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FOOTSTAR INC  
Form 10-Q  
September 30, 2005

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

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FORM 10-Q

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

For the quarterly period ended July 2, 2005  
Commission File Number 1-11681

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FOOTSTAR, INC.  
(Exact name of registrant as specified in its charter)

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DELAWARE  
(State or other jurisdiction  
of incorporation for organization)

22-3439443  
(IRS Employer Identification No.)

933 MACARTHUR BLVD., MAHWAH, NEW JERSEY 07430  
(Address of principal executive offices)

(201) 934-2000  
(Registrant's telephone number, including area code)

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Indicate by check mark whether registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities and 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      X  
-----      -----

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

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

The aggregate market value of the common stock held by non-affiliates of the registrant as of July 30, 2005, was approximately \$125.8 million.

Number of shares outstanding of common stock, par value \$.01 per share, as of July 30, 2005: 20,349,976

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FOOTSTAR, INC. AND SUBSIDIARY COMPANIES  
 CONSOLIDATED STATEMENTS OF OPERATIONS  
 FOR THE THREE AND SIX MONTHS ENDED JULY 2, 2005 AND JULY 3, 2004  
 (Unaudited)  
 (amounts in millions)

	Three Months Ended		Six Months Ended
	July 2, 2005	July 3, 2004	July 2005
Net sales	\$192.6	\$216.5	\$347.0
Cost of sales	130.0	144.0	240.0
GROSS PROFIT	62.6	72.5	106.0
Store operating, selling, general and administrative expenses	47.0	62.6	94.0
Depreciation and amortization	1.8	7.2	3.0
Interest expense	1.2	3.9	2.0
INCOME (LOSS) BEFORE REORGANIZATION ITEMS	12.6	(1.2)	6.0
Reorganization items	5.9	3.9	9.0

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INCOME (LOSS) BEFORE INCOME TAXES, MINORITY INTERESTS AND DISCONTINUED OPERATIONS	6.7	(5.1)	(3.1)
Income tax (provision) benefit	(5.8)	(0.5)	2.1
INCOME (LOSS) BEFORE MINORITY INTERESTS AND DISCONTINUED OPERATIONS	0.9	(5.6)	(0.1)
Minority interests in net (income) loss	--	(2.1)	--
INCOME (LOSS) FROM CONTINUING OPERATIONS	0.9	(7.7)	(0.1)
(Loss) income from discontinued operations	--	(31.2)	(0.1)
(Loss) gain from disposal of discontinued operations	--	34.8	--
NET INCOME (LOSS)	\$ 0.9	\$ (4.1)	\$ (0.1)
NET INCOME (LOSS) PER SHARE:			
Basic:			
Income (loss) from continuing operations	\$ 0.04	\$ (0.38)	\$ (0.1)
(Loss) income from discontinued operations	--	0.18	--
Net income (loss)	\$ 0.04	\$ (0.20)	\$ (0.1)
Diluted:			
Income (loss) from continuing operations	\$ 0.04	\$ (0.38)	\$ (0.1)
(Loss) income from discontinued operations	--	(0.18)	--
Net income (loss)	\$ 0.04	\$ (0.20)	\$ (0.1)
Average common shares outstanding:			
Basic	20.5	20.5	20.5
Diluted	20.5	20.5	20.5

See accompanying notes to condensed consolidated financial statements.

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FOOTSTAR, INC. AND SUBSIDIARY COMPANIES  
CONSOLIDATED BALANCE SHEETS  
(in millions, except share amounts)

	July 2, 2005	January 1, 2005
	(unaudited)	
ASSETS		
Current Assets:		
Cash and cash equivalents	\$ 218.5	\$ 189.6
Accounts receivable, net	14.7	22.1
Inventories	103.7	98.9
Prepaid expenses and other current assets	29.9	28.4
Assets of discontinued operations	--	6.2
Total current assets	366.8	345.2
Property and equipment, net	32.1	35.4

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Intangible assets, net	10.3	10.3
Deferred charges and other assets	2.2	3.2
	-----	-----
Total assets	\$ 411.4	\$ 394.1
	=====	=====
LIABILITIES AND SHAREHOLDERS' EQUITY		
Liabilities not subject to compromise:		
Accounts payable	66.6	\$ 48.0
Accrued expenses	41.1	48.0
Amount due under Kmart Settlement	57.0	45.0
Income taxes payable	--	2.0
Liabilities of discontinued operations	3.0	3.5
Liabilities subject to compromise	150.2	152.3
	-----	-----
Total current liabilities	317.9	298.8
Other long-term liabilities	37.3	38.5
Amount due under Kmart Settlement	5.5	5.5
	-----	-----
Total liabilities	360.7	342.8
Shareholders' Equity:		
Common stock \$.01 par value: 100,000,000 shares authorized, 31,061,545 and 31,018,065 shares issued	0.3	0.3
Additional paid-in capital	342.9	343.1
Treasury stock: 10,711,569 shares at cost	(310.6)	(310.6)
Unearned compensation	(0.3)	(0.4)
Retained earnings	18.4	18.9
	-----	-----
Total shareholders' equity	50.7	51.3
	-----	-----
Total liabilities and shareholders' equity	\$ 411.4	\$ 394.1
	=====	=====

See accompanying notes to condensed consolidated financial statements.

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FOOTSTAR, INC. AND SUBSIDIARY COMPANIES  
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS  
FOR THE SIX MONTHS ENDED JULY 2, 2005 AND JULY 3, 2004  
(Unaudited)  
(amounts in millions)

	Six Months Ended	
	July 2, 2005	July 3, 2004
	-----	-----
Net cash provided by operating activities	\$ 26.7	\$ 29.4
	-----	-----
Cash flows provided by investing activities:		
Additions to property and equipment	(0.8)	(1.7)
Proceeds from sale of furniture and equipment	0.3	--
Proceeds from the sale of Athletic Division	--	215.7
	-----	-----

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Net cash provided by investing activities	(0.5)	214.0
	-----	-----
Cash flows used in financing activities:		
Repayments on notes payable	--	(198.0)
Other	0.1	0.4
	-----	-----
Net cash provided by (used in) financing activities	0.1	(197.6)
	-----	-----
Cash provided by discontinued operations	2.6	34.3
	-----	-----
Net increase in cash and cash equivalents	28.9	80.1
Cash and cash equivalents, beginning of period	189.6	1.1
	-----	-----
Cash and cash equivalents, end of period	\$218.5	\$ 81.2
	=====	=====

See accompanying notes to condensed consolidated financial statements.

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### FOOTSTAR, INC. AND SUBSIDIARY COMPANIES) NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

#### THE COMPANY

Footstar, Inc., ("Footstar", the "Company", "we", "us", or "our") is a holding company in which our businesses are operated through its subsidiaries. We are principally a retailer conducting business through our Meldisco Segment and, prior to our sale of certain stores to certain affiliates of Foot Locker, Inc. ("Foot Locker") on May 2, 2004 and the closing of underperforming stores, its Athletic Segment. The Meldisco Segment sells family footwear through licensed footwear departments and wholesale arrangements. The Athletic Segment sold athletic footwear and apparel through various retail chains (for example, Footaction and Just For Feet), and via catalogs and the Internet.

#### 1. BUSINESS RISKS - BANKRUPTCY FILING

Commencing March 2, 2004 ("Petition Date"), Footstar and most of its subsidiaries (collectively, the "Debtors") filed voluntary petitions for reorganization under Chapter 11 of Title 11 of the United States Code ("Bankruptcy Code" or "Chapter 11") in the United States Bankruptcy Court for the Southern District of New York in White Plains ("Court"). The Chapter 11 cases are being jointly administered under the caption "In re: Footstar, Inc., et al. Case No. 04-22350 (ASH)" (the "Chapter 11 Cases"). The Debtors are currently operating their business and managing their properties as debtors-in-possession pursuant to Sections 1107(a) and 1108 of the Bankruptcy Code. As debtors-in-possession, we are authorized to continue to operate as an ongoing business but may not engage in transactions outside the ordinary course of business without the approval of the Court.

Under the Bankruptcy Code, we have the ability to reject executory contracts and unexpired leases, subject to the approval of the Court and certain other conditions. Parties affected by the rejection of a contract or lease may file claims against us in the Court in accordance with the Bankruptcy Code. Due to the uncertain nature of many of the potential claims, which have been or may be asserted against us, we are unable to project the magnitude of such claims with certainty. We have incurred, and will continue to incur, significant costs

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associated with our reorganization. In order to exit Chapter 11 successfully, we will need to obtain Court confirmation of a Chapter 11 plan that satisfies the requirements of the Bankruptcy Code.

On November 12, 2004, we filed a proposed joint plan of reorganization with the Court. Following the Kmart Settlement, as defined below, we anticipate filing an amended plan with the Court (the "Amended Plan"). The Amended Plan is expected to provide for an orderly reorganization of the Company and certain cash distributions and be subject to a vote by eligible ballot holders. The Amended Plan is also expected to provide for some flexibility in the timing of its confirmation and our emergence from bankruptcy. The Amended Plan is also expected to provide that we will not emerge from bankruptcy until we file with the Securities and Exchange Commission ("SEC") this periodic report as required by the SEC. Although we expect that creditors in the bankruptcy will be paid in full, the timing of such payments is currently subject to negotiation and is expected to be specified in the Amended Plan.

On July 2, 2005, the Company and Kmart entered into an agreement (the "Kmart Settlement") with respect to the assumption, interpretation and amendment of the Master Agreement with Kmart, effective July 1, 1995, as amended (the "Master Agreement"). On August 25, 2005, the Court approved the Kmart Settlement. The Kmart Settlement, which takes effect beginning January 2,

FOOTSTAR, INC. AND SUBSIDIARY COMPANIES)  
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
 (UNAUDITED)

2005, allows us to continue operating the footwear departments in Kmart stores pursuant to the Master Agreement as amended by the Kmart Settlement (the "Amended Master Agreement") See Note 4. Kmart footwear department sales were as follows (in millions):

Three Months Ended		Six Months Ended	
July 2, 2005	July 3, 2004	July 2, 2005	July 3, 2004
\$183.2	\$206.7	\$324.2	\$370.9

2. BASIS OF PRESENTATION

The consolidated financial statements contained herein have been prepared on a going concern basis, which assumes continuity of operations and realization of assets and satisfaction of liabilities in the ordinary course of business, and in accordance with the provisions of Statement of Position 90-7 "Financial Reporting by Entities in Reorganization Under the Bankruptcy Code" ("SOP 90-7"). Pursuant to SOP 90-7, our pre-petition liabilities that are subject to compromise are reported separately in the accompanying consolidated balance sheets as an estimate of the amount that will ultimately be allowed by the Court. SOP 90-7 also requires separate reporting of certain expenses, realized gains and losses and provisions for losses related to our bankruptcy filing as reorganization items (see Notes 6 and 8).

The accompanying consolidated financial statements are unaudited but, in the

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opinion of management, contain all adjustments (which are of a normal recurring nature) necessary to present fairly the financial position, results of operations and cash flows for the periods presented. All significant intercompany accounts and transactions have been eliminated.

Detailed footnote information is not included in this report. The financial information set forth herein should be read in conjunction with the Notes to Consolidated Financial Statements contained in our fiscal 2004 Annual Report on Form 10-K for the period ended January 1, 2005 filed with the SEC.

The results of operations for the six months ended July 2, 2005 are not necessarily indicative of results to be expected for the entire fiscal year ended December 31, 2005.

### 3. DISCONTINUED OPERATIONS

The disposition of our Athletic Segment and within our Meldisco Segment, the sale or liquidation of all our Shoe Zone stores as well as our exit from the footwear departments in 44 Gordmans, Inc. stores and the footwear departments in 87 stores operated by subsidiaries of Federated Department Stores, Inc. has been accounted for as discontinued operations in accordance with FASB Statement No. 144, "Accounting for the Impairment or Disposal of Long Lived Assets". Accordingly, we have reported our results of the discontinued operations as a separate component of operations. As of July 2, 2005 the estimated gain from disposal of the Athletic Segment was approximately \$21.4 million.

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#### FOOTSTAR, INC. AND SUBSIDIARY COMPANIES) NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

Net sales and operating loss from discontinued operations for the three and six months ended July 2, 2005 and July 3, 2004 were as follows (in millions):

	Three Months Ended		Six Months Ended	
	July 2, 2005	July 3, 2004	July 2, 2005	July 3, 2004
Net sales	\$ --	\$ 40.6	\$ --	\$241.2
Operating income (loss) from discontinued operations	\$0.2	\$(21.7)	\$0.1	\$(38.6)

### 4. MELDISCO'S RELATIONSHIP WITH KMART

Our arrangement with Kmart was governed by the Master Agreement. The Master Agreement provided us with the non-transferable, exclusive right and license to operate a footwear department in every Kmart store. The initial term of the Master Agreement would have expired on July 1, 2012, and was renewable for a 15 year term upon mutual agreement, unless either party gave notice of termination at least four years prior to the end of the applicable term. Under the Master Agreement, the Company and Kmart had formed in excess of 1,500 Shoemart Corporations in which we had a 51% ownership interest and Kmart had a 49% interest, other than 23 of the Shoemart Corporations which were wholly-owned by us. On July 2, 2005, the Company and Kmart entered into the Kmart Settlement. On

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August 25, 2005, the Court approved the Kmart Settlement. The Kmart Settlement, which takes effect beginning January 2, 2005, allows us to continue operating the footwear departments in Kmart stores pursuant to the Amended Master Agreement. The significant provisions of the Kmart Settlement are as follows:

- Elimination of all outstanding litigation between Kmart and us.
- Expiration of the Amended Master Agreement at the end of 2008 and the requirement that Kmart will purchase our Shoemart inventory (but not our brands) at book value, which will allow for an orderly wind down of the business without the need for a complex liquidation and the attendant costs.

Kmart has agreed to purchase all of the inventory (excluding inventory that is damaged, unsaleable and seasonal inventory, as defined) that is in our remaining stores on December 31, 2008, or that is on order on that date pursuant to Kmart's written request, for an amount equal to the book value of the inventory, as defined. We will vacate those stores and the Amended Master Agreement will expire.

- Our cure obligation to Kmart is fixed at \$45.0 million.

The cure amount is inclusive of all claims of Kmart, including, without limitation, retained earnings, and retained deficit of all stores that were no longer in operation as of January 1, 2005 and any dividend/excess fees. This entire amount was paid to Kmart on August 26, 2005. A loss of \$6.3 million resulting from the Kmart Settlement was recorded in December 2004.

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### FOOTSTAR, INC. AND SUBSIDIARY COMPANIES) NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

- Elimination of all annual fees/payments previously paid Kmart in favor of annual payments to Kmart equal to 14.625% of gross sales plus a miscellaneous expense fee of \$23,500 per store per year; elimination of Kmart's equity interests in the Shoemart Corporations.

Kmart's equity interests in the Shoemart Corporations have been extinguished effective as of January 2, 2005 and accordingly Kmart will no longer share in the profits or losses of these entities for fiscal 2005 or subsequent years. Beginning on January 2, 2005, we were required to begin paying Kmart 14.625% of the gross sales of the footwear departments. Effective August 25, 2005, we are also required to pay Kmart a miscellaneous expense fee of \$23,500 per store per year. These are the only material fees which we will be required to pay Kmart pursuant to the Kmart Settlement.

Kmart will have a capital claim against us in the amount of \$11,000 for each store that is an existing store, as defined, on August 25, 2005, which is generally payable by us to Kmart at the time a store closes or converts to another retail format in accordance with the 550 store limitation described below. However, upon the expiration of the Amended Master Agreement or upon early termination of that agreement other than as a result of our breach, all capital claims not yet due and payable will be waived for any remaining stores. If the Amended Master Agreement is terminated as a result of our breach, capital



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claims for remaining stores will not be waived and will become immediately due and payable.

- Kmart will be prohibited from reducing the number of stores in which we operate below specified levels, unless it pays us the stipulated loss value for the loss of each incremental store.

Kmart will be permitted to terminate our rights to operate footwear departments in up to 550 existing Kmart stores during the remaining term of the Amended Master Agreement by disposing of, closing or converting these stores. The number of such terminations per year is capped at 85 in 2005, 150 in 2006 and 160 in each of 2007 and 2008, with any unused cap carried over to the following year. For each store that is closed or converted, Kmart must purchase all of our in-store inventory (excluding inventory that is damaged, unsaleable and seasonal inventory, as defined) at book value, as defined. In addition, for all closings and conversions above the annual cap or the 550 aggregate limit, Kmart must pay us a nonrefundable stipulated loss value per store equal to \$100,000 for closings and conversions occurring in 2005, \$60,000 for closings and conversions occurring in 2006, \$40,000 for closings and conversions occurring in 2007 and \$20,000 for closings and conversions occurring in 2008. A termination of the entire Amended Master Agreement in accordance with its terms does not trigger a stipulated loss value payment.

- Reduction of staffing obligations as sales decline.

We must spend at least 10% of gross sales in the footwear departments on staffing for the stores; and we must schedule staffing in each store at a minimum of 40 hours per week.

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### FOOTSTAR, INC. AND SUBSIDIARY COMPANIES) NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

- Elimination of the performance standards in favor of a minimum sales test.

The Company and Kmart will each have the right to terminate the Amended Master Agreement if the gross sales of the footwear departments are less than \$550.0 million in any year, less \$0.4 million for each store that is closed or converted after August 25, 2005. We will also have a separate, unilateral right to terminate the Amended Master Agreement if either (i) the number of Kmart stores is less than 900 or (ii) the gross sales of the footwear departments in any four consecutive fiscal quarters is less than \$450.0 million. Upon termination under either circumstance, Kmart must purchase all of the inventory at the stores, (including inventory that is on order but excluding inventory that is damaged, unsaleable and seasonal inventory, as defined) for an amount equal to the book value of the inventory, as defined.

- Kmart is required to allocate 52 weekend newspaper advertising insert pages per year to our products.

## 5. ASSETS AND LIABILITIES RELATED TO DISCONTINUED OPERATIONS

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Assets and liabilities related to discontinued operations consisted of the following (in millions):

	July 2, 2005 -----	January 1, 2005 -----
ASSETS		
Accounts receivable, net	\$ -- ----	\$6.2 ----
LIABILITIES		
Accrued expenses	\$3.0 ----	\$3.5 ----

### 6. LIABILITIES SUBJECT TO COMPROMISE

Liabilities subject to compromise represent our current estimate of the amount of the pre-petition claims that are subject to restructuring in the Chapter 11 Cases. Pursuant to Court orders, we have been authorized to pay certain pre-petition operating liabilities incurred in the ordinary course of business and reject certain of our pre-petition obligations. We have notified all known pre-petition creditors of the establishment of a bar date by which creditors must file a proof of claim, which bar date has now passed for all creditors. Differences between liability amounts recorded by us and claims filed by creditors are being reconciled and, if necessary, the Court will make a final determination of allowable claims.

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### FOOTSTAR, INC. AND SUBSIDIARY COMPANIES NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

Liabilities subject to compromise consisted of the following (in millions):

	July 2, 2005 -----	January 1, 2005 -----
Accounts payable	\$ 75.5	\$ 75.9
Accrued expenses	68.1	69.8
Long-term liabilities	6.6	6.6
	-----	-----
Total	\$150.2(a) =====	\$152.3(a) =====

(a) Includes approximately \$109.4 and \$112.5 of liabilities subject to compromise from discontinued operations as of July 2, 2005 and January 1, 2005, respectively.

### 7. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

As of July 2, 2005, there have been no material changes to any of the

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significant accounting policies described in our Annual Report on Form 10-K for the year ending January 1, 2005.

### 8. REORGANIZATION ITEMS

Reorganization items, which consist of income and expenses that are related to our bankruptcy proceedings, were comprised of the following for the three and six months ended July 2, 2005 and July 3, 2004 (in millions):

	Three Months Ended		Six Months Ended	
	July 2, 2005	July 3, 2004	July 2, 2005	July 3, 2004
Store and distribution center closing and related asset impairment costs	\$ 0.1	\$ 2.2	\$ 0.1	\$ 2.2
Professional fees	6.2	0.5	10.1	2.4
Trustee fees	1.0	1.3	2.0	3.9
Interest income	(1.4)	(0.1)	(2.6)	(0.1)
	-----	-----	-----	-----
Total	\$ 5.9	\$ 3.9	\$ 9.6	\$ 8.4
	=====	=====	=====	=====

### 9. EARNINGS PER SHARE

Basic EPS is computed by dividing net income available for common stockholders by the weighted average number of common shares outstanding for the period.

Diluted EPS is computed by dividing net income available to common stockholders by the weighted average shares outstanding, after giving effect to the potential dilution that could occur if outstanding options or other contracts or obligations to issue common stock were exercised or converted.

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The following table reflects average shares outstanding used to compute basic and diluted loss per share (in millions):

	Three Months Ended		Six Months Ended	
	July 2, 2005	July 3, 2004	July 2, 2005	July 3, 2004
Average shares outstanding	20.3	20.2	20.3	20.2
Contingently issuable shares (1)	0.2	0.3	0.2	0.3
	----	----	----	----
Average shares outstanding - basic	20.5	20.5	20.5	20.5
	=====	=====	=====	=====
Average shares outstanding - diluted (2)	20.5	20.5	20.5	20.5
	=====	=====	=====	=====

-----  
 (1) Represents shares earned under our stock incentive plans

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- (2) The computation of diluted EPS does not assume conversion, exercise or issuance of shares that would have an anti-dilutive effect on EPS. During the three months ended July 3, 2004, and the six months ended July 2, 2005 and July 3, 2004, we had a net loss; as a result, any assumed conversions would result in reducing the loss per share and, therefore, are not included in the calculation. There were no assumed shares having an anti-dilutive effect on EPS in any period.

### 10. INCOME TAXES

Although the Kmart Settlement was effective as of January 2, 2005, the effective date for tax purposes is August 25, 2005, the date the Kmart Settlement was approved by the Court. As a result, two tax periods are required for fiscal 2005. Due to the minority interests in each Shoemart store for the period January 2, 2005 through August 25, 2005, we can not file a consolidated federal tax return. As losses from stores cannot therefore be offset against profits from other stores, this has resulted in an unusually high estimated tax rate of approximately 88% for 2005. As the minority interests are eliminated as of August 25, 2005, subsequent federal tax returns will be filed on a consolidated basis.

### 11. COMMITMENTS AND CONTINGENCIES

On the Petition Date, we commenced the Chapter 11 Cases under the Bankruptcy Code. We have continued to manage our business as debtors-in-possession, subject to the supervision of the Court and in accordance with the provisions of the Bankruptcy Code.

An immediate effect of the filing of the Chapter 11 Cases was the imposition of the automatic stay under section 362 of the Bankruptcy Code, which, with limited exceptions, enjoins the commencement or continuation of all collection efforts by creditors, enforcement of liens against any assets of the Company and litigation against us arising prior to the Petition Date. However, the automatic stay is applicable only to litigation against us, and not against any of our officers and directors.

Prior to our November 13, 2002 announcement that management had discovered discrepancies in the reporting of our accounts payable balances, we notified the Staff of the SEC concerning the discovery of the accounting discrepancies. Following that notification, the SEC began an

enforcement proceeding captioned, In the Matter of Footstar, Inc., MNY-7122, including an investigation into the facts and circumstances giving rise to the discrepancies. On November 25, 2003, the SEC issued a Formal Order that enforcement proceeding, authorizing an investigation and empowering certain members of the SEC staff to take certain actions in the course of the investigation, including requiring testimony and the production of documents. We cannot predict the outcome of the proceeding.

On or about March 3, 2005, a first amended complaint was filed against us in the U.S. District Court for the District of Oregon, captioned Adidas America, Inc. and Adidas - Salomon AG v Kmart Corporation and Footstar, Inc. The first amended complaint seeks injunctive relief and unspecified monetary damages for trademark infringement, trademark dilution, unfair competition, deceptive trade practices and breach of contract arising out of use of four stripes as a design element on footwear which Adidas alleges infringes on its registered three strip trademark.

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While it is too early in litigation to predict the outcome of the claims against us, we believe that we have meritorious defenses to the claims asserted by Adidas and have filed an answer denying the allegations.

Pursuant to an agreement between the Company and FMI International ("FMI") for warehouse and distribution services, we are obligated to pay to FMI a minimum of \$15.1 million in both 2005 and 2006.

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### ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

#### FORWARD-LOOKING STATEMENTS

This report contains forward-looking statements made in reliance upon the safe harbor provisions of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. These statements may be identified by the use of words such as "anticipate," "estimates," "should," "expect," "guidance," "project," "intend," "plan," "believe" and other words and terms of similar meaning, in connection with any discussion of our financial statements, business, results of operations, liquidity and future operating or financial performance. Factors that could affect our forward-looking statements include, among other things:

- the pace at which Kmart terminates our business relationship and our ability to develop viable business alternatives to offset the termination of that relationship;
- our ability to emerge from bankruptcy protection and operate as a going concern without those protections;
- our ability to operate pursuant to the terms of the Amended DIP and Exit Facility and to otherwise obtain financing necessary to operate our business on satisfactory terms both during and after our emergence from bankruptcy protection;
- our ability to obtain Court approval and any other required approvals with respect to motions in the Chapter 11 proceeding prosecuted by us from time to time;
- our ability to develop, prosecute, confirm and consummate one or more plans of reorganization with respect to the Chapter 11 Cases;
- risks associated with third parties seeking and obtaining Court approval to terminate or shorten the exclusivity period that we have to propose and confirm one or more plans of reorganization, to appoint a Chapter 11 trustee or to convert the Chapter 11 Cases to Chapter 7 cases;
- our ability to obtain and maintain normal terms with vendors and service providers and to maintain contracts that are critical to our operations;
- our compliance with the requirements of Sarbanes-Oxley;
- negative reactions from our stockholders, creditors or vendors to our delay in providing financial information and the delisting of our common stock by the NYSE;

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- the impact and result of any litigation (including private litigation), or any action by the SEC relating to us or the financial statement restatement process;
- the impact of Hurricane Katrina on our Southern Region;
- our ability to successfully implement internal controls and procedures that ensure timely, effective and accurate financial reporting;
- our ability to reduce overhead costs commensurate with any decline in sales;
- higher than anticipated employee levels, capital expenditures and operating expenses, including our ability to reduce overhead and rationalize assets, both generally and with respect to the changes made to address the results of the investigation and the restatement;
- adverse results on our business relating to increased review and scrutiny by regulatory authorities, media and others of financial reporting issues and practices or otherwise;
- any adverse developments in existing commercial disputes or legal proceedings; and
- intense competition in the markets in which we compete.

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Additionally, due to material uncertainties, it is not possible to predict the length of time we will operate under Chapter 11 protection, the outcome of the proceeding in general, whether we will continue to operate under our current organizational structure, or the effect of the proceeding on our businesses and the interests of various creditors and security holders.

Because the information in this Report on Form 10-Q is based solely on data currently available, it is subject to change and should not be viewed as providing any assurance regarding our future performance. Actual results and performance may differ from our current projections, estimates and expectations and the differences may be material, individually or in the aggregate, to our business, financial condition, results of operations, liquidity or prospects. Additionally, we assume no obligation to update any of our forward looking statements based on changes in assumptions, changes in results or other events subsequent to the date of this Quarterly Report on Form 10-Q.

### OVERVIEW

Management confronts major challenges in reorganizing the Company through the Chapter 11 process, and managing the business after the Kmart Settlement. Meldisco is our only continuing business and substantially, all of our continuing net sales and profits result from Meldisco's business in Kmart stores. If we fail to develop viable business alternatives to offset this business, we will be forced to liquidate our business when the Kmart relationship ends.

Since the Petition Date, actions to collect pre-petition indebtedness are stayed and other contractual obligations against us may not be enforced. In addition, under the Bankruptcy Code, we may assume or reject executory contracts and unexpired leases including leases of non-residential real property. Parties

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affected by these rejections may file claims with the Court in accordance with the Bankruptcy Code and orders issued by the Court.

For the period from the Petition Date to July 30, 2005, we incurred \$40.1 million of professional fees, including trustee fees, associated with the Chapter 11 cases. We expect to continue to incur significant additional costs through the remaining Chapter 11 process.

Although the process for the disposition of our Athletic Segment commenced in 2003, as part of our initial reorganization plans after filing for Chapter 11, we closed 166 underperforming stores within the Athletic Segment comprised of all 88 Just For Feet stores, 75 Footaction stores and three Uprise stores.

After filing for bankruptcy protection, we received indications of significant interest from potential acquirers of the remaining 353 Footaction retail stores comprising the Athletic Segment. We determined that a sale of these stores was the best way to maximize the value of that business. This decision was driven in part by the absence of a commitment from Nike USA, Inc., the largest supplier of the Athletic Segment, to supply the Athletic Segment for more than a limited period of time in accordance with past business practices. Accordingly, we decided to establish an orderly sale process for the remaining Footaction retail stores.

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On April 21, 2004, we received Court approval to sell to Foot Locker 349 of the remaining Footaction stores (including all lease rights and inventory at these stores), along with the remaining inventory from the four remaining Footaction stores. Effective May 2, 2004, these assets were sold to Foot Locker for \$225.0 million in cash, subject to adjustment. Approximately \$13.0 million of the sale price was placed in escrow with respect to 14 store locations that were leased on a month-to-month basis. If Foot Locker entered into a new lease for any of these store locations, the escrow amount related to that location was paid to us. The escrow amount related to any location for which Foot Locker did not enter into a new lease was paid to Foot Locker, thereby reducing the purchase price by such amount. As of July 2, 2005, Foot Locker entered into new leases for 12 of the above-mentioned 14 store locations and one store location was leased by the landlord to a third party. As of July 2, 2005, approximately \$9.2 million of the above-mentioned \$13.0 million escrow amount was released to us, approximately \$2.2 million was released to Foot Locker and approximately \$1.6 million remained in escrow. The parties had previously agreed to extend until July 7, 2005, the one remaining month-to-month lease, but have been unable to agree to a further extension as Foot Locker continues to occupy the premises and negotiate a new lease. Accordingly, the \$1.6 million remains in escrow pending the parties resolution of the dispute relating to the release of such funds from escrow.

The sale to Foot Locker together with the closure of the Just For Feet and Footaction stores has been accounted for as discontinued operations in accordance with FASB Statement No. 144, "Accounting for the Impairment or Disposal of Long Lived Assets". Accordingly, we have reported the results of the discontinued Athletic Segment as a separate component of operations.

We have sold other assets, including our distribution centers in Mira Loma, California ("Mira Loma") in July 2004 and Gaffney, South Carolina in September 2004. The purchaser of Mira Loma, Thrifty Oil Co. has leased Mira Loma to FMI, which will provide us with warehousing and distribution services through June 30, 2012 under a receiving, warehousing and distribution services agreement (the "FMI Agreement"). Pursuant to the FMI Agreement, we are obligated to pay FMI a minimum of \$15.1 million in both 2005 and 2006.

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We previously operated a Shared Services Center in Dallas, Texas. The Shared Services Center administered accounts payable, loss prevention, payroll, benefits, store accounting and inventory control for the entire Company and also contained our information systems data center. In connection with our decision to sell the Athletic Segment and streamline our Meldisco business, we determined that from both an internal control and cost perspective, the Shared Services Center was no longer a viable concept given our significantly reduced operating structure. Accordingly, during 2004 we transitioned all Shared Services Center functions to the Meldisco headquarters building in Mahwah, New Jersey.

On November 12, 2004, we filed a proposed joint plan of reorganization with the Court. In connection with the Kmart Settlement, we anticipate filing an amended plan with the Court (the "Amended Plan"). The Amended Plan is expected to provide for an orderly reorganization of the Company and certain cash distributions and be subject to a vote by eligible ballot

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holders. The Amended Plan is also expected to provide for some flexibility in the timing of its confirmation and our emergence from bankruptcy. The Amended Plan is also expected to provide that we will not emerge from bankruptcy until we are current in filing periodic reports with the SEC. Although we expect that creditors will be paid in full, the timing of such payments is subject to negotiation and is expected to be specified in the Amended Plan.

Effective July 1, 2005 the DIP and Exit Facility was amended (the "Amended DIP and Exit Facility"). See "Liquidity and Capital Resources".

Hurricane Katrina may have an impact on our Southern Region. In addition to the possibility of destroyed stores, there will be a number of stores closed for a period of time. Furthermore, our logistics systems for the distribution of merchandise has been disrupted in this region. The impact of this hurricane on our results of operations for the remainder of fiscal 2005 has not yet been determined.

### KMART SETTLEMENT

On July 2, 2005, the Company and Kmart entered into the Kmart Settlement which dictates the structure of our relationship with Kmart. Under the Master Agreement, the Company and Kmart had formed in excess of 1,500 Shoemart Corporations in which we had a 51% ownership interest and Kmart had a 49% ownership interest, other than 23 of the Shoemart Corporations which were wholly-owned by us.

The Kmart Settlement provides that Kmart's equity interests in the Shoemart Corporations will be extinguished effective January 2, 2005, and accordingly, Kmart will not share in the profits or losses of those entities for fiscal 2005 or subsequent years. The Kmart Settlement fixed the cure amount with respect to our assumption of the Amended Master Agreement at \$45.0 million, which was paid on August 26, 2005. Beginning on January 2, 2005, we are required to pay Kmart 14.625% of the gross sales of the footwear departments. Effective August 25, 2005, we are required to pay Kmart a miscellaneous expense fee of \$23,500 per open store per year. Under the Kmart Settlement, the Amended Master Agreement will expire at the end of 2008 and Kmart will purchase our Shoemart inventory (but not our brands) at book value, as defined, to allow for an orderly wind down of the Shoemart business.

We and Kmart each will have the right to terminate the Amended Master Agreement



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early if the gross sales of the footwear departments are less than \$550.0 million in any year, provided that such gross sales minimum will be reduced by \$0.4 million for each store that is closed or converted after the Approval Date. The Company will also have the unilateral right to terminate the Amended Master Agreement if either (i) the number of Kmart stores is less than 900 or (ii) the gross sales of the footwear departments in any consecutive quarters are less than \$450.0 million. In the event of any such termination, Kmart will purchase all of the inventory (including inventory that is on order but excluding inventory that is damaged, unsaleable and seasonal inventory, as defined) that is in our remaining stores or on order, for an amount equal to the book value of the inventory, as defined.

Kmart will be permitted to terminate our rights to operate shoe departments in up to 550 existing Kmart stores during the remaining term of the Amended Master Agreement by disposing of, closing

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or converting those stores. The number of such terminations per year is capped at 85 in 2005, 150 in 2006 and 160 in each of 2007 and 2008, with any unused cap carried over to the following year. For each store that is closed or converted, Kmart must purchase all of our in-store inventory (excluding inventory that is damaged, unsaleable and seasonal inventory, as defined) at book value, as defined. In addition, for all closings and conversions above the annual cap or the 550 aggregate limit, Kmart must pay us a non-refundable stipulated loss value per store equal to \$100,000 for closings and conversions occurring in 2005, \$60,000 for closings and conversions occurring in 2006, \$40,000 for closings and conversions occurring in 2007 and \$20,000 for closings and conversions occurring in 2008. A termination of the entire Amended Master Agreement in accordance with its terms does not trigger a stipulated loss value payment.

The Kmart Settlement sets forth the parties' obligations with respect to staffing and advertising. Specifically, we must spend at least 10% of gross sales in the footwear departments on staffing costs, as defined, for the stores and we must schedule the staffing in each store at a minimum of 40 hours per week. Kmart is required to allocate at least 52 square tab weekend newspaper advertising insert pages per year to our products.

Kmart will have a capital claim against us in the amount of \$11,000 for each store that is an existing store, as defined, on August 25, 2005, which is generally payable by us to Kmart at the time a store closes or converts to another retail format in accordance with the 550 store limitation described above. However, upon the expiration of the Amended Master Agreement or upon early termination of that agreement other than as a result of our breach, all capital claims not yet due and payable will be waived for any remaining stores. If the Amended Master Agreement is terminated as a result of our breach, capital claims for remaining stores will not be waived and will become immediately due and payable.

### OUR BUSINESS RELATIONSHIP WITH WAL-MART

In October 2002, we began supplying Thom McAn family footwear on a wholesale basis to 300 Wal-Mart stores. In February 2003, we expanded our arrangement with Wal-Mart to supply Thom McAn family footwear on a wholesale basis to up to 1,500 Wal-Mart stores in the United States. As of July 30, 2005, we were supplying Thom McAn family footwear to 1,500 Wal-Mart stores in the United States and 13 stores in Puerto Rico. In 2004, we sold approximately \$28.6 million of Thom McAn products to Wal-Mart stores. Wal-Mart has advised us that, beginning in January

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2006, it will no longer be purchasing Thom McAn product for any of its stores in the United States. Wal-Mart has advised us that it will continue to buy Thom McAn footwear for Wal-Mart stores in Puerto Rico and will continue to source footwear from us for Wal-Mart stores under Wal-Mart's proprietary brands.

### RESULTS OF OPERATIONS - THREE MONTHS ENDED JULY 2, 2005 VERSUS THREE MONTHS ENDED JULY 3, 2004

The following is a discussion of the results of operations for the three months ended July 2, 2005 compared with the three months ended July 3, 2004.

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#### 2005 VERSUS 2004

Meldisco represents substantially all of our operations. Corporate (income) expense, net of royalties and commissions, was approximately \$(2.5) million in 2005 and \$9.3 million in 2004.

#### 2005 VERSUS 2004 - CORPORATE

Royalties and commissions, which were approximately \$3.2 million and \$3.7 million in 2005 and 2004, respectively, consisted of the following:

- The royalties Footstar charges Meldisco on the corporate trademarks which we own and Meldisco utilizes on its products.
- Commissions on goods sourced to third parties.
- Fees associated with third party services, such as the testing lab.

Corporate expenses (excluding other income, interest income and interest expense) were approximately \$0.7 million in 2005 and \$13.0 million in 2004. With the disposition of our Athletic Segment, corporate expenses were substantially reduced as the remaining corporate activities were transferred to Meldisco at the end of fiscal 2004.

#### MELDISCO

	2005 -----	2004 -----	% SALES - 2005 -----	% SALES - 2004 -----
Net Sales	\$192.6	\$216.5	100.0	100.0
Gross Profit	59.3	68.8	30.8	31.8
SG&A Expenses	46.3	51.3	24.0	23.7
Depreciation/Amortization	1.8	5.5	1.0	2.5
Operating Profit	\$11.2	\$12.0	5.8	5.5

As part of the Kmart Settlement, effective January 2, 2005 the fees paid to Kmart were revised and Kmart's equity interests in the Shoemart Corporations were eliminated. The effect of the Kmart Settlement in 2005 compared with 2004 is as follows:

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Increase in cost of sales     \$9.0 million  
 Decrease in SG&A expenses    \$4.8 million

The minority interests share in 2004 income were \$2.1 million.

### NET SALES

Net sales decreased \$23.9 million, or 11.0%, to \$192.6 million in 2005 compared with \$216.5 million in 2004. This sales decrease was primarily due to an 8.2% comparable store sales decline in Shoemart during 2005 and fewer open Kmart stores.

Shoemart sales were approximately \$183.3 million in 2005 and \$206.7 million in 2004.

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Shoemart sales are largely dependent on the number of open Kmart stores and Kmart comparable store sales.

Three Months Ended	Open Kmart Stores	Kmart Store Comps (A)	Shoemart Store Comps
July 2, 2005	1,454	(0.3%)	(8.2%)
July 3, 2004	1,504	(14.9%)	(11.3%)

(A) For quarter ended July of each year

In 2005, Shoemart comparable sales declined significantly relative to Kmart primarily due to weaker performance in approximately 900 lower volume stores. In 2004, we moved to aggressively clear aged product. Deep discounts on aged inventory drove 2004 sales which resulted in the decrease in comparable store sales being less than that experienced by Kmart. As there were significantly less clearance sales in 2005, the decrease in comparable store sales was greater than that experienced by Kmart.

### GROSS PROFIT

Gross profit decreased \$9.5 million to \$59.3 million in 2005 compared with \$68.8 million in 2004. This dollar decrease was partly due to the aforementioned \$9.0 million effect of the Kmart Settlement. The overall gross margin rate declined 1% as the effect of the Kmart Settlement was offset by the higher margin on 2005 sales resulting from a reduction in clearance sales that occurred in 2004.

### SG&A EXPENSES

SG&A expenses decreased \$5.0 million, or 9.7%, to \$46.3 million in 2005 compared with \$51.3 million in 2004. \$4.8 million of this decrease was due to the aforementioned Kmart Settlement. \$0.2 million of this decrease is attributable to a reduction in miscellaneous expense fees due to fewer open Kmart stores in 2005.

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### DEPRECIATION AND AMORTIZATION

Depreciation and amortization decreased \$3.7 million to \$1.8 million in 2005 compared with \$5.5 million in 2004 due to a significant write-off of assets during 2004.

### OPERATING PROFIT

Operating profit decreased \$0.8 million to \$11.2 million in 2005 compared with \$12.0 million in 2004 primarily due to the reasons noted above.

### RESULTS OF OPERATIONS - SIX MONTHS ENDED JULY 2, 2005 VERSUS SIX MONTHS ENDED JULY 3, 2004

The following is a discussion of the results of operations for the six months ended July 2, 2005 compared with the six months ended July 3, 2004.

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### 2005 VERSUS 2004

Meldisco represents substantially all of our operations. Corporate (income) expense, net of royalties and commissions, was approximately \$(5.5) million in 2005 and \$16.9 million in 2004.

### 2005 VERSUS 2004 - CORPORATE

Royalties and commissions, which were approximately \$6.7 million and \$6.9 million in 2005 and 2004, respectively, consisted of the following:

- The royalties Footstar charges Meldisco on the corporate trademarks which we own and Meldisco utilizes on its products.
- Commissions on goods sourced to third parties.
- Fees associated with third party services, such as the testing lab.

Corporate expenses (excluding other income, interest income and interest expense) were approximately \$1.2 million in 2005 and \$23.8 million in 2004. With the disposition of our Athletic Segment, corporate expenses were substantially reduced as the remaining corporate activities were transferred to Meldisco at the end of fiscal 2004.

### MELDISCO

	2005	2004	% SALES - 2005	% SALES - 2004
	-----	-----	-----	-----
Net Sales	\$347.4	\$393.4	100.0	100.0
	-----	-----	-----	-----
Gross Profit	100.1	121.1	28.8	30.8
SG&A Expenses	93.4	100.6	26.9	25.6
Depreciation/Amortization	3.6	9.1	1.0	2.3
	-----	-----	-----	-----
Operating Profit	\$ 3.1	\$ 11.4	0.9	2.9
	-----	-----	-----	-----

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As part of the Kmart Settlement, effective January 2, 2005 the fees paid to Kmart were revised and Kmart's equity interests in the Shoemart Corporations were eliminated. The effect of the Kmart Settlement in 2005 compared with 2004 is as follows:

Increase in cost of sales	\$15.5 million
Decrease in SG&A expenses	\$ 8.5 million

The minority interests share in 2004 losses were \$(1.0) million.

### NET SALES

Net sales decreased \$46.0 million, or 11.7%, to \$347.4 million in 2005 compared with \$393.4 million in 2004. This sales decrease was primarily due to a 9.4% comparable store sales decline in Shoemart during 2005 and fewer open Kmart stores. Shoemart sales were approximately \$324.2 million in 2005 and \$370.9 million in 2004.

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Shoemart sales are largely dependent on the number of open Kmart stores and Kmart comparable store sales.

Six Months Ended	Open Kmart Stores	Kmart Store Comps (A)	Shoemart Store Comps
-----	-----	-----	-----
July 2, 2005	1,454	(1.8%)	(9.4%)
July 3, 2004	1,504	(13.9%)	(10.4%)

(A) For six months ended July of each year

In 2005, Shoemart comparable sales declined significantly relative to Kmart primarily due to weaker performance in approximately 900 lower volume stores. In 2004, we moved to aggressively clear aged product. Deep discounts on aged inventory helped drive 2004 sales which resulted in the decrease in comparable store sales being less than that experienced by Kmart. As there were significantly less clearance sales in 2005, the decrease in comparable store sales was greater than that experienced by Kmart.

### GROSS PROFIT

Gross profit decreased \$21.0 million to \$100.1 million in 2005 compared with \$121.1 million in 2004. This dollar decrease and resulting decrease in the overall gross margin rate was partly due to the aforementioned \$15.5 million effect of the Kmart Settlement.

### SG&A EXPENSES

SG&A expenses decreased \$7.2 million, or 7.2%, to \$93.4 million in 2005 compared with \$100.6 million in 2004. \$8.5 million of this decrease was due to the aforementioned Kmart Settlement, which was partially offset by an overall

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increase in SG&A expenses.

### LIQUIDITY AND CAPITAL RESOURCES

Our principal sources of liquidity used in funding short-term operations are our operating cash flows and our Amended DIP and Exit Facility. The Amended DIP and Exit Facility is structured to support general corporate borrowing requirements while operating under Chapter 11 and upon emergence. We have also obtained improved payment terms with our vendors and factories overseas applicable to orders for merchandise placed on or after December 1, 2004. In addition to other improved payment terms, accounts payable also increased due to higher inventory levels at July 2, 2005 compared with January 1, 2005. Inventory is usually at its lowest level at year end.

In accordance with the Amended Master Agreement, on August 26, 2005, we made the \$45.0 million cure payment to Kmart. On August 29, 2005, we made an estimated payment to Kmart of \$14.0 million based on the revised percent of gross sales due under the Amended Master Agreement for the period January 2, 2005 through August 27, 2005 retroactive to January 2, 2005. On September 6, 2005, we paid an additional \$1.5 million to Kmart for the final determination of the amount due.

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Although we expect that creditors in the bankruptcy will be paid in full, the timing of such payments is currently subject to negotiation and is expected to be specified in the Amended Plan. Other factors that could affect our liquidity include, among other things, the success and Court approval of our Amended Plan, maintaining the support of our key vendors and lenders, retaining key personnel, the impact of subsequent financial results, many of which are beyond our control. We also cannot reasonably assess the impact on liquidity of the implementation of the Kmart Settlement, as the timing of the wind-down and ultimate liquidation of the Shoemart business is outside our control (within certain parameters described under the "Kmart Settlement" above), and it is currently unknown whether the board of directors of the reorganized Company will choose to commit its financial resources to the commencement of one or more new business activities. To the extent the Company does undertake any such new business activity, it is expected that it will do so utilizing its available cash and/or its then available credit facilities. If the Company does not develop viable business alternatives to offset the termination of its Kmart business at the end of 2008, it is expected that the Company will liquidate its business when the Kmart relationship ends. Due to these uncertainties, we cannot reasonably assess the impact on our short-term and long-term liquidity needs.

#### The Amended DIP and Exit Facility

Effective March 4, 2004, we entered into a two year, \$300.0 million senior secured Debtor-in-Possession Credit Agreement ("DIP Credit Agreement") with a syndicate of lenders co-led by Fleet National Bank ("Fleet") and GECC Capital Markets Group, Inc. The DIP Credit Agreement was subsequently amended (the "DIP and Exit Facility"), which, among other things, reduced the amount of DIP commitments to \$100.0 million, including a sub-limit for letters of credit with availability determined by a borrowing base formula based upon inventory and accounts receivable. Pursuant to the DIP and Exit Facility, upon emergence from Chapter 11, we would have the option, subject to satisfaction of certain conditions, to convert the DIP and Exit Facility to post-emergence financing which would have provided us with up to \$160.0 million in revolving commitments, including a \$75.0 million sub-limit for letters of credit.

Effective July 1, 2005, we entered into the Amended DIP and Exit Facility to,

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among other things, reflect a change in the maturity date for the debtor-in-possession portion of the facility from the earlier of (a) (i) March 4, 2006 or (ii) 15 days following confirmation of the Plan to the earlier of (b) (i) October 31, 2006 or (ii) emergence from Chapter 11. The maturity date of the exit portion of the Amended DIP and Exit Facility is the earlier of (c) (i) 36 months after our emergence from Chapter 11 or (ii) March 4, 2009.

Our borrowing availability under the Amended DIP and Exit Facility continues to be determined by a formula based upon accounts receivable and inventory. However, pursuant to the amendment, revolving commitments upon emergence from Chapter 11 have been reduced from \$160.0 million to \$100.0 million, including a \$40.0 million sub-limit for letters of credit at our option and upon satisfaction of certain conditions. The conditions to be satisfied prior to emergence from Chapter 11 include the absence of any default or event of default, confirmation of the Amended Plan and occurrence of all conditions related thereto and our delivery of forward looking projections acceptable to the lenders illustrating required availability levels.

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Borrowings under the Amended DIP and Exit Facility bear interest at either Fleet's prime rate plus 0.0% to 0.5% or LIBOR plus 1.75% to 2.50%, at our option, with the applicable margin based on quarterly excess availability levels. A quarterly fee of 0.3% per annum is payable on the unutilized balance.

Pursuant to the Amended DIP and Exit Facility we are required to maintain minimum excess availability equal to at least 10% of the borrowing base, as defined, provided, however, that prior to our emergence from Chapter 11, in the event that loans are outstanding, the minimum excess availability requirement will be an amount equal to (i) 10% of the borrowing base plus (ii) \$20.0 million.

The Amended DIP and Exit Facility is secured by substantially all of the assets of the Company and contains various affirmative and negative covenants, representations, warranties and events of default to which we are subject, including certain financial covenants and restrictions such as limitations on additional indebtedness, other liens, dividends, stock repurchases and capital expenditures. After our emergence from Chapter 11, if minimum excess availability falls below 20% of the borrowing base, we will be subject to a fixed charge coverage covenant.

The Amended DIP and Exit Facility also includes representations and warranties, that, on an ongoing basis, there are no material adverse events affecting our business, operations, property, assets, or condition. A failure by us to satisfy any of the covenants, representations or warranties would result in default or other adverse impact under the Amended DIP and Exit Facility. Upon the request of the Company, the lenders have extended the time for the delivery of the 2004 annual consolidated financial statements and certain compliance certifications until we exit from Chapter 11.

As of July 2, 2005, we had no loans outstanding and \$19.7 million of outstanding letters of credit under the DIP and Exit Facility. Letters of credit reduce the borrowing capacity of the DIP and Exit Facility.

### The Pre-Petition Credit Facility

Prior to the Petition Date, our principal sources of liquidity used in funding our short-term operations were our operating cash flows and our senior secured credit facility ("Credit Facility") with a syndicate of lenders led by Fleet.

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The Credit Facility has since been replaced by the Amended DIP and Exit Facility.

### CRITICAL ACCOUNTING ESTIMATES

Our discussion of results of operations and financial condition relies on our consolidated financial statements that are prepared based on certain critical accounting estimates that require management to make judgments and estimates that are subject to varying degrees of uncertainty. We believe that investors need to be aware of these policies and how they impact our financial statements as a whole, as well as our related discussion and analysis presented herein. While we believe that these accounting estimates are based on sound measurement criteria, actual future events can and often do result in outcomes that can be materially different from these estimates or forecasts.

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The accounting estimates and related risks described in our fiscal 2004 Annual Report on Form 10-K for the year ended January 1, 2005 are those that depend most heavily on these judgments and estimates. As of July 2, 2005, there have been no material changes to any of the critical accounting estimates contained therein.

### ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

#### DERIVATIVES

As of July 2, 2005, we were not materially exposed to changes in the underlying values of our assets or liabilities nor were we materially exposed to changes in the value of expected foreign currency cash flows. We historically have not entered into derivative instruments for any purpose other than to manage our interest rate exposure. That is, we do not hold derivative financial investments for trading or speculative purposes. On January 8, 2004, four interest rate swap agreements we had previously entered into to limit the variability of a portion of our interest expense in connection with outstanding variable rate debt under the Credit Facility expired.

#### INTEREST RATES

As of July 2, 2005, we had no borrowings outstanding under the DIP and Exit Facility, other than approximately \$19.7 million of outstanding letters of credit. The Company, from time to time, undertakes borrowings to finance working capital and other corporate requirements. Our peak borrowing periods coincide with peak inventory purchases.

We assess interest rate cash flow risk by continually identifying and monitoring changes in interest rate exposures that may adversely impact expected future cash flows and by evaluating hedging opportunities.

#### FOREIGN EXCHANGE

A significant percentage of our products are sourced or manufactured offshore, with China accounting for approximately 96% of all sources. Our offshore product sourcing and purchasing activities are currently, and have been historically, denominated in U.S. dollars, and, therefore, we do not currently have material exposure to cash flows denominated in foreign currencies nor have net foreign exchange gains or losses been material to operating results in the reporting periods presented in this report.



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### ITEM 4. CONTROLS AND PROCEDURES

Under the supervision of our Chief Executive Officer and Senior Vice President of Financial Reporting and Control, management conducted an evaluation of the effectiveness of the design and operation of our disclosure controls and procedures (as such term is defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the "Exchange Act")) as of the end of the period covered by this report (the "Evaluation Date"). There are inherent limitations to the effectiveness of any system of disclosure controls and procedures, including the possibility of human error and the circumvention or overriding of the controls and procedures. Accordingly, even effective disclosure controls and procedures can only provide reasonable assurance of achieving

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their control objectives. Based on such evaluation, the Chief Executive Officer and Senior Vice President of Financial Reporting and Control concluded that, as of the Evaluation Date, our disclosure controls and procedures were effective at a reasonable assurance level with the filing of our first and second quarter 2005 Form 10-Q's.

Commencing January 2, 2005, an analysis of the components of our landed cost accrual is performed monthly and we have corrected the design deficiency in our controls over in-transit inventory to ensure that inventory and accounts payable will be properly stated for all periods presented. With the filing of our first and second quarter 2005 Form 10-Q's we will be current in filings required under the Exchange Act.

There were no other changes in our internal control over financial reporting during the quarterly period covered by this report that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

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### SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

Footstar, Inc.

Date: September 27, 2005

By: /s/ Dale W. Hilpert

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Dale W. Hilpert  
Chairman of the Board,  
Chief Executive Officer and  
President

Date: September 27, 2005

By: /s/ Richard L. Robbins

-----  
Richard L. Robbins

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Senior Vice President Financial  
Reporting and Control  
(Principal Financial Officer and  
Principal Accounting Officer)