



**The Second Cup Ltd.**

Audited Financial Statements

**For the 52 weeks ended December 26, 2015 and December 27, 2014**

February 19, 2016

## **Independent Auditor's Report**

### **To the Shareholders of The Second Cup Ltd.**

We have audited the accompanying financial statements of The Second Cup Ltd., which comprise the statements of financial position as at December 26, 2015 and December 27, 2014 and the statements of operations and comprehensive loss, statements of changes in shareholders' equity and statements of cash flows for periods then ended, and the related notes, which comprise a summary of significant accounting policies and other explanatory information.

#### **Management's responsibility for the financial statements**

Management is responsible for the preparation and fair presentation of these financial statements in accordance with International Financial Reporting Standards (IFRS), and for such internal control as management determines is necessary to enable the preparation of 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 financial statements based on our audit. We conducted our audit 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 financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the 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 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 financial statements.

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

#### **Opinion**

In our opinion, the financial statements present fairly, in all material respects, the financial position of The Second Cup Ltd. as at December 26, 2015 and December 27, 2014 and its financial performance and its cash flows for the years then ended in accordance with International Financial Reporting Standards.

**Yours truly,**

*PricewaterhouseCoopers LLP*

**Chartered Professional Accountants, Licensed Public Accountants**

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"PwC" refers to PricewaterhouseCoopers LLP, an Ontario limited liability partnership.

# The Second Cup Ltd.

## Statements of Financial Position

As at December 26, 2015 and December 27, 2014

(Expressed in thousands of Canadian dollars)

	<b>2015</b>	<b>2014</b>
<b>ASSETS</b>		
<b>Current assets</b>		
Cash and cash equivalents	\$ 3,080	\$ 10,918
Restricted cash (note 22)	840	-
Trade and other receivables (note 6)	3,434	4,026
Notes and leases receivable (note 7)	120	81
Inventories (note 8)	229	221
Prepaid expenses and other assets	427	485
Income tax recoverable	687	699
	<u>8,817</u>	<u>16,430</u>
<b>Non-current assets</b>		
Notes and leases receivable (note 7)	268	302
Property and equipment (note 9)	4,761	4,380
Intangible assets (note 10)	32,639	32,337
	<u>32,639</u>	<u>32,337</u>
<b>Total assets</b>	<u>\$ 46,485</u>	<u>\$ 53,449</u>
<b>LIABILITIES</b>		
<b>Current liabilities</b>		
Accounts payable and accrued liabilities (note 11)	\$ 5,360	\$ 6,011
Provisions (note 12)	1,655	1,937
Other liabilities (note 13)	534	655
Gift card liability	3,554	3,727
Deposits from franchisees	701	378
Current portion of long-term debt (note 14)	-	10,976
	<u>11,804</u>	<u>23,684</u>
<b>Non-current liabilities</b>		
Provisions (note 12)	982	1,133
Other liabilities (note 13)	314	368
Long-term debt (note 14)	5,977	-
Deferred income taxes (note 19)	3,481	3,270
	<u>3,481</u>	<u>3,270</u>
<b>Total liabilities</b>	<u>22,558</u>	<u>28,455</u>
<b>SHAREHOLDERS' EQUITY</b>	<u>23,927</u>	<u>24,994</u>
<b>Total liabilities and shareholders' equity</b>	<u>\$ 46,485</u>	<u>\$ 53,449</u>
Contingencies, commitments and guarantees (note 23)		
See accompanying notes to financial statements.		

Approved by the Directors February 19, 2016

Michael Bregman, Director

Rael Merson, Director

# The Second Cup Ltd.

## Statements of Operations and Comprehensive Loss

For the periods ended December 26, 2015 and December 27, 2014

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

	2015		2014
<b>Revenue (note 15)</b>			
Company-owned cafés and product sales	\$ 22,082	\$	10,426
Franchise revenue	15,259		17,746
	<u>37,341</u>		<u>28,172</u>
<b>Operating costs and expenses (note 16)</b>			
Company-owned cafés and cost of product sales	22,382		11,279
Franchise	8,809		8,121
General and administrative	5,787		8,329
Loss (gain) on disposal of assets	(21)		360
Depreciation and amortization	1,465		1,272
Asset impairment charges	-		29,708
	<u>38,422</u>		<u>59,069</u>
<b>Loss from operations</b>	<u>(1,081)</u>		<u>(30,897)</u>
Interest and financing costs (note 18)	457		478
<b>Loss before income taxes</b>	<u>(1,538)</u>		<u>(31,375)</u>
Recovery of income taxes (note 19)	(385)		(4,343)
<b>Net loss and comprehensive loss for the period</b>	<u>\$ (1,153)</u>	<u>\$</u>	<u>(27,032)</u>
<b>Basic and diluted loss per share (note 20)</b>	<u>\$ (0.09)</u>	<u>\$</u>	<u>(2.66)</u>

See accompanying notes to financial statements.

## The Second Cup Ltd.

### Statements of Changes in Shareholders' Equity

For the periods ended December 26, 2015 and December 27, 2014

(Expressed in thousands of Canadian dollars)

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	Share Capital	Contributed Surplus	Retained Earnings (Deficit)	Total
<b>Balance - December 28, 2013</b>	\$ <u>1,000</u>	\$ <u>61,557</u>	\$ <u>(16,593)</u>	\$ <u>45,962</u>
Net loss for the period	-	-	(27,032)	(27,032)
Dividends to shareholders	-	-	(1,684)	(1,684)
Stock option plan expense (note 25)	-	92	-	92
Issuance of common shares, net of transaction costs (note 3)	7,652	-	-	7,652
	<hr/>	<hr/>	<hr/>	<hr/>
<b>Balance - December 27, 2014</b>	\$ <u>8,652</u>	\$ <u>61,649</u>	\$ <u>(45,309)</u>	\$ <u>24,994</u>
Net loss for the period	-	-	(1,153)	(1,153)
Dividends to shareholders	-	-	-	-
Stock option plan expense (note 25)	-	86	-	86
Issuance of common shares, net of transaction costs (note 3)	-	-	-	-
	<hr/>	<hr/>	<hr/>	<hr/>
<b>Balance - December 26, 2015</b>	\$ <u>8,652</u>	\$ <u>61,736</u>	\$ <u>(46,462)</u>	\$ <u>23,927</u>

See accompanying notes to financial statements.

# The Second Cup Ltd.

## Statements of Cash Flows

For the periods ended December 26, 2015 and December 27, 2014

(Expressed in thousands of Canadian dollars)

	2015	2014
<b>CASH PROVIDED BY (USED IN)</b>		
<b>Operating activities</b>		
Net loss for the period	\$ (1,153)	\$ (27,032)
Items not involving cash		
Depreciation of property and equipment	1,091	933
Amortization of intangible assets	374	339
Share-based compensation expense	86	92
Deferred income taxes (note 19)	211	(4,004)
Loss (gain) on disposal of capital related items	(21)	186
Change in fair value of interest rate swap (note 5)	4	3
Asset impairment charges	-	29,708
Other	(33)	7
Changes in non-cash working capital (note 21)	<u>(394)</u>	<u>220</u>
Cash provided by operating activities	<u>165</u>	<u>452</u>
<b>Investing activities</b>		
Proceeds from disposal of capital related items	497	234
Proceeds from disposal of intangible assets	-	84
Cash payments for capital expenditures (note 21)	(1,942)	(1,575)
Cash payments for intangible assets (note 21)	(733)	(750)
Proceeds from repayment of notes receivable - net	21	69
Proceeds from repayment of leases receivable - net	64	78
Change in restricted cash	<u>(840)</u>	<u>-</u>
Cash used in investing activities	<u>(2,933)</u>	<u>(1,860)</u>
<b>Financing activities</b>		
Dividends paid to shareholders	-	(1,684)
Issuance of common shares, net (note 3)	-	7,509
Repayment of term loan (note 14)	(5,000)	-
Repayment of swap (note 5)	<u>(70)</u>	<u>-</u>
Cash (used in) provided by financing activities	<u>(5,070)</u>	<u>5,825</u>
<b>Increase (decrease) in cash and cash equivalents during the period</b>	<b>(7,838)</b>	<b>4,417</b>
<b>Cash and cash equivalents - Beginning of the period</b>	<b><u>10,918</u></b>	<b><u>6,501</u></b>
<b>Cash and cash equivalents - End of the period</b>	<b>\$ <u>3,080</u></b>	<b>\$ <u>10,918</u></b>

See accompanying notes to financial statements. Supplemental cash flow information is provided in note 21.

Information on non-cash transactions and supplemental cash flow information are described further in notes 5 and 21, respectively.

# The Second Cup Ltd.

## Notes to the Financial Statements

For the periods ended December 26, 2015 and December 27, 2014

(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 310 (2014 - 347) cafés operating under the trade name Second Cup™ in Canada, of which 32 (2014 - 35) are Company-operated and the balance operated by franchisees.

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

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

### 2. Summary of significant accounting policies

#### a. Basis of preparation

The financial statements (the “financial statements”) have been prepared in accordance with International Financial Reporting Standards (“IFRS”) as issued by the International Accounting Standards Board (“IASB”). The financial statements have been prepared on the historical cost basis except for certain financial instruments that are measured at fair values at the end of each reporting period. The Company’s functional currency is the Canadian dollar.

The Company’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. Fiscal 2015 is a 52-week period (2014 - 52 weeks).

The Company manages an advertising and co-operative fund (the “Co-op Fund”) established to collect and administer funds contributed for use in advertising and promotional programs, and initiatives designed to increase sales and enhance the reputation of the Second Cup brand. Contributions to the Co-op Fund are required to be made from both franchised and Company-operated cafés and are based on a percentage of café sales. The revenue, expenses and cash flows of the Co-op Fund are not consolidated, but are netted on the Statement of Financial Position in accounts payable if there is a surplus, or in accounts receivable if there is a deficit to the extent that the Company will recover the deficit from franchisees. The assets and liabilities of the Co-op Fund are included in the assets and liabilities of the Company on the Statements of Financial Position. The policy is established because the contributions to the Co-op Fund are segregated, designated for a specific purpose and the Company is acting as an agent.

#### b. Segmented information and reporting

Operating segments are reported in a manner consistent with the internal reporting provided to the Chief Executive Officer. The Company substantially operates and is managed as one reportable segment. Operating revenues are comprised of royalties, the sale of goods from Company-operated cafes, the sale of goods through retail and other ancillary channels, and other service fees.

# The Second Cup Ltd.

## Notes to the Financial Statements

For the periods ended December 26, 2015 and December 27, 2014

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

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### 2. Summary of significant accounting policies (continued)

#### b. Segmented information and reporting (continued)

Management is organized based on the Company's operations as a whole rather than the specific revenue streams.

#### c. Critical accounting estimates and the use of judgement

The preparation of financial statements requires management to make estimates, assumptions, and use judgement in applying its accounting policies and estimates and assumptions about the future. Estimates and other judgements are continuously evaluated and are based on management's experience and other factors, including expectations about future events that are believed to be reasonable under the circumstances. Revisions to accounting estimates are recognized in the period in which the estimates are revised and in any future periods affected. The accounting estimates will, by definition, seldom equal the related actual results.

#### Estimates:

The following are examples of estimates and assumptions the Company makes:

- the recoverability of tangible and intangible assets subject to depreciation, amortization, or with indefinite lives;
- the derivation of income tax assets and liabilities;
- the estimated useful lives of assets;
- café lease provisions and restructuring charges;
- gift card breakage; and
- the allowance for doubtful accounts.

#### Use of judgement

The following discusses the most significant accounting judgements and estimates that the Company has made in the preparation of the financial statements:

##### (i) Impairment charges

Impairment analysis is an area involving management judgement as to whether the carrying value of assets is recoverable. The recoverable amount of a cash generating unit ("CGU") is calculated as the higher of the fair value less costs of disposal, and its value in use. Fair value is determined by estimating the net present value of future cash flows derived from such assets using cash flow projections that have been discounted at an appropriate rate and based on a market participant's view. In calculating the net present value of the future cash flows, certain assumptions are required to be made in respect of highly uncertain matters including:

- growth in total revenue;
- change and timing of cash flows such as the increase or decrease of expenditures;
- selection of discount rates to reflect the risks involved; and
- applying judgement in cash flows specific to CGUs.



# The Second Cup Ltd.

## Notes to the Financial Statements

For the periods ended December 26, 2015 and December 27, 2014

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

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### 2. Summary of significant accounting policies (continued)

#### c. Critical accounting estimates and the use of judgement (continued)

##### (i) *Impairment charges (continued)*

Changing the assumptions selected by management, in particular the discount rate and the growth rate used in the cash flow projections, could significantly affect the impairment evaluations and recoverable amounts.

The Company's impairment tests include key assumptions related to the scenarios discussed above. Further details are provided in note 17 to the financial statements.

##### (ii) *Deferred income taxes*

The timing of reversal of temporary differences and the expected income allocation to various tax jurisdictions within Canada affect the effective income tax rate used to compute the deferred income taxes. Management estimates the reversals based on historical and budgeted operating results and income tax laws existing at the reporting dates. In addition, management occasionally estimates the current or future deductibility of certain expenditures, affecting current or deferred income tax balances and expenses.

##### (iii) *Estimated useful lives*

The useful lives of property and equipment are based on the period during which the assets are expected to be available-for-use. The amounts and timing of recorded expenses for depreciation of property and equipment for any period are affected by these estimated useful lives. It is possible that changes in these factors may cause significant changes in the amount of depreciation recorded in respect of the Company's property and equipment in the future.

##### (iv) *Café lease provisions*

Café lease provisions are based on the evaluation of the likelihood and measurement of settlements, temporary payouts, or sub-leasing. Management works with landlords, franchisees and uses previous experience to obtain adequate information needed to make these assessments.

##### (v) *Gift card breakage*

Gift card breakage is based on the likelihood of gift cards not being redeemed by the customer. Management's determination of the gift card breakage rate is based upon Company-specific historical loads and redemption patterns.

##### (vi) *Allowance for doubtful accounts*

The allowance for impairment of trade and other receivables is established when there is objective evidence that the Company will not be able to collect all amounts due according to the original terms of the receivable. The carrying amount of the asset is reduced through the use of an allowance account, and the amount of the loss is recognized in expenses in the statement of operations and comprehensive loss. When an account is deemed uncollectible, it is written off against the allowance account. Subsequent recoveries of amounts previously written off are recognized as a recovery in expenses in the statement of operations and comprehensive loss.

# The Second Cup Ltd.

## Notes to the Financial Statements

For the periods ended December 26, 2015 and December 27, 2014

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

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### 2. Summary of significant accounting policies (continued)

#### d. Financial instruments

Financial assets and liabilities are recognized when the Company becomes a party to the contractual provisions of the instrument. Financial assets are derecognized when the rights to receive cash flows from the assets have expired or have been transferred and the Company has transferred substantially all risks and rewards of ownership. Financial liabilities are derecognized when obligations are discharged, cancelled or they expire.

Financial assets and liabilities are offset and the net amount reported in the Statements of Financial Position when there is a legally enforceable right to offset the recognized amounts and there is an intention to settle on a net basis or realize the asset and settle the liability simultaneously. Hedge accounting is not used.

On recognition, the Company classifies its financial instruments in the following categories depending on the purpose for which the instruments were acquired:

<b>Financial instrument</b>	<b>Categorization</b>	<b>Recognition method</b>
<b><i>Financial assets</i></b>		
Cash and cash equivalents	Loans and receivables	Amortized cost
Restricted cash	Loans and receivables	Amortized cost
Trade and other receivables	Loans and receivables	Amortized cost
Notes and leases receivable	Loans and receivables	Amortized cost
<b><i>Financial liabilities</i></b>		
Interest rate swap	Fair value through profit and loss	Fair value
Accounts payable and accrued liabilities	Other financial liabilities	Amortized cost
Gift card liability	Other financial liabilities	Amortized cost
Deposits from franchisees	Other financial liabilities	Amortized cost
Term credit facility	Other financial liabilities	Amortized cost

**(i) Cash and cash equivalents, restricted cash, trade and other receivables, and notes and leases receivable:**

Loans and receivables are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market. Loans and receivables are initially recognized at the amount expected to be received, and if necessary, less a present value discount if collection is to be expected beyond one year. Subsequently, loans and receivables are measured at amortized cost using the effective interest method less a provision for impairment, if necessary.

**(ii) Derivative financial instruments:** derivatives are used in the form of interest rate swaps to manage risks related to its variable rate long-term debt. Unrealized fair value gains and losses pertaining to the interest rate swap are included in interest income (expense).

# The Second Cup Ltd.

## Notes to the Financial Statements

For the periods ended December 26, 2015 and December 27, 2014

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

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### 2. Summary of significant accounting policies (continued)

#### d. Financial instruments (continued)

(iii) *Transaction costs*: Long-term debt is accounted for at fair value, net of any transaction costs incurred and, subsequently, at amortized cost using the effective interest method. Transaction costs pertaining to instruments categorized as fair value through profit or loss are recognized immediately. Transaction costs associated with instruments recognized at amortized cost are amortized over the expected life of the instrument. This classification has been selected as it results in better matching of the transaction costs with the periods benefiting from the transaction costs.

#### e. Cash and cash equivalents

Cash and cash equivalents include cash on hand, deposits held with banks and other short-term highly liquid investments with original maturities of three months or less. Restricted cash represents cash on deposit with banks that are held in trust of the Co-op Fund and Development Fund and not in the name of Second Cup.

#### f. Leases receivable

The Company has entered into lease agreements acting as the lessor with certain franchisees relating to point of sale systems ("POS"). The lease term is for the major part of the economic life of the POS although the title is not transferred. Leases are recognized as finance type leases and recorded as leases receivable at an amount equal to the net investment in the lease. Leases receivable are initially recognized at the amount expected to be received, less a present value discount if collection is to be expected beyond one year. Subsequently, leases receivable are measured at amortized cost using the effective interest method less a provision for impairment.

#### g. Inventories

Inventories are stated at the lower of cost and net realizable value, with cost being determined on an average cost basis. Net realizable value is the estimated recoverable amount less applicable selling expenses. If carrying value exceeds net realizable amount, a writedown is recognized. The writedowns are reversed if the circumstances that caused the initial writedown no longer exist.

#### h. Property and equipment

Property and equipment are stated at cost less accumulated depreciation net of any impairment losses. Cost includes expenditures that are directly attributable to the acquisition of the asset. Subsequent costs are included in the asset's carrying value or recognized as a separate asset, as appropriate, only when it is probable that future economic benefits associated with the item will flow to the Company and the cost can be measured reliably. The carrying value of a replaced asset is removed when replaced. Repairs and maintenance costs are charged to the Statements of Operations and Comprehensive Loss during the period in which they are incurred. Where property and equipment construction projects are of a sufficient size and duration, an amount is capitalized for the costs used to finance construction.

Depreciation is calculated using the straight-line basis as this approach best reflects consumption and benefit patterns pertaining to the asset's use. Depreciation is charged commencing when the asset is available for use. The following rates are based on the expected useful lives of the assets:

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

# The Second Cup Ltd.

## Notes to the Financial Statements

For the periods ended December 26, 2015 and December 27, 2014

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

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### 2. Summary of significant accounting policies (continued)

#### i. Intangible assets

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

##### (i) Trademarks

Trademarks consist of trade names, operating procedures and systems and other intellectual property used in connection with the operation of the Second Cup cafés in Canada and are recorded at the historical cost less impairment writedowns. The trademark is an indefinite life intangible asset that is tested annually for impairment or at any time an indicator for impairment exists. The trademark assets do not have continual renewal requirements nor is there any deterioration incurred due to usage. As a result of the combination of the aforementioned, the trademark assets are considered to have indefinite lives.

##### (ii) Franchise rights

As a result of the acquisition of The Second Cup Ltd. in 2009 by Second Cup Royalty Income Fund, franchise rights were recognized as an intangible asset. The franchise rights intangible asset is based on the net present value of the discounted future cash flows expected from the existing franchisees of Second Cup as at the date of acquisition, including royalties and franchise fees. Franchise rights are reviewed for impairment at any time that an indicator of impairment exists. Franchise rights are amortized based on the average remaining term of the existing franchise agreement.

##### (iii) Software

Purchased software costs are recorded at cost and are amortized commencing when the asset is available for use. Amortization is calculated using the straight-line basis as management believes this approach best reflects consumption and benefit patterns pertaining to the asset's use. The following rate is based on the expected useful life of the asset:

Software	3 to 7 years
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Where software implementation projects are of a sufficient size and duration, an amount is capitalized for the costs used to finance development.

#### j. Provisions

Provisions are recognized when there is a present legal or constructive obligation as a result of past events; it is more likely than not that an outflow of resources will be required to settle the obligation; and the amount can be reliably estimated. Provisions are measured at the best estimate of the expenditure required to settle the obligation at the end of the reporting period and are discounted to present value where the effect is material. Evaluations are performed to identify onerous contracts and, where applicable, provisions are recorded for such contracts.

Provisions for café closures are estimates for costs expected to be incurred by the Company for operational franchise-owned cafés. Lease and other occupancy costs not expected to be fully paid by the franchisee are recorded as the Company has liability on the café head lease.

# The Second Cup Ltd.

## Notes to the Financial Statements

For the periods ended December 26, 2015 and December 27, 2014

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

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### 2. Summary of significant accounting policies (continued)

#### k. Other liabilities

##### (i) *Deferred revenue*

The Company has entered into several supply agreement contracts and receives allowances from certain suppliers in consideration for the café network achieving certain volume thresholds over the term of the supply agreement. Deferred revenue is amortized over the term of the supply agreements based on the proportion of volume thresholds met during the fiscal year.

Cash received from franchisees for the commencement of a new franchise term or a pending transfer arrangement are deferred as deposits from franchisees until the revenue recognition criteria are met.

##### (ii) *Leasehold inducements*

Leasehold inducements are amortized to rent expense on a straight-line basis over the term of the lease.

#### l. Income taxes

Income taxes comprise current and deferred income taxes. Income taxes are recognized in the Statements of Operations and Comprehensive Loss except to the extent that they relate to items recognized directly in equity, in which case the income tax is also recognized directly in equity. Current income taxes are the expected taxes payable on the taxable income for the period, using tax rates enacted, or substantively enacted, at the end of the reporting period, and any adjustment to tax payable in respect of previous periods.

Deferred income taxes are recognized in respect of temporary differences arising between the tax bases of assets and liabilities and their carrying values in the financial statements. Deferred income taxes are determined on a non-discounted basis using tax rates and laws that have been enacted or substantively enacted at the Statements of Financial Position dates, and are expected to apply when the deferred income tax asset or liability is settled. Deferred income tax assets are recognized to the extent that it is probable that future taxable profit will be available against which the deductible temporary differences can be utilized.

#### m. Gift card liability

The gift card program allows customers to prepay for future purchases by loading a dollar value onto their gift cards through cash or credit/debit cards in the cafés or online through credit cards, when and as needed. The gift card liability represents liabilities related to unused balances on the 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. Gift cards do not have an expiration date and outstanding unused balances are not depleted.

When it is determined the likelihood of the remaining balance of a gift card being redeemed by the customer is remote, the amount is recorded as breakage. The determination of the gift card breakage rate is based upon Company-specific historical load and redemption patterns. The 2015 analysis determined that a breakage rate of 3% was applicable to gift card sales, which is consistent with 2014 estimates. Gift card breakage is recognized on a pro rata basis based on historical gift card redemption patterns. Breakage income is fully allocated to the Co-op Fund and not recorded in earnings.

# The Second Cup Ltd.

## Notes to the Financial Statements

For the periods ended December 26, 2015 and December 27, 2014

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

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### 2. Summary of significant accounting policies (continued)

#### n. Deposits from franchisees

The development process of a new or to be renovated café requires a deposit from a franchisee at the outset. Deposits from franchisees are applied against the cost of constructing a new café or the renovation of an existing café.

#### o. Revenue recognition

Revenue is recognized when it is probable that economic benefits will flow to the Company and delivery has occurred, the sales price is fixed or determinable, and collectability is reasonably assured. Revenue is measured at the fair value of the consideration received or receivable. Revenue is reduced for estimated customer returns, rebates and other revenue related concessions.

##### *(i) Royalties*

Royalty revenue from franchised cafés is based on agreed percentage royalty rates of the franchise location sales. Revenue is recognized on an accrual basis in accordance with the substance of the relevant agreement, provided that it is probable that the economic benefits will flow to the Company and the amount of revenue can be measured reliably.

##### *(ii) Services and other*

Services and other consists of initial franchise fees, renewal fees, transfer fees earned on the sale of cafes from one franchisee to another, construction administration fees, purchasing coordination fees, and other ancillary fees (such as IT support and training fees).

##### *(iii) Company-owned cafés and product sales*

Company-owned cafés and product sales revenue includes the sale of goods from Company owned cafés, as well as products sold in grocery stores through wholesale distribution channels and third party licensing agreements.

#### p. Operating costs and expenses

##### *(i) Company-owned cafés and cost of product sales*

Company-owned cafés and cost of product sales represents the product cost of goods sold in Company-operated cafés and through the wholesale grocery channel, plus the cost of direct labour to prepare and deliver the goods to the customers in the Company-operated cafés and any occupancy related costs.

##### *(ii) Franchise*

Franchise costs represent the cost of direct labour to support the network, travel and franchisee meetings, business development initiatives as well as professional fees directly related to franchise operations.

##### *(iii) General and administrative*

General and administrative costs include labour and related expenses for head office, professional fees not directly attributable to franchise operations and occupancy costs.

# The Second Cup Ltd.

## Notes to the Financial Statements

For the periods ended December 26, 2015 and December 27, 2014

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

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### 2. Summary of significant accounting policies (continued)

#### q. Operating leases

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

#### r. Long-term incentive plan and Directors' deferred share unit plan

The management long-term incentive plan ended in 2014. Units granted under the management long-term incentive plan vested over a three-year period and were paid out in cash at the end of each year's vesting period or upon termination of the individual's service. Units were granted based on a weighted average price of the Company's shares for the twenty days immediately prior to the grant date. The fair value of the grant was amortized over the respective vesting period using the graded amortization method. Compensation expense was adjusted for changes in fair value of the Company's share price thereafter.

Any dividends paid during the vesting period were accrued based on the total number of units granted. Forfeitures were adjusted and accounted for in the period incurred. Amounts recognized were recorded in general and administrative expenses.

Units granted under the Directors' deferred share unit plan have graded vesting for each month of service completed over the course of one year. Units are paid out in cash upon the termination of the director. Units are granted based on a weighted average price of the Company's shares on the five most recent days preceding the grant date. The fair value of the grants is amortized over the respective vesting period using the graded amortization method. Compensation expense is adjusted for changes in fair value of the Company's share price thereafter. Any dividends paid during the vesting period will be accrued based on the total number of units granted. Amounts recognized are recorded in general and administrative expenses.

Recorded values of both plans are presented as accounts payable and accrued liabilities in the Statements of Financial Position.

#### s. Impairment of financial assets

At each reporting date, the Company assesses whether there is objective evidence that a financial asset is impaired.

The criteria used to determine if there is objective evidence of an impairment loss include:

- significant financial difficulty of the borrower/lessee;
- delinquencies in interest or principal payments; and
- it becomes probable that the borrower/lessee will enter bankruptcy or other financial reorganization.

If such evidence exists, an impairment loss is recognized for assets carried at amortized cost as follows:

# The Second Cup Ltd.

## Notes to the Financial Statements

For the periods ended December 26, 2015 and December 27, 2014

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

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### 2. Summary of significant accounting policies (continued)

#### s. Impairment of financial assets (continued)

The loss is the difference between the amortized cost of the loan or receivable and the present value of the estimated future cash flows, discounted using the instrument's effective interest rate. The carrying value of the asset is reduced by this amount either directly or indirectly through the use of an allowance account.

Notes receivable and leases receivable are assessed for impairment on an individual basis based on the ability of the debtor/lessee to make the required payments and the value of the security. When there is no longer reasonable assurance that a note receivable or lease receivable will be collected, its carrying value is reduced and a charge is recorded in operating expenses.

Impairment losses on financial assets carried at amortized cost are reversed in subsequent years if the amount of the loss decreases and the decrease can be related objectively to an event's occurring after the impairment was recognized.

#### t. Impairment of non-financial assets

Property and equipment and intangible assets without indefinite lives are tested for impairment when events or changes in circumstances indicate the carrying value may not be recoverable. Assets with indefinite lives are subject to an annual impairment test or any time an impairment indicator exists. December 26, 2015 has been selected as the mandatory annual test date.

For the purpose of measuring recoverable amounts, assets are grouped at the lowest levels for which there are separately identifiable cash inflows that are largely independent of the cash inflows from their assets or group of assets, which represent a cash generating unit (CGU). The recoverable amount of each particular CGU is the higher of an asset's fair value less costs of disposal and value in use. CGUs have been determined to be as follows:

- franchising, distribution, and wholesale; and
- Company-operated cafés; each Company-operated café is considered a separate CGU.

The impairment analysis involves comparing the carrying value of the CGUs with their estimated recoverable amounts. An impairment loss is recognized for the amount by which the CGU's carrying value exceeds its recoverable amount. Impairment losses for a CGU reduce first the carrying value of any goodwill allocated to that CGU. Any remaining impairment loss is charged pro rata to the other assets in the CGU.

Impairment losses, other than goodwill impairment, are evaluated for potential reversals when events or circumstances warrant such consideration.

#### u. Related parties

For the purposes of these financial statements, a party is considered related to the Company if such party or the Company has the ability to, directly or indirectly, control or exercise significant influence over the other entity's financial and operating decisions, or if the Company and such party are subject to common influence. Related parties may be individuals or other entities and include members of key management of the Company. All transactions with related parties are recorded at fair value.



# The Second Cup Ltd.

## Notes to the Financial Statements

For the periods ended December 26, 2015 and December 27, 2014

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

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### 2. Summary of significant accounting policies (continued)

#### v. Dividends

Dividends on common shares are recognized in the financial statements in the period in which the dividends are approved by the Board of Directors.

#### w. Share-based compensation

For share option awards granted as part of the stock option plan, a fair value is determined at the date of grant and that fair value is recognized in the financial statements over the vesting period. Proceeds arising from the exercise of share option awards are credited to share capital, as are the recognized grant-date fair values of the exercised share option awards. Share option awards which are determined to be settled on a net-equity basis are accounted for as equity instruments. Share option awards which are determined to be settled on a net-cash settlement basis are accounted for as liability instruments. The stock option plan was introduced in May 2014 and is further discussed in note 25.

#### x. Reclassification

Certain comparable figures have been reclassified to conform to the current period's financial statement presentation. Reclassification has been identified to better capture the substance of the balances and presentation.

### Changes in accounting policies

#### *Recent accounting pronouncements not yet effective*

- *IFRS 15, Revenue from contracts with customers ("IFRS 15")*

In May 2014, the IASB issued IFRS 15. The core principle of the new standard is for companies to recognize revenue to depict the transfer of goods or services to customers in amounts that reflect the consideration to which the company expects to be entitled in exchange for those goods or services. IFRS 15 will also result in enhanced disclosures about revenue, provide guidance for transactions that were not previously addressed comprehensively and improve guidance for multiple-element arrangements. The standard will also address accounting for loyalty programs and breakage.

Application of IFRS 15 is effective for annual reporting periods beginning on or after January 1, 2018 and is to be applied using the retrospective or the modified transition approach. Early adoption is permitted. Management is currently assessing the impact of this standard.

- *IFRS 16, Leases ("IFRS 16")*

IFRS 16, Leases ("IFRS 16"), sets out the principles for the recognition, measurement, presentation and disclosure of leases for both parties to a contract, the customer ('lessee') and the supplier ('lessor'). This will replace IAS 17, Leases ("IAS 17"), and related Interpretations. IFRS 16 provides revised guidance on identifying a lease and for separating lease and non-lease components of a contract. IFRS 16 introduces a single accounting model for all lessees and requires a lessee to recognize right-of-use assets and lease

# The Second Cup Ltd.

## Notes to the Financial Statements

For the periods ended December 26, 2015 and December 27, 2014

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

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liabilities for leases with terms of more than 12 months, unless the underlying asset is of low value, and depreciation of lease assets separately from interest on lease liabilities in the income statement.

### 2. Summary of significant accounting policies (continued)

#### *Recent accounting pronouncements not yet effective (continued)*

- *IFRS 16, Leases ("IFRS 16") (continued)*

Under IFRS 16, lessor accounting for operating and finance leases will remain substantially unchanged. IFRS 16 is effective for annual periods beginning on or after January 1, 2019, with earlier application permitted for entities that apply IFRS 15, Revenue from Contracts with Customers. As the Company has contractual obligations in the form of operating leases under IAS 17, there may be a material increase to both assets and liabilities upon adoption of IFRS 16, and material changes to the timing of recognition of expenses associated with the lease arrangements. The Company is analyzing the new standard to determine its impact on the Company's statement of financial position and statement of operations and comprehensive loss.

### 3. Share capital

The Company is authorized to issue an unlimited number of common shares. Common shares are classified as equity and have no par value. Incremental costs directly attributable to the issue of new common shares are shown in equity as a deduction, net of tax, from the proceeds.

On November 27, 2014, the Company closed a private placement offering of 2,927,900 common shares at an average share price of \$2.75, for gross proceeds of \$8,052. The resulting increase in share capital of \$7,652 is net of transaction costs of \$543, with an associated tax benefit of \$143. Shares outstanding at the fiscal year ended December 26, 2015 are 12,830,945 (2014 - 12,830,945).

### 4. Management of capital

On December 15, 2015, the Company entered into an amendment with its lender and concurrently repaid \$5,000 of its long-term debt. The revised capital structure of the Company consists of a \$6,000 (2014 - \$11,000) non-revolving long-term loan and \$23,927 (2014 - \$24,994) in Shareholders' equity, which comprises share capital, contributed surplus, and retained earnings (deficit).

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

- safeguard its ability to continue as a going concern;
- maintain financial flexibility in order to preserve its ability to meet financial obligations;
- maintain a capital structure that provides financing options to the Company when the need arises to access capital; and
- deploy capital to provide an adequate return to its shareholders.

The Company's primary uses of capital are to finance capital expenditures.

# The Second Cup Ltd.

## Notes to the Financial Statements

For the periods ended December 26, 2015 and December 27, 2014

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

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### 5. Financial instruments and financial risk management

#### *Financial instruments*

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

<b>Financial instrument</b>	<b>Risks</b>
<i>Financial assets</i>	
Cash and cash equivalents	Credit and interest rate
Restricted cash	Credit and interest rate
Trade and other receivables	Credit
Notes and leases receivable	Credit
<i>Financial liabilities</i>	
Interest rate swap	Credit, liquidity, and interest rate
Accounts payable and accrued liabilities	Liquidity, currency, and commodity
Gift card liability	Liquidity
Deposits from franchisees	Liquidity
Term credit facility	Liquidity and interest rate

#### *Fair value of financial instruments*

The fair values of cash and cash equivalents, restricted cash, 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 term loan approximates its carrying value less transaction costs due to the floating interest rate of the term loan. The following table summarizes the financial instruments measured at fair value:

	<b>2015</b>	<b>2014</b>
<b>Interest rate swap</b>		
Opening fair value	\$ (143)	\$ (140)
Additions during the period	-	-
Repaid during the year	70	-
Change in fair value	(4)	(3)
Closing fair value	<u>\$ (77)</u>	<u>\$ (143)</u>

# The Second Cup Ltd.

## Notes to the Financial Statements

For the periods ended December 26, 2015 and December 27, 2014

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

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### 5. Financial instruments and financial risk management (continued)

Financial instruments that are measured subsequent to initial recognition at fair value are to be categorized in Levels 1 to 3 of 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 Level 2, was derived using market valuation reports provided by a tier one Canadian bank.

	Level 1	Level 2	Level 3
<b>As at December 27, 2014</b>			
Interest rate swap	\$ _____ -	\$ _____ (143)	\$ _____ -
<b>As at December 26, 2015</b>			
Interest rate swap	\$ _____ -	\$ _____ (77)	\$ _____ -

There were no changes between levels in the period ended December 26, 2015 versus the period ended December 27, 2014.

#### *Credit risk*

##### **a. Cash and cash equivalents, restricted cash and interest rate swap**

Credit risk associated with cash and cash equivalents, restricted cash 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**

Trade and other receivables and notes and lease receivable primarily comprise amounts due from franchisees. Credit risk associated with these receivables is mitigated as a result of the review and evaluation of franchisee account balances beyond a particular age. Prior to accepting a franchisee, the Company undertakes a detailed screening process which includes the requirement that a franchisee has sufficient financing. The risk is further mitigated due to a broad franchisee 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 franchisees. Credit risk is mitigated as a result of the Company directing and maintaining certain controls over the vendor relationship with the franchisees.

Specific bad debt provisions are accounted for when the expected recovery is less than the actual receivable.

# The Second Cup Ltd.

## Notes to the Financial Statements

For the periods ended December 26, 2015 and December 27, 2014

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

### 5. Financial instruments and financial risk management (continued)

#### b. Trade and other receivables, notes and leases receivable (continued)

An analysis of aging of trade and other receivables from the billing date net of an allowance for doubtful accounts is as follows:

	0-30 Days	31-60 Days	61-90 Days	> 90 Days	Total
Gross amount as at December 26, 2015	\$ 3,056	\$ 169	\$ 134	\$ 1,809	\$ 5,168
Allowance for doubtful accounts	(74)	(77)	(85)	(1,498)	(1,734)
Net amount 2015	<u>\$ 2,982</u>	<u>\$ 92</u>	<u>\$ 49</u>	<u>\$ 311</u>	<u>\$ 3,434</u>
Gross amount as at December 27, 2014	\$ 4,188	\$ 315	\$ 141	\$ 471	\$ 5,115
Allowance for doubtful accounts	(393)	(87)	(138)	(471)	(1,089)
Net amount 2014	<u>\$ 3,795</u>	<u>\$ 228</u>	<u>\$ 3</u>	<u>\$ -</u>	<u>\$ 4,026</u>

Trade and other receivables include a combined allowance for doubtful accounts of \$1,734 (December 27, 2014 - \$1,089). Credit terms vary by customer in the range of 30 to 90 days. The net amount due of \$311 aged over 90 days has no specific terms of repayment. Trade and other receivables are further discussed in note 6.

The payment maturity dates of the notes and leases receivable from December 26, 2015, 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
2015	\$ 32	\$ 88	\$ 103	\$ 165	\$ 388
2014	\$ 20	\$ 62	\$ 79	\$ 222	\$ 383

Notes and leases receivable included a combined allowance for doubtful accounts of \$12 (December 27, 2014 - \$2). Notes and leases receivable are further discussed in note 7.

#### **Liquidity risk**

Liquidity risk is managed through regular monitoring of forecast and actual cash flows, monitoring maturity dates of financial assets and liabilities, and also the management of the Company's capital structure and debt leverage ratios as outlined in note 14. The Company's main source of income is royalty receipts from its franchisees, corporate café sales, and sales from goods and services.

# The Second Cup Ltd.

## Notes to the Financial Statements

For the periods ended December 26, 2015 and December 27, 2014

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

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### 5. Financial instruments and financial risk management (continued)

#### b. Trade and other receivables, notes and leases receivable (continued)

##### *Interest rate risk*

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. A portion of the interest rate swap was terminated on December 15, 2015, resulting in a payment of \$70.

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

##### *Commodity and currency risk*

The Company purchases certain products, such as coffee, in U.S. dollars, thereby exposing the company to risks associated with fluctuations in currency exchange rates. The Company is also 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 product offerings. 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 franchisee 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 franchisee. This risk is mitigated 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 periods ended December 26, 2015 and December 27, 2014, assuming that a reasonably possible change in the relevant risk variable has occurred as at December 26, 2015 and December 27, 2014, respectively.

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

	<b>Pre-tax effects on net income (loss) - increase (decrease)</b>			
	<b>Liability amount</b>		<b>1% decrease in interest rates</b>	<b>1% increase in interest rates</b>
Term loan	\$	6,000	\$ 60	\$ (60)
Interest rate swap		77	(45)	45
		\$	<u>15</u>	<u>(15)</u>

# The Second Cup Ltd.

## Notes to the Financial Statements

For the periods ended December 26, 2015 and December 27, 2014

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

### 6. Trade and other receivables

	<b>2015</b>	<b>2014</b>
Trade and other receivables	\$ 5,168	\$ 5,115
Less: Allowance for doubtful accounts	<u>(1,734)</u>	<u>(1,089)</u>
Trade and other receivables - net	<u>\$ 3,434</u>	<u>\$ 4,026</u>

During the period, \$352 (2014 - \$961 expense) was recorded as a charge pertaining to trade and other receivables.

### 7. Notes and leases receivable

	<b>2015</b>	<b>2014</b>
Notes receivable - current	\$ 67	\$ 20
Lease receivable - current	65	62
Less: Allowance for doubtful accounts - current	<u>(12)</u>	<u>(1)</u>
Notes and leases receivable - current	<u>120</u>	<u>81</u>
Notes receivable - long-term	33	21
Lease receivable - long-term	235	282
Less: Allowance for doubtful accounts - long-term	<u>-</u>	<u>(1)</u>
Notes and leases receivable - long-term	<u>268</u>	<u>302</u>
Notes and leases receivable	<u>\$ 388</u>	<u>\$ 383</u>

Notes and leases receivable are discounted using an effective discount rate ranging between eight and nine percent.

### 8. Inventories

Inventories relate to goods held for resale at the corporate cafés and are comprised of the following:

	<b>2015</b>	<b>2014</b>
Merchandise held for resale	\$ 181	\$ 176
Supplies	<u>48</u>	<u>45</u>
	<u>229</u>	<u>221</u>

# The Second Cup Ltd.

## Notes to the Financial Statements

For the periods ended December 26, 2015 and December 27, 2014

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

### 9. Property and equipment

	Leasehold improvements	Equipment, furniture, fixtures and other	Computer hardware	Total
Net carrying value				
As at December 28, 2013				
Cost	\$ 1,725	\$ 4,134	\$ 443	\$ 6,302
Accumulated depreciation	(1,077)	(1,406)	(312)	(2,795)
As at December 28, 2013	648	2,728	131	3,507
Additions from operations	731	661	267	1,659
Additions from franchise stores reacquired	158	298	-	456
Disposals - original cost	(124)	(357)	(1)	(482)
Disposals - accumulated depreciation	95	196	-	291
Capitalized to lease	-	(74)	-	(74)
Capitalized to lease - accumulated depreciation	-	6	-	6
Impairment charge (note 17)	(50)	-	-	(50)
Depreciation	(124)	(710)	(99)	(933)
As at December 27, 2014	\$ 1,334	\$ 2,748	\$ 298	\$ 4,380
Net carrying value				
As at December 27, 2014				
Cost	\$ 2,440	\$ 4,662	\$ 709	\$ 7,811
Accumulated depreciation	(1,106)	(1,914)	(411)	(3,431)
As at December 27, 2014	1,334	2,748	298	4,380
Additions from operations	183	1,628	131	1,942
Additions from franchise stores reacquired	-	-	-	-
Disposals - original cost	(227)	(446)	(5)	(678)
Disposals - accumulated depreciation	118	106	2	226
Capitalized to lease	-	(18)	-	(18)
Impairment charge (note 17)	-	-	-	-
Depreciation	(309)	(659)	(123)	(1,091)
As at December 26, 2015	1,099	3,359	303	4,761
Cost	2,396	5,826	835	9,057
Accumulated depreciation	(1,297)	(2,467)	(532)	(4,296)
As at December 26, 2015	\$ 1,099	\$ 3,359	\$ 303	\$ 4,761



# The Second Cup Ltd.

## Notes to the Financial Statements

For the periods ended December 26, 2015 and December 27, 2014

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

### 10. Intangible assets

	Trademarks	Franchise rights	Software	Total
Net carrying value				
As at December 28, 2013				
Cost	\$ 60,802	\$ 1,331	\$ 1,381	\$ 63,514
Accumulated amortization	-	(1,273)	(511)	(1,784)
As at December 28, 2013	60,802	58	870	61,730
Additions (acquired)	-	-	750	750
Disposals - original cost	-	-	(176)	(176)
Disposals - accumulated amortization	-	-	46	46
Capitalized to lease	-	-	(16)	(16)
Impairment charge (note 17)	(29,658)	-	-	(29,658)
Amortization	-	(58)	(281)	(339)
As at December 27, 2014	<u>\$ 31,144</u>	<u>\$ -</u>	<u>\$ 1,193</u>	<u>\$ 32,337</u>
Cost	\$ 31,144	\$ 1,331	\$ 1,939	\$ 34,414
Accumulated amortization	-	(1,331)	(746)	(2,077)
As at December 27, 2014	<u>\$ 31,144</u>	<u>\$ -</u>	<u>\$ 1,193</u>	<u>\$ 32,337</u>
Net carrying value				
As at December 27, 2014				
Cost	\$ 31,144	\$ 1,331	\$ 1,939	\$ 34,414
Accumulated amortization	-	(1,331)	(746)	(2,077)
As at December 27, 2014	31,144	-	1,193	32,337
Additions (acquired)	-	-	733	733
Disposals - original cost	-	-	(53)	(53)
Disposals - accumulated amortization	-	-	-	-
Capitalized to lease	-	-	(4)	(4)
Impairment charge (note 17)	-	-	-	-
Amortization	-	-	(374)	(374)
As at December 26, 2015	<u>\$ 31,144</u>	<u>\$ -</u>	<u>\$ 1,495</u>	<u>\$ 32,639</u>
Cost	\$ 31,144	\$ 1,331	\$ 2,615	\$ 35,090
Accumulated amortization	-	(1,331)	(1,120)	(2,451)
As at December 26, 2015	<u>\$ 31,144</u>	<u>\$ -</u>	<u>\$ 1,495</u>	<u>\$ 32,639</u>

# The Second Cup Ltd.

## Notes to the Financial Statements

For the periods ended December 26, 2015 and December 27, 2014

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

### 11. Accounts payable and accrued liabilities

Accounts payable and accrued liabilities consist of:

	<b>2015</b>	<b>2014</b>
Accounts payable - trade	\$ 2,695	\$ 1,902
Accrued liabilities	2,241	3,593
Accrued salaries, wages, benefits, and incentives	199	322
Sales tax payable - government remittances payable	225	194
	<u>\$ 5,360</u>	<u>\$ 6,011</u>

### 12. Provisions

	<b>Headlease liabilities</b>	<b>Café leases (a)</b>	<b>Other (b)</b>	<b>Total</b>
As at December 28, 2013	\$ 128	\$ 1,418	\$ 681	\$ 2,227
Provisions charged during the period	-	2,893	1,847	4,740
Provisions utilized during the period	<u>(57)</u>	<u>(1,752)</u>	<u>(2,089)</u>	<u>(3,898)</u>
As at December 27, 2014	<u>\$ 72</u>	<u>\$ 2,559</u>	<u>\$ 439</u>	<u>\$ 3,070</u>
Current portion	\$ 41	\$ 1,457	\$ 439	\$ 1,937
Long-term portion	<u>31</u>	<u>1,102</u>	<u>-</u>	<u>1,133</u>
As at December 27, 2014	<u>\$ 72</u>	<u>\$ 2,559</u>	<u>\$ 439</u>	<u>\$ 3,070</u>
Provisions charged during the period	-	1,422	538	1,960
Provisions utilized during the period	<u>(46)</u>	<u>(1,560)</u>	<u>(787)</u>	<u>(2,393)</u>
As at December 26, 2015	<u>\$ 26</u>	<u>\$ 2,421</u>	<u>\$ 190</u>	<u>\$ 2,637</u>
Current portion	\$ 26	\$ 1,439	\$ 190	\$ 1,655
Long-term portion	<u>-</u>	<u>982</u>	<u>-</u>	<u>982</u>
As at December 26, 2015	<u>\$ 26</u>	<u>\$ 2,421</u>	<u>\$ 190</u>	<u>\$ 2,637</u>

# The Second Cup Ltd.

## Notes to the Financial Statements

For the periods ended December 26, 2015 and December 27, 2014

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

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### 12. Provisions (continued)

#### a. Café leases

Provisions for café leases are estimates for costs to be incurred by the Company as a result of the following circumstances: a) closure of cafés, and b) franchisee failure to make payment of occupancy costs at an operational café.

Provisions for café closures of \$1,422 (2014 - \$2,893) were charged in the year and are reflected in the franchise line on the Statements of Operations and Comprehensive Loss.

#### b. Other

Provisions for other items of \$538 (2014 - \$1,847) were charged in the year. Portions of these provisions have been settled throughout the course of the year.

### 13. Other liabilities

	2015	2014
Deferred revenue - current	\$ 418	\$ 473
Leasehold inducements - current	39	39
Interest rate swap	77	143
	<hr/>	<hr/>
Other liabilities - current	534	655
	<hr/>	<hr/>
Deferred revenue - long-term	-	20
Leasehold inducements - long-term	314	348
	<hr/>	<hr/>
Other liabilities - long-term	\$ 314	\$ 368
	<hr/>	<hr/>
Deferred revenue	\$ 418	\$ 493
Leasehold inducements	353	387
Interest rate swap	77	143
	<hr/>	<hr/>
Other liabilities	\$ 848	\$ 1,023
	<hr/>	<hr/>

# The Second Cup Ltd.

## Notes to the Financial Statements

For the periods ended December 26, 2015 and December 27, 2014

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

### 14. Borrowings

	<b>2015</b>	<b>2014</b>
Face value of borrowings	\$ 6,000	\$ 11,000
Unamortized transaction costs	<u>(23)</u>	<u>(24)</u>
	<u>\$ 5,977</u>	<u>\$ 10,976</u>

The credit facility is comprised of a \$6,000 (2014 - \$11,000) non-revolving term loan. The loan is collateralized by substantially all the assets of the Company and matures on January 1, 2017.

The Company amended its term loan in 2015, which included repaying \$5,000, eliminating the credit facility of \$2,000, extending the maturity to 2017 and revising certain financial covenants. Pursuant to the terms of the Company's amended term loan, the Company is subject to certain financial and other customary covenants. The Company is required to maintain certain covenants which are defined in the agreements:

- a minimum EBITDA amount for each of the four quarters
- a fixed charge coverage ratio; both of which are based on a trailing four-quarter basis

The facility matures on January 1, 2017 and bears interest at the bankers' acceptance ("BA") plus a margin range of 2.25% to 3.25% based on the Company's leverage ratio. As at December 26, 2015, the applicable margin pertaining to the aforementioned range was 3.25% (December 27, 2014 - 3.25%).

The Company has an interest rate swap agreement with a notional value of \$6,000 that expires on September 30, 2016. The swap fixes the interest rate on the Company's non-revolving term credit facility at 2.07% per annum plus the margin noted above, which results in a fixed effective interest rate of 5.32%.

As at December 26, 2015, there was an interest rate swap liability of \$77 recorded in the Statements of Financial Position (December 27, 2014 - \$143).

### 15. Revenue

	<b>2015</b>	<b>2014</b>
<b>Franchise revenue</b>		
Royalties	\$ 10,553	\$ 12,350
Services and other	<u>4,706</u>	<u>5,396</u>
	<u>15,259</u>	<u>17,746</u>
<b>Company-owned cafés and product sales</b>	<u>22,082</u>	<u>10,426</u>
	<u>\$ 37,341</u>	<u>\$ 28,172</u>

# The Second Cup Ltd.

## Notes to the Financial Statements

For the periods ended December 26, 2015 and December 27, 2014

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

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### 16. Operating expenses

	2015	2014
<b>Company-owned cafés and cost of product sales</b>		
Cost of product sales	\$ 7,068	\$ 2,903
Labour and related expenses	6,869	3,103
Occupancy and other	8,445	5,273
Depreciation of property and equipment	474	256
(Gain) loss on disposal of assets	(21)	360
	<u>22,835</u>	<u>11,895</u>
<b>Franchise</b>		
Labour and related expenses	4,069	2,905
Travel and franchisee meetings	492	416
Business development initiatives	653	599
Professional fees and other	3,595	4,201
	<u>8,809</u>	<u>8,121</u>
<b>General and administrative</b>		
Labour and related expenses	1,954	2,923
Professional fees and other	3,400	4,950
Occupancy	433	456
Depreciation and amortization	991	1,016
	<u>6,778</u>	<u>9,345</u>
Asset impairment charge	-	29,708
	<u>\$ 38,422</u>	<u>\$ 59,069</u>

# The Second Cup Ltd.

## Notes to the Financial Statements

For the periods ended December 26, 2015 and December 27, 2014

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

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### 17. Impairment charges

#### a. Impairment of trademarks

During the quarter ended September 27, 2014, impairment indicators were identified, primarily the decline in the Company's stock price and a decline in sales in comparison to internal projections and as a result, the Company performed an impairment test which resulted in a charge of \$29,658.

The trademarks were allocated fully to the franchising, distribution, and wholesale CGU. The CGU's recoverable amount has been determined using fair value less costs of disposal.

#### Key assumptions

The discounted cash flow methodology uses estimates and assumptions that are sensitive to change and require judgement. This methodology used to test impairment is classified as Level 3 per the hierarchy described in note 5. These key judgements include estimates of discount rates, forecast growth in system sales and other estimates impacting future cash flows. Changes in these estimates and assumptions may have a significant impact on recoverable amounts. General market uncertainty and the competitive operating environment for the Company and other similar retail entities were also factors taken into account in the analysis. The changes in the market growth rates reflect the current general economic pressures now impacting the national economy.

Probability weighted cash flow projections are used based on financial forecasts covering a three-year period. These projections are approved by the Board of Directors based on management's expectations of potential outcomes. Cash flows beyond the three-year period are extrapolated using the estimated growth rates as stated in the table below. The valuation of the franchising, distribution, and wholesale business CGU is based on various probabilities assigned to forecasted cash flows and includes key assumptions. The analysis performed as at December 26, 2015 does not indicate any further impairment (2014 - \$29,658). The following are key assumptions used in the fair value less costs of disposal calculation as well as a sensitivity analysis for the various range of assumptions used and the related impact.

	2015		2014	
	Low growth	High growth	Low growth	High growth
Discount rate	12.0%	16.0%	13.0%	17.0%
Forecast same café sales	-1.0%	9.3%	-6.0%	6.6%
Forecast system-wide café sales	-1.0%	28.2%	-9.5%	17.3%
Avg. growth rate used to extrapolate cash flows beyond the forecast period	0.0%	3.2%	0.0%	3.0%
Amount by which carrying amount exceeds recoverable amount	\$4,273	\$(23,814)	\$6,943	\$(30,159)

# The Second Cup Ltd.

## Notes to the Financial Statements

For the periods ended December 26, 2015 and December 27, 2014

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

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### 17. Impairment charges (continued)

#### b. Impairment of leasehold improvements, equipment, furniture, fixtures, and other

Impairment indicators include when an individual Company-operated café experiences poor performance directly impacting cash flows. The impairment analysis is based on historical and forecasted performance measures for each café with impairment indicators. The asset's recoverable amount has been determined using value in use. The recoverable amount was compared to the net book value of the assets. This methodology used to test impairment is classified as Level 3 per the hierarchy described in note 5. As a result of the impairment test, impairment charges of \$nil for the year ended December 26, 2015 (2014 - \$50) were recorded to assets that were not able to be redeployed to a different CGU as the carrying amount exceeded the recoverable amount. A sensitivity of 2% increase or decrease in sales for each CGU pertaining to the impacted assets would not have had an impact on the impairment recorded. The impacted assets were adjusted to a carrying value of \$nil.

#### c. Summary of impairment charges

	2015	2014
Trademarks	\$ -	\$ 29,658
Leasehold improvements	-	-
Equipment, furniture, fixtures and other	-	50
	<u>\$ -</u>	<u>\$ 29,708</u>

### 18. Interest and financing

	2015	2014
Interest expense	\$ 559	\$ 544
Amortization of deferred financing costs	21	27
Interest income	<u>(123)</u>	<u>(93)</u>
	<u>\$ 457</u>	<u>\$ 478</u>

# The Second Cup Ltd.

## Notes to the Financial Statements

For the periods ended December 26, 2015 and December 27, 2014

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

### 19. Income taxes

Income taxes, as reported, differ from the amount that would be computed by applying the combined Canadian federal and provincial statutory income tax rate to income before income taxes. The reasons for the differences are as follows:

	<b>2015</b>	<b>2014</b>
Loss before income taxes	\$ (1,538)	\$ (31,375)
Combined Canadian federal and provincial tax rate	<u>26.44%</u>	<u>26.49%</u>
Tax recovery at statutory rate	(407)	(8,311)
Increased (reduced) by following differences		
Change in tax rates	-	(5)
Non-deductible permanent differences	19	3,945
Other	<u>3</u>	<u>28</u>
Income tax recovery	<u>\$ (385)</u>	<u>\$ (4,343)</u>
Current income tax recovery	\$ (596)	\$ (339)
Deferred income tax expense (recovery)	<u>211</u>	<u>(4,004)</u>
Income tax recovery	<u>\$ (385)</u>	<u>\$ (4,343)</u>

The blended weighted average statutory income tax rate is an aggregate of the following:

	<b>2015</b>	<b>2014</b>
Basic federal rate	% 15.00	% 15.00
Weighted average provincial rate	<u>11.44</u>	<u>11.49</u>
Combined Canadian federal and provincial tax rates	<u>% 26.44</u>	<u>% 26.49</u>

The movement in deferred income tax (assets) and liabilities during the year is as follows:

	<b>Property and equipment</b>	<b>Trademarks</b>	<b>Intangible assets</b>	<b>Other</b>	<b>Total</b>
As at December 28, 2013	\$ 1,804	6,301	15	(702)	7,418
Charged (credited) to the income statement	(13)	(3,933)	(15)	(43)	(4,004)
Charged (credited) to equity	<u>-</u>	<u>-</u>	<u>-</u>	<u>(144)</u>	<u>(144)</u>
As at December 27, 2014	1,791	\$ 2,368	\$ -	\$ (889)	\$ 3,270
Charged (credited) to the income statement	<u>153</u>	<u>(4)</u>	<u>-</u>	<u>62</u>	<u>211</u>
As at December 26, 2015	<u>\$ 1,944</u>	<u>\$ 2,364</u>	<u>\$ -</u>	<u>\$ (827)</u>	<u>\$ 3,481</u>



# The Second Cup Ltd.

## Notes to the Financial Statements

For the periods ended December 26, 2015 and December 27, 2014

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

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### 20. Basic and diluted loss per share

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

	<b>2015</b>	<b>2014</b>
Net loss	\$ (1,153)	\$ (27,032)
Weighted average number of shares issued and outstanding	<u>12,830,945</u>	<u>10,151,716</u>
Basic and diluted loss per share	<u>\$ (0.09)</u>	<u>\$ (2.66)</u>

### 21. Supplemental cash flow information

	<b>2015</b>	<b>2014</b>
Changes in non-cash working capital inflow (outflow):		
Trade and other receivables	\$ 592	\$ 177
Notes and leases receivable	(90)	(150)
Inventories	(8)	(31)
Prepaid expenses and other assets	58	(295)
Accounts payable and accrued liabilities	(651)	1,426
Provisions	(388)	899
Other liabilities	(70)	(301)
Gift card liability	(172)	(168)
Deposits from franchisees	323	(500)
Income taxes	<u>12</u>	<u>(837)</u>
	<u>\$ (394)</u>	<u>\$ 220</u>
<b>Cash payments for capital expenditures</b>		
Cash payments for capital expenditures	\$ (1,942)	\$ (1,575)
Cash payments for intangible assets	<u>(733)</u>	<u>(750)</u>
	<u>\$ (2,675)</u>	<u>\$ (2,325)</u>

### Supplementary information

Interest paid	\$ 523	\$ 540
Income taxes paid	\$ -	\$ 674

# The Second Cup Ltd.

## Notes to the Financial Statements

For the periods ended December 26, 2015 and December 27, 2014

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

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### 22. Restricted cash

The Company has established certain accounts that have been classified restricted cash primarily representing: a) deposits from franchisees for the cost of constructing a new café or the renovation of an existing café, and b) funds contributed for use in advertising and promotional programs where the Company is acting as an agent on behalf of the Co-operative Fund.

### 23. Contingencies, commitments and guarantees

The Company has lease commitments for Company-operated cafés and acts as the head tenant on most leases, which it in turn subleases to franchisees. To the extent the Company may be required to make rent payments due to headlease commitments, a provision has been recognized (note 12). The lease commitments, over the term of the leases, as at December 26, 2015 are as follows:

	Headlease commitments		Sublease to franchisees		Net
December 31, 2016	\$ 18,736	\$	15,858	\$	2,878
December 30, 2017	16,840		14,126		2,714
December 29, 2018	14,962		12,316		2,646
December 28, 2018	13,313		10,703		2,610
December 26, 2020	10,710		8,268		2,442
Thereafter	27,803		20,489		7,314
	<u>\$ 102,364</u>	\$	<u>81,760</u>	\$	<u>20,604</u>

The Company believes it has sufficient resources to meet the net commitment of \$20,604 over the term of the leases.

The Company is involved in litigation and other claims arising in the normal course of business. Judgement must be used 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. It is believed that no significant losses or expenses will be incurred 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.

Contracts are in place with third party companies to purchase the coffee that is sold in all cafés. In terms of these supply agreements, there is a guaranteed minimum volume of coffee purchases of \$2,464 USD (2014 - \$2,965 USD) for the subsequent 12 months. The coffee purchase commitment is comprised of two components: unapplied futures commitment contract and fixed price physical contracts.

Due to the Company acting as the primary coordinator of café construction costs on behalf of its franchisees and for Company-operated cafés, there is \$265 (2014 - \$302) of contractual commitments pertaining to construction costs for new locations and renovations as at the end of the fiscal year. Construction costs financed for franchise projects are from deposits received from franchisees and for corporate projects from the Company's cash flows.

# The Second Cup Ltd.

## Notes to the Financial Statements

For the periods ended December 26, 2015 and December 27, 2014

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

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### 24. Related parties

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

#### Compensation of key management

Key management is defined as the senior management team and the Board of Directors. The following summarizes the compensation expense of key management personnel and the composition thereof:

	<b>2015</b>		<b>2014</b>
Salaries and short-term employee benefits	\$ 2,364	\$	2,125
Termination costs	142		1,040
Share-based compensation	<u>36</u>		<u>194</u>
Total compensation	<u>\$ 2,542</u>	\$	<u>3,359</u>

# The Second Cup Ltd.

## Notes to the Financial Statements

For the periods ended December 26, 2015 and December 27, 2014

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

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### 25. Share-based compensation

#### *Stock option plan*

The stock option plan was introduced in May 2014 to advance the interests of the Company by:

- providing eligible persons with incentives;
- encouraging share ownership by participants;
- increasing the proprietary interest of participants in the success of the Company;
- encouraging participants to remain with the Company or its affiliates; and
- attracting new directors and employees.

Stock options are to be settled on a net-equity basis. Compensation expense for stock awards is recognized using the fair value when the stock awards are granted using the Black-Scholes option pricing model. All options vest in tranches and are amortized over the awards' vesting period using the accelerated expense attribution method. Recognition of the expense is recorded as a charge to operating expenses with a corresponding increase to contributed surplus.

The following weighted average assumptions have been used to estimate the weighted average fair value per award of \$0.31 granted for the year ended December 26, 2015:

	<b>Assumption</b>
Risk-free interest rate (%)	1.94
Volatility (%)	31.49
Expected term (years)	6.5

The table below summarizes all activity for the year ended December 26, 2015:

	<b>Number of share options outstanding</b>	<b>Weighted average share option price</b>
As at December 27, 2014	535,000	\$ 4.21
Granted	<u>180,000</u>	<u>3.67</u>
As at December 26, 2015	<u>715,000</u>	<u>\$ 4.10</u>
Stock option plan expense during the 52-week period		<u>\$ 86</u>

The range of exercise prices for share options outstanding at the end of the period is \$3.53 to \$4.54. There were no share options exercisable at the end of the period. As at December 26, 2015, the weighted average years to expiration are ten years. Share award options are able to be exercised upon vesting.

# The Second Cup Ltd.

## Notes to the Financial Statements

For the periods ended December 26, 2015 and December 27, 2014

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

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### 26. Long-term incentive plan and directors' deferred share unit plan

The fair value of the units outstanding is determined based on the fair value of the underlying common shares of the Company. The Company's long-term incentive plan was discontinued in 2014.

A summary of the status of the Company's long-term incentive plan is presented below:

	<b>Notional units</b>		<b>Recorded value</b>
Notional units outstanding as at December 28, 2013	29,872	\$	121
Units paid out	(27,963)		(96)
Change in fair value	-		(18)
	<hr/>		<hr/>
Notional units outstanding as at December 27, 2014	1,909	\$	7
Recovered in the period		\$	(18)
	<hr/>		<hr/>
	<b>Notional units</b>		<b>Recorded value</b>
Notional units outstanding as at December 27, 2014	1,909	\$	7
Units forfeited	(1,909)		(7)
Units paid out	-		-
Units granted in lieu of dividends	-		-
Change in fair value	-		-
	<hr/>		<hr/>
Notional units outstanding as at December 26, 2015	-	\$	-
Recovered in the period		\$	(7)
	<hr/>		<hr/>

# The Second Cup Ltd.

## Notes to the Financial Statements

For the periods ended December 26, 2015 and December 27, 2014

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

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### 26. Long-term incentive plan and directors' deferred share unit plan (continued)

A summary of the status of the Company's directors' deferred share unit plan is presented below:

	<b>Notional units</b>		<b>Recorded value</b>
Notional units outstanding as at December 28, 2013	58,483	\$	253
Deferred units granted	39,354		170
Units exercised	(58,483)		(253)
Change in fair value	-		(50)
	<hr/>		<hr/>
Notional units outstanding as at December 27, 2014	39,354	\$	120
	<hr/>		<hr/>
Expensed in the period		\$	120
			<hr/>
	<b>Notional units</b>		<b>Recorded value</b>
Notional units outstanding as at December 27, 2014	39,354	\$	120
Deferred units granted	36,049		110
Change in fair value	-		(11)
	<hr/>		<hr/>
Notional units outstanding as at December 26, 2015	75,403	\$	219
	<hr/>		<hr/>
Expensed in the period		\$	99
			<hr/>

The fair value price of deferred units granted was \$3.05 (2014 - \$4.32).