

Pizza Pizza Royalty Income Fund

Notes to Interim Consolidated Financial Statements (Unaudited)

For the three and six months ended June 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 11.

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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 six months ended June 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 \$0.03.

4. Operations

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

	Three months ended June 30, 2007	Three months ended June 30, 2006	Six months ended June 30, 2007	Six months ended June 30, 2006
(in thousands of dollars, except number of restaurants in the Royalty Pool)				
Restaurants in Royalty Pool	531	501	531	501
System sales reported by restaurants in the Royalty Pool	\$ 92,162	\$ 86,015	\$ 181,680	\$ 168,498
Royalty - 6% of system sales	\$ 5,530	\$ 5,161	\$ 10,901	\$ 10,110
Partnership administrative and interest expenses	(498)	(455)	(836)	(894)
Partnership earnings for the period before under-noted Pizza Pizza interest	5,032	4,706	10,065	9,216
Pizza Pizza's interest	(1,508)	(1,314)	(3,017)	(2,589)
Equity income related to Pizza Pizza royalties earned by the Fund	\$ 3,524	\$ 3,392	\$ 7,048	\$ 6,627

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4. Operations, cont'd

- 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.
- 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 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 June 30, 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 January 1, 2007.

Pizza Pizza's agreement to maintain at least a 20% interest in the Fund expired on June 30, 2007. As at June 30, 2007, Pizza Pizza owned an effective 23% interest in the Fund. Pizza Pizza's interest was decreased to approximately 20% on July 24, 2007 as a result of the transaction described in note 12.

Effective July 1, 2007, the distributions on Pizza Pizza's minimum 20% are no longer subordinated under the subordination agreement.

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5. Investment in Pizza Pizza Royalty Limited Partnership

	June 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
Accretion of value on change in Royalty Pool	5,352	599
Equity income of the Partnership	7,048	14,090
Share of other comprehensive income of the Partnership	218	-
Distributions declared from the Partnership	(6,964)	(13,309)
Balance - end of period	\$ 146,472	\$ 140,520

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. 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 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.

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7. 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 June 30, 2007	Three months ended June 30, 2006	Six months ended June 30, 2007	Six months ended June 30, 2006 (restated)
Basic net earnings (loss)	\$ (4,726)	\$ 3,842	\$ (752)	\$ 7,527
Equity adjustment allocated to Class B Exchangeable Partnership units	1,059	864	2,117	1,688
Adjusted net earnings (loss)	\$ (3,667)	\$ 4,706	\$ 1,365	\$ 9,215

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	17,952,000
Pizza Pizza Class B partnership units	5,408,915	4,563,120	5,408,915	4,563,120
Weighted average number of units outstanding - diluted	23,360,915	22,515,120	23,360,915	22,515,120
Diluted earnings (loss) per Fund unit	\$ (0.16)	\$ 0.21	\$ 0.06	\$ 0.41

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8. 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.

9. Cash Flow Hedge

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

	Nominal Amount	June 30, 2007 Fair Value	January 1, 2007 Fair Value	Contract Expires
Interest rate swap	\$ 20,000	\$ 671	\$ 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 the \$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.

Subsequent to June 30, 2007, the fee payable was reduced from 1.75% to 1.25%.

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.

10. Supplementary Cash Flows Information

	Three months ended June 30, 2007	Three months ended June 30, 2006	Six months ended June 30, 2007	Six months ended June 30, 2006
Supplementary information:				
Interest received	\$ 450	\$ 450	\$ 900	\$ 900

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

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11. 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.

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.

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12. Subsequent Events

Acquisitions

Effective 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.

Effective July 24, 2007, Pizza Pizza acquired the shares of Pizza 73 for \$16,210. Immediately after the acquisition, Pizza Pizza and Pizza 73 amalgamated.

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.

Issuance of Units

Effective July 24, 2007, 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 through a private placement with the ultimate shareholder of Pizza Pizza and the vendors of Pizza 73 for gross proceeds of approximately \$7,000.

The net proceeds from the Offering, after deducting fees, together with the net borrowings under the Partnership's new credit facility, were used to fund the acquisition of the Pizza 73 Rights and Marks.

New Credit Facility

On July 24, 2007, the Partnership amended the existing credit agreement to increase the committed, non-revolving facility from \$20,000 to \$47,000 and to extend the term by five years to 2012. The \$1,000 revolving, operating facility continues. The facilities bear interest at Prime plus 0% to 0.25% or the Bankers Acceptance rate plus 1.0% to 1.75%, depending on the level of debt to earnings before interest, taxes, depreciation and amortization ("EBITDA"). The Partnership continued its current interest rate swap and entered into two additional interest rate swaps to mitigate the risk associated with the credit facilities bearing interest at a floating rate. The interest rate on the existing \$20,000 interest swap decreased to 4.8% from 5.3% until July 2012 and the incremental facility of \$27,000 will be initially fixed at 5.05% plus a 1.25% spread or 6.3% and may change based on the level of debt to EBITDA.