

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

## SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

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### FORM 10-Q

(Mark One)

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

For the quarterly period ended July 3, 2005

OR

**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)

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

01095

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

(Zip Code)

**(413) 543-2400**

(Registrant's Telephone Number, Including Area Code)

**Not Applicable**

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

Class	Outstanding at July 22, 2005
Common Stock, \$.01 par value	7,775,173 shares

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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)

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

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

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

**FRIENDLY ICE CREAM CORPORATION AND SUBSIDIARIES**



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## CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(Unaudited)

(In thousands, except per share data)

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

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



**FRIENDLY ICE CREAM CORPORATION AND SUBSIDIARIES**

**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**

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(Unaudited)

(In thousands)

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

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



**FRIENDLY ICE CREAM CORPORATION AND SUBSIDIARIES**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

(Unaudited)

**1. BASIS OF PRESENTATION AND SIGNIFICANT ACCOUNTING POLICIES**

*Interim Financial Information*

The accompanying condensed consolidated financial statements as of July 3, 2005 and for the three and six months ended July 3, 2005 and June 27, 2004 are unaudited, but have been prepared in accordance with generally accepted accounting principles ( GAAP ) for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statements. In the opinion of management, all adjustments which are necessary for a fair presentation of the consolidated financial position, results of operations, cash flows and comprehensive income (loss) of Friendly Ice Cream Corporation ( FICC ) and subsidiaries (unless the context indicates otherwise, collectively, the Company ) have been included. Such adjustments consist solely of normal recurring accruals. Operating results for the three and six month periods ended July 3, 2005 and June 27, 2004 are not necessarily indicative of the results that may be expected for the entire year due, in part, to the seasonality of the Company's business. Historically, higher revenues and operating income have been experienced during the second and third fiscal quarters. The Company's consolidated financial statements, including the notes thereto, which are contained in the 2004 Annual Report on Form 10-K/A for the fiscal year ended January 2, 2005 ( 2004 Annual Report on Form 10-K/A ), should be read in conjunction with these condensed consolidated financial statements. Capitalized terms not otherwise defined herein should be referenced to the 2004 Annual Report on Form 10-K/A.

*Use of Estimates in the Preparation of Financial Statements -*

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the dates of the financial statements and the reported amounts of revenues and expenses during the reporting periods. The critical accounting policies and most significant estimates and assumptions relate to revenue recognition, insurance reserves, recoverability of accounts receivable, income tax valuation allowances and pension and post-retirement medical and life insurance benefits expense. Actual amounts could differ significantly from the estimates.

*Inventories -*

Inventories are stated at the lower of first-in, first-out cost or market and consisted of the following at July 3, 2005 and January 2, 2005 (in thousands):

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	<b>July 3, 2005</b>	<b>January 2, 2005</b>
Raw materials	\$ 1,703	\$ 2,685
Goods in process	142	157
Finished goods	14,431	14,703
Total	\$ 16,276	\$ 17,545

*Other Assets*

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

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

*Other Accrued Expenses -*

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

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

*Lease Guarantees and Contingencies*

Primarily as a result of the Company's re-franchising efforts, the Company remains liable for certain lease assignments and guarantees. These leases have varying terms, the latest of which expires in 2020. As of July 3, 2005, the potential amount of undiscounted payments the Company could be required to make in the event of non-payment by the primary lessees was \$6,598,249. The present value of these potential payments discounted at the Company's pre-tax cost of debt at July 3, 2005 was \$5,105,000. The Company generally has cross-default provisions with franchisees that would put the franchisee in default of its franchise agreement in the event of non-payment under the lease. The Company believes these cross-default provisions significantly reduce the risk that the Company will be required to make payments under these leases and, historically, the Company has not been required to make such payments. Additionally, as of July 3, 2005, the Company has no reason to believe that any franchisee will be unable to fulfill its obligations. Accordingly, no liability had been recorded for exposure under such leases at July 3, 2005 and January 2, 2005.



*Income (Loss) Per Share*

Basic net income (loss) per share is calculated by dividing net income (loss) by the weighted average number of common shares outstanding during the period. Diluted net income (loss) per share is calculated by dividing net income (loss) by the weighted average number of shares of common stock and common stock equivalents outstanding during the period. Common stock equivalents are dilutive stock options and warrants that are assumed exercised for calculation purposes. There were 140,169 common stock equivalents included in diluted net income per share for the three months ended July 3, 2005 and no common stock equivalents included in diluted net loss per share for the six months ended July 3, 2005 and the three and six months ended June 27, 2004. The number of common stock options which could dilute basic net income (loss) per share in the future, that were not included in the computation of diluted net income (loss) per share because to do so would have been antidilutive, was 129,817 and 284,289 for the three months ended July 3, 2005 and June 27, 2004, respectively. The number of common stock options which could dilute basic net income (loss) per share in the future, that were not included in the computation of diluted net income (loss) per share because to do so would have been antidilutive, was 284,651 and 289,195 for the six months ended July 3, 2005 and June 27, 2004, respectively.

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



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

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

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

*Stock-Based Compensation*

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

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

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

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

*Recently Issued Accounting Pronouncements*

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

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

On December 16, 2004, the FASB issued SFAS No. 123 (revised 2004), *Share-Based Payment* (SFAS No. 123R), which is a revision of SFAS No. 123, *Accounting for Stock-Based Compensation*. SFAS No. 123R supersedes APB Opinion No. 25, *Accounting for Stock Issued to Employees*, and amends SFAS No. 95, *Statement of Cash Flows*. Generally, the approach in SFAS No. 123R is similar to the approach described in SFAS No. 123. However, SFAS No. 123R requires all share-based payments to employees, including grants of employee stock options, to be recognized in the income statement based on their fair values. Pro forma disclosure is no longer an alternative. SFAS No. 123R must be adopted no later than the first annual period beginning after June 15, 2005. Early adoption will be permitted in periods in which financial statements have not yet been issued. SFAS No. 123R allows companies to choose between the modified-prospective and modified-retrospective transition alternatives in adopting SFAS No. 123R. Under the modified-prospective transition method, compensation cost will be recognized in financial statements issued subsequent to the date of adoption for all 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 standard would have approximated the impact as described in the disclosure of pro forma net income (loss) and net income (loss) per share pursuant to SFAS No. 123. SFAS No. 123R also requires the benefits of tax deductions in excess of recognized compensation cost to be reported as a financing cash flow, rather than as an operating cash flow as required under current literature. This requirement will reduce net operating cash flows and increase net financing cash flows in



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

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

## 2. RESTATEMENT OF FINANCIAL STATEMENTS

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

The Company believed that its accounting treatment was permitted under GAAP and that such treatment was consistent with the practices of other public companies. Following a review of its lease accounting treatment and relevant accounting literature, the Company determined that it should: i) conform the depreciable lives for buildings on leased land and other leasehold improvements to the shorter of the economic life of the asset or the lease term used for determining the capital versus operating lease classification and calculating straight-line rent and ii) include option periods in the depreciable lives assigned to leased buildings and leasehold improvements and in the calculation of straight-line rent expense only in instances in 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 six months ended June 27, 2004 (in thousands):

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

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

**3. EMPLOYEE BENEFIT PLANS**

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

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

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

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

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



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

#### 4. WRITE-DOWNS OF PROPERTY

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

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

During the quarter ended July 3, 2005, the Company identified two restaurant properties to be disposed of other than by sale. The Company determined that the carrying value of these restaurant properties exceeded their estimated undiscounted cash flows and the carrying values were reduced by an aggregate of \$289,000 accordingly. During the six months ended June 27, 2004, the Company determined that the carrying value of a vacant restaurant land parcel and the carrying value of one restaurant property exceeded their estimated fair values less cost to sell. The carrying values were reduced by an aggregate of \$91,000.

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

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

### 5. SEGMENT REPORTING

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

The Company's restaurants target families with kids and adults who desire a reasonably-priced meal in a full-service setting. The Company's menu offers a broad selection of freshly-prepared foods which appeal to customers throughout all dayparts. The menu currently features over 100 items comprised of a broad selection of breakfast, lunch, dinner and afternoon and evening snack items. Foodservice operations manufactures premium ice cream dessert products and distributes such manufactured products and purchased finished goods to the Company's restaurants and franchised operations. Additionally, it sells premium ice cream dessert products to distributors and retail and institutional locations. The Company's franchise segment includes a royalty based on franchise restaurant revenue. In addition, the Company receives rental income from various franchised restaurants. The Company does not allocate general and administrative expenses associated with its headquarters operations to any business segment. These costs include expenses of legal, accounting, information systems and other headquarter functions.

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The accounting policies of the operating segments are the same as those described in the summary of significant accounting policies except that the financial results for the foodservice operating segment, prior to inter-segment eliminations, have been prepared using a management approach, which is consistent with the basis and manner in which the Company's management internally reviews financial information for the purpose of assisting in making internal operating decisions. Using this approach, the Company evaluates performance based on stand-alone operating segment income (loss) before income taxes and generally accounts for inter-segment sales and transfers as if the sales or transfers were to third parties, that is, at current market prices.

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

	For the Three Months Ended		For the Six Months Ended	
	July 3, 2005	June 27, 2004	July 3, 2005	June 27, 2004
	(in thousands)		(in thousands)	
<b>Revenues:</b>				
Restaurant	\$ 112,799	\$ 114,441	\$ 208,891	\$ 218,794
Foodservice	65,220	63,915	119,384	117,277
Franchise	3,876	3,255	7,126	6,313
<b>Total</b>	<b>\$ 181,895</b>	<b>\$ 181,611</b>	<b>\$ 335,401</b>	<b>\$ 342,384</b>
<b>Intersegment revenues:</b>				
Restaurant	\$	\$	\$	\$
Foodservice	(33,472)	(34,095)	(62,330)	(64,114)
Franchise				
<b>Total</b>	<b>\$ (33,472)</b>	<b>\$ (34,095)</b>	<b>\$ (62,330)</b>	<b>\$ (64,114)</b>
<b>External revenues:</b>				
Restaurant	\$ 112,799	\$ 114,441	\$ 208,891	\$ 218,794
Foodservice	31,748	29,820	57,054	53,163
Franchise	3,876	3,255	7,126	6,313
<b>Total</b>	<b>\$ 148,423</b>	<b>\$ 147,516</b>	<b>\$ 273,071</b>	<b>\$ 278,270</b>

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	For the Three Months Ended		For the Six Months Ended	
	July 3, 2005	June 27, 2004 (Restated)	July 3, 2005	June 27, 2004 (Restated)
	(in thousands)		(in thousands)	
<b>EBITDA:</b>				
Restaurant	\$ 12,303	\$ 11,336	\$ 19,072	\$ 20,590
Foodservice	4,234	2,870	6,382	6,403
Franchise	2,845	2,311	5,112	4,402
Corporate	(5,376)	(4,714)	(10,163)	(10,127)
Gain (loss) on property and equipment, net	910	(379)	2,142	295
Restructuring expenses				(2,627)
Gain on litigation settlement				3,644
Net Periodic pension expense (benefit) included in reporting segments	199	(507)	143	(1,058)
<b>Total</b>	<b>\$ 15,115</b>	<b>\$ 10,917</b>	<b>\$ 22,688</b>	<b>\$ 21,522</b>
Interest expense, net-Corporate	\$ 5,233	\$ 5,368	\$ 10,531	\$ 11,432
Other (income) expense, principally debt retirement costs	\$ (4)	\$ 2,343	\$ (16)	\$ 9,235
<b>Depreciation and amortization:</b>				
Restaurant	\$ 4,168	\$ 3,959	\$ 8,812	\$ 7,925
Foodservice	804	837	1,627	1,688
Franchise	40	68	79	116
Corporate	797	818	1,615	1,670
<b>Total</b>	<b>\$ 5,809</b>	<b>\$ 5,682</b>	<b>\$ 12,133</b>	<b>\$ 11,399</b>
<b>Other non-cash expense (income):</b>				
Net periodic pension expense (benefit)	\$ 199	\$ (507)	\$ 143	\$ (1,058)
Write-downs of property and equipment	289	91	289	91
<b>Total</b>	<b>\$ 488</b>	<b>\$ (416)</b>	<b>\$ 432</b>	<b>\$ (967)</b>
<b>Income (loss) before (provision for) benefit from income taxes:</b>				
Restaurant	\$ 8,135	\$ 7,377	\$ 10,260	\$ 12,665
Foodservice	3,430	2,033	4,755	4,715
Franchise	2,805	2,243	5,033	4,286
Corporate	(11,402)	(13,243)	(22,293)	(32,464)
Gain (loss) on property and equipment, net	621	(470)	1,853	204
Restructuring expenses				(2,627)
Gain on litigation settlement				3,644
<b>Total</b>	<b>\$ 3,589</b>	<b>\$ (2,060)</b>	<b>\$ (392)</b>	<b>\$ (9,577)</b>

	<b>For the Six Months Ended July 3, 2005</b>	<b>For the Year Ended January 2, 2005</b>
	(in thousands)	
Capital expenditures, including assets acquired under capital leases:		
Restaurant	\$ 6,222	\$ 20,309
Foodservice	784	1,700
Corporate	303	1,170
<b>Total</b>	<b>\$ 7,309</b>	<b>\$ 23,179</b>

	<b>July 3, 2005</b>	<b>January 2, 2005</b>
	(in thousands)	
Total assets:		
Restaurant	\$ 140,483	\$ 142,366
Foodservice	43,914	40,567
Franchise	7,545	7,726
Corporate	57,090	58,225
<b>Total</b>	<b>\$ 249,032</b>	<b>\$ 248,884</b>

**6. 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):

	Restructuring Reserves as of January 2, 2005	For the Six Months Ended July 3, 2005		Restructuring Reserves as of July 3, 2005
		Expense	Costs Paid	
Rent	\$ 92	\$	\$ (36)	\$ 56
Severance pay	952		(598)	354
Other	34		(34)	
Total	\$ 1,078	\$	\$ (668)	\$ 410

	Restructuring Reserves as of December 28, 2003	For the Six Months Ended June 27, 2004		Restructuring Reserves as of June 27, 2004
		Expense	Costs Paid	
Rent	\$ 319	\$	\$ (119)	\$ 200
Utilities and real estate taxes	40		(13)	27
Severance pay		2,549	(762)	1,787
Outplacement services		78	(78)	
Other	82		(41)	41
Total	\$ 441	\$ 2,627	\$ (1,013)	\$ 2,055

Based on information currently available, management believes that the restructuring reserves as of July 3, 2005 were adequate and not excessive.

**7. 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 July 3, 2005 and January 2, 2005 and for the three and six months ended July 3, 2005 and June 27, 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 July 3, 2005

(In thousands)

	Parent Company	Guarantor Subsidiary	Non- guarantor Subsidiaries	Eliminations	Consolidated
<b>Assets</b>					
<b>Current assets:</b>					
Cash and cash equivalents	\$ 11,954	\$ 1,389	\$ 2,042	\$	\$ 15,385
Restricted cash			1,306		1,306
Accounts receivable, net	12,389	2,292			14,681
Inventories	16,276				16,276
Deferred income taxes	6,705	18		130	6,853
Prepaid expenses and other current assets	11,439	1,412	7,782	(14,555)	6,078
Total current assets	58,763	5,111	11,130	(14,425)	60,579
Deferred income taxes	10,482	366		(130)	10,718
Property and equipment, net	106,524		44,514		151,038
Intangibles and deferred costs, net	17,416		2,173		19,589
Investments in subsidiaries	(1,537)			1,537	
Other assets	6,193	2,962	915	(2,962)	7,108
<b>Total assets</b>	<b>\$ 197,841</b>	<b>\$ 8,439</b>	<b>\$ 58,732</b>	<b>\$ (15,980)</b>	<b>\$ 249,032</b>
<b>Liabilities and Stockholders (Deficit) Equity</b>					
<b>Current liabilities:</b>					
Current maturities of long-term obligations	\$ 9,260	\$	\$ 1,175	\$ (7,776)	\$ 2,659
Accounts payable	24,000				24,000
Accrued expenses	40,540	3,897	5,414	(6,441)	43,410
Total current liabilities	73,800	3,897	6,589	(14,217)	70,069
Long-term obligations, less current maturities	181,666		50,087		231,753
Other long-term liabilities	47,474	1,016	7,119	(3,300)	52,309
Stockholders (deficit) equity	(105,099)	3,526	(5,063)	1,537	(105,099)
<b>Total liabilities and stockholders (deficit) equity</b>	<b>\$ 197,841</b>	<b>\$ 8,439</b>	<b>\$ 58,732</b>	<b>\$ (15,980)</b>	<b>\$ 249,032</b>

## Supplemental Condensed Consolidating Statement of Operations

For the Three Months Ended July 3, 2005

(In thousands)

	Parent Company	Guarantor Subsidiary	Non- guarantor Subsidiaries	Eliminations	Consolidated
Revenues	\$ 145,409	\$ 3,014	\$	\$	\$ 148,423
Costs and expenses:					
Cost of sales	55,502				55,502
Labor and benefits	39,903				39,903
Operating expenses and write-downs of property and equipment	30,543		(1,759)		28,784
General and administrative expenses	9,374	1,154			10,528
Depreciation and amortization	5,252		557		5,809
Gain on franchise sales of restaurant operations and properties	(1,219)				(1,219)
Loss on disposals of other property and equipment, net	298				298
Interest expense, net	4,107		1,126		5,233
Other income	(4)				(4)
Income before provision for income taxes and equity in net income of consolidated subsidiaries	1,653	1,860	76		3,589
Provision for income taxes	(254)	(762)	(56)		(1,072)
Income before equity in net income of consolidated subsidiaries	1,399	1,098	20		2,517
Equity in net income of consolidated subsidiaries	1,118			(1,118)	
Net income	\$ 2,517	\$ 1,098	\$ 20	\$ (1,118)	\$ 2,517

## Supplemental Condensed Consolidating Statement of Operations

For the Six Months Ended July 3, 2005

(In thousands)

	Parent Company	Guarantor Subsidiary	Non- guarantor Subsidiaries	Eliminations	Consolidated
Revenues	\$ 267,585	\$ 5,486	\$	\$	\$ 273,071
Costs and expenses:					
Cost of sales	103,257				103,257
Labor and benefits	76,436				76,436
Operating expenses and write-downs of property and equipment	56,803		(3,498)		53,305
General and administrative expenses	17,667	2,310			19,977
Depreciation and amortization	11,018		1,115		12,133
Gain on franchise sales of restaurant operations and properties	(2,528)				(2,528)
Loss on disposals of other property and equipment, net	368				368
Interest expense, net	8,286		2,245		10,531
Other income	(16)				(16)
(Loss) income before benefit from (provision for) income taxes and equity in net income of consolidated subsidiaries	(3,706)	3,176	138		(392)
Benefit from (provision for) income taxes	1,332	(1,302)	(107)		(77)
(Loss) income before equity in net income of consolidated subsidiaries	(2,374)	1,874	31		(469)
Equity in net income of consolidated subsidiaries	1,905			(1,905)	
Net (loss) income	\$ (469)	\$ 1,874	\$ 31	\$ (1,905)	\$ (469)

## Supplemental Condensed Consolidating Statement of Cash Flows

For the Six Months Ended July 3, 2005

(In thousands)

	Parent Company	Guarantor Subsidiary	Non- guarantor Subsidiaries	Eliminations	Consolidated
Net cash provided by operating activities	\$ 10,354	\$ 29	\$ 1,312	\$ (405)	\$ 11,290
Cash flows from investing activities:					
Purchases of property and equipment	(7,309)				(7,309)
Proceeds from sales of property and equipment	3,359				3,359
Purchases of marketable securities	(345)				(345)
Proceeds from sales of marketable securities	143				143
Return of investment in subsidiary	324			(324)	
Net cash used in investing activities	(3,828)			(324)	(4,152)
Cash flows from financing activities:					
Proceeds from borrowings under revolving credit facility	16,250				16,250
Repayments of obligations	(21,014)		(713)		(21,727)
Payments of deferred financing costs	(11)				(11)
Stock options exercised	330				330
Reinsurance deposits received			114	(114)	
Reinsurance payments made from deposits			(519)	519	
Dividends paid			(324)	324	
Net cash used in financing activities	(4,445)		(1,442)	729	(5,158)
Net increase (decrease) in cash and cash equivalents	2,081	29	(130)		1,980
Cash and cash equivalents, beginning of period	9,873	1,360	2,172		13,405
Cash and cash equivalents, end of period	\$ 11,954	\$ 1,389	\$ 2,042	\$	\$ 15,385
Supplemental disclosures:					
Interest paid	\$ 7,790	\$	\$ 2,485	\$	\$ 10,275
Income taxes (refunded) paid	(2,607)	2,552	105		50

## Supplemental Condensed Consolidating Balance Sheet

As of January 2, 2005

(In thousands)

	Parent Company	Guarantor Subsidiary	Non- guarantor Subsidiaries	Eliminations	Consolidated
<b>Assets</b>					
<b>Current assets:</b>					
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	10,991	2,512	7,782	(16,903)	4,382
Total current assets	53,662	5,790	11,665	(16,773)	54,344
Deferred income taxes	10,383	366		(130)	10,619
Property and equipment, net	110,887		45,525		156,412
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
<b>Total assets</b>	<b>\$ 196,132</b>	<b>\$ 7,372</b>	<b>\$ 60,381</b>	<b>\$ (15,001)</b>	<b>\$ 248,884</b>
<b>Liabilities and Stockholders (Deficit) Equity</b>					
<b>Current liabilities:</b>					
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)
<b>Total liabilities and stockholders (deficit) equity</b>	<b>\$ 196,132</b>	<b>\$ 7,372</b>	<b>\$ 60,381</b>	<b>\$ (15,001)</b>	<b>\$ 248,884</b>

## Supplemental Condensed Consolidating Statement of Operations

For the Three Months Ended June 27, 2004

(Restated)

(In thousands)

	Parent Company	Guarantor Subsidiary	Non- guarantor Subsidiaries	Eliminations	Consolidated
Revenues	\$ 144,863	\$ 2,653	\$	\$	\$ 147,516
Costs and expenses:					
Cost of sales	55,959				55,959
Labor and benefits	42,155				42,155
Operating expenses and write-downs of property and equipment	29,721		(1,736)		27,985
General and administrative expenses	8,599	1,155			9,754
Depreciation and amortization	5,118		564		5,682
Gain on franchise sales of restaurant operations and properties	(7)				(7)
Loss on disposals of other property and equipment, net	337				337
Interest expense, net	4,244		1,124		5,368
Other expenses, principally debt retirement costs	2,343				2,343
(Loss) income before benefit from (provision for) income taxes and equity in net income of consolidated subsidiaries	(3,606)	1,498	48		(2,060)
Benefit from (provision for) income taxes	1,302	(614)	(48)		640
(Loss) income before equity in net income of consolidated subsidiaries	(2,304)	884			(1,420)
Equity in net income of consolidated subsidiaries	884			(884)	
Net (loss) income	\$ (1,420)	\$ 884	\$	\$ (884)	\$ (1,420)

## Supplemental Condensed Consolidating Statement of Operations

For the Six Months Ended June 27, 2004

(Restated)

(In thousands)

	Parent Company	Guarantor Subsidiary	Non- guarantor Subsidiaries	Eliminations	Consolidated
Revenues	\$ 273,053	\$ 5,217	\$	\$	\$ 278,270
Costs and expenses:					
Cost of sales	101,547				101,547
Labor and benefits	82,089				82,089
Operating expenses and write-downs of property and equipment	56,588		(3,472)		53,116
General and administrative expenses	18,141	2,310			20,451
Restructuring expenses	2,627				2,627
Gain on litigation settlement	(3,644)				(3,644)
Depreciation and amortization	10,272		1,127		11,399
Gain on franchise sales of restaurant operations and properties	(913)				(913)
Loss on disposals of other property and equipment, net	505		3		508
Interest expense, net	9,177		2,255		11,432
Other expenses, principally debt retirement costs	9,235				9,235
(Loss) income before benefit from (provision for) income taxes and equity in net income of consolidated subsidiaries	(12,571)	2,907	87		(9,577)
Benefit from (provision for) income taxes	4,204	(1,192)	(97)		2,915
(Loss) income before equity in net income of consolidated subsidiaries	(8,367)	1,715	(10)		(6,662)
Equity in net income of consolidated subsidiaries	1,705			(1,705)	
Net (loss) income	\$ (6,662)	\$ 1,715	\$ (10)	\$ (1,705)	\$ (6,662)

## Supplemental Condensed Consolidating Statement of Cash Flows

For the Six Months Ended June 27, 2004

(In thousands)

	Parent Company	Guarantor Subsidiary	Non- guarantor Subsidiaries	Eliminations	Consolidated
Net cash (used in) provided by operating activities	\$ (92)	\$ (765)	\$ 604	\$ 490	\$ 237
Cash flows from investing activities:					
Purchases of property and equipment	(8,262)				(8,262)
Proceeds from sales of property and equipment	3,378				3,378
Purchases of marketable securities	(905)				(905)
Proceeds from sales of marketable securities	89				89
Return of investment in subsidiary	367			(367)	
Net cash used in investing activities	(5,333)			(367)	(5,700)
Cash flows from financing activities:					
Proceeds from issuance of New Senior Notes	175,000				175,000
Proceeds from borrowings under revolving credit facility	11,000				11,000
Repayments of obligations	(187,531)		(550)		(188,081)
Payments of deferred financing costs	(6,625)				(6,625)
Stock options exercised	749				749
Reinsurance deposits received			1,131	(1,131)	
Reinsurance payments made from deposits			(641)	641	
Dividends paid			(367)	367	
Net cash used in financing activities	(7,407)		(427)	(123)	(7,957)
Net (decrease) increase in cash and cash equivalents	(12,832)	(765)	177		(13,420)
Cash and cash equivalents, beginning of period	21,640	2,173	1,818		25,631
Cash and cash equivalents, end of period	\$ 8,808	\$ 1,408	\$ 1,995	\$	\$ 12,211
Supplemental disclosures:					
Interest paid	\$ 9,702	\$	\$ 2,273	\$	\$ 11,975
Income taxes (refunded) paid	(1,591)	1,508	99		16
Capital lease obligations incurred	2,280				2,280



**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, reimaginings 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 July 3, 2005, Friendly's operated 332 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 Six Months Ended	
	July 3, 2005	June 27, 2004	July 3, 2005	June 27, 2004
<b>Company Units:</b>				
Beginning of period	337	362	347	380
Openings	1		1	
Refranchised closings	(3)	(1)	(10)	(18)
Closings	(3)	(1)	(6)	(2)
End of period	332	360	332	360
<b>Franchised Units:</b>				
Beginning of period	201	182	195	163
Refranchised openings	3	1	10	18
Openings	1	3	2	5
Closings			(2)	
End of period	205	186	205	186

*Three months ended July 3, 2005 compared with three months ended June 27, 2004*

*Revenues:*

*Total Revenues* - Total revenues increased \$0.9 million, or 0.6%, to \$148.4 million for the three months ended July 3, 2005 from \$147.5 million for the same period in 2004.

*Restaurant Revenues* - Restaurant revenues decreased \$1.6 million, or 1.4%, to \$112.8 million for the three months ended July 3, 2005 from \$114.4 million for the same period in 2004. Comparable Company-operated restaurant revenues increased 3.4%, from the 2004 quarter to the 2005 quarter. Five and seven locations were re-imaged during the three months ended July 3, 2005 and June 27, 2004, respectively. The closing of 15 locations and the re-franchising of 20 locations over the past 15 months resulted in declines of \$2.1 million and \$5.1 million, respectively, in restaurant revenues in the second quarter of 2005 as compared to the same period in 2004. These declines were partially offset by increased revenues of \$1.6 million in the second 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 was one new restaurant opened during the second quarter of 2005.

*Foodservice Revenues* - Foodservice (product sales to franchisees and retail customers) revenues increased \$1.9 million, or 6.5% to \$31.7 million for the three months ended July 3, 2005 from \$29.8 million for the three months ended June 27, 2004. This increase was primarily due to a \$1.9 million increase in franchised restaurant product revenue resulting from the increased number of franchised restaurants in the second quarter of 2005 compared to the same period in 2004. Sales to foodservice retail supermarket customers and case volume in the Company's retail supermarket

business increased 0.3% and 3.3%, respectively, for the three months ended July 3, 2005 when compared to the three months ended June 27, 2004. Case volume increased primarily as a result of higher volume of individual sundae cups and the introduction of decorative cakes.

*Franchise Revenues* - Franchise royalty and fee revenues increased \$0.6 million, or 19.0%, to \$3.9 million for the three months ended July 3, 2005 compared to \$3.3 million for the same period in 2004.

Royalties on franchised sales increased \$0.4 million for the three months ended July 3, 2005 as compared to the same period in 2004. Comparable franchised revenues grew 5.4% from the three months ended June 27, 2004 to the three months ended July 3, 2005. The opening of eight new franchise restaurants and 20 re-franchised restaurants during the last 15 months increased royalty revenues by \$0.2 million while the closing of five under-performing locations during the same period had little impact.

Initial franchise fees remained relatively unchanged during the three months ended July 3, 2005 when compared to the same period in 2004. For the three months ended June 27, 2004, one Company-operated location was refranchised and two new restaurants and one cafe were opened compared to the three months ended July 3, 2005 in which three Company-operated locations were refranchised and two new locations were opened.

Additionally, an increase in rental income for leased and subleased franchise locations of \$0.2 million due primarily to an increased number of leased and subleased franchised locations contributed to the higher revenues for the three months ended July 3, 2005 compared to the same period in 2004. There were 205 and 186 franchise units open at July 3, 2005 and June 27, 2004, respectively.

*Cost of sales:*

Cost of sales decreased \$0.5 million, or 0.8%, to \$55.5 million for the three months ended July 3, 2005 from \$56.0 million for the same period in 2004. Cost of sales as a percentage of total revenues was 37.4% and 37.9% for the three months ended July 3, 2005 and June 27, 2004, respectively. Lower cream prices during the current quarter when compared to the same quarter in 2004 was the primary reason for the reduction in the percentage of cost of sales to total revenues. A decline in market losses realized due to unfavorable positions on commodity option contracts also reduced cost of sales as a percentage of total revenues, as market losses of \$0.2 million were realized in the 2004 period and insignificant market losses were realized in the current period. 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.

The growth in franchise revenues reduced cost of sales as a percentage of total revenues by 0.2% for the three months ended July 3, 2005 when compared to the 2004 period because franchise revenues have only limited costs associated with such revenues. The \$0.5 million decrease in cost of sales for the three months ended July 3, 2005 compared to the same period in 2004 was partially offset by a shift in sales mix from Company-operated restaurant sales to foodservice sales, which added to the increase in cost. Foodservice sales to franchisees and retail supermarket customers (21.4% and 20.2% of total revenues for the three months ended July 3, 2005 and June 27, 2004, respectively) have a higher cost as a percentage of revenue than sales in Company-operated restaurants to restaurant patrons. Foodservice retail sales promotional allowances, recorded as offsets to revenues, increased by 0.8% in the 2005 quarter as a percentage of sales to foodservice retail supermarket customers when compared to the 2004 quarter as a result of a more competitive climate in the northeast. This increase also had an unfavorable impact on the overall cost of sales as a percentage of total revenues.



Restaurant cost of sales as a percentage of restaurant revenues decreased to 26.6% in the second quarter of 2005 from 27.3% in the second 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.

For the remainder of 2005, the Company expects that cream prices will be lower than the prices experienced in 2004. 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 \$2.3 million, or 5.3%, to \$39.9 million for the three months ended July 3, 2005 from \$42.2 million for the three months ended June 27, 2004. Labor and benefits as a percentage of total revenues decreased to 26.9% in the 2005 quarter from 28.6% in the 2004 quarter. As a percentage of restaurant revenues, labor and benefits decreased to 35.4% in the 2005 quarter from 36.8% in the 2004 quarter. The decrease in labor and benefits was primarily due to the 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. Revenue increases derived from franchised locations, which do not have any associated restaurant labor and benefits, also contributed to the lower labor and benefits as a percentage of total revenues. Partially offsetting these benefits were increases in pension expense, unemployment taxes and workers compensation insurance costs in the 2005 period when compared to the 2004 period.

*Operating expenses:*

Operating expenses increased \$0.6 million, or 2.2%, to \$28.5 million for the three months ended July 3, 2005 from \$27.9 million for the three months ended June 27, 2004. Operating expenses as a percentage of total revenues were 19.2% and 18.9% in the 2005 and 2004 periods, respectively. The increase resulted from higher restaurant costs for maintenance, occupancy and supplies in the 2005 period when compared to the 2004 period. An increase in rent expense for leased and subleased franchise locations of \$0.3 million also contributed to the higher operating expenses in the 2005 period when compared to the 2004 period. Total advertising costs as a percentage of total revenues were lower in the 2005 period when compared to the same period in 2004.

*General and administrative expenses:*

General and administrative expenses were \$10.5 million and \$9.8 million for the three months ended July 3, 2005 and June 27, 2004, respectively. General and administrative expenses as a percentage of total revenues increased to 7.1% in the 2005 period from 6.6% in the 2004 period. The increase is primarily the result of increases in headquarter and field supervisor bonus expense, severance costs and professional fees. This increase was partially offset by lower costs for recruitment and restaurant mystery shopping service.

*Write-downs of property and equipment:*

Write-downs of property and equipment were \$0.3 million and \$0.1 million in the three months ended July 3, 2005 and June 27, 2004, respectively. During the three months ended July 3, 2005, the Company identified two restaurant properties to be disposed of other than by sale and determined that the carrying value 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 three months ended June 27, 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 \$5.8 million and \$5.7 million for the three months ended July 3, 2005 and June 27, 2004, respectively. Depreciation and amortization as a percentage of total revenues was 3.9% in the 2005 and 2004 quarters.

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

Gain on franchise sales of restaurant operations and properties was \$1.2 million in the three months ended July 3, 2005 associated with the sale of certain equipment assets, lease and sublease rights and franchise rights in three existing Friendly s restaurants.

*Loss on disposals of other property and equipment, net:*

The loss on disposals of other property and equipment, net, was \$0.3 for the three months ended July 3, 2005 and June 27, 2004. The table below identifies the components of the 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>July 3, 2005</b>	<b>June 27, 2004</b>
Restaurant equipment assets retired due to remodeling	\$ 220	\$ 173
Restaurant equipment assets retired due to replacement	43	87
Loss on property not held for disposition	26	