

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

# SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

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## FORM 10-Q

(Mark One)

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

For the quarterly period ended October 2, 2005

OR

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

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

Commission File No. 001-13579

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## FRIENDLY ICE CREAM CORPORATION

(Exact Name of Registrant as Specified in Its Charter)

**Massachusetts**  
(State or Other Jurisdiction of  
Incorporation or Organization)

**1855 Boston Road**  
**Wilbraham, Massachusetts**

**04-2053130**  
(IRS Employer  
Identification No.)

**01095**

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(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  No

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

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

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

| Class                         | Outstanding at October 31, 2005 |
|-------------------------------|---------------------------------|
| Common Stock, \$.01 par value | 7,898,591 shares                |

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## PART I FINANCIAL INFORMATION

## Item 1. Financial Statements

## FRIENDLY ICE CREAM CORPORATION AND SUBSIDIARIES

## CONDENSED CONSOLIDATED BALANCE SHEETS

(Unaudited)

(In thousands)

|  | October 2,<br>2005 | January 2,<br>2005 |
|--|--------------------|--------------------|
| <b>ASSETS</b>  |                    |                    |
| <b>CURRENT ASSETS:</b>   |                    |                    |
| 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              |
| <b>TOTAL CURRENT ASSETS</b>  | <b>65,879</b>      | <b>54,524</b>      |
| 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              |
| <b>TOTAL ASSETS</b>  | <b>\$ 250,884</b>  | <b>\$ 248,884</b>  |
| <b>LIABILITIES AND STOCKHOLDERS DEFICIT</b>                              |                    |                    |
| <b>CURRENT LIABILITIES:</b>  |                    |                    |
| 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             |
| <b>TOTAL CURRENT LIABILITIES</b>   | <b>67,870</b>      | <b>68,047</b>      |
| 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  |                    |                    |
| <b>STOCKHOLDERS DEFICIT:</b>   |                    |                    |
| Common stock   | 79                 | 77                 |

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|  |                  |                  |
|--|------------------|------------------|
| Additional paid-in capital                 | 144,218          | 143,115          |
| Accumulated other comprehensive loss       | (20,641)         | (20,670)         |
| Accumulated deficit                        | (224,610)        | (227,548)        |
| <b>TOTAL STOCKHOLDERS DEFICIT</b>          | <b>(100,954)</b> | <b>(105,026)</b> |
| 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,<br>2005         | September 26,<br>2004<br>(Restated) | October 2,<br>2005        | September 26,<br>2004<br>(Restated) |
| <b>REVENUES:</b>   |                            |                                     |                           |                                     |
| 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                               |
| <b>TOTAL REVENUES</b>  | <b>143,557</b>             | <b>153,055</b>                      | <b>416,628</b>            | <b>431,325</b>                      |
| <b>COSTS AND EXPENSES:</b>   |                            |                                     |                           |                                     |
| 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                                 |
| <b>OPERATING INCOME</b>  | <b>9,389</b>               | <b>8,062</b>                        | <b>19,512</b>             | <b>19,152</b>                       |
| <b>OTHER EXPENSES:</b>   |                            |                                     |                           |                                     |
| Interest expense, net  | 5,197                      | 5,235                               | 15,728                    | 16,667                              |
| Other (income) expense, principally debt retirement costs              | (1)                        |                                     | (17)                      | 9,235                               |
| <b>INCOME (LOSS) BEFORE (PROVISION FOR) BENEFIT FROM INCOME TAXES</b>  | <b>4,193</b>               | <b>2,827</b>                        | <b>3,801</b>              | <b>(6,750)</b>                      |
| (Provision for) benefit from income taxes                              | (786)                      | 651                                 | (863)                     | 3,566                               |
| <b>NET INCOME (LOSS)</b>   | <b>\$ 3,407</b>            | <b>\$ 3,478</b>                     | <b>\$ 2,938</b>           | <b>\$ (3,184)</b>                   |
| <b>BASIC NET INCOME (LOSS) PER SHARE</b>                               | <b>\$ 0.43</b>             | <b>\$ 0.45</b>                      | <b>\$ 0.38</b>            | <b>\$ (0.42)</b>                    |
| <b>DILUTED NET INCOME (LOSS) PER SHARE</b>                             | <b>\$ 0.43</b>             | <b>\$ 0.44</b>                      | <b>\$ 0.37</b>            | <b>\$ (0.42)</b>                    |
| <b>WEIGHTED AVERAGE SHARES:</b>  |                            |                                     |                           |                                     |
| Basic  | 7,840                      | 7,695                               | 7,770                     | 7,611                               |
| Diluted  | 7,988                      | 7,869                               | 7,909                     | 7,611                               |

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

## FRIENDLY ICE CREAM CORPORATION AND SUBSIDIARIES

## CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

(In thousands)

|  | For the Nine Months Ended |                                     |
|--|---------------------------|-------------------------------------|
|  | October 2,<br>2005        | September 26,<br>2004<br>(Restated) |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>   |                           |                                     |
| 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                               |
| <b>NET CASH PROVIDED BY OPERATING ACTIVITIES</b>   | <b>20,289</b>             | <b>12,392</b>                       |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>   |                           |                                     |
| 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                                  |
| <b>NET CASH USED IN INVESTING ACTIVITIES</b>   | <b>(5,617)</b>            | <b>(12,439)</b>                     |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>   |                           |                                     |
| 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                                 |
| <b>NET CASH USED IN FINANCING ACTIVITIES</b>   | <b>(3,943)</b>            | <b>(8,350)</b>                      |
| <b>NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS</b>                              | <b>10,729</b>             | <b>(8,397)</b>                      |
| <b>CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD</b>                                    | <b>13,405</b>             | <b>25,631</b>                       |
| <b>CASH AND CASH EQUIVALENTS, END OF PERIOD</b>  | <b>\$ 24,134</b>          | <b>\$ 17,234</b>                    |

## SUPPLEMENTAL DISCLOSURES:

Cash paid during the period for:

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|                                      |    |        |    |        |
|--------------------------------------|----|--------|----|--------|
| 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):

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|                  | October 2,<br>2005 | January 2,<br>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,<br>2005 | January 2,<br>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,<br>2005         | September 26,<br>2004 | October 2,<br>2005 | September 26,<br>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,<br>2005         | September 26,<br>2004 | October 2,<br>2005 | September 26,<br>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,<br>2005         | September 26,<br>2004 | October 2,<br>2005        | September 26,<br>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 share-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 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).

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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):

| <b>For the Three Months Ended September 26, 2004</b> |                                   |                    |                 |
|--|-----------------------------------|--------------------|-----------------|
|  | <b>As Previously<br/>Reported</b> | <b>Adjustments</b> | <b>Restated</b> |
| 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            |

| <b>For the Nine Months Ended September 26, 2004</b> |                                   |                    |                 |
|---|-----------------------------------|--------------------|-----------------|
|   | <b>As Previously<br/>Reported</b> | <b>Adjustments</b> | <b>Restated</b> |
| 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,<br>2005         | September 26,<br>2004 | October 2,<br>2005        | September 26,<br>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,<br>2005         | September 26,<br>2004 | October 2,<br>2005        | September 26,<br>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.

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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 |                       | For the Nine Months Ended |                       |
|---|----------------------------|-----------------------|---------------------------|-----------------------|
|   | October 2,<br>2005         | September 26,<br>2004 | October 2,<br>2005        | September 26,<br>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,<br>2005 | January 2,<br>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.

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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.

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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,<br>2005         | September 26,<br>2004 | October 2,<br>2005        | September 26,<br>2004 |
|                               | (in thousands)             |                       | (in thousands)            |                       |
| <b>Revenues:</b>              |                            |                       |                           |                       |
| 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                 |
| <b>Total</b>                  | <b>\$ 175,347</b>          | <b>\$ 189,033</b>     | <b>\$ 510,748</b>         | <b>\$ 531,416</b>     |
| <b>Intersegment revenues:</b> |                            |                       |                           |                       |
| Restaurant                    | \$                         | \$                    | \$                        | \$                    |
| Foodservice                   | (31,790)                   | (35,978)              | (94,120)                  | (100,091)             |
| Franchise                     |                            |                       |                           |                       |
| <b>Total</b>                  | <b>\$ (31,790)</b>         | <b>\$ (35,978)</b>    | <b>\$ (94,120)</b>        | <b>\$ (100,091)</b>   |
| <b>External revenues:</b>     |                            |                       |                           |                       |
| 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                 |
| <b>Total</b>                  | <b>\$ 143,557</b>          | <b>\$ 153,055</b>     | <b>\$ 416,628</b>         | <b>\$ 431,325</b>     |

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|  | For the Three Months Ended |                                     | For the Nine Months Ended |                                     |
|--|----------------------------|-------------------------------------|---------------------------|-------------------------------------|
|  | October 2,<br>2005         | September 26,<br>2004<br>(Restated) | October 2,<br>2005        | September 26,<br>2004<br>(Restated) |
|  | (in thousands)             |                                     | (in thousands)            |                                     |
| <b>EBITDA:</b>   |                            |                                     |                           |                                     |
| 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)                             |
| <b>Total</b>   | <b>\$ 15,243</b>           | <b>\$ 13,066</b>                    | <b>\$ 37,931</b>          | <b>\$ 34,588</b>                    |
| Interest expense, net-Corporate  | \$ 5,197                   | \$ 5,235                            | \$ 15,728                 | \$ 16,667                           |
| Other (income) expense, principally debt retirement costs              | \$ (1)                     | \$                                  | \$ (17)                   | \$ 9,235                            |
| <b>Depreciation and amortization:</b>                                  |                            |                                     |                           |                                     |
| Restaurant   | \$ 4,185                   | \$ 3,853                            | \$ 12,996                 | \$ 11,777                           |
| Foodservice  | 800                        | 814                                 | 2,427                     | 2,503                               |
| Franchise  | 37                         | 67                                  | 117                       | 183                                 |
| Corporate  | 760                        | 799                                 | 2,375                     | 2,469                               |
| <b>Total</b>   | <b>\$ 5,782</b>            | <b>\$ 5,533</b>                     | <b>\$ 17,915</b>          | <b>\$ 16,932</b>                    |
| <b>Other non-cash expense (income):</b>                                |                            |                                     |                           |                                     |
| Net periodic pension expense (benefit)                                 | \$ 72                      | \$ (529)                            | \$ 215                    | \$ (1,587)                          |
| Write-downs of property and equipment                                  |                            |                                     | 289                       | 91                                  |
| <b>Total</b>   | <b>\$ 72</b>               | <b>\$ (529)</b>                     | <b>\$ 504</b>             | <b>\$ (1,496)</b>                   |
| <b>Income (loss) before (provision for) benefit from income taxes:</b> |                            |                                     |                           |                                     |
| Restaurant   | \$ 5,755                   | \$ 7,992                            | \$ 16,016                 | \$ 20,658                           |
| Foodservice  | 3,544                      | 2,509                               | 8,298                     | 7,222                               |
| Franchise  | 2,699                      | 2,439                               | 7,731                     | 6,726                               |
| Corporate  | (9,577)                    | (10,118)                            | (31,870)                  | (42,582)                            |
| Gain on property and equipment, net                                    | 1,772                      | 5                                   | 3,626                     | 209                                 |
| Restructuring expenses   |                            |                                     |                           | (2,627)                             |
| Gain on litigation settlement  |                            |                                     |                           | 3,644                               |
| <b>Total</b>   | <b>\$ 4,193</b>            | <b>\$ 2,827</b>                     | <b>\$ 3,801</b>           | <b>\$ (6,750)</b>                   |

|   | <b>For the Nine<br/>Months Ended<br/>October 2,<br/>2005</b> | <b>For the Year<br/>Ended<br/>January 2,<br/>2005</b> |
|---|--|---|
|   | (in thousands)   |   |
| Capital expenditures, including assets acquired under capital leases: |  |   |
| Restaurant  | \$ 9,847   | \$ 20,309   |
| Foodservice   | 1,141  | 1,700   |
| Corporate   | 522  | 1,170   |
| Total   | \$ 11,510  | \$ 23,179   |

|               | <b>October 2,<br/>2005</b> | <b>January 2,<br/>2005</b> |
|---------------|----------------------------|----------------------------|
|               | (in thousands)             |                            |
| Total assets: |                            |                            |
| Restaurant    | \$ 137,861                 | \$ 142,366                 |
| Foodservice   | 37,336                     | 40,567                     |
| Franchise     | 7,319                      | 7,726                      |
| Corporate     | 68,368                     | 58,225                     |
| Total         | \$ 250,884                 | \$ 248,884                 |

## 7. RESTRUCTURING RESERVES

In March 2004, the Company recorded a pre-tax restructuring charge of \$2,627,000 for severance and outplacement services associated with reduction in force actions taken during the first quarter of 2004 that reduced headcount by approximately 20 permanent positions.

On October 10, 2001, the Company eliminated approximately 70 positions at corporate headquarters. In addition, approximately 30 positions in the restaurant construction and fabrication areas were eliminated by December 30, 2001. The purpose of the reduction was to streamline functions and reduce redundancy among its business segments. As a result of the elimination of the positions and the outsourcing of certain functions, the Company reported a pre-tax restructuring charge of \$2,536,000 for severance, rent and unusable construction supplies in the year ended December 30, 2001.

In March 2000, the Company's Board of Directors approved a restructuring plan that provided for the immediate closing of 81 restaurants at the end of March 2000 and the disposition of an additional 70 restaurants over the next 24 months. As a result of this plan, the Company reported a pre-tax restructuring charge of \$12,056,000 for severance, rent, utilities and real estate taxes, demarking, lease termination costs and certain other costs associated with the closing of the locations, along with a pre-tax write-down of property and equipment for these locations of approximately \$17,000,000 in the year ended December 31, 2000. The Company reduced the restructuring reserve by \$400,000 and \$1,900,000 during the years ended December 29, 2002 and December 30, 2001, respectively, since the reserve exceeded estimated remaining payments.

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The following represents the reserve and activity associated with the March 2004, October 2001 and March 2000 restructurings (in thousands):

|               | For the Nine Months Ended October 2, 2005    |         |            |  |
|---------------|--|---------|------------|--|
|               | Restructuring Reserves as of January 2, 2005 | Expense | Costs Paid | Restructuring Reserves as of October 2, 2005 |
| Rent          | \$ 92  | \$      | \$ (92)    | \$   |
| Severance pay | 952  |         | (778)      | 174  |
| Other         | 34   |         | (34)       |  |
| Total         | \$ 1,078                                     | \$      | \$ (904)   | \$ 174                                       |

|                                 | For the Nine Months Ended September 26, 2004   |          |            |   |
|---------------------------------|--|----------|------------|---|
|                                 | Restructuring Reserves as of December 28, 2003 | Expense  | Costs Paid | Restructuring Reserves as of September 26, 2004 |
| Rent                            | \$ 319   | \$       | \$ (165)   | \$ 154  |
| Utilities and real estate taxes | 40   |          | (16)       | 24  |
| Severance pay                   |  | 2,549    | (1,284)    | 1,265   |
| Outplacement services           |  | 78       | (78)       |   |
| Other                           | 82   |          | (53)       | 29  |
| Total                           | \$ 441   | \$ 2,627 | \$ (1,596) | \$ 1,472  |

Based on information currently available, management believes that the restructuring reserves as of October 2, 2005 were adequate and not excessive.

**8. SUPPLEMENTAL CONDENSED CONSOLIDATING FINANCIAL INFORMATION**

FICC's obligations related to its \$175,000,000 8.375% senior notes (the "New Senior Notes") issued in March 2004 are guaranteed fully and unconditionally by one of FICC's wholly owned subsidiaries. There are no restrictions on FICC's ability to obtain dividends or other distributions of funds from this subsidiary, except those imposed by applicable law. The following supplemental financial information sets forth, on a condensed consolidating basis, balance sheets, statements of operations and statements of cash flows for FICC (the "Parent Company"), Friendly's Restaurants Franchise, Inc. (the "Guarantor Subsidiary") and Friendly's International, Inc., Restaurant Insurance Corporation, Friendly's Realty I, LLC, Friendly's Realty II, LLC and Friendly's Realty III, LLC (collectively, the "Non-guarantor Subsidiaries"). All of the LLCs' assets were owned by the LLCs, which are separate entities with separate creditors which will be entitled to be satisfied out of the LLCs' assets. Separate complete financial statements and other disclosures of the Guarantor Subsidiary as of October 2, 2005 and January 2, 2005 and for the three and nine months ended October 2, 2005 and September 26, 2004 are not presented because management has determined that such information is not material to investors.

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

## Supplemental Condensed Consolidating Balance Sheet

As of October 2, 2005

(In thousands)

|  | Parent<br>Company | Guarantor<br>Subsidiary | Non-<br>guarantor<br>Subsidiaries | Eliminations       | Consolidated      |
|--|-------------------|-------------------------|-----------------------------------|--------------------|-------------------|
| <b>Assets</b>  |                   |                         |                                   |                    |                   |
| <b>Current assets:</b>                                     |                   |                         |                                   |                    |                   |
| Cash and cash equivalents                                  | \$ 19,159         | \$ 1,170                | \$ 3,805                          | \$                 | \$ 24,134         |
| Restricted cash  |                   |                         | 2,727                             |                    | 2,727             |
| Accounts receivable, net                                   | 8,404             | 1,820                   |                                   |                    | 10,224            |
| Inventories  | 15,622            |                         |                                   |                    | 15,622            |
| Deferred income taxes                                      | 6,705             | 18                      |                                   | 130                | 6,853             |
| Prepaid expenses and other current assets                  | 12,336            | 2,133                   | 7,783                             | (15,933)           | 6,319             |
| Total current assets                                       | 62,226            | 5,141                   | 14,315                            | (15,803)           | 65,879            |
| Deferred income taxes                                      | 9,675             | 366                     |                                   | (130)              | 9,911             |
| Property and equipment, net                                | 105,348           |                         | 43,298                            |                    | 148,646           |
| Intangibles and deferred costs, net                        | 17,022            |                         | 2,121                             |                    | 19,143            |
| Investments in subsidiaries                                | 1,568             |                         |                                   | (1,568)            |                   |
| Other assets   | 6,390             | 4,170                   | 915                               | (4,170)            | 7,305             |
| <b>Total assets</b>  | <b>\$ 202,229</b> | <b>\$ 9,677</b>         | <b>\$ 60,649</b>                  | <b>\$ (21,671)</b> | <b>\$ 250,884</b> |
| <b>Liabilities and Stockholders (Deficit) Equity</b>       |                   |                         |                                   |                    |                   |
| <b>Current liabilities:</b>                                |                   |                         |                                   |                    |                   |
| Current maturities of long-term obligations                | \$ 9,251          | \$                      | \$ 1,315                          | \$ (7,776)         | \$ 2,790          |
| Accounts payable   | 23,179            |                         |                                   |                    | 23,179            |
| Accrued expenses   | 39,696            | 4,091                   | 5,946                             | (7,832)            | 41,901            |
| Total current liabilities                                  | 72,126            | 4,091                   | 7,261                             | (15,608)           | 67,870            |
| Long-term obligations, less current maturities             | 182,354           |                         | 49,757                            |                    | 232,111           |
| Other long-term liabilities                                | 48,703            | 1,068                   | 6,581                             | (4,495)            | 51,857            |
| Stockholders (deficit) equity                              | (100,954)         | 4,518                   | (2,950)                           | (1,568)            | (100,954)         |
| <b>Total liabilities and stockholders (deficit) equity</b> | <b>\$ 202,229</b> | <b>\$ 9,677</b>         | <b>\$ 60,649</b>                  | <b>\$ (21,671)</b> | <b>\$ 250,884</b> |



## Supplemental Condensed Consolidating Statement of Operations

For the Three Months Ended October 2, 2005

(In thousands)

|  | Parent<br>Company | Guarantor<br>Subsidiary | Non-<br>guarantor<br>Subsidiaries | Eliminations | Consolidated |
|--|-------------------|-------------------------|-----------------------------------|--------------|--------------|
| Revenues   | \$ 140,721        | \$ 2,836                | \$                                | \$           | \$ 143,557   |
| Costs and expenses:  |                   |                         |                                   |              |              |
| Cost of sales  | 54,225            |                         |                                   |              | 54,225       |
| Labor and benefits   | 38,337            |                         |                                   |              | 38,337       |
| Operating expenses and write-downs of<br>property and equipment                                      | 31,075            |                         | (1,749)                           |              | 29,326       |
| General and administrative expenses  | 7,106             | 1,155                   | 1                                 |              | 8,262        |
| Depreciation and amortization  | 5,230             |                         | 552                               |              | 5,782        |
| Loss on franchise sales of restaurant<br>operations and properties                                   | 7                 |                         |                                   |              | 7            |
| Loss (gain) on disposals of other property<br>and equipment, net                                     | 385               |                         | (2,156)                           |              | (1,771)      |
| Interest expense, net  | 4,065             |                         | 1,132                             |              | 5,197        |
| Other income   | (1)               |                         |                                   |              | (1)          |
| Income before provision for income taxes<br>and equity in net income of consolidated<br>subsidiaries | 292               | 1,681                   | 2,220                             |              | 4,193        |
| Provision for income taxes   | (43)              | (689)                   | (54)                              |              | (786)        |
| Income before equity in net income of<br>consolidated subsidiaries                                   | 249               | 992                     | 2,166                             |              | 3,407        |
| Equity in net income of consolidated<br>subsidiaries   | 3,158             |                         |                                   | (3,158)      |              |
| Net income   | \$ 3,407          | \$ 992                  | \$ 2,166                          | \$ (3,158)   | \$ 3,407     |

## Supplemental Condensed Consolidating Statement of Operations

For the Nine Months Ended October 2, 2005

(In thousands)

|  | Parent<br>Company | Guarantor<br>Subsidiary | Non-<br>guarantor<br>Subsidiaries | Eliminations | Consolidated |
|--|-------------------|-------------------------|-----------------------------------|--------------|--------------|
| Revenues   | \$ 408,306        | \$ 8,322                | \$                                | \$           | \$ 416,628   |
| Costs and expenses:  |                   |                         |                                   |              |              |
| Cost of sales  | 157,482           |                         |                                   |              | 157,482      |
| Labor and benefits   | 114,773           |                         |                                   |              | 114,773      |
| Operating expenses and write-downs of<br>property and equipment  | 87,878            |                         | (5,247)                           |              | 82,631       |
| General and administrative expenses  | 24,773            | 3,465                   | 1                                 |              | 28,239       |
| Depreciation and amortization  | 16,248            |                         | 1,667                             |              | 17,915       |
| Gain on franchise sales of restaurant<br>operations and properties   | (2,521)           |                         |                                   |              | (2,521)      |
| Loss (gain) on disposals of other property<br>and equipment, net   | 753               |                         | (2,156)                           |              | (1,403)      |
| Interest expense, net  | 12,351            |                         | 3,377                             |              | 15,728       |
| Other income   | (17)              |                         |                                   |              | (17)         |
| (Loss) income before benefit from<br>(provision for) income taxes and equity in<br>net income of consolidated subsidiaries | (3,414)           | 4,857                   | 2,358                             |              | 3,801        |
| Benefit from (provision for) income taxes  | 1,289             | (1,991)                 | (161)                             |              | (863)        |
| (Loss) income before equity in net income<br>of consolidated subsidiaries  | (2,125)           | 2,866                   | 2,197                             |              | 2,938        |
| Equity in net income of consolidated<br>subsidiaries   | 5,063             |                         |                                   | (5,063)      |              |
| Net income   | \$ 2,938          | \$ 2,866                | \$ 2,197                          | \$ (5,063)   | \$ 2,938     |

## Supplemental Condensed Consolidating Statement of Cash Flows

For the Nine Months Ended October 2, 2005

(In thousands)

|  | Parent<br>Company | Guarantor<br>Subsidiary | Non-<br>guarantor<br>Subsidiaries | Eliminations | Consolidated |
|--|-------------------|-------------------------|-----------------------------------|--------------|--------------|
| Net cash provided by (used in) operating activities      | \$ 20,437         | \$ (190)                | \$ 676                            | \$ (634)     | \$ 20,289    |
| Cash flows from investing activities:                    |                   |                         |                                   |              |              |
| Purchases of property and equipment                      | (11,511)          |                         |                                   |              | (11,511)     |
| Proceeds from sales of property and equipment            | 3,358             |                         | 2,872                             |              | 6,230        |
| Purchases of marketable securities                       | (499)             |                         |                                   |              | (499)        |
| Proceeds from sales of marketable securities             | 163               |                         |                                   |              | 163          |
| Return of investment in subsidiary                       | 378               |                         |                                   | (378)        |              |
| Net cash (used in) provided by investing activities      | (8,111)           |                         | 2,872                             | (378)        | (5,617)      |
| Cash flows from financing activities:                    |                   |                         |                                   |              |              |
| Proceeds from borrowings under revolving credit facility | 16,250            |                         |                                   |              | 16,250       |
| Proceeds from issuance of mortgages                      | 1,115             |                         |                                   |              | 1,115        |
| Repayments of obligations                                | (21,399)          |                         | (903)                             |              | (22,302)     |
| Payments of deferred financing costs                     | (43)              |                         |                                   |              | (43)         |
| Stock options exercised                                  | 1,037             |                         |                                   |              | 1,037        |
| Reinsurance deposits received                            |                   |                         | 114                               | (114)        |              |
| Reinsurance payments made from deposits                  |                   |                         | (748)                             | 748          |              |
| Dividends paid   |                   |                         | (378)                             | 378          |              |
| Net cash used in financing activities                    | (3,040)           |                         | (1,915)                           | 1,012        | (3,943)      |
| Net increase (decrease) in cash and cash equivalents     | 9,286             | (190)                   | 1,633                             |              | 10,729       |
| Cash and cash equivalents, beginning of period           | 9,873             | 1,360                   | 2,172                             |              | 13,405       |
| Cash and cash equivalents, end of period                 | \$ 19,159         | \$ 1,170                | \$ 3,805                          | \$           | \$ 24,134    |
| Supplemental disclosures:                                |                   |                         |                                   |              |              |
| Interest paid  | \$ 7,982          | \$                      | \$ 3,396                          | \$           | \$ 11,378    |
| Income taxes (refunded) paid                             | (2,057)           | 2,584                   | 159                               |              | 686          |
| Capital lease obligations terminated                     | 51                |                         |                                   |              | 51           |

## Supplemental Condensed Consolidating Balance Sheet

As of January 2, 2005

(In thousands)

|  | Parent<br>Company | Guarantor<br>Subsidiary | Non-<br>guarantor<br>Subsidiaries | Eliminations | Consolidated |
|--|-------------------|-------------------------|-----------------------------------|--------------|--------------|
| <b>Assets</b>  |                   |                         |                                   |              |              |
| Current assets:                                      |                   |                         |                                   |              |              |
| Cash and cash equivalents                            | \$ 9,873          | \$ 1,360                | \$ 2,172                          | \$           | \$ 13,405    |
| Restricted cash                                      |                   |                         | 1,711                             |              | 1,711        |
| Accounts receivable, net                             | 8,548             | 1,900                   |                                   |              | 10,448       |
| Inventories  | 17,545            |                         |                                   |              | 17,545       |
| Deferred income taxes                                | 6,705             | 18                      |                                   | 130          | 6,853        |
| Prepaid expenses and other current assets            | 11,171            | 2,512                   | 7,782                             | (16,903)     | 4,562        |
| Total current assets                                 | 53,842            | 5,790                   | 11,665                            | (16,773)     | 54,524       |
| Deferred income taxes                                | 10,383            | 366                     |                                   | (130)        | 10,619       |
| Property and equipment, net                          | 110,707           |                         | 45,525                            |              | 156,232      |
| Intangibles and deferred costs, net                  | 18,234            |                         | 2,276                             |              | 20,510       |
| Investments in subsidiaries                          | (3,117)           |                         |                                   | 3,117        |              |
| Other assets   | 6,083             | 1,216                   | 915                               | (1,215)      | 6,999        |
| Total assets   | \$ 196,132        | \$ 7,372                | \$ 60,381                         | \$ (15,001)  | \$ 248,884   |
| <b>Liabilities and Stockholders (Deficit) Equity</b> |                   |                         |                                   |              |              |
| Current liabilities:                                 |                   |                         |                                   |              |              |
| Current maturities of long-term obligations          | \$ 13,309         | \$                      | \$ 1,224                          | \$ (7,776)   | \$ 6,757     |
| Accounts payable                                     | 21,536            |                         |                                   |              | 21,536       |
| Accrued expenses                                     | 38,085            | 4,829                   | 5,650                             | (8,810)      | 39,754       |
| Total current liabilities                            | 72,930            | 4,829                   | 6,874                             | (16,586)     | 68,047       |
| Long-term obligations, less current maturities       | 182,380           |                         | 50,752                            |              | 233,132      |
| Other long-term liabilities                          | 45,848            | 891                     | 7,524                             | (1,532)      | 52,731       |
| Stockholders (deficit) equity                        | (105,026)         | 1,652                   | (4,769)                           | 3,117        | (105,026)    |
| Total liabilities and stockholders (deficit) equity  | \$ 196,132        | \$ 7,372                | \$ 60,381                         | \$ (15,001)  | \$ 248,884   |

## Supplemental Condensed Consolidating Statement of Operations

For the Three Months Ended September 26, 2004

(Restated)

(In thousands)

|   | Parent<br>Company | Guarantor<br>Subsidiary | Non-<br>guarantor<br>Subsidiaries | Eliminations | Consolidated |
|---|-------------------|-------------------------|-----------------------------------|--------------|--------------|
| Revenues  | \$ 150,164        | \$ 2,891                | \$                                | \$           | \$ 153,055   |
| Costs and expenses:   |                   |                         |                                   |              |              |
| Cost of sales   | 57,368            |                         |                                   |              | 57,368       |
| Labor and benefits  | 42,990            |                         |                                   |              | 42,990       |
| Operating expenses and write-downs of<br>property and equipment   | 31,823            |                         | (1,739)                           |              | 30,084       |
| General and administrative expenses   | 7,899             | 1,155                   |                                   |              | 9,054        |
| Depreciation and amortization   | 4,975             |                         | 558                               |              | 5,533        |
| Gain on franchise sales of restaurant<br>operations and properties  | (189)             |                         |                                   |              | (189)        |
| Loss on disposals of other property and<br>equipment, net   | 140               |                         | 13                                |              | 153          |
| Interest expense, net   | 4,103             |                         | 1,132                             |              | 5,235        |
| Income before benefit from (provision for)<br>income taxes and equity in net income of<br>consolidated subsidiaries | 1,055             | 1,736                   | 36                                |              | 2,827        |
| Benefit from (provision for) income taxes   | 1,413             | (712)                   | (50)                              |              | 651          |
| Income (loss) before equity in net income<br>of consolidated subsidiaries   | 2,468             | 1,024                   | (14)                              |              | 3,478        |
| Equity in net income of consolidated<br>subsidiaries  | 1,010             |                         |                                   | (1,010)      |              |
| Net income (loss)   | \$ 3,478          | \$ 1,024                | \$ (14)                           | \$ (1,010)   | \$ 3,478     |

## Supplemental Condensed Consolidating Statement of Operations

For the Nine Months Ended September 26, 2004

(Restated)

(In thousands)

|  | Parent<br>Company | Guarantor<br>Subsidiary | Non-<br>guarantor<br>Subsidiaries | Eliminations | Consolidated |
|--|-------------------|-------------------------|-----------------------------------|--------------|--------------|
| Revenues   | \$ 423,217        | \$ 8,108                | \$                                | \$           | \$ 431,325   |
| Costs and expenses:  |                   |                         |                                   |              |              |
| Cost of sales  | 158,915           |                         |                                   |              | 158,915      |
| Labor and benefits   | 125,079           |                         |                                   |              | 125,079      |
| Operating expenses and write-downs of<br>property and equipment  | 88,411            |                         | (5,211)                           |              | 83,200       |
| General and administrative expenses  | 26,040            | 3,465                   |                                   |              | 29,505       |
| Restructuring expenses   | 2,627             |                         |                                   |              | 2,627        |
| Gain on litigation settlement  | (3,644)           |                         |                                   |              | (3,644)      |
| Depreciation and amortization  | 15,247            |                         | 1,685                             |              | 16,932       |
| Gain on franchise sales of restaurant<br>operations and properties   | (1,102)           |                         |                                   |              | (1,102)      |
| Loss on disposals of other property and<br>equipment, net  | 645               |                         | 16                                |              | 661          |
| Interest expense, net  | 13,280            |                         | 3,387                             |              | 16,667       |
| Other expenses, principally debt retirement<br>costs   | 9,235             |                         |                                   |              | 9,235        |
| (Loss) income before benefit from<br>(provision for) income taxes and equity in<br>net income of consolidated subsidiaries | (11,516)          | 4,643                   | 123                               |              | (6,750)      |
| Benefit from (provision for) income taxes  | 5,617             | (1,904)                 | (147)                             |              | 3,566        |
| (Loss) income before equity in net income<br>of consolidated subsidiaries  | (5,899)           | 2,739                   | (24)                              |              | (3,184)      |
| Equity in net income of consolidated<br>subsidiaries   | 2,715             |                         |                                   | (2,715)      |              |
| Net (loss) income  | \$ (3,184)        | \$ 2,739                | \$ (24)                           | \$ (2,715)   | \$ (3,184)   |

## Supplemental Condensed Consolidating Statement of Cash Flows

For the Nine Months Ended September 26, 2004

(In thousands)

|  | Parent<br>Company | Guarantor<br>Subsidiary | Non-<br>guarantor<br>Subsidiaries | Eliminations | Consolidated |
|--|-------------------|-------------------------|-----------------------------------|--------------|--------------|
| Net cash provided by (used in) operating activities  | \$ 11,526         | \$ (790)                | \$ 1,392                          | \$ 264       | \$ 12,392    |
| Cash flows from investing activities:                |                   |                         |                                   |              |              |
| Purchases of property and equipment                  | (15,554)          |                         |                                   |              | (15,554)     |
| Proceeds from sales of property and equipment        | 4,048             |                         |                                   |              | 4,048        |
| Purchases of marketable securities                   | (1,022)           |                         |                                   |              | (1,022)      |
| Proceeds from sales of marketable securities         | 89                |                         |                                   |              | 89           |
| Return of investment in subsidiary                   | 551               |                         |                                   | (551)        |              |
| Net cash used in investing activities                | (11,888)          |                         |                                   | (551)        | (12,439)     |
| Cash flows from financing activities:                |                   |                         |                                   |              |              |
| Proceeds from issuance of senior notes               | 175,000           |                         |                                   |              | 175,000      |
| Proceeds from other borrowings                       | 16,750            |                         |                                   |              | 16,750       |
| Repayments of obligations                            | (193,576)         |                         | (828)                             |              | (194,404)    |
| Payments of deferred financing costs                 | (6,625)           |                         |                                   |              | (6,625)      |
| Stock options exercised                              | 929               |                         |                                   |              | 929          |
| Reinsurance deposits received                        |                   |                         | 1,131                             | (1,131)      |              |
| Reinsurance payments made from deposits              |                   |                         | (867)                             | 867          |              |
| Dividends paid                                       |                   |                         | (551)                             | 551          |              |
| Net cash used in financing activities                | (7,522)           |                         | (1,115)                           | 287          | (8,350)      |
| Net (decrease) increase in cash and cash equivalents | (7,884)           | (790)                   | 277                               |              | (8,397)      |
| Cash and cash equivalents, beginning of period       | 21,640            | 2,173                   | 1,818                             |              | 25,631       |
| Cash and cash equivalents, end of period             | \$ 13,756         | \$ 1,383                | \$ 2,095                          | \$           | \$ 17,234    |
| Supplemental disclosures:                            |                   |                         |                                   |              |              |
| Interest paid  | \$ 9,891          | \$                      | \$ 3,407                          | \$           | \$ 13,298    |
| Income taxes (refunded) paid                         | (1,653)           | 1,529                   | 148                               |              | 24           |
| Capital lease obligations incurred                   | 3,250             |                         |                                   |              | 3,250        |

**Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**

*The following discussion should be read in conjunction with the Condensed Consolidated Financial Statements of the Company and the notes thereto included elsewhere herein.*

**Forward Looking Statements**

Statements contained herein that are not historical facts constitute forward looking statements as that term is defined in the Private Securities Litigation Reform Act of 1995. Words such as believes, plans, anticipates, expects, will and similar expressions are intended to identify forward looking statements. Forward looking statements include, but are not limited to, statements relating to the sufficiency of the Company's capital resources, changes in commodity prices, anticipated capital expenditures and the Company's plans with respect to restaurant openings, closings, reimagings and re-franchisings. All forward looking statements are subject to known and unknown risks, uncertainties and other factors which could cause actual results to differ materially from those anticipated. These factors include: the Company's highly competitive business environment; exposure to fluctuating commodity prices; risks associated with the foodservice industry, such as changes in consumer tastes and adverse publicity resulting from food quality, illness, injury or other health concerns; the ability to retain and attract new employees; government regulations; the Company's high geographic concentration in the Northeast and its attendant weather patterns; conditions needed to meet restaurant re-imaging and new opening targets; risks and uncertainties arising out of accounting adjustments; the Company's ability to service its debt and other obligations; the Company's ability to meet ongoing financial covenants contained in the Company's debt instruments, loan agreements, leases and other long-term commitments; and costs associated with improved service and other initiatives. Other factors that may cause actual results to differ from the forward looking statements contained herein and that may affect the Company's prospects in general are included in the Company's other filings with the Securities and Exchange Commission. The Company is not obligated to update any forward looking statements, whether as a result of new information, future events or otherwise.

**Overview**

The Company's revenues are derived primarily from the operation of full-service restaurants, the distribution and sale of premium ice cream desserts through retail and institutional locations and franchising. As of October 2, 2005, Friendly's operated 330 full-service restaurants, franchised 198 full-service restaurants and seven non-traditional units and manufactured a full line of premium ice cream desserts distributed through more than 4,500 supermarkets and other retail locations in 13 states.



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

|                          | For the Three Months Ended |                       | For the Nine Months Ended |                       |
|--------------------------|----------------------------|-----------------------|---------------------------|-----------------------|
|                          | October 2,<br>2005         | September 26,<br>2004 | October 2,<br>2005        | September 26,<br>2004 |
| <b>Company Units:</b>    |                            |                       |                           |                       |
| Beginning of period      | 332                        | 360                   | 347                       | 380                   |
| Openings                 |                            | 4                     | 1                         | 4                     |
| Refranchised closings    |                            |                       | (10)                      | (18)                  |
| Closings                 | (2)                        | (6)                   | (8)                       | (8)                   |
| End of period            | 330                        | 358                   | 330                       | 358                   |
| <b>Franchised Units:</b> |                            |                       |                           |                       |
| Beginning of period      | 205                        | 186                   | 195                       | 163                   |
| Refranchised openings    |                            |                       | 10                        | 18                    |
| Openings                 |                            | 2                     | 2                         | 7                     |
| Closings                 |                            | (2)                   | (2)                       | (2)                   |
| End of period            | 205                        | 186                   | 205                       | 186                   |

*Three months ended October 2, 2005 compared with three months ended September 26, 2004*

*Revenues:*

*Total Revenues* - Total revenues decreased \$9.5 million, or 6.2%, to \$143.6 million for the three months ended October 2, 2005 from \$153.1 million for the same period in 2004.

*Restaurant Revenues* - Restaurant revenues decreased \$11.4 million, or 9.5%, to \$109.0 million for the three months ended October 2, 2005 from \$120.4 million for the same period in 2004. Comparable Company-operated restaurant revenues decreased 4.0%, from the 2004 quarter to the 2005 quarter as the Company experienced declines in comparable Company-operated restaurant revenues of 11.4%, 14.9% and 11.2% during the first three weeks of September 2005. Higher prices for gasoline, especially during the three weeks in September 2005 post hurricane Katrina, appeared to have had a negative impact on the number of customer visits during all day-parts with the Company's afternoon and evening snack periods experiencing the greatest declines. The closing of 16 locations and the re-franchising of 19 locations over the past 15 months resulted in declines of \$2.6 million and \$5.5 million, respectively, in restaurant revenues in the third quarter of 2005 as compared to the same period in 2004. These declines were partially offset by increased revenues of \$1.0 million in the third quarter of 2005 as compared to the same period in 2004 due to the opening of five new restaurants over the past 15 months. There were no new restaurants opened during the third quarter of 2005.

*Foodservice Revenues* - Foodservice (product sales to franchisees and retail customers) revenues increased \$1.7 million, or 5.8% to \$30.8 million for the three months ended October 2, 2005 from \$29.1 million for the three months ended September 26, 2004. This increase was partially due to a \$0.7 million increase in franchised restaurant product revenue resulting from the increased number of franchised restaurants in the third quarter of 2005 compared to the same period in 2004. Sales to foodservice retail supermarket customers increased \$1.0 million due to fewer promotions during the 2005 quarter and a 0.3% increase in case volume in the Company's retail supermarket business in the three months ended October 2, 2005 when compared to the three months ended September 26, 2004. Case volume increased primarily as a result of higher volume of individual sundae cups and the introduction of new decorative cakes.

*Franchise Revenues* - Franchise royalty and fee revenues increased \$0.3 million, or 7.0%, to \$3.8 million for the three months ended October 2, 2005 compared to \$3.5 million for the same period in 2004 due primarily to increases in royalties on franchised sales and rental income for leased and subleased franchise locations, partially offset by a decline in franchise fees.

Royalties on franchised sales increased \$0.2 million for the three months ended October 2, 2005 as compared to the same period in 2004. Comparable franchised revenues decreased 2.6% from the three months ended September 26, 2004 to the three months ended October 2, 2005 largely due to a 7.8% decline in comparable sales in the month of September. Higher prices for gasoline, especially during the three weeks in September 2005 post hurricane Katrina, appeared to have had a negative impact on the number of customer visits. The opening of five new franchise restaurants and 19 re-franchised restaurants during the last 15 months increased royalty revenues by \$0.3 million while the closing of five under-performing locations during the same period had minimal impact.

Initial franchise fees decreased \$0.2 million during the three months ended October 2, 2005 when compared to the same period in 2004. During the three months ended September 26, 2004, the Company received \$0.1 million in franchise fees related to the sale of leasehold improvements and equipment and the assignment of a lease for one refranchised location and the sale of equipment at three other refranchised locations to the existing franchisee. Additionally, during the three months ended September 26, 2004, the Company received \$0.1 million in franchise fees from the opening of two new locations during that period.

An increase in rental income for leased and subleased franchise locations of \$0.3 million due primarily to an increased number of leased and subleased franchised locations contributed to the higher revenues for the three months ended October 2, 2005 compared to the same period in 2004. There were 205 and 186 franchise units open at October 2, 2005 and September 26, 2004, respectively.

*Cost of sales:*

Cost of sales decreased \$3.2 million, or 5.5%, to \$54.2 million for the three months ended October 2, 2005 from \$57.4 million for the same period in 2004. Cost of sales as a percentage of total revenues was 37.8% and 37.5% for the three months ended October 2, 2005 and September 26, 2004, respectively.



The slight increase in cost of sales as a percentage of total revenues for the three months ended October 2, 2005 compared to the same period in 2004 was primarily due to a shift in sales mix from Company-operated restaurant sales to foodservice sales. Foodservice sales to franchisees and retail supermarket customers (21.4% and 19.0% of total revenues for the three months ended October 2, 2005 and September 26, 2004, respectively) have higher food costs as a percentage of revenue, at 90.3%, than sales in Company-operated restaurants to restaurant patrons. The growth in franchise revenues reduced cost of sales as a percentage of total revenues by 0.1% for the three months ended October 2, 2005 when compared to the 2004 period since franchise revenues have no product costs associated with such revenues. Additionally, foodservice retail sales promotional allowances, recorded as offsets to revenues, decreased by 4.6% in the 2005 quarter as a percentage of sales to foodservice retail supermarket customers when compared to the 2004 quarter due to fewer promotions during the 2005 quarter. This decrease also had a favorable impact on the overall cost of sales as a percentage of total revenues as did a lower cost for cream in the 2005 period when compared to the same period in 2004. Manufacturing efficiencies improved in the current period when compared to the same period a year ago due to cost reductions associated with scheduling improvements; however, higher fuel costs in the 2005 period versus the 2004 period offset some of the benefit.

Restaurant cost of sales as a percentage of restaurant revenues decreased to 27.3% in the third quarter of 2005 from 27.5% in the third quarter of 2004. The decrease in the 2005 quarter when compared to the 2004 quarter was in part due to lower cream prices in the current period when compared the same period a year ago and fewer free dessert promotions in the 2005 quarter.

The cost of cream was approximately \$0.5 million lower in the three months ended October 2, 2005 when compared to the three months ended September 26, 2004. For the remainder of 2005, the Company expects that cream prices will be lower than the prices experienced in 2004. Futures and options on AA butter are traded on the Chicago Mercantile Exchange and AA butter is the commodity used to derive the price of cream. A table showing the average monthly price of a pound of AA butter obtained from market quotes provided by the USDA's Agricultural Marketing Service is included elsewhere herein.

*Labor and benefits:*

Labor and benefits decreased \$4.7 million, or 10.8%, to \$38.3 million for the three months ended October 2, 2005 from \$43.0 million for the three months ended September 26, 2004. Labor and benefits as a percentage of total revenues decreased to 26.7% in the 2005 quarter from 28.1% in the 2004 quarter. As a percentage of restaurant revenues, labor and benefits decreased to 35.2% in the 2005 quarter from 35.7% in the 2004 quarter. Lower hourly labor costs accounted for 0.4% of the decrease in labor and benefits costs as a percentage of restaurant revenues, which was the result of restructuring of the restaurant management team, with fewer guest service supervisors and more servers, resulting in lower average hourly rates. Restaurant general manager bonuses were also lower during the 2005 period when compared to the same period in 2004, due primarily to a change in the bonus plan, and accounted for 0.6% of the period to period decrease in labor and benefits costs as a percentage of restaurant revenues. Also as a percentage of restaurant revenues, partially offsetting these benefits, were increases in pension expense and other fringe costs of 0.4% and 0.1%, respectively, in the 2005 period when compared to the 2004 period. Revenue increases derived from franchised locations and product sales to franchisees and retail customers, which do not have any associated restaurant labor and benefits, also contributed to the lower labor and benefits as a percentage of total revenues.

*Operating expenses:*

Operating expenses decreased \$0.8 million, or 2.5%, to \$29.3 million for the three months ended October 2, 2005 from \$30.1 million for the three months ended September 26, 2004. Operating expenses as a percentage of total revenues were 20.4% and 19.7% in the 2005 and 2004 periods, respectively. The 0.7% increase in operating expenses as a percentage of total revenues resulted from higher restaurant costs for utilities and maintenance of 0.5% and 0.6% in the 2005 period when compared to the 2004 period, respectively. Total advertising costs as a percentage of total revenues were lower by 0.4% in the 2005 period when compared to the same period in 2004.

*General and administrative expenses:*

General and administrative expenses were \$8.3 million and \$9.1 million for the three months ended October 2, 2005 and September 26, 2004, respectively. General and administrative expenses as a percentage of total revenues decreased to 5.8% in the 2005 period from 5.9% in the 2004 period. The \$0.8 million decrease is primarily the result of decreases in bonuses, outside restaurant guest evaluation services, Sarbanes-Oxley related audit fees and recruitment costs of \$0.4 million, \$0.3 million, \$0.3 million and \$0.3 million, respectively. Partially offsetting these decreases were higher costs of \$0.4 million for other professional services and \$0.1 million for severance during the three-month period ended October 2, 2005.

*Depreciation and amortization:*

Depreciation and amortization was \$5.8 million and \$5.5 million for the three months ended October 2, 2005 and September 26, 2004, respectively. Depreciation and amortization as a percentage of total revenues was 4.0% and 3.6% in the 2005 and 2004 quarters, respectively. The increase in depreciation expense is primarily the result of the opening of five new restaurants over the last 15 months and the reduction of the lives of leasehold improvement assets as a result of management decisions to close certain leased properties sooner than previously anticipated.

*Gain on franchise sales of restaurant operations and properties:*

During the three months ended September 26, 2004, the Company sold leasehold improvements and equipment and assigned the lease for one refranchised location and sold equipment at three other refranchised locations to the existing franchisee, resulting in gains of approximately \$0.2 million.

*(Gain) loss on disposals of other property and equipment, net:*

The gain on disposals of other property and equipment, net, was \$1.8 million for the three months ended October 2, 2005 primarily due to the sale of two restaurant properties. The loss on disposals of other property and equipment, net was \$0.2 million for the three months ended September 26, 2004. The table below identifies the components of the (gain) loss on disposals of other property and equipment, net as shown on the accompanying condensed consolidated statements of operations (in thousands):

|   | <b>For the Three Months Ended</b> |                               |
|---|-----------------------------------|-------------------------------|
|   | <b>October 2,<br/>2005</b>        | <b>September 26,<br/>2004</b> |
| Restaurant equipment assets retired due to remodeling         | \$                                | \$ 22                         |
| Restaurant equipment assets retired due to replacement        |                                   | 131                           |
| Gain on property not held for disposition                     |                                   | (1,942)                       |
| All other   |                                   | 120                           |
| (Gain) loss on disposals of other property and equipment, net | \$                                | \$ 153                        |

*Interest expense, net:*

Interest expense, net of capitalized interest and interest income, was \$5.2 million for the three months ended October 2, 2005 and September 26, 2004.

*Provision for (benefit from) income taxes:*

The provision for income taxes was \$0.8 million, or 18.7% of income before provision for income taxes, for the three months ended October 2, 2005. Generally, the Company records income taxes based on the effective rate for the year with any changes in the valuation allowance reflected in the period of change. Had the Company used the effective tax rate anticipated for the fiscal year, an unreliable rate would have resulted due to the impact of federal tax credits on lower than originally anticipated pre-tax earnings. Accordingly, the Company chose to compute tax expense for the period using the statutory rate of 41% less the anticipated tax benefit from applicable tax credits.

The Company had approximately \$16.8 million of net deferred tax assets recorded as of October 2, 2005, for which no valuation allowance has been established since management believes it is more likely than not that the benefit of these assets will be realized in future periods from future taxable income. A key source of future taxable income includes gains from refranchising Company-operated restaurants, the benefits from future improvements to be made to customer service in Company-operated restaurants and additional taxable income from the Company's retail supermarket ice cream business. Management evaluates the need for a valuation allowance on a quarterly basis. A more in depth evaluation is made as part of the annual and strategic planning process conducted in the fourth quarter of each year.

The benefit from income taxes was \$0.7 million, an effective tax rate of 23.0%, for the three months ended September 26, 2004. The tax rate for the 2004 fiscal year was 68.8%, as the final benefit from income taxes for 2004 included a \$2.2 million reversal of income tax accruals recorded in prior years. These accruals related to tax matters that, based upon additional information obtained during the fourth quarter of 2004, were no longer necessary. The reversal was recorded in the fourth quarter of 2004.



*Net income:*

Net income was \$3.4 million and \$3.5 million for the three months ended October 2, 2005 and September 26, 2004, respectively, for the reasons discussed above.

*Nine months ended October 2, 2005 compared with nine months ended September 26, 2004*

*Revenues:*

*Total Revenues* - Total revenues decreased \$14.7 million, or 3.4%, to \$416.6 million for the nine months ended October 2, 2005 from \$431.3 million for the same period in 2004.

*Restaurant Revenues* - Restaurant revenues decreased \$21.3 million, or 6.3%, to \$317.9 million for the nine months ended October 2, 2005 from \$339.2 million for the same period in 2004. Comparable Company-operated restaurant revenues decreased 1.3% from the 2004 period to the 2005 period. Higher prices for gasoline, especially during the three weeks in September 2005 post hurricane Katrina, appeared to have had a negative impact on the number of customer visits during all day-parts, with the Company's afternoon and evening snack periods experiencing the greatest declines. Also contributing to the reduced comparable revenues was an unfavorable shift in the timing of the year-end holiday period as New Year's Day was included in the nine months ended September 26, 2004 but was not included in the 2005 period. Also, there were additional operating days lost due to weather closings in 2005 when compared to 2004 as most markets in New England recorded higher than normal snowfall. Additionally, the closing of 18 locations and the re-franchising of 37 locations over the past 21 months resulted in declines of \$6.0 million and \$15.0 million, respectively, in restaurant revenues in the nine months ended October 2, 2005 as compared to the same period in 2004. These declines were partially offset by increased revenues of \$3.9 million in the nine months ended October 2, 2005 as compared to the same period in 2004 due to the opening of five new restaurants over the past 21 months. There was one new restaurant opened during the nine months ended October 2, 2005.

*Foodservice Revenues* - Foodservice (product sales to franchisees and retail customers) revenues increased \$5.5 million, or 6.8%, to \$87.8 million for the nine months ended October 2, 2005 from \$82.3 million for the nine months ended September 26, 2004. This increase was primarily due to a \$4.3 million increase in franchised restaurant product revenue resulting from the increased number of franchised restaurants in the nine months ended October 2, 2005 compared to the same period in 2004. Sales to foodservice retail supermarket customers increased \$1.2 million, or 3.8%, during the nine months ended October 2, 2005 compared to the same period in 2004. Case volume in the Company's retail supermarket business increased 1.3% for the nine months ended October 2, 2005 when compared to the nine months ended September 26, 2004 primarily as a result of higher volume of individual sundae cups and the introduction of new decorative cakes.



*Franchise Revenues* - Franchise royalty and fee revenues increased \$1.1 million, or 10.8%, to \$10.9 million for the nine months ended October 2, 2005 compared to \$9.8 million for the same period in 2004 due primarily to increases in royalties on franchised sales and rental income for leased and subleased franchise locations, partially offset by a decline in franchise fees.

Royalties on franchised sales increased \$0.8 million in the nine months ended October 2, 2005 as compared to the same period in 2004. Comparable franchised revenues grew 1.4% from the nine months ended September 26, 2004 to the nine months ended October 2, 2005. The opening of 10 new franchise restaurants and 37 re-franchised restaurants during the last 21 months increased royalty revenues by \$0.9 million while the closing of five under-performing locations during the same period reduced royalties by \$0.1 million.

Franchise fees declined by \$0.6 million during the nine months ended October 2, 2005 when compared to the same period in 2004. The Company re-franchised 18 Company-operated restaurants and franchisees opened six new restaurants and one new café during the nine months ended September 26, 2004. Additionally in 2004, the Company received \$0.1 million in franchise fees associated with the sale of leasehold improvements and equipment and assignment of the lease for one re-franchised location and the sale of equipment at three other re-franchised locations to the existing franchisee. During the nine months ended October 2, 2005, the Company re-franchised 10 Company-operated locations and franchisees opened two new locations.

Additionally, an increase in rental income for leased and subleased franchise locations of \$0.9 million, due primarily to an increased number of leased and subleased franchised locations, contributed to the higher revenues in the nine months ended October 2, 2005 compared to the nine months ended September 26, 2004. There were 205 and 186 franchise units open at October 2, 2005 and September 26, 2004, respectively.

*Cost of sales:*

Cost of sales decreased \$1.4 million, or 0.9%, to \$157.5 million for the nine months ended October 2, 2005 from \$158.9 million for the same period in 2004. Cost of sales as a percentage of total revenues was 37.8 % and 36.8% for the nine months ended October 2, 2005 and September 26, 2004, respectively. A shift in sales mix from Company-operated restaurant sales to foodservice sales added to the increase in cost of sales as a percentage of total revenue. Foodservice sales to franchisees and retail supermarket customers (21.1% and 19.1% of total revenues for the nine months ended October 2, 2005 and September 26, 2004, respectively) have higher food costs as a percentage of revenue, at 91.1%, than sales in Company-operated restaurants to restaurant patrons. This increase was partially offset by the growth in franchise revenues, which reduced cost of sales as a percentage of total revenues by 0.2% for the nine months ended October 2, 2005 when compared to the 2004 period since franchise revenues have no product costs associated with such revenues. Additionally, foodservice retail sales promotional allowances, recorded as offsets to revenues, decreased by 0.9% in the 2005 period as a percentage of sales to foodservice retail supermarket customers when compared to the 2004 period due to fewer promotions during the 2005 period. This decrease also had a favorable impact on the overall cost of sales as a percentage of total revenues. Manufacturing efficiencies improved during the current period when compared to the same period a year ago, especially during the recent quarter, due to cost reductions associated with scheduling improvements; however, higher fuel costs in the 2005 period versus the 2004 period offset most of the benefit.

Restaurant cost of sales as a percentage of restaurant revenues was 27.1% in the nine months ended October 2, 2005 and September 26, 2004.

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The relatively high price of butter in December 2004 resulted in unfavorable cream costs in the first quarter of 2005, as the market price of butter is generally reflected in the Company's cost of sales approximately 30 days later. During the third quarter of 2005, butter prices had a favorable impact on the price of cream when compared to the same period in 2004. The cost of cream was approximately \$1.0 million lower in the nine months ended October 2, 2005 when compared to the nine months ended September 26, 2004. Additionally, in the nine months ended October 2, 2005, market losses of \$0.2 million were realized due to unfavorable positions on commodity option contracts while market gains of \$0.5 million were realized in the same period of 2004. The Company enters into commodity option contracts from time to time to manage dairy cost pressures. The Company's commodity option contracts do not meet hedge accounting criteria as defined by SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities, and its related amendment, SFAS No. 138, Accounting for Certain Derivative Instruments and Certain Hedging Activities, and, accordingly, are marked to market each period with the resulting gains or losses recognized in cost of sales.

For the remainder of 2005, the Company expects that cream prices will be lower than the prices experienced in 2004. However, the results derived from options for butter futures contracts are likely to continue to be unfavorable in 2005 when compared to the gains experienced in 2004.

The table below shows the average monthly price of a pound of AA butter. Futures and options on AA butter are traded on the Chicago Mercantile Exchange and AA butter is the commodity used to derive the price of cream. The prices represented were obtained from market quotes provided by the USDA's Agricultural Marketing Service.

| Month:           | 2005 |        | 2004 |        | 2003 |        | 2002 |        | 2001 |        | 2000 |        |
|------------------|------|--------|------|--------|------|--------|------|--------|------|--------|------|--------|
| January          | \$   | 1.5775 | \$   | 1.4320 | \$   | 1.0815 | \$   | 1.3454 | \$   | 1.2531 | \$   | 0.9090 |
| February         |      | 1.6145 |      | 1.7132 |      | 1.0405 |      | 1.2427 |      | 1.3852 |      | 0.9245 |
| March            |      | 1.5527 |      | 2.1350 |      | 1.0915 |      | 1.2473 |      | 1.5708 |      | 1.0200 |
| April            |      | 1.4933 |      | 2.2204 |      | 1.0906 |      | 1.1712 |      | 1.8217 |      | 1.0691 |
| May              |      | 1.4044 |      | 2.0363 |      | 1.0919 |      | 1.0590 |      | 1.8713 |      | 1.2450 |
| June             |      | 1.5313 |      | 1.9300 |      | 1.1142 |      | 1.0427 |      | 1.9783 |      | 1.2440 |
| July             |      | 1.6210 |      | 1.7458 |      | 1.1985 |      | 1.0302 |      | 1.8971 |      | 1.1790 |
| August           |      | 1.6861 |      | 1.5408 |      | 1.1708 |      | 0.9752 |      | 2.0880 |      | 1.1933 |
| September        |      | 1.6988 |      | 1.7656 |      | 1.1731 |      | 0.9635 |      | 2.0563 |      | 1.1727 |
| October          |      |        |      | 1.6475 |      | 1.1846 |      | 1.0315 |      | 1.4070 |      | 1.1462 |
| November         |      |        |      | 1.9238 |      | 1.2057 |      | 1.0425 |      | 1.3481 |      | 1.6490 |
| December         |      |        |      | 1.7083 |      | 1.2969 |      | 1.1198 |      | 1.2793 |      | 1.3700 |
| Mathematical Avg |      |        | \$   | 1.8166 | \$   | 1.1450 | \$   | 1.1059 | \$   | 1.6630 | \$   | 1.1768 |

The cost of cream, the principal ingredient used in making ice cream, affects cost of sales as a percentage of total revenues, especially in foodservice's retail business. A \$0.10 increase in the cost of a pound of AA butter adversely affects the Company's annual cost of sales by approximately \$0.9 million. This adverse impact may be offset by price increases or other factors. However, no assurance can be given that the Company will be able to offset any cost increases in the future and future increases in cream prices could have a material adverse effect on the Company's results of operations. To minimize risk, alternative supply sources continue to be pursued.

The Company purchases butter option contracts to minimize the impact of increases in the cost of cream. When available, options on butter futures are purchased to cover up to 50% of the cream needs of the manufacturing plant. Option contracts are offered in the months of March, May, July, September, October and December; however, there is often not enough open interest in them to allow the Company to buy even very limited coverage without paying an exorbitant premium.

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During the third quarter of 2005, the Chicago Mercantile Exchange launched a cash settled butter futures contract, which may provide Friendly s with additional hedging opportunities going forward. This new cash settled contract provides hedging opportunities in all twelve months versus the older deliverable butter contract, which was only available for six months out of the year. The Company is currently in the process of evaluating the liquidity of the cash settled butter futures contract and is developing a strategy for obtaining an appropriate level of coverage for its cream needs.

### *Labor and benefits:*

Labor and benefits decreased \$10.3 million, or 8.2%, to \$114.8 million for the nine months ended October 2, 2005 from \$125.1 million for the nine months ended September 26, 2004. Labor and benefits as a percentage of total revenues decreased to 27.5% in the 2005

period from 29.0% in the 2004 period. As a percentage of restaurant revenues, labor and benefits decreased to 36.1% in the 2005 period from 36.9% in the 2004 period. Lower hourly labor costs accounted for 0.7% of the decrease in labor and benefits costs as a percentage of restaurant revenues, which was the result of restructuring of the restaurant management team, with fewer guest service supervisors and more servers, resulting in lower average hourly rates. Restaurant general manager bonuses were also lower during the 2005 period when compared to the same period in 2004 due primarily to a change in the bonus plan and accounted for 0.6% of the period to period decrease in labor and benefits costs as percentage of restaurant revenues. Partially offsetting these benefits were increases in pension expense and other fringe costs of 0.4% and 0.1%, respectively, in the 2005 period when compared to the 2004 period. Revenue increases derived from franchised locations and product sales to franchisees and retail customers, which do not have any associated restaurant labor and benefits, also contributed to the lower labor and benefits as a percentage of total revenues.

*Operating expenses:*

Operating expenses were \$82.3 million and \$83.1 million for the nine months ended October 2, 2005 and September 26, 2004, respectively. Operating expenses as a percentage of total revenues were 19.8% and 19.3% in the 2005 and 2004 periods, respectively. The 0.5% increase in operating expenses as a percentage of total revenues resulted from higher restaurant costs for supplies, utilities and maintenance of 0.1%, 0.2% and 0.6% in the 2005 period when compared to the 2004 period, respectively. Total advertising costs as a percentage of total revenues were 0.4% lower in the 2005 period when compared to the same period in 2004.

*General and administrative expenses:*

General and administrative expenses were \$28.2 million and \$29.5 million for the nine months ended October 2, 2005 and September 26, 2004, respectively. General and administrative expenses as a percentage of total revenues were 6.8% in the 2005 and the 2004 periods. The \$1.3 million decrease is primarily the result of decreases in bonuses, outside restaurant guest evaluation services, Sarbanes-Oxley related audit fees, legal fees (net of insurance reimbursements of \$0.4 million) and recruitment costs of \$0.4 million, \$0.7 million, \$0.1 million, \$0.6 million and \$0.5 million, respectively. Partially offsetting these decreases were higher costs of \$0.7 million and \$0.4 million for other professional services and severance pay, respectively, during the nine-month period ended October 2, 2005 as compared to the 2004 period.

*Restructuring expenses:*

Restructuring expenses of \$2.6 million during the nine months ended September 26, 2004 related to severance and other benefits associated with reduction in force actions taken during the first quarter of 2004 that reduced headcount by approximately 20 permanent positions.

*Gain on litigation settlement:*

In January 2004, a settlement was reached in a lawsuit filed by the Company against a former administrator of one of the Company's benefit plans. The settlement was based on the administrator's alleged failure to adhere to the terms of a contract and resulted in a one-time payment to the Company of approximately \$3.8 million, which was received on April 2, 2004. As a result of this lawsuit, the Company incurred professional fees of approximately \$0.5 million which were included in the consolidated statement of operations for the year ended December 28, 2003 and an additional \$0.2 million in professional fees, which were offset against the payment in the accompanying condensed consolidated statement of operations for the nine months ended September 26, 2004.

*Write-downs of property and equipment:*

Write-downs of property and equipment were \$0.3 million and \$0.1 million in the nine months ended October 2, 2005 and September 26, 2004, respectively. During the nine months ended October 2, 2005, the Company identified two restaurant properties to be disposed of other than by sale and determined that the carrying values of these restaurant properties exceeded their estimated undiscounted cash flows. The carrying values were reduced by an aggregate of \$0.3 million accordingly. During the nine months ended September 26, 2004, it was determined that the carrying value of one property and a vacant land parcel exceeded their estimated fair values less costs to sell and the carrying values were reduced by an aggregate of \$0.1 million accordingly.

*Depreciation and amortization:*

Depreciation and amortization was \$17.9 million and \$16.9 million for the nine months ended October 2, 2005 and September 26, 2004, respectively. Depreciation and amortization as a percentage of total revenues was 4.3% and 3.9% in the 2005 and 2004 periods, respectively. The increase in depreciation expense is primarily the result of the opening of five new restaurants over the last 21 months and the reduction of the lives of leasehold improvement assets as a result of management decisions to close certain leased properties sooner than previously anticipated.

*Gain on franchise sales of restaurant operations and properties:*

Gain on franchise sales of restaurant operations and properties was \$2.5 million and \$1.1 million in the nine months ended October 2, 2005 and September 26, 2004, respectively. During the nine months ended October 2, 2005, the Company recognized a gain of \$2.5 million associated with the sale of certain equipment assets, lease and sublease rights and franchise rights in four existing restaurants to two franchisees. During the nine months ended September 26, 2004, the Company recognized a gain of approximately \$0.7 million associated with the sale of certain equipment assets, lease and sublease rights and franchise rights in 10 existing Company-operated restaurants to a franchisee. Additionally, during the nine months ended September 26, 2004, the Company sold leasehold improvements and equipment and assigned the lease for one re-franchised location and sold equipment at three other re-franchised locations to the existing franchisee, resulting in a gain of approximately \$0.2 million. The Company also sold the real property and equipment for one re-franchised location and assigned the lease and sold the equipment for a second re-franchised location to the existing franchisee, resulting in a gain of approximately \$0.2 million during the nine months ended September 26, 2004.

*(Gain) loss on disposals of other property and equipment, net:*

The gain on disposals of other property and equipment, net, was \$1.4 million for the nine months ended October 2, 2005 as compared to a loss of \$0.7 million for the nine months ended September 26, 2004. The table below identifies the components of the (gain) loss on disposals of other property and equipment, net as shown on the accompanying condensed consolidated statements of operations (in thousands):

|   | <b>For the Nine Months Ended</b> |                               |
|---|----------------------------------|-------------------------------|
|   | <b>October 2,<br/>2005</b>       | <b>September 26,<br/>2004</b> |
| Restaurant equipment assets retired due to remodeling         | \$ 220                           | \$ 195                        |
| Restaurant equipment assets retired due to replacement        | 146                              | 290                           |
| (Gain) loss on property not held for disposition              | (1,902)                          | 63                            |
| All other   | 133                              | 113                           |
| (Gain) loss on disposals of other property and equipment, net | \$ (1,403)                       | \$ 661                        |

*Interest expense, net:*

Interest expense, net of capitalized interest and interest income was \$15.7 million and \$16.7 million for the nine months ended October 2, 2005 and September 26, 2004, respectively. The decrease in interest expense in the first nine months of 2005 compared to the same period in 2004 is primarily due to lower interest rates on the Company's debt as a result of the refinancing of \$176.0 million of the Company's 10½% senior notes (the Senior Notes).

*Other (income) expense, principally debt retirement costs:*

Other (income) expense, principally debt retirement costs for the nine months ended September 26, 2004 represents the \$6.8 million premium and the write-off of unamortized deferred financing costs of \$2.5 million in connection with the tender offer for the \$176.0 million of Senior Notes. In March 2004, \$127.8 million of aggregate principal amount of Senior Notes were purchased pursuant to the tender offer and 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.

*Provision for (benefit from) income taxes:*

The provision for income taxes was \$0.9 million, or 22.7% of income before provision for income taxes, for the nine months ended October 2, 2005. During the second quarter of 2005, the Company reduced the benefit from income taxes by \$0.2 million due to certain items discussed with the IRS. Currently, the IRS is auditing fiscal years 2002 through 2004. Generally, the Company records income taxes based on the anticipated effective rate for the year with any changes in valuation allowances reflected in the period of change. Had the Company used the effective tax rate anticipated for the fiscal year, an unreliable rate would have resulted due to the impact of federal tax credits on lower than originally anticipated pre-tax earnings. Accordingly, the Company chose to compute tax expense for the period using the statutory rate of 41% less the anticipated tax benefit from applicable tax credits.





The Company had approximately \$16.8 million of net deferred tax assets recorded as of October 2, 2005, for which no valuation allowance has been established since management believes it is more likely than not that the benefit of these assets will be realized in future periods from future taxable income. A key source of future taxable income includes gains from re-franchising Company-operated restaurants, the benefits from future improvements to be made to customer service in Company-operated restaurants and additional taxable income from the Company's retail supermarket ice cream business. Management evaluates the need for a valuation allowance on a quarterly basis. A more in depth evaluation is made as part of the annual and strategic planning process conducted in the fourth quarter of each year.

The benefit from income taxes was \$3.6 million, an effective tax rate of 52.8%, for the nine months ended September 26, 2004. The tax rate for the 2004 fiscal year was 68.8%, as the final benefit from income taxes for 2004 included a \$2.2 million reversal of income tax accruals recorded in prior years. These accruals related to tax matters that, based upon additional information obtained during the fourth quarter of 2004, were no longer necessary. The reversal was recorded in the fourth quarter of 2004.

*Net income (loss):*

Net income was \$2.9 million for the nine months ended October 2, 2005 as compared to net loss of \$3.2 million for the nine months ended September 26, 2004 for the reasons discussed above.

**Liquidity and Capital Resources**

*General:*

The Company's primary sources of liquidity and capital resources are cash generated from operations and, if needed, borrowings under its revolving credit facility. Additional sources of liquidity consist of capital and operating leases for financing leased restaurant locations (in malls and shopping centers and land or building leases), restaurant equipment, manufacturing equipment, distribution vehicles and computer equipment. Additionally, sales of under-performing existing restaurant properties and other assets (to the extent FICC's and its subsidiaries' debt instruments permit) are sources of cash. The amount of debt financing that FICC will be able to incur is limited by the terms of its New Credit Facility and New Senior Notes indenture. Below was the financing status of the Company's operating restaurants at October 2, 2005:

|                                    |     |
|------------------------------------|-----|
| Owned and mortgaged                | 63  |
| Sold and leased back               | 60  |
| Owned land and building            | 26  |
| Leased land, owned building        | 73  |
| Leased land and building           | 108 |
| Total Company-operated restaurants | 330 |

The restaurants above not identified as owned and mortgaged or sold and leased back secure the Company's obligations under the New Credit Facility. Of the 26 restaurant properties identified as owned land and building, six were available to be sold.

In addition to the 63 properties identified as owned and mortgaged, the Company owns and mortgages an additional 10 properties in this category which are operated by franchisees.

*Operating Cash Flows:*

Net cash provided by operating activities was \$20.3 million and \$12.4 million for the nine months ended October 2, 2005 and September 26, 2004, respectively. The increase of \$7.9 million in cash provided by operating activities between the two periods was largely due to the \$6.8 million premium paid in 2004 in connection with the tender offer for the \$176.0 million of Senior Notes.

The Company had a working capital deficit of \$2.0 million and \$13.5 million as of October 2, 2005 and January 2, 2005, respectively. The working capital needs of companies engaged in the restaurant industry are generally low and as a result, restaurants are frequently able to operate with a working capital deficit because: (i) restaurant operations are conducted primarily on a cash (and cash equivalent) basis with a low level of accounts receivable; (ii) rapid turnover allows a limited investment in inventories; and (iii) cash from sales is usually received before related expenses for food, supplies and payroll are paid.

*Investing Cash Flows:*

Net cash used in investing activities was \$5.6 million and \$12.4 million for the nine months ended October 2, 2005 and September 26, 2004, respectively.

During the nine months ended October 2, 2005 and September 26, 2004, the Company spent \$11.5 million and \$18.8 million, respectively, on capital expenditures, of which \$9.8 million and \$16.7 million, respectively, was spent on restaurant operations. Capital expenditures were offset by proceeds from the sales of property and equipment of \$6.2 million and \$4.0 million for the nine months ended October 2, 2005 and September 26, 2004, respectively. The proceeds in 2005 were the result of re-franchising transactions and the sale of two restaurant properties. The proceeds in 2004 were primarily the result of re-franchising transactions.

During the nine months ended October 2, 2005, the Company completed two re-franchising transactions in which two existing franchisees purchased four existing Company restaurants and agreed to develop a total of five new restaurants in future years. Gross proceeds from these transactions were \$3.5 million, of which \$0.1 million was for franchise fees and \$3.4 million was for the sale of certain assets and leasehold rights. In addition, the Company completed three transactions in which three former employees received franchises to operate six existing restaurants with options to purchase the restaurants within two years. If the options are exercised, one franchisee will also agree to develop two new restaurants in future years. Proceeds from option transactions will be recognized upon purchase.

During the nine months ended September 26, 2004, the Company completed one re-franchising transaction in which a franchisee purchased a total of 10 existing restaurants and agreed to develop a total of 10 new restaurants in future years. Gross proceeds from the sale were \$3.2 million of which \$0.3 million was for franchise fees for the initial 10 restaurants. In addition, the Company sold the real property and equipment for one franchised location and assigned the lease and sold the equipment for four other franchised locations to the existing franchisees. Gross proceeds from the sales were \$1.3 million, of which \$0.2 million was for franchise fees and \$1.1 million was for the sale of assets and lease assignment.



*Financing Cash Flows:*

Net cash used in financing activities was \$3.9 million and \$8.4 million for the nine months ended October 2, 2005 and September 26, 2004, respectively.

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.

The Company anticipates requiring capital in the future principally to maintain existing restaurant and plant facilities and to continue to renovate and re-image existing restaurants. Capital expenditures for 2005 are anticipated to be between \$20.0 million and \$25.0 million in the aggregate, of which between \$17.0 million and \$21.0 million is expected to be spent on restaurants. The Company's actual 2005 capital expenditures may vary from these estimated amounts. The Company believes that the combination of the funds generated from operating activities and borrowing availability under its revolving credit facility will be sufficient to meet the Company's anticipated operating requirements, debt service requirements, lease obligations, capital requirements and obligations associated with the corporate restructurings.

There have been no material changes to the Company's contractual obligations and commitments from those disclosed in the Company's 2004 Annual Report on Form 10-K/A.

### **Seasonality**

Due to the seasonality of ice cream consumption, and the effect from time to time of weather on patronage of the restaurants, the Company's revenues and operating income are typically higher in its second and third quarters.

### **Geographic Concentration**

Approximately 98% of the Company-operated restaurants are located, and substantially all of its retail sales are generated, in the Northeast. As a result, a severe or prolonged economic recession or changes in demographic mix, employment levels, population density, weather, real estate market conditions or other factors specific to this geographic region may adversely affect the Company more than certain of its competitors which are more geographically diverse.

### **Critical Accounting Estimates**

The discussion and analysis of the Company's consolidated financial condition and results of operations are based upon the Company's interim condensed consolidated financial statements, which have been prepared in accordance with generally accepted accounting principles in the U.S. The preparation of these condensed consolidated financial statements requires the Company to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities. On an on-going basis, the Company evaluates its estimates, including those related to revenue recognition, insurance reserves, recoverability of accounts receivable, income tax valuation allowances and pension and other post-retirement benefits expense. The Company bases its estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources.

The critical accounting estimates that the Company believes affect the reported amounts of assets, liabilities, revenues and expenses, and the related disclosure of contingent assets and liabilities in the Company's condensed consolidated financial statements presented in this report are described in the Company's Management's Discussion and Analysis of Financial Condition and Results of Operations and in the Notes to the consolidated financial statements included in the Company's Annual Report on Form 10-K/A for the fiscal year ended January 2, 2005. There have been no material changes to the critical accounting estimates.





Actual results may differ from these estimates under different assumptions or conditions. Any differences may have a material impact on the Company's financial condition and results of operations. For a discussion of how these and other factors may affect the Company's business, see the Forward Looking Statements above and other factors included in the Company's other filings with the Securities and Exchange Commission.

#### **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 share-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 \$0.8 million and \$0.2 million 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.

**Item 3. Quantitative and Qualitative Disclosures About Market Risk**

There has been no material change in the Company's market risk exposure since the filing of the 2004 Annual Report on Form 10-K/A.

**Item 4. Controls and Procedures**

As of October 2, 2005, an evaluation was performed under the supervision and with the participation of the Company's management, including the Chief Executive Officer ( CEO ) and Chief Financial Officer ( CFO ), of the effectiveness of the design and operation of the Company's disclosure controls and procedures (as defined in Rule 13a-15(e) under the Exchange Act). Based on that evaluation, the Company's CEO and CFO concluded that the Company's disclosure controls and procedures were effective as of October 2, 2005.

There were no significant changes in the Company's internal control over financial reporting that occurred during the Company's last fiscal quarter that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

**PART II OTHER INFORMATION**

**Item 6. Exhibits**

Exhibits

The exhibit index is incorporated by reference herein.

**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.

Friendly Ice Cream Corporation

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By: /s/PAUL V. HOAGLAND  
Name: Paul V. Hoagland  
Title: Executive Vice President of Administration  
and Chief Financial Officer  
(Principal Financial Officer)  
Date: November 9, 2005

**EXHIBIT INDEX**

- 31.1 Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 signed by John L. Cutter.
- 31.2 Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 signed by Paul V. Hoagland.
- 32.1 Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 signed by John L. Cutter and Paul V. Hoagland.