CARTERS INC
Form 10-Q
August 09, 2006

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE QUARTERLY PERIOD ENDED JULY 1, 2006 OR

o TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE TRANSITION PERIOD FROM TO

Commission file number:

001-31829

CARTER S, INC.

(Exact name of Registrant as specified in its charter)

Delaware	**13-3912933**
(State or other jurisdiction of Incorporation or Organization)	(I.R.S. Employer Identification No.)

The Proscenium
1170 Peachtree Street NE, Suite 900
Atlanta, Georgia 30309
(Address of principal executive offices, including zip code)

(404) 745-2700
(Registrant s telephone number, including area code)

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 x No o

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

Large Accelerated Filer x Accelerated Filer o Non-Accelerated Filer o

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

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

Common Stock	**Outstanding Shares at August 9, 2006**
Common stock, par value $0.01 per share	58,163,110

CARTER S, INC.
INDEX

PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

CARTER S, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS
(dollars in thousands, except for share data)
(unaudited)

	July 1, 2006	**December 31, 2005**
ASSETS		
Current assets:		
Cash and cash equivalents	$ 41,624	$ 84,276
Accounts receivable, net	103,151	96,144
Inventories, net	190,524	188,454
Prepaid expenses and other current assets	8,413	6,262
Deferred income taxes	18,795	23,909
Total current assets	362,507	399,045
Property, plant, and equipment, net	76,192	79,458
Tradenames	322,233	322,233
Cost in excess of fair value of net assets acquired	283,122	284,172
Deferred debt issuance costs, net	7,118	8,257
Licensing agreements, net	15,022	17,150
Leasehold interests, net	1,385	1,619
Other assets	7,779	4,793
Total assets	$ 1,075,358	$ 1,116,727
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Current maturities of long-term debt	$ 3,979	$ 3,241
Accounts payable	57,074	63,735
Other current liabilities	55,490	89,627
Total current liabilities	116,543	156,603
Long-term debt	389,915	426,791
Deferred income taxes	127,613	124,439
Other long-term liabilities	21,528	22,250
Total liabilities	655,599	730,083
Commitments and contingencies		
Stockholders equity:		
Preferred stock; par value $.01 per share; 100,000 shares authorized; none issued or outstanding at July 1, 2006 and December 31, 2005		
Common stock, voting; par value $.01 per share; 150,000,000 shares authorized; 58,153,110 shares issued and outstanding at July 1, 2006; 40,000,000 shares authorized, 28,909,729 shares issued and outstanding at December 31, 2005	582	289
Additional paid-in capital	263,822	260,414
Deferred compensation		(2,749)
Accumulated other comprehensive income	3,215	1,354
Retained earnings	152,140	127,336
Total stockholders equity	419,759	386,644
Total liabilities and stockholders equity	$ 1,075,358	$ 1,116,727

See accompanying notes to the unaudited condensed consolidated financial statements

CARTER S, INC.
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(dollars in thousands, except for share data)
(unaudited)

	For the three-month periods ended		For the six-month periods ended	
	July 1, 2006	July 2, 2005	July 1, 2006	July 2, 2005
Net sales	$ 277,577	$ 192,500	$ 574,024	$ 398,707
Cost of goods sold	180,342	126,435	368,625	256,877
Gross profit	97,235	66,065	205,399	141,830
Selling, general, and administrative expenses	82,466	51,243	165,448	103,239
Closure costs	10	4,569	91	4,569
Royalty income	(6,654)	(2,813)	(13,828)	(6,336)
Operating income	21,413	13,066	53,688	40,358
Interest expense, net	6,929	4,055	13,813	8,457
Income before income taxes	14,484	9,011	39,875	31,901
Provision for income taxes	5,466	3,561	15,071	12,602
Net income	$ 9,018	$ 5,450	$ 24,804	$ 19,299
Basic net income per common share	$ 0.16	$ 0.10	$ 0.43	$ 0.34
Diluted net income per common share	$ 0.15	$ 0.09	$ 0.41	$ 0.32
Basic weighted-average number of shares outstanding	57,877,753	57,159,886	57,793,393	57,046,684
Diluted weighted-average number of shares outstanding	61,183,491	60,643,410	61,160,185	60,514,664

See accompanying notes to the unaudited condensed consolidated financial statements

CARTER S, INC.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(dollars in thousands)
(unaudited)

	For the six-month periods ended July 1, 2006	July 2, 2005
Cash flows from operating activities:		
Net income	$ 24,804	$ 19,299
Adjustments to reconcile net income to net cash (used in) provided by operating activities:		
Depreciation and amortization	12,735	9,378
Amortization of debt issuance costs	1,139	1,066
Accretion of debt discount		38
Income tax benefit from exercised stock options	(2,378)	2,958
Non-cash stock-based compensation expense	2,858	753
Non-cash closure costs		106
Loss on sale of property, plant, and equipment	108	28
Deferred income taxes	7,236	(264)
Effect of changes in operating assets and liabilities:		
Accounts receivable	(7,007)	(1,565)
Inventories	(2,070)	(18,852)
Prepaid expenses and other assets	(1,823)	(925)
Accounts payable and other liabilities	(38,311)	10,616
Net cash (used in) provided by operating activities	(2,709)	22,636
Cash flows from investing activities:		
Capital expenditures	(7,541)	(5,933)
Proceeds from sale of property, plant, and equipment	344	9
Transaction costs		(782)
Collections on loan		600
Net cash used in investing activities	(7,197)	(6,106)
Cash flows from financing activities:		
Payments on term loan	(36,138)	(35,261)
Income tax benefit from exercised stock options	2,378	
Proceeds from exercise of stock options	1,014	842
Net cash used in financing activities	(32,746)	(34,419)
Net decrease in cash and cash equivalents	(42,652)	(17,889)
Cash and cash equivalents, beginning of period	84,276	33,265
Cash and cash equivalents, end of period	$ 41,624	$ 15,376

See accompanying notes to the unaudited condensed consolidated financial statements

CARTER S, INC.
CONDENSED CONSOLIDATED STATEMENT OF CHANGES IN STOCKHOLDERS EQUITY
(dollars in thousands, except for share data)
(unaudited)

	Common stock	Additional paid-in capital	Deferred compensation	Accumulated other comprehensive income	Retained earnings	Total stockholders equity
Balance at December 31, 2005	$ 289	$ 260,414	$ (2,749)	$ 1,354	$ 127,336	$ 386,644
Tax benefit from exercise of stock options		2,378				2,378
Exercise of stock options (236,280 shares)	2	1,012				1,014
Stock-based compensation expense		2,518				2,518
Issuance of common stock (17,172 shares)		540				540
Reversal of deferred compensation (see Note 9)		(2,749)	2,749			
Two-for-one common stock split (see Note 8)	291	(291)				
Comprehensive income:						
Net income					24,804	24,804
Unrealized gain on interest rate swap, net of taxes of $991				1,756		1,756
Unrealized gain on interest rate collar, net of taxes of $61				105		105
Total comprehensive income				1,861	24,804	26,665
Balance at July 1, 2006	$ 582	$ 263,822	$	$ 3,215	$ 152,140	$ 419,759

See accompanying notes to the unaudited condensed consolidated financial statements

6

CARTER S, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(unaudited)

NOTE 1 THE COMPANY:

Carter s, Inc., and its wholly-owned subsidiaries (collectively, the Company, we, us, its, and our) design, source, and market branded newb and childrenswear under the *Carter s, Child of Mine, Just One Year, OshKosh B Gosh*, and related labels. Our products are sourced through contractual arrangements with manufacturers worldwide. Products are sourced for wholesale distribution to major domestic retailers, including the mass channel, and for our 200 *Carter s* brand and 143 *OshKosh* brand retail stores that market our brand name merchandise and other licensed products manufactured by other companies.

On July 14, 2005, Carter s, Inc., through its wholly-owned subsidiary, The William Carter Company (TWCC), acquired all of the outstanding common stock of OshKosh B Gosh, Inc. for a purchase price of $312.1 million, which included payment for vested stock options (the Acquisition). Established in 1895, OshKosh designs, sources, and markets apparel for children sizes newborn to 16. The accompanying unaudited condensed consolidated financial statements include the operations of OshKosh for the three and six-month periods ended July 1, 2006. Financial results for the three and six-month periods ended July 2, 2005 do not include the operations of OshKosh.

NOTE 2 BASIS OF PREPARATION:

The accompanying unaudited condensed consolidated financial statements comprise the consolidated financial statements of Carter s, Inc. and its subsidiaries. All intercompany accounts and transactions have been eliminated in consolidation.

In our opinion, the Company s accompanying unaudited condensed consolidated financial statements contain all adjustments necessary for a fair statement of our financial position as of July 1, 2006, the results of our operations for the three and six-month periods ended July 1, 2006 and July 2, 2005, cash flows for the six-month periods ended July 1, 2006 and July 2, 2005 and changes in stockholders equity for the six-month period ended July 1, 2006. Operating results for the six-month period ended July 1, 2006 are not necessarily indicative of the results that may be expected for the fiscal year ending December 30, 2006. Our accompanying condensed consolidated balance sheet as of December 31, 2005 is from our audited consolidated financial statements included in our most recently filed Annual Report on Form 10-K, but does not include all disclosures required by accounting principles generally accepted in the United States of America.

Certain information and footnote disclosure normally included in financial statements prepared in accordance with generally accepted accounting principles in the United States of America have been condensed or omitted pursuant to the rules and regulations of the Securities and Exchange Commission and the instructions to Form 10-Q. The accounting policies we follow are set forth in our most recently filed Annual Report on Form 10-K in the notes to our consolidated financial statements for the fiscal year ended December 31, 2005.

Our fiscal year ends on the Saturday in December or January nearest to the last day of December. The accompanying unaudited condensed consolidated financial statements for the second quarter and first half of fiscal 2006 reflect our financial position as of July 1, 2006. The second quarter and first half of fiscal 2005 ended on July 2, 2005.

Certain prior year amounts have been reclassified for comparative purposes.

NOTE 3 BUSINESS COMBINATION AND REFINANCING:

As noted above, on July 14, 2005, we acquired all of the outstanding common stock of OshKosh. The Acquisition was accounted for under the purchase method of accounting. The purchase price for the Acquisition, including related fees and expenses, was allocated to the fair value of tangible and identifiable intangible assets and liabilities acquired with the remainder allocated to cost in excess of fair value of net assets acquired. As part of financing the Acquisition, the Company refinanced its existing debt (the Refinancing), including its senior credit facility (former senior credit facility) and repurchased its $113.8 million 10.875% Senior Subordinated Notes due 2011 (the Notes). The repurchase of the Notes together with the Refinancing and Acquisition is referred to as the Transaction.

Financing for the Transaction was provided by a new $500 million Term Loan 1 (see Note 6) and a $125 million revolving credit facility (including a sub-limit for letters of credit of $80 million, the Revolver) entered into by TWCC with Bank of America, N.A., as administrative agent, Credit Suisse, and certain other financial institutions (the Senior Credit Facility). The term of the Revolver extends to July 14, 2011 and the term of the Term Loan 1 extends to July 14, 2012.

The proceeds of the Refinancing were used to purchase the outstanding common stock and vested stock options of OshKosh ($312.1 million), pay transaction expenses ($6.2 million), refinance the Company s former senior credit facility ($36.2 million), repurchase the Notes ($113.8 million), pay a redemption premium on the Company s Notes ($14.0 million), along with accrued and unpaid interest ($5.1 million), and pay debt issuance costs ($10.6 million). Other Transaction expenses paid prior and subsequent to the closing of the Transaction totaled $1.4 million, including $0.2 million in debt issuance costs.

As a result of the Refinancing, we expensed $4.5 million in unamortized debt issuance costs related to the former senior credit facility and Notes and expensed $0.5 million related to the debt discount on the Notes. Additionally, we expensed approximately $1.1 million of debt issuance costs associated with the Senior Credit Facility in accordance with Emerging Issues Task Force (EITF) No. 96-19, Debtor s Accounting for a Modification or Exchange of Debt Instruments.

The Senior Credit Facility requires us to hedge at least 25% of our variable rate debt under the term loan. On September 22, 2005, we entered into a swap agreement to receive floating interest and pay fixed interest. This swap agreement is designated as a cash flow hedge of the variable interest payments on a portion of our variable rate Term Loan 1 debt. The swap agreement matures on July 30, 2010. The unrealized gain, net of taxes, related to the interest rate swap was $0.8 million and $1.8 million, respectively, for the three and six-month periods ended July 1, 2006 and is included within accumulated other comprehensive income on the accompanying unaudited condensed consolidated balance sheet. During the three and six-month periods ended July 1, 2006, we reclassified approximately $0.2 million and $0.4 million, respectively, related to the swap agreement into earnings.

On May 25, 2006, we entered into an interest rate collar agreement (the collar) with a floor of 4.3% and a ceiling of 5.5%. The collar covers $100 million of our variable rate Term Loan 1 debt and is designated as a cash flow hedge of the variable interest payments on such debt. The collar matures on January 31, 2009. The unrealized gain, net of taxes, related to the collar was $0.1 million for the three-month period ended July 1, 2006 and is included within accumulated other comprehensive income on the accompanying unaudited condensed consolidated balance sheet.

A summary of the Acquisition purchase price allocation is as follows:

(dollars in thousands)	
Cash and cash equivalents	$ 9,500
Investments	18,355
Accounts receivable	15,979
Inventory	86,201
Deferred tax assets	13,453
Property, plant, and equipment	26,107
Tradename	102,000
Licensing agreements	19,100
Leasehold interests	1,833
Other assets	5,075
Accounts payable	(19,052)
Severance and relocation (Note 11)	(9,733)
Other exit costs (Note 11)	(2,167)
Lease termination costs (Note 11)	(7,200)
Contract termination costs (Note 11)	(1,533)
Deferred tax liabilities	(41,800)
Accrued and other liabilities	(40,474)
Cost in excess of fair value of net assets acquired	143,840
	$ 319,484

During the six-month period ended July 1, 2006, the following adjustments were made to the purchase price allocation:

(dollars in thousands)	
Cost in excess of fair value of net assets acquired at December 31, 2005	$ 144,890
Adjust accrued and other liabilities	(321)
Adjust severance and relocation (Note 11)	(780)
Adjust other exit, lease termination, and contract termination costs (Note 11)	51
Cost in excess of fair value of net assets acquired at July 1, 2006	$ 143,840

The following unaudited pro forma summary presents information as if the Transaction occurred on the first day of fiscal 2005 and assumes that there were no other changes in our operations. This pro forma information does not necessarily reflect the actual results that would have occurred had the Transaction occurred on that date, nor is it necessarily indicative of the future results of operations of the combined Company.

The results reflect the combined Company for the three and six-month periods ended July 2, 2005, adjusted to reflect increased interest expense, amortization of the capitalized value of OshKosh licensing agreements and leasehold interests, and incremental depreciation expense.

(dollars in thousands, except share data)	**For the three-month period ended July 2, 2005**	**For the six-month period ended July 2, 2005**
Pro forma net sales	$ 270,423	$ 561,126
Pro forma net income	$ 844	$ 11,685
Pro forma basic earnings per share	$ 0.01	$ 0.20
Pro forma diluted earnings per share	$ 0.01	$ 0.19

NOTE 4 COST IN EXCESS OF FAIR VALUE OF NET ASSETS ACQUIRED AND OTHER INTANGIBLE ASSETS:

In connection with the Acquisition, the Company recorded the cost in excess of fair value of net assets acquired and other intangible assets in accordance with Statement of Financial Accounting Standards (SFAS) No. 141, Business Combinations.

As of July 1, 2006, cost in excess of fair value of net assets acquired and other intangible assets resulting from the Acquisition were as follows:

(dollars in thousands)	**Weighted-average useful life**	**Gross amount**	**Accumulated amortization**
Cost in excess of fair value of net assets acquired	Indefinite	$ 143,840	$
OshKosh tradename	Indefinite	$ 102,000	$
OshKosh licensing agreements	4.7 years	$ 19,100	$ 4,078
Leasehold interests	4.1 years	$ 1,833	$ 448

Amortization expense for intangible assets subject to amortization was approximately $1.2 million and $2.4 million for the three and six-month periods ended July 1, 2006. Annual amortization expenses for the OshKosh licensing agreements and leasehold interests are expected to be as follows:

(dollars in thousands) **Fiscal Year**	**Estimated amortization expense**
2006 (period from July 2 through December 30)	$ 2,360
2007	4,447
2008	4,106
2009	3,717
2010	1,777
Total	$ 16,407

As described in Note 2 to our consolidated financial statements in our most recently filed Annual Report on Form 10-K, our existing *Carter s* tradename and cost in excess of fair value of net assets acquired have been deemed to have indefinite lives and are not being amortized.

NOTE 5 INVENTORIES:

Inventories consisted of the following:

(dollars in thousands)	**July 1, 2006**	**December 31, 2005**
Finished goods	$ 190,524	$ 185,472
Work in process		2,336
Raw materials and supplies	-	646
Total	$ 190,524	$ 188,454

NOTE 6 CREDIT FACILITY AMENDMENT:

On April 28, 2006, the Company entered into Amendment No. 1 (Amendment No. 1) to the Senior Credit Facility. Amendment No. 1 reduced the Company s interest rate by refinancing the existing Term Loan B (initially priced at LIBOR + 1.75% with a leverage-based pricing grid ranging from LIBOR + 1.50% to LIBOR + 1.75%) with a new Term Loan 1 having an applicable rate of LIBOR + 1.50% with no leverage-based pricing grid. If the Company makes any optional prepayments of its Term 1 Loans prior to the one-year anniversary of Amendment No. 1 in connection with any repricing transaction, the Company will be required to pay a prepayment premium of 1% of the amount of such Term 1 Loans being prepaid.

Amendment No. 1 also lowered the threshold for permitting restricted payments by raising the required leverage ratio (as defined) from 1.5 times to 2.5 times provided the Company has revolving loan commitments of $75.0 million available.

NOTE 7 EMPLOYEE BENEFIT PLANS:

Under a defined benefit plan, which was frozen in 1991, we offer a comprehensive post-retirement medical plan to current and certain future retirees and their spouses until they become eligible for Medicare or a Medicare supplement plan. We also offer life insurance to current and certain future retirees. We also have an obligation under a defined benefit plan covering certain former officers. See Note 7 Employee Benefit Plans to our consolidated financial statements in our most recently filed Annual Report on Form 10-K for further information.

The components of post-retirement life and medical benefit expense charged to operations are as follows:

	For the three-month periods ended		**For the six-month periods ended**	
(dollars in thousands)	**July 1, 2006**	**July 2, 2005**	**July 1, 2006**	**July 2, 2005**
Service cost benefits attributed to service during the period	$ 42	$ 25	$ 84	$ 50
Interest cost on accumulated post-retirement benefit obligation	159	168	317	333
Amortization of prior service cost	23		46	
Total net periodic pension benefit cost	$ 224	$ 193	$ 447	$ 383

The components of pension expense charged to operations are as follows:

	For the three-month periods ended		**For the six-month periods ended**	
(dollars in thousands)	**July 1, 2006**	**July 2, 2005**	**July 1, 2006**	**July 2, 2005**
Interest cost on accumulated pension benefit obligation	$ 19	$ 20	$ 38	$ 40

The Company maintains two defined benefit pension plans acquired in connection with the Acquisition. The benefits under these pension plans were frozen as of December 31, 2005, and cover certain current and former employees of OshKosh.

The Company s net periodic pension benefit related to these plans is comprised of the following components:

(dollars in thousands)	For the three-month period ended July 1, 2006	For the six-month period ended July 1, 2006
Service cost	$	$
Interest cost	651	1,301
Expected return on assets	(1,034)	(2,069)
Net periodic pension benefit	$ (383)	$ (768)

NOTE 8 COMMON STOCK:

On May 12, 2006, the Company amended Article V of its certificate of incorporation. The amendment increased the number of authorized shares of the Company s common stock from 40,000,000 to 150,000,000.

On June 6, 2006, the Company effected a two-for-one stock split (the stock split) through a stock dividend to stockholders of record as of May 23, 2006, of one share of our common stock for each share of common stock outstanding. Earnings per share for all prior periods presented have been adjusted to reflect the stock split.

During the second quarter of fiscal 2006, we issued 17,172 shares of common stock to our non-management Board members.

NOTE 9 STOCK-BASED COMPENSATION:

Under our Amended and Restated 2003 Equity Incentive Plan (the Plan), the compensation committee of our Board of Directors may award incentive stock options (ISOs and non-ISOs), stock appreciation rights (SARs), restricted stock, unrestricted stock, stock deliverable on a deferred basis, performance-based stock awards, and cash payments intended to help defray the cost of awards. All share and per share amounts have been adjusted to reflect the stock split discussed in Note 8 above.

On May 12, 2005, our Board of Directors implemented, and our stockholders approved an amendment to the Plan to increase the number of shares available to be delivered under the Plan by 2,800,000 to 11,488,392, with no more than 1,260,000 of such additional shares able to be used for awards other than stock options and to reduce the number of shares for which stock options may be granted to any individual or which can be subject to SARs granted to any individual in any calendar year from 8,000,000 to 2,000,000. As of July 1, 2006, there were 2,222,283 shares available for grant under the Plan. The Plan makes provision for the treatment of awards upon termination of service or in the case of a merger or similar corporate transaction. Participation in the Plan is limited to Directors and those key employees selected by the compensation committee. The limit on shares available under the Plan, the individual limits, and other award terms are subject to adjustment to reflect stock splits or stock dividends, combinations, and certain other events. All stock options issued under the Plan expire no later than ten years from the date of grant. The Company believes that the current level of authorized shares is sufficient to satisfy future option exercises.

There are currently three types of stock options outstanding under the Plan: basic, performance, and retained options. Basic options issued prior to May 12, 2005 vest in equal annual installments over a five-year period. Basic options granted on and subsequently to May 12, 2005 vest in equal annual installments over a four-year period. Performance options vest upon the achievement of pre-determined performance criteria. Retained stock options are options that were outstanding prior to the Company s 2001 acquisition by Berkshire Partners LLC and became fully vested in connection with the 2001 acquisition.

In December 2004, the Financial Accounting Standards Board (FASB) issued SFAS No. 123 (revised 2004), Share-Based Payment (SFAS 123R), which replaced SFAS 123, Accounting for Stock-Based Compensation (SFAS 123) as amended by SFAS No. 148, Accounting for Stock-Based Compensation-Transition and Disclosure (SFAS 148), and supercedes Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees, (APB 25). SFAS 123R requires companies to expense the fair value of employee stock options and similar awards. Effective January 1, 2006, the Company adopted SFAS 123R and began recognizing compensation expense for its share-based payments based on the fair value of the awards at the grant date. Under SFAS 123R, the pro forma disclosures previously permitted under SFAS 123 are no longer an alternative to financial statement recognition.

The Company adopted SFAS 123R using the modified prospective application method of transition. Therefore, prior period financial statements have not been restated. Under the modified prospective application method, for awards granted prior to January 1, 2006, compensation expense is recorded as options vest subsequent to January 1, 2006 based upon the grant-date fair value estimated in accordance with the original provisions of SFAS 123, adjusted for estimated forfeitures. For stock options granted subsequent to January 1, 2006, compensation expense will be recorded as options vest based upon the grant-date fair value estimated in accordance with SFAS 123R, with forfeitures estimated at the time of grant. Forfeiture estimates will be adjusted periodically based on the extent to which actual forfeitures differ, or are expected to differ, from previous estimates.

The fair value of stock options under SFAS 123R is determined using the Black-Scholes option pricing model, which is consistent with our valuation techniques previously utilized for stock options in pro forma footnote disclosure required under SFAS 123. Prior to the filing of our first Registration Statement on Form S-1 on August 23, 2002 in connection with our initial public offering, we used the minimum value method to value stock options, as provided by SFAS 123, as amended by SFAS 148. Under SFAS 123R, no compensation expense has been recorded for options recorded under the minimum value method.

The fair value of restricted stock is determined based on the number of shares granted and the quoted closing price of our common stock on the date of grant, consistent with our treatment of such awards under APB 25 prior to the adoption of SFAS 123R.

In connection with the adoption and provisions of SFAS 123R, the Company reversed its deferred compensation balance of $2,749,000 on January 1, 2006 related to restricted stock awards.

The adoption of SFAS 123R has resulted in additional pre-tax, share-based compensation expense (a component of selling, general, and administrative expenses) in the amount of approximately $988,000 and $1.9 million related to stock options for the three and six-month periods ended July 1, 2006, than if the Company had continued to account for share-based compensation under APB 25. The impact on net income for the three-month period ended July 1, 2006 was a reduction of approximately $615,000, or $0.01, on both basic and diluted earnings per share. The impact on net income for the six-month period ended July 1, 2006 was a reduction of approximately $1.2 million, or $0.02, on both basic and diluted earnings per share. For the fiscal year ended December 30, 2006, the adoption of SFAS 123R is expected to result in a reduction in net income of approximately $2.4 million, or $0.04 per basic and diluted earnings per share.

Prior to the adoption of SFAS 123R, we presented all tax benefits resulting from the exercise of stock options as operating cash inflows in the consolidated statements of cash flows, in accordance with the provisions of the EITF Issue No. 00-15, Classification in the Statement of Cash Flows of the Income Tax Benefit Received by a Company upon Exercise of a Nonqualified Employee Stock Option. SFAS 123R requires the benefit of tax deductions in excess of the compensation cost recognized for exercised options and restricted stock that vests to be classified as financing cash inflows rather than operating cash inflows, on a prospective basis. This amount is now shown as Income tax benefit from exercised stock options on the accompanying unaudited condensed consolidated statement of cash flows.

The income tax benefit from exercised stock options during the six-month period ended July 1, 2006 was approximately $2.4 million. Prior periods have not been restated.

Prior to the adoption of SFAS 123R, we accounted for stock-based compensation on stock options under the intrinsic value method consistent with APB 25. Under this method, we recorded compensation expense equal to the difference between the exercise price of the stock option and the fair market value of the underlying stock as of the date of the option grant. Forfeitures on stock option awards with expense recorded in accordance with APB 25 were accounted for as they occurred, rather than based on estimates of future forfeitures. There was no material impact or cumulative effect adjustment required as a result of estimating the impact of future forfeitures on awards previously expensed in accordance with APB 25. For disclosure purposes only, we also estimated the impact on our net income of applying the fair value method of measuring compensation cost on stock options with the fair value of the Company s common stock. In our pro forma disclosure we accounted for forfeitures as they occurred, rather than based on estimates of future forfeitures.

The following table provides supplemental information for the three and six-month periods ended July 2, 2005 as if stock-based compensation had been computed under SFAS 123, as amended by SFAS 148:

(dollars in thousands, except per share data)	**For the three-month period ended July 2, 2005**	**For the six-month period ended July 2, 2005**
Net income, as reported	$ 5,450	$ 19,299
Add:		
Stock-based employee compensation (under APB 25) included in reported net income, net of related tax effects	433	477
Deduct:		
Total stock-based employee compensation expense determined under the fair value based method (under SFAS 123 and SFAS 148) for all awards, net of related tax effects	(798)	(1,181)
Pro forma net income	$ 5,085	$ 18,595
Net income per common share:		
Basic-as reported	$ 0.10	$ 0.34
Basic-pro forma	$ 0.09	$ 0.33
Diluted-as reported	$ 0.09	$ 0.32
Diluted-pro forma	$ 0.08	$ 0.31

A summary of stock option activity under the Plan (in number of shares that may be purchased) is as follows for the six-month period ended July 1, 2006:

Basic Stock Options

	Basic stock options	Weighted-average exercise price per share	Weighted-average grant-date fair value
Outstanding, December 31, 2005	4,844,128	$ 6.23	$ 2.76
Granted	184,600	$ 33.73	$ 15.34
Exercised	(236,280)	$ 4.29	$ 2.04
Forfeited	(17,000)	$ 31.43	$ 12.66
Expired		$	$
Outstanding, July 1, 2006	4,775,448	$ 7.29	$ 3.25
Exercisable, July 1, 2006	2,918,007	$ 4.34	$ 1.89

During the three months ended July 1, 2006, the Company granted 37,800 basic stock options. In connection with this grant of basic stock options, the Company recognized approximately $16,000 in compensation expense during the three-month period ended July 1, 2006.

During the six months ended July 1, 2006, the Company granted 184,600 basic stock options. In connection with this grant of basic stock options, the Company recognized approximately $199,000 in compensation expense during the six-month period ended July 1, 2006.

A summary of basic stock options outstanding and exercisable at July 1, 2006 is as follows:

	Outstanding				Exercisable			
Range of exercise prices	Number	Weighted-average remaining contractual life	Weighted-average exercise price	Weighted-average grant-date fair value	Number	Weighted-average remaining contractual life	Weighted-average exercise price	Weighted-average grant-date fair value
$3-$5	3,383,128	5.27 years	$ 3.14	$ 1.29	2,577,767	5.25 years	$ 3.12	$ 1.29
$6-$7	323,400	7.21 years	$ 6.98	$ 4.88	86,760	7.21 years	$ 6.98	$ 4.88
$13-$17	619,920	7.85 years	$ 14.88	$ 6.71	218,480	7.82 years	$ 14.86	$ 6.67
$22-$27	240,000	9.05 years	$ 23.82	$ 9.52	35,000	8.88 years	$ 22.10	$ 8.75
$31-$35	209,000	9.61 years	$ 33.47	$ 15.03		-	$	$
	4,775,448	6.12 years	$ 7.29	$ 3.25	2,918,007	5.55 years	$ 4.34	$ 1.89

At July 1, 2006, the aggregate intrinsic value of all outstanding basic options is approximately $92.9 million, and the aggregate intrinsic value of currently exercisable basic options is approximately $64.5 million. The intrinsic value of basic options exercised during the three and six-month periods ended July 1, 2006 was approximately $4.5 million and $6.7 million. At July 1, 2006, the total estimated compensation cost related to non-vested basic options not yet recognized is approximately $7.4 million with a weighted-average expense recognition period of 3.06 years.

Performance Stock Options

	Performance stock options	Weighted-average exercise price per share	Weighted-average grant-date fair value
Outstanding, December 31, 2005	600,000	$ 25.06	$ 9.40
Granted		$	$
Exercised		$	$
Forfeited		$	$
Expired		$	$
Outstanding, July 1, 2006	600,000	$ 25.06	$ 9.40
Exercisable, July 1, 2006		$	$

A summary of performance stock options outstanding and exercisable at July 1, 2006 is as follows:

	Outstanding				**Exercisable**			
Range of exercise prices	**Number**	**Weighted-average remaining contractual life**	**Weighted-average exercise price**	**Weighted-average grant-date** fair value	**Number**	**Weighted-average remaining contractual life**	**Weighted-average exercise price**	**Weighted average grant-date** fair value
$22-$32	600,000	9.03 years	$ 25.06	$ 9.40			$	$

At July 1, 2006, the aggregate intrinsic value of all outstanding performance options is approximately $1.8 million. No performance options are currently exercisable. At July 1, 2006, the total estimated compensation cost related to non-vested performance options not yet recognized is approximately $4.3 million with a weighted-average expense recognition period of 2.91 years.

Retained Stock Options

	Retained stock options	Weighted-average exercise price per share
Outstanding, December 31, 2005	1,708,270	$ 0.75
Granted		$
Exercised		$
Forfeited		$
Expired		$
Outstanding, July 1, 2006	1,708,270	$ 0.75
Exercisable, July 1, 2006	1,708,270	$ 0.75

The weighted-average contractual life of the 1,708,270 retained stock options outstanding and exercisable as of July 1, 2006 is 5.13 years. At July 1, 2006, the aggregate intrinsic value of all outstanding retained options, which are all currently exercisable, is approximately $43.9 million.

The weighted-average contractual life for the basic, performance, and retained stock options in aggregate as of July 1, 2006 is approximately 6.13 years.

The fair value of each option grant is estimated on the date of grant using the Black-Scholes option pricing method with the following weighted-average assumptions used for grants issued during the six-month period ended July 1, 2006:

	For the six-month period ended July 1, 2006	
Volatility	38.89	%
Risk-free interest rate	4.69	%
Expected term (years)	6.0	
Dividend yield		

Volatility This is a measure of the amount by which a stock price has fluctuated or is expected to fluctuate. The Company uses actual monthly historical changes in the market value of our stock since the Company s initial public offering on October 29, 2003, supplemented by peer company data for periods prior to our initial public offering covering the expected life of options being valued. An increase in the expected volatility will increase compensation expense.

Risk-free interest rate This is the U.S. Treasury rate as of the grant date having a term equal to the expected term of the option. An increase in the risk-free interest rate will increase compensation expense.

Expected term This is the period of time over which the options granted are expected to remain outstanding and is based on historical experience and estimated future exercise behavior. Separate groups of employees that have similar historical exercise behavior are considered separately for valuation purposes. An increase in the expected term will increase compensation expense.

Dividend yield The Company does not have plans to pay dividends in the foreseeable future. An increase in the dividend yield will decrease compensation expense.

Restricted Stock

All restricted stock awards issued under the plan vest based upon continued service. Restricted stock awards vest in equal annual installments over a four-year period or cliff vest after a three or four-year period. As noted above, the fair value of restricted stock is determined based on the number of shares granted and the quoted closing price of our common stock on the date of grant.

The following table summarizes our restricted stock award activity during the six-month period ended July 1, 2006:

	Restricted stock	
Outstanding, December 31, 2005	134,270	
Granted	90,200	
Vested	(2,500	)
Forfeited	(8,000	)
Outstanding, July 1, 2006	213,970	

During the three-month period ended July 1, 2006, the Company granted 16,000 shares of restricted stock to employees. In connection with this issuance, we recorded approximately $16,000 of compensation expense.

During the six-month period ended July 1, 2006, the Company granted 90,200 shares of restricted stock to employees. Compensation expense recorded during the six-month period ended July 1, 2006 for all restricted stock awards totaled approximately $618,000. The total amount of estimated compensation expense related to unvested restricted stock awards is approximately $4.8 million as of July 1, 2006.

Unrecognized stock-based compensation expense related to outstanding stock options and restricted stock awards is expected to be recorded as follows:

(dollars in thousands)	Basic options	Performance options	Restricted stock	Total
2006 (period from July 2 through December 30)	$ 1,192	$ 755	$ 735	$ 2,682
2007	2,496	1,508	1,462	5,466
2008	2,385	1,520	1,435	5,340
2009				