FRIENDLY ICE CREAM CORP
Form 10-Q
November 09, 2005

# SECURITIES AND EXCHANGE COMMISSION

**Washington, D.C. 20549**

# 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 October 2, 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**

# FRIENDLY ICE CREAM CORPORATION

(Exact Name of Registrant as Specified in Its Charter)

| | |
|---|---|
| **Massachusetts**<br>(State or Other Jurisdiction of Incorporation or Organization) | **04-2053130**<br>(IRS Employer Identification No.) |
| **1855 Boston Road**<br>**Wilbraham, Massachusetts** | **01095** |

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

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 October 31, 2005** |
|---|---|
| Common Stock, $.01 par value | 7,898,591 shares |

## PART I FINANCIAL INFORMATION

### Item 1. Financial Statements

### FRIENDLY ICE CREAM CORPORATION AND SUBSIDIARIES

### CONDENSED CONSOLIDATED BALANCE SHEETS

(Unaudited)

(In thousands)

| | October 2, 2005 | January 2, 2005 |
|---|---|---|
| ASSETS | | |
| CURRENT ASSETS: | | |
| Cash and cash equivalents | $ 24,134 | $ 13,405 |
| Restricted cash | 2,727 | 1,711 |
| Accounts receivable, net | 10,224 | 10,448 |
| Inventories | 15,622 | 17,545 |
| Deferred income taxes | 6,853 | 6,853 |
| Prepaid expenses and other current assets | 6,319 | 4,562 |
| TOTAL CURRENT ASSETS | 65,879 | 54,524 |
| DEFERRED INCOME TAXES | 9,911 | 10,619 |
| PROPERTY AND EQUIPMENT, net of accumulated depreciation and amortization | 148,646 | 156,232 |
| INTANGIBLE ASSETS AND DEFERRED COSTS, net of accumulated amortization | 19,143 | 20,510 |
| OTHER ASSETS | 7,305 | 6,999 |
| TOTAL ASSETS | $ 250,884 | $ 248,884 |
| | | |
| LIABILITIES AND STOCKHOLDERS DEFICIT | | |
| CURRENT LIABILITIES: | | |
| Current maturities of long-term debt | $ 1,378 | $ 5,224 |
| Current maturities of capital lease and finance obligations | 1,412 | 1,533 |
| Accounts payable | 23,179 | 21,536 |
| Accrued salaries and benefits | 8,908 | 8,740 |
| Accrued interest payable | 5,049 | 1,427 |
| Insurance reserves | 10,912 | 9,927 |
| Restructuring reserves | 174 | 1,078 |
| Other accrued expenses | 16,858 | 18,582 |
| TOTAL CURRENT LIABILITIES | 67,870 | 68,047 |
| CAPITAL LEASE AND FINANCE OBLIGATIONS, less current maturities | 6,302 | 7,380 |
| LONG-TERM DEBT, less current maturities | 225,809 | 225,752 |
| ACCRUED PENSION COST | 17,746 | 17,532 |
| OTHER LONG-TERM LIABILITIES | 34,111 | 35,199 |
| COMMITMENTS AND CONTINGENCIES | | |
| STOCKHOLDERS DEFICIT: | | |
| Common stock | 79 | 77 |

| | | |
|---|---|---|
| Additional paid-in capital | 144,218 | 143,115 |
| Accumulated other comprehensive loss | (20,641) | (20,670) |
| Accumulated deficit | (224,610) | (227,548) |
| TOTAL STOCKHOLDERS DEFICIT | (100,954) | (105,026) |
| TOTAL LIABILITIES AND STOCKHOLDERS DEFICIT | $ 250,884 | $ 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 | | For the Nine Months Ended | |
|---|---|---|---|---|
| | **October 2, 2005** | **September 26, 2004 (Restated)** | **October 2, 2005** | **September 26, 2004 (Restated)** |
| REVENUES: | | | | |
| Restaurant | $ 109,018 | $ 120,436 | $ 317,909 | $ 339,230 |
| Foodservice | 30,786 | 29,110 | 87,840 | 82,273 |
| Franchise | 3,753 | 3,509 | 10,879 | 9,822 |
| TOTAL REVENUES | 143,557 | 153,055 | 416,628 | 431,325 |
| | | | | |
| COSTS AND EXPENSES: | | | | |
| Cost of sales | 54,225 | 57,368 | 157,482 | 158,915 |
| Labor and benefits | 38,337 | 42,990 | 114,773 | 125,079 |
| Operating expenses | 29,326 | 30,084 | 82,342 | 83,109 |
| General and administrative expenses | 8,262 | 9,054 | 28,239 | 29,505 |
| Restructuring expenses | | | | 2,627 |
| Gain on litigation settlement | | | | (3,644) |
| Write-downs of property and equipment | | | 289 | 91 |
| Depreciation and amortization | 5,782 | 5,533 | 17,915 | 16,932 |
| Loss (gain) on franchise sales of restaurant operations and properties | 7 | (189) | (2,521) | (1,102) |
| (Gain) loss on disposals of other property and equipment, net | (1,771) | 153 | (1,403) | 661 |
| | | | | |
| OPERATING INCOME | 9,389 | 8,062 | 19,512 | 19,152 |
| | | | | |
| OTHER EXPENSES: | | | | |
| Interest expense, net | 5,197 | 5,235 | 15,728 | 16,667 |
| Other (income) expense, principally debt retirement costs | (1) | | (17) | 9,235 |
| | | | | |
| INCOME (LOSS) BEFORE (PROVISION FOR) BENEFIT FROM INCOME TAXES | 4,193 | 2,827 | 3,801 | (6,750) |
| | | | | |
| (Provision for) benefit from income taxes | (786) | 651 | (863) | 3,566 |
| | | | | |
| NET INCOME (LOSS) | $ 3,407 | $ 3,478 | $ 2,938 | $ (3,184) |
| | | | | |
| BASIC NET INCOME (LOSS) PER SHARE | $ 0.43 | $ 0.45 | $ 0.38 | $ (0.42) |
| | | | | |
| DILUTED NET INCOME (LOSS) PER SHARE | $ 0.43 | $ 0.44 | $ 0.37 | $ (0.42) |
| | | | | |
| WEIGHTED AVERAGE SHARES: | | | | |
| Basic | 7,840 | 7,695 | 7,770 | 7,611 |
| Diluted | 7,988 | 7,869 | 7,909 | 7,611 |

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 Nine Months Ended October 2, 2005 | September 26, 2004 (Restated) |
|---|---|---|
| CASH FLOWS FROM OPERATING ACTIVITIES: | | |
| Net income (loss) | $ 2,938 | $ (3,184) |
| Adjustments to reconcile net income (loss) to net cash provided by operating activities: | | |
| Stock compensation expense | 68 | 427 |
| Depreciation and amortization | 17,915 | 16,932 |
| Write-offs of deferred financing costs | | 2,445 |
| Write-downs of property and equipment | 289 | 91 |
| Deferred income tax expense (benefit) | 688 | (3,566) |
| Gain on disposals of other property and equipment, net | (3,929) | (459) |
| Changes in operating assets and liabilities: | | |
| Accounts receivable | 224 | 83 |
| Inventories | 1,923 | (2,985) |
| Other assets | (2,692) | (3,585) |
| Accounts payable | 1,643 | 4,960 |
| Accrued expenses and other long-term liabilities | 1,222 | 1,233 |
| NET CASH PROVIDED BY OPERATING ACTIVITIES | 20,289 | 12,392 |
| | | |
| CASH FLOWS FROM INVESTING ACTIVITIES: | | |
| Purchases of property and equipment | (11,511) | (15,554) |
| Proceeds from sales of property and equipment | 6,230 | 4,048 |
| Purchases of marketable securities | (499) | (1,022) |
| Proceeds from sales of marketable securities | 163 | 89 |
| NET CASH USED IN INVESTING ACTIVITIES | (5,617) | (12,439) |
| | | |
| CASH FLOWS FROM FINANCING ACTIVITIES: | | |
| Proceeds from issuance of New Senior Notes | | 175,000 |
| Proceeds from borrowings under revolving credit facility | 16,250 | 16,750 |
| Proceeds from issuance of mortgages | 1,115 | |
| Repayments of debt | (21,153) | (193,555) |
| Payments of deferred financing costs | (43) | (6,625) |
| Principal payments of capital lease and finance obligations | (1,149) | (849) |
| Stock options exercised | 1,037 | 929 |
| NET CASH USED IN FINANCING ACTIVITIES | (3,943) | (8,350) |
| | | |
| NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS | 10,729 | (8,397) |
| | | |
| CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD | 13,405 | 25,631 |
| | | |
| CASH AND CASH EQUIVALENTS, END OF PERIOD | $ 24,134 | $ 17,234 |
| | | |
| SUPPLEMENTAL DISCLOSURES: | | |
| Cash paid during the period for: | | |

| | | | | |
|---|---|---|---|---|
| Interest | $ | 11,378 | $ | 13,298 |
| Income taxes | | 686 | | 24 |
| Capital lease obligations terminated | | (51) | | |
| Capital lease obligations incurred | | | | 3,250 |

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 October 2, 2005 and for the three and nine months ended October 2, 2005 and September 26, 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 nine month periods ended October 2, 2005 and September 26, 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 October 2, 2005 and January 2, 2005 (in thousands):

| | | October 2, 2005 | | January 2, 2005 |
|---|---|---|---|---|
| Raw materials | $ | 1,635 | $ | 2,685 |
| Goods in process | | 141 | | 157 |
| Finished goods | | 13,846 | | 14,703 |
| Total | $ | 15,622 | $ | 17,545 |

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*Other Assets*

Other assets included notes receivable of $4,434,000 and $4,524,000, which were net of allowances for doubtful accounts totaling $263,000 as of October 2, 2005 and January 2, 2005, respectively. As of January 2, 2005, notes receivable included a balloon payment of $3,903,000, due from a franchisee on April 15, 2006, for a subordinated promissory note. On July 29, 2005, the Company agreed to extend the term of the note for one year, with a new balloon payment of $3,796,000 due on April 15, 2007.

Also included in other assets as of October 2, 2005 and January 2, 2005 were payments made to fronting insurance carriers of $1,404,000 and $1,402,000, respectively, to establish loss escrow funds.

*Other Accrued Expenses*

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

| | October 2, 2005 | January 2, 2005 |
|---|---|---|
| Accrued rent | $ 4,684 | $ 4,781 |
| Gift cards outstanding | 2,324 | 4,068 |
| Accrued meals and other taxes | 2,284 | 2,766 |
| Accrued advertising | 2,153 | 1,824 |
| Accrued construction costs | 1,325 | 1,236 |
| Unearned revenues | 1,286 | 1,056 |
| Accrued bonus | 78 | 751 |
| All other | 2,724 | 2,100 |
| Total | $ 16,858 | $ 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 October 2, 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 $6,093,000. The present value of these potential payments discounted at the Company s pre-tax cost of debt at October 2, 2005 was $4,704,000. 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 October 2, 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 October 2, 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. 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 125,086 and 133,989 for the three months ended October 2, 2005 and September 26, 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 125,086 and 271,404 for the nine months ended October 2, 2005 and September 26, 2004, respectively.

During the nine months ended October 2, 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 dates of grants. During the nine months ended October 2, 2005, 185,312 employee stock options were exercised. The weighted-average exercise prices of the options granted and options exercised were $8.87 and $5.59, respectively.

Presented below is the reconciliation between basic and diluted weighted average shares for the three and nine months ended October 2, 2005 and September 26, 2004 (in thousands):

| | For the Three Months Ended | | | |
|---|---|---|---|---|
| | Basic | | Diluted | |
| | October 2, 2005 | September 26, 2004 | October 2, 2005 | September 26, 2004 |
| Weighted average number of common shares outstanding during the period | 7,840 | 7,695 | 7,840 | 7,695 |
| Adjustments: | | | | |
| Assumed exercise of stock options | | | 148 | 174 |
| Weighted average number of shares outstanding | 7,840 | 7,695 | 7,988 | 7,869 |

| | For the Nine Months Ended | | | |
|---|---|---|---|---|
| | Basic | | Diluted | |
| | October 2, 2005 | September 26, 2004 | October 2, 2005 | September 26, 2004 |
| Weighted average number of common shares outstanding during the period | 7,770 | 7,611 | 7,770 | 7,611 |
| Adjustments: | | | | |
| Assumed exercise of stock options | | | 139 | |
| Weighted average number of shares outstanding | 7,770 | 7,611 | 7,909 | 7,611 |

*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 stock option awards was included in net income (loss) for the nine months ended October 2, 2005 and September 26, 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 Nine Months Ended | |
|---|---|---|---|---|
| | **October 2, 2005** | **September 26, 2004** | **October 2, 2005** | **September 26, 2004** |
| Net income (loss) as reported | $ 3,407 | $ 3,478 | $ 2,938 | $ (3,184) |
| Add stock-based compensation expense included in reported net income (loss), net of related income tax benefit | | | 40 | 131 |
| Less stock-based compensation expense determined under fair value method for all stock options, net of related income tax benefit | (27) | (103) | (67) | (315) |
| Pro forma net income (loss) | $ 3,380 | $ 3,375 | $ 2,911 | $ (3,368) |
| Basic net income (loss) per share, as reported | $ 0.43 | $ 0.45 | $ 0.38 | $ (0.42) |
| Basic net income (loss) per share, pro forma | $ 0.43 | $ 0.44 | $ 0.37 | $ (0.44) |
| Diluted net income (loss) per share, as reported | $ 0.43 | $ 0.44 | $ 0.37 | $ (0.42) |
| Diluted net income (loss) per share, pro forma | $ 0.42 | $ 0.43 | $ 0.37 | $ (0.44) |

*Recently Issued Accounting Pronouncements*

In October 2005, the FASB issued FASB Staff Position 13-1, Accounting for Rental Costs Incurred during a Construction Period (FSP 13-1 ). The FSP concludes that rental costs incurred during and after a construction period are for the right to control the use of a leased asset during and after construction of a leased asset and that there is no distinction between the right to use a leased asset during the construction period and the right to use that asset after the construction period. Therefore, rental costs associated with ground or building operating leases that are incurred during a construction period should be recognized as rental expense. The guidance is effective for periods beginning after December 15, 2005. The adoption of FSP 13-1 is not expected to have a material effect on the Company s consolidated financial position or results of operations.

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 principles and requires retrospective application to prior periods financial statements of changes in accounting principles, 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 principles. 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 statement 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 nine months ended September 26, 2004 (in thousands except per share data):

| | For the Three Months Ended September 26, 2004 | | |
|---|---|---|---|
| | As Previously Reported | Adjustments | Restated |
| Operating expenses | $ 29,997 | $ 87 | $ 30,084 |
| Depreciation and amortization | 5,407 | 126 | 5,533 |
| Operating income | 8,275 | (213) | 8,062 |
| Income before benefit from income taxes | 3,040 | (213) | 2,827 |
| Benefit from income taxes | 563 | 88 | 651 |
| Net income | 3,603 | (125) | 3,478 |
| | | | |
| Basic net income per share | 0.47 | (0.02) | 0.45 |
| Diluted net income per share | 0.46 | (0.02) | 0.44 |

| | For the Nine Months Ended September 26, 2004 | | |
|---|---|---|---|
| | As Previously Reported | Adjustments | Restated |
| Operating expenses | $ 82,855 | $ 254 | $ 83,109 |
| Depreciation and amortization | 16,583 | 349 | 16,932 |
| Operating income | 19,755 | (603) | 19,152 |
| Loss before benefit from income taxes | (6,147) | (603) | (6,750) |
| Benefit from income taxes | 3,319 | 247 | 3,566 |
| Net loss | (2,828) | (356) | (3,184) |
| | | | |
| Basic and diluted net loss per share | (0.37) | (0.05) | (0.42) |

**3. EMPLOYEE BENEFIT PLANS**

The components of net periodic pension expense (benefit) for the three and nine months ended October 2, 2005 and September 26, 2004 were (in thousands):

| | For the Three Months Ended | | For the Nine Months Ended | |
|---|---|---|---|---|
| | October 2, 2005 | September 26, 2004 | October 2, 2005 | September 26, 2004 |
| Interest cost | $ 1,671 | $ 1,651 | $ 5,013 | $ 4,953 |
| Expected return on assets | (2,072) | (2,348) | (6,216) | (7,043) |
| Net amortization: | | | | |
| Unrecognized net actuarial loss | 473 | 168 | 1,418 | 503 |
| Net periodic pension expense (benefit) | $ 72 | $ (529) | $ 215 | $ (1,587) |

The components of the net postretirement medical and life insurance benefit cost for the three and nine months ended October 2, 2005 and September 26, 2004 were (in thousands):

| | For the Three Months Ended | | For the Nine Months Ended | |
|---|---|---|---|---|
| | October 2, 2005 | September 26, 2004 | October 2, 2005 | September 26, 2004 |
| Service cost | $ 41 | $ 28 | $ 122 | $ 84 |
| Interest cost | 114 | 116 | 344 | 348 |
| Recognized actuarial loss | 21 | 23 | 62 | 68 |
| Net amortization of unrecognized prior service benefit | (36) | (35) | (107) | (106) |
| Net postretirement benefit cost | $ 140 | $ 132 | $ 421 | $ 394 |

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 became 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 ending January 1, 2006.

**4. WRITE-DOWNS OF PROPERTY**

In accordance with SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets, 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 October 2, 2005, the Company committed to a plan to sell one closed restaurant property. The Company determined that the plan of sale criteria in SFAS No. 144 was met. Accordingly, the carrying values of this property as of October 2, 2005 and January 2, 2005, respectively, of $165,000 and $180,000 was included in prepaid expenses and other current assets in the accompanying condensed consolidated balance sheets. The carrying value of this property was not adjusted since the carrying value is less than the estimated fair market value less costs to sell.

During the nine months ended October 2, 2005, the Company identified two restaurant properties to be disposed of other than by sale. The Company determined that the carrying values 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 nine months ended September 26, 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 costs to sell. The carrying values were reduced by an aggregate of $91,000.

The table below identifies the components of the (Gain)/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 October 2, 2005 | For the Three Months Ended September 26, 2004 | For the Nine Months Ended October 2, 2005 | For the Nine Months Ended September 26, 2004 |
|---|---|---|---|---|
| Restaurant equipment assets retired due to remodeling | $ | $ 22 | $ 220 | $ 195 |
| Restaurant equipment assets retired due to replacement | 51 | 131 | 146 | 290 |
| (Gain) loss on property not held for disposition | (1,942) | | (1,902) | 63 |
| All other | 120 | | 133 | 113 |
| (Gain) loss on disposals of other property and equipment, net | $ (1,771) | $ 153 | $ (1,403) | $ 661 |

**5. DEBT**

Debt at October 2, 2005 and January 2, 2005 consisted of the following (in thousands):

| | October 2, 2005 | January 2, 2005 |
|---|---|---|
| New Senior Notes, 8 3/8%, due June 15, 2012 | $ 175,000 | $ 175,000 |
| Revolving credit loans, due June 30, 2007 | | 4,000 |
| Mortgage loans, due October 3, 2005 through January 1, 2022 | 52,187 | 51,976 |
| Total debt | 227,187 | 230,976 |
| Less: current portion | (1,378) | (5,224) |
| Total long-term debt | $ 225,809 | $ 225,752 |

In February 2004, the Company announced a cash tender offer and consent solicitation for $176 million of its Senior Notes to be financed with the proceeds from a $175 million private offering of new 8.375% senior notes (the New Senior Notes ), available cash and an amended revolving credit facility. In March 2004, $127.4 million of aggregate principal amount of Senior Notes were purchased at the tender offer and consent solicitation price of 104% of the principal amount and $0.4 million of aggregate principal amount of Senior Notes were purchased at the tender offer price of 102% of the principal amount. In April 2004, the remaining $48.2 million of Senior Notes were redeemed in accordance with the Senior Notes indenture at 103.5% of the principal amount. In connection with the tender offer, the Company wrote off unamortized deferred financing costs and incurred other direct expenses of $9.2 million that were included in the accompanying condensed consolidated statement of operations for the nine months ended September 26, 2004.

The $175 million of New Senior Notes issued in March 2004 are unsecured senior obligations of FICC, guaranteed on an unsecured senior basis by FICC s Friendly s Restaurants Franchise, Inc. subsidiary, but are effectively subordinated to all secured indebtedness of FICC, including the indebtedness incurred under the New Credit Facility (as defined below). The New Senior Notes mature on June 15, 2012. Interest on the New Senior Notes is payable at 8.375% per annum semi-annually on June 15 and December 15 of each year. The New Senior Notes are redeemable, in whole or in part, at any time on or after June 15, 2008 at FICC s option at redemption prices from 104.188% to 100.00%, based on the redemption date. In addition, at any time prior to June 15, 2007, FICC may redeem, subject to certain conditions, up to 35% of the aggregate principal amount of the New Senior Notes with the proceeds of one or more qualified equity offerings, as defined, at a redemption price of 108.375% of the principal amount, plus accrued interest.

The Company has a $35.0 million revolving credit facility (the New Credit Facility ). The $35.0 million revolving credit commitment less outstanding letters of credit is available for borrowing to provide working capital and for other corporate needs. As of October 2, 2005 and January 2, 2005, total letters of credit outstanding were $16.0 million and $15.2 million, respectively. During the nine months ended October 2, 2005 and September 26, 2004, there were no drawings against the letters of credit. The revolving credit loans bear interest at the Company s option at either (a) the Base Rate plus the applicable margin as in effect from time to time (the Base Rate ) (9.25% at October 2, 2005) or (b) the Eurodollar rate plus the applicable margin as in effect from time to time (the Eurodollar Rate ) (8.30% at October 2, 2005). As of October 2, 2005 there were no revolving credit loans outstanding. As of January 2, 2005, $4.0 million of revolving credit loans were outstanding. As of October 2, 2005 and January 2, 2005, $19.0 million and $15.8 million, respectively, was available for borrowing.

The New Credit Facility has an annual clean-up provision, which obligates the Company to repay in full any and all outstanding revolving credit loans on or before September 30, 2005 and maintain a zero balance on such revolving credit for at least 30 consecutive days, to include September 30, 2005 immediately following the date of such repayment. Commencing in 2006, the annual clean-up provision will require the Company to repay in full any and all outstanding revolving credit loans on or before June 15 (or if June 15 is not a business day, as defined, then the next business day) of each year and maintain a zero balance on such revolving credit for at least 15 consecutive days, to include June 15, immediately following the date of such repayment.

The New Credit Facility includes certain restrictive covenants including limitations on indebtedness, restricted payments such as dividends and stock repurchases and sales of assets and of subsidiary stock. Additionally, the New Credit Facility limits the amount which the Company may spend on capital expenditures, restricts the use of proceeds, as defined, from asset sales and requires the Company to comply with certain financial covenants. On July 23, 2004 and October 19, 2004, the Company obtained limited waivers regarding certain financial covenants of its New Credit Facility, which the Company was not in full compliance with as of June 27, 2004 and September 26, 2004. On December 17, 2004, the Company amended the New Credit Facility to, among other things, (i) revise certain financial covenants and eliminate the minimum quarterly EBITDA requirement, (ii) amend the Company s annual capital expenditures limit and (iii) increase the commitment fee from 0.50% to 0.75% of the unused commitment amount. The Company was in compliance with the covenants under the New Credit Facility as of October 2, 2005.

At this time, the Company believes that it may not be in compliance with certain financial covenants under the New Credit Facility as of January 1, 2006. Based on ongoing discussions with its lenders, its projected limited borrowings under the New Credit Facility and its projected liquidity related to the fourth quarter and beyond, the Company believes it will likely seek and obtain a covenant waiver and amendment to the New Credit Facility or a new credit facility will be secured. In the event that the Company is not able to remedy such covenant violations at January 1, 2006, the Company will be in default under the New Credit Facility and, pursuant to cross default provisions, a technical default could be triggered regarding the Company s New Senior Notes, which would require a waiver or an amendment of that facility in order to maintain the current payment schedule of the New Senior Notes.

In connection with the Company s financial restructuring completed in December 2001, the Company received proceeds of $55.0 million in a long-term mortgage financing (the

Mortgage Financing ). Pursuant to the terms of the Mortgage Financing, the Company may sell properties securing the Mortgage Financing obligations provided that other properties are substituted in place of the sold properties to secure the Mortgage Financing. The substituted properties must meet certain requirements under the terms of the Mortgage Financing. In August 2005, proceeds of $0.4 million and $2.7 million were received in connection with the sale of two mortgaged properties. Substitution properties must secure the Mortgage Financing obligations no later than March 1, 2006. As of October 2, 2005, balances of $0.4 million and $1.3 million were held as collateral pending property substitution and were included in restricted cash on the accompanying condensed consolidated balance sheet as of October 2, 2005.

In September 2005, the Company acquired mortgage financing secured by its newly constructed Milford, MA restaurant. The financing provided for a real estate improvement and equipment loan. The real estate improvement loan has a principal balance of $0.8 million, maturing October 1, 2010 and is amortized over 15 years. The equipment loan has a principal balance of $0.3 million, maturing October 1, 2010 and is amortized over 7 years. The interest rate is variable and is the sum of the 30-day LIBOR rate in effect (3.86% at October 2, 2005) plus 4% on an annual basis. Changes in the interest rate are calculated monthly and recognized annually when the monthly payment amount is adjusted. Changes in the monthly payment amounts owed, due to interest rate changes, are reflected in the principal balances, which are re-amortized over the remaining life of the mortgages. The variable rate notes are subject to prepayment penalties during the first three years.

**6. SEGMENT REPORTING**

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

The Company s restaurants target families with kids and adults who desire a reasonably-priced meal in a full-service setting. The Company s menu offers a broad selection of freshly-prepared foods which appeal to customers throughout all dayparts. The menu currently features over 100 items comprised of a broad selection of breakfast, lunch, dinner and afternoon and evening snack items. Foodservice operations manufactures premium ice cream dessert products and distributes such manufactured products and purchased finished goods to 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.

| | For the Three Months Ended | | For the Nine Months Ended | |
|---|---|---|---|---|
| | October 2, 2005 | September 26, 2004 | October 2, 2005 | September 26, 2004 |
| | (in thousands) | | (in thousands) | |
| Revenues: | | | | |
| Restaurant | $ 109,018 | $ 120,436 | $ 317,909 | $ 339,230 |
| Foodservice | 62,576 | 65,088 | 181,960 | 182,364 |
| Franchise | 3,753 | 3,509 | 10,879 | 9,822 |
| Total | $ 175,347 | $ 189,033 | $ 510,748 | $ 531,416 |
| | | | | |
| Intersegment revenues: | | | | |
| Restaurant | $ | $ | $ | $ |
| Foodservice | (31,790) | (35,978) | (94,120) | (100,091) |
| Franchise | | | | |
| Total | $ (31,790) | $ (35,978) | $ (94,120) | $ (100,091) |
| | | | | |
| External revenues: | | | | |
| Restaurant | $ 109,018 | $ 120,436 | $ 317,909 | $ 339,230 |
| Foodservice | 30,786 | 29,110 | 87,840 | 82,273 |
| Franchise | 3,753 | 3,509 | 10,879 | 9,822 |
| Total | $ 143,557 | $ 153,055 | $ 416,628 | $ 431,325 |

| | For the Three Months Ended | | For the Nine Months Ended | |
|---|---|---|---|---|
| | October 2, 2005 | September 26, 2004 (Restated) | October 2, 2005 | September 26, 2004 (Restated) |
| | (in thousands) | | (in thousands) | |
| EBITDA: | | | | |
| Restaurant | $ 9,940 | $ 11,845 | $ 29,012 | $ 32,435 |
| Foodservice | 4,344 | 3,323 | 10,725 | 9,725 |
| Franchise | 2,736 | 2,506 | 7,848 | 6,909 |
| Corporate | (3,621) | (4,084) | (13,784) | (14,211) |
| Gain on property and equipment, net | 1,772 | 5 | 3,915 | 300 |
| Restructuring expenses | | | | (2,627) |
| Gain on litigation settlement | | | | 3,644 |
| Net periodic pension expense (benefit) included in reporting segments | 72 | (529) | 215 | (1,587) |
| Total | $ 15,243 | $ 13,066 | $ 37,931 | $ 34,588 |
| | | | | |
| Interest expense, net-Corporate | $ 5,197 | $ 5,235 | $ 15,728 | $ 16,667 |
| | | | | |
| Other (income) expense, principally debt retirement costs | $ (1) | $ | $ (17) | $ 9,235 |
| | | | | |
| Depreciation and amortization: | &nbs | | | |