PIZZA PIZZA ROYALTY CORP.

Consolidated Annual Financial Statements
For the years ended December 31, 2018 and 2017

INDEPENDENT AUDITOR'S REPORT

To the Shareholders of Pizza Pizza Royalty Corp.

Opinion

We have audited the consolidated financial statements of Pizza Pizza Royalty Corp. and its subsidiaries (the Company) which comprise the consolidated statement of financial position as at December 31, 2018 and December 31, 2017, and the consolidated statements of earnings, comprehensive earnings, shareholders' equity and cash flows for the years then ended, and notes to the consolidated financial statements, including a summary of significant accounting policies.

In our opinion, the accompanying consolidated financial statements present fairly, in all material respects the consolidated financial position of the Company as at December 31, 2018 and December 31, 2017, and its consolidated financial performance and its consolidated cash flows for the years then ended in accordance with International Financial Reporting Standards (IFRSs).

Basis for opinion

We conducted our audit in accordance with Canadian generally accepted auditing standards. Our responsibilities under those standards are further described in the *Auditor's Responsibilities for the Audit of the Consolidated Financial Statements* section of our report. We are independent of the Company in accordance with the ethical requirements that are relevant to our audit of the consolidated financial statements in Canada, and we have fulfilled our ethical responsibilities in accordance with these requirements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Other Information

Management is responsible for the other information. The other information comprises:

- Management's Discussion and Analysis
- The information, other than the consolidated financial statements and our auditor's report thereon, in the Annual Report

Our opinion on the financial statements does not cover the other information and we do not express any form of assurance conclusion thereon.

In connection with our audit of the consolidated financial statements, our responsibility is to read the other information, and in doing so, consider whether the other information is materially inconsistent with the consolidated financial statements or our knowledge obtained in the audit or otherwise appears to be materially misstated.

We obtained Management's Discussion and Analysis prior to the date of this auditor's report. If, based on the work we have performed, we conclude that there is a material misstatement of this other information, we are required to report that fact. We have nothing to report in this regard.

Responsibilities of Management and Those Charged with Governance for the Consolidated Financial Statements

Management is responsible for the preparation and fair presentation of the consolidated financial statements in accordance with IFRSs, and for such internal control as management determines is necessary to enable the preparation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

In preparing the consolidated financial statements, management is responsible for assessing the Company's ability to continue as a going concern, disclosing, as applicable, matters related to going concern and using the going concern basis of accounting unless management either intends to liquidate the Company or to cease operations, or has no realistic alternative but to do so.

Those charged with governance are responsible for overseeing the Group's financial reporting process.

Auditor's Responsibilities for the Audit of the Consolidated Financial Statements

Our objectives are to obtain reasonable assurance about whether the consolidated financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with Canadian generally accepted auditing standards will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these consolidated financial statements.

As part of an audit in accordance with Canadian generally accepted auditing standards, we exercise professional judgment and maintain professional skepticism throughout the audit. We also:

- Identify and assess the risks of material misstatement of the consolidated financial statements, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.
- Obtain an understanding of internal control relevant to the audit 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 Group's internal control.
- Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by management.
- Conclude on the appropriateness of management's use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the Group's ability to continue as a going concern. If we conclude that a material uncertainty exists, we are required to draw attention in our auditor's report to the related disclosures in the consolidated financial statements or, if such disclosures are inadequate, to modify our opinion. Our conclusions are based on the audit evidence obtained up to the date of our auditor's report. However, future events or conditions may cause the Group to cease to continue as a going concern.
- Evaluate the overall presentation, structure, and content of the consolidated financial statements, including the disclosures, and whether the consolidated financial statements represent the underlying transactions and events in a manner that achieves fair presentation.

We communicate with those charged with governance regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that we identify during our audit.

We also provide those charged with governance with a statement that we have complied with relevant ethical requirements regarding independence, and to communicate with them all relationships and other matters that may reasonably be thought to bear on our independence, and where applicable, related safeguards.

The engagement partner on the audit resulting in this independent auditor's report is Mark Vrooman.

Ernst & Young LLP

Chartered Professional Accountants
Licensed Public Accountants

Toronto, Canada
March 1, 2019

Pizza Pizza Royalty Corp.

Consolidated Statements of Financial Position
As at December 31, 2018 and 2017
(Expressed in thousands of Canadian dollars)

	December 31, 2018 $	December 31, 2017 $
Assets		
Current assets		
Cash	1,160	2,122
Short-term investments	2,750	2,750
Receivable from Pizza Pizza Limited (note 10)	3,156	3,288
Trade and other receivables	75	65
Total current assets	**7,141**	**8,225**
Non-current assets		
Pizza Pizza Rights and Marks (note 3)	270,225	267,338
Pizza 73 Rights and Marks (note 3)	78,191	73,796
Derivative financial instruments (note 12)	204	177
Total non-current assets	**348,620**	**341,311**
Total assets	**355,761**	**349,536**
Liabilities and shareholders' equity		
Current liabilities		
Trade and other payables (note 4)	451	485
Payable to Pizza Pizza Limited (note 10)	687	762
Dividends payable to shareholders	1,755	1,755
Income taxes payable	37	173
Total current liabilities	**2,930**	**3,175**
Non-current liabilities		
Borrowings (note 5)	46,993	46,985
Deferred tax liability (note 7)	20,545	19,599
Total non-current liabilities	**67,538**	**66,584**
Shareholders' equity		
Share capital (note 8)	242,030	242,030
Exchangeable Shares (note 6)	77,547	70,265
Accumulated other comprehensive earnings	371	405
Deficit	(34,655)	(32,923)
Total shareholders' equity	**285,293**	**279,777**
Total liabilities and shareholders' equity	**355,761**	**349,536**

The accompanying notes are an integral part of these consolidated financial statements.

Pizza Pizza Royalty Corp.

Consolidated Statements of Earnings
For the years ended December 31, 2018 and 2017
(Expressed in thousands of Canadian dollars, except number of shares and per share amounts)

	December 31, 2018 $	December 31, 2017 $
Royalty Pool System Sales (note 9)	546,343	551,127
Royalty income (note 9)	35,408	35,614
Administrative expenses	(562)	(645)
Operating earnings	**34,846**	**34,969**
Interest expense on borrowings (note 5)	(1,278)	(932)
Earnings for the year before income taxes	**33,568**	**34,037**
Current tax expense (note 7)	(5,728)	(5,754)
Deferred tax expense (note 7)	(954)	(1,235)
Earnings for the year attributable to shareholders	**26,886**	**27,048**
Weighted average number of shares – basic and diluted (note 8)	31,666,003	31,213,495
Basic and diluted earnings per share (note 8)	**0.85**	**0.87**

The accompanying notes are an integral part of these consolidated financial statements.

Pizza Pizza Royalty Corp.

Consolidated Statements of Comprehensive Earnings
For the years ended December 31, 2018 and 2017
(Expressed in thousands of Canadian dollars)

	December 31, 2018 $	December 31, 2017 $
Earnings for the year	**26,886**	**27,048**
Other comprehensive earnings (loss)		
Items that may be reclassified subsequently to net earnings:		
Cash flow hedges	(42)	752
Deferred tax impact of cash flow hedges	8	(157)
Total comprehensive earnings	**26,852**	**27,643**

The accompanying notes are an integral part of these consolidated financial statements.

Pizza Pizza Royalty Corp.

Consolidated Statements of Changes in Shareholders' Equity
For the years ended December 31, 2018 and 2017
(Expressed in thousands of Canadian dollars)

	Share capital $	Exchangeable Shares $	Accumulated other comprehensive earnings (loss) $	Deficit $	Total shareholders' equity $
	(note 8)	**(note 6)**			
At December 31, 2017	**242,030**	**70,265**	**405**	**(32,923)**	**279,777**
Comprehensive earnings					
Earnings for the year	-	-	-	26,886	26,886
Cash flow hedges	-	-	(42)	-	(42)
Deferred tax impact of cash flow hedges	-	-	8	-	8
Total comprehensive earnings	**-**	**-**	**(34)**	**26,886**	**26,852**
Transactions with shareholders					
Exchangeable Shares (note 6)	-	7,282	-	-	7,282
Dividends declared to shareholders	-	-	-	(21,063)	(21,063)
Distributions on Class B and Class D Exchangeable Shares	-	-	-	(7,555)	(7,555)
Total transactions with shareholders	**-**	**7,282**	**-**	**(28,618)**	**(21,336)**
At December 31, 2018	**242,030**	**77,547**	**371**	**(34,655)**	**285,293**
At December 31, 2016	**242,030**	**65,501**	**(190)**	**(31,945)**	**275,396**
Comprehensive earnings					
Earnings for the year	-	-	-	27,048	27,048
Cash flow hedges	-	-	752	-	752
Deferred tax impact of cash flow hedges	-	-	(157)	-	(157)
Total comprehensive earnings	**-**	**-**	**595**	**27,048**	**27,643**
Transactions with shareholders					
Exchangeable Shares (note 6)	-	4,764	-	-	4,764
Dividends declared to shareholders	-	-	-	(21,063)	(21,063)
Distributions on Class B and Class D Exchangeable Shares	-	-	-	(6,963)	(6,963)
Total transactions with shareholders	**-**	**4,764**	**-**	**(28,026)**	**(23,262)**
At December 31, 2017	**242,030**	**70,265**	**405**	**(32,923)**	**279,777**

The accompanying notes are an integral part of these consolidated financial statements.

Pizza Pizza Royalty Corp.

Consolidated Statements of Cash Flows
For the years ended December 31, 2018 and 2017
(Expressed in thousands of Canadian dollars)

	December 31, 2018 $	December 31, 2017 $
Cash provided by (used in)		
Operating activities		
Earnings for the year	26,886	27,048
Amortization of deferred financing fees	8	8
Off-market swap payments	(69)	(384)
Deferred tax expense	954	1,235
Changes in non-cash working capital (note 11)	(123)	107
Cash provided by operating activities	**27,656**	**28,014**
Financing activities		
Dividends paid to shareholders	(21,063)	(21,063)
Distributions on Class B and Class D Exchangeable Shares	(7,555)	(6,963)
Cash used in financing activities	**(28,618)**	**(28,026)**
Decrease in cash	**(962)**	**(12)**
Cash, beginning of year	**2,122**	**2,134**
Cash, end of year	**1,160**	**2,122**
Supplementary information		
Interest paid	1,339	1,308

Total cash and short-term investments	December 31, 2018 $	December 31, 2017 $
Cash	1,160	2,122
Short-term investments	2,750	2,750
Total cash and short-term investments	**3,910**	**4,872**

The accompanying notes are an integral part of these consolidated financial statements.

1. General information

The Pizza Pizza Royalty Corp. (the "Company") is governed by the *Business Corporations Act* (Ontario) pursuant to its articles of incorporation dated April 4, 2012 and articles of arrangement dated December 31, 2012. The Company's common shares are traded on the Toronto Stock Exchange under the stock symbol PZA. The Company is incorporated and domiciled in Canada and the address of its registered office is 500 Kipling Avenue, Toronto, Ontario, Canada.

The Company acquired, through the Pizza Pizza Royalty Limited Partnership (the "Partnership"), the trademarks, trade names, operating procedures, systems and other intellectual property and proprietary rights associated therewith owned by Pizza Pizza Limited ("PPL") used in connection with the operation of all restaurants operated by PPL, its subsidiaries and its franchisees (collectively, the "Pizza Pizza Rights and Marks").

Concurrent with the acquisition of the Pizza Pizza Rights and Marks on July 6, 2005, the Partnership granted PPL an exclusive and unlimited licence to use the Pizza Pizza Rights and Marks for an initial term of 99 years for which PPL pays a royalty equal to 6% of system sales from all Pizza Pizza restaurants in the Royalty Pool, as defined in the Pizza Pizza Licence and Royalty Agreement.

On July 24, 2007, the Company, through the Partnership, acquired the trademarks, trade names, operating procedures and systems, and other intellectual property and proprietary rights owned by Pizza 73, Inc. and its affiliated companies (together, "Pizza 73") used in connection with the operation of all restaurants operated by Pizza 73 and its partners (collectively, the "Pizza 73 Rights and Marks").

Concurrent with the acquisition of the Pizza 73 Rights and Marks, the Partnership granted PPL an exclusive and unlimited licence to use the Pizza 73 Rights and Marks for an initial term of 99 years for which PPL pays a royalty equal to 9% of system sales from all Pizza 73 restaurants in the Royalty Pool, as defined in the Pizza 73 Licence and Royalty Agreement.

As at December 31, 2018, there were 652 Pizza Pizza restaurants (2017 – 651) and 106 Pizza 73 restaurants (2017 – 100) in the Royalty Pool; the Royalty Pool is adjusted annually on January 1.

The Company pays monthly dividends directly to public shareholders. For the year ended December, 2018, the Company declared dividends of $0.8556 per share (2017 – $0.8556 per share).

PPL, a privately owned corporation headquartered in Toronto, Ontario, operates in the food service industry primarily throughout Ontario and Alberta, and primarily franchises and operates quick-service restaurant businesses under the Pizza Pizza and Pizza 73 brands. PPL derives revenue from franchisees through the sale of franchise restaurants, food and supplies and royalties. PPL also derives revenue from company owned and jointly controlled restaurants through the sale of food products to retail customers. The Company's revenue is earned from certain operations of PPL and, accordingly, the revenue of the Company and its ability to pay dividends to shareholders are dependent on the ability of PPL to generate and pay royalties to the Company.

2. Significant accounting policies

The significant accounting policies applied in the preparation of these consolidated financial statements are set out below. These policies have been consistently applied to all periods presented unless otherwise stated.

a. Basis of preparation

The Company prepares its consolidated financial statements in accordance with International Financial Reporting Standards ("IFRS") as issued by the International Accounting Standards Board ("IASB").

The policies applied in these consolidated financial statements are based on IFRS standards, which have been applied consistently to all periods presented. These consolidated financial statements were issued and effective as at March 1, 2019, the date the Board of Directors approved the consolidated financial statements.

b. Changes to accounting policies and disclosures

IFRS 15, *Revenue from Contracts with Customers* ("IFRS 15")
IFRS 15 establishes a single comprehensive model for entities to use in accounting for revenue arising from contracts with customers. The new standard establishes a five-step model to account for revenue arising from contracts with customers. Under IFRS 15, revenue is recognized at an amount that reflects the consideration to which an entity expects to be entitled in exchange for transferring goods or services to a customer. The principles in IFRS 15 provide a more structured approach to measuring and recognizing revenue.

The standard requires entities to exercise judgment, taking into consideration all of the relevant facts and circumstances when applying each step of the model to contracts with their customers. The standard also specifies the accounting for the incremental costs of obtaining a contract and the costs directly related to fulfilling a contract. The Company adopted IFRS 15 using the modified retrospective method and has elected to apply the standard retrospectively only to contracts that are not completed contracts at the date of initial application. The Company applied certain practical expedients, as permitted by the standard in determining the impact on transition.

The Company's accounting policy for revenue recognition is described below.

The Company collects royalty income from PPL based on system sales of Pizza Pizza and Pizza 73 restaurants. Royalty income is recognized on an accrual basis equal to 6% of system sales from all Pizza Pizza restaurants in the Royalty Pool and 9% of system sales from all Pizza 73 restaurants in the Royalty Pool.

Under the new standard, there have been no changes to the recognition of royalty income and no retrospective restatements have been made. IFRS 15 includes an exception relating to the recognition of sales or usage based royalties from licenses of intellectual property, which the Company has applied.

IFRS 9, *Financial Instruments* ("IFRS 9")
IFRS 9 replaces IAS 39, *Financial Instruments: Recognition and Measurement* ("IAS 39") for annual periods beginning on or after January 1, 2018, bringing together all three aspects of the accounting for financial instruments: classification and measurement; impairment; and hedge accounting. The Company is applying IFRS 9 retrospectively, with no adjustment to retained earnings as of January 1, 2018.

Classification and measurement

With the new standard, the Company notes there have been no changes in classification and measurement of its financial instruments. The classification is based on two criteria: the Company's business model for managing the assets; and whether the instruments' contractual cash flows represent "solely payments of principal and interest" on the principal amount outstanding (the "SPPI criterion"). Based on the Company's assessment, short-term investments, receivable from PPL, and trade and other receivables are carried at amortized cost, as these financial assets are held within a business model with the objective to hold the financial assets in order to collect the contractual cash flows that meet the SPPI criterion.

The assessment of the Company's business models was made as of the date of initial application, January 1, 2018, and then applied retrospectively to those financial assets that were not derecognized before January 1, 2018. The assessment on whether contractual cash flows on debt instruments are solely composed of principal, and interest was made based on the facts and circumstances as at the initial recognition of the assets.

The accounting for the Company's financial liabilities remains largely the same as it was under IAS 39. Similar to the requirements of IAS 39, the Company continues to measure its financial liabilities at amortized cost.

Impairment

The adoption of IFRS 9 has changed the accounting for impairment losses, with respect to financial assets, by replacing IAS 39's incurred loss approach with a forward-looking expected credit loss ("ECL") approach. However, given the nature of the Company's business, it is not expected that impairment losses will be materially different under IFRS 9, as compared to the incurred loss approach.

IFRS 9 requires the Company to record an allowance for ECLs for all loans and other debt financial assets that are not held at fair value through profit and loss.

ECLs are based on the difference between the contractual cash flows due in accordance with the contract and all the cash flows that the Company expects to receive. The shortfall is then discounted at an approximation to the asset's original effective interest rate.

The Company notes that its short-term investments are high-grade investments that are held with reputable financial institutions. As such, these assets are considered to be low credit risk investments. It is the Company's policy to measure such instruments on a 12-month ECL basis. In all cases, the Company will consider that there has been an increase in credit risk when contractual payments are past due.

For trade and other receivables, as well as the receivable from PPL, the Company has applied the standard's simplified approach and has calculated ECLs based on lifetime expected credit losses. The Company has established a provision matrix that is based on the Company's historical credit loss experience, adjusted for forward-looking factors specific to the debtors and the economic environment.

The adoption of the ECL requirements of IFRS 9 resulted in no changes to impairment allowances of the Company's financial assets. As such, there were no retrospective adjustments made upon transition.

Hedge accounting

The Company has applied hedge accounting prospectively. At the date of initial application, all of the Company's existing hedging relationships were eligible to be treated as continuing hedging relationships. Consistent with prior periods, the Company has continued to designate the change in fair value of the entire forward contract in the Company's cash flow hedge relationship and will continue to measure changes in fair value of the interest rate swaps in other comprehensive earnings (loss) to the extent the hedge continues to be highly effective. The related other comprehensive earnings (loss) amounts are allocated to the consolidated statements of earnings in the same period in which the hedged item affects earnings. To the extent the change in fair value of the derivative financial instruments is not completely offset by the change in the fair value of the hedged item, the ineffective portion of the hedging relationship is recorded immediately in the consolidated statements of earnings.

The adoption of the new hedge accounting requirements resulted in no transitional adjustment to how the Company has applied hedge accounting under IFRS 9. As such, there were no retrospective adjustments made upon transition.

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

c. Future changes in accounting policy and disclosure

Standards, amendments and interpretations to existing standards that are not yet effective and have not yet been early adopted by the Company are as follows:

IFRS 16, *Leases* ("IFRS 16")
In January 2016, the IASB issued IFRS 16, its new leases standard that requires lessees to recognize assets and liabilities for most leases on their balance sheets. Lessees applying IFRS 16 will have a single accounting model for all leases, with certain exemptions. Lessor accounting is substantially unchanged. The new standard will be effective from January 1, 2019 with limited early application permitted. Based on the analysis to date, the Company has not identified any lease arrangements of more than 12 months that fall within the scope of the standard. As such, the Company does not anticipate any impact upon transition to IFRS 16.

d. Consolidation

The consolidated financial statements incorporate the assets and liabilities of the Company and its subsidiaries as at December 31, 2018 and 2017 and the results of these subsidiaries for the years then ended. The Company's subsidiaries and its respective holdings at December 31, 2018 and 2017 are outlined below:

Subsidiary	December 31, 2018	December 31, 2017
Pizza Pizza GP Inc.	77.7%	78.9%
Pizza Pizza Royalty Limited Partnership	77.7%	78.9%

An investor controls an investee when it is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee. Furthermore, an investor controls an investee if and only if the investor has all the following: power over the investee; exposure, or rights to variable returns from its involvement with the investee and the ability to use its power over the investee to affect the amount of the investor's returns.

Subsidiaries are fully consolidated from the date on which control is transferred to the Company and de-consolidated from the date that control ceases. Inter-entity transactions, balances and unrealized gains/losses on transactions between entities are eliminated. There are no unconsolidated structured entities.

e. Financial assets and liabilities (Policy applicable before January 1, 2018 per IAS 39)

A financial asset or liability is recognized if the Company becomes a party to the contractual provisions of the asset or liability. A financial asset or liability is recognized initially (at trade date) at its fair value plus, in the case of a financial asset or liability not at fair value through profit or loss, transaction costs that are directly attributable to the acquisition or issue of the instrument. Financial assets and liabilities carried at fair value through profit or loss are initially recognized at fair value and transaction costs are expensed in the consolidated statements of earnings.

After initial recognition, financial assets are measured at their fair value, except for loans and receivables and held-to-maturity financial assets, which are measured at amortized cost. After initial recognition, financial liabilities are measured at amortized cost except for financial liabilities at fair value through profit or loss which are measured at fair value.

The Company classifies its financial assets and liabilities according to their characteristics and management's choices and intentions related thereto for the purposes of ongoing measurement.

Classification choices for financial assets include:

i) Fair value through profit or loss - measured at fair value with changes in fair value recorded in the consolidated statements of earnings;
ii) Held-to-maturity - recorded at amortized cost with gains and losses recognized in the consolidated statements of earnings in the period that the asset is no longer recognized or impaired;
iii) Available for sale - measured at fair value with changes in fair value recognized in other comprehensive income for the current period until realized through disposal or impairment; and
iv) Loans and receivables - recorded at amortized cost with gains and losses recognized in profit or loss in the period that the asset is no longer recognized or impaired.

Classification choices for financial liabilities include:

i) Fair value through profit or loss - measured at fair value with changes in fair value recorded in the consolidated statements of earnings; and
ii) Other financial liabilities - measured at amortized cost with gains and losses recognized in the consolidated statements of earnings in the period that the liability is no longer recognized.

The Company's financial assets and liabilities are classified and measured as follows:

Assets/liabilities	**Category**	**Measurement**
Cash	Loans and receivables	Amortized cost
Short-term investments	Loans and receivables	Amortized cost
Receivable from Pizza Pizza Limited	Loans and receivables	Amortized cost
Trade and other receivables	Loans and receivables	Amortized cost
Trade and other payables	Other financial liabilities	Amortized cost
Payable to Pizza Pizza Limited	Other financial liabilities	Amortized cost
Dividends payable to shareholders	Other financial liabilities	Amortized cost
Borrowings	Other financial liabilities	Amortized cost
Derivative financial instruments	Derivatives used for hedging	Fair value

Financial assets are derecognized if the Company's contractual rights to the cash flows from the financial assets expire, or if the Company transfers the financial asset to another party without retaining control or substantially all risks and rewards of the asset. Financial liabilities are derecognized if the Company's obligations specified in the contract are cancelled, discharged or expire.

f. Impairment of financial assets

The Company assesses at the end of each reporting period whether there is objective evidence that a financial asset or group of financial assets, other than those at fair value through profit or loss, is impaired. A financial asset or group of financial assets is impaired and impairment losses are incurred only if there is objective evidence of impairment as a result of one or more events that have occurred after the initial recognition of the asset (a loss event) and that loss event has an impact on the estimated future cash flows of the financial asset or group of financial assets that can be reliably estimated.

The amount of the loss is measured as the difference between the asset's carrying amount and the present value of estimated future cash flows discounted at the financial asset's original effective interest rate. The asset's carrying amount is reduced and the amount of the loss is recognized in the consolidated statements of earnings.

If, in a subsequent period, the amount of the impairment loss decreases and the decrease can be related objectively to an event occurring after the impairment was recognized, the previously recognized impairment losses are reversed.

g. Derivative financial instruments and hedging activities

Derivative financial instruments include interest rate swaps and are initially measured at fair value on the date the derivative contract is entered into and are subsequently remeasured at each reporting date at their fair value. The Company designates its interest rate swaps as cash flow hedges.

The Company documents, at the inception of the transaction, the relationship between the hedging instrument and the hedged item, as well as its risk management objectives and strategy for undertaking the hedging transaction. The Company also documents its assessment, both at inception and at each reporting date, of whether the derivative that is used has been highly effective in offsetting cash flows of hedged items.

The changes in fair value of the interest rate swaps are included in other comprehensive earnings to the extent the hedge continues to be highly effective. The related other comprehensive earnings (loss) amounts are allocated to the consolidated statements of earnings in the same period in which the hedged item affects earnings. To the extent the change in fair value of the derivative financial instruments is not completely offset by the change in the fair value of the hedged item, the ineffective portion of the hedging relationship is recorded immediately in the consolidated statements of earnings.

The fair value of the interest rate swaps is estimated based on the standard swap valuation methodology; that is, the value of the swap is calculated as the difference between the present values of the future cash flows associated with the floating-receive leg and the fixed-pay leg.

h. Short-term investments

The short-term investments include amounts invested in Guaranteed Investment Certificates with maturities at acquisition between 90 and 365 days.

i. Trade and other receivables

Trade and other receivables are initially recognized at fair value and subsequently measured at amortized cost using the effective interest method, less any provision for impairment. If collection is expected in one year or less, they are classified as current assets. If not, they are presented as non-current assets.

j. Pizza Pizza and Pizza 73 Rights and Marks

Rights and Marks that have an indefinite life are recorded at cost and are not being amortized. Management considers the Pizza Pizza and Pizza 73 Rights and Marks to be indefinite-life assets. Indefinite-life intangible assets principally comprise those trademarks for which there is no foreseeable limit to the period over which they are expected to generate net cash inflows. Rights and Marks are considered to have an indefinite life given the strength and durability of the brands and the level of marketing support. Brands that are classified as indefinite have been in the market for many years, and the nature of the industry PPL operates in is such that brand obsolescence is not common if appropriately supported by advertising and marketing spending.

A description of each of the Rights and Marks is as follows:

Pizza Pizza Rights and Marks
The Rights and Marks include the Pizza Pizza Marks and all goodwill associated therewith and the copyrights, the trade names, trade secrets, methods, systems and procedures for the construction, design or operation of Pizza Pizza restaurants using certain types of equipment, supplies, ingredients, recipes, merchandising, advertising and business techniques, together with the rights to order phone numbers and order website domain names that are currently owned by PPL and used in connection with the operation of Pizza Pizza restaurants.

The Marks include all trademarks that are registered or the subject of pending applications for registration under the Trade-marks Act (Canada) and other unregistered trademarks used in connection with the Pizza Pizza restaurant businesses.

Pizza 73 Rights and Marks
The Rights and Marks include all intellectual property rights, whether registered or not, including the Pizza 73 Marks and all goodwill associated therewith, all know-how and related technical knowledge and all other proprietary rights pertaining to or used in connection with the Pizza 73 business, including all copyrights, trade names, business names, trade secrets, confidential information, uniform standards, methods, systems and procedures for establishment, construction, design, operation or marketing of Pizza 73 Restaurants using certain types of equipment, supplies, ingredients, recipes, merchandising, advertising and business techniques, together with the rights to order phone numbers and order website domain names that are currently owned by Pizza 73 and used in connection with the operation of Pizza 73 Restaurants, and all copyrights in the operations manuals and similar manuals or documents for the Unit Companies, as amended from time to time, as well as all copyrights in all menus and advertising and promotional materials.

The Marks include all trademarks that are registered or the subject of pending applications for registration under the Trade-marks Act (Canada) and other unregistered trademarks, trade dress, distinguishing guises, logos, slogans, brand names, domain names, commercial symbols and other indicia of origin used in connection with the Pizza 73 business.

k. Impairment of Rights and Marks

The Rights and Marks have an indefinite useful life, are not subject to amortization and are tested annually for impairment or more frequently if there are indications that the asset may be impaired. If the estimated recoverable amount of the Rights and Marks is less than their carrying amount, the Rights and Marks are written down to their estimated recoverable amount and an impairment loss is recognized in the consolidated statements of earnings. The recoverable amount of the Rights and Marks is the higher of their fair value less costs to sell and value in use. For the purposes of assessing impairment, assets are grouped at the lowest levels for which there are separately identifiable cash inflows (cash-generating units or CGUs). There are two CGUs: Pizza Pizza restaurants and Pizza 73 restaurants.

Rights and Marks on which an impairment had previously been recorded are reviewed for possible reversal of the impairment at each reporting date.

l. Trade and other payables

Trade and other payables are obligations to pay for goods or services that have been acquired in the ordinary course of business from suppliers. Trade and other payables are classified as current liabilities if payment is due within one year or less.

m. Borrowings

Borrowings are initially recognized at fair value net of any financing fees. Borrowings are classified as current liabilities unless the Company has an unconditional right to defer settlement of the liability for more than 12 months. After initial recognition, borrowings are carried at amortized cost with any difference between the proceeds (net of financing fees) and the redemption value recognized in the consolidated statements of earnings over the period of the borrowing, using the effective interest method.

n. Exchangeable Shares

The Class B Units and Class D Units of the Partnership qualify as equity under IAS 32 and are economically equivalent to, and exchangeable into, the common shares of the Company ("Exchangeable Shares"). Therefore, Exchangeable Shares are presented as part of parent equity.

o. Income taxes

Income tax expense for the year is comprised of current and deferred tax. Income tax is recognized in the consolidated statements of earnings except to the extent it relates to items recognized in other comprehensive earnings or directly in equity.

Current income tax
Current income tax expense is based on the profit for the year as adjusted for items that are not taxable or not deductible. Current tax is calculated using tax rates and laws that were substantively enacted at the end of the reporting year. Management periodically evaluates positions taken in tax returns with respect to situations in which applicable tax regulation is subject to interpretation and establishes provisions where appropriate on the basis of amounts expected to be paid to the tax authorities.

Deferred tax
Deferred tax is recognized using the liability method on temporary differences arising between the tax bases of assets and liabilities and their carrying amounts in the consolidated financial statements.

Deferred tax is determined using tax rates (and laws) that have been enacted or substantively enacted by the consolidated balance sheet dates and are expected to apply when the related deferred tax asset is realized or the deferred tax liability is settled. The measurement of deferred tax assets and liabilities reflect the tax consequences that would follow from the manner in which the Company expects, at the end of the reporting period, to recover or settle the carrying amounts of its assets and liabilities.

Deferred tax assets are recognized only to the extent that it is probable that future taxable profit will be available against which the temporary differences can be utilized.

Deferred tax assets and liabilities are offset when there is a legally enforceable right to offset, and when the deferred tax assets and liabilities relate to income taxes levied by the same taxation authority where there is an intention to settle the balances on a net basis.

p. Revenue recognition

Royalty income is recognized on an accrual basis equal to 6% of reported sales from specific Pizza Pizza restaurants, and 9% of reported sales from specific Pizza 73 restaurants (collectively the "Royalty Pool"), provided that it is probable that the economic benefits will flow to the Company and the amount can be measured reliably, as restaurant sales occur.

Interest income is recognized using the effective interest rate method.

q. Dividends to shareholders

The amount of dividends is determined with reference to distributable cash, which is calculated as earnings for the year adjusted for non-cash charges less payment of interest on the borrowings and current income tax expense. Dividends to shareholders are recorded when declared, and paid monthly.

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

r. Segment reporting

Operating segments are reported in a manner consistent with the internal reporting provided to the chief operating decision-maker. The Board of Directors is the chief operating decision-maker, which is responsible for allocating resources and assessing performance of the operating segment. The Company has determined that it has one operating segment being the receipt of royalty income from the ownership of the Pizza Pizza and Pizza 73 Rights and Marks.

s. Critical accounting estimates and assumptions

The Company makes estimates and assumptions concerning the future. The resulting accounting estimates will, by definition, seldom equal the related actual results. The estimates and assumptions that have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within the next period are addressed below.

i. Impairment of Rights and Marks
Determining whether the Rights and Marks are impaired requires an estimation of the recoverable amount of the CGU in which the assets are included. The value-in-use calculation requires that the Company estimate the future cash flows expected to arise from the CGU and a suitable discount rate in order to calculate present value. The significant estimates and assumptions used in the impairment tests performed at December 31, 2018 and December 31, 2017 are disclosed in note 3.

ii. Consolidation
Determining whether the Partnership is consolidated by the Company or PPL requires judgment. The significant judgments that were used to apply IFRS 10 included assessing which party had the power or current ability to direct decisions over the value creation and maintenance of the Pizza Pizza Rights and Marks and Pizza 73 Rights and Marks in the context of the purpose and design of the Partnership. Based on an assessment of the activities of the Partnership, it was concluded that the Company controls the Partnership and therefore consolidates its operations.

iii. Fair value of derivatives
The fair value of the interest rate swaps that are not traded in an active market is determined using valuation techniques. The Company uses its judgment to select a variety of methods and makes assumptions that are mainly based on market conditions existing at the end of each reporting period.

3. Pizza Pizza and Pizza 73 Rights and Marks

	Pizza Pizza Rights and Marks $	Pizza 73 Rights and Marks $	Total $
Net book value at December 31, 2016	**262,703**	**73,667**	**336,370**
Accretion of value – January 1, 2017 vend-in	4,560	-	4,560
Accretion of value – January 1, 2016 true-up	75	129	204
Net book value at December 31, 2017	**267,338**	**73,796**	**341,134**
Accretion of value – January 1, 2018 vend-in	-	4,395	4,395
Accretion of value – January 1, 2017 true-up	2,887	-	2,887
Net book value at December 31, 2018	**270,225**	**78,191**	**348,416**

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

The Company, through its interest in the Partnership, acquired the Pizza Pizza Rights and Marks used in the Pizza Pizza quick service restaurant business in Canada in July 2005. Funding for the purchase came from the completion of the Pizza Pizza Royalty Income Fund's initial public offering in July 2005 and from proceeds of the term loan. Concurrent with the acquisition of the Pizza Pizza Rights and Marks, the Partnership granted PPL an exclusive and unlimited licence to use the Pizza Pizza Rights and Marks for an initial term of 99 years, for which PPL pays a royalty equal to 6% of system sales for all Pizza Pizza restaurants in the Royalty Pool, as defined in the Pizza Pizza Licence and Royalty Agreement.

In July 2007, the Company, through its interest in the Partnership, acquired the Pizza 73 Rights and Marks from Pizza 73. The purchase was funded by a public and private placement of Fund units and proceeds from the term loan. Concurrent with the acquisition of the Pizza 73 Rights and Marks, the Partnership granted PPL an exclusive and unlimited licence to use the Pizza 73 Rights and Marks for an initial term of 99 years, for which PPL pays a royalty equal to 9% of system sales of all Pizza 73 restaurants included in the Royalty Pool, as defined in the Pizza 73 Licence and Royalty Agreement.

Annually, on January 1 (the "Adjustment Date"), the Royalty Pool is 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. Similarly, on the Adjustment Date, the Royalty Pool is adjusted to include the forecasted system sales from new Pizza 73 restaurants opened on or before September 1 of the prior year, less any Pizza 73 restaurants permanently closed during the calendar year. In return for adding net additional royalty revenue, PPL receives the right to indirectly acquire additional shares of the Company through an adjustment to the Class B and Class D Exchange Multiplier (see note 6).

As a result of adding new restaurants to the Royalty Pool on January 1, 2018, the Rights and Marks increased by $4,395 in 2018 (2017 – $4,560) and increased by $2,887 related to the January 1, 2017 true-up (2017 – $204).

Impairment test on the Rights and Marks

The Company performed impairment tests for both the Pizza Pizza and Pizza 73 Rights and Marks at December, 31, 2018 and 2017 in accordance with the accounting policy as described in note 2. The recoverable amount of each CGU was determined based on value-in-use calculations. These calculations used cash flow projections based on financial budgets approved by the Board of Directors covering a one year period and extrapolated for three years. Cash flows beyond the four year period are estimated using a terminal growth rate as stated below.

The key assumptions used for the value-in-use calculation as at December 31, 2018 were as follows:

	Terminal Growth rate	Pre-tax discount rate
Pizza Pizza CGU	2.5%	9.5%
Pizza 73 CGU	2.5%	9.6%

The key assumptions used for the value-in-use calculation as at December 31, 2017 were as follows:

	Terminal Growth rate	Pre-tax discount rate
Pizza Pizza CGU	2.5%	9.1%
Pizza 73 CGU	2.5%	9.2%

The impairment tests performed resulted in no impairment of the Rights and Marks as at December 31, 2018 or 2017.

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

4. Trade and other payables

	December 31, 2018 $	December 31, 2017 $
Accruals	116	156
Other payables	335	329
Total trade and other payables	**451**	**485**

5. Borrowings

	December 31, 2018 $	December 31, 2017 $
Borrowings	47,000	47,000
Less: unamortized deferred financing fees	7	15
Total borrowings	**46,993**	**46,985**

The borrowings are a committed, non-revolving, five-year facility maturing on April 24, 2020, and were used to finance a portion of the acquisition costs of the Pizza Pizza Rights and Marks in 2005 and the Pizza 73 Rights and Marks in 2007. As security for repayment of the facility, PPL grants a continuing, general security interest subject to certain exceptions, in all present and acquired property of PPL, which may not be assigned without the prior consent of PPL. The facility bears interest at a fixed Bankers' Acceptance rate plus 0.875% to 1.375%, depending on the level of certain covenant calculations. The Partnership has entered into two interest rate swap agreements that fixed the facility interest rate until April 2020 at the Bankers' Acceptance rate of 1.875% plus a credit spread that was initially set at 0.875%. Included in the Bankers' Acceptance rate of 1.875% is 0.6% that relates to blending and extending the two previous swap agreements.

Interest expense incurred and paid on borrowings are as follows:

	December 31, 2018 $	December 31, 2017 $
Interest expense	1,270	924
Loan fee amortization	8	8
Interest expense incurred on borrowings	1,278	932
Interest paid to draw down swap termination and out-of-market costs	69	384
Interest paid on borrowings and loan fee amortization	1,347	1,316

Principal repayments on borrowings of $47,000 are due on April 24, 2020. The effective interest rate as at December 31, 2018 on the $47,000 was 2.75% (2017 – 2.75%).

The facility is subject to certain financial covenants, all of which have been met as at December 31, 2018. The borrowings are held within the Partnership, and therefore, the financial covenants for the borrowings pertain only to the results of the Partnership and not the Company.

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

6. Exchangeable Shares

As at December 31, 2018, PPL indirectly holds an effective 22.3% interest in the Company (December 31, 2017 – 21.1%) by holding all Class B and Class D Units of the Partnership. Subject to the Amended and Restated Exchange Agreement, PPL has the right to exchange one Class B or Class D Unit indirectly for that number of shares equal to the Class B Exchange Multiplier or Class D Exchange Multiplier, respectively, applicable at the date of such exchange, as described under "Licence and Royalty Adjustment of the Royalty Pool Changes in the Restaurants in the Royalty Pool".

Subject to the prior rights of the Company's Class C Limited Partnership units, PPL's Class B and Class D Units are entitled to receive monthly distributions, and the Company's Class A Limited Partnership units receive the remaining available, monthly distributable cash.

The equivalent number of Class B and Class D Exchangeable Shares outstanding are as follows:

	Number of Class B Exchangeable Shares	Number of Class D Exchangeable Shares	Total Number of Exchangeable Shares	Amount $
At December 31, 2016	**4,559,542**	**1,743,307**	**6,302,849**	**65,501**
Add: January 1, 2017 vend-in	277,519	-	277,519	4,560
Add: January 1, 2016 true-up	5,422	9,313	14,735	204
At December 31, 2017	**4,842,483**	**1,752,620**	**6,595,103**	**70,265**
Add: January 1, 2018 vend-in	-	276,781	276,781	4,395
Add: January 1, 2017 true-up	175,727	-	175,727	2,887
At December 31, 2018	**5,018,210**	**2,029,401**	**7,047,611**	**77,547**

a. 2017 Royalty Pool Adjustment

In early January 2018, adjustments to royalty payments and PPL's Class B Exchange Multiplier were made based on the actual performance of the 23 new restaurants added to the Royalty Pool on January 1, 2017. As a result of the adjustments, the new Class B Exchange Multiplier is 2.000691 and Class B Units can be exchanged for 5,018,210 shares, which is an increase of 175,727 shares, effective January 1, 2017.

In early January 2018, adjustments to royalty payments and PPL's Class D Exchange Multiplier were made based on the actual performance of the four Pizza 73 restaurants added to the Royalty Pool on January 1, 2017. As a result of the adjustments, the new Class D Exchange Multiplier remains unchanged at 17.52620 and Class D Units can be exchanged for 1,752,620 shares effective January 1, 2017.

b. 2018 Royalty Pool Adjustment – Class B Exchange Multiplier

On January 1, 2018, one net Pizza Pizza restaurant was added to the Royalty Pool as a result of 17 new restaurants opening and 16 closing from January 1, 2017 to December 31, 2017. The total number of Pizza Pizza restaurants in the Royalty Pool has increased to 652. The additional system sales from the 17 new restaurants are estimated at $3,860 annually, less sales of $3,861 from 16 permanently closed Pizza Pizza restaurants, resulting in the Estimated Determined Amount being ($1). As per the Pizza Pizza Royalty Limited Partnership agreement, whenever the Estimated Determined Amount is negative it shall be deemed to be zero. Accordingly, the Class B Exchange Multiplier remained unchanged at 2.000691. The second adjustment to the Class B Exchange Multiplier will be adjusted to be effective January 1, 2018, once the actual performance of the new restaurants is determined in early 2019. See Subsequent Events – Note 13.

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

c. 2018 Royalty Pool Adjustment – Class D Exchange Multiplier

On January 1, 2018, six net Pizza 73 restaurants were added to the Royalty Pool as a result of eight new restaurants opening between September 2, 2016 and September 1, 2017 and two restaurants closing between January 1, 2017 and December 31, 2017. The forecasted additional system sales from the eight new restaurants are estimated at $4,836 annually, less $260 in system sales attributable to the two closed Pizza 73 restaurants, resulting in net estimated Pizza 73 sales of $4,576 added to the Royalty Pool. The total number of Pizza 73 restaurants in the Royalty Pool has increased to 106. The yield of the shares was determined to be 5.39% calculated using $15.88 as a weighted average share price. Weighted average share price is calculated based on the market price of the shares traded on the Toronto Stock Exchange during the period of twenty consecutive days ending on the fifth trading day before January 1, 2018. As a result of the contribution of the additional net sales to the Royalty Pool, the Class D Exchange Multiplier increased fractionally by 80% of the total adjustment or 2.76781 (or 276,781 exchangeable shares); the new Class D Multiplier is 20.29401 and the Class D Units can be exchanged for 2,029,401 shares effective January 1, 2018. This adjustment will also increase the entitlement of the holders of the Class D units to distributions of cash and allocations of income from the Partnership. The second adjustment to the Class D Exchange Multiplier will be adjusted to be effective January 1, 2018, once the actual performance of the new restaurants is determined in early 2019. See Subsequent Events – Note 13.

d. Pizza Pizza Royalty Corp. Outstanding Shares

PPL's Class B equivalent Share entitlement is unchanged for 2018, due to the fact that, in any year that the forecasted system sales (less closed restaurant sales and other adjustments) are negative, as was the case with the Class B equivalent Share entitlement calculation for 2018, no increase or decrease in the Exchange Multiplier is made. PPL will only have a Class B equivalent Share entitlement for 2018 if the actual sales performance of the 17 new Pizza Pizza restaurants significantly exceeds forecasted system sales and yields net, positive sales, which will be determined in early 2019. See Subsequent Events – Note 13.

In exchange for adding the forecasted Pizza 73 system sales to the Royalty Pool, PPL has received 276,781 additional equivalent Shares (through the change to the Class D Exchange Multiplier). These represent 80% of the forecasted equivalent Shares entitlement to be received (345,977 equivalent Shares represent 100%), with the final equivalent Shares entitlement to be determined when the new restaurants' 2018 actual sales performance is known with certainty in early 2019. See Subsequent Events – Note 13.

After giving effect to PPL's entitlement to additional equivalent Shares at January 1, 2018, PPL owns equivalent Shares representing 22.3% of the Company's fully diluted shares.

7. Income taxes

The provision for income taxes differs from that which would be obtained by applying the statutory tax rate as a result of the following:

	December 31, 2018 $	December 31, 2017 $
Earnings for the year before income taxes	33,568	34,037
Combined Canadian federal and provincial rates	26.5%	26.5%
Computed expected income tax expense	**8,896**	**9,020**
Earnings not taxable in the Company	(1,984)	(1,903)
Other	(230)	(128)
Income tax expense	**6,682**	**6,989**

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

The components of the deferred tax liability are as follows:

	December 31, 2018 $	December 31, 2017 $
Pizza Pizza and Pizza 73 Rights and Marks	20,246	19,301
Deferred financing fees	-	1
Interest rate swap	299	297
Deferred tax liability	**20,545**	**19,599**

An analysis of the deferred tax liabilities is as follows:

	December 31, 2018 $	December 31, 2017 $
Deferred tax liabilities to be settled after more than a year	20,545	19,598
Deferred tax liabilities to be settled within a year	-	1
Deferred tax liability	**20,545**	**19,599**

The movement in the deferred tax liabilities is as follows:

	December 31, 2018 $	December 31, 2017 $
Opening balance – deferred tax liability	19,599	18,207
Change in other comprehensive earnings – interest rate swap	(8)	157
Change in temporary differences	954	1,235
Deferred tax liability	**20,545**	**19,599**

8. Share capital

a. Authorized

The Company is authorized to issue an unlimited number of common shares and an unlimited number of preference shares, issuable in series. As at December 31, 2018, 24,618,392 common shares and no preference shares are issued and fully paid. Each common share carries the right to one vote at meetings of shareholders, other than meetings of holders of another class of shares, and to participate equally and rateably in dividends of the Company, if any, and in the remaining property and assets of the Company upon its liquidation, dissolution or wind-up. Each series of preference shares issued shall have rights, privileges, restrictions and conditions as determined by the Board of Directors prior to their issuance. Preference shares may carry voting rights as determined by the Board of Directors and are entitled to a preference over the common shares in the remaining property and assets of the Company in the event of its liquidation, dissolution or wind-up.

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

b. Issued

The following is a summary of the activity during the year:

	December 31, 2018		December 31, 2017	
Share capital	Number of Shares	Amount $	Number of Shares	Amount $
Shares, beginning of year	24,618,392	242,030	24,618,392	242,030
Shares, end of year	**24,618,392**	**242,030**	**24,618,392**	**242,030**

The Company's objectives when managing capital, which remained unchanged, are to:

i) Safeguard its ability to continue as a going concern, so that it can continue to provide returns for shareholders and benefits for other stakeholders;
ii) Provide an adequate return to shareholders while maintaining adequate reserves; and
iii) Ensure sufficient liquidity to pursue its growth strategy while taking a conservative approach towards financial leverage and management of financial risk.

The Company evaluates its capital as all components of equity, other than amounts in accumulated other comprehensive earnings relating to the cash flow hedges.

The Company's amount of capital is set in proportion to risk. The Company manages its structure and makes adjustments in light of changes in economic conditions and risk characteristics of the underlying assets. The Company's primary use of capital was to finance acquisitions, supported by the credit facility at the Partnership level.

c. Earnings per share

The basic earnings per share is calculated by dividing earnings for the year by the weighted average number of shares outstanding during the year. The denominator in basic earnings per share includes PPL's Class B and Class D Exchangeable Shares, since they are exchangeable into and economically equivalent to the Company's common shares. There were no potentially dilutive instruments outstanding during the years ended December 31, 2018 or 2017.

The following table illustrates the computation of basic and diluted earnings per share:

	December 31, 2018	December 31, 2017
Weighted average number of:		
Common shares	24,618,392	24,618,392
Exchangeable Shares (note 6)	7,047,611	6,595,103
Weighted average number of shares outstanding – basic and diluted	31,666,003	31,213,495
Basic and diluted earnings per share	**$0.85**	**$0.87**

9. Royalty income

Royalty income earned by the Company has been derived as shown in the table below:

	December 31, 2018	December 31, 2017
(in thousands of dollars, except number of restaurants in the Royalty Pool)		
Restaurants in Royalty Pool	758	751
System sales reported by Pizza Pizza restaurants in the Royalty Pool	458,748	466,249
System sales reported by Pizza 73 restaurants in the Royalty Pool	87,595	84,878
Total system sales	**546,343**	**551,127**
Royalty – 6% on Pizza Pizza system sales	27,525	27,975
Royalty – 9% on Pizza 73 system sales	7,883	7,639
Royalty income	**35,408**	**35,614**

System sales do not represent the consolidated operating results of the Company but are used to calculate the royalty income as presented above.

10. Related party transactions and balances

PPL is a related party by virtue of holding Class B and Class D Exchangeable Shares that are exchangeable into Shares of the Company. Disclosure related to these Exchangeable Shares is provided in note 6.

PPL, pursuant to the Partnership Agreement, is providing certain administrative services to the Company. The fee for these services, which on an annual basis shall not exceed $25, has been waived for the year.

The Company has a receivable from PPL as at December 31, 2018 of $3,156 (December 31, 2017 – $3,288) and a payable to PPL as at December 31, 2018 of $687 (December 31, 2017 – $762). The receivable relates to royalty amounts receivable from the Royalty Pool system sales, while the payable to PPL relates to distributions payable to PPL by virtue of holding Class B and Class D Exchangeable Shares and other expenses paid by PPL on behalf of the Partnership.

Transactions with related parties are in the normal course of operations. No amount of related party balances was written off during the years ended December 31, 2018 and 2017.

11. Consolidated statements of cash flows information

Changes in non-cash working capital are as follows:

	December 31, 2018 $	December 31, 2017 $
Receivable from Pizza Pizza Limited	132	23
Trade and other receivables	(10)	16
Trade and other payables	(34)	5
Payable to Pizza Pizza Limited	(75)	189
Income taxes payable	(136)	(126)
Changes in non-cash working capital	**(123)**	**107**

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

12. Financial risk management

Fair value

The following table presents the carrying amount and the fair value of the Company's financial instruments. Amortized cost is calculated using the effective interest rate method. Fair value is estimated as disclosed below. These amounts represent point-in-time estimates and may not reflect fair value in the future. These calculations are subjective in nature, involve uncertainties and are a matter of significant judgment. The only financial instruments carried at fair value in the consolidated statements of financial position are the derivative financial instruments.

The carrying amounts of the cash, short-term investments, receivable from PPL, trade and other receivables, trade and other payables, dividends payable to shareholders, and payable to PPL all approximate their fair value given the short-term maturity of these financial instruments.

The carrying value and fair value of all financial instruments are as follows:

	December 31, 2018		December 31, 2017	
	Carrying value $	Fair value $	Carrying value $	Fair value $
Cash	1,160	1,160	2,122	2,122
Short-term investments	2,750	2,750	2,750	2,750
Receivable from Pizza Pizza Limited	3,156	3,156	3,288	3,288
Trade and other receivables	75	75	65	65
Derivative financial instruments (asset)	203	203	177	177
Trade and other payables	451	451	485	485
Dividends payable to shareholders	1,755	1,755	1,755	1,755
Payable to Pizza Pizza Limited	687	687	762	762
Borrowings	46,993	47,000	46,985	47,000

The different fair value hierarchy levels are as follows:

- Level 1: Quoted prices (unadjusted) in active markets for identical financial assets or financial liabilities;
- Level 2: Inputs other than quoted prices included within Level 1 that are observable for the financial asset or financial liability, either directly or indirectly; and
- Level 3: Inputs for the financial assets or financial liabilities that are not based on observable market data.

As at December 31, 2018, inputs used to fair value the derivative financial instruments were Level 2 and based on observable inputs available for similar assets and liabilities in the active markets, as provided by sources independent from the Company.

The fair value of the borrowings was determined using the discounted cash flow method, a generally accepted valuation technique. The discount factor is based on market rates for debt with similar terms and remaining maturities and based on the Company's credit risk. The Company has no plans to prepay these instruments prior to maturity. The valuation is determined using Level 2 inputs, which are observable inputs or inputs that can be corroborated by observable market data for substantially the full term of the asset or liability.

Credit risk

The Company is exposed to credit risk in the event of non-payment by PPL and due to the fact that PPL's operations are all within the same segment, commercial food services. The credit risk is mitigated since monthly royalty payments are received from PPL based on sales generated by a large number of Pizza Pizza and Pizza 73 restaurants in diverse geographical regions. These royalty payments are used to fund monthly distributions to the Company on its Class A and C Limited Partnership Units and to fund distributions to PPL on its Class B and D Partnership Units. All trade and other receivables, and the amount receivable from PPL, are current and no amounts have been written off or provided for during the year.

Credit risk also arises from cash and derivative financial instruments with banks and financial institutions. The Company places its cash and transacts in derivative financial instruments with institutions of high creditworthiness.

Maximum credit risk exposure, which is equivalent to the carrying amount, represents the loss that would be incurred if all of the Company's counterparties were to default at the same time.

Liquidity risk

The Company is subject to liquidity risk with respect to trade and other payables, borrowings, provision for other charges and funding the distributions payable to Company shareholders. The Company receives monthly royalties from PPL, and the Company is of the opinion that this risk is mitigated by the large number of Pizza Pizza and Pizza 73 restaurants in diverse geographical areas that generate the royalties used to fund the monthly royalties.

The dividends payable to Company shareholders and trade and other payables, are expected to be paid within 30 days of the date of the consolidated statements of financial position.

Interest rate risk

The Company's interest rate risk arises from borrowings. Borrowings issued at variable rates expose the Company to interest rate cash flow risk, which is offset by entering into interest rate swaps that fix the interest payable.

The designated hedging relationship was effective as at December 31, 2018.

The interest rate swaps eliminate the Company's interest rate cash flow risk by fixing the rate of interest that is paid on the borrowings. However, the Company is still exposed to fair value interest rate risk as a result of fair value movements in the value of the interest rate swaps that are recorded in other comprehensive earnings (loss) to the extent that the interest rate swaps are highly effective as cash flow hedges. If interest rates changed by plus/minus 10% of the existing rate, total comprehensive earnings and equity would change by plus/minus $108 as at December 31, 2018 (December 31, 2017 – $191) based on movements in the fair value of the interest rate swaps.

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

13. Subsequent events

The chart below shows the Company shares that would be outstanding if all of the Class B and Class D Units held by PPL were converted to Company shares after accounting for their respective multipliers and adjustments as described below.

Shares outstanding & issuable on January 1, 2019		
Shares outstanding		24,618,392
Class B equivalent Shares held by PPL at December 31, 2018	5,018,210	
PPL additional Class B equivalent Shares - True-up Holdback as at December 31, 2018	-	
Additional PPL Class B equivalent Shares as of January 1, 2019	150,398	5,168,608
Class D equivalent Shares held by PPL at December 31, 2018	2,029,401	
PPL additional Class D equivalent Shares - True-up Holdback as at December 31, 2018	98,380	
Additional PPL Class D equivalent Shares as of January 1, 2019	52,925	2,180,706
Number of fully diluted shares		31,967,706
		23.0%

a. 2018 Royalty Pool Adjustment

In early January 2019, adjustments to royalty payments and PPL's Class B Exchange Multiplier were made based on the actual performance of the 17 new restaurants added to the Royalty Pool on January 1, 2018. As a result of the adjustments, the Class B Exchange Multiplier remains unchanged at 2.000691 and Class B Units can be exchanged for 5,018,210 shares effective January 1, 2018.

In early January 2019, adjustments to royalty payments and PPL's Class D Exchange Multiplier were made based on the actual performance of the eight Pizza 73 restaurants added to the Royalty Pool on January 1, 2018. As a result of the adjustments, the Class D Exchange Multiplier is 21.27782 and Class D Units can be exchanged for 2,127,782 shares effective January 1, 2018.

b. 2019 Royalty Pool Adjustment – Class B Exchange Multiplier

On January 1, 2019, eight net Pizza Pizza restaurants were added to the Royalty Pool as a result of 18 new restaurants opening and 10 closing from January 1, 2018 to December 31, 2018. The total number of Pizza Pizza restaurants in the Royalty Pool has increased to 660. The additional system sales from the 18 new restaurants are estimated at $5,860 annually, less sales of $2,135 from 10 permanently closed Pizza Pizza restaurants, resulting in net estimated Pizza Pizza sales of $3,725 added to the Royalty Pool. The yield of the shares was determined to be 9.5% calculated using $9.05 as a weighted average share price. Weighted average share price is calculated based on the market price of the shares traded on the Toronto Stock Exchange during the period of twenty consecutive days ending on the fifth trading day before January 1, 2019. As a result of the contribution of the additional net sales to the Royalty Pool, the Class B Exchange Multiplier increased fractionally by 80% of the total adjustment or 0.059961; the new Class B Multiplier is 2.060652. 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, 2019, once the actual performance of the new restaurants is determined in early 2020.

c. 2019 Royalty Pool Adjustment – Class D Exchange Multiplier

On January 1, 2019, six net Pizza 73 restaurants were added to the Royalty Pool as a result of seven new restaurants opening between September 2, 2017 and September 1, 2018 and one restaurant closing between January 1, 2018 and December 31, 2018. The forecasted additional system sales from the seven new restaurants are estimated at $2,472 annually, less $161 in system sales attributable to the one closed Pizza 73 restaurant. The net estimated sales were further reduced by $1,438 in system sales attributable to certain restaurants previously added to the Royalty Pool whose territory adjusted a previously existing restaurant; resulting in overall net estimated Pizza 73 sales of $873 added to the Royalty Pool. The total number of Pizza 73 restaurants in the Royalty Pool has increased to 112. The yield of the shares was determined to be 9.5% calculated using $9.05 as a weighted average share price. Weighted average share price is calculated based on the market price of the shares traded on the Toronto Stock Exchange during the period of twenty consecutive days ending on the fifth trading day before January 1, 2019. As a result of the contribution of the additional net sales to the Royalty Pool, the Class D Exchange Multiplier increased fractionally by 80% of the total adjustment or 0.52925; the new Class D Multiplier is 21.80706. This adjustment will also increase the entitlement of the holders of the Class D units to distributions of cash and allocations of income from the Partnership. The second adjustment to the Class D Exchange Multiplier will be adjusted to be effective January 1, 2019, once the actual performance of the new restaurants is determined in early 2020.

d. Pizza Pizza Royalty Corp. Outstanding Shares

In exchange for adding the forecasted Pizza Pizza system sales to the Royalty Pool, PPL has received 150,398 additional equivalent Shares (through the change to the Class B Exchange Multiplier). These represent 80% of the forecasted equivalent Shares entitlement to be received (187,997 equivalent Shares represent 100%), with the final equivalent Shares entitlement to be determined when the new restaurants' 2019 actual sales performance is known with certainty in early 2020.

In exchange for adding the forecasted Pizza 73 system sales to the Royalty Pool, PPL has received 52,925 additional equivalent Shares (through the change to the Class D Exchange Multiplier). These represent 80% of the forecasted equivalent Shares entitlement to be received (66,156 equivalent Shares represent 100%), with the final equivalent Shares entitlement to be determined when the new restaurants' 2019 actual sales performance is known with certainty in early 2020.

After giving effect to PPL's entitlement to additional equivalent Shares at January 1, 2019, PPL owns equivalent Shares representing 23.0% of the Company's fully diluted shares.