

FRIENDLY ICE CREAM CORP

Form 10-K

March 06, 2007

**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**FORM 10-K**

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

For the fiscal year ended December 31, 2006

OR

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

**For the transition period from**                    to



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**FRIENDLY ICE CREAM CORPORATION**

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(Exact Name of Registrant as Specified in Its Charter)



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

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

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

**01095**  
(Zip Code)

**(413) 731-4000**

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(Registrant's Telephone Number, Including Area Code)

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

Title of class

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

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

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Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes  No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or 15(d) of the Exchange Act. Yes  No

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 the filing requirements for at least the past 90 days. Yes  No

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 a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act.

Large Accelerated Filer

Accelerated Filer

Non-Accelerated Filer

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

The aggregate market value of the registrant's common stock held by non-affiliates of the registrant on July 2, 2006, based upon the closing sales price of the common stock on the American Stock Exchange, was \$53,301,000. For purposes 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 8,117,235 as of January 31, 2007.

### Documents Incorporated By Reference

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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 December 31, 2006.

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### Forward-Looking Statements

Certain statements contained herein are forward-looking statements, within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. These statements involve known and unknown risks, uncertainties and other factors which may cause our or the foodservice industry's actual results, performance or achievements to be materially different from any future results, performance or achievements expressed or implied by the forward-looking statements. Forward-looking statements include, but are not limited to statements regarding:

- our business strategies;
- anticipated benefits and results from our key initiatives;
- timing and success of new or improved product offerings;
- commodity prices;
- restaurant development, including the number of expected restaurant openings, re-imaging, and franchising transactions;
- expectations relating to increases in comparable restaurant sales and Company restaurant margins;
- expected amount of capital expenditures for re-imaging and other development projects;
- our ability to maintain effective internal controls;
- our ability to meet ongoing financial covenants contained in our debt instruments, loan agreements, leases and other long-term commitments;
- the impact and costs and expenses of any litigation and other similar matters we may be subject to now or in the future;
- anticipated trends relating to our financial condition or results of operations; and
- our capital resources and the adequacy thereof.

In some cases, forward-looking statements can be identified by terms such as may, will, should, could, would, expect, plan, anticipate, estimate, project, predict, potential and similar expressions intended to identify forward-looking statements. These statements are only predictions and involve known and unknown risks, uncertainties, and other factors that may cause actual results, levels of activity, performance or achievements to be materially different from any future results, levels of activity, performance or achievements expressed or implied by such forward-looking statements. Given these uncertainties, you should not place undue reliance on these forward-looking statements. Also, these forward-looking statements represent our estimates and assumptions only as of the date of this report. Except as otherwise required by law, we expressly disclaim any obligation or undertaking to release publicly any updates or revisions to any forward-looking statement contained in this report to reflect any change in expectations or any change in events, conditions or circumstances on which any of our forward-looking statements are based. Factors that could cause or contribute to differences in future financial results include those discussed in the risk factors set forth in Item 1A below as well as those discussed elsewhere in this report. We qualify all of our forward-looking statements by these cautionary statements.

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Unless the context indicates otherwise: (i) references herein to we, us, our, Friendly's or the Company refer to Friendly Ice Cream Corporation, its predecessors and its consolidated subsidiaries; (ii) references herein to FICC refer to Friendly Ice Cream Corporation and not its subsidiaries; and (iii) 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.





## **PART I**

### **Item 1. BUSINESS**

#### **General**

We are a leading full-service, casual dining restaurant company and provider of premium ice cream products with locations primarily in the Northeast. As of December 31, 2006, we operated 316 full-service restaurants and franchised 198 full-service restaurants and seven non-traditional units, located in 16 states. We offer our customers a unique dining experience by serving a variety of high quality, reasonably priced breakfast, lunch and dinner items, as well as Friendly's own signature premium ice cream desserts, in a fun and casual neighborhood setting. In addition to our restaurant operations, we manufacture and sell a complete line of packaged premium ice cream desserts distributed through more than 4,000 supermarkets and other retail locations in 12 states.

Our 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. Fiscal years ended December 31, 2006 and January 1, 2006 contained 52 weeks, while fiscal year ended January 2, 2005 contained 53 weeks. For the year ended December 31, 2006, we generated \$531.5 million in total revenues and earned income from continuing operations of \$1.5 million. For the years ended December 31, 2006, January 1, 2006 and January 2, 2005, restaurant sales were approximately 75%, 75% and 78%, respectively, of our total revenues. As of December 31, 2006, January 1, 2006, and January 2, 2005, approximately 94%, 97% and 96%, respectively, of the Company-operated restaurants were located in the Northeast.

We are a Massachusetts corporation. Our principal executive offices are located at 1855 Boston Road, Wilbraham, Massachusetts 01095 and our telephone number is 413-731-4000. Our Internet website address is <http://www.friendlys.com>. Information on our website is not part of this report.

#### **Friendly's Concept**

Founded in 1935, we believe that we are viewed as an institution in the Northeast, known for our ice cream treats served in a casual neighborhood setting. As a result, we enjoy strong brand awareness associated with good food and good memories and a unique position in the competitive restaurant industry. This differentiation helps us to target both families with children and adults who desire a reasonably priced meal in a full-service setting.

Our menu offers a broad selection of freshly prepared foods for all dayparts, including over 100 food and dessert items available for breakfast, lunch and dinner plus afternoon and evening snacks. Breakfast items include specialty omelettes and our combination breakfasts featuring eggs, pancakes, French toast, bacon and sausage. Our lunch and dinner menu features signature products including Friendly's SuperMelt sandwiches, specialty burgers, award winning clam chowder, entrée salads and a full line of dinner entrées, such as chicken, steak and seafood items. In addition, we offer a broad kid's menu and a special senior's menu for guests over 60. Entrée selections are complemented by Friendly's ice cream desserts and beverages featuring Fribble® shakes, old fashioned milk shakes, classic ice cream sundaes and banana splits, plus specialty sundaes of many varieties and flavors.

Most Friendly's restaurants offer our full line of premium ice cream desserts, including traditional hand-scooped ice cream and soft serve ice cream products, and certain of our food menu items through carryout windows. Reserved parking is available at many of our freestanding restaurants to facilitate quick carryout service. During 2006, approximately 11.9% of our restaurant revenues from our Company-operated restaurants were derived from our carryout business. In addition, approximately 1.4% of 2006 restaurant revenues came from sales of packaged premium ice cream in display cases within our restaurants.

### Key Initiatives

We have implemented and continue to support a number of key initiatives intended to enhance the Friendly's dining experience, provide increased value to our customers, and strengthen our overall financial and operating performance. Some of our current key initiatives include:

- *Improved Restaurant Customer Service.* We are focused on improving our customer service, including the speed and interactiveness of service, through operational improvements and menu re-engineering. We are testing cashier banking which allows guests to check out more quickly by paying their check at a cash register rather than with the server. Speeding up customer service is intended to result in quicker customer turnover and a more enjoyable restaurant experience.
- *Expand Retail Product Portfolio.* We are evaluating ways to improve the profitability of our retail operations by introducing new products with higher margins and greater consumer appeal. In recent years we have seen great success in our specialty ice cream products, such as our decorated ice cream cakes and rolls. More recently, we decided to convert our 56-ounce traditional brick ice cream container to the more contemporary and user-friendly two-part square packaging (a rectangular shaped container with rounded corners and a separate base and lid). We expect this package conversion will take place in the second quarter of 2007, and believe that this new packaging will be more appealing to consumers.
- *Enhanced Marketing Initiatives.* We are enhancing our marketing efforts for our ice cream products to promote cross-marketing of our retail and restaurant businesses. For example, we plan to include coupons redeemable at our restaurants with our 56-ounce ice cream containers.
- *Remodeling our Restaurants.* We are continuing to remodel and re-image our restaurants to incorporate our Company's heritage and brand and reflect a light and lively guest experience during each daypart. By enhancing the appearance of our restaurants, we expect to improve our customers' experience and generate more frequent repeat visits.
- *Expand Through Franchising.* Our franchising strategy is primarily focused on expanding our presence in under-penetrated markets and accelerating restaurant growth in new markets. These efforts include our sale of Company-operated restaurants to franchisees, and the requirement that new franchisees sign area development agreements pursuant to which franchisees must open a specified number of new restaurants in a defined period of time.
- *Dispose of Under-Performing Restaurants.* We are continually reviewing the performance and prospects of our restaurants, and seek to dispose of under-performing restaurants.

### Restaurant Design and Site Selection

Our restaurants are built to our specifications on sites that we have approved, with emphasis on freestanding facilities, end caps and conversions. Our current prototype is 3500 square feet with 155 seats and 37 parties, and is designed to be expanded to 203 seats and 50 parties. This building was designed to reduce the size and therefore the cost of construction while maintaining sufficient party count, seating count, design elements and equipment needs. Two exterior schemes have been developed making the building adaptable to both the northern and southern areas of the country. Both schemes incorporate design elements and trade dress recognizable as a Friendly's. These same elements along with the interior design can be incorporated into end caps and conversions. The interior of our current prototype has been improved adding more color and excitement while maintaining a mid-scale restaurant environment.

We believe that the specific location of a restaurant is critical to our long-term success and we devote significant resources to the investigation and evaluation of potential restaurant sites. Each potential location must be approved by the Real Estate Committee, which is comprised of representatives from



operations, finance and development. Site selection for all new restaurants is made after an economic analysis and review of demographic data and other information relating to population density, traffic, competition, restaurant visibility and access, available parking, surrounding businesses and opportunities for market penetration.

### **Restaurant Operations**

*Restaurant Management.* The key to growing our customer base is ensuring that our customers have an enjoyable dine-in or carry-out experience. To ensure a positive guest experience, we must have competent and skilled restaurant management and service personnel at each of our locations. A typical Company-operated Friendly's restaurant employs between two and four management team members, which may include one general manager and one to three managers, depending on sales volume, and one to four managers-in-training in each of our 60 training restaurants. The general manager is directly responsible for day-to-day operations.

General managers report to a district manager who typically has responsibility for an average of five to eight restaurants. District managers report to a regional director, who typically has responsibility for approximately 40 to 60 restaurants. A portion of both general manager and district manager compensation is tied to the performance of their restaurant(s). Regional directors report to our Vice President, Company Restaurant Operations who oversees all Company-operated restaurants.

The average Friendly's restaurant is staffed with four to 28 employees per shift, including the salaried restaurant management. Shift staffing levels vary by sales volume level, building configuration and time of day.

*Training.* One regional training coordinator in each of our six regions supports the training function with an emphasis on managers-in-training, implementation of corporate initiatives and ongoing manager development through workshops, seminars, food safety training and side-by-side development.

Our initial management-training program is a six-week program coordinated by the district manager and regional training coordinator. The program includes skill level competencies, shift management and the fundamentals that are required to successfully manage the business. Our restaurant manager development program is designed to build on skills and knowledge acquired during our initial management-training program. Managers at all levels are responsible for self-development based on clear, measurable benchmarks. Learning is sequenced to gradually introduce the manager to financial and crew development results, and accountability is introduced sequentially and commensurate to the manager's level of experience and knowledge. As managers complete each set of benchmarks, they are responsible to teach a fellow or subordinate manager and pass along the assigned level of responsibility. This builds an environment of structured and ongoing development for internal candidates, crew level employees, managers and general managers.

General managers that have training duties are also responsible for measuring the success of managers-in-training, providing support for new general managers, and becoming district leaders for ongoing development in addition to their restaurant responsibilities. We expect general managers with these responsibilities to build the skills necessary to manage multiple units, which ultimately creates a pool of internal district manager candidates.

*Customer Satisfaction and Quality Control.* We devote significant resources toward ensuring that our restaurants offer quality food and good customer service. Our future success depends on our consistent commitment to exceeding our guests' expectations. This commitment is monitored at Company-operated restaurants through the use of online guest satisfaction surveys, a toll-free guest service line, a mystery shop program, frequent on-site visits and formal inspections by management and training personnel. Franchised restaurants are monitored by periodic inspections by our franchise field operations personnel,

online guest satisfaction surveys, and a toll-free guest service line, in addition to their own internal management oversight procedures. These guest satisfaction measurement tools provide means for both continuing and improving our excellence in customer service.

*Capital Expenditures.* Our capital investment program is primarily targeted at improving and upgrading our restaurant facilities in order to provide a well-maintained, comfortable environment and to enhance the overall customer dining experience. During 2006, 2005 and 2004, we spent approximately \$21.7 million, \$16.9 million and \$19.7 million, respectively, in capital expenditures, of which \$9.2 million, \$10.4 million and \$11.0 million, respectively, was spent on upgrades of existing Company-operated restaurants; \$5.2 million, \$1.2 million and \$1.4 million, respectively, was spent on restaurant remodeling and re-imaginings; and \$1.7 million, \$3.1 million and \$4.4 million, respectively, was spent on new restaurant construction. The remaining capital dollars were spent on the foodservice business segment and at our executive offices.

As part of our re-imaging plan, we have remodeled 88 Company-operated restaurants over the past three years, at an average cost of slightly less than \$0.1 million. During 2006, we completed 67 of these remodels. Our remodeling efforts are focused primarily on the restaurant exterior to create curb appeal with the intent of driving increased guest traffic. The typical components of a remodel include, among other things, sand blasting and painting of the building exterior, new or repaired signage, parking lot sealing and striping. Our remodeling efforts also include interior wallpaper, painting and new carpets where necessary.

In 2006, we opened two new restaurants at an average cash investment cost of \$1.3 million. In 2007, we expect to open one additional new restaurant at a lower average cash investment cost of approximately \$0.3 million. This new restaurant represents a conversion of a former franchisee operated restaurant. We continue to evaluate the appropriate level of growth.

#### **Franchising Program**

Our franchising strategy is designed to expand our restaurant presence in under-penetrated markets, accelerate restaurant growth in new markets, increase marketing and distribution efficiencies and preempt competition by acquiring restaurant locations in our targeted markets. As of December 31, 2006, franchisees operated 198 Friendly's restaurants and seven non-traditional units. From December 2002 to December 2006, the number of restaurants owned by franchisees increased 27%, rising from 29% of our total restaurants to 39% of our total restaurants, and revenue from franchisees increased 63% during that period. In 2007, we expect that our franchisees will open between eight and 12 new franchised restaurants.

The expansion of our franchising activities includes the acquisition of Company-operated restaurants by franchisees through either a current sale or an option to purchase at a future date and the development of new restaurants by franchisees. Our franchising transactions have included, among other things, the sale and/or lease of owned real property, leasehold improvements or equipment and subletting or assignment of leases. We expect that all future franchising transactions will require the franchisee to also sign an area development agreement in which the franchisee commits to open new restaurants within a specified period of time, in specified geographical territories. We also expect to pursue such area development agreements with new franchisees in new markets. We seek franchisees that have related business experience, sufficient capital to build-out the Friendly's concept and no other operations, which have directly competitive restaurant or food concepts.

During 2006, we completed three transactions in which three existing franchisees purchased five existing Company-operated restaurants and agreed to develop a total of 10 new restaurants in future years. Gross proceeds from these transactions were \$3.1 million, of which \$0.3 million was for franchise and development fees and \$2.8 million was for the sale of certain assets and leasehold rights.

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During 2006, three franchisees operating Company restaurants under options to purchase restaurants exercised their options. In doing so, they purchased eight existing restaurants and agreed to develop a total of 10 new restaurants in future years. Gross proceeds from these transactions were \$2.2 million, of which \$0.3 million was for franchise and development fees and \$1.9 million was for the sale of certain assets and leasehold rights.

During 2005, we completed four transactions in which four existing franchisees purchased nine existing Company-operated restaurants and agreed to develop a total of 10 new restaurants in future years. Gross proceeds from these transactions were \$4.1 million, of which \$0.3 million was for franchise and development fees and \$3.8 million was for the sale of certain assets and leasehold rights. In addition, we completed three transactions in which three former employees received franchises to operate six existing restaurants for a period of two years with options to purchase the restaurants within the two years. If the options are exercised, one franchisee has agreed to develop two new restaurants in future years. Proceeds from option transactions will be recognized upon purchase.

In October 2005, we entered into a second development agreement with our second largest franchisee. The franchisee currently has 34 locations and agreed to open 33 new restaurants over the next 27 years (eight more than their prior commitment). We expect that they will open a total of four new restaurants by 2010.

We provide franchisees assistance with both the development and ongoing operation of their restaurants. Our management personnel assist with site selection, approve all restaurant sites and provide franchisees with prototype plans and construction support and specifications for their restaurants. Our staff provides both on-site and off-site instruction to franchised restaurant management personnel. Managers of franchised restaurants are required to complete the same training as managers of Company-operated units. Our support continues after a restaurant opening with periodic training programs, operating manuals, updates relating to product specifications and customer service and quality control procedures, advertising and marketing materials and assisting with particular advertising and marketing needs. Franchise field representatives visit all franchisees to support the successful operation of their restaurants.

All franchised restaurants are required to serve only Friendly approved menu items. In addition to our manufactured products, franchisees served by our distribution centers purchase from us food and supplies of other approved manufacturers at our negotiated cost, plus a markup to cover our distribution operation. Using these services enables franchisees to benefit from our purchasing power and assists us in monitoring compliance with our quality standards and specifications.

In addition to certain franchise royalty fees (generally 4% of franchise restaurant revenues) and other related fees including rent, we generate revenues from franchisees from our distribution operation and the sale of our own manufactured premium ice cream desserts and products.

Through 2006, our franchise agreement required franchisees to contribute 3.0% of their net sales to its regional marketing fund, and spend an additional 0.5% to 1.0% in local advertising. We had also offered franchisees the opportunity to participate in a supplemental advertising program under which the franchisee paid an additional 0.75% of net sales into the marketing fund in exchange for a fixed reduction in the list price of bulk ice cream. In 2006, all but one of our franchisees elected to participate in this supplemental program.

Beginning in 2007, substantially all of our franchisees agreed to increase their contribution to the marketing fund from 3.0% to 3.5%, in exchange for a reduction in the list price of bulk ice cream.

Although financing is the sole responsibility of the franchisee, we make available to franchisees information about financial institutions interested in financing the costs of restaurant development for qualified franchisees. None of these financial institutions is our affiliate or agent, and we have no control over the terms or conditions of any financing arrangement offered by these financial institutions.

### **Retail (Packaged Goods) Sales**

We offer a branded product line that includes approximately 50 varieties of premium ice cream shop flavors and unique sundae combinations, frozen yogurt and sherbet. Specialty products and flavors include Royal Banana Split Sundae, Caramel Fudge Blast® and Fudgeberry Swirl. Proprietary products include the Jubilee Roll®, Wattamelon Roll®, Orange Crème Roll and Friendly's branded ice cream cakes. We also license from Hershey Foods Corporation ( Hershey ) the right to feature certain candy brands including Reese's Pieces® and Reese's® Peanut Butter Cups.

We focus our marketing and distribution efforts in the highly developed markets of Albany, Boston, Hartford and Springfield. We have developed a distributor network designed to protect product quality through proper product handling and to enhance the merchandising of our premium ice cream desserts. Our experienced sales force manages this network to serve specific retailer needs on a market-by-market basis.

We expect to improve the profitability of our retail business in our current retail markets by continuing to develop our product portfolio beyond the 56-ounce ice cream container with our unique specialty products, such as decorated ice cream cakes and rolls. Our specialty products typically have higher margins and fewer direct competitors than the more traditional 56-ounce ice cream containers, making them less susceptible to discounting.

Based on consumer feedback, we will be converting our 56 oz packaging format from the traditional brick container to the more contemporary and consumer-friendly sqround package. Sqround is a term used in the industry for a rectangular shaped container with rounded corners and a separate base and lid. This package conversion is expected to take place during the second quarter of 2007.

### **Marketing**

Our overall marketing strategy is to build on the equity of our brand in order to maximize and leverage our 70-year heritage and touch what consumers emotionally feel about Friendly's.

Our marketing objectives are to increase our share of visits from frequent casual and family dining customers, to build top-of-mind awareness of Friendly's restaurants and the Friendly's brand and to maintain a leadership position in ice cream. Friendly's advertising attempts to build on the past emotional connections and experiences of families and children with our brand to present current offers and new menu items. Our advertising, media, promotion and product strategies are focused on delivering these objectives.

Media is planned and purchased on a market-by-market basis to maximize the efficiencies and opportunities in each market. Our primary advertising medium is spot television in Friendly's major markets with radio used in the secondary markets or as a frequency builder for special events. Due to the seasonality of ice cream consumption, and the effect from time to time of weather on patronage of the restaurants, our revenues and operating income are typically higher in our second and third quarters. Accordingly, a significant portion of our media advertising is focused during this period. We use targeted local restaurant marketing programs such as print (cooperative free-standing inserts and direct mail), school reading programs, Family Fun Nights (fundraisers for schools, church groups, youth sports, etc.) and other local store marketing initiatives to meet our marketing objectives in those markets where penetration does not allow for efficient broadcast media advertising.

We believe that our integrated restaurant and retail (supermarket) marketing efforts provide significant support for the development of our retail business. Specifically, the retail business benefits from the overall awareness of the Friendly's brand generated by the ongoing restaurant advertising program. This, combined with the use of a common advertising campaign for both restaurant and retail communications, delivers a significantly higher level of consumer exposure and usage compared to our



packaged premium ice cream competitors, which have only retail distribution. In turn, sales of our premium ice cream products through more than 4,000 retail locations provide additional consumer awareness which we believe benefits the restaurants. Advertising and promotion expense was approximately \$16.8 million for 2006, \$18.7 million for 2005 and \$20.7 million for 2004.

### **Manufacturing**

We produce all of our premium ice cream and the majority of our syrups and toppings in our Wilbraham, MA Company-operated manufacturing plant. As of December 31, 2006, the Wilbraham plant employed a total of approximately 150 people. During 2006, the Wilbraham plant operated at an average capacity of 78%, attaining 80% capacity for the months of June through August of 2006. In 2005, our Wilbraham plant operated at an average capacity of 75%, attaining 84% capacity for the months of June through August of 2005. In 2006, we produced over 13.7 million gallons of ice cream, sherbets and yogurt in bulk and 56-ounce packages, 8.4 million sundae cups, 2.1 million premium ice cream dessert rolls, pies and cakes and 0.8 million gallons of fountain syrups and toppings. In comparison, in 2005, we produced over 13.2 million gallons of ice cream, sherbets and yogurt in bulk and 56-ounce packages, 7.2 million sundae cups, 2.2 million premium ice cream dessert rolls, pies and cakes and 0.8 million gallons of fountain syrups and toppings.

### **Purchasing and Distribution**

The majority of the cost of materials related to the manufacture of our premium ice cream, toppings, and specialty dessert products is in dairy products and sweeteners. In addition to the procurement of raw materials and packaging used in the manufacturing plant, our purchasing department buys all of the food, carryout supplies, disposables, cleaning chemicals, china, glass and flatware used in Company-operated and franchised restaurants. Occasionally, we may purchase option and/or futures contracts (when available) to hedge our price exposure on one or more exchange-traded agricultural commodities such as butter, coffee, orange juice, bacon or soybean oil, where we believe it is appropriate. Additionally, we may forward contract where appropriate for up to a three-year period. Since not all of our purchases are hedgeable or have adequate open interest to meet our needs, sudden market price increases can pose substantial price risks to us, such as those that happened in 1998 and 2004 to the price of cream, which could have a material adverse effect on our business in the future.

The purchasing department regularly monitors the cost of all items purchased to ensure that vendors are billing us the correct amount per contract, pricing agreement or spot market. The purchasing department conducts business related to food and raw material purchases with numerous vendors, many of which have had long-term relationships with us. Contracts are executed on a multi-year, annual, semi-annual, quarterly or monthly basis, depending on the nature of the item and the opportunities within the marketplace. In order to promote competitive pricing and uninterrupted supply, we routinely work with prospective vendors on existing products, as well as on items that may make up a new menu offering. In order to maximize our purchasing power, we purchase directly from manufacturers and service providers and attempt to avoid as much as possible any third party participation.

We own one distribution center and lease two others. We distribute our product lines to most of our Company-operated and franchised restaurants from warehouses in Chicopee, MA and York, PA through our combined non-union workforce of approximately 175 employees. For economic efficiency, we contract with a third party distributor to provide some distribution services to restaurants located in Florida markets. Based on fleet availability and economics, we distribute our packaged premium ice cream desserts to our retail customers. We are currently distributing produce and dairy products to approximately 78% of our restaurants. The Chicopee, Wilbraham and York warehouses encompass approximately 60,000, 127,000 and 85,000 square feet, respectively. In 2003, we constructed an 18,000 square foot freezer addition

to our Wilbraham facility. We believe that our distribution facilities operate at or above industry standards with respect to timeliness and accuracy of deliveries.

We have distributed our products since our inception to protect the product integrity of our premium ice cream desserts. As described above, we deliver products to most restaurants using our own fleet of tractors and trailers. The entire fleet is specially built to be compatible with storage access doors, thus protecting premium ice cream desserts from temperature shock. The trailer fleet is designed to have individual temperature controls for three distinct compartments. To provide us with additional efficiency and cost savings, the truck fleet backhauls by bringing purchased raw materials and finished products back to the distribution centers on approximately 42% of its delivery trips.

### **Employees**

The total number of our employees varies between 12,000 and 16,000 depending on the season of the year. As of December 31, 2006, we employed approximately 12,800 employees, of which approximately 12,250 were employed in Friendly's restaurants (including approximately 50 in field management), approximately 300 were employed at our manufacturing and distribution facilities and approximately 250 were employed at our corporate headquarters and other offices. None of our employees is a party to a collective bargaining agreement.

### **Licenses and Trademarks**

We regard our trademarks, service marks, business know-how and proprietary recipes as having significant value and as being an important factor in the marketing of our products. Our policy is to establish, enforce and protect our intellectual property rights using the intellectual property laws, and/or through contractual arrangements, such as franchising, development and license agreements.

We are the owner or licensee of the most significant trademarks and service marks (the Marks) used in our business. The Marks Friendly® and Friendly's® are owned by us and are federally registered with the U.S. Patent and Trademark Office (the PTO). The Mark Friendly's® is critically important to us and, subject to our continued use of that Mark, we have the right to perpetually renew the federal registration of such Mark with the PTO. We intend to exercise our rights to renew this Mark.

Upon the sale of Friendly's by Hershey to The Restaurant Company in 1988, Hershey licensed to us all of the trademarks and service marks used in Friendly's business at that time which did not contain the word Friendly (the Non-Friendly Marks). In September 2002, Hershey assigned the Non-Friendly Marks to us.

Hershey entered into non-exclusive licenses with us for certain candy trademarks used by us in our premium ice cream sundae cups (the Cup License) and pints (the Pint License). The Cup License and Pint License automatically renew for unlimited one-year terms subject to certain non-renewal rights held by both parties. Hershey is subject to a non-compete provision in the sundae cup business for a period of two years if the Cup License is terminated by Hershey without cause, provided that we maintain our current level of market penetration in the sundae cup business. However, Hershey is not subject to a non-compete provision if it terminates the Pint License without cause. We have not produced pints since 2001.

We also have a non-exclusive license agreement with Leaf, Inc. (Leaf), a subsidiary of Hershey, for use of the Heath® Bar candy trademark. The term of the royalty-free Leaf license continues indefinitely subject to termination by Leaf upon 60 days notice.

In January 2006, we signed a license agreement with RTBD, Inc. (RTBD) granting us a non-exclusive, royalty-free license for use of the mark Colossal Burgers®. The term of the license continues

indefinitely, subject to RTBD's right to terminate the license in the event we discontinue using the mark for a period of 3 consecutive years.

In January 2007, we signed a trademark agreement with Bravo! Brands, Inc. ( Bravo ), the owner of a federal trademark, Slammers®, in which Bravo agreed not to contest our right to use the mark Slammertm in connection with certain beverages in our restaurants.

### **Competition**

The restaurant business is highly competitive and is affected by changes in the public's eating habits and preferences, population trends and traffic patterns, as well as by local and national economic conditions affecting consumer spending habits, many of which are beyond our control. Key competitive factors in the industry are the quality and value of the food products offered, quality and speed of service, attractiveness of facilities, advertising, name brand awareness and image and restaurant locations. Each of our restaurants competes directly or indirectly with locally-owned restaurants as well as restaurants with national or regional images and, to a limited extent based on location, restaurants operated by our franchisees. A number of our significant competitors are larger or more diversified and have substantially greater resources than we do. Our retail operations compete with national and regional manufacturers of premium ice cream desserts, many of which have greater financial resources and more established channels of distribution than ours. Key competitive factors in the retail food business include brand awareness, access to retail locations, price and quality.

### **Government Regulation**

We are subject to various federal, state and local laws affecting our business. Our facilities and restaurants are subject to licensing and regulation by a number of governmental authorities, which include health, safety, sanitation, building and fire agencies in the state or municipality in which the restaurant is located. These licensing and regulation matters relate to environmental, building, construction and zoning requirements and the preparation and sale of food products. Difficulties in obtaining or failures to obtain required licenses or approvals, or the loss of such licenses and approvals once obtained, can delay, prevent the opening of or close a restaurant in a particular area. We are also subject to federal and state environmental regulations, but these have not had a material adverse effect on our operations.

Substantive state laws that regulate the franchisor-franchisee relationship presently exist or are being considered in a significant number of states. In addition, bills may be introduced in Congress that would provide for federal regulation of substantive aspects of the franchisor-franchisee relationship. These current and proposed franchise relationship laws limit, among other things, the rights of a franchisor to approve the transfer of a franchise, the ability of a franchisor to terminate or refuse to renew a franchise and the ability of a franchisor to designate sources of supply. Due to the scope of our business and the complexity of franchise regulations, we may encounter minor compliance issues from time to time. We do not believe, however, that any of these issues will have a material adverse effect on our operations.

Our operations are also subject to federal and state laws governing such matters as wages, hours, working conditions, civil rights and eligibility to work. Some states have set minimum wage requirements higher than the federal level. Significant numbers of hourly personnel at our restaurants are paid at rates related to the federal minimum wage and, accordingly, increases in the minimum wage at a federal and/or state level could increase labor costs at our restaurants. Other governmental initiatives such as mandated health insurance, if implemented, could adversely affect us as well as the restaurant industry in general. We are also subject to the Americans with Disabilities Act of 1990, which, among other things, may require certain renovations to our restaurants to meet federally-mandated requirements. In addition, our employment practices are subject to the requirements of the Immigration and Naturalization Service relating to citizenship and residency.

## Available Information

Our Internet website address is <http://www.friendlys.com>. Our Annual Reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934 are available through this Internet website as soon as reasonably practicable after such material is electronically filed with, or furnished to, the Securities and Exchange Commission. Our corporate governance materials, including our corporate governance guidelines, Nominating and Corporate Governance Charter, Audit Committee Charter, Compensation Committee Charter, Code of Business Conduct and Ethics and Code of Ethics for our Chief Executive Officer and other Senior Financial Officers, are available on our Internet website, free of charge. Our Internet website and the information contained therein or connected thereto are not intended to be incorporated into this Annual Report on Form 10-K.

## Item 1A. RISK FACTORS

*This report contains forward-looking statements that involve risks and uncertainties, such as statements of our objectives, expectations and intentions. The cautionary statements made in this report are applicable to all forward-looking statements wherever they appear in this report. Our actual results could differ materially from those discussed herein. Risk factors that could cause or contribute to such differences include those discussed below, as well as those discussed elsewhere in this report.*

### **We and our franchisees may not be successful at operating profitable restaurants.**

Our financial success depends on our ability and the ability of our franchisees to operate restaurants profitably. The profitability of our restaurants is dependent on a number of factors, including:

- our ability to successfully implement our key initiatives;
- our ability to hire, train and retain quality management, restaurant staff and other personnel;
- our ability to timely and effectively meet customer demands and maintain a strong customer base;
- our ability to provide innovative products to our customers at a reasonable price;
- our ability to manage increases in food, labor and other operating costs;
- effective advertising and marketing campaigns;
- our ability to obtain appropriate financing at reasonable terms, if at all.

### **We operate in a highly competitive business environment.**

The restaurant business is highly competitive and is affected by changes in the public's eating habits and preferences, population trends and traffic patterns, as well as by local and national economic conditions affecting consumer spending habits, many of which are beyond our control. Key competitive factors in the industry are the quality and value of the food products offered, quality and speed of service, attractiveness of facilities, advertising, name brand awareness and image and restaurant location. Each of our restaurants competes directly or indirectly with locally owned restaurants as well as restaurants with national or regional images, and to a limited extent, restaurants operated by our franchisees. A number of our significant competitors are larger or more diversified and have substantially greater resources than we have. Our retail operations compete with national and regional manufacturers of premium ice cream desserts, many of which have greater financial resources and more established channels of distribution than ours. Key competitive factors in the retail food business include brand awareness, access to retail locations, price and quality.

**Increases in the prices of, or interruptions in the supply of, raw materials and other essential food supplies may increase the costs of our products, create shortages in the manufacturing of products or cause interruptions in the supply of products to our customers.**

The cost, availability and quality of the ingredients that we use to prepare our food are subject to a range of factors, including fluctuations in supply and demand and political and economic conditions, which are beyond our control. Our ability to maintain consistent quality throughout our restaurants depends in part upon our ability to acquire fresh food products and related items from reliable sources in accordance with our specifications. If these suppliers do not perform adequately or otherwise fail to distribute products or supplies to our restaurants, we may be unable to replace the suppliers in a short period of time on acceptable terms.

The basic raw materials for the manufacture of our premium ice cream desserts are dairy products and sugar. Our purchasing department purchases other food products, such as coffee, in large quantities. We rarely hedge our positions in these commodities other than with respect to cream as a matter of policy, but may opportunistically purchase some of these items in advance of a specific need. As a result, we are subject to the risk of substantial and sudden price increases, shortages or interruptions in supply of such items, which could have a material adverse effect on our business. Increases in the price of cream have adversely affected our financial results in the past and may do so in the future because we may be unable to pass along all price increases.

**Increased energy costs may harm our business.**

Higher energy costs could increase the costs to operate our business and may result in fewer guests at our restaurants, both of which can have an adverse effect on our business. We purchase energy-related products such as electricity, oil and natural gas for use in our restaurants. In addition, our private truck fleet requires fuel to deliver our product lines to our Company-operated and franchised restaurants and to our retail customers. Our suppliers must purchase gasoline in order to transport food and supplies to us. Our guests purchase energy to heat and cool their homes and fuel their automobiles. When energy prices, such as those for gasoline, heating and air increase, we incur greater costs to operate our restaurants. Likewise, our guests have lower disposable income, which may reduce the frequency in which they dine out or cause them to find less expensive restaurants when eating outside the home. The costs of energy-related items fluctuate due to factors that may not be predictable, such as the economy, current political/international relations and weather conditions. We cannot control these types of factors. As a result, we are subject to the risk of substantial and sudden price increases, shortages or interruptions in the supply of energy-related items, which could have a material adverse effect on our business.

**Changes in consumer preferences and economic conditions could adversely affect our financial performance.**

Food service businesses are often affected by changes in consumer tastes, national, regional and local economic conditions, demographic trends, traffic patterns, the cost and availability of labor, purchasing power, availability of products and the type, number and location of competing restaurants. In addition, factors such as increased food, labor and benefits costs, regional weather conditions and the potential scarcity of experienced management and hourly employees may also adversely affect the food service industry in general and the results of our operations and financial condition in particular. In addition, purchases at our restaurants are discretionary for consumers and, therefore, we are susceptible to economic slowdowns. Consumers are generally more willing to make discretionary purchases during periods in which favorable conditions prevail. A general slowdown in the United States economy could adversely affect consumer confidence and spending habits, which could negatively impact our sales.

**Our business may be harmed by highly publicized incidents at one or more of our restaurants.**

Multi-unit food service businesses can be materially and adversely harmed by publicity resulting from poor food quality, illness, injury or other health concerns or employee relations or other operating issues stemming from one location or a limited number of locations, whether or not the Company is liable, or from consumer concerns with respect to the nutritional value of certain food. In addition, we cannot guarantee that our internal controls and training will be fully effective in preventing all food-borne illnesses. Some food-borne illness incidents could be caused by third party food suppliers and transporters outside of our control. Any outbreak of such illness attributed to one or more of our restaurants or to a similar multi-unit restaurant chain, or the perception of such an outbreak, could harm our business.

**We may not be able to successfully continue the development and implementation of our franchising program.**

The success of our business strategy depends, in part, on the continued development and implementation of our franchising program. We can provide no assurance that we will be able to continue to successfully locate and attract suitable franchisees or that these franchisees will have the business abilities or sufficient access to capital to open restaurants or will operate restaurants in a manner consistent with the Friendly's concept and standards or in compliance with franchise agreements. The success of our franchising program will also be dependent upon factors not within our control or the control of our franchisees, including the availability of suitable sites on acceptable lease or purchase terms, permitting and regulatory compliance and general economic and business conditions.

In addition, even if our franchising program is successful, we can provide no assurance that it will prove advantageous to us from an operational standpoint. The interests of franchisees may conflict with our interests. For example, whereas franchisees are concerned with individual business strategies and objectives, we are responsible for ensuring the success of the entire range of our products and services.

Finally, although we evaluate and screen potential franchisees, we can provide no assurance that franchisees will have the business acumen or financial resources necessary to operate successful franchises in their franchise areas. The failure of franchisees to operate successfully could have an adverse effect on our business, reputation and brand and our ability to attract prospective franchisees.

**Our operations are highly concentrated in the Northeast region.**

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

**Our cash flows may fluctuate due to seasonality.**

Due to the seasonality of premium ice cream dessert consumption, and the effect from time to time of weather on patronage of our restaurants, our revenues and operating income are typically higher in the second and third quarters. This seasonality may adversely affect our cash flows.

**The locations where we have restaurants may cease to be attractive which could negatively affect our sales at these locations.**

The success of Company-operated and franchised restaurants is significantly influenced by location. Current locations may not continue to be as attractive as demographic patterns change. Likewise, we may face difficulties in acquiring new locations at reasonable costs. It is possible that the neighborhood or

economic conditions where our restaurants are located could decline in the future, potentially resulting in reduced sales in those locations.

**We and our franchisees may experience delays in restaurant openings, which could adversely affect our ability to increase revenues and profitability.**

We and our franchisees have experienced delays in restaurant openings from time to time and may experience delays in the future. Delays in opening new restaurants in accordance with our current plans and the current plans of our franchisees could materially adversely affect our expected revenues and profitability.

Our ability or the ability of our franchisees to open new restaurants will depend on a number of factors, some of which are beyond our control, including:

- the availability of funding;
- the identification and availability of suitable restaurant sites;
- negotiation of favorable leases or financing terms;
- the timely development in certain cases of commercial, residential, street or highway construction near restaurants;
- dependence on contractors to construct new restaurants in a timely manner;
- management of construction and development costs of new restaurants;
- securing required local, state and federal governmental approvals and permits; and
- recruitment of qualified operating personnel.

**If our manufacturing and distribution operation is damaged or otherwise interrupted for any prolonged period of time, our operations would be harmed.**

Our business depends on our ability to reliably produce ice cream dessert products and deliver them to retailers, distributors and restaurants on a regular schedule. We currently produce most of our ice cream dessert products in a single manufacturing facility in Wilbraham, Massachusetts. As a result, our business is vulnerable to damage or interruption from fire, severe drought, flood, power loss, telecommunications failure, break-ins, snow and ice storms, work stoppages and similar events. Any such damage or failure could disrupt our operations and result in the loss of sales and current and potential customers if we are unable to quickly recover from such events. Our business interruption insurance may not be adequate to compensate for our losses if any of these events occur. In addition, business interruption insurance may not be available to us in the future on acceptable terms or at all. Even if we carry adequate insurance, such events could harm our business.

**The restaurant and food distribution industries are heavily regulated.**

We are subject to various federal, state and local laws affecting our business. Our restaurants and facilities are subject to licensing and regulation by a number of governmental authorities, which include health, safety, sanitation, environmental, building and fire agencies in the state or municipality in which the restaurant is located. Difficulties in obtaining or failures to obtain required licenses or approvals, or the losses of such licenses and approvals, can delay, prevent the opening of or close a restaurant in a particular area.

Our relationship with our current and potential franchisees is governed by state laws, which regulate substantive aspects of the franchisor-franchisee relationship. Current and proposed franchise relationship





laws limit, among other things, the rights of a franchisor to approve the transfer of a franchise, the ability of a franchisor to terminate or refuse to renew a franchise and the ability of a franchisor to designate sources of supply.

We are also subject to the Americans with Disabilities Act of 1990, which, among other things, may require certain renovations to our restaurants to meet federally mandated requirements.

**Increasing labor costs could adversely affect our profitability.**

Our restaurant operations are subject to federal and state laws governing such matters as wages, hours, working conditions, civil rights and eligibility to work. Some states have set minimum wage requirements higher than the federal level. Significant numbers of hourly personnel at our restaurants are paid at rates related to the federal minimum wage and, accordingly, increases in the minimum wage at a federal and/or state level could increase labor costs at our restaurants. Other governmental initiatives such as mandated health insurance, if implemented, could adversely affect us as well as the restaurant industry in general.

**A failure to attract and retain qualified employees may adversely affect us.**

Our success depends upon our ability to attract and retain a sufficient number of qualified employees, including key executives, skilled management, customer service personnel and wait and kitchen staff. We face significant competition in the recruitment of qualified employees. Our inability to recruit and retain qualified individuals could have a material adverse effect on our ability to implement our strategies and initiatives, result in higher employee turnover, affect our ability to provide a high quality customer experience in restaurants or exert pressure on wages or other employee benefits to attract qualified personnel. Any of these consequences could have a material adverse effect on our business and results of operations.

**We may not be able to protect our trademarks and other proprietary rights.**

We believe that our trademarks and other proprietary rights are important to our success and competitive position. Accordingly, we devote substantial resources to the establishment and protection of our trademarks and proprietary rights. However, the actions we take to protect our intellectual property may be inadequate to prevent imitation of our products and concepts by others.

**Our substantial debt could harm our business, results of operations, financial position and cash flows.**

We have substantial debt and may incur additional debt in the future. The principal and interest payment obligations of such debt may restrict future operations and operating expenditures and impair our ability to meet our obligations under our debt instruments, loan agreements, letters of credit, leases and other long-term commitments, and may otherwise affect our profitability. In addition, our credit facility and our mortgage loans contain floating interest rates and any increase in the prevailing rates could have an adverse effect on our business.

As of December 31, 2006, we had approximately \$230.4 million of total indebtedness outstanding, including capital leases. In addition, the indenture governing our 8.375% senior notes permits us to incur additional debt. Our substantial levels of debt may have important consequences. For instance, it could:

- make it more difficult for us to satisfy our financial obligations;
- require us to dedicate a substantial portion of any cash flow from operations to the payment of interest and principal due on our debt, which will reduce funds available for other business purposes;

- increase our vulnerability to general adverse economic and industry conditions;
- limit flexibility in planning for, or reacting to, changes in the business and in the industries in which we operate;
- place us at a competitive disadvantage compared with some of our competitors that have less debt; and
- limit our ability to obtain additional financing required to fund working capital and capital expenditures and for other general corporate purposes.

Our ability to satisfy our obligations and to reduce our total debt depends on future operating performance and on economic, financial, competitive and other factors, many of which are beyond our control. Our business may not generate sufficient cash flow, and future financings may not be available to provide sufficient net proceeds, to meet these obligations or to successfully execute our business strategy.

**The instruments governing our 8.375% senior notes and other debt impose restrictions.**

The indenture governing our 8.375% senior notes and our other debt instruments, including without limitation our credit facility, contain, and other agreements we may enter into in the future may contain, covenants imposing significant restrictions on our business. These restrictions may affect our ability to operate our business and may limit our ability to take advantage of potential business opportunities as they arise. These covenants place restrictions on our ability to, among other things:

- incur additional debt,
- create liens,
- make investments,
- enter into transactions with affiliates,
- sell assets,
- declare or pay dividends,
- redeem stock or make other distributions to shareholders,
- enter into sale and leaseback transactions, and
- consolidate or merge.

Our ability to comply with these covenants may be affected by events beyond our control, including prevailing economic, financial and industry conditions. The breach of any of these restrictions could result in a default under the indenture. An event of default under our debt agreements would permit some of our lenders to declare all amounts borrowed from them to be due and payable, together with accrued and unpaid interest. If we were unable to repay debt to secured lenders, they could proceed against our assets securing that debt.

**We are exposed to potential risks as a result of the internal control testing and evaluation process mandated by Section 404 of the Sarbanes-Oxley Act of 2002.**

We assessed the effectiveness of our internal control over financial reporting as of December 31, 2006 and assessed all deficiencies on both an individual basis and in combination to determine if, when aggregated, they constitute more than an inconsequential deficiency. As a result of this evaluation, no significant deficiencies or material weaknesses were identified. Although we have completed the documentation and testing of the effectiveness of our internal control over financial reporting for 2006 as



required by Section 404 of the Sarbanes-Oxley Act of 2002, we expect to continue to incur costs, including accounting fees and staffing salaries, in order to maintain compliance with that section of the Sarbanes-Oxley Act. We continue to monitor controls for any weaknesses or deficiencies. However, no evaluation can provide complete assurance that our internal controls will detect or uncover all failures of persons within our Company to disclose material information otherwise required to be reported. The effectiveness of our controls and procedures could also be limited by simple errors or faulty judgments.

In the future, if we fail to complete the Sarbanes-Oxley Section 404 evaluation in a timely manner, or if our independent registered public accounting firm cannot attest in a timely manner to our evaluation, we could be subject to regulatory scrutiny and a loss of public confidence in our internal controls. In addition, any failure to implement required new or improved controls, or difficulties encountered in their implementation, could harm our operating results or cause us to fail to meet our reporting obligations. Although we intend to devote substantial time and incur costs as necessary to ensure ongoing compliance, we cannot be certain that we will be successful in complying with Section 404.

**We have incurred and may incur significant additional and unforeseen expenses and costs to defend or pursue litigation and related matters.**

From time to time we are named as a defendant in legal actions arising in the ordinary course of our business. We are currently a party to litigation brought by S. Prestley Blake ( Blake ), holder of approximately 12% of our common stock. On February 25, 2003, Mr. Blake sued us and our Chairman in a purported derivative action in Hampden Superior Court, Massachusetts. The suit alleges breach of fiduciary duty and misappropriation of corporate assets, and alleges that we paid certain expenses relating to a corporate jet and the Chairman's use of that jet and use of an office in Illinois. The suit seeks to require the Chairman to reimburse us and for Friendly's to pay Blake's attorneys' fees. Friendly's and our Chairman have denied Blake's allegations and are vigorously defending the lawsuit. We cannot guarantee that we will be successful in defending the Blake litigation or any other litigation.

In addition to the Blake litigation, we may incur additional costs and expenses in connection with a potential proxy contest threatened by The Lion Fund, L.P., a hedge fund controlled by Sardar Biglari. The Lion Fund has notified us of its intention to nominate Sardar Biglari and Philip Cooley for election as directors at our upcoming Annual Meeting of Shareholders. In the event of a proxy contest, we expect to incur additional costs and expenses to solicit proxies in favor of our nominees for election of director and against The Lion Fund's nominees for election of director. These additional solicitation costs may include, among others, additional costs and fees payable to a proxy solicitation firm, fees of outside counsel to advise us in connection with the contested solicitation, increased costs associated with public relations matters, increased mailing and printing costs, and possible litigation.

The incurrence of significant additional and unforeseen costs and expenses to defend or pursue litigation or other investigations relating to the matters subject to the litigation, or in connection with any proxy contest, could have a material adverse effect on our business and results of operations.

**ITEM 1B. UNRESOLVED STAFF COMMENTS**

None.

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**Item 2. PROPERTIES**

The table below identifies the location of the 514 restaurants operating as of December 31, 2006.

| State          | Company-Operated Restaurants |           | Franchised Restaurants      |                               | Total Restaurants |
|----------------|------------------------------|-----------|-----------------------------|-------------------------------|-------------------|
|                | Freestanding                 | Other (a) | Leased/Owned by Franchisees | Leased to Franchisees By FICC |                   |
| Connecticut    | 36                           | 9         |                             | 1                             | 46                |
| Delaware       |                              |           | 7                           | 2                             | 9                 |
| Florida        | 11                           |           | 4                           |                               | 15                |
| Maine          | 9                            |           |                             |                               | 9                 |
| Maryland       |                              |           | 13                          | 6                             | 19                |
| Massachusetts  | 80                           | 23        | 3                           | 1                             | 107               |
| New Hampshire  | 12                           | 2         |                             |                               | 14                |
| New Jersey     | 26                           | 8         | 17                          | 6                             | 57                |
| New York       | 27                           | 10        | 76                          | 5                             | 118               |
| North Carolina |                              |           | 1                           |                               | 1                 |
| Ohio           |                              |           | 6                           | 17                            | 23                |
| Pennsylvania   | 31                           | 8         | 14                          | 7                             | 60                |
| Rhode Island   | 5                            | 1         |                             |                               | 6                 |
| South Carolina |                              |           | 4                           |                               | 4                 |
| Vermont        | 9                            | 1         |                             |                               | 10                |
| Virginia       | 8                            |           | 6                           | 2                             | 16                |
| <b>Total</b>   | <b>254</b>                   | <b>62</b> | <b>151</b>                  | <b>47</b>                     | <b>514</b>        |

(a) Includes primarily malls and strip centers.

The 254 freestanding restaurants range in size from approximately 2,400 square feet to approximately 5,000 square feet. The 62 mall and strip center restaurants range in size from approximately 2,200 square feet to approximately 4,500 square feet. Of the 316 Company-operated restaurants at December 31, 2006, we owned the buildings and the land for 77 restaurants, owned the buildings and leased the land for 76 restaurants and leased both the buildings and the land for 163 restaurants. Our leases generally provide for the payment of fixed monthly rentals and related occupancy costs (e.g., property taxes and insurance). Additionally, most mall and strip center leases require the payment of common area maintenance charges and incremental rent of between 2% and 6% of the restaurant's sales.

In addition to the Company-operated restaurants, we own an approximately 240,000 square foot facility on 35 acres in Wilbraham, MA, which houses our corporate headquarters, a training facility, a manufacturing and distribution facility and a warehouse. We also lease (i) an approximately 60,000 square foot distribution facility in Chicopee, MA and (ii) an approximately 85,000 square foot distribution and office facility in York, PA.

Under our lease/sublease agreement on the 47 properties franchisees lease from FICC, we have certain rights to gain control of a restaurant in the event of default under the franchise agreement.

**Item 3. LEGAL PROCEEDINGS**

From time to time we are named as a defendant in legal actions arising in the ordinary course of our business. We do not believe that the resolutions of these claims will have a material adverse effect on our consolidated financial condition or consolidated results of operations.

On February 25, 2003, S. Prestley Blake ( Blake ), holder of approximately 12% of our outstanding common stock, sued Friendly s and our Chairman in a purported derivative action in Hampden Superior Court, Massachusetts (the Court ). The suit alleges breach of fiduciary duty and misappropriation of corporate assets in that we paid certain expenses relating to a corporate jet and the Chairman s use of that jet and use of an office in Illinois. The suit seeks to require the Chairman to reimburse us and for Friendly s to pay Blake s attorneys fees.

On June 27, 2005, Mr. Blake sent a demand letter to our Board of Directors demanding that our Board of Directors address his concerns and beliefs that are subject to the litigation filed on February 25, 2003. On July 14, 2005, our Board of Directors formed a special litigation committee consisting solely of independent directors (the Committee ) to investigate the concerns and beliefs raised in Blake s demand letter dated June 27, 2005. The Committee issued its report on October 24, 2005 and a supplemental report on November 30, 2005. Based on its findings, the Committee filed a motion to dismiss the claims made by Mr. Blake. On May 24, 2006, the Court denied the Committee s motion to dismiss and allowed the joinder, as defendants, of current Board members Steven L. Ezzes, Michael J. Daly and Burton J. Manning, and former Board member Charles A. Ledsinger, Jr., and The Restaurant Company, The Restaurant Holding Corporation and TRC Realty, LLC.

On July 26, 2006, director defendants Michael J. Daly, Steven L. Ezzes, and Burton J. Manning, and former director defendant Charles A. Ledsinger, Jr., filed motions to dismiss the claims brought against them for failure to state a claim on the grounds that both the exculpatory provision in the Company s Restated Articles of Organization and the business judgment rule barred the plaintiff s claims. On December 20, 2006, the Court granted the directors motion and dismissed from the Blake litigation director defendants Michael J. Daly, Steven L. Ezzes, Burton J. Manning and former director defendant Charles A. Ledsinger, Jr. The Court has set a deadline for fact discovery of May 31, 2007, with a trial, if necessary, to begin on January 7, 2008. Friendly s and its Chairman have denied Blake s allegations and are vigorously defending the lawsuit.

On September 28, 2004 we were served with a civil lawsuit filed in Connecticut Superior Court, Judicial District of Hartford by three employees from a Connecticut restaurant on behalf of themselves and other similarly situated individuals. The plaintiffs allege that pursuant to Connecticut law, they should have been paid a higher wage for work they performed that was unrelated to serving our customers. The plaintiffs sought class certification and damages for the purported class members. On January 25, 2006, the court denied the plaintiffs request for class certification. We have denied the allegations and are vigorously defending the lawsuit.

**Item 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS**

None.

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**EXECUTIVE OFFICERS OF THE REGISTRANT**

Our executive officers and their respective ages and positions are as follows:

*George M. Condos, 51*, was appointed as our President and Chief Executive Officer and a member of our Board of Directors on January 8, 2007. Mr. Condos has 30 years of experience in the restaurant and hospitality industry. Most recently, he served as Brand Officer for Dunkin Donuts from 2003 to 2006. Dunkin Donuts is owned by Dunkin Brands, which also owns Baskin-Robbins ice cream and Togos sandwich shops. As Brand Officer, Mr. Condos was directly responsible for leading and executing brand strategy for more than 4,850 franchised stores in the United States generating \$4.3 billion in sales. Prior to that, from 1987 through 2003, Mr. Condos served in various roles for U.S. and international operations for Allied Domecq QSR (the former parent company for Dunkin Donuts, Baskin-Robbins and Togos), including vice president of Retail Brand Operations from 2001 to 2003 and vice president of Marketing, Development and Operations from 1994 to 2001. Prior to his tenure at Allied Domecq, Mr. Condos held various operational and managerial positions for International Dairy Queen.

*Paul V. Hoagland, 54*, has served as our Executive Vice President of Administration and Chief Financial Officer, Treasurer and Assistant Clerk since February 2003. He served as our Senior Vice President, Chief Financial Officer, Treasurer and Assistant Clerk from May 2001 to February 2003. Prior to joining us, Mr. Hoagland served as the Executive Vice President and Chief Financial Officer of New England Restaurant Company, Inc. from October 1992 to January 2001.

*Gregory A. Pastore, 42*, has served as our Vice President, General Counsel and Clerk since February 2004. Prior to joining us, Mr. Pastore served as the Vice President of Development, General Counsel and Secretary of Bertucci's Corporation from April 1999 to February 2004. Prior to April 1999, Mr. Pastore was affiliated with the law firm of Hutchins, Wheeler & Dittmar from April 1994 to April 1999.

*Garrett J. Ulrich, 56*, has served as our Vice President of Human Resources since September 1991. Prior to joining us, Mr. Ulrich served as the Vice President of Human Resources of Dun & Bradstreet Information Services, North America from 1988 to 1991. From 1978 to 1988, Mr. Ulrich held various human resource executive and managerial positions at Pepsi Cola Company, a division of PepsiCo.

*Kenneth D. Green, 43*, was appointed as our Senior Vice President, Restaurant Operations in October 2006. He served as our Vice President of Company Restaurant Operations from August 2004 to October 2006. He served as a Regional Director of our Restaurant Operations from April 2003 to August 2004. Prior to joining us, Mr. Green served as Vice President of Operations of Cosi, Inc. from April 2001 to April 2003 in New York City, NY, and previously had ten years experience in the T.G.I. Fridays restaurant systems.

*Florence A. Tassinari, 43*, has served as our Controller since May 2006. She served as our Assistant Controller from 1996 to May 2006. Ms. Tassinari is a certified public accountant.

**PART II****Item 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES**

Our common stock is traded on the American Stock Exchange ( AMEX ) under the symbol FRN. The following table sets forth the high and low sale price per share of our common stock during each fiscal quarter within the two most recent fiscal years as reported on AMEX:

**MARKET PRICE OF COMMON STOCK**

|                | High     | Low     |
|----------------|----------|---------|
| <u>2006</u>    |          |         |
| First Quarter  | \$ 10.33 | \$ 7.42 |
| Second Quarter | 8.95     | 7.49    |
| Third Quarter  | 11.00    | 7.45    |
| Fourth Quarter | 12.72    | 10.01   |
| <u>2005</u>    |          |         |
| First Quarter  | \$ 9.95  | \$ 7.61 |
| Second Quarter | 11.20    | 8.10    |
| Third Quarter  | 13.85    | 8.75    |
| Fourth Quarter | 10.35    | 7.85    |

*Holder s of Record.* The number of shareholders of record of our common stock as of January 31, 2007 was 529.

*Dividends.* We currently intend to retain any earnings to finance future growth and, therefore, do not anticipate paying any cash dividends on our common stock in the foreseeable future. Any determination as to the payment of dividends will depend upon our future results of operations, capital requirements and financial condition and such other facts as our Board of Directors may consider, including any contractual or statutory restrictions on our ability to pay dividends. Our credit facility and the indenture relating to our 8.375% senior notes each limit our ability to pay dividends on our common stock and we are currently prohibited from paying any dividends (other than stock dividends) under these provisions. We have not paid any dividends in the last five years.

*Recent Sales of Unregistered Securities.* We did not sell unregistered securities during 2006.

*Issuer s Purchases of Equity Securities.* We did not repurchase any of our equity securities during the fourth quarter of 2006.

*Equity Compensation Plan Information.* The information required by this Item 5 with respect to securities authorized for issuance under equity compensation plans is set forth in Part III, Item 12 of this Form 10-K.



*Performance Graph.*

The following indexed graph indicates Friendly's total shareholder return for the period beginning December 30, 2001 and ending December 31, 2006 as compared to the total return for the Standard & Poor's 500 Composite Index and the Standard & Poor's Restaurant Index, assuming an investment of \$100 in each as of December 30, 2001. Friendly's is not included in either of these indices. Total shareholder return for Friendly's, as well as for the indices, is based on the cumulative amount of dividends for a given period (assuming dividend reinvestment) and the difference between the share price at the beginning and at the end of the period.

**Cumulative Total Return**

(in dollars)

**Item 6. SELECTED CONSOLIDATED FINANCIAL INFORMATION**

The following table sets forth selected consolidated historical financial information, which has been derived from our audited Consolidated Financial Statements for each of the five most recent years ended December 31, 2006. This information should be read in conjunction with the Consolidated Financial Statements and related Notes thereto and Management's Discussion and Analysis of Financial Condition and Results of Operations appearing elsewhere herein. See Note 2 of Notes to Consolidated Financial Statements for a discussion of the basis of the presentation and significant accounting policies of the consolidated historical financial information set forth below. No dividends were declared or paid for any period presented.

| (in thousands, except per share data)                                   | Fiscal Year(a)     |              |                      |            |            |
|---|--------------------|--------------|----------------------|------------|------------|
|   | 2006<br>(53 weeks) | 2005         | 2004<br>(b, c, d, e) | 2003 (b)   | 2002       |
| <b>Statement of Operations Data:</b>                                    |                    |              |                      |            |            |
| Revenues:   |                    |              |                      |            |            |
| Restaurant  | \$ 395,999         | \$ 400,821   | \$ 431,763           | \$ 442,416 | \$ 437,426 |
| Foodservice   | 120,055            | 116,072      | 112,637              | 110,190    | 106,331    |
| Franchise   | 15,401             | 14,454       | 13,199               | 9,822      | 9,472      |
| Total revenues  | 531,455            | 531,347      | 557,599              | 562,428    | 553,229    |
| Operating income  | 21,559             | 13,202       | 21,521               | 38,523     | 32,094     |
| Income (loss) before benefit from (provision for) income taxes          | 1,402              | (7,592 )     | (10,009 )            | 14,366     | 7,224      |
| Benefit from (provision for) income taxes(f)                            | 83                 | (20,002 )    | 7,145                | (4,604 )   | (1,581 )   |
| Income (loss) from continuing operations                                | 1,485              | (27,594 )    | (2,864 )             | 9,762      | 5,643      |
| Income (loss) from discontinued operations, net of income tax effect(g) | 3,461              | 335          | (553 )               | (259 )     | 17         |
| Net income (loss)   | \$ 4,946           | \$ (27,259 ) | \$ (3,417 )          | \$ 9,503   | \$ 5,660   |
| Basic income (loss) per share:  |                    |              |                      |            |            |
| Income (loss) from continuing operations                                | \$ 0.19            | \$ (3.53 )   | \$ (0.38 )           | \$ 1.31    | \$ 0.77    |
| Income (loss) from discontinued operations, net of income tax effect    | 0.44               | 0.04         | (0.07 )              | (0.03 )    |            |
| Net income (loss)   | \$ 0.63            | \$ (3.49 )   | \$ (0.45 )           | \$ 1.28    | \$ 0.77    |
| Diluted income (loss) per share:  |                    |              |                      |            |            |
| Income (loss) from continuing operations                                | \$ 0.18            | \$ (3.53 )   | \$ (0.38 )           | \$ 1.28    | \$ 0.75    |
| Income (loss) from discontinued operations, net of income tax effect    | 0.43               | 0.04         | (0.07 )              | (0.03 )    |            |
| Net income (loss)   | \$ 0.61            | \$ (3.49 )   | \$ (0.45 )           | \$ 1.25    | \$ 0.75    |
| <b>WEIGHTED AVERAGE SHARES:</b>   |                    |              |                      |            |            |
| Basic   | 7,939              | 7,802        | 7,637                | 7,447      | 7,372      |
| Diluted   | 8,084              | 7,802        | 7,637                | 7,609      | 7,551      |

|   | December 31,<br>2006 | January 1,<br>2006 | January 2,<br>2005 | December 28,<br>2003 | December 29,<br>2002 |
|---|----------------------|--------------------|--------------------|----------------------|----------------------|
| <b>Balance Sheet Data:</b>  |                      |                    |                    |                      |                      |
| Working capital (deficit)(h)  | \$ (10,580 )         | \$ (16,634 )       | \$ (10,131 )       | \$ (1,489 )          | \$ 3,197             |
| Total assets  | \$ 220,167           | \$ 218,242         | \$ 248,884         | \$ 247,288           | \$ 252,163           |
| Total long-term debt, capital lease<br>and finance obligations, excluding<br>current maturities | \$ 227,332           | \$ 231,067         | \$ 233,132         | \$ 233,710           | \$ 236,874           |
| Total stockholders deficit  | \$ (126,896 )        | \$ (141,838 )      | \$ (105,026 )      | \$ (103,152 )        | \$ (108,145 )        |

- (a) 2004 included 53 weeks of operations. All other years presented included 52 weeks of operations.
- (b) In 2004, lump-sum cash payments to pension plan participants were in excess of the interest cost component of net periodic pension cost. As a result, we recorded additional pension expense of \$2,204 in accordance with Statement of Financial Accounting Standards ( SFAS ) No. 88, Employers Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits.
- In November 2003, we 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 will continue to be credited with interest. As a result, we recognized a one-time pension curtailment gain of \$8,113 in 2003.
- (c) In March 2004, we recorded a pre-tax restructuring charge of \$2,627 for severance and outplacement services associated with reduction in force actions taken during the first quarter. We reduced the 2001 restructuring reserve by \$400 during the year ended December 29, 2002 since the reserve exceeded estimated remaining payments.
- (d) In January 2004, we reached a settlement in a lawsuit filed against a former administrator of one of our 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 us of \$3,775, which was received on April 2, 2004. As a result of this lawsuit, we incurred professional fees of approximately \$500 which were included in the consolidated statement of operations for the year ended December 28, 2003 and an additional \$131 in professional fees that were offset against the payment in the accompanying consolidated statement of operations for the year ended January 2, 2005.
- (e) In March 2004, \$127,357 of aggregate principal amount of our then outstanding 10.5% senior notes was purchased at the tender offer and consent solicitation price of 104% of the principal amount and \$476 of aggregate principal amount of our then outstanding 10.5% senior notes were purchased at the tender offer price of 102% of the principal amount. In April 2004, the remaining \$48,144 of our 10.5% senior notes was redeemed in accordance with our senior notes indenture at 103.5% of the principal amount. In connection with the tender offer, we wrote off unamortized deferred financing costs of \$2,445 and paid a premium of \$6,790 that was included in the accompanying consolidated statement of operations for the year ended January 2, 2005.
- (f) During the fourth quarter of 2005, we entered a three-year cumulative loss position and revised our projections of the amount and timing of profitability in future periods. As a result, we increased our deferred income tax valuation allowance by approximately \$26,729 (\$22,184 to income tax expense and \$4,545 to accumulated other comprehensive loss) to reduce the carrying value of deferred tax assets to zero (Note 8 of Notes to Consolidated Financial Statements).
- (g) In accordance with SFAS No. 144, the results of operations of the eight properties that were disposed of during 2006 and the 14 properties that were disposed of during 2005, and any related net gain on the disposals, as well as the results of operations of the four properties held for sale at December 31,



2006 were reported separately as discontinued operations in the accompanying consolidated statements of operations for all years presented. (Note 5 of Notes to Consolidated Financial Statements).

(h) Working capital (deficit) includes assets classified as held for sale in accordance with SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets for all years presented (Note 5 of Notes to Consolidated Financial Statements).

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**Item 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

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

**Overview**

We are a leading full-service, casual dining restaurant company and provider of premium ice cream products with locations primarily in the Northeast. As of December 31, 2006, we operated 316 full-service restaurants and franchised 198 full-service restaurants and seven non-traditional units, located in 16 states.

Our revenues are derived from three primary sources:

- Restaurant revenue, which consists of sales from Company-operated full-service restaurants;
- Foodservice revenue, which consists of sales of food and premium ice cream products that we distribute and sell to our franchisees and to more than 4,000 supermarkets and other retail locations in 12 states; and
- Franchise revenue, which consists of franchise fees, royalty income we receive from our franchisees, and other franchise income. Initial franchise fees typically range from \$30,000 to \$35,000 for each restaurant opened. Franchise royalties are generally 4% of each franchise restaurant's monthly net sales. Other franchise income includes rental income on any properties we own and lease or sublease to franchisees.

The casual dining industry, the segment of the restaurant industry in which we operate, is highly competitive and there are many factors that affect our operations. Our industry and our results of operations are susceptible to changes in consumer tastes, national, regional and local economic conditions, demographic trends, traffic patterns, the cost and availability of labor, purchasing power, availability of products and the type, number and location of competing restaurants. In addition, factors such as increased food, labor and benefits costs, regional weather conditions and the potential scarcity of experienced management and hourly employees may also adversely affect the food service industry in general and the results of our operations and financial condition in particular.

When evaluating and assessing our financial performance, we focus on a number of measurements to gauge our progress including, but not limited to, the following:

- Comparable restaurant sales—a year over year comparison of sales for restaurants, that, in the current year, have been open at least 18 months in order to remove the impact of new openings in comparing the operations of existing restaurants. Increases in Company-operated and franchised comparable restaurant sales increases our Company-operated restaurant revenues and our franchise royalties. Comparable restaurant sales are derived by increases in the average guest check and/or increases in guest traffic. Average guest check increases result from menu price increases and/or a change in menu mix.
- Company restaurant margin (Company-operated restaurant sales less cost of sales, labor and benefits and operating expenses) Company-operated restaurant margin is significantly dependent on comparable sales performance at Company-operated restaurants, and is also susceptible to fluctuations in commodity costs (such as the price of dairy products), labor costs and other operating costs such as utilities. Our goal is to steadily grow Company-operated restaurant margins each year. In 2006 and 2005, Company-operated restaurant margin was 13.2% and 12.0%, respectively. The improvement in margin for 2006 followed our positive comparable Company-operated restaurant sales performance for the year.



- Franchise development new franchise openings reflect the overall strength of our franchise program. In 2006 and 2005, franchise openings totaled four and six, respectively. A number of new restaurants were in development at the end of 2006, and therefore we expect franchisees to open eight to 12 restaurants in 2007.
- Growth in retail case volume of specialty products includes our higher revenue margin line of rolls and decorated cakes. In 2006 this volume totaled 941,000 cases, which represented an increase of 16.2%. In 2005, the year we introduced decorated cakes into retail locations, this volume was 810,000 cases.

Over the years, our liquidity and profitability have been severely impacted primarily as a result of the high leverage associated with The Restaurant Company's (TRC) acquisition of our Company from Hershey Foods Corporation in 1988. As of December 31, 2006, we had a stockholders' deficit of \$126.9 million. Cumulative net interest expense of \$626.9 million since the TRC Acquisition has significantly contributed to the deficit. Our net income in 2006 of \$4.9 million included \$20.5 million of interest expense, net. The degree to which we are leveraged could have important consequences, including the following: (i) potential impairment of our ability to obtain additional financing in the future; (ii) because borrowings under our credit facility and mortgage financing in part bear interest at floating rates, we could be adversely affected by any increase in prevailing rates; (iii) we are more leveraged than certain of our principal competitors, which may place us at a competitive disadvantage; and (iv) our substantial leverage may limit our ability to respond to changing business and economic conditions and make us more vulnerable to a downturn in general economic conditions. We have reported net income (loss) of \$4.9 million, (\$27.3 million), (\$3.4 million), \$9.5 million and \$5.7 million for 2006, 2005, 2004, 2003 and 2002, respectively.

#### *Friendly's Restaurants*

The table below provides a summary of Company-operated and franchised units at each fiscal year end from fiscal 2004 through 2006:

|                                 | <b>For the Years Ended</b>   |                            |                            |
|---------------------------------|------------------------------|----------------------------|----------------------------|
|                                 | <b>December 31,<br/>2006</b> | <b>January 1,<br/>2006</b> | <b>January 2,<br/>2005</b> |
| <b><u>Company Units:</u></b>    |                              |                            |                            |
| Beginning of year.              | 314                          | 347                        | 355                        |
| Openings                        | 2                            | 2                          | 4                          |
| Acquired from franchisees.      | 11                           |                            |                            |
| Acquired by franchisees.        | (6 )                         | (15 )                      | (27 )                      |
| Closings.                       | (5 )                         | (20 )                      | (5 )                       |
| End of year                     | 316                          | 314                        | 327                        |
| <b><u>Franchised Units:</u></b> |                              |                            |                            |
| Beginning of year.              | 213                          | 195                        | 163                        |
| Openings                        | 4                            | 6                          | 8                          |
| Acquired by franchisees.        | 6                            | 15                         | 27                         |
| Acquired from franchisees.      | (11 )                        |                            |                            |
| Closings.                       | (7 )                         | (3 )                       | (3 )                       |
| End of year.                    | 205                          | 213                        | 195                        |



*Discontinued Operations*

During 2005, we disposed of five properties by sale and nine properties other than by sale, including lease terminations. During December 2005, we closed seven restaurants and committed to a plan to sell those seven restaurants as well as four restaurants that were closed in 2004. At January 1, 2006, these 11 properties met the criteria for held for sale as defined in SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets. During 2006, we sold eight of these 11 properties and, at December 31, 2006, the remaining three properties still met the criteria for held for sale as defined in SFAS No. 144.

In accordance with SFAS No. 144, the results of operations of the eight properties that were disposed of during 2006 and the 14 properties that were disposed of during 2005, and any related net gain on the disposals, as well as the results of operations of three properties held for sale at December 31, 2006 were reported separately as discontinued operations in the accompanying consolidated statements of operations for all years presented.

During 2006, we disposed of two properties by sale and two properties other than by sale, including lease terminations. Additionally, we closed one restaurant and committed to a plan to sell that restaurant. At December 31, 2006, this property met the criteria for held for sale as defined in SFAS No. 144. The results of operations and any related gain or loss associated with the disposition of these restaurants were not material and therefore were reported within continuing operations in the accompanying consolidated statements of operations for all years presented.

**Results of Operations**

The following table contains information derived from our consolidated statements of operations expressed as a percentage of total revenues:

|   | 2006    | 2005    | 2004    |
|---|---------|---------|---------|
| Restaurant Revenues   | 74.5 %  | 75.4 %  | 77.4 %  |
| Foodservice Revenues  | 22.6 %  | 21.9 %  | 20.2 %  |
| Franchise Revenues  | 2.9 %   | 2.7 %   | 2.4 %   |
| REVENUES  | 100.0 % | 100.0 % | 100.0 % |
| <b>COSTS AND EXPENSES:</b>  |         |         |         |
| Cost of sales   | 37.8 %  | 38.6 %  | 37.7 %  |
| Labor and benefits  | 26.5 %  | 27.1 %  | 28.4 %  |
| Operating expenses  | 19.6 %  | 19.9 %  | 18.8 %  |
| General and administrative expenses                               | 8.1 %   | 7.3 %   | 7.2 %   |
| Pension settlement expense  |         |         | 0.3 %   |
| Restructuring expense   |         |         | 0.4 %   |
| Gain on litigation settlement                                     |         |         | (0.6) % |
| Write-downs of property and equipment                             | 0.1 %   | 0.5 %   |         |
| Depreciation and amortization                                     | 4.3 %   | 4.4 %   | 4.1 %   |
| Gain on franchise sales of restaurant operations and properties   | (0.7) % | (0.5) % | (0.2) % |
| Loss on disposals of other property and equipment, net            | 0.2 %   | 0.2 %   |         |
| OPERATING INCOME  | 4.1 %   | 2.5 %   | 3.9 %   |
| Interest expense, net   | 3.9 %   | 3.9 %   | 4.0 %   |
| Other (income) expense  | (0.1) % |         | 1.7 %   |
| INCOME (LOSS) BEFORE BENEFIT FROM<br>(PROVISION FOR) INCOME TAXES | 0.3 %   | (1.4) % | (1.8) % |
| Benefit from (provision for) income taxes                         |         | (3.8) % | 1.3 %   |
| INCOME (LOSS) FROM CONTINUING OPERATIONS                          | 0.3 %   | (5.2) % | (0.5) % |

**2006 Compared to 2005***Revenues:*

*Total revenues* Total revenues increased \$0.2 million to \$531.5 million for the year ended December 31, 2006 compared to \$531.3 million for 2005.

*Restaurant revenues* Restaurant revenues decreased \$4.8 million, or 1.2%, to \$396.0 million for the year ended December 31, 2006 from \$400.8 million for 2005. Comparable Company-operated restaurant revenues during the year increased by \$4.0 million, or 1.4%. Increases in comparable Company-operated restaurant revenues occurred in most dayparts, with the largest occurring during the dinner and afternoon snack periods. Restaurant revenues were positively impacted in 2006 due to fewer operating days lost from weather closings when compared to 2005. Additionally, the opening of four new restaurants over the past 24 months and the acquisition of eleven restaurants from franchisees in December of 2006 increased restaurant revenues by \$4.6 million. These increases were more than offset by the closing of five locations and the acquisition of 21 Company-operated locations by franchisees over the past 24 months resulting in declines of \$2.3 million and \$11.1 million, respectively, in restaurant revenues in 2006 as compared to 2005.

There were two new restaurants opened during both 2006 and 2005. There were 67 and 12 restaurants remodeled during 2006 and 2005, respectively.

*Foodservice revenues* Foodservice revenues (product sales to franchisees and retail customers) increased \$4.0 million, or 3.4%, to \$120.1 million for the year ended December 31, 2006 compared to \$116.1 million for 2005. Sales to foodservice retail supermarket customers increased \$0.5 million in 2006 compared to 2005 primarily due to a slight increase in overall case volume of our ice cream products. In 2006, we experienced a 16.2% increase in sales volume of our specialty product line of cups, rolls and decorated cakes, our higher revenue margin line of specialty products. This increase was partially offset by a 3.4% decline in sales volume for our 56 oz carton line. The increased sales volume of our specialty products is consistent with our retail strategy to focus on developing and growing volume of our higher margin total specialty product line, particularly our retail cake business, by leveraging our retail sales channel.

Franchised restaurant product revenue increased \$3.5 million in 2006 compared to 2005, primarily due to the higher average number of operating franchised restaurants throughout the year, 208 for 2006 compared to 197 for 2005. This increase in franchised restaurant product revenue was partially offset by a 0.9% reduction in comparable franchised restaurant revenues during 2006 compared to 2005.

*Franchise revenues* Franchise revenues increased \$0.9 million, or 6.6%, to \$15.4 million for the year ended December 31, 2006 compared to \$14.5 million for 2005.

Royalties of \$10.9 million increased \$0.4 million for the year ended December 31, 2006 as compared \$10.5 million in 2005 due primarily to an increase in the average number of operating franchised restaurants throughout the year (208 in 2006 compared to 197 in 2005). During the last 24 months, a total of 10 new franchise restaurants were opened and 21 restaurants were acquired by franchisees, which more than offset the eleven restaurants acquired from franchisees in December of 2006 and the closing of 10 under-performing locations during the same period. This increase in royalties was partially offset, however, by a 0.9% reduction in comparable franchised restaurant revenues which was experienced during the year ended December 31, 2006, following the 0.4% increase in comparable franchised restaurant revenues experienced in the year ended January 1, 2006.

Franchise fees and other franchise income of \$4.5 million increased \$0.5 million during the year ended December 31, 2006 when compared to 2005 primarily resulting from \$0.3 million in forfeitures and penalties recognized in 2006 related to the closing of one franchised restaurant during the year and the eleven restaurants acquired from franchisees in December of 2006.

*Cost of sales:*

Cost of sales decreased \$4.5 million, or 2.2%, to \$200.8 million for the year ended December 31, 2006 from \$205.3 million for 2005. Cost of sales as a percentage of total revenues was 37.8% and 38.6% for the years ended December 31, 2006 and January 1, 2006, respectively. This improvement resulted primarily from a reduction in cost of sales within the restaurant segment of 0.7% and a reduction in cost of sales within the foodservice segment of 3.0% which was partially offset by a slightly unfavorable shift in sales mix away from Company restaurant revenues (which carried a lower cost of sales percentage of 26.3%) to foodservice revenues (which carried a higher cost of sales percentage of 80.6%) during the year ended December 31, 2006. Company restaurant revenues declined as a percentage of total revenue from 75.4% in the 2005 period to 74.5% in the 2006 period, while foodservice revenues increased as a percentage of total revenues from 21.8% in the 2005 period to 22.6% in the 2006 period.

Restaurant cost of sales as a percentage of restaurant revenues decreased to 26.3% for the year ended December 31, 2006 from 27.0% for 2005. This improvement was due to menu price increases and product re-formulations, as overall prices for food commodities were generally flat against the prior year. Decreases in commodity prices for certain meat, poultry, fish and dairy products (primarily cream) were

offset by increases in commodity prices for certain other food product categories, such as frozen foods (waffle fries) and beverages.

Foodservice cost of sales as a percentage of foodservice revenues decreased to 80.6% in the year ended December 31, 2006 from 83.6% in 2005. This improvement was primarily a result of lower cream costs in 2006 compared to 2005.

The cost of cream, the principal ingredient used in making ice cream, affects our costs of sales as a percentage of total revenues, especially in our foodservice retail business. The price of cream is directly affected by changes in the market price for AA butter traded on the Chicago Mercantile Exchange. As an example, a \$0.10 increase in the cost of a pound of AA butter affects our annual costs of sales by approximately \$0.9 million. This adverse impact may be offset by price increases or other factors. However, no assurance can be given that we will be able to offset any cost increases in the future and future increases in cream prices could have a material adverse effect on our results of operations. To minimize risk, alternative supply sources continue to be pursued.

The overall cost of cream was approximately \$3.3 million lower in 2006 (weighted average price of butter at \$1.24 per pound) when compared to 2005 (weighted average price of butter at \$1.64 per pound); however, market losses on butter option and/or futures contracts were \$0.3 million greater than the losses experienced on butter option and/or futures contracts during 2005. Approximately 70% of this \$3.0 million net cost of sales benefit on a year to date basis, or approximately \$2.1 million, was reported within our foodservice segment.

When available, we purchase butter option and/or futures contracts to minimize the impact of increases in the cost of cream. Our strategy related to hedging is never to hedge more than 50% of our needs using these instruments, so as not to put us in an uncompetitive position. Option contracts are offered in the months of March, May, July, September, October and December; however, there is often not enough open interest in them to allow us to buy even very limited coverage without paying high premiums. Our commodity option contracts and cash-settled butter futures contracts do not meet hedge accounting criteria as defined by SFAS No. 133, Accounting for Certain Derivative Instruments and Certain Hedging Activities, and its related amendment, SFAS No. 138, Accounting for Certain Derivative Instruments and Certain Hedging Activities, and accordingly, are marked to market each period with the resulting gains or losses recognized in cost of sales.

For the remainder of 2007, we expect that cream prices will be slightly higher than the prices experienced for the same period in 2006 due to the spread in the nearby futures market compared to the actual prices of late last year.

On September 19, 2005, the Chicago Mercantile Exchange launched the first electronically traded, cash-settled butter futures contract. This new futures contract is designed to meet the needs of food and dairy companies that have exposure to butterfat price risk but do not want to expose themselves to the possibility of being compelled to take physical delivery of butter. The size of the contract is 20,000 pounds of AA butter, versus the traditional butter futures contract, which is 40,000 pounds. The contract is cash settled based upon the USDA monthly weighted average price for butter in the United States. With this new type of futures contract, there is no risk of delivery of butter; therefore, it offers us the ability to hedge the price risk of cream (on a butter basis) without having to take delivery of commodity butter. We have evaluated this new hedging instrument and believe it is an attractive way to hedge the price risk related to cream. At December 31, 2006, we held 70 contracts, four of them for December 2006 and the remainder spread over the first nine months of 2007. These contracts correspond to approximately 20% of our anticipated cream purchases for the periods represented.

*Labor and benefits:*

Labor and benefits, which were only reported within our restaurant segment, decreased \$2.9 million, or 2.0%, to \$141.1 million for the year ended December 31, 2006 from \$144.0 million for the year ended January 1, 2006. As a percentage of total revenues, labor and benefits decreased to 26.6% for the year ended December 31, 2006 from 27.1% for the year ended January 1, 2006. This reduction was due to both the 0.9% shift in sales mix away from Company restaurant revenues to foodservice revenues, and to a marginal improvement in labor and benefits within the restaurant segment to 35.6% for the year ended December 31, 2006 from 35.9% for 2005. This improvement was due to menu price increases and slightly lower health benefit costs, as labor productivity levels remained the same year over year, and average hourly rates of crew level employees increased by 1.8%.

*Operating expenses:*

Operating expenses were \$104.0 million and \$105.8 million for the years ended December 31, 2006 and January 1, 2006, respectively. Operating expenses as a percentage of total revenues were 19.6% and 19.9% in 2006 and 2005, respectively. A significant portion of these expenses (\$98.7 million in 2006 and \$100.4 million in 2005) were reported within our restaurant segment. In the year ended December 31, 2006, these costs consisted of \$14.9 million in supplies, \$19.2 million in utilities, \$12.8 million in maintenance and cleaning, \$15.3 million in advertising, \$21.3 million in occupancy and \$15.2 million in other restaurant expenses. Decreases in advertising and maintenance and cleaning costs of \$1.6 million and \$1.2 million, respectively, were partially offset by higher costs for utilities of \$1.1 million in 2006 when compared to 2005.

*General and administrative expenses:*

General and administrative expenses were \$43.3 million and \$38.7 million for the years ended December 31, 2006 and January 1, 2006, respectively. General and administrative expenses as a percentage of total revenues increased to 8.1% in 2006 from 7.3% in 2005. The \$4.6 million increase was primarily the result of an increase in bonus compensation to senior and middle management of \$3.2 million (a minimal amount of bonus compensation was incurred in 2005) due to achievement of Company performance targets, severance costs of \$0.6 million due primarily to the resignation of our former President and Chief Executive Officer in the third quarter of 2006, pension costs of \$0.6 million and stock compensation expense of \$0.4 million. These increases were partially offset by a decrease in legal fees of \$0.5 million.

The decrease in legal fees was primarily due to insurance recoveries received in connection with the ongoing shareholder derivative lawsuit filed by S. Prestley Blake against us and certain of our directors (the Blake Litigation). Pursuant to a settlement agreement with our insurance company in connection with costs and expenses we have incurred in the defense of the Blake Litigation, during the year ended December 31, 2006, we received insurance recoveries of \$1.4 million (of which \$0.7 million related to legal costs incurred in 2005) and we recorded at year end a receivable in the amount of \$0.2 million for expected additional insurance recoveries. Although we have received certain insurance recoveries and may receive additional recoveries in the future, we expect to continue to incur additional legal fees in the defense of the Blake Litigation.

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In addition to the Blake Litigation, we may incur additional costs and expenses in connection with a potential proxy contest threatened by The Lion Fund, L.P., a hedge fund controlled by Sardar Biglari. The Lion Fund has notified us of its intention to nominate Sardar Biglari and Philip Cooley for election as directors at our upcoming Annual Meeting of Shareholders. In the event of a proxy contest, we expect to incur additional costs and expenses to solicit proxies in favor of our nominees for election of director and against The Lion Fund's nominees for election of director. These additional solicitation costs may include, among others, additional costs and fees payable to a proxy solicitation firm, fees of outside counsel to advise us in connection with the contested solicitation, increased costs associated with public relations matters, increased mailing and printing costs, and possible litigation.

### *Stock-based compensation expense:*

On January 2, 2006, we adopted the Financial Accounting Standards Board's Statement of Financial Accounting Standard No. 123 (revised 2004), Share-Based Payment, (SFAS No. 123R), using the modified prospective application method. Compensation cost was calculated on the date of grant using the fair value of the options as determined by the Black-Scholes valuation model. The Black-Scholes valuation model requires us to make several assumptions, including volatility. We have considered the guidance in SFAS No. 123R and believe that our historical estimated volatility is materially indicative of expectations about future volatility.

During the year ended December 31, 2006, we recognized \$0.4 million of total stock-based compensation expense as a result of the adoption of SFAS No. 123R, which was included in general and administrative expenses. We expect to recognize \$0.5 million of stock compensation expense during 2007 related to the awards outstanding at December 31, 2006.

As of December 31, 2006, there was \$1.0 million of total unrecognized compensation cost related to unvested share-based awards. That cost is expected to be recognized over a weighted-average period of 1.7 years.

See Note 3 of Notes to Consolidated Financial Statements for further information regarding our adoption of SFAS No. 123R.

### *Write-downs of property and equipment:*

Write-downs of property and equipment were \$0.7 million and \$2.5 million in the years ended December 31, 2006 and January 1, 2006, respectively. During the year ended December 31, 2006, we determined that the carrying values of three restaurant properties exceeded their estimated fair values less costs to sell and the carrying values were reduced by an aggregate of \$0.7 million accordingly. During 2005, we determined that the carrying values of six restaurant properties and certain capital inventory used to replace restaurant equipment exceeded their estimated fair values less costs to sell. The carrying values were reduced by an aggregate of \$2.5 million accordingly.

### *Depreciation and amortization:*

Depreciation and amortization was \$22.9 million and \$23.4 million for the years ended December 31, 2006 and January 1, 2006, respectively. Depreciation and amortization as a percentage of total revenues was 4.3% and 4.4% in 2006 and 2005, respectively. Depreciation was higher in 2005 primarily due to a reduction of the lives of leasehold improvement assets as a result of management decisions to close certain underperforming leased properties sooner than previously anticipated.

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

Gain on franchise sales of restaurant operations and properties was \$3.9 million and \$2.7 million in the years ended December 31, 2006 and January 1, 2006, respectively.

During 2006, we recognized a gain of \$2.1 million associated with the sale of certain assets and leasehold rights of five existing restaurants to three existing franchisees. Additionally during 2006, we recognized a gain of \$1.6 million associated with three transactions in which three existing franchisees exercised purchase options on eight restaurants and agreed to develop a total of ten new restaurants in future years. The remaining gain of \$0.2 million relates to the elimination of a reserve against a previous franchise transaction.

During the year ended January 1, 2006, we recognized a gain of \$2.7 million associated with the sale of certain equipment assets, lease and sublease rights and franchise rights in nine existing Company-operated restaurants to four franchisees.

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

The loss on disposals of other property and equipment, net was \$0.9 million and \$1.0 million for the years ended December 31, 2006 and January 1, 2006, respectively. The table below identifies the components of the loss on disposals of other property and equipment, net as shown on the accompanying consolidated statements of operations (in thousands):

|  | <b>For the Years Ended</b> |                   |
|--|----------------------------|-------------------|
|  | <b>December 31,</b>        | <b>January 1,</b> |
|  | <b>2006</b>                | <b>2006</b>       |
| Restaurant assets retired due to remodeling.               | \$ 863                     | \$ 225            |
| Restaurant equipment assets retired due to replacement     | 285                        | 200               |
| (Gain) loss on property not held for disposition           | (667 )                     | 118               |
| Loss on abandoned capital projects and architectural plans | 234                        | 108               |
| Gain due to restaurant flood                               | (53 )                      |                   |
| All other  | 239                        | 379               |
| Loss on disposals of other property and equipment, net.    | \$ 901                     | \$ 1,030          |

*Interest expense, net:*

Interest expense, net of capitalized interest and interest income, was \$20.5 million and \$20.9 million for the years ended December 31, 2006 and January 1, 2006, respectively. The decrease in interest expense in 2006 compared to 2005 was primarily due to an increase in interest income related to slightly higher levels of investment in short term marketable securities throughout the year, reduced amounts of interest on capital leases and lower interest rates on our mortgage financing. Total outstanding debt, including capital lease and finance obligations, decreased from \$233.9 million at January 1, 2006 to \$230.4 million at December 31, 2006.

*Other (income) expense:*

During the year ended December 31, 2006, other (income) expense consisted of income of \$0.1 million from the settlement of a title insurance class action lawsuit in which we were a class member and \$0.2 million in settlement related to a Mastercard/Visa class action lawsuit in which we were a class member.

During the year ended January 1, 2006, other (income) expense consisted of \$0.1 million which represented the realized gains on investments sold in association with the dissolution of our nonqualified deferred compensation plan.

*Benefit from (provision for) income taxes:*

The benefit from income taxes was \$0.1 million for the year ended December 31, 2006 compared to a provision for income taxes of \$20.0 million for the year ended January 1, 2006.

Management evaluates the need for a valuation allowance on a quarterly basis. A more in depth evaluation is made as part of the annual and strategic planning process conducted in the fourth quarter of each year.

As of December 31, 2006 and January 1, 2006, we had approximately \$28.4 and \$32.1 million of net deferred tax assets relating to net operating loss carryforwards, tax credit carryforwards and other temporary differences that are available to reduce income taxes in future years. SFAS No. 109 Accounting for Income Taxes requires that a valuation allowance be established when it is more likely than not that all or a portion of deferred tax assets will not be realized. A review of all available positive and negative evidence needs to be considered, including a company's performance, the market environment in which the Company operates, length of carryback and carryforward periods, and projections of future operating results. Where there are cumulative losses in recent years, SFAS No. 109 creates a strong presumption that a valuation allowance is needed. The presumption can be overcome in very limited circumstances.

During the fourth quarter of 2005, we entered a three-year cumulative loss position and revised our projections of the amount and timing of profitability in future periods. As a result, we increased the valuation allowance by approximately \$26.7 million (\$22.2 million to income tax expense and \$4.5 million to stockholders' deficit) to reduce the carrying value of deferred tax assets to zero.

As of December 31, 2006 we remain in a three-year cumulative loss position and expect to record valuation allowances on future tax benefits until we can sustain an appropriate level of profitability. However, we have incurred approximately \$1.1 million of federal tax liabilities for 2005 and 2006 combined. Approximately \$0.9 million of the \$1.1 million would be available for refund if 2007 resulted in a loss for income tax purposes. As a result, the valuation allowances as of December 31, 2006 of \$27.4 million will reduce the carrying value of net deferred tax assets to \$0.9 million. Should our future profitability provide sufficient evidence, in accordance with SFAS No. 109, to support the ultimate realization of income tax benefits attributable to net operating loss (NOL) and credit carryforwards and other deductible temporary differences, a reduction in the valuation allowance may be recorded and the carrying value of deferred tax assets may be restored, resulting in a non-cash credit to earnings.

The 2005 provision for income taxes included a \$1.4 million increase in income tax accruals resulting from certain items then being discussed with the IRS, which have since been resolved.

*Income from continuing operations:*

Income from continuing operations was \$1.5 million for the year ended December 31, 2006 compared to loss from continuing operations of \$27.6 million for the year ended January 1, 2006 for the reasons discussed above.

*Income (loss) from discontinued operations:*

In accordance with SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets, the results of operations of a component of an entity that either has been disposed of or is classified as held for sale and any related gain (loss) on the sales are reported in discontinued operations if both of the following conditions are met: (a) the operations and cash flows of the component have been (or will be) eliminated from the ongoing operations of the entity as a result of the disposal transaction and (b) the entity will not have any significant continuing involvement in the operations of the component after the disposal transaction.



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During 2005, we disposed of five properties by sale and nine properties other than by sale, including lease terminations. During December 2005, we closed seven restaurants and committed to a plan to sell those seven restaurants as well as four restaurants that were closed in 2004. At January 1, 2006, these 11 properties met the criteria for held for sale as defined in SFAS No. 144. During 2006, we sold eight of these 11 properties and, at December 31, 2006, the remaining three properties still met the criteria for held for sale as defined in SFAS No. 144.

In accordance with SFAS No. 144, the results of operations of the eight properties that were disposed of during 2006 and the 14 properties that were disposed of during 2005, and any related net gain on the disposals, as well as the results of operations of three properties held for sale at December 31, 2006 were reported separately as discontinued operations in the accompanying consolidated statements of operations for all years presented.

For the years ended December 31, 2006 and January 1, 2006, these discontinued results consisted of the following (in thousands):

|   | For the Years Ended  |                    |
|---|----------------------|--------------------|
|   | December 31,<br>2006 | January 1,<br>2006 |
| Net sales                                   | \$                   | \$ 10,499          |
| Operating loss                              | (360 )               | (1,548 )           |
| Gain on disposals of property and equipment | 4,359                | 2,115              |
| Income tax expense                          | (538 )               | (232 )             |
| Income from discontinued operations         | \$ 3,461             | \$ 335             |

During 2006, we disposed of two properties by sale and two properties other than by sale, including lease terminations. Additionally, we closed one restaurant and committed to a plan to sell that restaurant. At December 31, 2006, this property met the criteria for held for sale as defined in SFAS No. 144. The results of operations and any related gain or loss associated with the disposition of these restaurants were not material and therefore were reported within continuing operations in the accompanying consolidated statements of operations for all years presented.

### ***2005 Compared to 2004***

#### *Revenues:*

***Total Revenues*** Total revenues decreased \$26.3 million, or 4.7%, to \$531.3 million in 2005 from \$557.6 million in 2004. Fiscal 2004 included a 53<sup>rd</sup> week of operations. The additional week contributed \$10.7 million in total revenues as restaurants, foodservice and franchise segments provided \$9.0 million, \$1.5 million and \$0.2 million, respectively.

***Restaurant Revenues*** Restaurant revenues decreased \$31.0 million, or 7.2%, to \$400.8 million in 2005 from \$431.8 million in 2004. Comparable Company-operated restaurant revenues decreased 1.2% from 2004 to 2005. Higher prices for gasoline, especially during the three weeks in September 2005 post hurricane Katrina, appeared to have had a negative impact on the number of customer visits during all day-parts, with our afternoon and evening snack periods experiencing the greatest declines. Comparable sales decreased 1.3% for the fourth quarter of 2005 compared to the same period in 2004, but were flat the last two months of 2005. Also contributing to the reduced comparable revenues was an unfavorable shift in the timing of the year-end holiday period as 2004 included January 1, 2004 and January 1, 2005. There were additional operating days lost due to weather closings in 2005 when compared to 2004 as most markets in New England recorded higher than normal snowfall. The 53<sup>rd</sup> week of operations in 2004 contributed \$9.0 million to the restaurant sales decline. Additionally, the closing of five locations and the

acquisition of 42 Company-operated locations by franchisees over the past 24 months resulted in declines of \$1.6 million and \$20.3 million, respectively, in restaurant revenues in 2005 as compared to 2004. These declines were partially offset by increased revenues of \$4.1 million in 2005 as compared to 2004 due to the opening of six new restaurants over the past 24 months. There were two new restaurants opened during the year ended January 1, 2006.

*Foodservice Revenues* Foodservice (product sales to franchisees and retail customers) revenues increased \$3.5 million, or 3.0%, to \$116.1 million in 2005 from \$112.6 million in 2004. This increase was primarily due to a \$3.9 million increase in franchised restaurant product revenue resulting from the increased number of franchised restaurants in 2005 compared to 2004, partially offset by a decrease in franchised restaurant product revenue of \$1.1 million due to the 53<sup>rd</sup> week of operations in 2004. Additionally, Foodservice revenues were adversely impacted by a \$0.4 million decrease in sales to foodservice retail supermarket customers in 2005 compared to 2004 as a result of greater discounting in 2005. Case volume in our retail supermarket business increased 0.7% for the year ended January 1, 2006 when compared to the year ended January 2, 2005 primarily as a result of higher volume of individual sundae cups and the introduction of new decorative cakes. Discounting and sales allowances were 0.7% greater as a percentage of gross revenues in 2005 when compared to 2004. Foodservice retail revenues were \$0.4 million during the 53<sup>rd</sup> week in 2004.

*Franchise Revenues* Franchise revenues increased \$1.3 million, or 9.5%, to \$14.5 million in 2005 compared to \$13.2 million in 2004 due primarily to increases in royalties on franchised sales and rental income for leased and subleased franchise locations, partially offset by a decline in franchise fees.

Royalties on franchised sales increased \$0.8 million in 2005 as compared to 2004. Comparable franchised revenues grew 0.4% from the year ended January 2, 2005 to the year ended January 1, 2006. The opening of 13 new franchise restaurants and one café and the acquisition of 42 Company operated restaurants by franchisees during the last 24 months increased royalty revenues by \$1.1 million while the closing of six under-performing locations during the same period reduced royalties by \$0.2 million. Royalties were \$0.2 million during the 53<sup>rd</sup> week in 2004.

Franchise fees and other franchise income increased by \$0.5 million during 2005 when compared to 2004. An increase in rental income for leased and subleased franchise locations of \$1.0 million was due primarily to an increased number of leased and subleased franchised locations as there were 213 and 195 franchise units open at January 1, 2006 and January 2, 2005, respectively. Franchisees acquired fifteen Company-operated restaurants and opened six new restaurants during 2005 as compared to the acquisition of 27 Company-operated restaurants and the opening of seven new restaurants and one new café during 2004. Additionally in 2004, we received \$0.1 million in franchise fees when two franchisees operating restaurants under options to purchase elected to exercise their options.

*Cost of sales:*

Cost of sales decreased \$5.2 million, or 2.4%, to \$205.3 million in 2005 from \$210.5 million in 2004. Cost of sales as a percentage of total revenues was 38.6% and 37.7% in 2005 and 2004, respectively. A shift in sales mix from Company-operated restaurant sales to foodservice sales added to the increase in cost of sales as a percentage of total revenue. Foodservice sales to franchisees and retail supermarket customers (21.8% and 20.2% of total revenues for the years ended January 1, 2006 and January 2, 2005, respectively) have higher food costs as a percentage of revenue, at 92.2%, than sales in Company-operated restaurants to restaurant patrons. This increase was partially offset by the growth in franchise revenues, which reduced cost of sales as a percentage of total revenues by 0.2% in 2005 when compared to 2004 since franchise revenues have no product costs associated with such revenues. Additionally, foodservice retail sales promotional allowances, recorded as offsets to revenues, increased by 0.7% in 2005 as a percentage of sales to foodservice retail supermarket customers when compared to 2004 due to an increase in discounting

activities during 2005. This increase had an unfavorable impact on the overall cost of sales as a percentage of total revenues. Manufacturing efficiencies improved during the current year when compared to a year ago, especially during the third and fourth quarters, due to cost reductions associated with scheduling improvements; however, higher fuel costs in 2005 versus 2004 offset most of the benefit.

Restaurant cost of sales as a percentage of restaurant revenues was 27.0% and 27.2% in 2005 and 2004, respectively.

The relatively high price of butter in December 2004 resulted in unfavorable cream costs in the first quarter of 2005, as the market price of butter is generally reflected in our cost of sales approximately 30 days later. During the remainder of 2005, butter prices had a favorable impact on the price of cream when compared to the same period in 2004. The cost of cream was approximately \$1.1 million lower in the year ended January 1, 2006 when compared to the year ended January 2, 2005. In 2005, market losses of \$0.2 million were realized due to unfavorable positions on commodity option contracts while market gains of \$0.6 million were realized in 2004. We enter into commodity option contracts from time to time to manage dairy cost pressures. Our 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 the fourth quarter of 2005 we purchased a small number of cash-settled butter futures contracts through the Chicago Mercantile Exchange, but did not achieve a significant level of protection.

*Labor and benefits:*

Labor and benefits decreased \$14.1 million, or 9.0%, to \$144.0 million in 2005 from \$158.1 million in 2004. Labor and benefits as a percentage of total revenues decreased to 27.1% in 2005 from 28.4% in 2004. As a percentage of restaurant revenues, labor and benefits decreased to 35.9% in 2005 from 36.6% in 2004. Lower hourly labor costs accounted for 0.7% of the decrease in labor and benefits costs as a percentage of restaurant revenues, which was primarily the result of restructuring of the restaurant management team with fewer guest service supervisors and more servers, resulting in lower average hourly rates. Restaurant general manager bonuses were also lower during 2005 when compared to 2004 due primarily to a change in the bonus plan and accounted for 0.5% of the decrease in labor and benefits costs as percentage of restaurant revenues. Partially offsetting these benefits were increases in pension expense and other fringe costs of 0.4% and 0.1%, respectively, in 2005 when compared to 2004. Revenue increases derived from franchised locations and product sales to franchisees and retail customers, which do not have any associated restaurant labor and benefits, also contributed to the lower labor and benefits as a percentage of total revenues.

*Operating expenses:*

Operating expenses were \$105.8 million and \$104.7 million in 2005 and 2004, respectively. Operating expenses as a percentage of total revenues were 19.9% and 18.8% in 2005 and 2004, respectively. The 1.1% increase in operating expenses as a percentage of total revenues resulted from higher restaurant costs for maintenance and utilities of 0.6% and 0.4% in 2005 when compared to 2004, respectively. Foodservice retail supermarket selling expenses increased 0.1% as a percentage of total revenues. Total advertising costs as a percentage of total revenues were 0.1% lower in 2005 when compared to 2004.

*General and administrative expenses:*

General and administrative expenses were \$38.7 million and \$40.0 million in 2005 and 2004, respectively. General and administrative expenses as a percentage of total revenues were 7.3% and 7.2% in

2005 and 2004, respectively. The \$1.3 million decrease was primarily the result of decreases in bonuses (\$0.6 million), outside restaurant guest evaluation services (\$1.0 million), Sarbanes-Oxley related audit fees (\$0.2 million), legal fees (\$0.2 million, net of insurance reimbursements of \$0.6 million), Board of Director fees (\$0.2 million) and recruitment costs (\$0.5 million). Partially offsetting these decreases were higher costs of \$0.9 million and \$0.6 million for other professional services and severance pay, respectively, during 2005 as compared to 2004.

*Pension settlement expense (curtailment gain):*

Certain of our employees are covered under a noncontributory defined benefit pension plan. During 2004, lump-sum cash payments to participants exceeded the interest cost component of net periodic pension cost for the plan year. As a result of the settlement volume, we recorded additional pension expense of \$2.2 million.

*Restructuring expenses:*

Restructuring expenses of \$2.6 million during the year ended January 2, 2005 related to severance and other benefits associated with reduction in force actions taken during the first quarter of 2004 that reduced headcount by approximately 20 permanent positions.

*Gain on litigation settlement:*

In January 2004, we reached a settlement in a lawsuit that we filed against a former administrator of one of our 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 us of approximately \$3.8 million, which was received on April 2, 2004. As a result of this lawsuit, we incurred professional fees of approximately \$0.5 million that were included in the consolidated statement of operations for the year ended December 28, 2003 and an additional \$0.2 million in professional fees that were offset against the payment in the accompanying consolidated statement of operations for the year ended January 2, 2005.

*Write-downs of property and equipment:*

Write-downs of property and equipment were \$2.5 million and \$0.1 million in 2005 and 2004, respectively. During 2005, we determined that the carrying values of six restaurant properties and certain capital inventory used to replace restaurant equipment exceeded their estimated fair values less costs to sell. The carrying values were reduced by an aggregate of \$2.5 million accordingly. During 2004, it was determined that the carrying value of one property and a vacant land parcel exceeded their estimated fair values less costs to sell and the carrying values were reduced by an aggregate of \$0.1 million accordingly.

*Depreciation and amortization:*

Depreciation and amortization was \$23.4 million and \$22.6 million in 2005 and 2004, respectively. Depreciation and amortization as a percentage of total revenues was 4.4% and 4.1% in 2005 and 2004, respectively. The increase in depreciation expense was primarily the result of the opening of six new restaurants over the last 24 months and the reduction of the lives of leasehold improvement assets as a result of management decisions to close certain underperforming leased properties sooner than previously anticipated.

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

Gain on franchise sales of restaurant operations and properties was \$2.7 million and \$1.3 million in 2005 and 2004, respectively.

During the year ended January 1, 2006, we recognized a gain of \$2.7 million associated with the sale of certain equipment assets, lease and sublease rights and franchise rights in nine existing Company-operated restaurants to four franchisees.

During the year ended January 2, 2005, we recognized a gain of approximately \$0.7 million associated with the sale of certain equipment assets, lease and sublease rights and franchise rights in 10 existing Company-operated restaurants to a franchisee. Additionally, during 2004, we recognized a gain of approximately \$0.6 million associated with two transactions in which two existing franchisees exercised purchase options on six restaurants.

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

The loss on disposals of other property and equipment, net, was \$1.0 million and \$0.2 million in 2005 and 2004, respectively. The table below identifies the components of the loss on disposals of other property and equipment, net as shown on the accompanying consolidated statements of operations (in thousands):

|  | For the Years Ended |                    |
|--|---------------------|--------------------|
|  | January 1,<br>2006  | January 2,<br>2005 |
| Restaurant equipment assets retired due to remodeling      | \$ 225              | \$ 195             |
| Restaurant equipment assets retired due to replacement     | 200                 | 442                |
| Loss on property not held for disposition                  | 118                 | 63                 |
| Loss on abandoned capital projects and architectural plans | 108                 |                    |
| Gain on property held for disposition                      |                     | (782 )             |
| All other  | 379                 | 295                |
| Loss on disposals of other property and equipment, net     | \$ 1,030            | \$ 213             |

### *Interest expense, net:*

Interest expense, net of capitalized interest and interest income was \$20.9 million and \$22.3 million in 2005 and 2004, respectively. The decrease in interest expense in 2005 compared to 2004 was primarily due to lower interest rates on our debt as a result of the refinancing of \$176.0 million of our 10.5% senior notes due December 1, 2007.

### *Other (income) expense:*

Other (income) expense of \$0.1 million in 2005 represented the realized gains on investments sold in association with the dissolution of our nonqualified deferred compensation plan. Other (income) expense in 2004 represented the \$6.8 million premium and the write-off of unamortized deferred financing costs of \$2.4 million in connection with the tender offer for the \$176.0 million of 10.5% senior notes. In March 2004, \$127.8 million of aggregate principal amount of 10.5% senior notes were purchased pursuant to the tender offer and in April 2004, the remaining \$48.2 million of 10.5% senior notes were redeemed in accordance with the 10.5% senior notes indenture at 103.5% of the principal amount.

### *(Provision for) benefit from income taxes:*

The provision for income taxes was \$20.0 million in 2005. Management evaluates the need for a valuation allowance on a quarterly basis. A more in depth evaluation is made as part of the annual and strategic planning process conducted in the fourth quarter of each year.

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As of January 1, 2006, we had approximately \$32.1 million of net deferred tax assets relating to net operating loss carryforwards, tax credit carryforwards and other temporary differences that are available to reduce income taxes in future years. SFAS No. 109 Accounting for Income Taxes requires that a valuation allowance be established when it is more likely than not that all or a portion of deferred tax assets will not be realized. A review of all available positive and negative evidence needs to be considered, including a company's performance, the market environment in which we operate, length of carryback and carryforward periods, and projections of future operating results. Where there are cumulative losses in recent years, SFAS No. 109 creates a strong presumption that a valuation allowance is needed. The presumption can be overcome in very limited circumstances.

During the fourth quarter of 2005, we entered a three-year cumulative loss position and revised our projections of the amount and timing of profitability in future periods. As a result, we increased the valuation allowance by approximately \$26.7 million (\$22.2 million to income tax expense and \$4.5 million to stockholders' deficit) to reduce the carrying value of deferred tax assets to zero.

The 2005 provision for income taxes also included a \$1.4 million increase in income tax accruals related to income tax audits and other tax matters resulting from certain items then being discussed with the IRS, which have since been resolved.

The benefit from income taxes was \$7.1 million, an effective tax rate of 71.4%, in 2004, as the final benefit from income taxes for 2004 included a \$2.2 million reversal of income tax accruals recorded in prior years. These accruals related to tax matters that, based upon additional information obtained during the fourth quarter of 2004, were no longer necessary. The reversal was recorded in the fourth quarter of 2004. The benefit from income taxes in 2004 was favorably impacted by the generation of Federal General Business Credits.

*(Loss) income from continuing operations:*

Loss from continuing operations was \$27.6 million and \$2.9 million for 2005 and 2004, respectively, for the reasons discussed above.

*Income (loss) from discontinued operations:*

In accordance with SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets, the results of operations of a component of an entity that either has been disposed of or is classified as held for sale and any related gain (loss) on the sales are reported in discontinued operations.

Income (loss) from the discontinued operations of 14 properties that were disposed of during 2005 and 11 properties that were classified as held for sale at January 1, 2006 consisted of the following (in thousands):

|   | <b>For the Years Ended</b> |                            |
|---|----------------------------|----------------------------|
|   | <b>January 1,<br/>2006</b> | <b>January 2,<br/>2005</b> |
| Net sales                                   | \$ 10,499                  | \$ 16,898                  |
| Pretax loss                                 | (1,548 )                   | (938 )                     |
| Gain on disposals of property and equipment | 2,115                      |                            |
| Income tax (expense) benefit.               | (232 )                     | 385                        |
| Income (loss) from discontinued operations  | \$ 335                     | \$ (553 )                  |

**Liquidity and Capital Resources***General:*

Our primary sources of liquidity and capital resources are cash generated from operations and, if needed, borrowings under our \$35 million revolving credit facility (the Credit Facility). Additional sources of liquidity consist of capital and operating leases for financing leased restaurant locations (in malls and shopping centers and land or building leases), restaurant equipment, manufacturing equipment, distribution vehicles and computer equipment. Other sources of cash are sales of under-performing existing restaurant properties and other assets and sales of Company-operated locations to franchisees (to the extent our debt instruments permit). The amount of debt financing that we are able to incur is limited by the terms of our Credit Facility and 8.375% senior notes indenture. Below was the financing status of our operating restaurants and properties that we lease to our franchisees as of December 31, 2006:

|  | <b>Company<br/>Operated</b> | <b>Franchise<br/>Operated</b> |
|--|-----------------------------|-------------------------------|
| Owned land and building, mortgaged     | 59                          | 12                            |
| Leased land, owned building, mortgaged | 1                           | 0                             |
| Sold and leased back                   | 57                          | 3                             |
| Owned land and building                | 18                          | 4                             |
| Leased land, owned building            | 75                          | 19                            |
| Leased land and building               | 106                         | 9                             |
| Total                                  | 316                         | 47                            |

The Company-operated restaurants above not identified as owned land and building, mortgaged or sold and leased back secure our obligations under the Credit Facility. Of the 18 restaurant properties identified as owned land and building, five were available to be sold.

In addition to our 316 operating restaurants, we have four closed properties that are classified as held for sale in accordance with SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets.

*Operating Cash Flows:*

Net cash provided by operating activities was \$21.7 million and \$14.0 million in 2006 and 2005, respectively. In 2006, cash provided by operating activities included net income of \$4.9 million, increased by \$2.8 million relating to the gains on sales of fixed assets, \$23.4 million for other non-cash expenses of depreciation and amortization and stock compensation expense and \$1.9 million in insurance recoveries, \$1.4 million of which is pursuant to a settlement agreement with our insurance company in connection with our claims for reimbursement of costs and expenses we have incurred in the defense of the ongoing shareholder derivative lawsuit brought by S. Prestley Blake against us and certain of our directors. We also received cash refunds of federal income taxes and the release of escrow funds related to two previously mortgaged properties of \$1.2 million and \$1.7 million, respectively. These increases were partially offset by unfavorable changes in inventory related to the inventory build required as part of the retail sqround packaging conversion and a contribution to our defined benefit cash balance pension plan of \$2.2 million as a result of the Pension Protection Act of 2006. We anticipate an additional contribution to our defined benefit cash balance pension plan of approximately \$3.5 million in 2008 as a result of the Pension Protection Act of 2006.

We had a working capital deficit of \$10.6 million and \$16.6 million as of December 31, 2006 and January 1, 2006, respectively. Our working capital deficit includes assets classified as held for sale in accordance with SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets. The working capital needs of companies engaged in the restaurant industry are generally low and as a result,

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restaurants are frequently able to operate with a working capital deficit because: (i) restaurant operations are conducted primarily on a cash (and cash equivalent) basis with a low level of accounts receivable; (ii) rapid turnover allows a limited investment in inventories; and (iii) cash from sales is usually received before related expenses for food, supplies and payroll are paid.

### *Investing Cash Flows:*

Net cash used in investing activities was \$8.3 million and \$7.7 million in 2006 and 2005, respectively.

During 2006 and 2005, we spent \$21.7 million and \$16.9 million, respectively, on capital expenditures, excluding capital leases, of which \$16.1 million and \$14.7 million, respectively, was spent on restaurant operations. Capital expenditures were offset by proceeds from the sales of property and equipment of \$13.4 million and \$8.2 million in 2006 and 2005, respectively. The proceeds in 2006 and 2005 were the result of the sale of Company-operated locations to franchisees and the sale of restaurant properties.

During 2005, we disposed of five properties by sale and nine properties other than by sale, including lease terminations. During December 2005, we closed seven restaurants and committed to a plan to sell those seven restaurants as well as four restaurants that were closed in 2004. At January 1, 2006, these 11 properties met the criteria for held for sale as defined in SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets. During 2006, we sold eight of these 11 properties. Net proceeds received on the sale of these restaurant properties during the years ended December 31, 2006 and January 1, 2006 were \$6.9 million and \$4.5 million, respectively.

During 2006, we disposed of two properties by sale and two properties other than by sale, including lease terminations. Additionally, we closed one restaurant and committed to a plan to sell that restaurant. At December 31, 2006, this property met the criteria for held for sale as defined in SFAS No. 144. The results of operations and any related gain or loss associated with the disposition of these restaurants were not material and therefore were reported within continuing operations in the accompanying consolidated statements of operations for all years presented. During 2006, we received net proceeds of \$1.6 million from the sale of two of these properties.

During 2006, we completed three transactions in which three existing franchisees purchased five existing Company-operated restaurants and agreed to develop a total of 10 new restaurants in future years. Gross proceeds from these transactions were \$3.1 million, of which \$0.3 million was for franchise and development fees and \$2.8 million was for the sale of certain assets and leasehold rights.

During 2006, three franchisees operating restaurants under options to purchase elected to exercise their options. In doing so, they purchased eight existing restaurants and agreed to develop a total of 10 new restaurants in future years. Gross proceeds from these transactions were \$2.2 million, of which \$0.3 million was for franchise and development fees and \$1.9 million was for the sale of certain assets and leasehold rights.

### *Financing Cash Flows:*

Net cash used in financing activities was \$2.9 million and \$5.1 million in 2006 and 2005, respectively.

### *Outstanding Debt:*

*Sale/Leaseback and Mortgage Financings.* In December 2001, we completed a financial restructuring plan which included the repayment of all amounts outstanding under our then existing credit facility and the purchase of approximately \$21.3 million of our 10.5% senior notes with the proceeds from \$55.0 million in long-term mortgage financing (the Mortgage Financing ) and a \$33.7 million sale and leaseback transaction (the Sale/Leaseback Financing ).



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In connection with the Sale/Leaseback Financing, we 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.

Interest on \$10.0 million of the original \$55.0 million from the Mortgage Financing is variable ( Variable Mortgages ) and the remaining \$45.0 million of the original \$55.0 million from the Mortgage Financing bears interest at a fixed annual rate of 10.16% ( Fixed Mortgages ). The Fixed Mortgages have a maturity date of January 1, 2022 and are amortized over 20 years.

On December 30, 2005, we completed a refinancing of the Variable Mortgages (the Variable Refinancing ). Under the terms of the loan agreement for the Variable Refinancing, we borrowed an aggregate sum of \$8.5 million. The interest rate is variable and is the sum of the 90-day LIBOR rate in effect (5.36% at December 31, 2006) plus 4% on an annual basis. Changes in the interest rate are calculated monthly and recognized annually when the monthly payment amount is adjusted. Changes in the monthly payment amounts owed due to interest rate changes are reflected in the principal balances, which are re-amortized over the remaining life of the mortgages. The loans under the Variable Refinancing have a maturity date of January 1, 2020 and are being amortized over 14 years.

The primary purposes of the Variable Refinancing were to (i) reduce the variable interest rate on the Variable Mortgages from LIBOR plus 6% on an annual basis to LIBOR plus 4% on an annual basis, (ii) enable the partial prepayment of the loans, subject to applicable prepayment premiums during the first three years and an agreed upon release value for properties released in connection with partial prepayments, and (iii) permit partial lien releases on the properties subject to the loans upon partial prepayments. In addition, in connection with this transaction, we prepaid two mortgage loans from the lender in the aggregate amount of \$1.0 million from existing cash.

Pursuant to the terms of the Mortgage Financing, we may sell properties securing our obligations provided that other properties are substituted in place of the sold properties. The substituted properties must meet certain requirements under the terms of the Mortgage Financing. In August 2005, proceeds of \$0.4 million and \$2.7 million were received in connection with the sale of two mortgaged properties of which \$0.4 million and \$1.3 million of such amounts was placed in escrow pending the inclusion of a substitute property. As of January 1, 2006, these balances were held as collateral and were included in restricted cash on the accompanying consolidated balance sheet as of January 1, 2006. In connection with the Variable Refinancing, the mortgage on one of these properties was released and the remaining \$0.4 million related to the sale of this property was released from escrow during the first quarter of 2006. A substitute property for the second property was obtained during the second quarter of 2006 in compliance with the substitution agreement. On June 15, 2006, the remaining \$1.3 million was released from escrow.

All mortgage financings are subject to annual covenants, including various minimum fixed charge coverage ratios. We were in compliance with the covenants for the Variable Mortgages and Fixed Mortgages as of December 31, 2006.

*8.375% Senior Notes.* In March 2004, we issued \$175 million of 8.375% senior notes (the Senior Notes ) in a private offering to finance the redemption in full of our then outstanding 10.5% senior notes. The Senior Notes 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 our Credit Facility. The Senior Notes mature on June 15, 2012. Interest on the Senior Notes is payable at 8.375% per annum semi-annually on June 15 and December 15 of each year. The 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 Senior Notes with the proceeds of one or

more qualified equity offerings, as defined, at a redemption price of 108.375% of the principal amount, plus accrued interest. The indenture for the Senior Notes contains certain covenants that limit our ability to, among other things, incur additional debt, create liens, make investments, enter into transactions with affiliates, sell assets, declare or pay dividends, redeem stock or make other distributions to shareholders, enter into sale and leaseback transactions, and consolidate or merge. We were in compliance with the covenants contained in the indenture as of December 31, 2006. The indenture also contains provisions that could require repayment of the Senior Notes at 101% of their face amount, plus accrued and unpaid interest, in the event of a change of control as defined in the indenture.

*Revolving Credit Facility.* We have a \$35 million Credit Facility which is available for borrowings to provide working capital, for issuances of letters of credit and for other corporate needs. As of December 31, 2006 and January 1, 2006, total letters of credit outstanding were \$15.5 million and \$16.0 million, respectively. During 2006 and 2005, there were no drawings against the letters of credit. The revolving credit loans bear interest at our option at either (a) the base rate plus the applicable margin as in effect from time to time (the *Base Rate*) (10.25% at December 31, 2006) or (b) the Eurodollar rate plus the applicable margin as in effect from time to time (the *Eurodollar Rate*) (9.32% at December 31, 2006). As of December 31, 2006 and January 1, 2006, there were no revolving credit loans outstanding. As of December 31, 2006 and January 1, 2006, \$19.5 million and \$19.0 million, respectively, was available for borrowing.

The Credit Facility has an annual *clean-up* provision which obligates us to repay in full any and all outstanding revolving credit loans for a period of not less than 15 consecutive days during the period beginning on or after May 1 and ending on or before June 15 (or the next business day, if, in any year, June 15 is not a business day) of each calendar year, such that immediately following the date of such repayment, the amount of all outstanding revolving credit loans shall be zero.

The Credit Facility includes certain restrictive covenants including limitations on indebtedness, restricted payments such as dividends and stock repurchases, liens, mergers, investments and sales of assets and of subsidiary stock. Additionally, the Credit Facility limits the amount which we may spend on capital expenditures, restricts the use of proceeds, as defined, from asset sales and requires that we comply with certain financial covenants. We were in compliance with the covenants in the Credit Facility as of December 31, 2006.

On August 1, 2006, we amended our \$35 million Credit Facility to, among other things, (i) extend the maturity date from June 30, 2007 to June 30, 2010, (ii) eliminate the interest coverage requirement and (iii) reduce by .50% to .75% the applicable margin rates at which the revolving credit loans bear interest to a range of 3.00% to 4.00% (depending on the leverage ratio).

We incurred approximately \$0.5 million of costs associated with this amendment to the \$35 million Credit Facility which was deferred and is being amortized over the life of the amended \$35 million Credit Facility.

We anticipate requiring capital in the future principally to maintain existing restaurant and plant facilities and to continue to renovate and re-image existing restaurants. We anticipate that capital expenditures for 2007 will be between \$20.0 million and \$23.0 million in the aggregate, of which we expect to spend between \$17.0 million and \$20.0 million on restaurants. Our actual 2007 capital expenditures may vary from these estimated amounts. We believe that the combination of the funds generated from operating activities and borrowing availability under our Credit Facility will be sufficient to meet our anticipated operating requirements, debt service requirements, lease obligations and capital requirements.

## Contractual Obligations

The following represents our contractual obligations and commercial commitments as of December 31, 2006 (in thousands):

| Contractual Obligations:              | Payments Due by Period |                   |             |             | Fiscal Years Beyond 2011 |
|---------------------------------------|------------------------|-------------------|-------------|-------------|--------------------------|
|                                       | Total                  | Fiscal Years 2007 | 2008 & 2009 | 2010 & 2011 |                          |
| Long-term debt                        | \$ 224,213             | \$ 1,563          | \$ 3,635    | \$ 5,086    | \$ 213,929               |
| Capital lease and finance obligations | 8,095                  | 2,091             | 3,073       | 842         | 2,089                    |
| Operating leases.                     | 105,451                | 18,966            | 33,342      | 26,541      | 26,602                   |
| Purchase commitments *                | 111,390                | 102,134           | 9,256       |             |                          |

| Other Commercial Commitments: | Amount of Commitment Expiration by Period |      |                          |             | Fiscal Years Beyond 2011 |
|-------------------------------|---|------|--------------------------|-------------|--------------------------|
|                               | Total                                     | 2007 | Fiscal Years 2008 & 2009 | 2010 & 2011 |                          |
| Letters of credit             | \$ 15,474                                 | \$   | \$                       | \$ 15,474   | \$                       |

\* Purchase commitments include commitments for raw materials, food products and supplies used in the normal course of business. On February 7, 2007, we entered into a 10 year contract to purchase approximately \$340,000 in liquid nitrogen annually.

## Inflation

The inflationary factors that have historically affected our results of operations include increases in the costs of cream, sweeteners, purchased food, labor and other operating expenses. Approximately 14% of our restaurant employees are paid minimum wage under applicable federal and state minimum hourly wage rates. Accordingly, any changes to the federal or state minimum hourly wage rates would have an immediate impact on wages paid to these employees. In addition, a significant change in the federal or state minimum hourly wage rates may result in an increase in hourly wage rates for other employees that are currently paid above the minimum rates. The proposed minimum wage increase being contemplated by the Federal government is not expected to have a material impact to our cost of labor, since many of the states in which we operate already have higher minimum wage levels in effect.

We are able to minimize the impact of inflation on occupancy costs by owning the underlying real estate for approximately 24% of our restaurants. Consistent with industry practice, we typically attempt to offset the effect of inflation, at least in part, through periodic menu price increases and various cost reduction programs. However, no assurance can be given that we will be able to offset such inflationary cost increases in the future.

## Seasonality

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

## Geographic Concentration

Approximately 94% of the Company-operated restaurants are located, and substantially all of our retail sales are generated, in the Northeast. As a result, a severe or prolonged economic recession or changes in demographic mix, employment levels, population density, weather, real estate market

conditions or other factors specific to this geographic region may adversely affect us more than certain of our competitors which are more geographically diverse.

### **Critical Accounting Policies**

Financial Reporting Release No. 60 issued by the Securities and Exchange Commission requires all companies to include a discussion of critical accounting policies or methods used in the preparation of financial statements. The following is a brief discussion of the more significant accounting policies and methods that we use. Our Consolidated Financial Statements, including the Notes thereto, which are included elsewhere herein, should be read in conjunction with this discussion.

#### *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 that we 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 and notes receivable, pension and post-retirement medical and life insurance benefits expense, asset impairment analysis, stock compensation expense, income tax rates and valuation allowances and tax contingency reserves. Actual amounts could differ significantly from the estimates.

#### *Revenue Recognition*

Our 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. We recognize restaurant revenue upon receipt of payment from the customer and foodservice revenue (product sales to franchisees and retail customers), 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 plans prepared by our retail sales force. Due to the high volume of trade promotion activity and the difficulty of coordinating trade promotion pricing with our customers, differences between our accrual and the subsequent settlement amount occur frequently. To address the financial impact of these differences, our estimating methodology takes these smaller differences into account. We believe our methodology has been reasonably reliable in recording trade promotion accruals. The accrual for future trade promotion settlements as of December 31, 2006 and January 1, 2006 was \$5.4 million and \$5.1 million, respectively. A variation of five percent in the 2006 accrual would change retail sales by approximately \$0.3 million. 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 the opening of the restaurant.

#### *Insurance Reserves*

We are self-insured through retentions or deductibles for the majority of our workers' compensation, automobile, general liability, employer's liability, product liability and group health insurance programs. Self-insurance amounts vary up to \$0.5 million per occurrence. Insurance with third parties, some of which is then reinsured through Restaurant Insurance Corporation (RIC), our wholly owned subsidiary, is in place for claims in excess of these self-insured amounts. RIC reinsures 100% of the risk from \$0.5 million to \$1.0 million 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, we discontinued our use of RIC as a captive insurer for new claims.

Our liabilities for estimated ultimate losses for workers' compensation, automobile, general liability, employer's liability and product liability coverages are actuarially determined and recorded in the accompanying consolidated financial statements on an undiscounted basis. The projections of estimated ultimate losses are based on commonly used actuarial procedures. These procedures take into consideration certain actuarial assumptions or management judgments regarding economic conditions, the frequency and severity of claims and claim settlement practices. While the estimated ultimate losses are reasonable, any actuarial estimate is subject to uncertainty due to the volatility inherent in casualty exposures and changes in the assumptions. Our provision for insurance expense reflects estimated amounts for the current year as well as revisions in estimates to prior years. Actual losses could vary significantly from the estimated losses and would have a material effect on our insurance expense. Our reserves have historically been within the range of management's expectations.

We record a liability for our group health insurance programs for all estimated unpaid claims based primarily upon loss development analyses derived from actual claim payment experience provided by our third party administrators.

#### *Concentration of Credit Risk*

Financial instruments, which potentially expose us to concentrations of credit risk, consist principally of accounts receivable. We perform ongoing credit evaluations of our customers and generally require no collateral to secure accounts receivable. The credit review is based on both financial and non-financial factors. We maintain a reserve for potentially uncollectible accounts receivable based on our assessment of the collectibility of accounts receivable. We recognize 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 we become 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. Our reserves have historically been within the range of management's expectations.

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

Certain of our employees are covered under a noncontributory defined benefit pension plan. The determination of our 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 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.

We used a discount rate assumption of 5.75%, 6.00% and 6.25% in the calculation of net periodic pension benefit cost for 2006, 2005 and 2004, respectively. A one-percentage point decrease in the discount rate assumption would have increased 2006 net periodic pension cost by \$1.0 million and a one percentage point increase in the discount rate assumption would have decreased 2006 net periodic pension cost by \$0.9 million.

We increased our discount rate assumption to 6.00% for valuing obligations as of January 1, 2007 from 5.75% at January 1, 2006, due to the escalating interest rate environment as of the measurement date. Keeping all other assumptions constant, a one percentage point decrease in the discount rate assumption from 6.00% would have increased the December 31, 2006 pension benefit obligation by \$16.4 million and a one percentage point increase in the discount rate assumption from 6.00% would have decreased the December 31, 2006 pension benefit obligation by \$13.7 million.

For 2006, 2005 and 2004, an asset return assumption of 8.75%, 8.75% and 9.00%, respectively, was used in the calculation of net periodic pension cost and the expected return on plan assets component of net periodic pension benefit cost was based on the market-related value of pension plan assets. A one percentage point decrease in the long term asset return assumption would have increased 2006 net periodic pension cost by \$0.9 million and a one percentage point increase in the long term asset return assumption would have decreased 2006 net periodic pension cost by \$0.9 million.

#### *Long-Lived Assets*

In accordance with SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, we review our Non-Friendly Marks, which were assigned to us by Hershey in September 2002, for impairment on a quarterly basis. We recognize impairment has occurred when the carrying value of the Non-Friendly Marks license agreement fee exceeds the estimated future undiscounted cash flows of the trademarked products. Additionally, we review 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. We evaluate restaurants using a two-year history of cash flow as the primary indicator of potential impairment. Based on the best information available, we write down an impaired restaurant to its estimated fair market value, which becomes its new cost basis. Estimated fair market value is based on our experience selling similar properties and local market conditions, less costs to sell for properties to be disposed of. In addition, restaurants scheduled for closing are reviewed for impairment and depreciable lives are adjusted. The impairment evaluation is based on the estimated cash flows from continuing use through the expected disposal date and the expected terminal value. SFAS No. 144 requires a long-lived asset to be disposed of other than by sale to be classified as held and used until it is disposed of.

SFAS No. 144 also requires the results of operations of a component of an 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 entity component from the ongoing operations of the company and no significant continuing involvement in the operations of the entity component 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 these estimates.

During 2005, we disposed of five properties by sale and nine properties other than by sale, including lease terminations. During December 2005, we closed seven restaurants and committed to a plan to sell those seven restaurants as well as four restaurants that were closed in 2004. At January 1, 2006, these 11 properties met the criteria for held for sale as defined in SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*. During 2006, we sold eight of these 11 properties and, at December 31, 2006, the remaining three properties still met the criteria for held for sale as defined in SFAS No. 144.

In accordance with SFAS No. 144, the results of operations of the eight properties that were disposed of during 2006 and the 14 properties that were disposed of during 2005, and any related net gain on the disposals, as well as the results of operations of three properties held for sale at December 31, 2006 were reported separately as discontinued operations in the accompanying consolidated statements of operations for all years presented.

During 2006, we disposed of two properties by sale and two properties other than by sale, including lease terminations. Additionally, we closed one restaurant and committed to a plan to sell that restaurant. At December 31, 2006, this property met the criteria for held for sale as defined in SFAS No. 144. The results of operations and any related gain or loss associated with the disposition of these restaurants were not material and therefore were reported within continuing operations in the accompanying consolidated statements of operations for all years presented.

During the year ended December 31, 2006, we determined that the carrying values of three operating restaurant properties exceeded their estimated fair values less costs to sell and the carrying values were reduced by an aggregate of \$0.7 million accordingly. During the year ended January 1, 2006, we determined that the carrying values of six restaurant properties and certain capital inventory used to replace restaurant equipment exceeded their estimated fair values less costs to sell. The carrying values were reduced by an aggregate of \$2.5 million.

#### *Leases and Deferred Straight-Line Rent Payable*

We lease many of our 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. Leasehold improvements that are acquired subsequent to the inception of a lease are amortized over the lesser of the useful life of the asset or a term that includes option periods that are reasonably assured at the date of the purchase.

For leases that contain rent escalations, we record the total rent payable during the lease term, as determined above, on a straight-line basis over the term of the lease and record 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 our strategy to sell Company-operated restaurants to franchisees, we remain liable for certain lease assignments and guarantees. These leases have varying terms, the latest of which expires in 2020. As of December 31, 2006, the potential amount of undiscounted payments we could be required to make in the event of non-payment by the primary lessees was \$6,648,000. The present value of these potential payments discounted at our pre-tax cost of debt at December 31, 2006 was \$5,041,000. We generally have cross-default provisions with franchisees that would put them in default of their franchise agreement in the event of non-payment under the lease. We believe these cross-default provisions significantly reduce the risk that we will be required to make payments under these leases and, historically, we have not been required to make such payments. Accordingly, no liability has been recorded for exposure under such leases at December 31, 2006 and January 1, 2006.

*Income Taxes*

We account 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. We record deferred tax assets to the extent we believe there will be sufficient future taxable income to utilize those assets prior to their expiration. To the extent deferred tax assets may be unable to be utilized, we record a valuation allowance against the potentially unrealizable amount and record a charge against earnings. The calculation of our tax liabilities involves dealing with uncertainties in the application of complex tax regulations in several different tax jurisdictions. We are periodically reviewed by tax authorities regarding the amount of taxes due. These reviews include questions regarding the timing and amount of deductions. In evaluating the exposure associated with various filing positions, we record estimated reserves for probable exposures.

Due to ever-changing tax laws and income tax rates, significant judgment is required to estimate the effective tax rate expected to apply to tax differences that are expected to reverse in the future. We must also make estimates about the sufficiency of taxable income in future periods to offset any deductions related to deferred tax assets currently recorded. Accordingly, we believe estimates related to income taxes are critical.

*Derivative Instruments and Hedging Agreements*

When available, we purchase butter option and/or futures contracts to minimize the impact of increases in the cost of cream. Our strategy related to hedging is never to hedge more than 50% of our needs using these instruments, so as not to put us in an uncompetitive position. Option contracts are offered in the months of March, May, July, September, October and December; however, there is often not enough open interest in them to allow us to buy even very limited coverage without paying high premiums.

In addition to hedging, we pursue fixed price cream contracts to manage dairy cost pressures. We have been unable to find a supplier interested in an agreement for a fixed-price load of cream since 2003. The situation surrounding the supply of cream (which depends on milk production, milk per cow, number of cows, butter inventories, etc.) is uncertain in the wake of the National Milk Producers Federation's *Cooperatives Working Together* program.

On September 19, 2005, the Chicago Mercantile Exchange launched the first electronically traded, cash-settled butter futures contract. This new futures contract is designed to meet the needs of food and dairy companies that have exposure to butterfat price risk but do not want to expose themselves to the possibility of being compelled to take physical delivery of butter. The size of the contract is 20,000 pounds of AA butter, versus the traditional butter futures contract, which is 40,000 pounds. The contract is cash settled based upon the USDA monthly weighted average price for butter in the United States. With this new type of futures contract, there is no risk of delivery of butter; therefore it offers us the ability to hedge the price risk of cream (on a butter basis) without having to take delivery of commodity butter. We have evaluated this new hedging instrument and believe it is an attractive way to hedge the price risk related to cream.

At December 31, 2006, we held 70 contracts, four of them for December 2006 and the remainder spread over the first nine months of 2007. These contracts correspond to approximately 20% of our anticipated cream purchases for the periods represented.

Our commodity option contracts and the cash-settled butter futures 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 2006, 2005 and 2004, (losses) gains of approximately (\$0.5 million), (\$0.2 million) and \$0.6 million, respectively, were included in cost of sales related to these contracts.

#### *Contingencies*

From time to time we are named as a defendant in legal actions arising in the ordinary course of our business. We are currently a party to litigation brought by S. Prestley Blake ( Blake ), holder of approximately 12% of our common stock. On February 25, 2003, Mr. Blake sued us and our Chairman in a purported derivative action in Hampden Superior Court, Massachusetts. The suit alleges breach of fiduciary duty and misappropriation of corporate assets, and alleges that we paid certain expenses relating to a corporate jet and the Chairman's use of that jet and use of an office in Illinois. The suit seeks to require the Chairman to reimburse us and for Friendly's to pay Blake's attorneys' fees. Friendly's and our Chairman have denied Blake's allegations and are vigorously defending the lawsuit. We cannot guarantee that we will be successful in defending the Blake litigation or any other litigation.

In addition to the Blake litigation, we may incur additional costs and expenses in connection with a potential proxy contest threatened by The Lion Fund, L.P., a hedge fund controlled by Sardar Biglari. The Lion Fund has notified us of its intention to nominate Sardar Biglari and Philip Cooley for election as directors at our upcoming Annual Meeting of Shareholders. In the event of a proxy contest, we expect to incur additional costs and expenses to solicit proxies in favor of our nominees for election of director and against The Lion Fund's nominees for election of director. These additional solicitation costs may include, among others, additional costs and fees payable to a proxy solicitation firm, fees of outside counsel to advise us in connection with the contested solicitation, increased costs associated with public relations matters, increased mailing and printing costs, and possible litigation.

The incurrence of significant additional and unforeseen costs and expenses to defend or pursue litigation or other investigations relating to the matters subject to the litigation, or in connection with any proxy contest, could have an adverse effect on our business and results of operations.

#### *Stock-Based Compensation*

The adoption of SFAS No. 123R, Share-Based Payment, in the first quarter of fiscal 2006 required that stock-based compensation expense associated with stock options is recognized in the statement of operations, rather than being disclosed in a pro forma footnote to the consolidated financial statements. Determining the amount of stock-based compensation to be recorded requires us to develop estimates to be used in calculating the grant-date fair value of stock options. We calculate the grant-date fair values using the Black-Scholes valuation model. The use of valuation models requires us to make estimates of the following assumptions:

Expected volatility - we are responsible for estimating volatility and have used historical volatility to estimate the grant-date fair value of stock options. Management considered the guidance in SFAS No. 123R and believes that the historical estimated volatility is materially indicative of expectations about future volatility. In general, the higher the expected volatility used in the Black-Scholes valuation model, the higher the grant-date fair value of the option.

Expected term - we use historical employee exercise and option expiration data to estimate the expected term assumption for the Black-Scholes grant-date valuation. We believe that this historical data is currently the best estimate of the expected term of a new option. Currently stock options are only issued to corporate officers and directors. In general, the longer the expected term used in the Black-Scholes valuation model, the higher the grant-date fair value of the option.

Risk-free interest rate - the yield on zero-coupon U.S. Treasury securities for a period that is commensurate with the expected term assumption is used as the risk-free interest rate.

Expected dividend yield - we have not paid any dividends in the last five years and currently intend to retain any earnings to finance future growth and, therefore, do not anticipate paying any cash dividends on our common stock in the foreseeable future.

The amount of stock-based compensation recognized during a period is based on the value of the portion of the awards that are ultimately expected to vest. SFAS No. 123R requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. The term forfeitures is distinct from cancellations or expirations and represents only the unvested portion of the surrendered option. In September 2006, John Cutter, our former President and Chief Executive Officer, resigned. As of December 31, 2006, we have adjusted our stock compensation expense to reflect his forfeitures. We will apply an annual forfeiture rate to all options outstanding as of December 31, 2006 and future options granted based on an analysis of our historical forfeitures. This analysis will be re-evaluated quarterly and the forfeiture rate will be adjusted as necessary. Ultimately, the actual expense recognized over the vesting period will only be for those shares that vest.

### **Recently Issued Accounting Pronouncements**

In October 2006, the Financial Accounting Standards Board ( FASB ) issued SFAS No. 158, Employers Accounting for Defined Benefit Pension and Other Postretirement Plans, an amendment of FASB Statements No. 87, 88, 106 and 132(R) ( SFAS No. 158 ), which requires an entity to: (a) recognize in its statement of financial position an asset for a defined benefit postretirement plan s overfunded status or a liability for a plan s underfunded status, (b) measure a defined benefit postretirement plan s assets and obligations that determine its funded status as of the end of the employer s fiscal year, and (c) recognize changes in the funded status of a defined benefit postretirement plan in comprehensive income in the year in which the changes occur. The requirement to recognize the funded status of a defined benefit postretirement plan and the disclosure requirements are effective for our 2006 fiscal year.

Because our cash balance pension plan was frozen effective December 31, 2003, the projected benefit obligation and the accumulated benefit obligation are the same resulting in no incremental effect of applying SFAS No. 158. As of December 31, 2006, the 2006 measurement date, this plan had an accumulated benefit obligation of \$115.6 million, which exceeded the fair value of plan assets of \$95.3 million. As a result of a decrease in the underfunded status of the plan, we reduced other comprehensive loss during the year ended December 31, 2006 by \$8.0 million.

In July 2006, the FASB issued FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109 ( FIN 48 ), which clarifies the accounting for uncertainty in tax positions. FIN 48 requires that we recognize in our financial statements the impact of a tax position, if that position is more likely than not of being sustained on audit based on the technical merits of the position. The provisions of FIN 48 are effective as of the beginning of our 2007 fiscal year, with the cumulative effect of the change in accounting principle recorded as an adjustment to opening retained earnings. The adoption of FIN 48 is not expected to have a material effect on our consolidated financial position or results of operations.

**Item 7a. QUANTITATIVE AND QUALITATIVE DISCLOSURE ABOUT MARKET RISKS**

We have market risk exposure to interest rates on our fixed and variable rate debt obligations. We do not enter into contracts for trading purposes. The information below summarizes our market risk associated with our debt obligations as of December 31, 2006. The table presents principal cash flows and related interest rates by expected year of maturity. For variable rate debt obligations, the average variable rates are based on implied forward rates as derived from appropriate monthly spot rate observations as of year-end. Because the mortgage loans are privately held, we believe that the carrying value of the mortgage loans as of December 31, 2006 approximated the fair value.

**EXPECTED YEAR OF MATURITY  
(dollars in thousands)**

|                        | 2007     | 2008     | 2009     | 2010     | 2011     | Thereafter | Total      | Fair Value |
|------------------------|----------|----------|----------|----------|----------|------------|------------|------------|
| <b>Fixed Rate:</b>     |          |          |          |          |          |            |            |            |
| Senior Notes           | \$       | \$       | \$       | \$       | \$       | \$ 175,000 | \$ 175,000 | \$ 166,075 |
| Fixed interest rate    |          |          |          |          |          | 8.38       | % 8.38     | %          |
| Mortgage loans         | \$ 1,190 | \$ 1,306 | \$ 1,459 | \$ 1,617 | \$ 1,792 | \$ 33,277  | \$ 40,641  | \$ 40,641  |
| Fixed interest rate    | 10.16    | % 10.16  | % 10.16  | % 10.16  | % 10.16  | % 10.16    | % 10.16    | %          |
| <b>Variable Rate:</b>  |          |          |          |          |          |            |            |            |
| Mortgage loans         | \$ 373   | \$ 415   | \$ 455   | \$ 1,230 | \$ 447   | \$ 5,652   | \$ 8,572   | \$ 8,572   |
| Average interest rates | 9.24     | % 8.89   | % 8.88   | % 9.02   | % 9.11   | % 9.53     | % 9.36     | %          |

We are subject to volatility in food costs as a result of market risk associated with commodity prices. Our ability to recover increased costs through higher pricing is, at times, limited by the competitive environment in which we operate. We manage exposure to this risk primarily through contractual commitments to purchase 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. Additionally, on a limited basis, we occasionally purchase butter option and/or futures contracts to minimize the impact of increases in the cost of cream. Option and/or futures contracts entered into for the fiscal years ended December 31, 2006, January 1, 2006 and January 2, 2005 did not significantly impact our cost of sales.

**Item 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA**

The response to this item is included in a separate section of this report. See [Index to Consolidated Financial Statements](#) on page F-1.

**Item 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE**

None.

**Item 9A. CONTROLS AND PROCEDURES**

*Evaluation of Disclosure Controls and Procedures.* We maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed in our reports under the Securities Exchange Act of 1934, as amended (the Exchange Act), is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms, and that such information is accumulated and communicated to management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure. In designing and evaluating the disclosure controls and procedures, management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving

the desired control objectives, as ours are designed to do, and management necessarily was required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures.

In connection with the preparation of this Annual Report on Form 10-K, as of December 31, 2006, an evaluation was performed under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rule 13a-15(e) and Rule 15d-15(e) under the Exchange Act). Based on that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective as of December 31, 2006.

*Management's Annual Report on Internal Control over Financial Reporting.* We are responsible for establishing and maintaining adequate internal control over financial reporting. Internal control over financial reporting is defined in Rule 13a-15(f) and Rule 15d-15(f) under the Exchange Act as a process designed by, or under the supervision of our principal executive and principal financial officers and effected by our Board of Directors, management and other personnel to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles and includes those policies and procedures that:

- pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and disposition of our assets;
- provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that our receipts and expenditures are being made only in accordance with authorization of our management and directors; and
- provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of our assets that could have a material effect on the financial statements.

Our internal control system is designed to provide reasonable assurance to our management and Board of Directors regarding the preparation and fair presentation of published financial statements. Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Projections of any evaluation of effectiveness to future periods are subject to the risks that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

We have assessed the effectiveness of our internal control over financial reporting as of December 31, 2006. In making this assessment, we used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in Internal Control-Integrated Framework.

Based on our assessment, we believe that, as of December 31, 2006, our internal control over financial reporting was effective at a reasonable assurance level based on these criteria.

Ernst & Young, our independent registered public accounting firm, has issued an audit report on our assessment of our internal control over financial reporting. This report, in which they expressed an unqualified opinion, is included below.

**Report of Independent Registered Public Accounting Firm on Internal Control over Financial Reporting**

We have audited management's assessment, included in the accompanying Management's Report on Internal Control over Financial Reporting, that Friendly Ice Cream Corporation maintained effective internal control over financial reporting as of December 31, 2006, based on criteria established in Internal Control - Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO criteria). Friendly Ice Cream Corporation's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assessment and an opinion on the effectiveness of the Company's internal control over financial reporting based on our audit.

We conducted our audit 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 effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the Company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the Company are being made only in accordance with authorizations of management and directors of the Company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the Company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, management's assessment that Friendly Ice Cream Corporation maintained effective internal control over financial reporting as of December 31, 2006, is fairly stated, in all material respects, based on the COSO criteria. Also, in our opinion, Friendly Ice Cream Corporation maintained, in all material respects, effective internal control over financial reporting as of December 31, 2006, based on the COSO criteria.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets as of December 31, 2006 and January 1, 2006 and the related consolidated statements of operations, stockholders' deficit and cash flows for each of the three years in the period ended December 31, 2006 of Friendly Ice Cream Corporation and our report dated February 21, 2007 expressed an unqualified opinion thereon.

/s/ Ernst & Young LLP  
Ernst & Young LLP

Boston, Massachusetts  
February 21, 2007

*Change in Internal Control Over Financial Reporting.* There were no changes in our internal control over financial reporting that occurred during our last fiscal quarter that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

**Item 9B. OTHER INFORMATION**

*2006 Long-Term Incentive Plan*

Pursuant to a long-term incentive plan for fiscal 2006 approved by the Compensation Committee of the Board of Directors (the "Compensation Committee") under the Company's 2003 Incentive Plan, as amended (the "2003 Incentive Plan"), the Compensation Committee established target EBITDA levels for the Company for fiscal 2006 and target awards for each officer named below based on a percentage (ranging from 50% to 70%) of each such officer's base salary. The actual awards for each officer are payable in shares of restricted stock (representing approximately two-thirds of the value of the target award) and stock options to purchase shares of Common Stock (representing approximately one-third of the value of the target award).

On March 21, 2006, pursuant to the long-term incentive plan for fiscal 2006, the Company issued options to purchase 24,109, 10,122, 11,668 and 11,717 shares of Common Stock, with an exercise price of \$8.10 per share (the closing price of the Company's Common Stock as reported on the American Stock Exchange on March 21, 2006), to each of Messrs. Hoagland, Pastore, Green, and Ulrich. These stock options vest in three equal annual installments, subject to the officer's continued employment with the Company.

Under the 2006 long-term incentive plan, if the Company were to meet or exceed a threshold EBITDA for fiscal 2006, then the officer would be entitled to receive an award payable in shares of Common Stock of the Company. The award value is determined based on the Company's actual EBITDA for fiscal 2006 compared to projected EBITDA for fiscal 2006 and the percentage (ranging from 50% to 150%) of the officer's target award applicable to those results (the "2006 Award Value").

On February 28, 2007 the Compensation Committee determined that the Company exceeded the threshold EBITDA for fiscal 2006, and awarded shares of Common Stock under the Company's 2003 Incentive Plan to each of the officers named below. The number of shares of Common Stock issued to each officer was determined by dividing the officer's 2006 Award Value by 90% of the closing price of the Company's Common Stock on the date of grant as reported on the American Stock Exchange. 25% of the shares of Common Stock issued to each officer are fully vested upon issuance. The remaining 75% of the shares of Common Stock will vest in three equal annual installments following issuance if the officer remains employed by the Company. The unvested shares will also fully vest upon a change in control, as provided in the 2003 Incentive Plan.

The following table sets forth each officer's 2006 Award Value and the number of shares of Common Stock the officer received under the long-term incentive plan for fiscal 2006.

| Name            | Award Value | Number of Shares |
|-----------------|-------------|------------------|
| Paul Hoagland   | \$ 188,664  | 17,469           |
| Gregory Pastore | \$ 79,207   | 7,334            |
| Kenneth Green   | \$ 91,304   | 8,454            |
| Garrett Ulrich  | \$ 91,690   | 8,490            |

*2007 Long-Term Incentive Plan*

On February 28, 2007 the Compensation Committee approved a similar long-term incentive plan for fiscal 2007 under the Company's 2003 Incentive Plan, pursuant to which the Compensation Committee

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established target EBITDA levels for the Company for fiscal 2007 and target awards for each officer named below based on a percentage (ranging from 50% to 100%) of each officer's base salary. The actual awards for each officer are payable in shares of restricted stock (representing approximately two-thirds of the value of the target award) and stock options to purchase shares of Common Stock (representing approximately one-third of the value of the target award).

The stock options will be granted two business days after the Company's files its Annual Report on Form 10-K for the year ended December 31, 2006. The number of stock options an officer will receive will be calculated by dividing approximately one-third of the officer's target award by 40% of the closing price of the Company's Common Stock on the date of grant, as reported by the American Stock Exchange (or such other exchange on which the Company is traded). The stock options will have an exercise price equal to the closing price on the date of grant as reported on the American Stock Exchange (or such other exchange on which the Company is traded), and will vest in three equal installments on each of the three anniversary dates of the date of grant.

With respect to the potential restricted stock awards, the Compensation Committee approved the issuance of restricted stock unit award agreements (the Restricted Stock Units Award Agreements) for each of the officers named below, pursuant to which each officer is eligible to receive a certain number of shares of Common Stock of the Company calculated in accordance with the terms of the officer's individual Restricted Stock Unit Award Agreement. If the Company meets or exceeds a certain threshold EBITDA for fiscal 2007 (the 2007 Threshold EBITDA), then the officer will receive an award payable in shares of Common Stock having a value determined based on the Company's actual EBITDA for fiscal 2007 compared to projected EBITDA for fiscal 2007 and the percentage (ranging from 50% to 150%) of the officer's target award applicable to those results (the 2007 Award Value). In the event of a Change in Control, as provided under the 2003 Incentive Plan, prior to the Compensation Committee's determination of the 2007 Award Value, the 2007 Threshold EBITDA shall be deemed to have been achieved and the 2007 Award Value shall be deemed to be equal to the target EBITDA for fiscal 2007. The number of shares of Common Stock to be issued to the officer, if any, will be calculated by dividing the 2007 Award Value by 90% of the closing price of the Company's Common Stock on the date of grant as reported by the American Stock Exchange (or such other exchange on which the Company's Common Stock is traded) (the Award Shares).

The following table sets forth the range of Award Values each officer may receive under the long-term incentive plan for fiscal 2007:

| Name             | Value of Award |    |            |
|------------------|----------------|----|------------|
| George M. Condos | \$ 159,125     | To | \$ 477,375 |
| Paul Hoagland    | \$ 83,670      | To | \$ 251,009 |
| Gregory Pastore  | \$ 35,477      | To | \$ 106,430 |
| Kenneth Green    | \$ 44,053      | To | \$ 132,158 |
| Garrett Ulrich   | \$ 41,071      | To | \$ 123,213 |

The 2007 Award Value will be determined, and the date of grant of any Award Shares will occur, upon the earlier of (i) the date of the Compensation Committee's first regularly scheduled meeting held after the completion of the Company's independent audit for fiscal 2007 and the Company's Audit Committee's recommendation to include the Company's audited financial statements in the Company's Annual Report on Form 10-K or (ii) immediately prior to the consummation of a Change in Control of the Company (the Issue Date). If the officer's employment with the Company or one of its affiliates is terminated due to death, disability, retirement, involuntary (with or without cause) or voluntary termination prior to the Issue Date, then the officer's Restricted Stock Unit Award Agreement shall terminate and the officer shall have no right to receive any Award Shares.

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If Award Shares are issued to the officer, 25% of the shares of Common Stock issued to each officer will be fully vested upon issuance. The remaining 75% of the shares of Common Stock will vest in three equal annual installments following issuance if the officer remains employed by the Company. The unvested shares will also fully vest upon a change in control, as provided in the 2003 Incentive Plan.

### *Annual Incentive Plan*

Each year, the Compensation Committee approves an annual incentive plan ( AIP Plan ), which is structured to provide a variable pay opportunity to executives and employees based on the Company's and the individual's performance. Under the AIP Plan, the Compensation Committee establishes financial objectives for the Company. The financial objectives are based upon the Company's achievement of specified levels of earnings as measured by EBITDA. These EBITDA goals are considered achievable but require above-average performance. The President and Chief Executive Officer establishes his own individual objectives, submits those objectives to the Compensation Committee, and the Compensation Committee determines whether to approve or modify such objectives. Next, each executive develops and proposes individual objectives based upon corporate and other business unit objectives and then presents these goals to the President and Chief Executive Officer. The President and Chief Executive Officer reviews and finalizes these individual objectives and submits them for review and approval by the Compensation Committee. During fiscal 2006, the target award for each of the officers named below was based on a percentage (ranging from 35% to 50%) of each officer's base salary. Maximum awards for superior performance were capped at 150% of target awards.

On February 28, 2007, the Compensation Committee approved the following cash bonuses under the Company's AIP Plan for fiscal 2006 to each of the officers listed below:

| Name            | Cash Bonus Amount |
|-----------------|-------------------|
| Paul Hoagland   | \$ 183,568        |
| Gregory Pastore | \$ 71,960         |
| Kenneth Green   | \$ 124,463        |
| Garrett Ulrich  | \$ 87,498         |

The Compensation Committee also approved an AIP Plan for fiscal 2007, and established financial objectives based upon achievement of specified levels of EBITDA and other business and individual objectives for fiscal 2007. The target award for each officer named below is based on a percentage (ranging from 35% to 75%) of each officer's base salary. Awards are payable only if the Company meets or exceeds certain thresholds, including EBITDA, for fiscal 2007. If the minimum thresholds are met or exceeded, the officer will be eligible to receive an award payable in cash ranging in amount from 50% to 150% of the target award. The following table sets forth the range of bonus awards each officer may receive under the AIP Plan for fiscal 2007:

| Name             | Range of Bonus Award |    |            |  |
|------------------|----------------------|----|------------|--|
| George M. Condos | \$ 178,125           | To | \$ 534,375 |  |
| Paul Hoagland    | \$ 89,200            | To | \$ 267,600 |  |
| Gregory Pastore  | \$ 37,065            | To | \$ 111,195 |  |
| Kenneth Green    | \$ 65,750            | To | \$ 197,250 |  |
| Garrett Ulrich   | \$ 42,910            | To | \$ 128,730 |  |



**PART III****Item 10. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE**

Information required by this Item 10 relating to our directors, the Audit Committee of the Board of Directors and the audit committee financial expert and any other information required by Item 407 of Regulation S-K is incorporated herein by reference to the section entitled ELECTION OF DIRECTORS of our definitive proxy statement which will be filed no later than 120 days after December 31, 2006. The information required by this Item 10 relating to our executive officers is set forth under the heading Executive Officers of the Registrant following Item 4 of Part I of this report. The information required by this Item 10 under Item 405 of Regulation S-K is incorporated herein by reference to the section entitled OTHER MATTERS Section 16(a) Beneficial Ownership Reporting Compliance of our definitive proxy statement which will be filed no later than 120 days after December 31, 2006.

We have adopted a code of ethics that applies to our Chief Executive Officer, Chief Financial Officer, Controller and other persons performing similar functions. We have posted a copy of the code on our Internet website at the Internet address <http://www.friendlys.com>. Copies of the code may be obtained free of charge from our website at the above Internet address. We intend to satisfy the disclosure requirement under Item 5.05 of Current Report of Form 8-K regarding an amendment to, or waiver from, a provision of this code by posting such information on our website, at the address specified above.

**Item 11. EXECUTIVE COMPENSATION**

Information required by this Item 11 is incorporated herein by reference to the section entitled EXECUTIVE COMPENSATION of our definitive proxy statement which will be filed no later than 120 days after December 31, 2006.

**Item 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS**

Information related to security ownership required by this Item 12 is incorporated herein by reference to the section entitled STOCK OWNERSHIP, of our definitive proxy statement which will be filed no later than 120 days after December 31, 2006. The Equity Compensation Plan Information required by Item 12 is set forth in the table below.

Securities authorized under equity compensation plans as of December 31, 2006 were as follows:

| Plan Category  | Equity Compensation Plan Information                                   |  |   |
|--|--|--|---|
|  | Column a   | Column b   | Column c  |
|  | Number of securities to be issued upon exercise of outstanding options | Weighted-average exercise price of outstanding options | Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column a) |
| Equity compensation plans approved by security holders     | 281,928 (1)  | 5.37   | 352,211 (2)   |
| Equity compensation plans not approved by security holders | 230,352  | 6.90   | 4,027 (3)   |
| Total  | 512,280  | 6.06   | 356,238   |

(1) Includes options to purchase 221,928 shares of our common stock. Also includes 60,000 restricted stock units (the right to receive shares of our common stock in the future after certain restrictions have lapsed) that were awarded under our 2003 Incentive Plan on December 2, 2005 and November 1, 2006.

(2) Represents 803 unissued shares available under the 1997 Restricted Stock Plan, which provides for the issuance of restricted stock, 3,540 unissued shares under the 1997 Stock Option Plan and 347,868 unissued shares available under the 2003 Incentive Plan.

(3) Represents unissued shares available under the 1997 Stock Option Plan.

In 1997, the Board of Directors adopted a stock option plan, pursuant to which 395,000 shares of common stock options were authorized for issuance. Our shareholders originally approved the 1997 Stock Option Plan in October 1997. However, in 2000 and 2001, the total number of shares reserved for issuance under the 1997 Stock Option Plan was subsequently increased by 439,970 and 200,000 shares, respectively, by the Board of Directors without seeking additional shareholder approval. Accordingly, in the foregoing chart, awards outstanding under the 1997 Stock Option Plan are included in columns (a) and (c) under both the approved by security holders and not approved by security holders categories. Shares covered by awards that expire or otherwise terminate will again become available for grant.

In 1997, the Board of Directors adopted the 1997 Restricted Stock Plan, pursuant to which 371,285 shares were authorized for issuance. Our shareholders approved the 1997 Restricted Stock Plan in October 1997. The 1997 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 us 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. Our Board of Directors, in its sole discretion, may designate employees and persons providing material services to us as eligible for participation in the 1997 Restricted Stock Plan. In connection with the approval of the 2003 Incentive Plan, the shares authorized for issuance under the 1997 Restricted Stock Plan were reduced by 156,217 shares of stock.

On April 9, 2003, the Board of Directors adopted an equity incentive plan (the 2003 Incentive Plan ), which was approved by shareholders on May 14, 2003. On May 10, 2006, the shareholders approved an amendment to the 2003 Incentive Plan to increase the number of shares of common stock reserved for issuance under the 2003 Incentive Plan from 307,000 to 607,000 shares.

### **Item 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS AND DIRECTOR INDEPENDENCE**

Information required by this Item 13 is incorporated herein by reference to the sections entitled CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS and ELECTION OF DIRECTORS of our definitive proxy statement which will be filed no later than 120 days after December 31, 2006.

### **Item 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES**

Information required by this Item 14 is incorporated herein by reference to the section entitled RATIFICATION OF APPOINTMENT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM of our definitive proxy statement, which will be filed no later than 120 days after December 31, 2006.

**PART IV**

**Item 15. EXHIBITS AND FINANCIAL STATEMENT SCHEDULES**

- (a)
1. Financial statements:  
For a listing of consolidated financial statements that are included in this document, see page F-1.
  2. Financial statement schedules:  
The following consolidated financial statement schedule is included pursuant to Item 15(c): Schedule II Valuation and Qualifying Accounts. All other schedules for which provision is made in the applicable accounting regulation of the Securities and Exchange Commission are not required under the related instructions or are inapplicable and, therefore, have been omitted.
  3. Exhibits:  
The exhibit index is incorporated by reference herein.
- (b) Exhibits:  
Included in Item 15(a)(3) above.
- (c) Financial statement schedules:  
Included in Item 15(a)(2) above.

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**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  
 Name: Paul V. Hoagland  
 Title: Executive Vice President of Administration and Chief Financial Officer  
 Date: March 6, 2007

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed by the following persons on behalf of the registrant and in the capacities and on the date indicated.

| Name                                       | Title (Capacity)  | Date          |
|--|---|---------------|
| /s/ GEORGE M. CONDOS<br>George M. Condos   | President and Chief Executive Officer<br>and Director (Principal Executive Officer)                                       | March 6, 2007 |
| /s/ PAUL V. HOAGLAND<br>Paul V. Hoagland   | Executive Vice President of<br>Administration and Chief Financial Officer<br>(Principal Financial and Accounting Officer) | March 6, 2007 |
| /s/ DONALD N. SMITH<br>Donald N. Smith     | Chairman of the Board   | March 6, 2007 |
| /s/ STEVEN L. EZZES<br>Steven L. Ezzes     | Director  | March 6, 2007 |
| /s/ BURTON J. MANNING<br>Burton J. Manning | Director  | March 6, 2007 |
| /s/ MICHAEL J. DALY<br>Michael J. Daly     | Director  | March 6, 2007 |
| /s/ PERRY D. ODAK<br>Perry D. Odak         | Director  | March 6, 2007 |

**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 December 31, 2006 and January 1, 2006 and the related consolidated statements of operations, stockholders' deficit and cash flows for each of the three years in the period ended December 31, 2006. 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 December 31, 2006 and January 1, 2006, and the consolidated results of their operations and their cash flows for each of the three years in the period ended December 31, 2006, 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.

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 December 31, 2006 based on criteria established in Internal Control - Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated February 21, 2007 expressed an unqualified opinion thereon.

/s/ Ernst & Young LLP

Boston, Massachusetts  
February 21, 2007

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## FRIENDLY ICE CREAM CORPORATION AND SUBSIDIARIES

## CONSOLIDATED BALANCE SHEETS

(In thousands, except share and per share data)

|   | December 31,<br>2006 | January 1,<br>2006 |
|---|----------------------|--------------------|
| <b>ASSETS</b>   |                      |                    |
| <b>CURRENT ASSETS:</b>  |                      |                    |
| Cash and cash equivalents   | \$ 25,077            | \$ 14,597          |
| Restricted cash   | 517                  | 2,549              |
| Accounts receivable, net  | 11,435               | 10,757             |
| Inventories   | 17,059               | 15,775             |
| Assets held for sale  | 896                  | 933                |
| Prepaid expenses and other current assets   | 3,127                | 5,044              |
| <b>TOTAL CURRENT ASSETS</b>   | <b>58,111</b>        | <b>49,655</b>      |
| DEFERRED INCOME TAXES   | 928                  |                    |
| PROPERTY AND EQUIPMENT, net of accumulated depreciation and amortization  | 137,425              | 143,514            |
| INTANGIBLE ASSETS AND DEFERRED COSTS, net of accumulated amortization of \$13,204 and \$11,247 at December 31, 2006 and January 1, 2006, respectively                               | 17,783               | 19,063             |
| OTHER ASSETS  | 5,920                | 6,010              |
| <b>TOTAL ASSETS</b>   | <b>\$ 220,167</b>    | <b>\$ 218,242</b>  |
| <b>LIABILITIES AND STOCKHOLDERS DEFICIT</b>   |                      |                    |
| <b>CURRENT LIABILITIES:</b>   |                      |                    |
| Current maturities of long-term debt  | \$ 1,563             | \$ 1,426           |
| Current maturities of capital lease and finance obligations   | 1,541                | 1,419              |
| Accounts payable  | 22,247               | 24,968             |
| Accrued salaries and benefits   | 8,230                | 8,212              |
| Accrued interest payable  | 1,173                | 1,324              |
| Insurance reserves  | 11,462               | 9,002              |
| Restructuring reserves  |                      | 72                 |
| Other accrued expenses  | 22,475               | 19,866             |
| <b>TOTAL CURRENT LIABILITIES</b>  | <b>68,691</b>        | <b>66,289</b>      |
| CAPITAL LEASE AND FINANCE OBLIGATIONS, less current maturities  | 4,682                | 6,173              |
| LONG-TERM DEBT, less current maturities   | 222,650              | 224,894            |
| LIABILITY FOR PENSION BENEFITS  | 20,302               | 28,904             |
| OTHER LONG-TERM LIABILITIES   | 30,738               | 33,820             |
| COMMITMENTS AND CONTINGENCIES   |                      |                    |
| <b>STOCKHOLDERS DEFICIT:</b>  |                      |                    |
| Common stock, par value \$.01 per share; authorized 50,000,000 shares; 8,117,235 and 7,898,591 shares issued and outstanding at December 31, 2006 and January 1, 2006, respectively | 81                   | 79                 |
| Preferred stock, par value \$.01 per share; authorized 1,000,000 shares; no shares issued and outstanding   |                      |                    |
| Additional paid-in capital  | 146,398              | 144,675            |
| Accumulated other comprehensive loss  | (23,514 )            | (31,785 )          |
| Accumulated deficit   | (249,861 )           | (254,807 )         |
| <b>TOTAL STOCKHOLDERS DEFICIT</b>   | <b>(126,896 )</b>    | <b>(141,838 )</b>  |
| <b>TOTAL LIABILITIES AND STOCKHOLDERS DEFICIT</b>   | <b>\$ 220,167</b>    | <b>\$ 218,242</b>  |

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

## FRIENDLY ICE CREAM CORPORATION AND SUBSIDIARIES

## CONSOLIDATED STATEMENTS OF OPERATIONS

(In thousands, except per share data)

|  | For the Years Ended<br>December 31,<br>2006 | January 1,<br>2006  | January 2,<br>2005<br>(53 weeks) |
|--|---|---------------------|----------------------------------|
| <b>REVENUES:</b>   |   |                     |                                  |
| Restaurant   | \$ 395,999                                  | \$ 400,821          | \$ 431,763                       |
| Foodservice  | 120,055                                     | 116,072             | 112,637                          |
| Franchise  | 15,401                                      | 14,454              | 13,199                           |
| <b>TOTAL REVENUES</b>  | <b>531,455</b>                              | <b>531,347</b>      | <b>557,599</b>                   |
| <b>COSTS AND EXPENSES:</b>   |   |                     |                                  |
| Cost of sales  | 200,828                                     | 205,332             | 210,477                          |
| Labor and benefits   | 141,148                                     | 143,973             | 158,133                          |
| Operating expenses   | 104,030                                     | 105,809             | 104,681                          |
| General and administrative expenses  | 43,284                                      | 38,746              | 40,006                           |
| Pension settlement expense (Note 11)   |   |                     | 2,204                            |
| Restructuring expense (Note 9)   |   |                     | 2,627                            |
| Gain on litigation settlement (Note 19)  |   |                     | (3,644 )                         |
| Write-downs of property and equipment (Note 5)   | 719   | 2,478               | 91                               |
| Depreciation and amortization  | 22,913                                      | 23,435              | 22,592                           |
| Gain on franchise sales of restaurant operations and properties  | (3,927 )                                    | (2,658 )            | (1,302 )                         |
| Loss on disposals of other property and equipment, net   | 901   | 1,030               | 213                              |
| <b>OPERATING INCOME</b>  | <b>21,559</b>                               | <b>13,202</b>       | <b>21,521</b>                    |
| <b>OTHER EXPENSES (INCOME):</b>  |   |                     |                                  |
| Interest expense, net of capitalized interest of \$103, \$25 and \$61 and interest income of \$1,097, \$682 and \$702 for the years ended December 31, 2006, January 1, 2006 and January 2, 2005, respectively | 20,491                                      | 20,924              | 22,295                           |
| Other (income) expense   | (334 )                                      | (130 )              | 9,235                            |
| <b>INCOME (LOSS) BEFORE BENEFIT FROM PROVISION FOR INCOME TAXES</b>  | <b>1,402</b>                                | <b>(7,592 )</b>     | <b>(10,009 )</b>                 |
| Benefit from (provision for) income taxes  | 83  | (20,002 )           | 7,145                            |
| <b>INCOME (LOSS) FROM CONTINUING OPERATIONS</b>  | <b>1,485</b>                                | <b>(27,594 )</b>    | <b>(2,864 )</b>                  |
| Income (loss) from discontinued operations, net of income tax effect of (\$538), (\$232) and \$385 for the years ended December 31, 2006, January 1, 2006 and January 2, 2005, respectively.                   | 3,461                                       | 335                 | (553 )                           |
| <b>NET INCOME (LOSS)</b>   | <b>\$ 4,946</b>                             | <b>\$ (27,259 )</b> | <b>\$ (3,417 )</b>               |
| <b>BASIC NET INCOME (LOSS) PER SHARE:</b>  |   |                     |                                  |
| Income (loss) from continuing operations   | \$ 0.19                                     | \$ (3.53 )          | \$ (0.38 )                       |
| Income (loss) from discontinued operations   | 0.44  | 0.04                | (0.07 )                          |
| Net income (loss)  | \$ 0.63                                     | \$ (3.49 )          | \$ (0.45 )                       |
| <b>DILUTED NET INCOME (LOSS) PER SHARE:</b>  |   |                     |                                  |
| Income (loss) from continuing operations   | \$ 0.18                                     | \$ (3.53 )          | \$ (0.38 )                       |
| Income (loss) from discontinued operations   | 0.43  | 0.04                | (0.07 )                          |
| Net income (loss)  | \$ 0.61                                     | \$ (3.49 )          | \$ (0.45 )                       |
| <b>WEIGHTED AVERAGE SHARES:</b>  |   |                     |                                  |
| Basic  | 7,939                                       | 7,802               | 7,637                            |
| Diluted  | 8,084                                       | 7,802               | 7,637                            |

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





## FRIENDLY ICE CREAM CORPORATION AND SUBSIDIARIES

## CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS DEFICIT

(In thousands, except share data)

|   | Common Stock<br>Shares | Amount | Additional<br>Paid-In<br>Capital | Accumulated<br>Other<br>Comprehensive<br>(Loss) Income | Accumulated<br>Deficit | Total         |
|---|------------------------|--------|----------------------------------|--|------------------------|---------------|
| 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 )        |
| Net unrealized gains on marketable securities (net of income tax expense of \$20) |                        |        |                                  | 29   |                        | 29            |
| 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           |
| BALANCE, JANUARY 2, 2005  | 7,713,279              | \$ 77  | \$ 143,115                       | \$ (20,670 )   | \$ (227,548 )          | \$ (105,026 ) |
| Comprehensive loss:   |                        |        |                                  |  |                        |               |
| Net loss  |                        |        |                                  |  | (27,259 )              | (27,259 )     |
| Minimum pension liability (net of income tax benefit of \$4,545)                  |                        |        |                                  | (6,541 )   |                        | (6,541 )      |
| Deferred tax valuation allowance  |                        |        |                                  | (4,545 )   | (4,545 )               |               |
| Net unrealized gains on marketable securities (net of income tax expense of \$20) |                        |        |                                  | (29 )  |                        | (29 )         |
| Total comprehensive loss  |                        |        |                                  | (11,115 )  | (27,259 )              | (38,374 )     |
| Stock options exercised   | 185,312                | 2      | 1,035                            |  |                        | 1,037         |
| Income tax benefit of stock options exercised                                     |                        |        | 450                              |  |                        | 450           |
| Stock compensation expense  |                        |        | 75                               |  |                        | 75            |
| BALANCE, JANUARY 1, 2006  | 7,898,591              | \$ 79  | \$ 144,675                       | \$ (31,785 )   | \$ (254,807 )          | \$ (141,838 ) |
| Comprehensive income:   |                        |        |                                  |  |                        |               |
| Net income  |                        |        |                                  |  | 4,946                  | 4,946         |
| Defined benefit plan:   |                        |        |                                  |  |                        |               |
| Net actuarial gain (Note 11) (net of income tax benefit of \$3,283)               |                        |        |                                  | 4,724  |                        | 4,724         |
| Deferred tax valuation allowance  |                        |        |                                  | 3,283  |                        | 3,283         |
| Total comprehensive income  |                        |        |                                  | 8,007  | 4,946                  | 12,953        |
| Adjustment to initially apply SFAS No. 158 (net of income tax benefit of \$108)   |                        |        |                                  | 156  |                        | 156           |
| Deferred tax valuation allowance  |                        |        |                                  | 108  |                        | 108           |
| Stock options exercised   | 218,644                | 2      | 1,141                            |  |                        | 1,143         |
| Income tax benefit of stock options exercised                                     |                        |        | 145                              |  |                        | 145           |
| Stock compensation expense  |                        |        | 437                              |  |                        | 437           |
| BALANCE, DECEMBER 31, 2006  | 8,117,235              | \$ 81  | \$ 146,398                       | \$ (23,514 )   | \$ (249,861 )          | \$ (126,896 ) |

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<br>December 31,<br>2006 | January 1,<br>2006 | January 2,<br>2005<br>(53 weeks) |
|--|---|--------------------|----------------------------------|
| <b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>   |   |                    |                                  |
| Net income (loss)  | \$ 4,946                                    | \$ (27,259 )       | \$ (3,417 )                      |
| Adjustments to reconcile net income (loss) to net cash provided by operating activities: |   |                    |                                  |
| Stock compensation expense   | 437   | 75                 | 495                              |
| Depreciation and amortization  | 22,913                                      | 23,435             | 22,592                           |
| Non-cash (income) loss from discontinued operations                                      | (4,359 )                                    | (1,560 )           | 639                              |
| Write-offs of deferred financing costs   |   |                    | 2,445                            |
| Write-downs of property and equipment  | 719   | 2,478              | 91                               |
| Deferred income tax (benefit) expense  | (928 )                                      | 17,849             | (7,383 )                         |
| Tax benefit from exercise of stock options   | (145 )                                      | (450 )             | (818 )                           |
| Gain on disposals of property and equipment, net   | (2,828 )                                    | (1,616 )           | (1,107 )                         |
| Pension settlement expense   |   |                    | 2,204                            |
| Changes in operating assets and liabilities:   |   |                    |                                  |
| Accounts receivable  | (678 )                                      | (309 )             | (64 )                            |
| Inventories  | (1,284 )                                    | 1,770              | (1,876 )                         |
| Other assets   | 4,039                                       | (1,428 )           | (3,000 )                         |
| Accounts payable   | (2,721 )                                    | 3,432              | (939 )                           |
| Accrued expenses and other long-term liabilities   | 3,746                                       | (2,422 )           | (3,253 )                         |
| Contribution to defined benefit pension plan   | (2,150 )                                    | (2,422 )           | (3,253 )                         |
| <b>NET CASH PROVIDED BY OPERATING ACTIVITIES</b>   | <b>21,707</b>                               | <b>11,573</b>      | <b>3,356</b>                     |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>   |   |                    |                                  |
| Purchases of property and equipment  | (21,670 )                                   | (16,902 )          | (19,734 )                        |
| Proceeds from sales of property and equipment  | 13,360                                      | 8,245              | 6,035                            |
| Purchases of marketable securities   |   | (665 )             | (1,130 )                         |
| Proceeds from sales of marketable securities   |   | 1,643              | 152                              |
| <b>NET CASH USED IN INVESTING ACTIVITIES</b>   | <b>(8,310 )</b>                             | <b>(7,679 )</b>    | <b>(14,677 )</b>                 |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>   |   |                    |                                  |
| Proceeds from issuance of New Senior Notes   |   |                    | 175,000                          |
| Proceeds from borrowings under revolving credit facility                                 | 8,000                                       | 16,250             | 26,250                           |
| Proceeds from issuance of mortgages  |   | 9,615              |                                  |
| Repayments of debt   | (10,107 )                                   | (30,521 )          | (199,338 )                       |
| Payments of deferred financing costs   | (675 )                                      | (429 )             | (6,650 )                         |
| Repayments of capital lease and finance obligations                                      | (1,423 )                                    | (1,526 )           | (1,216 )                         |
| Stock options exercised  | 1,143                                       | 1,037              | 978                              |
| Tax benefit from exercise of stock options   | 145   | 450                | 818                              |
| <b>NET CASH USED IN FINANCING ACTIVITIES</b>   | <b>(2,917 )</b>                             | <b>(5,124 )</b>    | <b>(4,158 )</b>                  |
| <b>NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS</b>                              | <b>10,480</b>                               | <b>(1,230 )</b>    | <b>(15,479 )</b>                 |
| <b>CASH AND CASH EQUIVALENTS, BEGINNING OF YEAR.</b>                                     | <b>14,597</b>                               | <b>13,405</b>      | <b>25,631</b>                    |
| <b>CASH AND CASH EQUIVALENTS, END OF YEAR.</b>   | <b>\$ 25,077</b>                            | <b>\$ 12,175</b>   | <b>\$ 10,152</b>                 |
| <b>SUPPLEMENTAL DISCLOSURES:</b>   |   |                    |                                  |
| Cash paid during the period for:   |   |                    |                                  |
| Interest   | \$ 20,138                                   | \$ 20,169          | \$ 21,953                        |
| Income taxes   | 60  | 691                | 70                               |
| Capital lease obligations incurred   | 54  | 256                | 3,445                            |
| Capital lease obligations terminated   |   | 51                 |                                  |

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

**FRIENDLY ICE CREAM CORPORATION AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**1. NATURE OF OPERATIONS**

As of December 31, 2006, Friendly's operated 316 full-service restaurants and franchised 198 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 12 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 December 31, 2006, January 1, 2006 and January 2, 2005, restaurant sales were approximately 75%, 75% and 78%, respectively, of the Company's total revenues. As of December 31, 2006, January 1, 2006 and January 2, 2005, approximately 94%, 97% and 96%, respectively, of the Company-operated restaurants were located in the Northeast United States.

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.

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

|                           | <b>For the Years Ended</b>   |                            |                            |
|---------------------------|------------------------------|----------------------------|----------------------------|
|                           | <b>December 31,<br/>2006</b> | <b>January 1,<br/>2006</b> | <b>January 2,<br/>2005</b> |
| <b>Company Units:</b>     |                              |                            |                            |
| Beginning of year         | 314                          | 347                        | 355                        |
| Openings                  | 2                            | 2                          | 4                          |
| Acquired from franchisees | 11                           |                            |                            |
| Acquired by franchisees   | (6 )                         | (15 )                      | (27 )                      |
| Closings                  | (5 )                         | (20 )                      | (5 )                       |
| End of year               | 316                          | 314                        | 327                        |
| <b>Franchised Units:</b>  |                              |                            |                            |
| Beginning of year         | 213                          | 195                        | 163                        |
| Openings                  | 4                            | 6                          | 8                          |
| Acquired by franchisees   | 6                            | 15                         | 27                         |
| Acquired from franchisees | (11 )                        |                            |                            |
| Closings                  | (7 )                         | (3 )                       | (3 )                       |
| End of year               | 205                          | 213                        | 195                        |

**2. 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.

*Reclassifications*

Certain prior year amounts have been reclassified on the statement of cash flows related to the tax benefit from the exercise of stock options to conform with current year presentation.

*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,



**FRIENDLY ICE CREAM CORPORATION AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**2. SUMMARY OF BASIS OF PRESENTATION AND SIGNIFICANT ACCOUNTING POLICIES (Continued)**

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 and notes receivable, pension and post-retirement medical and life insurance benefits expense, asset impairment analysis, income tax valuation allowances and tax contingency reserves. 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 foodservice revenue (product sales to franchisees and retail customers), 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 plans 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. 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 December 31, 2006 and January 1, 2006 and was \$5,373,000 and \$5,127,000, respectively. A variation of five percent in the 2006 accrual would change retail sales by approximately \$269,000. 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

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**FRIENDLY ICE CREAM CORPORATION AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**2. SUMMARY OF BASIS OF PRESENTATION AND SIGNIFICANT ACCOUNTING POLICIES (Continued)**

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 December 31, 2006 and January 1, 2006, accounts receivable of \$11,435,000 and \$10,757,000 were net of allowances for doubtful accounts totaling \$1,310,000 and \$758,000, 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 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 December 31, 2006 and January 1, 2006, cash of \$517,000 and \$899,000, respectively, was restricted.

**FRIENDLY ICE CREAM CORPORATION AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**2. SUMMARY OF BASIS OF PRESENTATION AND SIGNIFICANT ACCOUNTING POLICIES (Continued)**

Pursuant to the terms of the Mortgage Financing, the Company may sell properties securing its obligations provided that other properties are substituted in place of the sold properties. The substituted properties must meet certain requirements under the terms of the Mortgage Financing. In August 2005, proceeds of \$415,000 and \$2,650,000 were received in connection with the sale of two mortgaged properties, of which \$400,000 and \$1,250,000 of such amounts was placed in escrow pending the inclusion of a substitute property. As of January 1, 2006, these balances were held as collateral and were included in restricted cash on the accompanying consolidated balance sheet as of January 1, 2006. In connection with the Variable Refinancing, the mortgage on one of these properties was released and the remaining \$400,000 related to the sale of this property was released from escrow during the first quarter of 2006. A substitute property for the second property was obtained during the second quarter of 2006 in compliance with the substitution agreement. On June 15, 2006, the remaining \$1,250,000 was released from escrow.

*Inventories*

Inventories are stated at the lower of first-in, first-out cost or market and consisted of the following at December 31, 2006 and January 1, 2006 (in thousands):

|                  | December 31,<br>2006 | January 1,<br>2006 |
|------------------|----------------------|--------------------|
| Raw materials    | \$ 1,640             | \$ 1,657           |
| Goods in process | 158                  | 106                |
| Finished goods   | 15,261               | 14,012             |
| Total            | \$ 17,059            | \$ 15,775          |

*Long-Lived Assets*

In accordance with Statement of Financial Accounting Standards ( SFAS ) No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets, the Company reviews its trademarks and service 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 these 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. SFAS No. 144 requires a long-lived asset to be disposed of other than by sale to be classified as held and used until it is disposed of.

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



**FRIENDLY ICE CREAM CORPORATION AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**2. SUMMARY OF BASIS OF PRESENTATION AND SIGNIFICANT ACCOUNTING POLICIES (Continued)**

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 requires the results of operations of a component of an 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 entity component from the ongoing operations of the Company and no significant continuing involvement in the operations of the entity component 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 December 31, 2006 and January 1, 2006, property and equipment included (in thousands):

|   | <b>December 31,<br/>2006</b> | <b>January 1,<br/>2006</b> |
|---|------------------------------|----------------------------|
| Land  | \$ 24,796                    | \$ 25,960                  |
| Buildings and improvements  | 97,558                       | 98,015                     |
| Leasehold improvements  | 41,405                       | 38,908                     |
| Assets under capital leases   | 12,190                       | 12,272                     |
| Equipment   | 212,801                      | 227,749                    |
| Construction in progress  | 4,982                        | 2,326                      |
| Property and equipment  | 393,732                      | 405,230                    |
| Less:   |                              |                            |
| accumulated depreciation and amortization property and equipment      | (246,701 )                   | (253,098 )                 |
| accumulated depreciation and amortization assets under capital leases | (9,606 )                     | (8,618 )                   |
| Property and equipment, net   | \$ 137,425                   | \$ 143,514                 |

Depreciation expense was \$20,958,000, \$21,576,000 and \$20,780,000 for the years ended December 31, 2006, January 1, 2006 and January 2, 2005, respectively. Additionally, depreciation of \$0, \$555,000 and \$639,000 was included in discontinued operations for the years ended December 31, 2006, January 1, 2006 and January 2, 2005, respectively.

**FRIENDLY ICE CREAM CORPORATION AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**2. SUMMARY OF BASIS OF PRESENTATION AND SIGNIFICANT ACCOUNTING POLICIES (Continued)**

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 \$4,688,000 and \$4,401,000, which were net of allowances for doubtful accounts totaling \$48,000 and \$263,000 as of December 31, 2006 and January 1, 2006, respectively. Also included in other assets as of December 31, 2006 and January 1, 2006 were payments made to fronting insurance carriers of \$1,439,000 and \$1,556,000, respectively, to establish loss escrow funds.

*Other Accrued Expense*

Other accrued expenses consisted of the following at December 31, 2006 and January 1, 2006 (in thousands):

|  | December 31,<br>2006 | January 1,<br>2006 |
|--|----------------------|--------------------|
| Accrued rent                               | \$ 5,178             | \$ 4,739           |
| Gift cards outstanding                     | 4,317                | 4,280              |
| Accrued bonus                              | 3,635                | 58                 |
| Accrued meals and other taxes              | 2,241                | 2,219              |
| Income taxes payable                       | 1,962                | 2,761              |
| Unearned revenues                          | 1,153                | 1,205              |
| Accrued advertising                        | 1,150                | 1,211              |
| Accrued construction costs                 | 918                  | 1,335              |
| Current portion of deferred gains (Note 7) | 638                  | 638                |
| All other                                  | 1,283                | 1,420              |
| <b>Total</b>                               | <b>\$ 22,475</b>     | <b>\$ 19,866</b>   |

*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. The Company records deferred tax assets to the extent it believes there will be sufficient future taxable income to utilize those assets prior to their expiration. To the extent deferred tax assets may be unable to be utilized, the Company records a valuation allowance against the potentially unrealizable amount and records a charge against earnings. The calculation of the Company's tax liabilities involves dealing with uncertainties in the application of complex tax regulations in several different tax jurisdictions. The Company is periodically reviewed by tax authorities regarding the amount of taxes due. These reviews include questions regarding the timing and amount of deductions. In evaluating the exposure associated with various filing positions, the Company records estimated reserves for probable exposures.

**FRIENDLY ICE CREAM CORPORATION AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**2. SUMMARY OF BASIS OF PRESENTATION AND SIGNIFICANT ACCOUNTING POLICIES (Continued)**

Due to ever-changing tax laws and income tax rates, significant judgment is required to estimate the effective tax rate expected to apply to tax differences that are expected to reverse in the future. The Company must also make estimates about the sufficiency of taxable income in future periods to offset any deductions related to deferred tax assets currently recorded. Accordingly, the Company believes estimates related to income taxes are critical.

During the fourth quarter of 2005, the Company entered a three-year cumulative loss position and revised its projections of the amount and timing of profitability in future periods. As a result, the Company increased the valuation allowance during the fourth quarter of 2005 by \$26,729,000 (\$22,184,000 to income tax expense and \$4,545,000 to stockholders' deficit) to reduce the carrying value of deferred tax assets to zero.

As of December 31, 2006 the Company remains in a three-year cumulative loss position and expects to record valuation allowances on future tax benefits until it can sustain an appropriate level of profitability. However, the Company has incurred approximately \$1,093,000 of federal tax liabilities for 2005 and 2006 combined. Approximately \$928,000 of the \$1,093,000 would be available for refund if 2007 resulted in a loss for income tax purposes. As a result, the valuation allowances as of December 31, 2006 of \$27,429,000 will reduce the carrying value of net deferred tax assets to \$928,000. Should the Company's future profitability provide sufficient evidence, in accordance with SFAS No. 109, to support the ultimate realization of income tax benefits attributable to net operating loss (NOL) and credit carryforwards and other deductible temporary differences, a reduction in the valuation allowance may be recorded and the carrying value of deferred tax assets may be restored, resulting in a non-cash credit to earnings.

*Derivative Instruments and Hedging Agreements*

The Company enters into commodity option and/or futures contracts from time to time to manage dairy cost pressures. On September 19, 2005, the Chicago Mercantile Exchange launched the first electronically traded, cash-settled butter futures contract. This new futures contract is designed to meet the needs of food and dairy companies that have exposure to butterfat price risk but do not want to expose themselves to the possibility of being compelled to take physical delivery of butter. The size of the contract is 20,000 pounds of AA butter, versus the traditional butter futures contract, which is 40,000 pounds. The contract is cash settled based upon the U.S. Department of Agriculture's monthly weighted average price for butter in the United States. With this new type of futures contract, there is no risk of delivery of butter; therefore it offers the Company the ability to hedge the price risk of cream (on a butter basis), without having to take delivery of commodity butter. The Company has evaluated this new hedging instrument and believes it is an attractive way to hedge the price risk related to cream.

The Company's commodity option contracts and the cash-settled butter futures 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 2006, 2005 and 2004, (losses) gains of approximately (\$497,000), (\$238,000) and \$623,000 were included in cost of sales related to these contracts,

**FRIENDLY ICE CREAM CORPORATION AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**2. SUMMARY OF BASIS OF PRESENTATION AND SIGNIFICANT ACCOUNTING POLICIES (Continued)**

respectively. The fair value of the contracts outstanding at December 31, 2006 and January 1, 2006 was \$35,000 and \$71,000, respectively.

At December 31, 2006, the Company held 70 contracts, four of them for December 2006 and the remainder spread over the first nine months of 2007. These contracts correspond to approximately 20% of the Company's anticipated cream purchases for the periods represented.

*Advertising*

The Company expenses advertising costs as incurred. For the years ended December 31, 2006, January 1, 2006 and January 2, 2005, advertising expenses were \$16,801,000, \$18,694,000 and \$20,734,000, respectively.

*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. Leasehold improvements that are acquired subsequent to the inception of a lease are amortized over the lesser of the useful life of the asset or a term that includes option periods that are reasonably assured at the date of the purchase.

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 strategy to sell Company-operated restaurants to franchisees, the Company remains liable for certain lease assignments and guarantees. These leases have varying terms, the latest of which expires in 2020. As of December 31, 2006, the potential amount of undiscounted payments the Company could be required to make in the event of non-payment by the primary lessees was \$6,648,000. The present value of these potential payments discounted at the Company's pre-tax cost of debt at December 31, 2006 was \$5,041,000. 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 had not been required to make such payments. Accordingly, no liability has been recorded for exposure under such leases at December 31, 2006 and January 1, 2006.

**FRIENDLY ICE CREAM CORPORATION AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**2. SUMMARY OF BASIS OF PRESENTATION AND SIGNIFICANT ACCOUNTING POLICIES (Continued)**

*Net Income (Loss) Per Share*

Basic net income (loss) per share is calculated by dividing net income (loss) by the weighted average number of common shares outstanding during the period. Diluted net income (loss) per share is calculated by dividing net income (loss) by the weighted average number of shares of common stock and common stock equivalents outstanding during the period. Common stock equivalents are dilutive stock options and warrants that are assumed exercised for calculation purposes. The number of common stock options which could dilute basic earnings per share in the future, that were not included in the computation of diluted income (loss) per share because to do so would have been antidilutive, was 151,000, 273,000 and 320,000 for the years ended December 31, 2006, January 1, 2006 and January 2, 2005, respectively.

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

|  | <b>For the Years Ended</b>   |                            |                            |
|--|------------------------------|----------------------------|----------------------------|
|  | <b>December 31,<br/>2006</b> | <b>January 1,<br/>2006</b> | <b>January 2,<br/>2005</b> |
| Basic weighted average number of common shares outstanding during the year   | 7,939                        | 7,802                      | 7,637                      |
| Adjustments:   |                              |                            |                            |
| Assumed exercise of stock options and vesting of restricted stock units      | 145                          |                            |                            |
| Diluted weighted average number of common shares outstanding during the year | 8,084                        | 7,802                      | 7,637                      |

*Stock-Based Compensation*

Prior to January 2, 2006, the Company accounted for stock-based compensation for employees under Accounting Principles Board ( APB ) Opinion No. 25, Accounting for Stock Issued to Employees, and related interpretations. The Company had adopted the disclosure-only provisions of SFAS No. 123, Accounting for Stock-Based Compensation and the disclosures required by SFAS No. 148, Accounting for Stock-Based Compensation Transition and Disclosure. In accordance with APB Opinion No. 25, the Company generally recognized no stock-based compensation cost, as all options granted during that period had an exercise price equal to the market value of the stock on the date of grant. Stock-based compensation cost of \$68,000 and \$238,000 related to modified option awards was included in net loss for the years ended January 1, 2006 and January 2, 2005, respectively, for the Company s 1997 Stock Option Plan and the Company s 2003 Equity Incentive Plan.

On December 16, 2004, the Financial Accounting Standards Board ( FASB ) issued SFAS No. 123 (revised 2004), Share-Based Payment ( SFAS No. 123R ). SFAS No. 123R supersedes APB Opinion No. 25 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 at the date of grant. Pro forma disclosure is no longer an alternative.

**FRIENDLY ICE CREAM CORPORATION AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**2. SUMMARY OF BASIS OF PRESENTATION AND SIGNIFICANT ACCOUNTING POLICIES (Continued)**

On January 2, 2006 (the first day of its 2006 fiscal year), the Company adopted SFAS No. 123R using the modified prospective method as permitted under SFAS No. 123R. Under this transition method, compensation cost recognized for the year ended December 31, 2006 included: (a) compensation cost for all share-based payments granted prior to but not yet vested as of January 1, 2006, based on the grant-date fair value estimated in accordance with the provisions of SFAS No. 123, and (b) compensation cost for all share-based payments granted subsequent to January 1, 2006, based on the grant-date fair value estimated in accordance with the provisions of SFAS No. 123R. In accordance with the modified prospective method of adoption, the Company's results of operations and financial position for prior periods have not been restated.

*Recently Issued Accounting Pronouncements*

In July 2006, the FASB issued FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* an interpretation of FASB Statement No. 109 ( *FIN 48* ), which clarifies the accounting for uncertainty in tax positions. FIN 48 requires that the Company recognize in its financial statements the impact of a tax position, if that position is more likely than not of being sustained on audit based on the technical merits of the position. The provisions of FIN 48 are effective as of the beginning of the Company's 2007 fiscal year, with the cumulative effect of the change in accounting principle recorded as an adjustment to opening retained earnings. The adoption of FIN 48 is not expected to have a material effect on the Company's consolidated financial position or results of operations.

**3. STOCK BASED COMPENSATION**

In 1997, the Board of Directors 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.

The issued shares vested on a straight-line basis over eight years or on an accelerated basis if certain performance criteria were 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 year ended January 2, 2005, the Company recorded stock compensation expense of \$257,000, which was included in general and administrative expenses in the accompanying consolidated statements of operations.

*Equity Compensation Plans*

The Company currently grants stock awards under the following equity compensation plans:

*1997 Stock Option Plan ( 1997 Plan )* The 1997 Plan was adopted by the Company's Board of Directors and stockholders in November 1997 and was subsequently amended on March 27, 2000 and

**FRIENDLY ICE CREAM CORPORATION AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**3. STOCK BASED COMPENSATION (Continued)**

October 24, 2001. Under the 1997 Plan, the Company's Board of Directors may grant options to purchase up to 1,034,970 shares of common stock to employees, executive officers and directors. The 1997 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). The Compensation Committee of the Board of Directors determines the employees who will receive awards under the 1997 Plan and the terms of such awards. The exercise price of a stock option or SAR granted or awarded under the 1997 Plan may 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 2003 Equity Incentive Plan (the 2003 Incentive Plan)* On April 9, 2003, the Board of Directors adopted an equity incentive plan, which was approved by shareholders on May 14, 2003. On May 10, 2006, the shareholders approved an amendment to the 2003 Incentive Plan to increase the number of shares of common stock reserved for issuance under the 2003 Incentive Plan from 307,000 to 607,000 shares. 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. The Compensation Committee of 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 granted or awarded under the 2003 Incentive Plan may not be less than the fair market value of one share of common stock on the date the stock option or SAR is granted.

Outstanding options issued prior to December 20, 2004 are fully vested. Options issued on and subsequent to December 20, 2004 generally vest over three years. Options issued prior to July 24, 2002 expire 10 years from the date of grant. Options issued subsequent to that date have a five year expiration date.

As of December 31, 2006, no SARs had been issued.

*Grant-Date Fair Value*

The Company uses the Black-Scholes option pricing model to calculate the grant-date fair value of an award. The fair value of options granted during the years ended December 31, 2006, January 1, 2006 and January 2, 2005 were calculated based on the following:

|   | 2006          | 2005            | 2004            |
|---|---------------|-----------------|-----------------|
| Options granted                         | 168,409       | 142,453         | 160,819         |
| Weighted-average exercise price         | \$8.44        | \$9.02          | \$11.43         |
| Weighted-average grant date fair value  | \$3.96        | \$4.28 - \$4.70 | \$5.03 - \$7.72 |
| Estimated Weighted Average Assumptions: |               |                 |                 |
| Risk free interest rate                 | 4.52%-4.68%   | 3.58%-4.50%     | 3.03%-3.87%     |
| Expected life (in years)                | 4             | 4-5             | 4-5             |
| Expected volatility                     | 52.92%-54.86% | 55.98%-58.16%   | 71.23%-73.59%   |
| Expected dividend yield                 | 0.00%         | 0.00%           | 0.00 %          |

**FRIENDLY ICE CREAM CORPORATION AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**3. STOCK BASED COMPENSATION (Continued)**

**Risk-free interest rate** the yield on zero-coupon U.S. Treasury securities for a period that is commensurate with the expected term assumption is used as the risk-free interest rate.

**Expected life** the Company uses historical employee exercise and option expiration data to estimate the expected life assumption for the Black-Scholes grant-date valuation. The Company believes that this historical data is currently the best estimate of the expected life of a new option.

**Expected volatility** the Company is responsible for estimating volatility and has used historical volatility to estimate the grant-date fair value of stock options. Management considered the guidance in SFAS No. 123R and believes that the historical estimated volatility is materially indicative of expectations about future volatility.

**Expected dividend yield** the Company has not paid any dividends in the last five years and currently intends to retain any earnings to finance future growth and, therefore, does not anticipate paying any cash dividends on its common stock in the foreseeable future.

*Expense*

The Company used the straight-line attribution method to recognize expense for all options granted. Stock-based compensation is included in general and administrative expenses in the accompanying consolidated statements of operations.

The amount of stock-based compensation recognized during a period is based on the value of the portion of the awards that are ultimately expected to vest. SFAS No. 123R requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. The term *forfeitures* is distinct from cancellations or expirations and represents only the unvested portion of the surrendered option. In September 2006, John Cutter, the Company's former President and Chief Executive Officer, resigned. As of December 31, 2006, the Company adjusted its stock compensation expense to reflect his forfeitures. The Company will apply an annual forfeiture rate to all options outstanding as of December 31, 2006 and future options granted based on an analysis of its historical forfeitures. This analysis will be re-evaluated quarterly and the forfeiture rate will be adjusted as necessary. Ultimately, the actual expense recognized over the vesting period will only be for those shares that vest.

The adoption of SFAS No. 123R on January 2, 2006 resulted in lower income from continuing operations, lower operating income before tax and lower net income of \$437,000 for the year ended December 31, 2006. Additionally, the adoption of SFAS No. 123R on January 2, 2006 resulted in lower basic and diluted net income per share of \$0.06 and \$0.05, respectively. The total income tax benefit recognized in the accompanying consolidated statement of operations for the year ended December 31, 2006 for share-based compensation arrangements was \$2,000.



**FRIENDLY ICE CREAM CORPORATION AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**3. STOCK BASED COMPENSATION (Continued)**

The following table details the effect on net loss and net loss per share had stock-based compensation expense been recorded in fiscal 2005 and fiscal 2004 based on the fair-value method under SFAS No. 123 (in thousands, except per share data). The reported and pro forma net income and net income per share for the year ended December 31, 2006 are the same since stock-based compensation expense was calculated under the provisions of SFAS No. 123R.

|   | <b>For the Years Ended</b> |                            |
|---|----------------------------|----------------------------|
|   | <b>January 1,<br/>2006</b> | <b>January 2,<br/>2005</b> |
| Net loss as reported  | \$ (27,259 )               | \$ (3,417 )                |
| Add stock-based compensation expense included in reported net loss, net of related income tax effect of \$0 and \$97, respectively                                  | 75                         | 140                        |
| Less stock-based compensation expense determined under fair value method for all stock options, net of related income tax benefit of \$0 and \$752, respectively(a) | (172 )                     | (1,082 )                   |
| Pro forma net loss  | \$ (27,356 )               | \$ (4,359 )                |
| Basic and diluted net loss per share, as reported.  | \$ (3.49 )                 | \$ (0.45 )                 |
| Basic and diluted net loss per share, pro forma   | \$ (3.51 )                 | \$ (0.57 )                 |

(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 two fiscal years.

**FRIENDLY ICE CREAM CORPORATION AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**3. STOCK BASED COMPENSATION (Continued)**

*Option Activity*

A summary of the activity under the Company's equity compensation plans as of December 31, 2006 and changes during the three years ended December 31, 2006 is presented below:

|  | Options<br>Outstanding | Weighted-<br>Average<br>Remaining<br>Contractual<br>Life in Years | Weighted-<br>Average<br>Exercise Price | Aggregate<br>Intrinsic<br>Value |
|--|------------------------|---|--|---------------------------------|
| Options outstanding at December 28, 2003 | 809,075                |   | \$ 5.60                                |                                 |
| Granted                                  | 160,819                |   | \$ 11.43                               |                                 |
| Cancelled                                | (9,730 )               |   | \$ 11.84                               |                                 |
| Forfeited                                | (50,697 )              |   | \$ 8.48                                |                                 |
| Exercised                                | (223,801 )             |   | \$ 4.37                                |                                 |
| Options outstanding at January 2, 2005   | 685,666                |   | \$ 7.06                                |                                 |
| Granted                                  | 142,453                |   | \$ 9.02                                |                                 |
| Cancelled                                | (10,893 )              |   | \$ 13.01                               |                                 |
| Forfeited                                | (10,464 )              |   | \$ 8.86                                |                                 |
| Exercised                                | (185,312 )             |   | \$ 5.59                                |                                 |
| Options outstanding at January 1, 2006   | 621,450                |   | \$ 7.82                                |                                 |
| Granted                                  | 168,409                |   | \$ 8.44                                |                                 |
| Cancelled                                | (37,021 )              |   | \$ 12.33                               |                                 |
| Forfeited                                | (81,914 )              |   | \$ 8.38                                |                                 |
| Exercised                                | (218,644 )             |   | \$ 5.23                                |                                 |
| Options outstanding at December 31, 2006 | 452,280                | 3.33  | \$ 8.83                                | \$ 2,094,153                    |
| Options exercisable at December 31, 2006 | 277,788                | 2.91  | \$ 8.87                                | \$ 1,133,873                    |

A summary of the status of the Company's non-vested shares as of December 31, 2006, and changes during the year ended December 31, 2006, is presented below:

|  | Options<br>Outstanding | Weighted-<br>Average<br>Grant Date<br>Fair Value |
|--|------------------------|--|
| Non-vested options at January 1, 2006  | 131,989                | \$ 4.68  |
| Granted                                | 168,409                | \$ 3.96  |
| Forfeited                              | (81,914 )              | \$ 4.15  |
| Vested                                 | (43,992 )              | \$ 4.68  |
| Nonvested options at December 31, 2006 | 174,492                | \$ 4.01  |

During the years ended December 31, 2006, January 1, 2006 and January 2, 2005, the total intrinsic value of options exercised (i.e., the difference between the market price at exercise and the price paid by the employee to exercise the options) was \$1,100,000, \$1,097,000 and \$1,989,000, respectively and the total amount of cash received from exercise of stock options was \$1,143,000, \$1,037,000 and \$978,000, respectively.

**FRIENDLY ICE CREAM CORPORATION AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**3. STOCK BASED COMPENSATION (Continued)**

As of December 31, 2006, there was \$547,000 of unrecognized compensation cost related to unvested stock options. That cost is expected to be recognized over a weighted-average period of 2.16 years.

The total fair value of shares vested during the years ended December 31, 2006, January 1, 2006 and January 2, 2005 was \$206,000, \$0 and \$1,519,000, respectively.

Pursuant to a stockholder rights plan (the *Stockholder Rights Plan*) that FICC adopted in 1997, 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*.

*Restricted Stock Unit Activity*

On December 2, 2005, 30,000 restricted stock units were issued to directors with a weighted average fair value of \$8.90 at grant date. On November 1, 2006, 30,000 restricted stock units were issued to directors with a weighted average fair value of \$10.61 at grant date. The restricted stock units were issued pursuant to and subject to the terms of the Company's 2003 Incentive Plan. Subject to the terms of the 2003 Incentive Plan, each restricted stock unit provides the holder with the right to receive one share of Common Stock of the Company when the restrictions lapse or vest. The restricted stock units granted to the directors vest three years after the date of grant if the recipient is a member of the Company's Board of Directors on such date, subject to accelerated vesting in the event of a change in control or the director's death, disability or retirement.

During the years ended December 31, 2006 and January 1, 2006, stock-based compensation cost of \$106,400 and \$7,400, respectively, was recorded related to these units. As of December 31, 2006, there was \$471,500 of total unrecognized compensation cost related to unvested restricted stock units. That cost is expected to be recognized over a weighted-average period of 2.38 years.

Pursuant to a long-term incentive plan for fiscal 2006 approved by the Compensation Committee of the Board of Directors under the Company's 2003 Incentive Plan, the Compensation Committee established target EBITDA levels for the Company for fiscal 2006 and target awards for each officer named below based on a percentage (ranging from 50% to 100%) of each such officer's base salary.

**FRIENDLY ICE CREAM CORPORATION AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**3. STOCK BASED COMPENSATION (Continued)**

In August 2006, the Compensation Committee approved terms of awards under the long-term incentive for fiscal 2006 which provides that, if the Company meets or exceeds a threshold EBITDA for fiscal 2006, then the officer would be entitled to receive an award payable in shares of Common Stock of the Company. The award value is determined based on the Company's actual EBITDA for fiscal 2006 compared to projected EBITDA for fiscal 2006 and the percentage (ranging from 50% to 150%) of the officer's target award applicable to those results (the 2006 Award Value). The following table sets forth the range of award values each officer was eligible to receive:

| <b>Name</b>     | <b>Value of Award</b> |               |
|-----------------|-----------------------|---------------|
| John Cutter     | \$ 174,267            | To \$ 522,801 |
| Paul Hoagland   | \$ 82,028             | To \$ 246,084 |
| Gregory Pastore | \$ 34,438             | To \$ 103,314 |
| Kenneth Green   | \$ 39,698             | To \$ 119,093 |
| Garrett Ulrich  | \$ 39,865             | To \$ 119,595 |

During the year ended December 31, 2006, stock-based compensation of \$98,000 was recorded related to the foregoing awards.

On February 28, 2007 the Compensation Committee determined that the Company exceeded the threshold EBITDA for fiscal 2006, and awarded shares of Common Stock under the Company's 2003 Incentive Plan to each of the officers named below. The number of shares of Common Stock issued to each officer was determined by dividing the officer's 2006 Award Value by 90% of the closing price of the Company's Common Stock on the date of grant as reported on the American Stock Exchange. 25% of the shares of Common Stock issued to each officer are fully vested upon issuance. The remaining 75% of the shares of Common Stock will vest in three equal annual installments following issuance if the officer remains employed by the Company. The unvested shares will also fully vest upon a change in control, as provided in the 2003 Incentive Plan.

The following table sets forth each officer's 2006 Award Value and the number of shares of Common Stock the officer received under the long-term incentive plan for fiscal 2006.

| <b>Name</b>     | <b>Award Value</b> | <b>Number of Shares</b> |
|-----------------|--------------------|-------------------------|
| Paul Hoagland   | \$ 188,664         | 17,469                  |
| Gregory Pastore | \$ 79,207          | 7,334                   |
| Kenneth Green   | \$ 91,304          | 8,454                   |
| Garrett Ulrich  | \$ 91,690          | 8,490                   |

John Cutter, the Company's former President and Chief Executive Officer, resigned in September 2006 and did not receive any shares of Common Stock under the long-term incentive plan for fiscal 2006. Accordingly, no expense was recognized related to Mr. Cutter's awards.

**FRIENDLY ICE CREAM CORPORATION AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**4. INTANGIBLE ASSETS AND DEFERRED COSTS**

Intangible assets and deferred costs as of December 31, 2006 and January 1, 2006 were (in thousands):

|  | December 31,<br>2006 | January 1,<br>2006 |
|--|----------------------|--------------------|
| 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 | 11,234               | 10,557             |
| Other  | 1,103                | 1,103              |
| Intangible assets and deferred costs   | 30,987               | 30,310             |
| Less: accumulated amortization   | (13,204 )            | (11,247 )          |
| Net  | \$ 17,783            | \$ 19,063          |

Amortization expense was \$1,955,000, \$1,859,000 and \$1,812,000 for the years ended December 31, 2006, January 1, 2006 and January 2, 2005, respectively.

Future amortization expense related to these intangible assets and deferred costs as of December 31, 2006 was (in thousands):

| Year        | Amount    |
|-------------|-----------|
| 2007        | \$ 1,769  |
| 2008        | 1,761     |
| 2009        | 1,751     |
| 2010        | 1,611     |
| 2011        | 1,436     |
| Thereafter. | 9,455     |
| Total       | \$ 17,783 |

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 December 31, 2006, January 1, 2006 and January 2, 2005, no impairments were recorded.

In February 2004, the Company announced a cash tender offer and consent solicitation for \$175,977,000 of its then outstanding 10.5% senior notes. In connection with the tender offer, the Company wrote off unamortized deferred financing costs for the purchase of the 10.5% senior notes in March 2004 and the redemption of the remaining 10.5% senior notes in April 2004 of \$1,788,000 and \$657,000, respectively. The \$2,445,000 was included in other (income) expense 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 new 8.375% senior notes and the amendment to the

**FRIENDLY ICE CREAM CORPORATION AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**4. INTANGIBLE ASSETS AND DEFERRED COSTS (Continued)**

revolving credit facility, which were included in intangible assets and deferred costs in the accompanying consolidated balance sheets as of December 31, 2006 and January 1, 2006. These costs are being amortized over the terms of the 8.375% senior notes and the Credit Facility.

**5. ASSET IMPAIRMENT AND DISCONTINUED OPERATIONS**

During 2005, the Company disposed of five properties by sale and nine properties other than by sale, including lease terminations. During December 2005, the Company closed seven restaurants and committed to a plan to sell those seven restaurants as well as four restaurants that were closed in 2004. At January 1, 2006, these 11 properties met the criteria for held for sale as defined in SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets. During 2006, the Company sold eight of these 11 properties. Net proceeds from these transactions were \$6,855,000. The Company recognized a net gain related to the sales of the assets of \$4,359,000. At December 31, 2006, the remaining three properties and one property that closed in 2006 met the criteria for held for sale as defined in SFAS No. 144. The carrying values of these four properties of \$896,000, and \$933,000 as of December 31, 2006 and January 1, 2006, respectively, were reported as assets held for sale in the accompanying consolidated balance sheets. The carrying values of these properties were not adjusted since the carrying values were less than the estimated fair market values less costs to sell.

SFAS No. 144 requires the results of operations of a component of an 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 entity component from the ongoing operations of the Company and no significant continuing involvement in the operations of the entity component after the disposal transaction.

In accordance with SFAS No. 144, the results of operations of the eight properties that were disposed of during 2006 and the 14 properties that were disposed of during 2005, and any related net gain on the disposals, as well as the results of operations of three properties held for sale at December 31, 2006 were reported separately as discontinued operations in the accompanying consolidated statements of operations for all years presented. For the years ended December 31, 2006, January 1, 2006 and January 2, 2005, these discontinued results consisted of the following (in thousands):

|   | <b>For the Years Ended</b>   |                            |   |
|---|------------------------------|----------------------------|---|
|   | <b>December 31,<br/>2006</b> | <b>January 1,<br/>2006</b> | <b>January 2,<br/>2005<br/>(53 weeks)</b> |
| Net sales                                   | \$                           | \$ 10,499                  | \$ 16,898                                 |
| Operating loss                              | (360 )                       | (1,548 )                   | (938 )                                    |
| Gain on disposals of property and equipment | 4,359                        | 2,115                      |   |
| Income tax (expense) benefit                | (538 )                       | (232 )                     | 385                                       |
| Income (loss) from discontinued operations  | \$ 3,461                     | \$ 335                     | \$ (553 )                                 |

**FRIENDLY ICE CREAM CORPORATION AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**5. ASSET IMPAIRMENT AND DISCONTINUED OPERATIONS (Continued)**

During 2006, the Company disposed of two properties by sale and two properties other than by sale, including lease terminations. Additionally, the Company closed one restaurant and committed to a plan to sell that restaurant. At December 31, 2006, this property met the criteria for held for sale as defined in SFAS No. 144. The results of operations and any related gain or loss associated with the disposition of these restaurants were not material and therefore were reported within continuing operations in the accompanying consolidated statements of operations for all years presented.

During 2004, the Company disposed of two properties by sale and one property other than by sale. The results of operations and any related gain or loss associated with the disposition of these restaurants were not material and therefore were reported within continuing operations in 2004.

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

|  | <b>For the Years Ended</b> |                   |                   |
|--|----------------------------|-------------------|-------------------|
|  | <b>December 31,</b>        | <b>January 1,</b> | <b>January 2,</b> |
|  | <b>2006</b>                | <b>2006</b>       | <b>2005</b>       |
| Restaurant assets retired due to remodeling                | \$ 863                     | \$ 225            | \$ 195            |
| Restaurant equipment assets retired due to replacement     | 285                        | 200               | 442               |
| Gain on property held for disposition                      |                            |                   | (782 )            |
| (Gain) loss on property not held for disposition           | (667 )                     | 118               | 63                |
| Loss on abandoned capital projects and architectural plans | 234                        | 108               |                   |
| Gain due to restaurant flood                               | (53 )                      |                   |                   |
| All other  | 239                        | 379               | 295               |
| Loss on disposals of other property and equipment, net     | \$ 901                     | \$ 1,030          | \$ 213            |

During 2006, the Company determined that the carrying values of three operating restaurant properties exceeded their estimated fair values less costs to sell and the carrying values were reduced by an aggregate of \$719,000 accordingly.

During the year ended January 1, 2006, the Company determined that the carrying values of six restaurant properties and certain capital inventory used to replace restaurant equipment exceeded their estimated fair values less costs to sell. The carrying values were reduced by an aggregate of \$2,478,000.

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.

**FRIENDLY ICE CREAM CORPORATION AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**6. DEBT**

Debt at December 31, 2006 and January 1, 2006 consisted of the following (in thousands):

|   | December 31,<br>2006 | January 1,<br>2006 |
|---|----------------------|--------------------|
| Senior Notes, 8.375%, due June 15, 2012                     | \$ 175,000           | \$ 175,000         |
| Revolving credit loans                                      |                      |                    |
| Mortgage loans, due January 1, 2007 through January 1, 2022 | 49,213               | 51,320             |
| Total debt  | 224,213              | 226,320            |
| Less: current portion                                       | (1,563 )             | (1,426 )           |
| Total long-term debt  | \$ 222,650           | \$ 224,894         |

Principal payments due as of December 31, 2006 were as follows (in thousands):

| Year       | Amount     |
|------------|------------|
| 2007       | \$ 1,563   |
| 2008       | 1,721      |
| 2009       | 1,914      |
| 2010       | 2,847      |
| 2011       | 2,239      |
| Thereafter | 213,929    |
| Total      | \$ 224,213 |

In December 2001, the Company completed a financial restructuring plan which included the repayment of all amounts outstanding under its then existing credit facility and the purchase of approximately \$21,273,000 of its 10.5% 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 ).

Interest on \$10,000,000 of the original \$55,000,000 from the Mortgage Financing is variable ( Variable Mortgages ) and 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% ( Fixed Mortgages ). The Fixed Mortgages have a maturity date of January 1, 2022 and are amortized over 20 years.

On December 30, 2005, the Company completed a refinancing of the Variable Mortgages (the Variable Refinancing ). Under the terms of the loan agreement for the Variable Refinancing, the Company borrowed an aggregate sum of \$8,500,000 at a variable interest rate equal to the sum of the 90-day LIBOR rate in effect (5.36% at December 31, 2006) plus 4% on an annual basis. Changes in the interest rate are calculated monthly and recognized annually when the monthly payment amount is adjusted. Changes in the monthly payment amounts owed due to interest rate changes are reflected in the principal balances, which are re-amortized over the remaining life of the mortgages. The loans under the Variable Mortgages have a maturity date of January 1, 2020 and are being amortized over 14 years.

In connection with the Variable Refinancing, the Company incurred direct expenses of \$71,300 that were included in the accompanying consolidated statement of operations for the year ended January 1, 2006 and \$186,600 of costs that were included in intangible assets and deferred costs in the accompanying



**FRIENDLY ICE CREAM CORPORATION AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**6. DEBT (Continued)**

consolidated balance sheets as of December 31, 2006 and January 1, 2006. These costs are being amortized over the term of the Variable Mortgages.

Pursuant to the terms of the Mortgage Financing, the Company may sell properties securing its obligations provided that other properties are substituted in place of the sold properties. The substituted properties must meet certain requirements under the terms of the Mortgage Financing. In August 2005, proceeds of \$415,000 and \$2,650,000 were received in connection with the sale of two mortgaged properties, of which \$400,000 and \$1,250,000 of such amounts was placed in escrow pending the inclusion of a substitute property. As of January 1, 2006, these balances were held as collateral and were included in restricted cash on the accompanying consolidated balance sheet as of January 1, 2006. In connection with the Variable Refinancing, the mortgage on one of these properties was released and the remaining \$400,000 related to the sale of this property was released from escrow during the first quarter of 2006. A substitute property for the second property was obtained during the second quarter of 2006 in compliance with the substitution agreement. On June 15, 2006, the remaining \$1,250,000 was released from escrow.

All mortgage financings are subject to annual covenants, including various minimum fixed charge coverage ratios. The Company was in compliance with the covenants for the Variable Mortgages and Fixed Mortgages as of December 31, 2006.

In 2003 and 2004, the Company purchased or redeemed all of its remaining outstanding 10.5% senior notes in a series of transactions. In February 2004, the Company announced a cash tender offer and consent solicitation for \$176,000,000 of its 10.5% senior notes which was financed with the proceeds from a \$175,000,000 private offering of new 8.375% senior notes (the Senior Notes), available cash and its Credit Facility. In March 2004, \$127,357,000 of aggregate principal amount of the 10.5% 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 10.5% senior notes were purchased at the tender offer price of 102% of the principal amount. In April 2004, the remaining \$48,144,000 of the 10.5% senior notes was redeemed in accordance with the 10.5% senior notes indenture at 103.5% of the principal amount.

The \$175,000,000 of 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 Company's Credit Facility. The Senior Notes mature on June 15, 2012. Interest on the Senior Notes is payable at 8.375% per annum semi-annually on June 15 and December 15 of each year. The 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 Senior Notes with the proceeds of one or more qualified equity offerings, as defined, at a redemption price of 108.375% of the principal amount, plus accrued interest.

The Company has a \$35,000,000 Credit Facility which is available for borrowings to provide working capital, for issuances of letters of credit and for other corporate needs. As of December 31, 2006 and January 1, 2006, total letters of credit outstanding were \$15,474,000 and \$15,974,000, respectively. During 2006 and 2005, 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) (10.25% at December 31, 2006) or (b) the Eurodollar rate plus the applicable margin as in effect from time to time (the Eurodollar Rate) (9.32% at December 31, 2006). As of

**FRIENDLY ICE CREAM CORPORATION AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**6. DEBT (Continued)**

December 31, 2006 and January 1, 2006, there were no revolving credit loans outstanding. As of December 31, 2006 and January 1, 2006, \$19,526,000 and \$19,026,000, respectively, was available for borrowing.

The Credit Facility has an annual clean-up provision which obligates the Company to repay in full any and all outstanding revolving credit loans for a period of not less than 15 consecutive days during the period beginning on or after May 1 and ending on or before June 15 (or the next business day, if, in any year, June 15 is not a business day) of each calendar year, such that immediately following the date of such repayment, the amount of all outstanding revolving credit loans shall be zero.

The Credit Facility includes certain restrictive covenants including limitations on indebtedness, restricted payments such as dividends and stock repurchases, liens, mergers, investments and sales of assets and of subsidiary stock. Additionally, the 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 that the Company comply with certain financial covenants. The Company was in compliance with the covenants in the Credit Facility as of December 31, 2006.

On August 1, 2006, the Company amended its \$35,000,000 Credit Facility to, among other things, (i) extend the maturity date from June 30, 2007 to June 30, 2010, (ii) eliminate the interest coverage requirement and (iii) reduce by 0.50% to 0.75% the applicable margin rates at which the revolving credit loans bear interest to a range of 3.00% to 4.00% (depending on the leverage ratio).

The Company incurred \$519,000 of costs associated with this amendment to the \$35,000,000 Credit Facility which were deferred and are being amortized over the life of the amended \$35,000,000 Credit Facility.

The financial covenant requirements, as defined under the Credit Facility, and actual ratios/amounts as of and for the years ended December 31, 2006 and January 1, 2006 were (dollars in thousands):

|                             | <b>December 31, 2006</b> | <b>Actual</b> | <b>January 1, 2006</b> | <b>Actual</b> |
|-----------------------------|--------------------------|---------------|------------------------|---------------|
|                             | <b>Requirement</b>       |               | <b>Requirement</b>     |               |
| Leverage ratio              | 5.75 to 1                | 4.46 to 1     | 5.80 to 1              | 5.69 to 1     |
| Interest coverage ratio     | N/A                      | N/A           | 2.00 to 1              | 2.06 to 1     |
| Fixed charge coverage ratio | 1.05 to 1                | 1.34 to 1     | 1.05 to 1              | 1.14 to 1     |
| Capital expenditures(a)     | \$ 26,000                | \$ 21,124     | \$ 25,500              | \$ 17,158     |
| Consolidated EBITDA(b)      | \$ 40,500                | \$ 51,764     | \$ 42,000              | \$ 43,100     |

(a) The Credit Facility's definition of capital expenditures differs from the Company's total capital expenditures.

(b) The 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 adjusted EBITDA computation presented elsewhere herein.

**FRIENDLY ICE CREAM CORPORATION AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**6. DEBT (Continued)**

The fair values of the Company's long-term debt at December 31, 2006 and January 1, 2006 were as follows (in thousands):

|                        | December 31, 2006  |               | January 1, 2006    |               |
|------------------------|--------------------|---------------|--------------------|---------------|
|                        | Carrying<br>Amount | Fair<br>Value | Carrying<br>Amount | Fair<br>Value |
| Senior Notes           | \$ 175,000         | \$ 166,075    | \$ 175,000         | \$ 156,625    |
| Revolving credit loans |                    |               |                    |               |
| Mortgage loans         | 49,213             | 49,213        | 51,320             | 51,320        |
| Total                  | \$ 224,213         | \$ 215,288    | \$ 226,320         | \$ 207,945    |

The fair values of the Senior Notes were determined based on the actual trade prices occurring closest to December 31, 2006 and January 1, 2006. Because the mortgage loans are privately held, the Company believes that the carrying value of the mortgage loans as of December 31, 2006 and January 1, 2006 approximated the fair value.

**7. LEASES**

As of December 31, 2006 and January 1, 2006, the Company operated 316 and 314 restaurants, respectively. These operations were conducted in premises owned or leased as follows:

|                                | December 31,<br>2006 | January 1,<br>2006 |
|--------------------------------|----------------------|--------------------|
| Land and building owned        | 77                   | 79                 |
| Land leased and building owned | 76                   | 70                 |
| Land and building leased       | 163                  | 165                |
|                                | 316                  | 314                |

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 Sale/Leaseback Financing in December 2001, 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 loss 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 \$10,050,000 was included in other accrued expenses and other long-term liabilities. The deferred gain is being amortized straight-line over 20 years.

**FRIENDLY ICE CREAM CORPORATION AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**7. LEASES (Continued)**

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 December 31, 2006 were (in thousands):

| Year   | Commitments         |  |                                   |
|--|---------------------|--|-----------------------------------|
|  | Operating<br>Leases | Capital<br>Lease and<br>Finance<br>Obligations | Operating<br>Lease<br>Receivables |
| 2007   | \$ 18,966           | \$ 2,091                                       | \$ 2,723                          |
| 2008   | 17,357              | 2,051  | 2,604                             |
| 2009   | 15,985              | 1,022  | 2,613                             |
| 2010   | 14,090              | 444  | 2,414                             |
| 2011   | 12,451              | 398  | 2,048                             |
| Thereafter   | 26,602              | 2,089  | 22,204                            |
| Total future minimum lease payments                              | \$ 105,451          | 8,095  | \$ 34,606                         |
| Less amounts representing interest                               |                     | (1,872 )                                       |                                   |
| Present value of minimum lease payments                          |                     | 6,223  |                                   |
| Less current maturities of capital lease and finance obligations |                     | (1,541 )                                       |                                   |
| Long-term maturities of capital lease and finance obligations    |                     | \$ 4,682                                       |                                   |

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 December 31, 2006 were (in thousands):

| Year       | Amount   |
|------------|----------|
| 2007       | \$ 1,541 |
| 2008       | 1,666    |
| 2009       | 793      |
| 2010       | 258      |
| 2011       | 235      |
| Thereafter | 1,730    |
| Total      | \$ 6,223 |

**FRIENDLY ICE CREAM CORPORATION AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**7. LEASES (Continued)**

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

|                    | <b>For the Years Ended<br/>December 31,<br/>2006</b> | <b>January 1,<br/>2006</b> | <b>January 2,<br/>2005</b> |
|--------------------|--|----------------------------|----------------------------|
| Minimum rentals    | \$ 20,251  | \$ 19,847                  | \$ 20,668                  |
| Contingent rentals | 736  | 815                        | 968                        |
| Total              | \$ 20,987  | \$ 20,662                  | \$ 21,636                  |

**8. INCOME TAXES**

The benefit from (provision for) income taxes for the years ended December 31, 2006, January 1, 2006 and January 2, 2005 were as follows (in thousands):

|   | <b>For the Years Ended<br/>December 31,<br/>2006</b> | <b>January 1,<br/>2006</b> | <b>January 2,<br/>2005</b> |
|---|--|----------------------------|----------------------------|
| Current (provision) benefit:  |  |                            |                            |
| Federal   | \$ (1,134 )  | \$ (726 )                  | \$ 837                     |
| State   | (228 )   | (213 )                     | (89 )                      |
| Increase in tax accruals  | (21 )  | (1,446 )                   | (601 )                     |
| Total current (provision) benefit                                   | \$ (1,383 )  | \$ (2,385 )                | \$ 147                     |
| Deferred benefit (provision):                                       |  |                            |                            |
| Federal   | \$ 928   | \$ (17,212 )               | \$ 3,662                   |
| State   |  | (637 )                     | 964                        |
| Reversal of tax accruals  |  |                            | 2,757                      |
| Total deferred benefit (provision)                                  | \$ 928   | \$ (17,849 )               | \$ 7,383                   |
| Income tax provision (benefit) allocated to discontinued operations | \$ 538   | \$ 232                     | \$ (385 )                  |
| Total benefit from (provision for) income taxes                     | \$ 83  | \$ (20,002 )               | \$ 7,145                   |

**FRIENDLY ICE CREAM CORPORATION AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**8. INCOME TAXES (Continued)**

A reconciliation of the benefit from (provision for) income taxes that would result from applying the federal statutory rate to income tax provision follows (in thousands):

|   | <b>For the Years Ended</b> |                   |                   |
|---|----------------------------|-------------------|-------------------|
|   | <b>December 31,</b>        | <b>January 1,</b> | <b>January 2,</b> |
|   | <b>2006</b>                | <b>2006</b>       | <b>2005</b>       |
| Statutory federal income tax                      | \$ (491 )                  | \$ 2,657          | \$ 3,503          |
| State income taxes net of federal benefit         | (84 )                      | 456               | 601               |
| Effect of change in valuation allowance           | 797                        | (22,184 )         | 12                |
| Effect of expired state NOL carryforwards         | (1,781 )                   |                   |                   |
| Effect of the present value of Medicare Subsidies | 197                        |                   |                   |
| Tax credits                                       | 1,268                      | 372               | 896               |
| Nondeductible expenses                            | (98 )                      | (130 )            | (226 )            |
| Adjustment of income tax accruals                 | (21 )                      | (1,446 )          | 2,157             |
| Other   | 296                        | 273               | 202               |
| Benefit from (provision for) income taxes         | \$ 83                      | \$ (20,002 )      | \$ 7,145          |

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 December 31, 2006 and January 1, 2006 were as follows (in thousands):

|                                  | <b>December 31,</b> | <b>January 1,</b> |
|----------------------------------|---------------------|-------------------|
|                                  | <b>2006</b>         | <b>2006</b>       |
| Property and equipment           | \$ (10,015 )        | \$ (13,788 )      |
| Net operating loss carryforwards | 1,684               | 3,732             |
| Insurance reserves               | 13,041              | 12,690            |
| Inventories                      | 237                 | 285               |
| Pension                          | 8,323               | 11,850            |
| Intangible assets                | (4,142 )            | (4,333 )          |
| Tax credit carryforwards         | 10,808              | 11,958            |
| Deferred gain                    | 3,669               | 3,930             |
| Other                            | 4,752               | 5,820             |
| Net deferred tax asset           | 28,357              | 32,144            |
| Valuation allowance              | (27,429 )           | (32,144 )         |
| Net deferred tax asset           | \$ 928              | \$                |
| Total deferred tax assets        | \$ 43,296           | \$ 50,932         |
| Total deferred tax liabilities   | (14,939 )           | (18,788 )         |
| Valuation allowance              | (27,429 )           | (32,144 )         |
| Net deferred tax asset           | \$ 928              | \$                |

As of December 31, 2006, the Company had approximately \$28,357,000 of net deferred tax assets relating to net operating loss carryforwards, tax credit carryforwards and other temporary differences that

**FRIENDLY ICE CREAM CORPORATION AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**8. INCOME TAXES (Continued)**

are available to reduce income taxes in future years. SFAS No. 109 Accounting for Income Taxes requires that a valuation allowance be established when it is more likely than not that all or a portion of deferred tax assets will not be realized. A review of all available positive and negative evidence needs to be considered, including a company's performance, the market environment in which the company operates, length of carryback and carryforward periods, and projections of future operating results. Where there are cumulative losses in recent years, SFAS No. 109 creates a strong presumption that a valuation allowance is needed. The presumption can be overcome in very limited circumstances.

As of January 1, 2006, the Company had approximately \$32,144,000 of net deferred tax assets relating to net operating loss carryforwards, tax credit carryforwards and other temporary differences that were available to reduce income taxes in future years.

During the fourth quarter of 2005, the Company entered a three-year cumulative loss position and revised its projections of the amount and timing of profitability in future periods. As a result, the Company increased its valuation allowance by approximately \$26,729,000 (\$22,184,000 to income tax expense and \$4,545,000 to stockholders' deficit) to reduce the carrying value of net deferred tax assets to zero.

As of December 31, 2006 the Company remains in a three-year cumulative loss position and expects to record valuation allowances on future tax benefits until it can sustain an appropriate level of profitability. However, the Company has incurred approximately \$1,093,000 of federal tax liabilities for 2005 and 2006 combined. Approximately \$928,000 of the \$1,093,000 would be available for refund if 2007 resulted in a loss for income tax purposes. As a result, the valuation allowances as of December 31, 2006 of \$27,429,000 will reduce the carrying value of net deferred tax assets to \$928,000. Should the Company's future profitability provide sufficient evidence, in accordance with SFAS No. 109, to support the ultimate realization of income tax benefits attributable to NOL and credit carryforwards and other deductible temporary differences, a reduction in the valuation allowance may be recorded and the carrying value of deferred tax assets may be restored, resulting in a non-cash credit to earnings.

The income tax provision for the year ended December 31, 2006 included a decrease in the valuation allowance of \$797,000.

The income tax provision for the year ended January 1, 2006 included the above referenced increase in the valuation allowance of \$22,184,000 and an increase in income tax accruals of \$1,446,000 related to ongoing tax audits and other tax matters. The increase in the valuation allowance and the increase in income tax accruals accounted for 292.1% and 19.0%, respectively, of the Company's effective tax rate of 263.5%.

During the year ended December 31, 2006, the Company generated federal taxable income of approximately \$12,025,000. During the year ended January 1, 2006, the Company generated federal taxable income of approximately \$926,000. The Company had aggregate state NOL carryforwards, the tax effect of which was approximately \$1,684,000 and \$3,732,000 as of December 31, 2006 and January 1, 2006, respectively. The state NOL carryforwards expire between 2007 and 2025. The tax effect of state NOL carryforwards expired by the end of 2006 without being used was approximately \$1,745,000. That portion of the valuation allowance specifically allocated to these state NOLs was reduced accordingly.

As of December 31, 2006 and January 1, 2006, the Company had federal general business credit carryforwards of \$7,757,000 and \$9,535,000, respectively, which expire between 2020 and 2026. The

**FRIENDLY ICE CREAM CORPORATION AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**8. INCOME TAXES (Continued)**

Company had \$3,051,000 and \$2,721,000 of state tax credit carryforwards as of December 31, 2006 and January 1, 2006, respectively, which either expire between 2007 and 2011 or have no expiration date.

Taxes payable were reduced or refundable taxes, credit carryforwards and state loss carryforwards were increased by an aggregate of \$145,000 and \$450,000 in 2006 and 2005, respectively, as a result of stock options exercised.

**9. 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.

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.

The Company reduced the restructuring reserves 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 reserve and activity associated with the March 2004, October 2001 and March 2000 restructurings (in thousands):

|               | For the Year Ended December 31, 2006        |         |                             | Restructuring Reserve as of December 31, 2006 |
|---------------|---|---------|-----------------------------|---|
|               | Restructuring Reserve as of January 1, 2006 | Expense | Costs Paid and Reclassified |   |
| Severance pay | \$ 72                                       | \$      | \$ (72 )                    | \$  |
| Total         | \$ 72                                       | \$      | \$ (72 )                    | \$  |

|               | For the Year Ended January 1, 2006          |         |                             | Restructuring Reserve as of January 1, 2006 |
|---------------|---|---------|-----------------------------|---|
|               | Restructuring Reserve as of January 2, 2005 | Expense | Costs Paid and Reclassified |   |
| Rent          | \$ 92                                       | \$      | \$ (92 )                    | \$  |
| Severance pay | 952   |         | (880 )                      | 72  |
| Other         | 34  |         | (34 )                       |   |
| Total         | \$ 1,078                                    | \$      | \$ (1,006 )                 | \$ 72                                       |

**10. FRANCHISE TRANSACTIONS**

During 2006, the Company completed three transactions in which three existing franchisees purchased five existing Company-operated restaurants and agreed to develop a total of 10 new restaurants in future years. Gross proceeds from these transactions were \$3,130,000, of which \$300,000 was for franchise and



**FRIENDLY ICE CREAM CORPORATION AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**10. FRANCHISE TRANSACTIONS (Continued)**

development fees and \$2,830,000 was for the sale of certain assets and leasehold rights. During the year ended December 31, 2006, the Company recorded \$150,000 of franchise fee revenue for the initial locations acquired by franchisees and deferred \$150,000 related to future development. The \$150,000 will be recognized into income as restaurants are opened. In addition, the Company recognized a gain of \$2,106,000 related to the sale of assets.

During 2006, three franchisees operating restaurants under options to purchase elected to exercise their options. In doing so, they purchased eight existing restaurants and agreed to develop a total of 10 new restaurants in future years. Gross proceeds from these transactions were \$2,224,000, of which \$315,000 was for franchise and development fees and \$1,909,000 was for the sale of certain assets and leasehold rights. During the year ended December 31, 2006, the Company recorded \$265,000 of franchise fee revenue for the initial locations acquired by franchisees and deferred \$50,000 related to future development. The \$50,000 will be recognized into income as restaurants are opened. In addition, the Company recognized a gain of \$1,622,000 related to the sale of assets.

During 2005, the Company completed four transactions in which four existing franchisees purchased nine existing Company-operated restaurants and agreed to develop a total of 10 new restaurants in future years. Gross proceeds from these transactions were \$4,102,000, of which \$295,000 was for franchise and development fees and \$3,807,000 was for the sale of certain assets and leasehold rights. During the year ended January 1, 2006, the Company recorded \$210,000 of franchise fee revenue for the initial locations acquired by franchisees and deferred \$85,000 related to future development. The \$85,000 will be recognized into income as restaurants are opened. In addition, the Company recognized a gain of \$2,712,000 related to the sale of assets.

During 2004, two franchisees operating restaurants under options to purchase elected to exercise their options. In doing so, they purchased six existing restaurants and committed to develop a total of five new restaurants over the next six years with an option to open an additional five restaurants in the following five years. Gross proceeds from these transactions were \$1,360,000, of which \$275,000 was for franchise and development fees and \$1,085,000 was for the sale of certain assets and leasehold rights. During the year ended January 2, 2005, the Company recorded \$200,000 of franchise fee revenue for the initial locations acquired by these franchisees and deferred \$75,000 related to future development. The \$75,000 will be recognized into income as restaurants are opened. In addition, the Company recognized a gain of \$542,000 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 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 six years following the date of the agreement with an option for 15 more restaurants in the following five years. Gross proceeds from the sale were approximately \$3,150,000 of

**FRIENDLY ICE CREAM CORPORATION AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**10. FRANCHISE TRANSACTIONS (Continued)**

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 the year ended January 1, 2006, Central Florida opened two new restaurants. In December 2006, Central Florida defaulted under its leases and franchise agreements and peaceably surrendered 11 restaurants to the Company and closed one restaurant. The Company is currently operating the 11 restaurants for a limited period of time while the parties seek a substitute franchisee to take over the operations at these restaurants. If the properties are not franchised, the Company, at its option, may acquire or close the restaurants. The Company and Central Florida's lenders and landlord have entered into agreements pursuant to which the Company has agreed to make recurring monthly rent and loan payments and the lenders and landlord have agreed not to interfere with the Company operations while it operates the restaurants. Except for the Company's agreement to make certain payments while it is operating the restaurants, the Company has not assumed any of Central Florida's obligations to its lender.

**11. 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 was 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. 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 made prior to that date. Cash balance accounts continue to be credited with interest after December 31, 2003.

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.

In October 2006, the FASB issued SFAS No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans*, an amendment of FASB Statements No. 87, 88, 106 and 132(R) (SFAS No. 158), which requires an entity to: (a) recognize in its statement of financial position an asset for a defined benefit postretirement plan's overfunded status or a liability for a plan's underfunded status, (b) measure a defined benefit postretirement plan's assets and obligations that determine its funded status as of the end of the employer's fiscal year, and (c) recognize changes in the funded status of a defined benefit postretirement plan in comprehensive income in the year in which the changes occur. The requirement to recognize the funded status of a defined benefit postretirement plan and the disclosure requirements are effective for the Company's 2006 fiscal year.

**FRIENDLY ICE CREAM CORPORATION AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**11. PENSION PLAN (Continued)**

Because the Company's cash balance pension plan was frozen effective December 31, 2003, the projected benefit obligation and the accumulated benefit obligation are the same resulting in no incremental effect of applying SFAS No. 158.

For the years ended December 31, 2006 and January 1, 2006, the reconciliation of the projected benefit obligation was (in thousands):

|                                      | <b>December 31,<br/>2006</b> | <b>January 1,<br/>2006</b> |
|--------------------------------------|------------------------------|----------------------------|
| Beginning of year benefit obligation | \$ 119,949                   | \$ 110,042                 |
| Interest cost                        | 6,783                        | 6,684                      |
| Assumption changes                   | (3,900 )                     | 5,151                      |
| Actuarial loss                       | 760                          | 4,693                      |
| Disbursements                        | (7,977 )                     | (6,621 )                   |
| End of year benefit obligation       | \$ 115,615                   | \$ 119,949                 |

The reconciliation of the fair value of assets of the plan as of December 31, 2006 and January 1, 2006 was (in thousands):

|  | <b>December 31,<br/>2006</b> | <b>January 1,<br/>2006</b> |
|--|------------------------------|----------------------------|
| Beginning of year fair value of assets         | \$ 91,045                    | \$ 92,510                  |
| Actual return on plan assets (net of expenses) | 10,095                       | 5,156                      |
| Employer contributions                         | 2,150                        |                            |
| Disbursements                                  | (7,977 )                     | (6,621 )                   |
| End of year fair value of assets               | \$ 95,313                    | \$ 91,045                  |

The funded status of the plan as of December 31, 2006 and January 1, 2006 was (in thousands):

|                                | <b>December 31,<br/>2006</b> | <b>January 1,<br/>2006</b> |
|--------------------------------|------------------------------|----------------------------|
| Accumulated benefit obligation | \$ 115,615                   | \$ 119,949                 |
| Fair value of plan assets      | 95,313                       | 91,045                     |
| Funded status                  | (20,302 )                    | (28,904 )                  |

**FRIENDLY ICE CREAM CORPORATION AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**11. PENSION PLAN (Continued)**

The components of net periodic pension cost and other amounts recognized in other comprehensive income for the years ended December 31, 2006, January 1, 2006 and January 2, 2005 were (in thousands):

|   | December 31,<br>2006 | January 1,<br>2006 | January 2,<br>2005 |
|---|----------------------|--------------------|--------------------|
| <b>Net Periodic Pension Cost:</b>   |                      |                    |                    |
| Interest cost   | \$ 6,783             | \$ 6,684           | \$ 6,604           |
| Expected return on assets   | (7,930 )             | (8,288 )           | (9,391 )           |
| Net amortization:   |                      |                    |                    |
| Unrecognized prior service benefit  |                      |                    |                    |
| Unrecognized net actuarial loss   | 2,702                | 1,890              | 671                |
| Periodic pension cost (benefit) before adjustments  | 1,555                | 286                | (2,116 )           |
| Settlement expense  |                      |                    | 2,204              |
| Net periodic pension cost   | \$ 1,555             | \$ 286             | \$ 88              |
| <b>Other Changes in Plan Assets and Benefit Obligations Recognized in Other Comprehensive Income:</b> |                      |                    |                    |
| Net actuarial gain  | \$ (5,305 )          |                    |                    |
| Recognized actuarial gain   | (2,702 )             |                    |                    |
| Total recognized in other comprehensive income (before tax effect)                                    | \$ (8,007 )          |                    |                    |
| Total recognized in net pension cost and other comprehensive income (before tax effect)               | \$ (6,452 )          |                    |                    |

Items not yet recognized as a component of net periodic pension cost of \$38,162,000 consisted of net actuarial losses. The estimated net loss for the defined benefit pension plan that will be amortized from accumulated other comprehensive income into net periodic pension cost during 2007 is \$2,443,000.

A summary of the Company's key actuarial assumptions used to determine benefit obligations as of December 31, 2006 and January 1, 2006 follows:

|                                   | December 31,<br>2006 | January 1,<br>2006 |
|-----------------------------------|----------------------|--------------------|
| Discount rate                     | 6.00 %               | 5.75 %             |
| Salary increase rate              | N/A                  | N/A                |
| Expected long-term rate of return | 8.75 %               | 8.75 %             |

A summary of the Company's key actuarial assumptions used to determine net periodic pension cost for the years ended December 31, 2006, January 1, 2006 and January 2, 2005 follows:

|                                   | December 31,<br>2006 | January 1,<br>2006 | January 2,<br>2005 |
|-----------------------------------|----------------------|--------------------|--------------------|
| Discount rate                     | 5.75 %               | 6.00 %             | 6.25 %             |
| Salary increase rate              | N/A                  | N/A                | N/A                |
| Expected long-term rate of return | 8.75 %               | 8.75 %             | 9.00 %             |

**FRIENDLY ICE CREAM CORPORATION AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**11. PENSION PLAN (Continued)**

The Company determines its expected long-term rate of return based on its 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 estimates as deemed appropriate. As of December 31, 2006, 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 was 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 December 31, 2006 and January 1, 2006 by asset category were as follows:

| Asset Category    | December 31,<br>2006 | January 1,<br>2006 |
|-------------------|----------------------|--------------------|
| Equity securities | 69 %                 | 66 %               |
| Debt securities   | 18 %                 | 21 %               |
| Real estate       | 12 %                 | 12 %               |
| Other             | 1 %                  | 1 %                |
| <b>Total</b>      | <b>100 %</b>         | <b>100 %</b>       |

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 monitors 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 December 31, 2006 or January 1, 2006.

In August 2006, the Pension Protection Act of 2006 (the Act) was signed into law. The Act clarified funding rules and rates for determining deficit reduction. As a result, the Company contributed \$2,150,000 to the Company's defined benefit cash balance pension plan during the year ended December 31, 2006.

**FRIENDLY ICE CREAM CORPORATION AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**11. PENSION PLAN (Continued)**

The Company does not anticipate a contribution in 2007. Funding requirements for subsequent years are uncertain and will significantly depend on whether the plan's actuary changes any assumptions used to calculate plan funding levels, the actual return on plan assets, changes in the employee groups covered by the plan, and any legislative or regulatory changes affecting plan funding requirements. For tax planning, financial planning, cash flow management or cost reduction purposes the Company may increase, accelerate, decrease or delay contributions to the plan to the extent permitted by law. Currently, the Company expects to contribute approximately \$3,500,000 in 2008.

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

| <b>Year</b>  | <b>Amount</b>    |
|--------------|------------------|
| 2007         | \$ 3,841         |
| 2008         | 4,164            |
| 2009         | 4,540            |
| 2010         | 4,945            |
| 2011         | 4,949            |
| 2012 - 2016  | 36,548           |
| <b>Total</b> | <b>\$ 58,987</b> |

**12. POSTRETIREMENT MEDICAL AND LIFE INSURANCE BENEFITS**

The Company provides medical and life insurance benefits to certain groups of employees upon retirement. Eligible employees may continue their coverage 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 medical coverage from participants who retired after September 1, 1989. Medical 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.

In October 2006, the FASB issued SFAS No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans*, an amendment of FASB Statements No. 87, 88, 106 and 132(R) (SFAS No. 158), which requires an entity to: (a) recognize in its statement of financial position an asset for a defined benefit postretirement plan's overfunded status or a liability for a plan's underfunded status, (b) measure a defined benefit postretirement plan's assets and obligations that determine its funded status as of the end of the employer's fiscal year, and (c) recognize changes in the funded status of a defined benefit postretirement plan in comprehensive income in the year in which the changes occur. The requirement to recognize the funded status of a defined benefit postretirement plan and the disclosure requirements are effective for the Company's 2006 fiscal year.

**FRIENDLY ICE CREAM CORPORATION AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**12. POSTRETIREMENT MEDICAL AND LIFE INSURANCE BENEFITS (Continued)**

The incremental effect of applying SFAS No. 158 for the year ended December 31, 2006 was (in thousands):

|  | Before<br>Application of<br>SFAS No. 158 | Adjustments | After<br>Application of<br>SFAS No. 158 |
|--|--|-------------|---|
| Benefit obligation                     | \$ (7,155 )                              | \$ 264      | \$ (6,891 )                             |
| Deferred income taxes                  | 28,465                                   | (108 )      | 28,357                                  |
| Valuation allowance                    | (27,537 )                                | 108         | (27,429 )                               |
| Current liabilities                    | (68,098 )                                | (593 )      | (68,691 )                               |
| Noncurrent liabilities                 | (279,229 )                               | 857         | (278,372 )                              |
| Accumulated other comprehensive income | 23,778                                   | (264 )      | 23,514                                  |
| Total stockholders' deficit            | 127,160                                  | (264 )      | 126,896                                 |

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 December 31, 2006 and January 1, 2006 was as follows (in thousands):

|                                      | December 31,<br>2006 | January 1,<br>2006 |
|--------------------------------------|----------------------|--------------------|
| Beginning of year benefit obligation | \$ 6,850             | \$ 7,985           |
| Service cost                         | 150                  | 162                |
| Interest cost                        | 386                  | 407                |
| Plan participants' contributions     | 176                  | 208                |
| MMA Retiree drug subsidy             | 56                   |                    |
| Actuarial loss (gain)                | 42                   | (1,243 )           |
| Disbursements                        | (769 )               | (669 )             |
| End of year benefit obligation       | \$ 6,891             | \$ 6,850           |

The reconciliation of the funded status of the plan as of December 31, 2006 and January 1, 2006 included the following components (in thousands):

|                                | December 31,<br>2006 | January 1,<br>2006 |
|--------------------------------|----------------------|--------------------|
| Accumulated benefit obligation | \$ (6,891 )          | \$ (6,850 )        |
| Fair value of plan assets      |                      |                    |
| Funded status                  | (6,891 )             | (6,850 )           |

**FRIENDLY ICE CREAM CORPORATION AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**12. POSTRETIREMENT MEDICAL AND LIFE INSURANCE BENEFITS (Continued)**

The components of net postretirement medical and life insurance benefit cost and other amounts recognized in other comprehensive income for the years ended December 31, 2006, January 1, 2006 and January 2, 2005 were (in thousands):

|  | December 31,<br>2006 | January 1,<br>2006 | January 2,<br>2005 |
|--|----------------------|--------------------|--------------------|
| <b><u>Net Benefit Cost:</u></b>  |                      |                    |                    |
| Service cost   | \$ 150               | \$ 162             | \$ 141             |
| Interest cost  | 386                  | 407                | 456                |
| Recognized actuarial loss  | 24                   | 35                 | 70                 |
| Net amortization of unrecognized prior service benefit                                       | (142 )               | (142 )             | (142 )             |
| Net benefit cost   | \$ 418               | \$ 462             | \$ 525             |
| <b><u>Other Changes in Benefit Obligations Recognized in Other Comprehensive Income:</u></b> |                      |                    |                    |
| Net actuarial loss   | \$ 956               |                    |                    |
| Prior service credit.  | (1,220 )             |                    |                    |
| Total recognized in accumulated other comprehensive income (before tax effect).              | \$ (264 )            |                    |                    |
| Total recognized in net pension cost and other comprehensive income (before tax effect).     | \$ 154               |                    |                    |

The estimated net loss and prior service credit for the postretirement medical and life insurance benefit plan that will be amortized from accumulated other comprehensive income into net postretirement medical and life insurance benefit cost during 2007 are \$16,000 and \$142,000, respectively.

A summary of the Company's key actuarial assumptions used to determine benefit obligations as of December 31, 2006 and January 1, 2006 follows:

|                            | December 31,<br>2006 | January 1,<br>2006 |
|----------------------------|----------------------|--------------------|
| Discount rate              | 6.00 %               | 5.75 %             |
| Salary increase rate       | N/A                  | N/A                |
| <b>Medical cost trend:</b> |                      |                    |
| First year                 | 9.00 %               | 8.50 %             |
| Ultimate                   | 4.75 %               | 4.75 %             |
| Years to reach ultimate    | 5                    | 3                  |



**FRIENDLY ICE CREAM CORPORATION AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**12. POSTRETIREMENT MEDICAL AND LIFE INSURANCE BENEFITS (Continued)**

A summary of the Company's key actuarial assumptions used to determine net periodic benefit cost for the years ended December 31, 2006, January 1, 2006 and January 2, 2005 follows:

|                         | December 31,<br>2006 | January 1,<br>2006 | January 2,<br>2005 |
|-------------------------|----------------------|--------------------|--------------------|
| Discount rate           | 5.75 %               | 6.00 %             | 6.25 %             |
| Salary increase rate    | N/A                  | N/A                | N/A                |
| Medical cost trend:     |                      |                    |                    |
| First year              | 8.50 %               | 9.50 %             | 8.50 %             |
| Ultimate                | 4.75 %               | 5.50 %             | 5.50 %             |
| Years to reach ultimate | 2                    | 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:

|  | One Percentage<br>Point Increase | One Percentage<br>Point Decrease |
|--|----------------------------------|----------------------------------|
| Effect on total of service and interest cost | \$ 45,502                        | \$ (39,408 )                     |
| Effect on accumulated benefit obligation     | \$ 425,076                       | \$ (376,103 )                    |

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

| Year        | Payments net<br>of Medicare D<br>Subsidies | Medicare D<br>Subsidies |
|-------------|--|-------------------------|
| 2007        | \$ 666                                     | \$ 56                   |
| 2008        | 665  | 55                      |
| 2009        | 656  | 54                      |
| 2010        | 640  | 52                      |
| 2011        | 631  | 49                      |
| 2012 - 2016 | 2,899                                      | 188                     |
| Total       | \$ 6,157                                   | \$ 454                  |

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

**FRIENDLY ICE CREAM CORPORATION AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**12. POSTRETIREMENT MEDICAL AND LIFE INSURANCE BENEFITS (Continued)**

Based on regulations issued by the Centers for Medicare & Medicaid Services, the Company has concluded that, for certain participants, the benefits provided are at least actuarially equivalent to benefits available through Medicare Part D. The accumulated benefit obligation of the Company's postretirement medical and life insurance plan at January 1, 2006 decreased by \$900,000 due to the effect of the federal subsidy and the net periodic benefit cost for 2005 was reduced by \$99,900.

**13. 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 December 31, 2006, January 1, 2006 and January 2, 2005, 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. 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 \$838,000, \$866,000 and \$972,000 for the years ended December 31, 2006, January 1, 2006 and January 2, 2005, respectively.

**14. INSURANCE RESERVES**

At December 31, 2006 and January 1, 2006 insurance reserves of approximately \$32,488,000 and \$32,097,000, respectively, had been recorded. Insurance reserves at December 31, 2006 and January 1, 2006 included RIC's reserves for the Company's insurance liabilities of approximately \$6,371,000 and \$7,461,000, 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):

|           | December 31,<br>2006 | January 1,<br>2006 |
|-----------|----------------------|--------------------|
| Current   | \$ 11,462            | \$ 9,002           |
| Long-term | 21,026               | 23,095             |
| Total     | \$ 32,488            | \$ 32,097          |

Following is a summary of the activity in the insurance reserves for the years ended December 31, 2006, January 1, 2006 and January 2, 2005 (in thousands):

|                   | December 31,<br>2006 | January 1,<br>2006 | January 2,<br>2005 |
|-------------------|----------------------|--------------------|--------------------|
| Beginning balance | \$ 32,097            | \$ 32,435          | \$ 30,952          |
| Provision         | 10,623               | 11,023             | 12,621             |
| Payments          | (10,232 )            | (11,361 )          | (11,138 )          |
| Ending balance    | \$ 32,488            | \$ 32,097          | \$ 32,435          |

**FRIENDLY ICE CREAM CORPORATION AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**14. INSURANCE RESERVES (Continued)**

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.

**15. RELATED PARTY TRANSACTIONS**

While FICC's Chairman of the Board was an officer of The Restaurant Company ( TRC ), FICC entered into a sublease for certain land, building and equipment from a subsidiary of TRC. For the years ended December 31, 2006, January 1, 2006 and January 2, 2005, rent expense related to the sublease was approximately \$71,000, \$70,000 and \$69,000, respectively.

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 December 31, 2006, January 1, 2006 and January 2, 2005, purchases were approximately \$360,000, \$353,000 and \$340,000, respectively.

On May 22, 2006, The Ice Cream Company ( TICC ) purchased, at fair market value, certain assets and leasehold rights for three existing Company-operated restaurants located in Lancaster and York, Pennsylvania. At closing, TICC was also granted an exclusive right to develop six new Friendly's restaurants in Lancaster, Chester and Montgomery counties, Pennsylvania by April 2012. Gross proceeds from this transaction were \$1,725,000, of which \$90,000 was for initial franchise fees, \$90,000 was for development fees and \$1,545,000 was for the sale of certain assets and leasehold rights at the three existing restaurants. During the year ended December 31, 2006, the Company recorded \$90,000 as franchise fee revenue and recognized a gain of \$1,146,000 related to the sale of the assets.

The owners of TICC are family members of the Company's Chairman of the Board of Directors. Prior to the closing of this transaction on May 22, 2006, TICC operated three Friendly's restaurants under franchise agreements with Friendly's Restaurants Franchise, Inc. ( FRFI ), a subsidiary of Friendly's. The terms of the franchise agreements with TICC are identical in all material respects to the terms generally offered to unrelated franchisees of FRFI in the ordinary course of Friendly's business.

TICC purchases from Friendly's certain food products used in the normal course of its franchise business. During 2006, 2005 and 2004, TICC paid Friendly's \$3,405,000, \$2,110,000 and \$2,080,000, respectively, for franchise royalty fees, marketing fees, food purchases and miscellaneous other products and services.

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 purchases from Friendly's certain food products used in the normal course of its franchise business. During 2006, 2005 and 2004, Treats paid Friendly's \$439,000, \$428,000 and \$422,000, respectively, for franchise royalty fees, marketing fees, food purchases and miscellaneous other products and services.

**FRIENDLY ICE CREAM CORPORATION AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**16. 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.

On February 25, 2003, S. Prestley Blake ( Blake ), holder of approximately 12% of the Company's outstanding common stock, sued Friendly's and its Chairman in a purported derivative action in Hampden Superior Court, Massachusetts. The suit alleges breach of fiduciary duty and misappropriation of corporate assets in that Friendly's paid certain expenses relating to a corporate jet and the Chairman's use of that jet and use of an office in Illinois. The suit seeks to require the Chairman to reimburse Friendly's and for Friendly's to pay Blake's attorneys' fees. Friendly's and its Chairman have denied Blake's allegations and are vigorously defending the lawsuit.

On June 27, 2005, Mr. Blake sent a demand letter to the Company's Board of Directors demanding that its Board of Directors address his concerns and beliefs that are subject to the litigation filed on February 25, 2003. On July 14, 2005, the Company's Board of Directors formed a special litigation committee consisting solely of independent directors (the Committee ) to investigate the concerns and beliefs raised in Blake's demand letter dated June 27, 2005. The Committee issued its report on October 24, 2005 and a supplemental report on November 30, 2005. Based on its findings, the Committee filed a motion to dismiss the claims made by Mr. Blake. On May 24, 2006, the Court denied the Committee's motion to dismiss and allowed the joinder, as defendants, of current Board members Steven L. Ezzes, Michael J. Daly and Burton J. Manning, and former Board member Charles A. Ledsinger, Jr., and The Restaurant Company, The Restaurant Holding Corporation and TRC Realty, LLC.

On July 26, 2006, director defendants Michael J. Daly, Steven L. Ezzes, and Burton J. Manning, and former director defendant Charles A. Ledsinger, Jr., filed motions to dismiss the claims brought against them for failure to state a claim on the grounds that both the exculpatory provision in the Company's Restated Articles of Organization and the business judgment rule barred the plaintiff's claims. On December 20, 2006, the Court granted the directors' motion and dismissed from the Blake litigation director defendants Michael J. Daly, Steven L. Ezzes, Burton J. Manning and former director defendant Charles A. Ledsinger, Jr. The Court has set a deadline for fact discovery of May 31, 2007, with a trial, if necessary, to begin on January 7, 2008. Friendly's and its Chairman have denied Blake's allegations and are vigorously defending the lawsuit.

As of December 31, 2006, the Company had commitments to purchase approximately \$111,390,000 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.

On February 7, 2007, the Company entered into a 10 year contract to purchase approximately \$340,000 in liquid nitrogen annually.

**17. 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 operating segments include restaurant, foodservice and franchise. The revenues from these segments include both sales to unaffiliated customers and intersegment sales, which generally are accounted for on a basis consistent with

**FRIENDLY ICE CREAM CORPORATION AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**17. SEGMENT REPORTING (Continued)**

sales to unaffiliated customers. Intersegment sales and other intersegment transactions have been eliminated in the accompanying consolidated financial statements.

The Company's restaurants target families with children 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 Company-operated and franchised restaurants. Additionally, it sells premium ice cream dessert products to distributors and retail 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 headquarter 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 intersegment 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. Using this approach, the Company evaluates performance based on stand-alone operating segment income (loss) before income taxes and generally accounts for intersegment sales and transfers as if the sales or transfers were to third parties, that is, at current market prices.

Adjusted EBITDA represents net income (loss) from continuing operations before (i) (provision for) benefit from income taxes, (ii) interest expense, net, (iii) depreciation and amortization, (iv) write-downs of property and equipment, (v) net periodic pension cost and (vi) other non-cash items. Adjusted EBITDA is a non-GAAP financial measure. The Company has included information concerning adjusted EBITDA in this Form 10-K because the Company's management incentive plan pays bonuses based on achieving operating segment adjusted 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. Adjusted EBITDA should not be considered as an alternative to, or more meaningful than, earnings (loss) from continuing operations or other traditional indications of the Company's operating performance.

During the year ended December 31, 2006, the Company stopped the allocation of one financial department to the restaurant segment as it was determined that this department should be reported with general and administrative corporate expenses. Adjusted EBITDA and income (loss) from continuing operations before (provision for) benefit from income taxes have been restated to remove the costs associated with this department of \$0.2 million for both years ended January 1, 2006 and January 2, 2005.

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**FRIENDLY ICE CREAM CORPORATION AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**17. SEGMENT REPORTING (Continued)**

|                               | <b>For the Years Ended<br/>December 31,<br/>2006</b> | <b>January 1,<br/>2006</b> | <b>January 2,<br/>2005<br/>(53 weeks)</b> |
|-------------------------------|--|----------------------------|---|
|                               | (in thousands)                                       |                            |   |
| <b>Revenues:</b>              |  |                            |   |
| Restaurant                    | \$ 395,999   | \$ 400,821                 | \$ 431,763                                |
| Foodservice                   | 235,782  | 238,099                    | 245,484                                   |
| Franchise                     | 15,401   | 14,454                     | 13,199                                    |
| Total                         | \$ 647,182   | \$ 653,374                 | \$ 690,446                                |
| <b>Intersegment revenues:</b> |  |                            |   |
| Restaurant                    | \$   | \$                         | \$  |
| Foodservice                   | (115,727 )   | (122,027 )                 | (132,847 )                                |
| Franchise.                    |  |                            |   |
| Total.                        | \$ (115,727 )  | \$ (122,027 )              | \$ (132,847 )                             |
| <b>External revenues:</b>     |  |                            |   |
| Restaurant                    | \$ 395,999   | \$ 400,821                 | \$ 431,763                                |
| Foodservice                   | 120,055  | 116,072                    | 112,637                                   |
| Franchise                     | 15,401   | 14,454                     | 13,199                                    |
| Total                         | \$ 531,455   | \$ 531,347                 | \$ 557,599                                |

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**FRIENDLY ICE CREAM CORPORATION AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**17. SEGMENT REPORTING (Continued)**

|   | For the Years Ended<br>December 31,<br>2006 | January 1,<br>2006 | January 2,<br>2005<br>(53 weeks) |
|---|---|--------------------|----------------------------------|
|   | (in thousands)                              |                    |                                  |
| <b>Adjusted EBITDA:</b>   |   |                    |                                  |
| Restaurant  | \$ 37,427                                   | \$ 35,277          | \$ 42,318                        |
| Foodservice   | 16,182                                      | 11,563             | 12,983                           |
| Franchise   | 10,314                                      | 10,274             | 9,384                            |
| Corporate   | (21,471 )                                   | (19,609 )          | (20,186 )                        |
| Gain on property and equipment, net   | 3,073                                       | 1,610              | 892                              |
| Restructuring expenses  |   |                    | (2,627 )                         |
| Gain on litigation settlement   |   |                    | 3,644                            |
| Less pension expense (benefit) included in reporting segments                                     | 1,555                                       | 286                | (2,116 )                         |
| <b>Total</b>  | <b>\$ 47,080</b>                            | <b>\$ 39,401</b>   | <b>\$ 44,292</b>                 |
| Interest expense, net-Corporate   | \$ 20,491                                   | \$ 20,924          | \$ 22,295                        |
| Other (income) expense  | \$  | \$ (130 )          | \$ 9,235                         |
| <b>Depreciation and amortization:</b>   |   |                    |                                  |
| Restaurant  | \$ 16,221                                   | \$ 16,845          | \$ 15,636                        |
| Foodservice   | 2,882                                       | 3,216              | 3,376                            |
| Franchise   | 325   | 172                | 286                              |
| Corporate   | 3,485                                       | 3,202              | 3,294                            |
| <b>Total</b>  | <b>\$ 22,913</b>                            | <b>\$ 23,435</b>   | <b>\$ 22,592</b>                 |
| <b>Other non-cash expenses (income):</b>  |   |                    |                                  |
| Pension expense (benefit)   | \$ 1,555                                    | \$ 286             | \$ (2,116 )                      |
| Pension settlement expense  |   |                    | 2,204                            |
| Write-downs of property and equipment.  | 719   | 2,478              | 91                               |
| <b>Total.</b>   | <b>\$ 2,274</b>                             | <b>\$ 2,764</b>    | <b>\$ 179</b>                    |
| <b>Income (loss) from continuing operations before (provision for) benefit from income taxes:</b> |   |                    |                                  |
| Restaurant  | \$ 21,206                                   | \$ 18,432          | \$ 26,682                        |
| Foodservice   | 13,300                                      | 8,347              | 9,607                            |
| Franchise   | 9,989                                       | 10,102             | 9,098                            |
| Corporate   | (45,447 )                                   | (43,605 )          | (55,010 )                        |
| Gain (loss) on property and equipment, net  | 2,354                                       | (868 )             | 801                              |
| Pension settlement expense  |   |                    | (2,204 )                         |
| Restructuring expenses  |   |                    | (2,627 )                         |
| Gain on litigation settlement   |   |                    | 3,644                            |
| <b>Total</b>  | <b>\$ 1,402</b>                             | <b>\$ (7,592 )</b> | <b>\$ (10,009 )</b>              |

**FRIENDLY ICE CREAM CORPORATION AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**17. SEGMENT REPORTING (Continued)**

|   | <b>For the Years Ended</b> |                   |
|---|----------------------------|-------------------|
|   | <b>December 31,</b>        | <b>January 1,</b> |
|   | <b>2006</b>                | <b>2006</b>       |
|   | <b>(in thousands)</b>      |                   |
| Capital expenditures, including assets acquired under capital leases: |                            |                   |
| Restaurant  | \$ 16,068                  | \$ 14,674         |
| Foodservice   | 4,306                      | 1,516             |
| Corporate   | 1,350                      | 968               |
| Total   | \$ 21,724                  | \$ 17,158         |

|               | <b>December 31,</b>   | <b>January 1,</b> |
|---------------|-----------------------|-------------------|
|               | <b>2006</b>           | <b>2006</b>       |
|               | <b>(in thousands)</b> |                   |
| Total assets: |                       |                   |
| Restaurant    | \$ 119,787            | \$ 131,810        |
| Foodservice   | 40,875                | 38,609            |
| Franchise     | 11,827                | 7,634             |
| Corporate     | 47,678                | 40,189            |
| Total         | \$ 220,167            | \$ 218,242        |

**18. INSURANCE RECOVERY**

On January 27, 2006, the Company initiated litigation against its insurance carrier to recoup defense expenses related to the Blake litigation. On September 27, 2006, the Company entered into a settlement agreement with its insurance carrier which provides, in part, for 1) a lump sum payment to settle past disputed expenses and 2) clarification of coverage of future defense expenses related to this matter.

During the year ended December 31, 2006, the Company received insurance recoveries of \$1,596,000, of which \$1,428,000 was pursuant to the settlement agreement with the Company's insurance carrier, related to costs and expenses incurred related to the above matter. Additionally, the Company has recorded a receivable for insurance recoveries to the extent defense expenses have been incurred and realization of a related insurance claim is probable. As of December 31, 2006, the receivable for insurance recoveries totaled \$170,000.

**19. 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.



**FRIENDLY ICE CREAM CORPORATION AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**20. QUARTERLY FINANCIAL DATA (UNAUDITED)**

|  | For the Quarters Ended |                 |                    |                         |
|--|------------------------|-----------------|--------------------|-------------------------|
|  | April 2,<br>2006       | July 2,<br>2006 | October 1,<br>2006 | December 31,<br>2006(b) |
| (in thousands, except per share amounts)                             |                        |                 |                    |                         |
| <b>2006</b>  |                        |                 |                    |                         |
| Revenues   | \$ 125,715             | \$ 141,490      | \$ 141,884         | \$ 122,366              |
| Operating income   | \$ 984                 | \$ 9,382        | \$ 7,385           | \$ 3,808                |
| (Loss) income from continuing operations                             | \$ (4,436 )            | \$ 3,985        | \$ 2,003           | \$ (67 )                |
| Income (loss) from discontinued operations, net of income tax effect | \$ 2,616               | \$ 674          | \$ (32 )           | \$ 203                  |
| Net (loss) income  | \$ (1,820 )            | \$ 4,659        | \$ 1,971           | \$ 136                  |
| Basic (loss) income per share:                                       |                        |                 |                    |                         |
| (Loss) income from continuing operations                             | \$ (0.56 )             | \$ 0.50         | \$ 0.24            | \$ (0.01 )              |
| Income from discontinued operations, net of income tax effect        | \$ 0.33                | \$ 0.09         | \$                 | \$ 0.03                 |
| Net (loss) income  | \$ (0.23 )             | \$ 0.59         | \$ 0.24            | \$ 0.02                 |
| Diluted (loss) income per share:                                     |                        |                 |                    |                         |
| (Loss) income from continuing operations                             | \$ (0.56 )             | \$ 0.50         | \$ 0.24            | \$ (0.01 )              |
| Income from discontinued operations, net of income tax effect        | \$ 0.33                | \$ 0.08         | \$                 | \$ 0.03                 |
| Net (loss) income  | \$ (0.23 )             | \$ 0.58         | \$ 0.24            | \$ 0.02                 |
| Weighted average shares:   |                        |                 |                    |                         |
| Basic  | 7,901                  | 7,913           | 7,925              | 8,019                   |
| Diluted  | 7,901                  | 8,044           | 8,044              | 8,160                   |

|  | April 3,<br>2005                         | July 3,<br>2005 | October 2,<br>2005 | January 1,<br>2006(a, b) |
|--|--|-----------------|--------------------|--------------------------|
|  | (in thousands, except per share amounts) |                 |                    |                          |
| <b>2005</b>  |  |                 |                    |                          |
| Revenues.  | \$ 121,663                               | \$ 145,093      | \$ 141,141         | \$ 123,450               |
| Operating income (loss)  | \$ 1,928                                 | \$ 9,041        | \$ 7,718           | \$ (5,485 )              |
| (Loss) income from continuing operations                             | \$ (2,618 )                              | \$ 2,648        | \$ 2,421           | \$ (30,045 )             |
| (Loss) income from discontinued operations, net of income tax effect | \$ (368 )                                | \$ (131 )       | \$ 986             | \$ (152 )                |
| Net (loss) income  | \$ (2,986 )                              | \$ 2,517        | \$ 3,407           | \$ (30,197 )             |
| Basic (loss) income per share:                                       |  |                 |                    |                          |
| (Loss) income from continuing operations                             | \$ (0.34 )                               | \$ 0.34         | \$ 0.31            | \$ (3.80 )               |
| (Loss) income from discontinued operations, net of income tax effect | \$ (0.05 )                               | \$ (0.02 )      | \$ 0.12            | \$ (0.02 )               |
| Net (loss) income  | \$ (0.39 )                               | \$ 0.32         | \$ 0.43            | \$ (3.82 )               |
| Diluted (loss) income per share:                                     |  |                 |                    |                          |
| (Loss) income from continuing operations                             | \$ (0.34 )                               | \$ 0.34         | \$ 0.31            | \$ (3.80 )               |
| (Loss) income from discontinued operations, net of income tax effect | \$ (0.05 )                               | \$ (0.02 )      | \$ 0.12            | \$ (0.02 )               |
| Net (loss) income  | \$ (0.39 )                               | \$ 0.32         | \$ 0.43            | \$ (3.82 )               |
| Weighted average shares:   |  |                 |                    |                          |
| Basic  | 7,717                                    | 7,753           | 7,840              | 7,899                    |
| Diluted  | 7,717                                    | 7,893           | 7,988              | 7,899                    |



**FRIENDLY ICE CREAM CORPORATION AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**20. QUARTERLY FINANCIAL DATA (UNAUDITED) (Continued)**

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(a) During the fourth quarter of 2005, the Company entered a three-year cumulative loss position and revised its projections of the amount and timing of profitability in future periods. As a result, the Company increased its valuation allowance by approximately \$26,729,000 (\$22,184,000 to income tax expense and \$4,545,000 to stockholders' deficit) to reduce the carrying value of deferred tax assets to zero (Note 8).

(b) The fourth quarters in 2006 and 2005 included asset impairment write-downs of \$198,000 and \$2,190,000, respectively (Note 5).

**21. SUPPLEMENTAL CONSOLIDATING FINANCIAL INFORMATION**

FICC's obligation related to the 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 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 limited liability companies (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 December 31, 2006 and January 1, 2006 and for the years ended December 31, 2006 and January 1, 2006 and January 2, 2005 were 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.

**FRIENDLY ICE CREAM CORPORATION AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**21. SUPPLEMENTAL CONSOLIDATING FINANCIAL INFORMATION (Continued)**

**Supplemental Consolidating Balance Sheet**  
**As of December 31, 2006**  
**(in thousands)**

|  | Parent<br>Company | Guarantor<br>Subsidiary | Non-<br>guarantor<br>Subsidiaries | Eliminations | Consolidated |
|--|-------------------|-------------------------|-----------------------------------|--------------|--------------|
| <b>Assets</b>  |                   |                         |                                   |              |              |
| Current assets:  |                   |                         |                                   |              |              |
| Cash and cash equivalents                                | \$ 22,057         | \$ 798                  | \$ 2,222                          | \$           | \$ 25,077    |
| Restricted cash  |                   |                         | 517                               |              | 517          |
| Accounts receivable, net                                 | 9,593             | 1,842                   | 7,776                             | (7,776 )     | 11,435       |
| Inventories  | 17,059            |                         |                                   |              | 17,059       |
| Assets held for sale                                     | 896               |                         |                                   |              | 896          |
| Deferred income taxes                                    |                   | 156                     |                                   | (156 )       |              |
| Prepaid expenses and other<br>current assets             | 3,181             | (2 )                    | 9                                 | (61 )        | 3,127        |
| Total current assets                                     | 52,786            | 2,794                   | 10,524                            | (7,993 )     | 58,111       |
| Deferred income taxes                                    | 928               | 288                     |                                   | (288 )       | 928          |
| Property and equipment, net                              | 96,850            |                         | 40,575                            |              | 137,425      |
| Intangibles and deferred costs, net                      | 15,759            |                         | 2,024                             |              | 17,783       |
| Investments in subsidiaries                              | 107               |                         |                                   | (107 )       |              |
| Other assets   | 5,005             | 851                     | 915                               | (851 )       | 5,920        |
| Total assets   | \$ 171,435        | \$ 3,933                | \$ 54,038                         | \$ (9,239 )  | \$ 220,167   |
| <b>Liabilities and Stockholders<br/>(Deficit) Equity</b> |                   |                         |                                   |              |              |
| Current liabilities:                                     |                   |                         |                                   |              |              |
| Current maturities of long-term<br>obligations           | \$ 9,387          | \$                      | \$ 1,493                          | \$ (7,776 )  | \$ 3,104     |
| Accounts payable   | 22,247            |                         |                                   |              | 22,247       |
| Accrued expenses   | 39,926            | 2,098                   | 1,533                             | (217 )       | 43,340       |
| Total current liabilities                                | 71,560            | 2,098                   | 3,026                             | (7,993 )     | 68,691       |
| Long-term obligations, less<br>current maturities        | 180,665           |                         | 46,667                            |              | 227,332      |
| Other long-term liabilities                              | 46,106            | 702                     | 5,371                             | (1,139 )     | 51,040       |
| Stockholders' (deficit) equity                           | (126,896 )        | 1,133                   | (1,026 )                          | (107 )       | (126,896 )   |
| Total liabilities and stockholders<br>(deficit) equity   | \$ 171,435        | \$ 3,933                | \$ 54,038                         | \$ (9,239 )  | \$ 220,167   |

**FRIENDLY ICE CREAM CORPORATION AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**21. SUPPLEMENTAL CONSOLIDATING FINANCIAL INFORMATION (Continued)**

**Supplemental Consolidating Statement of Operations**  
**For the Year Ended December 31, 2006**  
**(in thousands)**

|  | Parent<br>Company | Guarantor<br>Subsidiary | Non-<br>guarantor<br>Subsidiaries | Eliminations | Consolidated |
|--|-------------------|-------------------------|-----------------------------------|--------------|--------------|
| Revenues   | \$ 519,666        | \$ 11,789               | \$                                | \$           | \$ 531,455   |
| Costs and expenses:  |                   |                         |                                   |              |              |
| Cost of sales  | 200,828           |                         |                                   |              | 200,828      |
| Labor and benefits   | 141,148           |                         |                                   |              | 141,148      |
| Operating expenses and write- downs of<br>property and equipment   | 111,515           |                         | (6,766 )                          |              | 104,749      |
| General and administrative expenses  | 38,663            | 4,621                   |                                   |              | 43,284       |
| Depreciation and amortization  | 20,736            |                         | 2,177                             |              | 22,913       |
| Gain on franchise sales of restaurant<br>operations and properties   | (3,927 )          |                         |                                   |              | (3,927 )     |
| Loss (gain) on disposals of other property<br>and equipment, net   | 1,612             |                         | (711 )                            |              | 901          |
| Interest expense, net  | 16,110            |                         | 4,381                             |              | 20,491       |
| Other income   | (334 )            |                         |                                   |              | (334 )       |
| (Loss) income before benefit from<br>(provision for) income taxes and equity in<br>net income of consolidated subsidiaries | (6,685 )          | 7,168                   | 919                               |              | 1,402        |
| Benefit from (provision for) income taxes  | 3,255             | (2,939 )                | (233 )                            |              | 83           |
| (Loss) income from continuing operations   | (3,430 )          | 4,229                   | 686                               |              | 1,485        |
| Income from discontinued operations, net<br>of income tax expense  | 3,461             |                         |                                   |              | 3,461        |
| Income before equity in net income of<br>consolidated subsidiaries   | 31                | 4,229                   | 686                               |              | 4,946        |
| Equity in net income of consolidated<br>subsidiaries   | 4,915             |                         |                                   | (4,915 )     |              |
| Net income (loss)  | \$ 4,946          | \$ 4,229                | \$ 686                            | \$ (4,915 )  | \$ 4,946     |

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**FRIENDLY ICE CREAM CORPORATION AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**21. SUPPLEMENTAL CONSOLIDATING FINANCIAL INFORMATION (Continued)**

**Supplemental Consolidating Statement of Cash Flows**  
**For the Year Ended December 31, 2006**  
**(in thousands)**

|  | Parent<br>Company | Guarantor<br>Subsidiary | Non-<br>guarantor<br>Subsidiaries | Eliminations | Consolidated |
|--|-------------------|-------------------------|-----------------------------------|--------------|--------------|
| Net cash provided by operating activities                | \$ 18,887         | \$ 18                   | \$ 3,892                          | \$ (1,090 )  | \$ 21,707    |
| Cash flows from investing activities:                    |                   |                         |                                   |              |              |
| Purchases of property and equipment                      | (20,805 )         |                         | (865 )                            |              | (21,670 )    |
| Proceeds from sales of property and equipment            | 11,797            |                         | 1,563                             |              | 13,360       |
| Return of investment in subsidiary                       | 1,496             |                         |                                   | (1,496 )     |              |
| Net cash (used in) provided by investing activities      | (7,512 )          |                         | 698                               | (1,496 )     | (8,310 )     |
| Cash flows from financing activities:                    |                   |                         |                                   |              |              |
| Proceeds from borrowings under revolving credit facility | 8,000             |                         |                                   |              | 8,000        |
| Repayments of obligations                                | (9,476 )          |                         | (2,054 )                          |              | (11,530 )    |
| Payments of deferred financing costs                     | (675 )            |                         |                                   |              | (675 )       |
| Stock options exercised                                  | 1,143             |                         |                                   |              | 1,143        |
| Tax Benefit from exercise of stock options               | 145               |                         |                                   |              | 145          |
| Reinsurance payments made from deposits                  |                   |                         | (1,090 )                          | 1,090        |              |
| Dividends paid   |                   |                         | (1,496 )                          | 1,496        |              |
| Net cash used in financing activities                    | (863 )            |                         | (4,640 )                          | 2,586        | (2,917 )     |
| Net increase (decrease) in cash and cash equivalents     | 10,512            | 18                      | (50 )                             |              | 10,480       |
| Cash and cash equivalents, beginning of period           | 11,546            | 780                     | 2,271                             |              | 14,597       |
| Cash and cash equivalents, end of period.                | \$ 22,058         | \$ 798                  | \$ 2,221                          | \$           | \$ 25,077    |
| Supplemental disclosures:                                |                   |                         |                                   |              |              |
| Interest paid  | \$ 15,808         | \$                      | \$ 4,330                          | \$           | \$ 20,138    |
| Income taxes (refunded) paid                             | (2,727 )          | 2,615                   | 172                               |              | 60           |
| Non-cash dividend paid to parent                         | 8,500             | (8,500 )                |                                   |              |              |
| Capital lease obligations incurred                       | 54                |                         |                                   |              | 54           |

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**FRIENDLY ICE CREAM CORPORATION AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**21. SUPPLEMENTAL CONSOLIDATING FINANCIAL INFORMATION (Continued)**

**Supplemental Consolidating Balance Sheet**  
**As of January 1, 2006**  
**(in thousands)**

|  | Parent<br>Company | Guarantor<br>Subsidiary | Non-<br>guarantor<br>Subsidiaries | Eliminations | Consolidated |
|--|-------------------|-------------------------|-----------------------------------|--------------|--------------|
| <b>Assets</b>  |                   |                         |                                   |              |              |
| Current assets:  |                   |                         |                                   |              |              |
| Cash and cash equivalents                                | \$ 11,546         | \$ 780                  | \$ 2,271                          | \$           | \$ 14,597    |
| Restricted cash  |                   |                         | 2,549                             |              | 2,549        |
| Accounts receivable, net                                 | 9,036             | 1,721                   |                                   |              | 10,757       |
| Inventories  | 15,775            |                         |                                   |              | 15,775       |
| Assets held for sale                                     | 933               |                         |                                   |              | 933          |
| Deferred income taxes                                    | (131)             | ) 26                    |                                   | 105          |              |
| Prepaid expenses and other<br>current assets             | 7,571             | 2,565                   | 7,785                             | (12,877)     | 5,044        |
| Total current assets                                     | 44,730            | 5,092                   | 12,605                            | (12,772)     | 49,655       |
| Deferred income taxes                                    | (276)             | ) 381                   |                                   | (105)        |              |
| Property and equipment, net                              | 101,004           |                         | 42,510                            |              | 143,514      |
| Intangibles and deferred costs,<br>net                   | 16,808            |                         | 2,255                             |              | 19,063       |
| Investments in subsidiaries                              | 5,188             |                         |                                   | (5,188)      |              |
| Other assets   | 5,095             | 5,118                   | 915                               | (5,118)      | 6,010        |
| Total assets   | \$ 172,549        | \$ 10,591               | \$ 58,285                         | \$ (23,183)  | \$ 218,242   |
| <b>Liabilities and Stockholders<br/>(Deficit) Equity</b> |                   |                         |                                   |              |              |
| Current liabilities:                                     |                   |                         |                                   |              |              |
| Current maturities of long-term<br>obligations           |                   |                         |                                   |              |              |
|  | \$ 9,253          | \$                      | \$ 1,368                          | \$ (7,776)   | \$ 2,845     |
| Accounts payable   | 24,968            |                         |                                   |              | 24,968       |
| Accrued expenses   | 37,237            | 4,258                   | 1,825                             | (4,844)      | 38,476       |
| Total current liabilities                                | 71,458            | 4,258                   | 3,193                             | (12,620)     | 66,289       |
| Long-term obligations, less<br>current maturities        |                   |                         |                                   |              |              |
|  | 182,221           |                         | 48,846                            |              | 231,067      |
| Other long-term liabilities                              | 60,708            | 930                     | 6,461                             | (5,375)      | 62,724       |
| Stockholders' (deficit) equity                           | (141,838)         | ) 5,403                 | (215)                             | (5,188)      | (141,838)    |
| Total liabilities and stockholders<br>(deficit) equity   | \$ 172,549        | \$ 10,591               | \$ 58,285                         | \$ (23,183)  | \$ 218,242   |

**FRIENDLY ICE CREAM CORPORATION AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**21. SUPPLEMENTAL CONSOLIDATING FINANCIAL INFORMATION (Continued)**

**Supplemental Consolidating Statement of Operations**  
**For the Year Ended January 1, 2006**  
**(in thousands)**

|   | Parent<br>Company | Guarantor<br>Subsidiary | Non-<br>guarantor<br>Subsidiaries | Eliminations | Consolidated |
|---|-------------------|-------------------------|-----------------------------------|--------------|--------------|
| Revenues.   | \$ 520,369        | \$ 10,978               | \$                                | \$           | \$ 531,347   |
| Costs and expenses:   |                   |                         |                                   |              |              |
| Cost of sales   | 205,332           |                         |                                   |              | 205,332      |
| Labor and benefits  | 143,973           |                         |                                   |              | 143,973      |
| Operating expenses and write-downs of<br>property and equipment   | 115,239           |                         | (6,952 )                          |              | 108,287      |
| General and administrative expenses   | 34,126            | 4,620                   |                                   |              | 38,746       |
| Depreciation and amortization   | 21,230            |                         | 2,205                             |              | 23,435       |
| Gain on franchise sales of restaurant<br>operations and properties  | (2,658 )          |                         |                                   |              | (2,658 )     |
| Loss on disposals of other property and<br>equipment, net   | 1,030             |                         |                                   |              | 1,030        |
| Interest expense, net   | 16,345            |                         | 4,579                             |              | 20,924       |
| Other income  | (130 )            |                         |                                   |              | (130 )       |
| (Loss) income before provision for<br>income taxes and equity in net income of<br>consolidated subsidiaries | (14,118 )         | 6,358                   | 168                               |              | (7,592 )     |
| Provision for income taxes  | (17,175 )         | (2,607 )                | (220 )                            |              | (20,002 )    |
| (Loss) income from continuing operations  | (31,293 )         | 3,751                   | (52 )                             |              | (27,594 )    |
| (Loss) income from discontinued<br>operations, net of income taxes  | (1,517 )          |                         | 1,852                             |              | 335          |
| (Loss) income before equity in net income<br>of consolidated subsidiaries                                   | (32,810 )         | 3,751                   | 1,800                             |              | (27,259 )    |
| Equity in net income of consolidated<br>subsidiaries  | 5,551             |                         |                                   | (5,551 )     |              |
| Net (loss) income   | \$ (27,259 )      | \$ 3,751                | \$ 1,800                          | \$ (5,551 )  | \$ (27,259 ) |

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**FRIENDLY ICE CREAM CORPORATION AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**21. SUPPLEMENTAL CONSOLIDATING FINANCIAL INFORMATION (Continued)**

**Supplemental Consolidating Statement of Cash Flows**  
**For the Year Ended January 1, 2006**  
**(in thousands)**

|  | Parent<br>Company | Guarantor<br>Subsidiary | Non-<br>guarantor<br>Subsidiaries | Eliminations | Consolidated |
|--|-------------------|-------------------------|-----------------------------------|--------------|--------------|
| Net cash provided by (used in) operating activities      | \$ 14,482         | \$ (580 )               | \$ 1,356                          | \$ (813 )    | \$ 14,445    |
| Cash flows from investing activities:                    |                   |                         |                                   |              |              |
| Purchases of property and equipment                      | (16,902 )         |                         |                                   |              | (16,902 )    |
| Proceeds from sales of property and equipment            | 5,375             |                         | 2,870                             |              | 8,245        |
| Purchases of marketable securities                       | (665 )            |                         |                                   |              | (665 )       |
| Proceeds from sales of marketable securities             | 1,643             |                         |                                   |              | 1,643        |
| Return of investments in subsidiaries, net               | 1,367             |                         |                                   | (1,367 )     |              |
| Net cash (used in) provided by investing activities      | (9,182 )          |                         | 2,870                             | (1,367 )     | (7,679 )     |
| Cash flows from financing activities:                    |                   |                         |                                   |              |              |
| Proceeds from borrowings under revolving credit facility | 16,250            |                         |                                   |              | 16,250       |
| Proceeds from issuance of mortgages                      | 1,115             |                         | 8,500                             |              | 9,615        |
| Repayments of obligations                                | (21,786 )         |                         | (10,261 )                         |              | (32,047 )    |
| Payments of deferred financing costs.                    | (243 )            |                         | (186 )                            |              | (429 )       |
| Stock options exercised                                  | 1,037             |                         |                                   |              | 1,037        |
| Reinsurance deposits received                            |                   |                         | 114                               | (114 )       |              |
| Reinsurance payments made from deposits                  |                   |                         | (927 )                            | 927          |              |
| Capital contributions                                    |                   |                         | 503                               | (503 )       |              |
| Dividends paid   |                   |                         | (1,870 )                          | 1,870        |              |
| Net cash used in financing activities                    | (3,627 )          |                         | (4,127 )                          | 2,180        | (5,574 )     |
| Net increase (decrease) in cash and cash equivalents     | 1,673             | (580 )                  | 99                                |              | 1,192        |
| Cash and cash equivalents, beginning of year             | 9,873             | 1,360                   | 2,172                             |              | 13,405       |
| Cash and cash equivalents, end of year.                  | \$ 11,546         | \$ 780                  | \$ 2,271                          | \$           | \$ 14,597    |
| Supplemental disclosures:                                |                   |                         |                                   |              |              |
| Interest paid  | \$ 15,517         | \$                      | \$ 4,652                          | \$           | \$ 20,169    |
| Income taxes (refunded) paid                             | (2,118 )          | 2,594                   | 215                               |              | 691          |
| Income tax benefit of stock options exercised            | 450               |                         |                                   |              | 450          |
| Capital lease obligations incurred                       | 256               |                         |                                   |              | 256          |
| Capital lease obligations terminated                     | 51                |                         |                                   |              | 51           |

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 DECEMBER 31, 2006, JANUARY 1, 2006 and JANUARY 2, 2005  
(in thousands)

| Column A<br>Description                                | Column B<br>Balance at<br>Beginning<br>of Year | Column C<br>Charged to<br>Costs and<br>Expenses | Charged to<br>Other<br>Accounts | Column D<br>Deductions | Column E<br>Balance at<br>End<br>of Year |
|--|--|---|---------------------------------|------------------------|--|
| <b>2006</b>  |  |   |                                 |                        |  |
| Reserve for restructuring costs                        | \$ 72  | \$  | \$                              | \$ 72                  | \$                                       |
| Allowance for doubtful accounts<br>accounts receivable | \$ 758   | \$ 522  | \$ 30                           | \$                     | \$ 1,310                                 |
| Allowance for doubtful accounts<br>notes receivable    | \$ 263   | \$  | \$ 48                           | \$ 263                 | \$ 48                                    |
| <b>2005</b>  |  |   |                                 |                        |  |
| Reserve for restructuring costs.                       | \$ 1,078                                       | \$  | \$                              | \$ 1,006               | \$ 72                                    |
| Allowance for doubtful accounts<br>accounts receivable | \$ 539   | \$ 222  | \$ (3 )                         | \$                     | \$ 758                                   |
| Allowance for doubtful accounts<br>notes receivable    | \$ 263   | \$  | \$                              | \$                     | \$ 263                                   |
| <b>2004</b>  |  |   |                                 |                        |  |
| Reserve for restructuring costs                        | \$ 441   | \$ 2,627  | \$                              | \$ 1,990               | \$ 1,078                                 |
| Allowance for doubtful accounts<br>accounts receivable | \$ 696   | \$ 88   | \$ (245 )                       | \$                     | \$ 539                                   |
| Allowance for doubtful accounts<br>notes receivable    | \$ 313   | \$  | \$                              | \$ 50                  | \$ 263                                   |

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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 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).
  - 4.2 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 Amended and Restated Revolving Credit Agreement dated as of March 15, 2006 (Incorporated by reference to Exhibit 4.9 to the Company s Annual Report on Form 10-K for the fiscal year ended January 1, 2006, File No. 001-13579).
  - 10.2 Amendment Number One to Amended and Restated Revolving Credit Agreement dated as of August 1, 2006 (Incorporated by reference to Exhibit 4.10 to the Company s Quarterly Report on Form 10-Q for the quarterly period ended July 2, 2006, File No. 001-13579).
  - 10.3 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).
  - 10.4 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).
  - 10.5 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).
  - 10.6 Loan Agreement between the Company s subsidiary, Friendly s Realty I, LLC and G.E. Capital Franchise Finance Corporation effective as of December 30, 2005. (Incorporated by reference to Exhibit 4.15 to the Company s Annual Report on Form 10-K for the fiscal year ended January 1, 2006, File No. 001-13579).
  - 10.7 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).\*
  - 10.8 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).\*
  - 10.9 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).\*
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- 10.10 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).\*
  - 10.11 The Company's 2003 Incentive Plan (as amended May 10, 2006) (Incorporated by reference to Exhibit 10.1 to the Company's Registration Statement on Form S-8, Reg. No. 333-135438).\*
  - 10.12 Form of 1997 Stock Option Plan Award Agreement for Officers. (Incorporated by reference to Exhibit 10.10 to the Company's Annual Report on Form 10-K for the fiscal year ended January 1, 2006, File No. 001-13579).\*
  - 10.13 Form of 1997 Stock Option Plan Award Agreement for Directors (Incorporated by reference to Exhibit 10.10 to the Company's Annual Report on Form 10-K for the fiscal year ended January 1, 2006, File No. 001-13579).\*
  - 10.14 Form of 2003 Incentive Plan Stock Option Award Agreement for Officers (Incorporated by reference to Exhibit 10.10 to the Company's Annual Report on Form 10-K for the fiscal year ended January 1, 2006, File No. 001-13579).\*
  - 10.15 Form of 2003 Incentive Plan Stock Option Award Agreement for Directors.\*
  - 10.16 Form of 2003 Incentive Plan Restricted Stock Unit Award Agreement for Directors (Incorporated by reference to Exhibit 10.11 to the Company's Annual Report on Form 10-K for the fiscal year ended January 1, 2006, File No. 001-13579).\*
  - 10.17 Key Executive Stock Option Award Agreement between the Company and George M. Condos as of January 8, 2007.\*
  - 10.18 The Company's 2005 Annual Incentive Plan for Corporate Employees (Incorporated by reference to Exhibit 10.6 to the Company's Annual Report on Form 10-K for the fiscal year ended January 1, 2006, File No. 001-13579).\*
  - 10.19 The Company's 2005 Annual Incentive Plan for Corporate and Company Restaurants Group (Incorporated by reference to Exhibit 10.7 to the Company's Annual Report on Form 10-K for the fiscal year ended January 1, 2006, File No. 001-13579).\*
  - 10.20 The Company's 2006 Annual Incentive Plan for Corporate Employees.\*
  - 10.21 The Company's 2006 Annual Incentive Plan for Corporate Officers.\*
  - 10.22 The Company's 2006 Annual Incentive Plan for Officers of the Corporate and Company Restaurants Group.\*
  - 10.23 Summary of Board of Directors Compensation.\*
  - 10.24 Form of Change of Control Agreement between the Company and each of Messrs. Hoagland, Green, Pastore, Ulrich and Hopkins (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).\*
  - 10.25 Form of Franchise Agreement.
  - 10.26 Form of Franchise Development Agreement.
  - 10.27 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).
  - 10.28 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).
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- 10.29 Domestic Relocation Policy for Executives and Regional Directors (Incorporated by reference to Exhibit 10.2 to the Company's Quarterly Report on Form 10-Q for the quarterly period ended July 3, 2005, File No. 001-13579).\*
- 10.30 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).\*
- 10.31 Memorandum of Agreement between Lawrence A. Rusinko and the Company effective May 31, 2005 (Incorporated by reference to Exhibit 10.1 to the Company's Quarterly Report on Form 10-Q for the quarterly period ended July 3, 2005, File No. 001-13579).\*
- 10.32 Amendment to Memorandum of Agreement between Lawrence A. Rusinko and the Company effective as of September 2, 2005 (Incorporated by reference to Exhibit 10.16 to the Company's Current Report on Form 8-K filed with the Commission on September 9, 2005).\*
- 10.33 Memorandum of Agreement between Allan J. Okscin and Friendly Ice Cream Corporation effective January 23, 2006 (Incorporated by reference to Exhibit 10.1 to the Company's Current Report on 8-K filed with the Commission on January 26, 2006).\*
- 10.34 Memorandum of Agreement between the Company and John L. Cutter effective as of September 28, 2006 (Incorporated by reference to Exhibit 10.1 to the Company's Quarterly Report on Form 10-Q for the quarterly period ended October 1, 2006, File No. 001-13579).\*
- 10.35 Memorandum of Agreement between the Company and George M. Condos as of January 8, 2007.\*
- 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.
- 31.1 Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 signed by George M. Condos.
- 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 George M. Condos and Paul V. Hoagland.

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\*Management Contract or Compensatory Plan or Arrangement

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