

RED ROBIN GOURMET BURGERS INC  
Form 10-Q  
August 11, 2006

# UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

## FORM 10-Q

(Mark One)

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

For the quarterly period ended July 9, 2006

or

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number: 0-49916

## RED ROBIN GOURMET BURGERS, INC.

(Exact name of registrant as specified in its charter)

**Delaware**

(State or other jurisdiction of incorporation or organization)

**84-1573084**

(I.R.S. Employer Identification No.)

**6312 S. Fiddler's Green Circle, Suite 200N**

**Greenwood Village, CO**

(Address of principal executive offices)

**80111**

(Zip Code)

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(303) 846-6000

(Registrant's telephone number, including area code)

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

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

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

Large accelerated filer ☒

Accelerated filer ☐

Non-accelerated filer ☐

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

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

| Class                                     |
|---|
| Common Stock, \$0.001 par value per share |

| Outstanding at August 9, 2006 |
|-------------------------------|
| 16,553,730 shares             |

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**PART I FINANCIAL INFORMATION****Item 1. Financial Statements****RED ROBIN GOURMET BURGERS, INC. AND SUBSIDIARIES****CONDENSED CONSOLIDATED BALANCE SHEETS****(In thousands, except share amounts)****(Unaudited)**

|  | <b>July 9,<br/>2006</b> | <b>December 25,<br/>2005</b> |
|--|-------------------------|------------------------------|
| <b>Assets:</b>   |                         |                              |
| Current Assets:  |                         |                              |
| Cash and cash equivalents  | \$ 5,609                | \$ 3,340                     |
| Accounts receivable, net   | 2,958                   | 3,589                        |
| Inventories  | 6,981                   | 6,485                        |
| Prepaid expenses and other current assets  | 3,537                   | 5,340                        |
| Income tax refund receivable   |                         | 1,516                        |
| Deferred tax asset   | 2,571                   | 2,046                        |
| Restricted current assets - marketing funds  | 900                     | 1,548                        |
| Total current assets   | 22,556                  | 23,864                       |
| Property and equipment, net  | 310,661                 | 270,279                      |
| Deferred tax asset   | 4,884                   | 4,129                        |
| Goodwill and intangible assets, net  | 32,904                  | 33,092                       |
| Other assets, net  | 3,186                   | 3,057                        |
| Total assets   | \$ 374,191              | \$ 334,421                   |
| <b>Liabilities and Stockholders' Equity:</b>   |                         |                              |
| Current Liabilities:   |                         |                              |
| Trade accounts payable   | \$ 5,652                | \$ 5,675                     |
| Construction related payables  | 16,976                  | 8,340                        |
| Accrued payroll and payroll related liabilities  | 21,661                  | 17,459                       |
| Unredeemed gift certificates   | 4,680                   | 7,273                        |
| Accrued liabilities  | 12,045                  | 10,137                       |
| Accrued liabilities - marketing funds  | 900                     | 1,548                        |
| Current portion of long-term debt and capital lease obligations  | 1,562                   | 2,861                        |
| Total current liabilities  | 63,476                  | 53,293                       |
| Deferred rent  | 16,570                  | 15,331                       |
| Long-term debt and capital lease obligations   | 64,271                  | 55,663                       |
| Other non-current liabilities  | 5,456                   | 5,275                        |
| Total liabilities  | 149,773                 | 129,562                      |
| Commitments and contingencies  |                         |                              |
| Stockholders' Equity:  |                         |                              |
| Common stock; \$0.001 par value: 30,000,000 shares authorized; 16,534,127 and 16,474,224 shares issued and outstanding, respectively | 17                      | 16                           |
| Preferred stock, \$0.001 par value: 3,000,000 shares authorized; no shares issued and outstanding                                    |                         |                              |
| Treasury stock, 11,517 shares, at cost   | (83)                    | (83)                         |
| Paid-in capital  | 142,312                 | 137,294                      |
| Accumulated other comprehensive income, net of tax   |                         | 9                            |
| Retained earnings  | 82,172                  | 67,623                       |

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|  |            |            |
|--|------------|------------|
| Total stockholders' equity                 | 224,418    | 204,859    |
| Total liabilities and stockholders' equity | \$ 374,191 | \$ 334,421 |

See notes to condensed consolidated financial statements.

**RED ROBIN GOURMET BURGERS, INC. AND SUBSIDIARIES****CONDENSED CONSOLIDATED STATEMENTS OF INCOME****(In thousands, except per share data)****(Unaudited)**

|   | <b>Twelve Weeks Ended</b> |                          | <b>Twenty-eight Weeks Ended</b> |                          |
|---|---------------------------|--------------------------|---------------------------------|--------------------------|
|   | <b>July 9,<br/>2006</b>   | <b>July 10,<br/>2005</b> | <b>July 9,<br/>2006</b>         | <b>July 10,<br/>2005</b> |
| <b>Revenues:</b>  |                           |                          |                                 |                          |
| Restaurant revenue  | \$ 132,071                | \$ 110,832               | \$ 297,722                      | \$ 247,815               |
| Franchise royalties and fees  | 3,751                     | 3,210                    | 8,547                           | 7,287                    |
| Rent revenue  | 38                        | 62                       | 124                             | 211                      |
| Total revenues  | 135,860                   | 114,104                  | 306,393                         | 255,313                  |
| <b>Costs and expenses:</b>  |                           |                          |                                 |                          |
| <b>Restaurant operating costs:</b>  |                           |                          |                                 |                          |
| Cost of sales   | 29,781                    | 26,113                   | 67,876                          | 58,593                   |
| Labor (includes \$201, \$0, \$478 and \$0 of stock-based compensation expense, respectively)                            | 45,649                    | 37,567                   | 103,189                         | 83,468                   |
| Operating   | 20,177                    | 16,318                   | 45,510                          | 36,927                   |
| Occupancy   | 7,858                     | 6,789                    | 17,931                          | 15,640                   |
| Depreciation and amortization   | 7,381                     | 5,957                    | 16,503                          | 13,243                   |
| General and administrative (includes \$1,168, \$59, \$2,808 and \$72 of stock-based compensation expense, respectively) | 11,382                    | 8,296                    | 27,229                          | 19,520                   |
| Pre-opening costs   | 1,912                     | 992                      | 4,155                           | 2,812                    |
| Total costs and expenses  | 124,140                   | 102,032                  | 282,393                         | 230,203                  |
| Income from operations  | 11,720                    | 12,072                   | 24,000                          | 25,110                   |
| <b>Other expense (income):</b>  |                           |                          |                                 |                          |
| Interest expense, net   | 937                       | 704                      | 2,007                           | 1,519                    |
| Other   | (19)                      | 18                       | 16                              | 63                       |
| Total other expenses  | 918                       | 722                      | 2,023                           | 1,582                    |
| Income before income taxes  | 10,802                    | 11,350                   | 21,977                          | 23,528                   |
| Provision for income taxes  | 3,608                     | 3,927                    | 7,428                           | 8,142                    |
| Net income  | \$ 7,194                  | \$ 7,423                 | \$ 14,549                       | \$ 15,386                |
| <b>Earnings per share:</b>  |                           |                          |                                 |                          |
| Basic   | \$ 0.44                   | \$ 0.46                  | \$ 0.88                         | \$ 0.95                  |
| Diluted   | \$ 0.43                   | \$ 0.45                  | \$ 0.87                         | \$ 0.93                  |
| <b>Weighted average shares outstanding:</b>   |                           |                          |                                 |                          |
| Basic   | 16,522                    | 16,255                   | 16,509                          | 16,199                   |
| Diluted   | 16,727                    | 16,679                   | 16,719                          | 16,619                   |

See notes to condensed consolidated financial statements.



**RED ROBIN GOURMET BURGERS, INC. AND SUBSIDIARIES**  
**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**

(In thousands)

(Unaudited)

|   | <b>Twenty-eight Weeks Ended</b> |                          |
|---|---------------------------------|--------------------------|
|   | <b>July 9,<br/>2006</b>         | <b>July 10,<br/>2005</b> |
| <b>Cash Flows From Operating Activities:</b>                                      |                                 |                          |
| Net income  | \$ 14,549                       | \$ 15,386                |
| Adjustments to reconcile net income to net cash provided by operating activities: |                                 |                          |
| Depreciation and amortization   | 16,503                          | 13,243                   |
| Stock-based compensation expense  | 3,286                           | 72                       |
| Income tax benefit from exercise of stock options                                 |                                 | 1,791                    |
| Other, net  | (990 )                          | 865                      |
| Changes in operating assets and liabilities                                       | 9,201                           | 6,034                    |
| Cash provided by operating activities   | 42,549                          | 37,391                   |
| <b>Cash Flows From Investing Activities:</b>                                      |                                 |                          |
| Changes in marketing fund restricted cash   | (707 )                          | (145 )                   |
| Purchases of property and equipment   | (47,747 )                       | (39,377 )                |
| Cash used in investing activities   | (48,454 )                       | (39,522 )                |
| <b>Cash Flows From Financing Activities:</b>                                      |                                 |                          |
| Borrowings of long-term debt  | 12,638                          | 9,301                    |
| Payments of long-term debt  | (4,491 )                        | (8,842 )                 |
| Repayment of stockholders/officers notes  |                                 | 3,600                    |
| Proceeds from exercise of stock options and employee stock purchase plan          | 1,067                           | 2,901                    |
| Excess tax benefit related to exercise of stock options                           | 242                             |                          |
| Debt issuance costs   | (446 )                          |                          |
| Payments of other debt and capital lease obligations                              | (836 )                          | (2,779 )                 |
| Cash provided by financing activities   | 8,174                           | 4,181                    |
| Net change in cash and cash equivalents   | 2,269                           | 2,050                    |
| Cash and cash equivalents, beginning of period                                    | 3,340                           | 4,980                    |
| Cash and cash equivalents, end of period  | \$ 5,609                        | \$ 7,030                 |
| <b>Supplemental Disclosure of Cash Flow Information:</b>                          |                                 |                          |
| Income taxes paid   | \$ 5,974                        | \$ 5,696                 |
| Interest paid, net of amounts capitalized   | 1,710                           | 1,330                    |
| <b>Supplemental Disclosure of Non-Cash Items:</b>                                 |                                 |                          |
| Purchases of property and equipment on account                                    | \$ 8,636                        | \$ 1,760                 |

See notes to condensed consolidated financial statements.





**RED ROBIN GOURMET BURGERS, INC. AND SUBSIDIARIES**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**1. Basis of Presentation and Recent Accounting Pronouncements**

Red Robin Gourmet Burgers, Inc. (Red Robin or the Company), a Delaware corporation, develops and operates casual-dining restaurants. At July 9, 2006, the Company operated 180 company-owned restaurants located in 22 states. The Company also sells franchises, of which there were 142 restaurants in 25 states and two Canadian provinces as of July 9, 2006. The Company operates its business as one reportable segment.

*Basis of Presentation*

The accompanying unaudited condensed consolidated financial statements include the accounts of Red Robin and its wholly owned subsidiaries. All material intercompany accounts and transactions have been eliminated in consolidation. The Company's financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America (GAAP) for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. In the opinion of management, all adjustments (consisting of normal recurring adjustments) considered necessary for a fair presentation have been included. The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Some of the more significant estimates included in the preparation of these financial statements pertain to impairment of long-lived assets, fixed asset lives, impairment of goodwill, estimated useful lives of other intangible assets, bonuses, self-insurance liabilities, stock-based compensation expense and income taxes. Actual results could differ from those estimates. The results of operations for any interim period are not necessarily indicative of results for the full year. For further information, refer to the consolidated financial statements and notes included in the Company's annual report on Form 10-K for the year ended December 25, 2005.

The Company's quarter which ended July 9, 2006, is referred to as second quarter 2006, or the twelve weeks ended July 9, 2006; the first quarter ended April 16, 2006, is referred to as first quarter 2006, or the sixteen weeks ended April 16, 2006; and, together the first and second quarters of 2006 are referred to as the twenty-eight weeks ended July 9, 2006. The Company's quarter which ended July 10, 2005, is referred to as second quarter 2005, or the twelve weeks ended July 10, 2005; the first quarter ended April 17, 2005, is referred to as first quarter 2005, or the sixteen weeks ended April 17, 2005; and, together the first and second quarters of 2005 are referred to as the twenty-eight weeks ended July 10, 2005.

*Reclassifications*

Certain reclassifications have been made to prior year amounts in the Condensed Consolidated Statements of Cash Flows to conform to the current year presentation of changes in marketing fund restricted cash.

*Stock Based Compensation*

Effective December 26, 2005, the Company adopted the fair value recognition provisions of Statement of Financial Accounting Standards (SFAS) No. 123R, *Share-Based Payment*, (SFAS 123R), a revision of SFAS 123, *Accounting for Stock-Based Compensation*, (SFAS 123), using the modified prospective transition method and therefore has not retrospectively adjusted results for prior periods. Under this transition method, stock-based compensation expense for fiscal year 2006 includes compensation expense for all stock-based compensation awards granted prior to, but not yet vested as of December 26, 2005, based on the grant date fair value estimated in accordance with the original provision of SFAS 123. Stock-based compensation expense for all stock-based compensation awards granted after December 26, 2005 is based on the grant-date fair value estimated in accordance with the provisions of SFAS 123R. The Company recognizes these compensation costs on a graded vesting basis over the requisite service period of the award, which is generally the weighted option vesting term of three years. Prior to the adoption of SFAS 123R, the Company recognized stock-based compensation expense in accordance with Accounting Principles Board (APB) Opinion No. 25, *Accounting for Stock Issued to Employees*, (APB 25). The Company has applied the provisions of SAB 107 in its adoption of SFAS 123R. See Note 2 to the Condensed Consolidated Financial Statements for a further discussion on stock-based compensation.



### *Recent Accounting Pronouncements*

In July 2006, the Financial Accounting Standards Board's (FASB) issued Financial Interpretation No. 48, *Accounting for Uncertainty in Income Taxes - an interpretation of FASB Statement No. 109* (FIN 48). FIN 48 prescribes a comprehensive financial statement model of how a company should recognize, measure, present, and disclose uncertain tax positions that the company has taken or expects to take in its income tax returns. FIN 48 requires that only income tax benefits that meet the more likely than not recognition threshold be recognized or continue to be recognized on the effective date. Initial derecognition amounts would be reported as a cumulative effect of a change in accounting principle. FIN 48 is effective for fiscal years beginning after December 15, 2006. The Company is assessing the impact of the new guidance on all of our open tax positions and it is not expected to have a material impact on earnings, financial condition or cash flows.

In March 2006, the FASB Emerging Issues Task Force (EITF) issued Issue 06-3, *How Sales Taxes Collected From Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement* (EITF 06-3). A consensus was reached that entities may adopt a policy of presenting sales taxes in the income statement on either a gross or net basis. If taxes are significant, an entity should disclose its policy of presenting taxes and the amounts of taxes. The guidance is effective for periods beginning after December 15, 2006. The Company presents sales net of sales taxes. EITF 06-3 will not impact the method for recording these sales taxes in the consolidated financial statements.

## **2. Stock-Based Compensation**

The Company has four stock based compensation plans: the 1996 Stock Option Plan (the 1996 Stock Plan), the 2000 Management Performance Common Stock Option Plan (the 2000 Stock Plan), the 2002 Incentive Stock Option Plan (2002 Stock Plan) and the 2004 Performance Incentive Plan (the 2004 Stock Plan).

As of July 9, 2006, there are no remaining options authorized for grant under the 1996, 2000 or 2002 Stock Plans. In general, options granted under these plans were issued at the estimated fair market value at the date of grant. Vesting of awards under these plans were time based over a period of one to four years; however, in some cases, options under these plans vested based on the attainment of certain financial results. Options granted under these plans expire within ten years from the date of grant.

In 2004, stockholders approved the 2004 Stock Plan which authorizes stock options, stock appreciation rights, restricted stock, stock bonuses and other forms of awards granted or denominated in the Company's common stock or units of the Company's common stock, as well as cash bonus awards pursuant to the plan. Persons eligible to receive awards under the 2004 Stock Plan include officers or employees of the Company or any of the Company's subsidiaries, directors of the Company, and certain consultants and advisors to the Company or any of its subsidiaries. The maximum number of shares of the Company's common stock that may be issued or transferred pursuant to awards under the 2004 Stock Plan is equal to 2,697,613 shares. Vesting of the awards under the 2004 Stock Plan is determined at the date of grant by the plan administrator. Each award granted under the 2004 Stock Plan may, at the discretion of the plan administrator, become fully vested, exercisable, and/or payable, as applicable, upon a change in control event if the award will not be assumed or substituted for or otherwise continued after the event. Each award expires on such date as shall be determined at the date of grant, however, the maximum term of options, SARs and other rights to acquire common stock under the plan is ten years after the initial date of the award, subject to provisions for further deferred payment in certain circumstances. Any shares subject to awards under the 1996 Stock Plan, the 2000 Stock Plan, the 2002 Stock Plan and the 2004 Stock Plan that are not paid or exercised before they expire or are terminated will become available for other award grants under the 2004 Stock Plan. The 2004 Stock Plan terminates on April 12, 2014, if not sooner terminated by the Company's board of directors. Options are the only types of awards currently outstanding under the 2004 Stock Plan.

Effective December 26, 2005, the beginning of the first quarter of fiscal 2006, the Company adopted the fair value recognition provisions of SFAS 123R using the modified prospective transition method and, therefore, has not retrospectively adjusted prior periods' results. Under this transition method, stock-based compensation expense in fiscal 2006 includes compensation expense for all stock-based compensation awards granted prior to, but not yet vested as of, December 26, 2005, based on the grant date fair value estimated in accordance with the original provisions of SFAS 123. Stock-based compensation expense for all stock-based payment awards granted after December 26, 2005 is based on the grant date fair value estimated in accordance with the provisions of SFAS 123R. The Company recognizes these compensation costs net of a forfeiture rate and recognizes the compensation costs for only those shares expected to vest on a graded vesting basis over the requisite service period of the award, which is generally the weighted option vesting term of three years. The Company estimated the forfeiture rate based on its historical experience during the preceding four fiscal years.



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Prior to December 26, 2005, the Company provided pro forma disclosure amounts in accordance with SFAS No. 148, *Accounting for Stock-Based Compensation Transition and Disclosure* (SFAS 148), as if the fair value method defined by SFAS 123 had been applied to its stock-based compensation.

For the prior year's disclosure under SFAS 123, for the twelve and twenty-eight weeks ended July 10, 2005, the Company determined compensation costs based on the fair value at the date of grant for its stock options, net income and earnings per share reflected the following pro forma amounts (in thousands, except per share data):

|  | <b>Twelve Weeks<br/>Ended<br/>July 10, 2005</b> | <b>Twenty-eight Weeks<br/>Ended<br/>July 10, 2005</b> |
|--|---|---|
| Net income, as reported  | \$ 7,423  | \$ 15,386   |
| Add: Stock-based employee compensation costs included in reported net income, net of tax benefit | 39  | 47  |
| Deduct: Stock-based employee compensation costs based on fair value method, net of tax benefit   | (739)   | (1,396)   |
| Pro forma net income   | \$ 6,723  | \$ 14,037   |
| Basic earnings per share:  |   |   |
| As reported  | \$ 0.46   | \$ 0.95   |
| Pro forma  | \$ 0.41   | \$ 0.87   |
| Diluted earnings per share:  |   |   |
| As reported  | \$ 0.45   | \$ 0.93   |
| Pro forma  | \$ 0.40   | \$ 0.84   |

At July 9, 2006, the Company recognized total compensation expense related to all stock-based payment awards made to our employees and directors including employee stock option awards and employee stock purchases made under our Employee Stock Purchase Plan ( ESPP ) of \$1.4 million and \$3.3 million for the twelve and twenty-eight weeks ended July 9, 2006, respectively. Stock-based compensation capitalized as part of fixed assets was \$122,000 and \$151,000 for the twelve and twenty-eight weeks ended July 9, 2006. Prior to December 26, 2005, the Company accounted for those awards under the recognition and measurement provisions of APB 25. Accordingly, the Company generally recognized compensation expense only when it granted options with a discounted exercise price. Any resulting compensation expense was recognized ratably over the associated service period, which was generally the option vesting term.

The table below summarizes the status of the Company's stock based compensation plans:

|                                      | <b>Shares<br/>(in<br/>thousands)</b> | <b>Weighted<br/>Average<br/>Exercise<br/>Price</b> | <b>Weighted<br/>Average<br/>Remaining<br/>Years of<br/>Contractual<br/>Life</b> | <b>Aggregate<br/>Intrinsic<br/>Value (in<br/>thousands)</b> |
|--------------------------------------|--------------------------------------|--|---|---|
| Outstanding, as of December 25, 2005 | 1,110                                | \$ 34.11   |   |   |
| Awards granted                       | 324                                  | 41.78  |   |   |
| Awards forfeited or expired          | (43)                                 | 42.53  |   |   |
| Awards exercised                     | (36)                                 | 12.97  |   |   |
| Outstanding, as of April 16, 2006    | 1,355                                | \$ 36.24   | 8.39  | \$ 12,726   |
| Awards granted                       | 73                                   | 42.49  |   |   |
| Awards forfeited or expired          | (19)                                 | 41.05  |   |   |
| Awards exercised                     | (18)                                 | 18.91  |   |   |
| Outstanding, as of July 9, 2006      | 1,391                                | \$ 36.72   | 8.27  | \$ 12,263   |

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|  |       |    |       |      |    |        |
|--|-------|----|-------|------|----|--------|
| Exercisable as of July 9, 2006                 | 514   | \$ | 27.89 | 7.05 | \$ | 8,886  |
| Vested and expected to vest as of July 9, 2006 | 1,278 | \$ | 36.15 | 8.19 | \$ | 11,973 |

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The weighted-average Black-Scholes fair value of options at their grant date during the twelve and twenty-eight weeks ended July 9, 2006 and July 10, 2005, where the exercise price equaled the market price on the grant date was \$10.36, \$11.20, \$18.80 and \$18.67, respectively. The total intrinsic value of options exercised during the twelve weeks ended July 9, 2006 and July 10, 2005 was \$1.1 million and \$3.7 million, respectively. For the twenty-eight weeks ended July 9, 2006 and July 10, 2005, the total intrinsic value of options exercised was \$2.1 million and \$5.0 million, respectively. As of July 9, 2006, there was \$8.4 million of total unrecognized compensation cost, excluding estimated forfeitures, related to nonvested options granted under the Company's stock-based compensation plans. That cost is expected to be recognized over a weighted-average period of 1.4 years.

The estimated fair value of each option grant is calculated using the Black-Scholes multiple option-pricing model. The assumptions used in the model were as follows:

|                               | Twelve Weeks Ended |                  | Twenty-Eight Weeks Ended |                  |
|-------------------------------|--------------------|------------------|--------------------------|------------------|
|                               | July 9,<br>2006    | July 10,<br>2005 | July 9,<br>2006          | July 10,<br>2005 |
| Risk-free interest rate       | 5.1 %              | 3.8 %            | 4.8 %                    | 4.0 %            |
| Expected years until exercise | 3.0                | 5.5              | 3.0                      | 5.5              |
| Expected stock volatility     | 38.2 %             | 30.3 %           | 36.2 %                   | 31.2 %           |
| Dividend yield                | 0.0 %              | 0.0 %            | 0.0 %                    | 0.0 %            |

The risk-free interest rate was based on the rate for zero coupon U.S. Government issues with a remaining term similar to the expected life. The expected life of the options represents the period of time the options are expected to be outstanding and is based on historical trends. The expected stock price volatility represents an average of the Company's historical volatility measured over a period approximating the expected life. The dividend yield assumption is based on the Company's history and expectations of dividend payouts.

### 3. Borrowings

Borrowings at July 9, 2006 and December 25, 2005 are summarized below (in thousands):

|                              | July 9,<br>2006 | December 25,<br>2005 |
|------------------------------|-----------------|----------------------|
| Revolving credit agreement   | \$ 50,211       | \$ 42,329            |
| Capital lease obligations    | 10,102          | 10,064               |
| Collateralized notes payable | 5,520           | 6,131                |
|                              | 65,833          | 58,524               |
| Current portion              | (1,562)         | (2,861)              |
| Long-term debt               | \$ 64,271       | \$ 55,663            |

As of July 9, 2006 and December 25, 2005, borrowings under the revolving credit agreement bore interest at approximately 5.9% and 5.4%, respectively. Subsequent to July 9, 2006, the Company borrowed approximately \$33.5 million in connection with the acquisition of 11 franchised Red Robin® restaurants in the state of Washington on July 10, 2006. See the discussion in Note 8.

The Company maintains an outstanding letter of credit to back the Company's self-insured workers' compensation program. This letter of credit reduces the amount of future borrowings available under the revolving credit agreement. The amount outstanding under this letter of credit was \$3.6 million at July 9, 2006 and December 25, 2005.

### 4. Earnings Per Share

Basic earnings per share amounts are calculated by dividing net income by the weighted-average number of common shares outstanding during the period. Diluted earnings per share amounts are calculated based upon the weighted-average number of common and potentially dilutive



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common shares outstanding during the period. Potentially dilutive shares are excluded from the computation in periods in which they have an anti-dilutive effect. Diluted earnings per share reflect the potential dilution that could occur if holders of options exercised their options into common stock. During the twelve and twenty-eight weeks ended July 9, 2006, respectively, approximately 847,000 and 741,000 stock options outstanding were not included in the computation of diluted earnings per share because to do so would have been anti-dilutive for the period presented. During the twelve and twenty-eight weeks ended July 10, 2005, a total of 27,000 and 124,000 stock options outstanding were not included in the computation of diluted earnings per share because to do

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so would have been anti-dilutive for the period presented. The Company uses the treasury stock method to calculate the impact of outstanding stock options. The computations for basic and diluted earnings per share are as follows (in thousands, except per share data):

|   | Twelve Weeks Ended |                  | Twenty-eight Weeks Ended |                  |
|---|--------------------|------------------|--------------------------|------------------|
|   | July 9,<br>2006    | July 10,<br>2005 | July 9,<br>2006          | July 10,<br>2005 |
| Net income                                  | \$ 7,194           | \$ 7,423         | \$ 14,549                | \$ 15,386        |
| Basic weighted-average shares outstanding   | 16,522             | 16,255           | 16,509                   | 16,199           |
| Dilutive effect of stock options            | 205                | 424              | 210                      | 420              |
| Diluted weighted-average shares outstanding | 16,727             | 16,679           | 16,719                   | 16,619           |
| Earnings per share:                         |                    |                  |                          |                  |
| Basic                                       | \$ 0.44            | \$ 0.46          | \$ 0.88                  | \$ 0.95          |
| Diluted                                     | \$ 0.43            | \$ 0.45          | \$ 0.87                  | \$ 0.93          |

### 5. Related Party Transactions

The Company's former chief executive officer (who owns approximately 8% of the Company's outstanding common stock) and the Company's chief concept officer own 31.0% and 7.0%, respectively, of Mach Robin, LLC (Mach Robin), and an entity that directly or indirectly owns or controls 100% of Red Robin Restaurants of Canada, Ltd. (RRRC). Mach and RRRC operate Red Robin® restaurants under franchise agreements in the U.S. and Canada, respectively. The Company recognized royalty income from Mach Robin in the amounts of \$255,000 and \$593,000 during the twelve and twenty-eight weeks ended July 9, 2006, and \$226,000 and \$507,000 during the same periods ended July 10, 2005. The Company recognized royalty income from RRRC of \$273,000 and \$606,000 during the twelve and twenty-eight weeks ended July 9, 2006, and \$213,000 and \$496,000 during the same period ended July 10, 2005.

In August 2006, the Board of Directors of the Company voted to terminate the informal unpaid consulting agreement with the Company's former chief executive officer, into which the Company entered with him upon his retirement from the Company in August 2005. No consulting services were requested from or provided by him at any time under the arrangement.

For further related party information, refer to the consolidated financial statements and notes thereto included in the Company's annual report on Form 10-K for the year ended December 25, 2005.

### 6. Other Comprehensive Income

Comprehensive income consisted of (in thousands):

|  | Twelve Weeks Ended |                  | Twenty-eight Weeks Ended |                  |
|--|--------------------|------------------|--------------------------|------------------|
|  | July 9,<br>2006    | July 10,<br>2005 | July 9,<br>2006          | July 10,<br>2005 |
| Net income                                     | \$ 7,194           | \$ 7,423         | \$ 14,549                | \$ 15,386        |
| Unrealized gain on cash flow hedge, net of tax |                    | 4                |                          | 27               |
| Total comprehensive income                     | 7,194              | 7,427            | 14,549                   | 15,413           |

The interest rate swap agreement the Company had entered into in December 2002, to reduce exposure to rising interest rates, expired January 2006.

### 7. Contingencies

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On August 11, 2005, the Company announced certain management changes that followed an internal investigation conducted by a special committee of the board of directors relating to use of chartered aircraft and travel and entertainment expenses. The special committee, which retained independent counsel to conduct the investigation, identified various expenses incurred since 2001 by the person who formerly served as chairman, president and chief executive officer that were inconsistent with Company policies or that lacked sufficient documentation.

On February 1, 2006, the Company received a notice from the SEC that the SEC had issued a formal order of

investigation related to the above-mentioned internal investigation. The SEC indicated in its order that it had not determined whether the Company has violated the law in any way. The Company has cooperated with the SEC and intends to continue to cooperate fully with the SEC in its formal investigation.

On August 15, 2005, Andre Andropolis filed a purported class action complaint against the Company, the former chief executive officer and former chief financial officer (the *Andropolis Complaint*) in the United States District Court for the District of Colorado on behalf of himself and all other purchasers of the Company's common stock during the putative class period of November 8, 2004 through August 11, 2005. On September 30, 2005, Mark Baird filed a similar purported class action complaint on behalf of himself and the same class of stockholders as defined in the *Andropolis Complaint* (the *Baird Complaint*) in the United States District Court for the District of Colorado. Both complaints allege that the Company and the Company's former chief executive officer and former chief financial officer violated Sections 10(b) and 20(a) of the Securities Exchange Act of 1934 (the *Exchange Act*) and Rule 10(b)(5) adopted pursuant to the Exchange Act by disseminating false and misleading financial reports on behalf of the Company, by withholding adverse financial information on behalf of the Company from the class and the individual defendants were control persons who caused the Company to engage in such former acts for their own benefit. The plaintiffs further allege that, because of the actions of the former chief executive officer and chief financial officer, the Company's stock price became inflated between November 8, 2004 and August 11, 2005, and on August 12, 2005, the Company's stock price fell sharply following their departures from their positions with the Company. The class has not been certified and no discovery has occurred. Lead counsel and lead plaintiff, City of Philadelphia Board of Pensions and Retirement, (the *Lead Plaintiff*), have been appointed for both of these class actions. We refer below to these class actions collectively as *Andropolis*.

On February 28, 2006, the *Lead Plaintiff* filed a consolidated complaint. In addition to the allegations in the initial *Andropolis Complaint* against the Company and the Company's former chief executive officer and former chief financial officer, the consolidated complaint alleges that the Company and the Company's current chief executive officer and current chief financial officer violated Sections 10(b) and 20(a) of the Exchange Act in connection with the Company's announcement on January 10, 2006 that it was lowering its guidance for the quarter ended December 25, 2005, alleges claims against the Company's former controller and alleges violations of Section 14(a) of the Exchange Act. The consolidated complaint seeks damages on behalf of a putative class of purchasers of the Company's common stock during the putative class period of August 13, 2004 and January 9, 2006 (inclusive). All defendants have filed motions to dismiss the consolidated complaint that are currently pending before the court.

On August 31, 2005, Elliot Wilster commenced a stockholder's derivative suit on behalf of the Company in the United States District Court for the District of Colorado (the *Wilster Complaint*). The action was brought against the Company as a nominal defendant and against the former chief executive officer, then-current board members and the Company's current senior vice president and chief concept officer. The *Wilster Complaint* alleged that several of the individual defendants improperly profited from their sales of Company stock while they knew proprietary, non-public information regarding the former chief executive officer's alleged abuse of his corporate position. The *Wilster Complaint* also alleged that the defendants breached their fiduciary duty, abused their control, engaged in gross mismanagement, wasted corporate assets and were unjustly enriched at the expense of and to the detriment of the Company by failing to act on the former chief executive officer's alleged abuse of his corporate position and by waiving a conflict of interest resulting from proposed franchise development involving the former chief executive officer and the senior vice president and chief concept officer. The *Wilster Complaint* sought monetary damages against the individual defendants, equitable relief, restitution and attorneys' fees. On December 15, 2005, Wilster filed an amended stockholder derivative complaint (the *Amended Wilster Complaint*) that added the Company's former chief financial officer as a defendant. On August 3, 2006, the Court in the *Wilster* case granted the Company's motion to dismiss all claims against all defendants for failure to plead demand futility. The Court ruled that the *Wilster* plaintiff failed to allege particularized facts to show that a majority of the Board lacks independence or is interested in the challenged transactions and activity such that a pre-litigation demand on the Board was futile.

The *Wilster* case had been consolidated for pretrial purposes with the *Andropolis* case. There have been no other material developments in *Andropolis*.

In January 2006, the Company was served with a purported class action lawsuit, *Huggett v. Red Robin International, Inc.* This lawsuit was filed in the Superior Court of the State of California. The *Huggett* lawsuit alleges failure to comply with California wage and hour regulations, including those governing meal and rest periods, payment of wages upon termination and provision of itemized statements to employees, as well as unlawful business practices and

unfair competition. The complaint states claims for damages, including punitive and exemplary damages and injunctive relief. The Company has filed an answer to the Huggett complaint and has removed the case to the United States District Court for the Central District of California. On March 13, 2006, Huggett filed a motion to remand the case to the California state court. On June 9, 2006, the Court denied the motion to remand.

Although we plan to vigorously defend these suits, we cannot predict the outcome of these lawsuits or what actions the SEC may take. It is possible that we may be required to pay damages, settlement costs, legal costs or other amounts that may not be covered by insurance, which could have a material adverse effect on our financial condition and results of operations.

In the normal course of business, there are various other claims in process, matters in litigation and other contingencies. These include claims resulting from slip and fall accidents, employment related claims and claims from guests or team members alleging illness, injury or other food quality, health or operational concerns. To date, no claims of these types of litigation, certain of which are covered by insurance policies, have had a material effect on us. While it is not possible to predict the outcome of these other suits, legal proceedings and claims with certainty, management is of the opinion that adequate provision for potential losses associated with these other matters has been made in the financial statements and that the ultimate resolution of these other matters will not have a material adverse effect on the Company's financial position and results of operations.

## **8. Acquisition of Red Robin Franchised Restaurants**

On July 10, 2006, the Company closed on the acquisition of 11 of 13 franchised Red Robin® restaurants in the state of Washington. The franchised restaurants were owned by various entities (the Sellers) affiliated with Great Western Dining, the former manager of the restaurants. The total purchase price for the acquisition of the 13 restaurants was approximately \$42 million, plus the assumption of approximately \$1.4 million of negative working capital. Of this amount, approximately \$33.5 million was paid to the Sellers at the first closing, of which \$0.8 million was paid into escrow as security for the Sellers' indemnification obligations, plus the assumption of approximately \$1.2 million of negative net working capital.

Effective July 10, 2006, the Company also assumed management of the remaining two restaurant locations owned by the Washington franchisees under a management services agreement. The Company expects to close on the remaining two restaurants assuming finalization of acceptable lease terms with the landlords of each of those properties. The financial results for all 13 restaurants will be reflected in the Company's financial results beginning July 10, 2006. At the closing for the final two restaurants, the Company will pay approximately \$8.2 million to the Sellers of which an additional \$0.2 million will be deposited in escrow.

The purchase price was paid in cash, funded through borrowings under the Company's existing credit facility. Amounts to be paid with respect to the second closing will not be borrowed under the credit facility until the time of the second closing.

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

Management's Discussion and Analysis of Financial Condition and Results of Operations provides a narrative on our financial performance and condition that should be read in conjunction with the accompanying condensed consolidated financial statements.

**Overview**

All comparisons under this heading between 2006 and 2005 refer to the twelve-week and twenty-eight-week periods ending July 9, 2006 and July 10, 2005, respectively, unless otherwise indicated.

As of July 9, 2006, there were 322 Red Robin® Gourmet Burger casual dining restaurants in 35 states and Canada, of which 180 are company-owned and of which the remaining 142 operate under franchise agreements. In fiscal 2006, we plan to open a total of 30 - 32 new company-owned Red Robin Gourmet Burger restaurants excluding acquisitions and we believe our franchisees will open approximately 15 - 17 new restaurants.

Our primary source of revenue is from the sale of food and beverages at company-owned restaurants. We also earn revenue from royalties and fees from franchised restaurants.

Our challenges include increased competition among casual dining restaurant chains for the guest's discretionary dining dollars, increasing labor and benefit costs, increased energy and petroleum-based product prices, and increasing real-estate and new restaurant construction costs. In light of these complexities and challenges, management is pursuing a disciplined growth strategy that includes the addition of company-owned restaurants and programs to increase sales at existing restaurants. In addition, management is focused on managing restaurant operating and development costs and building our corporate infrastructure to facilitate our long-term growth expectations.

The following summarizes the most significant events occurring during fiscal 2006:

- **Franchise Acquisitions.** On July 10, 2006, the Company closed on the acquisition of 11 of 13 franchised Red Robin® restaurants in the state of Washington. The franchised restaurants were owned by various entities affiliated with Great Western Dining, the former manager of the restaurants. Effective July 10, 2006, the Company also assumed management of the remaining two restaurant locations owned by the Washington franchisees under a management services agreement. The Company expects to close on the remaining two restaurants assuming finalization of acceptable lease terms with the landlords of each of those properties.
- **Company-Owned Restaurant Sales.** We increased our company-owned restaurant revenues 19.2% over the second quarter of 2005 and 20.1% on a year to date basis, which reflects increases in both comparable restaurant sales of 3.3% and 4.1%, respectively, over the prior year as well as increased revenues from the opening of new company-owned restaurants in 2005 and 2006. We consider restaurants as comparable in the first period following five full quarters of operations.
- **Reduced Commodity Food Costs.** We have generally experienced an improvement in the prices for several food cost categories including hamburger, meats, dairy, fresh produce and canned goods. We expect to continue to benefit from lower commodity prices compared to prior years with offsetting increases in higher fuel surcharges and delivery costs.
- **Increased Labor and Benefits Costs.** As we have increased the number of company-owned restaurants during 2005 and 2006, we continue to see increases in labor and related costs, both on an absolute basis and as a percentage of restaurant revenue. The increases include stock-based compensation, higher hourly and management salaries, higher incentive bonuses and increased health and workers' compensation costs related to our self-insured benefit programs.

- *Adoption of SFAS No. 123R.* In the first quarter 2006, the Company adopted the fair value recognition provisions of Statement of Financial Accounting Standards (SFAS) No. 123R, *Share-Based Payment*, (SFAS 123R), a revision of SFAS 123, *Accounting for Stock-Based Compensation*, (SFAS 123), using the modified prospective transition method and therefore has not retrospectively adjusted results for prior periods. For the quarter ended July 9, 2006, we recognized total pre-tax stock-based compensation expense of \$1.4 million, of which \$201,000 and \$1.2 million were recognized in labor and general and administrative expenses,

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respectively. We recognized total stock-base compensation expense of \$3.3 million for the twenty-eight weeks ended July 9, 2006, of which \$478,000 and \$2.8 million were recognized in labor and general and administrative expenses, respectively.

### Restaurant Data and Comparable Restaurant Sales

The following table details restaurant unit data for our company-owned and franchise locations for the period indicated.

|  | Twelve Weeks Ended |               | Twenty-eight Weeks Ended |               |
|--|--------------------|---------------|--------------------------|---------------|
|  | July 9, 2006       | July 10, 2005 | July 9, 2006             | July 10, 2005 |
| Company-owned:                         |                    |               |                          |               |
| Beginning of period                    | 172                | 145           | 163                      | 137           |
| Opened during period                   | 8                  | 3             | 17                       | 11            |
| End of period                          | 180                | 148           | 180                      | 148           |
| Franchised:                            |                    |               |                          |               |
| Beginning of period                    | 139                | 123           | 136                      | 118           |
| Opened during period                   | 3                  | 4             | 6                        | 9             |
| Closed during period                   |                    | (1)           |                          | (1)           |
| End of period                          | 142                | 126           | 142                      | 126           |
| Total number of Red Robin® restaurants | 322                | 274           | 322                      | 274           |

Since July 9, 2006 and through August 11, 2006, we have opened 2 additional company-owned restaurants and our franchisees have opened 2 additional restaurants. We expect to open an additional 11 - 13 company-owned restaurants, not including the restaurants acquired on July 10, 2006, during the remainder of 2006. We anticipate that our franchisees will open approximately 9 - 11 restaurants during the remainder of 2006.

### Results of Operations

Operating results for each period presented below are expressed as a percentage of total revenues, except for the components of restaurant operating costs, which are expressed as a percentage of restaurant revenues.

This information has been prepared on a basis consistent with the audited 2005 annual financial statements and, in the opinion of management, includes all adjustments, consisting only of normal recurring adjustments, necessary for a fair presentation of the information for the periods presented. Our operating results may fluctuate significantly as a result of a variety of factors, and operating results for any period presented are not necessarily indicative of results for a full fiscal year. The 2006 results include the impact of stock-based compensation expense.

|  | Twelve Weeks Ended |               | Twenty-eight Weeks Ended |               |
|--|--------------------|---------------|--------------------------|---------------|
|  | July 9, 2006       | July 10, 2005 | July 9, 2006             | July 10, 2005 |
| Revenues:  |                    |               |                          |               |
| Restaurant   | 97.2 %             | 97.1 %        | 97.2 %                   | 97.1 %        |
| Franchise royalties and fees   | 2.8                | 2.8           | 2.8                      | 2.9           |
| Rent revenue   | 0.0                | 0.1           | 0.0                      | 0.1           |
| Total revenues   | 100.0              | 100.0         | 100.0                    | 100.0         |
| Costs and Expenses:  |                    |               |                          |               |
| Restaurant operating costs:  |                    |               |                          |               |
| Cost of sales  | 22.5               | 23.6          | 22.8                     | 23.6          |
| Labor (includes 0.2%, 0%, 0.2% and 0% of stock-based compensation expense, respectively) | 34.6               | 33.9          | 34.7                     | 33.7          |
| Operating  | 15.3               | 14.7          | 15.3                     | 14.9          |
| Occupancy  | 5.9                | 6.1           | 6.0                      | 6.3           |
| Total restaurant operating costs   | 78.3               | 78.3          | 78.8                     | 78.5          |
| Depreciation and amortization  | 5.4                | 5.2           | 5.4                      | 5.2           |





|   |     |       |       |       |
|---|-----|-------|-------|-------|
| General and administrative (includes 0.9%, 0%, 0.9% and 0% of stock-based compensation expense, respectively) | 8.4 | 7.3   | 8.9   | 7.6   |
| Pre-opening costs   | 1.4 | 0.9   | 1.4   | 1.1   |
| Income from operations  | 8.6 | 10.6  | 7.8   | 9.8   |
| Interest expense, net   | 0.7 | 0.6   | 0.7   | 0.6   |
| Other   |     |       |       |       |
| Income before income taxes  | 7.9 | 9.9   | 7.1   | 9.2   |
| Provision for income taxes  | 2.7 | 3.4   | 2.4   | 3.2   |
| Net income  | 5.3 | % 6.5 | % 4.7 | % 6.0 |

Certain percentage amounts in the table above do not sum due to rounding as well as the fact that restaurant operating costs are expressed as a percentage of restaurant revenues, as opposed to total revenues.

### Total Revenues

| (In thousands, except percentages) | Twelve Weeks Ended |               |                | Twenty-eight Weeks Ended |               |                |    |
|------------------------------------|--------------------|---------------|----------------|--------------------------|---------------|----------------|----|
|                                    | July 9, 2006       | July 10, 2005 | Percent Change | July 9, 2006             | July 10, 2005 | Percent Change |    |
| Restaurant revenue                 | \$ 132,071         | \$ 110,832    | 19.2           | % \$ 297,722             | \$ 247,815    | 20.1           | %  |
| Franchise royalties and fees       | 3,751              | 3,210         | 16.9           | % 8,547                  | 7,287         | 17.3           | %  |
| Rent revenue                       | 38                 | 62            | (38.7)         | )% 124                   | 211           | (41.2)         | )% |
| Total revenues                     | \$ 135,860         | \$ 114,104    | 19.1           | % \$ 306,393             | \$ 255,313    | 20.0           | %  |
| Average weekly sales volumes:      |                    |               |                |                          |               |                |    |
| Comparable restaurants             | \$ 65,404          | \$ 64,655     | 1.2            | % \$ 65,371              | \$ 64,213     | 1.8            | %  |
| Non-comparable restaurants         | \$ 58,330          | \$ 61,828     | (5.7)          | )% \$ 57,544             | \$ 59,895     | (3.9)          | )% |

Restaurant revenues, which are comprised almost entirely of food and beverage sales, increased by \$21.2 million, or 19.2%, compared to the second quarter 2005. Of this increase, \$10.1 million was attributable to new company-owned restaurants opened during 2006, \$8.2 million in additional revenues from non-comparable restaurants opened in 2005 and 2004, and \$2.9 million from a 3.3% increase in comparable restaurant sales. The increase in comparable restaurant sales was driven by a 0.9% increase in guest counts and a 2.4% increase in the average guest check.

For the twenty-eight weeks ended July 9, 2006, restaurant revenues increased by \$49.9 million, or 20.1%, compared to the same period in fiscal 2005. Of this increase, \$13.2 million was attributable to new company-owned restaurants opened during 2006, \$28.1 million in additional revenues from non-comparable restaurants opened in 2005 and 2004, and \$8.7 million from a 4.1% increase in comparable restaurant sales. The increase in comparable restaurant sales was driven by a 2.7% increase in guest counts and a 1.4% increase in the average guest check. The increase in average guest checks for both the twelve and twenty-eight weeks ended July 9, 2006, is attributable to an approximate 1% and 1.5% price increase implemented in March 2006 and June 2005, respectively.

Average weekly sales volumes represent the total restaurant revenue for a population of restaurants in both a comparable and non-comparable category for each time period presented divided by the number of operating weeks in the period. Comparable restaurants average weekly sales volumes include those restaurants that are in the comparable base during each period presented. At the end of the twenty-eight weeks ended July 9, 2006, there were 137 comparable restaurants compared to 115 restaurants at the end of the twenty-eight weeks ended July 10, 2005. Non-comparable restaurants included in the average weekly sales calculation include those restaurants that had not yet achieved the five full quarters of operations during the periods presented. At the end of the second quarter 2006, there were 43 non-comparable restaurants versus 33 at the end of the second quarter 2005. The increase in comparable average weekly sales during the second quarter 2006 was primarily the result of the increase in same store sales growth partially offset by a higher weighting of the seven less mature restaurants entering the comparable base in the second quarter 2006. Similarly, the increase in comparable average weekly sales during the twenty-eight weeks ended July 9, 2006 was primarily the result of the increase in same stores sales growth partially offset by a higher weighting of the 12 less mature restaurants entering the comparable base during 2006. The performance of these newer restaurants entering the comparable base reflects the historical ramp up of our restaurants during the early years of operations. The decrease in the non-comparable restaurants average weekly sales volumes in 2006 compared to 2005 is primarily attributed to the heavier weighting in 2006 of the number of operating weeks from new restaurants recently opened in new markets. Typically, a restaurant in a new market does not have the brand recognition of a restaurant that opens in an existing market, and therefore the sales volumes for a restaurant in a new market ramp up more slowly.



Franchise royalties and fees, which consist primarily of royalty income and initial franchise fees, increased by 16.9% and 17.3% for the twelve and twenty-eight weeks ended July 9, 2006, respectively, over the same periods last year. This increase is due primarily to the 19 restaurants opened by our franchisees during 2005. For the twelve weeks ended July 9, 2006, our franchisees reported that comparable sales for U.S. and Canadian restaurants increased 2.6% and 9.0%, respectively. Comparable sales for U.S. and Canadian franchise restaurants for the twenty-eight weeks ended July 9, 2006 increased 3.3% and 9.7%, respectively over the prior year.

***Costs and Expenses***

*Cost of Sales*

| (In thousands, except percentages) | Twelve Weeks Ended |               |         | Percent Change | Twenty-eight Weeks Ended |               |         | Percent Change |
|------------------------------------|--------------------|---------------|---------|----------------|--------------------------|---------------|---------|----------------|
|                                    | July 9, 2006       | July 10, 2005 |         |                | July 9, 2006             | July 10, 2005 |         |                |
| Cost of sales                      | \$ 29,781          | \$ 26,113     | 14.0    | %              | \$ 67,876                | \$ 58,593     | 15.8    | %              |
| As a percent of restaurant revenue | 22.5               | % 23.6        | % (1.1) | )%             | 22.8                     | % 23.6        | % (0.8) | )%             |

Cost of sales, comprised of food and beverage expenses, are variable and generally fluctuate with sales volume. As a percentage of restaurant revenues, cost of sales improved 1.1% and 0.8%, for the twelve and twenty-eight weeks ended July 9, 2006, respectively, due primarily to lower commodity costs, menu mix changes to lower costs items and purchasing initiatives designed to reduce food and beverage costs, as well as the leverage from price increases implemented since June 2005. These benefits were partially offset by higher freight and delivery charges.

*Labor*

| (In thousands, except percentages) | Twelve Weeks Ended |               |       | Percent Change | Twenty-eight Weeks Ended |               |       | Percent Change |
|------------------------------------|--------------------|---------------|-------|----------------|--------------------------|---------------|-------|----------------|
|                                    | July 9, 2006       | July 10, 2005 |       |                | July 9, 2006             | July 10, 2005 |       |                |
| Labor                              | \$ 45,649          | \$ 37,567     | 21.5  | %              | \$ 103,189               | \$ 83,468     | 23.6  | %              |
| As a percent of restaurant revenue | 34.6               | % 33.9        | % 0.7 | %              | 34.7                     | % 33.7        | % 1.0 | %              |

Labor costs include restaurant hourly wages, fixed management salaries, stock-based compensation, bonuses, taxes and benefits for restaurant team members. Labor as a percentage of restaurant revenue increased 0.7% and 1.0% for the twelve and twenty-eight weeks ended July 9, 2006, respectively. These increases were the result of increases in salaried labor costs, incentive bonuses and benefits (including stock-based compensation costs).

*Operating*

| (In thousands, except percentages) | Twelve Weeks Ended |               |       | Percent Change | Twenty-eight Weeks Ended |               |       | Percent Change |
|------------------------------------|--------------------|---------------|-------|----------------|--------------------------|---------------|-------|----------------|
|                                    | July 9, 2006       | July 10, 2005 |       |                | July 9, 2006             | July 10, 2005 |       |                |
| Operating                          | \$ 20,177          | \$ 16,318     | 23.6  | %              | \$ 45,510                | \$ 36,927     | 23.2  | %              |
| As a percent of restaurant revenue | 15.3               | % 14.7        | % 0.6 | %              | 15.3                     | % 14.9        | % 0.4 | %              |

Operating costs include variable costs such as restaurant supplies, advertising and energy costs, and fixed costs such as service repairs and maintenance costs. Operating costs as a percent of restaurant revenue increased 0.6% and 0.4% for the twelve and twenty-eight weeks ended July 9, 2006, respectively. The increases were the result of higher energy, maintenance and supplies expense. The higher energy costs were experienced through increased rates charged to our restaurants for natural gas and oil-based utilities. Maintenance expense reflects an increase in repairs and maintenance costs that arise as needed. Supplies expense also reflects higher petroleum-based materials costs, fuel surcharges and transportation costs that began an increasing trend in our base supply costs in 2005.

*Occupancy*

| (In thousands, except percentages) | Twelve Weeks Ended |               |  | Percent Change | Twenty-eight Weeks Ended |               |  | Percent Change |
|------------------------------------|--------------------|---------------|--|----------------|--------------------------|---------------|--|----------------|
|                                    | July 9, 2006       | July 10, 2005 |  |                | July 9, 2006             | July 10, 2005 |  |                |
| Occupancy                          | \$ 7,858           | \$ 6,789      |  | 15.7           | % \$ 17,931              | \$ 15,640     |  | 14.6           |
| As a percent of restaurant revenue | 5.9                | % 6.1         |  | % (0.2)        | )% 6.0                   | % 6.3         |  | % (0.3)        |

Occupancy costs include fixed rents, percentage rents, common area maintenance charges, real estate and personal property taxes, general liability insurance and other property costs. Our occupancy costs generally increase as the number of company-owned restaurants increases but decline as a percentage of restaurant revenues as we leverage our fixed costs. Occupancy expense as a percent of restaurant revenue improved over the prior year periods due to the leverage provided by the increase in restaurant sales.

*Depreciation and Amortization*

| (In thousands, except percentages) | Twelve Weeks Ended |               |  | Percent Change | Twenty-eight Weeks Ended |               |  | Percent Change |
|------------------------------------|--------------------|---------------|--|----------------|--------------------------|---------------|--|----------------|
|                                    | July 9, 2006       | July 10, 2005 |  |                | July 9, 2006             | July 10, 2005 |  |                |
| Depreciation and amortization      | \$ 7,381           | \$ 5,957      |  | 23.9           | % \$ 16,503              | \$ 13,243     |  | 24.6           |
| As a percent of total revenues     | 5.4                | % 5.2         |  | % 0.2          | % 5.4                    | % 5.2         |  | % 0.2          |

Depreciation and amortization includes depreciation on capital expenditures for restaurants and corporate assets as well as amortization of franchise rights and liquor licenses. Depreciation and amortization expense as a percentage of total revenues has increased primarily due to the increase in the per restaurant costs capitalized for restaurants opened in the last year as well as corporate asset additions.

*General and Administrative*

| (In thousands, except percentages) | Twelve Weeks Ended |               |  | Percent Change | Twenty-eight Weeks Ended |               |  | Percent Change |
|------------------------------------|--------------------|---------------|--|----------------|--------------------------|---------------|--|----------------|
|                                    | July 9, 2006       | July 10, 2005 |  |                | July 9, 2006             | July 10, 2005 |  |                |
| General and administrative         | \$ 11,382          | \$ 8,296      |  | 37.2           | % \$ 27,229              | \$ 19,520     |  | 39.5           |
| As a percent of total revenues     | 8.4                | % 7.3         |  | % 1.1          | % 8.9                    | % 7.6         |  | % 1.3          |

General and administrative costs include all corporate and administrative functions that support existing operations, franchises, and provide infrastructure to facilitate our future growth. Components of this category include corporate management, supervisory and staff salaries, bonuses, stock-based compensation and related employee benefits, travel, information systems, training, office rent, franchise administrative support, legal, professional and consulting fees and marketing costs. For the twelve weeks ended July 9, 2006, the 1.1% increase as a percent of total revenues is due primarily to:

- 0.9% increase in stock-based compensation expense,
- 0.4% increase in marketing activities,
- 0.3% increase in legal fees,
- (0.3%) decrease due to leverage from headcount, salaries and related costs, and
- (0.2%) other.

For the twenty-eight weeks ended July 9, 2006, the 1.3% increase as a percent of total revenues is due primarily to:

- 0.9% increase in stock-based compensation expense,

- 0.3% increase in marketing costs, and a
- 0.1% increase in legal fees.

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**Pre-opening Costs**

| (In thousands, except percentages)       | Twelve Weeks Ended |                  |                   | Twenty-eight Weeks Ended |                  |                   |
|--|--------------------|------------------|-------------------|--------------------------|------------------|-------------------|
|  | July 9,<br>2006    | July 10,<br>2005 | Percent<br>Change | July 9,<br>2006          | July 10,<br>2005 | Percent<br>Change |
| Pre-opening costs                        | \$ 1,912           | \$ 992           | 92.7              | % \$ 4,155               | \$ 2,812         | 47.8 %            |
| As a percent of total revenues           | 1.4 %              | 0.9 %            | 0.5               | % 1.4                    | % 1.1            | 0.3 %             |
| Average per restaurant pre-opening costs | \$ 239             | \$ 219           | 9.1               | % \$ 235                 | \$ 211           | 11.4 %            |

Pre-opening costs, which are expensed as incurred, consist of the costs of labor, hiring and training the initial hourly work force for our new restaurants, travel expenses for our training teams, the cost of food and beverages used in training, marketing costs, lease costs incurred prior to opening and other direct costs related to the opening of new restaurants. Pre-opening costs for the twelve weeks ended July 9, 2006 and July 10, 2005 reflect the opening of eight and three new restaurants respectively. For the twenty-eight weeks ended July 9, 2006 and July 10, 2005, pre-opening costs reflect the opening of 17 and 11 new restaurants respectively. In addition, these amounts include the costs incurred during the periods presented for restaurants under construction. The increases in our average pre-opening costs per restaurant reflects an increase in lease costs incurred prior to opening. These increased lease costs are driven by the number of restaurants built on purchased land versus restaurants built on lease land. Our 2006 new restaurants are weighted more heavily to leased land than our 2005 new restaurants openings.

**Interest Expense, net**



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Interest expense was \$937,000 and \$704,000 for the twelve weeks ended July 9, 2006 and July 10, 2005, respectively and \$2.0 million and \$1.5 million for the twenty-eight weeks ended July 9, 2006 and July 10, 2005, respectively. Interest expense in 2006 was higher due to higher borrowings outstanding under our revolving credit facility and a slightly higher average interest rate of 6.9% versus 6.8% in 2005. In late 2005, we amended our revolving credit facility to include more favorable interest terms. However, we believe interest expense will increase in 2006 as we continue to fund our restaurant unit growth and finance the acquisition of the 13 franchised restaurants with additional borrowings.

### *Provision for Income Taxes*

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The provision for income taxes for the second quarter decreased \$319,000, or 8.1%, to \$3.6 million in 2006, from \$3.9 million in 2005. The provision for income taxes for the twenty-eight week period ended July 9, 2006 and the same period 2005 were \$7.4 million and \$8.1 million, respectively. These decreases were due primarily to decreased pre-tax earnings and higher income tax credits in 2006. Our effective income tax rate for the second quarter 2006 was 33.4% compared to 34.6% for the second quarter 2005. The effective tax rate for the twenty-eight weeks ended July 9, 2006 and July 10, 2005 was 33.8% and 34.6%, respectively.

### **Liquidity and Capital Resources**

*General.* Cash and cash equivalents increased \$2.3 million to \$5.6 million during the first twenty-eight weeks of fiscal 2006, compared to \$3.3 million at the end of fiscal 2005. This increase was due primarily to higher cash flows provided by operating activities and net borrowings under the revolving credit agreement. We continue to reinvest available cash flows from operations to develop new restaurants or enhance existing restaurants.

*Financial Condition.* The Company and the restaurant industry in general, maintain relatively low levels of accounts receivable and inventories. Vendors grant trade credit for purchases such as food and supplies. We also continually invest in our business through the addition of new restaurants and refurbishment of existing restaurants, which are reflected as long-term assets and not as part of working capital.

*Credit Facility.* Our credit facility is currently comprised of a \$200 million revolving credit facility maturing on December 14, 2010. Borrowings under the amended credit agreement bear interest at one of the following rates as selected by the Company: an Alternative Base Rate (ABR), which is based on the Prime Rate plus 0.00% to 0.25% or a London Interbank Offered Rate (LIBOR), which is based on the relevant one, two, three or six month LIBOR, at the Company's discretion, plus 0.625% to 1.25%. In addition to the ABR and LIBOR loans, the agreement provides for a swing-line loan sub-facility which allows the Company to borrow up to \$7.5 million. The credit facility also requires the payment of an annual commitment fee based on the unused portion of the credit facility. The annual commitment rate and the credit facility's interest rates are based on a financial leverage ratio, as defined in the credit agreement. The Company

and certain of its subsidiaries granted liens in substantially all personal property assets and certain real property assets to secure our respective obligations under the credit facility. As long as the Company meets a certain financial leverage ratio, the Company will not be required to mortgage or encumber real property assets acquired in the future. Additionally, certain of our real and personal property secure other indebtedness of the Company. At July 9, 2006, we had \$50.2 million of borrowings under our revolving credit facility and had letters of credit outstanding against our credit facility of \$3.6 million.

*Covenants.* We are subject to a number of customary covenants under our various credit agreements, including limitations on additional borrowings, acquisitions, dividend payments, and requirements to maintain certain financial ratios. As of July 9, 2006, we were in compliance with all debt covenants.

Total debt outstanding increased to \$65.8 million at July 9, 2006 from \$58.5 million at December 25, 2005, due to additional borrowings to construct new restaurants and acquire other assets, offset by payments made on capital lease obligations. For the acquisition of the 11 franchisee-owned restaurants on July 10, 2006, the Company borrowed approximately \$33.5 million under our existing revolving bank credit facility. Amounts to be paid with respect to the acquisition of the two remaining restaurants will be borrowed under the credit facility at the time of the subsequent closing.

*Capital Expenditures.* Cash paid for capital expenditures, including capital lease obligations, were \$47.7 million and \$39.4 million for the twenty-eight weeks ended July 9, 2006 and July 10, 2005, respectively. The twenty-eight weeks ended July 9, 2006, compared with the same period 2005, includes higher expenditures for new restaurants as well as increases in facility improvements.

During fiscal year 2006, we expect capital expenditures to be \$100 million to \$105 million, excluding capital expenditures for the acquisition of 13 franchised restaurants. We plan to open approximately 30-32 new company-owned restaurants and plan to continue our investment in restaurant remodels and capital improvements as well as expanding our corporate infrastructure to support our growth model.

*Future Liquidity.* We require capital principally to grow the business through new restaurant construction, as well as to maintain, improve and refurbish existing restaurants, and for general operating purposes. In addition, we may use capital to acquire franchise restaurants. Our primary short-term and long-term sources of liquidity are expected to be cash flows from operations and the revolving bank credit facility. Based upon current levels of operations and anticipated growth, we expect that cash flows from operations, combined with other financing alternatives in place or available, will be sufficient to meet debt service, capital expenditures and working capital requirements. In addition, our acquisition of 11 franchisee-owned restaurants on July 10, 2006 was funded primarily from our revolving bank credit facility. Our anticipated acquisition of the two remaining restaurants will be funded through borrowing under the revolving credit facility.

#### **Inflation**

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The primary inflationary factors affecting our operations are food, labor costs, energy costs and materials used in the construction of new restaurants. A large number of our restaurant personnel are paid at rates based on the applicable minimum wage, and increases in the minimum wage directly affect our labor costs. Many of our leases require us to pay taxes, maintenance, repairs, insurance and utilities, all of which are generally subject to inflationary increases. We believe inflation has had a negative impact on our financial condition and results of operations in the current year, due primarily to higher energy costs, higher costs for certain supplies and petroleum based products, and higher costs for materials and labor related to construction of our new restaurants. Uncertainties related to fluctuating costs, including energy costs, commodity prices, wages and construction materials make it difficult to predict what impact, if any, inflation may have on our business during 2006.

### **Seasonality**

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Our business is subject to seasonal fluctuations. Historically, sales in most of our restaurants have been higher during the summer months and winter holiday season. Our quarterly and annual operating results and comparable restaurant sales may fluctuate significantly as a result of seasonality and other factors. Accordingly, results for any one quarter are not necessarily indicative of results to be expected for any other quarter or for any year and comparable restaurant sales for any particular future period may decrease.

**Off Balance Sheet Arrangements**

We have no off balance sheet arrangements.

**Critical Accounting Policies and Estimates**

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We have identified the following as the Company's most critical accounting policies, which are those that are most important to the portrayal of the Company's financial condition and results and require management's most subjective and complex judgments. Information regarding the Company's other significant accounting policies are disclosed in Note 1 of our consolidated financial statements.

*Stock-Based Compensation Expense.* Effective December 26, 2005, the beginning of the first quarter of fiscal 2006, we adopted the fair value recognition provisions of SFAS 123R, using the modified prospective transition method, and therefore have not restated prior periods' results. Under the fair value recognition provisions of SFAS 123R, we recognize stock-based compensation using the Black-Scholes option pricing model and recognize expense on a graded vesting basis over the requisite service periods of an option. Determining the appropriate fair value model and calculating the fair value of share-based payment awards requires the input of highly subjective and judgmental assumptions including volatility, forfeiture rates, and expected option life. If any of the assumptions used in the model change significantly, share-based compensation expense may differ materially in the future from that recorded in the current period.

*Property and Equipment.* Property and equipment is recorded at cost. Expenditures for major additions and improvements are capitalized and minor replacements, maintenance and repairs are charged to expense as incurred. Depreciation is computed using the straight-line method over the estimated useful life for owned assets and the shorter of the estimated useful life or the term of the underlying lease for leased assets. Changes in circumstances, such as changes to our business model or changes in our capital strategy, can result in the actual useful lives differing from our estimates. In those cases where management determines that the useful life of property and equipment should be shortened, we would depreciate the net book value over its revised remaining useful life thereby increasing depreciation and amortization expense. Factors such as changes in the planned use of fixtures or closing of facilities could also result in shortened useful lives.

Our accounting policies regarding property and equipment include judgments by management regarding the estimated useful lives of these assets, the expected lease term for assets related to properties under lease and the determination as to what constitutes enhancing the value of or increasing the life of existing assets. These judgments and estimates may produce materially different amounts of depreciation and amortization expense than would be reported if different assumptions were used. As discussed further below, these judgments may also impact management's need to recognize an impairment charge on the carrying amount of these assets as the cash flows associated with the assets are realized.

*Impairment of Long-Lived Assets.* Long-lived assets, including restaurant sites, leasehold improvements, other fixed assets and amortized intangible assets are reviewed when indicators of impairment are present. Expected cash flows associated with an asset are the key factor in determining the recoverability of the asset. Identifiable cash flows are generally measured at the restaurant level. The estimate of cash flows is based upon, among other things, certain assumptions about expected future operating performance. Management's estimates of undiscounted cash flows may differ from actual cash flows due to, among other things, changes in economic conditions, changes to our business model or changes in operating performance. If the sum of the undiscounted cash flows is less than the carrying value of the asset, we recognize an impairment loss, measured as the amount by which the carrying value exceeds the fair value of the asset.

Judgments made by management related to the expected useful lives of long-lived assets and our ability to realize undiscounted cash flows in excess of the carrying amounts of such assets are affected by factors such as the ongoing maintenance and improvements of the assets, changes in economic conditions and changes in operating performance. As the ongoing expected cash flows and carrying amounts of long-lived assets are assessed, these factors could cause us to realize a material impairment charge. There were no asset impairment charges during the twenty-eight weeks ended July 9, 2006 and July 10, 2005.

*Goodwill.* We also evaluate goodwill annually or more frequently if indicators of impairment are present. The evaluation is based upon a comparison of the carrying value of our net assets including goodwill balances to the fair value of our net assets using the quoted market price of our common stock. We completed our most recent goodwill impairment test in December 2005 and determined that there were no impairment losses related to goodwill. In the event that business conditions change and our market value were to drop significantly below year-end levels, future tests may result in a need to record a loss due to a write-down of the value of goodwill. At July 9, 2006, goodwill recorded in the consolidated balance sheet totaled \$25.7 million.





*Lease Accounting.* Under the provisions of certain of our leases, there are rent holidays and/or escalations in payments over the base lease term, as well as renewal periods. The effects of rent holidays and escalations are reflected in rent costs on a straight-line basis over the expected lease term, which includes cancelable option periods when it is deemed to be reasonably assured that we will exercise such option periods due to the fact that we would incur an economic penalty for not doing so. The lease term commences on the date when we become legally obligated for the rent payments which generally coincides with the time when the landlord delivers the property for us to develop and we waive contract contingencies. All rent costs recognized during construction periods are expensed immediately as pre-opening expenses.

Judgments made by management for its lease obligations include the probable term for each lease that affects the classification and accounting for a lease as capital or operating; the rent holidays and/or escalations in payments that are taken into consideration when calculating straight-line rent; and the term over which leasehold improvements for each restaurant facility are amortized. These judgments may produce materially different amounts of depreciation, amortization and rent expense than would be reported if different assumed lease terms were used.

*Insurance/Self-Insurance Liabilities.* The Company is self-insured for a portion of losses related to group health insurance, general liability and workers' compensation. We maintain stop-loss coverage with third party insurers to limit our total exposure. The self-insurance liability represents an estimate of the cost of claims incurred and unpaid as of the balance sheet date. The estimated liability is not discounted and is established based upon analysis of historical data and actuarial based estimates, and is closely monitored and adjusted when warranted by changing circumstances. In addition, our history of self-insured experience is short and our significant rate of growth could affect the accuracy of estimates based on historical experience. Should a greater amount of claims occur compared to what was estimated, or should medical costs increase beyond what was expected, our accrued liabilities might not be sufficient and additional expenses may be recorded. Actual claims experience could also be more favorable than estimated, resulting in expense reductions. Unanticipated changes may produce materially different amounts of expense than that reported under these programs.

#### **Recent Accounting Pronouncements**

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In July 2006, the Financial Accounting Standards Board (FASB) issued Financial Interpretation No. 48, *Accounting for Uncertainty in Income Taxes - an interpretation of FASB Statement No. 109* (FIN 48). FIN 48 prescribes a comprehensive financial statement model of how a company should recognize, measure, present, and disclose uncertain tax positions that the company has taken or expects to take in its income tax returns. FIN 48 requires that only income tax benefits that meet the more likely than not recognition threshold be recognized or continue to be recognized on the effective date. Initial derecognition amounts would be reported as a cumulative effect of a change in accounting principle. FIN 48 is effective for fiscal years beginning after December 15, 2006. We are assessing the impact of the new guidance on all of our open tax positions and it is not expected to have a material impact on earnings.

In March 2006, the Financial Accounting Standards Board (FASB) Emerging Issues Task Force (EITF) issued Issue 06-3, *How Sales Taxes Collected From Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement* (EITF 06-3). A consensus was reached that entities may adopt a policy of presenting sales taxes in the income statement on either a gross or net basis. If taxes are significant, an entity should disclose its policy of presenting taxes and the amounts of taxes. The guidance is effective for periods beginning after December 15, 2006. We present company sales net of sales taxes. EITF 06-3 will not impact the method for recording these sales taxes in our consolidated financial statements.

### Forward-Looking Statements

Certain information and statements contained in this report that reflect the Company's current expectations regarding, among other things, future results of operations, economic performance, liquidity and capital resources, financial condition and achievements of the Company, are forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended and Section 21E of the Securities Exchange Act of 1934, as amended. Forward-looking statements include statements regarding our expectations, beliefs, intentions, plans, objectives, goals, strategies, future events or performance and underlying assumptions and other statements which are other than statements of historical facts. These statements may be identified, without limitation, by the use of forward-looking terminology such as anticipate, assume, believe, estimates, expects, intend, plan, project, will, would or comparable and similar terms or the negative thereof. Certain forward-looking statements are included in this Form 10-Q, principally in the sections captioned Financial Statements and Management's Discussion and Analysis. All forward-looking statements included in this Form 10-Q are based on information available to the Company on the date hereof. Such statements speak only as of the date hereof and we undertake no obligation to update any such statement to reflect events

or circumstances arising after the date hereof. These statements are based on assumptions believed by us to be reasonable, and involve known and unknown risks and uncertainties that could cause actual results to differ materially from those described in the statements. These risks and uncertainties include, but are not limited to, the following: our ability to consummate the acquisition of the remaining two restaurants from our franchisee in Washington; finalization of purchase price and purchase accounting adjustments related to the acquisition of the Washington franchised restaurants; our ability to integrate the acquired restaurants and operate them as expected; our ability to achieve and manage our planned expansion; lack of market awareness in new markets; the concentration of our restaurants in the Western United States; changes in consumer preferences, general economic conditions or consumer discretionary spending; effectiveness of our management strategies, initiatives and decisions; changes in availability of capital or credit facility borrowings; changes in the availability and costs of food; increases in energy costs; changes in the cost and availability of building materials and restaurant supplies; our ability to reduce construction costs in our buildings; potential increases in labor expense due to pending minimum wage legislation in some states; costs of legal fees related to defending purported class actions and other lawsuits and legal matters; the costs associated with pending litigation and investigations including diversion of management time and attention and any expense related to settlement of such matters; our quarterly operating results due to seasonality and other factors; the effect of increased competition in the casual dining market; the continued service of key management personnel; our ability to protect our name and logo and other proprietary information; our ability to attract, motivate and retain qualified team members; the ability of our franchisees to open and manage new restaurants; our franchisees' adherence to our practices, policies and procedures; additional costs associated with compliance, including the Sarbanes-Oxley Act and related regulations and requirements; the effectiveness of our internal controls over financial reporting; future changes in financial accounting standards; and other risk factors described from time to time in the Company's Annual Report on Form 10-K for 2005 filed with the SEC.

### Item 3. Quantitative and Qualitative Disclosures About Market Risk

Market risk exposures for our assets are related to cash, cash equivalents and investments. We invest our excess cash in highly liquid short-term investments with maturities of less than one year. These investments are not held for trading or other speculative purposes. Changes in interest rates affect the investment income we earn on our investments and, therefore, impact our cash flows and results of operations.

Under our revolving credit agreement, amended in December 2005, we are exposed to market risk from changes in interest rates on borrowings, which bear interest at one of the following rates we select: an Alternate Base Rate (ABR), based on the Prime Rate plus 0.00% to 0.25%, or a LIBOR, based on the relevant one, two, three or six-month LIBOR, at our discretion, plus 0.625% to 1.25%. The spread, or margin, for ABR and LIBOR loans under the revolving credit agreement are subject to quarterly adjustment based on our then current leverage ratio, as defined by the agreement.

Our objective in managing exposure to interest rate changes is to limit the impact of interest rate changes on earnings and cash flows and to lower overall borrowing costs. To achieve this objective, we may use interest rate swaps and caps to manage our net exposure to interest rate changes related to our borrowings. The interest rate swap agreement the Company had entered into in December 2002, to reduce exposure to rising interest rates, expired January 2006. As appropriate, on the date derivative contracts are entered into, we designate derivatives as either a hedge of the fair value of a recognized asset or liability or of an unrecognized firm commitment (fair value hedge), or a hedge of a forecasted transaction or of the variability of cash flows to be received or paid related to a recognized asset or liability (cash flow hedge).

Our variable rate based loans with GE Capital bear interest at the 30-day commercial paper rate plus a fixed percentage of 3.0% to 3.5%.

As of July 9, 2006, we had \$55.7 million of borrowings subject to variable interest rates, and a plus or minus 1.0% change in the effective interest rate applied to these loans would have resulted in pre-tax interest expense fluctuation of \$557,000 on an annualized basis.

Primarily all of our transactions are conducted, and our accounts are denominated, in United States dollars. Accordingly, we are not exposed to significant foreign currency risk.

Many of the food products purchased by us are affected by changes in weather, production, availability, seasonality and other factors outside our control. In an effort to control some of this risk, we have entered into some fixed price purchase commitments. In addition, we believe that almost all of our food and supplies are available from several sources, which helps to control food commodity risks.

#### **Item 4. Controls and Procedures**

##### *Evaluation of Disclosure Controls and Procedures*

The Company maintains disclosure controls and procedures that are designed to ensure that information required to be disclosed in the Company's reports under the Securities Exchange Act of 1934, as amended (the Exchange Act), is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms, and that such information is accumulated and communicated to the management of Red Robin Gourmet Burgers, Inc. (Management), including the Company's Chief Executive Officer (CEO) and Chief Financial Officer (CFO), as appropriate, to allow timely decisions regarding required disclosure. In designing and evaluating the disclosure controls and procedures, Management recognizes that any controls and procedures, no matter how well designed and operated, can only provide reasonable assurance of achieving the desired control objectives. As a result, the Company's CEO and CFO have concluded that, based upon the evaluation of disclosure controls and procedures (as defined in Rule 13a-15(e) or 15d-15(e) under the Exchange Act), the Company's disclosure controls and procedures were effective as of the end of the period covered by this report.

##### *Changes in Internal Control Over Financial Reporting*

The Company's Management, with the participation of the CEO and CFO, have evaluated whether any change in the Company's internal control over financial reporting occurred during the fiscal quarter ended July 9, 2006. Based on that evaluation, Management concluded that there has been no change in the Company's internal control over financial reporting during the fiscal quarter ended July 9, 2006 that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

## **PART II - OTHER INFORMATION**

#### **Item 1. Legal Proceedings**

In January 2006, the Company was served with a purported class action lawsuit, *Huggett v. Red Robin International, Inc.* This lawsuit was filed in the Superior Court of the State of California. The Huggett lawsuit alleges failure to comply with California wage and hour regulations, including those governing meal and rest periods, payment of wages upon termination and provision of itemized statements to employees, as well as unlawful business practices and unfair competition. The complaint states claims for damages, including punitive and exemplary damages, and injunctive relief. The Company has filed an answer to the Huggett complaint and has removed the case to the United States District Court for the Central District of California. On March 13, 2006, Huggett filed a motion to remand the case to the California state court. On June 9, 2006, the Court denied the motion to remand.

On August 31, 2005, Elliot Wilster commenced a stockholder's derivative suit on behalf of the Company in the United States District Court for the District of Colorado (the Wilster Complaint). The action was brought against the Company as a nominal defendant and against the former chief executive officer, then-current board members and the Company's current senior vice president and chief concept officer. The Wilster Complaint alleged that several of the individual defendants improperly profited from their sales of Company stock while they knew proprietary, non-public information regarding the former chief executive officer's alleged abuse of his corporate position. The Wilster Complaint also alleged that the defendants breached their fiduciary duty, abused their control, engaged in gross mismanagement, wasted corporate assets and were unjustly enriched at the expense of and to the detriment of the Company by failing to act on the former chief executive officer's alleged abuse of his corporate position and by waiving a conflict of interest resulting from proposed franchise development involving the former chief executive officer and the senior vice president and chief concept officer. The Wilster Complaint sought monetary damages against the individual defendants, equitable relief, restitution and attorneys' fees. On December 15, 2005, Wilster filed an amended stockholder derivative complaint (the Amended Wilster Complaint) that added the Company's former chief financial officer as a defendant. On August 3, 2006, the Court in the Wilster case granted the Company's motion to dismiss all claims against all defendants for failure to plead demand futility. The Court ruled that the Wilster plaintiff failed to allege particularized facts to show that a majority of the Board lacks independence or is interested in the challenged transactions and activity such that a pre-litigation demand on the Board was futile.

The Wilster case had been consolidated for pretrial purposes with the *Andropolis* case. There have been no other material developments in *Andropolis*.

See Note 7 *Contingencies*, in the Notes to Condensed Consolidated Financial Statements, for additional information regarding certain legal proceedings to which the Company is a party.

## Item 1A. Risk Factors

A description of the risk factors associated with our business is contained in Item 1A, Risk Factors, of our 2005 Annual Report on Form 10-K filed with the Securities and Exchange Commission on February 23, 2006 and incorporated herein by reference. There have been no material changes in our Risk Factors disclosed in our 2005 Annual Report on Form 10-K.

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

The following matters were submitted to a vote of security holders during the Company's annual meeting of stockholders held on June 1, 2006.

|   | Number of Shares |                |             |
|---|------------------|----------------|-------------|
| Description of Matter   | Voted For        | Votes Withheld | Abstentions |
| 1. Election of Class I Directors  |                  |                |             |
| James T. Rothe  | 15,415,328       | 630,443        | 0           |
| J. Taylor Simonton  | 15,440,342       | 605,429        | 0           |
| Richard J. Howell   | 15,441,059       | 630,712        | 0           |
| 2. Ratification of Appointment of Independent Registered Public Accounting Firm | 15,967,280       | 57,696         | 20,793      |

There were no broker non-votes on any proposals.

Directors whose terms continued following the meeting are Dennis Mullen, Benjamin Graebel, Edward Harvey and Gary Singer.

## Item 6. Exhibits

| Exhibit Number | Description   |
|----------------|---|
| 10.1           | Asset Purchase Agreement dated July 1, 2006 between Red Robin International, Inc., South Sound Red Robin, Inc., Zanner-Hubert, Inc., Northwest Robins, LLC and Washington Robins, LLC |
| 10.2           | Management Services Agreement dated July 10, 2006 between Red Robin International, Inc., South Sound Red Robin, Inc. and Northwest Robins, LLC  |
| 31.1           | Rule 13a-14(a) Certification of Chief Executive Officer   |
| 31.2           | Rule 13a-14(a) Certification of Chief Financial Officer   |
| 32.1           | Section 1350 Certifications of Chief Executive Officer and Chief Financial Officer  |

**SIGNATURE**

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.

August 11, 2006  
(Date)

Red Robin Gourmet Burgers, Inc.

/s/ Katherine L. Scherping  
Katherine L. Scherping  
Chief Financial Officer