FRIENDLY ICE CREAM CORP
Form 10-Q
August 04, 2005

# SECURITIES AND EXCHANGE COMMISSION

**Washington, D.C. 20549**

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# FORM 10-Q

**(Mark One)**

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

**For the quarterly period ended July 3, 2005**

**OR**

| | |
|---|---|
| **o** | **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** | **04-2053130** |
|---|---|
| (State or Other Jurisdiction of Incorporation or Organization) | (IRS Employer Identification No.) |

**01095**

**1855 Boston Road**
**Wilbraham, Massachusetts**
(Address of Principal Executive Offices) (Zip Code)

**(413) 543-2400**

(Registrant s Telephone Number, Including Area Code)

**Not Applicable**

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

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 ý No o

Indicate by check mark whether the registrant is an accelerated filer (as defined in Exchange Act Rule 12b-2). Yes ý No o

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 22, 2005 |
| --- | --- |
| Common Stock, $.01 par value | 7,775,173 shares |

**PART I FINANCIAL INFORMATION**

**Item 1. Financial Statements**

**FRIENDLY ICE CREAM CORPORATION AND SUBSIDIARIES**

**CONDENSED CONSOLIDATED BALANCE SHEETS**

(Unaudited)

(In thousands)

| | July 3, 2005 | January 2, 2005 |
|---|---|---|
| ASSETS | | |
| CURRENT ASSETS: | | |
| Cash and cash equivalents | $ 15,385 | $ 13,405 |
| Restricted cash | 1,306 | 1,711 |
| Accounts receivable, net | 14,681 | 10,448 |
| Inventories | 16,276 | 17,545 |
| Deferred income taxes | 6,853 | 6,853 |
| Prepaid expenses and other current assets | 6,078 | 4,382 |
| TOTAL CURRENT ASSETS | 60,579 | 54,344 |
| DEFERRED INCOME TAXES | 10,718 | 10,619 |
| PROPERTY AND EQUIPMENT, net of accumulated depreciation and amortization | 151,038 | 156,412 |
| INTANGIBLE ASSETS AND DEFERRED COSTS, net of accumulated amortization | 19,589 | 20,510 |
| OTHER ASSETS | 7,108 | 6,999 |
| TOTAL ASSETS | $ 249,032 | $ 248,884 |
| | | |
| LIABILITIES AND STOCKHOLDERS DEFICIT | | |
| CURRENT LIABILITIES: | | |
| Current maturities of long-term debt | $ 1,175 | $ 5,224 |
| Current maturities of capital lease and finance obligations | 1,484 | 1,533 |
| Accounts payable | 24,000 | 21,536 |
| Accrued salaries and benefits | 10,666 | 8,740 |
| Accrued interest payable | 1,169 | 1,427 |
| Insurance reserves | 11,588 | 9,927 |
| Restructuring reserves | 410 | 1,078 |
| Other accrued expenses | 19,577 | 18,582 |
| TOTAL CURRENT LIABILITIES | 70,069 | 68,047 |
| CAPITAL LEASE AND FINANCE OBLIGATIONS, less current maturities | 6,666 | 7,380 |
| LONG-TERM DEBT, less current maturities | 225,087 | 225,752 |
| ACCRUED PENSION COST | 17,675 | 17,532 |
| OTHER LONG-TERM LIABILITIES | 34,634 | 35,199 |
| COMMITMENTS AND CONTINGENCIES STOCKHOLDERS DEFICIT: | | |
| Common stock | 78 | 77 |
| Additional paid-in capital | 143,512 | 143,115 |

| | | | | |
|---|---|---|---|---|
| Accumulated other comprehensive loss | | (20,672) | | (20,670) |
| Accumulated deficit | | (228,017) | | (227,548) |
| TOTAL STOCKHOLDERS DEFICIT | | (105,099) | | (105,026) |
| TOTAL LIABILITIES AND STOCKHOLDERS DEFICIT | $ | 249,032 | $ | 248,884 |

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 July 3, 2005 | For the Three Months Ended June 27, 2004 (Restated) | For the Six Months Ended July 3, 2005 | For the Six Months Ended June 27, 2004 (Restated) |
|---|---|---|---|---|
| REVENUES: | | | | |
| Restaurant | $ 112,799 | $ 114,441 | $ 208,891 | $ 218,794 |
| Foodservice | 31,748 | 29,820 | 57,054 | 53,163 |
| Franchise | 3,876 | 3,255 | 7,126 | 6,313 |
| TOTAL REVENUES | 148,423 | 147,516 | 273,071 | 278,270 |
| COSTS AND EXPENSES: | | | | |
| Cost of sales | 55,502 | 55,959 | 103,257 | 101,547 |
| Labor and benefits | 39,903 | 42,155 | 76,436 | 82,089 |
| Operating expenses | 28,495 | 27,894 | 53,016 | 53,025 |
| General and administrative expenses | 10,528 | 9,754 | 19,977 | 20,451 |
| Restructuring expenses | | | | 2,627 |
| Gain on litigation settlement | | | | (3,644) |
| Write-downs of property and equipment | 289 | 91 | 289 | 91 |
| Depreciation and amortization | 5,809 | 5,682 | 12,133 | 11,399 |
| Gain on franchise sales of restaurant operations and properties | (1,219) | (7) | (2,528) | (913) |
| Loss on disposals of other property and equipment, net | 298 | 337 | 368 | 508 |
| OPERATING INCOME | 8,818 | 5,651 | 10,123 | 11,090 |
| OTHER EXPENSES: | | | | |
| Interest expense, net | 5,233 | 5,368 | 10,531 | 11,432 |
| Other (income) expense, principally debt retirement costs | (4) | 2,343 | (16) | 9,235 |
| INCOME (LOSS) BEFORE (PROVISION FOR) BENEFIT FROM INCOME TAXES | 3,589 | (2,060) | (392) | (9,577) |
| (Provision for) benefit from income taxes | (1,072) | 640 | (77) | 2,915 |
| NET INCOME (LOSS) | $ 2,517 | $ (1,420) | $ (469) | $ (6,662) |
| BASIC NET INCOME (LOSS) PER SHARE | $ 0.32 | $ (0.19) | $ (0.06) | $ (0.88) |
| DILUTED NET INCOME (LOSS) PER SHARE | $ 0.32 | $ (0.19) | $ (0.06) | $ (0.88) |
| WEIGHTED AVERAGE SHARES: | | | | |
| Basic | 7,753 | 7,611 | 7,735 | 7,569 |
| Diluted | 7,893 | 7,611 | 7,735 | 7,569 |

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 3, 2005 | June 27, 2004 (Restated) |
|---|---|---|
| CASH FLOWS FROM OPERATING ACTIVITIES: | | |
| Net loss | $ (469) | $ (6,662) |
| Adjustments to reconcile net loss to net cash provided by operating activities: | | |
| Stock compensation expense | 68 | 380 |
| Depreciation and amortization | 12,133 | 11,399 |
| Write-offs of deferred financing costs | | 2,445 |
| Write-downs of property and equipment | 289 | 91 |
| Deferred income tax benefit | (99) | (2,915) |
| Gain on disposals of other property and equipment, net | (2,166) | (405) |
| Changes in operating assets and liabilities: | | |
| Accounts receivable | (4,233) | (4,016) |
| Inventories | 1,269 | (2,038) |
| Other assets | (1,200) | (4,103) |
| Accounts payable | 2,464 | 5,013 |
| Accrued expenses and other long-term liabilities | 3,234 | 1,048 |
| NET CASH PROVIDED BY OPERATING ACTIVITIES | 11,290 | 237 |
| | | |
| CASH FLOWS FROM INVESTING ACTIVITIES: | | |
| Purchases of property and equipment | (7,309) | (8,262) |
| Proceeds from sales of property and equipment | 3,359 | 3,378 |
| Purchases of marketable securities | (345) | (905) |
| Proceeds from sales of marketable securities | 143 | 89 |
| NET CASH USED IN INVESTING ACTIVITIES | (4,152) | (5,700) |
| | | |
| CASH FLOWS FROM FINANCING ACTIVITIES: | | |
| Proceeds from issuance of New Senior Notes | | 175,000 |
| Proceeds from borrowings under revolving credit facility | 16,250 | 11,000 |
| Repayments of debt | (20,964) | (187,527) |
| Payments of deferred financing costs | (11) | (6,625) |
| Principal payments of capital lease and finance obligations | (763) | (554) |
| Stock options exercised | 330 | 749 |
| NET CASH USED IN FINANCING ACTIVITIES | (5,158) | (7,957) |
| | | |
| NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS | 1,980 | (13,420) |
| | | |
| CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD | 13,405 | 25,631 |
| | | |
| CASH AND CASH EQUIVALENTS, END OF PERIOD | $ 15,385 | $ 12,211 |
| | | |
| SUPPLEMENTAL DISCLOSURES: | | |
| Cash paid during the period for: | | |
| Interest | $ 10,275 | $ 11,975 |
| Income taxes | 50 | 16 |
| Capital lease obligations incurred | | 2,280 |

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. BASIS OF PRESENTATION AND SIGNIFICANT ACCOUNTING POLICIES

*Interim Financial Information*

The accompanying condensed consolidated financial statements as of July 3, 2005 and for the three and six months ended July 3, 2005 and June 27, 2004 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 Friendly Ice Cream Corporation ( FICC ) and subsidiaries (unless the context indicates otherwise, collectively, the Company ) have been included. Such adjustments consist solely of normal recurring accruals. Operating results for the three and six month periods ended July 3, 2005 and June 27, 2004 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 2004 Annual Report on Form 10-K/A for the fiscal year ended January 2, 2005 ( 2004 Annual Report on Form 10-K/A ), should be read in conjunction with these condensed consolidated financial statements. Capitalized terms not otherwise defined herein should be referenced to the 2004 Annual Report on Form 10-K/A.

*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, income tax valuation allowances and pension and post-retirement medical and life insurance benefits expense. 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 3, 2005 and January 2, 2005 (in thousands):

| | July 3, 2005 | January 2, 2005 |
|---|---|---|
| Raw materials | $ 1,703 | $ 2,685 |
| Goods in process | 142 | 157 |
| Finished goods | 14,431 | 14,703 |
| Total | $ 16,276 | $ 17,545 |

*Other Assets*

Other assets included notes receivable of $4,490,000 and $4,524,000, which were net of allowances for doubtful accounts totaling $263,000 as of July 3, 2005 and January 2, 2005, respectively. As of July 3, 2005, notes receivable included a balloon payment of $3,903,460, due from a franchisee on April 15, 2006, for a subordinated promissory note. On June 30, 2005, the franchisee requested that the term of the note be extended for one year, with a new balloon payment of $3,796,303 due on April 15, 2007. On July 29, 2005, the Company agreed to the extension.

Also included in other assets as of as of July 3, 2005 and January 2, 2005 were payments made to fronting insurance carriers of $1,343,000 and $1,402,000, respectively, to establish loss escrow funds.

*Other Accrued Expenses -*

Other accrued expenses consisted of the following at July 3, 2005 and January 2, 2005 (in thousands):

| | July 3, 2005 | January 2, 2005 |
|---|---|---|
| Accrued rent | $ 4,515 | $ 4,781 |
| Accrued meals and other taxes | 2,685 | 2,766 |
| Gift cards outstanding | 2,583 | 4,068 |
| Accrued advertising | 2,433 | 1,824 |
| Accrued construction costs | 2,216 | 1,236 |
| Unearned revenues | 1,391 | 1,056 |
| Accrued bonus | 1,350 | 751 |
| All other | 2,404 | 2,100 |
| Total | $ 19,577 | $ 18,582 |

*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 3, 2005, the potential amount of undiscounted payments the Company could be required to make in the event of non-payment by the primary lessees was $6,598,249. The present value of these potential payments discounted at the Company s pre-tax cost of debt at July 3, 2005 was $5,105,000. The Company generally has cross-default provisions with franchisees that would put the franchisee in default of its 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. Additionally, as of July 3, 2005, the Company has no reason to believe that any franchisee will be unable to fulfill its obligations. Accordingly, no liability had been recorded for exposure under such leases at July 3, 2005 and January 2, 2005.

*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. There were 140,169 common stock equivalents included in diluted net income per share for the three months ended July 3, 2005 and no common stock equivalents included in diluted net loss per share for the six months ended July 3, 2005 and the three and six months ended June 27, 2004. The number of common stock options which could dilute basic net income (loss) per share in the future, that were not included in the computation of diluted net income (loss) per share because to do so would have been antidilutive, was 129,817 and 284,289 for the three months ended July 3, 2005 and June 27, 2004, respectively. The number of common stock options which could dilute basic net income (loss) per share in the future, that were not included in the computation of diluted net income (loss) per share because to do so would have been antidilutive, was 284,651 and 289,195 for the six months ended July 3, 2005 and June 27, 2004, respectively.

During the six months ended July 3, 2005, the Company granted employee stock options to purchase approximately 120,000 shares of common stock at an exercise price equal to the closing market prices on the date of grants. During the six months ended July 3, 2005, 60,194 employee stock options were exercised. The weighted-average exercise prices of the options granted and options exercised were $8.87 and $5.49, respectively.

Presented below is the reconciliation between basic and diluted weighted average shares for the three and six months ended July 3, 2005 and June 27, 2004 (in thousands):

| | For the Three Months Ended | | | |
|---|---|---|---|---|
| | Basic | | Diluted | |
| | July 3, 2005 | June 27, 2004 | July 3, 2005 | June 27, 2004 |
| Weighted average number of common shares outstanding during the period | 7,753 | 7,611 | 7,753 | 7,611 |
| Adjustments: | | | | |
| Assumed exercise of stock options | | | 140 | |
| Weighted average number of shares outstanding | 7,753 | 7,611 | 7,893 | 7,611 |

| | For the Six Months Ended | | | |
|---|---|---|---|---|
| | Basic | | Diluted | |
| | July 3, 2005 | June 27, 2004 | July 3, 2005 | June 27, 2004 |
| Weighted average number of common shares outstanding during the period | 7,735 | 7,569 | 7,735 | 7,569 |
| Adjustments: | | | | |
| Assumed exercise of stock options | | | | |
| Weighted average number of shares outstanding | 7,735 | 7,569 | 7,735 | 7,569 |

*Stock-Based Compensation*

The Company accounts for stock-based compensation for employees under Accounting Principles Board ( APB ) Opinion No. 25, Accounting for Stock Issued to Employees, and elected the disclosure-only alternative under Statement of Financial Accounting Standards ( SFAS ) No. 123, Accounting for Stock-Based Compensation. Stock-based compensation cost of $68,000 and $222,000 related to modified option awards was included in net loss for the six months ended July 3, 2005 and June 27, 2004, respectively, for the Company s Stock Option Plan and the Company s 2003 Incentive Plan.

In December 2002, the Financial Accounting Standards Board ( FASB ) issued SFAS No. 148, Accounting for Stock-Based Compensation Transition and Disclosure, which amended SFAS No. 123. SFAS No. 148 allowed for three methods of transition for those companies that adopt SFAS No. 123 s provisions for fair value recognition. SFAS No. 148 s transition guidance and provisions for annual disclosures were effective for fiscal years ending after December 15, 2002. In accordance with SFAS No. 148, the Company continued to disclose the required pro-forma information in the notes to the condensed consolidated financial statements.

In accordance with SFAS No. 148, the following table presents the effect on net income (loss) and net income (loss) per share had compensation cost for the Company s stock plans been determined consistent with SFAS No. 123 (in thousands, except per share data):

| | For the Three Months Ended | | For the Six Months Ended | |
|---|---|---|---|---|
| | **July 3, 2005** | **June 27, 2004** | **July 3, 2005** | **June 27, 2004** |
| Net income (loss) as reported | $ 2,517 | $ (1,420) | $ (469) | $ (6,662) |
| Add stock-based compensation expense included in reported net income (loss), net of related income tax (expense) benefit | 40 | | 40 | 131 |
| Less stock-based compensation expense determined under fair value method for all stock options, net of related income tax benefit | (50) | (106) | (64) | (211) |
| Pro forma net income (loss) | $ 2,507 | $ (1,526) | $ (493) | $ (6,742) |
| Basic net income (loss) per share, as reported | $ 0.32 | $ (0.19) | $ (0.06) | $ (0.88) |
| Basic net income (loss) per share, pro forma | $ 0.32 | $ (0.19) | $ (0.06) | $ (0.88) |
| Diluted net income (loss) per share, as reported | $ 0.32 | $ (0.19) | $ (0.06) | $ (0.88) |
| Diluted net income (loss) per share, pro forma | $ 0.32 | $ (0.19) | $ (0.06) | $ (0.88) |

*Recently Issued Accounting Pronouncements*

In June 2005, the FASB s Emerging Issues Task Force reached a consensus on Issue No. 05-6, Determining the Amortization Period for Leasehold Improvements ( EITF 05-6 ). The guidance requires that leasehold improvements acquired in a business combination or purchased subsequent to the inception of a lease be amortized over the lesser of the useful life of the assets or a term that includes renewals that are reasonably assured at the date of the business combination or purchase. The guidance is effective for periods beginning after June 29, 2005. The adoption of EITF 05-6 is not expected to have a material effect on the Company s consolidated financial position or results of operations.

In May 2005, the FASB issued SFAS No. 154, Accounting Changes and Error Corrections A Replacement of APB Opinion No. 20 and FASB Statement No. 3. SFAS No. 154 applies to all voluntary changes in accounting principle and requires retrospective application to prior periods financial statements of changes in accounting principle, unless it is impracticable. SFAS No. 154 requires that a change in depreciation, amortization, or depletion method for long-lived, nonfinancial assets be accounted for as a change of estimate affected by a change in accounting principle. SFAS No. 154 also carries forward without change the guidance in APB Opinion No. 20 with respect to accounting for changes in accounting estimates, changes in the reporting unit and correction of an error in previously issued financial statements. The Company is required to adopt SFAS No. 154 for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. The adoption of SFAS No. 154 is not expected to have a material effect on the Company s consolidated financial position or results of operations.

On December 16, 2004, the FASB issued SFAS No. 123 (revised 2004), Share-Based Payment ( SFAS No. 123R ), which is a revision of SFAS No. 123, Accounting for Stock-Based Compensation. SFAS No. 123R supersedes APB Opinion No. 25, Accounting for Stock Issued to Employees, 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. Pro forma disclosure is no longer an alternative. SFAS No. 123R must be adopted no later than the first annual period beginning after June 15, 2005. Early adoption will be permitted in periods in which financial statements have not yet been issued. SFAS No. 123R allows companies to choose between the modified-prospective and modified-retrospective transition alternatives in adopting SFAS No. 123R. Under the modified-prospective transition method, compensation cost will be recognized in financial statements issued subsequent to the date of adoption for all shared-based payments granted, modified or settled after the date of adoption, as well as for any unvested awards that were granted prior to the date of adoption. Under the modified-retrospective transition method, compensation cost will be recognized in a manner consistent with the modified-prospective transition method, however, prior period financial statements will also be restated by recognizing compensation cost as previously reported in the pro forma disclosures under SFAS No. 123. The restatement provisions can be applied to either a) all periods presented or b) to the beginning of the fiscal year in which SFAS No. 123R is adopted. The Company expects to adopt SFAS No. 123R on January 2, 2006 using the modified-prospective method. As the Company previously adopted only the pro forma disclosure provisions of SFAS No. 123, the Company will recognize compensation cost relating to the unvested portion of awards granted prior to the date of adoption using the same estimate of the grant-date fair value and the same attribution method used to determine the pro forma disclosures under SFAS No. 123.

As permitted by SFAS No. 123, the Company currently accounts for share-based payments to employees using APB Opinion No. 25 s intrinsic value method and, as such, generally recognizes no compensation cost for employee stock options. Accordingly, the adoption of SFAS No. 123R s fair value method will have an impact on the Company s results of operations, although it will have no impact on the overall financial position. The impact of the adoption of SFAS No. 123R cannot be determined at this time because it will depend upon levels of share-based payments granted in the future. However, had the Company adopted SFAS No. 123R in prior periods, the impact of that standard would have approximated the impact as described in the disclosure of pro forma net income (loss) and net income (loss) per share pursuant to SFAS No. 123. SFAS No. 123R also requires the benefits of tax deductions in excess of recognized compensation cost to be reported as a financing cash flow, rather than as an operating cash flow as required under current literature. This requirement will reduce net operating cash flows and increase net financing cash flows in

periods after adoption. While the Company cannot estimate what those amounts will be in the future (because they depend on, among other things, when employees exercise stock options), the amount of operating cash flows recognized in prior years for such excess tax deductions were $818,000 and $165,000 in 2004 and 2003, respectively.

In November 2004, the FASB issued SFAS No. 151, Inventory Costs, an amendment of Accounting Research Bulletin No. 43, Chapter 4 . The amendments made by SFAS No. 151 clarify that abnormal amounts of idle facility expense, freight, handling costs, and wasted materials (spoilage) should be recognized as current-period charges and require the allocation of fixed production overheads to inventory based on the normal capacity of the production facilities. SFAS No. 151 is the result of a broader effort by the FASB to improve the comparability of cross-border financial reporting by working with the International Accounting Standards Board toward development of a single set of high-quality accounting standards. The guidance is effective for inventory costs incurred during fiscal years beginning after June 15, 2005. The adoption of SFAS No. 151 is not expected to have a material effect on the Company s consolidated financial position or results of operations.

**2. RESTATEMENT OF FINANCIAL STATEMENTS**

Following a review of the Company s lease accounting and leasehold depreciation practices in 2004, the Company restated its previously reported financial statements in its 2004 Annual Report on Form 10-K/A. The Company corrected its computation of straight-line rent expense and the related deferred rent liability as well as depreciation expense. Historically, when accounting for lease renewal options, rent expense was recorded on a straight-line basis over the non-cancelable lease term. The depreciable lives of certain leasehold improvements and other long-lived assets on those properties were not aligned with the non-cancelable lease term.

The Company believed that its accounting treatment was permitted under GAAP and that such treatment was consistent with the practices of other public companies. Following a review of its lease accounting treatment and relevant accounting literature, the Company determined that it should: i) conform the depreciable lives for buildings on leased land and other leasehold improvements to the shorter of the economic life of the asset or the lease term used for determining the capital versus operating lease classification and calculating straight-line rent and ii) include option periods in the depreciable lives assigned to leased buildings and leasehold improvements and in the calculation of straight-line rent expense only in instances in the which the exercise of the option period can be reasonably assured and failure to exercise such options would result in an economic penalty. The Company restated its financial statements in its 2004 Annual Report on Form 10-K/A to accelerate depreciation for certain leasehold improvements and to record additional rent expense (the Restatement ).

The following is a summary of the impact of the Restatement on the Company s condensed consolidated statement of operations for the three and six months ended June 27, 2004 (in thousands):

| | For the Three Months Ended June 27, 2004 | | |
|---|---|---|---|
| | As Previously Reported | Adjustments | Restated |
| Operating expenses | $ 27,806 | $ 88 | $ 27,894 |
| Depreciation and amortization | 5,570 | 112 | 5,682 |
| Operating income | 5,851 | (200) | 5,651 |
| Loss before benefit from income taxes | (1,860) | (200) | (2,060) |
| Benefit from income taxes | 558 | 82 | 640 |
| Net loss | (1,302) | (118) | (1,420) |
| | | | |
| Basic and diluted net loss per share | (0.17) | (0.02) | (0.19) |

| | For the Six Months Ended June 27, 2004 | | |
|---|---|---|---|
| | As Previously Reported | Adjustments | Restated |
| Operating expenses | $ 52,858 | $ 167 | $ 53,025 |
| Depreciation and amortization | 11,176 | 223 | 11,399 |
| Operating income | 11,480 | (390) | 11,090 |
| Loss before benefit from income taxes | (9,187) | (390) | (9,577) |
| Benefit from income taxes | 2,756 | 159 | 2,915 |
| Net loss | (6,431) | (231) | (6,662) |
| | | | |
| Basic and diluted net loss per share | (0.85) | (0.03) | (0.88) |

**3. EMPLOYEE BENEFIT PLANS**

The components of net periodic pension expense (benefit) for the three and six months ended July 3, 2005 and June 27, 2004 were (in thousands):

| | For the Three Months Ended | | For the Six Months Ended | |
|---|---|---|---|---|
| | July 3, 2005 | June 27, 2004 | July 3, 2005 | June 27, 2004 |
| Interest cost | $ 1,715 | $ 1,675 | $ 3,342 | $ 3,302 |
| Expected return on assets | (2,047) | (2,364) | (4,144) | (4,695) |
| Net amortization: | | | | |
| Unrecognized net actuarial loss | 531 | 182 | 945 | 335 |
| Net periodic pension expense (benefit) | $ 199 | $ (507) | $ 143 | $ (1,058) |

The components of the net postretirement medical and life insurance benefit cost for the three and six months ended July 3, 2005 and June 27, 2004 were (in thousands):

| | For the Three Months Ended | | For the Six Months Ended | |
|---|---|---|---|---|
| | July 3, 2005 | June 27, 2004 | July 3, 2005 | June 27, 2004 |
| Service cost | $ 41 | $ 28 | $ 81 | $ 56 |
| Interest cost | 115 | 116 | 230 | 232 |
| Recognized actuarial loss | 20 | 23 | 41 | 45 |
| Net amortization of unrecognized prior service benefit | (35) | (35) | (71) | (71) |
| Net postretirement benefit cost | $ 141 | $ 132 | $ 281 | $ 262 |

On December 8, 2003, the Medicare Prescription Drug, Improvement and Modernization Act of 2003 (the Act ), which introduced a Medicare prescription drug benefit, as well as a federal subsidy to sponsors of retiree health care benefit plans that provide a benefit that is at least actuarially equivalent to the Medicare benefit, was enacted. On May 19, 2004, the FASB issued Financial Staff Position No. 106-2, Accounting and Disclosure Requirements Related to the Medicare Prescription Drug, Improvement and Modernization Act of 2003 ( FSP 106-2 ) to discuss certain accounting and disclosure issues raised by the Act. FSP 106-2 addresses accounting for the federal subsidy for the sponsors of single employer postretirement health care plans and disclosure requirements for plans for which the employer has not yet been able to determine actuarial equivalency. Except for certain nonpublic entities, FSP 106-2 is effective for the first interim or annual period beginning after June 15, 2004 (the quarter ended September 26, 2004 for the Company).

Based on regulations issued by the Centers for Medicare & Medicaid Services, the Company has concluded that, for certain participants, the benefits provided are at least actuarially equivalent to benefits available through Medicare Part D. The Company has determined that the effects of the Act are not significant. Therefore, the reported net benefit cost and the accumulated benefit obligation of the Company s postretirement medical and life insurance plan in the accompanying condensed consolidated financial statements and notes thereto does not reflect the effects of the Act. The Company will recognize the effect on the next measurement date, which will be included in the consolidated financial statements for the year ended January 1, 2006.

**4. WRITE-DOWNS OF PROPERTY**

In accordance with SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets, which was adopted in 2002, the Company reviews long-lived assets related to each restaurant to be held and used in the business quarterly for impairment, or whenever events or changes in circumstances indicate that the carrying amount of a restaurant may not be recoverable. The Company evaluates restaurants using a two-year history of cash flow as the primary indicator of potential impairment. Based on the best information available, the Company writes down an impaired restaurant to its estimated fair market value, which becomes its new cost basis. Estimated fair market value is based on the Company s experience selling similar properties and local market conditions, less costs to sell for properties to be disposed of. In addition, restaurants scheduled for closing are reviewed for impairment and depreciable lives are adjusted. The impairment evaluation is based on the estimated cash flows from continuing use through the expected disposal date and the expected terminal value. SFAS No. 144 requires a long-lived asset to be disposed of other than by sale to be classified as held and used until it is disposed of.

Considerable management judgment is necessary to estimate future cash flows, including cash flows from continuing use, terminal value, closure costs and sublease income. Accordingly, actual results could vary from estimates.

During the quarter 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. During the six months ended June 27, 2004, the Company determined that the carrying value of a vacant restaurant land parcel and the carrying value of one restaurant property exceeded their estimated fair values less cost to sell. The carrying values were reduced by an aggregate of $91,000.

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

| | For the Three Months Ended | | For the Six Months Ended | |
|---|---|---|---|---|
| | July 3, 2005 | June 27, 2004 | July 3, 2005 | June 27, 2004 |
| Restaurant equipment assets retired due to remodeling | $ 220 | $ 173 | $ 220 | $ 173 |
| Restaurant equipment assets retired due to replacement | 43 | 87 | 95 | 159 |
| Loss on property not held for disposition | 26 | 62 | 40 | 63 |
| All other | 9 | 15 | 13 | 113 |
| Loss on disposals of other property and equipment, net | $ 298 | $ 337 | $ 368 | $ 508 |

**5. 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 the Company s restaurants and franchised operations. Additionally, it sells premium ice cream dessert products to distributors and retail and institutional 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 legal, accounting, information systems and other headquarter functions.

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.

EBITDA represents net income (loss) before (i) provision for (benefit from) income taxes, (ii) other (income) expense, principally debt retirement costs, (iii) interest expense, net, (iv) depreciation and amortization, (v) write-downs of property and equipment, (vi) net periodic pension expense (benefit) and (vii) other non-cash items. The Company has included information concerning EBITDA in this Form 10-Q because the Company s management incentive plan pays bonuses based on achieving 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. EBITDA should not be considered as an alternative to, or more meaningful than, income (loss) from operations or other traditional indications of a company s operating performance.