Pizza Pizza Royalty Income Fund

Notes to Interim Consolidated Financial Statements (Unaudited)
For the three months ended March 31, 2007 and 2006

(Expressed in Thousands of Dollars Except Number of Units and Per Unit Amounts)

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 ("GAAP") on a basis consistent with those used and described in the annual consolidated financial statements for the year-ended December 31, 2006. The disclosures contained in these interim consolidated financial statements do not include all requirements of Canadian GAAP for annual financial statements; however, all requirements for interim financial statements have been satisfied.

These interim consolidated financial statements should be read in conjunction with the annual consolidated financial statements for the year-ended December 31, 2006.

2. Changes in Accounting Policies

a) Financial Instruments, Hedges and Comprehensive Income

Commencing January 1, 2007, the Fund has adopted three new Canadian Institute of Chartered Accountants' ("CICA") accounting standards: (i) *Financial Instruments – Recognition and Measurements*; (ii) *Hedges;* and (iii) *Comprehensive Income*, as they affect the accounting of the Pizza Pizza Royalty Limited Partnership (the "Partnership").

As allowed under the transitional provisions for the implementation of new accounting standards, prior periods have not been restated. As a result, the Fund has recorded its share of the Partnership's increase of $298 to opening fiscal 2007 Accumulated Other Comprehensive Income and Investment in Pizza Pizza Royalty Limited Partnership, for the cumulative prior period effect arising on adoption of the new accounting standards. This transition impact arose from recognizing in other comprehensive income, the value of the deferred gains and losses on transition date relating to the interest rate swap, designated as a cash flow hedge by the Partnership.

i) *Financial Instruments*

The new standards require all financial assets and financial liabilities to be carried at fair value in the Consolidated Balance Sheet, except loans and receivables, securities designated as held-to-maturity and non-trading financial liabilities. The method used by the Fund is unchanged as a result of implementing these new accounting standards.

The Fund has decided to elect its accounts receivable from Pizza Pizza Limited, receivable from Pizza Pizza Royalty Limited Partnership and loan receivable from Pizza Pizza Limited as a loan and receivable.

The Fund has decided to elect its distributions payable to Fund unitholders as a financial liability not held for trading.

2. Changes in Accounting Policies, cont'd

ii) *Hedges*

The criteria specifying when a derivative instrument may be accounted for as a hedge has not changed substantially. There are three main types of hedges: (i) fair value hedges;, (ii) cash flow hedges; and (iii) net investment hedges.

The Partnership's interest rate swap qualifies as a cash flow hedge and thus is being accounted for under this Handbook Section; thus the Fund has reflected the change in the investment in Partnership for the equity share of comprehensive earnings.

iii) *Comprehensive Income*

A new Statement of Comprehensive Income now forms part of the Fund's consolidated financial statements and displays current period net income and other comprehensive income.

Accumulated other comprehensive income (loss) is a separate component of shareholders' equity. The Consolidated Statement of Accumulated Other Comprehensive Income reflects changes in accumulated other comprehensive income, comprised of changes in unrealized gains and losses on available-for-sale assets as well as changes in the fair value of derivatives designated as cash flow hedges, to the extent they are effective.

The above result in various adjustments to the opening financial statements as follows:

	Increase (Decrease)	
Investment in Pizza Pizza Royalty Limited Partnership	$	298
Accumulated other comprehensive income – beginning		298

b) Accounting Changes

Effective January 1, 2007, the Fund has adopted the new recommendations of the CICA Handbook Section 1506, Accounting Changes. Under these new recommendations, voluntary changes in accounting policy are permitted only when they result in the financial statements providing reliable and more relevant information;, requires changes in accounting policy to be applied retrospectively unless doing so is impracticable;, requires prior period errors to be corrected retrospectively and requires enhanced disclosures about the effects of changes in accounting policies, estimates and errors on the financial statements. These recommendations also require the disclosure of new primary sources of generally accepted accounting principles that have been issued but not yet effective.

The impact that the adoption of this section will have on the Fund's financial statements will depend on the nature of future accounting changes and the required additional disclosure on Recent Accounting Pronouncements is disclosed in note 10.

2. Changes in Accounting Policies, cont'd

c) Cash Flow Statements

Effective January 1, 2007, the Fund has adopted the new recommendations of the Canadian Institute of Chartered Accountants' Handbook Section 1540, Cash Flow Statements, which has been amended to include disclosure of the extent to which cash distributions are non-discretionary. These requirements apply to all cash distributions on financial instruments classified as equity that are determined in accordance with a contractual agreement or relevant constating document. The Fund does not expect the adoption of this standard to have a material impact on disclosure in its financial statements.

3. Accounting Adjustment

The Fund changed its policy regarding the accounting for the investment in the Partnership as new restaurants are added to the Royalty Pool. This change has been applied retroactively and as a result of this change, comparative figures for March 31, 2006 have been restated where the Fund previously recorded a loss on effective disposition of its partnership interest. As a result, loss on effective disposition of Partnership interest decreased by $635, net income increased by $635, income per Fund unit increased by $0.04 and diluted income per Fund unit increased by $0.03.

4. Operations

a. Equity income earned by the Fund through its interest in the Partnership has been derived as shown in the table below:

	March 31, 2007	March 31, 2006
(in thousands of dollars, except number of restaurants in the Royalty Pool)		
Restaurants in Royalty Pool	531	501
System sales reported by restaurants in the Royalty Pool	$ 89,518	$ 82,484
Royalty - 6% of system sales	$ 5,371	$ 4,949
Partnership administrative and interest expenses	(338)	(439)
Partnership earnings for the period before under-noted Pizza Pizza interest	5,033	4,510
Pizza Pizza's interest	(1,509)	(1,275)
Equity income related to Pizza Pizza royalties earned by Fund	$ 3,524	$ 3,235

(Expressed In Thousands of Dollars Except Number of Units and Per Unit Amounts)

4. Operations, cont'd

b. On January 1, 2007, adjustments to royalty payments and Pizza Pizza's Class B Exchange Multiplier were made based on the actual performance of the five restaurants added to the Royalty Pool on January 1, 2006. As a result of the adjustments, the new Class B Exchange Multiplier is 1.02345 and Pizza Pizza's exchangeable units can be exchanged into 4,593,233 Fund units which is an increase of 30,113 Fund units, effective January 1, 2006, which equates to 20.37% of the fully diluted units of the Fund.

c. On January 1, 2007, 30 net, new restaurants were added to the Royalty Pool as a result of 35 new restaurants opening from September 2, 2005 to December 31, 2006 and five closing from January 1, 2006 to December 31, 2006. The additional system sales from the 30 net, new restaurants are estimated at $15.4 million annually. The total number of restaurants in the Royalty Pool has increased to 531. The yield of the Fund units was determined to be 10.56% calculated using $7.94 as a weighted average unit price. Weighted average unit price is calculated based on the market price of the units traded on the TSX during the period of twenty consecutive days ending on the fifth trading day before January 1, 2007. As a result of the contribution of the additional net sales to the Royalty Pool, Pizza Pizza's Class B Exchange Multiplier increased fractionally by 80% of the total adjustment or 0.18174; the new Class B Multiplier is 1.20519. 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. The second adjustment to the Class B Exchange Multiplier will be adjusted to be effective January 1, 2007, once the actual performance of the new restaurants is determined in early 2008.

   As a result of the Adjusted Class B Exchange Multiplier, Pizza Pizza Limited will hold Class B Partnership units exchangeable into 5,408,915 Fund units which equates to 23% of the fully diluted units of the Fund as of January 1, 2007. As at March 31, 2007, the Fund reported an increase in its investment in the Partnership and a contributed surplus of $5,352 (December 31, 2006 – $599), to reflect the increase in value as a result of the vend-in of the new royalty stream.

   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.

5. Investment in Pizza Pizza Royalty Limited Partnership

	March 31, 2007	December 31, 2006
Balance - beginning of period, as originally reported	$ 140,520	$ 139,140
Accounting policy change	298	-
Balance – beginning of period, restated	140,818	139,140
Accretion of value on change in Royalty Pool	5,352	599
Equity income of the Partnership	3,524	14,090
Share of other comprehensive income of the Partnership	5	-
Distributions declared from the Partnership	(3,482)	(13,309)
Balance - end of period	$ 146,217	$ 140,520

(Expressed In Thousands of Dollars Except Number of Units and Per Unit Amounts)

5. Investment in Pizza Pizza Royalty Limited Partnership, cont'd

The business of the Partnership is the ownership and licensing of “Pizza Pizza Rights” and through a “Licence and Royalty Agreement” with Pizza Pizza, to exploit the use of the “Pizza Pizza Rights” by Pizza Pizza. 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”.

6. Income per unit

Basic net income per unit is calculated by dividing net income 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, income is adjusted for income 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 income to the diluted net income:

	March 31, 2007	March 31, 2006 (restated)
Basic net income	$ 3,974	$ 3,685
Equity adjustment allocated to Class B Exchangeable Partnership units	1,058	824
Adjusted net income	$ 5,032	$ 4,509

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
Pizza Pizza Class B partnership units	5,408,915	4,563,120
Weighted average number of units outstanding - diluted	23,360,915	22,515,120
Diluted income per Fund unit	$ 0.22	$ 0.20

(Expressed In Thousands of Dollars Except Number of Units and Per Unit Amounts)

7. 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.

8. Cash Flow Hedge

The following is information about the Partnership's cash flow hedge:

	Notional Amount	March 31, 2007 Fair Value	January 1, 2007 Fair Value	Contract Expires
Interest rate swap	$ 20,000	$ 394	$ 387	January 6, 2010

The Fund uses equity accounting for its interest in the Partnership's earnings and has recorded its share, effectively 77%, of the comprehensive income generated by the Partnership.

The Partnership has entered into an Interest Rate Swap Agreement to mitigate the risk associated with the fact that the bank loan bears interest at floating rates. The notional amount of the Swap is equal to $20,000 of the outstanding principal balance on the bank loan. The Partnership is obligated to pay the Swap Counterparty an amount based upon a fixed interest rate of 3.55% per annum plus a fee of 1.75% and the Swap Counterparty is obligated to pay the Partnership an amount equal to the Canadian Banker's Acceptance rate.

Fair value of the above-noted item was determined using estimated future discounted cash flows using a comparable current market rate of interest, and the change in value has been accounted for in other comprehensive income.

9. Supplementary Cash Flow Information

	Three months ended March 31, 2007	Three months ended March 31, 2006
Supplementary information:		
Interest received	$ 450	$ 450

Total cash distributions disclosed in the statement of cash flows are discretionary.

10. Recent Accounting Pronouncements

Recent accounting pronouncements issued and not yet effective:

Capital Disclosures

CICA Handbook Section 1535, Capital Disclosures, requires disclosure of an entity's objectives, policies and processes for managing capital, quantitative data about what the entity regards as capital and whether the entity has complied with any capital requirements and, if it has not complied, the consequences of such non-compliance. This standard is effective for the Fund for interim and annual financial statements beginning on January 1, 2008. The Fund has not yet determined the impact of the adoption of this change on the disclosure in its financial statements.

Financial Instruments Disclosures

CICA Handbook Section 3862, Financial Instruments – Disclosures, increases the disclosures currently required that will enable users to evaluate the significance of financial instruments for an entity's financial position and performance, including disclosures about fair value. In addition, disclosure is required of qualitative and quantitative information about exposure to risks arising from financial instruments, including specified minimum disclosures about liquidity risk and market risk. The quantitative disclosures must also include a sensitivity analysis for each type of market risk to which an entity is exposed, showing how net income and other comprehensive income would have been affected by reasonably possible changes in the relevant risk variable. This standard is effective for the Fund for interim and annual financial statements beginning on January 1, 2008. The Fund has not yet determined the impact of the adoption of this change on the disclosure in its financial statements.

Financial Instruments Presentation

CICA Handbook Section 3863, Financial Instruments – Presentation, replaces the existing requirements on presentation of financial instruments which have been carried forward unchanged to this new section. This standard is effective for the Fund for interim and annual financial statements beginning on January 1, 2008. The Fund does not expect the adoption of this standard to have a material impact on presentation in its financial statements.

International Financial Reporting Standards

The CICA plans to converge Canadian GAAP with International Financial Reporting Standards (IFRS) over a transition period expected to end in 2011. The impact of the transition to IFRS on the Fund's financial statements is not yet determinable.