

LUBYS INC
Form 10-Q
June 11, 2010
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

☒ **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the quarterly period ended May 5, 2010

or

☐ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the Transition Period From _____ to _____

Commission file number 001-08308

Luby s, Inc.

(Exact name of registrant as specified in its charter)

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Delaware
*(State or other jurisdiction of
incorporation or organization)*

74-1335253
*(IRS Employer
Identification Number)*

13111 Northwest Freeway, Suite 600

Houston, Texas
(Address of principal executive offices)

(713) 329-6800

77040
(Zip Code)

(Registrant's telephone number, including area code)

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes ☐ No ☐

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

| | | | |
|-------------------------|--------------------------|---------------------------|-------------------------------------|
| Large accelerated filer | <input type="checkbox"/> | Accelerated filer | <input checked="" type="checkbox"/> |
| Non-accelerated filer | <input type="checkbox"/> | Smaller reporting company | <input type="checkbox"/> |

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

As of May 31, 2010, there were 28,053,253 shares of the registrant's common stock outstanding.

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Luby s, Inc.

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Quarter ended May 5, 2010

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Additional Information

We file reports with the Securities and Exchange Commission, including annual reports on Form 10-K, quarterly reports on Form 10-Q and current reports on Form 8-K. The public may read and copy any materials we file with the SEC at its Public Reference Room at 100 F Street, N.E., Washington, D.C. 20549. The public may obtain information on the operation of the Public Reference Room by calling the SEC at 1-800-SEC-0330. We are an electronic filer, and the SEC maintains an Internet site at <http://www.sec.gov> that contains the reports, proxy and information statements, and other information that we file electronically. Our website address is <http://www.lubys.com>. Please note that our website address is provided as an inactive textual reference only. We make available free of charge through our website our annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and all amendments to those reports as soon as reasonably practicable after such material is electronically filed with or furnished to the SEC. The information provided on our website is not part of this report, and is therefore not incorporated by reference unless such information is specifically referenced elsewhere in this report.

Table of Contents**Part I - FINANCIAL INFORMATION****Item 1. Financial Statements****Luby's, Inc.****Consolidated Balance Sheets***(In thousands, except share data)*

| | May 5, 2010 <i>(Unaudited)</i> | August 26, 2009 |
|--|--------------------------------------|--------------------|
| ASSETS | | |
| Current Assets: | | |
| Cash and cash equivalents | \$ 7,698 | \$ 882 |
| Trade accounts and other receivables, net | 1,495 | 1,463 |
| Short-term investments | 5,725 | |
| Food and supply inventories | 2,770 | 2,814 |
| Prepaid expenses | 612 | 661 |
| Assets related to discontinued operations | 90 | 372 |
| Deferred income taxes | 26 | 192 |
| Total current assets | 18,416 | 6,384 |
| Property and equipment, net | 136,908 | 147,345 |
| Long-term investments | | 6,903 |
| Deferred incomes taxes | 6,017 | 5,082 |
| Property held for sale | 2,075 | 3,870 |
| Assets related to discontinued operations | 23,919 | 24,705 |
| Other assets | 397 | 223 |
| Total assets | \$ 187,732 | \$ 194,512 |
| LIABILITIES AND SHAREHOLDERS' EQUITY | | |
| Current Liabilities: | | |
| Accounts payable | \$ 8,913 | \$ 11,595 |
| Liabilities related to discontinued operations | 695 | 1,816 |
| Accrued expenses and other liabilities | 12,855 | 14,063 |
| Total current liabilities | 22,463 | 27,474 |
| Credit facility debt | | |
| Liabilities related to discontinued operations | 971 | 382 |
| Other liabilities | 3,241 | 3,524 |
| Total liabilities | 26,675 | 31,380 |
| Commitments and Contingencies | | |
| SHAREHOLDERS' EQUITY | | |
| Common stock, \$0.32 par value; 100,000,000 shares authorized; shares issued were 28,552,577 and 28,494,511, respectively; shares outstanding were 28,052,577 and 27,994,511, respectively | 9,137 | 9,118 |
| Paid-in capital | 22,859 | 21,989 |
| Retained earnings | 133,391 | 136,800 |

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| | | |
|---|------------|------------|
| Accumulated other comprehensive income | 445 | |
| Less cost of treasury stock, 500,000 shares | (4,775) | (4,775) |
| Total shareholders' equity | 161,057 | 163,132 |
| Total liabilities and shareholders' equity | \$ 187,732 | \$ 194,512 |

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

Table of Contents**Luby's, Inc.****Consolidated Statements of Operations (unaudited)***(In thousands except per share data)*

| | Quarter Ended | | Three Quarters Ended | |
|---|---------------------------------------|---------------------------------------|---------------------------------------|---------------------------------------|
| | May 5, 2010 (12 weeks) | May 6, 2009 (12 weeks) | May 5, 2010 (36 weeks) | May 6, 2009 (36 weeks) |
| SALES: | | | | |
| Restaurant sales | \$ 53,947 | \$ 57,470 | \$ 153,399 | \$ 173,830 |
| Culinary contract services | 3,262 | 2,968 | 9,514 | 9,001 |
| TOTAL SALES | 57,209 | 60,438 | 162,913 | 182,831 |
| COSTS AND EXPENSES: | | | | |
| Cost of food | 14,796 | 15,484 | 41,781 | 47,452 |
| Payroll and related costs | 18,932 | 20,468 | 55,587 | 61,762 |
| Other operating expenses | 10,482 | 12,619 | 33,208 | 37,969 |
| Opening costs | 31 | 32 | 183 | 127 |
| Cost of culinary contract services | 2,945 | 2,866 | 8,660 | 8,207 |
| Depreciation and amortization | 3,443 | 3,656 | 10,461 | 10,985 |
| General and administrative expenses | 5,163 | 5,955 | 15,648 | 17,702 |
| Provision for asset impairments, net | | | 32 | 233 |
| Net gain on disposition of property and equipment | (237) | (485) | (965) | (720) |
| Total costs and expenses | 55,555 | 60,595 | 164,595 | 183,717 |
| INCOME (LOSS) FROM OPERATIONS | 1,654 | (157) | (1,682) | (886) |
| Interest income | 7 | 22 | 23 | 181 |
| Interest expense | (127) | (66) | (300) | (208) |
| Gain on sales and redemptions (impairment in fair value) of investments | | (664) | (438) | (794) |
| Other income, net | 204 | 263 | 617 | 754 |
| Income (loss) before income taxes and discontinued operations | 1,738 | (602) | (1,780) | (953) |
| Provision (benefit) for income taxes | 462 | (244) | (240) | (338) |
| Income (loss) from continuing operations | 1,276 | (358) | (1,540) | (615) |
| Loss from discontinued operations, net of income taxes | (546) | (695) | (1,869) | (2,484) |
| NET INCOME (LOSS) | \$ 730 | \$ (1,053) | \$ (3,409) | \$ (3,099) |
| Income (loss) per share from continuing operations: | | | | |
| Basic | \$ 0.05 | \$ (0.01) | \$ (0.05) | \$ (0.02) |
| Assuming dilution | 0.05 | (0.01) | (0.05) | (0.02) |
| Loss per share from discontinued operations: | | | | |
| Basic | \$ (0.02) | \$ (0.03) | \$ (0.07) | \$ (0.09) |
| Assuming dilution | (0.02) | (0.03) | (0.07) | (0.09) |
| Net income (loss) per share: | | | | |
| Basic | \$ 0.03 | \$ (0.04) | \$ (0.12) | \$ (0.11) |
| Assuming dilution | 0.03 | (0.04) | (0.12) | (0.11) |

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| | | | | |
|--------------------------------------|--------|--------|--------|--------|
| Weighted average shares outstanding: | | | | |
| Basic | 28,145 | 28,061 | 28,125 | 28,078 |
| Assuming dilution | 28,151 | 28,061 | 28,125 | 28,078 |

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

Note: The Company's Cash Flow Improvement and Capital Redeployment Plan (the Plan) was approved in the first quarter of fiscal year 2010. As a result, the Company reclassified 24 stores to discontinued operations for current and prior fiscal periods.

Table of Contents**Luby's, Inc.****Consolidated Statement of Shareholders' Equity and Comprehensive Income (Loss) (unaudited)***(In thousands)*

| | Common Stock Issued | | Treasury | | Paid-In Capital | Retained Earnings | Accumulated Other Comprehensive Income | Total Shareholders' Equity |
|---|------------------------|----------|----------|------------|--------------------|----------------------|---|----------------------------------|
| | Shares | Amount | Shares | Amount | | | | |
| BALANCE AT AUGUST 26, 2009 | 28,495 | \$ 9,118 | 500 | \$ (4,775) | \$ 21,989 | \$ 136,800 | \$ | \$ 163,132 |
| Common stock issued under nonemployee director plans | 36 | 12 | | | 186 | | | 198 |
| Share based compensation expense | 22 | 7 | | | 684 | | | 691 |
| Comprehensive income (loss): | | | | | | | | |
| Net Loss | | | | | | (3,409) | | (3,409) |
| Unrealized gain on investments, net of tax | | | | | | | 445 | 445 |
| Total comprehensive loss | | | | | | | | (2,964) |
| BALANCE AT MAY 5, 2010 | 28,553 | \$ 9,137 | 500 | \$ (4,775) | \$ 22,859 | \$ 133,391 | \$ 445 | \$ 161,057 |

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

Table of Contents**Luby's, Inc.****Consolidated Statements of Cash Flows (unaudited)***(In thousands)*

| | Three Quarters Ended | |
|--|---|---|
| | May 5, 2010 (36 weeks) | May 6, 2009 (36 weeks) |
| CASH FLOWS FROM OPERATING ACTIVITIES: | | |
| Net loss | \$ (3,409) | \$ (3,099) |
| Adjustments to reconcile net loss to net cash provided by operating activities: | | |
| Net (gains) and losses on property sales and provision for asset impairments | (2,501) | (859) |
| Depreciation and amortization | 10,732 | 13,051 |
| Impairment charge for decrease in fair value of investments, net of gains | 438 | 794 |
| Amortization of debt issuance cost | 187 | 60 |
| Non-cash compensation expense | 198 | 195 |
| Share-based compensation expense | 691 | 906 |
| Deferred tax benefit | (1,317) | (1,816) |
| Cash provided by operating activities before changes in operating assets and liabilities | 5,019 | 9,232 |
| Changes in operating assets and liabilities: | | |
| Decrease (increase) in trade accounts and other receivables, net | (17) | 176 |
| Decrease (increase) in food and supply inventories | 261 | (205) |
| Decrease in prepaid expenses and other assets | 80 | 286 |
| Decrease in accounts payable, accrued expenses and other liabilities | (5,099) | (6,094) |
| Net cash provided by operating activities | 244 | 3,395 |
| CASH FLOWS FROM INVESTING ACTIVITIES: | | |
| Proceeds from sale and redemption of long-term investments | 1,414 | 525 |
| Proceeds from disposal of assets, property insurance proceeds and property held for sale | 7,802 | 2,244 |
| Purchases of property and equipment | (2,266) | (10,335) |
| Net cash provided by (used in) investing activities | 6,950 | (7,566) |
| CASH FLOWS FROM FINANCING ACTIVITIES: | | |
| Credit facility borrowings | 21,300 | 14,000 |
| Credit facility repayments | (21,300) | (12,000) |
| Debt issuance costs | (378) | |
| Net cash provided by (used in) financing activities | (378) | 2,000 |
| Net increase (decrease) in cash and cash equivalents | 6,816 | (2,171) |
| Cash and cash equivalents at beginning of period | 882 | 4,566 |
| Cash and cash equivalents at end of period | \$ 7,698 | \$ 2,395 |
| Cash paid for: | | |
| Income taxes | \$ | \$ |
| Interest | 94 | 135 |

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

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Luby s, Inc.

Notes to Consolidated Financial Statements (unaudited)

May 5, 2010

Note 1. Basis of Presentation

The accompanying unaudited consolidated financial statements of Luby s, Inc. (the Company or Luby s) have been prepared in accordance with U.S. generally accepted accounting principles (GAAP) for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statements that are prepared for the Company s Annual Report on Form 10-K. In the opinion of management, all adjustments (consisting of normal recurring adjustments) considered necessary for a fair presentation have been included. Operating results for the period ended May 5, 2010 are not necessarily indicative of the results that may be expected for the fiscal year ending August 25, 2010.

The balance sheet dated August 26, 2009, included in this Form 10-Q, has been derived from the audited financial statements at that date. However, this Form 10-Q does not include all of the information and footnotes required by GAAP for an annual filing of complete financial statements. Therefore, these financial statements should be read in conjunction with the consolidated financial statements and footnotes included in the Company s Annual Report on Form 10-K for the fiscal year ended August 26, 2009.

The results of operations, assets and liabilities for all units included in the disposal plan discussed in Note 7, have been reclassified to discontinued operations in the statements of operations and balance sheets for all periods presented.

Note 2. Accounting Periods

The Company s fiscal year ends on the last Wednesday in August. As such, each fiscal year normally consists of 13 four-week periods, accounting for 364 days. Each of the first three quarters of each fiscal year consists of three four-week periods (12 weeks), while the fourth quarter normally consists of four four-week periods (16 weeks). Comparability between accounting periods will be affected by varying lengths of the periods, as well as the seasonality associated with the restaurant business.

Note 3. Fair Value Measurement

The Financial Accounting Standards Board (FASB) issued Accounting Standards Codification (ASC) Topic 820, *Fair Value Measurements* (ASC 820), which defines fair value, establishes a framework for using fair value to measure assets and liabilities, and expands disclosure about fair value measurements. ASC 820 applies whenever other statements require or permit asset or liabilities to be measured at fair value.

ASC 820 establishes a three-tier fair value hierarchy, which prioritizes the inputs used to measure fair value. These tiers include:

Level 1: Defined as observable inputs such as quoted prices in active markets for identical assets or liabilities as of the reporting date. Active markets are those in which transactions for the asset or liability occur in sufficient frequency and volume to provide pricing information on an ongoing basis.

Level 2: Defined as pricing inputs other than quoted prices in active markets included in Level 1, which are either directly or indirectly observable as of the reporting date. Level 2 includes those financial instruments that are valued using models or other valuation methodologies. These models are primarily industry-standard models that consider various assumptions, including quoted forward prices for commodities, time value, volatility factors, and current market and contractual prices for the underlying instruments, as well as other relevant economic measures.

Level 3: Defined as pricing inputs that are unobservable from objective sources. These inputs may be used with internally developed methodologies that result in management s best estimate of fair value.

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As of May 5, 2010, the Company held auction rate securities, which are classified as available-for-sale investments under investments on the balance sheet and are required to be measured at fair value on a recurring basis. As discussed in Note 4, the continued illiquidity in the auction rate market has affected the fair market value of the Company's auction rate securities because the auctions continue to fail. Therefore, in the absence of an active market, the Company estimated the fair value of these investments using price submissions from financial consultants specializing in valuing these types of securities. These valuations considered, among other things, the collateralization underlying the security, the creditworthiness of the counterparty, the timing of the expected future cash flows, the interest rate of the Company's investments compared to similar investments, the current illiquidity of the investments, and the estimated next successful auction of the security.

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The assets measured at fair value on a recurring basis were as follows:

| | Quoted Prices in Active Markets for Identical Assets (Level 1) | Fair Value Measurement Using | |
|--|---|---|--|
| | | Significant Other Observable Inputs (Level 2) (In thousands) | Significant Unobservable Inputs (Level 3) |
| Balance at August 27, 2008 | \$ | \$ | \$ 8,525 |
| Purchase of long-term investments | | | |
| Sale of long-term investments | | | |
| Calls or redemptions at par value as scheduled by Issuer | | | (625) |
| Total gains or losses (realized and unrealized)included in net income (loss) | | | (997) |
| Balance at August 26, 2009 | | | 6,903 |
| Purchase of long-term investments | | | |
| Sale of long-term investments | | | (1,364) |
| Calls or redemptions at par value as scheduled by Issuer | | | (50) |
| Total unrealized gains or losses recorded in other comprehensive income on the balance sheet | | | 674 |
| Total gains or losses (realized and unrealized)included in net income (loss) | | | (438) |
| Balance at May 5, 2010 | \$ | \$ | \$ 5,725 |

The carrying value of cash and cash equivalents, trade accounts and other receivable, accounts payable and accrued expenses approximate fair value based on the short term nature of these accounts.

Note 4. Investments

Investments include available-for-sale securities which are reported at fair value with unrealized gains and losses excluded from earnings and reported in shareholders' equity unless such losses are considered other-than-temporary. The Company held \$7.1 million par value (\$5.7 million fair value) as short-term investments and \$8.7 million par value (\$6.9 million fair value) as long-term investments as of May 5, 2010 and August 26, 2009, respectively, in auction rate municipal bonds. Adjustments to fair value were recorded in fiscal years 2008 and 2009 and the first quarter ended November 18, 2009 based on the continued illiquidity of the auction rate securities market and a valuation of the securities. The Company recognized cumulative unrealized losses of \$2.1 million and \$1.8 million losses as of May 5, 2010 and August 26, 2009, respectively; no additional losses were recognized in the quarter ended May 5, 2010. The cumulative unrealized losses are considered other-than-temporary and are recorded as a charge to earnings. However, as a result of an increase in fair market value of the securities at the end of the quarter ended May 5, 2010, the company recorded an unrealized gain of \$0.6 million. This unrealized gain was recorded in other comprehensive income on the balance sheet, net of taxes.

The auction rate securities market, which directly affects the Company, continues to be inactive and auctions continue to fail. Therefore, the Company estimated the fair value of its auction rate securities using pricing valuation models and methodologies from financial consultants specializing in the securities. Based on these valuation models and methodologies and the possible long-term illiquidity of the markets, the Company has recognized other-than-temporary impairments. See Note 3, Fair Value Measurement.

The auction rate municipal securities are long-term debt obligations that are secured by certain revenue streams (airport, sewer, hospital, etc.). These auction rate securities have insurance policies guaranteeing, with respect to each bond, the payment of principal and accrued interest, as scheduled, if the issuer is unable to service the debt and have been issued ratings ranging from A1 Aa3 (Moody's) and A AAA (Standard and Poor's). The bonds have experienced this disparity in credit ratings because of the insurance company's revised credit ratings issued by Moody's and Standard and Poor's. As these securities continue to fail at auction, interest income will continue to accrue at a designated benchmark rate.

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plus a premium; otherwise, they will be sold. At each of the resets between February 12, 2008 and May 5, 2010, the Company received all accrued interest due and all accounts payable upon scheduled principal redemptions.

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When normal trading on the auction rate securities market halted in February 2008, the Company had sell orders on all of its holdings. In fiscal year 2009, the Company received par value of \$625,000 plus accrued interest on the bonds upon scheduled principal redemptions. Through the second quarter ended May 5, 2010, the Company sold one auction rate municipal bond with a par value of \$1.6 million (\$1.3 million book value) at a 12% discount and received \$1.4 million including accrued interest and received par value of \$50,000 plus accrued interest from a scheduled principal redemption.

These municipal bonds have underlying maturity dates ranging from October 1, 2022 through February 1, 2042 offering rates tied to benchmarks plus a premium. Historically, the auction process allowed investors to obtain immediate liquidity by selling the securities at their face amounts. Liquidity for these securities was historically provided by entering sell orders through a Dutch-auction process that resets interest rates on these investments every 7, 28 or 35 days. However, the disruptions in the credit markets have continued to adversely affect the auction market for these types of securities.

In October 2008, the Company had sought relief from the illiquid investments and by filing for arbitration against its broker with Financial Industry Regulatory Authority (FINRA) Dispute Resolution, Inc. and submitting a statement of claim for the par value of the auction rate securities. The arbitration hearing took place in April 2010, and a final award was announced on May 21, 2010 in favor of the Company whereby the broker was ordered to purchase the auction rate securities at par value. The Company continues to pursue its claim against its broker for \$0.2 million in losses related to a previous sale. In June 2010, the Company received \$7.1 million from the sale of the securities to the broker at par including interest and will recognize a \$1.8 million gain in the fourth quarter of fiscal year 2010. The Company is also entitled to receive a 6% per annum fee on the par value of the securities from and including May 29, 2010 through and including the date the award is paid in full.

Note 5. Income Taxes

For the three quarters ended May 5, 2010, including both continuing and discontinued operations, the Company generated a gross taxable loss of approximately \$5.3 million. No cash payments of estimated income taxes were made during the three quarters ended May 5, 2010.

Deferred tax assets and liabilities are recorded based on differences between the financial reporting basis and the tax basis of assets and liabilities using currently enacted rates and laws that will be in effect when the differences are expected to reverse. Deferred tax assets are recognized to the extent future taxable income is expected to be sufficient to utilize those assets prior to their expiration. If current available information and projected future results raises doubt about the realization of the deferred tax assets, a valuation allowance is necessary. Such a valuation allowance was established through a charge to income tax expense which adversely affected the Company's reported operating results. Management concluded that for the quarter ended May 5, 2010 no change in the valuation allowance was necessary. The valuation allowance partially offsets the Company's net operating loss (NOL) carryovers to future years and its carryover of employment tax credits.

Management believes that adequate provisions for income taxes have been reflected in the financial statements and is not aware of any significant exposure items that have not been reflected in the financial statements. Amounts considered probable of settlement within one year have been included in the accrued expenses and other liabilities in the accompanying consolidated balance sheet. The Company does not anticipate any material change in the total amount of unrecognized tax benefits to occur within the next thirteen four-week periods.

Table of Contents**Note 6. Property and Equipment**

The cost, net of impairment, and accumulated depreciation of property and equipment at May 5, 2010 and August 26, 2009, together with the related estimated useful lives used in computing depreciation and amortization, were as follows:

| | May 5, 2010 | August 26, 2009 | Estimated Useful Lives |
|--|----------------|--------------------|---|
| <i>(In thousands)</i> | | | |
| Land | \$ 39,582 | \$ 41,434 | |
| Restaurant equipment and furnishings | 91,950 | 92,672 | 3 to 15 years |
| Buildings | 150,476 | 148,998 | 20 to 33 years |
| | 21,980 | 22,722 | Lesser of lease term or estimated useful life |
| Leasehold and leasehold improvements | | | |
| Office furniture and equipment | 6,278 | 6,280 | 3 to 10 years |
| Construction in progress | 337 | 544 | |
| | 310,603 | 312,650 | |
| Less accumulated depreciation and amortization | (173,695) | (165,305) | |
| Property and equipment, net | \$ 136,908 | \$ 147,345 | |

Note 7. Impairment of Long-Lived Assets, Discontinued Operations and Property Held for Sale***Impairment of Long-Lived Assets and Store Closings***

The Company periodically evaluates long-lived assets held for use and held for sale whenever events or changes in circumstances indicate that the carrying amount of those assets may not be recoverable. The Company analyzes historical cash flows of operating locations and compares results of poorer performing locations to more profitable locations. The Company also analyzes lease terms, condition of the assets and related need for capital expenditures or repairs, as well as construction activity and the economic and market conditions in the surrounding area.

For assets held for use, the Company estimates future cash flows using assumptions based on possible outcomes of the areas analyzed. If the undiscounted future cash flows are less than the carrying value of the location's assets, the Company records an impairment loss based on an estimate of discounted cash flows. The estimates of future cash flows, based on reasonable and supportable assumptions and projections, require management's subjective judgments. Assumptions and estimates used include operating results, changes in working capital, discount rate, growth rate, anticipated net proceeds from disposition of the property and if applicable, lease terms. The span of time for which future cash flows are estimated is often lengthy, increasing the sensitivity to assumptions made. The time span is longer and could be 20 to 25 years for newer properties, but only 5 to 10 years for older properties. Depending on the assumptions and estimates used, the estimated future cash flows projected in the evaluation of long-lived assets can vary within a wide range of outcomes. The Company considers the likelihood of possible outcomes in determining the best estimate of future cash flows. The measurement for such an impairment loss is then based on the fair value of the asset as determined by discounted cash flows. The Company operates 96 restaurants and periodically experiences unanticipated changes in its assumptions and estimates. Those changes could have a significant impact on discounted cash flow models with a corresponding significant impact on the measurement of an impairment. Gains are not recognized until the assets are disposed.

Discontinued Operations

As a result of the first quarter fiscal year 2010 adoption of the Company's Cash Flow Improvement and Capital Redeployment Plan (the Plan), the Company reclassified 23 operating stores and one previously closed location to discontinued operations. The results of operations, assets and liabilities for all units included in the Plan have been reclassified to discontinued operations in the statement of operations and balance sheets for all periods presented.

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Assets related to discontinued operations include food inventory, prepaid expenses, deferred tax assets, unimproved land, closed restaurant properties and related equipment for locations classified as discontinued operations. The following table sets forth the assets and liabilities for all discontinued operations:

| | May 5, 2010 | August 26, 2009 |
|---|-----------------------|--------------------|
| | <i>(in thousands)</i> | |
| Trade accounts and other receivable, net | \$ | \$ 16 |
| Food and supply inventories | | 217 |
| Prepaid expenses | 90 | 139 |
| Assets related to discontinued operations current | \$ 90 | \$ 372 |
| Property and equipment | \$ 22,561 | \$ 23,812 |
| Deferred income taxes | 1,347 | 859 |
| Other assets | 11 | 34 |
| Assets related to discontinued operations non-current | \$ 23,919 | \$ 24,705 |
| Accounts payable | \$ | \$ 47 |
| Accrued expenses and other liabilities | 609 | 1,622 |
| Deferred income taxes | 86 | 147 |
| Liabilities related to discontinued operations current | \$ 695 | \$ 1,816 |
| Other liabilities | \$ 971 | \$ 382 |
| Liabilities related to discontinued operations non-current | \$ 971 | \$ 382 |

In conjunction with the Plan adoption, the Company recorded in the fourth quarter of fiscal year 2009 a non-cash, pre-tax impairment charge of \$19.0 million. Of the total impairment charge, \$13.1 million related to newly closed locations, \$4.4 million related to stores that have not been closed, \$0.9 million related to stores previously closed and \$0.6 million related to unimproved properties that will be sold.

No further impairments were recognized in the first, second or third quarters of fiscal year 2010. However, in the first quarter of fiscal year 2010, the Company sold two recently closed properties and recognized a gain of \$1.2 million. One property was sold in the second quarter of fiscal year 2010 resulting in a recognized a gain of \$0.4 million. No discontinued locations were sold in the third quarter of fiscal year 2010.

During the third quarter of fiscal year 2010, the Company entered into a lease agreement with an independent third-party tenant for one of our closed locations. No gain or loss was recorded as part of the transaction; however, the property will no longer be included in discontinued operations.

As of May 5, 2010, the Company had 26 properties classified as discontinued operations assets.

The 26 properties include:

17 owned properties that each include land and restaurant building

2 owned undeveloped properties (land)

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3 ground leased properties that each include a restaurant building

2 undeveloped ground leased properties (land leases)

2 in-line leased properties (leased shopping center space)

As of May 5, 2010, the asset carrying value of the owned properties is \$22.6 million and is included in assets related to discontinued operations. The asset carrying values of the ground leases and in-line leases have previously been impaired to zero.

The Company is actively marketing these properties for lease or sale; and the Company's results of discontinued operations will be affected by the disposal of properties related to discontinued operations to the extent proceeds from the sales exceed or are less than net book value.

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The following table sets forth the sales and pretax losses reported for all discontinued locations:

| | Three Quarters Ended | |
|---|--|------------------------------|
| | May 5, 2010 (36 weeks) | May 6, 2009 (36 weeks) |
| | <i>(In thousands, except discontinued locations)</i> | |
| Sales | \$ 3,520 | \$ 25,815 |
| Pretax losses | (2,873) | (3,777) |
| Income tax benefit on discontinued operations | 1,004 | 1,293 |
| Net loss on discontinued operations | (1,869) | (2,484) |
| Discontinued locations closed during the period | 22 | |

During the three quarters ended May 5, 2010, the Company expensed \$0.7 million for lease exit costs and future rental costs related to closed locations. The Company incurred \$0.7 million and zero in employee settlement costs in the three quarters ended May 5, 2010 and May 6, 2009, respectively.

The following table summarizes discontinued operations for the periods presented:

| | Three Quarters Ended | |
|---|--|------------------------------|
| | May 5, 2010 (36 weeks) | May 6, 2009 (36 weeks) |
| | <i>(In thousands, except per share data)</i> | |
| Impairments | \$ | \$ |
| Gains (losses) | 1,568 | (187) |
| Net (impairments) gains | 1,568 | (187) |
| Other | (3,437) | (2,297) |
| Discontinued operations | \$ (1,869) | \$ (2,484) |
| Effect on EPS from discontinued operations decrease basic | \$ (0.07) | \$ (0.09) |

Within discontinued operations, the Company offsets gains from applicable property disposals against total impairments. The amounts in the table described as Other include employment termination and shut-down costs, as well as operating losses through each restaurant's closing date and carrying costs until the locations are finally disposed.

The impairment charges included above relate to properties closed and designated for immediate disposal. The assets of these individual operating units have been written down to their net realizable values. In turn, the related properties have either been sold or are being actively marketed for sale. All dispositions are expected to be completed within one to three years. Within discontinued operations, the Company also recorded the related fiscal year-to-date net operating results, employee terminations and basic carrying costs of the closed units.

Property Held for Sale

The Company periodically reviews long-lived assets against its plans to retain or ultimately dispose of properties. If the Company decides to dispose of a property, it will be moved to property held for sale and actively marketed. Property held for sale is recorded at amounts not in excess of what management currently expects to receive upon sale, less costs of disposal. The Company analyzes market conditions each reporting period and records additional impairments due to declines in market values of like assets. The fair value of the property is determined by observable inputs such as appraisals and prices of comparable properties in active markets for assets like the Company's. Gains are not recorded or realized until the properties are disposed.

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Property held for sale includes unimproved land, closed restaurant properties and related equipment for locations not classified as discontinued operations. The specific assets are valued at the lower of net depreciable value or net realizable value.

At August 26, 2009, the Company had a total of four owned properties and two ground leases recorded at approximately \$3.9 million in property held for sale.

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As of May 5, 2010, the Company had three owned properties and one ground lease held for sale with a carrying value of approximately \$2.1 million. During the second quarter of fiscal year 2010, the Company was able to negotiate a settlement for one of the ground leases. During the third quarter of fiscal year 2010, the Company sold one owned location for a gross sales price of \$2.0 million and a gain of approximately \$250,000 was recognized.

The Company is actively marketing the locations currently classified as property held for sale.

The Company's results of continuing operations will be affected by the disposal of properties held for sale to the extent proceeds from the sales exceed or are less than net book value.

Note 8. Commitments and Contingencies

Off-Balance Sheet Arrangements

The Company has no off-balance sheet arrangements.

Pending Claims

Certain current and former hourly restaurant employees filed a lawsuit against the Company in the U.S. District Court for the Southern District of Texas alleging violations of the Fair Labor Standards Act with respect to the inclusion of certain employees in a tip pool. The lawsuit seeks penalties and attorney's fees and was conditionally certified as a collective action in October 2008. The Company intends to vigorously defend its position. It is not possible at this time to reasonably estimate the possible loss or range of loss, if any.

From time to time, the Company is subject to various other private lawsuits, administrative proceedings and claims that arise in the ordinary course of its business. A number of these lawsuits, proceedings and claims may exist at any given time. These matters typically involve claims from guests, employees and others related to issues common to the restaurant industry. The Company currently believes that the final disposition of these types of lawsuits, proceedings and claims will not have a material adverse effect on its financial position, results of operations or liquidity. It is possible; however, that the Company's future results of operations for a particular quarter or fiscal year could be impacted by changes in circumstances relating to lawsuits, proceedings or claims.

Construction Activity

From time to time, the Company enters into non-cancelable contracts for the construction of its new restaurants. This construction activity exposes the Company to the risks inherent in new construction including but not limited to rising material prices, labor shortages, delays in getting required permits and inspections, adverse weather conditions, and injuries sustained by workers. The Company had no non-cancelable contracts as of May 5, 2010.

Note 9. Related Parties

Affiliate Services

The Company's Chief Executive Officer, Christopher J. Pappas, and Chief Operating Officer, Harris J. Pappas, own two restaurant entities (the Pappas entities) that may provide services to the Company and its subsidiaries, as detailed in the Master Sales Agreement dated December 9, 2005 among the Company and the Pappas entities.

Under the terms of the Master Sales Agreement, the Pappas entities may provide specialized (customized) equipment fabrication and basic equipment maintenance, including stainless steel stoves, shelving, rolling carts, and chef tables. The total costs under the Master Sales Agreement of custom-fabricated and refurbished equipment in the three quarters ended May 5, 2010 and May 6, 2009 were \$33,000 and \$312,000, respectively. Services provided under this agreement are subject to review and approval by the Finance and Audit Committee.

Operating Leases

The Company previously leased from the Pappas entities property that was used to accommodate the Company's in-house repair and fabrication center, which was referred to as the Houston Service Center. The Company terminated this lease in August 2008. The Company paid zero dollars pursuant to the terms of this lease in the three quarters ended May 5, 2010 and May 6, 2009. The Company leases from an unrelated third

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party a new property that combines both the offices of the Company's Facility Services and Warehouse Operations. The property is approximately 60,000 square feet.

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The Company also previously leased from the Pappas entities approximately 27,000 square feet of warehouse space to complement the Houston Service Center at a monthly rate of approximately \$0.21 per square foot. No payments were due pursuant to the terms of this lease in the three quarters ended May 5, 2010 and May 6, 2009. On February 29, 2008, the Company terminated this lease.

In the third quarter of fiscal year 2004, Messrs. Pappas became partners in a limited partnership which purchased a retail strip center in Houston, Texas. Messrs. Pappas collectively own a 50% limited partnership interest and a 50% general partnership interest in the limited partnership. A third party company manages the center. One of the Company's restaurants rented space in that center since July 1969 through July 2008.

On November 22, 2006, the Company executed a new lease agreement in connection with the replacement of the existing restaurant with a new prototype restaurant in the retail strip center described above. The new restaurant opened in July 2008 and the new lease agreement provides for a primary term of approximately twelve years with two subsequent five-year options. The new lease also gives the landlord an option to buy out the agreement on or after the calendar year 2015 by paying the unamortized cost of the Company's improvements. The Company is currently obligated to pay rent of \$20.00 per square foot (\$22.00 per square foot beginning January 2014) plus maintenance, taxes, and insurance during the primary term of the lease. Thereafter, the lease provides for reasonable increases in rent at set intervals. The Company made payments of \$228,000 and \$224,000 in the three quarters ended May 5, 2010 and May 6, 2009, respectively. The new lease agreement was approved by the Finance and Audit Committee and full Board of Directors.

Affiliated rents paid for a Houston restaurant property lease represented 6.1% and 6.8% of total rents for continuing operations for the three quarters ended May 5, 2010 and May 6, 2009, respectively.

| | Three Quarters Ended | |
|---|------------------------------|------------------------------|
| | May 5, 2010 (36 weeks) | May 6, 2009 (36 weeks) |
| (In thousands, except percentages) | | |
| AFFILIATED COSTS INCURRED: | | |
| General and administrative expenses professional and other costs | \$ 50 | \$ 101 |
| Capital expenditures custom-fabricated and refurbished equipment and furnishings | 33 | 312 |
| Other operating expenses and opening costs, including property leases | 240 | 141 |
| Total | \$ 323 | \$ 554 |
| RELATIVE TOTAL COMPANY COSTS: | | |
| General and administrative expenses | \$ 15,648 | \$ 17,702 |
| Capital expenditures | 2,266 | 10,335 |
| Other operating expenses and opening costs | 33,391 | 38,096 |
| Total | \$ 51,305 | \$ 66,133 |
| AFFILIATED COSTS INCURRED AS A PERCENTAGE OF RELATIVE TOTAL COMPANY COSTS | | |
| | 0.63% | 0.84% |

Board of Directors

Pursuant to the terms of a separate Purchase Agreement dated March 9, 2001, entered into by and among the Company, Christopher J. Pappas and Harris J. Pappas, the Company agreed to submit three persons designated by Christopher J. Pappas and Harris J. Pappas as nominees for election at the 2002 Annual Meeting of Shareholders. Messrs. Pappas designated themselves and Frank Markantonis as their nominees for directors, all of whom were subsequently elected. Christopher J. Pappas and Harris J. Pappas are brothers. Frank Markantonis is an attorney whose principal client is Pappas Restaurants, Inc., an entity owned by Harris J. Pappas and Christopher J. Pappas.

As amended in June 2004, the Purchase Agreement allows Messrs. Pappas to continue to nominate persons for election to the board, which, if such nominees are elected, would result in Messrs. Pappas having nominated three of the then-serving directors of the Company. Messrs. Pappas retain their right for so long as they both are executive officers of the Company.

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Christopher J. Pappas is a member of the advisory board of Amegy Bank, National Association, which is a lender and syndication agent under the Company's 2009 revolving credit facility, as amended ("New Credit Facility").

Table of Contents**Key Management Personnel**

In November 2005, Christopher and Harris Pappas entered into new employment agreements that were subsequently amended in April 2010 to extend the expiration date thereof to August 2011. In November 2009, Messrs. Pappas' fixed annual base salaries were reduced to their current level. Both continue to devote their primary time and business efforts to the Company while maintaining their roles at Pappas Restaurants, Inc.

On February 1, 2010, the Board of Directors of the Company approved the renewal of a consultant agreement with Ernest Pekmezaris, the Company's former Chief Financial Officer. Under the agreement, Mr. Pekmezaris will continue to furnish to the Company advisory and consulting services related to finance and accounting matters and other related consulting services. The agreement expiring on January 31, 2011 was renewed for twelve months at a lower monthly rate. Mr. Pekmezaris is also the Treasurer of Pappas Restaurants, Inc. Compensation for the services provided by Mr. Pekmezaris to Pappas Restaurants, Inc. is paid entirely by that entity.

Peter Tropoli, Senior Vice President, Administration, General Counsel and Secretary of the Company, is an attorney who, in the past, has provided litigation services to entities controlled by Christopher J. Pappas and Harris J. Pappas. Mr. Tropoli is the stepson of Frank Markantonis, who is a director of the Company.

Paulette Gerukos, Vice President of Human Resources of the Company, is the sister-in-law of Harris J. Pappas, the Chief Operating Officer.

Note 10. Share-Based Compensation**Stock Options**

The Company has an Incentive Stock Plan for officers and employees (Employee Stock Plans) and a Non-employee Director Stock Option Plan for non-employee directors. These plans authorize the granting of stock options, restricted stock and other types of awards consistent with the purpose of the plans. Approximately 2.8 million shares were authorized for issuance under the Company's plans as of May 5, 2010, of which approximately 1.0 million shares were available for future issuance. Stock options granted under the Incentive Stock Plan and the Non-employee Director Stock Option Plan have an exercise price equal to the market price of the Company's common stock at the date of grant. Option awards under the Employee Stock Plans generally vest 25% each year on the anniversary of the grant date and expire six to ten years from the grant date. Option awards under the Non-employee Director Stock Option Plan generally vest 100% on the first anniversary of the grant date and expire ten years from the grant date.

A summary of the Company's stock option activity for the three quarters ended May 5, 2010 is presented below:

| | Shares Under Fixed Options | Weighted-Average Exercise Price | Weighted-Average Remaining Contractual Term (Years) | Aggregate Intrinsic Value (In thousands) |
|--------------------------------|-------------------------------|------------------------------------|--|--|
| Outstanding at August 26, 2009 | 1,025,451 | \$ 8.77 | 4.58 | \$ 43 |
| Granted | 306,750 | 3.44 | | |
| Exercised | | | | |
| Forfeited or Expired | 4,000 | 10.81 | | |
| Outstanding at May 5, 2010 | 1,328,201 | 7.54 | 4.75 | 194 |
| Exercisable at May 5, 2010 | 636,071 | \$ 9.92 | 2.87 | \$ 32 |

Restricted Stock

Restricted stock grants consist of the Company's common stock and generally vest after three years, with the exception of grants under the Nonemployee Director Stock Option Plan, which vest when granted because they are granted in lieu of a cash payment. All restricted stock grants are cliff-vested. Restricted stock awards are valued at the average market price of the Company's common stock at the date of grant.

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A summary of the Company's restricted stock activity during the three quarters ended May 5, 2010 is presented in the following table:

| | Restricted Stock Units | Weighted-Average Fair Value (Per share) | Weighted-Average Remaining Contractual Term (Years) |
|-----------------------------|---------------------------|---|--|
| Unvested at August 26, 2009 | 80,155 | \$ 9.62 | 1.06 |
| Granted | 16,000 | 3.46 | |
| Vested | 26,889 | 7.67 | |
| Forfeited | 10 | 9.62 | |
| Unvested at May 5, 2010 | 69,256 | \$ 8.31 | 1.06 |

Note 11. Earnings Per Share

Basic net income per share is computed by dividing net income available to common shareholders by the weighted average number of common shares outstanding and unvested restricted stock for the reporting period. Diluted net income per share reflects the potential dilution that could occur if securities or other contracts to issue common stock were exercised or converted into common stock. For the calculation of diluted net income per share, the basic weighted average number of shares is increased by the dilutive effect of stock options determined using the treasury stock method. Stock options with exercise prices exceeding current market prices that were excluded from the computation of net income per share amounted to approximately 1,008,000 shares and 868,000 shares for the three quarters ended May 5, 2010 and May 6, 2009, respectively.

The components of basic and diluted net income per share are as follows:

| | Quarter Ended | | Three Quarters Ended | |
|---|------------------------------|------------------------------|------------------------------|------------------------------|
| | May 5, 2010 (12 weeks) | May 6, 2009 (12 weeks) | May 5, 2010 (36 weeks) | May 6, 2009 (36 weeks) |
| (In thousands except share data) | | | | |
| Numerator: | | | | |
| Income (loss) from continuing operations | \$ 1,276 | \$ (358) | \$ (1,540) | \$ (615) |
| Loss from discontinued operations | (546) | (695) | (1,869) | (2,484) |
| Net income (loss) | \$ 730 | \$ (1,053) | \$ (3,409) | \$ (3,099) |
| Denominator: | | | | |
| Denominator for basic earnings per share weighted-average shares | 28,145 | 28,061 | 28,125 | 28,078 |
| Effect of potentially dilutive securities: | | | | |
| Employee and non-employee stock options | 6 | | | |
| Denominator for earnings per share assuming dilution | 28,151 | 28,061 | 28,125 | 28,078 |
| Income (loss) per share from continuing operations: | | | | |
| Basic | \$ 0.05 | \$ (0.01) | \$ (0.05) | \$ (0.02) |
| Assuming dilution | \$ 0.05 | \$ (0.01) | \$ (0.05) | \$ (0.02) |
| Loss per share from discontinued operations: | | | | |
| Basic | \$ (0.02) | \$ (0.03) | \$ (0.07) | \$ (0.09) |
| Assuming dilution | \$ (0.02) | \$ (0.03) | \$ (0.07) | \$ (0.09) |
| Net income (loss) per share: | | | | |
| Basic | \$ 0.03 | \$ (0.04) | \$ (0.12) | \$ (0.11) |

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| | | | | |
|-------------------|---------|-----------|-----------|-----------|
| Assuming dilution | \$ 0.03 | \$ (0.04) | \$ (0.12) | \$ (0.11) |
|-------------------|---------|-----------|-----------|-----------|

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Note 12. New Adopted Accounting Pronouncements

Recent Accounting Pronouncements

The FASB issued Accounting Standards Update (ASU) 2009-05, 2009-12 and 2010-06 amending certain disclosure requirements regarding fair value measurements. The new guidance requires more robust disclosures about the different classes of assets and liabilities measured at fair value, the valuation techniques and inputs used, the activity in Level 3 fair value measurements, and the transfers between Levels 1, 2, and 3. The expanded disclosures of Level 1 and 2 are required for reporting periods beginning after December 15, 2009. The expanded disclosures for Level 3 activity are required for reporting periods beginning after December 15, 2010. These updates did not or will not materially impact the Company's consolidated financial statements.

On August 27, 2009, the Company adopted the FASB Accounting Standards Codification (ASC) Topic 105, The FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles a replacement of FASB Statement No. 162 (ASC 105). ASC 105 provides for the FASB Accounting Standards Codification (the Codification) to become the single source of authoritative, nongovernmental U.S. GAAP. The Codification did not change or alter GAAP but reorganizes the literature and changes the referencing of financial standards. The Codification is effective for interim and annual periods ending after September 15, 2009.

On August 27, 2009, the Company adopted ASC subtopic 260-10, *Determining Whether Instruments Granted in Share-Based Payment Transactions Are Participating Securities*, which provides that unvested share-based payment awards that contain nonforfeitable rights to dividends that are paid or unpaid are participating securities and shall be included in the computation of earnings per share based on the two-class method. The two-class method is an earnings allocation method for computing earnings per share when an entity's capital structure includes either two or more classes of common stock or common stock and participating securities. The Company applied the provision of this accounting guidance for all periods presented. The adoption did not have a material impact on the Company's financial statements.

Note 13. Subsequent Event

In June 2010, the Company received \$7.1 million, including interest, from the sale of auction rate securities held as investments. See Note 4. The company will recognize a \$1.8 million, pre-tax gain on the sale of these securities in the fourth quarter of fiscal year 2010. The Company is pursuing reimbursement from its broker for a \$0.2 million loss, recognized as the result of a previous sale of auction rate securities below par.

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

Management's discussion and analysis of financial condition and results of operations should be read in conjunction with the consolidated financial statements and footnotes for the period ended May 5, 2010 included in Item 1 of Part I of this Quarterly Report on Form 10-Q, and the audited financial statements included in our Annual Report on Form 10-K for the fiscal year ended August 26, 2009.

The following presents an analysis of the results and financial condition of our continuing operations. Except where indicated otherwise, the results of discontinued operations are excluded from this discussion.

Overview

As of May 5, 2010, we operated 96 restaurants, of which 95 are traditional cafeterias and one of which primarily serves seafood. These establishments are located in close proximity to retail centers, business developments and residential areas in four states. Of the 96 restaurants, 68 are located on property that we own and 28 are on leased premises.

Also as of May 5, 2010 we operated 17 culinary contract service facilities. These facilities are located within healthcare and education settings in Texas and Louisiana. These facilities provide food service options to varied populations including in-hospital-room patient meal service, retail food-court style restaurant dining, and coffee/snack kiosks.

Accounting Periods

Our fiscal year ends on the last Wednesday in August. As such, each fiscal year normally consists of 13 four-week periods, or accounting periods, accounting for 364 days in the aggregate. Each of the first three quarters of each fiscal year consists of three four-week periods, while the fourth quarter normally consists of four four-week periods. Comparability between quarters may be affected by varying lengths of the

quarters, as well as the seasonality associated with the restaurant business.

Table of Contents***Same-Store Sales***

The restaurant business is highly competitive with respect to food quality, concept, location, price, and service, all of which may have an effect on same-store sales. Our same-store sales calculation measures the relative performance of a certain group of restaurants. To qualify for inclusion in this group, a store must have been in operation for 18 consecutive accounting periods. Stores that close on a permanent basis are removed from the group in the fiscal quarter when operations cease at the restaurant, but remain in the same-store group for previously reported fiscal quarters. Although management believes this approach leads to more effective year-over-year comparisons, neither the time frame nor the exact practice may be similar to those used by other restaurant companies.

RESULTS OF OPERATIONS***For the Third Quarter and Year-to-Date Fiscal Year 2010 versus the Third Quarter and Year-to-Date Fiscal Year 2009******Sales***

Total sales decreased approximately \$3.2 million, or 5.3%, in the quarter ended May 5, 2010 compared to the quarter ended May 6, 2009, consisting of a \$3.5 million decrease in restaurant sales offset by a \$0.3 million increase in culinary contract services. The \$3.5 million decline in restaurant sales included \$0.8 million in sales from two units that were in operation during the quarter ended May 6, 2009, but closed subsequent to that date and not reclassified to discontinued operations. We neither closed nor opened any restaurants during the quarter ended May 5, 2010. During the quarter ended May 6, 2009, we opened one location which was subsequently closed. The prior year results of restaurants closed as part of the Cash Flow Improvement and Capital Redeployment Plan (the Plan) have been reclassified to discontinued operations. Year-over-year same store sales declined 4.8% in the third quarter ended May 5, 2010 compared to a year-over-year decline of 8.9% in the third quarter ended May 6, 2009.

Total sales decreased approximately \$19.9 million, or 10.9% in the three quarters ended May 5, 2010, compared to the three quarters ended May 6, 2009, consisting of a \$20.4 million decrease in restaurant sales offset by a \$0.5 million increase in culinary contract services revenue. The \$20.4 million decline in restaurant sales included \$2.8 million in sales from five units that were in operation during a portion of the three quarters ended May 6, 2009, but closed subsequent to that date and reclassified to discontinued operations. The prior year results of restaurants closed as part of the Plan have been reclassified to discontinued operations. Year-over-year same store sales declined 10.2% in the three quarters ended May 5, 2010 compared to a year-over-year decline of 6.3% in the three quarters ended May 6, 2009.

Cost of Food

Food costs decreased approximately \$0.7 million, or 4.4%, in the quarter ended May 5, 2010 compared to the quarter ended May 6, 2009 due to lower sales volumes. As a percentage of restaurant sales, food costs increased 0.5%, to 27.4% in the quarter ended May 5, 2010 compared to 26.9% in the quarter ended May 6, 2009, primarily due to lower menu prices and limited time offers.

Food costs decreased approximately \$5.7 million, or 11.9%, in the three quarters ended May 5, 2010 compared to the three quarters ended May 6, 2009, due to lower sales volumes. As a percentage of restaurant sales, food costs were 27.2% in the three quarters ended May 5, 2010 compared to 27.3% for the three quarters ended May 6, 2009, primarily due to operational improvements in food production, lower commodity costs and menu management partially offset by lower menu prices and limited time offers in the three quarters ended May 5, 2010.

Payroll and Related Costs

Payroll and related costs decreased approximately \$1.5 million in the quarter ended May 5, 2010 compared to the quarter ended May 6, 2009. Payroll and related expenses decreased primarily due to increased efficiencies in crew scheduling, lower crew overtime hours, and lower management costs partially offset by higher average wages paid to our crew employees. As a percentage of restaurant sales, these costs decreased 0.5%, to 35.1%, in the quarter ended May 5, 2010 compared to 35.6% in the quarter ended May 6, 2009. The change in workers compensation expense, as a percentage of restaurant sales, increased payroll and related costs by approximately 0.2% in the quarter ended May 6, 2009.

Payroll and related costs decreased approximately \$6.2 million in the three quarters ended May 5, 2010 compared to the three quarters ended May 6, 2009 due primarily to lower crew overtime hours and lower management costs, offset by higher average wages paid to our crew employees. As a percentage of restaurant sales, payroll and related costs increased 0.7%, to 36.2%, in the three quarters ended May 5, 2010 compared to 35.5% in the three quarters ended May 6, 2009, primarily due to reduced restaurant sales offset by lower use of crew overtime and lower management costs.

Table of Contents***Other Operating Expenses***

Other operating expenses primarily include restaurant-related expenses for utilities, repairs and maintenance, advertising, insurance, services, supplies and occupancy costs. Other operating expenses decreased by approximately \$2.1 million, or 16.9%, in the quarter ended May 5, 2010 compared to the quarter ended May 6, 2009. Other operating expenses decreased primarily due to 1) an approximate \$0.7 million reduction in marketing and advertising expenses as efforts were focused on store specific limited time offers which generally did not require broad based marketing efforts; 2) an approximate \$0.5 million reduction in utility expenses; 3) an approximate \$0.3 million reduction in repairs and maintenance expense; 4) an approximate net \$0.1 million reduction in supplies, services, and other operating expenses; and 5) the receipt of insurance proceeds of approximately \$0.5 million related to a Hurricane Ike claim settlement for business interruption. As a percentage of restaurant sales, other operating expenses decreased 2.6%, to 19.4%, in the quarter ended May 5, 2010 compared to 22.0% in the quarter ended May 6, 2009.

Other operating expenses decreased by approximately \$4.8 million, or 12.5%, in the three quarters ended May 5, 2010 compared to the three quarters ended May 6, 2009. As a percentage of restaurant sales, these costs decreased 0.2%, to 21.6%, in the three quarters ended May 5, 2010 compared to 21.8% in the three quarters ended May 6, 2009. Other operating expenses decreased primarily due to 1) an approximate \$1.7 million reduction in utility expenses; 2) a \$1.0 million reduction due to the non-recurrence of Hurricane Ike-related expenses that were recorded in the three quarters ended May 6, 2009; 3) an approximate \$1.0 million reduction in supplies and services expenses; and 4) an approximate \$0.6 million reduction in repairs and maintenance, marketing and advertising, and occupancy costs. Other operating expenses for the three quarters ended May 5, 2010 were also reduced due to the receipt of insurance proceeds of approximately \$0.5 million related to a Hurricane Ike claim settlement for business interruption.

Opening Costs

Opening costs include labor, supplies, occupancy, and other costs necessary to support the restaurant through its opening period. Opening costs were approximately \$31,000 in the quarter ended May 5, 2010 compared to approximately \$32,000 in the quarter ended May 6, 2009. The quarter ended May 5, 2010 and the quarter ended May 6, 2009 included carrying costs of locations to be developed for future restaurant openings.

Opening costs were approximately \$183,000 in the three quarters ended May 5, 2010 compared to approximately \$127,000 in the three quarters ended May 6, 2009. Opening costs in the three quarters ended May 5, 2010 and the three quarters ended May 6, 2009 included the carrying costs of locations to be developed for future restaurant openings. The three quarters ended May 5, 2010 also included an impairment charge for assets that will not be fully incorporated into the final design of the unit.

Cost of Culinary Contract Services

Cost of culinary contract services increased by approximately \$0.1 million in the quarter ended May 5, 2010 compared to the quarter ended May 6, 2009. Cost of culinary contract services includes the food, labor, and other direct operating expenses associated with culinary contract services. During the quarter ended May 5, 2010, culinary services operated 16 facilities compared to 12 for the quarter ended May 6, 2009.

Cost of culinary contract services increased by approximately \$0.5 million in the three quarters ended May 5, 2010 compared to the three quarters ended May 6, 2009. Cost of culinary contract services includes the food, labor, and other direct operating expenses associated with culinary contract services.

Depreciation and Amortization

Depreciation and amortization expense decreased by approximately \$0.2 million, or 5.8%, in the quarter ended May 5, 2010 compared to the quarter ended May 6, 2009, due to a slightly lower depreciable asset base reflecting reduced capital spending, and certain assets reaching the end of their depreciable lives.

Depreciation and amortization expense decreased by approximately \$0.5 million, or 4.8%, in the three quarters ended May 5, 2010 compared to the three quarters ended May 6, 2009, due to a slightly lower depreciable asset base reflecting reduced capital spending, and certain assets reaching the end of their depreciable lives.

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General and Administrative Expenses

General and administrative expenses include corporate salaries and benefits-related costs, including restaurant area leaders, share-based compensation, professional fees, travel and recruiting expenses and other office expenses. General and administrative expenses decreased by approximately \$0.8 million, or 13.3%, in the quarter ended May 5, 2010 compared to the quarter ended May 6, 2009. The decrease was due to a \$0.7 million decrease in corporate salary and benefit expense as a result of reductions in corporate support headcount, partially offset by higher professional fees. As a percentage of total sales, general and administrative expenses increased to 9.0% in the quarter ended May 5, 2010 compared to 9.9% in the quarter ended May 6, 2009.

General and administrative expenses decreased by approximately \$2.1 million, or 11.6%, in the three quarters ended May 5, 2010 compared to the three quarters ended May 6, 2009. As a percentage of total sales, general and administrative expenses decreased to 9.6% in the three quarters ended May 5, 2010 compared to 9.7% in the three quarters ended May 6, 2009. The decrease was mainly due to reductions in salary and benefit expense as a result of reductions in corporate support headcount.

Net (Gain) Loss on Disposition of Property and Equipment

The net gain on disposition of property and equipment was approximately \$0.2 million in the quarter ended May 5, 2010. The net gain on disposition of property and equipment was primarily from the gain on the sale of one closed restaurant property offset by asset retirement activity in our restaurant units.

The net gain on disposition of property and equipment was approximately \$1.0 million in the three quarters ended May 5, 2010. The net gain included a gain on the sales of an easement right and the sale of one unit in excess of net book value offset by normal asset retirement activity in our restaurant units. The net gain on disposition of property and equipment was approximately \$0.7 million in the three quarters ended May 6, 2009. The net gain reflects the gain on the sale of one closed restaurant property and insurance proceeds of approximately \$0.6 million related to property damage associated with Hurricane Ike, which were received in March 2009 and recognized in the quarter ended May 6, 2009, offset by asset retirement activity in our restaurant units.

Interest Income

Interest income decreased by approximately \$15,000 in the quarter ended May 5, 2010 compared to the quarter ended May 6, 2009, primarily related to lower cash and cash equivalents.

Interest income decreased by approximately \$158,000 for the three quarters ended May 5, 2010 compared to the three quarters ended May 6, 2009, primarily related to lower cash and cash equivalents and lower interest rates.

Interest Expense

Interest expense in the quarter ended May 5, 2010 increased by approximately \$61,000 compared to the interest expense in the quarter ended May 6, 2009 due to the acceleration of the amortization of pre-paid financing costs associated with the amended credit facility.

Interest expense in the three quarters ended May 5, 2010 increased by approximately \$92,000 in the three quarters ended May 6, 2010 compared to the three quarters ended May 6, 2009 due to the acceleration of the amortization of pre-paid financing costs associated with the amended credit facility.

Gain on Sales and Redemptions (Impairment of Fair Market Value) of Investments

The provision for impairment of fair market value of investments of approximately zero and \$0.7 million for the quarters ended May 5, 2010 and May 6, 2009, respectively was due to the continued illiquidity of the auction rate securities markets.

The reduction in fair value of the investments was derived through valuation and is considered other-than-temporary. See Liquidity and Capital Resources Status of Investments and Liquidity below for additional information regarding these investments.

The net provision for impairment of fair market value of investments for the three quarters ended May 5, 2010 was approximately \$0.4 million. The net provision for impairment charges for the three quarters ended May 6, 2009 was approximately \$0.8 million.

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Other Income, Net

Other income, net consisted primarily of the following components: net rental property income and expenses relating to property for which we are the landlord; prepaid sales tax discounts earned through our participation in state tax prepayment programs; oil and gas royalty income; and de-recognition of gift certificate liability resulting from the expiration of state statutes of limitation on gift certificate amounts. Other income, net in the quarter ended May 5, 2010 decreased approximately \$59,000 compared to the quarter ended May 6, 2009. Other income, net in the three quarters ended May 5, 2010 decreased approximately \$137,000 compared to the three quarters ended May 6, 2009.

Taxes

The income tax provision for the quarter ended May 5, 2010 is approximately \$0.5 million compared to a tax benefit of approximately \$0.2 million for the quarter ended May 6, 2009.

The income tax benefit for the three quarters ended May 5, 2010 reflects an effective tax rate of 13.5% of the pre-tax loss from continuing operations offset by a valuation allowance. The income tax benefit decreased \$0.1 million for the three quarters ended May 5, 2010 compared to the three quarters ended May 6, 2009.

The income tax benefit recorded for the three quarters ended May 6, 2009 reflects an effective tax rate of 35.5% of the results of continuing operations. There was no valuation allowance at the end of the quarter ended May 6, 2009.

Discontinued Operations

The loss from discontinued operations was \$0.5 million in the quarter ended May 5, 2010 compared to a \$0.7 million loss in the quarter ended May 6, 2009. The loss from discontinued operations was \$1.9 million in the three quarters ended May 5, 2010 compared to a \$2.5 million loss in the three quarters ended May 6, 2009. The loss in the three quarters ended May 5, 2010 included a \$1.6 million gain related to the sale of closed properties.

LIQUIDITY AND CAPITAL RESOURCES

Cash and Cash Equivalents

General. Our primary sources of short-term and long-term liquidity are cash flows from operations and our revolving credit facility. Although the current macroeconomic conditions continue to adversely affect our cash flows from operations, we have made improvements in our controllable costs. We have reduced our discretionary capital expenditures but plan to continue the level of capital and repair and maintenance expenditures necessary to keep our restaurants attractive and operating efficiently.

Our cash requirements consist principally of:

capital expenditures for culinary contract services development and construction, restaurant renovations and upgrades and information technology; and

working capital primarily for our owned restaurants and culinary contract service agreements.

Through reduction in purchases of property and equipment and proceeds from the sale of assets, as of May 5, 2010 we had no loans outstanding under our New Credit Facility. Under the current terms of our New Credit Facility (as defined below in Debt 2009 Revolving Credit Facility), capital expenditures are limited to a maximum amount in fiscal 2010 and to an amount based on our EBITDA, as defined in the credit agreement governing our New Credit Facility, in subsequent years. The amount of borrowings are also limited based on our EBITDA. However, we do not expect these limits to have a material impact on our operations. Based upon our level of past and projected capital requirements, we expect that our current cash on hand, proceeds from the sale of assets and cash flows from operations, combined with other financing alternatives in place or available, will be sufficient to meet our capital expenditures and working capital requirements during the next twelve months.

As is common in the restaurant industry, we maintain relatively low levels of accounts receivable and inventories, and our vendors grant trade credit for purchases such as food and supplies. However, high levels of accounts receivable are typical for culinary contract services.

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Cash and cash equivalents increased to \$7.7 million at May 5, 2010 from \$0.9 million at the beginning of the fiscal year. This increase is primarily due to an increase in cash provided by proceeds from the sale of assets. We generally reinvest available cash flows from operations to develop new restaurants, enhance existing restaurants and to support culinary contract services.

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The following table summarizes our cash flows from operating, investing and financing activities:

| | Three Quarters Ended | |
|--|---------------------------------------|---------------------------------------|
| | May 5, 2010 (36 weeks) | May 6, 2009 (36 weeks) |
| | <i>(In thousands)</i> | |
| Total cash provided by (used in): | | |
| Operating activities | \$ 244 | \$ 3,395 |
| Investing activities | 6,950 | (7,566) |
| Financing activities | (378) | 2,000 |
| Increase (decrease) in cash and cash equivalents | \$ 6,816 | \$ (2,171) |

Operating Activities. In the three quarters ended May 5, 2010, operating cash flow decreased \$3.2 million compared to the three quarters ended May 6, 2009, primarily due to reduced sales generating lower operating income.

Investing Activities. Cash flows provided by investing activities were \$7.0 million in the three quarters ended May 5, 2010 compared to \$7.6 million in cash used in the three quarters ended May 6, 2009, primarily due to \$7.8 million in proceeds received on the sale of four restaurant properties and an easement on one restaurant property and \$1.4 million in proceeds from sale of long term investments offset by \$2.3 million in purchases of property and equipment. Our capital expenditure program includes, among other things, restaurant remodeling, information technology enhancements and Culinary Contract Service locations. We used \$1.5 million for purchases of property and equipment in the three quarters ended May 5, 2010 compared to \$8.8 million in the three quarters ended May 6, 2009. We expect to spend approximately \$3.0 million to \$4.0 million on capital expenditures in fiscal year 2010.

Financing Activities. Cash provided by (used in) financing activities decreased from a \$2.0 million source of cash to a \$0.4 million use of cash, compared to the three quarters ended May 6, 2009, due primarily to net borrowings under our Amended Facility (as described below under Debt First Amendment to 2007 Revolving Credit Facility) and our New Credit Facility that replaced the Amended Facility during the three quarters ended May 6, 2009. Net borrowings under our New Credit Facility during the three quarters ended May 5, 2010 was zero.

Status of Investments and Liquidity

At May 5, 2010, we held \$7.1 million, par value (\$5.7 million, fair value) in auction rate municipal bonds as investments. These securities are long-term bonds with underlying maturities in years 2022 through 2042 but have historically had short-term features intended for the investor's liquidity. Prior to the collapse of the auction rate securities market in February 2008, these bonds were purchased or sold through a Dutch-auction process in short-term intervals of 7, 28 or 35 days, whereby the interest rate on the security is reset. The prevailing market auction failures resulted in the an other-than-temporary impairment net loss of \$1.0 million in fiscal year 2009 and \$0.4 million in the three quarters ended May 5, 2010. Since our securities estimate of fair market value increased at the quarter ended May 5, 2010, we recorded a \$0.6 million unrealized gain. The unrealized gain was recorded in other comprehensive income on the balance sheet.

In October 2008, we had sought relief from the illiquid investments by filing for arbitration against our broker with FINRA Dispute Resolution, Inc. and submitting a statement of claim for the par value of the auction rate securities. The arbitration hearing took place in April 2010, and a final award was announced on May 21, 2010, in our favor whereby the broker was ordered to purchase the auction rate securities at par value. We continue seeking recovery from our broker, \$0.2 million related to a previous below par sale of auction rate securities. In June 2010, we received \$7.1 million, including interest, from the sale of the securities to the broker at par. We also are entitled to receive a 6% per annum fee on the par value of the securities from and including May 29, 2010 through and including the date the award is paid in full.

Status of Trade Accounts and Other Receivables, Net

We monitor our receivables aging and record provisions for uncollectability as appropriate. Credit terms of accounts receivable associated with our culinary contract service business vary from 30 to 60 days based on contract terms.

Working Capital

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We had a working capital deficit of \$4.0 million as of May 5, 2010, compared to a working capital deficit of \$21.1 million as of August 26, 2009. The reduction of the deficit is primarily due to the \$6.8 million increase in cash, the reclassification of a \$5.7 million net long-term investment in auction rate securities to short-term, a decrease in accounts payable of \$2.7 million, a decrease in accrued payroll of \$0.8 million, and a decrease in accrued property taxes payable of \$1.4 million. We expect to meet our working capital requirements through cash flows from operations, sales of properties and availability under our New Credit Facility.

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Capital Expenditures

Capital expenditures consist of purchases of real estate for future restaurant sites, new units construction, purchases of new and replacement restaurant furniture and equipment, and ongoing remodeling programs. Capital expenditures for the three quarters ended May 5, 2010 were approximately \$2.2 million, and related to maintaining our investment in existing operating units. We expect to be able to fund all capital expenditures in fiscal year 2010 using cash flows from operations and availability under our New Credit Facility (as defined below). We expect to spend approximately \$3.0 million to \$4.0 million on capital expenditures in fiscal year 2010.

DEBT

2009 Revolving Credit Facility

On November 9, 2009, we entered into a revolving credit facility (the *New Credit Facility*), which amends and restates the 2007 Revolving Credit Facility, as amended, and reflects the following changes to the Amended Facility (as defined below):

Reduced the aggregate amount of the lenders' commitments from \$30.0 million to \$20.0 million. The amounts available under the New Credit Facility may still be increased by up to \$10.0 million, subject to certain terms and conditions, for a maximum total facility size of \$30.0 million.

Changed the maturity date to June 30, 2011.

Required security interest in selected real estate and other Company assets.

Increased interest rate margins from a range of 1.75% to 2.50%, subject to an interest rate floor of 3.50%, to a range of 2.75% to 3.50%, subject to a 4.00% interest rate floor. The applicable spread continues to be dependent upon the ratio of our debt to EBITDA at the most recent determination date, as defined in the credit agreement, as amended.

Modified certain financial covenants for the fiscal year 2010, including the addition of minimum fiscal year 2010 quarterly EBITDA requirements, and reduced restaurant capital expenditures in fiscal year 2010, as defined.

We incurred approximately \$0.4 million in related fees and expenses to be incurred associated with the closing of the New Credit Facility. Management recognized \$54,000 in unamortized pre-paid financing fees outstanding in fiscal year 2010 as a result of the reduction in the facility size and maturity.

The New Credit Facility contains customary covenants and restrictions on our ability to engage in certain activities, asset sales, letters of credit, and acquisitions, and contains customary events of default. As of May 5, 2010, we were in compliance with all covenants.

The New Credit Facility was amended on January 31, 2010 to extend the time permitted for us to finalize a portion of our real estate related financing obligations and to clarify covenant language related to the sale or lease of our assets.

As of May 5, 2010, we had no outstanding loans and \$1.6 million committed under letters of credit, which were issued as security for the payment of insurance obligations.

At May 5, 2010, \$18.4 million was available under the New Credit Facility.

First Amendment to 2007 Revolving Credit Facility

On March 18, 2009, we entered into Amendment No. 1 to the 2007 Revolving Credit Facility (the *Amended Facility*), which amended the 2007 Revolving Credit Facility as follows:

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Reduced the aggregate amount of the lenders' commitments from \$50.0 million to \$30.0 million. The amounts available under the Amended Facility may still be increased by up to \$70.0 million, subject to certain terms and conditions, for a maximum total facility size of \$100 million.

Modified the restriction on capital expenditures in fiscal years 2009 through June 30, 2012. In the original 2007 Revolving Credit Facility, capital expenditures were limited to the extent of our annual four-quarter rolling EBITDA plus 75% of the unused availability for capital expenditures from the immediately preceding fiscal year. We revised the level of spending allowed for capital expenditures by creating a floor of \$20.0 million. The amount of agreed capital expenditures was the greater of (1) \$20.0 million in each fiscal year, or (2) the amount of 100% of the preceding fiscal year's EBITDA; plus, in either case, all of the unused availability for capital expenditures from the immediately preceding fiscal year.

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Modified the interest rate margins to a range of 1.75% to 2.50% per annum. The applicable spread under each option continues to be dependent upon the ratio of our debt to EBITDA at the most recent determination date.

Amended the quarterly commitment fee, which is dependent upon the ratio of our debt to EBITDA, to a range of 0.30% to 0.45% per annum. We will also continue to pay quarterly fees with respect to any letters of credit issued and outstanding. In addition, we were obligated to pay the lenders a one-time fee in connection with the closing of the Amended Facility.

In the original 2007 Revolving Credit Facility, we were permitted to invest in any auction rate securities rated Aaa by Moody's or AAA by S&P. Because the ratings of our auction rate securities have dropped below these thresholds, the Amended Facility limited these types of investments to a specific list of auction rate securities which we hold.

Modified certain financial covenants, including: (1) the Interest Coverage Ratio from not less than 2.50 to not less than 2.00, (2) the debt-to-EBITDA ratio from not greater than 3.00 to not greater than 2.75. The Amended Facility also amends the Interest Coverage Ratio calculation to include one-fifth of the principal balance of the loans in the denominator.

2007 Revolving Credit Facility

On July 13, 2007, we entered into a \$50.0 million unsecured Revolving Credit Facility (the "2007 Revolving Credit Facility") with Wells Fargo Bank, National Association, as Administrative Agent, and Amegy Bank, National Association, as Syndication Agent. The 2007 Revolving Credit Facility may, subject to certain terms and conditions, be increased once by an amount up to \$50.0 million for a maximum total facility size of \$100.0 million. The 2007 Revolving Credit Facility allowed for up to \$15.0 million of the available credit to be extended in the form of letters of credit. All amounts owed by us under the 2007 Revolving Credit Facility were guaranteed by our subsidiaries and must be repaid in full upon the maturity date on June 30, 2012. We amended the 2007 Revolving Credit Facility on March 18, 2009, as described above under First Amendment to 2007 Revolving Credit Facility.

At any time throughout the term of the facility, we had the option to elect one of two bases of interest rates. One interest rate option was the greater of (a) the Federal Funds Effective Rate plus 0.50%, or (b) prime, plus, in either case, an applicable spread that ranges from zero to 0.50% per annum. The other interest rate option was the London InterBank Offered Rate plus a spread that ranges from 0.75% to 2.00% per annum. The applicable spread under each option was dependent upon the ratio of our debt to EBITDA at the most recent determination date.

We paid a quarterly commitment fee based on the unused available balance of the 2007 Revolving Credit Facility, which was also dependent upon the ratio of our debt to EBITDA, ranging from 0.20% to 0.30% per annum. We also paid quarterly fees with respect to any letters of credit issued and outstanding. In addition, we paid the lenders a one-time fee in connection with the closing of the 2007 Revolving Credit Facility.

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

The Consolidated Financial Statements included in Item 1 of Part 1 of this report were prepared in conformity with U.S. generally accepted accounting principles. Preparation of the financial statements requires us to make judgments, estimates and assumptions that affect the amounts of assets and liabilities in the financial statements and revenues and expenses during the reporting periods. Due to the significant, subjective and complex judgments and estimates used when preparing our consolidated financial statements, management regularly reviews these assumptions and estimates with the Finance and Audit Committee of our Board of Directors. Management believes the following are critical accounting policies used in the preparation of these financial statements.

Income Taxes

We record the estimated future tax effects of temporary differences between the tax bases of assets and liabilities and amounts reported in the accompanying consolidated balance sheets, as well as operating loss and tax credit carry backs and carry forwards. We periodically review the recoverability of tax assets recorded on the balance sheet and provide valuation allowances as management deems necessary.

Management makes judgments regarding the interpretation of tax laws that might be challenged upon an audit and cause changes to previous estimates of tax liability. In addition, we operate within multiple taxing jurisdictions and are subject to audit in these jurisdictions as well as by the Internal Revenue Service. In management's opinion, adequate provisions for income taxes have been made for all years. We regularly assess the potential outcomes of examinations in determining the adequacy of our provision for income taxes and our income tax liabilities. We believe

that we have adequately provided for any reasonable and foreseeable outcome related to uncertain tax matters.

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Investments

Investments include available-for-sale securities, which are reported at fair value. Securities available for sale consist of auction rate securities. Declines in fair value of available for sale securities are analyzed to determine if the decline is temporary or other-than-temporary. Temporary unrealized gains and losses on available-for-sale securities are excluded from earnings and reported in shareholders' equity. Other than-temporary declines reduce earnings. Any increases in other-than-temporary declines in fair value will not be recognized until the securities are sold.

Impairment of Long-Lived Assets

We periodically evaluate long-lived assets held for use and held for sale whenever events or changes in circumstances indicate that the carrying amount of those assets may not be recoverable. We analyze historical cash flows of operating locations and compare results of poorer performing locations to more profitable locations. We also analyze lease terms, condition of the assets and related need for capital expenditures or repairs, as well as construction activity and the economic and market conditions in the surrounding area.

For assets held for use, we estimate future cash flows using assumptions based on possible outcomes of the areas analyzed. If the undiscounted future cash flows are less than the carrying value of the location's assets, we record an impairment based on an estimate of discounted cash flows. The estimates of future cash flows, based on reasonable and supportable assumptions and projections, require management's subjective judgments. Assumptions and estimates used include operating results, changes in working capital, discount rate, growth rate, anticipated net proceeds from disposition of the property and if applicable, lease terms. The span of time for which future cash flows are estimated is often lengthy, increasing the sensitivity to assumptions made. The time span is longer and could be 20 to 25 years for newer properties, but only 5 to 10 years for older properties. Depending on the assumptions and estimates used, the estimated future cash flows projected in the evaluation of long-lived assets can vary within a wide range of outcomes. We consider the likelihood of possible outcomes in determining the best estimate of future cash flows. The measurement for such an impairment loss is then based on the fair value of the asset as determined by discounted cash flows. We operate 96 restaurants and periodically experience unanticipated changes in our assumptions and estimates. Those changes could have a significant impact on discounted cash flow models with a corresponding significant impact on the measurement of an impairment. Gains are not recognized until the assets are disposed. We believe we have approximately \$5.5 million in net carrying value of assets held for use where an impairment charge is reasonably possible within the next 12 months.

Property Held for Sale

We periodically review long-lived assets against its plans to retain or ultimately dispose of properties. If we decide to dispose of a property, it will be moved to property held for sale and actively marketed. Property held for sale is recorded at amounts not in excess of what management currently expects to receive upon sale, less costs of disposal. We analyze market conditions each reporting period and records additional impairments due to declines in market values of like assets. The fair value of the property is determined by observable inputs such as appraisals and prices of comparable properties in active markets for assets like the ours. Gains are not recorded or realized until the properties are disposed.

Property held for sale includes unimproved land, closed restaurant properties and related equipment for locations not classified as discontinued operations. The specific assets are valued at the lower of net depreciable value or net realizable value.

We are actively marketing the locations currently classified as property held for sale.

Our results of continuing operations will be affected by the disposal of properties held for sale to the extent proceeds from the sales exceed or are less than net book value.

Insurance and Claims

We self-insure a significant portion of risks and associated liabilities under our employee injury, workers' compensation and general liability programs. We maintain insurance coverage with third party carriers to limit our per-occurrence claim exposure. We have recorded accrued liabilities for self-insurance based upon analysis of historical data and actuarial estimates, and we review these amounts on a quarterly basis to ensure that the liability is appropriate.

The significant assumptions made by the actuary to estimate self-insurance reserves, including incurred but not reported claims, are as follows: (1) historical patterns of loss development will continue in the future as they have in the past (Loss Development Method), (2) historical trend patterns and loss cost levels will continue in the future as they have in the past (Bornhuetter-Ferguson Method), and (3) historical claim counts and exposures are used to calculate historical frequency rates and average claim costs are analyzed to get a projected severity (Frequency and Severity Method). The results of these

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methods are blended by the actuary to provide the reserves estimates. The third party actuary utilizes methods and assumptions that are in accordance with generally accepted actuarial practices and we believe the conclusions reached are reasonable.

Actual workers' compensation, employee injury and general liability claims expense may differ from estimated loss provisions. The ultimate level of claims under the in-house safety program are not known, and declines in incidence of claims as well as claims costs experiences or reductions in reserve requirements under the program may not continue in future periods.

Share-Based Compensation

Share-based compensation is estimated for equity awards at fair value at the grant date. We determine the fair value of equity awards using the Black Scholes model which requires the use of certain assumptions. The assumptions include the risk-free interest rate based on the United States Treasury yield curve at the time of the grant, expected dividend yield, expected volatility, expected forfeitures and expected life of the award.

INFLATION

Our policy is to maintain stable menu prices without regard to seasonal variations in food costs. General increases in cost of food, wages, supplies, transportation and services may require us to increase our menu prices from time to time. To the extent prevailing market conditions allow, we intend to adjust menu prices to maintain profit margins.

FORWARD-LOOKING STATEMENTS

This Quarterly Report on Form 10-Q contains statements that are forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. All statements contained in this Form 10-Q, other than statements of historical facts, are forward-looking statements for purposes of these provisions, including any statements regarding:

future operating results;

future capital expenditures, including expected reductions in capital expenditures;

future debt, including liquidity and the sources and availability of funds related to debt;

projections regarding the financial performance of our new prototype restaurants;

plans for expansion of our business;

plans for expansion of our culinary contract services business;

scheduled openings of new units;

closing existing units;

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effectiveness of management's Cash Flow Improvement and Capital Redeployment Plan;

future sales of assets and the gains or losses that may be recognized as a result of any such sale;

plans relating to our short-term and long-term investments; and

continued compliance with the terms of our existing revolving credit facility.

In some cases, investors can identify these statements by forward-looking words such as anticipate, believe, could, estimate, expect, intend, outlook, may, should, will, and would or similar words. Forward-looking statements are based on certain assumptions and analyses made by management in light of their experience and perception of historical trends, current conditions, expected future developments and other factors we believe are relevant. Although management believes that their assumptions are reasonable based on information currently available, those assumptions are subject to significant risks and uncertainties, many of which are outside of our control. The following factors, as well as the factors set forth in Item 1A of our Annual Report on Form 10-K for the fiscal year ended August 26, 2009 and any other cautionary language in this Quarterly Report on Form 10-Q, provide examples of risks, uncertainties, and events that may cause our financial and operational results to differ materially from the expectations described in our forward-looking statements:

general business and economic conditions;

the impact of competition;

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our operating initiatives, changes in promotional, coupon and advertising strategies and the success of management's business plans;

fluctuations in the costs of commodities, including beef, poultry, seafood, dairy, cheese, oils and produce;

ability to successfully increase sales of existing restaurants to achieve profitability;

ability to raise menu prices, and customers acceptance of changes in menu items;

increases in utility costs, including the costs of natural gas and other energy supplies;

changes in the availability and cost of labor, including the ability to attract qualified managers and team members;

the effectiveness of our marketing activities;

the seasonality of the business;

collectability of accounts receivable;

changes in governmental regulations, including changes in minimum wages and health care benefit regulation;

the effects of inflation and changes in our customers' disposable income, spending trends and habits;

the ability to realize property values;

the availability and cost of credit;

weather conditions in the regions in which our restaurants operate;

costs relating to legal proceedings;

impact of adoption of new accounting standards;

effects of actual or threatened future terrorist attacks in the United States;

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unfavorable publicity relating to operations, including publicity concerning food quality, illness or other health concerns or labor relations; and

the continued service of key management personnel.

Each forward-looking statement speaks only as of the date of this Form 10-Q, and we undertake no obligation to publicly update or revise any forward-looking statements, whether as a result of new information, future events or otherwise. Investors should be aware that the occurrence of the events described above and elsewhere in this Form 10-Q could have material adverse effect on our business, results of operations, cash flows and financial condition.

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Item 3. Quantitative and Qualitative Disclosures About Market Risk

We are exposed to market risk from changes in interest rates affecting our variable-rate debt. During the quarter ended May 5, 2010, the total amount of debt subject to interest rate fluctuations outstanding under our New Credit Facility was zero. Assuming an average debt balance of \$5.0 million, a 1.0% increase in prevailing interest rates above our 4.0% interest rate floor per our New Credit Facility, effective November 9, 2009, would increase our annual interest expense by \$50,000.

Although we are not currently using interest rate swaps, we have previously used and may in the future use these instruments to manage cash flow risk on a portion of our variable-rate debt.

Many ingredients in the products sold in our restaurants are commodities, subject to unpredictable price fluctuations. We attempt to minimize price volatility by negotiating fixed price contracts for the supply of key ingredients and in some cases by passing increased commodity costs through to the customer by adjusting menu prices or menu offerings. Our ingredients are available from multiple suppliers so we are not dependent on a single vendor for our ingredients.

Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

Management, under the supervision and with the participation of our Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of our disclosure controls and procedures (as such term is defined in Rule 13a-15(e) under the Securities Exchange Act of 1934, as amended (the Exchange Act)), as of May 5, 2010. Based on that evaluation, our Chief Executive Officer and Chief Financial Officer have concluded that, as of May 5, 2010, our disclosure controls and procedures were effective in providing reasonable assurance that information required to be disclosed by us in the reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms.

Changes in Internal Control over Financial Reporting

There were no changes in our internal control over financial reporting during the quarter ended May 5, 2010 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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Part II - OTHER INFORMATION

Item 1. Legal Proceedings

There have been no material changes to our legal proceedings as disclosed in Legal Proceedings in Item 3 of Part I of our Annual Report on Form 10-K for the fiscal year ended August 26, 2009.

Item 6. Exhibits

- 10.1 Amendment No. 4 dated as of April 15, 2010 to Employment Agreement dated as of November 9, 2005 and as amended on October 29, 2007, November 19, 2008, and November 19, 2009 between Luby's, Inc. and Christopher J. Pappas (filed as Exhibit 10.1 to the Company's Current Report on Form 8-K dated April 15, 2010 and incorporated herein by reference).
- 10.2 Amendment No. 4 dated as of April 15, 2010 to Employment Agreement dated as of November 9, 2005 and as amended on October 29, 2007, November 19, 2008, and November 19, 2009 between Luby's, Inc. and Harris J. Pappas (filed as Exhibit 10.2 to the Company's Current Report on Form 8-K dated April 15, 2010 and incorporated herein by reference).
- 31.1 Rule 13a-14(a)/15d-14(a) certification of the Principal Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2 Rule 13a-14(a)/15d-14(a) certification of the Principal Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32.1 Section 1350 certification of the Principal Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 32.2 Section 1350 certification of the Principal Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

LUBYS, INC.

(Registrant)

Date: June 11, 2010

By: /s/ Christopher J. Pappas
Christopher J. Pappas
President and Chief Executive Officer

Date: June 11, 2010

By: /s/ K. Scott Gray
K. Scott Gray
Senior Vice President and Chief Financial Officer,

the Company's Principal Accounting Officer

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