

FRIENDLY ICE CREAM CORP  
Form 10-K/A  
March 08, 2005

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## SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

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### FORM 10-K/A (Amendment No. 1)

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

For the fiscal year ended January 2, 2005

OR

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_  
Commission File No. 001-13579

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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.)

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

01095  
(Zip Code)

(413) 543-2400

(Registrant's Telephone Number, Including Area Code)

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Securities registered pursuant to Section 12(b) of the Act: None

Securities registered pursuant to Section 12(g) of the Act:

Title of class

Common Stock, \$.01 par value  
Rights to Purchase Series A Junior  
Preferred Stock, \$.01 par value

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes ý No o

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Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

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

The aggregate market value of the registrant's common stock held by nonaffiliates of the registrant on June 25, 2004, based upon the closing sales price of the common stock on the American Stock Exchange, was \$88,571,000. For purpose of the foregoing calculation only, all members of the Board of Directors and executive officers of the registrant have been deemed affiliates. The number of shares of common stock outstanding was 7,713,279 as of January 31, 2005.

### **Documents Incorporated By Reference:**

Part III of this Form 10-K incorporates information by reference from the registrant's definitive proxy statement which will be filed no later than 120 days after January 2, 2005.

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**Introductory Note:**

This Amendment No. 1 to Form 10-K for the year ended January 2, 2005 ("Form 10-K/A") has been filed by Friendly Ice Cream Corporation (the "Company") to include the following sentence which was unintentionally omitted in the fourth paragraph of the Report of Independent Registered Public Accounting Firm: "As discussed in Note 4 to the accompanying financial statements, the Company has restated its financial statements for the years ended December 28, 2003 and December 29, 2002." This Form 10-K/A does not amend, modify or update any other information.

**SIGNATURES**

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

FRIENDLY ICE CREAM CORPORATION

By: /s/ PAUL V. HOAGLAND

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Name: Paul V. Hoagland

Title: *Executive Vice President of Administration and Chief  
Financial Officer*

Date: March 8, 2005

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**FRIENDLY ICE CREAM CORPORATION AND SUBSIDIARIES**

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**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

The Board of Directors and Stockholders of Friendly Ice Cream Corporation

We have audited the accompanying consolidated balance sheets of Friendly Ice Cream Corporation and subsidiaries as of January 2, 2005 and December 28, 2003 and the related consolidated statements of operations, stockholders' deficit and cash flows for each of the three years in the period ended January 2, 2005. Our audits also included the financial statement schedule listed in the Index at Item 15(a). These financial statements and schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and schedule based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Friendly Ice Cream Corporation and subsidiaries at January 2, 2005 and December 28, 2003, and the consolidated results of their operations and their cash flows for each of the three years in the period ended January 2, 2005, in conformity with U.S. generally accepted accounting principles. Also, in our opinion, the related financial statement schedule, when considered in relation to the basic financial statements taken as a whole, presents fairly in all material respects the information set forth therein.

As discussed in Note 4 to the accompanying financial statements, the Company has restated its financial statements for the years ended December 28, 2003 and December 29, 2002.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of Friendly Ice Cream Corporation and subsidiaries internal control over financial reporting as of January 2 2005, based on criteria established in Internal Control Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated March 2, 2005 expressed an adverse opinion thereon.

/s/ ERNST & YOUNG LLP

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ERNST & YOUNG LLP

Boston, Massachusetts  
March 2, 2005

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## FRIENDLY ICE CREAM CORPORATION AND SUBSIDIARIES

## CONSOLIDATED BALANCE SHEETS

(In thousands, except share and per share data)

	January 2, 2005	December 28, 2003
	<u>          </u>	<u>          </u>
		(restated)
<b>ASSETS</b>		
<b>CURRENT ASSETS:</b>		
Cash and cash equivalents	\$ 13,405	\$ 25,631
Restricted cash	1,711	1,671
Accounts receivable, net	10,448	10,384
Inventories	17,545	15,669
Deferred income taxes	6,853	7,160
Prepaid expenses and other current assets	4,382	1,539
	<u>          </u>	<u>          </u>
<b>TOTAL CURRENT ASSETS</b>	<b>54,344</b>	<b>62,054</b>
<b>DEFERRED INCOME TAXES</b>	<b>10,619</b>	<b>1,761</b>
<b>PROPERTY AND EQUIPMENT, net of accumulated depreciation and amortization</b>	<b>156,412</b>	<b>159,671</b>
<b>INTANGIBLE ASSETS AND DEFERRED COSTS, net of accumulated amortization of \$9,389 and \$12,122 at January 2, 2005 and December 28, 2003, respectively</b>	<b>20,510</b>	<b>17,890</b>
<b>OTHER ASSETS</b>	<b>6,999</b>	<b>5,912</b>
	<u>          </u>	<u>          </u>
<b>TOTAL ASSETS</b>	<b>\$ 248,884</b>	<b>\$ 247,288</b>
	<u>          </u>	<u>          </u>
<b>LIABILITIES AND STOCKHOLDERS' DEFICIT</b>		
<b>CURRENT LIABILITIES:</b>		
Current maturities of long-term debt	\$ 5,224	\$ 1,127
Current maturities of capital lease and finance obligations	1,533	911
Accounts payable	21,536	22,475
Accrued salaries and benefits	8,740	9,635
Accrued interest payable	1,427	2,033
Insurance reserves	9,927	10,041
Restructuring reserves	1,078	441
Other accrued expenses	18,582	20,306
	<u>          </u>	<u>          </u>
<b>TOTAL CURRENT LIABILITIES</b>	<b>68,047</b>	<b>66,969</b>
	<u>          </u>	<u>          </u>
<b>CAPITAL LEASE AND FINANCE OBLIGATIONS, less current maturities</b>	<b>7,380</b>	<b>5,773</b>
<b>LONG-TERM DEBT, less current maturities</b>	<b>225,752</b>	<b>227,937</b>
<b>ACCRUED PENSION COST</b>	<b>17,532</b>	<b>16,127</b>
<b>OTHER LONG-TERM LIABILITIES</b>	<b>35,199</b>	<b>33,634</b>
<b>COMMITMENTS AND CONTINGENCIES</b>		
<b>STOCKHOLDERS' DEFICIT:</b>		
Common stock, par value \$.01 per share; authorized 50,000,000 shares 7,713,279 and 7,489,478 shares issued and outstanding at January 2, 2005 and December 28, 2003, respectively	77	75
Preferred stock, par value \$.01 per share; authorized 1,000,000 shares; no shares issued and outstanding		
Additional paid-in capital	143,115	140,826
Accumulated other comprehensive loss	(20,670)	(19,922)
Accumulated deficit	(227,548)	(224,131)

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	January 2, 2005	December 28, 2003
	<u>                    </u>	<u>                    </u>
	<u>                    </u>	<u>                    </u>
TOTAL STOCKHOLDERS' DEFICIT	(105,026)	(103,152)
	<u>                    </u>	<u>                    </u>
TOTAL LIABILITIES AND STOCKHOLDERS' DEFICIT	\$ 248,884	\$ 247,288
	<u>                    </u>	<u>                    </u>

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

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## FRIENDLY ICE CREAM CORPORATION AND SUBSIDIARIES

## CONSOLIDATED STATEMENTS OF OPERATIONS

(In thousands, except per share data)

	For the Years Ended		
	January 2, 2005	December 28, 2003	December 29, 2002
	(53 weeks)	(Restated)	(Restated)
<b>REVENUES:</b>			
Restaurant	\$ 448,661	\$ 459,758	\$ 454,569
Foodservice	112,637	110,190	106,331
Franchise	13,199	9,822	9,472
<b>TOTAL REVENUES</b>	<b>574,497</b>	<b>579,770</b>	<b>570,372</b>
<b>COSTS AND EXPENSES:</b>			
Cost of sales	215,264	207,071	202,418
Labor and benefits	165,675	166,982	161,647
Operating expenses	109,549	108,632	109,095
General and administrative expenses	40,006	41,657	39,462
Pension settlement expense (curtailment gain) (Note 12)	2,204	(8,113)	
Restructuring expenses (reversal of restructuring expenses), net (Note 10)	2,627		(400)
Gain on litigation settlement (Note 20)	(3,644)		
Write-downs of property and equipment (Note 6)	91	26	976
Depreciation and amortization	23,231	23,387	25,148
Gain on franchise sales of restaurant operations and properties	(1,302)		(675)
Loss on disposals of other property and equipment, net	213	2,044	578
<b>OPERATING INCOME</b>	<b>20,583</b>	<b>38,084</b>	<b>32,123</b>
<b>OTHER EXPENSES:</b>			
Interest expense, net of capitalized interest of \$61, \$144 and \$0 and interest income of \$702, \$838 and \$808 for the years ended January 2, 2005, December 28, 2003 and December 29, 2002, respectively	22,295	24,157	24,870
Other expenses, principally debt retirement costs	9,235		
<b>(LOSS) INCOME BEFORE BENEFIT FROM (PROVISION FOR) INCOME TAXES</b>	<b>(10,947)</b>	<b>13,927</b>	<b>7,253</b>
Benefit from (provision for) income taxes	7,530	(4,424)	(1,593)
<b>NET (LOSS) INCOME</b>	<b>\$ (3,417)</b>	<b>\$ 9,503</b>	<b>\$ 5,660</b>
<b>BASIC NET (LOSS) INCOME PER SHARE</b>	<b>\$ (0.45)</b>	<b>\$ 1.28</b>	<b>\$ 0.77</b>
<b>DILUTED NET (LOSS) INCOME PER SHARE</b>	<b>\$ (0.45)</b>	<b>\$ 1.25</b>	<b>\$ 0.75</b>
<b>WEIGHTED AVERAGE SHARES:</b>			
Basic	7,637	7,447	7,372
Diluted	7,637	7,609	7,551

For the Years Ended

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

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## FRIENDLY ICE CREAM CORPORATION AND SUBSIDIARIES

## CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' DEFICIT

(In thousands, except share data)

	Common Stock		Additional Paid-In Capital	Accumulated Other Comprehensive (Loss) Income	Accumulated Deficit	Total
	Shares	Amount				
BALANCE, DECEMBER 30, 2001 (as previously reported)	7,353,435	\$ 74	\$ 139,290	\$	(235,378)	\$ (96,014)
Cumulative effect of restatement on prior years (Note 4)					(3,916)	(3,916)
BALANCE, DECEMBER 30, 2001 (as restated)	7,353,435	74	139,290		(239,294)	(99,930)
Comprehensive (loss) income:						
Net income					5,660	5,660
Minimum pension liability (net of income tax benefit of \$10,117)				(14,559)		(14,559)
Total comprehensive (loss) income				(14,559)	5,660	(8,899)
Shares forfeited in connection with the Restricted Stock Plan	(7,846)					
Stock options exercised	46,552		153			153
Stock compensation expense			531			531
BALANCE, DECEMBER 29, 2002	7,392,141	74	139,974	(14,559)	(233,634)	(108,145)
Comprehensive (loss) income:						
Net income					9,503	9,503
Minimum pension liability (net of income tax benefit of \$3,727)				(5,363)		(5,363)
Total comprehensive (loss) income				(5,363)	9,503	4,140
Shares forfeited in connection with the Restricted Stock Plan	(1,609)					
Stock options exercised	98,946	1	357			358
Income tax benefit of stock options exercised			165			165
Stock compensation expense			330			330
BALANCE, DECEMBER 28, 2003	7,489,478	\$ 75	\$ 140,826	(19,922)	(224,131)	(103,152)
Comprehensive (loss) income:						
Net loss					(3,417)	(3,417)
Minimum pension liability (net of income tax benefit of \$540)				(777)		(777)
				29		29

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Net unrealized gains on marketable securities (net of income tax expense of \$20)	Common Stock		Accumulated Other Comprehensive (Loss) Income			
Total comprehensive loss				(748)	(3,417)	(4,165)
Stock options exercised	223,801	2	976			978
Income tax benefit of stock options exercised			818			818
Stock compensation expense			495			495
<b>BALANCE, JANUARY 2, 2005</b>	<b>7,713,279</b>	<b>\$ 77</b>	<b>\$ 143,115</b>	<b>\$ (20,670)</b>	<b>\$ (227,548)</b>	<b>\$ (105,026)</b>

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

## FRIENDLY ICE CREAM CORPORATION AND SUBSIDIARIES

## CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

	For the Years Ended		
	January 2, 2005  (53 weeks)	December 28, 2003	December 29, 2002
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>			
Net (loss) income	\$ (3,417)	\$ 9,503	\$ 5,660
Adjustments to reconcile net (loss) income to net cash provided by operating activities:			
Stock compensation expense	495	330	531
Depreciation and amortization	23,231	23,387	25,148
Write-offs of deferred financing costs	2,445	44	
Write-downs of property and equipment	91	26	976
Deferred income tax (benefit) expense	(7,383)	4,192	588
(Gain) loss on disposals of property and equipment, net	(1,107)	2,044	(104)
Pension settlement expense (curtailment gain)	2,204	(8,113)	
Changes in operating assets and liabilities:			
Accounts receivable	(64)	469	(884)
Inventories	(1,876)	1,609	(4,291)
Other assets	(3,000)	(76)	(2,693)
Accounts payable	(939)	(1,427)	3,397
Accrued expenses and other long-term liabilities	(3,253)	(6,142)	4,143
<b>NET CASH PROVIDED BY OPERATING ACTIVITIES</b>	<b>7,427</b>	<b>25,846</b>	<b>32,471</b>
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>			
Purchases of property and equipment	(19,734)	(29,791)	(17,877)
Proceeds from sales of property and equipment	6,035	79	6,263
Purchases of marketable securities	(1,130)		
Proceeds from sales of marketable securities	152		
<b>NET CASH USED IN INVESTING ACTIVITIES</b>	<b>(14,677)</b>	<b>(29,712)</b>	<b>(11,614)</b>
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>			
Proceeds from issuance of New Senior Notes	175,000		
Proceeds from other borrowings	26,250		
Repayments of debt	(199,338)	(3,797)	(1,004)
Payments related to deferred financing costs	(6,650)		(80)
Repayments of capital lease and finance obligations	(1,216)	(1,404)	(1,927)
Stock options exercised	978	357	153
<b>NET CASH USED IN FINANCING ACTIVITIES</b>	<b>(4,976)</b>	<b>(4,844)</b>	<b>(2,858)</b>
<b>NET (DECREASE) INCREASE IN CASH AND CASH EQUIVALENTS</b>	<b>(12,226)</b>	<b>(8,710)</b>	<b>17,999</b>
<b>CASH AND CASH EQUIVALENTS, BEGINNING OF YEAR</b>	<b>25,631</b>	<b>34,341</b>	<b>16,342</b>
<b>CASH AND CASH EQUIVALENTS, END OF YEAR</b>	<b>\$ 13,405</b>	<b>\$ 25,631</b>	<b>\$ 34,341</b>

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For the Years Ended

SUPPLEMENTAL DISCLOSURES:

Cash paid during the period for:

Interest	\$	21,953	\$	23,981	\$	23,764
Income taxes		70		1,246		398
Income tax benefit of stock options exercised		818		165		
Capital lease obligations incurred		3,445		1,682		215
Lease incentive equipment received				243		

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

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**FRIENDLY ICE CREAM CORPORATION AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**1. ORGANIZATION**

In September 1988, The Restaurant Company ("TRC") and another investor acquired Friendly Ice Cream Corporation ("FICC"). Subsequent to the acquisition, Friendly Holding Corporation ("FHC") was organized to hold the outstanding common stock of FICC, and in March 1996, FHC was merged into FICC. Additionally, in March 1996, TRC distributed its shares of FICC's voting common stock to TRC's shareholders and FICC deconsolidated from TRC.

In November 1997, FICC completed a public offering of five million shares of its common stock (the "Common Stock Offering") for net proceeds of \$81,900,000 and a public offering of \$200,000,000 of senior notes (the "Senior Notes") (collectively, the "Offerings"). Concurrent with the Offerings, FICC entered into a new senior secured credit facility consisting of (i) \$90,000,000 of term loans, (ii) a \$55,000,000 revolving credit facility and (iii) a \$15,000,000 letter of credit facility (collectively, the "Old Credit Facility"). Proceeds from the Offerings and the Old Credit Facility were primarily used to repay the \$353,700,000 outstanding under FICC's then existing credit facility (collectively, the "Recapitalization").

In December 2001, the Company completed a financial restructuring plan (the "Refinancing Plan") which included the repayment of the \$64,545,000 outstanding on the Old Credit Facility and the repurchase of approximately \$21,273,000 in Senior Notes with the proceeds from \$55,000,000 in long-term mortgage financing (the "Mortgage Financing") and a \$33,700,000 sale and leaseback transaction (the "Sale/Leaseback Financing"). In addition, FICC secured a new \$30,000,000 revolving credit facility (the "New Credit Facility"). In connection with the Mortgage Financing, three new limited liability companies ("LLCs") were organized. Friendly Ice Cream Corporation is the sole member of each LLC. On July 3, 2003, FICC obtained a limited waiver to the New Credit Facility allowing the purchase of certain of the Senior Notes in an amount up to \$3,000,000, subject to certain conditions. In July 2003, FICC purchased \$2,750,000 in aggregate principal amount of the Senior Notes for \$2,826,000, the then current market value.

In February 2004, the Company announced a cash tender offer and consent solicitation for the \$175,977,000 of the remaining outstanding Senior Notes to be financed with the proceeds from a private offering of new senior notes (the "New Senior Notes"), available cash and an amended New Credit Facility (the "2004 Refinancing"). In March 2004, \$127,357,000 of aggregate principal amount of Senior Notes were purchased at the tender offer and consent solicitation price of 104% of the principal amount and \$476,000 of aggregate principal amount of Senior Notes were purchased at the tender offer price of 102% of the principal amount. In April 2004, the remaining \$48,144,000 of Senior Notes were redeemed in accordance with the Senior Notes indenture at 103.5% of the principal amount.

References herein to "Friendly's" or the "Company" refer to Friendly Ice Cream Corporation, its predecessor and its consolidated subsidiaries; references herein to "FICC" refer to Friendly Ice Cream Corporation and not its subsidiaries; and as used herein, "Northeast" refers to the Company's core markets, which include Connecticut, Maine, Massachusetts, New Hampshire, New Jersey, New York, Pennsylvania, Rhode Island and Vermont.

**2. NATURE OF OPERATIONS**

As of January 2, 2005, Friendly's operated 347 full-service restaurants and franchised 188 full-service restaurants and seven non-traditional units. The Company manufactures and distributes a full line of premium ice cream dessert products. These products are distributed to Friendly's restaurants, supermarkets and other retail locations in 13 states. The restaurants offer a wide variety of

breakfast, lunch and dinner menu items as well as premium ice cream dessert products. For the years ended January 2, 2005, December 28, 2003 and December 29, 2002, restaurant sales were approximately 78%, 79% and 80%, respectively, of the Company's total revenues. As of January 2, 2005, December 28, 2003 and December 29, 2002, approximately 96%, 89% and 89%, respectively, of the Company-operated restaurants were located in the Northeast United States.

### 3. SUMMARY OF BASIS OF PRESENTATION AND SIGNIFICANT ACCOUNTING POLICIES

#### *Principles of Consolidation*

The consolidated financial statements include the accounts of FICC and its wholly owned subsidiaries after elimination of intercompany accounts and transactions.

#### *Fiscal Year*

Friendly's fiscal year ends on the last Sunday in December, unless that day is earlier than December 27, in which case the fiscal year ends on the following Sunday. The fiscal year ended January 2, 2005 included 53 weeks. All other years presented included 52 weeks. The additional week in 2004 contributed \$10,689,000 in total revenues.

#### *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.

#### *Revenue Recognition*

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. The Company recognizes restaurant revenue upon receipt of payment from the customer and retail revenue, net of discounts and allowances, upon delivery of product. Reserves for discounts and allowances from retail sales (trade promotions) are estimated and accrued when revenue is recorded based on promotional planners prepared by the Company's retail sales force. Due to the high volume of trade promotion activity and the difficulty of coordinating trade promotion pricing with its customers, differences between the Company's accrual and the subsequent settlement amount occur frequently. Usually these differences are individually insignificant. To address the financial impact of these differences, the Company's estimating methodology takes these smaller differences into account. The Company believes its methodology has been reasonably reliable in recording trade promotion accruals. The accrual for future trade promotion settlements as of January 2, 2005 and December 28, 2003 was \$4,930,000 and \$3,672,000, respectively. A variation of five percent in the 2004 accrual would change retail sales by approximately \$247,000. Franchise royalty income, generally calculated as 4% of net sales of franchisees, is recorded monthly based upon the actual sales reported by each franchisee



for the month just completed. Franchise fees are recorded as revenue upon completion of all significant services, generally upon opening of the restaurant.

*Shipping and Handling Costs*

Costs related to shipping and handling are included in cost of sales in the accompanying consolidated statements of operations for all periods presented.

*Insurance Reserves*

The Company is self-insured through retentions or deductibles for the majority of its workers' compensation, automobile, general liability, employer's liability, product liability and group health insurance programs. Self-insurance amounts vary up to \$500,000 per occurrence. Insurance with third parties, some of which is then reinsured through Restaurant Insurance Corporation ("RIC"), the Company's wholly owned subsidiary, is in place for claims in excess of these self-insured amounts. RIC reinsures 100% of the risk from \$500,000 to \$1,000,000 per occurrence through September 2, 2000 for FICC's workers' compensation, general liability, employer's liability and product liability insurance. Subsequent to September 2, 2000, the Company discontinued its use of RIC as a captive insurer for new claims. FICC's and RIC's liabilities for estimated incurred losses are actuarially determined and recorded in the accompanying consolidated financial statements on an undiscounted basis. Actual incurred losses may vary from the estimated incurred losses and could have a material effect on the Company's insurance expense.

*Accounts Receivable and Allowance for Doubtful Accounts*

At January 2, 2005 and December 28, 2003, accounts receivable of \$10,448,000 and \$10,384,000 were net of allowances for doubtful accounts totaling \$539,000 and \$696,000, respectively. Accounts receivable consists primarily of amounts due from the sale of products to franchisees and supermarkets. Accounts receivable also includes amounts related to franchise royalties, rents and other miscellaneous items.

The Company recognizes allowances for doubtful accounts to ensure receivables are not overstated due to uncollectibility. Bad debt reserves are maintained for customers in the aggregate based on a variety of factors, including the length of time receivables are past due, significant one-time events and historical experience. An additional reserve for individual accounts is recorded when the Company becomes aware of a customer's inability to meet its financial obligations, such as in the case of bankruptcy filings or deterioration in the customer's operating results or financial position. If circumstances change, estimates of the recoverability of receivables would be further adjusted.

*Pension and Post-Retirement Medical and Life Insurance Benefits*

The determination of the Company's obligation and expense for pension and post-retirement medical and life insurance benefits is dependent upon the selection of certain assumptions used by actuaries in calculating such amounts. Those assumptions include, among other things, the discount rate, expected long-term rate of return on plan assets and rates of increase in health care costs. In accordance with accounting principles generally accepted in the United States, actual results that differ from the assumptions are accumulated and amortized over future periods and, therefore, generally

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affect the recognized expense and recorded obligation in such future periods. Significant differences in actual experience or significant changes in the assumptions may materially affect the future pension and post-retirement medical and life insurance obligations and expense.

### *Cash and Cash Equivalents*

The Company considers all investments with an original maturity of three months or less when purchased to be cash equivalents.

### *Restricted Cash*

RIC is required to hold assets in trust whose value is at least equal to certain of RIC's outstanding estimated insurance claim liabilities. Accordingly, as of January 2, 2005 and December 28, 2003, cash of \$1,711,000 and \$1,671,000, respectively, was restricted.

### *Inventories*

Inventories are stated at the lower of first-in, first-out cost or market and consisted of the following at January 2, 2005 and December 28, 2003 (in thousands):

	January 2, 2005	December 28, 2003
Raw materials	\$ 2,685	\$ 1,557
Goods in process	157	114
Finished goods	14,703	13,998
Total	\$ 17,545	\$ 15,669

### *Long-Lived Assets*

In accordance with Statement of Financial Accounting Standards ("SFAS") No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets," which was adopted in 2002, the Company reviews its Non-Friendly Marks, which were assigned to the Company by Hershey in September 2002, for impairment on a quarterly basis. The Company recognizes impairment has occurred when the carrying value of the Non-Friendly Marks exceeds the estimated future undiscounted cash flows of the trademarked products. Additionally, 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.

Store closure costs include costs of disposing of the assets as well as other facility-related expenses from previously closed stores. These store closure costs are expensed as incurred. Additionally, at the

date the closure occurs, the Company records a liability for the amount of any remaining operating lease obligations subsequent to the expected closure date, net of estimated sublease income, if any.

SFAS No. 144 also requires the results of operations of a component entity that is classified as held for sale or that has been disposed of to be reported as discontinued operations in the statement of operations if certain conditions are met. These conditions include commitment to a plan of disposal after the effective date of this statement, elimination of the operations and cash flows of the component entity from the ongoing operations of the company and no significant continuing involvement in the operations of the component entity after the disposal transaction.

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 significantly from estimates.

*Property and Equipment*

Property and equipment are carried at cost. Depreciation of property and equipment is computed using the straight-line method over the following estimated useful lives:

Buildings 30 years

Building improvements and leasehold improvements lesser of lease term or 20 years

Equipment 3 to 10 years

At January 2, 2005 and December 28, 2003, property and equipment included (in thousands):

	January 2, 2005	December 28, 2003
Land	\$ 30,227	\$ 31,189
Buildings and improvements	97,566	94,870
Leasehold improvements	37,716	37,002
Assets under capital leases	14,602	10,769
Equipment	230,275	237,408
Construction in progress	4,177	4,775
Property and equipment	414,563	416,013
Less: accumulated depreciation and amortization	(258,151)	(256,342)
Property and equipment, net	\$ 156,412	\$ 159,671

Depreciation expense was \$21,419,000, \$21,679,000 and \$23,236,000 for the years ended January 2, 2005, December 28, 2003 and December 29, 2002, respectively.

Major renewals and betterments are capitalized. Replacements and maintenance and repairs which do not extend the lives of the assets are charged to operations as incurred.

*Other Assets*

Other assets included notes receivable of \$4,524,000 and \$4,638,000, which were net of allowances for doubtful accounts totaling \$263,000 and \$313,000 as of January 2, 2005 and December 28, 2003, respectively. Also included in other assets as of January 2, 2005 and December 28, 2003 were payments

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made to fronting insurance carriers of \$1,402,000 and \$1,211,000, respectively, to establish loss escrow funds.

### *Other Accrued Expenses*

Other accrued expenses consisted of the following at January 2, 2005 and December 28, 2003 (in thousands):

	<b>January 2, 2005</b>	<b>December 28, 2003</b>
	<u>                    </u>	<u>                    </u>
Gift cards outstanding	\$ 4,068	\$ 3,975
Accrued rent	4,781	3,667
Accrued meals and other taxes	2,766	2,947
Accrued advertising	1,824	1,554
Accrued construction costs	1,236	2,331
Unearned revenues	1,056	894
Accrued bonus	751	2,853
All other	2,100	2,085
	<u>                    </u>	<u>                    </u>
<b>Total</b>	<b>\$ 18,582</b>	<b>\$ 20,306</b>
	<u>                    </u>	<u>                    </u>

### *Income Taxes*

The Company accounts for income taxes in accordance with SFAS No. 109, "Accounting for Income Taxes," which requires recognition of deferred tax assets and liabilities for the expected future tax consequences of events that have been included in the financial statements or tax returns. A valuation allowance is recorded for deferred tax assets whose realization is not likely. The Company records income taxes based on the effective rate expected for the year with any changes in the valuation allowance reflected in the period of change. As of January 2, 2005 and December 28, 2003, a valuation allowance of \$2,985,000 and \$10,130,000 existed related to state NOL carryforwards due to restrictions on the usage of state NOL carryforwards and short carryforward periods for certain states. The reduction of the valuation allowance is due to the expiration of many of the carryforwards. Taxable income by state for future periods is difficult to estimate. The amount and timing of any future taxable income may affect the usage of such carryforwards, which could result in a material change in the valuation allowance.

### *Derivative Instruments and Hedging Agreements*

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. During 2004, gains of approximately \$623,000 were included in cost of sales related to these option contracts as compared to losses of approximately \$277,000 and \$253,000 in 2003 and 2002, respectively.

*Advertising*

The Company expenses advertising costs as incurred. For the years ended January 2, 2005, December 28, 2003 and December 29, 2002, advertising expenses were \$20,734,000, \$21,700,000 and \$20,264,000, respectively.

*Marketable Securities*

The Company accounts for marketable securities in accordance with SFAS No. 115, "Accounting for Certain Investments in Debt and Equity Securities." The Company's investments in marketable securities are classified as available-for-sale, and as a result, are reported at fair value. Unrealized gains and losses are reported as a component of accumulated other comprehensive loss in stockholders' deficit. The Company follows its investment managers' methods of determining the cost basis in computing realized gains and losses on the sale of its available-for-sale securities, which is the average cost method. Realized gains and losses are included in other expenses, principally debt retirement costs in the accompanying consolidated statements of operations (See Note 14).

*Leases and deferred straight-line rent payable*

The Company leases many of its restaurant properties. Leases are accounted for under the provisions of SFAS No. 13, "Accounting for Leases," as amended, which requires that leases be evaluated and classified as operating or capital leases for financial reporting purposes. The lease term used for lease evaluation includes option periods 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.

For leases that contain rent escalations, the Company records the total rent payable during the lease term, as determined above, on a straight-line basis over the term of the lease and records the difference between the rents paid and the straight-line rent as a deferred straight-line rent payable.

Certain leases contain provisions that require additional rental payments based upon restaurant sales volume ("contingent rentals"). Contingent rentals are accrued each period as the liabilities are incurred utilizing prorated periodic sales targets.

*Lease Guarantees and Contingencies*

Primarily as a result of the Company's 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 January 2, 2005, the potential amount of undiscounted payments the Company could be required to make in the event of non-payment by the primary lessees was \$7,613,000. The present value of these potential payments discounted at the Company's pre-tax cost of debt at January 2, 2005 was \$5,886,000. The Company generally has cross-default provisions with franchisees that would put them in default of their 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 January 2, 2005, the Company has no reason to believe that the franchisees will be unable to fulfill their obligations. Accordingly, no liability has been recorded for exposure under such leases at January 2, 2005 and December 28, 2003.

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### *(Loss) Earnings Per Share*

Basic (loss) earnings per share is calculated by dividing net (loss) income by the weighted average number of common shares outstanding during the period. Diluted (loss) earnings per share is calculated by dividing net (loss) income by the weighted average number of shares of common stock and common stock equivalents outstanding during the period. Common stock equivalents are dilutive stock options and warrants that are assumed exercised for calculation purposes. The number of common stock options which could dilute basic earnings per share in the future, that were not included in the computation of diluted income per share because to do so would have been antidilutive, was 320,000, 163,000 and 108,000 for the years ended January 2, 2005, December 28, 2003 and December 29, 2002, respectively.

Presented below is the reconciliation between basic and diluted weighted average shares (in thousands):

	<b>For the Years Ended</b>		
	<b>January 2, 2005</b>	<b>December 28, 2003</b>	<b>December 29, 2002</b>
Basic weighted average number of common shares outstanding during the period	7,637	7,447	7,372
Adjustments:			
Assumed exercise of stock options		162	179
Diluted weighted average number of common shares outstanding during the period	7,637	7,609	7,551

### *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 SFAS No. 123, "Accounting for Stock-Based Compensation." Stock-based compensation cost of approximately \$238,000 and \$71,000 related to modified option awards was included in net (loss) income for the years ended January 2, 2005 and December 28, 2003, respectively, for the Company's Stock Option Plan and the Company's 2003 Incentive Plan. There was no stock-based compensation cost recorded during 2002.

In December 2002, the Financial Accounting Standards Board ("FASB") issued SFAS No. 148, "Accounting for Stock-Based Compensation Transition and Disclosure," which amends SFAS No. 123. SFAS No. 148 allows 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 are effective for fiscal years ending after December 15, 2002. In accordance with SFAS No. 148, the Company will continue to disclose the required pro-forma information in the notes to the consolidated financial statements.

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

	For the Years Ended		
	January 2, 2005	December 28, 2003	December 29, 2002
Net (loss) income as reported	\$ (3,417)	\$ 9,503	\$ 5,660
Add stock-based compensation expense included in reported net (loss) income, net of related income tax effect	140	42	
Less stock-based compensation expense determined under fair value method for all stock options, net of related income tax benefit (a)	(1,082)	(370)	(385)
Pro forma net (loss) income	\$ (4,359)	\$ 9,175	\$ 5,275
Basic net (loss) income per share, as reported	\$ (0.45)	\$ 1.28	\$ 0.77
Basic net (loss) income per share, pro forma	\$ (0.57)	\$ 1.23	\$ 0.72
Diluted net (loss) income per share, as reported	\$ (0.45)	\$ 1.25	\$ 0.75
Diluted net (loss) income per share, pro forma	\$ (0.57)	\$ 1.21	\$ 0.70

(a)

On December 20, 2004, the Company's Board of Directors approved the vesting of all outstanding and unvested options for the Company's Stock Option Plan and the Company's 2003 Incentive Plan. This action was taken to reduce, or eliminate to the extent permitted, the transition expense related to outstanding stock option awards under SFAS No. 123 (revised 2004), "Share-Based Payment" ("SFAS No. 123R"). The 259,850 options that were vested included 145,239 options with exercise prices greater than the Company's closing stock price on the modification date. Under the accounting guidance of APB Opinion No. 25, the accelerated vesting resulted in stock-based compensation cost of \$9,400 (net of related income tax benefit of \$6,600), which was included in net loss for the year ended January 2, 2005. Additionally, the effect of the accelerated vesting in the Company's pro-forma disclosure was incremental stock-based compensation of approximately \$666,000 (net of related income tax benefit of \$463,000). This stock-based compensation expense would otherwise have been recognized in accordance with SFAS No. 123R in the Company's consolidated statements of operations over the next three fiscal years.

Fair value was estimated on the grant date using the Black-Scholes option-pricing model with the following assumptions:

	2004	2003	2002
Risk free interest rate	3.03%-3.87%	3.04%-3.21%	3.60%
Expected life	4-5 years	5 years	5 years
Expected volatility	71.23%-73.59%	74.23%-75.47%	79.97%
Dividend yield	0.00%	0.00%	0.00%
Fair value	\$5.03-\$7.72	\$4.27-\$5.63	\$4.99

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*Recently Issued Accounting Pronouncements*

On December 16, 2004, the Financial Accounting Standards Board ("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 interim or annual period beginning after June 15, 2005. Early adoption will be permitted in periods in which financial statements have not yet been issued. The Company expects to adopt SFAS No. 123R on July 5, 2005 using the modified-prospective method in which compensation cost is recognized beginning with the effective date based on the requirements of SFAS No. 123R for all share-based payments granted after the effective date. As of January 2, 2005, there were no awards granted to employees that remain unvested.

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 a significant 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 (loss) income and (loss) earnings per share pursuant to SFAS No. 123 in Note 3 of Notes to Consolidated Financial Statements. 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 periods for such excess tax deductions were \$0.8 million, \$0.2 million and \$0 in 2004, 2003 and 2002, 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.



On December 8, 2003, the Medicare Prescription Drug, Improvement and Modernization Act of 2003 (the "Act"), which introduces 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 defined benefit postretirement healthcare 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).

Actuarial equivalence will be determined under regulations issued by the Centers for Medicare & Medicaid Services ("CMS"). Based on proposed CMS regulations issued to date, the Company is unable to conclude whether benefits provided are at least actuarially equivalent to benefits available through Medicare Part D. Therefore, the reported net benefit cost and the accumulated benefit obligation of the Company's postretirement medical and life insurance plan in the accompanying consolidated financial statements and notes thereto does not reflect the effects of the Act. The Company does not believe at this time that the effects of the Act, once determined, will materially affect the accumulated benefit obligation or the net benefit cost reported in future periods.

#### 4. RESTATEMENT OF FINANCIAL STATEMENTS

Following a review of the Company's lease accounting and leasehold depreciation practices, the Company restated its previously reported financial statements. The Company has 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 generally accepted accounting principles ("GAAP") and that such treatment was consistent with the practices of other public companies. Following a review of its lease accounting treatment and relevant accounting literature, the Company determined that it should: i) conform the depreciable lives for buildings on leased land and other leasehold improvements to the shorter of the economic life of the asset or the lease term used for determining the capital versus operating lease classification and calculating straight-line rent and ii) include option periods in the depreciable lives assigned to leased buildings and leasehold improvements and in the calculation of straight-line rent expense only in instances in the which the exercise of the option period can be reasonably assured and failure to exercise such options would result in an economic penalty. The Company has restated its financial statements to accelerate depreciation for certain leasehold improvements and to record additional rent expense (the "Restatement").

The cumulative effect of the Restatement relating to fiscal years 1988 through 2003 is an increase in the deferred rent liability of \$1,251,000, an increase in depreciation expense of \$7,438,000 and an

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increase in deferred income tax assets of \$3,563,000. As a result, retained deficit at the end of 2003 increased by \$5,126,000, net of taxes. Rent expense for the years ended December 28, 2003 and December 29, 2002 increased by \$310,000 and \$266,000, respectively. Depreciation expense increased by \$848,000 and \$627,000 for the years ended December 28, 2003 and December 29, 2002, respectively. The Restatement decreased reported diluted net earnings per share by \$0.09 and \$0.07 for the years ended December 28, 2003 and December 29, 2002, respectively. The cumulative effect of the Restatement for all years prior to 2002 was \$3,916,000, net of taxes, which was recorded as an adjustment to opening stockholders' deficit at December 31, 2001. The Restatement did not have any impact on the Company's previously reported cash flows, sales or compliance with any covenant under its New Credit Facility or other debt instruments.

The following is a summary of the impact of the Restatement on the Company's consolidated balance sheet at December 28, 2003 and the consolidated statements of operations for the years ended December 28, 2003 and December 29, 2002 (in thousands):

	<b>As of December 28, 2003</b>		
	<b>As Previously Reported</b>	<b>Adjustments</b>	<b>Restated</b>
Short-term deferred income taxes	\$ 6,647	\$ 513	\$ 7,160
Total current assets	61,541	513	62,054
Long-term deferred income taxes		1,761	1,761
Property and equipment, net of accumulated depreciation	167,109	(7,438)	159,671
Total assets	252,452	(5,164)	247,288
Other accrued expenses	19,055	1,251	20,306
Total current liabilities	65,718	1,251	66,969
Long-term deferred income taxes	1,289	(1,289)	
Accumulated deficit	(219,005)	(5,126)	(224,131)
Total stockholders' deficit	(98,026)	(5,126)	(103,152)
Total liabilities and stockholders' deficit	252,452	(5,164)	247,288

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For the Year Ended December 28, 2003

	As Previously Reported	Adjustments	Restated
Operating expenses	\$ 108,322	\$ 310	\$ 108,632
Depreciation and amortization	22,539	848	23,387
Operating income	39,242	(1,158)	38,084
Income before provision for income taxes	15,085	(1,158)	13,927
Provision for income taxes	(4,899)	475	(4,424)
Net income	\$ 10,186	\$ (683)	\$ 9,503
<b>BASIC NET INCOME PER SHARE</b>	<b>\$ 1.37</b>	<b>\$ (0.09)</b>	<b>\$ 1.28</b>
<b>DILUTED NET INCOME PER SHARE</b>	<b>\$ 1.34</b>	<b>\$ (0.09)</b>	<b>\$ 1.25</b>

For the Year Ended December 29, 2002

	As Previously Reported	Adjustments	Restated
Operating expenses	\$ 108,829	\$ 266	\$ 109,095
Depreciation and amortization	24,521	627	25,148
Operating income	33,016	(893)	32,123
Income before provision for income taxes	8,146	(893)	7,253
Provision for income taxes	(1,959)	366	(1,593)
Net income	\$ 6,187	\$ (527)	\$ 5,660
<b>BASIC NET INCOME PER SHARE</b>	<b>\$ 0.84</b>	<b>\$ (0.07)</b>	<b>\$ 0.77</b>
<b>DILUTED NET INCOME PER SHARE</b>	<b>\$ 0.82</b>	<b>\$ (0.07)</b>	<b>\$ 0.75</b>

The Company has not amended and does not intend to amend its previously filed Annual Reports on Form 10-K or Quarterly Reports on Form 10-Q for the periods affected by the Restatement that ended prior to January 2, 2005. For this reason, the consolidated financial statements, auditors' reports and related financial information for the affected periods contained in such reports should no longer be relied upon.

Refer to Note 21 for the impact of the Restatement on 2004 and 2003 quarterly information. In addition, certain amounts in Notes 3, 7, 8, 9, 19 and 22 have been restated to reflect the Restatement adjustments described above.

**5. INTANGIBLE ASSETS AND DEFERRED COSTS**

Intangible assets and deferred costs as of January 2, 2005 and December 28, 2003 were (in thousands):

	<b>January 2, 2005</b>	<b>December 28, 2003</b>
	<u>          </u>	<u>          </u>
1988 Non-Friendly Marks license agreement fee amortized over 40 years on a straight-line basis	\$ 18,650	\$ 18,650
Deferred financing costs amortized over the terms of the related loans on an effective yield basis	10,146	10,486
Other	1,103	876
	<u>          </u>	<u>          </u>
Intangible assets and deferred costs	29,899	30,012
Less: accumulated amortization	(9,389)	(12,122)
	<u>          </u>	<u>          </u>
Net	\$ 20,510	\$ 17,890
	<u>          </u>	<u>          </u>

Amortization expense was \$1,812,000, \$1,708,000 and \$1,912,000 for the years ended January 2, 2005, December 28, 2003 and December 29, 2002, respectively.

Future amortization expense related to these intangible assets and deferred costs as of January 2, 2005 was (in thousands):

<b>Year</b>	<b>Amount</b>
	<u>          </u>
2005	\$ 1,865
2006	1,859
2007	1,648
2008	1,440
2009	1,433
Thereafter	12,265
	<u>          </u>
Total	\$ 20,510
	<u>          </u>

Upon the sale of the Company by Hershey Foods Corporation ("Hershey") in 1988, all of the trademarks and service marks used in the Company's business at that time which did not contain the word "Friendly" (the "Non-Friendly Marks") were licensed by Hershey to the Company. The Non-Friendly Marks license agreement fee was being amortized over the term of the agreement, which expired on September 2, 2028. In September 2002, Hershey assigned the Non-Friendly Marks to the Company. The Company will continue to amortize the Non-Friendly Marks license agreement fee over the original term of 40 years. The Company reviews the estimated future cash flows related to each trademarked product on a quarterly basis to determine whether any impairment has occurred. For the years ended January 2, 2005, December 28, 2003 and December 29, 2002, no impairments were recorded.

In July 2003, the Company repurchased \$2,750,000 in aggregate principal amount of its Senior Notes. Accordingly, the related unamortized deferred financing costs of \$44,000 were written off and included in operating expenses in the accompanying consolidated statement of operations for the year ended December 28, 2003.

In connection with the 2004 Refinancing, the Company wrote off unamortized deferred financing costs related to the tender offer for the Senior Notes in March 2004 and the redemption of the remaining Senior Notes in April 2004 of \$1,788,000 and \$657,000, respectively. The \$2,445,000 was included in other expenses, principally debt retirement costs in the accompanying consolidated statement of operations for the year ended January 2, 2005. Additionally, the Company incurred \$6,374,000 of costs associated with the issuance of the New Senior Notes and the amendment to the New Credit Facility, which were included in intangible assets and deferred costs in the accompanying consolidated balance sheet as of January 2, 2005. These costs will be amortized over the terms of the New Senior Notes and the amended New Credit Facility.

## **6. WRITE-DOWNS OF PROPERTY AND EQUIPMENT**

During the third quarter of 2004, the Company committed to a plan to close and sell four underperforming restaurants. The Company determined that the plan of sale criteria in SFAS No. 144 had been met and separately presented the properties as assets held for sale in the condensed consolidated balance sheets as of September 26, 2004 and December 28, 2003. During the fourth quarter of 2004, the Company sold two of these properties in separate transactions. Aggregate gross proceeds from the sales were \$1,795,000. The Company recognized an aggregate gain of \$782,000 related to the sales.

In December of 2004, the Company closed two additional properties. At that time, the Company decided to pursue ground lease opportunities rather than a strategy of selling assets. Based on this decision, the two properties closed in December did not meet the plan of sale criteria in SFAS No. 144. Additionally, the carrying values of the remaining two properties that were presented as assets held for sale in the condensed consolidated balance sheets as of September 26, 2004 and December 28, 2003 have been reclassified to Property and Equipment for the years ended January 2, 2005 and December 28, 2003. The carrying values of these properties was not adjusted since the carrying value for each property is less than the estimated fair market value less costs to sell.

At December 28, 2003 the properties held for disposition included a vacant land parcel, an abandoned warehouse, an abandoned restaurant office and one leased restaurant property related to the March 2000 restructuring (Note 10).

SFAS No. 144 also requires the results of operations of a component entity that is classified as held for sale or that has been disposed of to be reported as discontinued operations in the statement of operations if certain conditions are met. These conditions include commitment to a plan of disposal after the effective date of this statement, elimination of the operations and cash flows of the component entity from the ongoing operations of the company and no significant continuing involvement in the operations of the component entity after the disposal transaction. The results of operations and any related gain or loss associated with all closings or properties held for sale since the adoption of SFAS No. 144 were immaterial. In addition, with the Company's high market penetration in New England, the closing of these restaurants benefited other Company-operated restaurants. Therefore, the results of operations and any related gain or loss have been included in income from operations in the Company's financial statements for the years ended January 2, 2005, December 28, 2003 and December 29, 2002.

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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 consolidated statements of operations (in thousands):

	For the Years Ended		
	January 2, 2005	December 28, 2003	December 29, 2002
Restaurant assets retired due to remodeling	\$ 195	\$ 1,235	\$ 1,117
Restaurant equipment assets retired due to replacement	442	387	335
(Gain) loss on property held for disposition	(782)	280	(1,080)
Loss on property not held for disposition	63		
All other	295	142	206
Loss on disposals of other property and equipment, net	\$ 213	\$ 2,044	\$ 578

During the year ended January 2, 2005, the Company determined that the carrying value of a vacant restaurant land parcel and the carrying value of one restaurant property exceeded their estimated fair values less costs to sell. The carrying values were reduced by an aggregate of \$91,000. During the year ended December 28, 2003, it was determined that the carrying value of a vacant restaurant land parcel exceeded its estimated fair value less costs to sell. During the year ended December 29, 2002, it was determined that the carrying values of nine restaurant properties exceeded their estimated fair values less costs to sell. The carrying values of the 2003 and 2002 properties were reduced by an aggregate of \$26,000 and \$976,000, respectively.

**7. DEBT**

Debt at January 2, 2005 and December 28, 2003 consisted of the following (in thousands):

	January 2, 2005	December 28, 2003
New Senior Notes, 8 <sup>3</sup> / <sub>8</sub> %, due June 15, 2012	\$ 175,000	\$
Senior Notes, 10 <sup>1</sup> / <sub>2</sub> %, originally due December 1, 2007		175,977
Revolving credit loans, due September 30, 2005	4,000	
Mortgage loans, due January 3, 2005 through January 1, 2022	51,976	53,087
<b>Total debt</b>	<b>230,976</b>	<b>229,064</b>
Less: current portion	(5,224)	(1,127)
<b>Total long-term debt</b>	<b>\$ 225,752</b>	<b>\$ 227,937</b>

Principal payments due as of January 2, 2005 were as follows (in thousands):

Year	Amount
2005	\$ 5,224
2006	1,349
2007	1,489
2008	1,629
2009	1,813
Thereafter	219,472
<b>Total</b>	<b>\$ 230,976</b>

In December 2001, the Company completed a financial restructuring plan (the "Refinancing Plan") which included the repayment of all amounts outstanding under the Company's then existing credit facility and the purchase of approximately \$21,273,000 of its 10<sup>1</sup>/<sub>2</sub>% senior notes due December 1, 2007 (the "Senior Notes") with the proceeds from \$55,000,000 in long-term mortgage financing (the "Mortgage Financing") and a \$33,700,000 sale and leaseback transaction (the "Sale/Leaseback Financing"). In addition, FICC secured a new \$30,000,000 revolving credit facility (the "New Credit Facility") of which up to \$20,000,000 is available to support letters of credit.

The Mortgage Financing has a maturity date of January 1, 2022 and is amortized over 20 years. Interest on \$10,000,000 of the original \$55,000,000 from the Mortgage Financing is variable and is the sum of the 30-day LIBOR rate in effect (2.41% at January 2, 2005) plus 6% on an annual basis. Changes in the interest rate are calculated monthly and recognized annually when the monthly payment amount is adjusted. Changes in the monthly payment amounts owed due to interest rate changes are reflected in the principal balances, which are re-amortized over the remaining life of the mortgages. The remaining \$45,000,000 of the original \$55,000,000 from the Mortgage Financing bears interest at a fixed annual rate of 10.16%. The variable rate notes are subject to prepayment penalties during the first five years. The fixed rate notes may not be prepaid without the Company providing the note holders with a yield maintenance premium. In connection with the Mortgage Financing, three new limited liability companies ("LLCs") were organized, each of which is a borrower under the Mortgage Financing. Friendly Ice Cream Corporation is the sole member of each LLC. The Mortgage Financing requires the Company to maintain a fixed charge coverage ratio, as defined, of at least 1.10 to 1 and

each LLC to maintain a fixed charge coverage ratio, as defined, on an aggregate restaurant basis of at least 1.25 to 1, in each case calculated as of the last day of each fiscal year. The Company is in compliance with these covenants.

In 2003 and 2004, FICC purchased all of the remaining outstanding Senior Notes in a series of transactions. In July 2003, FICC purchased approximately \$2,750,000 in aggregate principal amount of the Senior Notes for approximately \$2,826,000, the then current market value. In February 2004, the Company announced a cash tender offer and consent solicitation for \$175,977,000 of Senior Notes to be financed with the proceeds from a \$175,000,000 private offering of new 8.375% senior notes (the "New Senior Notes"), available cash and an amended New Credit Facility (the "2004 Refinancing"). In March 2004, \$127,357,000 of aggregate principal amount of Senior Notes was purchased at the tender offer and consent solicitation price of 104% of the principal amount and \$476,000 of aggregate principal amount of Senior Notes were purchased at the tender offer price of 102% of the principal amount. In April 2004, the remaining \$48,144,000 of Senior Notes were redeemed in accordance with the Senior Notes indenture at 103.5% of the principal amount. Interest on the Senior Notes was payable at 10.5% per annum semi-annually on June 1 and December 1 of each year. In connection with the tender offer, the Company wrote off unamortized deferred financing costs of \$2,445,000 and paid a premium of \$6,790,000 that was included in the accompanying consolidated statement of operations for the year ended January 2, 2005.

The \$175,000,000 of New Senior Notes issued in March 2004 are unsecured senior obligations of FICC, guaranteed on an unsecured senior basis by FICC's Friendly's Restaurants Franchise, Inc. subsidiary, but are effectively subordinated to all secured indebtedness of FICC, including the indebtedness incurred under the New Credit Facility. The New Senior Notes mature on June 15, 2012. Interest on the New Senior Notes is payable at 8.375% per annum semi-annually on June 15 and December 15 of each year. The New Senior Notes are redeemable, in whole or in part, at any time on or after June 15, 2008 at FICC's option at redemption prices from 104.188% to 100.00%, based on the redemption date. In addition, at any time prior to June 15, 2007, FICC may redeem, subject to certain conditions, up to 35% of the aggregate principal amount of the New Senior Notes with the proceeds of one or more qualified equity offerings, as defined, at a redemption price of 108.375% of the principal amount, plus accrued interest.

In connection with the 2004 Refinancing, the New Credit Facility was amended to increase the total commitment amount from \$30,000,000 to \$35,000,000 and to extend the maturity date from December 17, 2005 to June 30, 2007, in addition to other changes. The \$35,000,000 revolving credit commitment less outstanding letters of credit is available for borrowing to provide working capital and for other corporate needs. As of January 2, 2005 and December 28, 2003, total letters of credit outstanding were \$15,224,000 and \$13,550,000, respectively. During 2004 and 2003, there were no drawings against the letters of credit. The revolving credit loans bear interest at the Company's option at either (a) the Base Rate plus the applicable margin as in effect from time to time (the "Base Rate") (7.75% at January 2, 2005) or (b) the Eurodollar rate plus the applicable margin as in effect from time to time (the "Eurodollar Rate") (6.82% at January 2, 2005). As of January 2, 2005, \$4,000,000 of revolving credit loans were outstanding. As of December 28, 2003, there were no revolving credit loans outstanding. As of January 2, 2005 and December 28, 2003, \$15,776,000 and \$16,450,000, respectively, was available for borrowing.



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

The New Credit Facility includes certain restrictive covenants including limitations on indebtedness, restricted payments such as dividends and stock repurchases and sales of assets and of subsidiary stock. Additionally, the New Credit Facility limits the amount which the Company may spend on capital expenditures, restricts the use of proceeds, as defined, from asset sales and requires the Company to comply with certain financial covenants. On July 23, 2004 and October 19, 2004, the Company obtained limited waivers regarding certain financial covenants of its New Credit Facility, which the Company was not in full compliance with as of June 27, 2004 and September 26, 2004. On December 17, 2004, the Company amended the New Credit Facility to, among other things, (i) revise certain financial covenants and eliminate the minimum quarterly EBITDA requirement, (ii) amend the Company's annual capital expenditures limit and (iii) increase the commitment fee under the New Credit Facility from 0.50% to 0.75% of the unused commitment amount (the "Amendment"). The Company was in compliance with the covenants under the New Credit Facility as of January 2, 2005 and December 28, 2003.

The financial covenant requirements, as defined under the New Credit Facility, and actual ratios/amounts as of and for the years ended January 2, 2005 and December 28, 2003 were (dollars in thousands):

	January 2, 2005		December 28, 2003	
	Requirement	Actual	Requirement	Actual
Leverage ratio	5.50 to 1	5.22 to 1	4.75 to 1	4.15 to 1
Interest coverage ratio	2.00 to 1	2.16 to 1	2.00 to 1	2.32 to 1
Fixed charge coverage ratio	1.00 to 1	1.15 to 1	1.05 to 1	1.20 to 1
Consolidated tangible net worth (deficit)	\$ (107,611)	\$ (99,213)	\$ (112,979)	\$ (95,994)
Capital expenditures (a)	\$ 23,500	\$ 22,179	\$ 21,000	\$ 18,971
Consolidated EBITDA (b)	\$ 46,500	\$ 48,190	\$ 48,700	\$ 56,288

Note: The covenant calculations were based upon accounting practices in place at December 31, 2000 and therefore did not include the effects of the restatement described in Note 4.

- (a) The New Credit Facility's definition of capital expenditures differs from the Company's total capital expenditures.
- (b) The New Credit Facility's definition of consolidated EBITDA allows non-cash losses and capitalized interest to be added back to net income (loss) which differs from the Company's internal EBITDA computation presented elsewhere herein.

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The fair values of the Company's long-term debt at January 2, 2005 and December 28, 2003 were as follows (in thousands):

	January 2, 2005		December 28, 2003	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
New Senior Notes and Senior Notes	\$ 175,000	\$ 169,313	\$ 175,977	\$ 182,031
Revolving credit loans	4,000	4,000		
Mortgage loans	51,976	51,976	53,087	53,087
Total	\$ 230,976	\$ 225,289	\$ 229,064	\$ 235,118

The fair values of the New Senior Notes and the Senior Notes were determined based on the actual trade prices occurring closest to January 2, 2005 and December 28, 2003. As the interest on the revolving credit loans is variable, the carrying value approximated the fair value. Because the mortgage loans are privately held, the Company believes that the carrying value of the mortgage loans as of January 2, 2005 and December 28, 2003 approximated the fair value.

### 8. LEASES

As of January 2, 2005 and December 28, 2003, the Company operated 347 and 380 restaurants, respectively. These operations were conducted in premises owned or leased as follows:

	January 2, 2005	December 28, 2003
Land and building owned	94	113
Land leased and building owned	79	92
Land and building leased	174	175
	347	380

Restaurants in shopping centers are generally leased for a term of 10 to 20 years. Leases of freestanding restaurants generally are for a 15 or 20 year lease term and provide for renewal options for three or four five-year renewals at the then current fair market value. Additionally, the Company leases certain equipment over lease terms from three to seven years.

In connection with the Refinancing Plan, the Company entered into and accounted for the Sale/Leaseback Financing, which provided approximately \$33,700,000 of proceeds to the Company. The Company sold 44 properties operating as Friendly's restaurants and entered into a master lease with the buyer to lease the 44 properties for an initial term of 20 years under a triple net lease. There are four five-year renewal options and lease payments are subject to escalator provisions every five years based upon increases in the Consumer Price Index. In accordance with SFAS No. 66, "Accounting for Sales of Real Estate" and SFAS No. 98, "Accounting for Leases", the Company recognized an aggregate loss of \$428,000 on two properties which was included in gain on disposals of other properties and equipment, net in 2001. The aggregate gain of \$11,377,000 on the remaining 42 properties was deferred and the unamortized balance of \$11,089,000 was included in other accrued expenses and other long-term liabilities. The deferred gain is being amortized straight-line over 20 years.

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Future minimum lease payments and amounts to be received as lessor or sublessor under noncancelable leases with an original term in excess of one year as of January 2, 2005 were (in thousands):

Year	Commitments		
	Operating Leases	Capital Lease and Finance Obligations	Operating Lease Receivables
2005	\$ 17,695	\$ 2,377	\$ 2,529
2006	16,306	2,082	2,215
2007	14,060	2,025	1,562
2008	12,429	1,965	1,489
2009	11,327	961	1,445
Thereafter	72,528	3,071	12,581
<b>Total future minimum lease payments</b>	<b>\$ 144,345</b>	<b>12,481</b>	<b>\$ 21,821</b>
Less amounts representing interest		(3,568)	
<b>Present value of minimum lease payments</b>		<b>8,913</b>	
Less current maturities of capital lease and finance obligations		(1,533)	
<b>Long-term maturities of capital lease and finance obligations</b>		<b>\$ 7,380</b>	

Capital lease and finance obligations reflected in the accompanying consolidated balance sheets have effective interest rates ranging from 6.00% to 12.00% and are payable in monthly installments through 2016. Maturities of such obligations as of January 2, 2005 were (in thousands):

Year	Amount
2005	\$ 1,533
2006	1,395
2007	1,491
2008	1,592
2009	738
Thereafter	2,164
<b>Total</b>	<b>\$ 8,913</b>

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Rent expense included in the accompanying consolidated statements of operations for operating leases was (in thousands):

	For the Years Ended		
	January 2, 2005	December 28, 2003	December 29, 2002
Minimum rentals	\$ 20,668	\$ 19,154	\$ 19,307
Contingent rentals	968	1,022	1,129
Total	\$ 21,636	\$ 20,176	\$ 20,436

### 9. INCOME TAXES

During the year ended January 2, 2005, the Company generated a federal net operating loss ("NOL") of approximately \$5,296,000. The Company intends to carry the 2004 federal NOL back to the 2003 and 2002 tax years.

As of December 30, 2001, the Company had aggregate federal NOL carryforwards of approximately \$13,000,000, which would have expired between 2010 and 2019. During the year ended December 29, 2002, the Company utilized all of its federal NOL carryforwards. Due to restrictions on the usage of state NOL carryforwards and short carryforward periods for certain states, valuation allowances of \$2,985,000 and \$10,130,000 existed related to state NOL carryforwards as of January 2, 2005 and December 28, 2003, respectively. The reduction of the valuation allowance was due to the expiration of many of the carryforwards.

As of January 2, 2005 and December 28, 2003, the Company had federal general business credit carryforwards of \$11,238,000 and \$8,374,000, respectively, which expire between 2011 and 2024. The Company also had \$813,000 of federal alternative minimum tax credit carryforwards as of December 28, 2003. There is no federal alternative minimum tax credit carryforward as of January 2, 2005 due to the expected carryback of the 2004 federal NOL.

The Company had \$2,430,000 and \$2,013,000 of state tax credit carryforwards as of January 2, 2005 and December 28, 2003, respectively, which either expire between 2005 and 2009 or have no expiration date. A full valuation allowance existed related to these carryforwards due to short carryforward periods for certain states and restrictions on the usage of carryforwards.

Taxes refundable and credit and state loss carryforwards were increased by \$818,000 and taxes payable were reduced by \$165,000 in 2004 and 2003, respectively, as a result of stock options exercised.

The benefit from income taxes for the year ended January 2, 2005 included a \$2,156,000 reversal of income tax accruals recorded in prior years. This accrual related to tax matters that, based upon additional information obtained during the fourth quarter, was no longer necessary. The reversal was recorded in the fourth quarter of 2004. This reversal accounted for approximately 19.7% of the Company's effective tax rate of 68.8%.

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The benefit from (provision for) income taxes for the years ended January 2, 2005, December 28, 2003 and December 29, 2002 were as follows (in thousands):

	For the Years Ended		
	January 2, 2005	December 28, 2003	December 29, 2002
<b>Current benefit (provision):</b>			
Federal	\$ 837	\$ (88)	\$ (720)
State	(89)	(144)	(285)
Reversal of tax accruals	(601)		
<b>Total current benefit (provision)</b>	<b>\$ 147</b>	<b>\$ (232)</b>	<b>\$ (1,005)</b>
<b>Deferred benefit (provision):</b>			
Federal	\$ 3,662	\$ (3,649)	\$ (785)
State	964	(543)	197
Reversal of tax accruals	2,757		
<b>Total deferred benefit (provision)</b>	<b>\$ 7,383</b>	<b>\$ (4,192)</b>	<b>\$ (588)</b>
<b>Total benefit from (provision for) income taxes</b>	<b>\$ 7,530</b>	<b>\$ (4,424)</b>	<b>\$ (1,593)</b>

A reconciliation of the difference between the statutory federal income tax rate and the effective income tax rate follows:

	For the Years Ended		
	January 2, 2005	December 28, 2003	December 29, 2002
Statutory federal income tax rate	35.0%	35.0%	35.0%
State income taxes net of federal benefit	6.0	6.0	6.0
Effect of change in valuation allowance	0.1	(0.6)	(2.0)
Tax credits	8.3	(6.7)	(18.0)
Nondeductible expenses	(2.1)	1.1	3.0
Reversal of income tax accruals	19.7		
Other	1.8	(3.0)	(2.0)
<b>Effective tax rate</b>	<b>68.8%</b>	<b>31.8%</b>	<b>22.0%</b>

Deferred tax assets and liabilities are determined as the difference between the financial statement and tax bases of the assets and liabilities multiplied by the enacted tax rates in effect for the year in

which the differences are expected to reverse. Significant deferred tax assets (liabilities) at January 2, 2005 and December 28, 2003 were as follows (in thousands):

	<b>January 2, 2005</b>	<b>December 28, 2003</b>
	<u>                    </u>	<u>                    </u>
Property and equipment	\$ (15,683)	\$ (18,171)
Net operating loss carryforwards (net of valuation allowance of \$2,985 and \$10,130 at January 2, 2005 and December 28, 2003, respectively)	720	117
Insurance reserves	8,670	8,321
Inventories	248	344
Pension	7,590	6,675
Intangible assets	(4,524)	(4,715)
Tax credit carryforwards (net of valuation allowance of \$2,430 and \$2,013 at January 2, 2005 and December 28, 2003, respectively)	11,238	9,176
Deferred gain	4,192	4,454
Other	5,021	2,720
	<u>                    </u>	<u>                    </u>
Net deferred tax asset	\$ 17,472	\$ 8,921
	<u>                    </u>	<u>                    </u>
Total deferred tax assets	\$ 38,265	\$ 35,073
Total deferred tax liabilities	(20,793)	(26,152)
	<u>                    </u>	<u>                    </u>
Net deferred tax asset	\$ 17,472	\$ 8,921
	<u>                    </u>	<u>                    </u>

**10. RESTRUCTURINGS**

During 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.

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

**For the Year Ended January 2, 2005**

	<b>Restructuring Reserve as of December 28, 2003</b>	<b>Expense</b>	<b>Costs Paid and Reclassified</b>	<b>Restructuring Reserve as of January 2, 2005</b>
Rent	\$ 319	\$	\$ (227)	\$ 92
Utilities and real estate taxes	40		(40)	
Severance pay		2,549	(1,597)	952
Outplacement services		78	(78)	
Other	82		(48)	34
<b>Total</b>	<b>\$ 441</b>	<b>\$ 2,627</b>	<b>\$ (1,990)</b>	<b>\$ 1,078</b>

**For the Year Ended December 28, 2003**

	<b>Restructuring Reserve as of December 29, 2002</b>	<b>Expense</b>	<b>Costs Paid and Reclassified</b>	<b>Restructuring Reserve as of December 28, 2003</b>
Rent	\$ 679	\$	\$ (360)	\$ 319
Utilities and real estate taxes	121		(81)	40
Equipment	77		(77)	
Other	60		22	82
<b>Total</b>	<b>\$ 937</b>	<b>\$</b>	<b>\$ (496)</b>	<b>\$ 441</b>

Based on information currently available, management believes that the restructuring reserve as of January 2, 2005 was adequate and not excessive.

## 11. FRANCHISE TRANSACTIONS

On September 13, 2004, the Company sold leasehold improvements and equipment and assigned the lease for one refranchised location and sold equipment at three other refranchised locations to the existing franchisee. In addition, as part of the Company's agreement with the franchisee, the franchisee committed to open five new restaurants in the Dayton, OH market over the next six years with an option to open an additional five restaurants in the following five years. Gross proceeds from the sale were approximately \$875,000, of which \$205,000 was for franchise fees, and \$670,000 was for the sale of assets and lease assignment. During the year ended January 2, 2005, the Company recorded \$130,000 of franchise fee revenue for the initial refranchised locations and deferred \$75,000 related to future development. The \$75,000, which represents one-half of future franchise fees, will be recognized into income as restaurants are opened. In addition, the Company recognized a gain of approximately \$292,000 related to the sale of assets.

On September 9, 2004, the Company entered into an agreement granting NL Ark Development, Inc. ("NL Ark") certain limited exclusive rights to operate and develop Friendly's Restaurants in designated areas within Palm Beach County, Florida. NL Ark has committed to open five new Friendly's Restaurants over the next five years. The Company received development fees of \$80,000, which represent one-half of future franchise fees. The \$80,000 will be recognized into income as restaurants are opened.

On March 5, 2004, the Company sold the real property and equipment for one refranchised location and assigned the lease and sold the equipment for a second refranchised location to the existing franchisee. Gross proceeds from the sale were approximately \$485,000, of which \$70,000 was for franchise fees and \$415,000 was for the sale of assets and lease assignment. In 2004, the Company recorded \$70,000 as franchise fee revenue and recognized a gain of approximately \$250,000 related to the sale of assets.

On January 15, 2004, the Company entered into an agreement granting Central Florida Restaurants LLC ("Central Florida") certain limited exclusive rights to operate and develop Friendly's full-service restaurants in designated areas within the Orlando, Florida market (the "Central Florida Agreement"). Pursuant to the Central Florida Agreement, Central Florida purchased certain equipment assets, lease and sublease rights and franchise rights in 10 existing Friendly's restaurants and committed to open an additional 10 restaurants over the next six years with an option for 15 more restaurants in the following five years. Gross proceeds from the sale were approximately \$3,150,000 of which \$310,000 was for franchise fees for the initial 10 restaurants. In 2004, the Company recorded \$310,000 as franchise fee revenue and recognized a gain of approximately \$679,000 related to the sale of the assets for the 10 locations.

During July 2003, the Company entered into a development agreement granting Jax Family Rest., Inc. ("Jax") certain limited exclusive rights to operate and develop Friendly's full-service restaurants in designated areas within Baker, Clay, Nassau, Putnam and St. John's counties, Florida (the "Jax Agreement"). Pursuant to the Jax Agreement, Jax agreed to open 10 new restaurants over the next seven years. The Company received development fees of \$155,000, which represent one-half of future franchise fees. The \$155,000 will be recognized into income as restaurants are opened. During the year ended January 2, 2005, Jax opened one new restaurant.

On November 13, 2002, the Company sold the real property and equipment for one franchised location and assigned the lease and sold the equipment for a second franchised location to the existing franchisee. Gross proceeds from the sale were approximately \$1,300,000, of which approximately



\$200,000 was for the assignment of the lease. The Company recognized a gain of approximately \$700,000 related to the sale in the year ended December 29, 2002.

In December 2000, the Company and its first franchisee, Friendco Restaurants Inc. ("Friendco"), a subsidiary of Davco Restaurants, Inc. ("Davco"), agreed to terminate Friendco's rights as the exclusive developer of new Friendly's restaurants in Maryland, Delaware, the District of Columbia and northern Virginia. Friendco also obtained the right to close or transfer restaurants to another approved franchisee. In June 2003, the Company entered into a Settlement Agreement and Mutual General Release with Davco releasing Davco from all obligations and guarantees related to leases associated with the franchised locations and providing for a payment of \$250,000 to the Company, which was recorded as revenue in the year ended December 28, 2003. Between January 2001 and January 2, 2005, Friendco closed a total of fifteen restaurants and transferred its rights to a total of thirty-two franchised locations to other parties. As of January 2, 2005, Friendco retained one franchised restaurant.

## 12. PENSION PLAN

Certain of the employees of the Company are covered by a non-contributory defined benefit cash balance pension plan. Plan benefits are based on years of service and participant compensation during their years of employment.

Under the cash balance plan, a nominal account for each participant is established. Through 2003, the Company made an annual contribution to each participant's account based on current wages and years of service. Each account earns a specified rate of interest which is adjusted annually. Plan expenses may also be paid from the assets of the plan.

In 1997, pension benefits were reduced to certain employees. In 1998, death benefits were increased. In 2002, pension benefits that were reduced in 1997 were restored to certain employees. Also in 2002, pension benefits were reduced to all employees, to be effective in 2003.

In November 2003, the Company announced that effective December 31, 2003, all benefits accrued under the pension plan would be frozen at the level attained on that date. The benefits accrued through December 31, 2003 were not reduced and cash balance accounts will continue to be credited with interest after that date. As a result, the Company recognized a one-time pension curtailment gain of \$8,113,000 in 2003 equal to the unamortized balances as of December 31, 2003 from all plan changes prior to that date.

During 2004, lump-sum cash payments to participants exceeded the interest cost component of net periodic pension cost. As a result of the unusual settlement volume, the Company recorded additional pension expense of \$2,204,000 during the year ended January 2, 2005.

As of December 31, 2004, the latest measurement date, the accumulated benefit obligation of the pension plan exceeded the fair value of plan assets. Accordingly, in accordance with SFAS No. 87, "Employer's Accounting for Pensions", the Company recorded an additional minimum pension liability of \$1,317,000 (\$777,000, net of income tax benefit). The Company initially recorded an additional minimum pension liability in 2002, the first measurement date where the accumulated benefit obligation exceeded the fair value of plan assets. The Company also recorded an additional minimum pension liability during the year ended December 28, 2003 of \$9,090,000 (\$5,363,000, net of income tax benefit). These adjustments were included in other accumulated comprehensive loss as a direct charge to stockholders' deficit. As of January 2, 2005, the cumulative additional minimum pension charge

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included in accumulated other comprehensive loss was \$35,083,000 (\$20,699,000, net of income tax benefit).

For the years ended January 2, 2005 and December 28, 2003, the reconciliation of the projected benefit obligation was (in thousands):

	<b>January 2, 2005</b>	<b>December 28, 2003</b>
	<u>          </u>	<u>          </u>
Beginning of year benefit obligation	\$ 106,998	\$ 98,881
Service cost		2,211
Interest cost	6,603	6,425
Actuarial loss	5,010	7,484
Plan amendments		(1,791)
Disbursements	(8,569)	(6,212)
	<u>          </u>	<u>          </u>
End of year benefit obligation	\$ 110,042	\$ 106,998
	<u>          </u>	<u>          </u>

The reconciliation of the fair value of assets of the plan as of January 2, 2005 and December 28, 2003 was (in thousands):

	<b>January 2, 2005</b>	<b>December 28, 2003</b>
	<u>          </u>	<u>          </u>
Beginning of year fair value of assets	\$ 90,871	\$ 81,881
Actual return on plan assets	10,208	15,202
Disbursements	(8,569)	(6,212)
	<u>          </u>	<u>          </u>
End of year fair value of assets	\$ 92,510	\$ 90,871
	<u>          </u>	<u>          </u>

The reconciliation of the funded status of the pension plan as of January 2, 2005 and December 28, 2003 included the following components (in thousands):

	<b>January 2, 2005</b>	<b>December 28, 2003</b>
	<u>          </u>	<u>          </u>
Projected benefit obligation	\$ 110,042	\$ 106,998
Fair value of plan assets	92,510	90,871
	<u>          </u>	<u>          </u>
Funded status	(17,532)	(16,127)
Unrecognized net actuarial loss	35,083	33,766
	<u>          </u>	<u>          </u>
Prepaid benefit cost	\$ 17,551	\$ 17,639
	<u>          </u>	<u>          </u>

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The amounts recognized in the consolidated balance sheets and the consolidated statements of changes in stockholders' deficit were (in thousands):

	January 2, 2005	December 28, 2003
Projected benefit obligation	\$ 110,042	\$ 106,998
Additional benefits based on future salary increases		
Accumulated benefit obligation	110,042	106,998
Fair value of plan assets	92,510	90,871
Minimum pension liability	(17,532)	(16,127)
Prepaid benefit cost	(17,551)	(17,639)
Accrued benefit liability	(35,083)	(33,766)
Income tax benefit	14,384	13,844
Accumulated other comprehensive loss	\$ (20,699)	\$ (19,922)

The components of net periodic pension cost (benefit) for the years ended January 2, 2005, December 28, 2003 and December 29, 2002 were (in thousands):

	January 2, 2005	December 28, 2003	December 29, 2002
Service cost	\$	\$ 2,211	\$ 3,241
Interest cost	6,604	6,425	6,634
Expected return on assets	(9,391)	(9,097)	(11,590)
Net amortization:			
Unrecognized prior service benefit		(1,278)	(728)
Unrecognized net actuarial loss (gain)	671	608	(275)
Periodic pension benefit before adjustments	(2,116)	(1,131)	(2,718)
Settlement expense (curtailment gain)	2,204	(8,113)	
Net periodic pension cost (benefit)	\$ 88	\$ (9,244)	\$ (2,718)

A summary of the Company's key actuarial assumptions used to determine benefit obligations as of January 2, 2005 and December 28, 2003 follows:

	January 2, 2005	December 28, 2003
Discount rate	6.00%	6.25%
Salary increase rate	3.25-4.75%	3.25-4.75%
Expected long-term rate of return	8.75%	9.00%

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A summary of the Company's key actuarial assumptions used to determine net periodic pension cost (benefit) for the years ended January 2, 2005, December 28, 2003 and December 29, 2002 follows:

	January 2, 2005	December 28, 2003	December 29, 2002
Discount rate	6.25%	6.75%	7.25%
Salary increase rate	3.25-4.75%	3.25-4.75%	3.25-4.75%
Expected long-term rate of return	9.00%	9.50%	10.00%

The Company determines its expected long-term rate of return based on the Company's expectations of future returns for the pension plan's investments based on target allocations of the pension plan's investments. Additionally, the Company considers historical returns on comparable equity, fixed income and real estate investments and adjusts its estimate as deemed appropriate. As of January 2, 2005, point estimates of the Company's long-term target allocation to equity (57.5%), fixed income (32.0%), real estate (10.0%) and other (0.5%) is expected to provide real rates of return of 7.23%, 2.21%, 1.90% and 1.50%, respectively. In addition, the long-term inflation assumption is 3.75%. The resulting weighted expected long-term rate of return on plan assets was 8.75%.

The Company's pension plan weighted average asset allocations at January 2, 2005 and December 28, 2003 by asset category were as follows:

Asset Category	January 2, 2005	December 28, 2003
Equity securities	65%	61%
Debt securities	19%	21%
Real estate	11%	11%
Other	5%	7%
Total	100%	100%

The Company actively manages its pension plan assets utilizing a registered investment advisor as recognized under the Investment Advisors Act of 1940, as amended. Oversight of the investment advisor is provided by the Company's Qualified Benefit Plans Committee ("QBPC"). The plan's trustee and investment advisor monitor transactions and performance monthly and the QBPC reviews performance monthly with a complete review of plan assets on a quarterly basis. Monthly, cash is withdrawn from the pension fund to meet benefit requirements. This provides the investment advisor with an opportunity to rebalance on a limited scale. If larger scale rebalancing is required, it is performed on an as needed basis.

The Company believes that a moderately aggressive risk posture is appropriate for the plan and is consistent with the actuarially-determined cash payment requirements. Accordingly, the investment of plan assets is governed by the Investment Policy of the Company's retirement program which reflects two primary objectives: 1) achieving investment results that will contribute to the proper funding of the plan, and 2) receiving from its investment advisor performance that is above the average market return. Asset mix guidelines exist within the Investment Policy that target equities at 30-80% of the portfolio, fixed income at 10-60% and real estate at 10%. It is expected that over long periods of time, these asset allocation parameters will enable the plan to meet or exceed actuarial assumptions.

The investment guidelines prohibit certain types of transactions, including the purchase of securities on margin, short-sale transactions, the purchase of letter stock or other non-registered securities, securities lending and any other investments or investment strategies disallowed by ERISA or related regulations.

Equity securities of the plan did not include any investment in the Company's common stock at January 2, 2005 or December 28, 2003.

The Company does not expect to contribute any cash to its pension plan in 2005.

The following benefit payments, which reflect expected future service, as appropriate, are expected to be paid (in thousands):

Year	Amount
2005	\$ 3,369
2006	3,347
2007	3,598
2008	4,402
2009	4,085
2010-2014	29,316
<b>Total</b>	<b>\$ 48,117</b>

### 13. POSTRETIREMENT MEDICAL AND LIFE INSURANCE BENEFITS

The Company provides health care and life insurance benefits to certain groups of employees upon retirement. Eligible employees may continue their coverages if they are receiving a pension benefit, are at least 55 years of age and have completed ten years of service. The plan requires contributions for health care coverage from participants who retired after September 1, 1989. Health care coverage may continue until age 65. Life insurance benefits are contributory for participants who retired after July 1, 2002. Medical benefits under the plan are provided through the Company's general assets.

The Company uses a December 31 measurement date for the plan.

The Company accrues the cost of postretirement medical and life insurance benefits over the years employees provide services to the date of their full eligibility for such benefits. The reconciliation of the accumulated benefit obligation for the years ended January 2, 2005 and December 28, 2003 was as follows (in thousands):

	January 2, 2005	December 28, 2003
Beginning of year benefit obligation	\$ 7,897	\$ 7,187
Service cost	141	99
Interest cost	456	470
Plan participants' contributions	199	170
Actuarial (gain) loss	(36)	595
Disbursements	(672)	(624)
<b>End of year benefit obligation</b>	<b>\$ 7,985</b>	<b>\$ 7,897</b>

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The reconciliation of the funded status of the plan as of January 2, 2005 and December 28, 2003 included the following components (in thousands):

	<b>January 2, 2005</b>	<b>December 28, 2003</b>
Accumulated benefit obligation	\$ (7,985)	\$ (7,897)
Fair value of plan assets		
	(7,985)	(7,897)
Funded status	(7,985)	(7,897)
Unrecognized prior service benefit	(1,505)	(1,647)
Unrecognized net actuarial loss	2,216	2,322
	(7,274)	(7,222)
Accrued benefit liability	\$ (7,274)	\$ (7,222)

The components of the net postretirement medical and life insurance benefit cost for the years ended January 2, 2005, December 28, 2003 and December 29, 2002 were (in thousands):

	<b>January 2, 2005</b>	<b>December 28, 2003</b>	<b>December 29, 2002</b>
Service cost	\$ 141	\$ 99	\$ 123
Interest cost	456	470	500
Recognized actuarial loss	70	62	49
Net amortization of unrecognized prior service benefit	(142)	(142)	(112)
	525	489	560
Net benefit cost	\$ 525	\$ 489	\$ 560

A summary of the Company's key actuarial assumptions used to determine benefit obligations as of January 2, 2005 and December 28, 2003 follows:

	<b>January 2, 2005</b>	<b>December 28, 2003</b>
Discount rate	6.00%	6.25%
Salary increase rate	3.25-4.75%	3.25-4.75%
Medical cost trend:		
First year	9.50%	8.50%
Ultimate	5.50%	5.50%
Years to reach ultimate	4	3

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A summary of the Company's key actuarial assumptions used to determine net periodic benefit cost for the years ended January 2, 2005, December 28, 2003 and December 29, 2002 follows:

	<u>January 2, 2005</u>	<u>December 28, 2003</u>	<u>December 29, 2002</u>
Discount rate	6.25%	6.75%	7.25%
Salary increase rate	3.25-4.75%	3.25-4.75%	3.25-4.75%
Medical cost trend:			
First year	8.50%	8.50%	9.50%
Ultimate	5.50%	5.50%	5.50%
Years to reach ultimate	3	3	3

Assumed health care cost trends have a significant effect on the amounts reported for health care plans. A one-percentage-point change in the assumed health care cost trend rate would have the following effects:

	<u>One Percentage- Point Increase</u>	<u>One Percentage- Point Decrease</u>
Effect on total of service and interest cost	\$ 57,144	\$ (53,420)
Effect on accumulated benefit obligation	\$ 553,545	\$ (507,651)

The following benefit payments, which reflect expected future service, as appropriate, are expected to be paid (in thousands):

<u>Year</u>	<u>Amount</u>
2005	\$ 617
2006	626
2007	638
2008	645
2009	642
2010-2014	3,310
<b>Total</b>	<b>\$ 6,478</b>

On December 8, 2003, the Medicare Prescription Drug, Improvement and Modernization Act of 2003 (the "Act"), which introduces 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 defined benefit postretirement healthcare 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).

Actuarial equivalence will be determined under regulations issued by the Centers for Medicare & Medicaid Services ("CMS"). Based on proposed CMS regulations issued to date, the Company is

unable to conclude whether benefits provided are at least actuarially equivalent to benefits available through Medicare Part D. Therefore, the reported net benefit cost and the accumulated benefit obligation of the Company's postretirement medical and life insurance plan in the accompanying consolidated financial statements and notes thereto does not reflect the effects of the Act. The Company does not believe at this time that the effects of the Act, once determined, will materially affect the accumulated benefit obligation or the net benefit cost reported in future periods.

#### **14. OTHER RETIREMENT BENEFIT PLANS**

The Company's Employee Savings and Investment Plan (the "Plan") covers all eligible employees and is intended to be qualified under Sections 401(a) and 401(k) of the Internal Revenue Code. For the years ended January 2, 2005 and December 28, 2003, the Company made matching contributions in an amount equal to 75% of the sum of the participants' contributions that do not exceed 6% of the participant's compensation for employees above the position of secondary management, as defined in the Plan. For the Plan year ending December 29, 2002, the Company made matching contributions at the rate of 75% of the first 2% of the participants' contributions and 50% of the next 4% of the participants' contributions for employees of certain job classifications. For other employees of the Company, the Company made matching contributions at the rate of 75% of the first 2% of the participants' contributions and 50% of the next 2% of the participants' contributions. All employee contributions are fully vested. Company contributions are vested at the completion of three years of service or at retirement, death, disability or termination at age 65 or over, as defined by the Plan. Company contributions and administrative expenses for the Plan were approximately \$972,000, \$755,000 and \$729,000 for the years ended January 2, 2005, December 28, 2003 and December 29, 2002, respectively.

During 2004, the Company established a nonqualified deferred compensation plan ("Deferred Comp Plan") that was developed as a retirement plan for a select group of management employees that are not allowed to participate in the Company's Employee Savings and Investment Plan. There are various types of compensation that can be deferred into the Deferred Comp Plan, e.g., regular salary, annual bonus or long-term bonus. There is also a Company contribution that is paid into the Deferred Comp Plan for participants that choose to defer a percentage of their base salary.

The Company accounts for the Deferred Comp Plan in accordance with Emerging Issues Task Force No. 97-14, "Accounting for Deferred Compensation Arrangements Where Amounts Are Held in a Rabbi Trust and Invested." The investments of the rabbi trust were included in other assets in the accompanying consolidated balance sheet as of January 2, 2005. A corresponding liability was included in other long-term liabilities.

The Deferred Comp Plan assets consisted of investments in marketable securities, including mutual funds and money markets, classified as available-for-sale and reported at fair value with the unrealized gains and losses reported as a component of accumulated other comprehensive loss in stockholders' deficit. The aggregate fair value of these investments was \$1,028,000 as of January 2, 2005. The Company followed its investment managers' methods of determining the cost basis in computing realized gains and losses on the sale of its securities, which was the average cost method. Realized gains and losses were included in other expenses, principally debt retirement costs in the accompanying consolidated statement of operations for the year ended January 2, 2005. Compensation expense, which offset the changes in the corresponding liability, was included in general and administrative expenses for the year ended January 2, 2005. Net unrealized gains of \$29,000, net of tax, were recorded as of January 2, 2005 and net realized losses were immaterial during the year ended January 2, 2005.



**15. INSURANCE RESERVES**

At January 2, 2005 and December 28, 2003 insurance reserves of approximately \$32,435,000 and \$30,952,000, respectively, had been recorded. Insurance reserves at January 2, 2005 and December 28, 2003 included RIC's reserves for the Company's insurance liabilities of approximately \$8,524,000 and \$8,139,000, respectively. Reserves also included accruals related to post employment benefits and postretirement medical and life insurance benefits. While management believes these reserves were adequate, it is reasonably possible that the ultimate liabilities may exceed such estimates.

Classification of the reserves was as follows (in thousands):

	January 2, 2005	December 28, 2003
Current	\$ 9,927	\$ 10,041
Long-term	22,508	20,911
<b>Total</b>	<b>\$ 32,435</b>	<b>\$ 30,952</b>

Following is a summary of the activity in the insurance reserves for the years ended January 2, 2005, December 28, 2003 and December 29, 2002 (in thousands):

	January 2, 2005	December 28, 2003	December 29, 2002
Beginning balance	\$ 30,952	\$ 30,986	\$ 30,562
Provision	12,621	10,684	11,352
Payments	(11,138)	(10,718)	(10,928)
<b>Ending balance</b>	<b>\$ 32,435</b>	<b>\$ 30,952</b>	<b>\$ 30,986</b>

The provision for insurance reserves each year was actuarially determined and reflected amounts for the current year as well as revisions in estimates to open reserves for prior years. Payments included amounts paid on open claims for all years.

**16. STOCKHOLDERS' DEFICIT**

In connection with the Recapitalization, FICC adopted a restricted stock plan (the "Restricted Stock Plan"), pursuant to which 371,285 shares were authorized for issuance. The Restricted Stock Plan provides for the award of common stock, the vesting of which is subject to conditions and limitations established by the Board of Directors. Such conditions may include continued employment with the Company or the achievement of performance measures. Upon the award of common stock, the participant has the rights of a stockholder, including but not limited to the right to vote such stock and the right to receive any dividends paid on such stock. The Board of Directors, in its sole discretion, may designate employees and persons providing material services to the Company as eligible for participation in the Restricted Stock Plan. In connection with the approval of the 2003 Incentive Plan, discussed elsewhere herein, the shares authorized for issuance under the Restricted Stock Plan were reduced by 156,217 shares of stock.

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A summary of the shares issued under the Restricted Stock Plan is presented below:

	<b>Number of Shares</b>
Shares outstanding at December 30, 2001	223,720
Forfeited	(7,846)
Shares outstanding at December 29, 2002	215,874
Forfeited	(1,609)
Shares outstanding at December 28, 2003	214,265
Forfeited	
Shares outstanding at January 2, 2005	214,265

The issued shares vest on a straight-line basis over eight years or on an accelerated basis if certain performance criteria are met. The Company recorded the fair value of the shares issued at the issuance dates as compensation expense over the estimated vesting periods. During the years ended January 2, 2005, December 28, 2003, and December 29, 2002, the Company recorded stock compensation expense of approximately \$257,000, \$330,000 and \$531,000, respectively, which was included in general and administrative expenses in the accompanying consolidated statements of operations. The stock compensation expense recognized in 2002 included expense for accelerated vesting.

In connection with the Recapitalization, the Board of Directors adopted a stock option plan (the "Stock Option Plan"), pursuant to which 395,000 shares of common stock options were authorized for issuance. The Board of Directors amended the Stock Option Plan to increase the shares available by 200,000 options and 439,970 options on October 24, 2001 and March 27, 2000, respectively. The Stock Option Plan provides for the issuance of nonqualified stock options and incentive stock options (which are intended to satisfy the requirements of Section 422 of the Internal Revenue Code) and stock appreciation rights ("SARs"). As of January 2, 2005, no SARs had been issued. The Board of Directors determines the employees who will receive awards under the Stock Option Plan and the terms of such awards. The exercise price of a stock option or SAR shall not be less than the fair market value of one share of common stock on the date the stock option or SAR is granted. The options generally expire 10 years from the date of grant. Options were issued on July 23, 2003 and July 24, 2002 with a five-year expiration date, which was approved by the Board of Directors. Options issued prior to February 10, 2000 vest over five years, options issued subsequent to that date vest over three years.

On April 9, 2003, the Board of Directors adopted a long-term incentive plan (the "2003 Incentive Plan"), subject to approval by the Company's shareholders. On May 14, 2003, the shareholders approved the 2003 Incentive Plan, which became effective as of March 30, 2003. The 2003 Incentive Plan provides for the issuance of nonqualified stock options and incentive stock options (which are intended to satisfy the requirements of Section 422 of the Internal Revenue Code), SARs, bonus stock, stock units, performance shares, performance units, restricted stock and restricted stock units. No more than 307,000 shares of common stock may be delivered to participants and their beneficiaries under the 2003 Incentive Plan. The Board of Directors determines the employees who will receive awards under the 2003 Incentive Plan and the terms of such awards. The exercise price of a stock option or SAR shall not be less than the fair market value of one share of common stock on the date the stock option or SAR is granted. The options generally expire five years from the date of grant. The Board of

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Directors may designate whether any such award being granted to any participant is intended to be performance-based compensation as that term is used in Section 162(m) of the Internal Revenue Code. Any such awards designated as intended to be performance-based compensation shall be conditioned on the achievement of one or more performance measures, to the extent required by Internal Revenue Code Section 162(m). Options were issued on July 23, 2003 and February 23, 2004; performance-based compensation performance unit awards were issued on May 14, 2003 and July 23, 2003, February 23, 2004 and May 18, 2004. As of January 2, 2005, no SARs had been issued.

A summary of the stock options outstanding pursuant to the Company's Stock Option Plan and 2003 Incentive Plan is presented below:

	Number of Shares	Average Exercise Price
Options outstanding at December 30, 2001	801,829	\$ 4.55
Granted	127,000	7.54
Forfeited	(86,603)	4.99
Exercised	(46,552)	3.30
Options outstanding at December 29, 2002	795,674	5.05
Granted	166,311	6.88
Forfeited	(53,964)	5.12
Exercised	(98,946)	3.61
Options outstanding at December 28, 2003	809,075	5.60
Granted	160,819	11.43
Forfeited	(60,427)	9.02
Exercised	(223,801)	4.37
Options outstanding at January 2, 2005	685,666	\$ 7.06

The following table summarizes information related to outstanding options as of January 2, 2005:

Range of Exercise Prices	Number Outstanding as of January 2, 2005	Weighted-Average Remaining Contractual Life (Years)	Weighted Average Exercise Price
\$ 0.00 - \$2.48	106,675	6.3	\$ 2.20
2.48 - 4.95	140,521	5.2	3.76
4.95 - 7.43	165,653	3.6	6.42
7.43 - 9.90	138,828	3.2	8.25
9.90 - 12.38	550	3.6	12.00
12.38 - 14.85	95,239	4.1	12.52
17.33 - 19.80	36,900	2.7	17.38
22.28 - 24.75	1,300	3.4	24.75
	685,666	4.3	\$ 7.06

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The following table summarizes information related to outstanding exercisable options as of January 2, 2005:

Range of Exercise Prices	Number Exercisable as of January 2, 2005	Weighted Average Exercise Price
\$ 0.00 - \$ 2.48	106,675	\$ 2.20
2.48 - 4.95	140,521	3.76
4.95 - 7.43	165,653	6.42
7.43 - 9.90	138,828	8.25
9.90 - 12.38	550	12.00
12.38 - 14.85	95,239	12.52
17.33 - 19.80	36,900	17.38
22.28 - 24.75	1,300	24.75
	685,666	\$ 7.06

Pursuant to a stockholder rights plan (the "Stockholder Rights Plan") that FICC adopted in connection with the Recapitalization, the Board of Directors declared a dividend distribution of one purchase right (a "Right") for each outstanding share of common stock. The Stockholder Rights Plan provides, in substance, that should any person or group (other than certain management and affiliates) acquire 15% or more of FICC's common stock, each Right, other than Rights held by the acquiring person or group, would entitle its holder to purchase a specified number of shares of common stock for 50% of their then current market value. Until a 15% acquisition has occurred, the Rights may be redeemed by FICC at any time prior to the termination of the Stockholder Rights Plan.

### 17. RELATED PARTY TRANSACTIONS

FICC's Chairman of the Board is an officer of TRC. FICC previously entered into a sublease for certain land, building and equipment from a subsidiary of TRC. For the years ended January 2, 2005, December 28, 2003 and December 29, 2002, rent expense related to the sublease was approximately \$69,000, \$69,000 and \$68,000, respectively. On January 15, 2004, the Company subleased this property in connection with the Central Florida Agreement (Note 11).

In 1994, TRC Realty LLC (a subsidiary of TRC, whose majority equity owner is the Company's Chairman) entered into a ten-year operating lease for an aircraft for use by both the Company and TRC (which operates restaurants using the trademark Perkins Restaurant and Bakery ("Perkins")). In 1999, this lease was cancelled and TRC Realty LLC entered into a new ten-year operating lease for a new aircraft. The Company shared proportionately with Perkins in reimbursing TRC Realty LLC for leasing, tax and insurance expenses. In addition, the Company also incurred actual usage costs. During the year ended December 29, 2002, the Company expensed its share of the expected net loss on the termination of the cost sharing arrangement as TRC Realty LLC anticipated terminating the lease and disposing of the aircraft by May 2003. The Company's share of the expected net loss was approximately \$950,000 and was included in operating expenses in the consolidated statement of operations for the year ended December 29, 2002. At the Company's July 23, 2003 Board of Directors meeting, the disinterested Board members approved a payment up to \$1,000,000 to TRC Realty LLC and on August 26, 2003, a payment of approximately \$868,000 was made to TRC Realty LLC that terminated

the Company's cost sharing arrangement with Perkins. The payment exceeded the remaining reserve for expected losses by approximately \$86,000, which was included in operating expenses for the year ended December 28, 2003. Under the cost sharing arrangement, which would have expired in January 2010, the Company paid approximately \$500,000 annually.

The Company purchased certain food products used in the normal course of business from a division of TRC at cost plus a mark-up. For the years ended January 2, 2005, December 28, 2003 and December 29, 2002, purchases were approximately \$340,000, \$322,000 and \$463,000, respectively.

During August 2003, Friendly's entered into a single restaurant franchise agreement with Treats of Huntersville LLC ("Treats"). The owner of Treats is a family member of the Company's Chairman of the Board of Directors. The transaction was a standard agreement in compliance with the terms and conditions of the Uniform Franchise Offering Circular allowing Treats to operate one location. The location, which was initially opened by a former franchisee but closed in July 2002, was reopened by Treats in August 2003. Treats paid an initial franchise fee of \$35,000, which was included in income during the year ended December 28, 2003.

## **18. COMMITMENTS AND CONTINGENCIES**

The Company is a party to various legal proceedings arising in the ordinary course of business which management believes, after consultation with legal counsel, will not have a material adverse effect on the Company's consolidated financial position or future operating results.

As of January 2, 2005, the Company had commitments to purchase approximately \$97,000,000 of raw materials, food products and supplies used in the normal course of business. The majority of the commitments cover periods of one to 12 months. Most of these commitments are noncancelable.

## **19. 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 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 the following functions: legal, accounting, personnel not directly related to a segment, information systems and other headquarters activities.

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 (loss) income before (i) benefit from (provision for) income taxes, (ii) other expenses, principally debt retirement costs, (iii) interest expense, net, (iv) depreciation and amortization, (v) write-downs of property and equipment, (vi) net periodic pension benefit and (vii) other non-cash items. The Company has included information concerning EBITDA in this Form 10-K 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, earnings (loss) from operations or other traditional indications of a company's operating performance.

	<b>For the Years Ended</b>		
	<b>January 2, 2005</b>	<b>December 28, 2003</b>	<b>December 29, 2002</b>
	<b>(53 weeks)</b>		
	<b>(in thousands)</b>		
<b>Revenues:</b>			
Restaurant	\$ 448,661	\$ 459,758	\$ 454,569
Foodservice	245,484	240,313	233,978
Franchise	13,199	9,822	9,472
<b>Total</b>	<b>\$ 707,344</b>	<b>\$ 709,893</b>	<b>\$ 698,019</b>
<b>Intersegment revenues:</b>			
Restaurant	\$	\$	\$
Foodservice	(132,847)	(130,123)	(127,647)
Franchise			
<b>Total</b>	<b>\$ (132,847)</b>	<b>\$ (130,123)</b>	<b>\$ (127,647)</b>
<b>External revenues:</b>			
Restaurant	\$ 448,661	\$ 459,758	\$ 454,569
Foodservice	112,637	110,190	106,331
Franchise	13,199	9,822	9,472
<b>Total</b>	<b>\$ 574,497</b>	<b>\$ 579,770</b>	<b>\$ 570,372</b>

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	For the Years Ended		
	January 2, 2005	December 28, 2003	December 29, 2002
	(53 weeks)		
	(in thousands)		
<b>EBITDA:</b>			
Restaurant	\$ 41,806	\$ 51,099	\$ 52,239
Foodservice	12,983	18,378	17,809
Franchise	9,384	6,763	6,240
Corporate	(19,973)	(20,656)	(18,455)
Gain (loss) on property and equipment, net	892	(2,200)	14
(Restructuring expenses) reversal of restructuring expenses	(2,627)		400
Gain on litigation settlement	3,644		
Less pension benefit included in reporting segments	(2,116)	(1,131)	(2,718)
	<u>\$ 43,993</u>	<u>\$ 52,253</u>	<u>\$ 55,529</u>
Interest expense, net-Corporate	\$ 22,295	\$ 24,157	\$ 24,870
Other expenses, principally debt retirement costs	\$ 9,235	\$	\$
<b>Depreciation and amortization:</b>			
Restaurant	\$ 16,275	\$ 16,270	\$ 16,004
Foodservice	3,376	3,084	3,242
Franchise	286	153	251
Corporate	3,294	3,880	5,651
	<u>\$ 23,231</u>	<u>\$ 23,387</u>	<u>\$ 25,148</u>

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Other non-cash (income) expenses:			
Pension benefit	\$ (2,116)	\$ (1,131)	\$ (2,718)
Pension settlement expense (curtailment gain)	2,204	(8,113)	
Write-downs of property and equipment	91	26	976
	<u>          </u>	<u>          </u>	<u>          </u>
Total	\$ 179	\$ (9,218)	\$ (1,742)
	<u>          </u>	<u>          </u>	<u>          </u>

Income (loss) before (provision for) benefit from income taxes:

Restaurant	\$ 25,531	\$ 34,829	\$ 36,235
Foodservice	9,607	15,294	14,567
Franchise	9,098	6,610	5,989
Corporate	(54,797)	(48,693)	(48,976)
Gain (loss) on property and equipment, net	801	(2,226)	(962)
Pension (settlement expense) curtailment gain	(2,204)	8,113	
(Restructuring expenses) reversal of restructuring expenses	(2,627)		400
Gain on litigation settlement	3,644		
	<u>          </u>	<u>          </u>	<u>          </u>
Total	\$ (10,947)	\$ 13,927	\$ 7,253
	<u>          </u>	<u>          </u>	<u>          </u>

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	For the Years Ended	
	January 2, 2005	December 28, 2003
	(in thousands)	
Capital expenditures, including assets acquired under capital leases:		
Restaurant	\$ 20,309	\$ 25,024
Foodservice	1,700	4,862
Corporate	1,170	1,830
<b>Total</b>	<b>\$ 23,179</b>	<b>\$ 31,716</b>
	(in thousands)	
Total assets:		
Restaurant	\$ 142,366	\$ 145,140
Foodservice	40,567	39,054
Franchise	7,726	8,644
Corporate	58,225	54,450
<b>Total</b>	<b>\$ 248,884</b>	<b>\$ 247,288</b>

## 20. GAIN ON LITIGATION SETTLEMENT

In January 2004, the Company reached a settlement in a lawsuit filed against a former administrator of one of the Company's benefit plans. The settlement was based on the administrator's alleged failure to adhere to the terms of a contract and resulted in a one-time payment to the Company of \$3,775,000, which was received on April 2, 2004. As a result of this lawsuit, the Company incurred professional fees of approximately \$500,000 which were included in the consolidated statement of operations for the year ended December 28, 2003 and an additional \$131,000 in professional fees that were offset against the payment in the accompanying consolidated statement of operations for the year ended January 2, 2005.

## 21. QUARTERLY FINANCIAL DATA (UNAUDITED)

(in thousands, except per share amounts)	For the Quarters Ended			
	March 28, 2004 (a) (b)	June 27, 2004 (b)	September 26, 2004	January 2, 2005 (c,d,e)
	(restated)	(restated)	(restated)	
<b>2004 (g)</b>				
Revenues	\$ 130,754	\$ 147,516	\$ 153,055	\$ 143,172
Operating income	\$ 5,439	\$ 5,651	\$ 8,062	\$ 1,431
Net (loss) income	\$ (5,242)	\$ (1,420)	\$ 3,478	\$ (233)
Basic and diluted (loss) income per share:				
Basic net (loss) income	\$ (0.70)	\$ (0.19)	\$ 0.45	\$ (0.03)
Diluted net (loss) income	\$ (0.70)	\$ (0.19)	\$ 0.44	\$ (0.03)
Weighted average shares:				
Basic	7,520	7,611	7,695	7,709
Diluted	7,520	7,611	7,869	7,709
(in thousands, except per share amounts)	March 30, 2003	June 29, 2003	September 28, 2003	December 28, 2003 (f)
	(restated)	(restated)	(restated)	(restated)
	<b>2003 (h)</b>			
Revenues	\$ 128,690	\$ 155,648	\$ 160,350	\$ 135,082
Operating income	\$ 3,748	\$ 10,099	\$ 13,142	\$ 11,095
Net (loss) income	\$ (1,657)	\$ 2,922	\$ 5,145	\$ 3,093
Basic and diluted (loss) income per share:				
Basic net (loss) income	\$ (0.22)	\$ 0.39	\$ 0.69	\$ 0.41
Diluted net (loss) income	\$ (0.22)	\$ 0.39	\$ 0.68	\$ 0.40
Weighted average shares:				
Basic	7,415	7,441	7,452	7,476
Diluted	7,415	7,574	7,606	7,710

(a) During 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.

In January 2004, the Company reached a settlement in a lawsuit filed against a former administrator of one of the Company's benefit plans. The settlement was based on the administrator's alleged failure to adhere to the terms of a contract and resulted in a one-time payment to the Company of \$3,775,000, which was received on April 2, 2004. As a result of this lawsuit, the Company incurred professional fees of approximately \$500,000 which were included in the consolidated statement of operations for the year ended December 28, 2003 and an additional \$131,000 in professional fees that were offset against the payment in the accompanying consolidated statement of operations for the year ended January 2, 2005.

(b) In March 2004, \$127,357,000 of aggregate principal amount of Senior Notes were purchased at the tender offer and consent solicitation price of 104% of the principal amount and \$476,000 of



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aggregate principal amount of Senior Notes were purchased at the tender offer price of 102% of the principal amount. In April 2004, the remaining \$48,144,000 of Senior Notes were redeemed in accordance with the Senior Notes indenture at 103.5% of the principal amount. In connection with the tender offer, the Company wrote off unamortized deferred financing costs of \$2,445,000 and paid a premium of \$6,790,000 that was included in the accompanying consolidated statement of operations for the year ended January 2, 2005.

- (c) The quarter ended January 2, 2005 included 14 weeks. All other quarters presented included 13 weeks. The additional week in 2004 contributed \$10,689,000 in total revenues.
- (d) During 2004, lump-sum cash payments to pension plan participants exceeded the interest cost component of net periodic pension cost. As a result of the settlement volume, the Company recorded additional pension expense of \$2,204,000 during the fourth quarter ended January 2, 2005.
- (e) The benefit from income taxes for the year ended January 2, 2005 included a \$2,156,000 reversal of income tax accruals recorded in prior years related to tax matters that were resolved and recorded in the fourth quarter of 2004.
- (f) In November 2003, the Company announced that effective December 31, 2003, all benefits accrued under the pension plan would be frozen at the level attained on that date. The benefits accrued through December 31, 2003 were not reduced and cash balance accounts will continue to be credited with interest after that date. As a result, the Company recognized a one-time pension curtailment gain of \$8,113,000 in the fourth quarter of 2003 equal to the unamortized balances as of December 31, 2003 from all plan changes prior to that date.
- (g) As described in Note 4, the Company has restated its consolidated statements of operations related to the calculation of straight-line rent expense and depreciation expense. The effect of the restatement on operating income is (\$190), (\$200) and (\$213) for the quarters ended March 28, 2004, June 27, 2004 and September 26, 2004, respectively. The effect of the restatement on the quarterly net (loss) income is (\$113), (\$118) and (\$125) for the quarters ended March 28, 2004, June 27, 2004 and September 26, 2004, respectively. The effect on reported quarterly basic and diluted net (loss) income per share is (\$0.02) for each of the quarters ended March 28, 2004, June 27, 2004 and September 26, 2004.
- (h) As described in Note 4, the Company has restated its consolidated statements of operations related to the calculation of straight-line rent expense and depreciation expense. The effect of the restatement on operating income is (\$286), (\$284), (\$288) and (\$300) for the quarters ended March 30, 2003, June 29, 2003, September 28, 2003 and December 28, 2003, respectively. The effect of the restatement on the quarterly net (loss) income is (\$168), (\$168), (\$170) and (\$177) for the quarters ended March 30, 2003, June 29, 2003, September 28, 2003 and December 28, 2003, respectively. The effect on reported quarterly basic net (loss) income per share is (\$0.02), (\$0.03), (\$0.02) and (\$0.03) for the quarters ended March 30, 2003, June 29, 2003, September 28, 2003 and December 28, 2003, respectively. The effect on reported quarterly diluted net (loss) income per share is (\$0.02) for each of the quarters ended March 30, 2003, June 29, 2003, September 28, 2003 and December 28, 2003.

**22. SUPPLEMENTAL CONDENSED CONSOLIDATING FINANCIAL INFORMATION**

FICC's obligation related to the New Senior Notes is 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 January 2, 2005 and December 28, 2003 and for the years ended January 2, 2005, December 28, 2003 and December 29, 2002 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 January 2, 2005**  
(in thousands)

	<b>Parent Company</b>	<b>Guarantor Subsidiary</b>	<b>Non- guarantor Subsidiaries</b>	<b>Eliminations</b>	<b>Consolidated</b>
<b>Assets</b>					
Current assets:					
Cash and cash equivalents	\$ 9,873	\$ 1,360	\$ 2,172	\$	\$ 13,405
Restricted cash			1,711		1,711
Accounts receivable, net	8,548	1,900			10,448
Inventories	17,545				17,545
Deferred income taxes	6,705	18		130	6,853
Prepaid expenses and other current assets	10,991	2,512	7,782	(16,903)	4,382
<b>Total current assets</b>	<b>53,662</b>	<b>5,790</b>	<b>11,665</b>	<b>(16,773)</b>	<b>54,344</b>
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)</b>					
<b>Equity</b>					
Current liabilities:					
Current maturities of long-term obligations	\$ 13,309	\$	\$ 1,224	\$ (7,776)	\$ 6,757
Accounts payable	21,536				21,536
Accrued expenses	38,085	4,829	5,650	(8,810)	39,754
<b>Total current liabilities</b>	<b>72,930</b>	<b>4,829</b>	<b>6,874</b>	<b>(16,586)</b>	<b>68,047</b>
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 Year Ended January 2, 2005**  
(in thousands)

	<u>Parent Company</u>	<u>Guarantor Subsidiary</u>	<u>Non- guarantor Subsidiaries</u>	<u>Eliminations</u>	<u>Consolidated</u>
Revenues	\$ 563,742	\$ 10,755	\$	\$	\$ 574,497
Costs and expenses:					
Cost of sales	215,264				215,264
Labor and benefits	165,675				165,675
Operating expenses and write-downs of property and equipment	116,229		(6,589)		109,640
General and administrative expenses	35,386	4,620			40,006
Restructuring expenses	2,627				2,627
Gain on litigation settlement	(3,644)				(3,644)
Pension settlement expense	2,204				2,204
Depreciation and amortization	20,972		2,259		23,231
Gain on franchise sales of restaurant operations and properties	(1,302)				(1,302)
Loss (gain) on disposals of other property and equipment, net	430		(217)		213
Interest expense, net	17,760		4,535		22,295
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	(17,094)	6,135	12		(10,947)
Benefit from (provision for) income taxes	10,247	(2,515)	(202)		7,530
(Loss) income before equity in net income of consolidated subsidiaries	(6,847)	3,620	(190)		(3,417)
Equity in net income of consolidated subsidiaries	3,430			(3,430)	
Net (loss) income	\$ (3,417)	\$ 3,620	\$ (190)	\$ (3,430)	\$ (3,417)

**Supplemental Condensed Consolidating Statement of Cash Flows**  
**For the Year Ended January 2, 2005**  
(in thousands)

	<u>Parent Company</u>	<u>Guarantor Subsidiary</u>	<u>Non- guarantor Subsidiaries</u>	<u>Eliminations</u>	<u>Consolidated</u>
Net cash (used in) provided by operating activities	\$ (4,959)	\$ 10,187	\$ 2,159	\$ 40	\$ 7,427
Cash flows from investing activities:					
Purchases of property and equipment	(19,734)				(19,734)
Proceeds from sales of property and equipment	6,035				6,035
Purchases of marketable securities	(1,130)				(1,130)
Proceeds from sales of marketable securities	152				152
Return of investment in subsidiary	11,734			(11,734)	
Net cash used in investing activities	(2,943)			(11,734)	(14,677)
Cash flows from financing activities:					
Proceeds from issuance of New Senior Notes	175,000				175,000
Proceeds from other borrowings	26,250				26,250
Repayments of obligations	(199,443)		(1,111)		(200,554)
Payments of deferred financing costs	(6,650)				(6,650)
Stock options exercised	978				978
Reinsurance deposits received			1,132	(1,132)	
Reinsurance payments made from deposits			(1,092)	1,092	
Dividends paid		(11,000)	(734)	11,734	
Net cash used in financing activities	(3,865)	(11,000)	(1,805)	11,694	(4,976)
Net (decrease) increase in cash and cash equivalents	(11,767)	(813)	354		(12,226)
Cash and cash equivalents, beginning of period	21,640	2,173	1,818		25,631
Cash and cash equivalents, end of period	\$ 9,873	\$ 1,360	\$ 2,172	\$	\$ 13,405
Supplemental disclosures:					
Interest paid	\$ 17,417	\$	\$ 4,536	\$	\$ 21,953
Income taxes (refunded) paid	(1,705)	1,576	199		70
Income tax benefit of stock options exercised	818				818
Capital lease obligations incurred	3,445				3,445

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**Supplemental Condensed Consolidating Balance Sheet**  
**As of December 28, 2003**  
(in thousands)

	<u>Parent Company</u>	<u>Guarantor Subsidiary</u>	<u>Non- guarantor Subsidiaries</u>	<u>Eliminations</u>	<u>Consolidated</u>
<b>Assets</b>					
Current assets:					
Cash and cash equivalents	\$ 21,640	\$ 2,173	\$ 1,818	\$	\$ 25,631
Restricted cash			1,671		1,671
Accounts receivable, net	9,163	1,221			10,384
Inventories	15,669				15,669
Deferred income taxes	7,072	18		70	7,160
Prepaid expenses and other current assets	7,148	1,469	7,778	(14,856)	1,539
<b>Total current assets</b>	<b>60,692</b>	<b>4,881</b>	<b>11,267</b>	<b>(14,786)</b>	<b>62,054</b>
Deferred income taxes	1,761	205		(205)	1,761
Property and equipment, net	112,321		47,350		159,671
Intangibles and deferred costs, net	15,396		2,494		17,890
Investments in subsidiaries	5,187			(5,187)	
Other assets	4,997	8,582	915	(8,582)	5,912
<b>Total assets</b>	<b>\$ 200,354</b>	<b>\$ 13,668</b>	<b>\$ 62,026</b>	<b>\$ (28,760)</b>	<b>\$ 247,288</b>
<b>Liabilities and Stockholders' (Deficit)</b>					
<b>Equity</b>					
Current liabilities:					
Current maturities of long-term obligations	\$ 8,687	\$	\$ 1,127	\$ (7,776)	\$ 2,038
Accounts payable	22,475				22,475
Accrued expenses	39,327	3,893	6,146	(6,910)	42,456
<b>Total current liabilities</b>	<b>70,489</b>	<b>3,893</b>	<b>7,273</b>	<b>(14,686)</b>	<b>66,969</b>
Deferred income taxes	135			(135)	
Long-term obligations, less current maturities	181,750		51,960		233,710
Other long-term liabilities	51,132	743	6,638	(8,752)	49,761
Stockholders' (deficit) equity	(103,152)	9,032	(3,845)	(5,187)	(103,152)
<b>Total liabilities and stockholders' (deficit) equity</b>	<b>\$ 200,354</b>	<b>\$ 13,668</b>	<b>\$ 62,026</b>	<b>\$ (28,760)</b>	<b>\$ 247,288</b>

**Supplemental Condensed Consolidating Statement of Operations**  
**For the Year Ended December 28, 2003**  
(in thousands)

	<b>Parent Company</b>	<b>Guarantor Subsidiary</b>	<b>Non- guarantor Subsidiaries</b>	<b>Eliminations</b>	<b>Consolidated</b>
Revenues	\$ 571,260	\$ 8,510	\$	\$	\$ 579,770
Costs and expenses:					
Cost of sales	207,071				207,071
Labor and benefits	166,982				166,982
Operating expenses and write-downs of property and equipment	115,306		(6,648)		108,658
General and administrative expenses	36,995	4,662			41,657
Pension curtailment gain	(8,113)				(8,113)
Depreciation and amortization	21,103		2,284		23,387
Loss on disposals of other property and equipment, net	1,892		152		2,044
Interest expense, net	19,548		4,609		24,157
Income (loss) before provision for income taxes and equity in net income of consolidated subsidiaries	10,476	3,848	(397)		13,927
Provision for income taxes	(2,652)	(1,578)	(194)		(4,424)
Income (loss) before equity in net income of consolidated subsidiaries	7,824	2,270	(591)		9,503
Equity in net income of consolidated subsidiaries	1,679			(1,679)	
Net income (loss)	\$ 9,503	\$ 2,270	\$ (591)	\$ (1,679)	\$ 9,503

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**Supplemental Condensed Consolidating Statement of Cash Flows**  
**For the Year Ended December 28, 2003**  
(in thousands)

	<u>Parent Company</u>	<u>Guarantor Subsidiary</u>	<u>Non- Guarantor Subsidiaries</u>	<u>Eliminations</u>	<u>Consolidated</u>
Net cash provided by operating activities	\$ 24,718	\$ 229	\$ 246	\$ 653	\$ 25,846
Cash flows from investing activities:					
Purchases of property and equipment	(29,791)				(29,791)
Proceeds from sales of property and equipment	79				79
Return of investment in subsidiary	714			(714)	
Net cash used in investing activities	(28,998)			(714)	(29,712)
Cash flows from financing activities:					
Repayments of obligations	(4,154)		(1,047)		(5,201)
Stock options exercised	357				357
Reinsurance deposits received			2,206	(2,206)	
Reinsurance payments made from deposits			(1,553)	1,553	
Dividends paid			(714)	714	
Net cash used in financing activities	(3,797)		(1,108)	61	(4,844)
Net (decrease) increase in cash and cash equivalents	(8,077)	229	(862)		(8,710)
Cash and cash equivalents, beginning of period	29,717	1,944	2,680		34,341
Cash and cash equivalents, end of period	\$ 21,640	\$ 2,173	\$ 1,818	\$	\$ 25,631
Supplemental disclosures:					
Interest paid	\$ 19,361	\$	\$ 4,620	\$	\$ 23,981
Income taxes (refunded) paid	(431)	1,264	413		1,246
Income tax benefit of stock options exercised	165				165
Capital lease obligations incurred	1,682				1,682
Lease incentive equipment received	243				243

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**ANNUAL REPORT ON FORM 10-K**  
**ITEM 15(c)**

**SCHEDULE II VALUATION AND QUALIFYING ACCOUNTS**  
**FRIENDLY ICE CREAM CORPORATION AND SUBSIDIARIES**  
**FOR THE YEARS ENDED JANUARY 2, 2005, DECEMBER 28, 2003 and DECEMBER 29, 2002**  
**(In thousands)**

Column A	Column B	Column C		Column D	Column E
Description	Balance at Beginning of Year	Charged to Costs and Expenses	Charged to Other Accounts	Deductions	Balance at End of Year
<b>2004</b>					
Reserve for restructuring costs	\$ 441	\$ 2,627		\$ 1,990	\$ 1,078
Allowance for doubtful accounts accounts receivable	\$ 696	\$ 88	\$ (245)		\$ 539
Allowance for doubtful accounts notes receivable	\$ 313			\$ 50	\$ 263
<b>2003</b>					
Reserve for restructuring costs	\$ 937			\$ 496	\$ 441
Allowance for doubtful accounts accounts receivable	\$ 767	\$ 233	\$ (304)		\$ 696
Allowance for doubtful accounts notes receivable	\$ 313				\$ 313
<b>2002</b>					
Reserve for restructuring costs	\$ 3,056	\$ (400)		\$ 1,719	\$ 937
Allowance for doubtful accounts accounts receivable	\$ 588	\$ 359	\$ 68	\$ 248	\$ 767
Allowance for doubtful accounts notes receivable	\$ 914		\$ (68)	\$ 533	\$ 313

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**EXHIBIT INDEX**

- 3.1 Restated Articles of Organization of Friendly Ice Cream Corporation (the "Company") (Incorporated by reference to Exhibit 3.1 to the Company's Registration Statement on Form S-1, Reg. No. 333-34633).
  - 3.2 Amended and Restated By-laws of the Company (Incorporated by reference to Exhibit 3(II) to the Company's current report on Form 8-K filed September 2, 2003, File No. 001-13579).
  - 4.1 Revolving Credit Agreement among the Company, Fleet National Bank and certain other banks and financial institutions ("Credit Agreement") dated as of December 17, 2001 (Incorporated by reference to Exhibit 4.1 to the Company's Annual Report on Form 10-K for the fiscal year ended December 30, 2001, File No. 001-13579).
  - 4.2 Consent, Limited Waiver and Amendment No. 1 to Revolving Credit Agreement dated as of February 15, 2002 (Incorporated by reference to Exhibit 4.1(a) to the Company's Annual Report on Form 10-K for the fiscal year ended December 29, 2002, File No. 001-13579).
  - 4.3 Limited Waiver and Amendment No. 2 to Revolving Credit Agreement dated as of December 27, 2002 (Incorporated by reference to Exhibit 4.1(b) to the Company's Annual Report on Form 10-K for the fiscal year ended December 29, 2002, File No. 001-13579).
  - 4.4 Limited Waiver to Revolving Credit Agreement dated as of July 3, 2003 (Incorporated by reference to Exhibit 4.4 to the Company's Annual Report on Form 10-K for the fiscal year ended January 2, 2005, File No. 001-13579).
  - 4.5 Consent and Amendment No. 3 to Revolving Credit Agreement dated as of January 16, 2004 (Incorporated by reference to Exhibit 4.5 to the Company's Annual Report on Form 10-K for the fiscal year ended January 2, 2005, File No. 001-13579).
  - 4.6 Amended and Restated Amendment No. 4 to Revolving Credit Agreement dated as of February 17, 2004 (Incorporated by reference to Exhibit 4.1 to the Company's Quarterly Report on Form 10-Q for the quarterly period ended March 28, 2004, File No. 001-13579).
  - 4.7 Limited Waiver to Revolving Credit Agreement dated as of October 19, 2004 (Incorporated by reference to Exhibit 4.7 to the Company's Annual Report on Form 10-K for the fiscal year ended January 2, 2005, File No. 001-13579).
  - 4.8 Amendment No. 5 to Revolving Credit Agreement dated as of December 17, 2004 (Incorporated by reference to Exhibit 10.1 to the Company's Form 8-K dated December 17, 2004, File No. 001-13579).
  - 4.9 Loan Agreement between the Company's subsidiary, Friendly's Realty I, LLC and G.E. Capital Franchise Finance Corporation effective as of December 19, 2001 (Incorporated by reference to Exhibit 4.2 to the Company's Annual Report on Form 10-K for the fiscal year ended December 30, 2001, File No. 001-13579).
  - 4.10 Loan Agreement between the Company's subsidiary, Friendly's Realty II, LLC and G.E. Capital Franchise Finance Corporation effective as of December 19, 2001 (Incorporated by reference to Exhibit 4.3 to the Company's Annual Report on Form 10-K for the fiscal year ended December 30, 2001, File No. 001-13579).
  - 4.11 Loan Agreement between the Company's subsidiary, Friendly's Realty III, LLC and G.E. Capital Franchise Finance Corporation effective as of December 19, 2001 (Incorporated by reference to Exhibit 4.4 to the Company's Annual Report on Form 10-K for the fiscal year ended December 30, 2001, File No. 001-13579).
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- 4.12 Rights Agreement between the Company and The Bank of New York, a Rights Agent (Incorporated by reference to Exhibit 4.3 to the Company's Registration Statement on Form S-1, Reg. No. 333-34633).
  - 4.13 Indenture Dated as of March 8, 2004, among Friendly Ice Cream Corporation, Friendly's Restaurants Franchise, Inc. and The Bank of New York, as Trustee (Incorporated by reference to Exhibit 4.2 to the Company's Quarterly Report on Form 10-Q for the quarterly period ended March 28, 2004, File No. 001-13579).
  - 10.1 The Company's 1997 Stock Option Plan (Incorporated by reference to Exhibit 10.3 to the Company's Registration Statement on Form S-1, Reg. No. 333-34633).\*
  - 10.2 The Company's 1997 Stock Option Plan (as amended effective March 27, 2000) (Incorporated by reference to Exhibit 10.1(a) to the Company's Annual Report on Form 10-K for the fiscal year ended December 29, 2002, File No. 001-13579).\*
  - 10.3 The Company's 1997 Stock Option Plan (as amended effective October 24, 2001) (Incorporated by reference to Exhibit 10.1(b) to the Company's Annual Report on Form 10-K for the fiscal year ended December 29, 2002, File No. 001-13579).\*
  - 10.4 The Company's 1997 Restricted Stock Plan (Incorporated by reference to Exhibit 10.4 to the Company's Registration Statement on Form S-1, Reg. No. 333-34633).\*
  - 10.5 The Company's 2003 Incentive Plan (as amended July 23, 2003) (Incorporated by reference to Exhibit 10.1 to the Company's Quarterly Report on Form 10-Q for the quarterly period ended September 28, 2003, File No. 001-13579).\*
  - 10.6 Purchase Agreement between Realty Income Corporation as buyer and the Company as seller dated December 13, 2001 (Incorporated by reference to Exhibit 10.3 to the Company's Annual Report on Form 10-K for the fiscal year ended December 30, 2001, File No. 001-13579).
  - 10.7 Sublease between SSP Company, Inc. and the Company, as amended, for the Chicopee, Massachusetts Distribution Center (Incorporated by reference to Exhibit 10.11 to the Company's Registration Statement on Form S-1, Reg. No. 333-34633).
  - 10.8 TRC Management Contract between the Company and The Restaurant Company (Incorporated by reference to Exhibit 10.13 to the Company's Registration Statement on Form S-1, Reg. No. 333-34633).
  - 10.9 Termination of Aircraft Reimbursement Agreement between the Company and TRC Realty Co. (Incorporated by reference to Exhibit 10.2 to the Company's Quarterly Report on Form 10-Q for the quarterly period ended September 28, 2003, File No. 001-13579).
  - 10.10 Agreement between the Company and Aaron B. Parker effective as of September 26, 2003 (Incorporated by reference to Exhibit 10.13 to the Company's Annual Report on Form 10-K for the fiscal year ended December 28, 2003, File No. 001-13579).\*
  - 10.11 Memorandum of Agreement Between Michael A. Maglioli and Friendly Ice Cream Corporation effective March 25, 2004 (Incorporated by reference to Exhibit 10.1 to the Company's Quarterly Report on Form 10-Q for the quarterly period ended March 28, 2004, File No. 001-13579).\*
  - 10.12 Form of Change of Control Agreement between the Company and the employees listed on the schedule attached thereto (Incorporated by reference to Exhibit 10.12 to the Company's Annual Report on Form 10-K for the fiscal year ended January 2, 2005, File No. 001-13579).\*
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- 10.13 The Company's Form of Stock Option Agreement for Executive Officers and Directors (Incorporated by reference to Exhibit 10.13 to the Company's Annual Report on Form 10-K for the fiscal year ended January 2, 2005, File No. 001-13579).\*
- 10.14 The Company's Annual Incentive Plan for Corporate Employees (Incorporated by reference to Exhibit 10.14 to the Company's Annual Report on Form 10-K for the fiscal year ended January 2, 2005, File No. 001-13579).\*
- 10.15 2004 Annual Incentive Plan for Corporate and Company Restaurants Group (Incorporated by reference to Exhibit 10.15 to the Company's Annual Report on Form 10-K for the fiscal year ended January 2, 2005, File No. 001-13579).\*
- 21.1 Subsidiaries of the Company (Incorporated by reference to Exhibit 21.1 to the Company's Annual Report on Form 10-K for the fiscal year ended December 29, 2002, File No. 001-13579).
- 23.1 Consent of Ernst & Young LLP (Incorporated by reference to Exhibit 23.1 to the Company's Annual Report on Form 10-K for the fiscal year ended January 2, 2005, File No. 001-13579).
- 31.1 Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 signed by John L. Cutter.
- 31.2 Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 signed by Paul V. Hoagland.
- 32.1 Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 signed by John L. Cutter and Paul V. Hoagland.
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Management Contract or Compensatory Plan or Arrangement

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