

RARE HOSPITALITY INTERNATIONAL INC

Form 10-K/A

November 15, 2006

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**UNITED STATES SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549**

**FORM 10-K/A  
(Amendment No. 1)  
ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d)  
OF THE SECURITIES EXCHANGE ACT OF 1934  
FOR THE FISCAL YEAR ENDED DECEMBER 25, 2005  
COMMISSION FILE NUMBER 0-19924**

**RARE HOSPITALITY INTERNATIONAL, INC.**  
(Exact name of registrant as specified in its charter)

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

**58-1498312**  
(I.R.S. Employer  
Identification No.)

**8215 ROSWELL ROAD, BLDG 600**  
**ATLANTA, GEORGIA**  
(Address of principal executive offices)

**30350**  
(Zip Code)

**770-399-9595**  
(Registrant's telephone number, including area code)  
Securities Registered Pursuant to Section 12(b) of the Act:

**NONE**

Securities Registered Pursuant to Section 12(g) of the Act:

**COMMON STOCK, NO PAR VALUE**

**SERIES A JUNIOR PARTICIPATING PREFERRED STOCK PURCHASE RIGHTS**

(Title of Class)

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

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

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of Registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act. (Check one):  
 Large accelerated filer  Accelerated filer  Non-accelerated filer

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



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The aggregate market value of the voting and non-voting common stock held by non-affiliates (assuming for these purposes, but not conceding, that all executive officers and directors are affiliates of the Registrant) of the Registrant was approximately \$980.1 million based upon the last reported sale price in the Nasdaq National Market of \$29.67 as of the last business day of the Registrant's most recently completed second fiscal quarter.

As of February 28, 2006, the number of shares outstanding of the Registrant's Common Stock, no par value, was 33,633,722 (excluding 1,951,500 shares held in the Company's treasury).

### **EXPLANATORY NOTE**

This Amendment No. 1 on Form 10-K/A to the Annual Report on Form 10-K for the fiscal year ended December 25, 2005, which was originally filed with the Securities and Exchange Commission on March 7, 2006, is being filed by RARE Hospitality International, Inc. (the Company) solely to present restated consolidated financial statements to reflect the Bugaboo Creek Steak House ( Bugaboo Creek ) operations as discontinued and the retrospective application of the Financial Accounting Standards Board's ( FASB ) FASB Staff Position 13-1, Accounting for Rental Costs Incurred During a Construction Period ( FSP 13-1 ).

On September 21, 2006, the Company announced that its Board of Directors had approved exiting the Bugaboo Creek Steak House business through the probable sale of the Bugaboo Creek restaurants and brand. Accordingly, financial results for Bugaboo Creek were presented as discontinued operations for each of the periods presented in the Company's quarterly report on Form 10-Q for the quarter ended October 1, 2006. At the time of the filing of the Company's quarterly report on Form 10-Q for the quarter ended October 1, 2006, the Company did not amend its previously filed Annual Reports on Form 10-K or Quarterly Reports on Form 10-Q to present the Bugaboo Creek operations as discontinued.

On October 6, 2005, the FASB issued FSP 13-1. FSP 13-1 was effective for the Company's 2006 fiscal year and required rental costs incurred during the construction period associated with ground or building operating leases to be expensed. FSP 13-1 allowed for retrospective application in accordance with FASB Statement No. 154, Accounting Changes and Error Corrections a replacement of APB Opinion No. 20 and FASB Statement No. 3. When adopting FSP 13-1, the Company elected to retrospectively apply the provisions of FSP 13-1 to its financial statements for all prior periods.

Prior to the issuance of FSP 13-1, the Company capitalized all rental costs associated with ground or building operating leases during each construction period. Pursuant to FSP 13-1, rental costs associated with ground or building operating leases incurred during construction are now recognized in pre-opening expense restaurants. Upon adoption of FSP 13-1 in the first fiscal quarter of 2006, the Company did not amend its previously filed Annual Reports on Form 10-K or Quarterly Reports on Form 10-Q for the retrospective application of FSP 13-1 (see note 1 to the consolidated financial statements).

This report on Form 10-K/A amends Items 6, 7 and 8 of the Company's Annual Report on Form 10-K, for the fiscal year ended December 25, 2005. In the accompanying restated consolidated financial statements, rental costs associated with ground or building operating leases incurred during construction are recognized in pre-opening expense restaurants and financial results relating to the Bugaboo Creek operations to be divested are presented as discontinued operations.

This document does not reflect events occurring after the filing of the Company's original Annual Report on Form 10-K or modify or update those disclosures, except as required to reflect the presentation of the Bugaboo Creek operating results as discontinued operations and the effects of the adoption of FSP 13-1.

### **Forward-Looking Statements**

Certain of the matters discussed in this Form 10-K/A, particularly regarding estimates of the number and locations of new restaurants that RARE Hospitality International, Inc. and its subsidiaries (the Company) intend to open during fiscal 2006 and statements included in the section of Management's Discussion and Analysis of Financial Condition and Results of Operations entitled OUTLOOK FOR FUTURE OPERATING RESULTS, constitute 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. These statements include statements regarding the intent, belief or current expectations of the Company and members of its Management team, as well as assumptions on which such statements are based. All forward-looking statements in this Form 10-K/A are based upon information available to the

Company on the date of this report.

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Forward-looking statements involve a number of risks and uncertainties, and in addition to the factors discussed elsewhere in this Form 10-K/A, other factors that could cause actual results, performance or developments to differ materially from those expressed or implied by those forward-looking statements include the following: the ability of the Company to execute capital structure and other initiatives intended to enhance long-term shareholder value; the ability of the Company to obtain financing on terms acceptable to the Company and maintain compliance with the covenants included in such financing; the ability of the Company to repurchase its shares in the expected number and at prices that would be accretive to the Company's financial results; the ability of the Company to effect the sale of its Bugaboo Creek Steak House restaurants on acceptable terms; failure of facts to conform to necessary Management estimates and assumptions regarding financial and operating matters; the Company's ability to identify and secure suitable locations for new restaurants on acceptable terms, open the anticipated number of new restaurants on time and within budget, achieve anticipated rates of same store sales, hire and train additional restaurant personnel and integrate new restaurants into its operations; the continued implementation of the Company's business discipline over a large and growing restaurant base; increases in the cost of construction of new restaurants; unexpected increases in cost of sales or employee, pre-opening or other expenses; the economic conditions in the new markets into which the Company expands and possible uncertainties in the customer base in these areas; fluctuations in quarterly operating results; seasonality; unusual weather patterns or events; changes in customer dining patterns; the impact of any negative publicity or public attitudes related to the consumption of beef or other products sold by the Company; unforeseen increases in commodity pricing; disruption of established sources of product supply or distribution; competitive pressures from other national and regional restaurant chains; legislation adversely affecting the restaurant industry, including (without limitation) minimum wage and mandatory healthcare legislation; business conditions, such as inflation or a recession, or other negative effect on dining patterns, or some other negative effect on the economy, in general, including (without limitation) war, insurrection and/or terrorist attacks on United States soil; growth in the restaurant industry and the general economy; changes in monetary and fiscal policies, laws and regulations; and the risks set forth in this Form 10-K/A and other risks identified from time to time in the Company's SEC reports, registration statements and public announcements. Any forward-looking statement speaks only as of the date on which it was made, and the Company undertakes no obligation to update or revise forward-looking statements to reflect changed assumptions, the occurrence of unanticipated events or changes to future operating results over time.

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**ITEM 6. SELECTED FINANCIAL DATA**

The following presents selected consolidated financial data as of and for each of the fiscal years in the five-year period ended December 25, 2005. The Consolidated Financial Statements as of December 25, 2005 and December 26, 2004 and for each of the fiscal years in the three-year period ended December 25, 2005 and the independent registered public accounting firm's report thereon are included in this Form 10-K/A. The selected consolidated financial data has been restated to reflect the Bugaboo Creek operations as discontinued and the retrospective application of the adoption of FASB Staff Position 13-1, Accounting for Rental Costs Incurred During a Construction Period. All share and per share amounts have been restated to give retroactive effect to the Company's 50% stock dividend in 2003 (see Note 1 to consolidated financial statements). The data should be read in conjunction with the Consolidated Financial Statements of the Company and related notes in this Form 10-K/A and Management's Discussion and Analysis of Financial Condition and Results of Operations, also included in this Form 10-K/A.

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	<b>FISCAL YEARS ENDED</b>				
	<b>DEC 25, 2005</b>	<b>DEC 26, 2004</b>	<b>DEC 28, 2003</b>	<b>DEC 29, 2002</b>	<b>DEC 30, 2001</b>
	<b>(in thousands, except per share data)</b>				
<b>STATEMENT OF OPERATIONS</b>					
<b>DATA:</b>					
Revenues:					
Restaurant sales	\$ 838,830	\$ 717,069	\$ 597,133	\$ 512,943	\$ 453,857
Franchise revenues	436	403	374	345	328
Total revenues	839,266	717,472	597,507	513,288	454,185
Costs and expenses:					
Cost of restaurant sales	307,741	264,307	214,814	185,064	165,455
Operating expenses restaurants	364,566	306,591	257,610	222,546	195,902
Provision for asset impairments, restaurant closings, and other charges	557	922		495	2,802
Depreciation and amortization restaurants	31,244	26,703	22,956	20,632	18,003
Pre-opening expense restaurants	7,483	7,190	5,692	3,607	4,250
General and administrative expenses	48,064	41,582	37,024	32,625	30,020
Total costs and expenses	759,655	647,295	538,096	464,969	416,432
Operating income	79,611	70,177	59,411	48,319	37,753
Interest expense, net	1,921	1,328	1,015	1,718	2,128
Early termination of interest rate swap agreement				1,540	1,100
Minority interest	215	300	300	448	639
Earnings from continuing operations before income taxes	77,475	68,549	58,096	44,613	33,886
Income tax expense	25,098	22,760	18,864	14,397	11,002
Income from continuing operations	52,377	45,789	39,232	30,216	22,884
Income (loss) from discontinued operations	(798)	1,200	2,715	2,983	3,119
Net earnings	\$ 51,579	\$ 46,989	\$ 41,947	\$ 33,199	\$ 26,003
Basic earnings per common share:					
Continuing operations	\$ 1.55	\$ 1.35	\$ 1.18	\$ 0.93	\$ 0.73
Discontinued operations	(0.02)	0.04	0.08	0.09	0.10



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Net earnings	\$ 1.53	\$ 1.39	\$ 1.26	\$ 1.02	\$ 0.83
Diluted earnings per common share: *					
Continuing operations	\$ 1.50	\$ 1.29	\$ 1.13	\$ 0.88	\$ 0.69
Discontinued operations	(0.02)	0.03	0.08	0.09	0.09
Net earnings	\$ 1.48	\$ 1.33	\$ 1.20	\$ 0.97	\$ 0.78
Weighted average common shares outstanding (basic)	33,764	33,811	33,162	32,586	31,503
Weighted average common shares outstanding (diluted)	34,817	35,374	34,843	34,268	33,216

\* Per share amounts do not necessarily sum to the total year amounts due to rounding.

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The following is a summary of the unaudited quarterly results for the years ended December 25, 2005 and December 26, 2004 (in thousands, except per share data):

	First Quarter	Second Quarter	Third Quarter	Fourth Quarter	Total Year
2005:					
Revenues	\$205,335	\$210,242	\$201,489	\$222,200	\$839,266
Operating income	22,504	20,548	15,149	21,410	79,611
Earnings from continuing operations before income taxes	22,121	20,094	14,607	20,653	77,475
Net earnings	15,350	13,734	9,588	12,907	51,579
Net earnings per share*:					
Basic	\$ 0.45	\$ 0.40	\$ 0.29	\$ 0.38	\$ 1.53
Diluted	\$ 0.43	\$ 0.39	\$ 0.28	\$ 0.37	\$ 1.48
2004:					
Revenues	\$176,831	\$180,449	\$171,087	\$189,105	\$717,472
Operating income	20,494	18,925	12,255	18,503	70,177
Earnings from continuing operations before income taxes	20,269	18,626	11,759	17,895	68,549
Net earnings	14,768	13,284	8,345	10,592	46,989
Net earnings per share*:					
Basic	\$ 0.44	\$ 0.39	\$ 0.25	\$ 0.31	\$ 1.39
Diluted	\$ 0.42	\$ 0.37	\$ 0.24	\$ 0.30	\$ 1.33

\* Quarterly per share amounts do not necessarily sum to the total year amounts due to changes in shares outstanding and rounding.

**FISCAL YEARS ENDED**

	<b>DEC 25, 2005</b>	<b>DEC 26, 2004</b>	<b>DEC 28, 2003</b>	<b>DEC 29, 2002</b>	<b>DEC 30, 2001</b>
			(in thousands)		
<b>BALANCE SHEET DATA:</b>					
Cash, cash equivalents, and short-term investments	\$ 18,310	\$ 54,382	\$ 44,416	\$ 31,414	\$ 25,938
Assets of discontinued operations	47,179	42,938	39,575	33,225	27,833
Total assets	600,925	561,979	464,572	387,286	350,876
Debt, net of current installments					10,000
Obligations under capital leases, net of current installments	38,991	37,136	27,462	22,406	20,867
Liabilities of discontinued operations	3,075	5,446	5,650	5,412	3,390
Minority interest	1,193	1,309	1,371	1,411	1,329
Total shareholders equity	424,294	399,086	347,048	295,455	252,090

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

**OVERVIEW**

On September 21, 2006, the Company announced that its Board of Directors had approved exiting the Bugaboo Creek Steak House business through the probable sale of the restaurants and brand. In the accompanying consolidated financial statements, financial results relating to the operations to be divested are presented as discontinued operations. Unless otherwise noted, this Management's Discussion and Analysis of financial condition and results of operations relates exclusively to the continuing operations of the Company.

On October 6, 2005, the FASB issued FSP 13-1. FSP 13-1 was effective for the Company's 2006 fiscal year and required rental costs incurred during the construction period associated with ground or building operating leases to be expensed. FSP 13-1 allowed for retrospective application in accordance with FASB Statement No. 154, Accounting Changes and Error Corrections—a replacement of APB Opinion No. 20 and FASB Statement No. 3. When adopting FSP 13-1, the Company elected to retrospectively apply the provisions of FSP 13-1 to its financial statements for all prior periods. The accompanying consolidated financial statements have been restated to reflect the retrospective application of FSP 13-1.

The Company's revenues are derived primarily from restaurant sales from Company-owned LongHorn Steakhouse and The Capital Grille restaurants. The Company also derives a small percentage of its total revenue from two Company-owned specialty restaurants and franchise revenues from three franchised LongHorn Steakhouse restaurants. Cost of restaurant sales consists of food and beverage costs for all restaurants other than the franchised LongHorn Steakhouse restaurants in Puerto Rico. Operating expenses—restaurants consist of other costs incurred by the Company to operate its restaurants, including the cost of labor, advertising, operating supplies, rent and utilities. Depreciation and amortization—restaurants includes the depreciation attributable to restaurant-level capital expenditures. The depreciation and amortization relating to non-restaurant level capital expenditures is included in general and administrative expenses.

Preopening costs include direct and incremental costs such as payroll, food and beverage costs, and trainer payroll and travel expenses incurred prior to opening of new restaurants. General and administrative expenses include restaurant supervision expenses, accounting, finance, management information systems and other administrative overhead related to support functions for Company-owned, joint venture, and franchise restaurant operations. Interest expense, net includes interest on capital lease obligations and amortization of loan issue costs partially offset by capitalized construction period interest and interest income. Minority interest consists of the partner's 50% share of earnings in the three LongHorn Steakhouse restaurants that are operated as joint venture restaurants.

The Company's management believes in the importance of building incremental top line sales at each restaurant to support the longer-term profitability of the Company. The change in year-over-year sales for the comparable restaurant base is referred to as same store sales. The Company defines the comparable restaurant base to include those restaurants open for a full 18 months prior to the beginning of each fiscal quarter. Same store sales increases can be generated by an increase in guest traffic counts ( guest counts ) and/or by increases in guest average check amount ( average check ). The average check can be affected by menu price changes and the mix of menu items sold ( menu mix ). The Company gathers sales data daily and regularly analyzes the guest counts and menu mix for each concept to assist in developing menu pricing, product offering and promotion strategies. Management believes that increases in guest counts are an indication of the long-term health of a concept, while increases in average check and menu mix contribute more significantly to current period profitability. The Company works to balance the pricing and product offerings with other initiatives to achieve the long-term goal of sustainable increases in same store sales.

Average weekly sales are defined as total restaurant sales divided by restaurant weeks. A restaurant week is one week during which a single restaurant is open, so that two restaurants open during the same week constitutes two restaurant weeks. Growth in average weekly sales includes the effect of newer restaurants that are not yet included in the same store sales base. Growth in average weekly sales in excess of growth in same store sales is generally an indication that newer restaurants are operating with sales levels in excess of the system average. Conversely, growth in average weekly sales less than growth in same store sales is generally an indication that newer restaurants are operating with sales levels lower than the system average. It is not uncommon in the casual dining industry for new

restaurant locations to open with an initial honeymoon period of higher than normalized sales volumes and then to experience a drop off in sales after initial customer trials.

The incremental sales generated as a result of increases in same store sales make a significant contribution to the Company's profitability through the leveraging of certain restaurant level expenses. Many restaurant level expenses are relatively fixed in nature and do not increase at the same rate as same store sales increases. With sales increasing and certain restaurant-level expenses staying fixed or semi-variable (rising more slowly than incremental sales), the incremental sales measured by these same store sales increases should be the Company's most profitable. When new restaurants are opened,

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there are preopening costs and certain relatively fixed costs including expense items such as management labor, rent and depreciation that must be absorbed. Additionally, it generally takes some period of time after opening before restaurant margins normalize. Accordingly, the sales at newly opened restaurants do not make a significant contribution to profitability in their initial months of operation.

The Company's revenues and expenses can be affected significantly by the number and timing of the opening of additional restaurants. For instance, preopening expenses for any particular period may reflect expenses associated with restaurants to be opened in future periods, in addition to those restaurants opened during the current period. The timing of restaurant openings also can affect the average weekly sales and other period-to-period comparisons.

The following table sets forth the percentage relationship to total revenues of the listed items included in the Company's consolidated statements of operations, except as indicated (percentages may not add due to rounding):

	<b>FISCAL YEARS ENDED</b>		
	<b>DECEMBER</b>		
	<b>25,</b>	<b>DECEMBER 26,</b>	<b>DECEMBER 28,</b>
	<b>2005</b>	<b>2004</b>	<b>2003</b>
Revenues:			
Restaurant sales:			
LongHorn Steakhouse	79.4%	80.6%	81.5%
The Capital Grille	19.7	18.3	17.1
Other restaurants	0.9	1.1	1.3
Total restaurant sales	99.9	99.9	99.9
Franchise revenues	0.1	0.1	0.1
Total revenues	100.0	100.0	100.0
Costs and expenses:			
Cost of restaurant sales(1)	36.7	36.8	36.0
Operating expenses restaurants(1)	43.4	42.7	43.1
Provision for asset impairments, restaurant closings, and other charges	0.1	0.1	
Depreciation and amortization restaurants(1)	3.7	3.7	3.8
Pre-opening expense restaurants(1)	0.9	1.0	1.0
General and administrative expenses	5.7	5.8	6.2
Total costs and expenses	90.5	90.3	90.1
Operating income	9.5	9.7	9.9
Interest expense, net	0.2	0.2	0.2
Minority interest	0.0	0.0	0.1

Earnings from continuing operations before income taxes	9.2	9.5	9.7
Income tax expense	3.0	3.2	3.1
Income from continuing operations	6.2	6.4	6.5
Income (loss) from discontinued operations	(0.1)	0.2	0.5
Net earnings	6.1%	6.5%	7.0%

(1) Cost of restaurant sales, operating expenses restaurants, depreciation and amortization restaurants and pre-opening expense restaurants are expressed as a percentage of total restaurant sales.

**RESULTS OF OPERATIONS**

*Year Ended December 25, 2005 Compared to Year Ended December 26, 2004*

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**REVENUES**

Total revenues increased 17.0% to \$839.3 million for 2005, compared to \$717.5 million for 2004.

*LongHorn Steakhouse:*

Sales in the LongHorn Steakhouse restaurants increased 15.2% to \$666.1 million for 2005, compared to \$578.3 million for 2004. The increase reflects a 12.4% increase in restaurant operating weeks in 2005 as compared to 2004, resulting from an increase in the restaurant base from 210 Company-owned and joint venture LongHorn Steakhouse restaurants at the end of 2004 to 237 restaurants at the end of 2005. Average weekly sales for Company-owned and joint venture LongHorn Steakhouse restaurants in 2005 were \$56,876, a 2.5% increase over 2004. Same store sales for LongHorn Steakhouse restaurants increased 2.8% in 2005 as compared to 2004. The increase in same store sales for 2005 at LongHorn Steakhouse was attributable to an increase in average check, as guest counts were approximately flat compared to the prior year. Menu price increases of approximately 2.0% to 2.5% account for a majority of the check average increase with the remainder due to the impact of quarterly promotions and menu mix shifts. Management believes a number of factors have contributed to the guest counts remaining flat compared to last year, including the negative impact of severe winter weather and hurricanes, as well as the general economic impact on consumer spending of higher gasoline prices.

*The Capital Grille:*

Sales in The Capital Grille restaurants increased 25.9% to \$165.2 million for 2005, compared to \$131.2 million for 2004. The increase reflects a 16.9% increase in restaurant operating weeks in 2005 as compared to 2004, resulting from the three new The Capital Grille restaurants opened during 2005, bringing the total The Capital Grille restaurants in operation to 23. Average weekly sales for The Capital Grille restaurants in 2005 were \$149,070, a 7.7% increase from 2004. Same store sales for The Capital Grille restaurants increased 5.8% in 2005, as compared to 2004. The increase in same store sales at The Capital Grille restaurants was primarily attributable to an increase in average check of approximately 4.8% and the remainder was due to an increase in guest counts. Management believes that a number of factors have contributed to the increase in check average, including price increases on menu items of approximately 3.0% and the introduction of higher-priced culinary specials that are not included on the menu.

*Franchise Revenue:*

The Company has a franchisee that operates three LongHorn Steakhouse restaurants in Puerto Rico. The Company earned \$436,000 and \$403,000 in franchise revenue in 2005 and 2004, respectively. Franchise revenue is computed based on a fixed percentage of the franchisee's sales; therefore, the increase in 2005 franchise revenue over the prior year was due to the 8.2% increase in sales for the Company's franchised restaurants.

**COSTS AND EXPENSES**

Cost of restaurant sales increased 16.4% to \$307.7 million for 2005, compared to \$264.3 million for 2004. Cost of restaurant sales, as a percentage of restaurant sales, decreased to 36.7% in 2005 from 36.8% in 2004. In addition to the leverage that was provided by a 2% - 3% increase in menu prices, this decrease resulted from lower priced beef contracts on a portion of the Company's beef purchases renewed in mid 2005, as well as favorable menu mix shifts.

Restaurant operating expenses increased as a percentage of total restaurant sales in 2005 to 43.4%, from 42.7% in 2004. During 2005, the Company experienced cost pressures from labor costs resulting from increases in state minimum wage rates, including mandated increases in the minimum wage for workers in Florida, Illinois, Maine, Minnesota, Nevada, New Jersey, New York and Vermont, and increases in unemployment taxes. Additionally, utility costs and credit card fees increased during 2005 as compared to 2004 as a percentage of restaurant sales. Utility costs increased by 0.10% as a percentage of sales due to operating inefficiencies related to the extreme winter weather in the first quarter of 2005 as compared to 2004 and generally higher utility costs in the third and fourth quarter of 2005. Increased credit card usage by customers caused credit card processing fees to increase by 0.10% as a percentage of sales. These increases in restaurant operating expenses were partially offset by the positive impact from increased average weekly sales in 2005, which leveraged fixed and semi-variable expenses as a percentage of total restaurant sales.

Depreciation and amortization - restaurants increased to \$31.2 million in 2005, from \$26.7 million in 2004, due to the Company's new restaurant construction and depreciation of capital expenditures associated with the Company's remodeling of older restaurants. The amount of depreciation expense per operating week increased slightly in 2005 as



compared to 2004; however, depreciation as a percentage of total restaurant sales was flat due to the leveraging effect of increased average weekly sales in 2005.

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Pre-opening expense restaurants increased to \$7.5 million or 0.9% of total restaurant sales in 2005 from \$7.2 million or 1.0% of total restaurant sales in 2004. This dollar increase was the result of the Company opening a total of 30 new restaurants in 2005 as compared to opening 27 restaurants in 2004. The amount of pre-opening expense per new restaurant in 2005 was approximately equal to preopening expense per new restaurant in 2004.

The provision for asset impairments, restaurant closings and other charges of approximately \$557,000 in 2005 consisted primarily of the write down of asset values for three LongHorn Steakhouse restaurants. The impairment for each LongHorn Steakhouse restaurant related to management's decision to not exercise future lease options for these restaurants as the current lease term expires. The impairment for all these restaurants related to forecasts by management that indicate that the investment for each of these restaurants would not be fully recovered by anticipated future cash flows. The impairment charge represents the sum of the differences between the estimated fair value, using discounted estimated future cash flows, and the carrying value of each of these restaurants.

General and administrative expenses increased to \$48.1 million in 2005, from \$41.6 million in 2004. As a percentage of total revenues, general and administrative expenses decreased slightly to 5.7% in 2005 from 5.8% in 2004. The leverage on fixed and semi-fixed general and administrative expenses resulting from higher average weekly sales volumes and greater number of restaurants in operation during 2005 as compared to 2004 was partially offset by higher accruals for management bonuses in 2005.

Interest expense, net increased to \$1.9 million in 2005, from \$1.3 million in 2004. The increase in interest expense, net was due to the interest expense associated with new capital lease obligations. The Company had no amounts outstanding under its revolving credit facility during 2004. There were no amounts outstanding under the revolving credit facility at the end of 2005; however, the Company did pay approximately \$100,000 in interest expense on borrowings under its revolving credit facility during the course of 2005 at an average rate of 6.2%.

Minority interest was \$215,000 in 2005 compared with \$300,000 in 2004. This expense reflects the joint venture partner's interest in the Company's three joint venture LongHorn Steakhouse restaurants.

Income tax expense associated with continuing operations in 2005 was 32.39% of earnings before income taxes as compared to 33.2% in 2004. This decrease in the Company's effective income tax rate is primarily due to an increase in the FICA tip tax credit recognized in 2005. The Company's effective income tax rate differs from applying the statutory Federal income tax rate of 35% to earnings before income taxes primarily due to employee FICA tip tax credits partially offset by state income taxes.

Net income (loss) from discontinued operations in 2005 was a net loss of \$798,000, as compared to net income from discontinued operations in 2004 of \$1,200,000. The net loss in 2005 was primarily due to a \$2,712,000 (\$1,810,000 after tax) charge for the write down of asset values for two Bugaboo Creek Steak House restaurants. This impairment charge represents the sum of the differences between the estimated fair value, using discounted estimated future cash flows, and the carrying value of each of these restaurants.

Net income of \$51.6 million in 2005, as compared to net income of \$47.0 million in 2004, reflects the net effect of the items discussed above.

**RESULTS OF OPERATIONS**

*Year Ended December 26, 2004 Compared to Year Ended December 28, 2003*

**REVENUES**

Total revenues increased 20.1% to \$717.5 million for 2004, compared to \$597.5 million for 2003.

*LongHorn Steakhouse:*

Sales in the LongHorn Steakhouse restaurants increased 18.7% to \$578.3 million for 2004, compared to \$487.2 million for 2003. The increase reflects a 12.4% increase in restaurant operating weeks in 2004 as compared to 2003, resulting from an increase in the restaurant base from 187 Company-owned and joint venture LongHorn Steakhouse restaurants at the end of 2003 to 210 restaurants at the end of 2004. Average weekly sales for Company-owned and joint venture LongHorn Steakhouse restaurants in 2004 were \$55,504, a 5.6% increase over 2003. Same store sales for LongHorn Steakhouse restaurants increased 5.0% in 2004 as compared to 2003. The increase in same store sales for 2004 at LongHorn Steakhouse was attributable to an increase in guest counts of approximately 1.1% and the remainder was due to an increase in average check. Management believes a number of factors have contributed to the increased guest counts including improved



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restaurant-level execution; menu evolution with more appealing menu offerings; and effective use of media advertising; all of which work together to provide a better overall customer experience.

### *The Capital Grille:*

Sales in The Capital Grille restaurants increased 28.1% to \$131.2 million for 2004, compared to \$102.4 million for 2003. The increase reflects a 15.5 % increase in restaurant operating weeks in 2004 as compared to 2003, resulting from the three new The Capital Grille restaurants opened during 2004, bringing the total The Capital Grille restaurants in operation to 20. Average weekly sales for The Capital Grille restaurants in 2004 were \$138,405, an 11.0% increase from 2003. Same store sales for The Capital Grille restaurants increased 11.7% in 2004, as compared to 2003. The increase in comparable restaurant sales at The Capital Grille restaurants was primarily attributable to an increase in guest counts of approximately 6.6% and the remainder was due to an increase in average check.

During 2004, average weekly sales increased at a rate slightly less than the increase in same store sales. The Capital Grille restaurants have historically opened at lower sales volumes and not experienced the drop off in sales after an initial honeymoon period commonly characteristic in the restaurant industry.

### *Franchise Revenue:*

As of December 25, 2005, the Company had a franchisee that operated three LongHorn Steakhouse restaurants in Puerto Rico. The Company earned \$403,000 and \$374,000 in franchise revenue in 2004 and 2003, respectively. Franchise revenue is computed based on a fixed percentage of the franchisee's sales; therefore, the increase in 2004 franchise revenue over the prior year was due to the 7.8% increase in sales for the Company's franchised restaurants.

## **COSTS AND EXPENSES**

Cost of restaurant sales, as a percentage of restaurant sales, increased to 36.8% in 2004 from 36.0% in 2003. This increase resulted primarily from higher contract pricing on commodities in 2004, particularly pricing with respect to beef contracts, and was partially offset by a 2% - 3% increase in menu prices.

Restaurant operating expenses decreased as a percentage of total restaurant sales in 2004 to 42.7%, from 43.1% in 2003. The increased average weekly sales rate in 2004 leveraged fixed and semi-variable expenses as a percentage of total restaurant sales. The leveraging of these fixed and semi-variable expenses was partially offset by slight increases in unemployment taxes, management labor, advertising spending and credit card fees as a percentage of restaurant sales. Increased credit card usage by customers caused credit card processing fees to increase slightly as a percentage of sales.

Depreciation and amortization - restaurants increased to \$26.7 million in 2004, from \$23.0 million in 2003, due to the Company's new restaurant construction and depreciation of capital expenditures associated with the Company's remodeling of older restaurants. Depreciation as a percentage of total restaurant sales decreased slightly due to the leveraging effect of increased average weekly sales in 2004. The amount of depreciation expense per operating week was approximately the same in 2004 as it was in 2003.

Pre-opening expense - restaurants increased to \$7.2 million or 1.0% of total restaurant sales in 2004 from \$5.7 million or 1.0% of total restaurant sales in 2003. This dollar increase was the result of the Company opening a total of 27 new restaurants in 2004 as compared to opening 23 restaurants in 2003. The amount of pre-opening expense per new restaurant in 2004 was approximately equal to preopening expense per new restaurant in 2003.

The provision for asset impairments, restaurant closings and other charges of approximately \$922,000 in 2004 consisted of the write down of asset values related to two LongHorn Steakhouse restaurants. The impairment charge represents the sum of the differences between the estimated fair value, using discounted estimated future cash flows, and the carrying value of each of these restaurants.

General and administrative expenses increased to \$41.6 million in 2004, from \$37.0 million in 2003. As a percentage of total revenues, general and administrative expenses decreased to 5.8% in 2004 from 6.2% in 2003. This decrease was primarily associated with lower management bonuses and the greater leverage of fixed and semi-fixed general and administrative expenses resulting from higher average weekly sales volumes in 2004.

Interest expense, net increased to \$1.3 million in 2004, from \$1.0 million in 2003. The increase in interest expense, net was due to the interest expense associated with new capital lease obligations partially offset by an increase in the level of capitalized interest associated with the Company's new restaurant development. The Company had no amounts outstanding under its revolving credit facility during 2004 or 2003.



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Minority interest was \$300,000 in both 2004 and 2003. This expense reflects the joint venture partner's interest in the Company's three joint venture LongHorn Steakhouse restaurants.

Income tax expense associated with continuing operations in 2004 was 33.2% of earnings before income taxes. The Company's effective income tax rate differs from applying the statutory Federal income tax rate of 35% to earnings before income taxes primarily due to employee FICA tip tax credits partially offset by state income taxes.

Net income from discontinued operations in 2004 was \$1,200,000, as compared to net income from discontinued operations in 2003 of \$2,715,000. This decrease in net income from discontinued operations was primarily due to a \$1,778,000 (\$1,187,000 after tax) charge for the write down of asset values for a Bugaboo Creek Steak House restaurant in 2004. This impairment charge represents the difference between the estimated fair value, using discounted estimated future cash flows, and the carrying value of the Bugaboo Creek Steak House restaurant.

Net income of \$47.0 million in 2004, as compared to net income of \$41.9 million in 2003, reflects the net effect of the items discussed above.

**LIQUIDITY AND CAPITAL RESOURCES**

The Company requires capital primarily for the development of new restaurants, selected acquisitions and the refurbishment of existing restaurants. The Company's principal sources of funds in 2005 were (i) cash provided by operating activities of continuing operations (\$114.4 million), which included the sale of short-term investments (\$28.7 million) and (ii) proceeds from the exercise of employee stock options (\$7.2 million). The primary uses of funds were capital expenditures (\$93.1 million) for new and improved facilities related to continuing operations, capital expenditures (\$11.1 million) for new and improved facilities related to discontinued operations and the purchase of common stock for treasury (\$39.3 million).

Due to the relatively short time period (less than 30 days) between the ordering of inventories, preparation for sale, collection of payment and subsequent payment for inventories, there are no material changes in the underlying drivers of cash flows that are not clearly identifiable in the Company's consolidated statement of cash flows.

Since substantially all sales in the Company's restaurants are for cash or credit card receipts, which are generally settled in three days, and accounts payable are generally due in seven to 30 days, the Company operates with little or negative working capital. The Company's working capital balance decreased from \$43.7 million on December 26, 2004, to \$6.3 million on December 25, 2005, principally due to the purchase of \$39.3 million of common stock for treasury during fiscal 2005.

The increases in accounts receivable, inventory, and accrued expenses are principally due to the new restaurants which were opened during 2005 and the result of generally higher average unit volumes experienced during 2005. Further increases in current asset and liability accounts are expected as the Company continues its restaurant development program.

The Company has a revolving credit facility, which allows the Company to borrow up to \$100.0 million through its maturity in July 2010. The terms of the revolving credit facility require the Company to pay interest on outstanding borrowings at LIBOR plus a margin of 0.50% to 1.25% (depending on the Company's leverage ratio) or the administrative agent's prime rate of interest, at the Company's option, and to pay a commitment fee of 0.1% to 0.2% (depending on the Company's leverage ratio) per year on any unused portion of the facility. No amounts were outstanding, and \$100.0 million was available, under the Company's revolving credit agreement on December 25, 2005. As of December 25, 2005, terms of the revolving credit facility provide for interest to be accrued at LIBOR plus 0.5% or the prime rate and payment of the commitment fee at a rate of 0.10% per year on any unused portion of the facility.

The revolving credit facility contains various covenants and restrictions which, among other things, require the maintenance of stipulated leverage and fixed charge coverage ratios, as defined, and limit the incurrence of additional indebtedness in excess of specified amounts. The Company is currently in compliance with such covenants.

As of December 25, 2005, the Company's plan for 2006 was to open 29 or 30 LongHorn Steakhouse restaurants, two Bugaboo Creek Steak House restaurants (including one restaurant closed due to a fire in the first quarter of 2005) and three The Capital Grille restaurants in 2006. The Company's 2006 capital plan provided for capital expenditures of approximately \$115 to \$125 million in 2006. The capital expenditure estimate for 2006 includes the estimated cost of developing 34 to 35 new restaurants (including the two Bugaboo Creek Steak House restaurants), ongoing

refurbishment in existing restaurants, costs associated with obtaining real estate for year 2007 planned openings and continued investment in improved management information systems.

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**TREASURY STOCK**

The Company's Board of Directors has authorized the purchase of shares of the Company's common stock from time to time through open market transactions, block purchases or in privately negotiated transactions. On April 20, 2005, the Board of Directors authorized the Company to use up to \$29.0 million to purchase shares of its common stock and on July 22, 2005, the Board of Directors authorized the repurchase of up to an additional \$30.0 million of the Company's common stock. During the second quarter of 2005, the Company repurchased 690,000 shares of its common stock at an average price of \$28.88 for an aggregate cost of approximately \$19.9 million. During the third quarter of 2005, the Company repurchased 669,000 shares of its common stock at an average price of \$28.95 for an aggregate cost of approximately \$19.4 million. The Company did not repurchase any of its common stock during the fourth quarter of 2005. As of December 25, 2005, approximately \$19.7 million remained available under the Company's aggregate \$59.0 million share repurchase authorization.

The Company expects that available borrowings under the Company's revolving credit facility and new borrowings under additional financing to be secured, together with cash on hand and cash provided by operating activities, will provide sufficient funds to finance its expansion and share repurchase plans through the year 2007.

**OUTLOOK FOR FUTURE OPERATING RESULTS**

The Company's fiscal year is a 52- or 53-week year ending on the last Sunday in each calendar year. All fiscal years since 2001 have been 52-week periods; however, since fiscal 2006 will end on December 31st, it will be a 53-week period. Each of the four fiscal quarters is typically made up of 13 weeks; however, the first quarter of 2006 will contain 14 weeks. During 2006, the Company expects to realize incremental profits from this extra week of sales and beneficial leverage of the sales during this extra sales week upon fixed and semi-fixed expenses.

*Revenues.* The Company plans to grow revenues by opening additional restaurants and by increasing average unit volumes at both existing and new restaurants. The Company's new restaurant development plans for 2006 are summarized in the section entitled **LIQUIDITY AND CAPITAL RESOURCES**.

*Cost of restaurant sales.* The Company anticipates increased commodity prices in 2006 based primarily on higher protein pricing particularly with respect to beef. Based on the fixed prices negotiated for its protein products, partially offset by current and anticipated menu price increases, the Company expects its costs of goods sold as a percentage of total restaurant sales to be flat to up 0.10% in 2006 as compared with 2005.

*Operating expenses – restaurants.* For the last several years, the Company has experienced cost pressure related to a number of operating expense line items including management and hourly labor. Additionally, several states in which the Company operates restaurants have either recently enacted or are considering enacting an increase in the minimum wage rate, which will result in an increase in hourly labor costs. The Company expects these trends to continue throughout 2006. In addition, the Company expects increases in (i) the cost of utilities, (ii) unemployment tax expense, and (iii) credit card processing fees due to the greater percentage of credit card usage.

*Pre-opening expense – restaurants.* Pre-opening costs are expensed as incurred and are expected to approximate \$195,000 for each LongHorn Steakhouse restaurant and \$400,000 for each The Capital Grille restaurant. Restaurant pre-opening expenses may vary materially from period to period depending on when restaurants open. The Company anticipates that pre-opening expenses will be higher in 2006 by approximately \$1.3 to \$1.5 million (including \$1.1 to \$1.2 million as a result of the change in accounting for rent during the construction period) as a result of the planned opening of more new restaurants in 2006, as compared to 2005.

*Depreciation and amortization – restaurants.* The Company expects depreciation and amortization to increase as it invests in the development of new restaurants and the ongoing refurbishment in existing restaurants. Due to an increase in the average cost to construct new restaurants offset by leverage of this fixed expense resulting from expected average weekly sales increases in 2006, the Company expects depreciation and amortization to remain flat as a percentage of restaurant sales.

*General and administrative expenses.* The Company expects general and administrative expenses to increase by approximately 0.80% to 0.90%, as a percent of total revenues in 2006 as compared with 2005. Approximately 0.70% of that increase reflects the impact of the Company's adoption of the stock-based expense provisions of SFAS 123R at the beginning of 2006.





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*Interest expense, net.* The Company does not plan to have any material amount outstanding under its revolving credit facility during 2006. However, due to the addition of capital leases during 2005 and expected additions of capital leases in 2006, as well as lower forecasted invested cash balances for 2006, the Company expects net interest expense to increase in 2006 compared with 2005.

*Income tax expense.* The Company expects its effective income tax rate for 2006 to be approximately 33.25% of earnings before income taxes.

*Earnings per share.* The Company expects fiscal 2006 diluted earnings per common share from continuing operations in a range of \$1.41 to \$1.43, which includes the impact of the Company's adoption of SFAS 123R and FSP 13-1.

**OFF-BALANCE SHEET ARRANGEMENTS**

The Company has not entered into any transactions with unconsolidated entities, that are financial guarantees, retained or contingent interests in transferred assets, derivative instruments, or obligations arising out of a variable interest entity that provides financing, liquidity, market risk or credit risk support to, or engages in leasing, hedging or research and development services with the Company and that have a material current effect, or that are reasonably likely to have a material future effect, on the Company's financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources.

**CONTRACTUAL OBLIGATIONS AND OTHER COMMITMENTS**

The table below summarizes the Company's significant contractual obligations of continuing operations, by maturity, as of December 25, 2005 (in thousands):

	<b>TOTAL</b>	<b>LESS THAN 1 YEAR</b>	<b>1 3 YEARS</b>	<b>4 5 YEARS</b>	<b>AFTER 5 YEARS</b>
Bank revolving credit facility	\$	\$	\$	\$	\$
Capital lease obligations (1)	94,411	3,897	8,191	8,631	73,692
Operating lease obligations (2)	115,894	19,074	35,446	28,500	32,874
Purchase obligations (3)	245,270	232,949	12,321		
Total contractual cash obligations	\$ 455,575	\$ 255,920	\$ 55,958	\$ 37,131	\$ 106,566

(1) Amounts reflected include imputed interest of \$55,151.

(2) Excludes operating lease obligations of Bugaboo Creek as follows:

<b>TOTAL</b>	<b>LESS THAN 1 YEAR</b>	<b>1 3 YEARS</b>	<b>4 5 YEARS</b>	<b>AFTER 5 YEARS</b>
\$26,466	\$ 3,574	\$6,873	\$5,963	\$10,056

Operating  
lease  
obligations of  
discontinued  
operations

- (3) Consists of purchase obligations and commitments under food contracts and the estimated costs of completing capital project commitments associated with continuing operations. Excludes \$1,397 in estimated costs for capital project commitments associated with discontinued operations.

#### **EFFECT OF INFLATION**

Management believes that inflation has not had a material effect on earnings during the past several years. Inflationary increases in the cost of labor, food and other operating costs could adversely affect the Company's restaurant operating margins. In the past, however, the Company generally has been able to modify its operations and increase menu prices to offset inflationary increases in its operating costs.

A majority of the Company's employees are paid hourly rates related to federal and state minimum wage laws and various laws that allow for credits to that wage. Although the Company has generally been able to and will continue to attempt to pass along increases in the minimum wage and in other costs through food and beverage price increases, there can

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be no assurance that all such increases can be reflected in its prices or that increased prices will be absorbed by customers without diminishing, at least to some degree, customer spending at its restaurants.

**RECENT ACCOUNTING PRONOUNCEMENTS**

On October 6, 2005, the Financial Accounting Standards Board (FASB) issued FASB Staff Position 13-1, Accounting for Rental Costs Incurred During a Construction Period ( FSP 13-1 ). FSP 13-1 is effective for the Company's fiscal 2006 and requires the Company to expense rental costs incurred during the construction period associated with ground or building operating leases. The Company has previously capitalized these costs. Retrospective application, which permits entities to restate financial statements of previous periods is permitted but not required. In the first quarter of fiscal 2006, the Company adopted the provisions of FSP 13-1 using retrospective application. This resulted in the revision of previously issued financial statements as if the provisions of FSP 13-1 had always been used. As noted in the section entitled EXPLANATORY NOTE, this report on Form 10-K/A restates the Company's consolidated financial statements to recognize rental costs associated with ground or building operating leases incurred during construction in pre-opening expense restaurants.

In December 2004, the FASB issued Statement of Financial Accounting Standards No. 123 (revised 2004), Share-Based Payment, (SFAS 123R). SFAS 123R is a revision of SFAS No. 123, Accounting for Stock-Based Compensation. Among other items, SFAS 123R eliminates the use of the intrinsic value method of accounting, and requires companies to recognize the cost of awards of equity instruments granted in exchange for employee services received, based on the grant date fair value of those awards, in their financial statements. The effective date of SFAS 123R was the first interim period beginning after June 15, 2005; however, on April 14, 2005, the SEC announced that the effective date of SFAS 123R was postponed until the first annual period beginning after June 15, 2005.

SFAS 123R permits companies to adopt its requirements using either a modified prospective method, or a modified retrospective method. Under the modified prospective method, compensation cost is recognized in the financial statements beginning with the effective date, based on the requirements of SFAS 123R for all share-based payments granted after that date, and based on the requirements of SFAS 123 for all unvested awards granted prior to the effective date of SFAS 123R. Under the modified retrospective method, the requirements are the same as under the modified prospective method, but this method also permits entities to restate financial statements of previous periods based on proforma disclosures made in accordance with SFAS 123. The Company adopted the provisions of SFAS 123R using modified prospective application in the first quarter of fiscal 2006.

The Company currently utilizes the Black-Scholes option-pricing model to measure the fair value of stock options granted to employees. While SFAS 123R permits entities to continue to use this model, the standard also permits the use of a lattice model. SFAS 123R also requires that the benefits associated with the tax deductions in excess of recognized compensation cost be reported as a financing cash flow, rather than as an operating cash flow as required under current standards. This requirement will reduce net operating cash flows and increase net financing cash flows in periods after the effective date. These future amounts cannot be estimated because they depend on, among other things, when employees exercise stock options.

As described in Note 1 to the Consolidated Financial Statements, compensation cost for stock options for which the requisite future service has not yet taken place is disclosed as a pro forma expense by applying the provisions of SFAS 123. The pro forma application of SFAS 123 had a dilutive effect of approximately \$0.12 per diluted share for 2005. Compensation cost for stock options vesting beginning in fiscal 2006, and all restricted stock, will be expensed in accordance with the provisions of SFAS 123R, which will be effective for the Company at the beginning of fiscal 2006. The Company estimates that stock-based compensation expense for fiscal 2006 will be approximately \$6.5 to \$7.5 million (\$5.0 to \$5.7 million after tax or \$0.14 to \$0.16 per diluted share). This estimate includes costs related to unvested stock options and restricted stock grants associated with new compensation programs.

In March 2005, the FASB issued FASB Interpretation No. 47, Accounting for Conditional Asset Retirement Obligations, an interpretation of FASB No. 143 ( FIN 47 ). Asset retirement obligations are legal obligations associated with the retirement of long-lived assets that result from the acquisition, construction, development and/or normal operation of a long-lived asset. FIN 47 clarifies that liabilities associated with asset retirement obligations whose timing or settlement method are conditional on future events should be recorded at fair value as soon as fair value is reasonably estimable. FIN 47 also provides guidance on the information required to reasonably estimate the fair value

of the liability. The provisions of FIN 47 are effective for fiscal years ending after December 15, 2005. The Company adopted the provisions of FIN 47 during the fourth quarter of 2005. The impact of adoption was not material.

In May 2005, the FASB issued SFAS No. 154, Accounting Changes and Error Corrections a replacement of APB Opinion No. 20 and FASB Statement No. 3 ( SFAS 154 ). SFAS 154 replaces APB No. 20, Accounting Changes, and

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SFAS No. 3, Reporting Accounting changes in Interim Financial Statements, and changes the requirements for the accounting for, and reporting of, a change in accounting principle. SFAS 154 requires retrospective application of changes in accounting principle, unless it is impracticable to determine either the period-specific effects or the cumulative effect of the change. SFAS 154 defines retrospective application as the application of a different accounting principle to prior accounting periods as if that principle had always been used or as the adjustment of previously issued financial statements to reflect a change in the reporting entity. SFAS 154 also redefines restatement as the revising of previously issued financial statements to reflect the correction of an error. SFAS 154 is effective for accounting changes and correction of errors made in fiscal years beginning after December 15, 2005.

**DISCUSSION OF CRITICAL ACCOUNTING POLICIES AND ESTIMATES**

In the ordinary course of business, the Company has made a number of estimates and assumptions relating to the reporting of results of operations and financial condition in the preparation of its financial statements in conformity with accounting principles generally accepted in the United States of America. Actual results could differ significantly from those estimates under different assumptions and conditions. The Company believes that the following discussion addresses the Company's most critical accounting policies, the judgments and uncertainties affecting the application of those policies, and the likelihood that materially different amounts would be reported under different conditions or using different assumptions.

***PROPERTY AND EQUIPMENT***

Property and equipment is recorded at cost and is depreciated on a straight-line basis over the estimated useful lives of such assets. Changes in circumstances such as technological advances, changes to the Company's business model or changes in the Company's capital strategy can result in the actual useful lives differing from the Company's estimates. In those cases where the Company determines that the useful life of property and equipment should be shortened, the Company would depreciate the net book value in excess of the salvage value, over its revised remaining useful life thereby increasing depreciation expense. Factors such as changes in the planned use of fixtures or software or closing of facilities could also result in shortened useful lives.

The Company's accounting policies regarding property and equipment include judgments by management regarding the estimated useful lives of these assets, the residual values to which the assets are depreciated, the expected lease term for assets related to leased properties 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 the Company's need to recognize an impairment charge on the carrying amount of these assets as the cash flows associated with the assets are realized.

***LEASE ACCOUNTING***

The Company is obligated under various lease agreements for certain restaurant facilities. For operating leases, the Company recognizes rent expense on a straight-line basis over the expected lease term. Capital leases are recorded as an asset and an obligation at an amount equal to the present value of the minimum lease payments during the lease term.

Under the provisions of certain of the Company's leases, there are rent holidays and/or escalations in payments over the base lease term, as well as renewal periods. The effects of the holidays and escalations have been reflected in rent expense on a straight-line basis over the expected lease term, which includes cancelable option periods when it is deemed to be reasonably assured that the Company will exercise such option periods due to the fact that the Company would incur an economic penalty for not doing so. The lease term commences on the date when the Company becomes legally obligated for the rent payments. The leasehold improvements and property held under capital leases for each restaurant facility are amortized on the straight-line method over the shorter of the estimated life of the asset or the same expected lease term used for lease accounting purposes. For each restaurant facility, the consolidated financial statements reflect the same lease term for amortizing leasehold improvements as the Company uses to determine capital versus operating lease classifications and in calculating straight-line rent expense. Percentage rent expense is generally based upon sales levels and is accrued at the point in time the Company determines that it is probable that such sales levels will be achieved. Leasehold improvements paid for by the lessor are recorded as leasehold improvements and deferred rent.

Judgments made by the Company related to the probable term for each restaurant facility lease affect i) the classification and accounting for a lease as capital or operating, ii) the rent holidays and/or escalations in payments that are taken into consideration when calculating straight-line rent and iii) 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.

***IMPAIRMENT OF LONG-LIVED ASSETS***

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Long-lived assets, including restaurant sites, leasehold improvements, and fixed assets are reviewed by the Company for impairment whenever events or changes in circumstances indicate that the carrying amount of any such asset may not be recoverable. Expected cash flows associated with an asset is a key factor in determining the recoverability of the asset. Identifiable cash flows are generally measured at the restaurant level. The estimate of cash flow is based upon, among other things, certain assumptions about expected future operating performance. The Company's estimates of undiscounted cash flow may differ from actual cash flow due to, among other things, technological changes, economic conditions, changes to its business model or changes in its operating performance. If the sum of the undiscounted cash flows is less than the carrying value of the asset, the Company recognizes an impairment loss, measured as the amount by which the carrying value exceeds the fair value of the asset.

Judgments made by the Company related to the expected useful lives of long-lived assets and the Company's 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 the Company to realize a material impairment charge. In 2005, the Company recognized a \$557,000 charge for the write down of asset values for three LongHorn Steakhouse restaurants and a \$2,712,000 charge for the write down of asset values for two Bugaboo Creek Steak House restaurants. In 2004, the Company recognized a \$922,000 charge for the write down of asset values related to two LongHorn Steakhouse restaurants and a \$1,778,000 charge for the write down of asset values related to one Bugaboo Creek Steak House restaurant.

***SELF-INSURANCE ACCRUALS***

The Company self-insures for a significant portion of expected losses under its workers' compensation, employee medical, employment practices and general liability programs. Accrued liabilities have been recorded based on estimates of the ultimate costs to settle incurred, but unpaid, claims.

The accounting policies regarding self-insurance programs include certain management judgments and assumptions regarding the frequency or severity of claims and claim development patterns, and claim reserve, management, and settlement practices. Unanticipated changes in these factors may produce materially different amounts of expense than that reported under these programs.

***INCOME TAXES***

Income taxes are accounted for by the Company in accordance with Statement of Financial Accounting Standards No. 109 ( SFAS 109 ), Accounting for Income Taxes which requires that deferred tax assets and liabilities be recognized for the effect of temporary differences between the book and tax bases of recorded assets and liabilities. SFAS 109 also requires that deferred tax assets be reduced by a valuation allowance if it is more likely than not that some portion or all of the deferred tax asset will not be realized.

The Company reviews and assesses the recoverability of any deferred tax assets recorded on the balance sheet and provides any necessary allowances as required. An adjustment to the deferred tax asset would be charged to income in the period such determination was made.



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

**RARE HOSPITALITY INTERNATIONAL, INC. AND SUBSIDIARIES**

**CONSOLIDATED FINANCIAL STATEMENTS**

**DECEMBER 25, 2005, DECEMBER 26, 2004 AND DECEMBER 28, 2003**

**WITH REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

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**Report of Independent Registered Public Accounting Firm**

The Board of Directors and Shareholders  
RARE Hospitality International, Inc.

We have audited the accompanying consolidated balance sheets of RARE Hospitality International, Inc. and subsidiaries (the Company) as of December 25, 2005 and December 26, 2004, and the related consolidated statements of operations, shareholders' equity and comprehensive income, and cash flows for each of the years in the three-year period ended December 25, 2005. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of RARE Hospitality International, Inc. and subsidiaries as of December 25, 2005 and December 26, 2004, and the results of their operations and their cash flows for each of the years in the three-year period ended December 25, 2005, in conformity with U.S. generally accepted accounting principles.

As discussed in note 1 to the consolidated financial statements, the Company has presented the results of operations of the Bugaboo Creek Steak House business as discontinued operations.

(signed) KPMG LLP  
Atlanta, Georgia  
November 15, 2006

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**RARE HOSPITALITY INTERNATIONAL, INC. AND SUBSIDIARIES**  
**CONSOLIDATED BALANCE SHEETS**  
**DECEMBER 25, 2005 AND DECEMBER 26, 2004**  
(in thousands)

	<b>2005</b>	<b>2004</b>
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 12,107	\$ 19,487
Short-term investments	6,203	34,895
Accounts receivable	15,807	9,212
Inventories	14,516	11,761
Prepaid expenses	6,558	6,835
Refundable income taxes		3,327
Deferred income taxes	9,425	7,898
Assets of discontinued operations	47,179	42,938
Total current assets	111,795	136,353
Property and equipment, less accumulated depreciation and amortization	451,619	392,233
Goodwill	19,187	19,187
Other	18,324	14,206
Total assets	\$ 600,925	\$ 561,979
<b>LIABILITIES AND SHAREHOLDERS EQUITY</b>		
Current liabilities:		
Accounts payable	\$ 30,026	\$ 33,113
Accrued expenses	71,010	53,884
Income taxes payable	1,152	
Current installments of obligations under capital leases	269	207
Liabilities of discontinued operations	3,075	5,446
Total current liabilities	105,532	92,650
Deferred income taxes	3,483	10,146
Obligations under capital leases, net of current installments	38,991	37,136
Other	27,432	21,652
Total liabilities	175,438	161,584
Minority interest	1,193	1,309
Shareholders equity:		

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Preferred stock, no par value. Authorized 10,000 shares, none issued		
Common stock, no par value. Authorized 60,000 shares; 35,436 and 34,802 shares issued; and 33,484 and 34,209 outstanding at December 25, 2005 and December 26, 2004, respectively	229,955	217,146
Unearned compensation restricted stock	(1,470)	(1,588)
Retained earnings	248,284	196,705
Treasury shares at cost; 1,952 shares and 593 shares at December 25, 2005 and December 26, 2004, respectively	(52,475)	(13,177)
Total shareholders equity	424,294	399,086
Total liabilities and shareholders equity	\$ 600,925	\$ 561,979

See accompanying notes to consolidated financial statements.

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**RARE HOSPITALITY INTERNATIONAL, INC. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF OPERATIONS**  
**YEARS ENDED DECEMBER 25, 2005, DECEMBER 26, 2004 AND DECEMBER 28, 2003**  
**(in thousands, except per share data)**

	2005	2004	2003
Revenues:			
Restaurant sales:			
LongHorn Steakhouse	\$ 666,073	\$ 578,297	\$ 487,221
The Capital Grille	165,169	131,208	102,414
Other restaurants	7,588	7,564	7,498
Total restaurant sales	838,830	717,069	597,133
Franchise revenues	436	403	374
Total revenues	839,266	717,472	597,507
Costs and expenses:			
Cost of restaurant sales	307,741	264,307	214,814
Operating expenses restaurants	364,566	306,591	257,610
Provision for asset impairments, restaurant closings, and other charges	557	922	
Depreciation and amortization restaurants	31,244	26,703	22,956
Pre-opening expense restaurants	7,483	7,190	5,692
General and administrative expenses	48,064	41,582	37,024
Total costs and expenses	759,655	647,295	538,096
Operating income	79,611	70,177	59,411
Interest expense, net	1,921	1,328	1,015
Minority interest	215	300	300
Earnings from continuing operations before income taxes	77,475	68,549	58,096
Income tax expense	25,098	22,760	18,864
Income from continuing operations	52,377	45,789	39,232
Income (loss) from discontinued operations, net of income tax (expense) benefit	(798)	1,200	2,715
Net earnings	\$ 51,579	\$ 46,989	\$ 41,947
Basic earnings per common share:			

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Continuing operations	\$ 1.55	\$ 1.35	\$ 1.18
Discontinued operations	(0.02)	0.04	0.08
Net earnings	\$ 1.53	\$ 1.39	\$ 1.26
Diluted earnings per common share:			
Continuing operations	\$ 1.50	\$ 1.29	\$ 1.13
Discontinued operations	(0.02)	0.03	0.08
Net earnings	\$ 1.48	\$ 1.33	\$ 1.20
Weighted average common shares outstanding (basic)	33,764	33,811	33,162
Weighted average common shares outstanding (diluted)	34,817	35,374	34,843

See accompanying notes to consolidated financial statements.

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**RARE HOSPITALITY INTERNATIONAL, INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF SHAREHOLDERS EQUITY  
AND COMPREHENSIVE INCOME**

**YEARS ENDED DECEMBER 25, 2005, DECEMBER 26, 2004 AND DECEMBER 28, 2003  
(in thousands)**

	COMMON STOCK SHARES	COMMON STOCK DOLLARS	UNEARNED COMPENSATION- RESTRICTED STOCK	RETAINED EARNINGS	TREASURY SHARES- AT COST	TOTAL SHAREHOLDERS EQUITY
<b>BALANCE, DECEMBER 29, 2002</b>	33,099	\$ 191,174	\$ (1,124)	\$ 107,769	\$ (2,364)	\$ 295,455
Net earnings and total comprehensive income				41,947		41,947
Purchase of common stock for treasury					(2,625)	(2,625)
Issuance of shares pursuant to restricted stock awards	47	969	(969)			
Amortization of restricted stock			790			790
Forfeiture of restricted stock	(11)	(263)				(263)
Issuance of shares pursuant to exercise of stock options	907	7,120				7,120
Tax benefit of stock options exercised		4,624				4,624
 <b>BALANCE, DECEMBER 28, 2003</b>	 34,042	 203,624	 (1,303)	 149,716	 (4,989)	 347,048
Net earnings and total comprehensive income				46,989		46,989
Purchase of common stock for treasury					(8,188)	(8,188)
Issuance of shares pursuant to restricted stock awards	61	1,565	(1,565)			
Forfeiture of restricted stock	(9)	(139)				(139)
Amortization of restricted stock			1,280			1,280
Issuance of shares pursuant to exercise of stock options	708	7,706				7,706
		4,390				4,390



Tax benefit of stock  
options exercised

<b>BALANCE, DECEMBER 26, 2004</b>	34,802	217,146	(1,588)	196,705	(13,177)	399,086
Net earnings and total comprehensive income				51,579		51,579
Purchase of common stock for treasury					(39,298)	(39,298)
Issuance of shares pursuant to restricted stock awards	55	1,656	(1,656)			
Forfeiture of restricted stock	(19)	(332)	174			(158)
Amortization of restricted stock			1,600			1,600
Issuance of shares pursuant to exercise of stock options	598	7,188				7,188
Tax benefit of stock options exercised		4,297				4,297
<b>BALANCE, DECEMBER 25, 2005</b>	35,436	\$ 229,955	\$ (1,470)	\$ 248,284	\$ (52,475)	\$ 424,294

See accompanying notes to consolidated financial statements.

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**RARE HOSPITALITY INTERNATIONAL, INC. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**  
**YEARS ENDED DECEMBER 25, 2005, DECEMBER 26, 2004 AND DECEMBER 28, 2003**  
(in thousands)

	<b>2005</b>	<b>2004</b>	<b>2003</b>
Cash flows from operating activities:			
Net earnings	\$ 51,579	\$ 46,989	\$ 41,947
Adjustments to reconcile net earnings to net cash provided by operating activities:			
(Income) loss from discontinued operations, net of income taxes	798	(1,200)	(2,715)
Depreciation and amortization	35,060	29,569	24,680
Provision for asset impairments, restaurant closings and other charges	549	922	
Minority interest	215	300	300
Deferred tax expense	(8,190)	4,797	3,709
Sale (purchase) of short-term investments, net	28,692	(10,859)	(6,301)
Changes in assets and liabilities:			
Accounts receivable	(6,595)	(482)	(2,154)
Inventories	(2,755)	(2,664)	(1,210)
Prepaid expenses	277	(1,846)	(1,547)
Other assets	(1,506)	(3,072)	(1,050)
Refundable income taxes	8,776	3,225	6,586
Accounts payable	(6,669)	6,044	229
Accrued expenses	10,619	5,793	6,253
Other liabilities	3,516	2,429	1,424
Net cash provided by operating activities of continuing operations	114,366	79,945	70,153
Net cash provided by operating activities of discontinued operations	11,093	8,826	9,063
Cash flows from investing activities:			
Purchase of property and equipment by continuing operations	(93,115)	(88,352)	(68,722)
Purchase of property and equipment by discontinued operations	(11,092)	(8,894)	(8,988)
Cash flows from financing activities:			
Payments for debt issuance costs	(370)		
Principal payments on capital leases	(195)	(128)	(79)
Distributions to minority partners	(331)	(362)	(340)
Increase in bank overdraft included in accounts payable and accrued expenses	4,375	8,486	1,194
Purchase of common stock for treasury	(39,298)	(8,188)	(2,625)
Proceeds from exercise of stock options	7,188	7,706	7,120
	(28,631)	7,514	5,270

Net cash provided by (used in) financing activities of continuing operations

Net increase (decrease) in cash and cash equivalents	(7,379)	(961)	6,776
Cash and cash equivalents at beginning of year	19,547	20,508	13,732
Cash and cash equivalents at end of year	\$ 12,168	\$ 19,547	\$ 20,508
Cash and cash equivalents of continuing operations at end of year	\$ 12,107	\$ 19,487	\$ 20,380
Cash and cash equivalents of discontinued operations at end of year	\$ 61	\$ 60	\$ 128
Supplemental disclosure of cash flow information:			
Cash paid for income taxes	\$ 23,779	\$ 15,085	\$ 9,737
Cash paid for interest net of amounts capitalized	\$ 2,594	\$ 1,589	\$ 1,078
Supplemental disclosure of non-cash financing and investing activities:			
Assets acquired under capital lease	\$ 2,112	\$ 9,885	\$ 5,181

See accompanying notes to consolidated financial statements.

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**RARE HOSPITALITY INTERNATIONAL, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**DECEMBER 25, 2005, DECEMBER 26, 2004 AND DECEMBER 28, 2003**

**(1) SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**  
**OPERATIONS**

RARE Hospitality International, Inc., including its wholly owned subsidiaries (the Company), is a multi-concept restaurant company, which, as of December 25, 2005, operated the following restaurants in 31 states (located primarily in the Eastern half of the United States) and the District of Columbia:

CONCEPT	NUMBER IN OPERATION
LongHorn Steakhouse	237
The Capital Grille	23
Other specialty concepts	2
<b>Total restaurants</b>	<b>262</b>

The Company is a 50 percent partner in joint ventures that operate three LongHorn Steakhouse restaurants, which are managed by the Company and included in the restaurant counts above. Due to the rights and duties assigned by the attendant joint venture and management agreements, the Company is deemed to have control over these joint ventures.

**BASIS OF PRESENTATION**

The consolidated financial statements include the financial statements of RARE Hospitality International, Inc., its wholly owned subsidiaries, and joint ventures over which the Company exercises control. All significant intercompany balances and transactions have been eliminated in consolidation.

On September 21, 2006, the Company announced that its Board of Directors had approved exiting the Bugaboo Creek Steak House business through the probable sale of the restaurants and brand. In the accompanying consolidated financial statements, the results of operations relating to the operations to be divested are presented as discontinued operations. The assets and liabilities of discontinued operations are primarily comprised of fixed assets and accrued liabilities, respectively. Financial results for Bugaboo Creek Steak House for each of the years in the three-year period ended December 25, 2005, were as follows (in thousands):

	Full Year 52 Weeks Ended		
	Dec. 25, 2005	Dec. 26, 2004	Dec. 28, 2003
Restaurant Sales	\$ 97,310	\$ 95,091	\$ 83,325
Costs and expenses:			
Cost of restaurant sales	35,447	35,141	30,280
Operating expenses-restaurants	51,165	48,088	41,368
Depreciation and amortization-restaurants	4,200	3,733	3,259
Pre-opening expense-restaurants	933	903	915
Provision for asset impairments, restaurant closings, and other charges	2,712	1,778	
General and administrative expenses	4,048	3,662	3,491
<b>Total costs and expenses</b>	<b>98,505</b>	<b>93,305</b>	<b>79,313</b>

Earnings (loss) before income taxes	(1,195)	1,786	4,012
Income tax expense (benefit)	(397)	586	1,297
Net earnings (loss)	\$ (798)	\$ 1,200	\$ 2,715

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Unless otherwise noted, discussions and amounts throughout these Notes to Consolidated Financial Statements relate to the Company's continuing operations.

On October 6, 2005, the Financial Accounting Standards Board ( FASB ) issued FASB Staff Position 13-1, Accounting for Rental Costs Incurred During a Construction Period ( FSP 13-1 ). FSP 13-1 was effective for the Company's 2006 fiscal year and requires the Company to expense rental costs incurred during the construction period associated with ground or building operating leases. FSP 13-1 allows for retrospective application in accordance with FASB Statement No. 154, Accounting Changes and Error Correction. When adopting FSP 13-1, the Company elected to retrospectively apply the provisions of FSP 13-1 to its financial statements for all prior periods.

Prior to the issuance of FSP 13-1, the Company capitalized all rental costs associated with ground or building operating leases during each construction period. Pursuant to FSP 13-1, in the accompanying restated consolidated financial statements, rental costs associated with ground or building operating leases incurred during construction are recognized in pre-opening expense restaurants. The retrospective application of FSP 13-1 reduced net earnings by \$503,000, \$540,000 and \$330,000 for the years ended December 25, 2005, December 26, 2004 and December 28, 2003, respectively. The reduction in net earnings is a result of increases in pre-opening expense of \$1,225,000, \$1,228,000 and \$824,000 partially offset by reductions of depreciation expense of \$412,000, \$357,000 and \$293,000, and reductions of income taxes of \$309,000, \$330,000 and \$202,000 for 2005, 2004 and 2003, respectively. The cumulative effect of the retrospective application is a reduction in retained earnings of \$4,680,000 as of the beginning of fiscal year 2003.

The Company's fiscal year is a 52- or 53-week year ending on the last Sunday in each calendar year. Each of the four fiscal quarters is typically made up of 13 weeks.

The Company effected a three-for-two stock split in the form of a 50% stock dividend paid on September 2, 2003 to shareholders of record on August 12, 2003. All references to the number of common shares and per share amounts prior to the stock split have been restated to give retroactive effect to the stock split for all periods presented.

### **CASH EQUIVALENTS**

The Company considers all highly liquid investments which have original maturities of three months or less to be cash equivalents. Cash equivalents are comprised of high-grade overnight repurchase agreements and totaled approximately \$5.9 million at December 25, 2005, \$14.4 million at December 26, 2004 and \$16.0 million at December 28, 2003. The carrying amount of these instruments approximates their fair market values. All overdraft balances have been reclassified as current liabilities.

### **SHORT TERM INVESTMENTS**

Short term investments consist of federal, state and municipal bonds, and commercial paper. The Company accounts for its investments under the provisions of Statement of Financial Accounting Standards No. 115,

Accounting for Certain Investments in Debt and Equity Securities ( SFAS 115 ). Pursuant to the provisions of SFAS 115, the Company has classified its investment portfolio as trading. Trading securities are bought and held principally for the purpose of selling them in the near term and are recorded at fair value. Unrealized gains and losses on trading securities are included in the determination of net earnings.

### **INVENTORIES**

Inventories, consisting principally of food and beverages, are stated at the lower of cost or market. Cost is determined using the first-in, first-out (FIFO) method.

### **PROPERTY AND EQUIPMENT**

Property and equipment are stated at cost. Property under capital leases is stated at the present value of minimum lease payments. Leasehold improvements and property held under capital leases are amortized on the straight-line method over the shorter of the estimated life of the asset or the lease term, including renewal periods when the exercise of such renewal periods is deemed to be reasonably assured (generally 15 years for building operating leases and 25 years for land-only operating leases and real property acquired under capital leases). Depreciation on owned property and equipment is calculated on the straight-line method over the estimated useful lives of the related assets, which approximates 25 years for buildings and land improvements, seven years for restaurant equipment, and three years for computer hardware and software.



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### **RENT EXPENSE**

The Company recognizes rent expense on a straight-line basis over the expected lease term, including cancelable option periods where failure to exercise such options would result in an economic penalty to the Company. The lease term commences on the date when the Company becomes legally obligated for the rent payments. Percentage rent expense is generally based upon sales levels and is accrued at the point in time the Company determines that it is probable that such sale levels will be achieved. The Company records leasehold improvements funded by landlords under operating leases as leasehold improvements and deferred rent. Prior to the adoption of FSP 13-1, rent expense incurred during the construction period was capitalized to property and equipment. As described later in this Note, under the section entitled ACCOUNTING STANDARDS ADOPTED IN FISCAL 2005, the Company's accounting for rent incurred during the construction period changed effective at the beginning of fiscal 2006. This report on Form 10-K/A restates the Company's consolidated financial statements to recognize rental costs associated with ground or building operating leases incurred during construction in pre-opening expense restaurants.

### **PRE-OPENING AND ORGANIZATION COSTS**

The Company accounts for pre-opening and organization costs in accordance with the American Institute of Certified Public Accountants Statement of Position (SOP) 98-5, Reporting on the Costs of Start-Up Activities. SOP 98-5 requires entities to expense as incurred all organization and pre-opening costs.

### **COMPUTER SOFTWARE FOR INTERNAL USE**

The Company accounts for the costs of developing or acquiring computer software in accordance with the American Institute of Certified Public Accountants SOP 98-1, Accounting for the Costs of Computer Software Developed or Obtained for Internal Use. SOP 98-1 identifies the characteristics of internal-use software and specifies that once the preliminary project stage is complete, certain external direct costs, certain direct internal payroll and payroll-related costs and interest costs incurred during the development of computer software for internal use should be capitalized and amortized.

### **REVENUE RECOGNITION**

Revenue from restaurant sales is recognized when food and beverage products are sold and receipts from all sales are classified as operating cash flows. Accounts receivable is primarily comprised of amounts due from the Company's credit card processor. The Company records a liability for gift certificates and gift cards at the time they are issued. Upon redemption, sales are recorded and the liability is reduced by the amount of certificates or card values redeemed. The Company began selling electronic gift cards in August of 2003. Unused gift cards will be recognized as revenue, in proportion to actual gift card redemptions, once the Company has sufficient data to make a reasonable determination of forfeiture levels. Revenues from the sales of franchises are recognized as income when substantially all of the Company's material obligations under the franchise agreement have been performed. Continuing royalties, which are a percentage of net sales of franchised restaurants, are accrued as income when earned.

### **COST OF RESTAURANT SALES**

Cost of restaurant sales include food and beverage costs, warehousing, and related purchasing and distribution costs. Vendor allowances received in connection with the purchase of a vendor's products are recognized as a reduction of the related food and beverage costs as earned. These allowances are recognized as earned in accordance with the underlying agreement with the vendor and completion of the earning process. Vendor agreements are generally for a period of one year or less, and payments received are recorded as a current liability until earned.

### **GOODWILL**

The Company accounts for goodwill in accordance with SFAS 142, Goodwill and Other Intangible Assets, which provides that goodwill should not be amortized, but shall be tested for impairment annually, or more frequently if circumstances indicate potential impairment, through a comparison of fair value to its carrying amount. The fair value of each reporting unit is compared to its carrying value to determine whether there is an indication that impairment may exist. If an impairment of goodwill is determined to exist, it is measured as the excess of its carrying value over its fair value. Upon performing the annual tests for impairment of the carrying value of the Company's goodwill, it has been concluded that there was no indication of impairment to goodwill. Accordingly, no impairment losses have been recorded.





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As of the date of adoption of SFAS 142, the Company had unamortized goodwill in the amount of approximately \$19.2 million, all of which is related to the acquisition of LongHorn Steakhouse franchise and joint venture rights. In accordance with SFAS 142, no goodwill amortization expense was recorded in the Company's financial statements for fiscal 2005, 2004 or 2003.

**OTHER ASSETS**

Other assets consist of the investments of the Company's Supplemental Deferred Compensation Plan, debt issuance costs, trademarks, deposits, and purchased liquor licenses. The Company applies the provisions of SFAS 142 to purchased liquor licenses and trademarks. The 2005 provision for asset impairments includes a \$47,000 charge to reflect the diminution in value of a purchased liquor license for a LongHorn Steakhouse restaurant location. Impairment of this liquor license was measured by the amount by which the carrying amount exceeded its fair market value. There has been no other impairment of purchased liquor licenses or trademarks since the adoption of SFAS 142 in 2002. Purchased liquor licenses related to continuing operations amounted to approximately \$4,831,000 and \$3,772,000 at December 25, 2005 and December 26, 2004, respectively. Purchased liquor licenses related to discontinued operations amounted to approximately \$442,000 at both December 25, 2005 and December 26, 2004. Purchased trademarks aggregated approximately \$0.4 million at December 25, 2005. Debt issuance costs are amortized on a straight-line basis over the expected term of the debt facility.

**RECOVERABILITY OF LONG-LIVED ASSETS**

The Company accounts for long-lived assets in accordance with Statement of Financial Accounting Standards No. 144 ( SFAS 144 ), Accounting for the Impairment or Disposal of Long-Lived Assets, which requires the Company to review its long-lived assets, which include property and equipment, related to each restaurant periodically or whenever events or changes in circumstances indicate that the carrying amount of the assets may not be recoverable. Recoverability of assets to be held and used is evaluated by a comparison of the carrying amount of an asset to future undiscounted net cash flows expected to be generated by the asset. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the fair value of the assets. Assets to be held and used are reported at the lower of the carrying amount or fair value, using discounted estimated future cash flows. Assets to be disposed of are reported at the lower of the carrying amount or fair value less costs to sell. Considerable management judgment is required to estimate cash flows and fair value less costs to sell. Accordingly, actual results could vary significantly from such estimates.

See Note 2 for further discussion of the Company's provision for asset impairments, restaurant closings and other charges.

**INCOME TAXES**

Income taxes are accounted for under the asset and liability method. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases and operating loss and tax credit carry forwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which the temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date.

Income tax benefits credited to equity relate to tax benefits associated with amounts that are deductible for income tax purposes but do not affect net earnings. These benefits are principally generated from employee exercises of stock options and vesting of employee restricted stock awards.

**STOCK-BASED COMPENSATION**

Prior to January 1, 1996, the Company accounted for its stock option plan in accordance with the provisions of Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees ( APB 25 ), and related interpretations. As such, compensation expense would be recorded on the date of grant only if the current market price of the underlying stock exceeded the exercise price. On January 1, 1996, the Company adopted Statement of Financial Accounting Standards No. 123 ( SFAS 123 ), Accounting for Stock-Based Compensation, which permits entities to recognize as expense over the vesting period the fair value of all stock-based awards on the date of grant.

Alternatively, SFAS 123 also allows entities to continue to apply the provisions of APB 25 and provide pro forma net earnings (loss) and pro forma earnings (loss) per share disclosures for employee stock option grants made in 1995

and future years as if the fair-value-based method defined in SFAS 123 had been applied. The Company has elected to continue to

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apply the provisions of APB 25 and provide the pro forma disclosures required by SFAS 123. The fair value of the options granted during 2005, 2004 and 2003 is estimated at approximately \$3.5 million, \$6.1 million and \$5.8 million, respectively, on the date of grant, using the Black-Scholes option pricing model, recognizing compensation cost on a straight-line basis, using the following assumptions:

	<b>2005</b>	<b>2004</b>	<b>2003</b>
Dividend yield	0%	0%	0%
Volatility	28.0%	34.2%	44.0%
Risk-free interest rate	4.375%	3.625%	3.25%
Average expected life	4yrs	4yrs	5yrs

In accordance with the provisions of APB 25, the Company did not recognize any compensation expense from the issuance of employee stock options. The following table represents the effect on net earnings and earnings per share if the Company had applied the fair value based method and recognition provisions of SFAS 123 (in thousands except per share amounts):

	<b>2005</b>	<b>2004</b>	<b>2003</b>
Net earnings, as reported	\$ 51,579	\$ 46,989	\$ 41,947
Add: stock-based employee compensation expense included in reported net earnings, net of related tax effects	989	795	490
Deduct: stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects	(5,229)	(4,784)	(4,343)
Pro forma net earnings	\$ 47,339	\$ 43,000	\$ 38,094
Basic earnings per common share:			
Net earnings, as reported	\$ 1.53	\$ 1.39	\$ 1.26
Net earnings, pro forma	\$ 1.40	\$ 1.27	\$ 1.15
Diluted earnings per common share:			
Diluted earnings, as reported	\$ 1.48	\$ 1.33	\$ 1.20
Diluted earnings, pro forma	\$ 1.37	\$ 1.23	\$ 1.11

In December 2004, the FASB issued Statement of Financial Accounting Standard No. 123 (revised 2004)

Share-Based Payment, ( SFAS 123R ), which requires companies to begin to expense the estimated fair value of employee stock options and similar awards. The accounting provisions of SFAS 123R will be effective for the Company's first quarter of fiscal 2006. The Company adopted the provisions of SFAS 123R using the Black-Scholes option pricing formula with a modified prospective application. Modified prospective application recognizes compensation expense for unvested awards as of the effective date of SFAS 123R over the remaining service period.

The pro forma disclosures provided are not likely to be representative of the effects on reported net income for future years due to future grants. The estimated impact of adopting SFAS 123R for fiscal 2006 will be \$6.5 to \$7.5 million (\$5.0 to \$5.7 million, net of tax or \$0.14 to \$0.16 per diluted share). This estimate includes costs related

to unvested stock options and restricted stock grants associated with new compensation programs.

See Note 10 for further discussion of the Company's stock option plans.

**MANAGING PARTNER PROGRAM**

The Company maintains a compensation program (the Managing Partner Program) for its lead restaurant managers (MPs). Under the Managing Partner Program, the Company enters into a 5-year employment contract with the MP that provides for i) a fixed salary; ii) quarterly bonuses calculated as a percentage of restaurant profits and as a percentage of any year-over-year increase in sales; and iii) an award of restricted Company common stock, which is issued annually, in arrears, in an amount equal to 10% of the previous four quarters aggregate salary and bonus paid under the Managing Partner

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Program. All salary, bonuses and restricted stock to be awarded to an MP under the Managing Partner Program is expensed as earned and reflected in the Company's consolidated statements of operations as compensation expense.

The Company's accounting for each annual award recognizes the expense associated with that specific award throughout the respective year based on management's estimates of the individual's annual salary and bonus for such period. Accordingly, the fair value of each annual award of restricted stock is expensed ratably over the year earned beginning in the first month of participation in the program. See Note 10 for further discussion of the Company's restricted stock plan.

**ADVERTISING EXPENSES**

The costs of programming, advertising and other promotions are expensed in the periods in which the costs are incurred. Production costs are charged to expense in the period the advertising is first aired. Total advertising expense for continuing operations included in operating expenses—restaurants was approximately \$25.7 million, \$21.4 million and \$17.6 million for the years ended December 25, 2005, December 26, 2004 and December 28, 2003, respectively. Total advertising expense for discontinued operations was approximately \$4.6 million, \$4.7 million and \$3.6 million for the years ended December 25, 2005, December 26, 2004 and December 28, 2003, respectively.

**SELF-INSURANCE ACCRUALS**

The Company self-insures a significant portion of expected losses under its workers' compensation, employee medical and general liability programs. Accrued liabilities have been recorded based on estimates of the ultimate costs to settle incurred claims, both reported and unreported.

**SEGMENT DISCLOSURE**

Due to the similar economic characteristics, as well as a single type of product, production process, distribution system and type of customer, the Company reports the operations of its different concepts on an aggregated basis and does not separately report segment information. Revenues from external customers are derived principally from food and beverage sales. The Company does not rely on any major customers as a source of revenue.

**EARNINGS PER SHARE**

The Company accounts for earnings per share in accordance with the provisions of Statement of Financial Accounting Standards No. 128, Earnings Per Share (SFAS 128). SFAS 128 requires dual disclosure of earnings per share—basic and diluted. Basic earnings per share equals net earnings divided by the weighted average number of common shares outstanding and does not include the dilutive effects of stock options and restricted stock. Diluted earnings per share is computed by dividing net earnings by the weighted average number of common shares outstanding after giving effect to dilutive stock options and restricted stock.

The following table presents a reconciliation of weighted average shares and earnings per share amounts (amounts in thousands, except per share data):

	<b>2005</b>	<b>2004</b>	<b>2003</b>
Weighted average number of common shares used in basic calculation	33,764	33,811	33,162
Dilutive effect of restricted stock awards	58	88	179
Dilutive effect of net shares issuable pursuant to stock option plans	995	1,475	1,502
Weighted average number of common shares used in diluted calculation	34,817	35,374	34,843
Income from continuing operations	\$ 52,377	\$ 45,789	\$ 39,232
Income (loss) from discontinued operations, net of income tax (expense) benefit	\$ (798)	\$ 1,200	\$ 2,715

Net earnings	\$ 51,579	\$ 46,989	\$ 41,947
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	<b>2005</b>	<b>2004</b>	<b>2003</b>
Basic earnings per common share:			
Continuing operations	\$ 1.55	\$ 1.35	\$ 1.18
Discontinued operations	(0.02)	0.04	0.08
Net earnings	\$ 1.53	\$ 1.39	\$ 1.26
Diluted earnings per common share: *			
Continuing operations	\$ 1.50	\$ 1.29	\$ 1.13
Discontinued operations	(0.02)	0.03	0.08
Net earnings	\$ 1.48	\$ 1.33	\$ 1.20

\* Per share amounts do not necessarily sum to the total year amounts due to rounding.

Options to purchase 389,083, 152,531 and 82,402 shares of common stock for fiscal 2005, 2004 and 2003, respectively were excluded from the computation of diluted earnings per common share because the related exercise prices were greater than the average market price for the respective year and would have been antidilutive.

**FINANCIAL INSTRUMENTS**

The carrying value of the Company's cash and cash equivalents, short-term investments, accounts receivable, accounts payable, accrued expenses, and obligations under capital leases approximates their fair value. The fair value of a financial instrument is the amount for which the instrument could be exchanged in a current transaction between willing parties. For cash and cash equivalents, short-term investments, accounts receivable, accounts payable and accrued expenses the carrying amounts approximate fair value because of the short maturity of these financial instruments.

**DERIVATIVE FINANCIAL INSTRUMENTS**

The Company attempts to mitigate substantially all its commodity price risk associated with the purchase of beef, its primary commodity. The Company uses fixed-price purchase agreements to purchase and take physical delivery of protein products and commodities to be used in the conduct of its business. These purchase agreements provide for the delivery of either agreed upon quantities or a prescribed portion of the Company's requirements. These contracts qualify under the normal purchase and normal sales exception of Statement of Financial Accounting Standards No. 133 Accounting for Derivative Instruments and Hedging Activities, ( FAS 133 ). Accordingly, purchases made under these fixed-price purchase agreements are placed in inventory at the contracted price. Any purchase contracts that do not comply with the purchase and sale exception would be measured at fair value in accordance with the mark-to-market provisions of FAS 133.

The Company, from time to time, has used interest rate swap agreements in the management of interest rate risk. These interest rate swap agreements were classified as a hedge of a cash flow exposure under SFAS No. 133, and accordingly, the effective portion of the initial fair value and subsequent changes in the fair value of those agreements are reported as a component of other comprehensive income and subsequently reclassified into earnings when the forecasted cash flows affect earnings. At December 25, 2005 and December 26, 2004, the Company had no interest rate swap agreements.

**USE OF ESTIMATES**



Management of the Company has made a number of estimates and assumptions relating to the reporting of assets and liabilities and the disclosure of contingent assets and liabilities to prepare these financial statements in conformity with accounting principles generally accepted in the United States of America. Actual results could differ from those estimates.

**COMPREHENSIVE INCOME**

During 2005, 2004 and 2003, net earnings were the same as comprehensive income.

**RECENTLY ISSUED ACCOUNTING STANDARDS NOT YET ADOPTED**

In December 2004, the FASB issued Statement of Financial Accounting Standards No. 123 (revised 2004), Share-Based Payment, (SFAS 123R). SFAS 123R is a revision of SFAS No. 123, Accounting for Stock-Based Compensation. Among other items, SFAS 123R eliminates the use of the intrinsic value method of accounting, and requires companies to recognize the cost of awards of equity instruments granted in exchange for employee services received, based on the grant date fair value of those awards, in the financial statements. The effective date of SFAS 123R was the first interim period

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beginning after June 15, 2005; however, on April 14, 2005, the Securities and Exchange Commission announced that the effective date of SFAS 123R was postponed until the first annual period beginning after June 15, 2005.

SFAS 123R permits companies to adopt its requirements using either a modified prospective method, or a modified retrospective method. Under the modified prospective method, compensation cost is recognized in the financial statements beginning with the effective date, based on the requirements of SFAS 123R for all share-based payments granted after that date, and based on the requirements of SFAS 123 for all unvested awards granted prior to the effective date of SFAS 123R. Under the modified retrospective method, the requirements are the same as under the modified prospective method, but this method also permits entities to restate financial statements of previous periods based on proforma disclosures made in accordance with SFAS 123. The Company adopted the provisions of SFAS 123R on December 26, 2005, using modified prospective application.

The Company currently utilizes the Black-Scholes option-pricing model to measure the fair value of stock options granted to employees. While SFAS 123R permits entities to continue to use this model, the standard also permits the use of a lattice model. SFAS 123R also requires that the benefits associated with the tax deductions in excess of recognized compensation cost be reported as a financing cash flow, rather than as an operating cash flow as required under the current standard. This requirement will reduce net operating cash flows and increase net financing cash flows in periods after the effective date. These future amounts cannot be estimated because they depend on, among other things, when employees exercise stock options.

As described earlier in this Note, under the section entitled STOCK-BASED COMPENSATION, compensation cost for stock options for which the requisite future service has not yet taken place is disclosed as a proforma expense by applying the provisions of SFAS 123. The proforma application of SFAS 123 had a dilutive effect of approximately \$0.12 per diluted share for 2005. Compensation cost for stock options vesting beginning in fiscal 2006, and all restricted stock, will be expensed in accordance with the provisions of SFAS 123R, which will be effective for the Company at the beginning of fiscal 2006. The Company estimates that stock-based compensation expense for fiscal 2006 will be approximately \$6.5 to \$7.5 million (\$5.0 to \$5.7 million after tax or \$0.14 to \$0.16 per diluted share). This estimate includes costs related to unvested stock options and restricted stock grants associated with new compensation programs.

In May 2005, the FASB issued SFAS No. 154, Accounting Changes and Error Corrections (SFAS 154). SFAS 154 replaces APB No. 20, Accounting Changes, and SFAS No. 3, Reporting Accounting changes in Interim Financial Statements, and changes the requirements for the accounting for, and reporting of, a change in accounting principle. SFAS 154 requires retrospective application of changes in accounting principle, unless it is impracticable to determine either the period-specific effects or the cumulative effect of the change. SFAS 154 defines retrospective application as the application of a different accounting principle to prior accounting periods as if that principle had always been used or as the adjustment of previously issued financial statements to reflect a change in the reporting entity. SFAS 154 also redefines restatement as the revising of previously issued financial statements to reflect the correction of an error. SFAS 154 is effective for accounting changes and correction of errors made in fiscal years beginning after December 15, 2005, and was applied in the adoption of FSP 13-1.

**ACCOUNTING STANDARDS ADOPTED IN FISCAL 2005**

On October 6, 2005, the Financial Accounting Standards Board (FASB) issued FASB Staff Position 13-1, Accounting for Rental Costs Incurred During a Construction Period (FSP 13-1). FSP 13-1 is effective for the Company's fiscal 2006 and requires the Company to expense rental costs incurred during the construction period associated with ground or building operating leases. The Company has previously capitalized these costs. Retrospective application, which permits entities to restate financial statements of previous periods is permitted but not required. In the first quarter of fiscal 2006, the Company adopted the provisions of FSP 13-1 using retrospective application. This resulted in the revision of previously issued financial statements as if the provisions of FSP 13-1 had always been used. As noted in the section entitled EXPLANATORY NOTE, this report on Form 10-K/A restates the Company's consolidated financial statements to recognize rental costs associated with ground or building operating leases incurred during construction in pre-opening expense restaurants.

In March 2005, the FASB issued FASB Interpretation No. 47, Accounting for Conditional Asset Retirement Obligations, an interpretation of FASB No. 143 (FIN 47). Asset retirement obligations are legal obligations associated

with the retirement of long-lived assets that result from the acquisition, construction, development and/or normal operation of a long-lived asset. FIN 47 clarifies that liabilities associated with asset retirement obligations whose timing or settlement method are conditional on future events should be recorded at fair value as soon as fair value is reasonably estimable. FIN 47 also provides guidance on the information required to reasonably estimate the fair value of the liability. The provisions of FIN 47 are effective for fiscal years ending after December 15, 2005. The Company adopted the provisions of FIN 47 during the fourth quarter of 2005. The impact of adoption was not material.

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**Table of Contents****RECLASSIFICATIONS**

Certain reclassifications have been made to the 2004 and 2003 consolidated financial statements to conform with the 2005 presentation. These reclassifications had no impact on net income or total shareholders' equity.

**(2) PROVISION FOR ASSET IMPAIRMENTS, RESTAURANT CLOSINGS, AND OTHER CHARGES**

The provision for asset impairments, restaurant closings, and other charges in continuing operations of approximately \$557,000 in 2005 consisted primarily of the write down of asset values for three LongHorn Steakhouse restaurants. The impairment for each LongHorn Steakhouse restaurant relates to management's decision to not exercise future lease options for these restaurants as the current lease term expires. Income (loss) from discontinued operations in 2005 included a \$2,712,000 charge for the write down of asset values for two Bugaboo Creek Steak House restaurants. The impairment charges in 2005 represent the sum of the differences between the estimated fair value, using discounted estimated future cash flows and the carrying value of each of these restaurants.

The provision for asset impairments, restaurant closings, and other charges in continuing operations of \$922,000 in 2004 consisted of the partial write down of asset values related to two LongHorn Steakhouse restaurants. Income from discontinued operations in 2004 included a \$1,778,000 charge for the write down of asset values related to one Bugaboo Creek Steak House restaurant. The impairment charges in 2004 were determined under SFAS 144 by comparing discounted estimated future cash flows to the carrying value of impaired assets.

**(3) PROPERTY AND EQUIPMENT**

Major classes of property and equipment at December 25, 2005 and December 26, 2004 are summarized as follows (in thousands):

	<b>2005</b>	<b>2004</b>
Land and improvements	\$ 70,353	\$ 59,364
Buildings	76,575	62,188
Leasehold improvements	256,443	216,701
Assets under capital lease	39,801	35,995
Restaurant equipment	102,883	92,475
Furniture and fixtures	44,096	38,844
Construction in progress	32,331	31,308
	622,482	536,875
Less accumulated depreciation and amortization	170,863	144,639
	\$ 451,619	\$ 392,236

Depreciation and amortization of restaurants on the consolidated statement of operations excludes depreciation of assets in the Company's corporate offices and training facility. Total depreciation and amortization of property and equipment related to continuing operations during 2005, 2004 and 2003 was \$33,509,000, \$28,404,000 and \$24,109,000, respectively. Total depreciation and amortization of property and equipment related to discontinued operations during 2005, 2004 and 2003 was \$4,250,000, \$3,793,000 and \$3,312,000, respectively.

The Company has, in the normal course of business, entered into agreements with vendors for the purchase of restaurant equipment, furniture, fixtures, buildings, and improvements for restaurants that have not yet opened. At December 25, 2005, such commitments associated with continuing operations and discontinued operations totaled approximately \$35.2 million and \$1.4 million, respectively.

**(4) ACCRUED EXPENSES**

Accrued expenses consist of the following at December 25, 2005 and December 26, 2004 (in thousands):

	<b>2005</b>	<b>2004</b>
Accrued self insurance reserves	\$ 7,735	\$ 4,807
Accrued provision for restaurant closings and other charges	281	330

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Accrued rent	6,725	4,572
Accrued compensation	15,255	13,008
Other taxes accrued	9,128	7,713
Unearned revenue gift cards and gift certificates	27,082	20,097
Other	4,804	3,357
	\$ 71,010	\$ 53,884

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**Table of Contents****(5) DEBT**

The Company has a variable interest rate revolving credit facility (the Revolving Credit Facility), which permits the Company to borrow up to \$100.0 million through the termination date in July 2010. The Revolving Credit Facility is the result of amendments to and a restatement of the Company's previous \$100.0 million credit facility. The Revolving Credit Facility bears interest at the Company's option of LIBOR plus a margin of 0.5% to 1.25% (the applicable margin) depending on the Company's leverage ratio or the administrative agent's prime rate of interest, and requires payment of a commitment fee on any unused portion at a rate of 0.1% to 0.2% per year (depending on the Company's leverage ratio). At December 25, 2005 and December 26, 2004, the applicable margin was 0.5%. On December 25, 2005 and December 26, 2004, there were no amounts outstanding under the Company's revolving credit facility. The commitment fee on the unused portion of the Revolving Credit Facility on December 25, 2005 and on December 26, 2004 was 0.1% and 0.3% per year, respectively. Amounts available under the Company's revolving credit facility totaled \$100.0 million on both December 25, 2005 and December 26, 2004.

The Revolving Credit Facility restricts payment of dividends, without prior approval of the lender, and contains certain financial covenants, including debt to capitalization, leverage and interest coverage ratios, as well as minimum net worth and maximum capital expenditure covenants. The Revolving Credit Facility is secured by the common stock of entities that own substantially all of the Bugaboo Creek Steak House and The Capital Grille restaurants. At December 25, 2005, the Company was in compliance with the provisions of the Revolving Credit Facility. The average interest rate paid on borrowings under the Company's Revolving Credit Facility during 2005 was 6.2%. There were no borrowings under the Revolving Credit Facility during 2004 or 2003.

Interest expense, net consists of the following (in thousands):

	<b>2005</b>	<b>2004</b>	<b>2003</b>
Imputed interest on capital leases	\$ 3,187	\$ 2,526	\$ 1,884
Interest expense	591	486	493
Capitalized interest	(998)	(1,312)	(1,067)
Interest income	(859)	(372)	(295)
Interest expense, net	\$ 1,921	\$ 1,328	\$ 1,015

**(6) INCOME TAXES**

Total income tax expense (benefit) consists of (in thousands):

	<b>2005</b>	<b>2004</b>	<b>2003</b>
Continuing Operations	\$ 25,098	\$ 22,760	\$ 18,864
Discontinued Operations	(397)	586	1,297
	\$ 24,701	\$ 23,346	\$ 20,161

The components of income tax expense (benefit) for continuing operations consists of (in thousands):

	<b>CURRENT</b>	<b>DEFERRED</b>	<b>TOTAL</b>
Year ended December 25, 2005:			
U.S. Federal	\$ 29,310	\$ (7,211)	\$ 22,099
State and local	3,978	(979)	2,999
	\$ 33,288	\$ (8,190)	\$ 25,098
Year ended December 26, 2004:			
U.S. Federal	\$ 15,920	\$ 4,251	\$ 20,171

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State and local	2,043	546	2,589
	\$ 17,963	\$ 4,797	\$ 22,760
Year ended December 28, 2003:			
U.S. Federal	\$ 13,622	\$ 3,329	\$ 16,951
State and local	1,533	380	1,913
	\$ 15,155	\$ 3,709	\$ 18,864

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The differences between the statutory Federal income tax rate and the effective income tax rate reflected in the consolidated statements of operations are as follows:

	<b>2005</b>	<b>2004</b>	<b>2003</b>
Federal statutory income tax rate	35.00%	35.00%	35.00%
State income taxes, net of federal benefit	3.09	2.90	2.60
Meals and entertainment	0.07	0.10	0.10
FICA tip credit	(5.78)	(4.90)	(4.70)
Other	0.01	0.10	(0.54)
Effective tax rates	32.39%	33.20%	32.46%

The Company expects to retain all deferred tax assets and liabilities after disposal of assets held for sale. The tax effects of temporary differences that give rise to significant portions of the deferred tax assets and liabilities at December 25, 2005 and December 26, 2004 are presented below (in thousands):

	<b>2005</b>	<b>2004</b>
Deferred tax assets (liabilities):		
Provisions for restaurant closings, and other charges	\$ 3,544	\$ 2,289
Accrued rent	9,120	7,580
Accrued insurance	432	293
Accrued workers' compensation	1,198	833
Property and equipment	(11,282)	(13,555)
Deferred compensation plan	3,460	2,586
Restricted stock	1,420	1,498
Smallwares	(3,348)	(2,909)
Other	1,398	(863)
Net deferred tax asset (liability)	\$ 5,942	\$ (2,248)

The Company's management considers whether it is more likely than not that some portion or all of the deferred tax assets will not be realized. The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income during the periods in which those temporary differences become deductible. The Company's management considers the scheduled reversal of deferred tax liabilities, projected future taxable income, and tax planning strategies in making this assessment. Based upon the level of historical taxable income and projections of future taxable income over the periods in which the temporary differences are deductible, the Company's management believes it is more likely than not the Company will realize the benefits of these deductible differences.

**(7) EMPLOYEE BENEFIT PLANS**

The Company provides employees who meet minimum service requirements with retirement benefits under a 401(k) plan (the RARE Plan). Under the RARE Plan, eligible employees may make contributions of between 1% and 20% of their annual compensation to one or more investment funds. Effective for 2001, officers and highly compensated employees do not participate in this plan. The Company makes quarterly matching contributions in an amount equal to 50% of the first 5% of employee compensation contributed, resulting in a maximum annual Company contribution of 2.5% of employee compensation. The Company's expense under the RARE Plan was \$772,000, \$613,000 and \$592,000 for 2005, 2004 and 2003, respectively.

Effective January 1, 2000, the Company implemented the Supplemental Deferred Compensation Plan (the Supplemental Plan), a nonqualified plan which allows officers and highly compensated employees to defer receipt of a portion of their compensation and contribute such amounts to one or more investment funds. The maximum aggregate amount deferred under the Supplemental Plan and the RARE Plan cannot exceed the lesser of 20% of annual



compensation or \$50,000. The Company makes quarterly matching contributions in an amount equal to 50% of the first 5% of employee compensation contributed, with a maximum annual Company contribution of the lesser of 2.5% of employee compensation or \$5,000 per year. The Company's expense under the Supplemental Plan was \$533,000, \$467,000 and \$414,000 for 2005, 2004 and 2003, respectively. Company contributions to both the RARE Plan and the Supplemental Plan vest at the rate of 20% each year beginning after the employee's first year of service and were made in the form of cash in 2005, 2004 and 2003.

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The Company entered into a rabbi trust agreement to protect the assets of the Supplemental Plan. Participant's accounts are comprised of their contribution, the Company's matching contribution and each participant's share of earnings or losses in the plan. In accordance with EITF No. 97-14, Accounting for Deferred Compensation Arrangements Where Amounts Are Held in a Rabbi Trust and Invested, the accounts of the rabbi trust are reported in the Company's consolidated financial statements. The Company's consolidated balance sheet includes the investments in other non-current assets and the offsetting obligation is included in other non-current liabilities. Such amounts at December 25, 2005 and December 26, 2004 totaled \$9,084,000 and \$6,820,000, respectively. The deferred compensation plan investments are considered trading securities and are reported at fair value with the realized and unrealized holding gains and losses related to these investments, as well as the offsetting compensation expense, recorded in operating income.

**(8) LEASES AND RELATED COMMITMENTS**

The Company is obligated under various capital leases for certain restaurant facilities that expire at various dates during the next 30 years. Capital leases are recorded as an asset and an obligation at an amount equal to the present value of the minimum lease payments during the lease term. The Company also has noncancelable operating leases for certain restaurant facilities. Rental payments include minimum rentals, plus contingent rentals based on restaurant sales at the individual stores. These leases generally contain renewal options for periods ranging from three to 15 years and require the Company to pay all executory costs such as insurance and maintenance. Under the provisions of certain leases, there are rent holidays and/or escalations in payments over the base lease term, as well as renewal periods. The effects of the holidays and escalations have been reflected in rent expense on a straight-line basis over the anticipated life of the leases. The leasehold improvements for each restaurant facility are amortized over a term that includes renewal options that are reasonably assured. For each restaurant facility, the financial statements reflect the same lease term for amortizing leasehold improvements as used to determine capital versus operating lease classifications and in calculating straight-line rent expense.

Future minimum lease payments under capital lease obligations and noncancelable operating leases of continuing operations at December 25, 2005 are as follows (in thousands):

	<b>CAPITAL</b>	<b>OPERATING</b>
<b>YEARS ENDING AT OR ABOUT DECEMBER 31:</b>		
2006	\$ 3,897	\$ 19,074
2007	4,054	18,554
2008	4,137	16,892
2009	4,243	15,450
2010	4,388	13,050
Thereafter	73,692	32,874
Total minimum lease payments	94,411	\$ 115,894
Less imputed interest (at 9%)	55,151	
Present value of minimum lease payments	39,260	
Less current maturities	269	
Obligations under capital leases, net of current maturities	\$ 38,991	

Rental expense related to continuing operations consisted of the following amounts (in thousands):

	<b>2005</b>	<b>2004</b>	<b>2003</b>
Minimum lease payments	\$ 19,443	\$ 17,071	\$ 14,896

Contingent rentals	3,446	2,615	2,109
Total rental expense	\$ 22,889	\$ 19,686	\$ 17,005

Future minimum lease payments under noncancelable operating leases of discontinued operations at December 25, 2005 are as follows (in thousands):

<b>YEARS ENDING AT OR ABOUT DECEMBER 31:</b>	<b>OPERATING</b>
2006	\$ 3,574
2007	3,522
2008	3,351
2009	3,141
2010	2,822
Thereafter	10,056
Total minimum lease payments	\$ 26,466

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Rental expense related to discontinued operations consisted of the following amounts (in thousands):

	<b>2005</b>	<b>2004</b>	<b>2003</b>
Minimum lease payments	\$ 3,560	\$ 3,135	\$ 2,783
Contingent rentals	170	201	177
Total rental expense	\$ 3,730	\$ 3,336	\$ 2,960

**(9) SHAREHOLDERS EQUITY**

In September 2001, the Company's Board of Directors authorized the Company to use up to \$15.0 million to purchase shares of its common stock through open market transactions, block purchases or in privately negotiated transactions through September 2002. In July 2002, the Company's Board of Directors extended this share repurchase program through April 2003. During the first quarter of 2003, the Company purchased 150,000 shares of its common stock for a total purchase price of approximately \$2.6 million (average price of \$17.50 per share). On July 23, 2003, the Company's Board of Directors authorized the Company to purchase up to an additional \$25.0 million of its common stock from time-to-time through May 2005. During the second quarter of 2004, the Company purchased 300,000 shares of its common stock for a total purchase price of approximately \$8.2 million (average price of \$27.29 per share).

The Company's Board of Directors has authorized the purchase of shares of the Company's common stock from time to time through open market transactions, block purchases or in privately negotiated transactions. On April 20, 2005, the Board of Directors authorized the Company to use up to \$29.0 million to purchase shares of its common stock and on July 22, 2005, the Board of Directors authorized the repurchase of up to an additional \$30.0 million of the Company's common stock. During the second quarter of 2005, the Company repurchased 690,000 shares of its common stock at an average price of \$28.88 for an aggregate cost of approximately \$19.9 million. During the third quarter of 2005, the Company repurchased 669,000 shares of its common stock at an average price of \$28.95 for an aggregate cost of approximately \$19.4 million. The Company did not repurchase any of its common stock during the fourth quarter of 2005. As of December 25, 2005, approximately \$19.7 million remained available under the Company's aggregate \$59.0 million share repurchase authorization.

The Company's Articles of Incorporation authorize 10,000,000 shares of preferred stock, no par value. The Board of Directors of the Company may determine the preferences, limitations, and relative rights of any class of shares of preferred stock prior to the issuance of such class of shares. In November 1997, in connection with the adoption of a Shareholders Rights Plan, the Board of Directors designated 500,000 shares of Series A Junior Participating Preferred Stock (the "Series A Stock") and filed such designation as an amendment to the Company's Articles of Incorporation. Holders of shares of Series A Stock are entitled to receive, when, as and if declared by the Board of Directors, (i) on each date that dividends or other distributions (other than dividends or distributions payable in common stock) are payable on the common stock comprising part of the Reference Package (as defined in the Articles of Incorporation), an amount per whole share of Series A Stock equal to the aggregate amount of dividends or other distributions that would be payable on such date to a holder of the Reference Package and (ii) on the last day of March, June, September and December in each year, an amount per whole share of Series A Stock equal to the excess of \$1.00 over the aggregate dividends paid per whole share of Series A Stock during the three-month period ending on such last day. If any shares of Series A Stock are outstanding, no dividends (other than dividends payable in common stock or any other stock ranking junior to the Series A Stock as to dividends and upon liquidation) may be declared or paid unless the full cumulative dividends on all outstanding shares of Series A Stock have been or are contemporaneously paid. Upon the liquidation, dissolution or winding up of the affairs of the Company and before any distribution or payment to the holders of common stock, holders of shares of the Series A Stock are entitled to be paid in full an amount per whole share of Series A Stock equal to the greater of (i) \$1.00 or (ii) the aggregate amount distributed or to be distributed prior to the date of such liquidation, dissolution or winding up to a holder of the Reference Package. After payment in full to each holder of shares of Series A Stock, the Series A Stock shall have no right or claim to any of the remaining assets of the Company. Each outstanding share of Series A Stock votes on all matters as a class with

any other capital stock comprising part of the Reference Package and shall have the number of votes that a holder of the Reference Package would have.

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As of December 25, 2005, there were no shares of Series A Stock issued and outstanding and all of such shares are issuable in accordance with the Company's Shareholders Rights Plan.

**(10) STOCK OPTIONS AND RESTRICTED STOCK**

The Company's Amended and Restated 2002 Long-Term Incentive Plan (the 2002 Plan), provides for the granting of incentive stock options, nonqualified stock options, and restricted stock to employees, officers, directors, consultants, and advisors. All stock options issued under the 2002 Plan were granted at prices which equate to or were higher than current market value on the date of the grant, are generally exercisable after three to five years, and must be exercised within ten years from the date of grant. The aggregate number of shares authorized to be awarded under the 2002 Plan is 4,270,000. Not more than 2,320,000 of such aggregate number of shares may be granted as awards of restricted stock.

Shares of Company common stock are issued as deferred compensation under the Company's Managing Partner Program. Total shares issued under this program were approximately 55,000, 61,000 and 47,000 for 2005, 2004 and 2003, respectively. Total compensation expense recognized in association with these awards was approximately \$1,600,000, \$1,280,000 and \$790,000 for 2005, 2004 and 2003, respectively.

The Company's 1997 Long-Term Incentive Plan, as amended (the 1997 Plan), provides for the granting of incentive stock options, nonqualified stock options, stock appreciation rights, performance units, restricted stock, dividend equivalents and other stock based awards to employees, officers, directors, consultants, and advisors. All stock options issued under the 1997 Plan were granted at prices which equate to or were higher than current market value on the date of the grant, are generally exercisable after three to five years, and must be exercised within ten years from the date of grant. The 1997 Plan authorized the granting of options to purchase 2,981,250 shares of common stock.

The Company's Amended and Restated 1996 Stock Plan for Outside Directors (the 1996 Stock Option Plan) provides for the automatic granting of non-qualified stock options to outside directors. The 1996 Stock Option Plan authorizes the granting of options to purchase up to an aggregate of 225,000 shares of common stock. All stock options issued under the 1996 Stock Option Plan are granted at prices which are equal to the current market value on the date of the grant, become exercisable six months and one day after the date of grant, and must be exercised within ten years from the date of grant.

As of December 25, 2005 and December 26, 2004, options to purchase 2,238,110 and 1,958,755 shares of common stock, respectively, were exercisable at weighted average exercise prices of \$14.94 and \$12.39 per share, respectively. Option activity under the Company's stock option plans is as follows:

	<b>SHARES</b>	<b>WEIGHTED AVERAGE PRICE (\$)</b>
Outstanding at December 29, 2002	3,939,177	10.57
Granted in 2003	732,003	20.01
Exercised in 2003	(907,252)	7.85
Canceled in 2003	(31,753)	16.17
Outstanding at December 28, 2003	3,732,175	12.99
Granted in 2004	701,066	27.20
Exercised in 2004	(709,152)	10.87
Canceled in 2004	(153,748)	17.58

Outstanding at December 26, 2004	3,570,341	16.07
Granted in 2005	394,408	30.63
Exercised in 2005	(598,043)	12.07
Canceled in 2005	(153,327)	22.14
Outstanding at December 25, 2005	3,213,379	18.35

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The following table summarizes information concerning options outstanding and exercisable as of December 25, 2005:

RANGE OF EXERCISE PRICES	OPTIONS OUTSTANDING			OPTIONS EXERCISABLE	
	NUMBER	WEIGHTED AVERAGE REMAINING LIFE	WEIGHTED AVERAGE EXERCISE PRICE (\$)	NUMBER	WEIGHTED AVERAGE PRICE (\$)
\$0.01 to \$5.00	47,500	2.10	4.33	47,500	4.33
\$5.01 to \$10.00	772,145	3.60	8.16	772,145	8.16
\$10.01 to \$15.00	527,699	5.00	14.62	445,195	14.58
\$15.01 to \$20.00	654,135	6.50	17.51	561,960	17.33
\$20.01 to \$25.00	222,015	7.80	22.36	142,449	22.33
\$25.01 to \$30.00	686,802	8.60	27.37	208,781	27.02
\$30.01 or greater	303,083	9.10	31.45	60,080	31.34

**(11) COMMITMENTS AND CONTINGENCIES****PURCHASE COMMITMENTS**

The Company has entered into purchasing agreements with certain meat suppliers requiring the Company to purchase contracted quantities of meat at established prices through their expiration on varying dates in 2006 and 2007. The contracted quantities are based on usage projections management believes to be estimates of actual requirements during the contract terms. The Company does not anticipate any material adverse effect on its financial condition or results of operations from these contracts.

**OTHER**

Under the Company's insurance programs, coverage is obtained for significant exposures as well as those risks required to be insured by law or contract. It is the Company's preference to self-insure a significant portion of certain expected losses related primarily to workers' compensation, employee medical, employment practices and general liability insurance costs. Provisions for losses expected under these programs are recorded based upon the Company's estimates of the aggregate liability for claims incurred.

The Company has deposits totaling \$5.9 million at December 25, 2005 that are being maintained as security under the Company's workers' compensation policies.

The Company is involved in various legal actions incidental to the normal conduct of its business. Management does not believe that the ultimate resolution of these incidental actions will have a material adverse effect on the Company's financial condition, results of operations or cash flows.

**(12) QUARTERLY FINANCIAL DATA (UNAUDITED)**

The following is a summary of the unaudited quarterly results for the years ended December 25, 2005 and December 26, 2004 (in thousands, except per share data):

	First Quarter	Second Quarter	Third Quarter	Fourth Quarter	Total Year
2005:					
Revenues	\$ 205,335	\$ 210,242	\$ 201,489	\$ 222,200	\$ 839,266
Operating income	22,504	20,548	15,149	21,410	79,611
Earnings from continuing operations before income taxes	22,121	20,094	14,607	20,653	77,475
Net earnings	15,350	13,734	9,588	12,907	51,579
Net earnings per share*:					
Basic	\$ 0.45	\$ 0.40	\$ 0.29	\$ 0.38	\$ 1.53



Diluted	\$ 0.43	\$ 0.39	\$ 0.28	\$ 0.37	\$ 1.48
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	First Quarter	Second Quarter	Third Quarter	Fourth Quarter	Total Year
2004:					
Revenues	\$ 176,831	\$ 180,449	\$ 171,087	\$ 189,105	\$ 717,472
Operating income	20,494	18,925	12,255	18,503	70,177
Earnings from continuing operations before income taxes	20,269	18,626	11,759	17,895	68,549
Net earnings	14,768	13,284	8,345	10,592	46,989
Net earnings per share*:					
Basic	\$ 0.44	\$ 0.39	\$ 0.25	\$ 0.31	\$ 1.39
Diluted	\$ 0.42	\$ 0.37	\$ 0.24	\$ 0.30	\$ 1.33

\* Quarterly per share amounts do not necessarily sum to the total year amounts due to changes in shares outstanding and rounding.

**(13) SUBSEQUENT EVENT**

On September 21, 2006, the Company announced that its Board of Directors had approved exiting the Bugaboo Creek Steak House business through the probable sale of the restaurants and brand. Earnings (loss) from discontinued operations for the third quarter of 2006 reflect a third quarter asset impairment charge of approximately \$12,280,000 (\$7,982,000, net of tax) (unaudited) based upon Management's estimate of the impairment to be realized upon the anticipated divestiture of the Bugaboo Creek Steak House business. Associated with this planned divestiture, in addition to costs included in the third quarter impairment charge, the Company expects to pay retention bonuses of approximately \$2.0 million and incur rent termination costs of approximately \$1.8 million. None of these amounts have been expensed or paid.

**EXHIBIT INDEX**

- 23(1) Consent of KPMG LLP.
- 31(1) Certification of Principal Executive Officer pursuant to Rule 13a-14(a) of the Exchange Act.
- 31(2) Certification of Principal Financial Officer pursuant to Rule 13a-14(a) of the Exchange Act.
- 32(1) Certification of Principal Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. (1).
- 32(2) Certification of Principal Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. (1).

(1) These exhibits are deemed to accompany this

report and are  
not filed as part  
of the report.

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**SIGNATURES**

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

RARE Hospitality International, Inc.

By /s/ Philip J. Hickey, Jr.  
Philip J. Hickey, Jr.  
Chairman of the Board and Chief Executive  
Officer

Date: November 15, 2006

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

	Date
By /s/ Philip J. Hickey, Jr.  Philip J. Hickey, Jr. Chairman of the Board and Chief Executive Officer (Principal Executive Officer)	November 15, 2006
By /s/ W. Douglas Benn  W. Douglas Benn Executive Vice President, Finance and Chief Financial Officer (Principal Financial Officer)	November 15, 2006
By /s/Benjamin A. Waites  Benjamin A. Waites Vice President, Controller and Chief Accounting Officer (Principal Accounting Officer)	November 15, 2006
By /s/Roger L. Boeve  Roger L. Boeve Director	November 15, 2006
By /s/Carolyn H. Byrd  Carolyn H. Byrd Director	November 15, 2006
By /s/Don L. Chapman	November 15, 2006

Don L. Chapman  
Director

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	Date
By /s/James D. Dixon  James D. Dixon Director	November 15, 2006
By /s/Dick R. Holbrook  Dick R. Holbrook Director	November 15, 2006
By /s/Lewis H. Jordan  Lewis H. Jordan Director	November 15, 2006
By /s/Eugene I. Lee, Jr.  Eugene I. Lee, Jr. President, Chief Operating Officer and Director	November 15, 2006
By /s/Ronald W. San Martin  Ronald W. San Martin Director	November 15, 2006