

RARE HOSPITALITY INTERNATIONAL INC  
Form 10-Q  
May 12, 2006

**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 April 2, 2006

Commission file number 0-19924

RARE Hospitality International, Inc.

(Exact name of registrant as specified in its charter)

Georgia  
(State or other jurisdiction of  
incorporation or organization)

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

8215 Roswell Rd; Bldg. 600; Atlanta, GA  
(Address of principal executive offices)

30350  
(Zip Code)

(770) 399-9595

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(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 is a large accelerated filer, an accelerated filer, or a non-accelerated filer (as defined in Rule 12b-2 of the Exchange Act).

Large accelerated filer

Accelerated filer

Non-accelerated filer

Indicate by check mark if the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes  No

As of May 10, 2006, there were 33,897,361 shares of common stock of the Registrant outstanding.

**RARE Hospitality International, Inc. and Subsidiaries**

**Index**

Part I - Financial Information	<u>Page</u>
Item 1. Consolidated Financial Statements:	
Consolidated Balance Sheets as of April 2, 2006 and December 25, 2005	1
Consolidated Statements of Operations for the quarters ended April 2, 2006 and March 27, 2005	2
Consolidated Statement of Shareholders' Equity and Comprehensive Income for the quarter ended April 2, 2006	3
Condensed Consolidated Statements of Cash Flows for the quarters ended April 2, 2006 and March 27, 2005	4
Notes to the Consolidated Financial Statements	5
Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations	14
Item 3. Quantitative and Qualitative Disclosures About Market Risk	18
Item 4. Controls and Procedures	18

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## Part II - Other Information

Item 1. Legal Proceedings	19
Item 1A. Risk Factors	19
Item 2. Changes in Securities and Use of Proceeds	19
Item 3. Defaults Upon Senior Securities	19
Item 4. Submission of Matters to a Vote of Securities Holders	19
Item 5. Other Information	19
Item 6. Exhibits	19
Signatures	19

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**Part I - Financial Information****Item 1. Consolidated Financial Statements****RARE Hospitality International, Inc. and Subsidiaries****Consolidated Balance Sheets****(In thousands)****(Unaudited)**

<u>Assets</u>	2, <u>2005</u>	April 25, <u>2006</u>	December  (As Adjusted - Note 2)
Current assets:			
Cash and cash equivalents	\$ 14,702	\$ 12,168	
Short-term investments	295	6,203	
Accounts receivable	14,153	15,807	
Inventories	15,645	15,428	
Prepaid expenses	5,919	6,623	
Deferred income taxes	<u>6,641</u>	<u>9,425</u>	
Total current assets	57,355	65,654	
Property & equipment, less accumulated depreciation and amortization of \$209,482 in 2006 and \$199,707 in 2005	514,877	497,220	
Goodwill	19,187	19,187	
Deferred income taxes	3,301	--	
Other	<u>19,844</u>	<u>18,864</u>	
Total assets	\$ 614,564	\$ 600,925	
 <u>Liabilities and Shareholders' Equity</u>			
Current liabilities:			
Accounts payable	\$ 22,362	\$ 30,026	
Accrued expenses	58,436	71,062	
Income taxes payable	11,648	1,152	
Current installments of obligations under capital leases	<u>276</u>	<u>269</u>	
Total current liabilities	92,722	102,509	
Obligations under capital leases, net			

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of current installments	39,704	38,991
Deferred income taxes	--	3,483
Other	<u>31,713</u>	<u>30,455</u>
Total liabilities	<u>164,139</u>	<u>175,438</u>
Minority interest	<u>1,208</u>	<u>1,193</u>
Shareholders' equity:		
Preferred stock - no par value: authorized 10,000 shares;		
none issued	--	--
Common stock	236,086	229,955
Unearned compensation-restricted stock	--	(1,470)
Retained earnings	265,606	248,284
Treasury stock at cost; 1,952 shares in 2006 and 2005	<u>(52,475)</u>	<u>(52,475)</u>
Total shareholders' equity	<u>449,217</u>	<u>424,294</u>
Total liabilities and shareholders' equity	<u>\$ 614,564</u>	<u>\$ 600,925</u>

See accompanying notes to consolidated financial statements

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RARE Hospitality International, Inc. and Subsidiaries

Consolidated Statements of Operations

(In thousands, except per share data)

(Unaudited)

	<u>Quarter Ended</u>	
	14 Weeks Ended	13 Weeks Ended
	April 2,	March 27,
	<u>2006</u>	<u>2005</u>
		(As Adjusted - Note 2)
Revenues:		
Restaurant sales:		
LongHorn Steakhouse		\$ 208,006
The Capital Grille		51,642
Bugaboo Creek Steak House		30,255
Specialty concepts		<u>2,080</u>
		<u>1,652</u>
Total restaurant sales		291,983
Franchise revenues		<u>133</u>
		<u>97</u>
Total revenues		<u>292,116</u>
		<u>229,970</u>
Costs and expenses:		
Cost of restaurant sales		106,505
Operating expenses - restaurants		127,680
Depreciation and amortization - restaurants		10,193
Pre-opening expense - restaurants		2,716
General and administrative expenses		<u>18,375</u>
		<u>12,423</u>
Total costs and expenses		<u>265,469</u>
		<u>206,605</u>
Operating income		26,647
Interest expense, net		670
Minority interest		<u>95</u>
		<u>126</u>
Earnings before income taxes		25,882
Income tax expense		<u>8,560</u>
		<u>7,632</u>
Net earnings		\$ 17,322
		\$ 15,350
Weighted average common shares outstanding:		
Basic		33,482
		34,132
Diluted		34,486
		35,378
Basic earnings per common share		\$ 0.52
		\$ 0.45
Diluted earnings per common share		\$ 0.50
		\$ 0.43

See accompanying notes to consolidated financial statements



**RARE Hospitality International, Inc. and Subsidiaries**

**Consolidated Statement of Shareholders Equity and Comprehensive Income**

**For the quarter ended April 2, 2006**

**(In thousands, unaudited)**

	<u>Common Stock</u>		Restricted <u>Stock</u>	Retained <u>Earnings</u>	Treasury <u>Stock</u>	Comprehensive <u>Income</u>	Total Shareholders <u>Equity</u>
	<u>Shares</u>	<u>Amount</u>					
Balance, December 25, 2005 (as adjusted - see Note 2)	35,436	\$229,955	\$(1,470)	\$248,284	\$(52,475)	\$ --	\$424,294
Adoption of FAS 123R (see Note 3)	--	875	1,470	--	--	--	2,345
Net earnings and total comprehensive income	--	--	--	17,322	--	--	17,322
Stock based compensation expense	--	2,077	--	--	--	--	2,077
Issuance of shares pursuant to restricted stock award	189	--	--	--	--	--	--
Forfeiture of restricted stock	--	--	--	--	--	--	--
Tax benefit of stock options exercised and vesting of restricted stock	--	1,111	--	--	--	--	1,111
Issuance of shares pursuant to exercise of stock options	<u>166</u>	<u>2,068</u>	<u>--</u>	<u>--</u>	<u>--</u>	<u>--</u>	<u>2,068</u>
Balance, April 2, 2006	35,791	\$236,086	\$ --	\$265,606	\$(52,475)	\$ --	\$449,217

See accompanying notes to consolidated financial statements

**RARE Hospitality International, Inc. and Subsidiaries**

**Condensed Consolidated Statements of Cash Flows**

**(In thousands, unaudited)**

<u>Quarter Ended</u>	
14 Weeks Ended	13 Weeks Ended
April 2,	March 27,
<u>2006</u>	<u>2005</u>

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Cash flows from operating activities:		
Net earnings	\$17,322	\$ 15,350
Adjustments to reconcile net earnings to net cash provided by operating activities:		
Depreciation and amortization	10,762	8,728
Stock-based compensation	2,077	389
Changes in working capital accounts	355	(7,685)
Minority interest	95	126
Deferred tax benefit	(4,000)	(640)
Sale (purchase) of short-term investments	<u>5,908</u>	<u>(8,457)</u>
Net cash provided by operating activities	<u>32,519</u>	<u>7,811</u>
Cash flows from investing activities:		
Purchase of property and equipment	<u>(28,414)</u>	<u>(17,809)</u>
Net cash used by investing activities	<u>(28,414)</u>	<u>(17,809)</u>
Cash flows from financing activities:		
Proceeds from exercise of stock options	2,068	1,667
Distributions to minority partners	(80)	(81)
(Decrease) increase in bank overdraft included in accounts payable and accrued liabilities	(5,390)	2,040
Principal payments on capital leases	(65)	(44)
Tenant incentives received under capital leases	785	--
Tax benefit from share-based compensation	<u>1,111</u>	<u>--</u>
Net cash (used in) provided by financing activities	<u>(1,571)</u>	<u>3,582</u>
Net increase (decrease) in cash and cash equivalents	2,534	(6,416)
Cash and cash equivalents, beginning of period	<u>12,168</u>	<u>19,547</u>
Cash and cash equivalents, end of period	\$ 14,702	\$ 13,131
Supplemental disclosure of cash flow information		
Cash paid for income taxes	\$ 859	\$ 849
Cash paid for interest net of amounts capitalized	\$ 760	\$ 469
Supplemental disclosure of non-cash financing and investing activities:		
Assets acquired under capital lease	\$ --	\$ --

See accompanying notes to consolidated financial statements

**Notes to Consolidated Financial Statements**

**(Unaudited)**

**1. Basis of Presentation**

The consolidated financial statements of RARE Hospitality International, Inc. and subsidiaries (the Company) as of April 2, 2006 and December 25, 2005 and for the quarters ended April 2, 2006 and March 27, 2005 have been prepared by the Company, pursuant to the rules and regulations of the Securities and Exchange Commission. The information furnished herein reflects all adjustments (consisting of normal recurring accruals and adjustments), which are, in the opinion of management, necessary to fairly present the operating results for the respective periods. Certain information and footnote disclosures normally presented in annual financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted pursuant to such rules and regulations. These financial statements should be read in conjunction with the consolidated financial statements and notes thereto contained in the Company's Annual Report on Form 10-K for the year ended December 25, 2005.

The Company records revenues for normal recurring sales upon the performance of services. Revenues from the sale of franchises are recognized as income when substantially all of the Company's material obligations under the franchise agreement have been performed. Continuing royalties, which are a percentage of net sales of franchised restaurants, are accrued as income when earned.

The Company's fiscal year is a 52- or 53-week year ending on the last Sunday in each calendar year. Each of the four fiscal quarters is typically made up of 13 weeks; however, since fiscal 2006 will be a 53-week period, the fiscal quarter ended April 2, 2006 contains 14 operating weeks, compared to 13 operating weeks in the fiscal quarter ended March 27, 2005.

The Company has made certain reclassifications to the fiscal 2005 consolidated financial statements, as previously reported, to conform to current classification. Reclassifications due to the retrospective adoption of Financial Accounting Standards Board (FASB) Staff Position 13-1, Accounting for Rental Costs Incurred During a Construction Period resulted in a change in net income as previously reported (see Note 2). Reclassifications associated with the adoption of Statement of Financial Accounting Standard No. 123 (revised 2004), Share Based Payment, requires certain share-based awards previously reported as liabilities and contra-equity accounts to be classified as common stock (see Note 3).

**2. Change in Accounting for Construction Period Rent**

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

Prior to the issuance of FSP 13-1, the Company capitalized rental costs associated with ground or building operating leases during the construction period. Pursuant to FSP 13-1, rental costs associated with ground or building operating leases incurred during construction are to be recognized as an expense as part of pre-opening expense - restaurants.

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The Company did not amend its previously filed Annual Reports on Form 10-K or Quarterly Reports on Form 10-Q for the retrospective application of FSP 13-1. Therefore, the financial statements and related financial information contained in those reports do not reflect this retrospective application of FSP 13-1.

The following tables contain information regarding the impact of the retrospective application of FSP 13-1. All amounts, except per share amounts are in thousands (amounts may not add due to rounding):

**RARE HOSPITALITY INTERNATIONAL, INC.**

**Consolidated Balance Sheets**

	March 27, 2005			December 25, 2005		
	As Originally Reported	As Adjusted	Effect of Change	As Originally Reported	As Adjusted	Effect of Change
<b>ASSETS</b>						
Current assets:						
Cash and cash equivalents	\$ 13,131	\$ 13,131	\$ --	\$ 12,168	\$ 12,168	\$ --
Short-term investments	43,352	43,352	--	6,203	6,203	--
Accounts receivable	10,215	10,215	--	15,807	15,807	--
Inventories	12,921	12,921	--	15,428	15,428	--
Prepaid expenses	6,125	6,125	--	6,623	6,623	--
Deferred income taxes	<u>9,156</u>	<u>12,669</u>	<u>3,513</u>	<u>11,320</u>	<u>9,425</u>	<u>(1,895)</u>
Total current assets	94,900	98,413	3,513	67,549	65,654	(1,895)
Property and equipment, less accumulated depreciation and amortization	447,477	442,650	(4,827)	503,762	497,220	(6,542)
Goodwill	19,187	19,187	--	19,187	19,187	--
Deferred income taxes						
Other	<u>15,553</u>	<u>15,553</u>	<u>--</u>	<u>18,864</u>	<u>18,864</u>	<u>--</u>
Total assets	<u>\$ 577,117</u>	<u>\$ 575,803</u>	<u>\$ (1,314)</u>	<u>\$ 609,362</u>	<u>\$600,925</u>	<u>\$ (8,473)</u>
<b>LIABILITIES AND SHAREHOLDERS EQUITY</b>						
Current liabilities:						
Accounts payable	\$ 26,487	\$ 26,487	\$ --	\$ 30,026	\$ 30,026	\$ --
Accrued expenses	64,266	50,128	(14,138)	89,171	71,062	(18,109)
Income taxes payable	3,073	3,073	--	1,152	1,152	--
Current installments of obligations under capital leases	<u>228</u>	<u>228</u>	<u>--</u>	<u>269</u>	<u>269</u>	<u>--</u>
Total current liabilities	94,054	79,916	(14,138)	120,618	102,509	(18,109)
Deferred income taxes	14,208	14,208	--	9,131	3,483	(5,648)

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Debt, net of current installments						
Obligations under capital leases, net of current installments	37,071	37,071	--	38,991	38,991	
Other	<u>7,232</u>	<u>25,718</u>	<u>18,486</u>	<u>9,084</u>	<u>30,455</u>	<u>21,371</u>
Total liabilities	152,565	156,913	4,348	177,824	175,438	(2,368)
Minority interest	1,354	1,354	--	1,193	1,193	--
Shareholders equity:						
Preferred stock, no par value. Authorized 10,000 shares, none issued	--	--	--	--	--	--
Common stock, no par value	220,236	220,236	--	229,955	229,955	--
Unearned compensation - restricted stock	(1,578)	(1,578)	--	(1,470)	(1,470)	--
Retained earnings	217,717	212,055	(5,662)	254,335	248,284	(6,051)
Treasury shares at cost	<u>(13,177)</u>	<u>(13,177)</u>	<u>--</u>	<u>(52,475)</u>	<u>(52,475)</u>	<u>--</u>
Total shareholders equity	<u>423,198</u>	<u>417,536</u>	<u>(5,662)</u>	<u>430,345</u>	<u>424,294</u>	<u>(6,051)</u>
Total liabilities and shareholders equity	<u>\$ 577,117</u>	<u>\$ 575,803</u>	<u>\$ (1,314)</u>	<u>\$ 609,362</u>	<u>\$ 600,925</u>	<u>\$ (8,437)</u>

**RARE HOSPITALITY INTERNATIONAL, INC.**

**Consolidated Statements of Operations**

	13 Weeks Ended		
	As Originally	<u>March 27, 2005</u> As	Effect of
	<u>Reported</u>	<u>Adjusted</u>	<u>Change</u>
Total revenues	\$ 229,970	\$ 229,970	\$ --
Costs and expenses:			
Cost of restaurant sales	83,698	83,698	--
Operating expenses - restaurants	100,302	100,302	--
Depreciation and amortization - restaurants	8,371	8,281	(90)
Pre-opening expense - restaurants	1,627	1,901	274
General and administrative expenses	<u>12,423</u>	<u>12,423</u>	--
Total operating costs and expenses	<u>206,421</u>	<u>206,605</u>	<u>184</u>
Operating income	23,549	23,365	(184)
Interest expense, net	257	257	--
Minority interest	<u>126</u>	<u>126</u>	<u>--</u>
Earnings before income taxes	23,166	22,982	(184)
Income tax expense	<u>7,702</u>	<u>7,632</u>	<u>(70)</u>
Net earnings	<u>\$ 15,464</u>	<u>\$ 15,350</u>	<u>\$ (114)</u>

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Weighted average common shares outstanding			
Basic	34,132	34,132	34,132
<hr/>			
Diluted	35,378	35,378	35,378
<hr/>			
Earnings per common share			
Basic	\$ 0.45	\$ 0.45	\$ (0.00)
<hr/>			
Diluted	\$ 0.44	\$ 0.43	\$ (0.00)
<hr/>			

	Year Ended		
	<u>December 25, 2005</u>		
	As Originally	As	Effect of
	<u>Reported</u>	<u>Adjusted</u>	<u>Change</u>
Total revenues	\$ 936,576	\$ 936,576	\$ --
Costs and expenses:			
Cost of restaurant sales	343,188	343,188	--
Operating expenses - restaurants	415,732	415,732	--
Provision for asset impairment	3,269	3,269	--
Depreciation and amortization - restaurants	35,857	35,445	(412)
Pre-opening expense - restaurants	7,191	8,416	1,225
General and administrative expenses	<u>52,112</u>	<u>52,112</u>	<u>--</u>
Total operating costs and expenses	<u>857,349</u>	<u>858,161</u>	<u>812</u>
Operating income	79,227	78,415	(812)
Interest expense, net	1,920	1,920	--
Minority interest	<u>215</u>	<u>215</u>	<u>--</u>
Earnings before income taxes	77,092	76,280	(812)
Income tax expense	<u>25,010</u>	<u>24,701</u>	<u>(309)</u>
Net earnings	\$ 52,082	\$ 51,579	\$ (503)
<hr/>			

Weighted average common shares outstanding			
Basic	33,764	33,764	33,764
<hr/>			
Diluted	34,817	34,817	34,817
<hr/>			
Earnings per common share			
Basic	\$ 1.54	\$ 1.53	\$ (0.01)
<hr/>			
Diluted	\$ 1.50	\$ 1.48	\$ (0.01)
<hr/>			

Year Ended

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	<u>December 25, 2004</u>		
	As Originally	As	Effect of
	<u>Reported</u>	<u>Adjusted</u>	<u>Change</u>
Total revenues	\$ 812,563	\$ 812,563	\$ --
Costs and expenses:			
Cost of restaurant sales	299,448	299,448	--
Operating expenses - restaurants	354,679	354,679	--
Provision for asset impairment	2,700	2,700	
Depreciation and amortization - restaurants	30,793	30,436	(357)
Pre-opening expense - restaurants	6,865	8,093	1,228
General and administrative expenses	<u>45,244</u>	<u>45,244</u>	--
Total operating costs and expenses	<u>739,729</u>	<u>740,600</u>	<u>871</u>
Operating income	72,834	71,963	(871)
Interest expense, net	1,328	1,328	--
Minority interest	<u>300</u>	<u>300</u>	--
Earnings before income taxes	71,206	70,335	(871)
Income tax expense	<u>23,676</u>	<u>23,345</u>	<u>(331)</u>
Net earnings	\$ 47,530	\$ 46,990	\$ (540)
<hr/>			
Weighted average common shares outstanding			
Basic	33,811	33,811	33,811
Diluted	35,374	35,374	35,374
<hr/>			
Earnings per common share			
Basic	\$ 1.41	\$ 1.39	\$ (0.02)
Diluted	\$ 1.34	\$ 1.33	\$ (0.02)

	Year Ended		
	<u>December 28, 2003</u>		
	As Originally	As	Effect of
	<u>Reported</u>	<u>Adjusted</u>	<u>Change</u>
Total revenue	\$ 680,832	\$ 680,832	\$ --
Cost and expenses:			
Cost of restaurant sales	245,094	245,094	--
Operating expenses	298,978	298,978	--
Depreciation and amortization - restaurants	26,508	26,215	(293)
Pre-opening expenses	5,782	6,607	825
General and administrative expenses	<u>40,515</u>	<u>40,515</u>	--
Total operating costs and expense	<u>616,877</u>	<u>617,409</u>	<u>532</u>
Operating income	63,955	63,423	(532)
Interest expense, net	1,015	1,015	--
Minority interest	<u>300</u>	<u>300</u>	--
Earnings before income taxes	62,640	62,108	(532)
Income tax expense	<u>20,363</u>	<u>20,163</u>	<u>(200)</u>

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Net earnings	\$ 42,277	\$ 41,945	\$ (332)
<hr/>			
Weighted average common shares outstanding			
Basic	33,162	33,162	33,162
<hr/>			
Diluted	34,843	34,843	34,843
<hr/>			
Earnings per common share			
Basic	\$ 1.27	\$ 1.26	\$ (0.01)
<hr/>			
Diluted	\$ 1.21	\$ 1.20	\$ (0.01)
<hr/>			

**3. Change in Accounting for Share-Based Compensation**

The Company has various share-based compensation programs, which provide for equity awards, including stock options, restricted stock and performance based restricted stock units. These equity awards are granted under several plans and are described below under Stock Options and Restricted Stock Programs.

Prior to January 1, 1996, the Company accounted for its stock option plans under the intrinsic method in accordance with the provisions of Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees ( APB 25 ), and related interpretations. As such, compensation expense associated with stock options would be recorded on the date of grant only if the current market price of the underlying stock exceeded the exercise price. All options awarded under the Company's share-based compensation plans were granted with an exercise price equal to the fair market value on the date of grant and, accordingly, no compensation expense was recognized for stock option awards. On January 1, 1996, the Company adopted Statement of Financial Accounting Standards No. 123 ( SFAS 123 ), Accounting for Stock-Based Compensation, which permitted entities to recognize as expense over the vesting period the fair value of all stock-based awards on the date of grant. Alternatively, SFAS 123 also allowed entities to continue to apply the provisions of APB 25 and provide pro forma net earnings (loss) and pro forma earnings (loss) per share disclosures for employee stock option grants made in 1995 and future years as if the fair-value-based method defined in SFAS 123 had been applied. The Company elected to continue to apply the provisions of APB 25 and did not recognize any compensation expense from the issuance of employee stock options, but rather provided the pro forma disclosures required by SFAS 123. Under both APB 25 and SFAS 123, compensation expense associated with the issuance of restricted stock awards is recognized over the requisite vesting period.

In December 2004, the FASB issued Statement of Financial Accounting Standards No. 123 (revised 2004), Share-Based Payment, ( SFAS 123R ). SFAS 123R is a revision of SFAS 123, supersedes APB 25, and amends SFAS No. 95, Statement of Cash Flows ( SFAS 95 ). Among other items, SFAS 123R eliminates the use of the intrinsic value method of accounting, and requires companies to recognize the cost of share-based payments granted in exchange for employee services received, based on the grant date fair value of those share-based payments, in the financial statements. SFAS 123R was effective for the first interim period beginning after June 15, 2005; however, on April 14, 2005, the Securities and Exchange Commission announced that the effective date of SFAS 123R was postponed until the first annual period beginning after June 15, 2005.

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

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disclosures made in accordance with SFAS 123.

Historically, the Company utilized the Black-Scholes option-pricing model to measure the fair value of stock options granted to employees. While SFAS 123R permits entities to continue to use this model, the standard also permits the use of a lattice model. SFAS 123R also requires that the benefits associated with the tax deductions in excess of recognized compensation cost be reported as a financing cash flow, rather than as an operating cash flow as required under SFAS 95. This requirement will reduce net operating cash flows and increase net financing cash flows in periods after the effective date. These future amounts cannot be estimated because they depend on, among other things, when employees exercise stock options.

Effective December 26, 2005, the start of the first quarter of fiscal 2006, the Company began recording compensation expense associated with share-based awards and other forms of equity compensation in accordance with SFAS 123R. The Company adopted SFAS 123R using the modified prospective transition method, and consequently has not retroactively adjusted results from prior periods. Under this transition method, compensation cost associated with share-based awards recognized in the first quarter of fiscal year 2006 includes: (a) compensation cost for all share-based payments granted prior to, but not yet vested as of, December 26, 2005, based on the grant-date fair value estimated in accordance with the provisions of SFAS 123, and (b) compensation cost for all share-based payments granted subsequent to December 25, 2005, based on the grant-date fair value estimated in accordance with the provisions of SFAS 123R. Consistent with the modified prospective transition method, all balances associated with unvested restricted stock were eliminated against the appropriate equity amounts upon the adoption of SFAS 123R. When determining grant date fair market value in accordance with the provisions of SFAS 123R, the Company elected to continue to utilize the Black-Scholes option-pricing model. The adoption of SFAS 123R did not have a material effect on the recognition of expense for restricted stock issued under the Company's Managing Partner Program discussed below.

### **Managing Partner Program**

The Company maintains a compensation program (the Managing Partner Program) for many of its lead restaurant managers (MPs). Under the Managing Partner Program, the Company enters into a 5-year employment contract with the MP that provides for i) a fixed salary; ii) quarterly bonuses calculated as a percentage of restaurant profits and as a percentage of any year-over-year increase in sales; and iii) an award of restricted common stock of the Company, which is issued annually, in arrears, in an amount equal to a percentage of the previous four quarters aggregate salary and bonus paid under the Managing Partner Program. All salary, bonuses and restricted stock to be awarded to an MP under the Managing Partner Program is expensed as earned and reflected in the Company's consolidated statements of operations as compensation expense. As of December 25, 2005, the Company had accrued \$2,345,000 in compensation expense for restricted stock awards not yet awarded.

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

### **Stock Options and Restricted Stock Programs**

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

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

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

On February 8, 2006, the Company awarded performance based restricted stock units to certain executives under the Company s 2002 Plan. Conversion of those performance based restricted stock units to common stock is contingent upon the Company meeting revenue growth and adjusted earnings per share performance goals. Each participant was granted a base number of performance based restricted stock units. At the end of the three-year performance period, the number of units converted to shares and issued to participants will be increased, decreased or remain the same based upon actual growth in revenue and adjusted earnings per share, versus targeted growth. The shares, as determined at the end of the performance year (fiscal 2008), will be issued in February, 2009 if the Company s targets are achieved. The total number of performance based restricted stock units granted in 2006 was 71,732. The amount expensed for the quarter ended April 2, 2006 was approximately \$92,000 based upon the number of units granted and management s estimate of the revenue and adjusted earnings per share to be achieved as compared to the respective targets. Amounts expensed will be periodically adjusted to reflect the most current projection of the achievement of performance goals.

Restricted stock awards are nonvested stock awards that may include grants of restricted stock shares or performance-based restricted stock units. Restricted stock awards are independent of option grants and are subject to forfeiture if employment terminates prior to the release of the restrictions. Such awards vest three years from the date of grant. During the vesting period, ownership of the shares cannot be transferred. Restricted stock shares represent newly issued shares, have the same cash dividend and voting rights as other common stock, and are considered to be currently issued and outstanding. Performance based restricted stock units have dividend equivalent rights equal to the cash dividend paid on restricted stock shares. However, performance based restricted stock units do not have voting rights of common stock and are not considered issued and outstanding. Performance-based restricted stock units become newly issued shares when vested. The Company expenses the cost of the restricted stock awards and performance based restricted stock units, which is the grant date fair value, ratably over the period during which the restrictions lapse. The grant date fair value is the Company s closing stock price on the date of grant.

The following table provides information about the common stock that may be issued under all of the Company s existing equity compensation plans as of April 2, 2006:

<u>Plan Category</u>	Number of Securities to	Weighted Average	Number of Securities
	be Issued Upon Exercise	Exercise Price of	Remaining Available
	of Outstanding Options	Outstanding Options	for Future Issuance

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Equity Compensation Plans	2,374,080	(1)	\$ 27.07	1,233,639 (6)
Approved by Shareholders	708,094	(2)	14.06	10,230
Equity Compensation Plans not Approved by Shareholders	126,562	(3)	16.98	11,251
	576,666	(4)	8.17	--
Total	3,823,902		\$ 21.29	1,255,120

- (1) RARE Hospitality International, Inc. Amended and Restated 2002 Long-Term Incentive Plan.
- (2) RARE Hospitality International, Inc. 1997 Long-Term Incentive Plan.
- (3) RARE Hospitality International, Inc. Amended and Restated 1996 Stock Plan for Outside Directors.
- (4) LongHorn Steaks, Inc. Amended and Restated 1992 Incentive Plan. No further options may be granted under the terms of this plan.
- (5) These options were granted on the same terms as those under the Company's 1997 Long-Term Incentive Plan and were granted at prices which equated to current market value on the date of grant, are exercisable after three to five years, and must be exercised within ten years from the date of grant.
- (6) Any and all of these shares may be granted as future awards of restricted stock.

Upon adoption of SFAS 123R, the Company elected to continue to use the Black-Scholes option pricing model to calculate the grant-date fair value of awards. The fair value of options granted during the first quarter of fiscal 2006 and the first quarter of fiscal 2005 were calculated using the following assumptions:

	14 Weeks Ended April 2,	13 Weeks Ended March 27,
	<u>2006</u>	<u>2005</u>
Expected life (in years)	4.00	4.00
Expected volatility	27.34%	28.00%
Risk-free interest rate	4.375%	4.375%
Expected dividend yield	0.00%	0.00%

**Expected life** The Company uses historical employee exercise and option expiration data to estimate the expected life assumption for the Black-Scholes grant-date valuation. The Company believes that this historical data is currently the best estimate of the expected term of a new option. The Company uses a weighted-average expected life for all awards. As part of its SFAS 123R adoption, the Company examined its historical pattern of option exercises and was unable to determine any discernable activity patterns based on different, specific employee populations. From this analysis the Company continued to calculate the expected life of option awards based on one employee population, the same policy used prior to adoption of SFAS 123R.

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**Expected volatility** The Company uses the Company stock's historical volatility for the same period of time as the expected life of option awards. The Company has no reason to believe that its future volatility will differ from the past.

**Risk-free interest rate** The rate is based on the U.S. Treasury yield curve in effect at the time of the grant for the same period of time as the expected life of option awards.

**Expected dividend yield** The calculation is based on the total expected annual dividend payout divided by the average stock price.

The Company uses the straight-line attribution method to recognize expense for all option and restricted stock awards with graded vesting and cliff vesting. Prior to the adoption of SFAS 123R, the Company did not have any significant restricted stock awards other than those issued under the Managing Partner Program. Share-based compensation expense for employees is recognized on a straight-line basis over the statutory vesting period of the award.

SFAS 123R requires compensation costs associated with share-based awards to be recognized over the requisite service period, which for the Company is the period between the earlier of the service inception date or the grant date and the award's stated vesting date. None of the Company's share-based awards are eligible to vest early in the event of retirement. Many of the Company's stock option and restricted stock awards vest early in the event of death, disability or a change in control of the Company. The Company immediately recognizes the entire amount of share-based compensation costs for employees in the event of death, disability, or any other early vesting.

The amount of share-based compensation recognized during a period is based on the value of the portion of the awards that are ultimately expected to vest. SFAS 123R requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. The term "forfeitures" is distinct from "cancellations" or "expirations" and represents only the unvested portion of the surrendered award. The Company currently expects, based on an analysis of its historical forfeitures, that approximately 83 percent of its unvested outstanding options and restricted stock awards will vest. This analysis will be re-evaluated at least annually and the forfeiture rate will be adjusted as necessary. Ultimately, the actual expense recognized over the vesting period will only be for those shares that vest. Prior to the adoption of SFAS 123R, forfeitures were recognized as they occurred.

Total share-based compensation expense of approximately \$2.1 million (\$1.5 million, net of tax) has been included in the Company's Consolidated Statements of Income for the quarter ended April 2, 2006. Included in this amount is approximately \$1.2 million (\$1.0 million, net of tax) of stock option expense that was recognized as a result of adopting SFAS 123R, \$402,000 of expense associated with restricted stock and performance based restricted stock units issued under the Company's new stock-based compensation programs and approximately \$462,000 of restricted stock expense under the Company's Managing Partner Program. No amount of share-based compensation was capitalized. The impact of adopting SFAS 123R is as follows (in thousands, except per share amounts):

	14 Weeks Ended
	<u>April 2, 2006</u>
General and administrative expenses	<u>\$ (1,615)</u>
Share-based compensation expense before income taxes	(1,615)
Tax benefit	<u>408</u>
Share-based compensation expense after income taxes	\$ (1,207)

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Effect on:

Earnings per share Basic	\$ ( 0.04)	_____
Earnings per share Diluted	\$ (0.03)	_____

Prior to the adoption of SFAS 123R, benefits of tax deductions in excess of recognized compensation costs (excess tax benefits) were reported as operating cash flows. SFAS 123R requires that such tax benefits be recorded as a financing cash inflow rather than a deduction of taxes paid. For the 14 weeks ended April 2, 2006, there was not any excess tax benefit recognized resulting from share-based compensation cost.

In November 2005, the FASB issued FASB Staff Position 123(R)-3, Transition Election Related to Accounting for the Tax Effects of Share-based Payment Awards ( FSP 123R-3 ). FSP 123R-3 provides an elective alternative transition method of calculating the additional paid in capital pool ( APIC Pool ) of excess tax benefits available to absorb tax deficiencies recognized subsequent to the adoption of SFAS 123R to the method otherwise required by paragraph 81 of SFAS 123R. The Company may take up to one year from the effective date of SFAS 123R-3 to evaluate its available alternatives and make its one-time election. The Company is in the process of evaluating the alternative methods for calculating the APIC Pool.

The following table details the effect on net income and earnings per share had share-based compensation expense been recorded for the first quarter of fiscal 2005 based on the fair-value method under SFAS 123. The reported and pro forma net income and earnings per share for the first quarter of fiscal 2006 are the same since share-based compensation expense was calculated under the provisions of SFAS 123R (in thousands, except per share amounts):

	13 Weeks Ended
	<u>March 27, 2005</u>
Net income, as reported	\$ 15,464
Add back: Share-based compensation expense recorded, net of related tax effects	241
Deduct: Total share-based compensation expense determined under fair-value-based method for all awards, net of related tax effects	<u>(1,225)</u>
Pro forma net income	\$14,480
_____	
Basic income per share:	
As reported	\$ 0.45
_____	
Pro forma	\$ 0.42
_____	
Diluted income per share:	
As reported	\$ 0.44
_____	
Pro forma	\$ 0.41
_____	

As of April 2, 2006, there were \$9,298,000 of unrecognized compensation costs related to unvested stock option awards that is expected to be recognized over a weighted average period of 1.3 years. As of April 2, 2006, there were \$4,308,000 of unrecognized compensation costs related to unvested restricted stock awards that is expected to be recognized over a weighted average period of 1.9 years.

### Share-based Activity

Option activity for the quarter ended April 2, 2006 was as follows:

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	Options	Weighted- Average Exercise Price
	<u>Options</u>	<u>Exercise Price</u>
Outstanding at December 25, 2005	3,213,379	\$ 18.36
Granted	778,510	31.50
Exercised	(166,221 )	12.44
Forfeited or Cancelled	(1,766 )	8.30
	<u>3,823,902</u>	<u>\$ 21.29</u>
Outstanding at April 2, 2006	<u>3,823,902</u>	\$ 21.29

The fair value of options granted in the first quarter of 2006 and 2005 was \$5,862,000 and \$2,352,000, respectively. The total intrinsic value of options exercised in the first quarter of 2006 and 2005 was \$2,917,000 and \$2,752,000 respectively. As of April 2, 2006, the total intrinsic value of options outstanding and options exercisable was approximately \$51.8 million and \$44.3 million, respectively. Intrinsic value is the difference between the Company's closing stock price on the respective trading day and the exercise price, multiplied by the number of options exercised.

The following table summarizes information concerning outstanding and exercisable options as of April 2, 2006:

Range of Exercise Prices	Options Outstanding			Options Exercisable	
	Options	Life <sup>1</sup>	Price <sup>2</sup>	Options	Price <sup>2</sup>
\$0.01-\$5.00	47,500	1.9	\$4.33	47,500	\$ 4.33
\$5.01-\$10.00	678,153	3.4			