FRIENDLY ICE CREAM CORP
Form 10-K/A
March 12, 2007

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K/A

(Amendment No. 1)

x 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

Commission File No. 001-13579

FRIENDLY ICE CREAM CORPORATION

(Exact Name of Registrant as Specified in Its Charter)

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

(413) 731-4000

(Registrant s Telephone Number, Including Area Code)

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

Title of class

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

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

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 o No x

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 x No o

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. o

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

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

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

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

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.

Introductory Note:

This Amendment No. 1 to Form 10-K for the year ended December 31, 2006 (Form 10-K/A) has been filed by Friendly Ice Cream Corporation (the Company) solely to amend Item 8, Financial Statements and Supplementary Data, to correct typographical errors in the Consolidated Statement of Cash Flows included on page F-6 of the Company s Annual Report on Form 10-K filed on March 6, 2007. The amounts reported in the line item Contribution to defined benefit pension plan for each of the years ended January 1, 2006 and January 2, 2005 should have been zero, but inadvertently duplicated the amounts reported in the immediately preceding line item under the Accrued expenses and other long-term liabilities for the same periods. This inadvertent duplication also impacted the amounts reported for net cash provided by operating activities, net increase (decrease) in cash and cash equivalents, and cash and cash equivalents, end of year, for the years ended January 1, 2006 and January 2, 2005. The Consolidated Statement of Cash Flows has been revised in this Form 10-K/A to reflect that (1) contribution to defined benefit pension plan was $0 for both years ended January 1, 2006 and January 2, 2005, and not $2,422 and $3,253, respectively, (2) net cash provided by operating activities for the years ended January 1, 2006 and January 2, 2005 was $13,995 and $6,609, respectively, and not $11,573 and $3,356, respectively,(3) net increase (decrease) in cash and cash equivalents for the years ended January 1, 2006 and January 2, 2005 was $1,192 and ($12,226), respectively, and not ($1,230) and ($15,479), respectively, and (4) cash and cash equivalents, end of year for the years ended January 1, 2006 and January 2, 2005 was $14,597 and $13,405, respectively, and not $12,175 and $10,152, respectively. This Form 10-K/A does not amend, modify or update any other information.

SIGNATURES

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

	Friendly Ice Cream Corporation
By:	/s/ PAUL V. HOAGLAND
	Name: Paul V. Hoagland
	Title: Executive Vice President of Administration and Chief Financial Officer
Date:	March 12, 2007

FRIENDLY ICE CREAM CORPORATION AND SUBSIDIARIES
INDEX TO CONSOLIDATED FINANCIAL STATEMENTS

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

FRIENDLY ICE CREAM CORPORATION AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

(In thousands, except share and per share data)

	December 31, 2006	January 1, 2006
ASSETS		
CURRENT ASSETS:		
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
TOTAL CURRENT ASSETS	58,111	49,655
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
TOTAL ASSETS	$ 220,167	$ 218,242
LIABILITIES AND STOCKHOLDERS DEFICIT		
CURRENT LIABILITIES:		
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
TOTAL CURRENT LIABILITIES	68,691	66,289
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		
STOCKHOLDERS DEFICIT:		
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)
TOTAL STOCKHOLDERS DEFICIT.	(126,896)	(141,838)
TOTAL LIABILITIES AND STOCKHOLDERS DEFICIT.	$ 220,167	$ 218,242

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

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FRIENDLY ICE CREAM CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF OPERATIONS

(In thousands, except per share data)

	For the Years Ended December 31, 2006	January 1, 2006	January 2, 2005 (53 weeks)
REVENUES:			
Restaurant	$ 395,999	$ 400,821	$ 431,763
Foodservice	120,055	116,072	112,637
Franchise	15,401	14,454	13,199
TOTAL REVENUES	531,455	531,347	557,599
COSTS AND EXPENSES:			
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
OPERATING INCOME	21,559	13,202	21,521
OTHER EXPENSES (INCOME):			
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
INCOME (LOSS) BEFORE BENEFIT FROM PROVISION FOR INCOME TAXES	1,402	(7,592)	(10,009)
Benefit from (provision for)income taxes	83	(20,002)	7,145
INCOME (LOSS) FROM CONTINUING OPERATIONS	1,485	(27,594)	(2,864)
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)
NET INCOME (LOSS)	$ 4,946	$ (27,259)	$ (3,417)
BASIC NET INCOME (LOSS) PER SHARE:			
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)
DILUTED NET INCOME (LOSS) PER SHARE:			
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)
WEIGHTED AVERAGE SHARES:			
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.

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FRIENDLY ICE CREAM CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS DEFICIT

(In thousands, except share data)

	Common Stock Shares	Amount	Additional Paid-In Capital	Accumulated Other Comprehensive (Loss) Income	Accumulated 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.

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FRIENDLY ICE CREAM CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

	For the Years Ended December 31, 2006	January 1, 2006	January 2, 2005 (53 weeks)
CASH FLOWS FROM OPERATING ACTIVITIES:			
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)		
NET CASH PROVIDED BY OPERATING ACTIVITIES	21,707	13,995	6,609
CASH FLOWS FROM INVESTING ACTIVITIES:			
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
NET CASH USED IN INVESTING ACTIVITIES	(8,310)	(7,679)	(14,677)
CASH FLOWS FROM FINANCING ACTIVITIES:			
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
NET CASH USED IN FINANCING ACTIVITIES	(2,917)	(5,124)	(4,158)
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	10,480	1,192	(12,226)
CASH AND CASH EQUIVALENTS, BEGINNING OF YEAR.	14,597	13,405	25,631
CASH AND CASH EQUIVALENTS, END OF YEAR.	$ 25,077	$ 14,597	$ 13,405
SUPPLEMENTAL DISCLOSURES:			
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:

	For the Years Ended		
	December 31, 2006	January 1, 2006	January 2, 2005
Company Units:			
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
Franchised Units:			
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

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, 2006	January 1, 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):

	December 31, 2006	January 1, 2006
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, 2006	**January 1, 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
Total	$ 22,475	$ 19,866

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):

	For the Years Ended		
	December 31, 2006	**January 1, 2006**	**January 2, 2005**
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.

	For the Years Ended	
	January 1, 2006	January 2, 2005
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 Outstanding	Weighted-Average Remaining Contractual Life in Years	Weighted-Average Exercise Price	Aggregate Intrinsic 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 Outstanding	Weighted-Average Grant Date 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:

Name	Value of Award		
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.

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

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, 2006	January 1, 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):

	For the Years Ended		
	December 31, 2006	**January 1, 2006**	**January 2, 2005 (53 weeks)**
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):

	For the Years Ended		
	December 31, 2006	**January 1, 2006**	**January 2, 2005**
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.

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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, 2006	January 1, 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):

	December 31, 2006 Requirement	Actual	January 1, 2006 Requirement	Actual
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 Carrying Amount	Fair Value	January 1, 2006 Carrying Amount	Fair 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, 2006	January 1, 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):

	Commitments		
Year	**Operating Leases**	**Capital Lease and Finance Obligations**	**Operating Lease 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):

	For the Years Ended December 31, 2006	January 1, 2006	January 2, 2005
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):

	For the Years Ended December 31, 2006	January 1, 2006	January 2, 2005
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):

	For the Years Ended December 31, 2006	January 1, 2006	January 2, 2005
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):

	December 31, 2006	January 1, 2006
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 carryforwrds 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 January 1, 2006	Expense	Costs Paid and Reclassified	Restructuring Reserve as of December 31, 2006
Severance pay	$ 72	$	$ (72)	$
Total	$ 72	$	$ (72)	$

	For the Year Ended January 1, 2006			
	Restructuring Reserve as of January 2, 2005	Expense	Costs Paid and Reclassified	Restructuring Reserve as of January 1, 2006
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
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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):

	December 31, 2006	January 1, 2006
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):

	December 31, 2006	January 1, 2006
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):

	December 31, 2006	January 1, 2006
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)