

SIR Royalty Income Fund

Consolidated Financial Statements
December 31, 2018 and 2017



Independent auditor's report

To the Unitholders of SIR Royalty Income Fund

Our opinion

In our opinion, the accompanying consolidated financial statements present fairly, in all material respects, the financial position of SIR Royalty Income Fund and its subsidiaries, (together, the Company) as at December 31, 2018 and 2017, and its financial performance and its cash flows for the years then ended in accordance with International Financial Reporting Standards as issued by the International Accounting Standards Board (IFRS).

What we have audited

The Company's consolidated financial statements comprise:

- the consolidated statements of financial position as at December 31, 2018 and 2017;
- the consolidated statements of earnings and comprehensive income for the years then ended;
- the consolidated statements of changes in unitholders' equity for the years then ended;
- the consolidated statements of cash flows for the years then ended; and
- the notes to the consolidated financial statements, which include a summary of significant accounting policies.

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 believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Independence

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. We have fulfilled our other ethical responsibilities in accordance with these requirements.

Other information

Management is responsible for the other information. The other information comprises the Management's Discussion and Analysis, which we obtained prior to the date of this auditor's report and the information,

PricewaterhouseCoopers LLP
PwC Centre, 354 Davis Road, Suite 600, Oakville, Ontario, Canada L6J 0C5
T: +1 905 815 6300, F: +1 905 815 6499

"PwC" refers to PricewaterhouseCoopers LLP, an Ontario limited liability partnership.



other than the consolidated financial statements and our auditor's report thereon, included in the annual report, which is expected to be made available to us after that date.

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

In connection with our audit of the consolidated financial statements, our responsibility is to read the other information identified above 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.

If, based on the work we have performed on the other information that we obtained prior to the date of this auditor's report, 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. When we read the information, other than the consolidated financial statements and our auditor's report thereon, included in the annual report, if we conclude that there is a material misstatement therein, we are required to communicate the matter to those charged with governance.

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 IFRS, 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 Company'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 Company'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 Company'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 Company 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.
- Obtain sufficient appropriate audit evidence regarding the financial information of the entities or business activities within the Company to express an opinion on the consolidated financial statements. We are responsible for the direction, supervision and performance of the group audit. We remain solely responsible for our audit opinion.

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 Adam Boutros.

PricewaterhouseCoopers LLP

Chartered Professional Accountants, Licensed Public Accountants

Oakville, Ontario
March 12, 2019

SIR Royalty Income Fund
 Consolidated Statements of Financial Position
 As at December 31, 2018 and 2017

	December 31, 2018 \$	December 31, 2017 \$
Assets		
Current assets		
Cash	296,246	373,651
Prepaid expenses and other assets	33,669	31,587
Amounts due from related parties (note 10)	4,164,408	3,927,558
	4,494,323	4,332,796
Loan receivable from SIR Corp. (notes 3, 4 and 5)	36,000,000	40,000,000
Investment in SIR Royalty Limited Partnership (note 6)	50,984,321	50,984,321
	91,478,644	95,317,117
Liabilities		
Current liabilities		
Accounts payable and accrued liabilities	105,352	121,788
Income taxes payable	139,895	499,904
Amounts due to related parties (note 10)	2,822,682	2,521,071
	3,067,929	3,142,763
Deferred income taxes (note 14)	1,893,000	1,841,000
	4,960,929	4,983,763
Fund units (note 8)	96,169,787	96,169,787
Deficit	(9,652,072)	(5,836,433)
Total unitholders' equity	86,517,715	90,333,354
	91,478,644	95,317,117
Subsequent events (notes 8 and 10)		

(Signed) Peter Luit
 Peter Luit, Director

(Signed) Peter Fowler
 Peter Fowler, Director

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

SIR Royalty Income Fund

Consolidated Statements of Earnings and Comprehensive Income

For the years ended December 31, 2018 and 2017

	Year ended December 31, 2018 \$	Year ended December 31, 2017 \$
Equity income from SIR Royalty Limited Partnership (notes 6 and 10)	11,489,779	11,051,459
Interest income on SIR Loan (note 5)	-	3,000,000
Change in estimated fair value of the SIR Loan (notes 3 and 5)	<u>(3,500,000)</u>	<u>-</u>
	7,989,779	14,051,459
General and administrative expenses (note 10)	<u>443,075</u>	<u>439,323</u>
Earnings before income taxes	7,546,704	13,612,136
Income tax expense (note 14)	<u>2,431,535</u>	<u>3,798,017</u>
Net earnings and comprehensive income for the year	<u>5,115,169</u>	<u>9,814,119</u>
Basic and diluted earnings per Fund unit (note 9)	\$ 0.61	\$ 1.17

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

SIR Royalty Income Fund

Consolidated Statements of Changes in Unitholders' Equity

For the years ended December 31, 2018 and 2017

	Year ended December 31, 2018			
	Number of Fund units	Amount \$	Deficit \$	Total \$
Balance - Beginning of year as previously reported	8,375,567	96,169,787	(5,836,433)	90,333,354
Change in accounting policy (note 3)	-	-	1,161,750	1,161,750
Balance - Beginning of year (note 3)	8,375,567	96,169,787	(4,674,683)	91,495,104
Net earnings for the year	-	-	5,115,169	5,115,159
Distributions declared and paid (note 8)	-	-	(10,092,558)	(10,092,558)
Balance - End of year	8,375,567	96,169,787	(9,652,072)	86,517,715

	Year ended December 31, 2017			
	Number of Fund units	Amount \$	Deficit \$	Total \$
Balance - Beginning of year	8,375,567	96,169,787	(5,934,894)	90,234,893
Net earnings for the year	-	-	9,814,119	9,814,119
Distributions declared and paid (note 8)	-	-	(9,715,658)	(9,715,658)
Balance - End of year	8,375,567	96,169,787	(5,836,433)	90,333,354

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

SIR Royalty Income Fund

Consolidated Statements of Cash Flows

For the years ended December 31, 2018 and 2017

	Year ended December 31, 2018 \$	Year ended December 31, 2017 \$
Cash provided by (used in)		
Operating activities		
Net earnings for the year	5,115,169	9,814,119
Items not affecting cash		
Change in estimated fair value of the SIR Loan (notes 3 and 5)	3,500,000	-
Current income taxes (note 14)	3,717,785	3,742,017
Deferred income taxes (note 14)	(1,286,250)	56,000
Equity income from SIR Royalty Limited Partnership (notes 6 and 10)	(11,489,779)	(11,051,459)
Distributions received from SIR Royalty Limited Partnership (note 10)	11,252,929	10,835,529
Interest received on SIR Loan (note 5)	3,000,000	-
Income taxes paid	(4,077,794)	(3,430,949)
Net change in non-cash working capital items (note 12)	283,093	(216,844)
	<hr/>	<hr/>
	10,015,153	9,748,413
Financing activities		
Distributions paid to unitholders	(10,092,558)	(9,715,658)
	<hr/>	<hr/>
Change in cash during the year	(77,405)	32,755
Cash - Beginning of year	373,651	340,896
	<hr/>	<hr/>
Cash - End of year	296,246	373,651
	<hr/>	<hr/>

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

SIR Royalty Income Fund

Notes to Consolidated Financial Statements

December 31, 2018 and December 31, 2017

1 Nature of operations and seasonality

Nature of operations

SIR Royalty Income Fund (the Fund) is a trust established on August 23, 2004 under the laws of the Province of Ontario, Canada.

On October 1, 2004, the Fund filed a final prospectus for a public offering of units of the Fund. The net proceeds of the offering to the Fund of \$51,166,670 were used by the Fund to acquire, directly, certain bank debt of SIR Corp. (the SIR Loan) and, indirectly, through SIR Holdings Trust (the Trust), all of the Ordinary LP Units of SIR Royalty Limited Partnership (the Partnership). The Partnership owns the Canadian trademarks (the SIR Rights) formerly owned or licensed by SIR Corp. (SIR) or its subsidiaries and used in connection with the operation of the majority of SIR's restaurants in Canada (the SIR Restaurants). The Partnership has granted SIR a 99-year licence to use the SIR Rights in most of Canada in consideration for a Royalty, payable by SIR to the Partnership, equal to 6% of the revenues of the restaurants included in the Royalty Pooled Restaurants (the Licence and Royalty Agreement). The Fund indirectly participates in the revenues generated under the Licence and Royalty Agreement through its Investment in the Partnership (note 4).

The address of the registered office of the Fund is 5360 South Service Road, Suite 200, Burlington, Ontario. The consolidated financial statements were approved by the Board of Trustees on March 8, 2019.

Seasonality

The full-service restaurant sector of the Canadian food-service industry, in which SIR operates, experiences seasonal fluctuations in revenues. Favourable summer weather generally results in increased revenues during SIR's fourth quarter (ending the last Sunday in August) when patios can be open. Additionally, certain holidays and observances also affect dining patterns both favourably and unfavourably. Accordingly, equity income from the Partnership recognized by the Fund will vary in conjunction with the seasonality in revenues experienced by SIR.

2 Basis of presentation

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

3 Summary of significant accounting policies

The significant accounting policies used in the preparation of the consolidated financial statements are as follows:

Basis of measurement

The consolidated financial statements have been prepared under the historical cost convention, with the exception of the loan receivable from SIR, which is recognized at fair value.

SIR Royalty Income Fund

Notes to Consolidated Financial Statements

December 31, 2018 and December 31, 2017

Consolidation

The Fund prepares its consolidated financial statements in accordance with IFRS and include the accounts of the Fund and its subsidiaries, namely the Trust and SIR GP Inc. All intercompany accounts and transactions have been eliminated.

The Fund consolidates an investee when it is exposed to or has rights to variable returns from its involvement with the investee and has the ability to affect these returns through its power over the investee. Subsidiaries are fully consolidated from the date on which control is obtained by the Fund and are deconsolidated from the date control ceases.

Use of estimates

The preparation of these consolidated financial statements requires management to make estimates and assumptions that affect income and expenses during the reporting periods, in addition to the reported amounts of assets and liabilities and the disclosure of contingent liabilities at the date of the consolidated financial statements. Actual results could differ materially from those estimates in the near term.

Financial instruments

Financial assets and liabilities are recognized when the Fund becomes a party to the contractual provisions of the instrument. Financial assets are derecognized when the rights to receive cash flows from the assets have expired or have been transferred and the Fund has transferred substantially all risks and rewards of ownership.

Financial assets and liabilities are offset and the net amount is reported in the consolidated statements of financial position when there is a legally enforceable right to offset the recognized amounts and there is an intention to settle on a net basis, or realize the asset and settle the liability simultaneously.

Under IFRS 9, financial assets are classified and measured based on the business model in which they are held and the characteristics of their contractual cash flows. At initial recognition, the Fund classifies its financial instruments in the following categories, depending on the purpose for which the instruments were acquired:

- i) Amortized cost: A financial asset shall be measured at amortized cost if both of the following conditions are met:
 - (a) The financial asset is held in order to collect contractual cash flows; and
 - (b) The contractual terms of the financial asset give rise on specific dates to cash flows that are solely payments of principal and interest on the principal amount outstanding.

SIR Royalty Income Fund

Notes to Consolidated Financial Statements

December 31, 2018 and December 31, 2017

- ii) Fair value through profit and loss (FVTPL): For financial assets classified as measured at FVTPL or designated at FVTPL, changes in fair value are recognized in the statement of earnings and comprehensive income as they arise.
- iii) Financial liabilities at amortized cost: Financial liabilities at amortized cost comprise accounts payable and accrued liabilities and amounts due to related parties. Accounts payable and accrued liabilities, and amounts due to related parties are initially recognized at the amount required to be paid less, when material, a discount to reduce the financial liabilities to fair value. Subsequently, accounts payable and accrued liabilities, and amounts due to related parties are measured at amortized cost using the effective interest method.

Financial liabilities are classified as current liabilities if payment is due within 12 months, otherwise, they are presented as non-current liabilities.

Impairment of financial assets

At each reporting date, the Fund assesses whether there is objective evidence that a financial asset at amortized cost is impaired. If such evidence exists, the Fund recognizes an impairment loss as the difference between the amortized cost of the loan or receivable and the present value of the estimated future cash flows, discounted using the instrument's original effective interest rate. The carrying amount of the asset is reduced by this amount either directly or indirectly through the use of an allowance account.

Impairment losses on financial assets carried at amortized cost are reversed in subsequent periods if the amount of the loss decreases and the decrease can be related objectively to an event occurring after the impairment was recognized.

Investments in associates and unconsolidated structured entities

Associates are entities over which the Fund has significant influence, but not control, and include the investment in the Partnership.

A structured entity is an entity that has been designed so that voting or similar rights are not the dominant factor in deciding who controls the entity, such as when any voting rights relate to administrative tasks only, and the relevant activities are directed by means of contractual arrangements. The Fund has determined that its investment in the Partnership is an investment in a structured entity.

The Partnership is a structured entity established to own the Canadian trademarks used in connection with the operations of the SIR Restaurants. SIR consolidates the Partnership, as the sale of Canadian trademarks to the Partnership had no impact on SIR's use of the Canadian trademarks. The Fund has voting control of SIR GP Inc., the managing general partner for the Partnership, with an 80% ownership of SIR GP Inc.'s common shares; however, the Fund does not have the ability to affect the returns on the investment in the Partnership through its power over the Partnership. Accordingly, since the Fund is able to significantly influence the Partnership, it is accounted for as an investment in an associate.

The financial results of the Fund's investments in associates are included in the Fund's consolidated results according to the equity method. Subsequent to the acquisition date, the Fund's share of profits or losses of associates is recognized in the consolidated statements of earnings and its share of other comprehensive income of associates is included in other comprehensive income.

SIR Royalty Income Fund

Notes to Consolidated Financial Statements

December 31, 2018 and December 31, 2017

Unrealized gains on transactions between the Fund and an associate are eliminated to the extent of the Fund's interest in the associate. Unrealized losses are also eliminated unless the transaction provides evidence of an impairment of the asset transferred. Dilution gains and losses arising from changes in interests in investments in associates are recognized in the consolidated statements of earnings.

The Fund assesses whether there is any objective evidence that its interest in its associate is impaired. If impaired, the carrying value of the Fund's share of the underlying assets of the associate is written down to its estimated recoverable amount (being the higher of fair value less cost to sell and value in use) and charged to the consolidated statements of earnings.

Earnings per Fund unit

Earnings per Fund unit are based on the weighted average number of Fund units outstanding during the period. Diluted earnings per Fund unit are calculated to reflect the dilutive effect, if any, of SIR exercising its right to exchange its Class A GP units into Fund units at the beginning of the period.

Distributions

Distributions to unitholders are intended to be made monthly in arrears and are recorded when declared by the Trustees of the Fund. Distributions to unitholders are recorded as a financing activity in the consolidated statements of cash flows.

Income taxes

Income taxes comprise current and deferred taxes and are recognized in the consolidated statements of earnings and comprehensive income.

Current income taxes are the expected taxes payable on taxable income for the year, using tax rates enacted, or substantively enacted, at the end of the reporting period.

In general, deferred income taxes are recognized in respect of temporary differences arising between the tax bases of assets and liabilities and their carrying amounts in the consolidated financial statements. Deferred income taxes are determined on a non-discounted basis using tax rates and laws that have been enacted, or substantively enacted, at the consolidated statements of financial position date and are expected to apply when the deferred income tax asset or liability is settled. Deferred income tax assets are recognized to the extent it is probable that the assets can be recovered.

SIR Royalty Income Fund

Notes to Consolidated Financial Statements

December 31, 2018 and December 31, 2017

Adoption of new accounting standards and amendments

IFRS 9, Financial Instruments

In July 2014, the IASB issued the final version of IFRS 9, Financial Instruments, bringing together the classification and measurement, impairment and hedge accounting phases of the IASB's project to replace IAS 39 Financial Instruments: Recognition and Measurement. The Fund adopted IFRS 9 using the modified retrospective approach which requires that the adjustment be recorded in the opening deficit and comparatives are not restated. IFRS 9 requires the Fund to record a provision for the expected credit losses on its amounts due from related parties which management has determined is not material to the consolidated financial statements.

Due to the ability of SIR to exchange the SIR Loan with its Class C GP Units of the Partnership, the SIR Loan does not meet the solely principal and interest requirement. Accordingly, under IFRS 9, the SIR Loan will be recognized at fair value with changes in fair value being recorded in the consolidated statement of earnings. As at January 1, 2018, the estimated fair value of the SIR Loan was approximately \$42,500,000. The difference between the fair value and the carrying value of \$40,000,000 was recorded in the deficit. The total impact on the Fund's unitholders' equity is as follows:

	Number of Fund units	Amount \$	Deficit \$	Total \$
Balance – December 31, 2017	8,375,567	96,169,787	(5,836,433)	90,333,354
Change in fair value of SIR Loan (note 3)	-	-	2,500,000	2,500,000
Deferred income taxes (note 14)	-	-	(1,338,250)	(1,338,250)
Adjustment to unitholders' equity from adoption of IFRS 9 on January 1, 2018	-	-	1,161,750	1,161,750
Balance – January 1, 2018	8,375,567	96,169,787	(4,674,683)	91,495,104

As at December 31, 2018, the estimated fair value of the SIR Loan was approximately \$36,000,000. Changes in the estimated fair value of the SIR Loan are recorded in the consolidated statement of earnings and comprehensive income.

IFRS 7, Financial Instruments - Disclosure

IFRS 7, Financial Instruments: Disclosure has been amended to require additional disclosures on transition from IAS 39 to IFRS 9. The additional disclosures are included in notes 3 and 5.

SIR Royalty Income Fund

Notes to Consolidated Financial Statements

December 31, 2018 and December 31, 2017

IFRS 15, Revenue from Contracts with Customers

IFRS 15, Revenue from Contracts with Customers specifies how and when to recognize revenue as well as requiring entities to provide users of financial statements with more informative, relevant disclosures. The standard supersedes IAS 18, Revenue, IAS 11, Construction Contracts, and a number of revenue-related interpretations. The Fund adopted IFRS 15 on January 1, 2018. Management has determined that the adoption of this standard has no impact on the consolidated financial statements.

4 Critical accounting estimates and judgments

The Fund makes estimates and assumptions concerning the future that will by definition seldom equal actual results. The following are estimates and judgments that have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within the next financial year:

Investment in the Partnership/consolidation of structured entities

The Partnership receives royalties on the SIR Rights, which are licensed to SIR for use in Royalty Pooled Restaurants. The Fund and SIR each hold an investment in the Partnership. Generally, the Partnership units have no voting rights, except in certain specified conditions.

The determination of the entity having the ability to affect the returns on their investment in the Partnership required significant judgment. Based on an evaluation of the activities of the Partnership and the Partnership Agreement, management concluded the substance of the relationships between the Partnership, SIR and the Fund indicates the Partnership is controlled by SIR. In addition, the evaluation of whether or not the Fund has significant influence over the Partnership is a matter of significant judgment. Based on a review of the operating and financing activities of the Partnership, management has concluded that the Fund is able to significantly influence these activities.

Valuation of the SIR Loan and investment in the Partnership

Management reviews for objective evidence whether there may be an impairment of the investment in the Partnership. The review includes a review of the earnings, cash flows and available cash of SIR on a prospective basis to assess SIR's ability to meet its obligations for payments to the Partnership for the Royalty. Based on the analysis completed during the years ended December 31, 2018 and 2017, no impairments have been recorded in the consolidated financial statements. On January 1, 2018, the Fund adopted IFRS 9 which resulted in a change in accounting for the SIR Loan. The SIR Loan is now accounted for at fair value through the statements of earnings which required management to discount the cash flows using a market interest rate. Management has estimated the discount rate by considering comparable corporate bond rates, risk free rates, and SIR's credit risk. A 0.25% increase or decrease in the discount rate will result in a \$1,000,000 decrease or increase in the fair value of the SIR Loan.

SIR Royalty Income Fund

Notes to Consolidated Financial Statements

December 31, 2018 and December 31, 2017

5 Loan receivable from SIR Corp.

	Year ended December 31, 2018 \$
Balance - Beginning of year as previously reported	40,000,000
Change in accounting policy (note 2)	<u>2,500,000</u>
Balance - Beginning of year as restated	42,500,000
Interest received	(3,000,000)
Change in estimated fair value of the SIR Loan	<u>(3,500,000)</u>
Balance - End of year	<u>36,000,000</u>

The SIR Loan of \$40,000,000 bears interest at 7.5% per annum, is due October 12, 2044 and is collateralized by a general security agreement covering substantially all of the assets of SIR and its subsidiaries in Canada. Interest of \$3,000,000 was received during the year ended December 31, 2018 (2017 – \$3,000,000).

The fair value of the SIR Loan is estimated by discounting the expected cash flows using a current market interest rate adjusted for SIR's credit risk. Management has used a discount rate of 8.46% as at December 31, 2018 (January 1, 2018 – 7.0%) to discount the expected cash flows. In determining the appropriate discount rate, management considered available market information as well as the credit risk for SIR.

The discount rate used at December 31, 2018 increased from 7.0% at January 1, 2018 to 8.46% at December 31, 2018. The change in the discount rate is driven by the change in the spread between similar corporate bonds and the risk free rate over the same periods (see note 7).

SIR has a credit agreement (Credit Agreement), as amended on December 8, 2017 and July 6, 2018, with a Schedule I Canadian chartered bank (the Lender). The Credit Agreement between SIR and the Lender provides for a maximum principal amount of \$50,000,000 consisting of a \$20,000,000 revolving term credit facility (Credit Facility 1), and a \$30,000,000 revolving term loan (Credit Facility 2). SIR and the Lender have also entered into a purchase card agreement providing credit of up to an additional \$5,000,000.

Credit Facility 1 is for general corporate and operating purposes, bearing interest at the prime rate plus 2.25% and/or the bankers' acceptance rate plus 3.25%, principal repaid in one bullet repayment on July 6, 2021. A standby fee of 0.65% is charged on the undrawn balance of Credit Facility 1. Provided SIR is in compliance with the Credit Agreement, the principal amount of Credit Facility 1 can be repaid and reborrowed at any time during the term of the Credit Agreement.

Credit Facility 2 bears interest at the prime rate plus 2.25% and/or the bankers' acceptance rate plus 3.25%. Under the Credit Agreement, subsequent advances on Credit Facility 2 may be requested (subject to availability and lender approval), in minimum multiples of \$1,000,000, to finance capital spending on new and renovated restaurants. Each advance under Credit Facility 2 is repayable in equal quarterly instalments based on a seven year amortization, with the remaining outstanding principal balance due on July 6, 2021.

SIR Royalty Income Fund

Notes to Consolidated Financial Statements

December 31, 2018 and December 31, 2017

The Credit Agreement is secured by substantially all of the assets of SIR and most of its subsidiaries, which are also guarantors. The Partnership and the Fund have not guaranteed the Credit Agreement. The Credit Agreement qualifies as “permitted indebtedness” within the meaning of the agreements between the Fund, the Partnership and SIR, and as a result the Fund and the Partnership have, as contemplated in the existing agreements, subordinated and postponed their claims against SIR to the claims of the Lender. The terms of the subordination are as contemplated in the previous agreements between the Fund, the Partnership and SIR. This subordination includes a subordination of the Partnership’s rights under the License and Royalty Agreement between the Partnership and SIR whereby the Partnership licenses to SIR the right to use trademarks and related intellectual property in return for royalty payments based on revenues and will be effected pursuant to the terms of an Intercreditor Agreement.

Under the Intercreditor Agreement, absent a default or event of default under the Credit Agreement, ordinary payments to the Fund and the Partnership can continue and the Partnership can exercise any and all of its rights to preserve the trademarks and related intellectual property governed by the License and Royalty Agreement. However, if a default or an event of default were to occur, the Fund and the Partnership agree not to take actions on their security until the Lender has been repaid in full. However, payments by SIR, to the Fund and the Partnership, will be permitted for such amounts as are required to fund their monthly operating expenses, up to an annual limit. In addition, the Fund, the Partnership and SIR will have the right, acting cooperatively, to reduce payments of Royalties and/or interest on the SIR Loan by up to 50% without triggering a cross default under the Credit Agreement for a period of up to nine consecutive months. SIR and each obligor provided an undertaking to cooperate and explore all options with the Fund to maximize value to the Fund’s unitholders and SIR and its shareholders in exchange for the subordinating parties not demanding repayment or enforcing security as a result of any such related party obligation default. The Intercreditor Agreement also contains various other typical covenants of the Fund and the Partnership.

SIR has the right to require the Fund to, indirectly, purchase the Class C GP Units and assume a portion of the SIR Loan as consideration for the acquisition of the Class C GP Units.

6 Investment in SIR Royalty Limited Partnership

On October 12, 2004, the Fund, indirectly through the Trust and SIR GP Inc., respectively, acquired all of the Ordinary LP Units and 99 Ordinary GP Units. The holders of the Ordinary LP Units are entitled to receive a pro rata share of distributions and the holders of the Ordinary GP Units receive a fixed monthly distribution of \$5 in aggregate.

The holders of the Class A LP Units are entitled to receive a pro rata share of all residual distributions of the Partnership. As at December 31, 2018, the Fund’s interest in the residual earnings of the Partnership was 80.6% (December 31, 2017 – 80.9%). Generally, the Partnership units have no voting rights, except in certain specified conditions.

The Partnership makes cash distributions to its partners in the following order of priority: i) First, to the holders of the Class C GP Units and the Class C LP Units, ii) second, to the holders of the Class B GP Units, iii) third, to the holders of the Ordinary GP Units, and iv) thereafter, to the holders of the Class A GP Units, the Class A LP Units, and the Ordinary LP Units.

SIR Royalty Income Fund
Notes to Consolidated Financial Statements
December 31, 2018 and December 31, 2017

The continuity of the Investment in the Partnership is as follows:

	Year ended December 31, 2018	Year ended December 31, 2017
	\$	\$
Balance - Beginning of year	50,984,321	50,984,321
Equity income	11,489,779	11,051,459
Distributions declared	<u>(11,489,779)</u>	<u>(11,051,459)</u>
Balance - End of year	<u>50,984,321</u>	<u>50,984,321</u>

The summarized financial information of the Partnership is as follows:

	As at December 31, 2018	As at December 31, 2017
	\$	\$
Cash	243,849	267,087
Other current assets	5,499,540	5,043,307
Intangible assets	<u>100,432,371</u>	<u>97,585,372</u>
Total assets	<u>106,175,760</u>	<u>102,895,766</u>
Current liabilities and total liabilities	<u>5,743,379</u>	<u>5,310,384</u>
Partners' Interest		
SIR Royalty Income Fund	35,616,956	35,616,956
SIR Corp.	<u>64,815,425</u>	<u>61,968,426</u>
Total partners' interest	<u>100,432,381</u>	<u>97,585,382</u>

SIR Royalty Income Fund

Notes to Consolidated Financial Statements

December 31, 2018 and December 31, 2017

	Year ended December 31, 2018 \$	Year ended December 31, 2017 \$
Revenues	18,042,845	17,302,269
Net earnings and comprehensive income of the Partnership	17,962,505	17,219,940

The reconciliation of the Fund's investment in the Partnership to the Partnership's partners' interest is as follows:

	As at December 31, 2018 \$	As at December 31, 2017 \$
Investment in the Partnership	50,984,321	50,984,321
Transaction costs incurred by the Partnership to issue the Ordinary LP units	(3,533,090)	(3,533,090)
Difference between carrying value and fair value on the conversion of the Class A GP units to Class A LP units	(11,834,275)	(11,834,275)
Partners' interest to SIR Royalty Income Fund	35,616,956	35,616,956

The reconciliation of the Partnership's net earnings to the Fund's equity income is as follows:

	Year ended December 31, 2018 \$	Year ended December 31, 2017 \$
Net earnings and comprehensive income of the Partnership	17,962,505	17,219,940
Priority income allocated to SIR Corp. (Class C GP and Class B GP units)	(3,090,983)	(3,000,012)
Residual earnings SIR Corp.'s share	14,871,522	14,219,928
	(3,381,743)	(3,168,469)
Equity income	11,489,779	8,320,956

SIR Royalty Income Fund

Notes to Consolidated Financial Statements

December 31, 2018 and December 31, 2017

The following table presents the carrying amounts of assets and liabilities recognized by the Fund relating to its interest in the Partnership as well as the Fund's maximum exposure to loss from those interests:

	As at December 31, 2018		As at December 31, 2017	
	Carrying Amount	Maximum Exposure to Loss	Carrying Amount	Maximum Exposure to Loss
Distributions receivable	3,914,408	3,914,408	3,677,558	3,677,558
Advances payable	(2,817,565)	(2,817,565)	(2,520,068)	(2,520,068)
Amounts due from related parties	1,096,843	1,096,843	1,157,490	1,157,490
Investment in SIR Royalty Limited Partnership	50,984,321	50,984,321	50,984,321	50,984,321
Total	52,081,164	52,081,164	52,141,811	52,141,811

The maximum exposure to loss is equal to the current carrying amounts of the assets and liabilities recognized by the Fund. The Fund does not provide financial support to the Partnership, nor has the Fund provided any guarantees or other contingent support to the Partnership.

SIR Royalty Income Fund

Notes to Consolidated Financial Statements

December 31, 2018 and December 31, 2017

7 Financial instruments

Classification

As at December 31, 2018 and December 31, 2017, the classifications of the financial instruments, as well as their carrying and fair values, are as follows:

	Classification	Carrying and fair value	
		As at December 31, 2018 \$	As at December 31, 2017 \$
Cash	Financial assets at amortized cost	296,246	373,651
Amounts due from related parties	Financial assets at amortized cost	4,164,408	3,927,558
Loan receivable from SIR Corp.	Financial assets at fair value through profit and loss	See below	See below
Accounts payable and accrued liabilities	Financial liabilities at amortized cost	105,352	121,788
Amounts due to related parties	Financial liabilities at amortized cost	2,822,682	2,521,071

Carrying and fair values

Cash, amounts due from related parties, accounts payable and accrued liabilities, and amounts due to related parties are short-term financial instruments whose fair value approximates the carrying amount given that they will mature in the short term. The carrying value of the SIR Loan as at December 31, 2018 is \$36,000,000 (December 31, 2017 – \$40,000,000). The fair value of the SIR Loan, which is also its carrying value after the adoption of IFRS 9, is estimated to be \$36,000,000 (December 31, 2017 - \$42,500,000). The fair value was estimated by discounting the expected cash flows using a current market interest rate adjusted for SIR's credit risk. The estimate of fair value is within level 3 of the fair value hierarchy.

Management has estimated the discount rate by considering comparable corporate bond rates, risk free rates and SIR's credit risk. Management estimated the discount rate at 7.0% at January 1, 2018 and 8.46% at December 31, 2018.

Management believes that there is no change in SIR's credit risk during the year ended December 31, 2018. The fair value of the SIR Loan is sensitive to changes in the discount rate. A 0.25% increase or decrease in the discount rate will result in a \$1,000,000 decrease or increase in the fair value of the SIR Loan.

SIR Royalty Income Fund

Notes to Consolidated Financial Statements

December 31, 2018 and December 31, 2017

8 Fund units

An unlimited number of Fund units may be issued pursuant to the Declaration of Trust. Fund units are redeemable by the holder at a price equal to the lesser of 90% of the market price of a Fund unit during the ten consecutive trading day period ending on the trading day immediately prior to the date on which the Fund units were surrendered for redemption and an amount based on the closing price on the redemption date, subject to certain restrictions. Each holder of Fund units participates pro rata in any distributions from the Fund.

As at December 31, 2018, there are 8,375,567 (December 31, 2017 – 8,375,567) Fund units issued and outstanding. Each Fund unit is entitled to one vote at any meeting of unitholders.

During the year ended December 31, 2018, the Fund declared distributions of \$1.21 per unit (2017 – \$1.16 per unit). Subsequent to December 31, 2018, distributions of \$0.105 per unit were declared and paid in the month of January and February 2019.

The distribution policy of the Fund is, at the discretion of the Trustees, to make distributions of its available cash to the fullest extent possible, taking into account trends in revenues, earnings and cash flows.

SIR Royalty Income Fund

Notes to Consolidated Financial Statements

December 31, 2018 and December 31, 2017

9 Earnings per Fund unit

Basic earnings per Fund unit is computed by dividing net earnings by the weighted average number of Fund units outstanding during the period.

SIR has the right to convert the Class A GP Units into Fund units. Diluted earnings per Fund unit is calculated using the weighted average number of Fund units outstanding adjusted to include the effect of the conversion of the Class A GP Units into Fund units.

The following table reconciles the basic and diluted weighted average number of Fund units outstanding and basic and diluted earnings per Fund unit:

	Basic	Adjustment for conversion of Class A GP Units	Diluted
Net earnings for the year ended December 31, 2018	\$ 5,115,169	\$ N/A	\$ 5,115,169
Net earnings per Fund unit for the year ended December 31, 2018	\$ 0.61		\$ 0.61
Weighted average number of Fund units outstanding for the year ended December 31, 2018	8,375,567	N/A	8,375,567
Net earnings for the year ended December 31, 2017	\$ 9,814,119	\$ 2,319,412	\$ 12,133,531
Net earnings per Fund unit for the year ended December 31, 2017	\$ 1.17		\$ 1.17
Weighted average number of Fund units outstanding for the year ended December 31, 2017	8,375,567	1,981,616	10,357,183

For the year ended December 31, 2018, the conversion of the Class A GP Units into Fund units is anti-dilutive. Therefore, the Class A GP Units are excluded from the calculation of diluted earnings per Fund unit.

SIR Royalty Income Fund

Notes to Consolidated Financial Statements

December 31, 2018 and December 31, 2017

10 Related party transactions and balances

During the year ended December 31, 2018, the Fund recorded equity income of \$11,489,779 (2017 - \$11,051,459) and received distributions of \$11,252,929 (2017 - \$10,835,529) from the Partnership. The Fund, indirectly through the Trust, is entitled to receive a pro rata share of all residual distributions. The Fund's equity income is dependent upon the revenues generated by SIR for the restaurants subject to the Licence and Royalty Agreement. Under the terms of the Licence and Royalty Agreement, SIR may be required to pay a Make-Whole Payment in respect of the reduction in revenues for restaurants permanently closed during a reporting period. SIR is not required to pay any Make-Whole Payment in respect of a permanently closed restaurant following the date on which the number of restaurants in the Royalty Pooled Restaurants is equal to or greater than 68 or following October 12, 2019, whichever occurs first. On January 1 of each year (the Adjustment Date), the restaurants subject to the Licence and Royalty Agreement are adjusted for new restaurants opened for at least 60 days preceding such Adjustment Date in the previous fiscal year. At each Adjustment Date, SIR will be entitled to convert its Class B GP Units into Class A GP Units based on a conversion formula defined in the Partnership Agreement.

On January 1 of each year, Class B GP Units are converted into Class A GP Units for new SIR Restaurants added to the Royalty Pooled Restaurants based on 80% of the initial estimated revenues and the formula defined in the Partnership Agreement. Additional Class B GP Units may be converted into Class A GP Units in respect of these new SIR Restaurants if actual revenues of the new SIR Restaurants exceeded 80% of the initial estimated revenues and the formula defined in the Partnership Agreement. Conversely, converted Class A GP Units will be returned by SIR if the actual revenues of the new SIR Restaurants are less than 80% of the initial estimated revenues. In December of each year, an additional distribution will be payable to the Class B GP unitholders provided that actual revenues of the new SIR Restaurants exceed 80% of the initial estimated revenues, or there will be a reduction in the distributions to the Class A GP unitholders if revenues are less than 80% of the initial estimated revenues.

On January 1, 2019, two (January 1, 2018 - three) new SIR Restaurants were added to Royalty Pooled Restaurants in accordance with the Partnership Agreement. As consideration for the additional Royalty associated with the addition of two new SIR Restaurants on January 1, 2019 (January 1, 2018 - three), as well as the Second Incremental Adjustment for three new SIR Restaurant added to Royalty Pooled Restaurants on January 1, 2018 (January 1, 2017 - one), SIR converted its Class B GP Units into Class A GP Units based on the formula defined in the Partnership Agreement. In addition, there was a re-conversion of Class A GP Units into Class B GP Units for the permanent closure of one (January 1, 2018 – three) SIR Restaurants during 2018. The net effect of these adjustments to Royalty Pooled Restaurants was that SIR converted 197,824 Class B GP Units into 197,824 Class A GP Units (January 1, 2018 – SIR converted 34,810 Class B GP Units into 34,810 Class A GP Units) on January 1, 2019 at a value of \$3,986,264 (January 1, 2018 - \$2,846,999).

In addition, the revenues of the three (January 1, 2017 – one) new SIR Restaurants added to Royalty Pooled Restaurants on January 1, 2018 exceeded 80% of the Initial Adjustment's estimated revenue (January 1, 2017 – revenue of the one new SIR Restaurant was less than 80% of the Initial Adjustment's estimated revenue) and, as a result, a special conversion distribution of \$90,971 was declared on the Class B GP Units in December 2018 and paid in January 2019 (the distributions of the Class A GP Units were reduced by a special conversion refund of \$52,078 in December 2017 and paid in January 2018). As a result of the permanent closure of one SIR Restaurant during the year, a Make-Whole Payment totalling \$11,986 (year ended December 31, 2017 – \$296,231) was paid by SIR to the Partnership.

SIR Royalty Income Fund
Notes to Consolidated Financial Statements
December 31, 2018 and December 31, 2017

Class A GP Units and Class B GP Units are held by SIR.

The Partnership has entered into an arrangement with the Fund and the Trust whereby the Partnership will provide or arrange for the provision of services required in the administration of the Fund and the Trust. The Partnership has arranged for these services to be provided by SIR GP Inc. in its capacity as the Managing General Partner, or SIR as the General Partner. SIR, on behalf of SIR GP Inc., also provides services to the Partnership for its administration. For the year ended December 31, 2018, the Partnership provided these services to the Fund and the Trust for consideration of \$24,000 (2017 - \$24,000), which was the amount of consideration agreed to by the related parties and has been recorded in general and administrative expenses.

Amounts due from (to) related parties consist of:

	As at December 31, 2018 \$	As at December 31, 2017 \$
SIR Corp.		
Interest receivable	250,000	250,000
Distributions receivable from SIR Royalty Limited Partnership	3,914,408	3,677,558
Amounts due from related parties	<u>4,164,408</u>	<u>3,927,558</u>
SIR Corp.		
Advances payable	5,117	1,003
Advances payable to SIR Royalty Limited Partnership	2,817,565	2,520,068
	<u>2,822,682</u>	<u>2,521,071</u>

Amounts due from (to) related parties are non-interest bearing and due on demand. All advances were conducted as part of the normal course of business operations.

Compensation of key management

The Fund does not have any employees. Compensation awarded to the Board of Trustees consists of fees of \$105,300 for the year ended December 31, 2018 (2017 - \$106,200) and is recorded within general and administrative expenses.

SIR Royalty Income Fund

Notes to Consolidated Financial Statements

December 31, 2018 and December 31, 2017

11 Capital management

The Fund's capital consists of units of the Fund, as described in note 8. The objectives in managing the capital are to safeguard the Fund's ability to continue as a going concern, to provide an adequate return to its unitholders appropriate to their level of risk and to distribute excess cash to the unitholders. The Fund has no third party debt or bank lines of credit. The Fund had no capital expenditures during the year ended December 31, 2018 and is not expected to have significant capital expenditures in the future.

SIR has a Credit Agreement, which requires the Fund and the Partnership to subordinate and postpone their claims against SIR to the claims of the Lender in the event of a default (note 5).

12 Net change in non-cash working capital items

Net change in non-cash working capital items comprises:

	Year ended December 31, 2018 \$	Year ended December 31, 2017 \$
Prepaid expenses and other assets	(2,082)	87
Amounts due from related parties	-	772
Accounts payable and accrued liabilities	(16,436)	20,494
Amounts due to related parties	301,611	(238,197)
	<u>283,093</u>	<u>(216,844)</u>

13 Economic dependence

The Fund's income is derived from the SIR Loan and distributions from the Partnership; accordingly, the Fund is economically dependent on SIR.

SIR Royalty Income Fund

Notes to Consolidated Financial Statements

December 31, 2018 and December 31, 2017

14 Income taxes

Income tax expense is recognized based on management's best estimate of the weighted average annual income tax rate expected for the full financial year.

Income tax expense is as follows:

	Year ended December 31, 2018 \$	Year ended December 31, 2017 \$
Current	3,717,785	3,742,017
Deferred – SIR Loan	(1,338,250)	-
Deferred - Other	52,000	56,000
	<u>2,431,535</u>	<u>3,798,017</u>

The Fund's income not distributed to its unitholders is taxable at a rate of 53.53% (2017 – 53.53%). Distributions to unitholders are taxable at the combined federal and provincial tax rate, which is 26.5% for the year ended December 31, 2018 (2017 – 26.5%).

The reconciliation of the Fund's effective tax rate to the combined Canadian federal and provincial tax rate is as follows:

	Year ended December 31, 2018 \$	Year ended December 31, 2017 \$
Earnings before income taxes	<u>7,546,704</u>	<u>13,612,136</u>
Income tax provision at 53.53% (2017 – 53.53%)	4,039,751	7,286,576
Add (deduct):		
Permanent differences related to SIR Loan	2,213,304	-
Other	(59,028)	174,346
Differences in tax rates	(3,762,492)	(3,662,905)
	<u>2,431,535</u>	<u>3,798,017</u>

SIR Royalty Income Fund

Notes to Consolidated Financial Statements

December 31, 2018 and December 31, 2017

Deferred tax liabilities consist of the following:

	Investment in the Partnership \$	Year ended December 31, 2018	
		Fair value of SIR Loan \$	Total \$
Balance – beginning of year as previously reported	1,841,000	-	1,841,000
Change in accounting policy (note 2)	-	1,338,250	1,338,250
Balance – beginning of year as restated	1,841,000	1,338,250	3,179,250
Charged to consolidated statements of earnings	52,000	(1,338,250)	(1,286,250)
Balance – end of year	<u>1,893,000</u>	<u>-</u>	<u>1,893,000</u>