FURRS RESTAURANT GROUP INC
Form 10-Q
August 21, 2002

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

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

For the quarterly period ended July 2, 2002

OR

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

COMMISSION FILE NO. 1-10725

FURR'S RESTAURANT GROUP, INC.

INCORPORATED IN DELAWARE   IRS EMPLOYER IDENTIFICATION NO. 75-2350724

3001 E. PRESIDENT GEORGE BUSH HWY., SUITE 200, RICHARDSON, TEXAS 75082

REGISTRANT'S TELEPHONE NUMBER, INCLUDING AREA CODE: (972) 808-2923

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Sections 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

YES X NO __

As of August 1, 2002 there were 9,767,926 shares of Common Stock outstanding.

1

FURR'S RESTAURANT GROUP, INC.

INDEX

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

FURR'S RESTAURANT GROUP, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS
JULY 2, 2002 AND JANUARY 1, 2002
(Dollars in Thousands, Except Par Value Amounts)

	(Unaudited) July 2, 2002
ASSETS	

CURRENT ASSETS:	
Cash and cash equivalents	$ -
Accounts and notes receivable (net of allowance for doubtful accounts of $101 and $108, respectively)	1,893
Inventories	7,664
Prepaid expenses and other	1,697
Total current assets	11,254
PROPERTY, PLANT AND EQUIPMENT, NET	41,386
DEFERRED TAX ASSET	-
DEFERRED LOAN COSTS	2,243
OTHER ASSETS	678
TOTAL ASSETS	$ 55,561

(Continued)

FURR'S RESTAURANT GROUP, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS
JULY 2, 2002 AND JANUARY 1, 2002
(Dollars in Thousands, Except Par Value Amounts)

	(Unaudited) July 2, 2002
LIABILITIES AND STOCKHOLDERS' EQUITY (DEFICIT)	
CURRENT LIABILITIES:	
Current maturities of long-term debt	$ 6,375
Trade accounts payable	8,656

Other payables and accrued expenses	14,185
Derivative liability, current	425
Reserve for store closings, current	367
Long-term debt classified as current (Note 4)	35,550
Total current liabilities	65,558
RESERVE FOR STORE CLOSINGS, NET OF CURRENT PORTION	1,667
LONG-TERM DEBT, NET OF CURRENT MATURITIES	-
OTHER PAYABLES	9,318
DERIVATIVE LIABILITY, NET OF CURRENT PORTION	-
EXCESS OF FUTURE LEASE PAYMENTS OVER FAIR VALUE NET OF AMORTIZATION	857
COMMITMENTS AND CONTINGENCIES	
STOCKHOLDERS' EQUITY (DEFICIT):	
Preferred Stock, $.01 par value; 5,000,000 shares authorized, none issued	
Common Stock, $.01 par value; 15,000,000 shares authorized, 9,767,926 issued and outstanding	98
Additional paid-in capital	56,407
Accumulated other comprehensive loss	(6,335)
Accumulated deficit	(72,009)
Total stockholders' equity (deficit)	(21,839)
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY (DEFICIT)	$ 55,561

See accompanying notes to condensed consolidated financial statements.

FURR'S RESTAURANT GROUP, INC. AND SUBSIDIARIES

UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
FOR THE THIRTEEN WEEKS ENDED JULY 2, 2002 AND JULY 3, 2001
(Dollars in Thousands, Except Per Share Amounts)

	Thirteen weeks ended	
	July 2, 2002	Jul 2

Sales	$ 41,535	$ 4
Costs and expenses:		
Cost of sales (excluding depreciation)	13,821	1
Labor and related costs	15,628	1
Occupancy and other expenses	10,492	
General and administrative expenses	2,518	
Depreciation and amortization	3,293	
	45,752	4
Operating income (loss)	(4,217)	
Gain (loss) on disposal of assets	41	
Interest expense	1,002	
Earnings (loss) before income taxes and extraordinary item	(5,178)	
Income tax expense (benefit)	18,442	
Earnings (loss) before extraordinary item	(23,620)	
Extraordinary gain on retirement of debt	-	
Net income (loss)	$ (23,620)	$
Weighted average shares:		
Basic	9,767,926	9,76
Diluted	9,769,958	9,77
Earnings (loss) before extraordinary item per share:		
Basic	$ (2.42)	$
Diluted	$ (2.42)	$
Extraordinary item per share:		
Basic	-	$
Diluted	-	$
Net income (loss) per share:		
Basic	$ (2.42)	$
Diluted	$ (2.42)	$

See accompanying notes to condensed consolidated financial statements.

FURR'S RESTAURANT GROUP, INC. AND SUBSIDIARIES

UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
FOR THE TWENTY-SIX WEEKS ENDED JULY 2, 2002 AND JULY 3, 2001
(Dollars in Thousands, Except Per Share Amounts)

	Twenty-six weeks ende	
	July 2, 2002	Jul 2
Sales	$ 84,812	$ 9
Costs and expenses:		
Cost of sales (excluding depreciation)	27,114	2
Labor and related costs	31,578	3
Occupancy and other expenses	18,765	1
General and administrative expenses	4,632	
Gain on termination of closed store obligations	(338)	
Depreciation and amortization	5,515	
	87,266	9
Operating income (loss)	(2,454)	
Gain on disposal of assets	12	
Interest expense	1,969	
Earnings (loss) before income taxes and extraordinary item	(4,411)	
Income tax expense	18,710	
Earnings (loss) before extraordinary item	(23,121)	
Extraordinary gain on retirement of debt	-	
Net income (loss)	$ (23,121)	$
Weighted average shares:		
Basic	9,767,926	9,76
Diluted	9,773,253	9,76
Earnings (loss) before extraordinary item per share:		
Basic	$ (2.37)	$
Diluted	$ (2.37)	$
Extraordinary item per share:		
Basic	-	$
Diluted	-	$

Net income (loss) per share:		
Basic	$ (2.37)	$
Diluted	$ (2.37)	$

See accompanying notes to condensed consolidated financial statements.

FURR'S RESTAURANT GROUP, INC. AND SUBSIDIARIES

UNAUDITED CONSOLIDATED STATEMENT OF CHANGES IN STOCKHOLDERS' EQUITY (D
FOR THE TWENTY-SIX WEEKS ENDED JULY 2, 2002
(Dollars in Thousands)

	Preferred Stock	Common Stock	Additional Paid-In Capital	Accumulated Other Comprehensive Loss
BALANCE, JANUARY 1, 2002	$ -	$ 98	$ 56,407	$ (6,286
Change in fair value of estimated cash flows related to interest rate swap	-	-	-	(360
Reclassification of interest rate swap to earnings	-	-	-	311
Net loss	-	-	-	-
BALANCE, JULY 2, 2002	$ -	$ 98	$ 56,407	$ (6,335

See accompanying notes to condensed consolidated financial statements.

FURR'S RESTAURANT GROUP, INC. AND SUBSIDIARIES

UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(Dollars in Thousands)

	Twenty-si
	July 2, 2002
Cash flows from operating activities:	
Net income (loss)	$ (23,121)
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:	
Amortization of deferred loan cost	246
Depreciation and amortization	5,515
Deferred tax expense	18,710
Gain on termination of closed store lease obligations	(338)
Gain on disposal of assets	(12)
Extraordinary gain on debt refinancing	-
Changes in operating assets and liabilities:	
Accounts and notes receivable	(259)
Inventories	(893)
Prepaid expenses and other	(719)
Reserve for store closings	(278)
Trade accounts payable, other payables, accrued expenses and other liabilities	(51)
Net cash provided by (used in) operating activities	(1,200)
Cash flows provided by (used in) investing activities:	
Purchases of property, plant and equipment	(1,725)
Proceeds from the sale or disposal of property, plant and equipment	-
Net cash provided by (used in) investing activities	(1,725)
Cash flows provided by financing activities:	
Payment of indebtedness	(1,275)
Payment of loan costs	-
Increase in cash overdraft	-
Net borrowing on revolver	4,200

Issuance of stock	
Net cash provided by (used in) financing activities	2,925
Decrease in cash and cash equivalents	-
Cash and cash equivalents at beginning of period	-
Cash and cash equivalents at end of period	$ -
Supplemental disclosure of cash flow information:	
Cash paid for interest (including $3,364 in 2001 classified as payment of indebtedness)	$ 1,719
Cash paid for income taxes	$ -
Non-cash investing and financing activities:	
Receivable related to involuntary equipment conversion	$ -

See accompanying notes to condensed consolidated financial statements.

8

FURR'S RESTAURANT GROUP, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)
(Dollars in Thousands)

1. Basis of Presentation

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with the instructions to Form 10-Q and do not include all of the information and note disclosures required by generally accepted accounting principles. These statements should be read in conjunction with Management's Discussion and Analysis of Financial Condition and Results of Operations and the consolidated financial statements and notes thereto included in the Company's Form 10-K for the year ended January 1, 2002. In the opinion of management, the accompanying unaudited condensed consolidated financial statements include all adjustments, consisting only of normal recurring adjustments, necessary for a fair presentation.

Interim results of operations may not be indicative of the results that may be expected for a full fiscal year.

2. Earnings Per Share

The following table reconciles the denominators of basic and diluted earnings per share for the periods ended July 2, 2002 and July 3, 2001.

	Thirteen Weeks Ended		Twenty-s
	July 2, 2002	July 3, 2001	July 2, 2002
Weighted average common shares outstanding-basic	9,767,926	9,767,926	9,767,926

Options	2,032	2,140	5,327
Weighted average common shares outstanding-diluted	9,769,958	9,770,066	9,773,253

The following table sets forth the options that were not included in the computation of diluted earnings per share because their exercise price was greater than the average market price of the common shares and therefore, the effect would be anti-dilutive.

	Thirteen Weeks Ended		Twenty-s
	July 2, 2002	July 3, 2001	July 2, 2002
Options	1,469,834	758,000	1,469,834

3. Comprehensive Income

The following table sets for the components of comprehensive income for the periods ende and July 3, 2001:

	Thirteen Weeks Ended		Twenty-s
	July 2, 2002	July 3, 2001	July 2, 2002
Net income (loss)	$ (23,620)	$ 3,924	$ (23,121)
Fair value of interest rate swap, net of tax in 2001	(176)	(217)	(49)
	$ (23,796)	$ 3,707	$ (23,170)

4. Income Taxes

The Company provided income tax expense (benefit) of $18,442 and ($101) for the thirteen weeks ended July 2, 2002 and July 3, 2001, respectively, and income tax expense of $18,710 and $438 for the twenty-six weeks ended on the same dates, respectively. During the thirteen weeks ended July 2, 2002, the Company s deferred tax asset was reduced by $18,442 through an increase in the valuation allowance. This action, which will not adversely affect the Company s cash flows or liquidity, was taken based on the Company s review of its recent operating results, and the Company s existing defaults under its credit agreement, which management believes create substantial uncertainty regarding the Company s ability in the near term to recover the asset by utilizing existing net operating losses available for carryforward to reduce future taxable income. Management does not believe it has sufficient information at this time to determine what portion, if any, of the tax asset might be recoverable over the longer term if the existing defaults of the Company s credit agreement are resolved and the Company s operating performance recovers to previous levels. Accordingly, a valuation allowance has been provided for the entire amount of the asset. The Company intends to review this determination on a periodic basis and, if conditions justify, may determine that it is appropriate to recognize some amount of deferred tax asset by decreasing the valuation allowance at a future date. No assurance can be given as to the timing or amount of any such action.

For the periods ended in 2001, the effective income tax rate is lower than the statutory Federal rate of 35% due to interest expense on restructured debt reduction, which is reported as debt rather than interest expense pursuant to Statement of Financial Accounting Standards No. 15, Accounting by Debtors and Creditors for Troubled Debt Restructurings (SFAS 15). There is no income tax expense associated with the extraordinary gain as this represents early disposition of the remaining restructured debt interest under SFAS 15.

5. Debt and Liquidity

On April 10, 2001, the Company entered into a $55,000 Revolving Credit and Term Loan Agreement (Credit Agreement) with various banks and lenders that allows the Company to borrow at either a Federal Funds Rate plus an applicable margin or at a Eurocurrency Reserve Rate plus an applicable margin. The Credit Agreement contains covenants with regard to maintaining certain leverage ratios, achieving certain levels of EBITDA, operating cash flow and limits on capital expenditures. In addition there are certain restrictions on the payment of dividends and incurrence of additional indebtedness.

The Credit Agreement provides that the Company can borrow up to $20,000 on a revolving basis until April, 2006, of which $9,000 was drawn at closing. As of July 2, 2002, the Company had borrowings of $11,200 on the revolver and $3,400 assigned to standby letters of credit related to the Company s workers compensation insurance policy. The remaining $5,400 would be available to be used for working capital and capital expenditures in the absence of the defaults existing under the Credit Agreement discussed below. The Credit Agreement contains a $30,000 Term Loan A and a $5,000 Term Loan B. The Term Loan A and Term Loan B provide for quarterly amortization through April, 2006 and April, 2007, respectively, with the remaining amounts outstanding then due. The Company s obligations under the Credit Agreement are secured by a security interest in and liens upon substantially all of the Company s assets.

The Company s reduced sales during the first half of 2002 contributed to the Company s operating losses and a significant reduction in its cash flow. The Company has continued to be out of compliance with the financial ratio covenants required by its Credit Agreement as of July 2, 2002, which has resulted in the lenders refusal to make further advances under the revolving portion of the Credit Agreement, requiring the Company to operate based on its available cash flow during this period. The Company has taken a number of actions to conserve and manage its cash, including withholding the principal payment of $1,300 under the Credit Agreement that was due July 2, 2002 and interest payments of $500 due subsequent to quarter end.

Because of the existing defaults, the Company s debt under the Credit Agreement is reflected as a current liability on its balance sheet. The lenders have not issued a notice of default or taken other action under the Credit Agreement in response to the payment and covenant defaults. However, the lenders have notified the Company that they are, based on the existence of these conditions, reserving their rights under the Credit Agreement to accelerate all amounts due to them and to seek to exercise the remedies upon default set forth in the Credit Agreement. These remedies include the right to foreclose upon and sell or otherwise dispose of the Company s assets which secure the Company s obligations under the Credit Agreement, any of which could significantly and negatively impact the Company s financial condition and operating results.

6. Interest Rate Risk Management

The Company uses variable-rate debt to finance its operations. In particular, it has borrowed money under a Credit Agreement providing for variable-rate interest to retire the bonds and notes that were due December 31, 2001. This debt obligation exposes the Company to variability in interest payments due to changes in interest rates. If interest rates increase, interest expense increases and conversely, if interest rates decrease, interest expense also decreases.

Management believes it is prudent to limit the variability of a portion of its interest payments. It is the Company s objective to hedge between 50 and 70 percent of its variable-rate long-term note interest payments. The Company s Credit Agreement also requires that the Company hedge at least $20,000 for a period of two years.

To meet this requirement, the Company has entered into a derivative instrument, in the form of an interest rate swap, to manage fluctuations in cash flows resulting from interest rate risk. The interest rate swap changes the variable-rate cash flow exposure to fixed-rate cash flows by entering into a receive-variable, pay-fixed interest rate swap. Under the interest rate swap, which has a notional amount of $20,000 and a two-year term, the Company receives variable interest rate payments based on LIBOR and makes fixed interest rate payments at 4.99%. The Company accounts for the interest rate swap in accordance with the provisions of Statement of Financial Accounting Standards (SFAS) No. 133, Accounting for Derivative Instruments and Hedging Activities, as amended. SFAS No. 133 requires that all derivative instruments be recorded in the balance sheet at fair value. The interest rate swap is a cash flow hedge under SFAS No. 133 and, accordingly, changes in fair value are reported in other comprehensive income and such amounts are reclassified into interest expense as a yield adjustment in the same period in which the related expense on the variable rate debt affects operations.

The Company does not enter into derivative instruments for any purpose other than cash flow hedging purposes. That is, the Company does not speculate using derivative instruments.

The Company assesses interest rate cash flow risk by identifying and monitoring changes in interest rate exposures that may adversely impact expected future cash flows and by evaluating hedging opportunities.

7. Business Segments

Following is a summary of segment information of the Company for the thirteen weeks ende
and July 3, 2001:

	Cafeterias	Dynamic Foods
2002:		
External revenues	$ 40,178	$ 1,357
Intersegment revenues	-	14,224
Depreciation and amortization	3,041	252
Segment profit (loss)	(4,409)	192
2001:		
External revenues	$ 47,134	$ 421
Intersegment revenues	-	15,351
Depreciation and amortization	2,787	261
Segment profit	1,035	328

Following is a summary of segment information of the Company for the twenty-six weeks en
and July 3, 2001:

	Cafeterias	Dynamic Foods
2002:		
External revenues	$ 82,710	$ 2,102
Intersegment revenues	-	28,411
Depreciation and amortization	5,014	501
Segment profit (loss)	(2,728)	274
2001:		
External revenues	$ 94,212	$ 830
Intersegment revenues	-	29,775
Depreciation and amortization	5,124	524
Segment profit	3,049	839

Following is a reconciliation of reportable segments to the Company's consolidated total
periods ended July 2, 2002 and July 3, 2001:

	Thirteen Weeks Ended		Twenty-si
	July 2, 2002	July 3, 2001	July 2, 2002
Revenues			
Total revenues of reportable segments	$ 55,759	$ 62,906	$113,223

Elimination of inter-segment revenue	(14,224)	(15,351)	(28,411)
Total consolidated revenues	$ 41,535	$ 47,555	$ 84,812

8. New Accounting Pronouncements

SFAS No. 144 supersedes SFAS No. 121, Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of and the accounting and reporting provisions of Accounting Principles Board Opinion No. 30 Reporting the Results of Operations-Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions. SFAS No. 144 retains the fundamental provisions of SFAS No. 121 but eliminates the requirement to allocate goodwill to long-lived assets to be tested for impairment. This statement also requires discontinued operations to be carried at the lower of cost or fair value less costs to sell and broadens the presentation of discontinued operations to include a component of an entity rather than a segment of a business. The adoption of SFAS No. 144 did not have a material impact on the Company s results of operations or financial position.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

Results of Operations

Thirteen Weeks Ended July 2, 2002 Compared to Thirteen Weeks Ended July 3, 2001:

Sales for the second fiscal quarter of 2002 were $41.5 million, a decrease of $6.0 million from the same quarter of 2001. Operating loss for the second quarter of 2002 was $4.2 million compared to $1.4 million of operating income in the comparable period in the prior year. Net loss for the second quarter of 2002 was $23.6 million, which includes $18.4 million of income tax expense, compared to net income of $3.9 million in the second quarter 2001, which includes a $3.6 million extraordinary gain on retirement of debt and ($.1) million of income tax benefit.

We believe the significant decline in sales and resulting decline in operating cash flow experienced during the first half of 2002 is attributable to a combination of factors: (i) the failure of our effort to reposition our service offering and pricing scheme beginning in April 2002 and our increased advertising expenditures in the second quarter to attract guests to our restaurants, (ii) the continuation of downward trends in customer traffic experienced by the Company and other cafeteria operators, which has been exacerbated by the age, location and condition of some of our restaurants and (iii) the effects on our guests of continuing adverse developments in the economy. In the face of declining sales, our limited ability to decrease our fixed costs, principally rent, utilities and payroll, has resulted in a substantial increase in the number of units experiencing operating losses during this period.

Sales. Comparable unit sales decreased 12% or $5.5 million from second quarter 2001. Of this decrease, $6.5 million was due to decreased guest count while $1.0 million was gained in increased ticket average. Second quarter 2001 sales included $1.5 million in sales from units that were subsequently closed during 2001. Sales by Dynamic Foods to third parties were $.9 million higher in second quarter 2002 than second quarter 2001.

Cost of sales. Excluding depreciation, cost of sales was 33.3% of sales for the second quarter of 2002 as compared to 29.4% for the same quarter of 2001. Cost of sales in the restaurants excluding cost of sales to third parties by Dynamic Foods, were 31.2% of sales for the second quarter of 2002 compared to 28.8% for the same quarter of 2001. The increase in the cost of sales percent was due to increased product costs and improvement in food quality and additional premium items offered to customers.

Labor and related costs. Labor and related costs decreased $1.3 million from second quarter 2001. $.6 million of the decrease was the result of stores that closed during 2001, and labor and related costs for comparable stores decreased by $.7 million from second quarter 2001 due to lower sales volume.

Occupancy and other expenses. Occupancy and other expenses increased $.7 million in second quarter 2002 from second quarter 2001. Of this increase, $1.4 million was due to increased marketing expense in comparable stores, offset by $.3 million of cost in stores that were closed during 2001 and $.4 million from decreased utilities cost in comparable stores.

General and administrative expenses. General and administrative expenses were comparable in second quarter 2002 and second quarter 2001.

Depreciation and amortization. Depreciation and amortization expense was higher by $.2 million in the second quarter of 2002 and includes a $.9 million write-down of impaired assets. Depreciation and amortization expense in the second quarter of 2001 included a $.6 million write-down of impaired assets.

Income Taxes. Income tax expense of $18.4 million was provided in the second quarter of 2002 compared to $.1 million of benefit provided in the second quarter of 2001. During the thirteen weeks ended July 2, 2002, our deferred tax asset was reduced by $18.4 million through an increase in the valuation allowance. This action, which will not adversely affect our cash flows or liquidity, was taken based on our review of our operating results and our existing defaults under our credit agreement, which we believe creates substantial uncertainty regarding our ability in the near term to recover the asset by utilizing existing net operating losses available for carryforward to reduce future taxable income. We do not believe we have sufficient information at this time to determine what portion, if any, of the tax asset might be recoverable over the longer term if the existing defaults of our credit agreement are resolved and our operating performance recovers to previous levels. Accordingly, the entire amount of the asset has been reduced. We intend to review this determination on a periodic basis and, if conditions justify, may determine that it is appropriate to recognize some amount of deferred tax asset by decreasing the valuation allowance at a future date. No assurance can be given as to the timing or amount of any such action. Our effective tax rate in second quarter 2001 was lower than the statutory Federal rate of 35% due to interest expense on restructured debt reduction, which is reported as debt rather than interest expense pursuant to Statement of Financial Accounting Standard No. 15, Accounting by Debtor and Creditors for Troubled Debt Restructurings.

Twenty-six Weeks Ended July 2, 2002 Compared to Twenty-Six Weeks Ended July 3, 2001:

Sales for the first half of 2002 were $84.8 million, a decrease of $10.2 million from the same period 2001. Operating loss for the first half of 2002 was $2.5 million compared to $3.9 million of operating income in the comparable period in the prior year. Net loss for the first half of 2002 was $23.1 million, which includes $18.7 million of income tax expense, compared to net income of $6.3 million in the first half of 2001, which includes a $3.6 million extraordinary gain on retirement of debt and $.4 million of income tax expense.

14

Sales. Comparable unit sales decreased 9% or $8.3 million from the first half of 2001. Of this decrease, $10.2 million was due to decreased guest count while $1.9 million was gained in increased ticket average. The first half of 2001 sales included $3.4 million in sales from units that were subsequently closed during 2001. Sales by Dynamic Foods to third parties were $1.3 million higher in the first half of 2002 than the same period of 2001.

Cost of sales. Excluding depreciation, cost of sales were 32% of sales for the first half of 2002 as compared to 28.7% for the same quarter of 2001. Cost of sales in the restaurants excluding cost for sales to third parties by Dynamic Foods, were 30.4% of sales for the first half of 2002 compared to 28.2% for the same period of 2001. The increase in the cost of sales percent was due to increased product costs and improvement in food quality and additional premium items offered to customers.

Labor and related costs. Labor and related costs decreased $2.1 million from the first half of 2001. $1.4 million of the decrease was the result of stores that closed during 2001, and labor and related costs for comparable stores decreased by $.7 million from second quarter 2001 due to lower sales volume.

Occupancy and other expenses. Occupancy and other expenses decreased $.7 million in first half of 2002 from the same period 2001. Of this decrease, $1.0 million was due to stores that closed during 2001 and $.9 million decreased utilities cost in comparable stores, offset by $.9 million of increased marketing cost and $.3 million increase in repairs and maintenance and other store expense.

General and administrative expenses. General and administrative expenses were $.4 million less in the first half of 2002 than the same period 2001.

Depreciation and amortization. Depreciation and amortization expense was lower by $.1 million in the first half of 2002 and includes a $.9 million write-down of impaired assets. Depreciation and amortization expense in the first half of 2001 included a $.6 million write-down of impaired assets.

Gain on termination of closed store obligations. In connection with its Chapter 11 bankruptcy proceeding, Kmart "rejected" leases on three of our closed units and as a result, we were relieved of our obligation on these units and recognized a $.3 million gain.

Income Taxes. Income tax expense of $18.7 million was provided in the first half of 2002 compared to $.4 million of expense provided in the same period of 2001. During the thirteen weeks ended July 2, 2002, our deferred tax asset was reduced by $18.4 million through an increase in the valuation allowance. This action, which will not adversely affect our cash flows or liquidity, was taken based on our review of our recent operating results, and our existing defaults under our credit agreement, which we believe creates substantial uncertainty regarding our ability in the near term to recover the asset by utilizing existing net operating losses available for carryforward to reduce future taxable income. We do not believe we have sufficient information at this time to determine what portion, if any, of the tax asset might be recoverable over the longer term if the existing defaults of our credit agreement are resolved and our operating performance recovers to previous levels. Accordingly, the entire amount of the asset has been reduced. We intend to review this determination on a periodic basis and, if conditions justify, may determine that it is appropriate to recognize some amount of deferred tax asset by decreasing the valuation allowance at a future date. No assurance can be given as to the timing or amount of any such action. Our effective tax rate in 2001 was lower than the statutory Federal rate of 35% due to interest expense on restructured debt reduction, which is reported as debt rather than interest expense pursuant to Statement of Financial Accounting Standard No. 15, Accounting by Debtor and Creditors for Troubled Debt Restructurings.

Liquidity and Capital Resources

During the first two quarters ended July 2, 2002, cash used in operating activities was $1.2 million compared to $6.2 million provided by operating activities in the same period of 2001. We made capital expenditures of $1.7 million during the first half of 2002 compared to $1.2 million during the same period of 2001. Due to the cash management arrangements available with our revolving credit facility, cash and temporary investments were $0 and cash overdraft (included in accounts payable) was $.4 million at July 2, 2002 compared to $0 and $.4 million at January 1, 2002 and $0 and $.5 million at July 3, 2001. Our current ratio was ..17:1 at July 2, 2002 compared to .42:1 at July 3, 2001 and .32:1 at January 1, 2002. Total assets at July 2, 2002 aggregated $55.6 million, compared to $81.1 million at July 3, 2001 and $76.6 million at January 1, 2002.

Our restaurants sales are collected immediately in cash or within several days from credit card companies. Funds available from cash sales are not needed to finance receivables and are not generally needed immediately to pay for food, supplies and certain other expenses of the restaurants. Therefore, the business and operations of the Company have not historically required proportionately large amounts of working capital, which is generally common among similar restaurant companies.

On April 10, 2001, we entered into a $55 million Revolving Credit and Term Loan Agreement (Credit Agreement) with various banks and lenders that allows us to borrow at either a Federal Funds Rate plus an applicable margin or at a Eurocurrency Reserve Rate plus an applicable margin. The Credit Agreement contains covenants with regard to maintaining certain leverage ratios, achieving certain levels of EBITDA, operating cash flow and limits on capital expenditures. In addition there are certain restrictions on the payment of dividends and incurrence of additional indebtedness. As a result of retiring the 12% Senior Secured Notes, we reported an extraordinary pre-tax gain of $3.6 million in the second quarter of fiscal 2001.

The Credit Agreement provides that we can borrow up to $20 million on a revolving basis until April, 2006, of which $9 million was drawn at closing. As of July 2, 2002, we had borrowings of $11.2 million on the revolver and $3.4 million assigned to standby letters of credit related to our workers compensation insurance policy. The remaining $5.4 million would be available to be used for working capital and capital expenditures in the absence of the defaults existing under the Credit Agreement discussed below. The Credit Agreement contains a $30 million Term Loan A and a $5 million Term Loan B. The Term Loan A and Term Loan B provide for quarterly amortization through April, 2006 and April, 2007, respectively, with the remaining amounts outstanding then due. Our obligations under the Credit Agreement are secured by a security interest in and liens upon substantially all of our assets.

Our reduced sales during the first half of 2002 contributed to our operating losses and a significant reduction in our cash flow. We have continued to be out of compliance with the financial ratio covenants required by our Credit Agreement as of July 2, 2002, which has resulted in the lenders refusal to make further advances of the revolving portion of the Credit Agreement, requiring us to operate based on our available cash flow during this period. We have taken a number of actions to conserve and manage our cash, including withholding the principal payment under the Credit Agreement that was due July 2, 2002 in the amount of $1.3 million and interest payments due subsequent to quarter end in the amount of $.5 million.

We have been in regular contact with our lenders regarding the current condition of the Company s business and existing covenant and payment defaults and we have retained a financial restructuring advisor acceptable to our lenders to evaluate the Company, assist us in addressing business issues resulting from our reduced cash flows and in providing information to our lenders. Because a resolution of the existing defaults has not been reached as of the date of this report, our debt under the Credit Agreement is reflected as a current liability on our balance sheet. The lenders have not issued a notice of default or taken other action under the Credit Agreement in response to the payment and covenant defaults other than declining to make further advances. They have notified us that they are reserving their rights under the Credit Agreement to accelerate all amounts due to them and to seek to exercise the remedies upon default set forth in the Credit Agreement, which include acceleration of the debt and the right to foreclose upon and sell collateral. While no assurance can be given as to the future actions of the lenders, we do not expect them to take any further adverse action against us under the Credit Agreement, absent any new material adverse developments affecting us, until our financial advisors have completed their review of our financial condition and plans and we have had the opportunity to discuss possible responses to that information with our lenders.

In view of these conditions, and in recognition that the third fiscal quarter has historically produced lower revenues and cash flow for us, with the assistance of our advisors, we are monitoring these conditions closely and are implementing, or continuing, a number of initiatives to increase our revenues and cash flow from operations. In addition, with our advisors, we will be working to develop business plans that will support reaching a long-term agreement with our lenders, renegotiating leases where necessary, including the remaining subleases with Kmart, and identifying other areas for cost reduction. Because of the difficulties resulting from the Company s reduced cash flow and the unavailability of revolving credit advances from its lenders, the Company s financial condition and liquidity are expected to be very sensitive to any further adverse developments in our business, including further declines in customer counts, further restrictions of credit or other adverse actions by our creditors, adverse developments in the economy that impact our customers, or an inability to realize substantial cost reductions, including rent reductions. There are potential limits to management s time and skill set to effectively address all the issues facing the Company. However, in conjunction with its advisors and Board of Directors, priorities are being established to address the Company s most pressing needs. Material negative developments in any one or a combination of these areas could require the Company to consider a Chapter 11 filing in United States Bankruptcy Court.

We operate thirty-seven (37) restaurants which were subleased from Kmart Corporation pursuant to a Master Sublease. Kmart filed a Chapter 11 bankruptcy proceeding in January, 2002 and has subsequently rejected one (1) of our ground subleases and ten (10) of our full premise subleases and announced its intent to reject the Master Sublease as to an additional twenty-two (22) properties subject to full premise subleases. We have signed new leases with the landlords on the ten (10) full premise lease properties that were rejected, and we were able to terminate our obligation to continue paying rent on three closed locations. The landlord of the rejected ground lease is claiming that the rejection of the lease by Kmart terminated our sublease. We believe the prior actions by the landlord created an acceptance of our sublease and that we will prevail in court.

We have been made aware that Kmart has entered into an agreement with the ultimate owners of the properties subject to the Master Sublease that would have the potential of permitting those parties to become the direct landlords of the Company under the terms of the Company s Master Sublease with Kmart. Upon information and belief, this agreement was entered into in the course of Kmart s bankruptcy proceedings and after Kmart had defaulted on its payment obligations to this landlord under its master lease. We are not a party to the recent agreements and negotiations between Kmart and the other parties to its master lease. We will strenuously defend our rights under the Master Sublease, and our rights under the Bankruptcy Code, and will resist any agreement that discriminates unfairly against us as compared to the treatment afforded other Kmart sublessees or that alters or extinguishes the economic benefits the Company is entitled to derive under the Master Sublease as a whole.

In order to limit our exposure to any conflicting claims regarding the proper payment of rent, we have not paid the rent due on the 22 restaurants as to which the Master Sublease has not been formally rejected that was due on July 1 and August 1, 2002 of approximately $.3 million per month. Given the uncertainties associated with these developments, we are awaiting discussions with the affected parties to establish reasonable assurance that we are paying the appropriate amounts to the proper parties.

Recent Accounting Pronouncements

The Financial Accounting Standards Board ("FASB") recently issued Statement of Financial Accounting Standards No. 146, Accounting for Costs Associated with Exit or Disposal Activities (SFAS No. 146). SFAS No. 146 requires all restructurings initiated after December 31, 2002 to be recorded when they are incurred and can be measured at fair value, with the recorded liability subsequently adjusted for changes in estimated cash flows. The Company is currently assessing the impact of SFAS No. 146 on its consolidated financial statements.

The FASB recently issued SFAS No. 145, Rescission of FASB Statements No. 4, 44, and 64, Amendment of FASB Statements No. 13, and Technical Corrections. SFAS No. 145 rescinds SFAS No. 4 and establishes new requirements for the accounting and presentation of gains and losses from Extinguishment of Debt. As a result, gains and losses should be classified as extraordinary only if they meet criteria set forth in APB 30. Applying APB 30 will distinguish transactions that are part of an entity's routine or recurring operations from those that are unusual or infrequent or that meet the criteria for classification as an extraordinary item. SFAS No. 44 was rescinded as the transitions to the Motor Carrier Act of 180 are completed. SFAS No. 64 amended SFAS No. 4 and is no longer necessary. SFAS No. 13 was amended to require sale-leaseback accounting for certain lease modifications that have economic effects that are similar to sale-leaseback transactions. SFAS No. 145 is effective for transactions occurring after May 15, 2002, with earlier adoption encouraged. The Company is currently assessing the impact of SFAS No. 145 on its consolidated financial statement.

In June 2001, the FASB issued SFAS No. 143, Accounting for Asset Retirement Obligations (SFAS No. 143). SFAS No. 143 requires the Company to record the fair value of an asset retirement obligation as a liability in the period in which it incurs a legal obligation associated with the retirement or tangible long-lived assets that result from the acquisition, construction, development and/or normal use of the assets. The Company also records a corresponding asset which is depreciated over the life of the asset. Subsequent to the initial measurement of the asset retirement obligation, the obligation will be adjusted at the end of each period to reflect the passage of time and changes in the estimated future cash flows underlying the obligation. The Company is required to adopt SFAS No. 143 on January 1, 2003 and does not expect this standard to have a material impact on its consolidated financial statements taken as a whole.

Critical Accounting Policies

We follow certain significant accounting policies when preparing our consolidated financial statements. A complete summary of these policies is included in note 1 of notes to consolidated financial statements which are included in our Form 10-K for the year ended January 1, 2002.

Certain of the policies require us to make significant and subjective estimates and assumptions which are sensitive to deviations of actual results from our assumptions. In particular, we make estimates regarding future undiscounted cash flows from the use of long-lived assets in assessing potential impairment whenever events or changes in circumstances indicate that the carrying value of a long-lived asset may not be recoverable and estimates of future taxable income when evaluating whether deferred tax assets are more likely than not recoverable.

We have estimated future undiscounted net cash flows from the use of long-lived assets based on actual historical results and expectations of about future economic circumstances including future business volume, operating costs and conditions of local real estate markets. The estimate of future cash flows from the use and eventual disposition of the assets could change if actual business volume or operating costs differ due to industry conditions or other factors affecting our business environment, and if real estate markets in which the assets are located experience declines.

We have estimated future taxable income in evaluating whether deferred tax assets are more likely than not recoverable. The estimate of future taxable income could change due to general economic conditions different than assumed by us, based on our ability to attract customers and compete in the marketplace and if operating costs are different than what we projected.

18

Item 3. Quantitative and Qualitative Disclosure About Market Risk

We are exposed to market risk from changes in commodity prices. We purchase certain commodities used in food preparation. These commodities are generally purchased based upon market prices established with vendors. These purchase arrangements may contain contractual features that limit the price paid by establishing certain price floors or caps. We do not use financial instruments to hedge commodity prices because these purchase arrangements help control the ultimate cost paid and any commodity price aberrations are generally short term in nature.

We are exposed to market risk from changes in interest rates affecting our variable rate debt. We use an interest rate swap to manage the cash flow risk on $20 million of our variable rate debt. The annual impact on our results of operations of a one-point interest rate change on the outstanding balance of our variable rate debt is approximately $400 thousand. We do not use derivatives for trading purposes.

This market risk discussion contains forward-looking statements. Actual results may differ materially from this discussion based upon general market conditions and changes in domestic and global financial markets.

19

PART II. OTHER INFORMATION

Items 1, 2, and 5 are not applicable and have been intentionally omitted.

Item 3. Defaults Upon Senior Securities

(a) The Company is party to a $55 million Revolving Credit and Term Loan Agreement (Credit Agreement) with various banks and lenders with an outstanding balance as of July 2, 2002 of $41.9 million. The Credit Agreement contains covenants with regard to maintaining certain leverage ratios, achieving certain levels of EBITDA, operating cash flow and limits on capital expenditures. In addition, there are certain restrictions on the payment of dividends and incurrence of additional indebtedness. The Company s reduced same-store sales during the first half of 2002 have caused the Company to incur operating losses and a significant reduction in its cash flow. The Company has continued to be out of compliance with the financial ratio covenants required by its Credit Agreement as of July 2, 2002, which has resulted in the lenders refusal to make further advances of the revolving portion of the Credit Agreement, requiring the Company to operate based on its available cash flow during this period. The Company has taken a number of actions to conserve and manage its cash, including withholding the principal payment under the Credit Agreement in the amount of $1.3 million that was due July 2, 2002 and interest payments totaling $.5 million due subsequent to quarter end.

(b) Not Applicable

Item 4. Submission of Matters to a Vote of Security Holders

The 2002 Annual Meeting of Stockholders was held on May 21, 2002. At the meeting, Stockholders voted to elect six directors to serve one-year terms and approved an amendment to the Company s 1995 Stock Option Plan to increase the number of options authorized to be issued pursuant to the Plan by 700,000.

The votes cast for each Director nominee were:

Robert N. Dangremond	7,326,944
Margaret B. Hampton	7,326,935
Damien W. Kovary	7,326,934
Craig S. Miller	7,326,951
Max Pine	7,326,944
Robert W. Sullivan	7,326,544

The votes cast to approve the amendment of the 1995 Stock Option Plan were:

6,662,245

Item 6. Exhibits and Reports on Form 8-K

The following exhibits are filed herewith:

1. Exhibit 10.1: Option Agreement between the Company and Craig Miller

2. Exhibit 99.1: Certification

SIGNATURES

Pursuant to the requirements 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.

DATE: August 21, 2002 FURR'S RESTAURANT GROUP, INC.

/s/ Craig S. Miller
Craig S. Miller
President and Chief Executive Officer
(Chief Financial Officer)

/s/ Nancy A. Ellefson
Nancy A. Ellefson
Vice President - Finance
(Chief Accounting Officer)

21