,252</u>
Operating income	226	1,027
Interest and financing (note 6)	<u>156</u>	<u>77</u>
Income before income taxes	70	950
Income taxes (note 7)	<u>14</u>	<u>262</u>
Net income and comprehensive income for the period	<u>\$ 56</u>	<u>\$ 688</u>
Basic and diluted earnings per share (note 8)	<u>\$ 0.01</u>	<u>\$ 0.07</u>

See accompanying notes to the unaudited condensed interim financial statements.

The Second Cup Ltd.

Condensed Interim Statements of Changes in Shareholders' Equity
(Unaudited, expressed in thousands of Canadian dollars)

	Share Capital	Contributed Surplus	Deficit	Total
Balance - December 29, 2012	\$ 1,000	\$ 61,557	\$ (5,857)	\$ 56,700
Net income for the period	-	-	688	688
Dividends to shareholders	<u> </u>	<u> </u>	<u>(842)</u>	<u>(842)</u>
Balance - March 30, 2013	<u>\$ 1,000</u>	<u>\$ 61,557</u>	<u>\$ (6,011)</u>	<u>\$ 56,546</u>
Balance - December 28, 2013	\$ 1,000	\$ 61,557	\$ (16,593)	\$ 45,964
Net income for the period	-	-	56	56
Dividends to shareholders	<u> </u>	<u> </u>	<u>(842)</u>	<u>(842)</u>
Balance - March 29, 2014	<u>\$ 1,000</u>	<u>\$ 61,557</u>	<u>\$ (17,379)</u>	<u>\$ 45,178</u>

See accompanying notes to the unaudited condensed interim financial statements.

The Second Cup Ltd.

Condensed Interim Statements of Cash Flows

(Unaudited, expressed in thousands of Canadian dollars)

	13 weeks ended March 29, 2014	13 weeks ended March 30, 2013
CASH PROVIDED BY (USED IN)		
Operating activities		
Net income for the period	\$ 56	\$ 688
Items not involving cash		
Depreciation of property and equipment	195	183
Amortization of intangible assets	71	117
Amortization of deferred financing charges	7	22
Amortization of leasehold inducements and lease provisions	(14)	72
Deferred income taxes	14	40
(Gain) loss on disposal of capital related items	(110)	7
Movement in fair value of interest rate swap	42	(95)
Changes in non-cash working capital (note 9)	166	5
Cash provided by operating activities	<u>427</u>	<u>1,039</u>
Investing activities		
Proceeds from disposal of capital related items	169	5
Cash payments for capital expenditures (note 9)	(840)	(521)
Proceeds from repayment of leases receivable	-	11
Proceeds from repayment of notes receivable	-	13
Investment in notes receivable	-	(10)
Cash used in investing activities	<u>(671)</u>	<u>(502)</u>
Financing activities		
Dividends paid to shareholders	(842)	(842)
Cash used in financing activities	<u>(842)</u>	<u>(842)</u>
Decrease in cash and cash equivalents during the period	(1,086)	(305)
Cash and cash equivalents - Beginning of the period	<u>6,501</u>	<u>3,880</u>
Cash and cash equivalents - End of the period	<u>\$ 5,415</u>	<u>\$ 3,575</u>

See accompanying notes to the unaudited condensed interim financial statements. Supplemental cash flow information is provided in note 9.

The Second Cup Ltd.

Notes to the Condensed Interim Financial Statements

March 29, 2014 and March 30, 2013

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

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1. Organization and nature of business

The Second Cup Ltd. (“Second Cup” or “the Company”) is a Canadian specialty coffee retailer with 357 cafés operating under the trade name, Second Cup™, in Canada, of which 11 are Company-operated and the balance are operated by franchise partners.

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

Second Cup was incorporated under the Business Corporations Act (Ontario) in 2011 and is domiciled in Canada. The address of its registered office is 6303 Airport Road, 2nd Floor, Mississauga, Ontario, L4V 1R8. The Company hereinafter refers to its head office activities as “Coffee Central”. The Company’s website is www.secondcup.com. The common shares of the Company are listed on the Toronto Stock Exchange under the symbol “SCU”.

2. Basis of preparation

These unaudited condensed interim financial statements for the 13 weeks ended March 29, 2014 have been prepared in accordance with International Financial Reporting Standards (“IFRS”), as applicable to condensed interim financial reports including International Accounting Standard 34, Interim Financial Reporting (“IAS 34”) and should be read in conjunction with the Company’s audited annual financial statements for the year ended December 28, 2013, which have been prepared in accordance with IFRS, as issued by the International Accounting Standards Board.

The accounting policies applied in these unaudited condensed interim financial statements are consistent with those of the previous financial year. The accounting policies are based on IFRS issued and outstanding as of May 8, 2014, the date the Board of Directors approved the unaudited condensed interim financial statements.

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

Operating segments are reported in a manner consistent with the internal reporting provided to the chief operating decision maker. The Company substantially operates and is managed as one reportable segment. The Company is structured as a franchisor with all of its operating revenues derived in Canada. Operating revenues are comprised of royalties, the sale of goods from Company-operated cafés and the sale of goods through retail and other ancillary channels, and other service fees.

3. Financial instruments and financial risk management

Financial instruments

The following summarizes the nature of certain risks applicable to the Company's financial instruments:

Financial instrument

Risks

Financial assets

Cash and cash equivalents	Credit and interest rate
Trade and other receivables	Credit
Notes and leases receivable	Credit

Financial liabilities

Interest rate swap	Credit, liquidity, and interest rate
Accounts payable and accrued liabilities	Liquidity, currency, and commodity
Gift card liability	Liquidity
Deposits from franchise partners	Liquidity
Term loan	Liquidity and interest rate

Fair value of financial instruments

The fair values of cash and cash equivalents, trade and other receivables, accounts payable and accrued liabilities, and gift card liability approximate their carrying values due to their short-term maturity. The fair value of notes and leases receivable approximates their carrying value as the implicit interest used to discount the base value is considered to be based on an appropriate credit and risk rate pertaining to the debtor.

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

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

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

The fair value for the interest rate swap, classified as a Level 2, was derived using market valuation reports provided by a tier one Canadian bank.

	Level 1	Level 2	Level 3
As at December 28, 2013			
Interest rate swap	\$ <u> -</u>	\$ <u> (140)</u>	\$ <u> -</u>
As at March 29, 2014			
Interest rate swap	\$ <u> -</u>	\$ <u> (182)</u>	\$ <u> -</u>

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

Credit risk

a. Cash and cash equivalents, and interest rate swap

The credit risk associated with cash and cash equivalents, and the interest rate swap is managed by ensuring these assets are placed with institutions of high creditworthiness.

b. Trade and other receivables, notes and leases receivable

The Company's trade and other receivables, notes and lease receivable primarily comprise amounts due from franchise partners. Credit risk associated with these receivables is mitigated as a result of the review and evaluation of franchise partner account balances beyond a particular age. Prior to accepting a franchise partner, the Company undertakes a detailed screening process which includes the requirement that a franchise partner have sufficient capital and financing. The risk is further mitigated due to a broad franchise partner base that is spread across the country, which limits the concentration of credit risk.

Other receivables may include amounts owing from large organizations where often those organizations have a simultaneous vendor relationship with the Company's franchise partners. Credit risk is mitigated as a result of the Company directing and maintaining certain controls over the vendor relationship with the franchise partners.

Management accounts for a specific bad debt provision when the expected recovery is less than the actual receivable. The bad debt expense is calculated on a specific identification basis based on historical information, trends and reasons for accounts being past due.

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An analysis of aging of the Company's trade and other receivables from billing date as at March 29, 2014 net of an allowance for doubtful accounts is as follows:

	0 - 30 Days	31 - 60 Days	61 - 90 Days	> 90 Days	Total
March 29, 2014	\$ 3,059	\$ 211	\$ 91	\$ 15	3,376
December 28, 2013	4,151	151	38	28	4,368

The Company's trade and other receivables included a combined allowance for doubtful accounts of \$878 (December 28, 2013 - \$663).

The payment maturity dates of the Company's notes and leases receivable from March 29, 2014 net of an allowance for doubtful accounts are as follows:

	< 90 Days	90 Days to < 1 year	1 year to < 2 years	2 years and after	Total
March 29, 2014	\$ 58	\$ 169	\$ 242	\$ 475	944
December 28, 2013	57	163	238	463	921

The Company's notes and leases receivable included a combined allowance for doubtful accounts of \$59 (December 28, 2013 - \$110).

Liquidity risk

The Company manages liquidity risk through regular monitoring of dividends, forecast and actual cash flows, monitoring maturity dates of financial assets and liabilities, and also the management of its capital structure and debt leverage ratios as outlined in note 4. The Company's main source of income is royalty receipts from its franchise partners.

Interest rate risk

The Company's financial instruments exposed to interest rate risk earn and bear interest at floating rates. The Company entered into an interest rate swap agreement to minimize risk on its long-term debt.

Interest expense on the term loan was adjusted to include the payments made or received under the interest rate swap agreement.

Currency risk

The Company transacts with a small number of vendors that operate in foreign currencies. The Company believes that due to low volumes of transactions, low number of vendors, and low magnitude of spend, the impact of currency risk is not material.

Commodity risk

The Company is directly and indirectly exposed to commodity market risk. The exposure relates to the changes in coffee commodity prices given it is a material input for the Company's product offerings. The direct risk pertaining to Company-operated cafés is not considered material given that there is a relatively small number of cafés. The direct exposure pertaining to the wholesale business is mitigated given that the Company has the ability to adjust its sales price if commodity prices rise over a threshold level. The indirect risk exists where

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franchise partner profitability may be impacted, thus potentially resulting in an impeded ability to collect accounts receivable or the need for other concessions to be made to the franchise partner. The Company mitigates this risk by entering fixed price purchase commitments through coffee commodity brokers and by having the ability to adjust retail selling prices.

Sensitivity analysis

The Company completes an assessment of sensitivity of its 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 financial instruments. The sensitivity analysis provided discloses the effect on net income for the period ended March 29, 2014, assuming that a reasonably possible change in the relevant risk variable has occurred as at March 29, 2014.

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

			Pre-tax effects on net income - increase (decrease)	
	Liability amount		1% decrease in interest rates	1% increase in interest rates
Term loan	\$ 11,000	\$	110	\$(110)
Interest rate swap	182		(110)	110
		\$	<u>-</u>	<u>-</u>

4. Long-term debt

	March 29, 2014	December 28, 2013
Face value of long-term debt	\$ 11,000	\$ 11,000
Fair value of interest rate swap	182	140
Unamortized transaction costs	<u>(44)</u>	<u>(51)</u>
	<u>\$ 11,138</u>	<u>\$ 11,089</u>

On September 26, 2013, the Company renegotiated its term loan and operating credit facilities, including an extension of the maturity of the credit facilities to September 30, 2016. The revised credit facilities are comprised of an \$11,000 non-revolving term credit facility, fully drawn, and an undrawn \$2,000 revolving operating credit facility. The term credit facilities are collateralized by substantially all the assets of the Company.

Pursuant to the terms of the Company's operating credit facility and term loan, the Company is subject to certain financial and other customary covenants.

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The Company has requirements to maintain:

- a ratio of senior debt to EBITDA ratio (“Leverage Ratio”);
- a fixed charge coverage ratio;
- both of which are based on a trailing four-quarter basis; and
- a maximum amount of permitted distributions and purchases of the Company’s own stock based on a trailing cumulative EBITDA, plus a carry-forward legacy surplus of permitted distributions.

As at March 29, 2014, the Company was in compliance with all financial and other covenants of the Company’s operating credit facility and term loan.

The \$11,000 non-revolving term credit facility bears interest at the bankers’ acceptance (“BA”) rate plus a margin range of 2.25% to 3.25% depending on the Company’s Leverage Ratio. As at March 29, 2014, the applicable margin pertaining to the aforementioned range is 2.75%. As at March 29, 2014, the full amount of the \$11,000 non-revolving term credit facility was drawn.

The \$2,000 operating credit facility bears interest at the BA rate plus a margin range of 2.25% to 3.25% depending on the Company’s Leverage Ratio. As at March 29, 2014, the applicable margin pertaining to the aforementioned range is 2.75%. As at March 29, 2014, no advances had been drawn on this facility.

On September 30, 2013, the Company entered into an interest rate swap agreement with a notional value of \$11,000 that expires on September 30, 2016. The swap fixed the interest rate on the Company’s non-revolving term credit facility at 2.07% per annum plus the margin noted above, which resulted in a fixed effective interest rate of 4.82%.

5. Operating expenses

	13 weeks ended March 29, 2014	13 weeks ended March 30, 2013
Coffee Central		
Salaries, wages, benefits, and incentives	\$ 1,819	\$ 1,924
Coffee Central overheads	1,555	1,604
Retail listing fees	988	-
Depreciation of property and equipment	159	137
Amortization of intangible assets	71	117
Restructuring	559	-
	<u>5,151</u>	<u>3,782</u>
Company-operated cafés		
Occupancy / lease costs and other	431	417
Depreciation of property and equipment	36	46
(Gain) loss on disposal of capital related items	(110)	7
	<u>357</u>	<u>470</u>
	<u>\$ 5,508</u>	<u>\$ 4,252</u>

The Company recorded \$559 (2013 - \$nil) of restructuring costs pertaining to the change in chief executive officers and other fundamental reorganizations that have a material effect on the nature and focus of the Company's operations.

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6. Interest and financing

	13 weeks ended March 29, 2014	13 weeks ended March 30, 2013
Interest expense	\$ 177	\$ 68
Amortization of deferred financing costs	7	22
Interest income	(28)	(13)
	<u>\$ 156</u>	<u>\$ 77</u>

7. Income taxes

Income taxes are recognized based on management's best estimate of the weighted average annual income tax rate expected for the full financial year. Income taxes, as reported, differ from the amount that would be computed by applying the combined Canadian federal and provincial statutory income tax rates to income before income taxes. The reasons for the differences are as follows:

	13 weeks ended March 29, 2014	13 weeks ended March 30, 2013
Income before income taxes	\$ 70	\$ 950
Combined Canadian federal and provincial tax rates	<u>26.53%</u>	<u>26.50%</u>
Tax provision at statutory rate	19	252
Increased (reduced) by the following differences		
Change in tax rates	5	-
Non-deductible permanent differences	(10)	3
Other	-	7
Income taxes	<u>\$ 14</u>	<u>\$ 262</u>
Current income taxes	\$ -	\$ 222
Deferred income taxes	14	40
Income taxes	<u>\$ 14</u>	<u>\$ 262</u>

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

8. Basic and diluted earnings per share

Earnings per share is based on the weighted average number of shares outstanding during the period. Basic and diluted earnings per share is determined as follows:

	13 weeks ended March 29, 2014	13 weeks ended March 30, 2013
Net income	\$ 56	\$ 688
Weighted average number of shares issued and outstanding	<u>9,903,045</u>	<u>9,903,045</u>
Basic and diluted earnings per share	<u>\$ 0.01</u>	<u>\$ 0.07</u>

9. Supplemental cash flow information

	13 weeks ended March 29, 2014	13 weeks ended March 30, 2013
Changes in non-cash working capital (inflow (outflow)):		
Trade and other receivables	\$ 992	\$ 1,505
Notes and leases receivable	38	29
Inventories	31	(149)
Prepaid expenses and other assets	29	508
Accounts payable and accrued liabilities	509	(550)
Provisions	(435)	21
Other liabilities	36	274
Gift card liability	(766)	(800)
Deposits from franchise partners	231	(275)
Income taxes	(499)	(558)
	<u>\$ 166</u>	<u>\$ 5</u>

Cash payments for capital expenditures

Purchase of property and equipment	\$ (304)	\$ (496)
Purchase of intangible assets	<u>(536)</u>	<u>(25)</u>
	<u>\$ (840)</u>	<u>\$ (521)</u>

Supplementary information

Interest paid	\$ 135	\$ 161
Income taxes paid	\$ 498	\$ 780

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10. Contingencies, commitments and guarantees

Second Cup has lease commitments for Company-operated cafés and acts as the head tenant on most leases, which it in turn subleases to franchise partners. To the extent the Company may be required to make rent payments due to headlease commitments, a provision has been recognized. The Company's lease commitments at March 29, 2014 are as follows:

	Headlease commitments	Sublease to franchisees	Net
March 29, 2015	\$ 19,618	\$ 18,297	\$ 1,321
March 29, 2016	18,148	16,930	1,218
March 29, 2017	15,917	14,692	1,225
March 29, 2018	13,828	12,670	1,158
March 29, 2019	11,909	10,832	1,077
Thereafter	31,080	27,793	3,287
	<u>\$ 110,500</u>	<u>\$ 101,214</u>	<u>\$ 9,286</u>

The Company believes it will have sufficient resources to meet the net commitment of \$9,286.

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 claim 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.

The Coffee "C" contract is the world benchmark for Arabica coffee. The contract prices physical delivery of exchange grade green beans from one of 19 countries of origin in a licensed warehouse to one of several ports in the U.S. and Europe, with stated premiums/discounts. Second Cup sources high altitude Arabica coffee, which tends to trade at a premium above the "C" coffee commodity price. Second Cup has contracts with third party companies to purchase the coffee that is sold in all Second Cup cafés. In terms of these supply agreements as at March 29, 2014, Second Cup has guaranteed a minimum volume of coffee purchases of \$6,250. The coffee purchase commitment is comprised of three components: unapplied futures commitment contracts, fixed price physical contracts and flat price physical contracts.

Second Cup is the primary coordinator of café construction costs on behalf its franchise partners and for Company-operated cafés. As at March 29, 2014, there is \$618 of contractual commitments pertaining to construction costs for new locations and renovations. The Company finances construction costs for franchise projects from deposits received from franchise partners and corporate projects from the Company's cash flows.

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11. Related parties

The Company has identified related parties as key management, members of the Board of Directors, and shareholders who effectively exercise significant influence over the Company. Such related parties include any entities acting with or on behalf of the aforementioned parties.

For the 13 weeks ended March 29, 2014, one of the Company's vendors purchased \$607 of product, in the ordinary course of business, on behalf of the Company and its franchise partners from a related party.

12. Subsequent event

On May 8, 2014, the Board of Directors of Second Cup approved a quarterly dividend of \$0.085 per common share, payable on June 6, 2014 to shareholders of record at the close of business on May 23, 2014.