

# Pizza Pizza Royalty Income Fund

## Notes to Interim Consolidated Financial Statements

For the nine months ended September 30, 2006

(Expressed In Thousands of Dollars Except Per Unit Amounts)

(Unaudited)

### 1. Basis of Presentation

Pizza Pizza Royalty Income Fund (the "Fund") prepares its interim consolidated financial statements in accordance with Canadian generally accepted accounting principles on a basis consistent with those used and described in the annual consolidated financial statements for the period from the commencement of operations July 6, 2005 to December 31, 2005. The disclosures contained in these interim consolidated financial statements do not include all requirements of Canadian generally accepted accounting principles for annual financial statements.

These interim consolidated financial statements should be read in conjunction with the annual consolidated financial statements for the period from the commencement of operations July 6, 2005 to December 31, 2005.

### 2. Royalty Pool Annual Adjustment and Change to the Seasoning Period for New Restaurants Added to the Royalty Pool

On January 1, each year (the "Adjustment Date"), Pizza Pizza restaurants in the Royalty Pool, on which Pizza Pizza pays a Royalty to the Fund, are adjusted to include the forecasted system sales from new Pizza Pizza restaurants opened on or before December 31 of the prior year, less system sales from any Pizza Pizza restaurants that have been permanently closed during the year. The change in the amount of the Royalty to be received by the Pizza Pizza Royalty Limited Partnership (the "Partnership") as a result of changes in the system sales of the Royalty Pool will affect the extent of Pizza Pizza's retained interest through the adjustment to the exchange rate at which the Class B Partnership units may ultimately be exchanged for Units of the Fund, referred to as the "Class B Exchange Multiplier" as defined in the Licence and Royalty Agreement. On the Adjustment Date, the adjustment to the Class B Exchange Multiplier involves first calculating the "Determined Amount", which is defined as 92.5% of the royalty revenue added to the Royalty Pool, divided by the yield of the Fund units. The Determined Amount is multiplied by 80%, then divided by the current market price of the units, and then further divided by the Class B Partnership units outstanding. This fraction is added to the Class B Exchange Multiplier from the preceding year, which was "one" on the closing of the initial public offering. On the following Adjustment Date, a second adjustment to the Class B Exchange Multiplier will be made in the same manner as the first adjustment once the forecasted system sales for new restaurants are known with certainty.

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### 2. Royalty Pool Annual Adjustment and Change to the Seasoning Period for New Restaurants Added to the Royalty Pool, cont'd

On August 26, 2006 the Board of Trustees unanimously approved amendments to the License and Royalty Agreement with Pizza Pizza and amendments to related provisions of the Partnership Agreement of the Partnership to remove the requirement that a restaurant be open for at least 120 consecutive days before inclusion in the Royalty Pool for the subsequent year. This change involves only a change in the timing of the inclusion of restaurants in the Royalty Pool and not the substance of the relationship between Pizza Pizza and the Fund. Previously, restaurants opened after September 1<sup>st</sup> of a given year would not be included in the Royalty Pool until January 1 of the second following year.

Pizza Pizza requested elimination of the 120-day seasoning period in order that the restaurant opening period would coincide with the fiscal year of the Fund. This change will benefit management's reporting of restaurant openings and closures in relation to the number of restaurants in the Royalty Pool.

This change will affect the determination of the Royalty Pool as at January 1, 2007 and subsequent years and the corresponding entitlements of Pizza Pizza to indirectly acquire additional Fund units. For January 1, 2007, new restaurants opened between September 1, 2005 and December 31, 2006 will be added to the Royalty Pool. For each January 1 thereafter, restaurants opened between January 1 and December 31 of the prior year will be included in the calculation.

### 3. Operations

On January 1, 2006, one net new restaurant was added to the Royalty Pool as a result of five new restaurants opening from March 14, 2005 to September 1, 2005 and four closing from March 14, 2005 to December 31, 2005. The additional system sales from the new restaurant are estimated at \$1.4 million annually. The total number of restaurants in the Royalty Pool has increased to 501. Based on the formula described in Note 2, the new Class B Exchange Multiplier is 1.01674. In the calculation, the yield of the Fund units was determined to be 8.06% using \$9.97 as the weighted average unit price calculated based on the market price of the units traded on the TSX during the 20 consecutive trading days ended on the fifth trading day before January 1, 2006. This adjustment will also increase the entitlement of the holders of the Class B Units to distributions of cash and allocations of income from the Partnership. As a result of the adjusted Class B Exchange Multiplier, Pizza Pizza holds Class B Partnership units exchangeable into 4,563,120 Fund units which equates to 20.3% of the fully diluted units of the Fund. The Fund reported an effective disposition of 0.3% of its interest in the Partnership, reducing its interest from 80% to 79.7%

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### 3. Operations, cont'd

This transaction can be summarized as follows:

Current assets	\$	6
Intangible assets		692
		698
Current liabilities		3
Long-term liabilities		60
		63
Excess of fair value of acquired net assets		635
Loss on effective disposition of Partnership interest		(635)
Purchase price	\$	-

Pizza Pizza has agreed to maintain at least a 20% ownership in the Fund until June 30, 2007, with distributions on the 20% interest to be subordinated pursuant to the terms of a subordination agreement.

### 4. Investment in Pizza Pizza Royalty Limited Partnership

	September 30, 2006	December 31, 2005
Balance - beginning of period	\$ 139,140	\$ -
Acquisition of Partnership units	-	147,795
Effective disposition on change in the royalty pool (note 2)	(635)	-
Loss in the initial public offering Partnership Structuring costs	-	(9,479)
Equity income of the Partnership	10,298	6,985
Distributions declared from the Partnership	(9,935)	(6,161)
Balance - end of period	\$ 138,868	\$ 139,140

The business of the Partnership is the ownership and licensing of the "Pizza Pizza Rights" and through a "Licence and Royalty Agreement" with Pizza Pizza Limited, to exploit the use of the "Pizza Pizza Rights" by Pizza Pizza Limited. Additionally, the Partnership will collect the Royalty payable under the "Licence and Royalty Agreement" as well as perform the administration of the Fund pursuant to the "Administration Agreement".

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### 5. Income per Unit

Basic net income per unit is calculated by dividing net earnings by the weighted average number of units outstanding during the period. Diluted net income per unit includes Pizza Pizza Class B exchangeable partnership units using the "if converted" method. Under the "if converted" method, earnings are adjusted for earnings allocated to the Class B exchangeable partnership units interest and the weighted average number of units is adjusted for the conversion of the Pizza Pizza Class B exchangeable partnership units. For the purposes of the calculation, units are determined to be outstanding from the date they are issued.

The following table reconciles the basic net earnings to the diluted net earnings:

	Three Months Ended September 30, 2006	Period from July 6 2005 to September 30, 2005	Nine Months Ended September 30, 2006
Basic net income	\$ 4,121	\$ 3,785	\$ 11,013
Equity adjustment allocated to Class B Exchangeable Partnership units	935	839	2,623
Adjusted net income	\$ 5,056	\$ 4,624	\$ 13,636

The following table reconciles the basic weighted average number of units outstanding to the diluted weighted average of units outstanding:

Weighted average number of:			
Units	17,952,000	17,952,000	17,952,000
Pizza Pizza Class B partnership units	4,563,120	4,488,000	4,563,120
Weighted average number of units outstanding - diluted	22,515,120	22,440,000	22,515,120
Diluted income per Fund unit	\$ 0.23	\$ 0.21	\$ 0.61

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### 6. Related party transactions

The Fund has an administration agreement with the Partnership, whereby the Partnership provides or arranges for the provision of services required in the administration of the Fund. Pizza Pizza, as general partner of the Partnership, and pursuant to the Partnership Agreement, is providing certain of these services. The fee for these services, which on an annual basis shall not exceed \$25, has been waived for the period.

Pizza Pizza is a related party by virtue of its holding of Class B Partnership units which are exchangeable into units of the Fund.

Other transactions with Pizza Pizza are referred to elsewhere in these consolidated financial statements.

### 7. Statement of cash flows information

Additional cash flows information is as follows:

	Three Months Ended September 30, 2006	Period from July 6 2005 to September 30, 2005	Nine Months Ended September 30, 2006
Receivable from Pizza Pizza Limited	\$ -	\$ (150)	\$ -
Interest received	\$ 450	\$ 430	\$ 1,350