The Second Cup Ltd.

ANNUAL REPORT 2012

SECOND CUP

There's a little love in every cup.™

Living Arts Drive

Westdale Village

Eglinton & Wincott

Limeridge Mall

Brant Street

Terra Cosa

Gordon Street

Limeridge Mall

Eglinton & Wincott

Our baristas continue to delight our guests with latte art on all of our European beverages.

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LETTER FROM THE CHAIRMAN AND PRESIDENT & CEO

of The Second Cup Ltd.

Michael Rosicki, Chairman

Stacey Mowbray, President & CEO

We are pleased to present our Annual Report for the fiscal year ended December 29, 2012, on behalf of the Board of Directors for the Second Cup Ltd. ("Second Cup"). All amounts stated are expressed in thousands of Canadian dollars, except shares, unless otherwise indicated.

SUMMARY

We experienced a marginal growth of 0.4% in system sales to $194,387. Corporate revenue increased from $25,001 in 2011 to $26,346 in 2012, however, adjusted earnings per share declined from $0.64 in 2011 to $0.42 in 2012. The financial results reflect the continuing intense competitive activity in the coffee category, as well as our continued investments in new initiatives, including a loyalty program, coffee revitalization and a new café design. These initiatives will be tested in 2013 and will roll out in the latter part of the year.

With our investment in a new point of sale system in 2011, we are able to better assess our business and are now using the system as a platform for building café business plans, national plans and for supporting our test initiatives.

2012 HIGHLIGHTS

At Second Cup, our care and commitment to quality set us apart from our competitors. In 2012, we reinforced this point of difference with the launch of latte art on all of our hero latte beverages. Our baristas delight our guests with their craftsmanship and consistently deliver on our brand promise, "There's a little love in every cup." We also surprised and delighted our guests with new products, such as our S'mores Hot Chocolate, new Maple Flavoured Coffee, Honey Vanilla Tea Latte and customizable Iced Coffee.

In 2012, we entered into a partnership with Kraft Canada Inc. to produce, market and sell Second Cup signature coffees across Canada using the Tassimo T-Disc on-demand beverage system. The results so far

New in 2012: Second Cup formed a partnership with Tassimo, Canada's leading on-demand coffee brand, to produce, market and sell Second Cup signature blend coffees and lattes across Canada.

When it comes to serving our guests, our goal is to make sure "There's a little love in every cup" to deliver on our brand promise.

We strive to surprise and delight our guests with tempting new product offerings and limited-time seasonal favourites.

have been encouraging and we are looking to expand the offerings in 2013. The partnership offers our cafés a new category of business for sales and traffic in the rapidly growing single-serve segment of the coffee business. It also provides a new income stream for Second Cup through the licencing agreement with Kraft and the sales of Second Cup branded Tassimo T-Discs into grocery and other channels outside of the café business.

We continued to improve our café network with the opening of 18 cafés and closure of 17 to complete the year at 360 cafés. Many of the new cafés have drive thru and several of them are located outside urban areas to grow our presence beyond our core markets. We also fully implemented the new point of sales system throughout the majority of our cafés. We are now tracking comparable data for business analytics both nationally and at the café level to drive sales.

The coolest part of summer

Canadian charity, Free the Children

In 2012, we also announced a long-term partnership with Free the Children, a Canadian charity founded by Craig and Marc Kielburger aimed at empowering and enabling young people to be agents of change. Second Cup cafés have become the Social Change Headquarters for youth to meet and plan activities in support of Free the Children initiatives. Additionally, Second Cup cafés provide bricks and mortar locations to support the retail of select Me To We products in an effort to raise funds and awareness for Free the Children, as well as being a part of a movement for social good. This partnership is just another way to celebrate our Care and Quality point of difference and our Canadian roots.

free the children

New in 2012: Long-term partnership with Canadian charity, Free the Children

BOARD OF DIRECTORS

The Board welcomed two new members:
Bryan Held, as independent Director and a member of the Audit Committee, and Stephen Kelley, also as an independent Director. James Anas became the Chair of the Audit Committee.

DIVIDENDS

The quarterly dividend has been reduced to $0.085 per share to allow for investments into the business, while still offering a good return for shareholders at 6.6% (based on the year-end price of $5.13).

2013 OUTLOOK

In 2013, we will continue to focus on our Care and Quality point of difference in the premium coffee segment. We will be testing and launching a loyalty program and customer relationship system. We believe this program will grow our transactions efficiently and create further loyalty in this very competitive environment.

We will continue to improve our café network by adding more drive-thru locations, closing underperforming cafés and penetrating into small centres outside of our core marketing areas. The launch of our new look café will be showcased in downtown Toronto. The design reflects care and quality with a real focus on our coffee roots and our community involvement. Portions of this design will be adaptable to our existing cafés.

Pumpkin Flavored trio

Hearty breakfast options

For bringing the love home

Our Frrrozen Hot Chocolate® drinks are made with an exclusive blend of rich, imported cocoas and Madagascar vanilla, blended with milk and ice.

Whether it's a fresh cranberry muffin or a raspberry Danish, our café treats match the gourmet quality of our signature coffees.

Throughout the year we will work towards regaining our leadership within brewed coffee and bean sales. We believe we have the highest quality coffee of any national chain, as well as the broadest selection of brewed beverages, the strongest flavour portfolio and the leading café brand when it comes to offering beans with Rain Forest Alliance and Fair Trade Organic certification. We also have the systems to support the delivery of a quality cup. These systems include:

- Freshly grinding the beans in our cafés prior to brewing
- Testing the beans 112 times before they are served to a guest
- Swiss water decaffeinating, which is a 100% non-chemical process
- Adding flavours at the roasting stage to infuse them into our coffees

All these systems ensure the highest quality for our guests. In 2013, we will celebrate our leadership in quality through new in-store merchandising, new limited-time product offerings and a "Custom Cup" one cup offer for guests wanting a special cup of coffee that is worth the wait.

As the second largest speciality coffee retailer in Canada and largest franchisor, we are confident in the strength of the Second Cup brand. Our commitment to caring, emphasis on quality and franchise partners differentiate us from the competition, and our initiatives allow us to further build our brand and leverage our core equities.

Sincerely,

Michael Rosicki
Chairman, The Second Cup Ltd.

Stacey Mowbray
President & CEO, The Second Cup Ltd.

Bakery treats

A lunchtime Favourite!

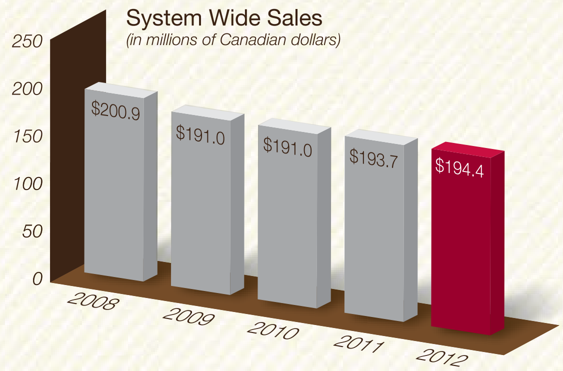
We offer a wide variety of cold beverages, from Icepresso® to Italian Sodas, which are always a popular choice in the hot summer months.

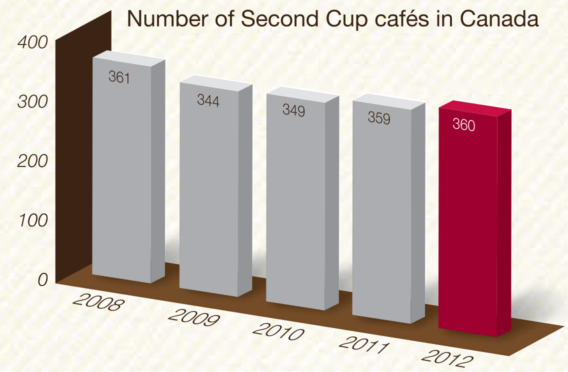
The Second Cup Ltd.

FINANCIAL HIGHLIGHTS

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

	13 weeks ended December 29, 2012	13 weeks ended December 31, 2011	52 weeks ended December 29, 2012	52 weeks ended December 31, 2011
System sales of cafés[1]	$53,515	$54,404	$194,387	$193,660
Number of cafés – end of period	360	359	360	359
Same café sales growth[1]	(4.2%)	1.2%	(1.9%)	(0.1%)
Total revenue	$7,785	$7,363	$26,346	$25,001
Gross profit	$6,638	$6,603	$22,823	$22,778
Operating expenses	4,332	3,393	15,779	13,176
Impairment of goodwill and trademarks	15,294	-	15,294	-
Operating (loss) income	($12,988)	$3,210	($8,250)	$9,602
Income before interest, tax, depreciation, amortization and impairment (“EBITDA”)[1]	$3,027	$3,647	$8,643	$10,600
(Loss) income before income taxes	($13,116)	$3,116	($8,753)	$8,887
Net (loss) income for the period	($12,024)	$2,352	($9,404)	$13,301
Adjusted net income[1]	$1,567	$2,116	$4,187	$6,358
Basic and diluted (loss) earnings per share as reported	($1.21)	$0.23	($0.95)	$1.34
Adjusted basic and diluted earnings per share[1]	$0.16	$0.21	$0.42	$0.64
Total assets	$88,680	$105,554	$88,680	$105,554





[1] “System sales of cafés”, “Same café sales growth”, “EBITDA”, “Adjusted net income” and “Adjusted basic and diluted earnings per share” are not recognized performance measures under IFRS and, accordingly, may not be comparable to similar computations as reported by other issuers.

We love nothing more than creating the perfect coffee experience. That's why we hand select our beans, so all we are left with is fairly traded, sustainable coffee from across the world.

The Second Cup Ltd.

MANAGEMENT'S DISCUSSION AND ANALYSIS

The following Management's Discussion and Analysis ("MD&A") has been prepared as of March 5, 2013 and is intended to assist in understanding the results of operations and financial condition of The Second Cup Ltd. ("Second Cup" or the "Company") for the 13 weeks (the "Quarter") and the year ended December 29, 2012, and should be read in conjunction with the audited financial statements of the Company and accompanying notes, which are available at www.sedar.com. Past performance may not be indicative of future performance. All amounts are presented in thousands of Canadian dollars, unless otherwise indicated and have been prepared in accordance with International Financial Reporting Standards ("IFRS").

In this MD&A, the Company also reports certain non-IFRS measures such as system sales of cafés, same café sales growth, EBITDA and adjusted net income. System sales of cafés and same café sales are discussed below under "System Sales". EBITDA represents earnings before interest, taxes, depreciation, amortization and impairment charges. As there is no generally accepted method of calculating EBITDA, the measure as calculated by the Company might not be comparable to similarly titled measures reported by other issuers. EBITDA is presented as management believes it is a useful indicator of the Company's ability to meet debt service and capital expenditure requirements and because management interprets trends in EBITDA as an indicator of relative operating performance. EBITDA should not be considered by an investor as an alternative to net income or cash flows as determined in accordance with IFRS.

As previously discussed, the Company (formerly Second Cup Income Fund) (the "Fund") converted from an income trust structure to a public corporation ("Conversion") on January 1, 2011. The Fund was not subject to income taxes to the extent that its taxable income was distributed to unitholders. On the IFRS transition date of January 1, 2010 an increase in the deferred tax liability was recorded by the Fund reflecting the highest marginal tax rate. After Conversion, the lower corporate tax rate resulted in a reduction in the deferred tax liability in 2011. The Company performed an impairment test on its franchise business cash generating unit (discussed below under "Operating Expenses") and recorded an impairment charge of $15,294 related to goodwill and trademarks for 2012. Management has separated the 2011 deferred income tax recovery due to Conversion and the 2012 impairment of goodwill and trademarks resulting in the non-IFRS measures of adjusted net income and adjusted basic and diluted earnings per share.

OVERVIEW AND BUSINESS OF SECOND CUP

Second Cup is Canada's largest specialty coffee café franchisor and retailer (as measured by the number of cafés) with 360 cafés operating under the trade name Second Cup™ in Canada, of which ten are Company-operated and the balance are operated by franchise partners who are selected and trained to retail Second Cup's product offering.

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, excluding the Territory of Nunavut.

Second Cup is incorporated and domiciled in Canada. The address of its registered office is 6303 Airport Road, 2nd Floor, Mississauga, Ontario L4V 1R8. The Company's website is www.secondcup.com.

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.

The common shares of the Company are listed on the Toronto Stock Exchange under the symbol "SCU."

As at March 5, 2013, the Company's issued share capital consisted of 9,903,045 common shares, unchanged from year end.

Additional information relating to the Company, including the Company's Annual Information Form, is on SEDAR at www.sedar.com.

BASIS OF PRESENTATION

The financial statements of Second Cup have been prepared in accordance with IFRS and International Financial Reporting Interpretation Committee ("IFRIC") interpretations.

The preparation of financial statements in accordance with IFRS requires the use of certain critical accounting estimates. It also requires management to exercise its judgement in the process of applying the Company's accounting policies. The areas involving a higher degree of judgement or complexity, or areas where assumptions and estimates are significant to the financial statements are disclosed in Note 4 of the financial statements.

The accounting policies applied in the financial statements are based on IFRS effective for the fiscal year ended December 29, 2012, as issued and outstanding as of February 28, 2013, the date the Board of Directors approved the financial statements.

The company's business is classified as one operating segment that is reported in a manner consistent with the internal reporting provided to the chief operating decision maker. The Company is structured as a franchisor with all of its operating revenues derived in Canada. Operating revenues comprise the sale of goods from Company-operated cafés and the sale of goods through ancillary channels, royalties and other service fees. Management is organized based on the Company's operations as a whole rather than the specific revenue streams.

As a franchisor, Second Cup opens, acquires, closes and refranchises individual café locations in the normal course of business.

FINANCIAL HIGHLIGHTS

The following table sets out selected IFRS financial information and other data of the Company and should be read in conjunction with the audited financial statements of the Company.

(in thousands of Canadian dollars, except number of cafés and per share amounts)	13 weeks ended December 29, 2012	13 weeks ended December 31, 2011	52 weeks ended December 29, 2012	52 weeks ended December 31, 2011
System sales of cafés[1]	$53,515	$54,404	$194,387	$193,660
Number of cafés – end of period	360	359	360	359
Same café sales growth[1]	(4.2%)	1.2%	(1.9%)	(0.1%)
Total revenue	$7,785	$7,363	$26,346	$25,001
Gross profit	$6,638	$6,603	$22,823	$22,778
Operating expenses	4,332	3,393	15,779	13,176
Impairment of goodwill and trademarks	15,294	-	15,294	-
Operating (loss) income	($12,988)	$3,210	($8,250)	$9,602
Amortization of property and equipment and intangible assets	324	287	1,167	832
Loss on disposal of property and equipment	42	20	70	36
Impairment of property and equipment	355	130	362	130
Impairment of goodwill and trademarks	15,294	-	15,294	-
Income before interest, tax, depreciation, amortization and impairment ("EBITDA")[1]	$3,027	$3,647	$8,643	$10,600
(Loss) income before income taxes	($13,116)	$3,116	($8,753)	$8,887
Current income tax (charge)	(596)	(894)	(1,644)	(1,527)
Deferred income tax recovery (charge) excluding Conversion	1,688	(106)	993	(1,002)
Deferred income tax recovery due to Conversion[2]	-	236	-	6,943
Net (loss) income for the period	($12,024)	$2,352	($9,404)	$13,301
Deferred income tax recovery due to Conversion[2]	-	(236)	-	(6,943)
Impairment of goodwill and trademarks	15,294	-	15,294	-
Tax effect	(1,703)	-	(1,703)	-
Adjusted net income[1]	$1,567	$2,116	$4,187	$6,358
Basic and diluted (loss) earnings per share as reported	($1.21)	$0.23	($0.95)	$1.34
Adjusted basic and diluted earnings per share[1]	$0.16	$0.21	$0.42	$0.64
Total assets	$88,680	$105,554	$88,680	$105,554

[1] "System sales of cafés", "Same café sales growth", "EBITDA", "Adjusted net income" and "Adjusted basic and diluted earnings per share" are not recognized performance measures under IFRS and, accordingly, may not be comparable to similar computations as reported by other issuers.

[2] At the annual and special meeting of unitholders held on June 10, 2010, the unitholders approved the proposed conversion from an income trust structure to a public corporation ("Conversion"). The Conversion was completed on January 1, 2011.

SYSTEM SALES

Overview of System Sales

System sales comprise the gross revenue reported to Second Cup by franchisees of Second Cup cafés and by cafés owned by Second Cup. Sales are reported by franchisees to Second Cup on a weekly basis without audit or other form of independent assurance. Second Cup's substantiation of sales reported by its franchisees is through analytical and financial reviews performed by management, comparison to sales data on the Point of Sales System ("POS"), on-site visits and analyses of raw materials purchased by the cafés as reported by authorized vendors.

Increases in system sales result from the addition of new cafés and same café sales growth. System sales from existing cafés are primarily dependent on pricing, product and marketing initiatives undertaken by Second Cup, maintaining operational excellence within the café network and general market conditions, including weather, disposable consumer income, consumer confidence, recessionary and inflationary trends, job security and unemployment, equity market levels, consumer credit availability and competitive activities. The primary factors influencing the number of cafés added to the Second Cup café network include the availability and cost of high quality locations, competition from other specialty coffee retailers and other businesses for prime locations, and the availability of qualified franchisees.

System sales are also affected by the permanent closure of Second Cup cafés. Cafés are closed when they cease to be viable or, occasionally, when a renewal of a lease for a particular location is not available or when an alternative, more preferable location is available.

Analysis of System Sales and Same Café Sales Growth

System sales for the 13 weeks ended December 29, 2012 were $53,515 compared to $54,404 for the 13 weeks ended December 31, 2011, representing a decrease of $889 or 1.6%. The total number of cafés at the end of the Quarter was 360 compared to 359 cafés at the end of the fourth quarter of 2011.

System sales for the 52 weeks ended December 29, 2012 were $194,387, compared to $193,660 for the 52 weeks ended December 31, 2011, representing an increase of $727 or 0.4%.

Same café sales represents percentage change, on average, in retail sales at cafés (franchised and Company-operated) operating system wide that have been open for 15 or more months. It is one of the key metrics the Company uses to assess its performance and provides a useful comparison between quarters. The two principal factors that affect same café sales growth are changes in customer traffic and changes in average check. These factors are dependent upon existing cafés maintaining operational excellence within each Second Cup café, general market conditions, pricing and marketing programs undertaken by Second Cup.

During the Quarter Second Cup continued to be impacted by increased competitive activity resulting in a same café sales decline of 4.2%, compared to an increase of 1.2% in the comparable quarter of 2011. For 2012, same café sales decline was 1.9% (2011 – 0.1% decline).

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

Seasonality of System Sales

The following table shows the percentage of annual system sales achieved, on average, in each fiscal reporting quarter over the last three fiscal years:

% of Annual System Sales	2010	2011	2012	Average
First quarter	23.8	23.5	24.2	23.9
Second quarter	24.4	24.4	24.4	24.4
Third quarter	24.0	24.0	23.9	23.9
Fourth quarter	27.8	28.1	27.5	27.8
	100.0	100.0	100.0	100.0

Historically, revenue has been higher in the fourth quarter, which includes the holiday sales periods of November and December. Because of this seasonality, the results for any quarter are not necessarily indicative of what may be achieved for any other quarter or for the full fiscal year.

CAFÉ NETWORK

	13 weeks ended December 29, 2012	13 weeks ended December 31, 2011	52 weeks ended December 29, 2012	52 weeks ended December 31, 2011
Number of cafés - beginning of period	358	359	359	349
Cafés opened	4	7	18	22
Cafés closed	(2)	(7)	(17)	(12)
Number of cafés - end of period	360	359	360	359
Number of cafés renovated	4	6	19	25

During the Quarter, four cafés were renovated (2011 - six), there were four café openings (2011 - seven) and two café closures (2011 - seven) with 360 cafés open at December 29, 2012. For the year, 19 cafés (2011 - 25) were renovated; there were 18 café openings (2011 - 22) and 17 café closures (2011 - 12).

INCOME, OPERATING EXPENSES AND NET INCOME

Fourth Quarter

Analysis of Revenues

Total revenues for the Quarter were $7,785 (2011 - $7,363) and consisted of royalty revenue, revenue from sale of goods and services revenue.

Royalty revenue for the Quarter was $4,017 (2011 - $4,346). The reduction in royalty revenue of $329 was mainly due to a decrease in system sales and a reduction in the effective royalty rate (excluding sales from Company-operated cafés) from 8.1% in 2011 to 7.7% in the Quarter as a result of the revised royalty structure for new cafés. New cafés that opened in 2011 and 2012 pay a royalty rate of 3% in the first year, a rate of 6% in the second year and, thereafter, a rate of 9%. In addition the effective royalty rate was impacted by café specific arrangements in place during the period.

Revenue from the sale of goods, which includes revenue from Company-operated cafés and the sale of coffee through wholesale and retail channels, was $1,597, compared to $1,042 for the 13 weeks ended December 31, 2011. The increase in revenue from the sale of goods was mainly due to operating twelve Company-operated cafés for most of the fourth quarter in 2012 compared to nine for most of the fourth quarter in 2011. The Company franchised two cafés late in the Quarter, ending the Quarter with ten Company-operated cafés.

Services revenue for the Quarter was $2,171 (2011 - $1,975). Services revenue includes initial franchise fees, renewal fees, transfer fees earned on the sale of cafés from one franchise partner to another, construction administration fees, product licencing revenue, purchasing coordination fees and other ancillary fees (IT support, tuition and construction black line drawings). The $196 increase in services revenue is mainly due to an increase in product licencing revenue, transfer fees and other ancillary fees offset by decreases in initial franchise fees and purchasing coordination fees. The increase in product licence revenue was as a result of the new partnership with Kraft Canada Inc. to produce, market and sell Second Cup signature blend coffees and lattes across Canada using the TASSIMO T-Disc on-demand beverage system.

Cost of Goods Sold

Cost of goods sold represents the product cost of goods sold in corporate cafés and through retail and wholesale channels plus the cost of direct labour to prepare and deliver the goods to the customers in the cafés. Cost of goods sold as a percentage of revenue from the sale of goods was 72% in the Quarter (2011 - 73%).

Operating Expenses

Operating expenses include the head office expenses of Second Cup and the overhead expenses of Company-operated cafés. Total operating expenses were $4,332 (2011 - $3,393), an increase of $939.

Head Office Operating Expenses

Head office expenses of Second Cup increased by $567 (19.8%) from $2,857 in 2011 to $3,424. Comparatively, the major expenses for the Quarter were salaries, wages and benefits $1,484 (2011 - $1,611), occupancy and lease costs $589 (2011 - $329), head office overheads $282 (2011 - $215), travel and franchise partner meetings $202 (2011 - $193), professional fees $164 (2011 - $84), legal costs $160 (2011 - $120), amortization of property and equipment $137 (2011 - $110), amortization of intangible assets $116 (2011 - $105), research and innovation $115 (2011 - $nil), advertising and franchise development $93 (2011 - $76), inventory markdowns $46 (2011 - $7), and bad debt expense $36 (2011 - $7). All material changes in operating expenses are explained in the table below.

Expenses	***Increase / Decrease in Expenses***	***Explanation for Change***
Salaries, wages and benefits	Decrease of $127	Reduction in incentives, severance costs, Directors' deferred share unit plan ("DSUP") and long-term incentive plan ("LTIP") offset by increases in Directors' fees and inflationary increases in salaries, wages and benefits. Directors' fees increased as a result of an additional Director in 2012.
Occupancy and lease costs	Increase of $260	Increase in provision for vacant properties which had not been sublet offset by recoveries for rent arrears from franchise partners.
Research and innovation	Increase of $115	New expenditure on test concepts and initiatives to build the brand and drive growth.
Professional fees	Increase of $80	Primarily due to the partial outsourcing of the cafés IT network support and upgrading head office accounting software and help desk software.
Head office overheads	Increase of $67	Increase in POS support costs as a result of an increase in the install base.
Legal costs	Increase of $40	Increased litigation costs in preparation for a trial from an outstanding 2009 landlord claim and due to increased leasing activity.

Impairment of Goodwill and Trademarks

The Company considers the franchise business as a separate cash generating unit ("CGU"). The Company performed its annual impairment test on the franchise business CGU and the valuation based on the forecasted cash flows and using an 11.5% discount rate indicated impairment. As a result, the Company recognized a total impairment charge of $15,294 which consisted of $2,444 to goodwill and $12,850 to trademarks in the Quarter. The after tax impact of these impairment charges were $13,591 and reduced earnings per share by $1.37. The impairment charges have no impact on the Company's liquidity, cash flow, borrowing capability or operations.

Corporate Café Operating Expenses
The overhead expenses in Company-operated cafés increased by $372 from $536 in 2011 to $908. Comparatively, the expenses for the Quarter were impairment of property and equipment $355 (2011 - $130), lease costs $282 (2011 - $178), other operating expenses $107 (2011 - $102), amortization of property and equipment $71 (2011 - $72), advertising and local marketing $51 (2011 - $34) and a loss on disposal of property and equipment $42 (2011 - $20).

The valuation of corporate cafés CGU based on revenue growth and future cash flows indicated an impairment. As a result, the Company recorded a loss of $355 (2011 - $130) on the impairment of two (2011 – one) Company-operated cafés.

Expenses	***Increase / Decrease in Expenses***	***Explanation for Change***
Impairment of property and equipment	Increase of $225	Leaseholds of two corporate cafés written off and property and equipment written down to their recoverable amount versus one corporate café (kiosk in mall) written down in 2011.
Lease costs	Increase of $104	The Company had ten (2011 - seven) Company-operated cafés at the end of the Quarter. The reduction in the amortization of liabilities arising from the 2009 acquisition of the Company by the Fund was $11.

Other Income and Expenses
The Company incurred interest expense of $159 (2011 - $177), and $22 (2011 - $18) in amortization of financing charges relating to the term loan. The Company also recorded a non-cash credit of $47 (2011 - $86) for the movement in the fair value of the derivative interest rate swap that fixes the interest rate on the Company's term loan. The Company earned other interest income of $10 (2011 - $20) primarily due to interest earned from short-term highly liquid bank investments with original maturities of three months or less and from notes receivable.

Income Taxes
Current income taxes of $596 (2011 - $894) were recorded in the Quarter. A deferred tax recovery of $1,688 (2011 - recovery of $130) was recorded in the Quarter. The deferred tax recovery was mainly due to the impairment charge of $15,294 to goodwill and trademarks in the Quarter.

EBITDA
EBITDA for the Quarter was $3,027 (2011 - $3,647). The decrease in EBITDA was due to an increase in gross profit of $35 offset by an increase in operating expenses of $655 (excluding amortization, loss on disposal of property and equipment and impairment charges) as discussed above.

Net Income
The Company's net loss for the Quarter was $12,024 or ($1.21) per share, compared to net income of $2,352 or $0.23 per share in 2011. Excluding the after tax impact of the goodwill and trademark impairment charge of $13,591 in 2012 and the Conversion deferred tax recovery of $236 in 2011, adjusted net income for the Quarter was $1,567 or $0.16 per share, compared to $2,116 or $0.21 per share in 2011. The decline in adjusted net income of $549 or $0.05 was mainly due to the $225 increase in impairment of property and equipment, the $714 increase in operating expenses (excluding the $225 impairment above), the $34 increase in net interest expense, offset by a $35 increase in gross profit and a $389 decrease in income taxes (excluding the income tax impact of Conversion and goodwill and trademarks impairment).

Reconciliation of Net (Loss) Income to EBITDA for the 13 Weeks Ended

	Dec. 29, 2012	Dec. 31, 2011
Net (loss) income	($12,024)	$2,352
Net interest expense	128	94
Income taxes (recovery)	(1,092)	764
Amortization of property and equipment	208	182
Amortization of intangible assets	116	105
Loss on disposal of property and equipment	42	20
Impairment of property and equipment	355	130
Impairment of goodwill and trademarks	15,294	-
EBITDA	$3,027	$3,647

Full Year

Analysis of Revenues

Revenues were $26,346 compared to $25,001 in 2011 and consisted of royalty revenue, revenue from the sale of goods and services revenue.

Royalty revenue was $14,927 (2011 - $15,631). The reduction in royalty revenue of $704 was mainly due to a reduction in the effective royalty rate (excluding sales from Company-operated cafés) from 8.2% in 2011 to 7.9% as a result of the revised royalty structure for new cafés as well as café specific arrangements in place during the period.

Revenue from the sale of goods, which includes revenue from Company-operated cafés and the sale of coffee through wholesale and retail channels, was $4,698 compared to $3,006 for the 52 weeks ended December 31, 2011. The increase in revenue from the sale of goods was mainly due to an increase in the weighted average number of Company-operated cafés from six in 2011 to eight in 2012. The Company ended the year with ten (2011 - seven) Company-operated cafés.

Services revenue was $6,721 (2011 - $6,364). The $357 increase in services revenue is mainly due to an increase in product licencing revenue, IT support fees, purchasing coordination fees and café resale fees offset by decreases in initial franchise fees, construction administration fees and renewal fees. Product licencing fees increased $443 largely due to the new partnership agreement with Kraft Canada Inc. to produce, market and sell Second Cup signature blend coffees and lattes across Canada using the TASSIMO T-Disc on-demand beverage system. IT support fees increased $172 and relate to POS implemented in the second half of 2011. Café resale fees increased $37 and are recognized when title transfers on the sale of a café between franchise partners. There were 28 cafés sold (2011 - 33) during the year reflecting a higher average price per transaction. Excluding new corporate cafés, the Company opened 17 new franchised cafés compared to 21 in 2011 and as a result initial franchise fees decreased by $178. Construction administration fees decreased by $138 as a result of lower franchise renovation projects which decreased from 25 in 2011 to 17 in 2012. The decrease in renewal fees is due to timing as renewal fees are recognized at the commencement of a new franchise term.

Cost of Goods Sold

Cost of goods sold as a percentage of revenue from the sale of goods was 75% compared to 74% for the 52 weeks ended December 31, 2011.

Operating Expenses

Operating expenses include the head office expenses of Second Cup and the overhead expenses of Company-operated cafés. Operating expenses were $15,779 (2011 - $13,176), an increase of $2,603.

Head Office Operating Expenses

Head office expenses of Second Cup increased by $1,744 from $12,008 in 2011 to $13,752 or 14.5%. Comparatively, the major expenses for the year ended December 29, 2012 were salaries, wages and benefits $6,540 (2011 - $7,311), occupancy and lease costs $1,614 (2011 - $882), travel and franchise partner meetings $1,010 (2011 - $888), head office overheads $992 (2001 - $833), professional fees $632 (2011 - $476), legal costs $518 (2011 - $394), amortization of property and equipment $506 (2011 - $289), research and innovation $476 (2011 - $nil), amortization of intangible assets $451 (2011 - $392), bad debt expense $422 (2011 - $257), advertising and franchise development $304 (2011 - $263) and inventory markdowns $287 (2011 - $23).

Impairment of Goodwill and Trademarks
As discussed above, the Company recognized an impairment charge of $2,444 to goodwill and $12,850 to trademarks.

Expenses	*Increase / Decrease in Expenses*	*Explanation for Change*
Salaries, wages and benefits	Decrease of $771	Reduction in incentives, severance costs, and DSUP offset by increases in Directors' fees, LTIP and inflationary increases in salaries, wages and benefits. LTIP increased due to the number of shares granted in December 2011 offset by a decrease in the share price.
Occupancy and lease costs	Increase of $732	The increase is mostly due to two vacant sites which have been vacant since 2009 and have not been successfully sublet.
Research and innovation	Increase of $476	New expenditure on test concepts and initiatives to build the brand and drive growth.
Inventory markdowns	Increase of $264	Inventory mark-downs increased as a result of 3 products which had sales below expectations.
Amortization of property and equipment	Increase of $217	Increase due to an increase in amortization on POS hardware and head office leasehold amortization. The Second Cup head office was renovated in the fourth quarter of 2011.
Bad debt expense	Increase of $165	Increase in the allowance for doubtful accounts and a discount factor for a promissory note.
Head office overheads	Increase of $159	Increase in IT support costs related to a larger install base of new POS.
Professional fees	Increase of $156	Primarily due to the partial outsourcing of the IT network support for cafés and upgrading head office accounting software and help desk software.
Legal costs	Increase of $124	Increased use of external legal professionals as a result of staff vacancies in the legal department as well as increased real estate activity and litigation costs.
Travel and franchise partner meetings	Increase of $122	Increase in the cost of the annual franchise partner convention and the induction program for new franchise partners.
Amortization of intangible assets	Increase of $59	Increase due to a greater number of POS installed in cafés.
Advertising and franchise development	Increase of $41	Increased new business development and advertising to attract new franchise partners.

Corporate Café Operating Expenses

The overhead expenses in Company-operated cafés increased by $859 to $2,027 from $1,168 in 2011. Comparatively, the major expenses for the 52 weeks ended December 29, 2012 were lease costs $885 (2011 - $504), impairment of property and equipment $362 (2011 - $130), other operating expenses $350 (2011 - $253), amortization of property and equipment $210 (2011 - $151), advertising and local marketing $150 (2011 - $94) and a loss on disposal of property and equipment $70 (2011 - $36).

As discussed above, the Company recorded a loss of $362 (2011 - $130) on the impairment of two Company-operated cafés.

Expenses	***Increase / Decrease in Expenses***	***Explanation for Change***
Lease costs	Increase of $381	The Company had ten (2011 - seven) Company-operated cafés at the end of year. The reduction in the amortization of liabilities arising from the 2009 acquisition of the Company by the Fund was $43.
Impairment of property and equipment	Increase of $232	Leaseholds of two corporate cafés written off and property and equipment written down to their recoverable amount versus one corporate café (kiosk in a mall) written down in 2011.
Other operating expenses	Increase of $97	Increased number of Company-operated cafés.
Advertising and local marketing	Increase of $56	Increased number of Company-operated cafés resulted in increased revenue subject to a 3% Co-op Fund contribution.
Amortization of property and equipment	Increase of $59	Increased number of Company-operated cafés.

Other Income and Expenses

The Company incurred interest expense of $672 (2011 - $717), and $82 (2011 - $72) in amortization of financing charges relating to the term loan. The reduction in interest expense is a result of renegotiating the term loan and operating credit facilities discussed below under "Term Loan, Operating Credit Facility and Interest Rate Swap". The Company also recorded a non-cash credit of $206 (2011 - $29) for the movement in the fair value of the derivative interest rate swap that fixes the interest rate on the Company's term loan. The Company earned other interest income of $61 (2011 - $67) primarily due to interest earned from short-term, highly liquid bank investments with original maturities of three months or less and from notes receivable.

Income Taxes

The income tax expense of $651 (2011 - recovery of $4,414) consists of:

- current income tax expense of $1,644 (2011 - $1,527);
- deferred income tax expense of $480 (2011 - $nil) due to the income tax rate change discussed below;
- deferred income tax recovery of $nil (2011 - $6,943), due to the Conversion; and
- deferred income tax (recovery) expense of ($1,473) (2011 - expense of $1,002), excluding the impact of the Conversion.

The increase in current income tax expense is a result of the Company reducing its 2011 current income taxes by utilizing tax losses carried forward from prior years. The Ontario 2012 budget was substantively enacted on June 20, 2012, freezing corporate tax cuts with the effect that the income tax rate would remain at 11.5% until the province can achieve a balanced budget. Previously, the corporate income tax rate was slated to decrease to 10.0% by 2014. The impact of the income tax rate change is estimated to be a future income tax increase of $480. The $1,473 deferred tax recovery in 2012 was mainly due to the impairment charge of $15,294 to goodwill and trademarks in the Quarter.

Prior to the Conversion in 2011, the Fund was an unincorporated open-ended trust and was not subject to income taxes to the extent that its taxable income was distributed to unitholders. As a result of new tax legislation substantively enacted on June 12, 2007, the Fund would have paid tax on distributions declared subsequent to January 1, 2011. As a result of this legislation, the Fund had provided for the future tax effect of existing temporary differences between the accounting and tax bases of assets and liabilities that were expected to reverse subsequent to January 1, 2011 at the specified investment flow through ("SIFT") entity tax rates under Canadian GAAP. Under IFRS, the taxation rate to apply to temporary differences of the Fund that were expected to reverse after 2010 was the highest marginal tax rate of 46.41% rather than the lower SIFT tax rate used previously of 28.25%. On the IFRS Transition Date, this IFRS adjustment resulted in an increase of $7,495 to the deferred tax liability and a corresponding decrease to equity. As a corporation, the deferred tax liability is measured using the corporate tax rate of 28.16% and resulted in a reduction in the deferred tax liability of $6,943 and a corresponding non-cash credit to income in the first quarter of 2011.

EBITDA

EBITDA was $8,643 (2011 - $10,600). The decline in EBITDA was due to an increase in gross profit of $45 offset by an increase in operating expenses of $2,002 (excluding amortization, loss on disposal of property and equipment and impairment charges) as discussed above.

Net Income

The Company's net loss was $9,404 or $0.95 per share, compared to net income of $13,301 or $1.34 per share in 2011. Excluding the 2011 deferred income tax recovery of $6,943 due to Conversion and the 2012 after tax impairment of goodwill and trademarks of $13,591, adjusted net income was $4,187 (2011 - $6,358). The reduction in adjusted net income of $2,171 was mainly due to the non-cash $232 increase in the impairment of property and equipment charge, the $2,371 increase in operating expenses (excluding the $232 impairment above) offset by the $212 decrease in net interest expense (including a non-cash $177 increase in the movement of the derivative interest rate swap), a $45 increase in gross profit and a $175 decrease in income taxes (excluding the recovery due to Conversion and the income tax impact of goodwill and trademarks impairment).

Reconciliation of Net (Loss) Income to EBITDA for the 52 Weeks Ended

	Dec. 29, 2012	**Dec. 31, 2011**
Net (loss) income	($9,404)	$13,301
Net interest expense	503	715
Income taxes (recovery)	651	(4,414)
Amortization of property and equipment	716	440
Amortization of intangible assets	451	392
Loss on disposal of property and equipment	70	36
Impairment of property and equipment	362	130
Impairment of goodwill and trademarks	15,294	-
EBITDA	$8,643	$10,600

Dividend
On February 28, 2013, the Board of Directors of Second Cup approved a dividend of $0.085 per common share, payable on March 28, 2013 to shareholders of record at the close of business on March 15, 2013. The dividend will be considered an eligible dividend for income tax purposes.

The Company's dividend policy is to continue to pay a portion of earnings while retaining funds for organic growth initiatives. The determination to declare and make payable dividends from Second Cup is at the discretion of the Board of Directors of Second Cup and, until declared payable, Second Cup has no requirement to pay cash dividends to shareholders. Taking into account current economic conditions and their impact on the profitability of Second Cup, the Board of Directors will continually review the level of dividends paid by the Company and there can be no assurance that the amount of the dividend will remain at the current level.

Annual General Meeting of Shareholders
The Board of Directors has set a record date of March 24, 2013 for the Annual General Meeting of shareholders. The Annual General Meeting will be held at 10:00 a.m. on Friday, May 3, 2013 at the offices of Stikeman Elliott LLP, 53rd Floor, 5300 Commerce Court West, 199 Bay Street, Toronto, Ontario.

SELECTED QUARTERLY INFORMATION

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

(in thousands of Canadian dollars, except number of cafés and per share amounts)	**Q4 2012[1]**	**Q3 2012**	**Q2 2012**	**Q1 2012**
System sales of cafés[2]	$53,515	$46,389	$47,382	$47,101
Same café sales growth[2]	(4.2%)	(2.8%)	(1.5%)	0.4%
Number of cafés at end of period	360	358	356	355
Total revenue	$7,785	$6,378	$6,175	$6,008
Operating (loss) income for the period	($12,988)	$1,133	$2,063	$1,542
Amortization of property and equipment and intangible assets	324	306	271	266
Loss (gain) on disposal of property and equipment	42	29	-	(1)
Impairment of property and equipment	355	-	-	7
Impairment of goodwill and trademarks	15,294	-	-	-
EBITDA[2]	$3,027	$1,468	$2,334	$1,814
Net (loss) income before income taxes	($13,116)	$1,017	$1,920	$1,426
Current income tax charge	596	275	422	351
Deferred income tax (recovery) charge	(1,688)	(4)	656	43
Net (loss) income for the period	($12,024)	$746	$842	$1,032
Basic/diluted (loss) earnings per share	($1.21)	$0.08	$0.09	$0.10
Dividends declared per share	$0.085	$0.15	$0.15	$0.15

	Q4 2011[1,3]	Q3 2011[3]	Q2 2011[3]	Q1 2011[3]
System sales of cafés[2]	$54,404	$46,369	$47,294	$45,593
Same café sales growth[2]	1.2%	(0.1%)	0.3%	(2.3%)
Number of cafés at end of period	359	359	350	352
Total revenue	$7,363	$6,138	$6,072	$5,428
Operating income for the period	$3,210	$2,362	$2,506	$1,524
Amortization of property and equipment and intangible assets	287	219	185	141
Loss on disposal of property and equipment	20	9	-	7
Impairment of property and equipment	130	-	-	-
EBITDA[2]	$3,647	$2,590	$2,691	$1,672
Net income before income taxes	$3,116	$2,095	$2,283	$1,393
Current income tax charge	894	511	122	-
Deferred income tax (recovery) charge	(130)	(68)	616	(6,359)
Net income for the period	$2,352	$1,652	$1,545	$7,752
Basic/diluted earnings per share	$0.23	$0.17	$0.16	$0.78
Dividends declared per share	$0.15	$0.15	$0.15	$0.00

1 The Company's fourth quarter system sales are higher than other quarters due to the seasonality of the business (see "Seasonality of System Sales" above).
2 System sales of cafés", "Same café sales growth" and "EBITDA" are not recognized performance measures under IFRS and, accordingly may not be comparable to similar computations as reported by other issuers.
3 Results for 2011 include deferred income tax (recovery) charge of ($6,756), $85, ($36) and ($236) in the first, second, third and fourth quarters respectively, as a result of the Conversion to a public corporation from an income trust structure.

LIQUIDITY AND CAPITAL RESOURCES

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

Fourth quarter

Cash Flows for the 13 Weeks Ended

	Dec. 29, 2012	Dec. 31, 2011
Cash flows from operating activities	$1,765	$3,574
Cash flows (used in) investing activities	(221)	(976)
Cash flows (used in) financing activities	(844)	(1,513)
Increase (decrease) in cash during the period	$700	$1,085

Cash generated by operating activities was $1,765 for the Quarter compared to $3,574 for the same quarter last year. The decrease is the result of increases in non-cash working capital including income taxes and a decrease in net income.

During the Quarter, cash used in investing activities was $221 (2011 - $976). The Company purchased $387 (2011 - $966) of property and equipment and $24 (2011 - $63) of software primarily for POS. The Company received proceeds of $159 (2011 - $35) on the disposal of property and equipment. The Company received proceeds of $31 (2011 - $26) on the repayment of leases receivable and promissory notes.

Financing activities resulted in cash usage of $844 (2011 - $1,513). During the Quarter, Second Cup paid a dividend totalling $842 (2011 - $1,485). The Company also paid $2 in financing charges related to the term loan. During 2011, the Company repaid $25 on a note payable to a previous landlord and made payments of $3.

Full Year

Working Capital as at

	Dec. 29, 2012	Dec. 31, 2011
Current assets	$9,593	$11,225
Current liabilities	10,649	12,025
Working capital (deficiency)	($1,056)	($800)

The Company has a working capital deficiency of $1,056 as of December 29, 2012. Second Cup has a gift card program that allows customers to prepay for future purchases by reloading a dollar value onto their gift cards. Current liabilities includes $4,560 (2011 - $4,353) gift card liability. The gift cards do not have an expiration date. The Company will honour all Second Cup gift cards presented for payment but may recognize breakage based on historical redemption patterns. Gift card holders are not entitled to any interest, dividends or returns on prepaid amounts and the Company does not charge a service fee. The gift card program continues to provide a source of working capital.

Cash Flows for the 52 Weeks Ended

	Dec. 29, 2012	Dec. 31, 2011
Cash flows from operating activities	$5,150	$8,305
Cash flows (used in) investing activities	(1,367)	(2,925)
Cash flows (used in) financing activities	(5,368)	(5,328)
(Decrease) increase in cash during the year	($1,585)	$52

Year to date, the Company generated cash from operations of $5,150 compared to $8,305 in 2011. The decrease is primarily the result of paying the 2011 income taxes of $1,548 and the 2012 income tax installments of $1,287.

Year to date, cash used by investing activities was $1,367 (2011 - $2,925). Second Cup purchased $1,758 (2011 - $2,731) of property and equipment primarily to renovate two corporate cafés, construct a new corporate café, purchase three cafés from franchise partners, POS and head office computer upgrades. In addition, $180 (2011 - $312) of software was purchased primarily for POS. Second Cup received proceeds of $350 (2011 - $49) on the disposal of property and equipment primarily from the sale of three cafés. The Company received proceeds of $221 (2011 - $97) on the repayment of leases receivable and promissory notes. During 2011, the Company agreed to finance certain franchisees $50 to enable them to purchase certain equipment, furniture and fixtures, all of which are owned by the Company as the underlying security. During 2011, the Company invested $291 in assets held for sale, which were sold for proceeds of $313.

Financing activities resulted in cash usage of $5,368 in 2012, compared to $5,328 in 2011. Second Cup paid dividends totalling $5,298 (2011 - $4,456) and the December 2010 distribution to unitholders of $759 in 2011. The Company repaid $18 (2011 - $101) on a note payable to a previous landlord and made payments of $2 (2011 - $12) on a long-term lease. Both the note payable and long-term lease have been fully repaid. The Company renegotiated its term loan and operating credit facilities and incurred $50 in financing charges related to the extension of the term loan to May 31, 2015 (see "Term Loan, Operating Credit Facility and Interest Rate Swap" below).

The Company had cash and cash equivalents of $3,880 at December 29, 2012 (December 31, 2011 - $5,465).
The Company continues to believe it has sufficient financial resources to pay future dividends and operating expenses when declared and due.

Term Loan, Operating Credit Facility and Interest Rate Swap

On June 12, 2012, the Company renegotiated its term loan and operating credit facilities including an extension of the maturity of the credit facilities, to May 31, 2015 and a decrease in interest rates. The revised credit facilities comprise an $11,000 non-revolving term credit facility, fully drawn, and an undrawn $2,000 revolving credit facility. As a result of the refinancing, the Company capitalized loan extension fees of $50. The term credit facilities are collateralized by substantially all the assets of the Company.

The $11,000 non-revolving term credit facility bears interest at the bankers' acceptance rate plus 2.75% (December 31, 2011 - 3.50%). As at December 29, 2012, the full amount of the $11,000 non-revolving term credit facility was drawn.

The $2,000 operating credit facility bears interest at the bankers' acceptance rate plus 2.75% (December 31, 2011 - 3.50%). As at December 29, 2012, no advances had been drawn on this facility.

The Company has an interest rate swap agreement with a notional value of $11,000 maturing on April 1, 2013, which fixes the interest rate on the Company's non-revolving credit facility at 3.04% per annum plus the margin noted above, which results in a fixed effective interest rate of 5.79% (December 31, 2011 - 6.54%). As at December 29, 2012, the estimated fair value of this contract is a $96 liability to the Company (December 31, 2011 - $302) which is recorded as a liability on the Company's Statements of Financial Position, and the fair value movement of the interest rate swap has been recorded as a non-cash credit to income on the Company's Statements of Operations and Comprehensive Income (Loss).

Pursuant to the terms of the Company's operating loan and term loan, the Company is subject to certain financial and other customary covenants, including requirements to maintain a ratio of senior debt to EBITDA and to maintain a trailing four-quarter fixed charge coverage ratio. During the year ended December 29, 2012, the Company was in compliance with all financial and other covenants of the Company's operating loan and term loan.

In accordance with IFRS 7, Financial Instruments: Disclosures, the term loan is presented net of transaction costs. Transaction costs are amortized to the Statements of Operations and Comprehensive Income (Loss) using the effective interest method.

OFF-BALANCE SHEET ARRANGEMENTS

Second Cup has lease commitments for Company-operated cafés and also acts as the head tenant on leases, which it, in turn, subleases to franchise partners. The Company's lease commitments at December 29, 2012 are as follows:

	Headlease commitments	Sublease to franchisees	Net
December 31, 2013	$ 19,246	$ 17,867	$ 1,379
December 31, 2014	18,346	17,121	1,225
December 31, 2015	16,710	15,474	1,236
December 31, 2016	14,676	13,430	1,246
December 31, 2017	12,667	11,501	1,166
Thereafter	35,706	31,647	4,059
	$ 117,351	$ 107,040	$ 10,311

The Company believes it has sufficient resources to meet the net commitment of $10,311.

Total occupancy and lease costs expensed in the quarter are as follows:

	52 weeks ended December 29, 2012	52 weeks ended December 31, 2011
Company head office and franchise café locations	$ 1,614	$ 882
Company-operated cafés	885	504
	$ 2,499	$ 1,386

Second Cup is involved in litigation and other claims arising in the normal course of business. Management must use its judgement 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 that it will not incur any significant loss or expense with such claims. However, there can be no assurance that unforeseen circumstances will not result in significant costs. The outcome of these actions is not determinable at this time and adjustments, if any, will be recorded in the period of settlement.

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 for ports and growth. Second Cup sources high altitude Arabica coffee which tends to trade at a premium above the "C" coffee commodity price. Second Cup has a contract with a third party company to purchase and roast the coffee that is sold in all Second Cup cafés by franchise partners. In terms of this supply agreement, Second Cup has guaranteed a minimum volume of coffee purchases amounting to $4,421 (2011 - $9,462). The coffee purchase commitment represents purchase commitments made up to the end of December 2013. The coffee purchase commitment is comprised of three components: unapplied futures commitment contracts, fixed price physical contracts and flat price physical contracts. As at December 29, 2012 most of the unapplied futures commitments for 2013 had been contracted, however, only a portion of the physical contracts had been negotiated. As a result, the majority of the decrease in the total commitments was due to a planned delay in committing to certain fixed price physical contracts.

Second Cup has entered into a marketing agreement with a third party through 2014 and has committed to spend $200 per year on advertising placed in various media offered by the third party over the term of the agreement.

FUTURE ACCOUNTING STANDARDS

Financial Instruments – Recognition and Measurement

IFRS 9, Financial Instruments ("IFRS 9"), was issued in November 2009 and addresses classification and measurement of financial assets. It replaces the multiple category and measurement models in International Accounting Standard 39, Financial Instruments: Recognition and Measurement ("IAS 39") for debt instruments with a new mixed measurement model having only two categories: amortized cost and fair value through profit and loss. IFRS 9 also replaces the models for measuring equity instruments. Such instruments are either recognized at fair value through profit or loss or at fair value through other comprehensive income. Where equity instruments are measured at fair value through other comprehensive income, dividends are recognized in profit or loss to the extent that they do not clearly represent a return of investment; however, other gains and losses (including impairments) associated with such instruments remain in accumulated comprehensive income indefinitely.

Requirements for financial liabilities were added to IFRS 9 in October 2010 and they largely carried forward existing requirements in IAS 39, except that fair value changes due to credit risk for liabilities designated at fair value through profit and loss are generally recorded in other comprehensive income.

IFRS 13, Fair Value Measurement ("IFRS 13"), is a comprehensive standard for fair value measurement and disclosure for use across all IFRS. The new standard clarifies that fair value is the price that would be received to sell an asset, or paid to transfer a liability in an orderly transaction between market participants, at the measurement date. Under existing IFRS, guidance on measuring and disclosing fair value is dispersed among the specific standards requiring fair value measurements and does not always reflect a clear measurement basis or consistent disclosures.

IFRS 9 and IFRS 13 are effective for annual periods beginning on or after January 1, 2015 and January 1, 2013, respectively, with earlier adoption permitted. The Company will adopt IFRS 13, effective January 1, 2013, but does not expect it to have a significant impact. The Company has not yet assessed the impact of IFRS 9 or determined whether it will early adopt the standard.

MANAGEMENT OF CAPITAL

The capital structure of the Company consists of $10,941 (2011 - $10,909) in long-term debt and $56,700 (2011 - $71,402) in shareholders' equity, which comprises issued shares and accumulated earnings, less accumulated cash distributions.

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

a) safeguard its ability to continue as a going concern;
b) maintain financial flexibility in order to preserve its ability to meet financial obligations;
c) maintain a capital structure that provides financing options to the Company when the need arises to access capital;
d) ensure it has sufficient cash and cash equivalents to pay declared dividends to its shareholders; and
e) deploy capital to provide an adequate return to its shareholders.

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

The Company determines the appropriate level of long-term debt in the context of its cash flow and overall business risks. The Company has historically generated sufficient cash flows to pay quarterly dividends to its shareholders. In order to maintain or modify the capital structure, Second Cup may adjust the amount of dividends paid to its shareholders. The current level of capital is considered adequate in the context of current operations.

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

There were no changes in the Company's approach to capital management during the Quarter.

OUTSTANDING UNIT AND SHARE DATA

	Income Fund Units		Share Capital	
	#	$	#	$
Balance December 31, 2010	9,903,045	89,972	-	-
Conversion January 1, 2011	(9,903,045)	(89,972)	9,903,045	89,972
Reduction in stated capital January 1, 2011	-	-	-	(88,972)
Balance December 31, 2011	-	-	9,903,045	1,000

At the annual and special meeting of unitholders held on June 2, 2010, the unitholders approved the Conversion to be undertaken on January 1, 2011. Included as part of the Conversion was a reduction in the stated capital from $89,972 to $1,000, resulting in a reduction of the deficit by $27,575 and an increase in contributed surplus of $61,397. The Conversion and the associated reduction in share capital were approved by court orders dated June 11, 2010 and December 17, 2010.

EVALUATION OF DISCLOSURE CONTROLS AND PROCEDURES

Multilateral Instrument 52-109 ("MI 52-109") requires the Company's Chief Executive Officer ("CEO") and Chief Financial Officer ("CFO") to make certain certifications related to the information contained in the Company's annual filings. Specifically, the CEO and CFO must acknowledge that they are responsible for establishing and maintaining disclosure controls and procedures and internal control over financial reporting ("ICFR") for the Company. The control framework used by the CEO and CFO to design the Company's ICFR is Internal Control Over Financial Reporting – Guidance for Smaller Public Companies issued by COSO. In addition, in respect of:

(a) Disclosure Controls and Procedures

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

As at December 29, 2012, the Company's management, under the supervision of, and with the participation of, the CEO and CFO, evaluated the design of the disclosure controls and procedures. Based on this evaluation, the CEO and CFO have concluded that, as at December 29, 2012, the Company's disclosure controls and procedures were appropriately designed.

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

(b) Internal Controls Over Financial Reporting

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

As at December 29, 2012, the Company's management, under the supervision of, and with the participation of, the CEO and CFO, evaluated the design of the controls over financial reporting. No material weaknesses in the design of these controls over financial reporting were identified. Based on this evaluation, the CEO and CFO have concluded that, as at December 29, 2012, the Company's controls over financial reporting were appropriately designed and are operating effectively.

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

During the 52 weeks ended December 29, 2012, there has been no change in the Company's internal control over financial reporting that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

CRITICAL ACCOUNTING ESTIMATES

The preparation of financial statements requires management to 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. Estimates and underlying assumptions are reviewed on an ongoing basis. Revisions to accounting estimates are recognized in the period in which the estimates are revised and in any future periods affected.

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

Impairment analysis

Impairment analysis is an area involving management judgement requiring assessment as to whether the carrying value of assets is recoverable. Fair value less cost to sell is determined by estimating the net present value of future cash flows derived from such assets using cash flow projections, which have been discounted at an appropriate rate. 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:

a) Growth in total revenue
b) Growth in cash flows, calculated as adjusted operating profit before depreciation and amortization,
c) Long term growth rates
d) Selection of discount rates to reflect the risks involved.

Management has estimated cash flows based on market participant assumptions and expected future operations.

The discount rate is based upon a weighted average cost of capital derived from the benchmark analysis from similar retail or franchise businesses in Canada and the United States.

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

The Company's review includes the key assumptions related to sensitivity in the cash flow projections. Further details are provided in Note 13 to the financial statements.

Recoverable amount and Cash Generating Units (CGUs)
A CGU is defined as the smallest identifiable group of assets that generates cash inflows that are largely independent of the cash inflows from other assets or group of assets.

Goodwill is not amortized but tested for impairment at least once a year or more frequently when there is an indication that it may be impaired.

An impairment test is performed at the level of each CGU within each operating segment. This allocation is reviewed if the Company changes the level at which it monitors goodwill or changes in operating segments.

An impairment charge is recognized when the carrying value of the assets and liabilities of the franchise business CGU is higher than its recoverable amount. The recoverable amount of the franchise business CGU was estimated based on fair value less costs to sell. Fair value less costs to sell is the best estimate of the amount obtainable from the sale of a CGU in an arm's length transaction between knowledgeable, willing parties, less costs to sell. This estimate is determined on December 29, 2012. The Company determined goodwill and trademarks were impaired and recognized an impairment charge of $2,444 and $12,850 respectively. The Company also determined the valuation of two corporate cafés indicated impairment and recognized an impairment charge of $362 mainly related to leaseholds.

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

Fair value of derivative
Second Cup's over-the-counter derivative consists of an interest rate swap used to economically hedge exposure to variable cash flows associated with interest payments on the Company's borrowings. Management estimates the fair value of this derivative as the present value of expected future cash flows to be received or paid, based on available market data, which includes market yields and counterparty credit spreads.

Estimated useful lives
Management estimates the useful lives of property and equipment based on the period during which the assets are expected to be available-for-use. The amounts and timing of recorded expenses for amortization of property and equipment for any period are affected by these estimated useful lives. The estimates are reviewed at least annually and are updated if expectations change as a result of physical wear and tear, technical or commercial obsolescence and legal or other limits to use. It is possible that changes in these factors may cause significant changes in the estimated useful lives of the Company's property and equipment in the future.

Provisions
Second Cup has lease commitments since it acts as the head tenant on café leases. In cases where the lease contract specifies a termination fee due to the landlord or a fee is negotiated with the landlord upon termination, the Company records the expense at the time written notice is given or agreed to by the landlord. When ceasing operations under operating leases where the landlord does not allow the Company to prematurely exit the lease, but allows for subleasing, the Company estimates the fair value of sublease income in calculating the provision to the end of the lease term.

RISKS AND UNCERTAINTIES

The performance of Second Cup is primarily dependent on its ability to maintain and increase the sales of existing cafés, add new profitable cafés to the network and redevelop and modernize cafés as their leases come due. System sales of the Second Cup café network are affected by various external factors that can affect the specialty coffee industry as a whole. Potential risks include the following:

The specialty coffee industry is characterized by intense competition with respect to price, location, coffee and food quality and numerous factors affecting discretionary consumer spending. Competitors include national and regional chains, all restaurants and food service outlets that serve coffee and supermarkets that compete in the whole bean segment. If Second Cup cafés are unable to successfully compete in the Canadian specialty coffee industry, system sales may be adversely affected, which, in turn, may adversely affect the ability of Second Cup to pay dividends.

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

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

A shortage in supply or an increase in the price of premium quality coffee beans could adversely affect Second Cup. Second Cup has no material long-term contracts with coffee bean suppliers and relies on historical relationships to ensure availability. While there are a number of coffee bean suppliers, there can be no assurance that coffee bean suppliers that have relationships with Second Cup will continue to supply coffee beans at competitive prices.

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

Second Cup relies heavily on information technology network infrastructure. The Company's ability to manage operations effectively and efficiently depends on the reliability and capacity of these technology systems, most of which are administered by third party suppliers. The Company relies on POS for system sales for both marketing trends and royalty calculations through the IT network infrastructure. Cafés rely on IT network infrastructure to order goods and process credit, debit and café card transactions. Head Office financial and administrative functions rely on IT infrastructure for accurate and reliable information. The failure of these systems to operate effectively, problems with upgrading or replacing systems could cause a material negative financial result. The Company is continually reviewing its systems and procedures to minimize risk.

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

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

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

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

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

OUTLOOK

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

The Second Cup business continues to operate in an increasingly competitive marketplace and a challenging consumer environment. For 2013, management will continue to re-invest in the business, specifically a loyalty and communications capability, a coffee revitalization plan, and a newly designed café. These initiatives will be in test in 2013 with expected roll-outs towards the end of the year. In addition, Second Cup will leverage new and growing commercial opportunities, including the expansion and support of the newly introduced Second Cup signature coffees and lattes using the TASSIMO T-Disc on demand beverage system and expects to increase its product licencing revenue as a result.

Second Cup will continue to improve the café network with the opening of cafés while closing below average performing cafés.

FORWARD-LOOKING INFORMATION

Certain statements in this MD&A may constitute forward looking information within the meaning of applicable securities legislation. Forward looking information can be identified by words such as "may", "will", "should", "expect", "anticipate", "believe", "plan", "intend" and other similar words. Forward-looking information reflects current expectations regarding future events and operating performance and speaks only as of the date of this MD&A. It should not be read as a guarantee of future performance or results and will not necessarily be an accurate indication of whether or not those results will be achieved. Forward looking information is based on a number of assumptions and is subject to known and unknown risks, uncertainties and other factors, many of which are beyond Second Cup's control that may cause Second Cup's actual results, performance or achievements, or those of Second Cup cafés, or industry results to be materially different from any future results, performance or achievements expressed or implied by such forward-looking information. The following are some of the factors that could cause actual results to differ materially from those expressed in the underlying forward looking information: competition; availability of premium quality coffee beans; the ability to attract qualified franchise partners; the location of Second Cup cafés; the closure of Second Cup cafés; loss of key personnel; compliance with government regulations; potential litigation; the ability to exploit and protect the Second Cup Marks; changing consumer preferences and discretionary spending patterns including, but not restricted to, the impact of weather and economic conditions on such patterns; reporting of system sales by franchise partners; and the results of operations and financial condition of Second Cup. The foregoing list of factors is not exhaustive, and investors should refer to the risks described under "Risks and Uncertainties" above and in Second Cup's Annual Information Form, which is available at www.sedar.com.

Although the forward looking information contained in this MD&A is based on what management believes are reasonable assumptions, there can be no assurance that actual results will be consistent with this forward looking information and, as a result, the forward-looking information may prove to be incorrect.

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

SECOND CUP
TM/MC

The Second Cup Ltd.

AUDITED FINANCIAL STATEMENTS

For the 52 week periods ended
December 29, 2012 and December 31, 2011

March 5, 2013

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 29, 2012 and December 31, 2011 and the statements of operations and comprehensive income (loss), statements of changes in equity and statements of cash flows for the two fifty-two week 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, 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 audits. We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the 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 audits 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 29, 2012 and December 31, 2011 and its financial performance and its cash flows for the fifty-two week periods then ended in accordance with International Financial Reporting Standards.

PricewaterhouseCoopers LLP

Chartered Accountants, Licensed Public Accountants

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The Second Cup Ltd.

STATEMENTS OF FINANCIAL POSITION

As at December 29, 2012 and December 31, 2011

(Expressed in thousands of Canadian dollars)

	December 29, 2012	December 31, 2011
ASSETS		
Current assets		
Cash and cash equivalents (note 6)	$ 3,880	$ 5,465
Trade and other receivables (note 7)	4,616	5,338
Current portion of notes and leases receivable (note 9)	265	149
Inventories (note 8)	137	79
Prepaid expenses and other assets	695	194
	9,593	11,225
Non-current assets		
Notes and leases receivable (note 9)	741	469
Property and equipment (note 10)	3,544	3,478
Goodwill (note 11)	-	2,444
Intangible assets (note 12)	74,802	87,938
Total assets	$ 88,680	$105,554
LIABILITIES		
Current liabilities		
Accounts payable and accrued liabilities (notes 14 and 27)	$ 3,313	$ 4,093
Current portion of other long-term liabilities (note 19)	189	166
Provisions (note 15)	365	447
Income tax payable	318	1,509
Gift card liability	4,560	4,353
Deposits from franchise partners	1,904	1,457
	10,649	12,025
Non-current liabilities		
Deferred income taxes (note 17)	9,190	10,183
Other long-term liabilities (note 19)	421	392
Provisions (note 15)	683	341
Fair value of derivative interest rate swap (note 18)	96	302
Term loan (note 18)	10,941	10,909
Total liabilities	31,980	34,152
Shareholders' equity (note 1)	56,700	71,402
Total liabilities and shareholders' equity	$ 88,680	$105,554

Contingencies, commitments and guarantees (note 20) and subsequent event (note 29)
See accompanying notes to financial statements.

Approved by the Directors February 28, 2013

Michael Rosicki, Director James Anas, Director

The Second Cup Ltd.

STATEMENTS OF OPERATIONS AND COMPREHENSIVE INCOME (LOSS)

For the years ended December 29, 2012 and December 31, 2011

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

	2012	2011
Revenue		
Royalty	$ 14,927	$ 15,631
Sale of goods	4,698	3,006
Services	6,721	6,364
	26,346	25,001
Cost of goods sold	3,523	2,223
Gross profit	22,823	22,778
Operating expenses (note 22)	15,779	13,176
Impairment of goodwill and trademarks (note 13)	15,294	-
	31,073	13,176
Operating (loss) income	(8,250)	9,602
Interest income	(61)	(67)
Interest expense (note 18)	564	782
Net interest expense	503	715
(Loss) income before income taxes	(8,753)	8,887
Income taxes (recovery) (note 16)		
Current	1,644	1,527
Deferred	(993)	(5,941)
	651	(4,414)
Net (loss) income for the year	(9,404)	13,301
Other comprehensive income	-	-
Comprehensive (loss) income	$ (9,404)	$ 13,301
Basic and diluted (loss) earnings per share (note 21)	$ (0.95)	$ 1.34

See accompanying notes to financial statements.

The Second Cup Ltd.

STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY

(Expressed in thousands of Canadian dollars)

	Share Capital (*see below)	Contributed Surplus	(Deficit) Retained Earnings	Total
Balance - December 31, 2010	$ 89,972	$ 160	$ (27,575)	$ 62,557
Reduction in share capital	(88,972)	61,397	27,575	-
Net income for the year	-	-	13,301	13,301
Dividends to shareholders	-	-	(4,456)	(4,456)
Balance - December 31, 2011	$ 1,000	$ 61,557	$ 8,845	$ 71,402
Net loss for the year	-	-	(9,404)	(9,404)
Dividends to shareholders	-	-	(5,298)	(5,298)
Balance - December 29, 2012	$ 1,000	$ 61,557	$ (5,857)	$ 56,700

* Prior to the conversion from an income trust structure to a public corporation ("Conversion") Share Capital was referred to as Income Fund Units (notes 1 and 5)

See accompanying notes to financial statements.

The Second Cup Ltd.

STATEMENTS OF CASH FLOWS

For the years ended December 29, 2012 and December 31, 2011

(Expressed in thousands of Canadian dollars)

	2012	2011
CASH PROVIDED BY (USED IN)		
Operating Activities		
Net (loss) income for the year	$ (9,404)	$ 13,301
Items not involving cash		
Amortization of deferred financing charges (note 3(m))	82	72
Amortization of intangible assets (note 3(i))	451	392
Amortization of leasehold inducements (note 3(l))	(35)	(3)
Amortization of property and equipment (note 3(g))	716	440
Amortization of provisions (note 3(k))	(89)	(112)
Deferred income taxes	(993)	(5,941)
Impairment of property and equipment	362	130
Impairment of goodwill	2,444	-
Impairment of trademarks	12,850	-
Loss on disposal of property and equipment	70	36
Movement in fair value of derivative interest rate swap	(206)	(29)
Income taxes	(1,191)	1,584
Leasehold inducement	61	406
Changes in non-cash working capital (note 24)	32	(1,971)
	5,150	8,305
Investing activities		
Investment in notes and leases receivable	-	(50)
Proceeds from disposal of assets held for sale	-	313
Proceeds from disposal of property and equipment	350	49
Proceeds from repayment of leases receivable	36	6
Proceeds from repayment of notes receivable	185	91
Purchase of assets held for sale	-	(291)
Purchase of property and equipment	(1,758)	(2,731)
Purchase of software	(180)	(312)
	(1,367)	(2,925)
Financing activities		
Deferred financing charges	(50)	-
Distributions paid to unitholders	-	(759)
Dividends paid to shareholders	(5,298)	(4,456)
Payments on long-term lease	(2)	(12)
Repayment of note payable	(18)	(101)
	(5,368)	(5,328)
(Decrease) increase in cash and cash equivalents during the year	(1,585)	52
Cash and cash equivalents - Beginning of year	5,465	5,413
Cash and cash equivalents - End of year	$ 3,880	$ 5,465

See accompanying notes to financial statements.

The Second Cup Ltd.

NOTES TO THE FINANCIAL STATEMENTS

For the years ended December 29, 2012 and December 31, 2011

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

1. ORGANIZATION AND NATURE OF BUSINESS

The Second Cup Ltd. ("Second Cup" or "the Company") is Canada's largest specialty coffee café franchisor (as measured by the number of cafés) with 360 cafés operating under the trade name Second Cup™ in Canada, of which ten are Company operated and the balance are operated by franchise partners who are selected and trained to retail Second Cup's product offering.

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, excluding the Territory of Nunavut.

Second Cup is incorporated and domiciled in Canada. The address of its registered office is 6303 Airport Road, 2nd Floor, Mississauga, Ontario, L4V 1R8. The Company's website is www.secondcup.com.

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.

Prior to January 1, 2011, Second Cup Income Fund (the "Fund") was an unincorporated open-ended trust established under the laws of the Province of Ontario. An unlimited number of units could have been issued pursuant to the Fund's declaration of trust. Units were redeemable by the holder at any time, subject to certain limitations.

The common shares of the Company are listed on the Toronto Stock Exchange under the symbol "SCU".

Conversion of the Fund

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

The exchange of the units of the Fund into shares of the Company was recorded at the carrying values of the Fund's assets and liabilities on January 1, 2011 in accordance with the continuity of interest method of accounting, as the Company is considered to be a continuation of the Fund.

As a result of the Conversion, unitholders' capital of $89,972 was reclassified to share capital. Included as part of the Conversion was a reduction in the stated capital from $89,972 to $1,000, resulting in a reduction of the deficit by $25,575 and an increase in contributed surplus of $61,397. The Conversion and the associated reduction in share capital were approved by court orders dated June 11, 2010 and December 17, 2010.

2. BASIS OF PREPARATION

The financial statements of Second Cup have been prepared in accordance with International Financial Reporting Standards ("IFRS") and International Financial Reporting Interpretation Committee ("IFRIC") interpretations.

The preparation of financial statements in accordance with IFRS requires the use of certain critical accounting estimates. It also requires management to exercise its judgement in the process of applying the Company's accounting policies.

The areas involving a higher degree of judgement or complexity, or areas where assumptions and estimates are significant to the financial statements are disclosed in note 4.

The accounting policies applied in the financial statements are based on IFRS effective for the fiscal year ended December 29, 2012, as issued and outstanding as of February 28, 2013, the date the Board of Directors approved the financial statements.

3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

(a) Basis of measurement
The financial statements have been prepared under the historical cost convention, except for certain financial instruments that are measured at fair values, as explained in the accounting policies below. Historical cost is generally based on the fair value of the consideration given in exchange for assets.

(b) Segmented information
Second Cup operates within Canada, which is considered to be its sole operating segment. As a franchisor, Second Cup opens, acquires, closes and refranchises individual café locations in the normal course of business.

(c) 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.

(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 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.

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

(i) Financial assets and liabilities at fair value through profit or loss ("FVTPL"): A financial asset or liability is classified in this category if acquired principally for the purpose of selling or repurchasing in the short-term. Derivatives are also included in this category unless they are designated as hedges. The only instruments held by the Company classified in this category are interest rate swaps (see (v) below). The Company fair values the swap at the end of each quarter with the change in fair value accounted through profit or loss.

Financial instruments in this category are recognized initially and subsequently at fair value. Transaction costs are expensed in the Statements of Operations and Comprehensive Income (Loss). Gains and losses arising from changes in fair value are presented in the Statements of Operations and Comprehensive Income (Loss) within other gains and losses in the year in which they arise. Financial assets and liabilities at FVTPL are classified as current, except for the portion expected to be realized or paid beyond 12 months of the Statements of Financial Position dates, which is classified as non-current.

(ii) Loans and receivables: Loans and receivables are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market. The Company's loans and receivables comprise trade receivables, notes receivable and cash and cash equivalents, and are included in current assets due to their short-term nature, except for the portion expected to be realized beyond 12 months of the Statements of Financial Position dates. Loans and receivables are initially recognized at the amount expected to be received, less, when material, a discount to reduce the loans and receivables to fair value. Subsequently, loans and receivables are measured at amortized cost using the effective interest method less a provision for impairment, if necessary.

(iii) Leases: The Company has entered into lease agreements with some franchise partners relating to point of sale systems ("POS"). The lease term is for the major part of the economic life of the POS although the Company does not transfer title. The Company recognizes leases as finance type leases and records a lease receivable at an amount equal to the net investment in the lease. The Company's leases receivable are included in current assets due to their short-term nature, except for the portion expected to be realized beyond 12 months of the Statements of Financial Position dates.

Leases receivable are initially recognized at the amount expected to be received, less, when material, a discount to reduce the leases receivable to fair value. Subsequently, leases receivable are measured at amortized cost using the effective interest method less a provision for impairment.

(iv) Financial liabilities at amortized cost: Financial liabilities at amortized cost include trade payables, deposits from franchise partners, gift card liability, bank debt and long-term debt. Trade payables are initially recognized at the amount required to be paid less, when material, a discount to reduce the payables to fair value. Subsequently, trade payables are measured at amortized cost using the effective interest method.

The sale process of a new café requires a deposit from a franchise partner at the outset, including an amount for franchise fees, which is recognized as revenue when the café opens. Deposits from franchise partners are applied against the cost of constructing a new café or the renovation of an existing café. Gift card liability represents liabilities related to unused balances on Second Cup's reloadable payment card ("Second Cup Café Card") net of estimated breakage. These balances are included as sales from franchised cafés, or as revenue of Company operated cafés at the time the customer redeems the amount in a café for products or services. Breakage represents management's estimate of balances outstanding relating to gift cards that may never be redeemed. Bank debt and long-term debt are recognized initially at fair value, net of any transaction costs incurred and, subsequently, at amortized cost using the effective interest method.

Financial liabilities are classified as current liabilities if payment is due within 12 months. Otherwise, they are presented as non-current liabilities.

(v) Derivative financial instruments: The Company uses derivatives in the form of interest rate swaps to manage risks related to its variable rate debt. All derivatives have been classified as FVTPL, are included on the Statements of Financial Position within other liabilities and are classified as current or non-current based on the contractual terms specific to the instrument.

Gains and losses on remeasurement are included in interest income (expense).

(vi) Classification as debt or equity: Debt and equity instruments issued by the Company are classified as either financial liabilities or as equity in accordance with the substance of the contractual arrangements and the definitions of a financial liability and an equity instrument.

(e) 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 objective evidence of an impairment loss include:

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

If such evidence exists, the Company recognizes an impairment loss, as follows:

(i) Financial assets carried at amortized cost: 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 quarterly 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 an impairment charge is recorded in the year.

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. Impairment losses on available-for-sale equity instruments are not reversed.

(f) Inventories

Inventories are stated at the lower of cost and net realizable value, with cost being determined on a first-in, first-out ("FIFO") method. Net realizable value is the estimated selling price less applicable selling expenses. If carrying value exceeds net realizable amount, a writedown is recognized. The writedown may be reversed in a subsequent year if the circumstances that caused it no longer exist.

(g) Property and equipment

Property and equipment are stated at cost less accumulated amortization 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 derecognized when replaced. Repairs and maintenance costs are charged to the Statements of Operations and Comprehensive Income (Loss) during the year in which they are incurred.

Amortization is calculated using the straight-line basis at the following rates, which are based on the expected useful lives of the asset:

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

Property and equipment are reviewed for impairment annually or at any time if an indicator of impairment exists (refer to note 3(j)).

(h) Goodwill

Goodwill represents the excess of the cost of acquisition over the fair values of assets, liabilities and contingent liabilities acquired. Goodwill is carried at cost less accumulated impairment losses.

Goodwill is reviewed for impairment annually or at any time if an indicator of impairment exists (refer to note 3(j)).

(i) Intangible assets

Intangible assets consist of trademarks, franchise rights and software, which are amortized or assessed for impairment (refer to note 3(j)) 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.

Management believes the trademarks related to Second Cup are very well established in the marketplace and will continue to provide benefits indefinitely into the future.

(ii) Franchise rights

As a result of the acquisition of Second Cup in 2009, franchise rights were recognized as an intangible asset. The franchise rights intangible asset is based on the net present value of the discounted future net cash flows expected from the existing franchise partners of Second Cup as at the date of acquisition, including royalties and franchise fees.

(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 at the following rates, which are based on the expected useful lives of the assets:

Franchise rights	average remaining term of the existing franchise agreement
Software	3 to 7 years

(j) Impairment of non-financial assets
Property and equipment and intangible assets are tested for impairment when events or changes in circumstances indicate the carrying value may not be recoverable. Long-lived assets that are not amortized are subject to an annual impairment test or any time an impairment indicator exists.

For the purpose of measuring recoverable amounts, assets are grouped at the lowest levels for which there are separately identifiable cash inflows (cash generating units or "CGUs"). The recoverable amount of each particular CGU is the higher of an asset's fair value less costs to sell and value in use. For the purposes of the impairment test, the Company estimates the fair value less costs to sell of the individual cash generating units.

The impairment analysis involves comparing the carrying value of the CGUs with their estimated recoverable amounts based on fair value less costs to sell values. Management considers a number of factors in estimating the recoverable value of each CGU. These factors are included in the discounted cash flow estimates. Each of these valuation methods use estimates and assumptions that are sensitive to change and require judgement. 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. Costs to sell are estimated based on the most recent transactions in the retail and franchise business.

An impairment loss is recognized for the amount by which the asset's carrying value exceeds its recoverable amount. Impairment losses for CGUs reduce first the carrying value of any goodwill allocated to that CGU. Any remaining impairment loss is charged pro rata to the other intangible assets in the CGU.

The Company evaluates impairment losses, other than goodwill impairment, for potential reversals when events or circumstances warrant such consideration.

(k) Provisions
Provisions are recognized when the Company has 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 management's 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. The Company performs evaluations to identify onerous contracts and, where applicable, records provisions for such contracts.

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

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

(l) Other long-term liabilities

(i) Deferred revenue
The Company has entered into several supply agreement contracts and receives an allowance from the supplier in consideration for achieving certain volume commitments over the term of the supply agreement. Deferred revenue is amortized over the term of the supply agreement based on the proportion of volume commitments met during the fiscal year. In addition, the Company defers construction administration fees received at the commencement of a new franchise term until the café renovation is completed.

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

(m) Deferred financing charges
Deferred financing charges represent costs associated with the Company's term loan, and are offset against the term loan and expensed to the Statements of Operations and Comprehensive Income (Loss) using the effective interest rate method.

(n) Income taxes
Income tax comprises current and deferred income taxes. Income taxes are recognized in the Statements of Operations and Comprehensive Income (Loss) except to the extent that it relates 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 year, using tax rates enacted, or substantively enacted, at the end of the reporting period, and any adjustment to tax payable in respect of previous years.

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.

Deferred income tax assets and liabilities are presented as non-current.

Prior to its Conversion in 2011, the Fund was an unincorporated open-ended trust and was not subject to income taxes to the extent that its taxable income was distributed to unitholders. As a result of new tax legislation substantively enacted on June 12, 2007, the Fund would have paid a tax on distributions declared subsequent to January 1, 2011. As a result of this legislation, the Fund had provided for the future income tax effect of existing temporary differences between the accounting and tax bases of assets and liabilities that were expected to reverse subsequent to January 1, 2011. On January 1, 2011, the Fund completed its conversion to a corporation. Second Cup is now subject to corporate income tax.

(o) Advertising and co-operative fund assets and liabilities
Second Cup 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, national training programs and, among other things, 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-owned and operated cafés and are based on a percentage of café sales. The revenue, expenses and cash flows of the Co-op Fund are not included in the Company's Statements of Operations and Comprehensive Income (Loss) and Cash Flows because the contributions to this fund are segregated and designated for a specific purpose. The assets and liabilities of the Co-op Fund are included in the assets and liabilities of the Company.

(p) Gift card liability
Second Cup has a gift card program that allows customers to prepay for future purchases by reloading a dollar value onto their gift cards through cash or credit/debit card in the cafés or online through credit cards, when and as needed. The purpose of the gift card program is to expand the Second Cup brand through increased exposure as well as to increase sales. Gift card liability represents liabilities related to unused balances on the Second Cup Café Card net of estimated breakage. These balances are included as sales from franchised cafés, or as revenue of Company operated cafés, at the time the customer redeems the amount in a café for products or services. Breakage represents management's estimates of balances outstanding relating to gift cards that may never be redeemed. This breakage factor is estimated based on historical redemption patterns and is reviewed quarterly by management. Breakage income is recognized by the Co-op Fund.

(q) Revenue recognition
Revenue is recognized when it is probable the 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 similar allowances.

Royalty revenue from franchised cafés is recognized as the products are sold as reported by the franchise partner.

Revenue from the sale of goods from Company operated cafés, from the sale of products through wholesale and e-commerce channels are recognized as the products are sold to customers.

Services revenue includes initial franchise fees, renewal fees, transfer fees earned on the sale of cafés from one franchise partner to another, construction administration fees, product licencing revenue, purchasing coordination fees and other ancillary fees (IT support and training fees).

Initial franchise fees are recognized as income when the café commences operations, renewal fees are recognized at the commencement of a new franchise term, café resale fees are recognized when title transfers on the sale of a café between franchise partners and construction administration fees are recognized on the completion of a café renovation and re-opening. All fees are recognized as revenue after the franchise agreement has been signed and the Company has performed substantially all services and met all material conditions required by the franchise agreement.

For Second Cup branded products sold by third parties, product licencing revenue is recognized when goods are shipped from the distributor.

Purchasing coordination fees are derived from purchases made by franchise partners from approved suppliers and are recognized as the services are rendered or goods delivered and all significant conditions have been met.

(r) Cost of goods sold
Cost of goods sold represents the product cost of goods sold in corporate cafés and through retail and wholesale channels plus the cost of direct labour to prepare and deliver the goods to the customers in the cafés.

(s) Operating leases
Operating lease payments are recognized as rent 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, the Company considers option periods for which failure to renew the lease impose an economic penalty on the Company of such an amount that the renewal appears to be reasonably assured at the inception of the lease.

(t) Long-term incentive plan and Directors deferred share unit plan
In December 2009, Second Cup implemented a long-term incentive plan (“LTIP”), as described in note 27. Under IFRS 2, Share-based Payment, the fair value of each tranche of the grants is amortized over their respective vesting period using the graded amortization method. Compensation expense is measured at the grant date at fair value and recognized over the service period based on the vesting period and is adjusted for any changes in fair value of the Company’s share price. Shares granted under the LTIP vest over a three-year period and are paid out in cash on December 15 of each year. In terms of the LTIP, any dividends paid by the Company during the vesting period will be accrued based on the total number of shares granted.

In January 2011, the Company implemented a Directors deferred share unit plan (“DSUP”), as described in note 27. Compensation expense is measured at the grant date (beginning of year) at fair value vesting on the last day of the year in which the shares are granted and is adjusted for any changes in fair value of the Company’s share price. Shares granted under the DSUP vest on the last day of the year in which they are granted and are paid out in cash on the termination of the director. In terms of the DSUP, any dividends paid by the Company during the vesting period will be accrued based on the total number of shares granted.

(u) Earnings per share
Basic earnings per share ("EPS") is calculated by dividing the net income (loss) for the year attributable to equity owners of the Company by the weighted average number of common shares outstanding during the year.

Diluted EPS is calculated by adjusting the weighted average number of common shares outstanding for dilutive instruments. The number of shares included with respect to options, warrants and similar instruments is computed using the treasury stock method.

(v) 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. All transactions with related parties are recorded at fair value.

(w) Dividends
Dividends on common shares are recognized in the Company's financial statements in the period in which the dividends are approved by the Board of Directors.

(x) Future changes in accounting policies
IFRS 9, Financial Instruments ("IFRS 9"), was issued in November 2009 and addresses classification and measurement of financial assets. It replaces the multiple category and measurement models in International Accounting Standard 39, Financial Instruments: Recognition and Measurement ("IAS 39"), for debt instruments with a new mixed measurement model having only two categories: amortized cost and FVTPL. IFRS 9 also replaces the models for measuring equity instruments. Such instruments are either recognized at FVTPL or at fair value through other comprehensive income. Where equity instruments are measured at fair value through other comprehensive income, dividends are recognized in profit or loss to the extent that they do not clearly represent a return of investment; however, other gains and losses (including impairments) associated with such instruments remain in accumulated comprehensive income indefinitely.

Requirements for financial liabilities were added to IFRS 9 in October 2010 and they largely carried forward existing requirements in IAS 39, except that fair value changes due to credit risk for liabilities designated at FVTPL are generally recorded in other comprehensive income.

IFRS 13, Fair Value Measurement ("IFRS 13"), is a comprehensive standard for fair value measurement and disclosure for use across all IFRS. The new standard clarifies that fair value is the price that would be received to sell an asset, or paid to transfer a liability in an orderly transaction between market participants, at the measurement date. Under existing IFRS, guidance on measuring and disclosing fair value is dispersed among the specific standards requiring fair value measurements and does not always reflect a clear measurement basis or consistent disclosures.

IFRS 9 and IFRS 13 are effective for annual periods beginning on or after January 1, 2015 and January 1, 2013, respectively, with earlier adoption permitted. The Company will adopt IFRS 13, effective January 1, 2013, but does not expect it to have a significant impact. The Company has not yet assessed the impact of IFRS 9 or determined whether it will early adopt the standard.

4. CRITICAL ACCOUNTING ESTIMATES

The preparation of financial statements requires management to 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. Estimates and underlying assumptions are reviewed on an ongoing basis. Revisions to accounting estimates are recognized in the year in which the estimates are revised and in any future years affected.

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

Impairment analysis

Impairment analysis is an area involving management judgement requiring assessment as to whether the carrying value of assets is recoverable. Fair value less cost to sell 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. 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:

a) Growth in total revenue
b) Growth in cash flows, calculated as adjusted operating profit before depreciation and amortization,
c) Long term growth rates
d) Selection of discount rates to reflect the risks involved

Management has estimated cash flows based on market participant assumptions and expected future operations.

The discount rate is based upon a weighted average cost of capital derived from the benchmark analysis from similar retail or franchise businesses in Canada and the United States.

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

The Company's impairment test includes the key assumptions related to sensitivity in the cash flow projections. Further details are provided in note 13 to the financial statements.

Recoverable amount and CGUs

A CGU is defined as the smallest identifiable group of assets that generates cash inflows that are largely independent of the cash inflows from other assets or group of assets.

Goodwill is not amortized but tested for impairment at least once a year or more frequently when there is an indication that it may be impaired.

An impairment test is performed at the level of each CGU within each operating segment. This allocation is reviewed if the Company changes the level at which it monitors goodwill or changes in operating segments.

An impairment loss is recognized when the carrying value of the assets and liabilities of the franchise business CGU is higher than its recoverable amount. The recoverable amount of the franchise business CGU was estimated based on fair value less costs to sell. Fair value less costs to sell is the best estimate of the amount obtainable from the sale of a CGU in an arm's length transaction between knowledgeable, willing parties, less costs to sell. This estimate is determined on December 29, 2012.

Deferred income taxes

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

Fair value of derivative

Second Cup's derivative consists of an interest rate swap used to economically hedge exposure to variable cash flows associated with interest payments on the Company's borrowings. Management estimates the fair value of this derivative as the present value of expected future cash flows to be received or paid, based on available market data, which includes market yields and counterparty credit spreads.

Estimated useful lives

Management estimates the useful lives of property and equipment based on the period during which the assets are expected to be available-for-use. The amounts and timing of recorded expenses for amortization of property and equipment for any year are affected by these estimated useful lives. The estimates are reviewed at least annually and are updated if expectations change as a result of physical wear and tear, technical or commercial obsolescence and legal or other limits to use. It is possible that changes in these factors may cause significant changes in the estimated useful lives of the Company's property and equipment in the future.

Provisions

Second Cup has lease commitments since it acts as the head tenant on café leases. In cases where the lease contract specifies a termination fee due to the landlord or a fee is negotiated with the landlord upon termination, the Company records the expense at the time written notice is given or agreed to by the landlord. When ceasing operations under operating leases where the landlord does not allow the Company to prematurely exit the lease, but allows for subleasing, the Company estimates the fair value of sublease income in calculating the provision to the end of the lease term.

5. SHARE CAPITAL

Second Cup is authorized to issue an unlimited number of common shares.

	Income Fund Units		**Share Capital**	
	#	**$**	**#**	**$**
Balance January 1, 2010	9,903,045	89,972	-	-
Balance December 31, 2010	9,903,045	89,972	-	-
Conversion January 1, 2011	(9,903,045)	(89,972)	9,903,045	89,972
Reduction in stated capital January 1, 2011	-	-	-	(88,972)
Balance December 31, 2011	-	-	9,903,045	1,000

At the annual and special meeting of unitholders held June 2, 2010, the unitholders approved the Conversion to be undertaken on January 1, 2011. Included as part of the Conversion was a reduction in the stated capital from $89,972 to $1,000, resulting in a reduction of the deficit by $27,575 and an increase in contributed surplus of $61,397. The Conversion and the associated reduction in share capital were approved by court orders dated June 11, 2010 and December 17, 2010.

6. CASH AND CASH EQUIVALENTS

	2012	**2011**
Cash	$ 2,836	$ 3,040
Cash equivalents	1,044	2,425
Cash and cash equivalents	$ 3,880	$ 5,465
Interest rate per annum	1.10%	1.10%

The cash equivalent represents short-term savings with maturity of less than three months since December 29.

7. TRADE AND OTHER RECEIVABLES

	2012	2011
Trade and other receivables	$ 4,839	$ 5,449
Less: Allowance for doubtful accounts	(223)	(111)
Trade and other receivables - net	$ 4,616	$ 5,338

The Company wrote-off $78 (2011 - $5), recovered $91 (2011 - $192) and increased the allowance for doubtful accounts $281 (2011 - $234) on trade and other receivables.

8. INVENTORIES

	2012	2011
Merchandise held for resale	$ 131	$ 67
Supplies	24	12
	155	79
Less: Provision for obsolete inventory	(18)	-
	$ 137	$ 79

9. NOTES AND LEASES RECEIVABLE

	2012	2011
Notes and leases receivable due in 1 year	$ 341	$ 162
Notes and leases receivable due after 1 year, but before 5 years	797	543
Notes and leases receivable due after 5 years	57	50
	1,195	755
Less: Allowance for doubtful accounts due in 1 year	(76)	(13)
Less: Allowance for doubtful accounts due after 1 year	(113)	(124)
	1,006	618
Less: Current portion	265	149
Notes and leases receivable - net	$ 741	$ 469

The Company entered into lease agreements with some franchise partners relating to POS. These leases bear interest at 8%. These were accounted for as finance leases totalling $209 (2011 - $74). The Company owns title to all POS. During 2012, the Company received proceeds from the repayment of leases receivable of $36 (2011 - $6).

In 2012 the Company did not provide financing to any franchise partners to assist them to purchase certain equipment, furniture and fixtures (2011 - $50). The Company received proceeds from the repayment of notes receivable of $185 (2011 - $91) related to previous agreements. The Company settled $741 (2011 - $437) of trade receivables in return for notes receivable during the year. The Company received repayments totalling $225 (2011 - $22) from capitalized trade receivables. In addition, the Company wrote-off $114 (2011 - $nil), recovered $24 (2011 - $nil) and increased the allowance for doubtful accounts $190 (2011 - $137) on notes and leases receivable.

10. PROPERTY AND EQUIPMENT

	Leasehold improvements	Equipment, furniture, fixtures and other	Computer hardware	Total
Net carrying value				
As at December 31, 2010				
Cost	$ 589	$ 1,257	$ 168	$ 2,014
Accumulated amortization	(247)	(171)	(105)	(523)
As at December 31, 2010	342	1,086	63	1,491
Additions	664	1,959	108	2,731
Disposals - original cost	(25)	(107)	-	(132)
Disposals - accumulated amortization	1	24	-	25
Capitalized to lease	-	(67)	-	(67)
Impairment charge	(81)	(49)	-	(130)
Amortization	(104)	(282)	(54)	(440)
As at December 31, 2011	$ 797	$ 2,564	$ 117	$ 3,478
Cost	$ 1,228	$ 3,042	$ 276	$ 4,546
Accumulated amortization	(431)	(478)	(159)	(1,068)
As at December 31, 2011	$ 797	$ 2,564	$ 117	$ 3,478
Net carrying value				
As at December 31, 2011				
Cost	$ 1,228	$ 3,042	$ 276	$ 4,546
Accumulated amortization	(431)	(478)	(159)	(1,068)
As at December 31, 2011	797	2,564	117	3,478
Additions	851	857	50	1,758
Disposals - original cost	(177)	(297)	-	(474)
Disposals - accumulated amortization	20	34	-	54
Capitalized to lease	-	(194)	-	(194)
Impairment charge	(345)	(17)	-	(362)
Amortization	(200)	(446)	(70)	(716)
As at December 29, 2012	$ 946	$ 2,501	$ 97	$ 3,544
Cost	$ 1,902	$ 3,408	$ 326	$ 5,636
Accumulated amortization	(956)	(907)	(229)	(2,092)
As at December 29, 2012	$ 946	$ 2,501	$ 97	$ 3,544

11. GOODWILL

	2012	2011
Opening balance	$ 2,444	$ 2,444
Impairment charge	(2,444)	-
Closing balance	$ -	$ 2,444

The Company determined goodwill was impaired and recognized an impairment charge of $2,444. There were no additions or disposals during the reporting periods (note 13).

12. INTANGIBLE ASSETS

	Trademarks	Franchise rights	Software	Total
Net carrying value				
As at December 31, 2010				
Cost	$ 86,905	$ 1,331	$ 312	$ 88,548
Accumulated amortization	-	(424)	(99)	(523)
As at December 31, 2010	86,905	907	213	88,025
Additions (acquired)	-	-	312	312
Disposals - original cost	-	-	(43)	(43)
Disposals - accumulated amortization	-	-	43	43
Capitalized to lease	-	-	(7)	(7)
Amortization	-	(283)	(109)	(392)
As at December 31, 2011	$ 86,905	$ 624	$ 409	$ 87,938
Cost	$ 86,905	$ 1,331	$ 574	$ 88,810
Accumulated amortization	-	(707)	(165)	(872)
As at December 31, 2011	$ 86,905	$ 624	$ 409	$ 87,938
Net carrying value				
As at December 31, 2011				
Cost	$ 86,905	$ 1,331	$ 574	$ 88,810
Accumulated amortization	-	(707)	(165)	(872)
As at December 31, 2011	86,905	624	409	87,938
Additions (acquired)	-	-	180	180
Capitalized to lease	-	-	(15)	(15)
Impairment charge	(12,850)	-	-	(12,850)
Amortization	-	(283)	(168)	(451)
As at December 29, 2012	$ 74,055	$ 341	$ 406	$ 74,802
Cost	$ 74,055	$ 1,331	$ 739	$ 76,125
Accumulated amortization	-	(990)	(333)	(1,323)
As at December 29, 2012	$ 74,055	$ 341	$ 406	$ 74,802

Management concluded trademarks were impaired and recognized an impairment charge of $12,850 (note 13).

13. IMPAIRMENT OF ASSETS

During the accounting periods presented, the Company had two CGUs - corporate cafés and franchise business.

Goodwill of $2,444 as well as the Trademark of $86,905 were allocated fully to the franchise business CGU. The CGUs recoverable amount has been determined using fair value less costs to sell.

Key assumptions

The discounted cash flow uses estimates and assumptions that are sensitive to change and require judgement. 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 recessionary 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.

These calculations use cash flow projections based on financial forecasts covering a five-year period. Cash flows beyond the five-year period are extrapolated using the estimated growth rates stated below. The following are key assumptions used in the fair value less costs to sell calculation:

Forecast same café sales growth	-2% to 4%
Forecast revenue growth	-2% to 8%
Average growth rate used to extrapolate cash flows beyond the budget period	2%
Discount rate	11.5%

The valuation of two corporate cafés based on revenue growth and future cash flows indicated an impairment of $362. The Company wrote down leasehold improvements and property and equipment to their estimated recoverable amounts for both cafés.

The valuation of the franchise business CGU based on the forecasted cash flows and using an 11.5% discount rate indicates impairment. The Company recognized an impairment charge of $2,444 to goodwill and $12,850 to trademarks.

The effect of a change in management's key assumptions is reflected below:

Sensitivity		
Key assumption	Low growth	High growth
Revenue growth	-2% to 2%	1% to 8%
Discount rate	11.0%	13.0%
Effect on fair value less cost to sell of CGU	($1,796)	$5,749
Impact on impairment loss	Additional impairment loss of $1,796	No impairment

14. ACCOUNTS PAYABLE AND ACCRUED LIABILITIES

Accounts payable and accrued liabilities consist of:

	2012	2011
Accounts payable - trade	$ 1,280	$ 1,157
Accrued salaries, wages and benefits	577	1,126
Sales tax payable	235	134
Accrued liabilities	1,221	1,676
	$ 3,313	$ 4,093

15. PROVISIONS

	Headlease Liabilities	Legal	Total
As at December 31, 2010	$ 955	$ 50	$ 1,005
Provisions charged during the year	132	9	141
Provisions utilized during the year	(299)	(59)	(358)
As at December 31, 2011	788	-	788
Less: Current portion	447	-	447
Provisions	$ 341	$ -	$ 341
As at December 31, 2011	$ 788	$ -	$ 788
Provisions charged during the year	689	-	689
Provisions utilized during the year	(429)	-	(429)
As at December 29, 2012	1,048	-	1,048
Less: Current portion	365	-	365
Provisions	$ 683	$ -	$ 683

16. INCOME TAXES

Income tax expense is recognized based on management's best estimate of the weighted average annual income tax rate expected for the full financial year. The Ontario 2012 budget was substantively enacted on June 20, 2012, freezing corporate tax cuts with the effect that the income tax rate would remain at 11.5% until the province can achieve a balanced budget. Previously, the corporate income tax rate was slated to decrease to 10.0% by 2014. The impact of the income tax rate change is estimated to result in an increase in income tax of $480 and has been recognized in the Statements of Operations and Comprehensive Income (Loss).

Under Canadian generally accepted accounting principles, income trusts were not subject to income taxes to the extent that their taxable income was distributed to unitholders. Under IAS 12 the rate to apply in 2010 was the highest marginal tax rate, which was estimated to be 46.41%. After the Conversion the tax rate is estimated to be 28.16%. The benefit of the rate reduction in 2011 due to the Conversion was $7,462. As a result of the Conversion, Second Cup recognized certain deferred income tax assets and liabilities that were not previously recognized, resulting in a net charge of $519 in 2011.

Income tax expense (recovery), as reported differs 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:

	2012	2011
(Loss) income before income taxes	$ (8,753)	$ 8,887
Combined Canadian federal and provincial tax rates	26.50%	28.16%
Tax (recovery) provision at statutory rate	(2,320)	2,503
Increased (reduced) by following differences		
Change in income tax rates	480	(7,462)
Deferred income tax assets and liabilities not previously recognized	-	519
Non-deductible permanent differences - impairment of goodwill and trademarks	2,350	-
Non-deductible permanent differences - other	13	9
Other	128	17
Income tax expense (recovery)	$ 651	$ (4,414)

17. DEFERRED INCOME TAX

The analysis of deferred income tax assets and liabilities is as follows:

	2012	2011
Deferred income tax assets		
Deferred tax asset to be recovered after more than 12 months	$ (133)	$ (234)
Deferred income tax asset to be recovered within 12 months	(361)	(237)
	(494)	(471)
Deferred income tax liabilities		
Deferred income tax liability to be recovered after more than 12 months	9,684	10,654
Deferred income tax liabilities - net	$ 9,190	$ 10,183
Beginning of year	$ 10,183	$ 16,124
Income tax expense due to change in Ontario tax rates	480	-
Income tax (recovery)	(1,473)	(5,941)
End of year	$ 9,190	$ 10,183

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

	Property and equipment	Trademarks	Intangible assets	Other	Total
As at December 31, 2010	$ (3,165)	$ 19,419	$ -	$ (130)	$ 16,124
Charged (credited) to the income statement	4,312	(10,070)	158	(341)	(5,941)
As at December 31, 2011	1,147	9,349	158	(471)	10,183
Charged (credited) to the income statement	391	(1,294)	(68)	(22)	(993)
As at December 29, 2012	$ 1,538	$ 8,055	$ 90	$ (493)	$ 9,190

18. TERM LOAN AND OPERATING FACILITY

On June 12, 2012, the Company renegotiated its term loan and operating credit facilities, including an extension of the maturity of the credit facilities, to May 31, 2015 and a decrease in interest rates. The revised credit facilities comprise an $11,000 non-revolving term credit facility, fully drawn, and an undrawn $2,000 revolving credit facility. As a result of the refinancing, the Company capitalized loan extension fees of $50. The term credit facilities are collateralized by substantially all the assets of the Company.

The $11,000 non-revolving term credit facility bears interest at the bankers' acceptance rate plus 2.75% (December 31, 2011 - 3.50%). As at December 29, 2012, the full amount of the $11,000 non-revolving term credit facility was drawn.

The $2,000 operating credit facility bears interest at the bankers' acceptance rate plus 2.75% (December 31, 2011 - 3.50%). As at December 29, 2012, no advances had been drawn on this facility.

The Company has an interest rate swap agreement with a notional value of $11,000 maturing on April 1, 2013, which fixes the interest rate on the Company's non-revolving credit facility at 3.04% per annum plus the margin noted above, which results in a fixed effective interest rate of 5.79% (December 31, 2011 - 6.54%). As at December 29, 2012, the estimated fair value of this contract is a $96 liability to the Company (December 31, 2011 - $302) which is recorded as a liability on the Company's Statements of Financial Position and the fair value movement of the interest rate swap has been recorded as a non-cash credit to income on the Company's Statements of Operations and Comprehensive Income (Loss).

Pursuant to the terms of the Company's operating loan and term loan, the Company is subject to certain financial and other customary covenants, including requirements to maintain a ratio of senior debt to EBITDA and to maintain a trailing four-quarter fixed charge coverage ratio. During the years ended December 29, 2012 and December 31, 2011, the Company was in compliance with all financial and other covenants of the Company's operating loan and term loan.

In accordance with IFRS 7, Financial Instruments: Disclosures ("IFRS 7"), the term loan is presented net of transaction costs. Transaction costs are amortized to the Statements of Operations and Comprehensive Income (Loss) using the effective interest method.

	2012	2011
Face value of long-term debt	$ 11,000	$ 11,000
Unamortized transaction costs	(59)	(91)
	$ 10,941	$ 10,909

At maturity on May 31, 2015, the Statements of Financial Position value of the term loan will be equal to the face value.

Interest expense consists of the following:

	2012	2011
Interest on term loan	$ 480	$ 525
Interest on derivative interest rate swap	192	192
Movement in fair value of derivative interest rate swap	(206)	(29)
Amortization of deferred financing charges	82	72
Other interest expense	16	22
	$ 564	$ 782

19. OTHER LONG-TERM LIABILITIES

	2012	2011
Deferred revenue (i)	$ 181	$ 135
Promissory note payable	-	18
Leasehold inducement (note 3(l))	429	403
Other	-	2
	$ 610	$ 558
Less: Current portion	189	166
	$ 421	$ 392

(i) Deferred revenue on purchasing co-ordination fees and new term fees will be earned as follows: 2013 - $150, 2014 - $11, 2016 - $20.

20. CONTINGENCIES, COMMITMENTS AND GUARANTEES

Second Cup has lease commitments for Company-operated cafés and also acts as the head tenant on leases, which it in turn subleases to franchise partners. To the extent that the Company may be required to make rent payments due to headlease commitments, a provision has been recognized (note 15). The Company's lease commitments at December 29, 2012 are as follows:

	Headlease commitments	Sublease to franchisees	Net
December 31, 2013	$ 19,246	$ 17,867	$ 1,379
December 31, 2014	18,346	17,121	1,225
December 31, 2015	16,710	15,474	1,236
December 31, 2016	14,676	13,430	1,246
December 31, 2017	12,667	11,501	1,166
Thereafter	35,706	31,647	4,059
	$ 117,351	$ 107,040	$ 10,311

Total occupancy and lease costs expensed in the year are as follows:

	2012	2011
Company head office and franchise café locations	$ 1,614	$ 882
Company operated cafés	885	504
	$ 2,499	$ 1,386

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

Second Cup has a contract with a third party company to purchase and roast the coffee that is sold in all Second Cup cafés by franchise partners. In terms of this supply agreement, Second Cup has guaranteed a minimum volume of coffee purchases of $4,421 (2011 - $9,462). The coffee purchase commitment represents purchase commitments made up to the end of December 2013.

Second Cup has entered into a marketing agreement with a third party through 2014 and has committed to spend $200 per year on advertising placed in various media offered by the third party over the term of the agreement.

21. BASIC AND DILUTED EARNINGS (LOSS) PER SHARE

Earnings (loss) per share are based on the weighted average number of shares outstanding during the year. Basic and diluted earnings (loss) per share are determined as follows:

	2012	2011
Net (loss) income	$ (9,404)	$ 13,301
Weighted average number of shares issued and outstanding	9,903,045	9,903,045
Basic and diluted (loss) earnings per share	$ (0.95)	$ 1.34

22. OPERATING EXPENSES

Expenses by nature

	2012	2011
Head office		
Salaries, wages and benefits	$ 6,540	$ 7,311
Occupancy and lease costs	1,614	882
Travel and franchise partner meetings	1,010	888
Head office overheads	992	833
Professional fees	632	476
Legal costs	518	394
Amortization of property and equipment	506	289
Research and innovation	476	-
Amortization of intangible assets	451	392
Bad debt expense	422	257
Advertising and franchise development	304	263
Inventory markdowns	287	23
	13,752	12,008
Company cafés		
Lease costs	885	504
Impairment of property and equipment	362	130
Other operating expenses	350	253
Amortization of property and equipment	210	151
Advertising and local marketing	150	94
Loss on disposal of property and equipment	70	36
	2,027	1,168
Operating expenses	$ 15,779	$ 13,176

Salaries, wages and employee benefits

	2012	2011
Salaries and wages	$ 5,868	$ 6,245
Employee benefits	705	651
Directors’ compensation	373	291
Severance costs	139	687
LTIP	130	93
Recovery from Co-op Fund	(675)	(656)
Total head office	$ 6,540	$ 7,311

23. COMPENSATION OF KEY MANAGEMENT

Key management is defined as the senior management team and the Board of Directors.

	2012	2011
Salaries and short-term employee benefits	$ 2,106	$ 2,083
Severance costs	-	687
Stock-based compensation - LTIP (note 27)	130	93
Stock-based compensation - DSUP (note 27)	40	89
Pension costs - defined contribution plans	33	29
Total compensation	$ 2,309	$ 2,981

24. SUPPLEMENTARY CASH FLOW INFORMATION

Changes in non-cash working capital are as follows:

	2012	2011
Trade and other receivables	$ 722	$ 505
Notes and leases receivable	(400)	(278)
Inventories	(58)	(30)
Prepaid expenses and other assets	(501)	167
Accounts payable and accrued liabilities	(780)	(2,350)
Provisions	349	(105)
Other long-term liabilities	46	(75)
Gift card liability	207	186
Deposits from franchise partners	447	9
	$ 32	$ (1,971)

	2012	2011
Supplementary information		
Interest paid	$ 689	$ 739
Income taxes paid (recovered)	$ 2,835	$ (57)

25. MANAGEMENT OF CAPITAL

The capital structure of the Company consists of $10,941 (2011 - $10,909) in long-term debt and $56,700 (2011 - $71,402) in shareholders' equity, which comprises issued shares and accumulated earnings, less accumulated cash dividends.

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

a) safeguard its ability to continue as a going concern;
b) maintain financial flexibility in order to preserve its ability to meet financial obligations;
c) maintain a capital structure that provides financing options to the Company when the need arises to access capital;
d) ensure it has sufficient cash and cash equivalents to pay declared dividends to its shareholders; and
e) deploy capital to provide an adequate return to its shareholders.

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

The Company determines the appropriate level of long-term debt in the context of its cash flows and overall business risks. The Company has historically generated sufficient cash flows to pay quarterly dividends to its shareholders. In order to maintain or modify the capital structure, Second Cup may adjust the amount of dividends paid to its shareholders. The current level of capital is considered adequate in the context of current operations.

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

There were no changes in the Company's approach to capital management during the year.

26. FINANCIAL INSTRUMENTS AND FINANCIAL RISK MANAGEMENT

Financial Instruments
The Company's financial instruments consist of cash and cash equivalents, trade and other receivables, notes receivable, accounts payable and accrued liabilities, gift card liability, other long-term liabilities, dividends payable to shareholders, term loan, the derivative interest rate swap and deposits from franchise partners.

Categories of financial instruments
The Company has designated each of its significant categories of financial instruments outstanding as follows:

	2012	2011
Financial assets		
Cash and cash equivalents	$ 3,880	$ 5,465
Loans and receivables		
Trade and other receivables	4,616	5,338
Leases receivable	245	71
Notes receivable	761	547
Financial liabilities		
FVTPL		
Derivative interest rate swap	96	302
Other financial liabilities		
Accounts payable and accrued liabilities	3,313	4,093
Gift card liability	4,560	4,353
Promissory note payable and other long-term liabilities	-	20
Term loan	10,941	10,909

Financial liabilities designated as at FVTPL

	2012	2011
Opening fair value	$ 302	$ 331
Additions during the year	-	-
Realized during the year	-	-
Change in value	(206)	(29)
Closing fair value	$ 96	$ 302

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 receivable approximates their carrying value as the interest charged is considered to be based on market rates.

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.

IFRS 7 requires financial instruments that are measured subsequent to initial recognition at fair value to be grouped 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 derivative interest rate swap, classified as a Level 2, was derived using a discounted cash flow model that considers various observable inputs including time to maturity, forward interest rates and credit spreads.

As at December 31, 2011	**Level 1**	**Level 2**	**Level 3**
Derivative interest rate swap	-	(302)	-
	$ -	$ (302)	$ -

As at December 29, 2012	**Level 1**	**Level 2**	**Level 3**
Derivative interest rate swap	-	(96)	-
	$ -	$ (96)	$ -

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

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

Credit Risk

The Company's financial instruments exposed to credit risk include cash and cash equivalents, trade and other receivables, leases receivable and notes receivable. The Company places its cash with institutions of high creditworthiness. The Company's trade and other receivables, leases receivable and notes receivable primarily comprise amounts due from franchise partners. Based on experience, management believes its trade and other receivables, leases receivable and notes receivable credit risk exposure is limited. Credit risk from trade and other receivables, leases receivable and notes receivable is minimized as a result of the review and evaluation of franchise partner account balances beyond a particular age, and management accounts for a specific bad debt provision when the expected recovery is less than the actual accounts receivable. The provision relating to past due trade and other receivables as at December 29, 2012 was $223 (December 31, 2011 - $111). The provision relating to past due leases receivable and notes receivable as at December 29, 2012 was $189 (December 31, 2011 - $137).

The maturities of the Company's trade and other receivables as at December 29, 2012 are as follows:

	Maturing in the next 90 days	**Maturing between 90 days and less than a year**	**Maturing between 1 year and less than 2 years**	**Maturing after 2 years**	**Total**
Total	$4,613	$3	$-	$-	$4,616

The creditworthiness of new franchise partners is reviewed during the application process. A new franchise partner requires a minimum 30% of their investment in unencumbered cash, written confirmation of financing for the remaining 70% from their bank and a deposit of $100 to accompany the signed franchise agreement.

The maturities of the Company's notes and leases receivable as at December 29, 2012 are as follows:

	Maturing in the next 90 days	Maturing between 90 days and less than a year	Maturing between 1 year and less than 2 years	Maturing after 2 years	Total
Total	$70	$195	$229	$512	$1,006

Liquidity Risk

Liquidity risk is the risk the Company will encounter difficulty in meeting obligations as they come due associated with its financial liabilities. The Company manages liquidity risk through regular monitoring of dividends, forecast and actual cash flows, and also the management of its capital structure and senior leverage ratios as outlined in note 18. The Company's main source of income is royalty receipts from its franchise partners.

The contractual maturities of the Company's financial liabilities as at December 29, 2012 are as follows:

	Maturing in the next 90 days	Maturing between 90 days and less than a year	Maturing between 1 year and less than 2 years	Maturing after 2 years	Total
Accounts payable and accrued liabilities	$ 2,873	$ 367	$ 73	$ -	$ 3,313
Gift card liability	4,560	-	-	-	4,560
Derivative interest rate swap	84	-	-	-	84
Term loan	76	334	445	11,188	12,043
Total	$ 7,593	$ 701	$ 518	$ 11,188	$ 20,000

Interest Rate Risk

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

The Company is exposed to interest rate risk on its cash and cash equivalents and term loan, which earn and bear interest at floating rates. The Company entered into an interest rate swap agreement to minimize risk.

Interest expense on the long-term debt is adjusted to include the payments made or received under the interest rate swap agreement. The interest rate swap agreement is recognized in the Statements of Financial Position at its estimated fair value. During the year ended December 29, 2012, the Company recorded a net interest recovery of $206 on the Statements of Operations and Comprehensive Income (Loss) relating to the interest rate swap (2011 - recovery of $29).

Sensitivity Analysis

IFRS 7 requires disclosure of a sensitivity analysis to illustrate the sensitivity of the Company's financial position and performance to changes in market variables such as interest rates as a result of changes in the fair value of cash flows associated with the Company's financial instruments. The sensitivity analysis provided discloses the effect on net loss as at December 29, 2012, assuming that a reasonably possible change in the relevant risk variable has occurred as at December 29, 2012.

The following table shows the Company's exposure to interest rate risk and the pre-tax effects on net loss for the year ended December 29, 2012 of a 1% change in interest rates management believes is reasonably possible:

	Pre-tax effects on net income – increase (decrease)		
	Carrying amount of liability	1% decrease in interest rates	1% increase in interest rates
Term loan	$ 11,000	$ (110)	$ 110
Interest rate swap agreement	96	110	(110)
		$ -	$ -

27.LONG-TERM INCENTIVE PLAN AND DIRECTORS DEFERRED SHARE UNIT PLAN

Shares granted under the LTIP vest over a three-year period and are paid out in cash on December 15 of each year. Shares are granted based on the weighted average price of the Company's shares for the 20 trading days prior to the grant date. The fair value of the shares outstanding is determined based on the market value of the underlying shares of the Company.

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

	Notional Shares	Fair value
Notional shares outstanding as at December 31, 2010	77,083	$ 445
Shares forfeited	(14,680)	(90)
Shares paid out	(6,263)	(50)
Shares granted in lieu of dividends	3,872	25
Shares granted on December 23, 2011	28,751	180
Change in fair value		(92)
Notional shares outstanding as at December 31, 2011	88,763	$ 418
Expensed in current year		$ 93

	Notional Shares	Fair value
Notional shares outstanding as at December 31, 2011	88,763	$ 418
Shares forfeited	(3,723)	(19)
Shares paid out	(32,682)	(175)
Shares granted in lieu of dividends	6,205	41
Change in fair value		(9)
Notional shares outstanding as at December 29, 2012	58,563	$ 256
Expensed in current year		$ 130

Shares granted under the DSUP vest on the last day of the year in which they are granted and are paid out in cash on the termination of the director. Shares are granted based on the weighted average price of the Company's shares for the five trading days prior to the grant date. The fair value of the shares outstanding is determined based on the market value of the underlying shares of the Company.

A summary of the status of the Company's DSUP is presented below:

	Notional Shares	Fair value
Notional shares outstanding as at December 31, 2010	-	$ -
Deferred share units granted	19,727	155
Shares granted in lieu of dividends	1,221	8
Shares forfeited	(4,367)	(34)
Shares paid out	(2,183)	(17)
Change in fair value		(23)
Notional shares outstanding as at December 31, 2011	14,398	$ 89
Expensed in current year		$ 89

	Notional Shares	Fair value
Notional shares outstanding as at December 31, 2011	14,398	$ 89
Deferred share units granted	9,018	55
Shares granted in lieu of dividends	1,760	12
Change in fair value		(27)
Notional shares outstanding as at December 29, 2012	25,176	$ 129
Expensed in current year		$ 40

28. SEGMENTED REPORTING

The Company's business is classified as one operating segment that is reported in a manner consistent with the internal reporting provided to the chief operating decision maker. The Company is structured as a franchisor with all of its operating revenues derived in Canada. Operating revenues comprise the sale of goods from Company-operated cafés and the sale of goods through ancillary channels, royalties and other service fees. Management is organized based on the Company's operations as a whole rather than the specific revenue streams.

29. SUBSEQUENT EVENT

On February 28, 2013, the Board of Directors of Second Cup approved a quarterly dividend of $0.085 per common share, payable on March 28, 2013 to shareholders of record at the close of business on March 15, 2013.

The Second Cup Ltd.

SHAREHOLDER INFORMATION

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Market Information
Shares Listed:
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THE SECOND CUP LTD.
Board of Directors

Michael Rosicki (1) (2)
Chairman

James Anas (1)
Bryna Goldberg (2)
Bryan Held (1)
Stephen Kelley
Peter Saunders (1) (2)

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

THE SECOND CUP LTD.
Senior Management Team

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President and
Chief Executive Officer

Robert Masson
Chief Financial Officer

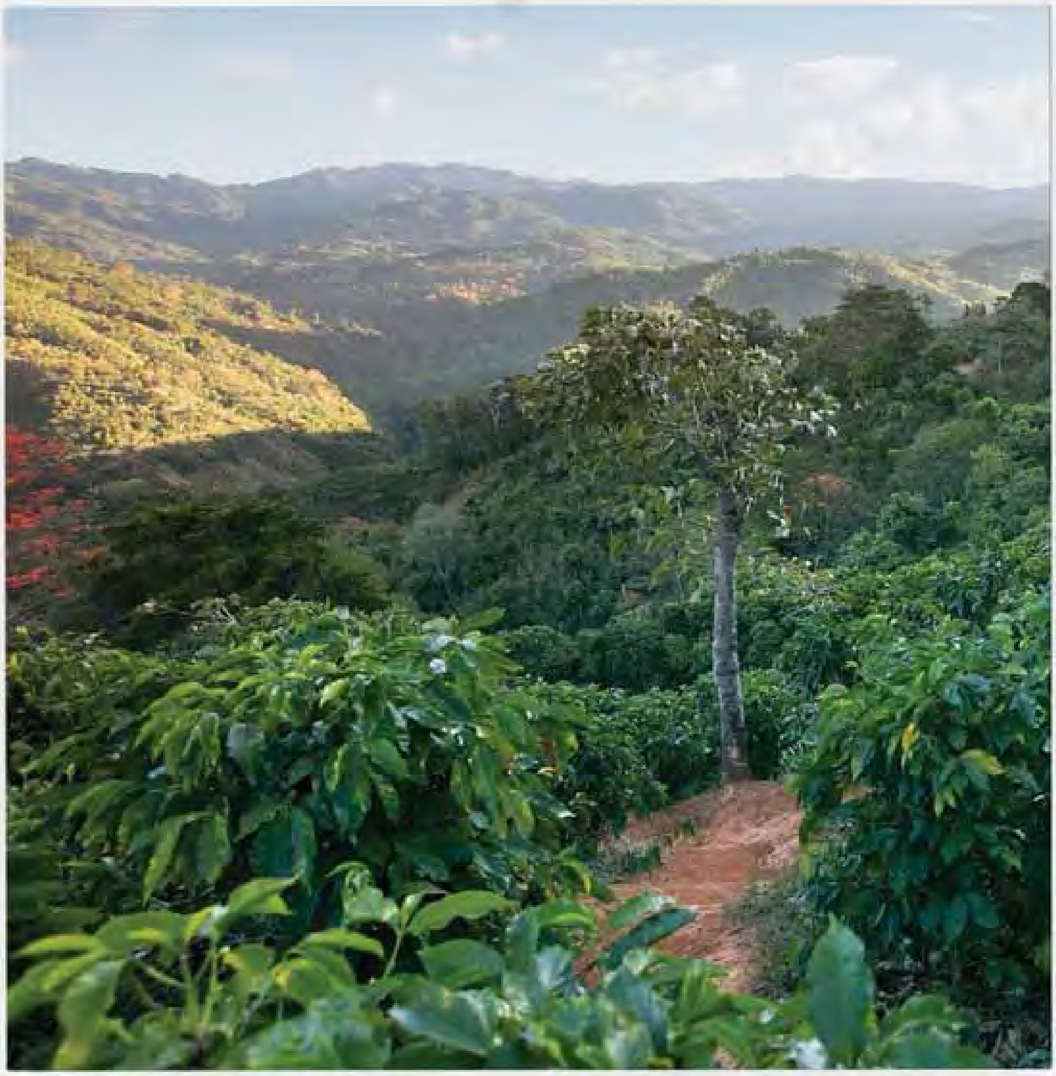
Wayne Vanderhorst
Vice President,
Franchise Development

Cathy Whelan Molloy
Chief Marketing Officer

Dan Caldarone
General Counsel,
VP Human Resources
and Corporate Secretary

Rita Toporowski
Vice President,
Corporate Planning and Development

Tom Zacharias
Vice President, Operations



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