

FRIENDLY ICE CREAM CORP  
Form 10-Q  
August 07, 2006

## SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

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### FORM 10-Q

(Mark One)

**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the quarterly period ended July 2, 2006

OR

**TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File No. 001-13579

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## FRIENDLY ICE CREAM CORPORATION

(Exact Name of Registrant as Specified in Its Charter)

**Massachusetts**

(State or Other Jurisdiction of  
Incorporation or Organization)

**04-2053130**

(IRS Employer  
Identification No.)

**1855 Boston Road**

**Wilbraham, Massachusetts**  
(Address of Principal Executive Offices)

**01095**

(Zip Code)

**(413) 731-4000**

(Registrant's Telephone Number, Including Area Code)

**Not Applicable**

(Former name, former address and former fiscal year, if changed since last report)

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Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act.

Large Accelerated Filer  Accelerated Filer  Non-Accelerated Filer

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes  No

Indicate the number of shares outstanding of each of the issuer's classes of common stock as of the latest practicable date.

Class	Outstanding at July 28, 2006
Common Stock, \$.01 par value	7,924,758 shares

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## PART I FINANCIAL INFORMATION

## Item 1. Financial Statements

## FRIENDLY ICE CREAM CORPORATION AND SUBSIDIARIES

## CONDENSED CONSOLIDATED BALANCE SHEETS

(Unaudited)  
(In thousands)

	July 2, 2006	January 1, 2006
<b>ASSETS</b>		
<b>CURRENT ASSETS:</b>		
Cash and cash equivalents	\$ 24,373	\$ 14,597
Restricted cash	393	2,549
Accounts receivable, net	18,976	10,757
Inventories	16,916	15,775
Assets held for sale	1,119	1,157
Prepaid expenses and other current assets	4,277	5,044
<b>TOTAL CURRENT ASSETS</b>	<b>66,054</b>	<b>49,879</b>
PROPERTY AND EQUIPMENT, net of accumulated depreciation and amortization	137,017	143,290
INTANGIBLE ASSETS AND DEFERRED COSTS, net of accumulated amortization	18,230	19,063
OTHER ASSETS	1,703	6,010
<b>TOTAL ASSETS</b>	<b>\$ 223,004</b>	<b>\$ 218,242</b>
<b>LIABILITIES AND STOCKHOLDERS DEFICIT</b>		
<b>CURRENT LIABILITIES:</b>		
Current maturities of long-term debt	\$ 1,531	\$ 1,426
Current maturities of capital lease and finance obligations	1,428	1,419
Accounts payable	23,938	24,968
Accrued salaries and benefits	9,877	8,212
Accrued interest payable	1,353	1,324
Insurance reserves	11,082	9,002
Restructuring reserves		72
Other accrued expenses	20,446	19,866
<b>TOTAL CURRENT LIABILITIES</b>	<b>69,655</b>	<b>66,289</b>
CAPITAL LEASE AND FINANCE OBLIGATIONS, less current maturities	5,436	6,173
LONG-TERM DEBT, less current maturities	224,101	224,894
ACCRUED PENSION COST	29,682	28,904
OTHER LONG-TERM LIABILITIES	32,864	33,820
<b>COMMITMENTS AND CONTINGENCIES</b>		
<b>STOCKHOLDERS DEFICIT:</b>		
Common stock	79	79
Additional paid-in capital	144,940	144,675
Accumulated other comprehensive loss	(31,785 )	(31,785 )
Accumulated deficit	(251,968 )	(254,807 )
<b>TOTAL STOCKHOLDERS DEFICIT</b>	<b>(138,734 )</b>	<b>(141,838 )</b>
<b>TOTAL LIABILITIES AND STOCKHOLDERS DEFICIT</b>	<b>\$ 223,004</b>	<b>\$ 218,242</b>

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



## FRIENDLY ICE CREAM CORPORATION AND SUBSIDIARIES

## CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(Unaudited)

(In thousands, except per share data)

	For the Three Months Ended		For the Six Months Ended	
	July 2, 2006	July 3, 2005	July 2, 2006	July 3, 2005
<b>REVENUES:</b>				
Restaurant	\$ 105,271	\$ 109,469	\$ 200,547	\$ 202,576
Foodservice	32,137	31,748	59,031	57,054
Franchise	4,082	3,876	7,627	7,126
<b>TOTAL REVENUES</b>	<b>141,490</b>	<b>145,093</b>	<b>267,205</b>	<b>266,756</b>
<b>COSTS AND EXPENSES:</b>				
Cost of sales	51,939	54,585	100,324	101,474
Labor and benefits	36,943	38,476	72,955	73,560
Operating expenses	26,816	27,488	50,815	50,889
General and administrative expenses	11,449	10,528	22,546	19,977
Write-downs of property and equipment		289	215	289
Depreciation and amortization	5,740	5,632	11,520	11,783
Gain on franchise sales of restaurant operations and properties	(1,145 )	(1,219 )	(2,011 )	(2,528 )
Loss on disposals of other property and equipment, net	366	273	475	342
<b>OPERATING INCOME</b>	<b>9,382</b>	<b>9,041</b>	<b>10,366</b>	<b>10,970</b>
Interest expense, net	5,147	5,229	10,567	10,515
<b>INCOME (LOSS) FROM CONTINUING OPERATIONS</b>				
<b>BEFORE PROVISION FOR INCOME TAXES</b>	<b>4,235</b>	<b>3,812</b>	<b>(201 )</b>	<b>455</b>
Provision for income taxes	(250 )	(1,163 )	(250 )	(424 )
<b>INCOME (LOSS) FROM CONTINUING OPERATIONS</b>	<b>3,985</b>	<b>2,649</b>	<b>(451 )</b>	<b>31</b>
<b>INCOME (LOSS) FROM DISCONTINUED OPERATIONS, net</b>				
of income tax effect of (\$450) and \$91 for the three months ended July 2, 2006 and July 3, 2005, respectively, and (\$450) and \$347 for the six months ended July 2, 2006 and July 3, 2005, respectively	674	(132 )	3,290	(500 )
<b>NET INCOME (LOSS)</b>	<b>\$ 4,659</b>	<b>\$ 2,517</b>	<b>\$ 2,839</b>	<b>\$ (469 )</b>
<b>BASIC NET INCOME (LOSS) PER SHARE:</b>				
Income (loss) from continuing operations	\$ 0.50	\$ 0.34	\$ (0.06 )	\$
Income (loss) from discontinued operations	0.09	(0.02 )	0.42	(0.06 )
Net income (loss)	\$ 0.59	\$ 0.32	\$ 0.36	\$ (0.06 )
<b>DILUTED NET INCOME (LOSS) PER SHARE:</b>				
Income (loss) from continuing operations	\$ 0.50	\$ 0.34	\$ (0.06 )	\$
Income (loss) from discontinued operations	0.08	(0.02 )	0.41	(0.06 )
Net income (loss)	\$ 0.58	\$ 0.32	\$ 0.35	\$ (0.06 )
<b>WEIGHTED AVERAGE SHARES:</b>				
Basic	7,913	7,753	7,907	7,735
Diluted	8,044	7,893	8,048	7,735

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

## FRIENDLY ICE CREAM CORPORATION AND SUBSIDIARIES

## CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)  
(In thousands)

	For the Six Months Ended	
	July 2, 2006	July 3, 2005
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>		
Net income (loss)	\$ 2,839	\$ (469 )
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Stock compensation expense	200	68
Depreciation and amortization	11,520	11,783
Noncash (income) loss from discontinued operations	(4,068 )	376
Write-downs of property and equipment	215	289
Deferred income tax benefit		(98 )
Gain on disposals of other property and equipment, net	(1,551 )	(2,192 )
Changes in operating assets and liabilities:		
Accounts receivable	(8,219 )	(4,233 )
Inventories	(1,141 )	1,269
Other assets	7,230	(1,201 )
Accounts payable	(1,030 )	2,464
Accrued expenses and other long-term liabilities	4,104	3,234
<b>NET CASH PROVIDED BY OPERATING ACTIVITIES</b>	<b>10,099</b>	<b>11,290</b>
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>		
Purchases of property and equipment	(7,967 )	(7,309 )
Proceeds from sales of property and equipment	9,200	3,359
Purchases of marketable securities		(345 )
Proceeds from sales of marketable securities		143
<b>NET CASH PROVIDED BY (USED IN) INVESTING ACTIVITIES</b>	<b>1,233</b>	<b>(4,152 )</b>
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>		
Proceeds from borrowings under revolving credit facility	8,000	16,250
Repayments of debt	(8,688 )	(20,964 )
Payments of deferred financing costs	(205 )	(11 )
Principal payments of capital lease and finance obligations	(728 )	(763 )
Stock options exercised	65	330
<b>NET CASH USED IN FINANCING ACTIVITIES</b>	<b>(1,556 )</b>	<b>(5,158 )</b>
<b>NET INCREASE IN CASH AND CASH EQUIVALENTS</b>	<b>9,776</b>	<b>1,980</b>
<b>CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD</b>	<b>14,597</b>	<b>13,405</b>
<b>CASH AND CASH EQUIVALENTS, END OF PERIOD</b>	<b>\$ 24,373</b>	<b>\$ 15,385</b>
<b>SUPPLEMENTAL DISCLOSURES:</b>		
Cash paid (refunded) during the period for:		
Interest	\$ 10,138	\$ 10,275
Income taxes	(287 )	50

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





**FRIENDLY ICE CREAM CORPORATION AND SUBSIDIARIES****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

(Unaudited)

**1. NATURE OF OPERATIONS**

As of July 2, 2006, Friendly's operated 309 full-service restaurants and franchised 210 full-service restaurants and seven non-traditional units. The Company manufactures and distributes a full line of premium ice cream dessert products. These products are distributed to Friendly's restaurants, supermarkets and other retail locations in 13 states. The restaurants offer a wide variety of breakfast, lunch and dinner menu items as well as premium ice cream dessert products.

References herein to Friendly's or the Company refer to Friendly Ice Cream Corporation, its predecessor and its consolidated subsidiaries; references herein to FICC refer to Friendly Ice Cream Corporation and not its subsidiaries; and as used herein, Northeast refers to the Company's core markets, which include Connecticut, Maine, Massachusetts, New Hampshire, New Jersey, New York, Pennsylvania, Rhode Island and Vermont.

Following is a summary of the Company-operated and franchised units:

	For the Three Months Ended		For the Six Months Ended	
	July 2, 2006	July 3, 2005	July 2, 2006	July 3, 2005
<b>Company Units:</b>				
Beginning of period	312	337	314	347
Openings	1	1	2	1
Refranchised closings	(3 )	(3 )	(4 )	(10 )
Closings	(1 )	(3 )	(3 )	(6 )
End of period	309	332	309	332
<b>Franchised Units:</b>				
Beginning of period	214	201	213	195
Refranchised openings	3	3	4	10
Openings	1	1	1	2
Closings	(1 )		(1 )	(2 )
End of period	217	205	217	205

**2. BASIS OF PRESENTATION AND SIGNIFICANT ACCOUNTING POLICIES***Interim Financial Information*

The accompanying condensed consolidated financial statements as of July 2, 2006 and for the three and six months ended July 2, 2006 and July 3, 2005 are unaudited, but have been prepared in accordance with generally accepted accounting principles ( GAAP ) for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statements. In the opinion of management, all adjustments which are necessary for a fair presentation of the consolidated financial position, results of operations, cash flows and comprehensive income (loss) of the Company have been included. Such adjustments consist solely of normal recurring accruals. Operating results for the three and six month periods ended July 2, 2006 and July 3, 2005 are not necessarily indicative of the results that may be expected for the entire year due, in part, to the seasonality of the Company's business. Historically, higher revenues and operating income have been experienced during the second and third fiscal quarters. The Company's consolidated financial statements, including the notes thereto, which are contained in the 2005 Annual Report on Form 10-K for the fiscal year ended January 1, 2006 ( 2005 Annual Report on Form 10-K ) should be read in conjunction with these condensed, consolidated financial statements. Capitalized terms not otherwise defined herein should be referenced to the 2005 Annual Report on Form 10-K.



*Use of Estimates in the Preparation of Financial Statements*

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the dates of the financial statements and the reported amounts of revenues and expenses during the reporting periods. The critical accounting policies and most significant estimates and assumptions relate to revenue recognition, insurance reserves, recoverability of accounts receivable, pension and post-retirement medical and life insurance benefits expense, asset impairment analysis, stock compensation expense and income tax valuation allowances and tax contingency reserves. Actual amounts could differ significantly from the estimates.

*Inventories*

Inventories are stated at the lower of first-in, first-out cost or market and consisted of the following at July 2, 2006 and January 1, 2006 (in thousands):

	<b>July 2, 2006</b>	<b>January 1, 2006</b>
Raw materials	\$ 1,494	\$ 1,657
Goods in process	203	106
Finished goods	15,219	14,012
Total	\$ 16,916	\$ 15,775

*Other Accrued Expenses*

Other accrued expenses consisted of the following at July 2, 2006 and January 1, 2006 (in thousands):

	<b>July 2, 2006</b>	<b>January 1, 2006</b>
Accrued rent	\$ 4,748	\$ 4,739
Accrued meals and other taxes	2,558	2,219
Gift cards outstanding	2,515	4,280
Accrued construction costs	2,203	1,335
Income taxes payable	1,998	2,761
Accrued advertising	1,578	1,211
Accrued bonus	1,377	58
Unearned revenues	1,157	1,205
Current portion of deferred gains	638	638
All other	1,674	1,420
Total	\$ 20,446	\$ 19,866

*Income Taxes*

The Company accounts for income taxes in accordance with Statement of Financial Accounting Standards ( SFAS ) No. 109, Accounting for Income Taxes, which requires recognition of deferred tax assets and liabilities for the expected future tax consequences of events that have been included in the financial statements or tax returns. The Company records deferred tax assets to the extent it believes there will be sufficient future taxable income to utilize those assets prior to their expiration. To the extent deferred tax assets may be unable to be utilized, the Company records a valuation allowance against the potentially unrealizable amount and records a charge against earnings. The calculation of the Company's tax liabilities involves uncertainties in the application of complex tax regulations in several different tax jurisdictions. The Company is periodically reviewed by tax authorities. These reviews include questions regarding the timing and amount of deductions. In evaluating the exposure associated with various filing positions, the Company records estimated reserves for probable exposures.

Due to ever-changing tax laws and income tax rates, significant judgment is required to estimate the effective tax rate expected to apply to tax differences that are expected to reverse in the future. The Company must also make estimates about the sufficiency of taxable income in future periods to offset any deductions related to deferred tax assets currently recorded. Accordingly, the Company believes estimates related to income taxes are critical.

During the fourth quarter of 2005, the Company entered a three-year cumulative loss position and revised its projections of the amount and timing of profitability in future periods. As a result, the Company increased the valuation allowance during the fourth quarter of 2005 by approximately \$26.7 million (\$22.2 million to income tax expense and \$4.5 million to stockholders' deficit) to reduce the carrying value of deferred tax assets to zero. The Company expects to record a full valuation allowance on tax benefits until it can sustain an appropriate level of profitability.

*Lease Guarantees and Contingencies*

Primarily as a result of the Company's re-franchising efforts, the Company remains liable for certain lease assignments and guarantees. These leases have varying terms, the latest of which expires in 2020. As of July 2, 2006, the potential amount of undiscounted payments the Company could be required to make in the event of non-payment by the primary lessees was \$7,588,000. The present value of these potential payments discounted at the Company's pre-tax cost of debt at July 2, 2006 was \$5,753,000. The Company generally has cross-default provisions with franchisees that would put them in default of their franchise agreement in the event of non-payment under the lease. The Company believes these cross-default provisions significantly reduce the risk that the Company will be required to make payments under these leases and, historically, the Company has not been required to make such payments. However, as of July 2, 2006, the Company believes that one franchisee may be unable to fulfill its lease obligations during 2006. Under the terms of the assignment of the leases to this franchisee, the Company has the right to recover possession of the premises before lease default. The Company believes that it has the management resources to assume operation of the restaurants if it were to take back possession of this franchisee's locations. Accordingly, no liability has been recorded for exposure under such leases at July 2, 2006 and January 1, 2006.

*Net Income (Loss) Per Share*

Basic net income (loss) per share is calculated by dividing net income (loss) by the weighted average number of common shares outstanding during the period. Diluted net income (loss) per share is calculated by dividing net income (loss) by the weighted average number of shares of common stock and common stock equivalents outstanding during the period. Common stock equivalents are dilutive stock options and warrants that are assumed exercised for calculation purposes. The number of common stock options which could dilute basic earnings per share in the future, that were not included in the computation of diluted earnings per share because to do so would have been antidilutive, was 274,158 and 129,817 for the three months ended July 2, 2006 and July 3, 2005, respectively. The number of common stock options which could dilute basic earnings per share in the future, that were not included in the computation of diluted earnings per share because to do so would have been antidilutive, was 274,158 and 284,651 for the six months ended July 2, 2006 and July 3, 2005, respectively.

Presented below is the reconciliation between basic and diluted weighted average shares for the three and six months ended July 2, 2006 and July 3, 2005 (in thousands):

	<b>For the Three Months Ended</b>			
	<b>Basic</b>		<b>Diluted</b>	
	<b>July 2, 2006</b>	<b>July 3, 2005</b>	<b>July 2, 2006</b>	<b>July 3, 2005</b>
Weighted average number of common shares outstanding during the period	7,913	7,753	7,913	7,753
Adjustments:				
Assumed exercise of stock options			131	140
Weighted average number of shares outstanding	7,913	7,753	8,044	7,893

	<b>For the Six Months Ended</b>			
	<b>Basic</b>		<b>Diluted</b>	
	<b>July 2, 2006</b>	<b>July 3, 2005</b>	<b>July 2, 2006</b>	<b>July 3, 2005</b>
Weighted average number of common shares outstanding during the period	7,907	7,735	7,907	7,735
Adjustments:				
Assumed exercise of stock options			141	
Weighted average number of shares outstanding	7,907	7,735	8,048	7,735

*Stock-Based Compensation*

Prior to January 2, 2006, the Company accounted for stock-based compensation for employees under Accounting Principles Board ( APB ) Opinion No. 25, Accounting for Stock Issued to Employees, and related interpretations. The Company had adopted the disclosure-only provisions of SFAS No. 123, Accounting for Stock-Based Compensation and the disclosures required by SFAS No. 148, Accounting for Stock-Based Compensation Transition and Disclosure. In accordance with APB Opinion No. 25, the Company generally recognized no stock-based compensation cost, as all options granted during that period had an exercise price equal to the market value of the stock on the date of grant. Stock-based compensation cost of \$68,000 related to modified option awards was included in net loss for the six months ended July 3, 2005, for the Company's 1997 Stock Option Plan and the Company's 2003 Equity Incentive Plan.

On December 16, 2004, the Financial Accounting Standards Board ( FASB ) issued SFAS No. 123 (revised 2004), Share-Based Payment ( SFAS No. 123R ). SFAS No. 123R supersedes APB Opinion No. 25 and amends SFAS No. 95, Statement of Cash Flows. Generally, the approach in SFAS No. 123R is similar to the approach described in SFAS No. 123. However, SFAS No. 123R requires all share-based payments to employees, including grants of employee stock options, to be recognized in the income statement based on their fair values at the date of grant. Pro forma disclosure is no longer an alternative.

On January 2, 2006 (the first day of its 2006 fiscal year), the Company adopted SFAS No. 123R using the modified prospective method as permitted under SFAS No. 123R. Under this transition method, compensation cost recognized in the six months ended July 2, 2006 included: (a) compensation cost for all share-based payments granted prior to but not yet vested as of January 1, 2006, based on the grant-date fair value estimated in accordance with the provisions of SFAS No. 123, and (b) compensation cost for all share-based payments granted subsequent to January 1, 2006, based on the grant-date fair value estimated in accordance with the provisions of SFAS No. 123R. In accordance with the modified prospective method of adoption, the Company's results of operations and financial position for prior periods have not been restated.

*Recently Issued Accounting Pronouncements*

In July 2006, the FASB issued FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109 ( FIN 48 ), which clarifies the accounting for uncertainty in tax positions. FIN 48 requires that the Company recognize in its financial statements the impact of a tax position, if that position is more likely than not of being sustained on audit based on the technical merits of the position. The provisions of FIN 48 are effective as of the beginning of the Company's 2007 fiscal year, with the cumulative effect of the change in accounting principle recorded as an adjustment to opening retained earnings. The Company is currently evaluating the impact of adopting FIN 48 on its financial statements.

### 3. STOCK BASED COMPENSATION

#### *Equity Compensation Plans*

The Company currently grants stock awards under the following equity compensation plans:

*1997 Stock Option Plan ( 1997 Plan )* - The 1997 Plan was adopted by the Company's Board of Directors in November 1997 and subsequently amended on March 27, 2000 and October 24, 2001. Under the 1997 Plan, the Company's Board of Directors may grant options to purchase up to 1,034,970 shares of common stock to employees, executive officers and directors. The 1997 Plan provides for the issuance of nonqualified stock options and incentive stock options (which are intended to satisfy the requirements of Section 422 of the Internal Revenue Code) and stock appreciation rights ( SARs ). The Compensation Committee of the Board of Directors determines the employees who will receive awards under the 1997 Plan and the terms of such awards. The exercise price of a stock option or SAR granted or awarded under the 1997 Plan may not be less than the fair market value of one share of common stock on the date the stock option or SAR is granted.

*The 2003 Equity Incentive Plan (the 2003 Incentive Plan )* - On April 9, 2003, the Board of Directors adopted an equity incentive plan, subject to approval by the Company's shareholders. On May 14, 2003, the shareholders approved the 2003 Incentive Plan, which became effective as of March 30, 2003. On May 10, 2006, the shareholders approved an amendment to the 2003 Incentive Plan, and increased the number of shares of common stock reserved for issuance under the 2003 Incentive Plan. The 2003 Incentive Plan provides for the issuance of nonqualified stock options and incentive stock options (which are intended to satisfy the requirements of Section 422 of the Internal Revenue Code), SARs, bonus stock, stock units, performance shares, performance units, restricted stock and restricted stock units. No more than 607,000 shares of common stock may be delivered to participants and their beneficiaries under the 2003 Incentive Plan. The Compensation Committee of the Board of Directors determines the employees who will receive awards under the 2003 Incentive Plan and the terms of such awards. The exercise price of a stock option or SAR granted or awarded under the 2003 Incentive Plan may not be less than the fair market value of one share of common stock on the date the stock option or SAR is granted.

On December 20, 2004, the Company's Board of Directors approved the vesting of all outstanding and unvested options under the Company's 1997 Plan and the 2003 Incentive Plan. This action was taken to reduce, or eliminate to the extent permitted, the transition expense related to outstanding stock option awards under SFAS No. 123R. The 259,850 options that were vested included 145,239 options with exercise prices greater than the Company's closing stock price on the modification date. Under the accounting guidance of APB Opinion No. 25, the accelerated vesting resulted in stock-based compensation cost of \$9,400 (net of related income tax benefit of \$6,600), which was included in net loss for the year ended January 2, 2005. Additionally, the effect of the accelerated vesting in the Company's pro-forma disclosure was incremental stock-based compensation of approximately \$666,000 (net of related income tax benefit of \$463,000). Stock-based compensation expense of \$434,000 and \$96,000 would otherwise have been recognized in accordance with SFAS No. 123R in the Company's consolidated statements of operations during the 2006 and 2007 fiscal years, respectively.

Options issued subsequent to December 20, 2004 generally vest over three years. Options issued prior to July 24, 2002 expire 10 years from the date of grant. Options issued subsequent to that date have a five year expiration date.

*Grant-Date Fair Value*

The Company uses the Black-Scholes option pricing model to calculate the grant-date fair value of an award. The fair value of options granted during the three and six months ended July 2, 2006 and July 3, 2005 were calculated using the following estimated weighted average assumptions:

	For the Three Months Ended		For the Six Months Ended	
	July 2, 2006	July 3, 2005	July 2, 2006	July 3, 2005
Options granted		6,000	145,409	119,953
Weighted-average exercise price	\$	9.04	\$	8.10
Weighted-average grant date fair value	\$	4.28	\$	3.82
Assumptions:				
Risk free interest rate	3.93		% 4.68	% 3.58%-3.93
Expected life (in years)	4		4	4-5
Expected volatility	56.56		% 54.86	% 56.00%-58.16
Expected dividend yield	0.00		% 0.00	% 0.00

**Risk-free interest rate** the yield on zero-coupon U.S. Treasury securities for a period that is commensurate with the expected term assumption is used as the risk-free interest rate.

**Expected life** the Company uses historical employee exercise and option expiration data to estimate the expected life assumption for the Black-Scholes grant-date valuation. The Company believes that this historical data is currently the best estimate of the expected life of a new option.

**Expected volatility** the Company is responsible for estimating volatility and has used historical volatility to estimate the grant-date fair value of stock options. Management considered the guidance in SFAS No. 123R and believes that the historical estimated volatility is materially indicative of expectations about future volatility.

**Expected dividend yield** the Company has not paid any dividends in the last five years and currently intends to retain any earnings to finance future growth and, therefore, does not anticipate paying any cash dividends on its common stock in the foreseeable future.

*Expense*

The Company used the straight-line attribution method to recognize expense for all options granted.

The amount of stock-based compensation recognized during a period is based on the value of the portion of the awards that are ultimately expected to vest. SFAS No. 123R requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. The term **forfeitures** is distinct from cancellations or expirations and represents only the unvested portion of the surrendered option. The Company currently expects, based on an analysis of its historical forfeitures that approximately 97% of its options will actually vest, and therefore has applied an annual forfeiture rate of 3% to options granted as of July 2, 2006. This analysis will be re-evaluated quarterly and the forfeiture rate will be adjusted as necessary. Ultimately, the actual expense recognized over the vesting period will only be for those shares that vest.

The adoption of SFAS No. 123R on January 2, 2006 resulted in lower operating income before tax and lower net income of \$120,000 and \$200,000 for the three and six months ended July 2, 2006, respectively.



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The following table details the effect on net income (loss) and income (loss) per share had stock-based compensation expense been recorded in fiscal 2005 based on the fair-value method under SFAS No. 123 (in thousands, except per share data). The reported and pro forma net income (loss) and income (loss) per share for the three and six months ended July 2, 2006 are the same since stock-based compensation expense was calculated under the provisions of SFAS No. 123R.

	Three Months Ended July 3, 2005	Six Months Ended July 3, 2005
Net income (loss) as reported	\$ 2,517	\$ (469 )
Add stock-based compensation expense included in reported net income (loss), net of related income tax benefit	40	40
Less stock-based compensation expense determined under fair value method for all stock options, net of related income tax benefit	(50 )	(64 )
Pro forma net income (loss)	\$ 2,507	\$ (493 )
Basic net income (loss) per share, as reported	\$ 0.32	\$ (0.06 )
Basic net income (loss) per share, pro forma	\$ 0.32	\$ (0.06 )
Diluted net income (loss) per share, as reported	\$ 0.32	\$ (0.06 )
Diluted net income (loss) per share, pro forma	\$ 0.32	\$ (0.06 )

*Option Activity*

A summary of the activity under the Company's equity compensation plans as of July 2, 2006 and changes during the six-month period then ended is presented below:

	Options Outstanding	Contractual Life in Years	Average Exercise Price	Intrinsic Value
Options outstanding at January 1, 2006	621,450		\$ 7.82	
Granted	145,409		\$ 8.10	
Cancelled	(11,140 )		\$ 13.12	
Forfeited	(4,027 )		\$ 8.86	
Exercised	(25,107 )		\$ 2.58	
Options outstanding at July 2, 2006	726,585	3.52	\$ 7.97	\$ 806,513
Options fully vested and exercisable at July 2, 2006	489,706	3.11	\$ 7.72	\$ 806,513

During the three and six months ended July 2, 2006, the total intrinsic value of options exercised (i.e. the difference between the market price at exercise and the price paid by the employee to exercise the options) was \$131,000 and \$145,000, respectively, and the total amount of cash received from exercise of stock options was \$46,000 and \$65,000, respectively.

As of July 2, 2006, there was \$859,000 of average unrecognized compensation cost related to unvested stock options. That cost is expected to be recognized over a weighted-average period of 2.46 years.

*Restricted Stock Unit Activity*

On December 2, 2005, 30,000 restricted stock units were issued to directors with a weighted average fair value of \$8.90 at grant date. During the three and six months ended July 2, 2006, stock-based compensation cost of \$22,000 and \$44,000, respectively, was recorded related to these units. No additional units were granted or forfeited during the six months ended July 2, 2006.

As of July 2, 2006, there was \$216,000 of total unrecognized compensation cost related to unvested restricted stock units. That cost is expected to be recognized over a weighted-average period of 2.42 years.

**4. EMPLOYEE BENEFIT PLANS**

The components of net periodic pension cost for the three and six months ended July 2, 2006 and July 3, 2005 were (in thousands):

	<b>For the Three Months Ended</b>		<b>For the Six Months Ended</b>	
	<b>July 2, 2006</b>	<b>July 3, 2005</b>	<b>July 2, 2006</b>	<b>July 3, 2005</b>
Interest cost	\$ 1,672	\$ 1,715	\$ 3,392	\$ 3,342
Expected return on assets	(1,996 )	(2,047 )	(3,965 )	(4,144 )
Net amortization of unrecognized net actuarial loss	632	531	1,351	945
Net periodic pension cost	\$ 308	\$ 199	\$ 778	\$ 143

The components of the net postretirement medical and life insurance benefit cost for the three and six months ended July 2, 2006 and July 3, 2005 were (in thousands):

	<b>For the Three Months Ended</b>		<b>For the Six Months Ended</b>	
	<b>July 2, 2006</b>	<b>July 3, 2005</b>	<b>July 2, 2006</b>	<b>July 3, 2005</b>
Service cost	\$ 41	\$ 41	\$ 82	\$ 81
Interest cost	95	115	190	230
Recognized actuarial loss	4	20	8	41
Net amortization of unrecognized prior service benefit	(36 )	(35 )	(72 )	(71 )
Net postretirement benefit cost	\$ 104	\$ 141	\$ 208	\$ 281

## 5. ASSET IMPAIRMENT AND DISCONTINUED OPERATIONS

As of January 1, 2006, the Company had 11 restaurants that were reported as held for sale in accordance with SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets. During the six months ended July 2, 2006, the Company sold seven of these restaurants. Gross proceeds from these transactions were \$6,892,000. The Company recognized a net gain related to the sales of the assets of \$4,068,000. At July 2, 2006, the remaining four properties, and one additional property that closed during the six months ended July 2, 2006, met the criteria for held for sale as defined in SFAS No. 144. The carrying values of these five properties of \$1,119,000 and \$1,157,000 as of July 2, 2006 and January 1, 2006, respectively, were reported as assets held for sale in the accompanying condensed consolidated balance sheets. The carrying values of these properties were not adjusted since the carrying values were less than the estimated fair market values less costs to sell.

The table below identifies the components of the Loss on disposals of other property and equipment, net as shown in the accompanying condensed consolidated statements of operations (in thousands):

	For the Three Months Ended		For the Six Months Ended	
	July 2, 2006	July 3, 2005	July 2, 2006	July 3, 2005
Restaurant equipment assets retired due to remodeling	\$ 296	\$ 220	\$ 296	\$ 220
Restaurant equipment assets retired due to replacement	67	43	142	95
Gain due to restaurant flood and fire	(79 )		(48 )	
All other	82	10	85	27
Loss on disposals of other property and equipment, net	\$ 366	\$ 273	\$ 475	\$ 342

SFAS No. 144 also requires the results of operations of a component of an entity that is classified as held for sale or that has been disposed of to be reported as discontinued operations in the statement of operations if certain conditions are met. These conditions include commitment to a plan of disposal after the effective date of this statement, elimination of the operations and cash flows of the entity component from the ongoing operations of the company and no significant continuing involvement in the operations of the entity component after the disposal transaction.

In accordance with SFAS No. 144, the results of operations of the seven properties that were disposed of during the six months ended July 2, 2006 and the 14 properties that were disposed of during 2005 and the related net gain on the disposals, as well as the results of operations of the properties held for sale at July 2, 2006, were reported separately as discontinued operations in the accompanying condensed consolidated statements of operations for all periods presented. Operating results for the three and six months ended July 2, 2006 and the net gain on disposals of the properties as well as operating results that were included in the restaurant segment in the previously issued Quarterly Report on Form 10-Q for the three and six months ended July 3, 2005 are summarized below (in thousands):

	For the Three Months Ended		For the Six Months Ended	
	July 2, 2006	July 3, 2005	July 2, 2006	July 3, 2005
Net sales	\$	\$ 3,330	\$	\$ 6,315
Operating loss	(79 )	(198 )	(328 )	(821 )
Gain (loss) on disposals of property and equipment	1,203	(25 )	4,068	(26 )
Income tax (expense) benefit	(450 )	91	(450 )	347
Income (loss) from discontinued operations	\$ 674	\$ (132 )	\$ 3,290	\$ (500 )

During the six months ended July 2, 2006, the Company determined that the carrying value of one operating restaurant property exceeded its estimated fair value less costs to sell and the carrying value was reduced by \$215,000 accordingly.

During the six months ended July 3, 2005, the Company identified two restaurant properties to be disposed of other than by sale. The Company determined that the carrying value of these restaurant properties exceeded their estimated undiscounted cash flows and the carrying values were reduced by an aggregate of \$289,000 accordingly.

## 6. SEGMENT REPORTING

Operating segments are components of an enterprise about which separate financial information is available that is evaluated regularly by the chief operating decision-maker, or decision-making group, in deciding how to allocate resources and in assessing performance. The Company's chief operating decision-maker is the Chief Executive Officer and President of the Company. The Company's operating segments include restaurant, foodservice and franchise. The revenues from these segments include both sales to unaffiliated customers and inter-segment sales, which generally are accounted for on a basis consistent with sales to unaffiliated customers. Intersegment sales and other inter-segment transactions have been eliminated in the accompanying condensed consolidated financial statements.

The Company's restaurants target families with kids and adults who desire a reasonably-priced meal in a full-service setting. The Company's menu offers a broad selection of freshly-prepared foods which appeal to customers throughout all dayparts. The menu currently features over 100 items comprised of a broad selection of breakfast, lunch, dinner and afternoon and evening snack items. Foodservice operations manufactures premium ice cream dessert products and distributes such manufactured products and purchased finished goods to Company-operated and franchised restaurants. Additionally, it sells premium ice cream dessert products to distributors and retail locations. The Company's franchise segment includes a royalty based on franchise restaurant revenue. In addition, the Company receives rental income from various franchised restaurants. The Company does not allocate general and administrative expenses associated with its headquarters operations to any business segment. These costs include expenses of the following functions: legal, accounting, personnel not directly related to a segment, information systems and other headquarter activities.

The accounting policies of the operating segments are the same as those described in the summary of significant accounting policies except that the financial results for the foodservice operating segment, prior to inter-segment eliminations, have been prepared using a management approach, which is consistent with the basis and manner in which the Company's management internally reviews financial information for the purpose of assisting in making internal operating decisions. Using this approach, the Company evaluates performance based on stand-alone operating segment income (loss) before income taxes and generally accounts for inter-segment sales and transfers as if the sales or transfers were to third parties, that is, at current market prices.

Adjusted EBITDA represents net income (loss) before (i) (provision for) benefit from income taxes, (ii) interest expense, net, (iii) depreciation and amortization, (iv) write-downs of property and equipment, (v) net periodic pension cost and (vi) other non-cash items. Adjusted EBITDA is a non-GAAP financial measure. The Company has included information concerning adjusted EBITDA in this Form 10-Q because the Company's management incentive plan pays bonuses based on achieving adjusted EBITDA targets and the Company believes that such information is used by certain investors as one measure of a company's historical ability to service debt. Adjusted EBITDA should not be considered as an alternative to, or more meaningful than, earnings (loss) from operations or other traditional indications of a company's operating performance.

	For the Three Months Ended		For the Six Months Ended	
	July 2, 2006 (in thousands)	July 3, 2005	July 2, 2006 (in thousands)	July 3, 2005
<b>Revenues:</b>				
Restaurant	\$ 105,271	\$ 109,469	\$ 200,547	\$ 202,576
Foodservice	62,891	65,220	117,849	119,384
Franchise	4,082	3,876	7,627	7,126
<b>Total</b>	<b>\$ 172,244</b>	<b>\$ 178,565</b>	<b>\$ 326,023</b>	<b>\$ 329,086</b>
<b>Intersegment revenues:</b>				
Restaurant	\$	\$	\$	\$
Foodservice	(30,754 )	(33,472 )	(58,818 )	(62,330 )
Franchise				
<b>Total</b>	<b>\$ (30,754 )</b>	<b>\$ (33,472 )</b>	<b>\$ (58,818 )</b>	<b>\$ (62,330 )</b>
<b>External revenues:</b>				
Restaurant	\$ 105,271	\$ 109,469	\$ 200,547	\$ 202,576
Foodservice	32,137	31,748	59,031	57,054
Franchise	4,082	3,876	7,627	7,126
<b>Total</b>	<b>\$ 141,490</b>	<b>\$ 145,093</b>	<b>\$ 267,205</b>	<b>\$ 266,756</b>

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	For the Three Months Ended		For the Six Months Ended	
	July 2, 2006 (in thousands)	July 3, 2005	July 2, 2006 (in thousands)	July 3, 2005
<b>Adjusted EBITDA:</b>				
Restaurant	\$ 11,929	\$ 12,382	\$ 18,764	\$ 19,658
Foodservice	5,638	4,234	8,185	6,382
Franchise	2,889	2,845	5,307	5,112
Corporate	(6,113 )	(5,434 )	(11,692 )	(10,279 )
Gain on property and equipment, net	779	935	1,537	2,169
Add back pension cost included in reporting segments	308	199	778	143
Total	\$ 15,430	\$ 15,161	\$ 22,879	\$ 23,185
Interest expense, net Corporate	\$ 5,147	\$ 5,229	\$ 10,567	\$ 10,515
<b>Depreciation and amortization:</b>				
Restaurant	\$ 4,021	\$ 3,992	\$ 8,164	\$ 8,462
Foodservice	720	803	1,456	1,627
Franchise	70	40	138	79
Corporate	929	797	1,762	1,615
Total	\$ 5,740	\$ 5,632	\$ 11,520	\$ 11,783
<b>Other non-cash expense:</b>				
Net periodic pension cost	\$ 308	\$ 199	\$ 778	\$ 143
Write-downs of property and equipment		289	215	289
Total	\$ 308	\$ 488	\$ 993	\$ 432
<b>Income (loss) from continuing operations before provision for income taxes:</b>				
Restaurant	\$ 7,908	\$ 8,390	\$ 10,600	\$ 11,196
Foodservice	4,918	3,431	6,729	4,755
Franchise	2,819	2,805	5,169	5,033
Corporate	(12,189 )	(11,460 )	(24,021 )	(22,409 )
Gain on property and equipment, net	779	646	1,322	1,880
Total	\$ 4,235	\$ 3,812	\$ (201 )	\$ 455

	<b>For the Six Months Ended July 2, 2006 (in thousands)</b>	<b>For the Year Ended January 1, 2006</b>
<b>Capital expenditures, including assets acquired under capital leases:</b>		
Restaurant	\$ 6,679	\$ 14,674
Foodservice	499	1,516
Corporate	789	968
<b>Total</b>	<b>\$ 7,967</b>	<b>\$ 17,158</b>

	<b>July 2, 2006 (in thousands)</b>	<b>January 1, 2006</b>
<b>Total assets:</b>		
Restaurant	\$ 126,254	\$ 131,810
Foodservice	39,098	38,609
Franchise	12,206	7,634
Corporate	45,446	40,189
<b>Total</b>	<b>\$ 223,004</b>	<b>\$ 218,242</b>

## 7. RELATED PARTY TRANSACTIONS

On March 20, 2006, Friendly's entered into an agreement with The Ice Cream Company ("TICC") pursuant to which TICC purchased, at fair market value, certain assets and leasehold rights for three existing Company-operated restaurants located in Lancaster and York, Pennsylvania. At closing, TICC was also granted an exclusive right to develop six new Friendly's restaurants in Lancaster, Chester and Montgomery counties, Pennsylvania by April 2012. Gross proceeds from this transaction were \$1,725,000, of which \$90,000 was for initial franchise fees, \$90,000 was for development fees and \$1,545,000 was for the assets and rights at the three existing restaurants. During the quarter ended July 2, 2006, the Company recorded \$90,000 as franchise fee revenue and recognized a gain of \$1,146,000 related to the sale of the assets.

The owners of TICC are family members of the Company's Chairman of the Board of Directors. Prior to the closing of this transaction on May 22, 2006, TICC operated three Friendly's restaurants under franchise agreements with Friendly's Restaurants Franchise, Inc. ("FRFI"), a subsidiary of Friendly's. The terms of the franchise agreement with TICC are identical in all material respects to the terms generally offered to unrelated franchisees of FRFI in the ordinary course of Friendly's business.

TICC purchases from Friendly's certain food products used in the normal course of its franchise business. For the six months ended July 2, 2006 and July 3, 2005, TICC paid Friendly's \$1,306,000 and \$1,063,000, respectively, for franchise royalty fees, marketing fees, food purchases and miscellaneous other products and services.

## 8. SUBSEQUENT EVENT

On August 1, 2006, the Company amended its \$35 million Credit Facility with Wells Fargo Foothill, to, among other things, (i) extend the maturity date from June 30, 2007 to June 30, 2010, (ii) eliminate the interest coverage requirement and (iii) reduce the applicable margin rates at which the revolving credit loans bear interest by .50% to .75% to a range of 3.00% to 4.00% (depending on the leverage ratios).

The Company expects to incur approximately \$473,000 of costs associated with the amendment to the \$35 million Credit Facility which will be deferred and amortized over the life of the amended \$35 million Credit Facility.

## 9. SUPPLEMENTAL CONDENSED CONSOLIDATING FINANCIAL INFORMATION

FICC's obligation related to its \$175,000,000 8.375% senior notes (the Senior Notes) issued in March 2004 is guaranteed fully and unconditionally by one of FICC's wholly owned subsidiaries. There are no restrictions on FICC's ability to obtain dividends or other distributions of funds from this subsidiary, except those imposed by applicable law. The following supplemental financial information sets forth, on a condensed consolidating basis, balance sheets, statements of operations and statements of cash flows for FICC (the Parent Company), Friendly's Restaurants Franchise, Inc. (the Guarantor Subsidiary) and Friendly's International, Inc., Restaurant Insurance Corporation, Friendly's Realty I, LLC, Friendly's Realty II, LLC and Friendly's Realty III, LLC (collectively, the Non-guarantor Subsidiaries). All of the LLCs' assets were owned by the LLCs, which are separate entities with separate creditors which will be entitled to be satisfied out of the LLCs' assets. Separate complete financial statements and other disclosures of the Guarantor Subsidiary as of July 2, 2006 and January 1, 2006 and for the three and six months ended July 2, 2006 and July 3, 2005 were not presented because management has determined that such information is not material to investors.

Investments in subsidiaries are accounted for by the Parent Company on the equity method for purposes of the supplemental consolidating presentation. Earnings of the subsidiaries are, therefore, reflected in the Parent Company's investment accounts and earnings. The principal elimination entries eliminate the Parent Company's investments in subsidiaries and intercompany balances and transactions.



**Supplemental Condensed Consolidating Balance Sheet**  
**As of July 2, 2006**  
(In thousands)

	Parent Company	Guarantor Subsidiary	Non- guarantor Subsidiaries	Eliminations	Consolidated
<b>Assets</b>					
<b>Current assets:</b>					
Cash and cash equivalents	\$ 20,532	\$ 1,426	\$ 2,415	\$	\$ 24,373
Restricted cash			393		393
Accounts receivable, net	16,572	2,404			18,976
Inventories	16,916				16,916
Assets held for sale	1,119				1,119
Deferred income taxes		26		(26)	)
Prepaid expenses and other current assets	5,606	1,475	7,785	(10,589)	) 4,277
<b>Total current assets</b>	<b>60,745</b>	<b>5,331</b>	<b>10,593</b>	<b>(10,615)</b>	<b>) 66,054</b>
Deferred income taxes		381		(381)	)
Property and equipment, net	94,719		42,298		137,017
Intangibles and deferred costs, net	16,091		2,139		18,230
Investments in subsidiaries	6,343			(6,343)	)
Other assets	788	6,813	915	(6,813)	) 1,703
<b>Total assets</b>	<b>\$ 178,686</b>	<b>\$ 12,525</b>	<b>\$ 55,945</b>	<b>\$ (24,152)</b>	<b>) \$ 223,004</b>
<b>Liabilities and Stockholders (Deficit) Equity</b>					
<b>Current liabilities:</b>					
Current maturities of long-term obligations	\$ 9,268	\$	\$ 1,467	\$ (7,776)	) \$ 2,959
Accounts payable	23,938				23,938
Deferred income taxes	131			(131)	)
Accrued expenses	39,739	4,107	1,499	(2,587)	) 42,758
<b>Total current liabilities</b>	<b>73,076</b>	<b>4,107</b>	<b>2,966</b>	<b>(10,494)</b>	<b>) 69,655</b>
Deferred income taxes	276			(276)	)
Long-term obligations, less current maturities	181,450		48,087		229,537
Other long-term liabilities	62,618	1,030	5,937	(7,039)	) 62,546
Stockholders (deficit) equity	(138,734)	) 7,388	(1,045)	) (6,343)	) (138,734)
<b>Total liabilities and stockholders (deficit) equity</b>	<b>\$ 178,686</b>	<b>\$ 12,525</b>	<b>\$ 55,945</b>	<b>\$ (24,152)</b>	<b>) \$ 223,004</b>

**Supplemental Condensed Consolidating Statement of Operations**  
**For the Three Months Ended July 2, 2006**  
(In thousands)

	Parent Company	Guarantor Subsidiary	Non- guarantor Subsidiaries	Eliminations	Consolidated
Revenues	\$ 138,434	\$ 3,056	\$	\$	\$ 141,490
Costs and expenses:					
Cost of sales	51,939				51,939
Labor and benefits	36,943				36,943
Operating expenses and write-downs of property and equipment	28,384		(1,568 )		26,816
General and administrative expenses	10,293	1,156			11,449
Depreciation and amortization	5,193		547		5,740
Gain on franchise sales of restaurant operations and properties	(1,145 )				(1,145 )
Loss on disposals of other property and equipment, net	263		103		366
Interest expense, net	4,064		1,083		5,147
Income (loss) before benefit from (provision for) income taxes and equity in net income of consolidated subsidiaries	2,500	1,900	(165 )		4,235
Benefit from (provision for) income taxes	587	(779 )	(58 )		(250 )
Income (loss) from continuing operations	3,087	1,121	(223 )		3,985
Income from discontinued operations, net of income tax effect	674				674
Income (loss) before equity in net income of consolidated subsidiaries	3,761	1,121	(223 )		4,659
Equity in net income of consolidated subsidiaries	898			(898 )	
Net income (loss)	\$ 4,659	\$ 1,121	\$ (223 )	\$ (898 )	\$ 4,659

**Supplemental Condensed Consolidating Statement of Operations**  
**For the Six Months Ended July 2, 2006**

(In thousands)

	Parent Company	Guarantor Subsidiary	Non- guarantor Subsidiaries	Eliminations	Consolidated
Revenues	\$ 261,531	\$ 5,674	\$	\$	\$ 267,205
Costs and expenses:					
Cost of sales	100,324				100,324
Labor and benefits	72,955				72,955
Operating expenses and write-downs of property and equipment	54,304		(3,274)	)	51,030
General and administrative expenses	20,235	2,311			22,546
Depreciation and amortization	10,430		1,090		11,520
Gain on franchise sales of restaurant operations and properties	(2,011)	)			(2,011)
Loss on disposals of other property and equipment, net	372		103		475
Interest expense, net	8,401		2,166		10,567
(Loss) income before benefit from (provision for) income taxes and equity in net income of consolidated subsidiaries	(3,479)	) 3,363	(85)	)	(201)
Benefit from (provision for) income taxes	1,241	(1,379)	) (112)	)	(250)
(Loss) income from continuing operations	(2,238)	) 1,984	(197)	)	(451)
Income from discontinued operations, net of income tax effect	3,290				3,290
Income (loss) before equity in net income of consolidated subsidiaries	1,052	1,984	(197)	)	2,839
Equity in net income of consolidated subsidiaries	1,787			(1,787)	)
Net income (loss)	\$ 2,839	\$ 1,984	\$ (197)	) \$ (1,787)	) \$ 2,839

**Supplemental Condensed Consolidating Statement of Cash Flows  
For the Six Months Ended July 2, 2006**

(In thousands)

	Parent Company	Guarantor Subsidiary	Non- guarantor Subsidiaries	Eliminations	Consolidated
Net cash provided by operating activities	\$ 7,151	\$ 646	\$ 2,826	\$ (524 )	\$ 10,099
Cash flows from investing activities:					
Purchases of property and equipment	(7,102 )		(865 )		(7,967 )
Proceeds from sales of property and equipment	9,200				9,200
Return of investment in subsidiary	633			(633 )	
Net cash provided by (used in) investing activities	2,731		(865 )	(633 )	1,233
Cash flows from financing activities:					
Proceeds from revolving credit facility	8,000				8,000
Repayments of obligations	(8,756 )		(660 )		(9,416 )
Payments of deferred financing costs	(205 )				(205 )
Stock options exercised	65				65
Reinsurance payments made from deposits			(524 )	524	
Dividends paid			(633 )	633	
Net cash used in financing activities	(896 )		(1,817 )	1,157	(1,556 )
Net increase in cash and cash equivalents	8,986	646	144		9,776
Cash and cash equivalents, beginning of period	11,546	780	2,271		14,597
Cash and cash equivalents, end of period	\$ 20,532	\$ 1,426	\$ 2,415	\$	\$ 24,373
Supplemental disclosures:					
Interest paid	\$ 8,016	\$	\$ 2,122	\$	\$ 10,138
Income taxes (refunded) paid	(2,975 )	2,574	114		(287 )

**Supplemental Condensed Consolidating Balance Sheet**  
**As of January 1, 2006**  
(In thousands)

	Parent Company	Guarantor Subsidiary	Non- guarantor Subsidiaries	Eliminations	Consolidated
<b>Assets</b>					
Current assets:					
Cash and cash equivalents	\$ 11,546	\$ 780	\$ 2,271	\$	\$ 14,597
Restricted cash			2,549		2,549
Accounts receivable, net	9,036	1,721			10,757
Inventories	15,775				15,775
Assets held for sale	1,157				1,157
Deferred income taxes	(131	) 26		105	
Prepaid expenses and other current assets	7,571	2,565	7,785	(12,877	) 5,044
Total current assets	44,954	5,092	12,605	(12,772	) 49,879
Deferred income taxes	(276	) 381		(105	)
Property and equipment, net	100,780		42,510		143,290
Intangibles and deferred costs, net	16,808		2,255		19,063
Investments in subsidiaries	5,188			(5,188	)
Other assets	5,095	5,118	915	(5,118	) 6,010
Total assets	\$ 172,549	\$ 10,591	\$ 58,285	\$ (23,183	) \$ 218,242
Liabilities and Stockholders (Deficit) Equity					
Current liabilities:					
Current maturities of long-term obligations	\$ 9,253	\$	\$ 1,368	\$ (7,776	) \$ 2,845
Accounts payable	24,968				24,968
Accrued expenses	37,237	4,258	1,825	(4,844	) 38,476
Total current liabilities	71,458	4,258	3,193	(12,620	) 66,289
Long-term obligations, less current maturities	182,221		48,846		231,067
Other long-term liabilities	60,708	930	6,461	(5,375	) 62,724
Stockholders (deficit) equity	(141,838	) 5,403	(215	) (5,188	) (141,838
Total liabilities and stockholders (deficit) equity	\$ 172,549	\$ 10,591	\$ 58,285	\$ (23,183	) \$ 218,242

**Supplemental Condensed Consolidating Statement of Operations**  
**For the Three Months Ended July 3, 2005**  
(In thousands)