

Pizza Pizza Royalty Income Fund

Notes to Interim Consolidated Financial Statements

For the three and nine months ended September 30, 2007 and 2006

(Expressed in Thousands of Dollars Except Number of Units and 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 ("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.

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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 unitholders' 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 fiscal 2007 opening financial statements as follows:

	Increase
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 12.

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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 the three and nine months ended September 30, 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 earnings increased by \$635, earnings per Fund unit increased by \$0.04 and diluted earnings per Fund unit increased by \$0.02.

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4. Operations

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

	Three months ended September 30, 2007	Three months ended September 30, 2006	Nine months ended September 30, 2007	Nine months ended September 30, 2006
(in thousands of dollars, except number of restaurants in the Royalty Pool)				
Restaurants in Royalty Pool ⁽ⁱ⁾	572	501	572	501
System sales reported by Pizza Pizza restaurants in the Royalty Pool	\$ 95,041	\$ 90,773	\$ 276,721	\$ 259,272
System sales reported by Pizza 73 restaurants in the Royalty Pool	13,894	-	13,894	-
	108,935	90,773	290,615	259,272
Royalty - 6% on Pizza Pizza system sales	\$ 5,703	\$ 5,446	\$ 16,604	\$ 15,556
Royalty - 9% on Pizza 73 system sales	1,250	-	1,250	-
Total royalty on system sales	6,953	5,446	17,854	15,556
Partnership administrative and interest expenses	(813)	(390)	(1,649)	(1,284)
Partnership earnings for the period before undernoted Pizza Pizza interest and issuance costs	6,140	5,056	16,205	14,272
Pizza Pizza's interest	(1,564)	(1,385)	(4,581)	(3,974)
Equity income before issuance costs	\$ 4,576	\$ 3,671	\$ 11,624	\$ 10,298
Less share of Partnership issuance costs	(169)	-	(169)	-
Equity income in the Partnership	\$ 4,407	\$ 3,671	\$ 11,455	\$ 10,298

⁽ⁱ⁾ On July 24, 2007, 41 Pizza 73 branded restaurants were added to the Royalty Pool. The royalty payment from Pizza Pizza to the Partnership is 9% of the Pizza 73 system sales, as defined in the License and Royalty Agreement.

- b) On January 1, 2007, adjustments to royalty payments and Pizza Pizza Limited's ("Pizza Pizza") 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.

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4. Operations, cont'd

- 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 \$15,400 annually. The total number of restaurants in the Royalty Pool 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 also increased 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 held Class B Partnership units exchangeable into 5,408,915 Fund units which equated to 23% of the fully diluted units of the Fund as of January 1, 2007. On January 1, 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.

On September 27, 2007, Pizza Pizza exchanged 414,872 of its Class B units, which equate to 500,000 equivalent Class B units when applied against the multiplier, into Fund units, and subsequently sold the 500,000 Fund units through a private placement. As a result of this transaction, contributed surplus decreased by \$550.

Pizza Pizza has an effective 18.4% interest in the Fund as of September 30, 2007. Pizza Pizza had agreed to maintain at least a 20% interest until June 30, 2007.

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5. Investment in Pizza Pizza Royalty Limited Partnership

	September 30, 2007	December 31, 2006
Balance - beginning of period, as originally reported	\$ 140,520	\$ 139,140
Accounting policy change (note 2)	298	-
Balance – beginning of period, restated	140,818	139,140
Investment in the Partnership, at cost, on July 24, 2007	30,257	-
Investment in the Partnership, at cost, on September 27, 2007	4,375	-
	175,450	139,140
Equity income of the Partnership	11,455	14,090
Accretion of value on change in Royalty Pool	5,352	599
Share of other comprehensive income (loss) of the Partnership	(300)	-
Distributions declared from the Partnership	(11,285)	(13,309)
Balance - end of period	\$ 180,672	\$ 140,520

The business of the Partnership is the ownership and licensing of the “Pizza Pizza Rights” and the “Pizza 73 Rights” and through two “Licence and Royalty Agreements” with Pizza Pizza, to exploit the use of the “Pizza Pizza Rights” and “Pizza 73 Rights” by Pizza Pizza. Additionally, the Partnership will collect the royalties payable under the two “Licence and Royalty Agreements” as well as perform the administration of the Fund pursuant to the “Administration Agreement”.

On July 24, 2007, the Fund, through the Pizza Pizza Holdings Trust, acquired 3,031,093.6 additional Class A Partnership units to enable the Partnership to acquire the Pizza 73 Rights. To fund the acquisition of Partnership units, the Fund issued 2,600,000 units to the public at \$9.15 per unit for gross proceeds of \$23,790 and 766,392 units at \$9.15 per unit through a private placement with the ultimate shareholder of Pizza Pizza and the vendors of Pizza 73 for gross proceeds of approximately \$7,013 (note 7).

On July 20, 2007, the Partnership acquired the trademarks and other intellectual property of Pizza 73, Inc. and its affiliated companies (together “Pizza 73”) for \$54,040 plus acquisition costs of \$2,757, using the investment by the Pizza Pizza Holdings Trust and the proceeds from its credit facility.

Effective July 24, 2007, Pizza Pizza acquired the shares of Pizza 73 for \$15,944 plus a working capital payable of \$1,427 and acquisition costs of \$887. The shareholders of Pizza 73 could be entitled to an additional \$3,000 of consideration if certain thresholds based on earnings and revenue are met post closing. Immediately after the acquisition, Pizza Pizza and Pizza 73 amalgamated, and the amalgamated entity is called Pizza Pizza Limited. Pizza Pizza has licensed the trademarks and other intellectual property associated with Pizza 73 from the Partnership for a 9% royalty payment on system sales of the Pizza 73 restaurants included in the Royalty Pool.

On September 27, 2007, Pizza Pizza converted 414,872 of its Class B Partnership units, which are equivalent to 500,000 Class B Partnership units, to Fund units. As a result of this transaction, the Fund, through the Holdings Trust increased its investment in the Class A units of the Partnership by 500,000 units valued at \$4,375 and the Fund issued an additional 500,000 units at \$9.85 per unit (note 7).

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6. Future Income Taxes

On October 31, 2006, the Department of Finance (Canada) announced proposed tax legislation which included a provision to eliminate the deduction of distributions from taxable income for certain forms of publicly traded income trusts and partnerships. The proposed legislation became a substantively enacted law on June 12, 2007 at which time the Fund, in accordance with Canadian GAAP, must give accounting recognition to these new taxes.

As a result of the new legislation, the Fund is required to recognize future income tax assets and liabilities with a corresponding adjustment to future tax expense, based on temporary differences expected to reverse after January 1, 2011 at the substantively enacted tax rate applicable to the Fund in 2011 and later. The future taxes will reverse in the period or periods in which the Rights and Marks in the Partnership are reduced by means of sale or some other event.

The future income tax liability arises as a result of the Fund's proportionate share of the temporary differences between the accounting and tax basis, at the 31.5% tax rate applicable to the Fund, on the Rights and Marks and financing expenses in the Partnership.

Future income tax expense is a non-cash item, which does not affect cash flow.

The Fund will not be liable for current income taxes until January 1, 2011.

7. Unitholders' Equity

On July 6, 2007, the Fund issued 2,600,000 subscription rights at \$9.15 per unit pursuant to a public underwriting for gross proceeds of \$23,790. On July 24, 2007, the 2,600,000 subscription rights were automatically exchanged for Fund units, and thereafter the former holders of the subscription receipts were entitled, as unit holders, to receive distributions from the Fund.

On July 24, 2007, the Fund issued 766,392 units at \$9.15 per unit through a private placement with the ultimate shareholder of Pizza Pizza and the vendors of Pizza 73 for gross proceeds of approximately \$7,013.

The Fund's share of the expenses of the offering was \$595 and was charged to unitholders' equity.

On September 27, 2007, the Fund issued 500,000 units at \$9.85 per unit, totaling \$4,925, through a private placement by Pizza Pizza Limited as part of the conversion of 414,872 Class B Partnership units, equivalent to 500,000 Class B Partnership units when applied against the multiplier. The Fund units were not issued for cash consideration, but for a greater entitlement to the income of the Partnership. Unitholders' equity was increased by \$4,925, investment in Pizza Pizza Royalty Limited Partnership was decreased by \$4,375 (note 5) and contributed surplus was decreased by \$550 (note 4(c)).

Balance - December 31, 2006	\$	177,795
Public offering of 2,600,000 units		23,790
Private offering of 766,392 units on July 24, 2007		7,013
Private offering of 500,000 units on September 27, 2007		4,925
Expense of offering on July 24, 2007		(595)
		35,133
Balance - September 30, 2007	\$	212,928

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8. Earnings per Unit

Basic net earnings per unit is calculated by dividing net earnings by the weighted average number of units outstanding during the period. Diluted net earnings per unit includes Pizza Pizza Class B exchangeable partnership units using the "if converted" method. Under the "if converted" method, earnings is 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, 2007	Three months ended September 30, 2006	Nine months ended September 30, 2007	Nine months ended September 30, 2006 (restated)
Basic net earnings (loss)	\$ 708	\$ 4,121	\$ (44)	\$ 11,648
Equity adjustment allocated to Class B Exchangeable Partnership units	1,076	935	3,193	2,623
Adjusted net earnings	\$ 1,784	\$ 5,056	\$ 3,149	\$ 14,271

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 ⁽ⁱ⁾	20,498,533	17,952,000	18,810,172	17,952,000
Pizza Pizza Class B Partnership units ⁽ⁱⁱ⁾	5,387,176	4,563,120	5,401,589	4,563,120
Weighted average number of units outstanding – diluted	25,885,709	22,515,120	24,211,761	22,515,120
Diluted earnings per Fund unit	\$ 0.03	\$ 0.23	\$ 0.00	\$ 0.63

For the three and nine months ended September 30, 2007, the Class B Partnership Units are anti-dilutive. Accordingly, for the three and nine months ended September 30, 2007, the diluted earnings per Fund unit equals the basic earnings per Fund unit.

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9. 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 interim consolidated financial statements.

10. Cash Flow Hedge

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

	Nominal Amount	September 30, 2007 Fair Value	January 1, 2007 Fair Value	Contract Expires
Interest rate swap	\$ 20,000	\$ 480	\$ 387	July 23, 2012
Interest rate swap	10,000	(178)	-	July 23, 2012
Interest rate swap	17,000	(305)	-	July 23, 2012

The Fund uses equity accounting for its interest in the Partnership's earnings and has recorded its share, effectively 82%, of the comprehensive income generated by the Partnership.

The Partnership has entered into three Interest Rate Swap Agreements to mitigate the risk associated with the fact that the \$47,000 bank loan bears interest at floating rates. The notional amount of the Swaps is \$20,000, \$10,000 and \$17,000 which total to the \$47,000 of the outstanding principal bank loan balance. On the \$20,000 Swap, 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 1.25% and the Swap Counterparty is obligated to pay the Partnership an amount equal to the Canadian Banker's Acceptance rate. On the \$10,000 and \$17,000 Swaps, the Partnership is obligated to pay the Swap Counterparty an amount based upon a fixed interest rate of 5.05% plus a fee of 1.25% and the Swap Counter party is obligated to pay the Partnership an amount equal to the Canadian Banker's Acceptance rate.

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

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11. Supplementary Cash Flows Information

	Three months ended September 30, 2007	Three months ended September 30, 2006	Nine months ended September 30, 2007	Nine months ended September 30, 2006
Supplementary information:				
Interest received	\$ 499	\$ 450	\$ 1,399	\$ 1,350

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

12. 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.

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12. Recent Accounting Pronouncements, cont'd

General Standards on Financial Statement Presentation

CICA Handbook Section 1400, General Standards on Financial Statement Presentation, has been amended to include requirements to assess and disclose an entity's ability to continue as a going concern. The changes are effective for the Fund for interim and annual financial statements beginning January 1, 2008. The Fund does not expect the adoption of these changes to have an impact on 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.