FRIENDLY ICE CREAM CORP
Form 10-Q
October 29, 2004

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 26, 2004

OR

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

For the transition period from to

Commission File No. 001-13579

FRIENDLY ICE CREAM CORPORATION

(Exact Name of Registrant as Specified in Its Charter)

Massachusetts (State or Other Jurisdiction of Incorporation or Organization)	**04-2053130** (IRS Employer Identification No.)
1855 Boston Road **Wilbraham, Massachusetts**	**01095**

(Address of Principal Executive Offices)	(Zip Code)

(413) 543-2400
(Registrant s Telephone Number, Including Area Code)

Not Applicable

(Former name, former address and former fiscal year, if changed since last report)

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

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

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

Class	Outstanding at October 15, 2004
Common Stock, $.01 par value	7,702,572 shares

PART I FINANCIAL INFORMATION

Item 1. Financial Statements

FRIENDLY ICE CREAM CORPORATION AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS

(In thousands)

	September 26, 2004 (unaudited)	December 28, 2003
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	$ 17,234	$ 25,631
Restricted cash	1,936	1,671
Accounts receivable, net	10,301	10,384
Inventories	18,654	15,669
Assets held for sale	1,463	1,448
Deferred income taxes	6,647	6,647
Prepaid expenses and other current assets	4,559	1,539
TOTAL CURRENT ASSETS	60,794	62,989
DEFERRED INCOME TAXES	2,030	
PROPERTY AND EQUIPMENT, net of accumulated depreciation and amortization	165,536	165,661
INTANGIBLE ASSETS AND DEFERRED COSTS, net of accumulated amortization	20,928	17,890
OTHER ASSETS	6,921	5,912
TOTAL ASSETS	$ 256,209	$ 252,452
LIABILITIES AND STOCKHOLDERS DEFICIT		
CURRENT LIABILITIES:		
Current maturities of long-term debt	$ 1,225	$ 1,127
Current maturities of capital lease and finance obligations	1,489	911
Accounts payable	27,435	22,475
Accrued salaries and benefits	10,211	9,635
Accrued interest payable	4,824	2,033
Insurance reserves	10,700	10,041
Restructuring reserves	1,472	441
Other accrued expenses	15,258	19,055
TOTAL CURRENT LIABILITIES	72,614	65,718
DEFERRED INCOME TAXES		1,289
CAPITAL LEASE AND FINANCE OBLIGATIONS, less current maturities	7,596	5,773
LONG-TERM DEBT, less current maturities	226,034	227,937
ACCRUED PENSION COST	14,540	16,127
OTHER LONG-TERM LIABILITIES	34,940	33,634
COMMITMENTS AND CONTINGENCIES		
STOCKHOLDERS DEFICIT:		
Common stock	77	75
Additional paid-in capital	142,180	140,826

Accumulated other comprehensive loss		(19,939)		(19,922)
Accumulated deficit		(221,833)		(219,005)
TOTAL STOCKHOLDERS DEFICIT		(99,515)		(98,026)
TOTAL LIABILITIES AND STOCKHOLDERS DEFICIT	$	256,209	$	252,452

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

FRIENDLY ICE CREAM CORPORATION AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(Unaudited)

(In thousands, except per share data)

	For the Three Months Ended September 26, 2004	For the Three Months Ended September 28, 2003	For the Nine Months Ended September 26, 2004	For the Nine Months Ended September 28, 2003
REVENUES:				
Restaurant	$ 120,436	$ 127,605	$ 339,230	$ 353,775
Foodservice	29,110	30,174	82,273	83,377
Franchise	3,509	2,571	9,822	7,536
TOTAL REVENUES	153,055	160,350	431,325	444,688
COSTS AND EXPENSES:				
Cost of sales	57,368	56,561	158,915	157,717
Labor and benefits	42,990	45,402	125,079	127,326
Operating expenses	29,997	28,739	82,855	82,784
General and administrative expenses	9,054	10,710	29,505	30,725
Restructuring expenses			2,627	
Gain on litigation settlement			(3,644)	
Write-downs of property and equipment		26	91	26
Depreciation and amortization	5,407	5,391	16,583	16,764
Gain on franchise sales of restaurant operations and properties	(189)		(1,102)	
Loss on disposals of other property and equipment, net	153	91	661	1,499
OPERATING INCOME	8,275	13,430	19,755	27,847
OTHER EXPENSES:				
Interest expense, net	5,235	6,048	16,667	18,242
Other expenses, principally debt retirement costs			9,235	
INCOME (LOSS) BEFORE BENEFIT FROM (PROVISION FOR) INCOME TAXES	3,040	7,382	(6,147)	9,605
Benefit from (provision for) income taxes	563	(2,067)	3,319	(2,689)
NET INCOME (LOSS)	$ 3,603	$ 5,315	$ (2,828)	$ 6,916
BASIC NET EARNINGS (LOSS) PER SHARE	$ 0.47	$ 0.71	$ (0.37)	$ 0.93
DILUTED NET EARNINGS (LOSS) PER SHARE	$ 0.46	$ 0.70	$ (0.37)	$ 0.91
WEIGHTED AVERAGE SHARES:				
Basic	7,695	7,452	7,611	7,436
Diluted	7,869	7,606	7,611	7,577

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

FRIENDLY ICE CREAM CORPORATION AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

(In thousands)

	For the Nine Months Ended			
	September 26, 2004		September 28, 2003	
CASH FLOWS FROM OPERATING ACTIVITIES:				
Net (loss) income	$	(2,828)	$	6,916
Adjustments to reconcile net (loss) income to net cash provided by operating activities:				
Stock compensation expense		427		184
Depreciation and amortization		16,583		16,764
Write-offs of deferred financing costs		2,445		44
Write-downs of property and equipment		91		26
Deferred income tax (benefit) expense		(3,319)		2,323
(Gain) loss on disposals of other property and equipment, net		(459)		1,499
Changes in operating assets and liabilities:				
Accounts receivable		83		401
Inventories		(2,985)		1,885
Other assets		(3,585)		(1,707)
Accounts payable		4,960		(1,337)
Accrued expenses and other long-term liabilities		979		(4,086)
NET CASH PROVIDED BY OPERATING ACTIVITIES		12,392		22,912
CASH FLOWS FROM INVESTING ACTIVITIES:				
Purchases of property and equipment		(15,554)		(21,291)
Proceeds from sales of property and equipment		4,048		63
Purchases of marketable securities		(1,022)		
Proceeds from sales of marketable securites		89		
NET CASH USED IN INVESTING ACTIVITIES		(12,439)		(21,228)
CASH FLOWS FROM FINANCING ACTIVITIES:				
Proceeds from issuance of senior notes		175,000		
Proceeds from other borrowings		16,750		
Repayments of debt		(193,555)		(3,510)
Payments of deferred financing costs		(6,625)		
Repayments of capital lease and finance obligations		(849)		(1,192)
Stock options exercised		929		228
NET CASH USED IN FINANCING ACTIVITIES		(8,350)		(4,474)
NET DECREASE IN CASH AND CASH EQUIVALENTS		(8,397)		(2,790)
CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD		25,631		34,341
CASH AND CASH EQUIVALENTS, END OF PERIOD	$	17,234	$	31,551
SUPPLEMENTAL DISCLOSURES:				
Cash paid during the period for:				
Interest	$	13,298	$	13,435
Income taxes		24		961
Capital lease obligations incurred		3,250		680
Lease incentive equipment received				243

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

FRIENDLY ICE CREAM CORPORATION AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

1. BASIS OF PRESENTATION AND SIGNIFICANT ACCOUNTING POLICIES

Interim Financial Information

The accompanying condensed consolidated financial statements as of September 26, 2004 and for the three and nine months ended September 26, 2004 and September 28, 2003 are unaudited, but, in the opinion of management, include all adjustments which are necessary for a fair presentation of the consolidated financial position, results of operations, cash flows and comprehensive income (loss) of Friendly Ice Cream Corporation (FICC) and subsidiaries (unless the context indicates otherwise, collectively, the Company). Such adjustments consist solely of normal recurring accruals. Operating results for the three and nine month periods ended September 26, 2004 and September 28, 2003 are not necessarily indicative of the results that may be expected for the entire year due, in part, to the seasonality of the Company s business. Historically, higher revenues and operating income have been experienced during the second and third fiscal quarters. The Company s consolidated financial statements, including the notes thereto, which are contained in the 2003 Annual Report on Form 10-K should be read in conjunction with these condensed consolidated financial statements. Capitalized terms not otherwise defined herein should be referenced to the 2003 Annual Report on Form 10-K.

Use of Estimates in the Preparation of Financial Statements -

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

Revenue Recognition -

The Company s revenues are derived primarily from the operation of full-service restaurants, the distribution and sale of premium ice cream desserts through retail and institutional locations and franchising. The Company recognizes restaurant revenue upon receipt of payment from the customer and retail revenue, net of discounts and allowances, upon delivery of product. Reserves for discounts and allowances from retail sales are estimated and accrued when revenue is recorded. Actual amounts could differ materially from the estimates. 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 condensed consolidated statements of operations for all periods presented.

Insurance Reserves -

The Company is self-insured through retentions or deductibles for the majority of its workers compensation, automobile, general liability, employer s liability, product liability and group health insurance programs. Self-insurance amounts vary up to $500,000 per occurrence. Insurance with third parties, some of which is then reinsured through Restaurant Insurance Corporation (RIC), the Company s wholly owned subsidiary, is in place for claims in excess of these self-insured amounts. RIC reinsures 100% of the risk from $500,000 to $1,000,000 per occurrence through September 2, 2000 for FICC s workers compensation, general liability, employer s liability and product liability insurance. Subsequent to September 2, 2000, the Company discontinued its use of RIC as a captive insurer for new claims. FICC s and RIC s liabilities for estimated incurred losses are actuarially determined and recorded in the accompanying condensed 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 September 26, 2004 and December 28, 2003, accounts receivable of $10,301,000 and $10,384,000 were net of allowances for doubtful accounts totaling $485,000 and $696,000, respectively. Accounts receivable consists primarily of amounts due from the sale of products to franchisees and supermarkets. Accounts receivable also includes amounts related to franchise royalties, rents and other miscellaneous items.

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

Pension and Other Post-Retirement Benefits -

The determination of the Company s obligation and expense for pension and other post-retirement 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 other post-retirement 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.

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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 September 26, 2004 and December 28, 2003, cash of $1,936,000 and $1,671,000, respectively, was restricted.

Inventories -

Inventories are stated at the lower of first-in, first-out cost or market and consisted of the following at September 26, 2004 and December 28, 2003 (in thousands):

	September 26, 2004	December 28, 2003
Raw materials	$ 2,354	$ 1,557
Goods in process	68	114
Finished goods	16,232	13,998
Total	$ 18,654	$ 15,669

Long-Lived Assets

In accordance with Statement of Financial Accounting Standards (SFAS) No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets, which was adopted in 2002, the Company reviews its Non-Friendly Marks, which were assigned to the Company by Hershey in September 2002, for impairment on a quarterly basis. The Company recognizes impairment has occurred when the carrying value of the Non-Friendly Marks exceeds the estimated future discounted cash flows of the trademarked products. Additionally, the Company reviews long-lived assets related to each restaurant to be held and used in the business quarterly for impairment, or whenever events or changes in circumstances indicate that the carrying amount of a restaurant may not be recoverable. The Company evaluates restaurants using a two-year history of cash flow as the primary indicator of potential impairment. Based on the best information available, the Company writes down an impaired restaurant to its estimated fair market value, which becomes its new cost basis. Estimated fair market value is based on the Company s experience selling similar properties and local market conditions, less costs to sell for properties to be disposed of. In addition, restaurants scheduled for closing are reviewed for impairment and depreciable lives are adjusted. The impairment evaluation is based on the estimated cash flows from continuing use through the expected disposal date and the expected terminal value.

Store closure costs include costs of disposing of the assets as well as other facility-related expenses from previously closed stores. These store closure costs are expensed as incurred. Additionally, at the date the closure occurs, the Company records a liability for the amount of any remaining operating lease obligations subsequent to the expected closure date, net of estimated sublease income, if any.

During the quarter ended September 26, 2004, the Company committed to a plan to close and sell four underperforming restaurants. The Company has determined that the plan of sale criteria in SFAS No. 144 has been met. Accordingly, the carrying value of these properties is separately presented as Assets Held For Sale in the accompanying condensed consolidated balance sheets as of September 26, 2004 and December 28, 2003. The carrying value of these properties was not adjusted since the carrying value for each property is less than the estimated fair market value less costs to sell.

SFAS No. 144 also requires the results of operations of a component entity that is classified as held for sale or that has been disposed of to be reported as discontinued operations in the statement of operations if certain conditions are met. These conditions include commitment to a plan of disposal after the effective date of this statement, elimination of the operations and cash flows of the component entity from the ongoing operations of the company and no significant continuing involvement in the operations of the component entity after the disposal transaction. The results of operations, and any related gain or loss, of stores meeting all of these conditions that were disposed of in 2004 or classified as held for sale at September 26, 2004 were not material for the quarters or nine months ended September 26, 2004 and September 28, 2003.

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.

During the nine months ended September 26, 2004, the Company determined that the carrying value of a vacant restaurant land parcel and the carrying value of one restaurant property exceeded their estimated fair market values less cost to sell. The carrying values were reduced by an aggregate of $91,000. During the nine months ended September 28, 2003, the Company determined that the carrying value of one land parcel exceeded its estimated fair market value less cost to sell. The carrying value was reduced by $26,000.

Other Assets

Other assets included notes receivable of $4,554,000 and $4,638,000, which were net of allowances for doubtful accounts totaling $263,000 and $313,000, as of September 26, 2004 and December 28, 2003, respectively. Also included in other assets as of September 26, 2004 and December 28, 2003 were payments made to fronting insurance carriers of $1,402,000 and $1,211,000, respectively, to establish loss escrow funds.

Other Accrued Expenses-

Other accrued expenses consisted of the following at September 26, 2004 and December 28, 2003 (in thousands):

	September 26, 2004	December 28, 2003
Accrued advertising	$ 3,443	$ 1,554
Accrued rent	3,155	2,416
Accrued meals and other taxes	2,451	2,947
Gift cards outstanding	1,882	3,975
Accrued construction costs	918	2,331
Unearned revenues	881	894
Accrued bonus	807	2,853
All other	1,721	2,085
Total	$ 15,258	$ 19,055

Income Taxes -

The Company accounts for income taxes in accordance with SFAS No. 109, Accounting for Income Taxes, which requires recognition of deferred tax assets and liabilities for the expected future tax consequences of events that have been included in the financial statements or tax returns. A valuation allowance is recorded for deferred tax assets whose realization is not likely. The Company records income taxes based on the effective rate expected for the year with any changes in the valuation allowance reflected in the period of change. As of September 26, 2004 and December 28, 2003, a valuation allowance of $10,130,000 existed related to state NOL carryforwards due to restrictions on the usage of state NOL carryforwards and short carryforward periods for certain states. Taxable income by state for future periods is difficult to estimate. The amount and timing of any future taxable income may affect the usage of such carryforwards, which could result in a material change in the valuation allowance.

Derivative Instruments and Hedging Agreements

The Company enters into commodity option contracts from time to time to manage dairy cost pressures. The Company s commodity option contracts do not meet hedge accounting criteria as defined by SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities, and, accordingly, are marked to market each period, with the resulting gains or losses recognized in cost of sales. There were no gains or losses recognized during the quarters ended September 26, 2004 and September 28, 2003. For the nine months ended September 26, 2004, gains of approximately $523,000 were included in cost of sales related to these option contracts as compared to losses of approximately $290,000 for the nine months ended September 28, 2003.

Marketable Securities -

The Company accounts for marketable securities in accordance with SFAS No. 115, Accounting for Certain Investments in Debt and Equity Securities. At September 26, 2004, the Company s investments in marketable securities were classified as available-for-sale, and as a result, were reported at fair value. Unrealized gains and losses are reported as a component of accumulated other comprehensive loss in stockholders deficit. The Company follows its investment managers methods of determining the cost basis in computing realized gains and losses on the sale of its available-for-sale securities, which is the average cost method. Realized gains and losses are included in other expenses, principally debt retirement costs in the accompanying condensed consolidated statements of operations.

Lease Guarantees and Contingencies

Primarily as a result of the Company s refranchising efforts, the Company remains liable for certain lease assignments and guarantees. These leases have varying terms, the latest of which expires in 2020. As of September 26, 2004, the potential amount of undiscounted payments the Company could be required to make in the event of non-payment by the primary lessees was $8,140,000. The present value of these potential payments discounted at the Company s pre-tax cost of debt at September 26, 2004 was $5,904,000. The Company generally has cross-default provisions with franchisees that would put them in default of their franchise agreement in the event of non-payment under the lease. The Company believes these cross-default provisions significantly reduce the risk that the Company will be required to make payments under these leases and, historically, the Company has not been required to make such payments. Additionally, as of September 26, 2004, the Company has no reason to believe that the franchisees will be unable to fulfill their obligations. Accordingly, no liability has been recorded for exposure under such leases at September 26, 2004 and December 28, 2003.

(Loss) Earnings Per Share

Basic (loss) earnings per share is calculated by dividing net (loss) income by the weighted average number of common shares outstanding during the period. Diluted (loss) earnings per share is calculated by dividing net (loss) income by the weighted average number of shares of common stock and common stock equivalents outstanding during the period. Common stock equivalents are dilutive stock options and warrants that are assumed exercised for calculation purposes. The number of common stock options which could dilute basic earnings per share in the future, that were not included in the computation of diluted earnings per share because to do so would have been antidilutive, was 133,989 and 158,236 for the three months ended September 26, 2004 and September 28, 2003, respectively. 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 (loss) earnings per share because to do so would have been antidilutive, was 271,404 and 195,626 for the nine months ended September 26, 2004 and September 28, 2003, respectively.

Presented below is the reconciliation between basic and diluted weighted average shares for the three and nine months ended September 26, 2004 and September 28, 2003 (in thousands):

	For the Three Months Ended			
	Basic		Diluted	
	September 26, 2004	September 28, 2003	September 26, 2004	September 28, 2003
Weighted average number of common shares outstanding during the period	7,695	7,452	7,695	7,452
Adjustments:				
Assumed exercise of stock options			174	154
Weighted average number of shares outstanding	7,695	7,452	7,869	7,606

	For the Nine Months Ended			
	Basic		Diluted	
	September 26, 2004	September 28, 2003	September 26, 2004	September 28, 2003
Weighted average number of common shares outstanding during the period	7,611	7,436	7,611	7,436
Adjustments:				
Assumed exercise of stock options				141
Weighted average number of shares outstanding	7,611	7,436	7,611	7,577

Stock-Based Compensation

The Company accounts for stock-based compensation for employees under Accounting Principles Board (APB) Opinion No. 25, Accounting for Stock Issued to Employees, and elected the disclosure-only alternative under SFAS No. 123, Accounting for Stock-Based Compensation. Stock-based compensation cost of approximately $222,000 related to modified option awards was included in net loss for the nine months ended September 26, 2004 for the Company s Stock Option Plan and the Company s 2003 Incentive Plan. No stock-based compensation cost was included in net income for the nine months ended September 28, 2003 for the Company s Stock Option Plan or the Company s 2003 Incentive Plan, as all options granted during this period had an exercise price equal to the market value of the stock on the date of grant.

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

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

	For the Three Months Ended September 26, 2004	For the Three Months Ended September 28, 2003	For the Nine Months Ended September 26, 2004	For the Nine Months Ended September 28, 2003
Net income (loss) as reported	$ 3,603	$ 5,315	$ (2,828)	$ 6,916
Add stock-based compensation expense included in reported net loss, net of related income tax benefit			131	
Less stock-based compensation expense determined under fair value method for all stock options, net of related income tax benefit	(103)	(97)	(315)	(273)
Pro forma net income (loss)	$ 3,500	$ 5,218	$ (3,012)	$ 6,643
Basic net income (loss) per share, as reported	$ 0.47	$ 0.71	$ (0.37)	$ 0.93
Basic net income (loss) per share, pro forma	$ 0.45	$ 0.64	$ (0.39)	$ 0.85
Diluted net income (loss) per share, as reported	$ 0.46	$ 0.70	$ (0.37)	$ 0.91
Diluted net income (loss) per share, pro forma	$ 0.44	$ 0.63	$ (0.39)	$ 0.83

Reclassifications

Certain prior year amounts have been reclassified to conform with current year presentation, including $771,000 and $2,328,000 from operating expenses to general and administrative expenses for the three and nine months ended September 28, 2003, respectively.

Recently Issued Accounting Pronouncements

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

Actuarial equivalence will be determined under regulations issued by the Centers for Medicare & Medicaid Services (CMS). Based on proposed CMS regulations issued to date, the Company is unable to conclude whether benefits provided are at least

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

In January 2003, the FASB issued Interpretation No. 46, Consolidation of Variable Interest Entities, an Interpretation of Accounting Research Bulletin (ARB) No. 51 (FIN 46). FIN 46 requires certain variable interest entities to be consolidated by the primary beneficiary of the entity if the equity investors in the entity do not have the characteristics of a controlling financial interest or do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support from other parties. FIN 46 is effective for all entities subject to this interpretation no later than the end of the first period that ends after March 15, 2004. The adoption of FIN 46 in 2003 had no material impact on the Company s results of operations or financial position.

2. DEBT

Debt at September 26, 2004 and December 28, 2003 consisted of the following (in thousands):

		September 26, 2004		December 28, 2003
New Senior Notes, 8 3/8%, due June 15, 2012	$	175,000	$	
Senior Notes, 10 1/2%, originally due December 1, 2007				175,977
Revolving credit loans, due June 30, 2007				
Mortgage loans, due October 1, 2004 through January 1, 2022		52,259		53,087
Total debt		227,259		229,064
Less: current portion		(1,225)		(1,127)
Total long-term debt	$	226,034	$	227,937

In November 1997, FICC entered into a credit facility that included revolving credit loans, term loans and letters of credit (the Old Credit Facility). Also in November 1997, FICC completed a public offering of $200,000,000 of senior notes (the Senior Notes).

In December 2001, the Company completed a financial restructuring plan (the Refinancing Plan) which included the repayment of the $64,545,000 outstanding under the Old Credit Facility and the purchase of $21,273,000 in Senior Notes with the proceeds from $55,000,000 in long-term mortgage financing (the Mortgage Financing) and a $33,700,000 sale and leaseback transaction (the Sale/Leaseback Financing). In addition, FICC secured a new $30,000,000 revolving credit facility (the New Credit Facility) of which up to $20,000,000 is available to support letters of credit. On July 3, 2003, FICC obtained a limited waiver to the New Credit Facility allowing the purchase of certain of the Senior Notes in an amount up to $3,000,000, subject to certain conditions. In July 2003, FICC purchased $2,750,000 in aggregate principal amount of the Senior Notes for $2,826,000, the then current market value.

In February 2004, the Company announced a cash tender offer and consent solicitation for the $175,977,000 of Senior Notes to be financed with the proceeds from a private offering of new senior notes (the New Senior Notes), available cash and an amended New Credit Facility (the 2004 Refinancing). In March 2004, $127,357,000 of aggregate principal amount of Senior Notes were purchased at the tender offer and consent solicitation price of 104% of the principal amount and $476,000 of aggregate principal amount of Senior Notes were purchased at the tender offer price of 102% of the principal amount. In April 2004, the remaining $48,144,000 of Senior Notes were redeemed in accordance with the Senior Notes indenture at 103.5% of the principal amount. The Senior Notes would have matured on December 1, 2007. Interest on the Senior Notes was payable at 10.5% per annum semi-annually on June 1 and December 1 of each year. In connection with the tender offer, the Company wrote off unamortized deferred financing costs of $2,445,000 and paid a premium of $6,790,000 that was included in the accompanying condensed consolidated statement of operations for the nine months ended September 26, 2004.

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

In connection with the 2004 Refinancing, the New Credit Facility was amended in March 2004. The total commitment amount was increased from $30,000,000 to $35,000,000 and the maturity date was extended from December 17, 2005 to June 30, 2007, in addition to other changes.

The New Credit Facility is secured by substantially all of the assets of FICC and two of its six subsidiaries, Friendly s Restaurants Franchise, Inc. and Friendly s International Inc. These two subsidiaries also guarantee FICC s obligations under the New Credit Facility.

The New Credit Facility includes certain restrictive covenants including limitations on indebtedness, restricted payments such as dividends and stock repurchases and sales of assets and of subsidiary stock. Additionally, the New Credit Facility limits the amount which the Company may spend on capital expenditures, restricts the use of proceeds, as defined, from asset sales and requires the Company to comply with certain financial covenants. On July 23, 2004, the Company successfully obtained a limited waiver regarding a quarterly EBITDA covenant of its New Credit Facility as of the June 27, 2004 measurement date.

On October 19, 2004, the Company successfully obtained a limited waiver regarding certain quarterly financial covenants of its New Credit Facility, which the Company was not in full compliance with at September 26, 2004. At this time, the Company believes that it again will not be in compliance with these financial covenants as of January 2, 2005. Based on ongoing discussions with its lenders, its projected limited use of the revolver portion of the facility and its projected liquidity related to the fourth quarter and beyond, the Company believes a covenant waiver, amendment to the existing facility or new credit facility will be secured. In the event that the Company is not able to remedy such covenant violations at January 2, 2005, a technical default could be triggered with the Company's New Senior Notes, which would require a waiver or an amendment of that facility in order to maintain the current payment schedule of those notes.

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

The $35,000,000 revolving credit commitment less outstanding letters of credit is available for borrowing to provide working capital and for other corporate needs. As of September 26, 2004 and December 28, 2003, total letters of credit outstanding were $14,474,000 and $13,550,000, respectively. During the nine months ended September 26, 2004 and September 28, 2003, there were no drawings against the letters of credit.

The revolving credit loans bear interest at the Company s option at either (a) the Base Rate plus the applicable margin in effect from time to time (the Base Rate) (7.25% at September 26, 2004) or (b) the Eurodollar rate plus the applicable margin in effect from time to time (the Eurodollar Rate) (6.27% at September 26, 2004). As of September 26, 2004 and December 28, 2003, there were no revolving credit loans outstanding and $20,526,000 and $16,450,000, respectively, was available for borrowing.

In connection with the Mortgage Financing in December 2001, three new limited liability companies (LLCs) were organized. Friendly Ice Cream Corporation is the sole member of each LLC. FICC sold 75 of its operating Friendly s restaurants to the LLCs in exchange for the proceeds from the Mortgage Financing. Promissory notes were issued for each of the 75 properties. Each LLC is a separate entity with separate creditors who will be entitled to be satisfied out of such LLC s assets. Each LLC is a borrower under the Mortgage Financing.

The Mortgage Financing has a maturity date of January 1, 2022 and is amortized over 20 years. Interest on $10,000,000 of the original $55,000,000 from the Mortgage Financing is variable and is the sum of the 30-day LIBOR rate in effect (1.84% at September 26, 2004) plus 6% on an annual basis. Changes in the interest rate are calculated monthly and recognized annually when the monthly payment amount is adjusted. Changes in the monthly payment amounts owed due to interest rate changes are reflected in the principal balances, which are re-amortized over the remaining life of the mortgages. The remaining $45,000,000 of the original $55,000,000 from the Mortgage Financing bears interest at a fixed annual rate of 10.16%. Each promissory note may be prepaid in full. The variable rate notes are subject to prepayment penalties during the first five years. The fixed rate notes may not be prepaid without the Company providing the note holders with a yield maintenance premium.

The Mortgage Financing requires the Company to maintain a fixed charge coverage ratio, as defined, of at least 1.10 to 1 and each LLC to maintain a fixed charge coverage ratio, as defined, on an aggregate restaurant basis of at least 1.25 to 1, in each case calculated as of the last day of each fiscal year. The Company is in compliance with these covenants.

3. INTANGIBLE ASSETS AND DEFERRED COSTS

Intangible assets and deferred costs as of September 26, 2004 and December 28, 2003 were (in thousands):

	September 26, 2004	December 28, 2003
1988 Non-Friendly Marks amortized over 40 years on a straight-line basis	$ 18,650	$ 18,650
Deferred financing costs amortized over the terms of the related loans on an effective yield basis	10,121	10,486
Other	1,083	876
Intangible assets and deferred costs	29,854	30,012
Less: accumulated amortization	(8,926)	(12,122)
Net	$ 20,928	$ 17,890

In connection with the 2004 Refinancing, the Company wrote off unamortized deferred financing costs related to the tender offer for the Senior Notes in March 2004 and the redemption of the remaining Senior Notes in April 2004 of $1,788,000 and $657,000, respectively. The $2,445,000 was included in other expenses, principally debt retirement costs in the accompanying condensed consolidated statement of operations for the nine months ended September 26, 2004. Additionally, the Company incurred $6,550,000 of costs associated with the issuance of the New Senior Notes and the amendment to the New Credit Facility, which were included in intangible assets and deferred costs in the accompanying condensed consolidated balance sheet as of September 26, 2004. These costs will be amortized over the terms of the New Senior Notes and the amended New Credit Facility.

Amortization expense was $451,000 and $426,000 for the three months ended September 26, 2004 and September 28, 2003, respectively. Amortization expense was $1,349,000 and $1,282,000 for the nine months ended September 26, 2004 and September 28, 2003, respectively.

Future amortization expense related to these intangible assets and deferred costs as of September 26, 2004 was (in thousands):

Year		Amount
2004	$	473
2005		1,804
2006		1,798
2007		1,628
2008		1,462
Thereafter		13,763
Total	$	20,928

4. WRITE-DOWNS OF PROPERTY AND EQUIPMENT AND PROPERTY HELD FOR SALE

During the quarter ended September 26, 2004, the Company committed to a plan to close and sell four underperforming restaurants. The Company has determined that the plan of sale criteria in SFAS No. 144 has been met. Accordingly, the carrying value of these properties is separately presented as Assets Held For Sale in the accompanying condensed consolidated balance sheets as of September 26, 2004 and December 28, 2003. The carrying value of these properties was not adjusted since the carrying value for each property is less than the estimated fair market value less costs to sell.

SFAS No. 144 also requires the results of operations of a component entity that is classified as held for sale or that has been disposed of to be reported as discontinued operations in the statement of operations if certain conditions are met. These conditions include commitment to a plan of disposal after the effective date of this statement, elimination of the operations and cash flows of the component entity from the ongoing operations of the company and no significant continuing involvement in the operations of the component entity after the disposal transaction. The Company adopted SFAS No. 144 on December 31, 2001. The results of operations and any related gain or loss associated with all closings or properties held for sale since the adoption of SFAS No. 144 were immaterial. In addition, with the Company s high market penetration in New England, the closing of these restaurants benefited other Company-operated restaurants. Therefore, the results of operations and any related gain or loss have been included in income from operations in the Company s financial statements for the three and nine-month periods ended September 26, 2004 and September 28, 2003.

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

	For the Three Months Ended		For the Nine Months Ended	
	September 26, 2004	September 28, 2003	September 26, 2004	September 28, 2003
Restaurant assets retired due to remodeling	$ 22	$ 47	$ 195	$ 945
Restaurant equipment assets retired due to replacement	131	103	290	302
Loss on property held for disposition		148		289
Loss on property not held for disposition			63	
All other		(207)	113	(37)
Loss on disposals of other property property and equipment, net	$ 153	$ 91	$ 661	$ 1,499

During the nine months ended September 26, 2004, the Company determined that the carrying value of a vacant restaurant land parcel and the carrying value of one restaurant property exceeded their estimated fair values less cost to sell. The carrying values were reduced by an aggregate of $91,000. During the nine months ended September 28, 2003, the Company determined that the carrying value of one land parcel exceeded its estimated fair value less cost to sell. The carrying value was reduced by $26,000.

5. EMPLOYEE BENEFIT PLANS

The components of net periodic pension benefit for the three and nine months ended September 26, 2004 and September 28, 2003 were (in thousands):

	For the Three Months Ended		For the Nine Months Ended	
	September 26, 2004	September 28, 2003	September 26, 2004	September 28, 2003
Service cost	$	$ 553	$	$ 1,658
Interest cost	1,651	1,606	4,953	4,818
Expected return on assets	(2,348)	(2,274)	(7,043)	(6,823)
Net amortization:				
Unrecognized prior service benefit		(319)		(959)
Unrecognized net actuarial loss	168	153	503	455
Net periodic pension benefit	$ (529)	$ (281)	$ (1,587)	$ (851)

The Company provides health care and life insurance benefits to certain groups of employees upon retirement. The components of the net postretirement benefit cost for the three and nine months ended September 26, 2004 and September 28, 2003 were (in thousands):

	For the Three Months Ended		For the Nine Months Ended	
	September 26, 2004	September 28, 2003	September 26, 2004	September 28, 2003
Service cost	$ 28	$ 25	$ 84	$ 74
Interest cost	116	117	348	352
Recognized actuarial loss	23	16	68	47
Net amortization of unrecognized prior service benefit	(35)	(36)	(106)	(107)
Net postretirement benefit cost	$ 132	$ 122	$ 394	$ 366

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

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

6. SEGMENT REPORTING

Operating segments are components of an enterprise about which separate financial information is available that is evaluated regularly by the chief operating decision-maker, or decision-making group, in deciding how to allocate resources and in assessing performance. The Company s chief operating decision-maker is the Chief Executive Officer and President of the Company. The Company s operating segments include restaurant, foodservice and franchise. The revenues from these segments include both sales to unaffiliated customers and intersegment sales, which generally are accounted for on a basis consistent with sales to unaffiliated customers. Intersegment sales and other intersegment transactions have been eliminated in the accompanying condensed 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 frozen dessert products and distributes such manufactured products and purchased finished goods to the Company s restaurants and franchised operations. Additionally, it sells frozen dessert products to distributors and retail and institutional locations. The Company s franchise segment includes a royalty based on franchise restaurant revenue. In addition, the Company receives rental income from various franchised restaurants. The Company does not allocate general and administrative expenses associated with its headquarters operations to any business segment. These costs include expenses of the following functions: legal, accounting, personnel not directly related to a segment, information systems and other headquarters activities.

The accounting policies of the operating segments are the same as those described in the summary of significant accounting policies except that the financial results for the foodservice operating segment, prior to 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 for the purpose of assisting in making internal operating decisions. Using this approach, the Company evaluates performance based on stand-alone operating segment income (loss) before income taxes and generally accounts for intersegment sales and transfers as if the sales or transfers were to third parties, that is, at current market prices.

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

	For the Three Months Ended		For the Nine Months Ended	
	September 26, 2004	September 28, 2003	September 26, 2004	September 28, 2003
	(in thousands)		(in thousands)	
Revenues:				
Restaurant	$ 120,436	$ 127,605	$ 339,230	$ 353,775
Foodservice	65,088	66,352	182,364	183,311
Franchise	3,509	2,571	9,822	7,536
Total	$ 189,033	$ 196,528	$ 531,416	$ 544,622
Intersegment revenues:				
Restaurant	$	$	$	$
Foodservice	(35,978)	(36,178)	(100,091)	(99,934)
Franchise				
Total	$ (35,978)	$ (36,178)	$ (100,091)	$ (99,934)
External revenues:				
Restaurant	$ 120,436	$ 127,605	$ 339,230	$ 353,775
Foodservice	29,110	30,174	82,273	83,377
Franchise	3,509	2,571	9,822	7,536
Total	$ 153,055	$ 160,350	$ 431,325	$ 444,688

	For the Three Months Ended		For the Nine Months Ended	
	September 26, 2004	September 28, 2003	September 26, 2004	September 28, 2003
	(in thousands)		(in thousands)	
EBITDA:				
Restaurant	$ 11,932	$ 17,308	$ 32,688	$ 41,791
Foodservice	3,323	5,573	9,726	14,020
Franchise	2,506	1,769	6,909	5,332
Corporate	(4,084)	(5,539)	(14,211)	(15,019)
Gain (loss) on property and equipment, net	5	(264)	300	(1,487)
Restructuring expenses			(2,627)	
Gain on litigation settlement			3,644	
Less pension benefit included in reporting segments	(529)	(281)	(1,587)	(851)
Total	$ 13,153	$ 18,566	$ 34,842	$ 43,786
Interest expense, net-Corporate	$ 5,235	$ 6,048	$ 16,667	$ 18,242
Other expenses, principally debt retirement costs	$	$	$ 9,235	$
Depreciation and amortization:				
Restaurant	$ 3,723	$ 3,648	$ 11,417	$ 11,412
Foodservice	818	770	2,514	2,253
Franchise	67	39	183	116
Corporate	799	934	2,469	2,983
Total	$ 5,407	$ 5,391	$ 16,583	$ 16,764
Other non-cash (income) expense:				
Net periodic pension benefit	$ (529)	$ (281)	$ (1,587)	$ (851)
Write-downs of property and equipment		26	91	26
Total	$ (529)	$ (255)	$ (1,496)	$ (825)