

# **Kahala Brands, Ltd.**

Consolidated Financial Statements - Year Ended December 31, 2015

(Expressed in US Dollars, unless otherwise noted)

## Independent Auditors' Report

To the Board of Directors of Kahala Brands, Ltd.

We have audited the accompanying consolidated financial statements of Kahala Brands, Ltd., which comprise the consolidated statement of financial position as at December 31, 2015, and the statements of income and comprehensive income, changes in equity and cash flows for the year then ended, and a summary of significant accounting policies and other explanatory information.

### Management's Responsibility for the Financial Statements

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

### Auditors' Responsibility

Our responsibility is to express an opinion on these consolidated financial statements based on our audit. We conducted our audit in accordance with Canadian generally accepted auditing standards. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements 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 entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

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

### Opinion

In our opinion, the consolidated financial statements present fairly, in all material respects, the financial position of Kahala Brands, Ltd. as at December 31, 2015, and its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards.

### Other Matter

Without modifying our opinion, we draw attention to Note 6 to the financial statements which indicates that the comparative information presented as at, and for the year ended December 31, 2014, has been corrected. As part of our audit of the financial statements as at, and for the year ended December 31, 2015, we audited the correction described in Note 6 to the consolidated financial statements that was applied to correct the comparative information presented as at and for the year ended December 31, 2014. In our opinion, the correction is appropriate and has been properly applied.

*MNP LLP*

Mississauga, Ontario

May 27, 2016

Chartered Professional Accountants

Licensed Public Accountants

**Kahala Brands, Ltd.**  
Consolidated Statement of Financial Position  
As At December 31, 2015

|   | 2015                  | 2014<br>(restated - note 6) |
|---|-----------------------|-----------------------------|
| <b>ASSETS</b>   |                       |                             |
| <b>Current Assets</b>   |                       |                             |
| Cash  | \$ 10,425,755         | \$ 8,487,998                |
| Restricted cash   | 187,269               | -                           |
| Accounts receivable   | 13,153,609            | 14,285,985                  |
| Prepaid expenses  | 5,405,688             | 3,187,009                   |
| Notes receivable, current portion (note 7)                      | 1,481,061             | 637,541                     |
| Deferred rent asset, current portion (note 21)                  | 548,301               | 1,473,998                   |
| Income taxes recoverable (note 17)                              | 5,791,122             | 2,000,000                   |
| Assets held-for-sale (note 8)                                   | 1,965,960             | 1,112,568                   |
|   | <b>38,958,765</b>     | <b>31,185,099</b>           |
| Notes receivable (note 7)                                       | 1,909,395             | 3,012,948                   |
| Property and equipment (note 9)                                 | 232,835               | 23,333                      |
| Deferred tax asset (note 17)                                    | -                     | 1,000,000                   |
| Deferred rent asset (note 21)                                   | 15,535,511            | 17,806,006                  |
| Intangible assets (note 10)                                     | 63,310,576            | 58,479,609                  |
| Goodwill (note 10)  | 65,925,377            | 67,149,341                  |
| <b>Total assets</b>   | <b>\$ 185,872,459</b> | <b>\$ 178,656,336</b>       |
| <b>LIABILITY AND SHAREHOLDERS' EQUITY</b>                       |                       |                             |
| <b>Current Liabilities</b>                                      |                       |                             |
| Accounts payable and accrued liabilities (note 11)              | \$ 13,227,773         | \$ 12,542,000               |
| Deferred revenue and deposits, current portion (notes 6 and 12) | 5,563,379             | 4,545,505                   |
| Deferred rent liability, current portion (note 21)              | 733,256               | 1,518,459                   |
| Unredeemed gift cards liability                                 | 56,821,648            | 55,048,392                  |
| Notes payable, current portion (note 13)                        | 41,195                | 4,306,406                   |
|   | <b>76,387,251</b>     | <b>77,960,762</b>           |
| Deferred revenue and deposits (notes 6 and 12)                  | 5,664,436             | 2,800,537                   |
| Deferred rent liability (note 21)                               | 16,087,050            | 18,458,770                  |
| Deferred tax liability (note 17)                                | 1,572,237             | -                           |
| Notes payable (note 13)   | 160,033               | 11,518,960                  |
|   | <b>99,871,007</b>     | <b>110,739,029</b>          |
| <b>Shareholders' equity</b>                                     |                       |                             |
| Share capital (note 15)   | 62,774,986            | 62,774,986                  |
| Treasury share  | (163,750)             | (163,750)                   |
| Contributed surplus   | 159,805,067           | 159,805,067                 |
| Deficit   | (136,415,843)         | (154,499,988)               |
| Accumulated other comprehensive income                          | 992                   | 992                         |
|   | <b>86,001,452</b>     | <b>67,917,307</b>           |
| <b>Total liabilities and shareholders' equity</b>               | <b>\$ 185,872,459</b> | <b>\$ 178,656,336</b>       |

Nature of operations (note 1)  
Commitments and contingencies (note 16)

Approved on behalf of the Board

Signed: CEO

Signed: President

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

**Kahala Brands, Ltd.**

## Consolidated Statement of Income and Comprehensive Income

For the Year Ended December 31, 2015

|  | <u>December 31, 2015</u> | <u>December 31, 2014</u> |
|--|--------------------------|--------------------------|
| <b>Revenue (notes 18 and 21)</b>   | <b>\$ 120,944,458</b>    | \$ 129,661,631           |
| <b>Cost of sales (note 19)</b>   | <b>22,504,457</b>        | 28,335,068               |
|  | <b>98,440,001</b>        | 101,326,563              |
| <b>Expenses</b>  |                          |                          |
| Rent (note 21)   | 41,743,963               | 52,470,887               |
| Salaries and benefits (note 14)  | 16,241,325               | 17,027,465               |
| General and administrative (note 20)   | 10,835,546               | 10,218,222               |
| Depreciation and amortization (notes 9 and 10)                                 | 2,669,148                | 2,807,190                |
|  | <b>71,489,982</b>        | 82,523,764               |
| <b>Other (income) loss</b>   |                          |                          |
| Gain on disposition of investment in CSC Japan, LLC                            | -                        | (2,288,586)              |
| Impairment of transitional stores  | 846,858                  | 277,744                  |
| Impairment of notes receivable   | 166,699                  | 2,500,000                |
| Impairment of property and equipment, intangible assets and goodwill (note 10) | 3,800,000                | 1,700,000                |
| (Gain) loss on disposition of assets (notes 8 and 9)                           | 98,999                   | (632,003)                |
| Foreign exchange (gain) loss   | 6,711                    | 1,634                    |
| Interest Income  | (197,573)                | -                        |
| Interest expense   | 301,230                  | 1,033,730                |
|  | <b>5,022,924</b>         | 2,592,519                |
| <b>Income before income taxes</b>  | <b>21,927,095</b>        | 16,210,280               |
| Income tax provision (recovery) (note 17)                                      | 3,842,950                | (1,000,000)              |
| <b>Net income</b>  | <b>18,084,145</b>        | 17,210,280               |
| Foreign exchange translation on foreign operations                             | -                        | 992                      |
| <b>Comprehensive income</b>  | <b>\$ 18,084,145</b>     | \$ 17,211,272            |

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

**Kahala Brands, Ltd.**Consolidated Statement of Changes in Equity  
For the Year Ended December 31, 2015

|   | Common Shares        | Treasury Shares     | Contributed Surplus   | Accumulated Other Comprehensive Income | Deficit                 | Total Shareholders' Equity |
|---|----------------------|---------------------|-----------------------|--|-------------------------|----------------------------|
| Balance at December 31, 2013                            | \$ 62,774,986        | \$ -                | \$ 159,903,317        | \$ 910,751                             | \$ (169,219,354)        | \$ 54,369,700              |
| Correction of error (note 6)                            | -                    | -                   | -                     | -                                      | (2,490,914)             | (2,490,914)                |
| Balance at December 31, 2013 (restated - note 6)        | \$ 62,774,986        | \$ -                | \$ 159,903,317        | \$ 910,751                             | \$ (171,710,268)        | \$ 51,878,786              |
| Sale of investment in CSC Japan, LLC                    | -                    | -                   | -                     | (910,751)                              | -                       | (910,751)                  |
| Repurchase and redemption of shares                     | -                    | (163,750)           | (98,250)              | -                                      | -                       | (262,000)                  |
| Foreign exchange translation                            | -                    | -                   | -                     | 992                                    | -                       | 992                        |
| Net income for the year                                 | -                    | -                   | -                     | -                                      | 17,210,280              | 17,210,280                 |
| <b>Balance at December 31, 2014</b> (restated - note 6) | <b>\$ 62,774,986</b> | <b>\$ (163,750)</b> | <b>\$ 159,805,067</b> | <b>\$ 992</b>                          | <b>\$ (154,499,988)</b> | <b>\$ 67,917,307</b>       |
| Net income for year                                     | -                    | -                   | -                     | -                                      | 18,084,145              | 18,084,145                 |
| <b>Balance at December 31, 2015</b>                     | <b>\$ 62,774,986</b> | <b>\$ (163,750)</b> | <b>\$ 159,805,067</b> | <b>\$ 992</b>                          | <b>\$ (136,415,843)</b> | <b>\$ 86,001,452</b>       |

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

**Kahala Brands, Ltd.**Consolidated Statement of Cash Flows  
For the Year Ended December 31, 2015

|   | December 31, 2015     | December 31, 2014    |
|---|-----------------------|----------------------|
| <b>Operating Activities</b>                       |                       |                      |
| Net income  | \$ 18,084,145         | \$ 17,210,280        |
| Items not affecting cash:                         |                       |                      |
| Deferred income taxes                             | 2,572,237             | (1,000,000)          |
| Depreciation of equipment                         | 36,696                | 1,667                |
| Amortization of intangible assets                 | 2,632,452             | 2,805,563            |
| (Gain) Loss on disposition of assets              | 98,999                | (482,081)            |
| Impairment of notes receivable                    | 166,699               | 609,510              |
| Interest on notes payable and receivable          | -                     | 1,036,768            |
| Impairment expense                                | 4,646,858             | 4,477,794            |
| Accounts receivable converted into notes          | -                     | (2,914,438)          |
| Accounts payable converted into notes             | -                     | 183,917              |
| Non cash rent expense (income)                    | -                     | (427,832)            |
| (Gain) Loss on disposition of CSC Japan, LLC      | -                     | (2,288,586)          |
| Changes in non-cash operating working capital:    |                       |                      |
| Accounts receivable                               | 1,966,860             | 2,904,158            |
| Prepaid expenses                                  | (972,624)             | 458,715              |
| Accounts payable and accrued liabilities          | (1,952,810)           | (2,851,254)          |
| Deferred revenue and deposits                     | 3,638,365             | (3,235,757)          |
| Deferred rent asset                               | 3,218,603             | -                    |
| Deferred rent liability                           | (3,465,006)           | -                    |
| Unredeemed gift cards liability                   | (272,538)             | 3,883,926            |
| Income taxes refundable                           | (3,791,122)           | (2,000,000)          |
| Cash provided by operating activities             | <u>26,607,814</u>     | <u>18,372,350</u>    |
| <b>Investing Activities</b>                       |                       |                      |
| Proceeds from disposition of transitional stores  | 151,500               | 1,924,202            |
| Acquisition of transitional stores                | (281,046)             | (296,157)            |
| Purchase of equipment                             | (105,186)             | (25,000)             |
| Acquisition of Tasti D-Lite, net of cash received | (1,609,928)           | -                    |
| Acquisition of Maui Wowi, net of cash received    | (3,771,487)           | -                    |
| Acquisition of Pinkberry, net of cash received    | (3,242,633)           | -                    |
| Proceeds from disposition of equipment            | -                     | 7,744,756            |
| Proceeds from disposition of CSC Japan, LLC       | -                     | 3,212,900            |
| Cash provided by (used in) investing activities   | <u>\$ (8,858,780)</u> | <u>\$ 12,560,701</u> |

*Continued on next page*

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

**Kahala Brands, Ltd.**Consolidated Statement of Cash Flows  
For the Year Ended December 31, 2015

|  | December 31, 2015        | December 31, 2014        |
|--|--------------------------|--------------------------|
| <b>Financing Activities</b> <i>(Continued from previous page)</i>          |                          |                          |
| Net receipts of notes receivable   | \$ 193,043               | \$ 2,355,898             |
| Repurchase of shares   | -                        | (262,000)                |
| Advances of notes payable  | -                        | 148,500                  |
| Repayment of note payable to entity related to the controlling shareholder | (15,000,000)             | (18,500,000)             |
| Net (payments) of notes payable, non-related                               | (817,051)                | (14,836,240)             |
| Change in restricted cash  | (187,269)                | 2,447,893                |
| Cash used by financing activities  | (15,811,277)             | (28,645,949)             |
| Increase in cash   | 1,937,757                | 2,287,102                |
| Effect of foreign exchange rate on held cash balances                      | -                        | 992                      |
| <b>Cash, beginning of the year</b>   | <b>8,487,998</b>         | <b>6,199,904</b>         |
| <b>Cash, end of the year</b>   | <b>\$ 10,425,755</b>     | <b>\$ 8,487,998</b>      |
|  | <b>December 31, 2015</b> | <b>December 31, 2014</b> |
| Cash paid for Interest   | \$ 301,230               | \$ 1,033,730             |
| Cash paid for income taxes   | \$ 4,991,122             | \$ 2,000,000             |

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

## **Kahala Brands, Ltd.**

Notes to the Consolidated Financial Statements  
For the Year Ended December 31, 2015

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### **1. Nature of operations**

Kahala Brands, Ltd. (formerly Kahala Corp.) (the “Company” or “Kahala”) is a franchisor of quick service food restaurants. The Company’s core business activities are the franchising and licensing of intellectual property and the administration, financing, management and operation of such intellectual property in the business of quick service food stores under the following trade names, trademarks, and associated insignia: Cold Stone Creamery, Blimpie, Taco Time, Surf City Squeeze, The Great Steak & Potato Company, NrGize Lifestyle Cafe, Samurai Sam’s Teriyaki Grill, Frullati Café & Bakery, Rollerz, Johnnie’s New York Pizzeria, Ranch One, America’s Taco Shop, Cereality, Tasti D-Lite, Planet Smoothie, Maui Wowi, and Pinkberry (collectively, the “Concepts”). The Company also temporarily operates certain restaurant locations as corporate-owned stores until such locations can be re-franchised.

The Company is incorporated in Delaware. The address of its registered office is 9311 East Via de Ventura, Scottsdale, Arizona. The controlling shareholder of the Company is USKAL Corporation LLC.

These consolidated statements were approved by the Company’s board of directors on May 27, 2016.

#### *Statement of compliance*

These consolidated financial statements have been prepared in accordance with International Financial Reporting Standards (“IFRS”) as issued by the International Accounting Standards Board (“IASB”).

#### *Basis of presentation*

The consolidated financial statements are prepared on a going concern basis and have been presented in US dollars which is the Company’s reporting currency. Standards not effective for the current accounting period are described in note 2. A summary of the significant accounting policies is set out below.

#### *Basis of measurement*

The consolidated financial statements have been prepared on the cost basis except as otherwise noted.

### **2. Significant accounting policies**

The accounting policies set out below have been applied consistently to all periods presented in the consolidated financial statements.

#### *Basis of consolidation*

The consolidated financial statements include the accounts of the Company and entities controlled directly or indirectly by the Company (its subsidiaries). Control is achieved where the Company is exposed, or has rights, to variable returns from its involvement with the entity and has the ability to affect those returns through its power over the entity. The principal subsidiaries of the Company are as follows:



## Kahala Brands, Ltd.

Notes to the Consolidated Financial Statements  
For the Year Ended December 31, 2015

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### 2. Significant accounting policies – continued

| <u>Principal subsidiary</u>   | <u>Percentage of equity interest</u> |
|-------------------------------|--------------------------------------|
| ActsInfo USA LLC              | 51%                                  |
| KAHA Acquisition I, LLC       | 100%                                 |
| KAHA Acquisition IV, LLC      | 100%                                 |
| Kahala Advertising, LLC       | 100%                                 |
| Kahala Brands Canada Inc.     | 100%                                 |
| Kahala Franchising, LLC       | 100%                                 |
| Kahala Management, LLC        | 100%                                 |
| Kahala Operations, LLC        | 100%                                 |
| Kahala Real Estate, LLC       | 100%                                 |
| Kahala Support, LLC           | 100%                                 |
| KGC, LLC                      | 100%                                 |
| MW Ventures, LLC              | 100%                                 |
| Pinkberry Holdings Corp.      | 100%                                 |
| Surf City Squeeze, Inc.       | 100%                                 |
| Tasti D-Lite, LLC             | 100%                                 |
| Taco Time International, Inc. | 100%                                 |

Revenues and expenses of subsidiaries are included in the consolidated statement of income and comprehensive income from the effective date of acquisition. The subsidiaries are consolidated from the acquisition date until the date on which the Company ceases to control them. Total comprehensive income or loss of subsidiaries is attributed to the owners of the Company and to the non-controlling interests even if this results in the non-controlling interests having a deficit balance.

All intercompany transactions, balances, revenues and expenses are eliminated in full upon consolidation.

#### *Functional currency*

The functional currency of the Company and its subsidiaries is the US dollars, except for Kahala Brands Canada, Inc., which is in the Canadian dollars. For this subsidiary, the Company translates monetary and non-monetary assets and liabilities that are denominated in foreign currencies into US dollars, which is the reporting currency of the Company at the exchange rates prevailing at the end of the reporting period; all revenue and expense items are translated at the exchange rate prevailing on the transaction date. Transaction gains and losses are reported in profit or loss and unrealized translation foreign exchange gains and losses are reported in other comprehensive income.

Where an entity has the US dollar as its functional currency, the Company translates monetary assets and liabilities that are denominated in currencies other than the US dollar at the exchange rates prevailing at the end of the reporting period; non-monetary assets denominated in foreign currencies are translated using the exchange rate prevailing at the transaction date; all revenue and expense items denominated in foreign currencies are translated at the exchange rate prevailing at the transaction date. All foreign exchange gains and losses are reported in profit or loss.

#### *Goodwill*

Goodwill arising on an acquisition of a business is carried at cost as established at the date of acquisition of the business less any accumulated impairment losses. Where goodwill forms part of a cash-generating unit and part of the operation within the unit is disposed of, the goodwill associated with the operation disposed of is included in the carrying amount of the operation when determining the gain or loss on disposal of the operation. Goodwill disposed of in this circumstance is measured based on the relative values of the operation and the portion of the cash-generating unit retained.

## **Kahala Brands, Ltd.**

Notes to the Consolidated Financial Statements  
For the Year Ended December 31, 2015

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### **2. Significant accounting policies - continued**

#### *Revenue recognition*

Revenue is recognized to the extent that it is probable that the economic benefits will flow to the Company and the revenue can be reliably measured, regardless of when the payment is expected to be made. Revenue is measured at the fair value of the consideration received or receivable, taking into account contractually defined terms of payment and excluding taxes and duty.

Revenue is generally recognized on the sale of products or services when the products are delivered or the services are performed, all significant contractual obligations have been satisfied and the collection is reasonably assured.

#### *i. Revenue from franchise locations*

Royalties are based either on a percentage of gross sales as reported by the franchisees or on a fixed monthly fee. They are recognized on an accrual basis in accordance with the substance of the relevant agreement, provided that it is probable that the economic benefits will flow to the Company and the amount of income can be measured reliably.

Initial franchise fees are recognized when substantially all of the initial services as required by the franchise agreement have been performed. This usually occurs when the location commences operations.

Revenue from the sales of franchise locations temporarily owned by the Company is recognized at the time the acquiring franchisee assumes control of the franchise location.

Revenue from equipment sales is recognized when the risk of ownership and title pass to the buyer, generally upon the shipment of the equipment.

Renewal and transfer fees are recognized when substantially all the applicable services required by the Company under the initial franchise agreement have been performed. This generally occurs on the effective date of the renewal or transfer agreement.

The Company has a store lease program whereby it is the master lessee and sub-lessor for leases on certain store locations. Under this program the Company earns rental revenues on those leases as sub-lessor and incurs rent expense as the master lessee. The Company's policy regarding the store lease program is more completely described below under Leasing.

#### *ii. Revenue from corporate-owned locations*

Revenue from corporate-owned locations is recorded as Store Sales within revenue when goods are delivered to customers.

#### *iii. Revenue from suppliers*

The Company earns revenue from certain suppliers as incentives for bulk purchases. This revenue is recorded as other revenue and is recognized as franchisees and corporate-owned stores purchase and receive the supplies under the terms of their supplier contracts.

#### *iv. Deferred revenue*

Initial franchise fees received are deferred until the related franchise opens. When revenue from initial fees is collectible over an extended period of time and collectability is not reasonably assured, revenue is recognized using the installment method as fees are collected.

## **Kahala Brands, Ltd.**

Notes to the Consolidated Financial Statements

For the Year Ended December 31, 2015

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### **2. Significant accounting policies - continued**

Fees received from the sale of Area Representative Agreements (“ARA’s”) or similar development arrangements covering a defined geographic region (such area referred to as the “Territory”) is recognized as follows: as individual franchise agreements are signed and the applicable initial franchise fee paid to the Company for locations within a Territory, that portion of the area development fee equal in amount to the initial franchise fee collected is recognized as revenue upon the applicable store opening for business to the public. Upon termination or expiration of an ARA, the balance, of any remaining development fees is recognized as revenue.

Suppliers contributions advanced to the Company under supplier contracts are deferred and recognized as revenue when the franchisees and corporate-owned stores purchase and receive the supplies under the terms of the supplier contracts.

#### *Leasing*

Leases are classified as finance leases is whenever the terms of the lease transfer substantially all the risks and rewards of ownership to the lessee. All other leases are classified as operating leases. The Company does not have any material finance leases.

#### The Company as sub-lessor

Revenues from operating leases is generally recognized on a straight-line basis over the term of the relevant leases except where another systematic basis is more representative of the time pattern in which economic benefits from the leased asset are realized. Contingent rental revenues arising under operating leases is recognized as revenue in the period in which it is earned. The difference between the actual annual lease obligation and the amount recognized on a straight-line basis is deferred.

Lease incentives received by the Company under the master lease are passed down to the franchisees and such incentives are recognized as assets. These incentives are recognized as a reduction of rental revenue on a straight-line basis, except where another systematic basis is more representative of the time pattern in which the incentive is consumed.

#### The Company as master lessee

Operating lease payments are recognized as an expense on a straight-line basis over the lease term, except where another systematic basis is more representative of the time pattern in which economic benefits from the leased asset are consumed. Contingent rentals arising under operating leases are recognized as an expense in the period in which they are incurred. The difference between the actual annual lease obligation and the amount recognized on a straight-line basis is deferred.

In the event that lease incentives are received by the Company as the master lessee to enter into certain operating leases, such incentives are recognized as a liability. The aggregate benefit of such incentives are recognized as a reduction of rental expense on a straight-line basis, except where another systematic basis is more representative of the time pattern in which economic benefits from the leased asset are consumed.

#### *Cash and cash equivalents*

Cash and cash equivalents is comprised of cash on hand and highly liquid investments that are readily convertible into known amounts of cash with maturities of three months or less.

## **Kahala Brands, Ltd.**

Notes to the Consolidated Financial Statements  
For the Year Ended December 31, 2015

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### **2. Significant accounting policies – continued**

#### *Property and equipment*

Property and equipment is stated at historical cost less accumulated depreciation and accumulated impairment losses. Depreciation is calculated on a straight-line basis, over its useful life of between 5 and 10 years.

Depreciation is recognized so as to write off the cost or valuation of assets (other than land) less their residual values over their useful lives, using the straight-line method. The estimated useful lives, residual values and depreciation methods are reviewed at the end of each year, with the effect of any changes in estimate accounted for on a prospective basis.

Property and equipment is derecognized upon disposal or at the time when no future economic benefits are expected to arise from the continued use of the asset. Any gain or loss arising on the disposal or retirement of equipment is determined as the difference between the sales proceeds and the carrying amount of the asset and is recognized in profit or loss.

#### *Transitional stores*

The Company has a transition store program that deals with franchise agreements that are franchisees that are in default. The Company acquires the assets held by the previous franchisee and cancels the sublease. The store location is then operated by the Company for a period of up to 48 months, with the intention of either refranchising or maintaining these locations as corporate-owned stores.

Upon acquisition, costs of purchasing store equipment and capital improvements are recorded at cost and classified as assets held-for-sale for stores that the Company intends to sell and re-franchise immediately after the improvement. Profit and loss during the 48-month probation period is recorded as part of continuing operations.

The Company reviews all transitional stores at the end of each reporting period for indicators of impairment. At the end of the 24 month period post-acquisition, the Company recognizes a full impairment of the store's cost basis, and its carrying value is reduced to nil.

When a location is converted into a corporate-owned store at the end of the probation period, any subsequent costs are capitalized and depreciated according to the Company's policy on property and equipment.

#### *Investment in associates*

The equity method of accounting is applied where the Company owns a non-controlling interest but has significant influence over the investee. Under the equity method, original investments are recorded at cost and adjusted for the Company's share of undistributed earnings or losses of these entities.

#### *Assets held-for-sale*

An asset is classified as held-for-sale if its carrying amount will be recovered principally through a sale transaction rather than through continuing use. This condition is regarded as met only when the sale is highly probable and the investment is available for immediate sale in its present condition. Management must be committed to the sale and expect the sale to be completed within a year from the date the investment is classified as held-for-sale. An asset classified as held-for-sale is measured at the lower of its carrying amount and its fair value less costs to sell. Impairment losses on an investment initially classified as held-for-sale and gains or losses on subsequent re-measurement are recognized in profit or loss. Once classified as held-for sale, property, plant and equipment and intangible assets are no longer depreciated and amortized.

## **Kahala Brands, Ltd.**

Notes to the Consolidated Financial Statements  
For the Year Ended December 31, 2015

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### **2. Significant accounting policies - continued**

#### *Intangible assets*

Intangible assets with finite useful lives that are acquired separately are carried at cost less accumulated amortization and accumulated impairment losses. Amortization is recognized on a straight-line basis over their estimated useful lives. The estimated useful lives and amortization methods are reviewed at the end of each year, with the effect of any changes in estimate being accounted for on a prospective basis. Intangible assets with indefinite useful lives that are acquired separately are carried at cost less accumulated impairment losses.

Intangible assets acquired in a business combination and recognized separately from goodwill are initially recognized at their fair value at the acquisition date.

Subsequent to initial recognition, intangible assets having a finite life acquired in a business combination are reported at cost less accumulated amortization and accumulated impairment losses, on the same basis as intangible assets that are acquired separately. Intangible assets having an indefinite life are not amortized and are therefore carried at cost less accumulated impairment losses, if applicable.

#### Franchise rights

The franchise rights acquired through business combinations are initially recognized at the fair value of the estimated future revenue stream related to the acquisition of franchises. The franchise rights are generally amortized on a straight-line basis over the term of the agreements which typically range between 10 to 20 years.

#### Trademarks

Trademarks acquired through business combinations are recognized at their fair value at the time of the acquisition and are not amortized. Trademarks are determined to have an indefinite useful life based on their strong brand recognition and ability to generate revenues with no foreseeable time limit.

#### *Impairment of tangible and intangible assets other than goodwill*

At the end of each reporting period, the Company reviews the carrying amounts of its tangible and intangible assets to determine whether there is any indication that those assets have suffered an impairment loss. If any such indication exists, the recoverable amount of the asset is estimated in order to determine the extent of the impairment loss. Where it is not possible to estimate the recoverable amount of an individual asset, the Company estimates the recoverable amount of the cash-generating unit ("CGU") to which the asset belongs. Where a reasonable and consistent basis of allocation can be identified, corporate assets are also allocated to an individual CGU. Otherwise they are allocated to the smallest group of CGU's for which a reasonable and consistent allocation basis can be identified.

Intangible assets with indefinite useful lives and intangible assets not yet available for use are tested for impairment at least annually, but also whenever there is an indication that the asset may be impaired.

The recoverable amount is the higher of fair value less costs to sell and value in use. In assessing value in use, the estimated future cash flows are discounted to their present value using a pre-tax discount rate that reflects current market assessments of the time value of money and the risks specific to the asset for which the estimates of future cash flows have not been adjusted.

If the recoverable amount of an asset (or CGU) is estimated to be less than its carrying amount, the carrying amount of the asset (or CGU) is reduced to its recoverable amount. An impairment loss is recognized immediately.

## **Kahala Brands, Ltd.**

Notes to the Consolidated Financial Statements

For the Year Ended December 31, 2015

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### **2. Significant accounting policies – continued**

#### *Impairment of tangible and intangible assets other than goodwill - continued*

If an impairment loss subsequently reverses, the carrying amount of the asset (or a CGU) is increased to the revised estimate of its recoverable amount, but only to the extent the increased carrying amount does not exceed the carrying amount that would have been determined had no impairment loss been recognized for the asset (or CGU) in prior years. A reversal of an impairment loss is recognized immediately.

#### *Impairment of goodwill*

For the purposes of impairment testing, goodwill is allocated to each of the Company's cash-generating units (or groups of CGUs) that are expected to benefit from the synergies of the business combination.

At the end of each reporting period, the Company reviews the carrying amount of goodwill to determine whether there is any indication that it has suffered an impairment loss. If any such indication exists, the recoverable amount of the CGU to which goodwill is allocated is estimated in order to determine the extent of the impairment loss. If the recoverable amount of the CGU is less than its carrying amount, the impairment loss is allocated first to reduce the carrying amount of any goodwill allocated to the unit and then to the other assets of the unit pro rata based on the carrying amount of each asset in the unit. Any impairment loss for goodwill is recognized directly in profit or loss in the consolidated statement of income and comprehensive income. An impairment loss recognized on goodwill is not reversed in subsequent periods. Regardless of whether there is an indication of impairment or not, goodwill is tested for impairment at least annually, but also whenever there is an indication that the asset may be impaired.

#### *Income taxes*

Income tax expense consists of current and deferred taxes. Current and deferred tax expenses are recognized in profit or loss except to the extent that they relate to items recognized directly in equity or other comprehensive income.

#### *Current tax*

Current tax is recognized and measured at the amount expected to be recovered from or payable to the taxation authorities based on the income tax rates enacted or substantively enacted at the end of the reporting period and includes any adjustment to taxes payable in respect of previous years.

#### *Deferred tax*

Deferred tax is recognized on any temporary differences between the carrying amounts of assets and liabilities in the consolidated financial statements and the corresponding tax bases used in the computation of taxable income. Deferred tax assets and liabilities are measured at the tax rates that are expected to apply in the period when the asset is realized and the liability is settled. The effect of a change in the enacted or substantively enacted tax rates is recognized in profit or loss and comprehensive income or in equity depending on the item to which the adjustment relates.

Deferred tax assets are recognized to the extent future recovery is probable. At the end of each reporting period, deferred tax assets are reduced to the extent that it is no longer probable that sufficient taxable earnings will be available to allow all or part of the asset to be recovered.

## Kahala Brands, Ltd.

Notes to the Consolidated Financial Statements

For the Year Ended December 31, 2015

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### 2. Significant accounting policies - continued

#### *Financial instruments*

Financial assets and financial liabilities are recognized when an entity becomes a party to the contractual provisions of the instrument.

Financial assets and financial liabilities are initially measured at fair value. Transaction costs that are directly attributable to the acquisition or issue of financial assets and financial liabilities (other than financial assets and financial liabilities at fair value through profit or loss) are added to or deducted from the fair value of the financial assets or financial liabilities, as appropriate, on initial recognition. Transaction costs directly attributable to the acquisition of financial assets or financial liabilities at fair value through profit or loss are recognized immediately in profit or loss.

The subsequent measurement of financial assets and financial liabilities is dependent on their classification as described below. Their classification depends on the purpose for which the financial instruments were acquired or issued, their characteristics and the Company's designation of such instruments.

#### Classification

|  |                             |
|--|-----------------------------|
| Cash                                     | Loans and receivables       |
| Restricted cash                          | Loans and receivables       |
| Accounts receivable                      | Loans and receivables       |
| Notes receivable                         | Loans and receivables       |
| Accounts payable and accrued liabilities | Other financial liabilities |
| Notes payable                            | Other financial liabilities |

Financial assets are classified into one of four categories:

- fair value through profit or loss ("FVTPL");
- held-to-maturity ("HTM");
- available-for-sale ("AFS"); and
- loans and receivables.

#### i. FVTPL financial assets

Financial assets are classified as FVTPL when the financial asset is held for trading or it is designated as FVTPL.

A financial asset is classified as held for trading if:

- it has been acquired principally for the purpose of selling in the near future;
- it is a part of an identified portfolio of financial instruments that the Company manages and has an actual pattern of short-term profit-taking; or
- it is a derivative that is not designated and effective as a hedging instrument.

Financial assets classified as FVTPL are stated at fair value with any resulting gain or loss recognized in profit or loss. The net gain or loss recognized incorporates any dividend or interest earned on the financial asset.

#### ii. HTM investments

HTM investments are recognized on a trade-date basis and are initially measured at fair value, including transaction costs and subsequently at amortized cost.

## **Kahala Brands, Ltd.**

Notes to the Consolidated Financial Statements

For the Year Ended December 31, 2015

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### **2. Significant accounting policies - continued**

#### iii. AFS financial assets

AFS financial assets are those non-derivative financial assets that are designated as available-for-sale or are not classified as loans and receivables, HTM or FVTPL. Gains and losses arising from changes in fair value are recognized in other comprehensive income, net of tax, and accumulated in equity in the investments revaluation reserve. Impairment losses, interest calculated using the effective interest method and foreign exchange gains and losses on monetary assets, are recognized directly in profit or loss rather than equity. When an investment is disposed of or is determined to be impaired, the cumulative gain or loss accumulated in the investments revaluation reserve is included in profit or loss for the period.

#### iv. Loans and receivables

Other receivables that have fixed or determinable payments that are not quoted in an active market are classified as loans and receivables.

Loans and receivables are initially recognized at the transaction value and subsequently carried at amortized cost less impairment losses. The impairment loss of receivables is based on a review of all outstanding amounts at the end of the reporting period. Bad debts are written off during the year in which they are identified. Interest income is recognized by applying the effective interest rate, except for short-term receivables where the recognition of interest would be immaterial.

#### v. Impairment of financial assets

Financial assets, other than those at FVTPL, are assessed for indicators of impairment at the end of each reporting period. Financial assets are impaired when there is objective evidence that, as a result of one or more events that occurred after the initial recognition of the financial asset, the estimated future cash flows of the investment have been impacted.

Objective evidence of impairment could include the following:

- significant financial difficulty of the issuer or counterparty;
- default or delinquency in interest or principal payments; or
- it has become probable that the borrower will enter bankruptcy or financial reorganization.

For financial assets carried at amortized cost, the amount of the impairment is the difference between the asset's carrying amount and the present value of the estimated future cash flows, discounted at the financial asset's original effective interest rate.

The carrying amount of all financial assets is directly reduced by the impairment loss. Changes in the carrying amount are recognized in profit or loss.

With the exception of AFS equity instruments, if, in a subsequent period, the amount of the impairment loss decreases and the decrease relates to an event occurring after the impairment was recognized; the previously recognized impairment loss is reversed through profit or loss. On the date of impairment reversal, the carrying amount of the financial asset cannot exceed its amortized cost had impairment not been recognized.



## **Kahala Brands, Ltd.**

Notes to the Consolidated Financial Statements

For the Year Ended December 31, 2015

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### **2. Significant accounting policies - continued**

#### vi. Financial liabilities and equity

Debt and equity instruments are classified as either financial liabilities or as equity in accordance with the substance of the contractual arrangement.

An equity instrument is any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities. Equity instruments issued by the Company are recorded at the proceeds received, net of any direct issue costs.

Financial liabilities are classified as either financial liabilities at FVTPL or other financial liabilities.

#### vii. Other financial liabilities

Other financial liabilities are initially measured at fair value, net of transaction costs, and are subsequently measured at amortized cost using the effective interest method, with interest expense recognized on an effective yield basis.

The effective interest method is a method of calculating the amortized cost of a financial instrument and of allocating interest expense over the corresponding period. The effective interest rate is the rate that exactly discounts estimated future cash payments over the expected life of the financial instrument, or, where appropriate, a shorter period, to the net carrying amount on initial recognition.

#### viii. Fair value hierarchy

The Company classifies its fair value measurements in accordance with the three levels fair value hierarchy as follows:

- Level 1 – Unadjusted quoted prices in active markets for identical assets or liabilities;
- Level 2 – Inputs other than quoted prices that are observable for the asset or liability either directly or indirectly; and
- Level 3 – Inputs that are not based on observable market data.

The Company does not have any financial instruments that requires fair value adjustment on a recurring basis.

#### *Provisions*

Provisions are recorded when a present legal or constructive obligation exists as a result of past events where it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation, and a reliable estimate of the amount of the obligation can be made.

The amount recognized as a provision is the best estimate of the consideration required to settle the present obligation at the end of the reporting period, taking into account the risks and uncertainties surrounding the obligation. Where a provision is measured using the cash flows estimated to settle the present obligation, its carrying amount is the present value of those cash flows. When some or all of the economic benefits required to settle a provision are expected to be recovered from a third party, the receivable is recognized as an asset if it is virtually certain that reimbursement will be received and the amount receivable can be measured reliably.

## **Kahala Brands, Ltd.**

Notes to the Consolidated Financial Statements  
For the Year Ended December 31, 2015

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### **2. Significant accounting policies - continued**

#### *Unredeemed gift cards liability*

The prepaid cards liability represents the Company's obligations related to unredeemed balances on activated prepaid program cards. At the end of the third year after the end of the year in which a prepaid gift card is activated, the Company estimates and recognizes as revenue the amount that would likely not be redeemed. The estimate is based on historical redemption patterns. Subsequent redemptions of gift cards that have been recognized as revenue are charged as expense during the period in which they are redeemed.

#### *Advertising funds*

The Company, acting as an agent, manages the advertising funds of its concepts. The Company collects and administers funds specifically for each concept. These funds are dedicated for use in advertising and promotional programs as well as other initiatives designed to increase sales and enhance the image and reputation of the concepts. Contributions to the funds are made based on a percentage of sales. The revenue and expenses of the promotional funds are not included in the Company's net income because the contributions to these funds are segregated and designated for specific purposes. These amounts are included in accounts payable and accrued liabilities.

Pursuant to the franchise agreements, franchisees must pay a fee based on sales to their respective advertising fund(s). These amounts are collected by the Company in its capacity as agent and must be used for promotional and advertising purposes, since the amounts are set aside to promote the respective concepts for the franchisees' benefit. The fees collected by the Company for the advertising funds are not recorded in the Company's consolidated statement of income and comprehensive income, but rather as accrued obligations in its capacity as agent operating on behalf of the respective advertising funds.

#### *Segmented reporting*

The Company currently operates as a single segment. Its principal business relates to franchising operations in the United States.

#### *Future accounting changes*

A number of new standards, interpretations and amendments to existing standards were issued by the International Accounting Standard Board ("IASB") that are not yet effective for the year ended December 31, 2015, and have not been applied in preparing these consolidated financial statements.

## Kahala Brands, Ltd.

Notes to the Consolidated Financial Statements  
For the Year Ended December 31, 2015

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### 2. Significant accounting policies - continued

The following standards may have a material impact on the consolidated financial statements of the Company:

| Standard   | Effective date <sup>1</sup> | Impact <sup>2</sup> |
|--|-----------------------------|---------------------|
| IAS 1 <i>Presentation of Financial Statements</i>    | January 1, 2016             | In assessment       |
| IFRS 9 <i>Financial Instruments</i>                  | January 1, 2018             | In assessment       |
| IFRS 15 <i>Revenue from contracts with customers</i> | January 1, 2017             | In assessment       |
| IAS 16 <i>Property, Plant and Equipment</i>          | January 1, 2016             | In assessment       |
| IAS 38 <i>Intangible Assets</i>                      | January 1, 2016             | In assessment       |
| IFRS 16 <i>Leases</i>                                | January 1, 2019             | In assessment       |

1) *Effective for annual periods starting on or after:*

2) *Impact on the consolidated financial statements estimated by the Company.*

An amendment was issued for IAS 1 in December 2014 as part of the IASB's Disclosure Initiative to address some concerns expressed about existing presentation and disclosure requirements and to ensure entities are able to use judgement when preparing their consolidated financial statements. These amendments are effective for annual periods beginning on or after January 1, 2016.

IFRS 9 replaces the guidance in IAS 39 Financial Instruments: Recognition and Measurement on the classification and measurement of financial assets and financial liabilities. The replacement of IAS 39 is a three-phase project with the objective of improving and simplifying the reporting for financial instruments. This is the first phase of that project.

IFRS 9 provides additional guidance on the classification and measurement so that financial assets will be classified by reference to the business model within which they are held. Also introduced is the "expected credit loss" model for the measurement of impairment. The de-recognition requirements are carried forward from IAS 39.

IFRS 15 specifies how and when revenue is recognized. As well it requires entities to provide users of financial statements with more informative, relevant disclosures. The standard provides a single, principles based five-step model to be applied to all contracts with customers.

Management is assessing the impact of the new standard as it would apply to franchise agreements which encompass initial franchise fees and royalties. Although early adoption is permitted, management has not applied this standard for the year ended December 31, 2015.

Amendments to IAS 16 Property, Plant and Equipment and IAS 38 Intangible Assets, issued by the IASB in May 2014, clarify that the use of revenue-based methods to calculate the depreciation of an asset is not appropriate. Amendments to IAS 38 specify that an amortization method based on revenue is generally presumed to be an inappropriate basis for measuring the consumption of the economic benefits embodied in an intangible asset. The amendments are effective for annual periods beginning on or after January 1, 2016.

IFRS 16 Leases was issued by the IASB on January 13, 2016 and replaces IAS 17. The new standard eliminates the classification of leases as either operating leases or finance leases for a lessee. Instead all leases are treated in a similar way to finance leases applying IAS 17. IFRS 16 does not require a lessee to recognize assets or liabilities for short-term leases and leases of low-value assets. The amendments are effective for annual periods beginning on or after January 1, 2019, with early adoption permitted for entities that also apply IFRS 15.

As part of its annual improvement process, the IASB has made improvements to several standards during this cycle:

- IFRS 1: *First-time Adoption of International Financial Reporting Standards*: Deletion of short-term exemptions for first-time adopters. This amendment was tentatively approved by the IASB in December 2013.

## **Kahala Brands, Ltd.**

Notes to the Consolidated Financial Statements

For the Year Ended December 31, 2015

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### **2. Significant accounting policies - continued**

- IAS 28: *Investments in Associates and Joint Ventures*: Clarification that measuring investees at fair value through profit or loss is an investment-by-investment choice. This amendment was tentatively approved by the IASB in January 2015.
- IAS 12: *Disclosure of Interests in Other Entities*: Clarification of the scope of the disclosure requirements in IFRS 12. This amendment was tentatively approved by the IASB in July 2015.

The Exposure Draft containing the proposed amendments was published on November 19, 2015 and the proposals were open for public comment until February 17, 2016.

### **3. Critical accounting judgements and key sources of estimation uncertainty**

The preparation of financial statements requires management to make judgments, estimates and assumptions that affect the application of policies and reported amounts of assets and liabilities, and revenue and expenses. The estimates and associated assumptions are based on historical experience and various other factors that are believed to be reasonable under the circumstances, the results of which form the basis of making the judgments about carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates.

The estimates and underlying assumptions are reviewed on an ongoing basis. Revisions to accounting estimates are recognized in the period in which the estimate is revised if the revision affects only that period or in the period of the revision and further periods if the review affects both current and future periods.

#### *Critical judgments in applying accounting policies*

##### Identification of cash-generating units

The Company assesses whether there are any indicators of impairment for all non-financial assets at each reporting period date. Doing so requires the identification of cash-generating units ("CGU"); the determination is made based on management's best estimation of what constitutes the lowest level at which an asset or group of assets has the possibility of generating cash inflows.

Management identifies each brand as a CGU and makes critical judgments pertaining to the future cash flow projections and the weighted average cost of capital ("WACC").

#### *Key sources of estimation uncertainty*

##### Impairment of non-financial assets

The recoverable amounts of the Company's assets are generally estimated based on value-in-use calculations as the values determined by this method are higher than their fair value less cost to sell. The fair value less cost to sell of corporate stores is generally determined by estimating the liquidation value of the restaurant equipment.

The value-in-use calculations take into account the Company's best estimate of future cash flows, using the previous year's cash flows for each CGU to extrapolate that CGU's future performance to the earlier of the termination of the lease (if applicable) or 5 years with a terminal value calculated beyond this period, assuming no growth to the cash flows of previous periods. For the current reporting period, a cash flow period of 5 years was used as predictability for periods beyond this cannot be estimated with reasonable accuracy.

**Kahala Brands, Ltd.**

Notes to the Consolidated Financial Statements  
For the Year Ended December 31, 2015

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**3. Critical accounting judgements and key sources of estimation uncertainty- continued**

Determining whether goodwill is impaired requires an estimation of the value in use of the CGUs to which goodwill has been allocated. The value in use calculation requires management to estimate the future cash flows expected to arise from the CGU and a suitable discount rate in order to calculate present value.

During the year, the Company recorded impairment on assets held-for-sale and intangibles and goodwill of \$846,858 and \$3,800,000, respectively (2014 - \$277,744 and \$1,700,000, respectively).

**Useful lives of property and equipment and intangible assets**

As described in Note 2 above, the Company reviews the estimated useful lives of property and equipment and intangible assets with definite useful lives at the end of each year and assesses whether the useful lives of certain items should be shortened or extended, due to various factors including technology, competition and revised service offerings. During the years ended December 31, 2015 and 2014, the Company was not required to adjust the useful lives of any assets based on the factors described above.

**Gift cards revenue**

The Company makes an annual assessment and recognizes revenue related to activated gift cards that will likely never be redeemed ("breakage"). Management makes assumptions and estimations based on historical trends of customer redemption patterns. The Company recognized breakage revenue of \$7,715,350 in 2015 (2014 - \$6,923,174).

**4. Segmented reporting**

The Company currently operates as a single segment. Its principal business relates to franchising of quick service food restaurants.

**Kahala Brands, Ltd.**

Notes to the Consolidated Financial Statements

For the Year Ended December 31, 2015

**5. Business acquisition**

(a) On June 2, 2015, the Company completed the acquisition of Tasti D-Lite, LLC ("TDL") whereby the Company, through a wholly-owned subsidiary, acquired 100% of the member units of TDL for a consideration of \$2,161,710, paid from the Company's cash on hand.

The preliminary purchase price allocation is as follows:

Net assets acquired**Current assets**

|                              |                  |
|------------------------------|------------------|
| Cash and cash equivalents    | \$ 551,782       |
| Accounts receivable          | 236,451          |
| Inventories                  | 38,582           |
| Prepaid expense and deposits | 235,971          |
| Other current assets         | 7,899            |
|                              | <hr/>            |
|                              | <b>1,070,685</b> |

|                               |                     |
|-------------------------------|---------------------|
| Property, plant and equipment | 54,200              |
| Deferred rent                 | 22,411              |
| Trade name and trademarks     | 806,000             |
| Franchise agreements          | 731,000             |
| Goodwill                      | 1,039,159           |
|                               | <hr/>               |
|                               | <b>\$ 3,723,455</b> |

**Current Liabilities**

|                                |                     |
|--------------------------------|---------------------|
| Accounts payable               | \$ 98,317           |
| Accrued expenses               | 155,062             |
| Unredeemed gift card liability | 388,047             |
| Other short term liabilities   | 145,289             |
|                                | <hr/>               |
|                                | <b>786,715</b>      |
| Long-term debt                 | 192,913             |
| Other long-term liabilities    | 582,117             |
|                                | <hr/>               |
|                                | <b>1,561,745</b>    |
|                                | <hr/>               |
| Net purchase price             | <b>\$ 2,161,710</b> |

**Kahala Brands, Ltd.**

Notes to the Consolidated Financial Statements

For the Year Ended December 31, 2015

**5. Business acquisition - continued**

The purchase price allocation is still preliminary as post-closing adjustments have not yet been finalized.

Since the date of acquisition in 2015, TDL has contributed approximately \$1,700,000 in revenue and has recognized approximately \$300,000 in net earnings. The Company has used a significant amount of judgment and has made assumptions in estimating the revenue and net earnings of TDL had the business acquisition occurred at the beginning of the year. Based on those assumptions, the Company has estimated that had the acquisition occurred at the beginning of the year TDL would have contributed \$3,500,000 in revenue and \$525,000 in earnings.

(b) On November 2, 2015, the Company acquired the premium smoothie and coffee brand Maui Wowi Hawaiian ("Maui") based in Denver, Colorado for the consideration of \$4.0 million, paid from the Company's cash on hand.

Net assets acquired**Current assets**

|                                   |                |
|-----------------------------------|----------------|
| Cash and cash equivalents         | \$ 228,513     |
| Accounts receivable               | 222,808        |
| Prepaid expense and deposits      | 36,911         |
| Notes receivable, current portion | 18,423         |
|                                   | <hr/>          |
|                                   | <b>506,655</b> |

|                               |                    |
|-------------------------------|--------------------|
| Property, plant and equipment | 28,990             |
| Notes receivable              | 81,286             |
| Trade name and trademarks     | 719,747            |
| Franchise agreements          | 1,904,508          |
| Goodwill                      | 1,056,639          |
|                               | <hr/>              |
|                               | <b>\$4,297,825</b> |

**Current liabilities**

|                                  |                |
|----------------------------------|----------------|
| Accounts payable                 | \$ 197,336     |
| Unredeemed gift card liabilities | 9,249          |
| Deferred Revenue                 | 91,240         |
|                                  | <hr/>          |
|                                  | <b>297,825</b> |

|                    |                                |
|--------------------|--------------------------------|
| Net purchase price | <hr/> <hr/> <b>\$4,000,000</b> |
|--------------------|--------------------------------|

The purchase price allocation is still preliminary as post-closing adjustments have not been finalized.

Since the date of acquisition in 2015, Maui has contributed approximately \$386,000 in revenue and has recognized \$1,750 in net earnings. The Company has used a significant amount of judgment and has made assumptions in estimating the revenue and net earnings of Maui had the business acquisition occurred at the beginning of the year. Based on those assumptions, the Company has estimated that had the acquisition occurred at the beginning of the year Maui would have contributed \$1,600,000 in revenue and \$240,000 in earnings.

## Kahala Brands, Ltd.

Notes to the Consolidated Financial Statements

For the Year Ended December 31, 2015

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### 5. Business acquisitions - continued

(c) On December 11, 2015, the Company acquired the United States operations and intellectual property rights of frozen yogurt brand Pinkberry based in Santa Monica, California, for a consideration of \$3,903,633, paid from the Company's cash on hand. The international operations were acquired by an entity related to the Company by common ownership for a consideration of \$5,100,000.

The preliminary purchase price allocation is as follows:

#### Net assets acquired

##### **Current assets**

|                              |                        |
|------------------------------|------------------------|
| Cash and cash equivalents    | \$ 661,000             |
| Accounts receivable          | 375,228                |
| Prepaid expense and deposits | 926,693                |
| Assets held for sale         | 1,669,703              |
|                              | <hr/> <b>3,632,624</b> |

|                               |                                |
|-------------------------------|--------------------------------|
| Property, plant and equipment | 57,822                         |
| Trade name and trademarks     | 1,745,892                      |
| Franchise agreements          | 1,556,272                      |
| Goodwill                      | 480,237                        |
|                               | <hr/> <b>\$7,472,847</b> <hr/> |

##### **Current Liabilities**

|                                |                                |
|--------------------------------|--------------------------------|
| Accounts payable               | \$ 517,562                     |
| Accrued expenses               | 942,904                        |
| Unredeemed gift card liability | 1,648,497                      |
| Deferred revenue               | 152,168                        |
| Deferred rent liability        | 308,083                        |
|                                | <hr/> <b>3,569,214</b> <hr/>   |
| Net purchase price             | <hr/> <b>\$3,903,633</b> <hr/> |

The purchase price allocation is still preliminary as post-closing adjustments have not been finalized.

Since the date of acquisition in 2015, Pinkberry has contributed approximately \$900,000 in revenue and has incurred a loss of approximately \$300,000. The Company has used a significant amount of judgment and has made assumptions in estimating the revenue and net earnings of Pinkberry had the business acquisition occurred at the beginning of the year. Based on those assumptions, the Company has estimated that had the acquisition occurred at the beginning of the year Pinkberry would have contributed \$1,700,000 in revenue and \$255,000 in earnings.

The purpose of these acquisitions was to broaden the Company's brand portfolio while providing a synergistic complement to many of its existing brands.



## Kahala Brands, Ltd.

Notes to the Consolidated Financial Statements

For the Year Ended December 31, 2015

### 6. Correction of error

Subsequent to the issuance of the audited financial statements for the year ended December 31, 2014, it was discovered that certain amounts received under three supplier contracts were incorrectly recognized in revenue in earlier years. These amounts should have been considered as deferred revenue until the proper revenue recognition criteria had been met.

The impact of this accounting error has been reflected in these consolidated financial statements, on a retroactive basis, with an increase to deferred revenue as at December 31, 2014 and an increase to Deficit of \$2,490,914 as at December 31, 2013 and 2014.

|  | Balance Originally<br>Reported |    | Restatement |    | Restated Balance |
|--|--------------------------------|----|-------------|----|------------------|
| Deferred revenue - current                         | \$ 4,361,903                   | \$ | 183,602     | \$ | 4,545,505        |
| Deferred revenue - long term                       | \$ 493,225                     | \$ | 2,307,312   | \$ | 2,800,537        |
| Total Liabilities                                  | \$ 108,248,115                 | \$ | 2,490,914   | \$ | 110,739,029      |
| Deficit as at December 31, 2013                    | \$ 169,219,354                 | \$ | 2,490,914   | \$ | 171,710,268      |
| Deficit as at December 31, 2014                    | \$ 152,009,074                 | \$ | 2,490,914   | \$ | 154,499,988      |
| Total shareholders' equity as at December 31, 2013 | \$ 54,369,700                  | \$ | (2,490,914) | \$ | 51,878,786       |
| Total shareholders' equity as at December 31, 2014 | \$ 70,408,221                  | \$ | (2,490,914) | \$ | 67,917,307       |

### 7. Notes receivable

|   | December 31, 2015  | December 31, 2014 |
|---|--------------------|-------------------|
| Loans made to franchisees, area developers and others at varying interest rates ranging from 5% - 8% with terms of 3 to 8 years | <b>\$3,611,323</b> | \$4,362,861       |
| Less: impairment allowance  | <b>(420,867)</b>   | (712,372)         |
| Demand note to HTI International Holdings, LLC at an interest rate of 24%   | <b>2,500,000</b>   | 2,500,000         |
| Less: impairment allowance  | <b>(2,300,000)</b> | (2,500,000)       |
|   | <b>3,390,456</b>   | 3,650,489         |
| Less: current portion   | <b>(1,481,061)</b> | (637,541)         |
|   | <b>\$1,909,395</b> | \$3,012,948       |

On December 2, 2013, the Company sold notes it held from Hydration Technology Innovations, LLC ("HTI") and Innovations Management, LLP ("IM") to HTI International Holdings, LLC ("HIH"), a company controlled by a former officer for total consideration of \$7,500,000. \$5,000,000 was paid in cash by HIH, with the remainder in the form of a note secured against the equity interest in HTI and IM, bearing interest at 24% per annum. HIH defaulted on payment which matured on December 31, 2014. Payments of \$200,000 were made on the note in 2016 and an impairment allowance has been provided on the remaining unpaid balance.

## Kahala Brands, Ltd.

Notes to the Consolidated Financial Statements

For the Year Ended December 31, 2015

### 8. Transitional stores

As of December 31, 2015, the Company had 46 stores (2014 – 23) under its transitional program with a carrying value of \$1,965,960 (2014 - \$1,112,568). For the twelve months ended December 31, 2015, the Company recorded an impairment loss of \$846,858 (2014 - \$277,744). The Company closed ten stores and recognized losses of \$98,999 on disposition of these assets (2014 - gain of \$703,966).

### 9. Property and equipment

| <u>Cost</u>                         | <u>Leasehold<br/>Improvements</u> | <u>Equipment<br/>&amp; Furniture</u> | <u>Aircraft</u> | <u>Vehicle</u>   | <u>Total</u>      |
|-------------------------------------|-----------------------------------|--------------------------------------|-----------------|------------------|-------------------|
| Balance at January 1, 2014          | \$ -                              | \$ -                                 | \$ 16,662,289   | \$ -             | \$ 16,662,289     |
| Additions                           | -                                 | -                                    | -               | 25,000           | 25,000            |
| Disposals                           | -                                 | -                                    | (16,662,289)    | -                | (16,662,289)      |
| Balance at December 31, 2014        | -                                 | -                                    | -               | 25,000           | 25,000            |
| Additions                           | 55,612                            | 190,585                              | -               | -                | 246,197           |
| Balance at December 31, 2015        | <u>\$ 55,612</u>                  | <u>\$ 190,585</u>                    | <u>\$ -</u>     | <u>\$ 25,000</u> | <u>\$ 271,197</u> |
| <br><u>Accumulated amortization</u> |                                   |                                      |                 |                  |                   |
| Balance at January 1, 2014          | \$ -                              | \$ -                                 | \$ 8,695,698    | \$ -             | \$ 8,695,698      |
| Eliminated on disposal of assets    | -                                 | -                                    | (9,145,475)     | -                | (9,145,475)       |
| Depreciation expense                | -                                 | -                                    | 449,777         | 1,667            | 451,444           |
| Balance at December 31, 2014        | -                                 | -                                    | -               | 1,667            | 1,667             |
| Depreciation expense                | 11,113                            | 20,582                               | -               | 5,000            | 36,695            |
| Balance at December 31, 2015        | <u>\$ 11,113</u>                  | <u>\$ 20,582</u>                     | <u>\$ -</u>     | <u>\$ 6,667</u>  | <u>\$ 38,362</u>  |
| <br><u>Carrying Amounts</u>         |                                   |                                      |                 |                  |                   |
| Balance at January 1, 2014          | \$ -                              | \$ -                                 | \$ 7,966,591    | \$ -             | \$ 7,966,591      |
| Balance at December 31, 2014        | \$ -                              | \$ -                                 | \$ -            | \$ 23,333        | \$ 23,333         |
| Balance at December 31, 2015        | <u>\$ 44,499</u>                  | <u>\$ 170,003</u>                    | <u>\$ -</u>     | <u>\$ 18,333</u> | <u>\$ 232,835</u> |

For the twelve month period ended December 31, 2015, fixed asset additions totaled \$246,198 in property and equipment. The Company incurred depreciation expense of \$36,696 (2014 - \$1,667).

In April 2014, the Company sold its Cessna aircraft to a third party for approximately \$8.4 million and recognized a loss of \$71,963. An impairment charge of \$1,328,778 was recognized in 2013. The proceeds from the sale along with \$2.0 million of restricted cash held as security, and additional cash of \$2.3 million were used to repay the balance of the secured note outstanding.

**Kahala Brands, Ltd.**

Notes to the Consolidated Financial Statements

For the Year Ended December 31, 2015

**10. Intangible assets and goodwill**

| <b>Cost</b>                     | <b>Franchise<br/>and License<br/>Agreements</b> | <b>Trade Names<br/>and Trade<br/>Secret<br/>Formulation</b> | <b>Goodwill</b>     | <b>Total</b>  |
|---------------------------------|---|---|---------------------|---------------|
| Balance at January 1, 2014      | \$32,794,735                                    | \$51,919,962  | \$68,849,341        | \$153,564,038 |
| Additions                       | -   | -   | -                   | -             |
| Impairment                      | -   | -   | (1,700,000)         | (1,700,000)   |
| Balance at December 31, 2014    | <b>32,794,735</b>                               | <b>51,919,962</b>   | <b>67,149,341</b>   | 151,864,038   |
| Business acquisitions (note 5)  | 4,191,780                                       | 3,271,639   | 2,576,036           | 10,039,455    |
| Impairment                      | -   | -   | (3,800,000)         | (3,800,000)   |
| Balance at December 31, 2015    | <b>36,986,515</b>                               | <b>55,191,601</b>   | <b>65,925,377</b>   | 158,103,493   |
| <b>Accumulated Amortization</b> |   |   |                     |               |
| Balance at January 1, 2014      | 23,429,565                                      | -   | -                   | 23,429,565    |
| Amortization expense            | 2,805,523                                       | -   | -                   | 2,805,523     |
| Balance at December 31, 2014    | <b>26,235,088</b>                               | -   | -                   | 26,235,088    |
| Amortization expense            | 2,632,452                                       | -   | -                   | 2,632,452     |
| Balance at December 31, 2015    | <b>28,867,540</b>                               | -   | -                   | 28,867,540    |
| <b>Carrying amounts</b>         |   |   |                     |               |
| Balance at December 31, 2014    | <b>\$6,559,647</b>                              | <b>\$51,919,962</b>   | <b>\$67,149,341</b> | \$125,628,950 |
| Balance at December 31, 2015    | <b>\$8,118,975</b>                              | <b>\$55,191,601</b>   | <b>\$65,925,377</b> | \$129,235,953 |

Goodwill was allocated to individual CGUs for impairment testing purposes. Each of the Company's brands is considered a separate CGU for goodwill impairment testing. The Company recognized an impairment charge of \$3,800,000 on the Blimpie brand CGU (2014 - \$1,700,000) in the consolidated statement of operations and comprehensive income for the year ended December 31, 2015. This CGU is an identifiable business operation for which discrete cash flows can be attributed. The Company identified lower than forecasted sales as an indicator of impairment and forecasted growth to be no greater than inflationary growth. The recoverable amount was determined based on its value in use using a pre-tax weighted average cost of capital ("WACC") of 12.8%. The recoverable amount as at December 31, 2015 was \$14,368,700 (2014 - \$19,505,000).

**Kahala Brands, Ltd.**

Notes to the Consolidated Financial Statements  
For the Year Ended December 31, 2015

**11. Accounts payable and accrued liabilities**

|   | <b>December 31, 2015</b> | December 31, 2014 |
|---|--------------------------|-------------------|
| Accounts payable                          | <b>\$4,754,843</b>       | \$6,648,687       |
| Accrued gift card expenses                | <b>672,887</b>           | 1,821,935         |
| Provision                                 | <b>825,000</b>           | 806,500           |
| Accrued professional fees                 | <b>892,325</b>           | 250,000           |
| Accrued payroll expense                   | <b>1,005,516</b>         | 788,616           |
| Accrued lease termination agreements      | <b>137,350</b>           | 862,306           |
| Accrued advertising expense               | <b>2,246,396</b>         | 310,573           |
| Refundable security deposits              | <b>694,623</b>           | 501,679           |
| Contingent earn out (America's Taco Shop) | <b>364,411</b>           | 364,411           |
| Accrued miscellaneous expenses            | <b>1,634,422</b>         | 187,293           |
|   | <b>\$13,227,773</b>      | \$12,542,000      |

**12. Deferred revenues and deposits**

The table below summarizes the Company's deferred revenues and deposits according to their nature:

|   | <b>December 31, 2015</b> | December 31, 2014<br>(restated – note 6) |
|---|--------------------------|--|
| Franchise fee deposits                      | <b>\$1,504,387</b>       | \$1,069,182                              |
| Deferred rent revenue                       | <b>2,414,938</b>         | 1,996,419                                |
| Equipment deposits                          | <b>104,466</b>           | -  |
| Supplier contributions and other allowances | <b>7,204,024</b>         | 4,280,441                                |
|   | <b>11,227,815</b>        | 7,346,042                                |
| Less: current portion                       | <b>5,563,379</b>         | 4,545,505                                |
|   | <b>\$5,664,436</b>       | \$2,800,537                              |

**Kahala Brands, Ltd.**

Notes to the Consolidated Financial Statements

For the Year Ended December 31, 2015

**13. Notes payable**

|   | <u>December 31, 2015</u> | December 31, 2014   |
|---|--------------------------|---------------------|
| Note due to an unrelated party, bearing no interest, due in varying monthly installments of \$800 - \$28,000, through July 2016.  | <b>\$18,960</b>          | \$190,122           |
| Note due to an unrelated party, bearing interest at 6% per annum, due in varying monthly payments of principal and interest with final payment due in 2015. This note is convertible, at par, to common shares of the Company upon an initial public offering. The Company fully repaid this note in 2015.  | -                        | 635,244             |
| Note due to an entity related to the controlling shareholders, bearing an interest rate of 4% per annum, (6% on past due amounts). Interest is payable monthly while principal is payable in a single installment at maturity on August 1, 2028. The Company may prepay principal at any time without penalty. The Company is required to retire principal equal to 50% of net proceeds received from issuance of debt. The Company fully repaid this note in 2015. | -                        | 15,000,000          |
| Note due to an unrelated party bearing no stated interest rate, using an implied rate of 8%. Principal and imputed interest is due quarterly through July 1, 2019.  | <b>182,268</b>           | -                   |
|   | <b>201,228</b>           | 15,825,366          |
| Less: current portion   | <b>(41,195)</b>          | (4,306,406)         |
|   | <b>\$160,033</b>         | <b>\$11,518,960</b> |

**14. Related party transactions**

Balances and transactions between the Company and its subsidiaries have been eliminated on consolidation.

Key management includes the CEO, COO, CFO, General Counsel and directors who have the authority and responsibility for planning, directing, and controlling the activities of the Company. The compensation was paid in the form of cash and short-term benefits. Total compensation for key management personnel for the year ended December 31, 2015 was \$968,838 (2014 - \$906,398).

**15. Share capital**

As of December 31, 2015, the Company had issued 1,649,027 common shares with 1,642,477 outstanding (2014 – 1,649,027 issued and 1,642,477 outstanding).

## **Kahala Brands, Ltd.**

Notes to the Consolidated Financial Statements  
For the Year Ended December 31, 2015

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### **16. Commitments and contingencies**

On August 25, 2014, the Company was served with a complaint that was filed in Oregon against the Company and a number of other defendants claiming that the Company aided and abetted a breach of fiduciary duty by other defendants allegedly owed to the Plaintiff, purported to result from the sale of Hydration Technology Innovations, LLC and Hydration Systems, LLC (collectively, "HTI"). The Company did not have any equity interest in HTI but had provided significant loans to HTI and its affiliates over the past several years. On December 3, 2015, the Company and all other parties in the lawsuit conducted a Mediation in Portland, Oregon. A representative of the Company's insurer attended and participated in the Mediation. At the conclusion of the Mediation, the Company, and all defendants other than Kevin Blackwell and Lake Management, LLC, entered into a Settlement Agreement which resolved all disputes, claims and differences among the parties, and provided the Company a Release from all of the Plaintiff's claims, and a Dismissal of the Lawsuit. Pursuant to the terms of the Settlement Agreement the Defendants have agreed to pay \$3,100,000 to the Plaintiff. The entire amount of the settlement was paid by the Company's insurer in January, 2016.

In the ordinary course of conducting its business, the Company may periodically be a defendant in various legal proceedings. Any estimated loss contingencies in excess of amounts covered by business liability insurance are included in accrued expenses. The Company determines the amount of the loss contingency based on the amount of exposure and an analysis of the likelihood that the Company will incur a loss. It is the best judgment of management that neither the financial position nor results of operations of the Company will be materially affected by the final outcome of these legal proceedings. For the year ended December 31, 2015, the Company has recorded a provision of \$825,000 (2014 - \$806,000). Management reviews this provision on a regular basis and adjusts the provision to reflect the impact of negotiations, settlements, rulings, advice of legal counsel, and other information and events pertaining to each case.

In connection with the change in control of the Company on August 19, 2013, the Company entered into a Contribution, Redemption and Share Purchase Agreement ("Contribution Agreement") with a former major creditor of the Company, which resolved litigation then pending between the Company and the creditor and reduced the outstanding indebtedness then due from the Company to the creditor. Pursuant to the terms in the Contribution Agreement, the Company has agreed to pay or cause to be paid to the former creditor without interest, the first \$40,000,000 of aggregate net proceeds received by the Company or the current majority shareholder in connection with any liquidity event.

The Company guarantees the leases of 12 of its store locations where the franchisees are the lessees. These lease terms range from 5 to 10 years and require monthly payments ranging from \$1,000 - \$9,800.

**Kahala Brands, Ltd.**

Notes to the Consolidated Financial Statements

For the Year Ended December 31, 2015

**17. Income taxes**

The reconciliation of the combined US federal and states statutory income tax rate of 38% (2014 – 38%) to the effective tax rate is as follows:

|  | <u>December 31, 2015</u>  | December 31, 2014    |
|--|---------------------------|----------------------|
| Income before income taxes                     | <u>\$21,927,095</u>       | \$16,210,280         |
| Expected income tax expense                    | <b>\$ 8,332,296</b>       | \$ 6,160,280         |
| Adjustment to prior year provision             | <b>(805,180)</b>          | -                    |
| Tax rate changes and other adjustments         | <b>(136,034)</b>          | (1,965,830)          |
| Non-deductible expenses                        | <b>83,664</b>             | 86,060               |
| Prior year state tax liabilities and penalties | <b>851,713</b>            |                      |
| Change in tax benefits not recognized          | <u><b>(4,483,509)</b></u> | <u>(5,280,510)</u>   |
| Provision for income taxes                     | <b>3,842,950</b>          | (1,000,000)          |
| Current tax expense                            | <u><b>1,270,713</b></u>   | -                    |
| Deferred tax expense                           | <u><b>\$2,572,237</b></u> | <u>\$(1,000,000)</u> |

The following table summarizes the components of deferred tax:

|   | <u>December 31, 2015</u>    | <u>December 31, 2014</u> |
|---|-----------------------------|--------------------------|
| Deferred tax assets:                            |                             |                          |
| Assets held for sale                            | <b>\$502,923</b>            | \$225,880                |
| Accounts and notes receivable                   | <b>809,578</b>              | 497,060                  |
| Accrued liabilities                             | <b>517,249</b>              | -                        |
| Property and equipment                          | -                           | 630                      |
| Unredeemed gift card and other deferred revenue | <b>11,886,867</b>           | 12,276,850               |
| Non-capital losses carried forward              | <b>1,203,158</b>            | 4,638,060                |
| Alternative minimum tax                         | <b>419,000</b>              | -                        |
|   | <u><b>15,338,775</b></u>    | <u>17,638,480</u>        |
| Deferred tax liabilities:                       | <b>(16,860,590)</b>         | (16,638,480)             |
| Intangible assets                               | <b>(50,422)</b>             | -                        |
| Property and equipment                          | <u><b>(16,911,012)</b></u>  | <u>(16,638,480)</u>      |
| Net deferred tax assets (liabilities)           | <u><b>\$(1,572,237)</b></u> | <u>\$1,000,000</u>       |

**Kahala Brands, Ltd.**

Notes to the Consolidated Financial Statements

For the Year Ended December 31, 2015

**17. Income taxes (continued)**

The Company has non-capital tax losses totaling \$14,811,948 with various expiry dates between 2030 to 2034. Due to the uncertainty in the utilization of these losses, the Company has allowed for \$11,715,188 of these losses.

**18. Revenue**

|                | <u>December 31, 2015</u> | December 31, 2014    |
|----------------|--------------------------|----------------------|
| Royalties      | <b>\$39,259,505</b>      | \$37,909,390         |
| Franchise fees | <b>3,583,573</b>         | 4,869,599            |
| Rent (note 21) | <b>39,335,098</b>        | 46,849,244           |
| Store sales    | <b>8,630,006</b>         | 14,021,477           |
| Other revenues | <b>30,136,276</b>        | 26,011,921           |
|                | <b>\$120,944,458</b>     | <b>\$129,661,631</b> |

**19. Cost of sales**

The table below summarizes cost of sales expenses according to their nature:

|                   | <u>December 31, 2015</u> | December 31, 2014   |
|-------------------|--------------------------|---------------------|
| Payroll (note 14) | <b>\$3,470,020</b>       | \$4,197,262         |
| Advertising       | <b>5,208,995</b>         | 4,976,770           |
| Franchising       | <b>4,468,836</b>         | 8,199,950           |
| Gift Card         | <b>6,953,177</b>         | 9,457,666           |
| Equipment Sales   | <b>2,403,429</b>         | 1,503,420           |
|                   | <b>\$22,504,457</b>      | <b>\$28,335,068</b> |

**20. General and administrative**

The table below summarizes general and administrative expenses according to their nature:

|                         | <u>December 31, 2015</u> | December 31, 2014   |
|-------------------------|--------------------------|---------------------|
| Professional fees       | <b>\$4,146,554</b>       | \$2,557,197         |
| Repairs and maintenance | <b>152,125</b>           | 876,904             |
| Office and general      | <b>1,746,292</b>         | 3,141,423           |
| Advertising             | <b>1,355,504</b>         | 1,357,334           |
| Franchise expenses      | <b>50,087</b>            | (251,703)           |
| Travel & entertainment  | <b>2,740,668</b>         | 1,861,051           |
| Insurance               | <b>644,316</b>           | 676,016             |
|                         | <b>\$10,835,546</b>      | <b>\$10,218,222</b> |



## Kahala Brands, Ltd.

Notes to the Consolidated Financial Statements

For the Year Ended December 31, 2015

### 21. Deferred rent and operating leases

The Company has entered into various long-term leases and has sub-leased substantially all of the premises based on the same terms and conditions as the original lease to unrelated franchisees. The minimum rental, exclusive of occupancy and escalation charges, and additional rent paid on a percentage of sales payable under the leases are as follows:

|            | Lease Commitments    | Sub-leases           | Net Commitments     |
|------------|----------------------|----------------------|---------------------|
| 2016       | \$32,171,771         | \$30,071,753         | \$2,100,018         |
| 2017       | 30,188,715           | 28,105,956           | 2,082,759           |
| 2018       | 27,790,540           | 25,822,750           | 1,967,790           |
| 2019       | 24,523,232           | 22,752,289           | 1,770,943           |
| 2020       | 21,937,603           | 20,809,567           | 1,128,036           |
| Thereafter | 95,375,313           | 92,428,544           | 2,946,769           |
|            | <b>\$231,987,174</b> | <b>\$219,990,859</b> | <b>\$11,996,315</b> |

For the twelve months ended December 31, 2015, the Company recognized rental expense of \$41,743,963 (2014 - \$52,470,887) and earned rental income of \$39,335,098 (2014 - \$46,849,244). The Company has recognized a deferred rent liability related to its lease commitments of \$16,820,306 (2014 - \$19,977,229), including a current liability of \$733,256 (2014 - \$1,518,459). The Company has recognized a deferred rent asset related to its lease commitments of \$16,083,812 (2014 - \$19,280,004), including a current asset of \$548,301 (2014 - \$1,473,998).

Operating leases as sub-lessor relate to the properties leased or owned by the Company, with lease terms ranging between 5 to 10 years. Some have options to extend the duration of the agreements for up to five renewal periods each of five years in duration. None of the agreements contain clauses that would enable the lessee or sub-lessee to acquire the property.

### 22. Financial instruments and risk management

#### *Risk management*

In the normal course of its business, the Company is exposed to a number of financial risks that can affect its operating performance. These risks, and the actions taken to manage them, are as noted below.

#### *Market risk*

Market risk is the risk that the fair value of the future cash flows of a financial instrument will fluctuate because of changes in the market prices. The Company's cash and restricted cash include cash held in bank accounts that earn interest at variable interest rates. Due to the short-term nature of these financial instruments, fluctuations in market rates do not have a significant impact on estimated fair values.

#### *Interest rate risk*

The Company is subject to cash flow interest rate risk due to fluctuations in the prevailing levels of market interest rates. As all loans receivable and notes payable bear interest at fixed rates, interest rate risk is limited to potential decreases on the interest rate offered on cash held with chartered American financial institutions. As a result of debt not being subject to floating interest rates, changes in prevailing interest rates would not be expected to have a material impact on profit or loss. The Company considers this risk to be immaterial.

## **Kahala Brands, Ltd.**

Notes to the Consolidated Financial Statements  
For the Year Ended December 31, 2015

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### **22. Financial instruments and risk management - continued**

#### *Credit risk and concentration risk*

Credit risk refers to the risk that a counterparty will default on its contractual obligations resulting in financial loss to the Company. Financial instruments which are potentially subject to credit risk for the Company consists primarily of accounts and notes receivable. The Company mitigates this risk by monitoring the payment history of its franchisees and sub-lessees. Virtually all of the Company's sub-lessees are also its franchisees. Credit risk, or the risk of a counterparty defaulting, is controlled by the application of regular monitoring procedures. Where appropriate, the Company obtains security deposits as collateral. The Company has the right to offset any monies owed to and from a franchisee.

The Company does recognize an allowance for doubtful accounts for its accounts receivable. When management observes a deterioration of credit quality of certain accounts receivable from franchisees, the Company may negotiate a payment plan with the franchisee and converts the receivable balance into a note, bearing interest between 4% and 10% per annum, and secured against the assets of the franchisee. Notes receivable are reviewed periodically for impairment. An allowance of \$420,867 (2014 - \$712,372) has been provided on these notes receivable.

The credit risk on cash is limited because the counterparties are banks with high credit ratings assigned by international credit rating agencies.

The carrying amount of financial assets recorded in the consolidated financial statements, net of any allowance for losses, represents the Company's maximum exposure to credit risk.

The concentration of credit risk is limited due to the fact that the customer base is large and unrelated.

#### *Liquidity risk*

Liquidity risk is the risk that the Company may not be able to generate sufficient cash resources to settle its obligations as they fall due. The Company's strategy is to satisfy its liquidity needs using cash on hand, cash flow generated from operating activities, and cash flow provided by financing activities. As of December 31, 2015, the Company had a working capital deficiency of \$37.4 million (2014 - \$46.8 million). Excluding the unredeemed gift cards liability, the Company would have a surplus of \$19.4 million (2014 - \$8.3 million). Management does not expect the entire unredeemed gift cards liability to be redeemed within the next 12 months.

### **23. Reclassification of comparative figures**

Certain comparative figures have been reclassified to conform to the current year's presentation. Such reclassifications did not affect total comprehensive income or shareholders' equity.

### **24. Subsequent events**

On May 25, 2016, the Company announced that it had signed an agreement to merge with an indirect, wholly-owned subsidiary of MTY Food Group Inc., a Canadian publicly-traded company. The closing of the transaction is expected to happen within 75 days of the signing of the agreement and is subject to numerous closing and regulatory conditions.