

CARROLS CORP  
Form 10-K  
March 23, 2007  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**  
WASHINGTON, D.C. 20549  
**FORM 10-K**

x ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF

THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended December 31, 2006

OR

“ TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF

THE SECURITIES EXCHANGE ACT OF 1934

**CARROLS RESTAURANT GROUP, INC.**

(Exact name of Registrant as specified in its charter)

Commission File Number: 001-33174

|   |  |
|---|--|
| <b>Delaware</b><br>(State or other jurisdiction of<br>incorporation or organization)            | <b>16-1287774</b><br>(I.R.S. Employer<br>Identification No.) |
| <b>968 James Street</b><br><b>Syracuse, New York</b><br>(Address of principal executive office) | <b>13203</b><br>(Zip Code)                                   |
| <b>Registrant's telephone number, including area code: (315) 424-0513</b>                       |  |

Securities registered pursuant to Section 12(b) of the Act:

|  |   |
|--|---|
| <b>Title of each class:</b><br>Common Stock, Carrols Restaurant Group, Inc., | <b>Name on each exchange on which registered:</b><br>The NASDAQ Global Market |
|--|---|

par value \$.01 per share

Securities registered pursuant to Section 12(g) of the Act: None

**CARROLS CORPORATION**

(Exact name of Registrant as specified in its charter)

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Commission File Number: 0-25629

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| <p><b>Delaware</b><br/>(State or other jurisdiction of<br/>incorporation or organization)<br/><b>968 James Street</b><br/><br/><b>Syracuse, New York</b><br/>(Address of principal executive office)</p> | <p><b>16-0958146</b><br/>(I.R.S. Employer<br/>Identification No.)<br/><br/><b>13203</b><br/>(Zip Code)<br/><b>Registrant's telephone number, including area code: (315) 424-0513</b></p> |
|--|--|

Securities registered pursuant to Section 12(b) of the Act: None

Securities registered pursuant to Section 12(g) of the Act: None

Carrols Corporation meets the conditions set forth in General Instruction I(1)(A) and (B) and is therefore filing this form with reduced disclosure format pursuant to General Instruction I(2).

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

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or 15(d) of the Exchange Act.

Carrols Restaurant Group, Inc. Yes  No

Carrols Corporation Yes  No

Indicate by check mark whether either of the registrants (1) have 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) have been subject to such filing requirements for the past 90 days. Yes  No

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

Indicate by check mark whether the registrants are large accelerated filers, accelerated filers, or non-accelerated filers. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer  Accelerated filer  Non-accelerated filer

Indicate by check mark whether either of the registrants are shell companies (as defined in Rule 12b-2 of the Exchange Act) Yes  No

As of March 16, 2007, Carrols Restaurant Group, Inc. had 21,550,826 shares of its common stock, \$.01 par value, outstanding and the aggregate market value of the common stock held by non-affiliates of Carrols Restaurant Group, Inc. was \$155,955,954. As of March 16, 2007, all outstanding equity securities of Carrols Corporation, which consisted of 10 shares of its common stock, were owned by Carrols Restaurant Group, Inc.

**DOCUMENTS INCORPORATED BY REFERENCE**

Portions of Carrols Restaurant Group, Inc.'s definitive Proxy Statement for Carrols Restaurant Group, Inc.'s 2007 Annual Meeting of Stockholders, which is expected to be filed pursuant to Regulation 14A no later than 120 days after conclusion of Carrols Restaurant Group, Inc.'s fiscal year ended December 31, 2006, are incorporated by reference into Part III of this report.



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**CARROLS RESTAURANT GROUP, INC.**

**FORM 10-K**

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**PART I**

Throughout this Annual Report on Form 10-K, we refer to Carrols Restaurant Group, Inc. as Carrols Restaurant Group and, together with its consolidated subsidiaries, as we, our and us unless otherwise indicated or the context otherwise requires. Any reference to Carrols refers to our wholly-owned subsidiary, Carrols Corporation, a Delaware corporation, and its consolidated subsidiaries, unless otherwise indicated or the context otherwise requires. This combined Annual Report on Form 10-K is filed by both Carrols Restaurant Group, Inc. and its wholly owned subsidiary, Carrols Corporation.

We use a 52 or 53 week fiscal year ending on the Sunday closest to December 31. For convenience, all references herein to the fiscal years ended December 29, 2002, December 28, 2003, January 2, 2005, January 1, 2006 and December 31, 2006 will hereinafter be referred to as the fiscal years ended December 31, 2002, 2003, 2004, 2005 and 2006, respectively. Our fiscal years ended December 31, 2002, 2003, 2005 and 2006 each contained 52 weeks. Our fiscal year ended December 31, 2004 contained 53 weeks.

We use the terms Segment EBITDA and Segment EBITDA margin in our 2006 Annual Report on Form 10-K because they are financial indicators that are reported to the chief operating decision maker for purposes of allocating resources to our segments and assessing their performance. Segment EBITDA (earnings attributable to the applicable segment before interest, income taxes, depreciation and amortization, impairment losses, stock-based compensation expense, bonus to employees and a director in connection with the December 2004 Transactions (as defined in Item 6. Selected Financial Data), other income and expense and loss on extinguishment of debt) may not be necessarily comparable to other similarly titled captions of other companies due to differences in methods of calculation. The calculation of Segment EBITDA for our Burger King restaurants includes general and administrative expenses related directly to our Burger King segment, as well as the expenses associated with administrative support for all three of our segments including executive management, information systems and certain accounting, legal and other administrative functions. Segment EBITDA margin means Segment EBITDA as a percentage of the total revenues of the applicable segment. We consider our Pollo Tropical restaurants, Taco Cabana restaurants and Burger King restaurants to each constitute a separate segment. See Note 13 to the accompanying consolidated financial statements.

In this Annual Report on Form 10-K, we refer to information, forecasts and statistics regarding the restaurant industry. Unless otherwise indicated, all restaurant industry data in this Annual Report on Form 10-K refers to the U.S. restaurant industry and is taken from or based upon the Technomic Information Services (Technomic) report entitled 2006 Technomic Top 500 Chain Restaurant Report. In addition, statements in this Annual Report on Form 10-K concerning the increasing disposable income of the Hispanic consumer base are based on an article appearing in the third quarter 2004 edition of Georgia Business and Economic Conditions, a publication of the Terry College of Business, The University of Georgia. In this Annual Report on Form 10-K we also refer to information, forecasts and statistics from the U.S. Census Bureau and the U.S. Bureau of Labor Statistics and regarding BKC, as defined below. Unless otherwise indicated, information regarding BKC in this Annual Report on Form 10-K has been made publicly available by BKC. Any reference to BKC in this Annual Report on Form 10-K refers to Burger King Holdings, Inc. (NYSE: BKC) and its wholly-owned subsidiaries, including Burger King Corporation. We believe that all of these sources are reliable, but we have not independently verified any of this information and cannot guarantee its accuracy or completeness. The information, forecasts and statistics we have used from Technomic may reflect rounding adjustments.

**Forward-Looking Statements**

This 2006 Annual Report on Form 10-K contains statements which constitute forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. Statements that are predictive in nature or that depend upon or refer to future events or conditions are forward-looking statements. These statements are often identified by the words may, might, will, should, anticipate, believe, expect, intend, estimate, hope or similar expressions.

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In addition, expressions of our strategies, intentions or plans are also forward looking statements. These statements reflect management's current views with respect to future events and are subject to risks and uncertainties, both known and unknown. You are cautioned not to place undue reliance on these forward-looking statements, which speak only as of their date. There are important factors that could cause actual results to differ materially from those in forward-looking statements, many of which are beyond our control. Investors are cautioned that any such forward-looking statements are not guarantees of future performance and involve risks and uncertainties, and that actual results may differ materially from those projected in the forward-looking statements. We have identified significant factors that could cause actual results to differ materially from those stated or implied in the forward-looking statements. For more information, please see Item 1A Risk Factors. We believe important factors that could cause actual results to differ materially from our expectations include the following, in addition to other risks and uncertainties discussed herein:

Competitive conditions;

Regulatory factors;

Environmental conditions and regulations;

General economic conditions, particularly at the retail level;

Weather conditions;

Fuel prices;

Significant disruptions in service or supply by any of our suppliers or distributors;

Changes in consumer perception of dietary health and food safety;

Labor and employment benefit costs;

The outcome of pending or future legal proceedings;

Our ability to manage our growth and successfully implement our business strategy;

The risks associated with the expansion of our business;

General risks associated with the restaurant industry;

Our inability to integrate any businesses we acquire;

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Our borrowing costs and credit ratings, which may be influenced by the credit ratings of our competitors;

The availability and terms of necessary or desirable financing or refinancing and other related risks and uncertainties;

The risk of events similar to those of September 11, 2001 or an outbreak or escalation of any insurrection or armed conflict involving the United States or any other national or international calamity;

Factors that affect the restaurant industry generally, including recalls if products become adulterated or misbranded, liability if product consumption causes injury, ingredient disclosure and labeling laws and regulations, reports of cases of mad cow disease and avian flu, and the possibility that consumers could lose confidence in the safety and quality of certain food products, as well as recent publicity concerning the health implications of obesity and transfatty acids; and

Other factors discussed under Item IA Risk Factors and elsewhere herein.

**Table of Contents****ITEM 1. BUSINESS****Overview*****Our Company***

We are one of the largest restaurant companies in the United States operating three restaurant brands in the quick-casual and quick-service restaurant segments with 547 restaurants located in 16 states as of December 31, 2006. We own and operate two Hispanic restaurant brands, Pollo Tropical® and Taco Cabana® (together referred to by us as our Hispanic Brands), which we acquired in 1998 and 2000, respectively. We are also the largest Burger King franchisee, based on the number of restaurants, and have operated Burger King restaurants since 1976. As of December 31, 2006, our company-owned restaurants included 76 Pollo Tropical restaurants and 143 Taco Cabana restaurants, and we operated 328 Burger King restaurants under franchise agreements. We also franchise our Hispanic Brand restaurants with 30 franchised restaurants located in Puerto Rico, Ecuador and the United States as of December 31, 2006. We believe that the diversification and strength of our restaurant brands as well as the geographic dispersion of our restaurants provide us with stability and enhanced growth opportunities. Our primary growth strategy is to develop new company-owned Hispanic Brand restaurants. For the year ended December 31, 2006, we had total revenues of \$751.4 million and net income of \$13.4 million.

On December 20, 2006, we and certain selling stockholders completed an initial public offering (the IPO) of 5,666,666 and 5,333,334 shares of our common stock, respectively (including 1,000,000 shares sold by the selling stockholders upon the underwriters' exercise of its over-allotment option). In connection with the IPO, our common stock was approved for listing on The NASDAQ Global Market and began trading on December 15, 2006 under the symbol TAST.

***Hispanic Brands.*** Our Hispanic Brands operate in the quick-casual restaurant segment, combining the convenience and value of quick-service restaurants with the menu variety, use of fresh ingredients and food quality more typical of casual dining restaurants. For the year ended December 31, 2006, our company-owned Pollo Tropical and Taco Cabana restaurants generated average annual sales per restaurant of \$2,135,000 and \$1,643,000, respectively, which we believe are among the highest in the quick-casual and quick-service segments. For the year ended December 31, 2006, aggregate revenues for our Hispanic Brands were \$382.5 million, which represented 50.9% of our total consolidated revenues.

***Pollo Tropical:*** Our Pollo Tropical restaurants are known for their fresh grilled chicken marinated in our own blend of tropical fruit juices and spices. Our menu also features other items including roast pork, sandwiches, grilled ribs offered with a selection of sauces, Caribbean style made from scratch side dishes and salads. Most menu items are made fresh daily in each of our Pollo Tropical restaurants, which feature open display cooking that enables customers to observe the preparation of menu items, including chicken grilled on large, open-flame grills. Pollo Tropical opened its first restaurant in 1988 in Miami. As of December 31, 2006, we owned and operated a total of 76 Pollo Tropical restaurants, of which 74 were located in Florida, one located in the New York City metropolitan area in northern New Jersey and one in Brooklyn, New York. For the year ended December 31, 2006, the average sales transaction at our company-owned Pollo Tropical restaurants was \$9.05 reflecting, in part, strong dinner traffic, with dinner sales representing the largest sales day-part of Pollo Tropical restaurant sales. For the year ended December 31, 2006, our Pollo Tropical restaurants generated total revenues of \$154.2 million.

***Taco Cabana:*** Our Taco Cabana restaurants serve fresh Tex-Mex and traditional Mexican style food, including sizzling fajitas, quesadillas, enchiladas, burritos, tacos, other Tex-Mex dishes, fresh-made flour tortillas, frozen margaritas and beer. Most menu items are made fresh daily in each of our Taco Cabana restaurants, which feature open display cooking that enables customers to observe the preparation of menu items, including fajitas cooking on a grill and a machine making fresh tortillas. A majority of our Taco Cabana restaurants are open 24 hours a day, generating customer traffic and restaurant sales across multiple day-parts by offering a convenient and quality experience to our customers. Taco Cabana pioneered the Mexican patio café concept with its first restaurant in San Antonio, Texas in 1978. As of December 31, 2006, we owned and operated 143 Taco Cabana restaurants located in Texas, Oklahoma and New Mexico,



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of which 137 were located in Texas. For the year ended December 31, 2006, the average sales transaction at our company-owned Taco Cabana restaurants was \$7.31 with dinner sales representing the largest sales day-part of Taco Cabana restaurant sales. For the year ended December 31, 2006, our Taco Cabana restaurants generated total revenues of \$228.3 million.

**Burger King:** Burger King is the second largest hamburger restaurant chain in the world (as measured by the number of restaurants and system-wide sales) and we are the largest franchisee in the Burger King system, based on number of restaurants. Burger King restaurants are part of the quick-service restaurant segment which is the largest of the five major segments of the U.S. restaurant industry based on 2006 sales. Burger King restaurants feature the popular flame-broiled Whopper sandwich, as well as a variety of hamburgers and other sandwiches, fries, salads, breakfast items and other offerings. According to BKC, historically it has spent between 4% and 5% of its annual system sales on marketing, advertising and promotion to sustain and increase its high brand awareness. We benefit from BKC's marketing initiatives as well as its development and introduction of new menu items. As of December 31, 2006, we operated 328 Burger King restaurants located in 12 Northeastern, Midwestern and Southeastern states. For the year ended December 31, 2006, the average sales transaction at our Burger King restaurants was \$5.23. For the year ended December 31, 2006, our Burger King restaurants generated total revenues of \$368.9 million.

**Corporate Information:** Carrols Restaurant Group is a Delaware Corporation, incorporated in 1986. Carrols Restaurant Group conducts all of its operations through its direct and indirect subsidiaries and has no assets other than the shares of Carrols, its direct wholly-owned subsidiary. Prior to November 21, 2006 Carrols Restaurant Group was known as Carrols Holdings Corporation. On November 21, 2006, we amended our certificate of incorporation to change our name to Carrols Restaurant Group, Inc.

## **Industry**

### ***The Restaurant Market***

According to Technomic, total restaurant industry revenues in the United States for 2005 were \$330.8 billion, an increase of 5.6% over 2004. Sales in the overall U.S. restaurant industry are projected by Technomic to increase at a compound annual growth rate of 5.3% from 2005 through 2010.

### ***Quick-Casual Restaurants***

Our Hispanic Brands operate in the quick-casual restaurant segment, combining the convenience of quick-service restaurants with the menu variety, use of fresh ingredients and food quality more typical of casual dining. We believe that the quick-casual restaurant segment is one of the fastest growing segments of the restaurant industry. According to Technomic, sales growth in 2005 of quick-casual chains in the Technomic Top 500 restaurant chains was 11.8% as compared to 7.0% for the overall Top 500 restaurant chains, which includes all five major segments.

Quick-casual restaurants are primarily distinguished by the following characteristics:

*Quick-service or self-service format.* Meals are purchased prior to receiving food. In some cases, payment may be made at a separate station from where the order was placed. Also, servers may bring orders to the customer's table.

*Check averages between \$7 and \$10.* Technomic reports that the average check at quick-casual restaurants in 2005 ranged between \$7 and \$10, which was higher than the average check at traditional quick-service restaurants.

*Food prepared to order.* We believe that in quick-casual concepts, customization of orders and open display cooking are common.

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*Fresh ingredients.* Many concepts use the word "fresh" in their concept positioning and feature descriptive menus highlighting these fresh ingredients.

*Broader range of menu offerings.* Typically quick-casual concepts provide greater variety and diversity in their menu offerings relative to traditional quick-service restaurants.

*Enhanced decor.* Wooden tables, upholstered seating and track lighting are some of the design features commonly found in quick-casual establishments.

We believe that our Hispanic Brands are positioned to benefit from growing consumer demand for quick-casual restaurants because of food quality, value and differentiation of flavors, as well as the increasing acceptance of ethnic foods. We also believe that our Hispanic Brands will benefit from two significant demographic factors: the expected population growth rates in regions in which our restaurants are currently located and the expected rate of growth of the Hispanic population in the United States, both as projected by the U.S. Census Bureau in its 2001 Statistical Abstract of the United States.

Our Burger King restaurants are part of the quick-service restaurant segment that Technomic indicates is the largest of the five major segments of the U.S. restaurant chain industry. Technomic identifies ten major types of restaurants comprising the quick-service segment: Hamburger; Pizza; Chicken; Other Sandwich; Mexican; Frozen Dessert; Donut; Beverage; Cafeteria/Buffer; and Family Steak. According to Technomic, the quick-service restaurants included in the Top 100 quick-service restaurant companies in 2005 were divided by menu category as follows (percentages are based on total sales for the quick-service segment):

According to Technomic, sales at all quick-service restaurants in the United States were \$168.8 billion in 2005, representing 51% of total U.S. restaurant industry sales. Sales in this segment are projected by Technomic to increase at a compound annual growth rate of 5.5% from 2005 through 2010.

Quick-service restaurants are distinguished by the following characteristics:

*High speed of service and efficiency.* Quick-service restaurants typically have order taking and cooking platforms designed specifically to order, prepare and serve menu items with speed and efficiency. Fast and consistent food service is a characteristic of quick-service restaurants.

*Convenience.* Quick-service restaurants are typically located in places that are easily accessed and convenient to customers' homes, places of work and commuter routes.

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*Limited menu choice and service.* The menus at most quick-service restaurants have a limited number of standardized items. Typically, customers order at a counter or drive thru and pick up food that then is taken to a seating area or consumed off the restaurant premises.

*Value prices.* At quick-service restaurants, average check amounts are generally lower than other major segments of the restaurant industry.

Our Burger King restaurants operate in the hamburger segment of the quick-service restaurant segment. The hamburger segment of the quick-service restaurant segment in the United States, which generated \$56.4 billion in sales in 2005, is the largest segment of the quick-service restaurant segment in the United States, according to Technomic.

We believe that the quick-service and quick-casual restaurant segments meet consumers' desire for a convenient, reasonably priced restaurant experience. In addition, we believe that the consumers' need for meals prepared outside of the home, including takeout, has increased significantly over historical levels as a result of the greater numbers of working women and single parent families. For example, according to the U.S. Bureau of Labor Statistics, the percentage of mothers with children under age six participating in the workforce has increased from 39% in 1975 to 64% in 2002. According to the U.S. Census Bureau, the number of children living in households with two parents has decreased from approximately 85% in 1970 to 70% in 2001.

### **Our Competitive Strengths**

We believe we have the following strengths:

***Strong Hispanic Brands.*** We believe that the following factors have contributed, and will continue to contribute, to the success of our Hispanic Brands:

freshly-prepared food at competitive prices with convenience and value;

a variety of menu items including signature dishes with Hispanic flavor profiles designed to appeal to consumers' desire for freshly-prepared food and menu variety;

successful dinner day-part representing the largest sales day-part at both of our Hispanic Brands, providing a higher average check size than other day-parts;

broad consumer appeal that attracts both the growing Hispanic consumer base, with increasing disposable income to spend on items such as traditional foods prepared at restaurants rather than at home, and non-Hispanic consumers in search of new flavor profiles, grilled rather than fried entree choices and varied product offerings at competitive prices in an appealing atmosphere;

ability to control the consistency and quality of the customer experience and the strategic growth of our restaurant operations through our system consisting of primarily company-owned restaurants compared to competing brands that focus on franchising;

high market penetration of company-owned restaurants in our core markets that provides operating and marketing efficiencies, convenience for our customers and the ability to effectively manage and enhance brand awareness;

well positioned to continue to benefit from the projected population growth in Florida and Texas;

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established infrastructure at our Hispanic Brands to manage operations and develop and introduce new menu offerings, positioning us to build customer frequency and broaden our customer base; and

well positioned to continue to capitalize on the home meal replacement trend.

For the year ended December 31, 2006, aggregate revenues for our Hispanic Brands were \$382.5 million which represented 50.9% of our total consolidated revenues.

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***Primarily Company-Owned Hispanic Brand Restaurants Enable us to Control our Hispanic Brands.*** As of December 31, 2006, our Hispanic Brands were comprised of 219 company-owned and 30 franchised restaurants, of which only five of these franchised restaurants were located in the United States. Our Hispanic Brand restaurants in the United States are primarily company-owned and we therefore exercise control over the day-to-day operations of our company-owned restaurants unlike many of our competitors that have multiple franchisees operating as a single brand. Consequently, our success does not depend on our control of our franchisees, or support by them of our marketing programs, new product offerings, strategic initiatives or new restaurant development strategies. In addition, because our Hispanic Brand restaurants are primarily company-owned, we believe we are less susceptible to third party franchisees adversely affecting the long-term development potential of our brands and we believe we are better able to provide customers a more consistent experience relative to competing brands that utilize franchisee-operated restaurants.

***Strong Restaurant Level Economics and Operating Metrics for our Hispanic Brands.*** We believe that we benefit from attractive restaurant level economics and operating profitability for our Hispanic Brands. We believe that the average annual sales at our company-owned Hispanic Brand restaurants for the year ended December 31, 2006 of \$2,135,000 for our Pollo Tropical restaurants and \$1,643,000 for our Taco Cabana restaurants, respectively, are among the highest in the quick-casual and quick-service segments. For the year ended December 31, 2006 our Pollo Tropical restaurants generated a Segment EBITDA margin of 18.4% which included general and administrative expenses of 5.8% of total Pollo Tropical revenues. For the year ended December 31, 2006, our Taco Cabana restaurants generated Segment EBITDA margins of 14.7%, which included general and administrative expenses of 5.1% of total Taco Cabana revenues. We believe that the average annual sales at our company-owned Hispanic Brand restaurants and the operating margins of our Hispanic Brands generate unit economics and returns on invested capital which will enable us to accelerate and sustain new unit growth.

***Well Positioned to Continue to Capitalize on Growing Population in Core Markets Served by Our Hispanic Brands.*** We expect sales from our Hispanic Brand restaurants in Florida and Texas to benefit from the projected continued overall population growth in these markets, which is projected by the U.S. Census Bureau to grow at a faster rate than the national average. According to the U.S. Census Bureau, the U.S. population is forecast to grow by 4.5% from 2005 to 2010 and the population in Florida and Texas is forecast to grow by 9.9% and 8.2%, respectively, during that same period.

***Well Positioned to Continue to Capitalize on the Growth of the Hispanic Population in the United States.*** We expect sales from our Hispanic Brand restaurants to benefit from the population growth of the U.S. Hispanic population which is projected by the U.S. Census Bureau to grow at a faster rate than the national average. The U.S. Census Bureau forecasts that the growth of the Hispanic population is expected to outpace overall population growth and increase from 11.8% of the total U.S. population in 2000 to 18.2% by 2025.

***Largest Burger King Franchisee.*** We are Burger King's largest franchisee and are well positioned to leverage the scale and marketing of one of the most recognized brands in the restaurant industry. The size of our Burger King business has contributed significantly to our large aggregate restaurant base, enabling us to enhance operating efficiencies and realize benefits across all three of our brands from economies of scale with respect to our management team and management information and operating systems. In addition, our Burger King business has significantly contributed, and is expected to continue to significantly contribute, to our consolidated operating cash flows. For the year ended December 31, 2006, revenues for our Burger King restaurants were \$368.9 million, which represented 49.1% of our total consolidated revenues.

***Infrastructure in Place for Growth.*** We believe that our operating disciplines, seasoned management, operational infrastructure and marketing and product development capabilities, supported by our corporate and restaurant management information systems and comprehensive training and development programs, will support significant expansion. We expect to leverage our significant investment in corporate infrastructure as we grow our business.

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***Experienced Management Team.*** We believe that our senior management team's extensive experience in the restaurant industry, knowledge of the demographic and other characteristics of our core markets and its long and successful history of developing, acquiring, integrating and operating quick-service and quick-casual restaurants, provide us with a competitive advantage.

### **Business Strategy**

Our primary business strategy is as follows:

***Develop New Hispanic Brand Restaurants in Core and Other Markets.*** We believe that we have significant opportunities to develop new Pollo Tropical and Taco Cabana restaurants in their respective core markets within Florida and Texas and expand into new markets both within Florida and Texas as well as other regions of the United States. Our Pollo Tropical restaurants are primarily concentrated in South and Central Florida and our Taco Cabana restaurants are primarily concentrated in larger cities in Texas. By increasing the number of restaurants we operate in a particular market, we believe that we can continue to increase brand awareness and effectively leverage our field supervision, corporate infrastructure and marketing expenditures. We also believe that the appeal of our Hispanic Brands and our high brand recognition in our core markets provide us with opportunities to expand into other markets in Florida and Texas. In addition, we believe that there are a number of geographic regions in the United States outside of Florida and Texas where the size of the Hispanic population and its influence on the non-Hispanic population provide significant opportunities for development of additional Hispanic Brand restaurants. In March 2006, we opened our first Pollo Tropical restaurant in the New York City metropolitan area, located in northern New Jersey. In December 2006, we opened a second Pollo Tropical restaurant in the New York City metropolitan area in Brooklyn, New York. In addition, we currently are exploring opportunities for expansion of the Taco Cabana concept in new markets. During the year ended December 31, 2006, we opened eight Pollo Tropical restaurants (including two restaurants in the Northeast as described above) and nine Taco Cabana restaurants in Texas. In 2007, we currently plan to open between seven and ten Pollo Tropical restaurants and between ten and twelve additional Taco Cabana restaurants.

Our staff of real estate and development professionals is responsible for new restaurant development. Before developing a new restaurant, we conduct an extensive site selection and evaluation process that includes in depth demographic, market and financial analyses. By selectively increasing the number of restaurants we operate in a particular market, we believe that we can continue to increase brand awareness and effectively leverage our field supervision, corporate infrastructure and marketing expenditures. Where possible, we intend to continue to utilize real estate leasing as a means of reducing the amount of cash invested in new restaurants. We believe that cash generated from operations, borrowings under our senior credit facility and leasing will enable us to continue to pursue our strategy of new restaurant development.

In addition to opportunities for expansion of our Hispanic Brands within our core markets, we believe there are significant growth opportunities in areas contiguous to our core markets and beyond such markets. We plan to open new restaurants in existing and new markets that may be either freestanding buildings or restaurants contained within strip shopping centers, which we sometimes refer to as in-line restaurants, to further leverage our existing brand awareness. Developing in-line restaurants allows us to selectively expand our brand penetration and visibility in certain of our existing markets, while doing so at a lower cost than developing a restaurant as a freestanding building. In addition, development of in-line restaurants permits us to further penetrate markets where freestanding opportunities may be limited.

***Increase Comparable Restaurant Sales.*** Our strategy is to grow sales in our existing restaurants by continuing to develop new menu offerings and enhance the effectiveness of our proprietary advertising and promotional programs for our Hispanic Brands, further capitalize on attractive industry and

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demographic trends and enhance the quality of the customer experience at our restaurants. We also believe that our Burger King restaurants are well positioned to benefit from BKC's initiatives with respect to the Burger King brand.

***Continue to Improve Income from Operations and Leverage Existing Infrastructure.*** We believe that our continuing development of new company-owned Hispanic Brand restaurants, combined with our strategy to increase sales at our existing Hispanic Brand restaurants, will increase revenues generated by our Hispanic Brands as a percentage of our consolidated revenues and position us to continue to improve our overall income from operations. We also believe that our large restaurant base, skilled management team, sophisticated management information and operating systems, and training and development programs support our strategy of enhancing operating efficiencies for our existing restaurants and profitably growing our restaurant base. Our operating systems allow us to effectively manage restaurant labor and food costs, effectively manage our restaurant operations and ensure consistent application of operating controls at each of our restaurants. In addition, our size and, in the case of Burger King, the size of the Burger King system, enable us to realize certain benefits from economies of scale, including leveraging our existing infrastructure as we grow.

***Utilize Financial Leverage to Maintain an Efficient Capital Structure to Support Growth.*** We intend to continue utilizing financial leverage in an effort to enhance returns to our stockholders. We believe our operating cash flows will allow us to allocate sufficient capital towards new store development and repayment of our outstanding indebtedness as part of our strategy to support earnings growth, while providing the flexibility to alter our capital allocation depending on changes in market conditions and available expansion opportunities.

### **Overview of Restaurant Concepts**

#### ***Pollo Tropical Restaurants***

Our Pollo Tropical quick-casual restaurants combine freshly-prepared, distinctive menu items and an inviting tropical setting with the convenience and value of quick-service restaurants. Pollo Tropical restaurants offer a unique selection of food items reflecting tropical and Caribbean influences and feature fresh grilled chicken marinated in our own blend of tropical fruit juices and spices. Chicken is grilled in view of customers on large, open-flame grills. Pollo Tropical also features additional menu items such as roast pork, a line of TropiChops® (a bowl containing rice, black beans and chicken or pork), sandwiches and grilled ribs that feature a selection of sauces. We also feature an array of Caribbean style made from scratch side dishes, including black beans and rice, yucatan fries and sweet plantains, as well as more traditional menu items such as french fries, corn and tossed and caesar salads. We also offer uniquely Hispanic desserts, such as flan and tres leches.

Our Pollo Tropical restaurants typically incorporate high ceilings, large windows, tropical plants, light colored woods, decorative tiles, a visually distinctive exterior entrance tower, lush landscaping and other signature architectural features, all designed to create an airy, inviting and tropical atmosphere. We design our restaurants to conveniently serve a high volume of customer traffic while retaining an inviting, casual atmosphere.

Our Pollo Tropical restaurants are generally open for lunch, dinner and late night orders seven days per week from 11:00 am to midnight and offer sit-down dining, counter take-out and drive-thru service to accommodate the varied schedules of families, business people and students. Our menu offers a variety of portion sizes to accommodate a single customer, family or large group. Pollo Tropical restaurants also offer an economical catering menu, with special prices and portions to serve parties in excess of 25 people.

Our Pollo Tropical restaurants typically provide seating for 80 to 100 customers and provide drive-thru service. As of December 31, 2006, all of our company-owned Pollo Tropical restaurants were freestanding buildings except for seven locations contained within strip shopping centers and two street-level storefront

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locations. Our typical freestanding Pollo Tropical restaurant ranges between 2,800 and 3,200 square feet. We anticipate that many of our new Pollo Tropical restaurants located in markets outside of Florida (including in the New York City metropolitan area) will be in-line restaurants located within strip-retail shopping centers or will be street-level storefront locations and will not offer drive-thru service. Consequently, such restaurants may be larger than our typical freestanding Pollo Tropical restaurants to provide more seating to accommodate increased sit-down dining.

***Taco Cabana Restaurants***

Our Taco Cabana quick-casual restaurants combine generous portions of freshly-prepared Tex-Mex and traditional Mexican style food with the convenience and value of quick-service restaurants. The restaurants typically provide interior, semi-enclosed and patio dining areas with a festive Mexican theme. Menu items include flame-grilled beef and chicken fajitas served on sizzling iron skillets, quesadillas, enchiladas, burritos, tacos and other traditional Mexican and American breakfasts, other Tex-Mex dishes and fresh flour tortillas. Our Taco Cabana restaurants also offer a variety of beverage choices, including frozen margaritas and beer. Most of the menu items offered at Taco Cabana are prepared at each restaurant from fresh meat, chicken and produce delivered by suppliers to the restaurant, usually three times each week. Taco Cabana utilizes fresh ingredients and prepares many items from scratch. In order to simplify operations and provide a more consistent product, Taco Cabana also uses a number of pre-prepared items.

Our typical Taco Cabana restaurants average approximately 3,200 square feet (exclusive of the exterior dining area) and provide seating for approximately 80 customers, with additional outside patio seating for approximately 50 customers. As of December 31, 2006, all of our company-owned Taco Cabana restaurants were freestanding buildings except for four locations contained within retail malls and two locations contained within strip shopping centers. Taco Cabana restaurants are typically distinctive in appearance, conveying a Mexican theme and permitting easy identification by passing motorists. Our Taco Cabana restaurants feature rounded fronts, as well as Southwest accents such as a clay tile roof, heavy wood beams and a trellis that shades the patio area, and the use of bright colors outside and inside. Corrugated metal wall panels, aged wood finishes and distressed stainless steel counter tops are featured inside.

Taco Cabana's interior restaurant design features open display cooking that enables customers to observe fajitas cooking on a grill, a machine making fresh flour tortillas and the preparation of other food items. Upon entry, the customer places an order selected from an overhead menu board, proceeds down a service line to where the order is picked up, and then passes a salsa bar en route to the dining area. The distinctive salsa bar offers Taco Cabana customers our own freshly-prepared Tex-Mex ingredients such as salsa de fuego (made with charred peppers and tomatoes), pico de gallo and salsa (all made from scratch throughout the day at each restaurant), as well as cilantro, pickled jalapeno slices, crisp chopped onions and fresh sliced limes. Depending on the season, time of day and personal preference, our customers can choose to dine in the restaurant's brightly colored and festive interior dining area or in either the semi-enclosed or outdoor patio areas.

Our Taco Cabana restaurants provide the convenience of drive-thru windows as well as the ability for customers to dine-in or take-out. A majority of our Taco Cabana restaurants are open 24 hours a day, although, hours of operation are continually evaluated for economic viability on a market and individual restaurant basis.

***Burger King Restaurants***

Burger King is the second largest hamburger restaurant chain in the world (as measured by the number of restaurants and system-wide sales). According to BKC, as of December 31, 2006, there were a total of 11,184 Burger King restaurants in 66 countries and U.S. territories, including 7,502 or 67% located in the United States and Canada. According to BKC, its total worldwide restaurant sales as of June 30, 2006 were approximately \$12.4 billion, of which approximately \$8.5 billion were in the United States and Canada.



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Have It Your Way<sup>®</sup> service, flame broiling, generous portions and competitive prices characterize the Burger King system marketing strategy. Our Burger King restaurants feature flame-broiled hamburgers and other sandwiches, the most popular of which is the WHOPPER<sup>®</sup> sandwich. The WHOPPER is a large, flame-broiled hamburger on a toasted bun garnished with mayonnaise, lettuce, onions, pickles and tomatoes. The basic menu of all Burger King restaurants consists of hamburgers, cheeseburgers, chicken and fish sandwiches, breakfast items, french fries, onion rings, salads, chili, shakes, desserts, soft drinks and other beverages. In addition, promotional menu items are introduced periodically for limited periods. We believe that BKC continually seeks to develop new products as it endeavors to enhance the menu and service of Burger King restaurants.

Our Burger King restaurants are typically open seven days per week and currently have minimum operating hours from 6:00 am to 11:00 pm. We anticipate that minimum operating hours will be extended in 2007 from 11:00 pm to midnight. Burger King restaurants are quick-service restaurants of distinctive design and are generally located in high-traffic areas throughout the United States. We believe that the primary competitive advantages of Burger King restaurants are:

brand recognition;

convenience of location;

speed of service;

quality; and

price.

Burger King restaurants are designed to appeal to a broad spectrum of consumers, with multiple day-part meal segments targeted to different groups of consumers.

Our Burger King restaurants consist of one of several building types with various seating capacities. BKC's traditional freestanding restaurant contains approximately 2,800 to 3,200 square feet with seating capacity for 90 to 100 customers, has drive-thru service windows, and has adjacent parking areas. As of December 31, 2006, 316 of our 328 Burger King restaurants were freestanding. We operate all of our Burger King restaurants under franchise agreements with BKC. See Operations Burger King Franchise Agreements and Franchise Fees, Royalties and Early Successor Program below.

**Table of Contents****Restaurant Economics**

Selected restaurant operating data for our three restaurant concepts is as follows:

|  | Year Ended December 31, |          |          |
|--|-------------------------|----------|----------|
|  | 2004(1)                 | 2005(1)  | 2006(1)  |
| <b>Pollo Tropical:</b>   |                         |          |          |
| Average annual sales per company-owned restaurant (in thousands) | \$ 2,018                | \$ 2,092 | \$ 2,135 |
| Average sales transaction  | \$ 8.25                 | \$ 8.72  | \$ 9.05  |
| Drive-through sales as a percentage of total sales               | 42.5%                   | 41.7%    | 41.7%    |
| Day-part sales percentages:                                      |                         |          |          |
| Lunch  | 45.7%                   | 45.8%    | 46.7%    |
| Dinner and late night (2)  | 54.3%                   | 54.2%    | 53.3%    |
| <b>Taco Cabana:</b>  |                         |          |          |
| Average annual sales per company-owned restaurant (in thousands) | \$ 1,604                | \$ 1,614 | \$ 1,643 |
| Average sales transaction  | \$ 6.88                 | \$ 7.08  | \$ 7.31  |
| Drive-through sales as a percentage of total sales               | 47.2%                   | 47.6%    | 47.6%    |
| Day-part sales percentages:                                      |                         |          |          |
| Breakfast  | 16.0%                   | 16.5%    | 16.8%    |
| Lunch  | 23.1%                   | 23.2%    | 23.4%    |
| Dinner   | 25.4%                   | 25.6%    | 25.1%    |
| Late night (9 pm to midnight)                                    | 14.1%                   | 13.7%    | 13.9%    |
| Other (2 pm to 5 pm and midnight to 6 am)                        | 21.4%                   | 21.0%    | 20.8%    |
| <b>Burger King:</b>  |                         |          |          |
| Average annual sales per restaurant (in thousands)               | \$ 1,034                | \$ 1,048 | \$ 1,114 |
| Average sales transaction  | \$ 4.74                 | \$ 5.03  | \$ 5.23  |
| Drive-through sales as a percentage of total sales               | 61.8%                   | 62.3%    | 62.8%    |
| Day-part sales percentages:                                      |                         |          |          |
| Breakfast  | 14.4%                   | 14.6%    | 14.2%    |
| Lunch  | 33.6%                   | 33.2%    | 33.0%    |
| Dinner   | 26.9%                   | 26.9%    | 27.1%    |
| Afternoon and late night.  | 25.1%                   | 25.3%    | 25.7%    |

- (1) 2005 and 2006 were each a 52-week fiscal year. 2004 was a 53-week fiscal year. Average annual sales for company owned or operated restaurants are derived by dividing restaurant sales for such year for the applicable segment by the average number of restaurants for the applicable segment for such year. For purposes of the calculation of average annual sales per company owned or operated restaurant in the table above, we have excluded restaurant sales data for the extra week in 2004.
- (2) Day part sales percentages for 2004, 2005 and 2006 include 2.8%, 2.9% and 2.8%, respectively, for late night.

**Restaurant Capital Costs**

The initial cost of equipment, seating, signage and other interior costs of a typical new free-standing Pollo Tropical restaurant currently is approximately \$400,000 (excluding the cost of the land, building and site improvements). Generally, in our core Florida market, the cost of land currently ranges from \$1,000,000 to \$1,250,000 and the cost of building and site improvements currently ranges from \$1,000,000 to \$1,250,000.

Costs in new markets may differ from and may be higher than these ranges. We believe that in the New York City metropolitan area, our new Pollo Tropical restaurants will not typically be free-standing and are more likely to be located as in-line units within strip retail shopping centers or as street-level storefront locations. We believe that these locations will typically be leased, that the cost to build-out the retail location to our specifications could range from \$500,000 to \$1,000,000 and that the initial cost of equipment will be approximately \$450,000.

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The initial cost of equipment, seating, signage and other interior costs of a typical new Taco Cabana restaurant currently is approximately \$440,000 (excluding the cost of the land, building and site improvements). Generally, in our core Texas market, the cost of land currently ranges from \$900,000 to \$1,000,000 and the cost of building and site improvements currently ranges from \$900,000 to \$1,000,000. Costs in new markets may differ from these ranges.

The initial cost of the franchise fee, equipment, seating, signage and other interior costs of a standard new Burger King restaurant currently is approximately \$385,000 (excluding the cost of the land, building and site improvements). In the markets in which we primarily operate, the cost of land generally ranges from \$400,000 to \$525,000 and the cost of building and site improvements generally ranges from \$550,000 to \$625,000.

We generally seek to acquire the land on which a new free-standing restaurant is to be situated, to fund construction of the restaurant building, and then at a later date enter into an arrangement to sell and leaseback the land and building under a long-term lease. Historically, we have been able to acquire and finance a large percentage of our locations under such leasing arrangements. Where we are unable to purchase the underlying land, we enter into a long-term lease for the land and fund the construction of the building from cash generated from our operations or with borrowings under our senior credit facility rather than through long-term leasing arrangements. We believe that in certain real estate markets, particularly Florida, an increasing number of our new restaurants likely may be situated on leased land.

The cost of developing and equipping new restaurants can vary significantly and depends on a number of factors, including the geographic location and site of those restaurants and national and local economic conditions. Accordingly, the cost of opening new restaurants in the future, including Pollo Tropical restaurants in the New York City metropolitan area, may differ substantially from, and may be significantly higher than, both the historical cost of restaurants previously opened and the estimated costs appearing above.

**Seasonality**

Our business is moderately seasonal due to regional weather conditions. Sales from our Pollo Tropical restaurants (primarily located in south and central Florida) are generally higher during the winter months than during the summer months. Sales from our Taco Cabana restaurants (located in Texas, Oklahoma and New Mexico) and our Burger King restaurants (primarily located in the northern United States) are generally higher during the summer months than during the winter months. We believe this seasonal impact is not material to our business as a whole because our multiple concepts operating in diverse geographic areas enable us to reduce our dependence on the economic performance of any one particular region.

**Restaurant Locations**

As of December 31, 2006, we owned and operated 76 Pollo Tropical restaurants, 74 of which were located in Florida and two in the New York City metropolitan area located in Northern New Jersey and in Brooklyn, New York. In addition, of 27 franchised Pollo Tropical restaurants as of December 31, 2006, 23 were in Puerto Rico; two were in Ecuador and two were on college campuses in Florida.

As of December 31, 2006, we owned and operated 143 Taco Cabana restaurants and franchised three Taco Cabana restaurants located in the following states:

|            | Owned | Franchised | Total |
|------------|-------|------------|-------|
| Texas      | 137   |            | 137   |
| Oklahoma   | 5     |            | 5     |
| New Mexico | 1     | 2          | 3     |
| Georgia    |       | 1          | 1     |
| Total      | 143   | 3          | 146   |

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The following table details the locations of our 328 Burger King restaurants as of December 31, 2006:

| State          | Total<br>Restaurants |
|----------------|----------------------|
| Indiana        | 5                    |
| Kentucky       | 9                    |
| Maine          | 4                    |
| Massachusetts  | 1                    |
| Michigan       | 25                   |
| New Jersey     | 2                    |
| New York       | 129                  |
| North Carolina | 37                   |
| Ohio           | 83                   |
| Pennsylvania   | 12                   |
| South Carolina | 20                   |
| Vermont        | 1                    |
| <b>Total</b>   | <b>328</b>           |

**Operations*****Management Structure***

We conduct substantially all of our executive management, finance, marketing and operations support functions from our corporate headquarters in Syracuse, New York, our Pollo Tropical division headquarters in Miami, Florida and our Taco Cabana division headquarters in San Antonio, Texas. The management structure for Pollo Tropical consists of an Executive Vice President, who has over 30 years of experience in the restaurant industry, and a Vice President of Operations and a Regional Director supported by nine district supervisors. The management structure of Taco Cabana consists of an Executive Vice President of Operations, who has over 30 years of restaurant experience, and a Regional Vice President and two Regional Directors supported by 18 district supervisors. Our Burger King operations are overseen by five Regional Directors, three of whom are Vice Presidents that have an average of 25 years of Burger King restaurant experience. Forty-four district supervisors that have an average of 22 years of restaurant management experience in the Burger King system support the Regional Directors.

For each of our concepts, a district supervisor is responsible for the direct oversight of the day-to-day operations of an average of approximately seven restaurants. Typically, district supervisors have previously served as restaurant managers at one of our restaurants. Regional directors, district supervisors and restaurant managers are compensated with a fixed salary plus an incentive bonus based upon the performance of the restaurants under their supervision. Typically, our restaurants are staffed with hourly employees who are supervised by a salaried manager and two or three salaried assistant managers.

***Training***

We maintain a comprehensive training and development program for all of our personnel and provide both classroom and in-restaurant training for our salaried and hourly personnel. The program emphasizes system-wide operating procedures, food preparation methods and customer service standards for each of the concepts. In addition, BKC's training and development programs are also available to us as a franchisee.

***Management Information Systems***

Our management information systems, which we believe are more sophisticated than systems typically utilized by many small quick-casual/quick-service restaurant operators and many other Burger King franchisees,

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provide us with the ability to efficiently and effectively manage our restaurants and to ensure consistent application of operating controls at our restaurants. Our size also affords us the ability to maintain an in-house staff of information and restaurant systems professionals dedicated to continuously enhancing our systems. In addition, these capabilities allow us to integrate newly developed or acquired restaurants and to leverage our investments in information technology over a larger base of restaurants.

Our restaurants generally employ touch-screen point-of-sale (POS) systems that are designed to facilitate accuracy and speed of order taking. These systems are user-friendly, require limited cashier training and improve speed-of-service through the use of conversational order-taking techniques. The POS systems are integrated with PC-based applications at the restaurant that are designed to facilitate financial and management control of our restaurant operations.

Our restaurant systems provide daily tracking and reporting of traffic counts, menu item sales, labor and food data, and other key operating information for each restaurant. We electronically communicate with our restaurants on a daily basis, which enables us to collect this information for use in our corporate management systems. Our corporate and divisional administrative headquarters house client/server-based systems that support all of our accounting, operating and reporting systems. We also operate a 24-hour, seven-day help desk at our corporate headquarters that enables us to provide systems and operational support to our restaurant operations as required. Among other things, our restaurant information systems provide us with the ability to:

- monitor labor utilization and sales trends on a real-time basis at each restaurant, enabling the restaurant manager to effectively manage to our established labor standards on a timely basis;

- reduce shrinkage using restaurant-level inventory management and centralized standard costing systems;

- analyze sales and product mix data to help restaurant management personnel forecast production levels;

- monitor day-part drive-thru speed of service at each of our restaurants;

- systematically communicate human resource and payroll data to our administrative offices for efficient centralized management of labor costing and payroll processing;

- employ centralized control over price, menu and inventory management activities at the restaurant utilizing the remote access capabilities of our systems;

- take advantage of electronic commerce including our ability to place orders with suppliers and to integrate detailed invoice, receiving and product data with our inventory and accounting systems; and

provide analyses, reporting and tools to enable all levels of management to review a wide-range of financial and operational data. Information from our systems is available daily to the restaurant manager, who is expected to react quickly to trends or situations in his or her restaurant. Our district supervisors also receive daily information for all restaurants under their control and have computer access to key operating data on a remote basis using our corporate intranet. Management personnel at all levels, from the restaurant manager through senior management, monitor key restaurant performance indicators.

### ***Site Selection***

We believe that the location of our restaurants is a critical component of each restaurant's success. We evaluate potential new sites on many critical criteria including accessibility, visibility, costs, surrounding traffic patterns, competition and demographic characteristics. Our senior

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management determines the acceptability of all acquisition prospects and new sites, based upon analyses prepared by our real estate and financial professionals and operations personnel.

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***Burger King Franchise Agreements***

Each of our Burger King restaurants operates under a separate franchise agreement with BKC. Our franchise agreements with BKC generally require, among other things, that all restaurants comply with specified design criteria and be operated in a prescribed manner, including utilization of the standard Burger King menu. In addition, our Burger King franchise agreements generally require that our restaurants conform to BKC's current image and provide for remodeling of our restaurants at the request of BKC during the tenth year of the agreements to conform to such current image, which may require the expenditure of considerable funds. These franchise agreements with BKC generally provide for an initial term of 20 years and currently have an initial franchise fee of \$50,000. In the event that we terminate any franchise agreement and close the related BKC restaurant prior to the expiration of its term, we may be required to pay BKC an amount calculated based on the net present value of the royalty stream that would have been realized by BKC had such franchise agreement not been terminated. Any franchise agreement, including renewals, can be extended at our discretion for an additional 20-year term, with BKC's approval, provided that, among other things, the restaurant meets the current Burger King operating and image standards and the franchisee is not in default under the terms of the franchise agreement. The franchise agreement fee for subsequent renewals is currently \$50,000. BKC may terminate any of the franchise agreements if an act of default is committed by us under these agreements. Defaults under the franchise agreements include, among other things, our failure to operate such Burger King restaurant in accordance with the operating standards and specifications established by BKC (including failure to use equipment, uniforms or decor approved by BKC), our failure to sell products approved or designated by BKC, our failure to pay royalties or advertising and sales promotion contributions as required, our unauthorized sale, transfer or assignment of such franchise agreement or the related restaurant, certain events of bankruptcy or insolvency with respect to us, conduct by us or our employees that has a harmful effect on the Burger King restaurant system, conviction of us or our executive officers for certain indictable offenses, our failure to maintain a responsible credit rating or the acquisition by us of an interest in any other hamburger restaurant business. We are not in default under any of the franchise agreements with BKC.

In order to obtain a successor franchise agreement with BKC, a franchisee is typically required to make capital improvements to the restaurant to bring it up to Burger King's current image standards. The required capital improvements will vary widely depending upon the magnitude of the required changes and the degree to which we have made interim improvements to the restaurant. We have 18 franchise agreements due to expire in 2007, 28 franchise agreements due to expire in 2008 and 17 franchise agreements due to expire in 2009. In recent years, the historical costs of improving our Burger King restaurants in connection with franchise renewals generally have ranged from \$200,000 to \$400,000 per restaurant. However, any future costs for improving Burger King restaurants in connection with franchise renewals may vary significantly and will depend on a number of factors, including the geographic location and the size of those restaurants. In addition, the cost of capital improvements made in connection with future franchise agreement renewals may differ substantially from past franchise renewals.

We believe that we will be able to satisfy BKC's normal franchise agreement renewal policies. Accordingly, we believe that renewal franchise agreements will be granted on a timely basis by BKC at the expiration of our existing franchise agreements. Historically, BKC has granted all of our requests for successor franchise agreements. However, there can be no assurances that BKC will grant these requests in the future.

We evaluate the performance of our Burger King restaurants on an ongoing basis. Such evaluation depends on many factors, including our assessment of the anticipated future operating results of the subject restaurants and the cost of required capital improvements that we would need to commit for such restaurants. If we determine that a Burger King restaurant is under-performing, we may elect to close such restaurant. We closed eight Burger King restaurants in 2006. We currently anticipate that we will likely elect to close approximately three to four Burger King restaurants in 2007. However, based on the current operating results of such restaurants, we believe that the impact on our results of operations as a result of such restaurant closures will not be material, although there can be no assurance in this regard. Our determination of whether to close such four restaurants is not final and is subject to further evaluation and may change. We may also elect to close additional Burger King restaurants in the future.

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In addition to the initial franchise fee, we generally pay to BKC a monthly royalty. For an explanation of the franchise fees and royalties see Franchise Fees, Royalties and Early Successor Program below. We also contribute 4% of restaurant sales from our Burger King restaurants to fund BKC's national and regional advertising. BKC engages in substantial national and regional advertising and promotional activities and other efforts to maintain and enhance the Burger King brand. We supplement from time to time BKC's marketing with our own local advertising and promotional campaigns. See Advertising and Promotion below.

Our franchise agreements with BKC do not give us exclusive rights to operate Burger King restaurants in any defined territory. Although we believe that BKC generally seeks to ensure that newly granted franchises do not materially adversely affect the operations of existing Burger King restaurants, we cannot assure you that franchises granted by BKC to third parties will not adversely affect any Burger King restaurants that we operate.

We are required to obtain BKC's consent before we acquire existing Burger King restaurants from other franchisees or develop new Burger King restaurants. BKC also has the right of first refusal to purchase any Burger King restaurant that is being offered for sale by a franchisee. To date, BKC has approved all of our acquisitions of Burger King restaurants from other franchisees; however, in two instances, BKC exercised its right of first refusal and purchased restaurants we sought to acquire.

***Franchise Fees, Royalties and Early Successor Program***

On July 1, 2000, BKC increased its royalty and franchise fees for most new restaurants. The franchise fee for new restaurants increased to \$50,000 for a 20-year agreement and the royalty rate generally increased from 3 1/2% of sales to 4 1/2% of sales. The royalty rates for existing franchise agreements are not affected by these changes until the time of renewal.

BKC offered a voluntary program to encourage franchisees to accelerate the renewal of their franchise agreements. Franchisees that elected to participate in the Early Successor Incentive Program were required to make capital improvements in their restaurants to bring them up to Burger King's then current design image. Franchise agreements entered into under this program contain special provisions regarding the royalty rates including a reduction in the royalty for a period of time.

For commitments made prior to July 1, 2000 to renew franchise agreements under BKC's Fiscal 2000 Early Successor Incentive Program, the renewal franchise fee remained at \$40,000. The royalty rate under this program remained at 3 1/2% of sales through March 31, 2002, at which time it was reduced to 2 3/4% of sales for the following five-year period. The royalty rate reverts back to 3 1/2% of sales effective April 1, 2007 for the remainder of any of the initial franchise term, and then increases to 4 1/2% of sales for the balance of the new agreement.

For commitments made between July 1, 2000 and June 30, 2001 to renew franchise agreements under BKC's Fiscal 2001 Early Successor Incentive Program, the renewal franchise fee increased to \$50,000. The royalty rate remained at 3 1/2% of sales through September 30, 2002, at which time it was reduced to 3% of sales for a three-year period. The royalty rate reverts back to 3 1/2% of sales effective October 1, 2005 for the remainder of any of the initial franchise term, and then increases to 4 1/2% of sales for the balance of the new franchise agreement.

After evaluating the applicable royalty reductions and the acceleration of the required capital improvements, in 2000 we elected to renew 48 franchise agreements under BKC's Early Successor Incentive Program. Burger King royalties, as a percentage of our Burger King restaurant sales, were 3.5% in 2006, 3.5% in 2005 and 3.4% in 2004. We anticipate our Burger King royalties, as a percentage of our Burger King restaurant sales, to increase to 3.7% in 2007 as a result of the above.



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### **Hispanic Brands Franchise Operations**

As of December 31, 2006, Pollo Tropical had three franchisees operating a total of 27 Pollo Tropical restaurants, 23 of which were located in Puerto Rico, two in Ecuador and two located on college campuses in Florida. As of December 31, 2006, Taco Cabana had two franchisees operating a total of three Taco Cabana restaurants. While our existing franchisees may open new restaurants from time to time, we are not actively expanding our franchise operations at the present time. However, we believe that there are significant opportunities to expand our Hispanic Brands outside of the United States and we may seek to franchise or license our Hispanic Brands in additional markets outside of the United States. Any such expansion into additional foreign markets ideally would take the form of a franchising or licensing arrangement with one or more experienced restaurant companies with operations in the target area. We believe that there are a number of geographic areas outside of the United States which have a significant component of the population with both adequate disposable income and a strong proclivity for foods similar to those offered by our Hispanic Brands. We currently have no understandings, commitments or agreements with respect to any such franchising or licensing arrangements of our Hispanic Brands outside of the United States other than for our franchised Pollo Tropical restaurants located in Puerto Rico and Ecuador.

All of our current franchisees are required to operate their restaurants in compliance with certain methods, standards and specifications developed by us regarding such matters as menu items, recipes, food preparation, materials, supplies, services, fixtures, furnishings, decor and signs. The franchisees have discretion to determine the prices to be charged to customers. In addition, all franchisees are required to purchase substantially all food, ingredients, supplies and materials from suppliers approved by us.

### **Advertising and Promotion**

We believe our Hispanic Brands are among the most highly recognized quick-casual restaurant brands in their core markets of south and central Florida and Texas. Pollo Tropical and Taco Cabana utilize an integrated, multi-level marketing approach that includes periodic chain-wide promotions, direct mail, in-store promotions, local store marketing and other strategies, including the use of radio and television advertising in their major markets. Combination value meals are also utilized as well as limited time offer menu item promotions. Pollo Tropical advertises in both English and Spanish media throughout the year. As a percentage of Pollo Tropical restaurant sales, Pollo Tropical's advertising expenditures were 1.6% in 2006, 1.9% in 2005 and 1.6% in 2004, due to lower television and radio advertising compared to prior years. As a percentage of our Taco Cabana restaurant sales, Taco Cabana's advertising expenditures were 4.1% in 2006, 4.2% in 2005 and 4.1% in 2004.

The efficiency and quality of advertising and promotional programs can significantly affect quick-casual/quick-service restaurant businesses. We believe that one of the major advantages of being a Burger King franchisee is the value of the extensive regional and national advertising and promotional programs conducted by BKC. In addition to the benefits derived from BKC's advertising spending, we supplement from time to time BKC's advertising and promotional activities with our own local advertising and promotions, including the purchase of additional television, radio and print advertising. The concentration of our Burger King restaurants in many of our markets permits us to leverage advertising in those markets. We also utilize promotional programs, such as combination value meals and discounted prices, targeted to our customers, in order to create a flexible and directed marketing program.

We are generally required to contribute 4% of restaurant sales from our Burger King restaurants to an advertising fund utilized by BKC for its advertising, promotional programs and public relations activities. BKC's advertising programs consist of national campaigns supplemented by local advertising. BKC's advertising campaigns are generally carried on television, radio and in circulated print media (national and regional newspapers and magazines).

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### **Product Development**

Each of Pollo Tropical and Taco Cabana has separate and complete product research and development functions, which we believe are comparable to other large multi-unit restaurant companies. These capabilities enable us to continually refine our menu offerings and develop new products for introduction in our Hispanic Brand restaurants. These functions include:

fully equipped test kitchens;

professional culinary and quality assurance team members;

consumer research protocol;

uniform and detailed product specification formats; and

product development committees that integrate marketing, operations, financial analysis and procurement.

Pollo Tropical's test kitchen is located in our Miami division headquarters. The facility includes cooking equipment that mirrors the capability of a Pollo Tropical restaurant and a tasting area. Permanent staff positions include a Senior Director of R&D, a Manager of R&D and a Corporate Chef.

Taco Cabana's test kitchen is located near our San Antonio division headquarters in leased commercial space. The facility includes a large test kitchen, with equipment that mirrors the capability of a Taco Cabana restaurant, office space for all R&D staff, and a large tasting and meeting room. Permanent staff positions include a Director of R&D, a Corporate Chef and a staff assistant.

### **Suppliers and Distributors**

For our Pollo Tropical and Taco Cabana restaurants, we have negotiated directly with local and national suppliers for the purchase of food and beverage products and supplies to ensure consistent quality and freshness and to obtain competitive prices. Pollo Tropical and Taco Cabana restaurants' food and supplies are ordered from approved suppliers and are shipped via distributors to the restaurants. Both brands are responsible for monitoring quality control and supervision of these suppliers and conduct inspections to observe the preparation and quality of products purchased. For our Pollo Tropical restaurants, Henry Lee, a division of Gordon Food Service, serves as our primary distributor of food and paper products under an agreement that expires on May 15, 2007. For our Taco Cabana restaurants, SYGMA Network, Inc. (SYGMA) serves as our primary distributor of food and beverage products and supplies. SYGMA purchases, warehouses and distributes products for these restaurants under a distribution service agreement that expires on June 1, 2009. We rely significantly on these suppliers but, in general, if any such suppliers are unable to service us, we believe that we have significant alternative sources available to us to avoid any material disruption in service. We also rely on Gold Kist under an agreement that expires on December 31, 2007 as our supplier and distributor of chicken for our Pollo Tropical restaurants and, although we believe that alternative sources of chicken are available to us, if such supplier is unable to service us, this could lead to a material disruption of service or supply until a new supplier is engaged, which could have a material adverse effect on our business. With respect to our distributors for our Pollo Tropical and Taco Cabana restaurants, although we believe that alternative distributors are available to us, if any of our distributors are unable to service us, this could lead to a material disruption of service or supply until a new distributor is engaged, which could have a material adverse effect on our business.

We are a member of a national purchasing cooperative, Restaurant Services, Inc., created for the Burger King system. Restaurant Services is a non-profit independent cooperative that acts as the purchasing agent for approved distributors to the Burger King system and serves to negotiate the lowest cost for the system. We use our purchasing power to negotiate directly with certain other vendors, to obtain favorable pricing and terms for supplying our Burger King restaurants. For our Burger King restaurants, we are required to purchase all of our foodstuffs, paper goods and packaging materials from BKC-approved suppliers. We currently utilize three distributors, Maines Paper & Food Service, Inc., Reinhart Food Service L.L.C. and MBM Food Service Inc., to



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supply our Burger King restaurants with the majority of their foodstuffs in various geographical areas and, as of December 31, 2006, such distributors supplied 63%, 32% and 5%, respectively, of our Burger King restaurants. We may purchase non-food items such as kitchen utensils, equipment maintenance tools and other supplies from any suitable source so long as such items meet BKC product uniformity standards. All BKC-approved distributors are required to purchase foodstuffs and supplies from BKC-approved manufacturers and purveyors. BKC is responsible for monitoring quality control and supervision of these manufacturers and conducts regular visits to observe the preparation of foodstuffs, and to run various tests to ensure that only quality foodstuffs are sold to BKC-approved suppliers. In addition, BKC coordinates and supervises audits of approved suppliers and distributors to determine continuing product specification compliance and to ensure that manufacturing plant and distribution center standards are met. Although we believe that we have alternative sources of supply available to our Burger King restaurants, in the event any distributors or suppliers for our Burger King restaurants are unable to service us, this could lead to a disruption of service or supply at our Burger King restaurants until a new distributor or supplier is engaged, which could have an adverse effect on our business.

### **Quality Assurance**

At each of our three concepts, our operational focus is closely monitored to achieve a high level of customer satisfaction via speed, order accuracy and quality of service. Our senior management and restaurant management staffs are principally responsible for ensuring compliance with our operating policies, and with respect to our Burger King restaurants, BKC's required operating procedures as well. We have uniform operating standards and specifications relating to the quality, preparation and selection of menu items, maintenance and cleanliness of the premises and employee conduct. In order to maintain compliance with these operating standards and specifications, we distribute to our restaurant operations management team detailed reports measuring compliance with various customer service standards and objectives, including the results of our mystery shopper program. These mystery shopper programs are conducted by an independent agency and consist of evaluations of speed, quality of service and other operational objectives including the cleanliness of our restaurants.

We also operate in accordance with quality assurance and health standards mandated by federal, state and local governmental laws and regulations. These standards include food preparation rules regarding, among other things, minimum cooking times and temperatures, maximum time standards for holding prepared food, food handling guidelines and cleanliness. To maintain these standards, we conduct unscheduled inspections of our restaurants. In addition, restaurant managers conduct internal inspections for taste, quality, cleanliness and food safety on a regular basis.

### **Trademarks**

We believe that our names and logos for our Hispanic Brands are important to our operations. We have registered our principal Pollo Tropical and Taco Cabana logos and designs with the U.S. Patent and Trademark Office on the Principal Register as a service mark for our restaurant services. We also have secured or have applied for state and federal registrations of several other advertising or promotional marks, including variations of our principal marks, and have applied for or been granted registrations in foreign countries of our principal marks and several other marks. We intend to protect both Pollo Tropical and Taco Cabana trademarks by appropriate legal action whenever necessary. In certain foreign countries, we have been involved in trademark opposition proceedings to defend our rights to register certain trademarks. In that regard, we have discovered that an individual unaffiliated with us has registered, without our knowledge, authorization or consent, a trademark in Spain and the European Community for a name and logo virtually identical to our Pollo Tropical name and logo. We intend to initiate a cancellation action to declare such unauthorized trademark registration null and void. Although we believe we will be successful in the action, there can be no assurance in this regard.

Other than the Pollo Tropical and Taco Cabana trademarks, we have no proprietary intellectual property other than the logo and trademark of Carrols. As a franchisee of Burger King, we also have contractual rights to use certain BKC-owned trademarks, service marks and other intellectual property relating to the Burger King concept.

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### **Government Regulation**

Various federal, state and local laws affect our business, including various health, sanitation, fire and safety standards. Restaurants to be constructed or remodeled are subject to state and local building code and zoning requirements. In connection with the development and remodeling of our restaurants, we may incur costs to meet certain federal, state and local regulations, including regulations promulgated under the Americans with Disabilities Act.

We are subject to the federal Fair Labor Standards Act and various state laws governing such matters as:

minimum wage requirements;

overtime; and

other working conditions and citizenship requirements.

A significant number of our food service personnel are paid at rates related to the federal, and where applicable, state minimum wage and, accordingly, increases in the minimum wage have increased and in the future will increase wage rates at our restaurants.

We are also subject to various federal, state and local environmental laws, rules and regulations. We believe that we conduct our operations in substantial compliance with applicable environmental laws and regulations. None of the applicable environmental laws or regulations has had a material adverse effect on our results of operations, cash flows or financial condition.

Taco Cabana is subject to alcoholic beverage control regulations that require state, county or municipal licenses or permits to sell alcoholic beverages at each location. Typically, licenses must be renewed annually and may be revoked or suspended for cause at any time. Licensing entities, authorized with law enforcement authority, may issue violations and conduct audits and investigations of the restaurant's records and procedures. Alcoholic beverage control regulations relate to numerous aspects of daily operations of Taco Cabana restaurants, including minimum age for consumption, certification requirements for employees, hours of operation, advertising, wholesale purchasing, inventory control and handling, storage and dispensing of alcoholic beverages. These regulations also prescribe certain required banking and accounting practices related to alcohol sales and purchasing.

Taco Cabana is subject to state dram-shop laws in the states in which it operates. Dram-shop laws provide a person injured by an intoxicated person the right to recover damages from an establishment that wrongfully served alcoholic beverages to the intoxicated or minor patron. We have specific insurance that covers claims arising under dram-shop laws. However, we cannot assure you that this insurance will be adequate to cover any claims that may be instituted against us.

With respect to the franchising of Pollo Tropical and Taco Cabana restaurants, we are subject to franchise and related regulations in the U.S. and certain foreign jurisdictions where we offer and sell franchises. These regulations include obligations to provide disclosure about our two concepts, the franchise agreements and the franchise system. The regulations also include obligations to register certain franchise documents in the U.S. and foreign jurisdictions, and obligations to disclose the substantive relationship between the parties to the agreements.

### **Competition**

The restaurant industry is highly competitive with respect to price, service, location and food quality. In each of our markets, our restaurants compete with a large number of national and regional restaurant chains, as well as locally owned restaurants, offering low and medium-priced fare. We also compete with convenience stores, delicatessens and prepared food counters in supermarkets, grocery stores, cafeterias and other purveyors of moderately priced and quickly prepared foods.

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We believe that:

product quality and taste;

brand recognition;

convenience of location;

speed of service;

menu variety;

price; and

ambiance

are the most important competitive factors in the quick-casual and quick-service restaurant segments and that our three concepts effectively compete in each category.

Pollo Tropical's competitors include national chicken-based concepts, such as Boston Market and KFC, and regional chicken-based concepts, as well as quick-service hamburger restaurant chains and other types of quick-casual restaurants.

Taco Cabana's restaurants, although part of the quick-casual segment of the restaurant industry, compete in Texas, Oklahoma and New Mexico with quick-service restaurants, including those in the quick-service Mexican segment such as Taco Bell, other quick-casual restaurants and traditional casual dining Mexican restaurants. We believe that Taco Cabana's combination of freshly prepared food, distinctive ambiance and superior service help to distinguish Taco Cabana restaurants from quick-service operators, while Taco Cabana's price-value relationship enables it to compete favorably with more expensive casual dining Mexican restaurants.

With respect to our Burger King restaurants, our largest competitors are McDonald's and Wendy's restaurants. According to Technomic, McDonald's restaurants had aggregate U.S. system-wide sales of \$25.6 billion for the year ended December 31, 2005 and operated 13,727 restaurants in the United States at that date, and Wendy's restaurants had aggregate system-wide sales of \$7.7 billion for the year ended December 31, 2005 and operated 6,018 restaurants in the United States at that date.

### **Employees**

As of December 31, 2006, we employed approximately 16,400 persons, of which approximately 300 were administrative personnel and approximately 16,000 were restaurant operations personnel. None of our employees is covered by collective bargaining agreements. We believe that our relations with our employees are good.

### **Availability of Information**

We file annual, quarterly and current reports and other information with the Securities and Exchange Commission (the "SEC"). The public may read and copy any materials we file with the SEC at the SEC's 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. The SEC also maintains an Internet site that contains reports, proxy and information statements and other information regarding issuers that file electronically with the SEC. The address of that site is <http://www.sec.gov>.

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We make available through our internet website ([www.carrols.com](http://www.carrols.com)) our annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended, as soon as reasonably practicable after electronically filing such material with the SEC. The reference to our website address is a textual reference only, meaning that it does not constitute incorporation by reference of the information contained on the website and should not be considered part of this document.

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### **ITEM 1A. RISK FACTORS**

You should carefully consider the risks described below, as well as other information and data included in this Annual Report on Form 10-K. Any of the following risks could materially adversely affect our business, consolidated financial condition or results of operations.

**Intense competition in the restaurant industry could make it more difficult to expand our business and could also have a negative impact on our operating results if customers favor our competitors or we are forced to change our pricing and other marketing strategies.**

The restaurant industry is highly competitive. In each of our markets, our restaurants compete with a large number of national and regional restaurant chains, as well as locally owned restaurants, offering low and medium-priced fare. We also compete with convenience stores, delicatessens and prepared food counters in grocery stores, supermarkets, cafeterias and other purveyors of moderately priced and quickly prepared food.

Pollo Tropical's competitors include national chicken-based concepts, such as Boston Market and Kentucky Fried Chicken (KFC), and regional chicken-based concepts as well as quick-service hamburger restaurant chains and other types of quick-casual restaurants. Our Taco Cabana restaurants, although part of the quick-casual segment of the restaurant industry, compete with quick-service restaurants, including those in the quick-service Mexican segment such as Taco Bell, other quick-casual restaurants and traditional casual dining Mexican restaurants. With respect to our Burger King restaurants, our largest competitors are McDonald's and Wendy's restaurants.

To remain competitive, we, as well as certain of the other major quick-casual and quick-service restaurant chains, have increasingly offered selected food items and combination meals at discounted prices. These changes in pricing and other marketing strategies have had, and in the future may continue to have, a negative impact on our sales and earnings.

**Factors specific to the quick-casual and quick-service restaurant segments may adversely affect our results of operations, which may cause a decrease in earnings and revenues.**

The quick-casual and quick-service restaurant segments are highly competitive and can be materially adversely affected by many factors, including:

changes in local, regional or national economic conditions;

changes in demographic trends;

changes in consumer tastes;

changes in traffic patterns;

increases in fuel prices, including a continuation of the current relatively higher levels of gasoline prices;

consumer concerns about health and nutrition;

increases in the number of, and particular locations of, competing restaurants;

inflation;



increases in utility costs;

increases in the cost of food, such as beef and chicken, and packaging;

consumer dietary considerations;

increased labor costs, including healthcare and minimum wage requirements;

regional weather conditions; and

the availability of experienced management and hourly-paid employees.

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**Our continued growth depends on our ability to open and operate new restaurants profitably, which in turn depends on our continued access to capital, and newly acquired or developed restaurants may not perform as we expect and we cannot assure you that our growth and development plans will be achieved.**

Our continued growth depends on our ability to develop additional Pollo Tropical and Taco Cabana restaurants and to selectively acquire and develop additional Burger King restaurants. Development involves substantial risks, including the following:

the inability to fund development;

development costs that exceed budgeted amounts;

delays in completion of construction;

the inability to obtain all necessary zoning and construction permits;

the inability to identify, or the unavailability of, suitable sites on acceptable leasing or purchase terms;

developed restaurants that do not achieve desired revenue or cash flow levels once opened;

incurring substantial unrecoverable costs in the event a development project is abandoned prior to completion;

the inability to recruit, train and retain managers and other employees necessary to staff each new restaurant;

changes in governmental rules, regulations and interpretations; and

changes in general economic and business conditions.

We cannot assure you that our growth and development plans can be achieved. Our development plans will require additional management, operational and financial resources. For example, we will be required to recruit and train managers and other personnel for each new restaurant. We cannot assure you that we will be able to manage our expanding operations effectively and our failure to do so could adversely affect our results of operations. In addition, our ability to open new restaurants and to grow, as well as our ability to meet other anticipated capital needs, will depend on our continued access to external financing, including borrowings under our senior credit facility. We cannot assure you that we will have access to the capital we need on acceptable terms or at all, which could materially adversely affect our business.

Additionally, we may encounter difficulties growing beyond our presence in our existing core markets. We cannot assure you that we will be able to successfully grow our market presence beyond the current key regions within our existing markets, as we may encounter well-established competitors in new areas. In addition, we may be unable to find attractive locations or successfully market our products as we attempt to expand beyond our existing core markets, as the competitive circumstances and consumer characteristics in these new areas may differ substantially from those in areas in which we currently operate. As a result of the foregoing, we cannot assure you that we will be able to successfully integrate or profitably operate our new restaurants outside our core markets.

**Our expansion into new markets may present increased risks due to our unfamiliarity with the area.**

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Some of our new restaurants are and will be located in areas where we have little or no meaningful experience. Those markets may have different competitive conditions, consumer tastes and discretionary spending patterns than our existing markets, which may cause our new restaurants to be less successful than restaurants in our existing markets or to incur losses. An additional risk of expanding into new markets is the lack of market awareness of the Pollo Tropical or Taco Cabana brand. Restaurants opened in new markets may open at lower average weekly sales volumes than restaurants opened in existing markets, and may have higher restaurant-level operating expense ratios than in existing markets. Sales at restaurants opened in new markets may take longer to reach average unit volumes, if at all, thereby adversely affecting our operating results.

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Opening new restaurants in areas in which we have little or no operating experience and in which potential customers may not be familiar with our restaurants may include costs related to the opening, operation and promotion of those restaurants that are substantially greater than those incurred by our restaurants in other areas. Even though we may incur substantial additional costs with respect to these new restaurants, they may attract fewer customers than our more established restaurants in existing markets.

### **We could be adversely affected by additional instances of mad cow disease, avian flu or other food-borne illness, as well as widespread negative publicity regarding food quality, illness, injury or other health concerns.**

Negative publicity about food quality, illness, injury or other health concerns (including health implications of obesity and transfatty acids) or similar issues stemming from one restaurant or a number of restaurants could materially adversely affect us, regardless of whether they pertain to our own restaurants or to restaurants owned or operated by other companies. For example, health concerns about the consumption of beef or chicken or by specific events such as the outbreak of mad cow disease or avian flu could lead to changes in consumer preferences, reduce consumption of our products and adversely affect our financial performance. These events could reduce the available supply of beef or chicken or significantly raise the price of beef or chicken.

In addition, we cannot guarantee that our operational controls and employee training will be effective in preventing food-borne illnesses, food tampering and other food safety issues that may affect our restaurants. Food-borne illness or food tampering incidents could be caused by customers, employees or food suppliers and transporters and, therefore, could be outside of our control. Any publicity relating to health concerns or the perceived or specific outbreaks of food-borne illnesses, food tampering or other food safety issues attributed to one or more of our restaurants, could result in a significant decrease in guest traffic in all of our restaurants and could have a material adverse effect on our results of operations. In addition, similar publicity or occurrences with respect to other restaurants or restaurant chains could also decrease our guest traffic and have a similar material adverse effect on us.

### **Our substantial indebtedness could adversely affect our financial condition and our ability to operate our business.**

We have a substantial amount of indebtedness. As of December 31, 2006, we had \$358.5 million of outstanding indebtedness, including \$118.4 million of indebtedness under our prior senior credit facility, as defined in Item 6 Selected Financial Data, (excluding \$15.0 million of outstanding letters of credit and \$35.0 million of unused revolving credit borrowing availability under our prior senior credit facility), \$180 million of 9% Senior Subordinated Notes due 2013 (the Notes), \$58.6 million of lease financing obligations and \$1.5 million of capital leases. On March 9, 2007, Carrols terminated its prior senior credit facility and entered into a loan agreement providing for a new senior credit facility with a syndicate of lenders (which we refer to herein as new senior credit facility). Our new senior credit facility totals approximately \$185.0 million, consisting of \$120.0 million principal amount of term loan A borrowings maturing on March 8, 2013 (or earlier on September 30, 2012 if the Notes are not refinanced by June 30, 2012) and a \$65.0 million revolving credit facility (including a sub limit of up to \$25.0 million for letters of credit and up to \$5.0 million for swingline loans), maturing on March 8, 2012. As a result, we are a highly leveraged company. This level of indebtedness could have important consequences, including the following:

it will limit our ability to borrow money to fund our working capital, capital expenditures, acquisitions and debt service requirements and other financing needs;

a substantial portion of our operating cash flow will be dedicated to the repayment of our indebtedness and related interest, including indebtedness we may incur in the future;

our interest expense would increase if interest rates in general increase because a substantial portion of our indebtedness, including all of our indebtedness under our senior credit facility, bears interest at floating rates;

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it may limit our flexibility in planning for, or reacting to, changes in our business and future business opportunities;

we are more highly leveraged than some of our competitors, which may place us at a competitive disadvantage;

it may make us more vulnerable to a downturn in our business, industry or the economy in general; and

there would be a material adverse effect on our business and financial condition if we were unable to service our indebtedness or obtain additional financing as needed.

**Despite our substantial indebtedness, we may still incur significantly more debt, which could further exacerbate the risks described above.**

Although covenants under our new senior credit facility and the Indenture (the Indenture ) dated as of December 15, 2004 among Carrols, the Subsidiary Guarantors (as defined therein) and The Bank of New York, as trustee, governing the Notes limit our ability and the ability of our present and future restricted subsidiaries to incur additional indebtedness, the terms of our new senior credit facility and the Indenture governing the Notes permit us to incur significant additional indebtedness, including unused availability under our new revolving credit facility. As of December 31, 2006, we had \$35.0 million available for additional revolving credit borrowings under our prior senior credit facility (after reserving for \$15.0 million of letters of credit outstanding), subject to compliance with customary borrowing conditions. The new senior credit facility provides for a \$65.0 million revolving credit facility of which \$4.3 million was borrowed upon the close of the new senior credit facility on March 9, 2007 (excluding \$15.0 million reserved for outstanding letters of credit). In addition, neither the new senior credit facility nor the Indenture governing the Notes prevent us from incurring obligations that do not constitute indebtedness as defined in those documents. To the extent that we incur additional indebtedness or other obligations, the risks associated with our substantial leverage described above, including our possible inability to service our debt, would increase.

**We may not be able to generate sufficient cash flows to meet our debt service obligations.**

Our ability to make payments on and to refinance our indebtedness and to fund planned capital expenditures will depend on our ability to generate cash from our future operations and on our continued access to external sources of financing. This, to a certain extent, is subject to general economic, financial, competitive, legislative, regulatory and other factors that are beyond our control.

Our business may not generate sufficient cash flow from operations and future borrowings under the new senior credit facility or from other sources may not be available to us in an amount sufficient to enable us to repay our indebtedness or to fund our other liquidity needs, including capital expenditure requirements. If we complete an acquisition, our debt service requirements could increase. A substantial portion of our indebtedness, including all of our indebtedness under the new senior credit facility, bears interest at floating rates, and therefore if interest rates increase, our debt service requirements will increase. We may need to refinance or restructure all or a portion of our indebtedness on or before maturity. We may not be able to refinance or restructure any of our indebtedness, including the new senior credit facility and the Notes, on commercially reasonable terms, or at all. If we cannot service or refinance or restructure our indebtedness, we may have to take actions such as selling assets, seeking additional equity or reducing or delaying capital expenditures, strategic acquisitions, investments and alliances, any of which could have a material adverse effect on our operations. Additionally, we may not be able to effect such actions, if necessary, on commercially reasonable terms, or at all.

In addition, upon the incurrence of specific kinds of change of control events, we must offer to purchase the Notes at 101% of the principal amount thereof plus accrued and unpaid interest to the purchase date. We may not have sufficient funds available to make any required repurchases of the Notes, and restrictions under our new senior credit facility may not allow that repurchase. If we fail to repurchase the Notes in that circumstance, we

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will be in default under the Indenture governing the Notes and, under cross-default clauses; we will also be in default under the new senior credit facility. In addition, certain change of control events will constitute an event of default under the new senior credit facility. A default under the new senior credit facility could result in an event of default under the Indenture if the administrative agent or the lenders accelerate the debt under the new senior credit facility. In the event of a default under our new senior credit facility or the Indenture, the holders of the applicable indebtedness generally would be able to declare all of that indebtedness to be due and payable as described in the following risk factor. Upon the occurrence of a change of control we could seek to refinance the indebtedness under the new senior credit facility and the Notes or obtain a waiver from the lenders or the noteholders. We cannot assure you, however, that we would be able to obtain a waiver or refinance our indebtedness on commercially reasonable terms, if at all, in which case we might be required to sell assets to satisfy our repayment obligations. Any future debt that we incur may also contain provisions requiring the repayments of that debt upon the occurrence of similar change of control events or restrictions on repayment of the Notes or borrowings under our new senior credit facility upon a change of control.

**Restrictive covenants in the new senior credit facility and the Indenture governing the Notes may restrict our ability to operate our business and to pursue our business strategies; and defaults under our debt instruments may allow the lenders to declare borrowings due and payable.**

The new senior credit facility and the Indenture governing the Notes limit our ability, among other things, to:

incur additional indebtedness or issue preferred stock;

pay dividends or make distributions in respect of our capital stock or make certain other restricted payments or investments;

sell assets, including capital stock of restricted subsidiaries;

agree to limitations on our ability and the ability of our restricted subsidiaries to make distributions;

enter into transactions with our subsidiaries and affiliates;

incur liens;

enter into new lines of business; and

engage in consolidations, mergers or sales of substantially all of our assets.

In addition, the new senior credit facility requires us to comply with various operational and other covenants and restricts our ability to prepay our subordinated indebtedness. Also, the prior senior credit facility required and the new senior credit facility requires, us to maintain compliance with specified financial ratios, including fixed charge coverage, senior leverage and total leverage ratios (as such terms are defined in the new senior credit facility). At December 31, 2006, we were in compliance with such covenants under the prior senior credit facility. At December 31, 2006, under the prior senior credit facility, our fixed charge coverage ratio was 1.41 to 1.00 which was in excess of the required minimum fixed charge coverage ratio under the prior senior credit facility at December 31, 2006 of 1.25 to 1.00, our senior leverage ratio was 1.33 to 1.00 which was lower than the maximum allowable senior leverage ratio under the prior senior credit facility at December 31, 2006 of 2.50 to 1.00 and our total leverage ratio was 3.32 to 1.00 which was lower than the maximum allowable total leverage ratio under the prior senior credit facility at December 31, 2006 of 5.00 to 1.00. However, our ability to comply with these ratios under the new senior credit facility may be affected by events beyond our control. Any other debt instruments we enter into in the future may also have provisions similar to those described above.

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The restrictions contained in the Indenture governing the Notes and the new senior credit facility and in any other debt instruments we may enter into in the future could:

limit our ability to plan for or react to market conditions or meet capital needs or otherwise restrict our activities or business plans; and

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adversely affect our ability to finance our operations, strategic acquisitions, investments or alliances or other capital needs or to engage in other business activities that would be in our interest.

As noted above, our ability to remain in compliance with agreements and covenants in our debt instruments depends upon our results of operations and may be affected by events beyond our control, including economic, financial and industry conditions. Accordingly, there can be no assurance that we will remain in compliance with those agreements and covenants.

In the event of a default under our new senior credit facility or the Indenture and in any other debt instruments we may enter into in the future, the holders of the applicable indebtedness generally would be able to declare all of that indebtedness, together with accrued interest, to be due and payable. In addition, borrowings under the new senior credit facility are secured by a pledge of all of the outstanding capital stock of Carrols and its material subsidiaries and, in the event of a default under that facility, the lenders generally would be entitled to seize the collateral. In addition, default under one debt instrument could in turn permit lenders under other debt instruments to declare borrowings outstanding under those other instruments to be due and payable pursuant to cross default clauses. Moreover, upon the occurrence of an event of default under the new senior credit facility, the commitment of the lenders to make any further loans to us would be terminated. Any such actions or events could force us into bankruptcy and liquidation and we cannot provide any assurance that we could repay our obligations under the new senior credit facility or the Notes or any other indebtedness we may incur in the future. Moreover, our assets and cash flow may not be sufficient to fully repay borrowings under our debt instruments, either upon maturity or if accelerated following a default. Accordingly, the occurrence of a default under any debt instrument, unless cured or waived, would likely have a material adverse effect on our business.

**We are highly dependent on the Burger King system and our ability to renew our franchise agreements with Burger King Corporation. The failure to renew our franchise agreements or Burger King's failure to compete effectively could materially adversely affect our results of operations.**

Due to the nature of franchising and our agreements with BKC, our success is, to a large extent, directly related to the success of the nationwide Burger King system. In turn, the ability of the nationwide Burger King system to compete effectively depends upon the success of the management of the Burger King system and the success of its advertising programs and new products. We cannot assure you that Burger King will be able to compete effectively with other quick-service restaurants. As a result, any failure of Burger King to compete effectively would likely have a material adverse effect on our operating results.

Under each of our franchise agreements with BKC, we are required to comply with operational programs established by BKC. For example, our franchise agreements with BKC require that our restaurants comply with specified design criteria. In addition, BKC generally has the right to require us during the tenth year of a franchise agreement to remodel our restaurants to conform to the then-current image of Burger King, which may require the expenditure of considerable funds. In addition, although not required by the franchise agreements, we may not be able to avoid adopting menu price discount promotions instituted by BKC that may be unprofitable.

Our franchise agreements typically have a 20-year term after which BKC's consent is required to receive a successor franchise agreement. Our franchise agreements with BKC that are set to expire over the next three years are as follows:

18 of our franchise agreements with BKC are due to expire in 2007;

28 of our franchise agreements with BKC are due to expire in 2008; and

17 of our franchise agreements with BKC are due to expire in 2009.

We cannot assure you that BKC will grant each of our future requests for successor franchise agreements, and any failure of BKC to renew our franchise agreements could adversely affect our operating results. In addition, as a condition of approval of a successor franchise agreement, BKC may require us to make capital improvements to particular restaurants to bring them up to Burger King current image standards, which may require us to incur substantial costs.



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In addition, our franchise agreements with BKC do not give us exclusive rights to operate Burger King restaurants in any defined territory. Although we believe that BKC generally seeks to ensure that newly granted franchises do not materially adversely affect the operations of existing Burger King restaurants, we cannot assure you that franchises granted by BKC to third parties will not adversely affect any Burger King restaurants that we operate.

### **If we fail to maintain an effective system of internal controls, we may not be able to accurately report our financial results.**

Effective internal controls are necessary for us to provide reliable financial reports and effectively prevent fraud. Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate. In the past, we have identified and reported material weaknesses in our internal control over financial reporting and concluded that our disclosure controls and procedures were ineffective. In addition, we may in the future discover areas of our internal controls that need improvement or that constitute material weaknesses. A material weakness is a control deficiency (within the meaning of Public Company Accounting Oversight Board Auditing Standard No. 2), or combination of control deficiencies, that results in more than a remote likelihood that a material misstatement of annual or interim financial statements will not be prevented or detected. We are continuing to work to improve our internal controls. We cannot be certain that these measures will ensure that we implement and maintain adequate controls over our financial processes and reporting in the future. Any failure to remediate material weaknesses in our internal control over financial reporting or to implement and maintain effective internal controls, or difficulties encountered in their implementation, could cause us to fail to timely meet our reporting obligations, result in material misstatements in our financial statements or could result in defaults under our new senior credit facility, the Indenture governing the Notes or under any other debt instruments we may enter into in the future. Deficiencies in our internal controls could also cause investors to lose confidence in our reported financial information, which could have a negative effect on the trading price of our common stock.

### **There can be no assurance that we will not have to restate our financial statements in the future.**

We have undergone several restatements of our financial statements. In response to this situation, we have taken what we believe to be the necessary measures to ensure that restatements will not occur in the future. However, there can be no assurance that future restatements will not be necessary due to evolving policies, revised or new accounting pronouncements or other factors. Any future restatements of our financial statements could cause us to fail to timely meet our reporting obligations or could result in defaults under our new senior credit facility, the Indenture governing the Notes or under any other debt instruments we may enter into in the future. Future restatements of our financial statements could also cause investors to lose confidence in our reported financial information, which could have a negative effect on the trading price of our common stock.

### **We may incur significant liability or reputational harm if claims are brought against us or against our franchisees.**

We or our franchisees may be subject to complaints, regulatory proceedings or litigation from guests or other persons alleging food-related illness, injuries suffered in our premises or other food quality, health or operational concerns, including environmental claims. In addition, in recent years a number of restaurant companies have been subject to lawsuits, including class action lawsuits, alleging, among other things, violations of federal and state law regarding workplace and employment matters, discrimination, harassment, wrongful termination and wage, rest break, meal break and overtime compensation issues and, in the case of quick service restaurants, alleging that they have failed to disclose the health risks associated with high-fat foods and that their marketing practices have encouraged obesity. We may also be subject to litigation or other actions initiated by governmental authorities, our employees and our franchisees, among others, based upon these and other matters. For example, in November 1998, the Equal Employment Opportunity Commission (the EEOC ) filed suit in the

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United States District Court for the Northern District of New York against Carrols, alleging that Carrols engaged in a pattern and practice of unlawful discrimination, harassment and retaliation against former and current female employees. Although the case was dismissed by the court, subject to possible appeal by the EEOC, the court noted that it was not ruling on the claims, if any, that individual employees might have against Carrols. A significant judgment against us could have a material adverse effect on our financial performance or liquidity. Adverse publicity resulting from such allegations or occurrences or alleged discrimination or other operating issues stemming from one of our locations, a number of our locations or our franchisees could adversely affect our business, regardless of whether the allegations are true, or whether we are ultimately held liable. Any cases filed against us could materially adversely affect us if we lose such cases and have to pay substantial damages or if we settle such cases. In addition, any such cases may materially and adversely affect our operations by increasing our litigation costs and diverting our attention and resources to address such actions. In addition, if a claim is successful, our insurance coverage may not cover or be adequate to cover all liabilities or losses and we may not be able to continue to maintain such insurance, or to obtain comparable insurance at a reasonable cost, if at all. If we suffer losses, liabilities or loss of income in excess of our insurance coverage or if our insurance does not cover such loss, liability or loss of income, there could be a material adverse effect on our results of operations. See Item 3. Legal Proceedings.

**Our franchisees could take actions that harm our reputation and reduce our franchise revenues.**

As of December 31, 2006, a total of 30 Pollo Tropical and Taco Cabana restaurants were owned and operated by our franchisees. We do not exercise control of the day-to-day operations of our franchisees. While we attempt to ensure that franchisee-owned restaurants maintain the same high operating standards as our company-owned restaurants, one or more of these franchisees may fail to meet these standards. Any shortcomings at our franchisee-owned restaurants are likely to be attributed to our company as a whole and could adversely affect our reputation and damage our brands, as well as have a direct negative impact on franchise revenues we receive from these franchisees

**If the sale/leaseback market requires significantly higher yields, we may not enter into sale/leaseback transactions and as a result would not receive the related net proceeds.**

From time to time, we sell our restaurant properties in sale-leaseback transactions. We historically have used, and intend to use, the net proceeds from such transactions to reduce outstanding debt and fund future capital expenditures for new restaurant development. However, the sale-leaseback market may cease to be a reliable source of additional cash flows for us in the future if capitalization rates become less attractive or other unfavorable market conditions develop. For example, should the sale-leaseback market require significantly higher yields (which may occur as interest rates rise), we may not enter into sale-leaseback transactions, which could adversely affect our ability to reduce outstanding debt and fund new capital expenditures for future restaurant development.

**Changes in consumer taste could negatively impact our business.**

We obtain a significant portion of our revenues from the sale of hamburgers, chicken, various types of sandwiches, and Mexican and other ethnic foods. The quick-casual and quick-service restaurant segments are characterized by the frequent introduction of new products, often accompanied by substantial promotional campaigns and are subject to changing consumer preferences, tastes, and eating and purchasing habits. Our success depends on our ability to anticipate and respond to changing consumer preferences, tastes and eating and purchasing habits, as well other factors affecting the restaurant industry, including new market entrants and demographic changes. We may be forced to make changes in our menu items in order to respond to changes in consumer tastes or dining patterns, and we may lose customers who do not prefer the new menu items. In recent years, numerous companies in the quick-casual and quick-service restaurant segments have introduced products positioned to capitalize on the growing consumer preference for food products that are, or are perceived to be, healthy, nutritious, low in calories and low in fat content. If we do not or, in the case of our Burger King

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restaurants, if BKC does not, continually develop and successfully introduce new menu offerings that appeal to changing consumer preferences or if we do not timely capitalize on new products, our operating results will suffer. In addition, any significant event that adversely affects consumption of our products, such as cost, changing tastes or health concerns, could adversely affect our financial performance.

**If a significant disruption in service or supply by any of our suppliers or distributors were to occur, it could create disruptions in the operations of our restaurants, which could have a material adverse effect on our business.**

Our financial performance is dependent on our continuing ability to offer fresh, quality food at competitive prices. If a significant disruption in service or supply by certain of our suppliers or distributors were to occur, it could create disruptions in the operations of our restaurants, which could have a material adverse effect on us.

For our Pollo Tropical and Taco Cabana restaurants, we have negotiated directly with local and national suppliers for the purchase of food and beverage products and supplies. Pollo Tropical and Taco Cabana restaurants' food and supplies are ordered from approved suppliers and are shipped via distributors to the restaurants. For our Pollo Tropical restaurants, Henry Lee, a division of Gordon Food Service, serves as our primary distributor of food and paper products under an agreement that expires on May 15, 2007. For our Taco Cabana restaurants, SYGMA Network, Inc. serves as our primary distributor of food and beverage products and supplies under a distribution services agreement that expires on June 1, 2009. We also rely on Gold Kist under an agreement that expires on December 31, 2007 as our supplier and distributor of chicken for our Pollo Tropical restaurants and if Gold Kist is unable to service us, this could lead to a material disruption of service or supply until a new supplier is engaged which could have a material adverse effect on our business. With respect to our distributors for our Pollo Tropical and Taco Cabana restaurants, if any of our distributors is unable to service us, this could lead to a material disruption of service or supply until a new distributor is engaged, which could have a material adverse effect on our business. For our Burger King restaurants, we are a member of a national purchasing cooperative, Restaurant Services, Inc., which serves as the purchasing agent for approved distributors to the Burger King system. We are required to purchase all of our foodstuffs, paper goods and packaging materials from BKC-approved suppliers for our Burger King restaurants. We currently utilize three distributors, Maines Paper & Food Service, Inc., Reinhart Food Service L.L.C. and MBM Food Service Inc., to supply our Burger King restaurants with the majority of their foodstuffs in various geographical areas and, as of December 31, 2006, such distributors supplied 63%, 32% and 5%, respectively of our Burger King restaurants. Although we believe that we have alternative sources of supply available to our Burger King restaurants, in the event any distributors or suppliers for our Burger King restaurants are unable to service us, this could lead to a disruption of service or supply at our Burger King restaurants until a new distributor or supplier is engaged, which could have an adverse effect on our business.

**If labor costs increase, we may not be able to make a corresponding increase in our prices and our operating results may be adversely affected.**

Wage rates for a substantial number of our employees are at or slightly above the minimum wage. As federal and/or state minimum wage rates increase, we may need to increase not only the wage rates of our minimum wage employees but also the wages paid to the employees at wage rates which are above the minimum wage, which will increase our costs. To the extent that we are not able to raise our prices to compensate for increases in wage rates, this could have a material adverse effect on our operating results.

**The efficiency and quality of our competitors' advertising and promotional programs and the extent and cost of our advertising could have a material adverse effect on our results of operations and financial condition.**

Should our competitors increase spending on advertising and promotion, should the cost of television or radio advertising increase, should our advertising funds materially decrease for any reason, or should our advertising and promotion be less effective than our competitors', there could be a material adverse effect on our results of operations and financial condition. In that regard, the success of our Burger King restaurants also depends in part upon advertising campaigns and promotions by BKC.

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### **Newly acquired or developed restaurants may reduce sales at our neighboring restaurants.**

We intend to continue to open restaurants in our existing core markets, particularly the core markets served by our Pollo Tropical and Taco Cabana restaurants. To the extent that we open a new restaurant in the vicinity of one or more of our existing restaurants within the same chain, it is possible that some of the customers who previously patronized those existing restaurants may choose to patronize the new restaurant instead, reducing sales at those existing restaurants. Accordingly, to the extent we open new restaurants in our existing markets, sales at some of our existing restaurants in those markets may decline.

### **Our business is regional and we therefore face risks related to reliance on certain markets.**

As of December 31, 2006, excluding our franchised locations, all but two of our Pollo Tropical restaurants were located in Florida and approximately 96% of our Taco Cabana restaurants were located in Texas. Also, as of December 31, 2006, 65% of our Burger King restaurants were located in New York and Ohio. Therefore, the economic conditions, state and local government regulations, weather conditions or other conditions affecting Florida, Texas, New York and Ohio and the tourism industry affecting Florida may have a material impact on the success of our restaurants in those locations. For example, the events of September 11, 2001 had a significant negative impact on tourism in Florida, which adversely impacted the revenues and operating results at our Pollo Tropical restaurants.

Many of our restaurants are located in regions that may be susceptible to severe weather conditions. As a result, adverse weather conditions in any of these areas could damage these restaurants, result in fewer guest visits to these restaurants and otherwise have a material adverse impact on our business. For example, our business was adversely impacted in the fourth quarter of 2005 and in the future may be adversely affected by hurricanes and severe weather in Florida and Texas.

### **We cannot assure you that the current locations of our existing restaurants will continue to be economically viable or that additional locations will be acquired at reasonable costs.**

The location of our restaurants has significant influence on their success. We cannot assure you that current locations will continue to be economically viable or that additional locations can be acquired at reasonable costs. In addition, the economic environment where restaurants are located could decline in the future, which could result in reduced sales in those locations. We cannot assure you that new sites will be profitable or as profitable as existing sites.

### **The loss of the services of our senior executives could have a material adverse effect on our business, financial condition or results of operations.**

Our success depends to a large extent upon the continued services of our senior management, including Alan Vituli, Chairman of the Board and Chief Executive Officer, and Daniel T. Accordino, President and Chief Operating Officer, who have substantial experience in the restaurant industry. We believe that it would be extremely difficult to replace Messrs. Vituli and Accordino with individuals having comparable experience. Consequently, the loss of the services of Mr. Vituli or Mr. Accordino could have a material adverse effect on our business, financial condition or results of operations.

### **Government regulation could adversely affect our financial condition and results of operations.**

We are subject to extensive laws and regulations relating to the development and operation of restaurants, including regulations relating to the following:

zoning;

the preparation and sale of food;

liquor licenses which allow us to serve alcoholic beverages at our Taco Cabana restaurants;



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employer/employee relationships, including minimum wage requirements, overtime, working and safety conditions, and citizenship requirements;

federal and state laws that prohibit discrimination and laws regulating design and operation of facilities, such as the Americans With Disabilities Act of 1990; and

federal and state regulations governing the operations of franchises, including rules promulgated by the Federal Trade Commission. In the event that legislation having a negative impact on our business is adopted, you should be aware that it could have a material adverse impact on us. For example, substantial increases in the minimum wage could adversely affect our financial condition and results of operations. Local zoning or building codes or regulations and liquor license approvals can cause substantial delays in our ability to build and open new restaurants. Local authorities may revoke, suspend or deny renewal of our liquor licenses if they determine that our conduct violates applicable regulations. Any failure to obtain and maintain required licenses, permits and approvals could adversely affect our operating results.

**If one of our employees sells alcoholic beverages to an intoxicated or minor patron, we may be liable to third parties for the acts of the patron.**

We serve alcoholic beverages at our Taco Cabana restaurants and are subject to the dram-shop statutes of the jurisdictions in which we serve alcoholic beverages. Dram-shop statutes generally provide that serving alcohol to an intoxicated or minor patron is a violation of the law.

In most jurisdictions, if one of our employees sells alcoholic beverages to an intoxicated or minor patron we may be liable to third parties for the acts of the patron. We cannot guarantee that those patrons will not be served or that we will not be subject to liability for their acts. Our liquor liability insurance coverage may not be adequate to cover any potential liability and insurance may not continue to be available on commercially acceptable terms or at all, or we may face increased deductibles on such insurance. Any increase in the number or size of dram-shop claims could have a material adverse effect on us as a result of the costs of defending against such claims; paying deductibles and increased insurance premium amounts; implementing improved training and heightened control procedures for our employees; and paying any damages or settlements on such claims.

**Federal, state and local environmental regulations relating to the use, storage, discharge, emission and disposal of hazardous materials could expose us to liabilities, which could adversely affect our results of operations.**

We are subject to a variety of federal, state and local environmental regulations relating to the use, storage, discharge, emission and disposal of hazardous materials. We own and lease numerous parcels of real estate on which our restaurants are located.

Failure to comply with environmental laws could result in the imposition of severe penalties or restrictions on operations by governmental agencies or courts of law that could adversely affect our operations. Also, if contamination is discovered on properties owned or operated by us, including properties we owned or operated in the past, we can be held liable for severe penalties and costs of remediation. These penalties could adversely affect our results of operations.

**We are subject to all of the risks associated with leasing space subject to long-term non-cancelable leases.**

Our leases generally have initial terms of 20 years, and typically provide for renewal options in five year increments as well as for rent escalations. Generally, our leases are net leases, which require us to pay all of the costs of insurance, taxes, maintenance and utilities. We generally cannot cancel these leases. Additional sites that we lease are likely to be subject to similar long-term non-cancelable leases. If an existing or future restaurant is

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not profitable, and we decide to close it, we may nonetheless be committed to perform our monetary obligations under the applicable lease including, among other things, paying all amounts due for the balance of the lease term. In addition, as each of our leases expire, we may fail to negotiate renewals, either on commercially acceptable terms or at all, which could cause us to close restaurants in desirable locations.

**We may, in the future, seek to pursue acquisitions and we may not find restaurant companies that are suitable acquisition candidates or successfully operate or integrate any restaurant companies we may acquire.**

We may in the future seek to acquire other restaurant chains. Although we believe that opportunities for future acquisitions may be available from time to time, increased competition for acquisition candidates exists and may continue in the future. Consequently, there may be fewer acquisition opportunities available to us as well as higher acquisition prices. There can be no assurance that we will be able to identify, acquire, manage or successfully integrate acquired restaurant companies without substantial costs, delays or operational or financial problems. In the event we are able to acquire other restaurant companies, the integration and operation of the acquired restaurants may place significant demands on our management, which could adversely affect our ability to manage our existing restaurants. We also face the risk that our existing systems, procedures and financial controls will be inadequate to support any restaurant chains we may acquire and that we may be unable to successfully integrate the operations and financial systems of any chains we may acquire with our own systems. While we may evaluate and discuss potential acquisitions from time to time, we currently have no understandings, commitments or agreements with respect to any acquisitions. We may be required to obtain additional financing to fund future acquisitions. There can be no assurance that we will be able to obtain additional financing on acceptable terms or at all. Both the new senior credit facility and the Indenture governing the Notes contain restrictive covenants that may prevent us from incurring additional debt or acquiring additional restaurant chains. See Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations Liquidity and Capital Resources.

**Our failure or inability to enforce our trademarks or other proprietary rights could adversely affect our competitive position or the value of our brand.**

We own certain common law trademark rights and a number of federal and international trademark and service mark registrations, including the Pollo Tropical name and logo and Taco Cabana name and logo, and proprietary rights relating to certain of our core menu offerings. We believe that our trademarks and other proprietary rights are important to our success and our competitive position. We, therefore, devote appropriate resources to the protection of our trademarks and proprietary rights. The protective actions that we take, however, may not be enough to prevent unauthorized usage or imitation by others, which could harm our image, brand or competitive position and, if we commence litigation to enforce our rights, cause us to incur significant legal fees.

We are not aware of any assertions that our trademarks or menu offerings infringe upon the proprietary rights of third parties, but we cannot assure you that third parties will not claim infringement by us in the future. Any such claim, whether or not it has merit, could be time-consuming, result in costly litigation, cause delays in introducing new menu items in the future or require us to enter into royalty or licensing agreements. As a result, any such claim could have a material adverse effect on our business, results of operations and financial condition.

**The market price of our common stock may be highly volatile or may decline regardless of our operating performance.**

The trading price of our common stock may fluctuate substantially. The price of our common stock that will prevail in the market may be higher or lower than the price you pay, depending on many factors, some of which are beyond our control. Broad market and industry factors may adversely affect the market price of our common stock, regardless of our actual operating performance. The fluctuations could cause a loss of all or part of an

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investment in our common stock. Factors that could cause fluctuation in the trading price of our common stock may include, but are not limited to the following:

price and volume fluctuations in the overall stock market from time to time;

significant volatility in the market price and trading volume of companies generally or restaurant companies (including BKC) in particular;

actual or anticipated variations in the earnings or operating results of our company or our competitors;

actual or anticipated changes in financial estimates by us or by any securities analysts who might cover our stock or the stock of other companies in our industry;

market conditions or trends in our industry and the economy as a whole;

announcements by us or our competitors of significant acquisitions, strategic partnerships or divestitures;

announcements of investigations or regulatory scrutiny of our operations or lawsuits filed against us;

capital commitments;

changes in accounting principles;

additions or departures of key personnel; and

sales of our common stock, including sales of large blocks of our common stock or sales by our directors and officers.

In addition, if the market for restaurant company stocks or the stock market in general experiences loss of investor confidence, the trading price of our common stock could decline for reasons unrelated to our business, results of operations or financial condition. The trading price of our common stock might also decline in reaction to events that affect other companies in our industry (including BKC) or related industries even if these events do not directly affect us.

In the past, following periods of volatility in the market price of a company's securities, class action securities litigation has often been brought against that company. Due to the potential volatility of our stock price, we may therefore be the target of securities litigation in the future. Securities litigation could result in substantial costs and divert management's attention and resources from our business, and could also require us to make substantial payments to satisfy judgments or to settle litigation.

**The concentrated ownership of our capital stock by insiders will likely limit your ability to influence corporate matters.**

Our executive officers, directors and funds managed by entities affiliated with Madison Dearborn Partners, LLC ( Madison Dearborn ) and BIB Holdings (Bermuda) Ltd. ( BIB ) together own approximately 45.5% of our common stock outstanding. In particular, BIB and funds managed by affiliates of Madison Dearborn in the aggregate each owned approximately 17.2% of our outstanding common stock outstanding, based on



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shares outstanding as of March 16, 2007. In addition, our executive officers and directors (excluding directors affiliated with Madison Dearborn and BIB) together owned approximately 11.1% of our common stock outstanding, based on shares outstanding as of March 16, 2007. As a result, our executive officers and these directors, if they act as a group, and BIB and the funds managed by affiliates of Madison Dearborn will be able to significantly influence matters that require approval by our stockholders, including the election of directors and approval of significant corporate transactions such as mergers and acquisitions. The directors will have the authority to make decisions affecting our capital structure, including the issuance of additional debt and the declaration of dividends. BIB and the funds managed by Madison Dearborn may also have interests that differ from yours and may vote in a way with which you disagree and which may be adverse to your interests. Corporate action might be taken even if

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other stockholders oppose them. This concentration of ownership might also have the effect of delaying or preventing a change of control of our company that other stockholders may view as beneficial, could deprive our stockholders of an opportunity to receive a premium for their common stock as part of a sale of our company and might ultimately depress the market price of our common stock.

### **A substantial number of shares of our common stock will be eligible for sale in the near future, which could cause our common stock price to decline significantly.**

If our stockholders sell, or the market perceives that our stockholders intend to sell, substantial amounts of our common stock in the public market, the market price of our common stock could decline significantly. These sales may also make it more difficult for us to sell equity or equity-related securities in the future at a time and price that we deem appropriate. As of March 16, 2007, we had 21,550,826 shares of our common stock outstanding. Of these shares, 9,925,286 shares sold in the IPO are freely tradable, 466,521 additional shares of common stock will be available for sale in the public market approximately 90 days after December 14, 2006, and 11,159,019 additional shares of common stock will be available for sale in the public markets 180 days after December 14, 2006 (subject to possible extension by up to an additional 34 days) following the expiration of the lock-up agreements entered into by our executive officers and directors and some of our stockholders in connection with the IPO. However, Wachovia Capital Markets, LLC and Banc of America Securities LLC, the lead underwriters in the IPO, may, in their sole discretion and at any time or from time to time, without notice, release all or any portion of the shares subject to the lock-up agreements.

In addition, holders of 9,561,382 shares of our common stock have the right to require us to register those shares under the Securities Act or to include those shares in subsequent registration statements we may file with the SEC, in each case to enable the holders to sell those shares in the public markets. In addition, an aggregate of 74,700 shares of restricted common stock and options to purchase an aggregate of 1,251,950 shares of our common stock were outstanding under our 2006 Stock Incentive Plan as of March 16, 2007, and we intend, in the near future, to register these shares of restricted stock and the shares issuable upon exercise of those options, as well as the other shares available for issuance under our 2006 Stock Incentive Plan.

### **We do not expect to pay any cash dividends for the foreseeable future, and the Indenture governing the Notes and the new senior credit facility limit Carrols' ability to pay dividends to us and consequently our ability to pay dividends to our stockholders.**

We do not anticipate that we will pay any cash dividends to holders of our common stock in the foreseeable future. The absence of a dividend on our common stock may increase the volatility of the market price of our common stock or make it more likely that the market price of our common stock will decrease in the event of adverse economic conditions or adverse developments affecting our company. We are a holding company and conduct all of our operations through our direct and indirect subsidiaries. As a result, for us to pay dividends, we would need to rely on dividends or distributions to us from Carrols and indirectly from subsidiaries of Carrols. The Indenture governing the Notes and the new senior credit facility limit, and the debt instruments that we and our subsidiaries may enter into in the future may limit, the ability of Carrols and its subsidiaries to pay dividends to us and our ability to pay dividends to our stockholders.

### **If securities analysts do not publish research or reports about our business or if they downgrade our stock, the price of our stock could decline.**

The trading market for our common stock will rely in part on the research and reports that industry or financial analysts publish about us or our business. We cannot assure you that these analysts will publish research or reports about us or that any analysts that do so will not discontinue publishing research or reports about us in the future. If one or more analysts who cover us downgrade our stock, our stock price could decline rapidly. If analysts do not publish reports about us or if one or more analysts cease coverage of our stock, we could lose visibility in the market, which in turn could cause our stock price to decline.

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**Provisions in our restated certificate of incorporation and amended and restated bylaws or Delaware law might discourage, delay or prevent a change of control of our company or changes in our management and, therefore, depress the trading price of our common stock.**

Delaware corporate law and our restated certificate of incorporation and amended and restated bylaws contain provisions that could discourage, delay or prevent a change in control of our company or changes in our management that the stockholders of our company may deem advantageous. These provisions:

require that special meetings of our stockholders be called only by our board of directors or certain of our officers, thus prohibiting our stockholders from calling special meetings;

deny holders of our common stock cumulative voting rights in the election of directors, meaning that stockholders owning a majority of our outstanding shares of common stock will be able to elect all of our directors;

authorize the issuance of blank check preferred stock that our board could issue to dilute the voting and economic rights of our common stock and to discourage a takeover attempt;

provide that approval of our board of directors or a supermajority of stockholders is necessary to make, alter or repeal our amended and restated bylaws and that approval of a supermajority of stockholders is necessary to amend, alter or change certain provisions of our restated certificate of incorporation;

establish advance notice requirements for stockholder nominations for election to our board or for proposing matters that can be acted upon by stockholders at stockholder meetings;

divide our board into three classes of directors, with each class serving a staggered 3-year term, which generally increases the difficulty of replacing a majority of the directors;

provide that directors only may be removed for cause by a majority of the board or by a supermajority of our stockholders; and

require that any action required or permitted to be taken by our stockholders must be effected at a duly called annual or special meeting of stockholders and may not be effected by any consent in writing.

### **We will incur increased costs as a result of being a public company.**

As a public company, we will incur significant legal, accounting and other expenses that we did not incur as a private company prior to completion of the IPO. The Sarbanes-Oxley Act of 2002 and related rules of the SEC, and The NASDAQ Stock Market regulate corporate governance practices of public companies. We expect that compliance with these public company requirements will increase our costs and make some activities more time-consuming. For example, we may be required to adopt additional internal controls and disclosure controls and procedures. In addition, we will incur additional expenses associated with our SEC reporting requirements. A number of those requirements will require us to carry out activities we have not done previously. For example, under Section 404 of the Sarbanes-Oxley Act, for our annual report on Form 10-K for the year ending December 31, 2007 we will need to document and test our internal control procedures, our management will need to assess and report on our internal control over financial reporting and our independent accountants will need to issue an opinion on that assessment and the effectiveness of those controls. Furthermore, if we identify any issues in complying with those requirements (for example, if we or our accountants identify a material weakness or significant deficiency in our internal control over financial reporting), we could incur additional costs rectifying those issues, and the existence of those issues could adversely affect us, our reputation or investor perceptions of us. We also expect that it will be difficult and expensive to obtain director and officer liability insurance, and we may be required to accept reduced

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policy limits and coverage or incur substantially higher costs to obtain the same or similar coverage. As a result, it may be more difficult for us to attract and retain qualified persons to serve on our board of directors or as executive officers. Advocacy efforts by stockholders and third parties may also prompt even more changes in governance and reporting requirements. We cannot predict or estimate the amount of additional costs we may incur as a result of being a public company or the timing of such costs.

**Table of Contents****ITEM 1B. UNRESOLVED STAFF COMMENTS**

Not Applicable.

**ITEM 2. PROPERTIES**

As of December 31, 2006, we owned or leased the following restaurant properties:

|                                    | <b>Owned<br/>Land;<br/>Owned<br/>Building</b> | <b>Leased<br/>Land;<br/>Owned<br/>Building</b> | <b>Leased<br/>Land;<br/>Leased<br/>Building(1)</b> | <b>Total(2)</b> |
|------------------------------------|---|--|--|-----------------|
| Restaurants:                       |   |  |  |                 |
| Pollo Tropical                     | 2   | 25   | 49   | 76              |
| Taco Cabana                        | 6   | 28   | 109  | 143             |
| Burger King                        | 11  | 25   | 292  | 328             |
| Total operating restaurants (1)(2) | 19  | 78   | 450  | 547             |

(1) Includes 17 restaurants located in mall shopping centers, four in-line or storefront locations and six co-branded locations.

(2) Excludes restaurants operated by our franchisees. In addition, as of December 31, 2006, we had four restaurants under construction, thirteen properties leased to third parties and three properties available for sale or lease.

As of December 31, 2006, we leased 97% of our Pollo Tropical restaurants, 96% of our Taco Cabana restaurants and 97% of our Burger King restaurants. We typically enter into leases (including options to renew) ranging from 20 to 40 years. The average remaining term for all leases, including options, was approximately 25 years at December 31, 2006. Generally, we have been able to renew leases, upon or prior to their expiration, at the prevailing market rates, although there can be no assurance that this will continue to occur.

Most of our Burger King restaurant leases are coterminous with the related franchise agreements. We believe that we generally will be able to renew, at commercially reasonable rates, the leases whose terms expire prior to the expiration of that location's Burger King franchise agreement, although there can be no assurance that this will occur.

Most leases require us, as lessee, to pay utility and water charges and real estate taxes. Certain leases also require contingent rentals based upon a percentage of gross sales of the particular restaurant that exceed specified minimums. In some of our mall locations, we are also required to pay certain other charges such as a pro rata share of the mall's common area maintenance costs, insurance and security costs.

In addition to the restaurant locations set forth under Restaurant Locations, we own a building with approximately 25,300 square feet at 968 James Street, Syracuse, New York, which houses our executive offices and most of our administrative operations for our Burger King restaurants. We lease five small regional offices that support the management of our Burger King restaurants. We also lease approximately 13,500 square feet at 7300 North Kendall Drive, 8th Floor, Miami, Florida, which houses most of our administrative operations for our Pollo Tropical restaurants. In addition, we lease approximately 17,700 square feet of office space at 8918 Tesoro Drive, Suite 200, San Antonio, Texas, which houses most of our administrative operations for our Taco Cabana restaurants.

**ITEM 3. LEGAL PROCEEDINGS**

On November 16, 1998, the EEOC filed suit in the United States District Court for the Northern District of New York (the Court), under Title VII of the Civil Rights Act of 1964, as amended, against Carrols. The complaint alleged that Carrols engaged in a pattern and practice of unlawful discrimination, harassment and



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retaliation against former and current female employees. The EEOC identified approximately 450 individuals (which was subsequently increased to 511 individuals) that it believed represented the class of claimants and was seeking monetary and injunctive relief from Carrols.

On April 20, 2005, the Court issued a decision and order granting Carrols' Motion for Summary Judgment that Carrols filed in January 2004. Subject to possible appeal by the EEOC, the case is dismissed, however the Court noted that it was not ruling on the claims, if any, that individual employees might have against Carrols. We do not believe that any individual claim, if any, would have a material adverse impact on our consolidated financial statements.

On February 27, 2006, Carrols filed a motion for summary judgment to dismiss all but between four and 17 of the individual claims. On July 10, 2006, in its response to that motion, the EEOC has asserted that, notwithstanding the Court's dismissal of the case as a class action, the EEOC may still maintain some kind of collective action on behalf of these claimants. Oral argument before the Court was held on October 4, 2006 and we are awaiting the Court's decision on Carrols' summary judgment motion. Although we believe that the EEOC's continued class litigation argument is without merit, it is not possible to predict the outcome of the pending motion.

On November 30, 2002, four former hourly employees commenced a lawsuit against Carrols in the United States District Court for the Western District of New York entitled Dawn Seever, et al. v. Carrols Corporation. The lawsuit alleges, in substance, that Carrols violated certain minimum wage laws under the federal Fair Labor Standards Act and related state laws by requiring employees to work without recording their time and by retaliating against those who complained. The plaintiffs seek damages, costs and injunctive relief. They also seek to notify, and eventually certify, a class consisting of current and former employees who, since 1998, have worked, or are working, for Carrols. As a result of the July 21, 2005 Status Conference, the parties agreed to withdraw Plaintiff's Motions to Certify and for National Discovery, and Defendant's Motion to Disqualify Counsel and related motions, to allow both sides limited additional discovery. Carrols has since filed a Motion for Summary Judgment as to the existing Plaintiffs that the Court has under consideration. On January 19, 2007, plaintiffs refiled a Motion to certify and for National Discovery and Carrols intends to oppose such Motion. It is too early to evaluate the likelihood of an unfavorable outcome or estimate the amount or range of potential loss. Consequently, it is not possible to predict what adverse impact, if any, this case could have on our consolidated financial condition or results of operations and cash flows. We intend to continue to contest this case vigorously.

We are a party to various other litigation matters incidental to the conduct of our business. We do not believe that the outcome of any of these other matters will have a material adverse effect on our consolidated financial statements.

**ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS**

In connection with our preparation for our IPO, a majority of our stockholders took action by written consent on one occasion during the quarter ended December 31, 2006.

On November 21, 2006, a majority of our stockholders acted by written consent to: (1) approve a Certificate of Amendment to our Certificate of Incorporation with respect to changing our name to Carrols Restaurant Group, Inc., (2) ratify, affirm, approve and adopt actions taken by certain of our officers in connection with the IPO, (3) approve and adopt the terms and provisions of our Restated Certificate of Incorporation, (4) approve and adopt the terms and provisions of our Amended and Restated Bylaws, (5) ratify, affirm, approve and adopt a forward stock split of 11.288 to one on our outstanding shares of common stock effective immediately prior to the effective date of the IPO, (6) elect Jack A. Smith and Joel M. Handel to fill vacancies on our Board of Directors effective immediately prior to the effective date of the IPO, (7) elect Alan Vituli and Daniel T. Accordino as Class I directors to our Board of Directors; Joel M. Handel and Clayton Wilhite as Class II directors to our Board of Directors; and Robin P. Selati, Jack A. Smith and Olaseni Adeyemi Sonuga as Class III directors to our Board of Directors, and (8) to approve and adopt the terms and provisions of our 2006 Stock Incentive Plan.

**Table of Contents****PART II****ITEM 5. MARKET FOR THE REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES**

In December 2006, we and certain selling stockholders completed the IPO in which Carrols Restaurant Group and those stockholders sold 5,666,666 and 5,333,334 shares of our common stock, respectively, (including 1,000,000 shares sold by the selling stockholders upon the underwriters' exercise of its over-allotment option) at an initial public offering price of \$13.00 per share. In connection with and prior to the IPO, we effected an 11.288 for one stock split on December 8, 2006. Our common stock commenced trading on The NASDAQ Global Market under the symbol TAST on December 15, 2006. The high and low closing prices of our common stock from December 15, 2006 through December 31, 2006 were \$15.20 and \$14.15, respectively. As of March 16, 2007, there were 21,550,826 shares of our common stock outstanding held by 702 holders of record. This excludes persons whose shares are held of record by a bank, brokerage house or clearing agency.

**Dividends**

We did not pay any cash dividends during the fiscal years 2006 or 2005. In December 2004, we made a one-time cash dividend of \$116.8 million to our stockholders and also distributed approximately \$20.3 million to employees and an outside director holding certain options to purchase our common stock from the net proceeds of the December 2004 Transactions. The special cash dividend was paid on December 28, 2004.

We do not anticipate paying any cash dividends on our common stock in the foreseeable future. We currently intend to retain all available funds to fund the development and growth of our business. In addition, we are a holding company and conduct all of our operations through our direct and indirect subsidiaries. As a result, for us to pay dividends, we need to rely on dividends or distributions to us from Carrols and indirectly from subsidiaries of Carrols. The Indenture governing the Notes and the new senior credit facility limit, and debt instruments that we and our subsidiaries may enter into in the future may limit the ability of Carrols and its subsidiaries to pay dividends to us and our ability to pay dividends to our stockholders.

**Equity Compensation Plans**

The following table summarizes the equity compensation plans under which our common stock may be issued as of December 31, 2006. Stockholders of the Company approved all plans.

|  | Number of securities to be<br>issued upon exercise of<br>outstanding options,<br>warrants, and rights | Weighted-average exercise<br>price of<br>outstanding<br>options | Number of securities<br>remaining available for<br>future issuance under<br>equity compensation plans |
|--|---|---|---|
| Equity compensation plans approved by security holders     | 1,317,550   | \$ 14.30  | 1,982,450   |
| Equity compensation plans not approved by security holders |   |   |   |
| <b>Total</b>   | <b>1,317,550</b>  | <b>\$ 14.30</b>   | <b>1,982,450</b>  |

**Purchases of Equity Securities by the Issuer and Affiliated Purchasers**

We did not repurchase any of our registered securities during the fourth quarter of 2006 and we do not have a formal or publicly announced stock repurchase program.

**Use of Proceeds**



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On December 14, 2006, our registration statement on Form S-1 (Registration No. 333-137524) was declared effective for our IPO, pursuant to which we and certain selling stockholders sold 5,666,666 and 5,333,334 shares of our common stock, respectively (including 1,000,000 shares sold by the selling stockholders upon the

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underwriters (exercise of its over-allotment option) at an initial public offering price of \$13.00 per share. The IPO closed on December 20, 2006 and, as a result, we received net proceeds of approximately \$65.4 million from the sale of shares of our common stock in the IPO after deducting underwriting discounts and commissions and offering expenses payable by us of approximately \$8.3 million. We contributed the net proceeds from the IPO to Carrols (before deducting offering expenses payable by us), which used such funds to repay approximately \$68.0 million principal amount of term loan borrowings under our prior senior credit facility. The joint book running managers of the IPO were Wachovia Capital Markets, LLC and Banc of America Securities LLC.

No payments for such expenses were made directly or indirectly to (i) any of our officers or directors or their associates, (ii) any persons owning 10% or more of any class of our equity securities, or (iii) any of our affiliates. We did not receive any proceeds from the sale of common stock in IPO by the selling stockholders. There has been no material change in the planned use of proceeds from our IPO from that described in the final prospectus filed with the SEC pursuant to Rule 424(b) of the Securities Act of 1933, as amended.

**Stock Performance Graph**

The following graph compares, from December 15, 2006 (the date on which our common stock began trading on The NASDAQ Global Market), the cumulative total stockholder return on our common stock with the cumulative total returns of The NASDAQ Composite Index and a peer group, The S&P Small Cap Restaurant Index. We have elected to use the S&P Small Cap Restaurant Index in compiling our stock performance graph because we believe the S&P Small Cap Restaurant Index represents a comparison to competitors with similar market capitalization as us.

The initial public offering price of our common stock in the IPO was \$13.00 and the closing price of our common stock on December 15, 2006 (the date on which our common stock began trading on The NASDAQ Global Market) was \$15.20. The following graph is based upon the closing price of our common stock from December 15, 2006 through December 31, 2006.

|                                 | 12/15/06  | 12/31/06  |
|---------------------------------|-----------|-----------|
| Carrols Restaurant Group, Inc.  | \$ 100.00 | \$ 93.29  |
| NASDAQ Composite                | \$ 100.00 | \$ 99.79  |
| S & P SmallCap Restaurant Index | \$ 100.00 | \$ 101.18 |

**Table of Contents****ITEM 6. SELECTED FINANCIAL DATA****December 2004 Transactions**

On December 15, 2004, Carrols completed the private placement of \$180.0 million of its 9% Senior Subordinated Notes due 2013, which we refer to as the Notes. Concurrently, Carrols repaid all outstanding borrowings under our then existing senior secured credit facility and amended and restated such senior credit facility with a new syndicate of lenders, which we refer to as the prior senior credit facility. Carrols received \$400.0 million in total proceeds that included the issuance of the Notes and term loan B borrowings of \$220.0 million under the prior senior credit facility. The proceeds were primarily utilized to repay borrowings outstanding under the then existing senior credit facility of \$74.4 million, to retire all of Carrols' 9 1/2% senior subordinated notes due 2008 (including redemption premiums) in the amount of \$175.9 million, to pay a dividend to Carrols Restaurant Group, the sole stockholder of Carrols, in the amount of \$116.8 million (and Carrols Restaurant Group concurrently paid a dividend to its stockholders in the aggregate amount of \$116.8 million), to pay fees and expenses related to the refinancing of \$8.8 million, and to pay a bonus to employees (including management) and an outside director, who owned options to purchase common stock of Carrols Restaurant Group, totaling \$20.9 million, which includes \$0.6 million of payroll taxes. We also recorded an \$8.9 million loss on early extinguishment of debt primarily from the write-off of previously deferred financing costs and premiums in conjunction with the retirement of the 9 1/2% Senior Subordinated Notes. In this Annual Report on Form 10-K we refer to the Notes offering, Carrols entering into the prior senior credit facility and the term loan borrowings thereunder, the repayment of all outstanding borrowings under the then existing senior credit facility, retirement of all of the outstanding 9 1/2% Senior Subordinated Notes, the payment of a dividend to our stockholders and the distribution to our employees (including management) and a director as the December 2004 Transactions.

**December 2006 IPO**

In December 2006, we and certain selling stockholders completed an IPO of 5,666,666 and 5,333,334 shares of our common stock, respectively, (including 1,000,000 shares sold by the selling stockholders upon the underwriters' exercise of its over-allotment option) shares of common stock, respectively, at an initial public offering price of \$13.00 per share. We received net proceeds of approximately \$65.4 million from the sale of shares of our common stock in the offering after deducting underwriting discounts and commissions and offering expenses payable by us. We contributed the net proceeds from the IPO to Carrols, which used such funds to repay approximately \$68.0 million principal amount of term loan borrowings under the prior senior credit facility.

The following table sets forth our selected consolidated financial data derived from our audited consolidated financial statements for each of the fiscal years ended December 31, 2002, 2003, 2004, 2005 and 2006. The information in the following table should be read together with our consolidated financial statements and accompanying notes as of December 31, 2005 and 2006 and for the years ended December 31, 2004, 2005 and 2006, and Management's Discussion and Analysis of Financial Condition and Results of Operations included under Item 7 of this report. These historical results are not necessarily indicative of the results to be expected in the future. Our fiscal years ended December 31, 2002, 2003, 2005 and 2006 each contained 52 weeks. Our fiscal year ended December 31, 2004 contained 53 weeks. The amounts in the table below reflect rounding adjustments.

The difference between the consolidated financial statements of Carrols Restaurant Group and Carrols is primarily due to additional rent expense of approximately \$6,000 per year for Carrols Restaurant Group and the composition of stockholders' deficit.

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|   | Year Ended December 31,                                |                 |                   |                   |                  |
|---|--|-----------------|-------------------|-------------------|------------------|
|   | 2002   | 2003            | 2004              | 2005              | 2006             |
|   | (Dollar in thousands, except share and per share data) |                 |                   |                   |                  |
| <b>Statements of operations data:</b>                 |  |                 |                   |                   |                  |
| Revenues:   |  |                 |                   |                   |                  |
| Restaurant sales                                      | \$ 655,545   | \$ 643,579      | \$ 696,343        | \$ 705,422        | \$ 750,069       |
| Franchise royalty revenues and fees                   | 1,482  | 1,406           | 1,536             | 1,488             | 1,357            |
| <b>Total revenues</b>                                 | <b>657,027</b>   | <b>644,985</b>  | <b>697,879</b>    | <b>706,910</b>    | <b>751,426</b>   |
| Costs and expenses:                                   |  |                 |                   |                   |                  |
| Cost of sales   | 183,976  | 181,182         | 202,624           | 204,620           | 211,236          |
| Restaurant wages and related expenses (1)             | 196,258  | 194,315         | 206,732           | 204,611           | 218,797          |
| Restaurant rent expense                               | 30,940   | 31,089          | 34,606            | 34,668            | 37,768           |
| Other restaurant operating expenses                   | 87,335   | 89,880          | 92,891            | 102,921           | 110,164          |
| Advertising expense                                   | 28,041   | 27,351          | 24,711            | 25,523            | 27,692           |
| General and administrative (1)                        | 36,460   | 37,388          | 43,585            | 58,621            | 49,756           |
| Depreciation and amortization                         | 39,434   | 40,228          | 38,521            | 33,096            | 33,534           |
| Impairment losses                                     | 1,285  | 4,151           | 1,544             | 1,468             | 1,019            |
| Bonus to employees and director (2)                   |  |                 | 20,860            |                   |                  |
| Other expense (income) (3)                            |  |                 | 2,320             |                   | (2,787)          |
| <b>Total operating expenses</b>                       | <b>603,729</b>   | <b>605,584</b>  | <b>668,394</b>    | <b>665,528</b>    | <b>687,179</b>   |
| Income from operations                                | 53,298   | 39,401          | 29,485            | 41,382            | 64,247           |
| Interest expense                                      | 39,329   | 37,334          | 35,383            | 42,972            | 44,262           |
| Loss on extinguishment of debt                        |  |                 | 8,913             |                   |                  |
| Income (loss) before income taxes                     | 13,969   | 2,067           | (14,811)          | (1,590)           | 19,985           |
| Provision (benefit) for income taxes                  | 4,929  | 741             | (6,720)           | 2,760             | 6,561            |
| <b>Net income (loss)</b>                              | <b>\$ 9,040</b>  | <b>\$ 1,326</b> | <b>\$ (8,091)</b> | <b>\$ (4,350)</b> | <b>\$ 13,424</b> |
| <b>Per share data (4):</b>                            |  |                 |                   |                   |                  |
| Basic and diluted net income (loss) per share         | \$ 0.70  | \$ 0.10         | \$ (0.63)         | \$ (0.29)         | \$ 0.83          |
| <b>Weighted average shares outstanding (4):</b>       |  |                 |                   |                   |                  |
| Basic   | 12,915,095   | 12,915,095      | 12,915,095        | 14,905,750        | 16,152,060       |
| Diluted   | 12,915,095   | 12,915,095      | 12,915,095        | 14,905,750        | 16,152,330       |
| <b>Other financial data:</b>                          |  |                 |                   |                   |                  |
| Net cash provided from operating activities           | \$ 54,194  | \$ 46,349       | \$ 59,211         | \$ 22,008         | \$ 48,755        |
| Total capital expenditures                            | 54,155   | 30,371          | 19,073            | 38,849            | 45,139           |
| <b>Operating Data:</b>                                |  |                 |                   |                   |                  |
| Total company-owned restaurants (at end of period)    | 529  | 532             | 537               | 540               | 547              |
| <b>Pollo Tropical:</b>                                |  |                 |                   |                   |                  |
| Company-owned restaurants (at end of period)          | 58   | 60              | 63                | 69                | 76               |
| Average number of company-owned restaurants           | 55.6   | 59.4            | 60.3              | 64.9              | 71.7             |
| Revenues:   |  |                 |                   |                   |                  |
| Restaurant sales                                      | \$ 100,444   | \$ 109,201      | \$ 124,000        | \$ 135,787        | \$ 153,062       |
| Franchise royalty revenues and fees                   | 1,053  | 993             | 1,101             | 1,196             | 1,145            |
| <b>Total revenues</b>                                 | <b>101,497</b>   | <b>110,194</b>  | <b>125,101</b>    | <b>136,983</b>    | <b>154,207</b>   |
| Average annual sales per company-owned restaurant (5) | 1,807  | 1,838           | 2,018             | 2,092             | 2,135            |
| Segment EBITDA (6)(9)                                 | 21,946   | 22,477          | 27,884            | 28,684            | 28,422           |

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|   |        |       |       |       |       |
|---|--------|-------|-------|-------|-------|
| Segment EBITDA margin (7)                               | 21.6%  | 20.4% | 22.3% | 20.9% | 18.4% |
| Change in comparable company-owned restaurant sales (8) | (4.2)% | 2.3%  | 10.6% | 4.7%  | 3.2%  |

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|   | 2002                   | 2003              | Year ended December 31, |                   |                   |
|---|------------------------|-------------------|-------------------------|-------------------|-------------------|
|   |                        |                   | 2004                    | 2005              | 2006              |
|   | (amounts in thousands) |                   |                         |                   |                   |
| <b>Taco Cabana:</b>                                     |                        |                   |                         |                   |                   |
| Company-owned restaurants (at end of period)            | 116                    | 121               | 126                     | 135               | 143               |
| Average number of company-owned restaurants             | 114.6                  | 118.9             | 123.9                   | 129.8             | 138.8             |
| Revenues:   |                        |                   |                         |                   |                   |
| Restaurant sales  | \$ 174,982             | \$ 181,068        | \$ 202,506              | \$ 209,539        | \$ 228,092        |
| Franchise royalty revenues and fees                     | 429                    | 413               | 435                     | 292               | 212               |
| <b>Total revenues</b>                                   | <b>175,411</b>         | <b>181,481</b>    | <b>202,941</b>          | <b>209,831</b>    | <b>228,304</b>    |
| Average annual sales per company-owned restaurant (5)   | 1,527                  | 1,523             | 1,604                   | 1,614             | 1,643             |
| Segment EBITDA (6)(10)                                  | 27,989                 | 24,206            | 30,082                  | 31,927            | 33,494            |
| Segment EBITDA margin (7)                               | 16.0%                  | 13.3%             | 14.8%                   | 15.2%             | 14.7%             |
| Change in comparable company-owned restaurant sales (8) | (0.2)%                 | (3.0)%            | 4.8%                    | 1.2%              | 1.7%              |
| <b>Burger King:</b>                                     |                        |                   |                         |                   |                   |
| Restaurants (at end of period)                          | 355                    | 351               | 348                     | 336               | 328               |
| Average number of restaurants                           | 355.6                  | 352.2             | 350.9                   | 343.5             | 331.2             |
| Restaurant sales  | \$ 380,119             | \$ 353,310        | \$ 369,837              | \$ 360,096        | \$ 368,915        |
| Average annual sales per restaurant (5)                 | 1,069                  | 1,003             | 1,034                   | 1,048             | 1,114             |
| Segment EBITDA (6)(11)                                  | 43,932                 | 37,350            | 36,582                  | 31,767            | 34,177            |
| Segment EBITDA margin (7)                               | 11.6%                  | 10.6%             | 9.9%                    | 8.8%              | 9.3%              |
| Change in comparable restaurant sales (8)               | (1.3)%                 | (7.2)%            | 2.9%                    | 1.0%              | 4.2%              |
| <b>Balance sheet data (at end of period):</b>           |                        |                   |                         |                   |                   |
| Total assets  | \$ 554,787             | \$ 499,054        | \$ 516,246              | \$ 496,945        | \$ 452,859        |
| Working capital   | (33,971)               | (39,835)          | (24,515)                | (25,441)          | (30,546)          |
| Debt:   |                        |                   |                         |                   |                   |
| Senior and senior subordinated debt                     | \$ 357,300             | \$ 294,100        | \$ 400,000              | \$ 391,800        | \$ 298,400        |
| Capital leases and other debt                           | 3,045                  | 1,732             | 1,225                   | 1,896             | 1,509             |
| Lease financing obligations                             | 102,738                | 106,808           | 111,715                 | 110,898           | 58,571            |
| <b>Total debt</b>                                       | <b>\$ 463,083</b>      | <b>\$ 402,640</b> | <b>\$ 512,940</b>       | <b>\$ 504,594</b> | <b>\$ 358,480</b> |
| Stockholders' equity (deficit)                          | \$ 8,011               | \$ 9,337          | \$ (115,548)            | \$ (103,537)      | \$ (25,767)       |

- (1) Restaurant wages and related expenses include stock-based compensation expense of \$6 for 2006. General and administrative expenses include stock-based compensation expense (income) for the year ended December 31, 2002, 2003, 2004, 2005 and 2006 of \$(151), \$253, \$1,818, \$16,432 and \$74, respectively.
- (2) In conjunction with the December 2004 Transactions, we approved a compensatory bonus payment to certain employees (including management) and a director. See Note 11 to our consolidated financial statements.
- (3) Other income in 2006 includes a gain of \$1,398 related to the sale of a Pollo Tropical leasehold in the fourth quarter of 2006 and a gain of \$1,389 from a reduction in certain reserves previously established for a \$1.1 million note receivable related to the sale of leasehold improvements at two of the closed restaurant locations that were written off as part of a restructuring charge in 2001 and a reduction in lease liability reserves of \$0.3 million for such locations due to an increase in estimates for future sublease income. Other expense in 2004 resulted from the write off of costs incurred in connection with a registration statement on Form S-1 for a proposed offering by us of Enhanced Yield Securities comprised of common stock and senior subordinated notes that was withdrawn by us in 2004. See Notes 5 and 9 to the consolidated financial statements.
- (4) In December 2006, the Company and certain selling stockholders completed the IPO of 5,666,666 and 5,333,334 shares of our common stock, respectively, (including 1,000,000 shares sold by the selling stockholders upon the underwriters' exercise of its over-allotment option) of common stock, respectively, at an initial public offering price of \$13.00 per share. In connection with and prior to the IPO, we effected an 11.288 for one stock split on December 8, 2006. Net income (loss) per share is based on shares of our common stock and dilutive options and also gives effect to the stock split on a retroactive basis. Basic and diluted net income (loss) per share amounts for periods prior to 2006 do not reflect the additional shares issued in our IPO.



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- (5) Average annual sales per restaurant are derived by dividing restaurant sales for such year for the applicable segment by the average number of company owned and operated restaurants for the applicable segment for such year. For comparative purposes, the calculation of average annual sales per restaurant is based on a 52-week year. 2004 was a 53-week fiscal year. For purposes of calculating average annual sales per restaurant for 2004, we have excluded restaurant sales data for the extra week of 2004.
- (6) Segment EBITDA is defined as earnings attributable to the applicable segment before interest, income taxes, depreciation and amortization, impairment losses, stock based compensation expense, bonus to employees and a director in connection with the December 2004 Transactions, other income and expense and loss on extinguishment of debt. The calculation of Segment EBITDA for our Burger King restaurants includes general and administrative expenses related directly to our Burger King segment, as well as the expenses associated with administrative support for all three of our segments including executive management, information systems and certain accounting, legal and other administrative functions. See Note 13 to our Consolidated Financial Statements.
- (7) Segment EBITDA margin means Segment EBITDA as a percentage of the total revenues of the applicable segment.
- (8) The changes in comparable restaurant sales are calculated using only those company-owned and operated restaurants open since the beginning of the earliest period being compared and for the entirety of both periods being compared. Restaurants are included in comparable restaurant sales after they have been open for 12 months for our Burger King restaurants and 18 months for our Pollo Tropical and Taco Cabana restaurants. For comparative purposes, the calculation of the changes in comparable restaurant sales is based on a 52-week year. 2004 was a 53-week fiscal year. For purposes of calculating the changes in comparable restaurant sales, we have excluded restaurant sales data for the extra week of 2004.
- (9) Includes general and administrative expenses related directly to our Pollo Tropical segment of approximately \$5.0 million, \$6.0 million, \$7.3 million, \$7.5 million and \$9.0 million for the years ended December 31, 2002, 2003, 2004, 2005 and 2006, respectively.
- (10) Includes general and administrative expenses related directly to our Taco Cabana segment of approximately \$9.2 million, \$11.1 million, \$11.1 million, \$10.2 million and \$11.6 million for the years ended December 31, 2002, 2003, 2004, 2005 and 2006, respectively.
- (11) Includes general and administrative expenses related directly to our Burger King segment as well as expenses associated with administrative support to all three of our segments including executive management, information systems and certain accounting, legal and other administrative functions. All of such expenses totaled approximately \$22.3 million, \$20.0 million, \$23.4 million, \$24.9 million and \$29.1 million for the years ended December 31, 2002, 2003, 2004, 2005 and 2006, respectively.

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

Carrols Restaurant Group is a holding company and conducts all of its operations through its direct and indirect subsidiaries and has no assets other than the shares of capital stock of Carrols, its direct wholly-owned subsidiary. The following Management's Discussion and Analysis of Financial Condition and Results of Operations ( MD&A ) relates to the consolidated financial statements of Carrols Restaurant Group and the consolidated financial statements for Carrols Corporation presented in Item 8.

The difference between the consolidated financial statements of Carrols Restaurant Group and Carrols is primarily due to additional rent expense of approximately \$6,000 per year for Carrols Restaurant Group and the composition of stockholders' deficit.

The following MD&A is written to help the reader understand our company. The MD&A is provided as a supplement to, and should be read in conjunction with, the Consolidated Financial Statements and the accompanying financial statement notes of each of Carrols Restaurant Group and Carrols appearing elsewhere in this Annual Report on Form 10-K for the year ended December 31, 2006. The overview provides our perspective on the individual sections of MD&A, which include the following:

*Company Overview* a general description of our business and our key financial measures.

*Recent and Future Events Affecting Our Results of Operations* a description of recent events that affect, and future events that may affect, our results of operations.



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*Executive Summary* an executive review of our performance for the year ended December 31, 2006.

*Liquidity and Capital Resources* an analysis of historical information regarding our sources of cash and capital expenditures, the existence and timing of commitments and contingencies, changes in capital resources and a discussion of cash flow items affecting liquidity.

*Results of Operations* an analysis of our results of operations for the years ended December 31, 2006, 2005 and 2004, including a review of the material items and known trends and uncertainties.

*Application of Critical Accounting Policies* an overview of accounting policies requiring critical judgments and estimates.

*Effects of New Accounting Standards* a discussion of new accounting standards and any implications related to our financial statements.

## **Company Overview**

We are one of the largest restaurant companies in the United States operating three restaurant brands in the quick-casual and quick-service restaurant segments with 547 restaurants located in 16 states as of December 31, 2006. We own and operate two Hispanic restaurant brands, Pollo Tropical and Taco Cabana (together referred to by us as our Hispanic Brands), which we acquired in 1998 and 2000, respectively. We are also the largest Burger King franchisee, based on the number of restaurants, and have operated Burger King restaurants since 1976. As of December 31, 2006, our company-owned restaurants included 76 Pollo Tropical restaurants and 143 Taco Cabana restaurants, and we operated 328 Burger King restaurants under franchise agreements. We also franchise our Hispanic Brand restaurants with 30 franchised restaurants located in Puerto Rico, Ecuador and the United States as of December 31, 2006. We believe that the diversification and strength of our restaurant brands as well as the geographic dispersion of our restaurants provide us with stability and enhanced growth opportunities. Our primary business strategy is to develop new company-owned Hispanic Brand restaurants. For the year ended December 31, 2006, we had total revenues of \$751.4 million and net income of \$13.4 million.

The following is an overview of the key financial measures discussed in our results of operations:

*Restaurant sales* consist of food and beverage sales, net of discounts, at our company-owned Hispanic Brand restaurants and the Burger King restaurants we operate under franchise agreements. Restaurant sales are influenced by menu price increases, new restaurant openings, closures of underperforming restaurants, and changes in comparable restaurant sales. The changes in comparable restaurant sales noted below are calculated using only those restaurants open since the beginning of the earliest period being compared and for the entirety of both periods being compared. Restaurants are included in comparable restaurant sales after they have been open for 12 months for our Burger King restaurants and 18 months for our Pollo Tropical and Taco Cabana restaurants. For comparative purposes, the calculation of the changes in comparable restaurant sales is based on a 52-week year. 2004 was a 53-week fiscal year. For purposes of calculating the changes in comparable restaurant sales, we have excluded restaurant sales data for the extra week of 2004.

*Cost of sales* consists of food, paper and beverage costs including packaging costs, less purchase discounts. Cost of sales is generally influenced by changes in commodity costs and the effectiveness of our restaurant-level controls to manage food and paper costs. For our Pollo Tropical and Taco Cabana restaurants, we have negotiated directly with local and national suppliers for the purchase of food and beverage products and supplies. Pollo Tropical and Taco Cabana restaurants' food and supplies are ordered from approved suppliers and are shipped via distributors to our restaurants. Key commodities for Pollo Tropical and Taco Cabana restaurants are generally purchased under annual contracts. We are a member of a national purchasing cooperative, Restaurant Services, Inc., a non-profit independent cooperative that serves as the purchasing agent for most of the commodities for the Burger King franchise system and which also contracts with various distributors to receive and ship orders for our Burger King restaurants.

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*Restaurant wages and related expenses* include all restaurant management and hourly productive labor costs, employer payroll taxes, restaurant-level bonuses and related benefits. Payroll and related benefits are subject to inflation, including minimum wage increases and increased costs for health insurance and workers' compensation insurance. A significant number of our hourly staff is paid at rates consistent with the applicable state minimum wage and, accordingly, increases in minimum wage rates will increase our labor costs. We are insured for workers' compensation, general liability and medical insurance claims under policies where we pay all claims, subject to annual stop-loss limitations both for individual claims and claims in the aggregate.

*Restaurant rent expense* includes base rent, contingent rent and common area maintenance on our leases characterized as operating leases, reduced by the amortization of gains on sale-leaseback transactions.

*Other restaurant operating expenses* include all other restaurant-level operating costs, the major components of which are royalty expenses for our Burger King restaurants, utilities, repairs and maintenance, real estate taxes and credit card fees.

*Advertising expense* includes all promotional expenses including television, radio, billboards and other media. Pollo Tropical and Taco Cabana utilize an integrated, multi-level marketing approach that includes periodic chain-wide promotions, direct mail, in-store promotions, local store marketing and other strategies, including the use of radio and television advertising in their major markets. We are generally required to contribute 4% of restaurant sales from our Burger King restaurants to an advertising fund utilized by the Burger King franchise system for its advertising, promotional programs and public relations activities. We also supplement from time to time, on a discretionary basis, BKC's advertising and promotional activities with our own local advertising and promotions which may include the purchase of additional media or other forms of advertising.

*General and administrative expenses* are comprised primarily of (1) salaries and expenses associated with corporate and administrative functions that support the development and operations of our restaurants, (2) legal and professional fees, including external auditing costs, and (3) stock-based compensation expense.

*Segment EBITDA*, which is the measure of segment profit or loss used by our chief operating decision maker for purposes of allocating resources to our segments and assessing their performance, is defined as earnings attributable to the applicable segment before interest, income taxes, depreciation and amortization, impairment losses, stock-based compensation expense, bonus to employees and a director in connection with the December 2004 Transactions, other income and expense and loss on extinguishment of debt. Segment EBITDA may not be necessarily comparable to other similarly titled captions of other companies due to differences in methods of calculation. Segment EBITDA for our Burger King restaurants includes general and administrative expenses related directly to the Burger King segment as well as the expenses associated with administrative support to all three of our segments including executive management, information systems and certain accounting, legal and other administrative functions.

*Depreciation and amortization* primarily includes the depreciation of fixed assets, including equipment and leasehold improvements, depreciation of assets under lease financing obligations and the amortization of Burger King franchise rights and franchise fees.

*Interest expense* consists primarily of interest expense associated with the Notes and on borrowings under our prior senior credit facility, and imputed interest expense on certain leases entered into in connection with sale-leaseback transactions which are accounted for as lease financing obligations. Interest expense may also include gains and losses from the settlement of lease financing obligations.

We use a 52 or 53 week fiscal year ending on the Sunday closest to December 31. The years ended December 31, 2006 and 2005 each consisted of 52 weeks and the year ended December 31, 2004 consisted of 53 weeks. As a result, some of the variations in our results of operations between 2004 and the other fiscal years may be due to the additional week included in 2004.

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### **Recent and Future Events Affecting our Results of Operations**

#### *Initial Public Offering*

In December 2006, we and certain selling stockholders completed the IPO of 5,666,666 and 5,333,334 shares of our common stock, respectively, (including 1,000,000 shares sold by the selling stockholders upon the underwriters' exercise of its over-allotment option) at an initial public offering price of \$13.00 per share. We received net proceeds of approximately \$65.4 million from the sale by us of shares of our common stock in the offering after deducting estimated underwriting discounts and commissions and estimated offering expenses payable by us. We contributed the net proceeds from the IPO to Carrols, which used such funds to repay approximately \$68.0 million principal amount of term loan borrowings under our prior senior credit facility.

#### *New Senior Credit Facility*

On March 9, 2007, Carrols terminated the prior senior credit facility and entered into a loan agreement governing our new senior credit facility with a syndicate of lenders. Carrols' new senior credit facility totals approximately \$185 million, consisting of \$120 million principal amount of term loan A borrowings maturing on March 8, 2013 (or earlier on September 30, 2012 if the Notes are not refinanced by June 30, 2012) and a \$65.0 million revolving credit facility (including a sub limit of up to \$25.0 million for letters of credit and up to \$5.0 million for swingline loans), maturing on March 8, 2012. The term loan A borrowings and an additional \$4.3 million of revolver borrowings from this facility were used to repay all outstanding borrowings and other obligations under the Carrols' prior senior credit facility and to pay certain fees and expenses incurred in connection with the new senior credit facility.

Both term loan and revolving credit borrowings under the new senior credit facility bear interest at a per annum rate, at Carrols' option, of either:

- 1) the applicable margin ranging from 0% to 0.25% based on Carrols' senior leverage ratio (as defined in the new credit facility) plus the greater of (i) the prime rate or (ii) the federal funds rate for that day plus 0.5%; or
  - 2) Adjusted LIBOR plus the applicable margin percentage in effect ranging from 1.0% to 1.5% based on Carrols' senior leverage ratio.
- For a more detailed discussion of the new senior credit facility, see *Liquidity and Capital Resources*.

Due to the reduction of outstanding debt as a result of our IPO and also to lower effective borrowing rates under the new senior credit facility of approximately 1%, we anticipate that interest expense in 2007 will be significantly lower than in 2006. In addition, we anticipate recording in the first quarter of 2007 a pretax charge of \$1.5 million related to the write off of unamortized debt issue costs associated with the prior senior credit facility.

#### *Issuance of Stock Options and Restricted Shares*

In connection with the IPO, we granted options to purchase 1,241,750 shares of our common stock and issued 75,800 shares of restricted stock under our 2006 Stock Incentive Plan to certain of our employees and directors. In 2006, stock-based compensation expense was \$0.1 million. The total stock-based compensation expense relating to the above options and restricted shares is approximately \$5.4 million and we will record compensation expense of approximately \$1.5 million in 2007 and additional compensation expense over the next four fiscal years. In addition, we will likely incur additional stock-based compensation expense in future periods for any additional stock option and restricted share grants we make.

#### *Public Company Costs*

As a public company, we will incur significant legal, accounting and other costs that we have not previously incurred as a private company. The Sarbanes-Oxley Act of 2002 and related rules of the SEC and The NASDAQ

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Stock Market regulate corporate governance practices of public companies. We expect that compliance with these public company requirements, including ongoing costs to comply with Section 404 of the Sarbanes-Oxley Act, which includes documenting, reviewing and testing our internal controls, will increase our general and administrative costs. These costs will also include the costs of our independent registered public accounting firm to issue an opinion on our assessment and the effectiveness of our internal controls on an annual basis. We will also incur higher costs for director and officer liability insurance. We anticipate additional expenses in 2007 as a consequence of becoming a public company of approximately \$2.0 million to \$2.5 million.

*Lease Financing Obligations*

We have, in the past, entered into sale-leaseback transactions involving certain restaurant properties that did not qualify for sale-leaseback accounting and, as a result, have been classified as financing transactions under Statement of Financial Accounting Standards ( SFAS ) No. 98. Under the financing method, the assets remain on our consolidated balance sheet and continue to be depreciated and proceeds received by us from these transactions are recorded as a financing liability. Payments under these leases are applied as payments of imputed interest and deemed principal on the underlying financing obligations.

During the year ended December 31, 2006, we exercised our right of first refusal under the leases for 14 restaurant properties subject to lease financing obligations and purchased these 14 restaurant properties from the respective lessors. Concurrently with these purchases, the properties were sold in qualified sale-leaseback transactions. We recorded deferred gains representing the amounts by which the sales prices exceeded the net book value of the underlying assets. Deferred gains are being amortized as an adjustment to rent expense over the term of the leases, which is generally 20 years.

We also amended lease agreements for 21 restaurant properties in the second quarter of 2006 and amended a master lease agreement covering 13 restaurant properties in the third quarter of 2006, all of which were previously accounted for as lease financing obligations, to eliminate or otherwise cure the provisions that precluded the original sale-leaseback accounting under SFAS 98. As a result of such amendments, we recorded these sale-leaseback transactions as sales, removed all of the respective assets under lease financing obligations and related liabilities from our consolidated balance sheet and recognized gains from the sales, which were generally deferred and are being amortized as an adjustment to rent expense over the remaining term of the underlying leases.

As a result of the above transactions that occurred during the year ended December 31, 2006, we reduced our lease financing obligations by \$52.8 million, reduced our assets under lease financing obligations by \$36.2 million and recorded deferred gains of \$18.3 million. We also recorded interest expense of \$2.0 million which represents the net amount by which the purchase price for the restaurant properties sold exceeded the lease financing obligations. Of these amounts, \$37.5 million of lease financing obligations and \$24.7 million of assets under lease financing obligations have been reflected as non-cash transactions in the consolidated statements of cash flows for the year ended December 31, 2006.

Beginning in the third quarter of 2006 the effect of the recharacterization of all of the transactions described above as qualified sales under SFAS 98 and the payments associated with the related operating leases as restaurant rent expense, rather than as payments of interest and principal associated with lease financing obligations, has been to reduce interest expense, reduce depreciation expense and increase restaurant rent expense.

Interest expense for the year ended December 31, 2006 was \$44.3 million. On a pro forma basis, after giving effect to the leasing transactions and the lease amendments described above as if these transactions and amendments occurred at the beginning of the respective periods, interest expense for the year ended December 31, 2006 would have been \$41.7 million or a reduction of \$2.6 million.

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Depreciation and amortization expense for the year ended December 31, 2006 was \$33.5 million. On a pro forma basis, after giving effect to the leasing transactions and the lease amendments described above as if these transactions and amendments occurred at the beginning of the respective periods, depreciation and amortization expense for the year ended December 31, 2006 would have been \$32.8 million or a reduction of \$0.7 million.

Restaurant rent expense for the year ended December 31, 2006 was \$37.8 million. On a pro forma basis, after giving effect to the leasing transactions and the lease amendments described above as if these transactions and amendments occurred at the beginning of the respective periods, restaurant rent expense for the year ended December 31, 2006 would have been \$39.6 million or an increase of \$1.8 million.

### *Future Burger King Restaurant Closures*

We evaluate the performance of our Burger King restaurants on an ongoing basis. Such evaluation depends on many factors, including our assessment of the anticipated future operating results of the subject restaurants and the cost of required capital improvements that we would need to commit for such restaurants. If we determine that a Burger King restaurant is underperforming, we may elect to close such restaurant. We closed eight Burger King restaurants in 2006. We currently anticipate that we will likely elect to close three to four Burger King restaurants in 2007. Based on the current operating results of such restaurants, we believe that the impact on our results of operations as a result of such restaurant closures will not be material, although there can be no assurance in this regard. Our determination of whether to close such restaurants is not final and is subject to further evaluation and may change. We may also elect to close additional Burger King restaurants in the future.

## **Executive Summary**

### ***Operating Performance for the Year ended December 31, 2006***

Total revenues for the year ended December 31, 2006 increased 6.3% to \$751.4 million from \$706.9 million in the prior year. Revenues from our Hispanic Brands increased 10.3% to \$382.5 million from \$346.8 million in the prior year and revenues from our Burger King restaurants increased 2.4% to \$368.9 million from \$360.1 million in the prior year. In 2006, we opened 17 new restaurants (eight Pollo Tropical and nine Taco Cabana restaurants) and closed ten restaurants including eight Burger King restaurants, one Pollo Tropical restaurant (upon the sale of our leasehold interest in such restaurant) and one underperforming Taco Cabana restaurant. Sales have grown from the continued expansion of our Hispanic brands, as well as continued sales increases from our restaurants. Comparable restaurant sales increased 3.2% in 2006 over 2005 for Pollo Tropical, 1.7% for Taco Cabana and 4.2% for our Burger King restaurants.

Income from operations was \$64.2 million in 2006 (including non-recurring gains of \$2.8 million related to the sale of a Pollo Tropical leasehold interest and from the reduction in reserves established in 2001 for certain restaurant closings) compared to \$41.4 million in 2005 (which included \$16.4 million of stock compensation expense). After adjusting for the 2006 non-recurring gains and 2005 stock compensation expense, income from operations increased 6.3%. The effect of the sale-leasebacks and lease amendments discussed above reduced operating margins by approximately 0.17%.

Segment EBITDA for our Hispanic Brands increased to \$61.9 million in 2006 from \$60.6 million in the prior year, an increase of 2.2%. Pollo Tropical operating margins for 2006 were impacted by higher restaurant hourly labor rates due to labor market conditions in Florida, including an increase in the Florida minimum wage rate. Segment EBITDA for our Burger King restaurants increased 7.6% in 2006 to \$34.2 million from \$31.8 million in 2005. Operating results in 2006 improved based on increases in sales for all three segments and higher operating margins at our Burger King restaurants, primarily from lower food costs as a percentage of restaurant sales.

Net income for the year ended December 31, 2006 was \$13.4 million, or \$0.83 per share (based upon 16.2 million weighted average diluted shares). This compares to a net loss of \$4.4 million in the prior year

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period, or a \$0.29 net loss per share (based upon 14.9 million weighted average diluted shares) for the year ended December 31, 2005. Net income for 2006 included non-recurring after-tax gains of \$1.9 million, or \$.12 per share. Net loss for 2005 included stock compensation expense of \$14.2 million, net of applicable taxes, or \$.95 per share.

During 2006, we continued to reduce our outstanding term loan borrowings under our prior senior credit facility by making principal prepayments of \$91.2 million, including \$68.0 million from the use of the net proceeds received by us from our IPO (after deducting underwriting discounts and commissions but before deducting costs and expense payable by us in connection with the IPO). The total principal amount outstanding under our prior senior credit facility decreased from \$211.8 million at December 31, 2005 to \$118.4 million at December 31, 2006.

Our capital expenditures totaled \$45.1 million in 2006 including \$28.1 million for the construction of new restaurants, \$6.4 million for remodeling, and \$10.6 million for maintenance and other capital expenditures.

## **Liquidity and Capital Resources**

We do not have significant receivables or inventory and receive trade credit based upon negotiated terms in purchasing food products and other supplies. We are able to operate with a substantial working capital deficit because:

restaurant operations are primarily conducted on a cash basis;

rapid turnover results in a limited investment in inventories; and

cash from sales is usually received before related liabilities for food, supplies and payroll become due.

Interest payments under our debt obligations, capital expenditures, and meeting our lease obligations represent significant liquidity requirements for us. We believe cash generated from our operations, availability under our revolving credit facility and proceeds from anticipated sale-leaseback transactions will provide sufficient cash availability to cover our anticipated working capital needs, capital expenditures (which include new restaurant development and represent a major investment of cash for us), and debt service requirements for the next twelve months.

*Operating activities.* Net cash provided from operating activities for the years ended December 31, 2006, 2005 and 2004 was \$48.8 million, \$22.0 million and \$59.2 million, respectively. The increase in 2006 primarily resulted from a reduction in net cash provided from operating activities of \$26.4 million in 2005 due to payments in the first quarter of 2005 associated with the December 2004 Transactions, which included a \$20.3 million bonus to employees (including management) and a director and the applicable taxes of \$0.6 million, as well as \$5.5 million of tax withholdings related to the dividend payment in late December of 2004.

Our income tax payments included in operating activities have been historically reduced due to the utilization of Federal net operating loss carryforwards in years prior to 2006 and for 2006 the utilization of tax credit carryforwards. We had no Federal net operating loss carryforwards as of December 31, 2005. For tax years beginning in 2007, we have available Federal alternative minimum tax credit carryforwards of \$0.5 million.

*Investing activities including capital expenditures and qualified sale-leaseback transactions.* Net cash used for investing activities for the years ended December 31, 2006, 2005 and 2004 was \$10.4 million, \$33.9 million and \$8.5 million, respectively. Capital expenditures represent a major investment of cash for us, and, excluding acquisitions, for the years ended December 31, 2006, 2005 and 2004, were \$45.1 million, \$34.6 million and \$19.1 million, respectively. Our capital expenditures included expenditures for development of new Pollo Tropical and Taco Cabana restaurants for the years ended December 31, 2006, 2005 and 2004, of \$27.8 million, \$19.4 million and \$8.6 million, respectively. In addition, we acquired four Taco Cabana restaurants from a franchisee for a cash purchase price of \$4.2 million in 2005. We sold other properties, primarily non-operating restaurant properties, in 2006, 2005 and 2004 for proceeds of \$1.8 million, \$0.8 million and \$1.2 million, respectively. The net proceeds from these sales were used to reduce outstanding borrowings under our prior senior credit facility.

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In 2006, we sold 24 restaurant properties in sale-leaseback transactions for net proceeds of \$36.3 million. Thirteen of these properties were acquired on June 30, 2006 from the lessor for \$16.2 million when we exercised our right of first refusal under the subject leases. The underlying leases for these 13 properties were previously treated as lease financing obligations and the purchases of these properties are shown in our consolidated statements of cash flows under financing activities as settlements of lease financing obligations. The proceeds from these sales, net of costs of the properties acquired and other transaction costs, were used to reduce outstanding borrowings under our prior senior credit facility. In 2005, we sold four restaurant properties in sale-leaseback transactions for net proceeds of \$5.2 million and in 2004 we sold eight restaurant properties in sale-leaseback transactions for net proceeds of \$11.0 million. The net proceeds from these sales were used to reduce outstanding debt under our prior senior credit facility. We also had expenditures related to the purchases of other restaurant properties to be sold in sale-leaseback transactions of \$3.4 million, \$1.1 million and \$1.6 million in 2006, 2005 and 2004, respectively.

Our capital expenditures are primarily for (1) new restaurant development, which includes the purchase of related real estate; (2) restaurant remodeling, which includes the renovation or rebuilding of the interior and exterior of our existing restaurants, including expenditures associated with Burger King franchise renewals; (3) other restaurant capital expenditures, which include capital restaurant maintenance expenditures for the ongoing reinvestment and enhancement of our restaurants; and (4) corporate and restaurant information systems.

The following table sets forth our capital expenditures for the periods presented (in thousands):

|  | Pollo<br>Tropical      | Taco<br>Cabana | Burger<br>King | Other    | Consolidated |
|--|------------------------|----------------|----------------|----------|--------------|
|  | (Dollars in thousands) |                |                |          |              |
| <b>Year Ended December 31, 2006:</b>         |                        |                |                |          |              |
| New restaurant development                   | \$ 14,336              | \$ 13,472      | \$ 324         | \$       | \$ 28,132    |
| Restaurant remodeling                        | 1,562                  | 253            | 4,557          |          | 6,372        |
| Other restaurant capital expenditures (1)    | 2,277                  | 3,326          | 3,446          |          | 9,049        |
| Corporate and restaurant information systems |                        |                |                | 1,586    | 1,586        |
| Total capital expenditures                   | \$ 18,175              | \$ 17,051      | \$ 8,327       | \$ 1,586 | \$ 45,139    |
| Number of new restaurant openings            | 8                      | 9              |                |          | 17           |
| <b>Year Ended December 31, 2005:</b>         |                        |                |                |          |              |
| New restaurant development                   | \$ 10,235              | \$ 9,143       | \$ 1,235       | \$       | \$ 20,613    |
| Restaurant remodeling                        | 1,384                  |                | 2,634          |          | 4,018        |
| Other restaurant capital expenditures (1)    | 2,505                  | 3,434          | 2,745          |          | 8,684        |
| Acquisition of Taco Cabana restaurants       |                        | 4,215          |                |          | 4,215        |
| Corporate and restaurant information systems |                        |                |                | 1,319    | 1,319        |
| Total capital expenditures                   | \$ 14,124              | \$ 16,792      | \$ 6,614       | \$ 1,319 | \$ 38,849    |
| Number of new restaurant openings            | 6                      | 6              | 1              |          | 13           |
| <b>Year Ended December 31, 2004:</b>         |                        |                |                |          |              |
| New restaurant development                   | \$ 4,542               | \$ 4,059       | \$ 1,053       | \$       | \$ 9,654     |
| Restaurant remodeling                        |                        |                | 845            |          | 845          |
| Other restaurant capital expenditures (1)    | 2,094                  | 2,496          | 2,913          |          | 7,503        |
| Corporate and restaurant information systems |                        |                |                | 1,071    | 1,071        |
| Total capital expenditures                   | \$ 6,636               | \$ 6,555       | \$ 4,811       | \$ 1,071 | \$ 19,073    |
| Number of new restaurant openings            | 3                      | 5              | 1              |          | 9            |

- (1) Excludes restaurant repair and maintenance expenses included in other restaurant operating expenses in our Consolidated Financial Statements. For the years ended December 31, 2006, 2005 and 2004, these restaurant repair and maintenance expenses were approximately \$17.4 million, \$18.1 million and \$15.8 million, respectively.





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In 2007, we anticipate that total capital expenditures will range from \$60 million to \$67 million, although the actual amount of capital expenditures may differ from these estimates. These capital expenditures are expected to include approximately \$35 million to \$40 million for the development of new restaurants and purchase of related real estate applicable to our Pollo Tropical and Taco Cabana restaurant concepts. In 2007 we anticipate opening approximately seven to ten new Pollo Tropical restaurants and ten to twelve new Taco Cabana restaurants. Capital expenditures in 2007 also are expected to include expenditures of approximately \$17 million to \$19 million for the ongoing reinvestment in our three restaurant concepts for remodeling costs and capital maintenance expenditures and approximately \$8 million in other capital expenditures, including the capital expenditures of approximately \$4 million related to the replacement and upgrade of our point-of-sale restaurant systems.

*Financing activities.* Net cash used for financing activities for the years ended December 31, 2006, 2005 and 2004 was \$43.7 million, \$10.2 million and \$21.7 million, respectively. Financing activities in these periods consisted of repayments under our debt arrangements and the sale of restaurants in sale-leaseback transactions accounted for as lease financing obligations with proceeds of \$4.5 million for the year ended December 31, 2004. The net proceeds from these sales were used to reduce outstanding borrowings under our prior senior credit facility.

In 2006, we received net proceeds of \$68.0 million from our IPO, which is net of underwriting discounts and commissions but before any offering expenses, which was used to repay term loan borrowings under the prior senior credit facility. We also made voluntary principal prepayments on outstanding borrowings under the prior senior credit facility of \$22.4 million and \$6.0 million in 2006 and 2005, respectively. In 2004, we completed the private placement of \$180.0 million of our Notes. Concurrently, we repaid all outstanding borrowings under our then existing senior secured credit facility and amended and restated that credit facility with a new syndicate of lenders. We received \$400.0 million in total proceeds that included the issuance of the Notes and \$220.0 million principal amount of term loan B borrowings under the prior senior credit facility. The net proceeds from the December 2004 Transactions were primarily utilized to repay borrowings outstanding under the then existing senior credit facility of \$74.4 million, to retire all of Carrols 9 1/2% senior subordinated notes due 2008 outstanding in the amount, including redemption premiums, of \$175.9 million, to pay a dividend to Carrols Restaurant Group's stockholders, in the amount of \$116.8, to pay fees and expenses related to the refinancing of \$8.8 million, and to pay a bonus to employees and a director totaling \$20.9 million, including payroll taxes of \$0.6 million (reflected as an operating activity on the statement of cash flows).

Financing activities in 2006 also included the payment of \$17.2 million, which was comprised of \$15.2 million of lease financing obligations and \$2.0 million of interest, to acquire fourteen leased properties previously accounted for as lease financing obligations. In addition, in 2005, we purchased one restaurant property subject to a lease financing obligation for \$1.1 million under our right of first refusal included in the subject lease. These purchases are shown as principal payments in the statement of cash flows as they relate to previously recorded lease financing obligations.

***Debt and Other Obligations***

*Indebtedness.* At December 31, 2006 we had total debt outstanding of \$358.5 million comprised of \$180.0 million of Notes, term loan borrowings of \$118.4 million under the prior senior credit facility, lease financing obligations of \$58.6 million and capital lease obligations of \$1.5 million. There were no outstanding borrowings at December 31, 2006 under the prior revolving credit facility. After reserving \$15.0 million for letters of credit guaranteed by the facility, \$35.0 million was available for borrowings under our revolving credit facility at December 31, 2006.

*New Senior Credit Facility.* On March 9, 2007, we terminated our prior senior credit facility and Carrols entered into a loan agreement providing for a new senior credit facility with a syndicate of lenders. Our new senior credit facility totals approximately \$185.0 million, consisting of \$120.0 million principal amount of term

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loan A borrowings maturing on March 8, 2013 (or earlier on September 30, 2012 if the Notes are not refinanced by June 30, 2012) and a \$65.0 million revolving credit facility (including a sub limit of up to \$25.0 million for letters of credit and up to \$5.0 million for swingline loans), maturing on March 8, 2012. The term loan A borrowings and an additional \$4.3 million of revolver borrowings from this facility were used to repay all outstanding borrowings and other obligations under the prior senior credit facility and to pay certain fees and expenses incurred in connection with the new senior credit facility.

Both term loan and revolving credit borrowings under the new senior credit facility bear interest at a per annum rate, at Carrols' option, of either:

- 1) the applicable margin ranging from 0% to 0.25% based on Carrols' senior leverage ratio (as defined in the new credit facility) (with an initial margin set at 0% until at least the end of the second quarter of fiscal 2007) plus the greater of (i) the prime rate or (ii) the federal funds rate for that day plus 0.5%; or
- 2) Adjusted LIBOR plus the applicable margin percentage in effect ranging from 1.0% to 1.5% based on Carrols' senior leverage ratio (with an initial margin set at 1.25% until at least the end of the second quarter of fiscal 2007).

Term loan A borrowings shall be due and payable in quarterly installments, beginning on June 30, 2008 as follows:

- 1) four quarterly installments of \$1.5 million beginning on June 30, 2008;
- 2) eight quarterly installments of \$3.0 million beginning on June 30, 2009;
- 3) four quarterly installments of \$4.5 million beginning on June 30, 2011; and
- 4) four quarterly installments of \$18.0 million beginning on June 30, 2012.

Under the new senior credit facility, Carrols is also required to make mandatory prepayments of principal on term loan A borrowings (a) annually in an initial amount equal to 50% of Excess Cash Flow (as defined in the senior credit facility) less any voluntary prepayments made by Carrols on the term loan A borrowings during the prior fiscal year, (b) in the event of certain dispositions of assets (all subject to certain exceptions) and insurance proceeds, in an amount equal to 100% of the net proceeds received by Carrols therefrom; *provided*, that, in the event of any of disposition of assets resulting from a Specified Asset Sale (as defined in the new senior credit facility), Carrols must prepay term loan A borrowings in an amount equal to 50% of the net proceeds received by Carrols therefrom, *provided, further*, that, if any of the remaining 50% of the net proceeds received by Carrols pursuant to a Specified Asset Sale are not used to effect a Permitted Repurchase (a repurchase of our common stock as defined in the new senior credit facility) within 270 days of receipt of such net proceeds, Carrols must use such unused net proceeds to prepay outstanding term loan A borrowings.

In general, Carrols' obligations under the new senior credit facility are guaranteed by Carrols Restaurant Group and all of Carrols' material subsidiaries and are collateralized by a pledge of the Carrols' common stock and the stock of each of the material Carrols' subsidiaries. The new senior credit facility contains certain covenants, including, without limitation, those limiting the Company's ability to incur indebtedness, incur liens, sell or acquire assets or businesses, change the nature of its business, engage in transactions with related parties, make certain investments or pay dividends. In addition, the Company is required to meet certain financial ratios, including fixed charge coverage, senior leverage, and total leverage ratios (all as defined under the new senior credit facility).

*Notes.* As part of the December 2004 Transactions, on December 15, 2004 Carrols issued \$180.0 million of 9% Senior Subordinated Notes due 2013. The Notes bear interest at a rate of 9% payable semi-annually on January 15 and July 15 and mature on January 15, 2013. The Notes are redeemable at the option of Carrols in whole or in part on or after January 15, 2009 at a price of 104.5% of the principal amount if redeemed before January 15, 2010, 102.25% of the principal amount if redeemed after January 15, 2010 but before January 15, 2011 and at 100% of the principal amount after January 15, 2011.



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The Notes are unsecured and guaranteed by Carrols' material subsidiaries. Restrictive covenants under the Notes include limitations with respect to, among other things, Carrols and its material subsidiaries' ability to incur additional debt, incur liens, sell or acquire assets or businesses, pay dividends and make certain investments. Carrols was in compliance as of and for the year ended December 31, 2006 with the restrictive covenants in the Indenture governing the Notes.

In connection with the sale of \$180 million of Notes, Carrols and its subsidiary guarantors entered into a registration rights agreement which provided that we and the guarantor subsidiaries agreed to file, and cause to become effective, a registration statement with the SEC in which we offered the holders of the Notes the opportunity to exchange such Notes for newly issued Notes that had terms which were identical to the Notes but that were registered under the Securities Act of 1933, as amended, which we refer to as the "exchange offer". Pursuant to the registration rights agreement, because we did not complete the exchange offer on or prior to June 13, 2005, the interest rate on our Notes was temporarily increased in accordance with the terms of such agreement. On December 14, 2005, the exchange offer was completed which eliminated the increased interest rate after such date. This resulted in additional interest expense of \$0.4 million during 2005.

**Contractual Obligations**

The following table summarizes our contractual obligations and commitments as of December 31, 2006 (in thousands):

|   | Total               | Payments due by period |                      |                       |                      |
|---|---------------------|------------------------|----------------------|-----------------------|----------------------|
|   |                     | Less than<br>1 Year    | 1 Year<br>to 3 Years | 3 Years<br>to 5 Years | More than<br>5 Years |
| <b>Contractual Obligations</b>                      |                     |                        |                      |                       |                      |
| Long-term debt obligations, including interest (1)  | \$ 435,018          | \$ 27,773              | \$ 55,084            | \$ 147,861            | \$ 204,300           |
| Capital lease obligations, including interest (2)   | 2,720               | 409                    | 433                  | 272                   | 1,606                |
| Operating lease obligations (3)                     | 451,917             | 40,743                 | 74,776               | 66,542                | 269,856              |
| Lease financing obligations, including interest (4) | 135,806             | 5,299                  | 11,275               | 11,492                | 107,740              |
| <b>Total contractual obligations</b>                | <b>\$ 1,025,461</b> | <b>\$ 74,224</b>       | <b>\$ 141,568</b>    | <b>\$ 226,167</b>     | <b>\$ 583,502</b>    |

(1) Our long-term debt obligations included \$180.0 million principal amount of Notes and \$118.4 million principal amount of term loan borrowings outstanding under the prior senior credit facility. Interest payments on our Notes of \$105.3 million for all years presented are included at the coupon rate of 9%. Interest payments included above totaling \$31.3 million for all years presented on our term loan borrowings under the senior credit facility are variable in nature and have been calculated using an assumed interest rate of 8.0% for each year (See Item 7A. Quantitative and Qualitative Disclosures about Market Risks - Interest Rate Risk).

(2) Includes interest of \$1.2 million in total for all years presented.

(3) Represents aggregate minimum lease payments. Many of our leases also require contingent rent in addition to the minimum base rent based on a percentage of sales and require expenses incidental to the use of the property all of which have been excluded from this table.

(4) Includes interest of \$131.2 million in total for all years presented. We reduced our lease financing obligations by \$52.8 million during 2006 by exercising our right of first refusal and purchasing fourteen restaurant properties which were concurrently sold in qualified sale-leaseback transactions and amending lease agreements for thirty-four properties accounted for as lease financing obligations to eliminate or otherwise cure the provisions that precluded the original sale-leaseback accounting under SFAS 98. These leases are reflected as operating lease obligations in the above table.

We have not included obligations under our postretirement medical benefit plans in the contractual obligations table as our postretirement plan is not required to be funded in advance, but is funded as retiree medical claims are paid. Also excluded from the contractual obligations table are payments we may make for workers' compensation, general liability and employee healthcare claims for which we pay all claims, subject to

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annual stop-loss limitations both for individual claims and claims in the aggregate. The majority of our recorded liabilities related to self-insured employee health and insurance plans represent estimated reserves for incurred claims that have yet to be filed or settled.

*Long-Term Debt Obligations.* Refer to Note 7 of the Consolidated Financial Statements for details of our long-term debt.

*Capital Lease and Operating Lease Obligations.* Refer to Note 6 of the Consolidated Financial Statements for details of our capital lease and operating lease obligations.

*Lease Financing Obligations.* Refer to Note 8 of the Consolidated Financial Statements for details of our lease financing obligations.

**Off-Balance Sheet Arrangements**

We have no off-balance sheet arrangements other than our operating leases, which are primarily for our restaurant properties and not recorded on our consolidated balance sheet.

**Inflation**

The inflationary factors that have historically affected our results of operations include increases in food and paper costs, labor and other operating expenses, and most recently, energy costs. Wages paid in our restaurants are impacted by changes in the Federal and state hourly minimum wage rates. Accordingly, changes in the Federal and state hourly minimum wage rates directly affect our labor costs. We typically attempt to offset the effect of inflation, at least in part, through periodic menu price increases and various cost reduction programs. However, no assurance can be given that we will be able to offset such inflationary cost increases in the future.

**Results of Operations**

The following table sets forth, for 2006, 2005 and 2004, selected operating results as a percentage of total restaurant sales:

|   | Year Ended December 31, |        |        |
|---|-------------------------|--------|--------|
|   | 2006                    | 2005   | 2004   |
| Restaurant sales:   |                         |        |        |
| Pollo Tropical  | 20.4%                   | 19.3%  | 17.8%  |
| Taco Cabana   | 30.4%                   | 29.7%  | 29.1%  |
| Burger King   | 49.2%                   | 51.0%  | 53.1%  |
| Total restaurant sales  | 100.0%                  | 100.0% | 100.0% |
| Costs and expenses:   |                         |        |        |
| Cost of sales   | 28.2%                   | 29.0%  | 29.1%  |
| Restaurant wages and related expenses                                   | 29.2%                   | 29.0%  | 29.7%  |
| Restaurant rent expense   | 5.0%                    | 4.9%   | 5.0%   |
| Other restaurant operating expenses                                     | 14.7%                   | 14.6%  | 13.3%  |
| Advertising expense   | 3.7%                    | 3.6%   | 3.5%   |
| General and administrative (including stock-based compensation expense) | 6.6%                    | 8.4%   | 6.3%   |

**Fiscal 2006 Compared to Fiscal 2005**

In 2006, we opened eight new Pollo Tropical restaurants and nine new Taco Cabana restaurants. During the same period, we closed eight Burger King restaurants, one Pollo Tropical restaurant (in connection with the sale of our leasehold interest in such restaurant) and one Taco Cabana restaurant.

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*Restaurant Sales.* Total restaurant sales in 2006 increased by \$44.7 million, or 6.3%, to \$750.1 million due primarily to sales increases at our Hispanic Brand restaurants of \$35.8 million, or 10.4%, to \$381.2 million in 2006.

Pollo Tropical restaurant sales increased \$17.3 million, or 12.7%, to \$153.1 million in 2006 due primarily to the opening of fourteen new Pollo Tropical restaurants since the beginning of 2005, which contributed \$13.1 million in sales in 2006, and a 3.2% increase in comparable restaurant sales at our Pollo Tropical restaurants in 2006 which included the effect of menu price increases of 2.4% for 2006 compared to 2005.

Taco Cabana restaurant sales increased \$18.6 million, or 8.9% to \$228.1 million in 2006 due primarily to the addition of fifteen new Taco Cabana restaurants since the beginning of 2005 and the acquisition of four Taco Cabana restaurants from a franchisee in July 2005. These 19 additional restaurants contributed \$15.6 million of additional sales in 2006. In addition, comparable restaurant sales at our Taco Cabana restaurants increased 1.7% in 2006 which included the effect of menu price increases of 1.2% for 2006 compared to 2005.

Burger King restaurant sales increased \$8.8 million, or 2.4%, to \$368.9 million, in 2006 due to a 4.2% increase in comparable restaurant sales at our Burger King restaurants in 2006 which included the effect of menu price increases of approximately 4% at the beginning of 2006. These factors were offset in part by the closure of 21 Burger King restaurants since the beginning of 2005.

*Operating Costs and Expenses.* Cost of sales (food and paper costs), as a percentage of total restaurant sales, decreased to 28.2% in 2006 from 29.0% in 2005. Pollo Tropical cost of sales, as a percentage of Pollo Tropical restaurant sales, decreased 1.0% to 32.3% in 2006 from 33.3% in 2005 due primarily to lower whole chicken commodity costs (1.2% of Pollo Tropical sales) offset by increases in the cost of other commodities including produce (0.2% of Pollo Tropical sales). Taco Cabana cost of sales, as a percentage of Taco Cabana restaurant sales, increased to 29.0% in 2006 from 28.8% in 2005 due primarily to higher commodity costs including paper costs. Burger King cost of sales, as a percentage of Burger King restaurant sales, decreased to 26.0% in 2006 from 27.5% in 2005 due primarily to the effect of menu price increases since the beginning of 2005 (0.9% of Burger King sales), lower beef commodity prices (0.4% of Burger King sales) and lower promotional discounting in 2006 (0.3% of Burger King sales).

Restaurant wages and related expenses, as a percentage of total restaurant sales, increased to 29.2% in 2006 from 29.0% in 2005. Pollo Tropical restaurant wages and related expenses, as a percentage of Pollo Tropical restaurant sales, increased 1.7% to 25.2% in 2006 from 23.5% in 2005 due primarily to increases in restaurant hourly labor rates in response to labor market conditions in Florida (1.1% of Pollo Tropical sales) and higher medical insurance costs (0.6% of Pollo Tropical sales). Taco Cabana restaurant wages and related expenses, as a percentage of Taco Cabana restaurant sales, increased to 28.5% in 2006 from 28.1% in 2005 due primarily to higher medical insurance costs (0.2% of Taco Cabana sales). Burger King restaurant wages and related expenses, as a percentage of Burger King restaurant sales, decreased to 31.2% in 2006 from 31.5% in 2005 due to the effect of higher sales volumes, including menu price increases, on fixed labor costs (0.5% of Burger King sales) offset in part by higher restaurant level bonuses (0.3% of Burger King sales).

Restaurant rent expense, as a percentage of total restaurant sales, increased to 5.0% in 2006 from 4.9% in 2005 due primarily to the effect of sale-leaseback transactions entered into since the beginning of the fourth quarter of 2005 (0.1% of total restaurant sales).

Other restaurant operating expenses, as a percentage of total restaurant sales, increased to 14.7% in 2006 from 14.6% in 2005. Pollo Tropical other restaurant operating expenses, as a percentage of Pollo Tropical restaurant sales, increased to 13.0% in 2006 from 12.4% in 2005 due primarily to increased utility costs resulting from higher natural gas and electricity prices (0.4% of Pollo Tropical sales) and higher credit card fees. Taco Cabana other restaurant operating expenses, as a percentage of Taco Cabana restaurant sales, increased slightly to 14.7% in 2006 from 14.6% in 2005 due primarily to increased utility costs from higher natural gas and electricity prices. Burger King other restaurant operating expenses, as a percentage of Burger King restaurant sales, were 15.4% in both 2006 and 2005.

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Advertising expense, as a percentage of total restaurant sales, increased to 3.7% in 2006 from 3.6% in 2005. Pollo Tropical advertising expense, as a percentage of Pollo Tropical restaurant sales, decreased to 1.6% in 2006 from 1.9% in 2005 due to higher television and radio advertising expenditures in 2005. Taco Cabana advertising expense, as a percentage of Taco Cabana restaurant sales, decreased slightly to 4.1% in 2006 from 4.2% in 2005 due primarily to the timing of promotions. Burger King advertising expense, as a percentage of Burger King restaurant sales, increased to 4.3% in 2006 from 3.9% in 2005 due to increased local promotional activities in certain of our Burger King markets.

General and administrative expenses, including stock-based compensation expense, as a percentage of total restaurant sales, decreased to 6.6% in 2006 from 8.4% in 2005. Stock-based compensation expense was \$0.1 million and \$16.4 million in 2006 and 2005, respectively, or as a percentage of total restaurant sales, 2.3% in 2005. Stock-based compensation expense in 2005 was primarily attributable to our issuance of common stock in exchange for all outstanding stock options in the second quarter of 2005. In addition to the decrease in stock-based compensation expense, general and administrative expenses increased 0.5% as a percentage of total restaurant sales, in 2006 compared to 2005 due primarily to higher administrative payroll costs, including related payroll taxes and benefits, (0.2% of total restaurant sales) and higher bonus accruals (0.2% of total restaurant sales).

*Segment EBITDA.* Segment EBITDA is a measure of segment profit or loss reported to the chief operating decision maker for purposes of allocating resources to our segments and assessing their performance. Segment EBITDA for our Pollo Tropical restaurants decreased 1.0% to \$28.4 million in 2006 from \$28.7 million in 2005. Segment EBITDA for our Taco Cabana restaurants increased 4.9% to \$33.5 million in 2006 from \$31.9 million in 2005. Segment EBITDA for our Burger King restaurants increased 7.6% to \$34.2 million in 2006 from \$31.8 million in 2005.

*Depreciation and Amortization and Impairment Losses.* Depreciation and amortization expense increased to \$33.5 million in 2006 from \$33.1 million in 2005. In 2006 depreciation and amortization increased \$1.4 million in total for our Pollo Tropical and Taco Cabana restaurants due primarily to the opening of new restaurants. This increase was partially offset by a decrease in depreciation and amortization for our Burger King restaurants in 2006 of \$1.0 million due primarily to Burger King restaurant closures over the past two years. Impairment losses were \$1.0 million in 2006 and were related to property and equipment of certain underperforming Taco Cabana restaurants of \$0.7 million and property and equipment for planned future closures of Burger King restaurants of \$0.3 million. Impairment losses were \$1.5 million in 2005 and were comprised of \$0.3 million related to Burger King franchise rights and \$1.1 million related to property and equipment of certain underperforming Burger King restaurants and planned future closures of Burger King restaurants and \$0.1 million for our Taco Cabana restaurants.

*Interest Expense.* Interest expense increased \$1.3 million to \$44.3 million in 2006 from \$43.0 million in 2005 due primarily to the inclusion in interest expense of \$1.7 million of settlement losses on lease financing obligations and higher effective interest rates on our floating rate borrowings under our prior senior credit facility. This increase was partially offset by the recharacterization of leases as qualified sale-leasebacks rather than lease financing obligations in the second and third quarters of 2006 which decreased interest expense by \$2.6 million in 2006. The weighted average interest rate on our long-term debt, excluding lease financing obligations, for the year ended December 31, 2006 increased to 8.3% from 7.3% in 2005. Interest expense on lease financing obligations, including settlement losses of \$1.7 million in 2006, was \$10.4 million in 2006 and \$11.2 million in 2005.

*Provision for Income Taxes.* The provision for income taxes for the year ended December 31, 2006 was derived using an estimated effective annual income tax rate for 2006 of 32.9% as well as the effect of any discrete tax items occurring in 2006. Although we had a pretax loss of \$1.6 million in 2005 we had a tax provision of \$2.8 million for the year ended December 31, 2005 due to the non-deductible portion of stock-based compensation expense related to stock awards in the second quarter of 2005. The Federal tax provision for 2005

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included \$3.3 million for the non-deductible portion of stock-based compensation expense and \$0.5 million of income tax expense associated with Ohio state tax legislation enacted in the second quarter of 2005.

*Net Income (Loss).* As a result of the foregoing, net income was \$13.4 million in 2006 compared to a net loss of \$4.4 million in 2005.

**Fiscal 2005 Compared to Fiscal 2004**

In 2005, we opened six new Pollo Tropical restaurants, six new Taco Cabana restaurants and one new Burger King restaurant. We also acquired four Taco Cabana restaurants from a former franchisee, closed 13 Burger King restaurants and one Taco Cabana restaurant. Fiscal 2005 included 52 weeks compared to 53 weeks in fiscal 2004.

*Restaurant Sales.* Total restaurant sales in 2005 increased by \$9.1 million, or 1.3% to \$705.4 million due to comparable sales increases at all three of our restaurant concepts and the net addition of three restaurants. The extra week in 2004 contributed consolidated sales of \$13.0 million in 2004 attributable to our three restaurant concepts as follows: Pollo Tropical \$2.3 million; Taco Cabana \$3.8 million; and Burger King \$6.9 million.

Pollo Tropical restaurant sales increased \$11.8 million, or 9.5%, including sales in the extra week in 2004 of \$2.3 million, to \$135.8 million in 2005 due in part to a 4.7% sales increase in comparable restaurant sales at our Pollo Tropical restaurants. This increase was from an increase in the average sales transaction due in part to menu price increases of approximately 4% near the end of the second quarter of 2005. The addition of nine restaurants since the beginning of 2004 contributed \$7.9 million of additional sales in 2005.

Taco Cabana restaurant sales increased \$7.0 million, or 3.5%, including sales in the extra week in 2004 of \$3.8 million to \$209.5 million in 2005 due primarily to the net addition of nine restaurants since the beginning of 2004 and the acquisition of four restaurants from a franchisee in the third quarter of 2005. These thirteen restaurants contributed \$8.6 million of additional sales in 2005. To a lesser extent, sales also increased from a 1.2% increase in comparable restaurant sales at our Taco Cabana restaurants resulting from an increase in the average sales transaction compared to 2004.

During October of 2005 our Pollo Tropical restaurants were negatively impacted by hurricanes Katrina and Wilma, and our Taco Cabana restaurants in the Houston market were negatively impacted by hurricane Rita. Although the restaurants collectively suffered only minimal property damage, our estimate of lost revenues from restaurants temporarily closed were, in the aggregate, approximately \$1.8 million.

Burger King restaurant sales were \$360.1 million in 2005, including sales in the extra week in 2004 of \$6.9 million, decreased \$9.7 million due primarily to the closing of 13 underperforming Burger King restaurants during 2005. Comparable restaurant sales at our Burger King restaurants increased 1.0% in 2005 over 2004 from an increase in the average sales transaction due to menu price increases.

*Operating Costs and Expenses.* Cost of sales (food and paper costs), as a percentage of total restaurant sales, decreased slightly to 29.0% in 2005 from 29.1% in 2004. Pollo Tropical cost of sales, as a percentage of Pollo Tropical restaurant sales, increased 1.9% to 33.3% in 2005 from 31.4% in 2004 due to significant increases in chicken commodity costs (1.5% of Pollo Tropical sales) and increases in other commodity costs (0.6% of Pollo Tropical sales) partially offset by menu price increases in 2005. Taco Cabana cost of sales, as a percentage of Taco Cabana restaurant sales, decreased to 28.8% in 2005 from 29.8% in 2004 due to improvements in restaurant-level food controls (0.8% of Taco Cabana sales) and higher vendor rebates (0.2% of Taco Cabana sales). The effect of menu price increases at our Taco Cabana restaurants in early 2005 substantially offset increases in commodity costs. Burger King cost of sales, as a percentage of Burger King restaurant sales, decreased to 27.5% in 2005 from 27.9% in 2004 due to the effect of menu price increases in 2005 (1.0% of Burger King sales) offset in part by an increase in beef commodity prices (0.2% of Burger King sales), higher promotional sales discounts (0.2% of Burger King sales) and lower rebates (0.1% of Burger King sales).



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Restaurant wages and related expenses, as a percentage of total restaurant sales, decreased to 29.0% in 2005 from 29.7% in 2004. Pollo Tropical restaurant wages and related expenses, as a percentage of Pollo Tropical restaurant sales, decreased 1.8% to 23.5% in 2005 from 25.3% in 2004 due primarily to the effect on fixed labor costs of higher comparable restaurant sales volumes (0.5% of Pollo Tropical sales), the effect of menu price increases in 2005 (0.5% of Pollo Tropical sales) and lower medical insurance costs (0.7% of Pollo Tropical sales). Taco Cabana restaurant wages and related expenses, as a percentage of Taco Cabana restaurant sales, decreased to 28.1% in 2005 from 28.5% in 2004 due primarily to the effect of menu price increases in 2005. Burger King restaurant wages and related expenses, as a percentage of Burger King restaurant sales, decreased to 31.5% in 2005 from 31.8% in 2004 due to lower medical insurance costs (0.1% of Burger King sales) and lower restaurant level bonuses (0.1% of Burger King sales).

Restaurant rent expense, as a percentage of total restaurant sales, decreased to 4.9% in 2005 from 5.0% in 2004 due primarily to the effect of comparable restaurant sales increases on fixed rental costs.

Other restaurant operating expenses, as a percentage of total restaurant sales, increased to 14.6% in 2005 from 13.3% in 2004. Pollo Tropical other restaurant operating expenses, as a percentage of Pollo Tropical restaurant sales, increased to 12.4% in 2005 from 10.9% in 2004 due primarily to higher utility costs resulting from higher natural gas and electricity prices (0.4% of Pollo Tropical sales), higher general liability claim costs (0.2% of Pollo Tropical sales) and increased fees due to increased levels of credit card sales (0.2% of Pollo Tropical sales). Taco Cabana other restaurant operating expenses, as a percentage of Taco Cabana restaurant sales, increased to 14.6% in 2005 from 13.2% in 2004 due primarily to higher utility costs from higher natural gas prices and increased electricity usage (0.7% of Taco Cabana sales) and higher maintenance costs associated with initiatives to enhance the appearance of our Taco Cabana restaurants (0.5% of Taco Cabana sales). Burger King other restaurant operating expenses, as a percentage of Burger King restaurant sales, increased to 15.4% in 2005 from 14.3% in 2004 due higher utility costs from higher natural gas rates and during summer months, higher electricity usage (0.5% of Burger King sales), and fees associated with the acceptance of credit cards (0.2% of Burger King sales) and higher repair and maintenance expense to enhance the appearance of our Burger King restaurants (0.3% of Burger King sales).

Advertising expense, as a percentage of total restaurant sales, increased slightly to 3.6% in 2005 from 3.5% in 2004. Pollo Tropical advertising expense, as a percentage of Pollo Tropical restaurant sales, increased to 1.9% in 2005 from 1.6% in 2004 due to higher television and radio advertising expenditures in 2005. Taco Cabana advertising expense, as a percentage of Taco Cabana restaurant sales, increased slightly to 4.2% in 2005 from 4.1% in 2004. Burger King advertising expense, as a percentage of Burger King restaurant sales, was 3.9% in both 2005 and 2004.

General and administrative expenses, including stock-based compensation expense, as a percentage of total restaurant sales, increased to 8.4% in 2005 from 6.3% in 2004. Stock-based compensation expense was \$16.4 million and \$1.8 million in 2005 and 2004, respectively, or as a percentage of total restaurant sales, 2.3% and 0.3%, respectively. Stock-based compensation expense in 2005 was substantially from the issuance by us of our common stock in exchange for stock options in the second quarter of 2005. General and administrative expenses increased in total \$15.4 million in 2005 due primarily to the \$14.6 million increase in stock-based compensation expense. General and administrative expenses further increased \$0.4 million in 2005 compared to 2004 due primarily to increased legal and professional fees, including audit fees, of \$1.8 million, higher administrative salaries of \$0.6 million, and higher Company 401(k) contributions of \$0.3 million, substantially offset by lower administrative bonus expense of \$2.3 million.

*Segment EBITDA.* Our fiscal year 2004 included 53 weeks. The effect of the additional week in 2004 increased segment EBITDA in 2004 by \$0.9 million for our Pollo Tropical restaurants, \$1.4 million for our Taco Cabana restaurants and \$2.1 million for our Burger King restaurants. Segment EBITDA for our Pollo Tropical restaurant segment increased to \$28.7 million in 2005 from \$27.9 million in 2004, Segment EBITDA for our Taco Cabana restaurant segment increased to \$31.9 million in 2005 from \$30.1 million in 2004, and Segment EBITDA for our Burger King restaurant segment decreased from \$36.6 million in 2004 to \$31.8 million in 2005.

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*Depreciation and Amortization and Impairment Losses.* Depreciation and amortization expense decreased to \$33.1 million in 2005 from \$38.5 million in 2004 due primarily to lower depreciation of restaurant equipment related to our Burger King restaurants of \$2.3 million, lower depreciation due to the closure of Burger King restaurants since the beginning of 2004 of \$0.7 million, lower depreciation of corporate information systems of \$0.7 million, lower leasehold improvement amortization depreciation for our Taco Cabana restaurants of \$1.4 million and lower depreciation due to the sale/leaseback of properties in the second half of 2004.

Impairment losses were \$1.5 million in 2005 and were comprised of \$0.3 million related to Burger King franchise rights and \$1.1 million related to property and equipment of certain underperforming Burger King restaurants and planned future closures of Burger King restaurants and \$0.1 million related to property and equipment of certain underperforming Taco Cabana restaurants. Impairment losses were \$1.5 million in 2004 and were comprised of \$0.3 million related to Burger King franchise rights and \$1.2 million related to property and equipment of certain underperforming Burger King restaurants and planned future closures of Burger King restaurants.

*Interest Expense.* Interest expense increased \$7.6 million to \$43.0 million in 2005 from \$35.4 million in 2004 due primarily to higher average outstanding debt balances resulting from the December 2004 Transactions and higher effective interest rates on our floating rate borrowings under our prior senior credit facility. However, the weighted average interest rate on our long-term debt, excluding lease financing obligations, for the year ended December 31, 2005 decreased to 7.3% from 7.8% in 2004. This decrease was due to increased borrowings under our prior senior credit facility in 2005 (as a result of the December 2004 Transactions), which are at a lower rate than our borrowings under our Notes, and which also comprised a higher percentage of our total outstanding long-term debt in 2005 compared to 2004.

*Provision (Benefit) for Income Taxes.* Although we had a pretax loss of \$1.6 million in 2005 we have a tax provision of \$2.8 million for the year ended December 31, 2005 due to the non-deductible portion of stock-based compensation expense related to stock awards in the second quarter of 2005. The Federal tax provision for 2005 includes \$3.3 million for the non-deductible portion of stock-based compensation expense and \$0.5 million of income tax expense associated with Ohio state tax legislation enacted in the second quarter of 2005.

During the fourth quarter of 2005, we established a valuation allowance of \$ 1.1 million against net deferred tax assets due to state net operating loss carryforwards where realization of related deferred tax asset amounts was not likely. The estimation of future taxable income for federal and state purposes and our resulting ability to realize deferred tax assets pertaining to state net operating loss carryforwards and tax credit carryforwards can significantly change based on future events and operating results. Thus, recorded valuation allowances may be subject to material future changes.

*Net Loss.* As a result of the foregoing, we incurred a net loss of \$4.4 million in 2005 compared to a net loss of \$8.1 million in 2004.

### **Application of Critical Accounting Policies**

Our Consolidated Financial Statements and accompanying notes are prepared in accordance with accounting principles generally accepted in the United States of America. Preparing consolidated financial statements requires us to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenue and expenses. These estimates and assumptions are affected by the application of our accounting policies. Our significant accounting policies are described in the Summary of Significant Accounting Policies footnote in the notes to our Consolidated Financial Statements. Critical accounting estimates are those that require application of management's most difficult, subjective or complex judgments, often as a result of matters that are inherently uncertain and may change in subsequent periods.

Sales recognition at company-owned and operated restaurants is straightforward as customers pay for products at the time of sale and inventory turns over very quickly. Payments to vendors for products sold in the restaurants are generally settled within 30 days. The earnings reporting process is covered by our system of

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internal controls, and generally does not require significant management estimates and judgments. However, critical accounting estimates and judgments, as noted below, are inherent in the assessment and recording of accrued occupancy costs, insurance liabilities, legal obligations, income taxes, the valuation of goodwill and intangible assets for impairment and assessing impairment of long-lived assets and lease accounting matters. While we apply our judgment based on assumptions believed to be reasonable under the circumstances, actual results could vary from these assumptions. It is possible that materially different amounts would be reported using different assumptions.

*Accrued occupancy costs.* We make estimates of accrued occupancy costs pertaining to closed restaurant locations on an ongoing basis. These estimates require assessment and continuous evaluation of a number of factors such as the remaining contractual period under our lease obligations, the amount of sublease income we are able to realize on a particular property and estimates of other costs such as property taxes. Differences between actual future events and prior estimates could result in adjustments to these accrued costs. At December 31, 2006, we had three non-operating restaurant properties.

*Insurance liabilities.* We are insured for workers' compensation, general liability and medical insurance claims under policies where we pay all claims, subject to annual stop-loss limitations both for individual claims and claims in the aggregate. At December 31, 2006, we had \$7.6 million accrued for these insurance claims. We record insurance liabilities based on historical and industry trends, which are continually monitored, and adjust accruals as warranted by changing circumstances. Since there are many estimates and assumptions involved in recording these insurance liabilities, including the ability to estimate the future development of incurred claims based on historical trends, differences between actual future events and prior estimates and assumptions could result in adjustments to these liabilities.

*Legal obligations.* In the normal course of business, we must make estimates of potential future legal obligations and liabilities, which require the use of management's judgment. Management may also use outside legal advice to assist in the estimating process. However, the ultimate outcome of various legal issues could be different than management estimates and adjustments to income could be required.

*Income taxes.* We record income tax liabilities utilizing known obligations and estimates of potential obligations. We are required to record a valuation allowance if it is more likely than not that the value of estimated deferred tax assets are different from those recorded. This would include making estimates and judgments on future taxable income, the consideration of feasible tax planning strategies and existing facts and circumstances. When the amount of deferred tax assets to be realized is expected to be different from that recorded, the asset balance and income statement would reflect any change in valuation in the period such determination is made.

*Evaluation of Goodwill.* We must evaluate our recorded goodwill under Statement of Financial Accounting Standards ( SFAS ) No. 142 Goodwill and Other Intangible Assets on an ongoing basis. We have elected to conduct our annual impairment review of goodwill at December 31. Our reviews at December 31, 2006 and 2005 indicated there had been no impairment as of those dates. This annual evaluation of goodwill requires us to make estimates and assumptions to determine the fair value of our reporting units including projections regarding future operating results of each restaurant over its remaining lease term and market values. These estimates may differ from actual future events and if these estimates or related projections change in the future, we may be required to record impairment charges for these assets.

*Impairment of Long-lived Assets.* We assess the potential impairment of long-lived assets, principally property and equipment, whenever events or changes in circumstances indicate that the carrying value may not be recoverable. We determine if there is impairment at the restaurant level by comparing undiscounted future cash flows from the related long-lived assets with their respective carrying values. In determining future cash flows, significant estimates are made by us with respect to future operating results of each restaurant over its remaining lease term. If assets are determined to be impaired, the impairment charge is measured by calculating the amount by which the asset carrying amount exceeds its fair value. This process of assessing fair values

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requires the use of estimates and assumptions, which are subject to a high degree of judgment. If these assumptions change in the future, we may be required to record impairment charges for these assets.

*Impairment of Burger King Franchise Rights.* We assess the potential impairment of Burger King franchise rights whenever events or changes in circumstances indicate that the carrying value may not be recoverable. We determine if there is impairment by comparing the aggregate undiscounted future cash flows from those acquired restaurants with the respective carrying value of franchise rights for each Burger King acquisition. In determining future cash flows, significant estimates are made by us with respect to future operating results of each group of acquired restaurants over their remaining franchise life. If acquired franchise rights are determined to be impaired, the impairment charge is measured by calculating the amount by which the franchise rights carrying amount exceeds its fair value. This process requires the use of estimates and assumptions, which are subject to a high degree of judgment. If these assumptions change in the future, we may be required to record impairment charges for these assets.

*Lease Accounting.* Judgments made by management for our lease obligations include the lease term including the determination of renewal options that are reasonably assured which can affect the classification of a lease as capital or operating for accounting purposes, the term over which related leasehold improvements for each restaurant are amortized, and any rent holidays and/or changes in rental amounts for recognizing rent expense over the term of the lease. These judgments may produce materially different amounts of depreciation, amortization and rent expense than would be reported if different assumed lease terms were used.

We also must evaluate under SFAS No. 98, *Accounting for Leases* ( SFAS 98 ), sales of our restaurants which occur in sale-leaseback transactions to determine the proper accounting for the proceeds of such sales either as a sale or a financing. This evaluation requires certain judgments in determining whether or not clauses in the lease or any related agreements constitute continuing involvement under SFAS 98. These judgments must also consider the various interpretations of SFAS 98 since its issuance in 1989. For those sale-leasebacks that are accounted for as financing transactions, we must estimate our incremental borrowing rate, or an alternative rate in cases where the incremental borrowing rate is not appropriate to utilize, for purposes of determining interest expense and the resulting amortization of the lease financing obligation. Changes in the determination of the incremental borrowing rates or other rates utilized in connection with the accounting for lease financing transactions could have a significant effect on the interest expense and underlying balance of the lease financing obligations.

In addition, if a purchase option exists for any properties subject to a lease financing obligation, the purchase option is evaluated for its probability of exercise on an ongoing basis. This evaluation considers many factors including, without limitation, our intentions, the fair value of the underlying properties, our ability to acquire the property, economic circumstances and other available alternatives to us for the continued use of the property. These factors may change and be considered differently in future assessments of probability.

*Stock-based Compensation.* Beginning in 2006, we account for stock-based compensation in accordance with SFAS No. 123(R), *Share-Based Payment* ( SFAS No. 123(R) ). As required by SFAS No. 123(R), stock-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 rate of interest, expected dividend yield, expected volatility, and the expected life of the award. The risk-free rate of interest is based on the zero coupon U.S. Treasury rates appropriate for the expected term of the award. There are no expected dividends as we do not currently plan to pay dividends on our common stock. Expected stock price volatility is based on the implied volatility of a peer group that had actively traded stock during the period immediately preceding the share-based award grant. This period is equal in length to the award's expected term as we currently do not have our own historical stock price data. Compensation expense is recognized only for those options expected to vest, with forfeitures estimated based on our historical experience and future expectations.

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**Effects of New Recent Accounting Developments**

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

In July 2006, the Financial Accounting Standards Board (the FASB ) issued FASB Interpretation No. 48 Accounting for Uncertainty in Income Taxes an Interpretation of FASB Statement No. 109 ( FIN 48 ). FIN 48 prescribes a comprehensive recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 requires that only income tax benefits that meet the more likely than not recognition threshold be recognized or continue to be recognized on the effective date. For those benefits to be recognized, a tax position must also be sustained upon examination by taxing authorities. Initial derecognition amounts would be reported as a cumulative effect of a change in accounting principle recorded as an adjustment to opening retained earnings. This interpretation will be effective for us beginning January 1, 2007. We have completed our initial review of the interpretation and do not expect that the adoption of FIN 48 will have a significant impact on our consolidated financial position, results of operations or cash flows.

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements, ( SFAS 157 ). This statement defines fair value, establishes a framework for using fair value to measure assets and liabilities and expands disclosures about fair value measurements. The statement applies whenever other pronouncements require or permit assets or liabilities to be measured at fair value. SFAS 157 is effective for our fiscal year beginning January 1, 2008. We are evaluating the impact the adoption of SFAS 157 will have on our consolidated financial statements.

In September 2006, the FASB issued SFAS No. 158, Employers Accounting for Defined Benefit Pension and Other Postretirement Benefits, an amendment of FAS 87, 88, 106 and 132(R) ( SFAS 158 ) which is effective for fiscal years ending after December 15, 2006. SFAS No. 158 requires an employer that sponsors postretirement plans to recognize an asset or liability on its balance sheet for the overfunded or underfunded status of the plan and to recognize changes in that funded status in the year in which the changes occur through comprehensive income. SFAS 158 does not change the amount of actuarially determined expense that is recorded in our consolidated statement of operations. SFAS 158 also requires an employer to measure plan assets and benefit obligations as of the date of the employer s balance sheet, which is consistent with our historical measurement date. Adoption of SFAS 158 resulted in recording a liability and a charge to accumulated other comprehensive income, a component of stockholders deficit, at December 31, 2006 equal to the difference between our accrued benefit cost and our projected benefit obligation which was \$1.7 million.

In September 2006, the Securities and Exchange Commission issued Staff Accounting Bulletin No. 108, Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements, ( SAB 108 ) to address diversity in practice in quantifying financial statement misstatements. SAB 108 requires that we quantify misstatements based on their impact on each of our financial statements (both the statement of operations and statement of financial position) and related disclosures. The application of SAB 108 in the fourth quarter of 2006 did not have any impact on our consolidated financial statements.

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Liabilities Including an amendment of FASB Statement No. 115, ( SFAS 159 ). This statement permits entities to choose to measure many financial instruments and certain other items at fair value. SFAS 159 is effective for the Company s fiscal year beginning January 1, 2008. We are currently evaluating the impact of adopting SFAS No. 159.

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**ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISKS**

**Interest Rate Risk**

We are exposed to market risk associated with fluctuations in interest rates, primarily limited to our senior credit facility. There were no borrowings outstanding under the prior revolving credit facility at December 31, 2006 and \$118.4 million of term loan borrowings outstanding under the prior senior credit facility. Revolving loans under our prior senior credit facility bore interest at a per annum rate, at our option of either:

- 1) the sum of (a) the greater of (i) the prime rate or (ii) the federal funds rate plus .50%, plus (b) a margin ranging from .50% to 1.50% based on our total leverage ratio (as defined in the senior credit facility); or
- 2) LIBOR plus a margin ranging from 2.0% to 3.0% based on our total leverage ratio.

Borrowings under the term loan facility bore interest at a per annum rate, at our option, of either:

- 1) the sum of (a) the greater of (i) the prime rate or (ii) the federal funds rate plus .50%, plus (b) a margin ranging from .75% to 1.0% based on our total leverage ratio; or
- 2) LIBOR plus a margin ranging from 2.25% to 2.50% based on the Company's total leverage ratio.

A 1% change in interest rates would have resulted in an increase or decrease in interest expense of approximately \$2.0 million for the year ended December 31, 2006.

On March 9, 2007, we repaid the borrowings outstanding under the prior senior credit facility and entered into a loan agreement providing for a new senior credit facility, consisting of \$120.0 million principal amount of term loan A borrowings and a \$65.0 million revolving credit facility (including a sub limit of up to \$25.0 million for letters of credit and up to \$5.0 million for swingline loans). Borrowings under the new senior credit facility bear interest at a per annum rate, at our option, of either:

- 1) the applicable margin ranging from 0% to 0.25% based on our senior leverage ratio (as defined in the new credit facility) plus the greater of (i) the prime rate or (ii) the federal funds rate for that day plus 0.5%; or
- 2) Adjusted LIBOR plus the applicable margin percentage in effect ranging from 1.0% to 1.5% based on our senior leverage ratio.

**Commodity Price Risk**

We purchase certain products which are affected by commodity prices and are, therefore, subject to price volatility caused by weather, market conditions and other factors which are not considered predictable or within our control. Although many of the products purchased are subject to changes in commodity prices, certain purchasing contracts or pricing arrangements have been negotiated in advance to minimize price volatility. Where possible, we use these types of purchasing techniques to control costs as an alternative to directly managing financial instruments to hedge commodity prices. In many cases, we believe we will be able to address commodity cost increases that are significant and appear to be long-term in nature by adjusting our menu pricing. However, long-term increases in commodity prices may result in lower restaurant-level operating margins.

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

The financial statements and supplementary data of Carrols Restaurant Group, Inc. and Carrols Corporation required by this Item are described in Item 15 of this Annual Report on Form 10-K and are presented beginning on page F-1.

**ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE**  
Not applicable.

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**ITEM 9A. CONTROLS AND PROCEDURES**

*Disclosure Controls and Procedures.* Our senior management is responsible for establishing and maintaining disclosure controls and procedures (as defined in Rule 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934 as amended (the Exchange Act)), designed to ensure 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 Securities and Exchange Commission's rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by an issuer in the reports that it files or submits under the Exchange Act is accumulated and communicated to the issuer's management, including its principal executive officer or officers and principal financial officer or officers, or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosure.

We have evaluated the effectiveness of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act) as of the end of the period covered by this report, with the participation of our Chief Executive Officer and Chief Financial Officer, as well as other key members of our management. Based on this evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective as of December 31, 2006.

*Changes in Internal Control over Financial Reporting.* No changes occurred in our internal control over financial reporting during the fourth quarter of 2006 that materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

This Annual Report on Form 10-K does not include a report of management's assessment regarding internal control over financial reporting or an attestation report of our registered public accounting firm due to a transition period established by the rules of the SEC for new public companies.

**ITEM 9B. OTHER INFORMATION**

None



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**PART III**

**ITEM 10. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE**

Incorporated by reference from Carrols Restaurant Group, Inc.'s Definitive Proxy Statement to be filed in connection with Carrols Restaurant Group, Inc.'s 2007 Annual Meeting of Stockholders.

We have adopted written codes of ethics applicable to our directors, officers and employees in accordance with the rules of The NASDAQ Stock Market and the SEC. We make our codes of ethics available free of charge through our internet website, *www.carrols.com*. We will disclose on our website amendments to or waivers from our codes of ethics in accordance with all applicable laws and regulations.

**ITEM 11. EXECUTIVE COMPENSATION**

Incorporated by reference from Carrols Restaurant Group, Inc.'s Definitive Proxy Statement to be filed in connection with Carrols Restaurant Group, Inc.'s 2007 Annual Meeting of Stockholders.

**ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS**

Incorporated by reference from Carrols Restaurant Group, Inc.'s Definitive Proxy Statement to be filed in connection with Carrols Restaurant Group, Inc.'s 2007 Annual Meeting of Stockholders.

**ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS AND DIRECTOR INDEPENDENCE**

Incorporated by reference from Carrols Restaurant Group, Inc.'s Definitive Proxy Statement to be filed in connection with Carrols Restaurant Group, Inc.'s 2007 Annual Meeting of Stockholders.

**ITEM 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES**

Incorporated by reference from Carrols Restaurant Group, Inc.'s Definitive Proxy Statement to be filed in connection with Carrols Restaurant Group, Inc.'s 2007 Annual Meeting of Stockholders.

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Schedules other than those listed are omitted for the reason that they are not required, not applicable, or the required information is shown in the financial statements or notes thereto.

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| <b>Exhibit</b> |   |
|----------------|---|
| <b>Number</b>  | <b>Description</b>  |
| 3.1            | Form of Restated Certificate of Incorporation of Carrols Restaurant Group, Inc. (incorporated by reference to Exhibit 3.1 to Carrols Restaurant Group Inc. s Registration Statement on Form S-1, as amended (Registration No. 333-137524))  |
| 3.2            | Form of Amended and Restated By-laws of Carrols Restaurant Group, Inc. (incorporated by reference to Exhibit 3.2 to Carrols Restaurant Group Inc. s Registration Statement on Form S-1, as amended (Registration No. 333-137524))   |
| 3.3            | Restated Certificate of Incorporation of Carrols Corporation (incorporated by reference to Exhibit 3.(3)(a) to Carrols Corporation s 1987 Annual Report on Form 10-K)   |
| 3.4            | Restated By-laws of Carrols Corporation (incorporated by reference to Exhibit 3.(3)(b) to Carrols Corporation s 1986 Annual Report on Form 10-K)  |
| 4.1            | Form of Registration Agreement by and among Carrols Restaurant Group, Inc., Atlantic Restaurants, Inc., Madison Dearborn Capital Partners, L.P., Madison Dearborn Capital Partners II, L.P., Alan Vituli, Daniel T. Accordino and Joseph A. Zirkman (incorporated by reference to Exhibit 10.24 to Carrols Corporation s 1996 Annual Report on Form 10-K)   |
| 4.2            | Registration Rights Agreement, relating to the 9% Senior Subordinated Notes, dated as of December 15, 2004 by and among Carrols Corporation, the Guarantors named therein, J.P. Morgan Securities Inc., Banc of America Securities LLC, Lehman Brothers Inc., Wachovia Capital Markets, LLC and SunTrust Capital Markets, Inc. (incorporated by reference to Exhibit 10.1 to Carrols Corporation s Form 8-K filed on December 21, 2004) |
| 4.3            | Indenture governing the 9% Senior Subordinated Notes due 2013, dated as of December 15, 2004, between Carrols Corporation, the Guarantors named therein and The Bank of New York, as Trustee (incorporated by reference to Exhibit 10.2 to Carrols Corporation s Form 8-K filed on December 21, 2004)   |
| 4.4            | Form of 9% Senior Subordinated Note due 2013 (incorporated by reference to Exhibit 4.5)   |
| 4.5            | Form of Stock Certificate for Common Stock (incorporated by reference to Exhibit 4.7 to Carrols Restaurant Group Inc. s Registration Statement on Form S-1, as amended (Registration No. 333-137524))   |
| 4.6            | Form of First Supplement to Indenture by and between Carrols Corporation and The Bank of New York (incorporated by reference to Exhibit 4.8 to Carrols Restaurant Group Inc. s Registration Statement on Form S-1, as amended (Registration No. 333-137524))  |
| 10.1           | Form of Second Amended and Restated Employment Agreement dated March 27, 1997 by and between Carrols Corporation and Alan Vituli (incorporated by reference to Exhibit 10.25 to Carrols Corporation s 1996 Annual Report on Form 10-K) (1)  |
| 10.2           | Form of Second Amended and Restated Employment Agreement dated March 27, 1997 by and between Carrols Corporation and Daniel T. Accordino (incorporated by reference to Exhibit 10.26 to Carrols Corporation s 1996 Annual Report on Form 10-K) (1)  |
| 10.3           | Extension of Employment Agreement dated March 27, 2002 by and between Carrols Corporation and Alan Vituli (incorporated by reference to Exhibit 10.27 to Carrols Corporation s June 30, 2002 Quarterly Report on Form 10-Q) (1)   |

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**Exhibit**

| <b>Number</b> | <b>Description</b>  |
|---------------|---|
| 10.4          | Extension of Employment Agreement dated March 27, 2002 by and between Carrols Corporation and Daniel T. Accordino (incorporated by reference to Exhibit 10.28 to Carrols Corporation's June 30, 2002 Quarterly Report on Form 10-Q) (1)   |
| 10.5          | Carrols Corporation Retirement Savings Plan dated April 1, 1999 (incorporated by reference to Exhibit 10.29 to Carrols Corporation's 1999 Annual Report on Form 10-K) (1)   |
| 10.6          | Carrols Restaurant Group, Inc. 2001 Taco Cabana Long-Term Incentive Plan (incorporated by reference to Exhibit 10.21 to Carrols Corporation's December 31, 2003 Annual Report or 10-K) (1)  |
| 10.7          | Carrols Corporation and Subsidiaries Deferred Compensation Plan dated January 1, 2002 (incorporated by reference to Exhibit 10.26 to Carrols Corporation's March 31, 2002 Quarterly Report on Form 10-Q) (1)  |
| 10.8          | Carrols Corporation Retirement Savings plan July 1, 2002 Restatement (incorporated by reference to Exhibit 10.29 to Carrols Corporation's September 29, 2002 Quarterly Report on Form 10-Q) (1)   |
| 10.9          | Addendum incorporating EGTRRA Compliance Amendment to Carrols Corporation Retirement Savings Plan dated September 12, 2002 (incorporated by reference to Exhibit 10.30 to Carrols Corporation's September 29, 2002 Quarterly Report on Form 10-Q) (1)   |
| 10.10         | First Amendment, dated as of January 1, 2004, to Carrols Corporation Retirement Savings Plan (incorporated by reference to Exhibit 10.35 to Carrols Corporation's December 31, 2003 Annual Report on Form 10-K) (1)   |
| 10.11         | Carrols Restaurant Group, Inc. First Amended and Restated 1998 Pollo Tropical Long-Term Incentive Plan (incorporated by reference to Exhibit 10.37 to Carrols Corporation's December 31, 2003 Annual Report on Form 10-K) (1)   |
| 10.12         | Amended and Restated Loan Agreement dated as of December 15, 2004 among Carrols Corporation, JPMorgan Chase Bank, Bank of America, N.A., Sun Trust Bank, Wachovia Bank, National Association, Manufacturers and Traders Trust Company, and other lenders now or hereafter parties hereto (incorporated by reference to Exhibit 10.3 to Carrols Corporation's Form 8-K filed on December 21, 2004) |
| 10.13         | Extension of Employment Agreement dated November 11, 2004 by and between Carrols Corporation and Alan Vituli (incorporated by reference to exhibit 10.30 to Carrols Corporation's 2004 Annual Report on Form 10-K) (1)  |
| 10.14         | Extension of Employment Agreement dated as of May 3, 2005 by and between Carrols Corporation and Alan Vituli (incorporated by reference to exhibit 10.31 to Carrols Corporation's 2004 Annual Report on Form 10-K) (1)  |
| 10.15         | Extension of Employment Agreement dated November 11, 2004 by and between Carrols Corporation and Daniel T. Accordino (incorporated by reference to exhibit 10.32 to Carrols Corporation's 2004 Annual Report on Form 10-K) (1)  |
| 10.16         | Extension of Employment Agreement dated as of May 3, 2005 by and between Carrols Corporation and Daniel T. Accordino (incorporated by reference to exhibit 10.33 to Carrols Corporation's 2004 Annual Report on Form 10-K) (1)  |
| 10.17         | Amendment to Carrols Restaurant Group, Inc. 1998 Pollo Tropical Long-Term Incentive Plan (incorporated by reference to Exhibit 10.1 to Carrols Corporation's Form 8-K filed on November 1, 2004) (1)  |
| 10.18         | Amendment to Carrols Restaurant Group, Inc. 2001 Taco Cabana Long-Term Incentive Plan (incorporated by reference to Exhibit 10.2 to Carrols Corporation's Form 8-K filed on November 1, 2004) (1)   |

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**Exhibit**

| <b>Number</b> | <b>Description</b>   |
|---------------|--|
| 10.19         | Form of Stock Award Agreement of Carrols Restaurant Group, Inc. dated as of May 3, 2005 (incorporated by reference to exhibit 10.38 to Carrols Corporation's 2004 Annual Report on Form 10-K) (1)  |
| 10.20         | Form of Exchange Agreement dated as of May 3, 2005 by and between Carrols Restaurant Group, Inc. and Vituli Family Trust (incorporated by reference to exhibit 10.39 to Carrols Corporation's 2004 Annual Report on Form 10-K) (1)   |
| 10.21         | Form of Stock Award Agreement dated as of May 3, 2005 by and between Carrols Restaurant Group, Inc. and Daniel T. Accordino (incorporated by reference to exhibit 10.40 to Carrols Corporation's 2004 Annual Report on Form 10-K) (1)  |
| 10.22         | 2006 Stock Incentive Plan (incorporated by reference to Exhibit 10.27 to Carrols Restaurant Group Inc.'s Registration Statement on Form S-1, as amended (Registration No. 333-137524)) (1)   |
| 10.23         | Form of Employment Agreement by and among Carrols Restaurant Group, Inc., Carrols Corporation and Alan Vituli (incorporated by reference to Exhibit 10.28 to Carrols Restaurant Group Inc.'s Registration Statement on Form S-1, as amended (Registration No. 333-137524)) (1)   |
| 10.24         | Form of Employment Agreement by and among Carrols Restaurant Group, Inc., Carrols Corporation and Daniel T. Accordino (incorporated by reference to Exhibit 10.29 to Carrols Restaurant Group Inc.'s Registration Statement on Form S-1, as amended (Registration No. 333-137524)) (1)   |
| 10.25         | Form of Change of Control/Severance Agreement (incorporated by reference to Exhibit 10.3 to Carrols Restaurant Group Inc.'s Registration Statement on Form S-1, as amended (Registration No. 333-137524)) (1)  |
| 10.26         | Form of Agreement, by and among Carrols Restaurant Group, Inc., Madison Dearborn Capital Partners, L.P., Madison Dearborn Capital Partners, II, L.P., BIB Holdings (Bermuda) Ltd., Alan Vituli, Daniel T. Accordino and Joseph A. Zirkman (incorporated by reference to Exhibit 10.31 to Carrols Restaurant Group Inc.'s Registration Statement on Form S-1, as amended (Registration No. 333-137524))                                 |
| 10.27         | Form of Amendment No. 1 to Registration Agreement, by and among Carrols Restaurant Group, Inc., Madison Dearborn Capital Partners, L.P., Madison Dearborn Capital Partners, II, L.P., BIB Holdings (Bermuda) Ltd., Alan Vituli, Daniel T. Accordino and Joseph A. Zirkman (incorporated by reference to Exhibit 10.32 to Carrols Restaurant Group Inc.'s Registration Statement on Form S-1, as amended (Registration No. 333-137524)) |
| 10.28         | Form of Consent and Waiver among Carrols Corporation, JPMorgan Chase Bank, N.A. and other lenders now or hereafter parties to the Amended and Restated Loan Agreement, dated December 15, 2004 (incorporated by reference to Exhibit 10.33 to Carrols Restaurant Group Inc.'s Registration Statement on Form S-1, as amended (Registration No. 333-137524))  |
| 10.29         | Loan Agreement dated as of March 9, 2007 among Carrols Corporation, Wachovia Bank, National Association, Bank of America, N.A., Raymond James Bank, FSB, Wells Fargo Bank National Association, Manufacturers, Traders Trust Company and each of the lenders who are or may from time to time become a party thereto (incorporated by reference to Exhibit 10.1 to Carrols Restaurant Group, Inc.'s Form 8-K filed on March 13, 2007)  |
| 10.30         | Pledge Agreement dated as of March 9, 2007 among Carrols Restaurant Group, Inc., Carrols Corporation and the Subsidiary Pledgors (as defined therein) in favor of the Agent (incorporated by reference to Exhibit 10.2 to Carrols Restaurant Group, Inc.'s Form 8-K filed on March 13, 2007)   |
| 10.31         | Parent Guaranty Agreement dated as of March 9, 2007 among Carrols Restaurant Group, Inc., in favor of the Agent (incorporated by reference to Exhibit 10.3 to Carrols Restaurant Group, Inc.'s Form 8-K filed on March 13, 2007)   |

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**Exhibit**

| <b>Number</b> | <b>Description</b>   |
|---------------|--|
| 10.32         | Subsidiary Guaranty Agreement dated as of March 9, 2007 among each of the Subsidiary Guarantors (as defined in the Subsidiary Guaranty Agreement) in favor of the Agent (incorporated by reference to Exhibit 10.4 to Carrols Restaurant Group, Inc.'s Form 8-K filed on March 13, 2007) |
| 14.1          | Carrols Restaurant Group, Inc. and Carrols Corporation Code of Ethics*   |
| 21.1          | List of Subsidiaries*  |
| 31.1          | Chief Executive Officer's Certificate Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 for Carrols Restaurant Group, Inc.*  |
| 31.2          | Chief Financial Officer's Certificate Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 for Carrols Restaurant Group, Inc.*  |
| 31.3          | Chief Executive Officer's Certificate Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 for Carrols Corporation*   |
| 31.4          | Chief Financial Officer's Certificate Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 for Carrols Corporation*   |
| 32.1          | Chief Executive Officer's Certificate Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 for Carrols Restaurant Group, Inc.*   |
| 32.2          | Chief Financial Officer's Certificate Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 for Carrols Restaurant Group, Inc.*   |
| 32.3          | Chief Executive Officer's Certificate Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 for Carrols Corporation*  |
| 32.4          | Chief Financial Officer's Certificate Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 for Carrols Corporation*  |

(1) Management contract or compensatory plan or arrangement identified pursuant to this report.

\* Filed herewith.

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**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

To the Board of Directors and Stockholders of

Carrols Restaurant Group, Inc.

Syracuse, New York

We have audited the accompanying consolidated balance sheets of Carrols Restaurant Group, Inc. and subsidiary (the Company) as of December 31, 2006 and January 1, 2006, and the related consolidated statements of operations, changes in stockholders' equity (deficit), and cash flows for each of the two years in the period ended December 31, 2006. Our audits also included the 2006 and 2005 financial statement schedules listed in the index at Item 15 (a)(2). These financial statements and financial statement schedules are the responsibility of the Company's management. Our responsibility is to express an opinion on the financial statements and financial statement schedules based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of the Company as of December 31, 2006 and January 1, 2006, and the results of its operations and its cash flows for each of the two years in the period ended December 31, 2006, in conformity with accounting principles generally accepted in the United States of America. Also, in our opinion, such 2006 and 2005 financial statement schedules, when considered in relation to the basic 2006 and 2005 financial statements taken as a whole present fairly in all material respects the information set forth therein.

/s/ Deloitte & Touche

Rochester, New York

March 21, 2007

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**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

To the Board of Directors and Stockholders

of Carrols Restaurant Group, Inc.:

In our opinion, the consolidated statements of operations, changes in stockholders' equity (deficit), and of cash flows for the year ended December 31, 2004, present fairly, in all material respects, the results of operations and cash flows of Carrols Restaurant Group, Inc. (formerly named Carrols Holdings Corporation) and its subsidiary for the year ended December 31, 2004, in conformity with accounting principles generally accepted in the United States of America. In addition, in our opinion, the accompanying financial statement schedules for the year ended December 31, 2004, present fairly, in all material respects, the information set forth therein when read in conjunction with the related consolidated financial statements. These financial statements and financial statement schedules are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and financial statement schedules based on our audit. We conducted our audit of these statements in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

As discussed in Note 2 to the consolidated financial statements included in the 2006 Form S-1 (Number 333-137524) of Carrols Restaurant Group, Inc. (not separately presented herein), the consolidated financial statements for the year ended December 31, 2004 have been restated.

/s/ PricewaterhouseCoopers LLP

Syracuse, New York

July 27, 2005, except for the restatements discussed in Note 2 to the consolidated financial statements included in the 2006 Form S-1 (Number 333-137524) of Carrols Restaurant Group, Inc. (not separately presented herein) as to which the date is June 29, 2006, the business segment information in Note 13 and the earnings per share information within the statements of operations and in Note 17 as to which the date is September 21, 2006, and the effects of the stock split described in Note 12, as to which the date is December 8, 2006.



**Table of Contents****CARROLS RESTAURANT GROUP, INC. AND SUBSIDIARY****CONSOLIDATED BALANCE SHEETS****December 31, 2006 and 2005**

(in thousands of dollars except share and per share amounts)

|  | <b>December 31,</b> |                   |
|--|---------------------|-------------------|
|  | <b>2006</b>         | <b>2005</b>       |
| <b>ASSETS</b>  |                     |                   |
| Current assets:  |                     |                   |
| Cash and cash equivalents  | \$ 3,939            | \$ 9,331          |
| Trade and other receivables (Note 9)   | 5,364               | 3,017             |
| Inventories  | 4,677               | 5,333             |
| Prepaid rent   | 4,130               | 4,476             |
| Prepaid expenses and other current assets  | 5,367               | 4,635             |
| Refundable income taxes  | 2,806               | 593               |
| Deferred income taxes (Note 10)  | 4,539               | 4,867             |
| <b>Total current assets</b>  | <b>30,822</b>       | <b>32,252</b>     |
| Property and equipment, net (Note 2)   | 182,742             | 217,506           |
| Franchise rights, net (Note 3)   | 83,268              | 86,490            |
| Goodwill (Note 3)  | 124,934             | 124,934           |
| Intangible assets, net (Note 3)  | 1,175               | 1,465             |
| Franchise agreements, at cost less accumulated amortization of \$5,431 and \$5,208, respectively   | 5,793               | 5,869             |
| Deferred income taxes (Note 10)  | 11,136              | 13,279            |
| Other assets   | 12,989              | 15,150            |
| <b>Total assets</b>  | <b>\$ 452,859</b>   | <b>\$ 496,945</b> |
| <b>LIABILITIES AND STOCKHOLDERS DEFICIT</b>  |                     |                   |
| Current liabilities:   |                     |                   |
| Current portion of long-term debt (Note 7)   | \$ 2,477            | \$ 2,588          |
| Accounts payable   | 17,860              | 19,022            |
| Accrued interest   | 7,861               | 7,615             |
| Accrued payroll, related taxes and benefits  | 18,445              | 15,703            |
| Accrued real estate taxes  | 4,102               | 3,933             |
| Other liabilities  | 10,623              | 8,832             |
| <b>Total current liabilities</b>   | <b>61,368</b>       | <b>57,693</b>     |
| Long-term debt, net of current portion (Note 7)  | 297,432             | 391,108           |
| Lease financing obligations (Note 8)   | 58,571              | 110,898           |
| Deferred income sale-leaseback of real estate  | 31,391              | 10,660            |
| Accrued postretirement benefits (Note 16)  | 6,370               | 4,068             |
| Other liabilities (Note 5)   | 23,494              | 26,055            |
| <b>Total liabilities</b>   | <b>478,626</b>      | <b>600,482</b>    |
| Commitments and contingencies (Notes 6 and 14)   |                     |                   |
| Stockholders' deficit (Note 12):   |                     |                   |
| Preferred stock, par value \$.01; authorized 20,000,000 shares, issued and outstanding none  |                     |                   |
| Voting common stock, par value \$.01; authorized 100,000,000 shares, issued and outstanding 21,550,827 and 15,917,176 shares, respectively | 216                 | 159               |
| Additional paid-in capital   | (3,108)             | (68,539)          |

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|  |            |            |
|--|------------|------------|
| Accumulated deficit                            | (21,733)   | (35,157)   |
| Accumulated other comprehensive loss (Note 16) | (1,001)    |            |
| Treasury stock, at cost                        | (141)      |            |
| Total stockholders' deficit                    | (25,767)   | (103,537)  |
| Total liabilities and stockholders' deficit    | \$ 452,859 | \$ 496,945 |

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

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**Table of Contents****CARROLS RESTAURANT GROUP, INC. AND SUBSIDIARY****CONSOLIDATED STATEMENTS OF OPERATIONS****Years Ended December 31, 2006, 2005 and 2004**

(in thousands of dollars except share and per share amounts)

|   | 2006             | 2005              | 2004              |
|---|------------------|-------------------|-------------------|
| <b>Revenues:</b>  |                  |                   |                   |
| Restaurant sales  | \$ 750,069       | \$ 705,422        | \$ 696,343        |
| Franchise royalty revenues and fees   | 1,357            | 1,488             | 1,536             |
| <b>Total revenues</b>   | <b>751,426</b>   | <b>706,910</b>    | <b>697,879</b>    |
| <b>Costs and expenses:</b>  |                  |                   |                   |
| Cost of sales   | 211,236          | 204,620           | 202,624           |
| Restaurant wages and related expenses   | 218,797          | 204,292           | 206,732           |
| Restaurant rent expense   | 37,768           | 34,668            | 34,606            |
| Other restaurant operating expenses   | 110,164          | 102,921           | 92,891            |
| Advertising expense   | 27,692           | 25,523            | 24,711            |
| General and administrative (including stock-based compensation expense of \$74, \$16,432 and \$1,818, respectively) | 49,756           | 58,940            | 43,585            |
| Depreciation and amortization   | 33,534           | 33,096            | 38,521            |
| Impairment losses (Note 4)  | 1,019            | 1,468             | 1,544             |
| Bonus to employees and a director (Note 11)   |                  |                   | 20,860            |
| Other expense (income) (Notes 5 and 9)  | (2,787)          |                   | 2,320             |
| <b>Total operating expenses</b>   | <b>687,179</b>   | <b>665,528</b>    | <b>668,394</b>    |
| <b>Income from operations</b>   | <b>64,247</b>    | <b>41,382</b>     | <b>29,485</b>     |
| Interest expense  | 44,262           | 42,972            | 35,383            |
| Loss on extinguishment of debt (Note 7)   |                  |                   | 8,913             |
| <b>Income (loss) before income taxes</b>  | <b>19,985</b>    | <b>(1,590)</b>    | <b>(14,811)</b>   |
| Provision (benefit) for income taxes (Note 10)  | 6,561            | 2,760             | (6,720)           |
| <b>Net income (loss)</b>  | <b>\$ 13,424</b> | <b>\$ (4,350)</b> | <b>\$ (8,091)</b> |
| <b>Basic and diluted net income (loss) per share (Note 17)</b>  | <b>\$ 0.83</b>   | <b>\$ (0.29)</b>  | <b>\$ (0.63)</b>  |
| Basic weighted average common shares outstanding (Note 17)  | 16,152,060       | 14,905,750        | 12,915,095        |
| Diluted weighted average common shares outstanding (Note 17)  | 16,152,330       | 14,905,750        | 12,915,095        |

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

**Table of Contents****CARROLS RESTAURANT GROUP, INC. AND SUBSIDIARY****CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS EQUITY (DEFICIT)****Years Ended December 31, 2006, 2005 and 2004**

(in thousands of dollars except share amounts)

|   | Voting<br>Common<br>Stock<br>Shares | Voting<br>Common<br>Stock | Additional<br>Paid-In<br>Capital | Accumulated<br>Deficit | Accumulated<br>Other<br>Comprehensive<br>Loss | Treasury<br>Stock | Total<br>Stockholders<br>Equity<br>(Deficit) |
|---|-------------------------------------|---------------------------|----------------------------------|------------------------|---|-------------------|--|
| Balance at January 1, 2004  | 12,915,095                          | \$ 129                    | \$ 31,924                        | \$ (22,716)            | \$  | \$                | \$ 9,337                                     |
| Net loss  |                                     |                           |                                  | (8,091)                |   |                   | (8,091)                                      |
| Dividends declared (Note 11)  |                                     |                           | (116,794)                        |                        |   |                   | (116,794)                                    |
| Balance at December 31, 2004  | 12,915,095                          | 129                       | (84,870)                         | (30,807)               |   |                   | (115,548)                                    |
| Net loss  |                                     |                           |                                  | (4,350)                |   |                   | (4,350)                                      |
| Issuance of stock (Note 12)   | 3,002,927                           | 30                        | 16,331                           |                        |   |                   | 16,361                                       |
| Purchase of treasury shares   | (846)                               |                           |                                  |                        |   |                   |  |
| Balance at December 31, 2005  | 15,917,176                          | 159                       | (68,539)                         | (35,157)               |   |                   | (103,537)                                    |
| Net income  |                                     |                           |                                  | 13,424                 |   |                   | 13,424                                       |
| Purchase of treasury shares   | (34,135)                            |                           |                                  |                        |   | (141)             | (141)  |
| Issuance of stock in connection with initial public offering, net of expenses | 5,666,666                           | 57                        | 65,362                           |                        |   |                   | 65,419                                       |
| Issuance of stock (Note 12)   | 1,120                               |                           | 16                               |                        |   |                   | 16   |
| Stock-based compensation  |                                     |                           | 53                               |                        |   |                   | 53   |
| Adjustment to adopt SFAS No. 158, net of tax (Note 16)                        |                                     |                           |                                  |                        | (1,001)                                       |                   | (1,001)                                      |
| Balance at December 31, 2006  | 21,550,827                          | \$ 216                    | \$ (3,108)                       | \$ (21,733)            | \$ (1,001)                                    | \$ (141)          | \$ (25,767)                                  |

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

**Table of Contents****CARROLS RESTAURANT GROUP, INC. AND SUBSIDIARY****CONSOLIDATED STATEMENTS OF CASH FLOWS****Years Ended December 31, 2006, 2005 and 2004**

(in thousands of dollars)

|  | 2006            | 2005            | 2004            |
|--|-----------------|-----------------|-----------------|
| <b>Cash flows provided from operating activities:</b>                                      |                 |                 |                 |
| Net income (loss)  | \$ 13,424       | \$ (4,350)      | \$ (8,091)      |
| Adjustments to reconcile net income (loss) to net cash provided from operating activities: |                 |                 |                 |
| Gain on disposal of property and equipment   | (1,398)         | (620)           | (176)           |
| Stock-based compensation   | 69              | 16,310          | 1,818           |
| Depreciation and amortization  | 33,534          | 33,096          | 38,521          |
| Amortization of deferred financing costs   | 1,449           | 1,529           | 1,527           |
| Amortization of unearned purchase discounts  | (2,155)         | (2,156)         | (2,154)         |
| Amortization of deferred gains from sale-leaseback transactions                            | (1,303)         | (481)           | (458)           |
| Accretion of interest on lease financing obligations                                       | 412             | 344             | 406             |
| Impairment losses  | 1,019           | 1,468           | 1,544           |
| Loss on extinguishment of debt   |                 |                 | 8,913           |
| Gain on settlements of lease financing obligations   | (120)           |                 |                 |
| Deferred income taxes  | 3,123           | 1,036           | (6,466)         |
| Changes in other operating assets and liabilities:   |                 |                 |                 |
| Refundable income taxes  | (2,213)         | 2,435           | (4,162)         |
| Accounts payable   | (670)           | 1,140           | (2,427)         |
| Accrued payroll, related taxes and benefits  | 2,742           | (9,186)         | 9,666           |
| Accrued bonus to employees and director  |                 | (20,860)        | 20,860          |
| Other liabilities current  | 1,960           | (931)           | 1,762           |
| Accrued interest   | 246             | 6,659           | (593)           |
| Other liabilities long-term  | (574)           | (603)           | (428)           |
| Other  | (790)           | (2,822)         | (851)           |
| <b>Net cash provided from operating activities</b>   | <b>48,755</b>   | <b>22,008</b>   | <b>59,211</b>   |
| <b>Cash flows used for investing activities:</b>   |                 |                 |                 |
| Capital expenditures:  |                 |                 |                 |
| New restaurant development   | (28,132)        | (20,613)        | (9,654)         |
| Restaurant remodeling  | (6,372)         | (4,018)         | (845)           |
| Other restaurant capital expenditures  | (9,049)         | (8,684)         | (7,503)         |
| Corporate and restaurant information systems   | (1,586)         | (1,319)         | (1,071)         |
| Acquisition of Taco Cabana restaurants   |                 | (4,215)         |                 |
| <b>Total capital expenditures</b>  | <b>(45,139)</b> | <b>(38,849)</b> | <b>(19,073)</b> |
| Properties purchased for sale-leaseback  | (3,413)         | (1,091)         | (1,574)         |
| Proceeds from sale-leaseback transactions  | 36,313          | 5,237           | 10,984          |
| Proceeds from sales of other properties  | 1,800           | 795             | 1,174           |
| <b>Net cash used for investing activities</b>  | <b>(10,439)</b> | <b>(33,908)</b> | <b>(8,489)</b>  |
| <b>Cash flows used for financing activities:</b>   |                 |                 |                 |
| Payments on revolving credit facility, net   |                 |                 | (600)           |
| Scheduled principal payments on term loans   | (2,200)         | (2,200)         | (10,125)        |
| Principal pre-payments on term loans   | (91,200)        | (6,000)         |                 |
| Proceeds from initial public offering, net of expenses                                     | 65,419          |                 |                 |
| Purchase of treasury shares  | (141)           |                 |                 |
| Proceeds from issuance of debt   |                 |                 | 400,000         |
| Tender and redemption of 9 1/2% senior subordinated notes                                  |                 |                 | (175,756)       |
| Repayments of borrowings under previous credit facility                                    |                 |                 | (113,375)       |

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|  |           |           |           |
|--|-----------|-----------|-----------|
| Financing costs associated with issuance of debt and lease financing obligations       | (542)     |           | (9,013)   |
| Proceeds from lease financing obligations  |           |           | 4,500     |
| Dividends paid   |           |           | (116,794) |
| Settlement of lease financing obligations  | (15,199)  | (1,074)   |           |
| Payments on other notes payable  |           |           | (117)     |
| Principal payments on capital leases   | (387)     | (419)     | (390)     |
| <br>   |           |           |           |
| Net cash used for financing activities   | (43,708)  | (10,235)  | (21,670)  |
| <br>   |           |           |           |
| Net increase (decrease) in cash and cash equivalents                                   | (5,392)   | (22,135)  | 29,052    |
| Cash and cash equivalents, beginning of year   | 9,331     | 31,466    | 2,414     |
| <br>   |           |           |           |
| Cash and cash equivalents, end of year   | \$ 3,939  | \$ 9,331  | \$ 31,466 |
| <br>   |           |           |           |
| Supplemental disclosures:  |           |           |           |
| Interest paid on long-term debt  | \$ 32,302 | \$ 23,763 | \$ 23,368 |
| Interest paid on lease financing obligations   | \$ 9,974  | \$ 10,677 | \$ 10,626 |
| Income taxes paid (refunded), net  | \$ 5,630  | \$ (824)  | \$ 3,905  |
| Increase (decrease) in accruals for capital expenditures                               | \$ (870)  | \$ 301    | \$ 1,153  |
| Capital lease obligations acquired and incurred  | \$        | \$ 1,090  | \$        |
| Non-cash reduction of assets under lease financing obligations due to lease amendments | \$ 24,707 | \$        | \$        |
| Non-cash reduction of lease financing obligations due to lease amendments              | \$ 37,544 | \$        | \$        |

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

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**CARROLS RESTAURANT GROUP, INC. AND SUBSIDIARY**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**Years Ended December 31, 2006, 2005 and 2004**

(in thousands of dollars, except share and per share amounts)

**1. Description of Business and Summary of Significant Accounting Policies**

*Basis of Consolidation.* The consolidated financial statements presented herein include the accounts of Carrols Restaurant Group, Inc. ( Carrols Restaurant Group or the Company ), formerly known as Carrols Holdings Corporation, and its wholly-owned subsidiary Carrols Corporation ( Carrols ). Carrols Restaurant Group is a holding company and conducts all of its operations through Carrols and its wholly-owned subsidiaries. Unless the context otherwise requires, Carrols Restaurant Group, Carrols and the direct and indirect subsidiaries of Carrols are collectively referred to as the Company. All intercompany transactions have been eliminated in consolidation.

The difference between the consolidated financial statements of Carrols Restaurant Group and Carrols is primarily due to additional rent expense of approximately \$6 per year for Carrols Restaurant Group and the composition of stockholders' deficit.

*Business Description.* At December 31, 2006, the Company operated, as franchisee, 328 quick-service restaurants under the trade name Burger King in 12 Northeastern, Midwestern and Southeastern states. At December 31, 2006, the Company also owned and operated 76 Pollo Tropical restaurants, of which 74 were located in Florida, one located in the New York City metropolitan area in northern New Jersey and one located in Brooklyn, New York and franchised a total of 27 Pollo Tropical restaurants, 23 in Puerto Rico, two in Ecuador and two on college campuses in Florida. At December 31, 2006, the Company owned and operated 143 Taco Cabana restaurants located primarily in Texas and franchised two Taco Cabana restaurants in New Mexico and one in Georgia.

*Use of Estimates.* The preparation of the consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the dates of the financial statements. Estimates also affect the reported amounts of revenues and expenses during the reporting periods. Significant items subject to such estimates and assumptions include: accrued occupancy costs, insurance liabilities, legal obligations, income taxes, evaluation for impairment of goodwill, impairment of long-lived assets and impairment of Burger King franchise rights, lease accounting and stock-based compensation. Actual results could differ from those estimates.

*Fiscal Year.* The Company uses a 52-53 week fiscal year ending on the Sunday closest to December 31. All references herein to fiscal years ended January 2, 2005, January 1, 2006 and December 31, 2006 will be referred to as fiscal years ended December 31, 2004, 2005 and 2006, respectively. The fiscal years ended December 31, 2006 and 2005 each contained 52 weeks. The fiscal year ended December 31, 2004 contained 53 weeks.

*Cash and Cash Equivalents.* The Company considers all highly liquid investments with an original maturity of three months or less when purchased to be cash equivalents. At December 31, 2005 the Company had \$2.0 million invested in money market funds.

*Inventories.* Inventories are stated at the lower of cost (first-in, first-out) or market. Inventories are primarily comprised of food and paper.

*Property and Equipment.* The Company capitalizes all direct costs incurred to construct and substantially improve its restaurants. These costs are depreciated and charged to expense based upon their property classification when placed in service. Property and equipment is recorded at cost. Repair and maintenance

**Table of Contents****CARROLS RESTAURANT GROUP, INC. AND SUBSIDIARY****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****Years Ended December 31, 2006, 2005 and 2004**

(in thousands of dollars, except share and per share amounts)

activities are expensed as incurred. Depreciation and amortization is provided using the straight-line method over the following estimated useful lives:

|                                  |                                      |
|----------------------------------|--------------------------------------|
| Owned buildings                  | 5 to 30 years                        |
| Equipment                        | 3 to 15 years                        |
| Computer hardware and software   | 3 to 7 years                         |
| Assets subject to capital leases | Shorter of useful life or lease term |

Leasehold improvements are being depreciated over the shorter of their estimated useful lives or the underlying lease term. In circumstances where an economic penalty, as defined under Statement of Financial Accounting Standards ( SFAS ) No. 13, Accounting for Leases , would be presumed by the non-exercise of one or more renewal options under the lease, the Company includes those renewal option periods when determining the lease term. For significant leasehold improvements made during the latter part of the lease term, the Company amortizes those improvements over the shorter of their useful life or an extended lease term. The extended lease term would consider the exercise of renewal options if the value of the improvements would cause a penalty to be incurred without the renewal of the option. Building costs incurred for new restaurants on leased land are depreciated over the lease term, which is generally a twenty year period.

*Burger King Franchise Rights.* For its Burger King restaurant acquisitions, the Company has generally allocated a portion of the purchase price to franchise rights, an intangible asset. Amounts allocated to franchise rights for each acquisition are amortized using the straight-line method over the average remaining term of the acquired franchise agreements at January 1, 2002 plus one twenty year renewal period.

*Burger King Franchise Agreements.* Fees for initial franchises and renewals are amortized using the straight-line method over the term of the agreement, which is generally twenty years.

*Goodwill.* Goodwill represents the excess of purchase price and related costs over the value assigned to the net tangible and identifiable intangible assets of businesses acquired. Goodwill is not amortized but is tested at least annually for impairment. The Company performs its impairment evaluation annually as of December 31.

*Long-Lived Assets.* The Company assesses the recoverability of property and equipment, franchise rights and intangible assets by determining whether the carrying value of these assets, over their respective remaining lives, can be recovered through undiscounted future operating cash flows. Impairment is reviewed whenever events or changes in circumstances indicate the carrying amounts of these assets may not be fully recoverable.

*Deferred Financing Costs.* Financing costs, that are included in other assets and were incurred in obtaining long-term debt and lease financing obligations, are capitalized and amortized over the life of the related obligation as interest expense using the effective interest method.

*Leases.* Leases are accounted for in accordance with SFAS 13 and other related authoritative guidance. Rent expense for leases that contain scheduled rent increases is recognized on a straight-line basis over the lease term, including any option period included in the determination of the lease term. Contingent rentals are generally based upon a percentage of sales or a percentage of sales in excess of stipulated amounts and are generally not considered minimum rent payments but are recognized as rent expense when incurred.

*Lease Financing Obligations.* Lease financing obligations pertain to real estate transactions accounted for under the financing method as required by SFAS No. 98, Accounting for Leases ( SFAS 98 ). The assets (land and building) subject to these obligations remain on the Company's consolidated balance sheet at their historical





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**CARROLS RESTAURANT GROUP, INC. AND SUBSIDIARY**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**Years Ended December 31, 2006, 2005 and 2004**

(in thousands of dollars, except share and per share amounts)

costs and such assets (excluding land) continue to be depreciated over their remaining useful lives. The proceeds received by the Company from these transactions are recorded as lease financing obligations and the lease payments are applied as payments of principal and interest. The selection of the interest rate on lease financing obligations is evaluated at inception of the lease based on the Company's incremental borrowing rate adjusted to the rate required to prevent recognition of a non-cash loss or negative amortization of the obligation through the end of the primary lease term. In addition, if a purchase option exists for any properties subject to a lease financing obligation, the purchase option is evaluated for its probability of exercise on an ongoing basis. This evaluation considers many factors including, without limitation, the Company's intentions, the fair value of the underlying properties, the Company's ability to acquire the property, economic circumstances and other available alternatives to the Company for the continued use of the property. At December 31, 2006 and 2005, no purchase options were considered probable of exercise by the Company.

*Revenue Recognition.* Revenues from Company owned and operated restaurants are recognized when payment is tendered at the time of sale. Franchise royalty revenues associated with Pollo Tropical and Taco Cabana restaurants are based on a percent of gross sales and are recorded as income when earned.

*Income Taxes.* The Company provides for income taxes in accordance with the provisions of SFAS No. 109, *Accounting for Income Taxes* (SFAS 109). Under the liability method specified by SFAS 109, deferred tax assets and liabilities are based on the difference between the financial statement and tax bases of assets and liabilities as measured by the tax rates that are anticipated to be in effect when those differences reverse. The deferred tax provision generally represents the net change in deferred tax assets and liabilities during the period. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in the results of operations in the period that includes the enactment date. A valuation allowance is established when it is necessary to reduce deferred tax assets to amounts for which realization is more likely than not. The Company also records a reserve for uncertain tax positions when it is probable and estimable. The Company and its subsidiary file a consolidated federal income tax return.

*Advertising Costs.* All advertising costs are expensed as incurred.

*Cost of Sales.* The Company includes the cost of food, beverage and paper, net of any discounts, in cost of sales.

*Insurance.* The Company is insured for workers' compensation, general liability and medical insurance claims under policies where it pays all claims, subject to annual stop-loss limitations both for individual claims and claims in the aggregate. Losses are accrued based upon the Company's estimates of the aggregate liability for claims based on Company experience and certain actuarial methods used to measure such estimates. The Company does not discount any of its self-insurance obligations.

*Fair Value of Financial Instruments.* The following methods were used to estimate the fair value of each class of financial instruments for which it is practicable to estimate the fair value:

*Current Assets and Liabilities.* The carrying value of cash and cash equivalents and accrued liabilities approximates fair value because of the short maturity of those instruments.

*Senior Subordinated Notes.* The fair values of outstanding senior subordinated notes are based on quoted market prices. The fair values at December 31, 2006 and 2005 were approximately \$184.1 million and \$174.6 million, respectively.

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*Revolving and Term Loan Facilities.* Rates currently available to the Company for debt with similar terms and remaining maturities are used to estimate fair value. The recorded amounts, as of December 31, 2006 and 2005, approximated fair value.

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

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*Income (Loss) per Share.* Basic income (loss) per share is computed by dividing net income (loss) for the period by the weighted average number of common shares outstanding during the period. Diluted income (loss) is computed by dividing net income (loss) for the period by the weighted average number of common shares outstanding plus the dilutive effect of outstanding stock options using the treasury stock method.

As discussed in Note 12, prior to October 27, 2004, the Company had a tracking stock capital structure under which it had three authorized classes of common stock comprised of the Carrols class of common stock, the Pollo Tropical class of common stock and the Taco Cabana class of common stock. No shares of Pollo Tropical or Taco Cabana classes of common stock (the tracking stock) were ever issued or outstanding and only options for such classes of common stock were granted and outstanding under the Company's equity incentive plans. Therefore, the Carrols class of common stock retained a 100% undivided interest in the net assets and net income of the Pollo Tropical and the Taco Cabana classes of common stock in accordance with the terms of the Company's certificate of incorporation.

On October 27, 2004, the Pollo Tropical and Taco Cabana authorized classes of common stock were eliminated and all outstanding options to purchase Pollo Tropical and Taco Cabana classes of common stock were converted into options to purchase the Company's current single class of common stock. Prior to the elimination of this capital structure, the Company calculated income (loss) per share using the two-class method which included the allocation of income or losses to each of the three classes of common stock in a consistent manner between the three classes. There was no basic income per share for the Pollo Tropical or Taco Cabana classes of common stock in any of the periods since no shares of these classes were ever issued or outstanding. The income allocated to the Pollo Tropical class of common stock was immaterial due to the small interest in that income by the option holders of that common stock and there was no income allocated to the Taco Cabana class of common stock since there was no interest in that income by the option holders of that common stock because the outstanding options were anti-dilutive. Accordingly, no diluted income per share for either of these classes of common stock has been presented in the accompanying financial statements.

*Stock-Based Compensation.* Effective January 2, 2006, the Company adopted SFAS No. 123(R), Share-Based Payment (SFAS 123R) using the modified prospective transition method and, as a result, did not retroactively adjust results from prior periods. The Company applies the Black-Scholes valuation model in determining the fair value of stock options granted to employees, which is then amortized on a straight-line basis to compensation expense over the requisite service period. For restricted stock awards, the fair market value of the award, determined based upon the closing value of the Company's stock price on the grant date, is recorded to compensation expense on a straight-line basis over the vesting period.

The Company adopted an incentive stock plan in 2006 under which incentive stock options, non-qualified stock options and restricted shares may be granted to employees and non-employee directors. In 2006, the Company granted incentive stock options, non-qualified stock options and restricted shares under these plans. The stock options granted generally vest at 20% per year and expire seven years from the date of grant. Restricted shares granted to employees generally vest 33% per year for three years and restricted shares granted to non-employee directors generally vest at 20% per year. The fair value of shares granted is determined based on the Company's closing stock price on the date of grant. Stock-based compensation related to these grants totaled \$0.1 million in 2006.

Prior to the adoption of SFAS 123R in 2006, the Company accounted for stock-based compensation using the intrinsic value method prescribed in Accounting Principles Board (APB) Opinion No. 25, Accounting for Stock Issued to Employees, (APB 25) and, as permitted by SFAS 123, Accounting for Stock-Based Compensation (SFAS 123), the Company provided pro forma net income disclosures for employee stock option grants as if the

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fair-value-based method defined in SFAS 123 had been applied in 2005 and 2004. Certain provisions of the Company's option plans caused the Company to account for stock options using a variable accounting treatment. Under variable accounting, compensation expense was remeasured each balance sheet date based on the difference between the current market price of the Company's stock and the option's exercise price. An accrual for compensation expense is determined based on the proportionate vested amount of each option as prescribed by Financial Interpretation No. 28, Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans. Each period, adjustments to the accrual are recognized in the income statement. Stock-based compensation expense for the Company's options was \$0.1 million in 2005 and \$1.8 million in 2004.

Effective May 3, 2005, the Company issued an aggregate of 2,941,521 shares of common stock in exchange for the cancellation and termination of an identical number of outstanding options to purchase shares of the Company's common stock. During the second quarter of 2005 the Company issued an additional 61,406 shares of common stock in separate awards. As a consequence of the exchange, all outstanding stock options were cancelled and terminated. The Company recorded a pre-tax compensation charge, including applicable payroll taxes, of \$16.4 million in the second quarter of 2005 due to these stock awards. See Note 12 for a complete discussion of the stock awards.

Pro forma disclosures for 2006 are not presented because the amounts are recognized in the consolidated financial statements. The following table presents the Company's pro forma net loss and basic and diluted loss per share for 2005 and 2004, had compensation cost been determined based upon the fair value of the stock options at the grant date consistent with the fair-value based method of SFAS No. 123:

|  | <b>Year Ended December 31,</b> |             |
|--|--------------------------------|-------------|
|  | <b>2005</b>                    | <b>2004</b> |
| Net loss, as reported  | \$ (4,350)                     | \$ (8,091)  |
| Add: Stock-based compensation expense included in reported net loss, net of related tax effects                                  |                                |             |
| (1)(2)   | 13,188                         | 13,279      |
| Deduct: Stock-based compensation expense determined under the fair-value based method for all awards, net of related tax effects | (12,011)                       | (5,656)     |
| Pro forma net loss   | \$ (3,173)                     | \$ (468)    |
| Basic and diluted loss per share:  |                                |             |
| As reported (Note 17)  | \$ (0.29)                      | \$ (0.63)   |
| Pro forma  | \$ (0.21)                      | \$ (0.04)   |

- (1) The amount of stock-based compensation expense included in reported net loss includes certain stock options requiring variable accounting (see Note 12) and for the year ended December 31, 2005, includes \$13.1 million of expense related to stock awards granted in the second quarter of 2005, net of tax. This expense, net of tax, has also been included in the determination of compensation expense determined under the fair-value based method for the year ended December 31, 2005.
- (2) For the year ended December 31, 2004, the equity value of the Company was reduced as a result of the December 2004 refinancing (See Note 7) in which a non-recurring dividend of \$116.8 million was paid to our stockholders. In conjunction with this, the Company also approved a compensatory bonus payment of approximately \$20.3 million to a number of employees (including management) and a director who owned stock options, on a pro rata basis in proportion to the number of shares of common stock issuable upon exercise of the options owned by such persons. The Company did not modify its outstanding stock options to reflect the reduction in equity value. Therefore, for the year ended December 31, 2004, this reduction has been offset against the \$20.3 million bonus payment recorded for the determination of compensation



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expense under SFAS 123. The \$20.3 million bonus payment, net of tax, has also been included in stock-based employee compensation expense included in reported net loss for the year ended December 31, 2004 in the above table. The Company did not grant any options in 2005. The fair value of each option grant in 2004 was estimated using the minimum value option-pricing model. The weighted average fair-value of options granted in 2006 was \$4.02 which was estimated using the Black-Scholes option pricing model with the following weighted-average assumptions:

|                         | 2006    | 2004    |
|-------------------------|---------|---------|
| Risk-free interest rate | 4.58%   | 3.38%   |
| Annual dividend yield   | 0%      | 0%      |
| Expected term           | 5 years | 5 years |
| Expected volatility     | 30%     | n/a     |

The assumptions include the risk-free rate of interest, expected dividend yield, expected volatility, and the expected term of the award. The risk-free rate of interest is based on the zero coupon U.S. Treasury rates appropriate for the expected term of the award. There are no expected dividends as the Company does not currently plan to pay dividends on its common stock. Expected stock price volatility is based on the expected volatility of a peer group that had actively traded stock during the period immediately preceding the share-based award grant. This period is equal in length to the award's expected term as the Company does not have its own historical stock price data. The expected term was estimated using the simplified method, as prescribed by SAB No. 107, for options granted in 2006. Compensation expense is recognized only for those options expected to vest, with forfeitures estimated based on our historical experience and future expectations. Prior to the adoption of SFAS 123R, the effect of forfeitures on the pro forma expense amounts was recognized as the forfeitures occurred. See also Note 12 to the consolidated financial statements.

*Recent Accounting Pronouncements.*

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

In July 2006, the Financial Accounting Standards Board ( FASB ) issued FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes an Interpretation of FASB Statement No. 109 ( FIN 48 ). FIN 48 prescribes a comprehensive recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 requires that only income tax benefits that meet the more likely than not recognition threshold be recognized or continue to be recognized on the effective date. For those benefits to be recognized, a tax position must also be sustained upon examination by taxing authorities. Initial derecognition amounts would be reported as a cumulative effect of a change in accounting principle. The provisions of FIN 48 are effective for fiscal years beginning after December 15, 2006, with the cumulative effect of the change in accounting principle recorded as an adjustment to opening retained earnings. This interpretation will be effective for the Company beginning January 1, 2007. The Company has completed its initial review of the interpretation and does not expect that the adoption of FIN 48 will have a significant impact on its consolidated financial statements.

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In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements* ( SFAS 157 ). This statement defines fair value, establishes a framework for using fair value to measure assets and liabilities and expands disclosures about fair value measurements. The statement applies whenever other pronouncements require or permit assets or liabilities to be measured at fair value. SFAS 157 is effective for the Company's fiscal year beginning January 1, 2008. The Company is evaluating the impact the adoption of SFAS 157 will have on the Company's consolidated financial statements.

In September 2006, the FASB issued SFAS No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Benefits*, an amendment of FAS 87, 88, 106 and 132(R) ( SFAS 158 ) which is effective for fiscal years ending after December 15, 2006. SFAS No. 158 requires an employer that sponsors postretirement plans to recognize an asset or liability on its balance sheet for the overfunded or underfunded status of the plan and to recognize changes in that funded status in the year in which the changes occur through comprehensive income. SFAS 158 does not change the amount of actuarially determined expense that is recorded in the Company's consolidated statement of operations. SFAS 158 also requires an employer to measure plan assets and benefit obligations as of the date of the employer's balance sheet, which is consistent with the Company's historical measurement date. Adoption of SFAS 158 resulted in recording a liability and a charge to accumulated other comprehensive income, a component of stockholders' deficit, at December 31, 2006 equal to the difference between the Company's accrued benefit cost and the Company's projected benefit obligation which was \$1.7 million. See Note 16.

In September 2006, the Securities and Exchange Commission issued Staff Accounting Bulletin No. 108, *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements*, ( SAB 108 ) to address diversity in practice in quantifying financial statement misstatements. SAB 108 requires that the Company quantify misstatements based on their impact on each of its financial statements and related disclosures. The application of SAB 108 in the fourth quarter of 2006 did not have any impact on the Company's consolidated financial statements.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Liabilities* Including an amendment of FASB Statement No. 115 ( SFAS 159 ). This statement permits entities to choose to measure many financial instruments and certain other items at fair value. SFAS 159 is effective for the Company's fiscal year beginning January 1, 2008. The Company is currently evaluating the impact of adopting SFAS No. 159.

**2. Property and Equipment**

Property and equipment at December 31 consisted of the following:

|  | December 31, |            |
|--|--------------|------------|
|  | 2006         | 2005       |
| Land   | \$ 37,971    | \$ 61,112  |
| Owned buildings                                | 43,855       | 76,502     |
| Leasehold improvements                         | 143,969      | 129,015    |
| Equipment                                      | 186,143      | 183,670    |
| Assets subject to capital leases               | 7,716        | 8,106      |
|  | 419,654      | 458,405    |
| Less accumulated depreciation and amortization | (236,912)    | (240,899)  |
|  | \$ 182,742   | \$ 217,506 |





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Assets subject to capital leases pertain to buildings leased for certain restaurant locations and had accumulated amortization at December 31, 2006 and 2005 of \$6,613 and \$6,872, respectively. At December 31, 2006 and 2005, land of \$23,972 and \$45,077, respectively, and owned buildings of \$28,547 and \$56,580, respectively, were subject to lease financing obligations accounted for under the lease financing method (See Note 8). Accumulated depreciation pertaining to owned buildings subject to lease financing obligations at December 31, 2006 and 2005 was \$11,420 and \$24,416, respectively.

Depreciation expense for all property and equipment for the years ended December 31, 2006, 2005 and 2004 was \$29,234, \$29,110 and \$34,462, respectively.

**3. Goodwill, Franchise Rights and Intangible Assets**

*Goodwill.* In accordance with SFAS No. 142, the Company reviews goodwill for impairment annually, or more frequently, when events and circumstances indicate that the carrying amounts may be impaired. The Company performs its annual impairment assessment as of December 31 and has determined its reporting units to be at the operating segment level: its Burger King restaurants, operating as a franchisee; Pollo Tropical and Taco Cabana at the brand level. No impairment losses have been recognized as a result of these tests since January 1, 2002. The Company recorded \$2.7 million of goodwill associated with the acquisition of four Taco Cabana restaurants in July of 2005. Changes in goodwill for the years ended December 31, 2006 and 2005 are summarized below:

|                            | <b>Pollo<br/>Tropical</b> | <b>Taco<br/>Cabana</b> | <b>Burger<br/>King</b> | <b>Total</b> |
|----------------------------|---------------------------|------------------------|------------------------|--------------|
| Balance, December 31, 2004 | \$ 56,307                 | \$ 64,484              | \$ 1,450               | \$ 122,241   |
| Goodwill acquired in 2005  |                           | 2,693                  |                        | 2,693        |
| Balance, December 31, 2005 | 56,307                    | 67,177                 | 1,450                  | 124,934      |
| Changes in goodwill        |                           |                        |                        |              |
| Balance, December 31, 2006 | \$ 56,307                 | \$ 67,177              | \$ 1,450               | \$ 124,934   |

*Burger King Franchise Rights.* Amounts allocated to franchise rights for each Burger King acquisition are amortized using the straight-line method over the average remaining term of the acquired franchise agreements at January 1, 2002 plus one twenty year renewal period. Following is a summary of the Company's Burger King franchise rights as of the respective balance sheet dates:

|                  | <b>December 31, 2006</b>             |                                     | <b>December 31, 2005</b>             |                                     |
|------------------|--------------------------------------|-------------------------------------|--------------------------------------|-------------------------------------|
|                  | <b>Gross<br/>Carrying<br/>Amount</b> | <b>Accumulated<br/>Amortization</b> | <b>Gross<br/>Carrying<br/>Amount</b> | <b>Accumulated<br/>Amortization</b> |
| Franchise rights | \$ 139,131                           | \$ 55,863                           | \$ 139,139                           | \$ 52,649                           |

Amortization expense related to Burger King franchise rights for the years ended December 31, 2006, 2005 and 2004 was \$3,214, \$3,215 and \$3,233, respectively. Estimated annual amortization is \$3,216 for each of the years ending 2007 through 2011.

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*Intangible Assets.* In July 2005, the Company acquired four Taco Cabana restaurants from a franchisee for a cash purchase price of approximately \$4.2 million. Under EITF Issue No. 04 -1 Accounting for Preexisting Relationships between the Parties to a Business Combination, certain reacquired rights, including the right to the acquirer's trade name, are required to be recognized as intangible assets apart from goodwill. The Company

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has allocated \$1.6 million of the purchase price to this intangible asset and determined its weighted average life to be approximately seven years, based on the remaining terms of the acquired franchise agreements. The Company recorded amortization expense relating to the intangible asset of approximately \$290 and \$145 for the years ended December 31, 2006 and 2005 and expects the annual expense for each of the next five years ending 2007 through 2011 to be \$289, \$211, \$133, \$125 and \$117, respectively.

|                   | December 31, 2006     |                          | December 31, 2005     |                          |
|-------------------|-----------------------|--------------------------|-----------------------|--------------------------|
|                   | Gross Carrying Amount | Accumulated Amortization | Gross Carrying Amount | Accumulated Amortization |
| Intangible assets | \$ 1,610              | \$ 435                   | \$ 1,610              | \$ 145                   |

**4. Impairment of Long-Lived Assets**

The Company reviews its long-lived assets, principally property and equipment, for impairment at the restaurant level. If an indicator of impairment exists for any of the assets, an estimate of undiscounted future cash flows produced by each restaurant is compared to that long-lived asset's carrying value. If the carrying value is greater than the undiscounted cash flow, the Company then determines the fair value of the asset. If an asset is determined to be impaired, the loss is measured by the excess of the carrying amount of the asset over its fair value.

The Company assesses the potential impairment of Burger King franchise rights whenever events or changes in circumstances indicate that the carrying value may not be recoverable. If an indicator of impairment exists, an estimate of the aggregate undiscounted cash flows from the acquired restaurants is compared to the respective carrying value of franchise rights for each Burger King acquisition. If an asset is determined to be impaired, the loss is measured by the excess of the carrying amount of the asset over its fair value. No impairment charges were recorded related to the Company's Burger King franchise rights for the year ended December 31, 2006. The Company recorded impairment charges related to its Burger King franchise rights of \$316 and \$283 for the years ended December 31, 2005 and 2004, respectively.

The Company recorded impairment losses on long-lived assets, including Burger King franchise rights, for its segments as follows:

|             | Year Ended December 31, |          |          |
|-------------|-------------------------|----------|----------|
|             | 2006                    | 2005     | 2004     |
| Burger King | \$ 276                  | \$ 1,373 | \$ 1,544 |
| Taco Cabana | 743                     | 95       |          |
|             | \$ 1,019                | \$ 1,468 | \$ 1,544 |

**5. Other Liabilities, Long-Term**

Other liabilities, long-term, at December 31, consisted of the following:

| December 31, |      |
|--------------|------|
| 2006         | 2005 |

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|                                    |           |           |
|------------------------------------|-----------|-----------|
| Unearned purchase discounts        | \$ 4,526  | \$ 6,686  |
| Accrued occupancy costs            | 8,683     | 10,674    |
| Accrued workers compensation costs | 4,595     | 4,615     |
| Other                              | 5,690     | 4,080     |
|                                    | \$ 23,494 | \$ 26,055 |

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Unearned purchase discounts are amortized as a reduction of cost of sales either over the life of the supplier contract or the estimated purchase commitment period. In 2000, Burger King Corporation arranged for the Coca-Cola Company and Dr. Pepper/Seven-Up, Inc. to provide funding to franchisees in connection with certain initiatives to upgrade restaurants. The Company received approximately \$19.8 million in 2000 and \$1.6 million in 2001 under this arrangement with these suppliers. The total amount of these purchase discounts amortized for each of the years ended December 31, 2006, 2005 and 2004 was \$2.2 million.

Accrued occupancy costs include obligations pertaining to closed restaurant locations, contingent rent, accruals to expense operating lease rental payments on a straight-line basis over the lease term, and acquired leases with above market rentals.

In 2001, management made the decision to close seven Taco Cabana restaurants in the Phoenix, Arizona market and discontinue restaurant development underway in that market. At December 31, 2006 and 2005, the Company had \$0.7 million and \$1.1 million in lease liability reserves, respectively, included in accrued occupancy costs. The following table presents the activity in the exit cost reserve included in accrued occupancy costs:

|  | Year ended December 31, |          |        |
|--|-------------------------|----------|--------|
|  | 2006                    | 2005     | 2004   |
| Beginning Balance                          | \$ 1,083                | \$ 756   | \$ 847 |
| Changes in estimates of accrued costs, net | (295)                   | 467      |        |
| Payments                                   | (132)                   | (140)    | (91)   |
| Balance, end of period                     | \$ 656                  | \$ 1,083 | \$ 756 |

In 2005, the exit cost reserve was increased by \$0.5 million due to a change in circumstances affecting the Company's estimates of future sub-lease revenue for one restaurant property. In 2006, the Company reduced its exit cost reserve by \$0.3 million due to an increase in the Company's estimates for future sublease income at certain locations. In addition, the Company reduced collection reserves previously established for a \$1.1 million note receivable that was paid in full in the fourth quarter of 2006 related to the sale of leasehold improvements at two of the closed locations that were written off as part of the restructuring charge in 2001. Other income in 2006 includes \$1.4 million as a result of these transactions.

**6. Leases**

The Company utilizes land and buildings in operation under various lease agreements. The Company does not consider any of these individual leases material to the Company's operations. Initial lease terms are generally for twenty years and, in many cases, provide for renewal options and in some cases rent escalations. Certain leases require contingent rent, determined as a percentage of sales as defined by the terms of the applicable lease agreement. For most locations, the Company is obligated for occupancy costs including payment of property taxes, insurance and utilities.

In the years ended December 31, 2006, 2005 and 2004, the Company sold twenty-four, four and eight restaurant properties in sale-leaseback transactions for net proceeds of \$36,313, \$5,237 and \$10,984, respectively. Deferred gains of \$22,034, \$2,556 and \$2,391 for the years ended December 31, 2006, 2005 and 2004, respectively, have been recorded as a result of these sale-leaseback transactions and are being amortized over the lives of the related leases. These related leases have been classified as operating leases and generally contain a twenty-year initial term with renewal options. The amortization of deferred gains related to these sale-leaseback transactions was \$1,303, \$481 and \$458 for the years ended December 31, 2006, 2005 and 2004, respectively.



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Minimum rent commitments under capital and non-cancelable operating leases at December 31, 2006 were as follows:

| Years Ending December 31,                         | Capital         | Operating         |
|---|-----------------|-------------------|
| 2007  | \$ 409          | \$ 40,743         |
| 2008  | 234             | 38,370            |
| 2009  | 199             | 36,406            |
| 2010  | 158             | 34,381            |
| 2011  | 114             | 32,161            |
| Thereafter  | 1,606           | 269,856           |
| <b>Total minimum lease payments</b>               | <b>2,720</b>    | <b>\$ 451,917</b> |
| Less amount representing interest                 | (1,211)         |                   |
| <b>Total obligations under capital leases</b>     | <b>1,509</b>    |                   |
| Less current portion                              | (277)           |                   |
| <b>Long-term obligations under capital leases</b> | <b>\$ 1,232</b> |                   |

Total rent expense on operating leases, including percentage rent on both operating and capital leases, was as follows:

|  | Year ended December 31, |                  |                  |
|--|-------------------------|------------------|------------------|
|  | 2006                    | 2005             | 2004             |
| Minimum rent on real property                | \$ 34,978               | \$ 32,416        | \$ 32,509        |
| Additional rent based on percentage of sales | 2,790                   | 2,252            | 2,097            |
| <b>Restaurant rent expense</b>               | <b>37,768</b>           | <b>34,668</b>    | <b>34,606</b>    |
| Administrative rent                          | 875                     | 822              | 783              |
| Equipment rent                               | 731                     | 739              | 526              |
|  | <b>\$ 39,374</b>        | <b>\$ 36,229</b> | <b>\$ 35,915</b> |

**7. Long-Term Debt**

Long-term debt at December 31 consisted of the following:

December 31,  
2006                      2005



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|   |            |            |
|---|------------|------------|
| Collateralized:                             |            |            |
| Senior Credit Facility-Term loan B facility | \$ 118,400 | \$ 211,800 |
| Unsecured:                                  |            |            |
| 9% Senior Subordinated Notes                | 180,000    | 180,000    |
| Capital leases (Note 6)                     | 1,509      | 1,896      |
|   | 299,909    | 393,696    |
| Less: current portion                       | (2,477)    | (2,588)    |
|   | \$ 297,432 | \$ 391,108 |

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

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(in thousands of dollars, except share and per share amounts)

*December 2004 Refinancing*

On December 15, 2004, Carrols completed the private placement of \$180.0 million of 9% Senior Subordinated Notes due 2013. Concurrently, Carrols repaid all outstanding borrowings under its prior senior secured credit facility and amended and restated that credit facility with a new syndicate of lenders. Carrols received \$400.0 million in total proceeds that included the issuance of the 9% senior subordinated notes and \$220.0 million principal amount of term loan B borrowings under the senior credit facility. Those proceeds were primarily utilized to repay borrowings outstanding under the prior senior credit facility of \$74.4 million, to retire all unsecured 9 1/2% senior subordinated notes due 2008 outstanding in the amount, including redemption premiums, of \$175.9 million, to pay a dividend to Carrols Restaurant Group's stockholders in the amount of \$116.8 million, to pay fees and expenses related to the refinancing of \$8.8 million, and to pay a bonus to employees and a director totaling \$20.9 million including payroll taxes of \$0.6 million. See discussion of the bonus and dividend payments in Note 11. The Company also recorded an \$8.9 million loss on early extinguishment of debt from the write-off of previously deferred financing costs and premiums in conjunction with the retirement of the 9 1/2% senior subordinated notes.

*Senior Secured Credit Facility:*

On December 15, 2004, Carrols entered into a senior secured credit facility with a syndicate of lenders. The senior secured credit facility provides for a revolving credit facility under which Carrols may borrow up to \$50.0 million (including a sub limit of up to \$20.0 million for letters of credit and up to \$5.0 million for swingline loans), a term loan B facility of \$220.0 million and incremental borrowing facilities, at Carrols' option, of up to \$100.0 million, subject to the satisfaction of certain conditions.

There were no borrowings outstanding on the revolving credit facility at December 31, 2006 or 2005. After reserving \$15.0 million for letters of credit guaranteed by the facility, \$35.0 million was available for borrowings under the revolving credit facility at December 31, 2006.

Borrowings under the revolving credit facility bear interest at a per annum rate, at Carrols' option, of either:

- 1) the sum of (a) the greater of (i) the prime rate or (ii) the federal funds rate plus .50%, plus (b) a margin ranging from .50% to 1.50% based on the Carrols' total leverage ratio (as defined in the senior credit facility); or
  - 2) LIBOR plus a margin ranging from 2.0% to 3.0% based on Carrols' total leverage ratio.
- Borrowings under the term loan B bear interest at a per annum rate, at the Carrols' option, of either:

- 1) the sum of (a) the greater of (i) the prime rate or (ii) the federal funds rate plus .50%, plus (b) a margin ranging from .75% to 1.0% based on Carrols' total leverage ratio; or
  - 2) LIBOR plus a margin ranging from 2.25% to 2.50% based on the Carrols' total leverage ratio.
- The revolving credit facility expires on December 31, 2009 and the term loan B facility matures on December 31, 2010. During 2006, the Company made prepayments of \$91.2 million on outstanding borrowings under the term loan B facility, from, in part, the use of proceeds of \$68.0 million received by the Company in its initial public offering.

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Amounts under the term loan B facility are repayable as follows:

- 1) four quarterly installments of \$0.55 million in each of fiscal years 2007 through 2009; and
- 2) two quarterly installments of \$2.25 million beginning with last day of the first fiscal quarter in 2010 and a final installment of \$7.3 million on the last day of the third fiscal quarter of 2010.

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Under the senior credit facility, Carrols is also required to make mandatory prepayments of principal on term loan B facility borrowings (a) annually in an initial amount equal to 50% of Excess Cash Flow (as defined in the senior credit facility), (b) in the event of certain dispositions of assets (all subject to certain exceptions) and insurance proceeds, in an amount equal to 100% of the net proceeds received by Carrols therefrom, and (c) in an amount equal to 100% of the net proceeds from any subsequent issuance of debt.

In general, Carrols' obligations under the senior credit facility are guaranteed by the Company and all of Carrols' material subsidiaries and are collateralized by all of Carrols' and its subsidiaries' assets, a pledge of Carrols' common stock and the stock of each of Carrols' subsidiaries. The senior credit facility contains certain covenants, including, without limitation, those limiting Carrols' and its subsidiaries' ability to incur indebtedness, incur liens, sell or acquire assets or businesses, change the nature of its business, engage in transactions with related parties, make certain investments or pay dividends. In addition, Carrols' is required to meet certain financial ratios, including fixed charge coverage, senior leverage, and total leverage ratios (all as defined under the senior credit facility). As of and for the years ended December 31, 2006 and 2005, Carrols was in compliance with these covenants in its senior credit facility.

*Senior Subordinated Notes:*

On December 15, 2004, Carrols issued \$180.0 million of 9% Senior Subordinated Notes due 2013. The senior subordinated notes bear interest at a rate of 9% payable semi-annually on January 15 and July 15 (commencing July 15, 2005) and mature on January 15, 2013. The notes are redeemable at the option of Carrols in whole or in part on or after January 15, 2009 at a price of 104.5% of the principal amount if redeemed before January 15, 2010, 102.25% of the principal amount if redeemed after January 15, 2010 but before January 15, 2011 and at 100% of the principal amount after January 15, 2011.

Restrictive covenants under the 9% senior subordinated notes include limitations with respect to Carrols' ability to incur additional debt, incur liens, sell or acquire assets or businesses, pay dividends and make certain investments. Carrols was in compliance as of and for the years ended December 31, 2006 and 2005 with the restrictive covenants in the indenture governing the senior subordinated notes.

At December 31, 2006, principal payments required on all long-term debt are as follows:

|            |                   |
|------------|-------------------|
| 2007       | \$ 2,477          |
| 2008       | 2,324             |
| 2009       | 2,300             |
| 2010       | 111,870           |
| 2011       | 32                |
| Thereafter | 180,906           |
|            | <b>\$ 299,909</b> |

The weighted average interest rate on all debt, excluding lease financing obligations, for the years ended December 31, 2006, 2005 and 2004 was 8.3%, 7.3% and 7.8%, respectively. Interest expense on the Company's long-term debt was \$33,852, \$31,728 and \$24,122 for the years ended December 31, 2005, 2004 and 2003, respectively.

*New Senior Credit Facility.* On March 9, 2007, Carrols terminated its existing senior credit facility and entered into a new senior credit facility with a syndicate of lenders. Carrols' new credit facility totals



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approximately \$185 million, consisting of \$120 million principal amount of term loan A borrowings maturing on March 8, 2013 (or earlier on September 30, 2012 if the Senior Subordinated Notes are not refinanced by June 30, 2012) and a \$65.0 million revolving facility (including a sub limit of up to \$25.0 million for letters of credit and up to \$5.0 million for swingline loans), maturing on March 8, 2012. The term loan A borrowings and an additional \$4.3 million of revolver borrowings from this facility were used to repay all outstanding borrowings and other obligations under the Carrols existing senior credit facility and to pay certain fees and expenses incurred in connection with the new senior credit facility.

Both term loan and revolving credit borrowings under the new senior credit facility bear interest at a per annum rate, at the Carrols option, of either:

- 1) the applicable margin ranging from 0% to 0.25% based on Carrols senior leverage ratio (as defined in the new credit facility) plus the greater of (i) the prime rate or (ii) the federal funds rate for that day plus 0.5%; or
  - 2) Adjusted LIBOR plus the applicable margin percentage in effect ranging from 1.0% to 1.5% based on Carrols senior leverage ratio.
- Term loan A borrowings shall be due and payable in quarterly installments, beginning on June 30, 2008 as follows:
- 1) four quarterly installments of \$1.5 million beginning on June 30, 2008;
  - 2) eight quarterly installments of \$3.0 million beginning on June 30, 2009;
  - 3) four quarterly installments of \$4.5 million beginning on June 30, 2011; and
  - 4) four quarterly installments of \$18.0 million beginning on June 30, 2012.

Under the new senior credit facility, Carrols is also required to make mandatory prepayments of principal on term loan A facility borrowings (a) annually in an initial amount equal to 50% of Excess Cash Flow (as defined in the senior credit facility), (b) in the event of certain dispositions of assets (all subject to certain exceptions) and insurance proceeds, in an amount equal to 100% of the net proceeds received by Carrols therefrom, and (c) in an amount equal to 100% of the net proceeds from any subsequent issuance of debt.

In general, Carrols obligations under the senior credit facility are guaranteed by the Company and all of Carrols material subsidiaries and are collateralized by a pledge of Carrols common stock and the stock of each of Carrols material subsidiaries. The new senior credit facility contains certain covenants, including, without limitation, those limiting the Carrols ability to incur indebtedness, incur liens, sell or acquire assets or businesses, change the nature of its business, engage in transactions with related parties, make certain investments or pay dividends. In addition, Carrols is required to meet certain financial ratios, including fixed charge coverage, senior leverage, and total leverage ratios (all as defined under the new senior credit facility).

**8. Lease Financing Obligations**

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The Company entered into sale-leaseback transactions in various years involving certain restaurant properties that did not qualify for sale-leaseback accounting and as a result have been classified as financing transactions under SFAS No. 98, Accounting For Leases . Under the financing method, the assets remain on the consolidated balance sheet and proceeds received by the Company from these transactions are recorded as a financing liability. Payments under these leases are applied as payments of imputed interest and deemed principal on the underlying financing obligations.

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These leases generally provide for an initial term of 20 years plus renewal options. The rent payable under such leases includes a minimum rent provision and in some cases, includes rent based on a percentage of sales provision. These leases also require payment of property taxes, insurance and utilities.

Purchase options related to certain properties sold in real estate transactions accounted for under the financing method were held by an entity wholly-owned by the nephew of the Chairman and Chief Executive Officer of the Company and such entity was deemed a related party for accounting purposes. In the fourth quarter of 2006, these purchase options were assigned to the Company for nominal consideration.

During 2006, the Company exercised its right of first refusal under the leases for 14 restaurant properties following the exercise of purchase options previously held by the related party and the Company purchased these 14 restaurant properties from the respective lessors. Concurrently with these purchases, the properties were sold in qualified sale-leaseback transactions. The Company recorded deferred gains representing the amounts by which the sales prices exceeded the net book value of the underlying assets. Deferred gains are being amortized as an adjustment to rent expense over the term of the leases, which is generally 20 years.

The Company also amended lease agreements for 21 restaurant properties and amended a master lease agreement covering 13 restaurant properties in 2006, all of which were previously accounted for as lease financing obligations, to eliminate or otherwise cure the provisions that precluded the original sale-leaseback accounting under SFAS No. 98. As a result of such amendments, the Company recorded these sale-leaseback transactions as sales, removed all of the respective assets under lease financing obligations and related liabilities from its consolidated balance sheet and recognized gains from the sales, which were generally deferred and are being amortized as an adjustment to rent expense over the remaining term of the underlying leases.

As a result of the above transactions, in 2006 the Company reduced its lease financing obligations by \$52.8 million, reduced its assets under lease financing obligations by \$36.2 million and recorded deferred gains of \$18.3 million. The Company also recorded interest expense of \$2.0 million which represents the net amount by which the purchase price for the restaurant properties sold exceeded the lease financing obligations. Of these amounts, \$37.5 million of lease financing obligations and \$24.7 million of assets under lease financing obligations have been reflected as non-cash transactions in the consolidated statements of cash flows.

At December 31, 2006, payments required on lease financing obligations are as follows:

|  |                  |
|--|------------------|
| 2007                                     | \$ 5,299         |
| 2008                                     | 5,629            |
| 2009                                     | 5,646            |
| 2010                                     | 5,696            |
| 2011                                     | 5,796            |
| Thereafter, through 2023                 | 107,740          |
| <b>Total minimum lease payments</b>      | <b>135,806</b>   |
| Less: Interest implicit in obligations   | (77,235)         |
| <b>Total lease financing obligations</b> | <b>\$ 58,571</b> |

The interest rates on lease financing obligations range from 8.5% to 12.4% at December 31, 2006. Interest expense on lease financing obligations totaled \$10,411, \$11,244 and \$11,261 for the years ended December 31, 2006, 2005 and 2004, respectively.





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**9. Other Expense (Income)**

In the fourth quarter of 2006, the Company entered into a lease termination agreement for one of its Pollo Tropical restaurants resulting in a gain of \$1.4 million that is presented in other income in the consolidated statements of operations. The lease termination amount payable to the Company of \$1.8 million is included in trade and other receivables on the consolidated balance sheet at December 31, 2006. The Company subsequently received this amount in January 2007.

During 2004, the Company filed a registration statement on Form S-1 to register an initial public offering of Enhanced Yield Securities (EYSs) comprised of its common stock and senior subordinated notes. On October 25, 2004, the Company withdrew and terminated its registration of such securities and expensed the costs incurred for this offering of \$2.3 million in 2004.

**10. Income Taxes**

The income tax provision (benefit) was comprised of the following:

|                     | Year ended December 31, |          |            |
|---------------------|-------------------------|----------|------------|
|                     | 2006                    | 2005     | 2004       |
| Current:            |                         |          |            |
| Federal             | \$ 2,952                | \$ 1,426 | \$ (1,250) |
| Foreign             | 305                     | 295      | 306        |
| State               | 181                     | 3        | 690        |
|                     | 3,438                   | 1,724    | (254)      |
| Deferred (prepaid): |                         |          |            |
| Federal             | 3,136                   | 661      | (3,981)    |
| State               | 84                      | (744)    | (2,485)    |
|                     | 3,220                   | (83)     | (6,466)    |
| Valuation allowance | (97)                    | 1,119    |            |
|                     | \$ 6,561                | \$ 2,760 | \$ (6,720) |

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The components of deferred income tax assets and liabilities are as follows:

|  | December 31,     |                  |
|--|------------------|------------------|
|  | 2006             | 2005             |
| Current deferred tax assets:                                   |                  |                  |
| Inventory and other reserves                                   | \$ 117           | \$ 124           |
| Accrued vacation benefits                                      | 2,193            | 2,084            |
| Other accruals   | 2,229            | 2,659            |
| <b>Current deferred tax assets</b>                             | <b>4,539</b>     | <b>4,867</b>     |
| Long term deferred tax assets/(liabilities):                   |                  |                  |
| Deferred income on sale-leaseback of certain real estate       | 11,657           | 5,784            |
| Lease financing obligations                                    | 6,387            | 10,317           |
| Postretirement benefit expenses                                | 1,864            | 1,609            |
| Accumulated other comprehensive income postretirement benefits | 654              |                  |
| Property and equipment depreciation                            | 3,357            | 387              |
| Net state operating loss carryforwards                         | 2,189            | 2,331            |
| Amortization of other intangibles, net                         | 1,625            | 2,294            |
| Amortization of franchise rights                               | (23,232)         | (22,542)         |
| Occupancy costs  | 3,443            | 4,128            |
| Tax credit carryforwards                                       | 896              | 5,786            |
| Unearned purchase discounts                                    | 2,617            | 3,489            |
| Other  | 701              | 815              |
| <b>Long-term net deferred tax assets</b>                       | <b>12,158</b>    | <b>14,398</b>    |
| Less: Valuation allowance                                      | (1,022)          | (1,119)          |
| <b>Total long-term deferred tax assets</b>                     | <b>11,136</b>    | <b>13,279</b>    |
| <b>Carrying value of net deferred tax assets</b>               | <b>\$ 15,675</b> | <b>\$ 18,146</b> |

The Company's state net operating loss carryforwards expire in varying amounts beginning in 2007 through 2026. In addition, the Company has available Federal alternative minimum tax credit carryforwards of \$0.5 million with no expiration date.

The Company establishes a valuation allowance to reduce the carrying amount of deferred tax assets when it is more likely than not that it will not realize some portion or all of the tax benefit of its deferred tax assets. The Company evaluates whether its deferred tax assets are probable of realization on a quarterly basis. In performing this analysis, the Company considers all available evidence, both positive and negative, including historical operating results, the estimated timing of future reversals of existing taxable temporary differences and estimated future taxable income exclusive of reversing temporary differences and carryforwards. As of December 31, 2006, the Company has a valuation allowance of \$1,022 against net deferred tax assets due primarily to state net operating loss carryforwards where realization of the related deferred tax asset amounts was not more likely than not. The estimation of future taxable income for federal and state purposes and the Company's resulting ability to realize deferred tax assets pertaining to state net operating loss carryforwards and tax credit carryforwards can significantly change based on

future events and operating results. Thus, recorded valuation allowances may be subject to future changes that could be material.

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A reconciliation of the statutory federal income tax provision (benefit) to the effective tax provision for the years ended December 31, 2006, 2005 and 2004 is as follows:

|  | 2006     | 2005     | 2004       |
|--|----------|----------|------------|
| Statutory federal income tax provision     | \$ 6,994 | \$ (538) | \$ (5,036) |
| State income taxes, net of federal benefit | 172      | (500)    | (1,366)    |
| Stock based compensation expense           | 9        | 3,302    |            |
| Change in valuation allowance              | (97)     | 1,119    |            |
| Non-deductible expenses                    | 56       | 56       | 5          |
| Foreign taxes                              | 305      | 295      | 306        |
| Employment tax credits                     | (423)    | (552)    | (287)      |
| Foreign tax credits                        | (305)    | (295)    | (306)      |
| Miscellaneous                              | (150)    | (127)    | (36)       |
|  | \$ 6,561 | \$ 2,760 | \$ (6,720) |

On May 18, 2006, the state of Texas enacted House Bill 3, which replaces the state's current franchise tax with a margin tax. This legislation significantly affects the tax system for most corporate taxpayers. The margin tax, which is based on revenues less certain allowed deductions, will be accounted for as an income tax, following the provisions of SFAS No. 109, *Accounting for Income Taxes*. The Company has reviewed the provisions of this legislation and has concluded that the impact on its deferred taxes is immaterial.

On June 30, 2005, tax legislation in the state of Ohio was enacted that significantly restructured the state's tax system for most corporate taxpayers. Included in the legislation is a multi-year phase-out of the state franchise tax and tangible personal property tax. These taxes have been replaced with a Commercial Activity Tax that will be phased-in over a five-year period. In 2005, the Company recorded a tax expense of \$0.5 million related to the impact of this legislation due to the reduction of deferred tax assets associated with the future utilization of Ohio net operating loss carryforwards.

**11. Dividend and Bonus Payments**

On December 22, 2004, the Board of Directors of the Company approved the payment of a cash dividend of \$116.8 million to its stockholders from the net proceeds of the December 2004 refinancing. The cash dividend was paid on December 28, 2004.

In conjunction with the December 2004 refinancing, the Company also approved a compensatory bonus payment of approximately \$20.3 million to a number of employees (including management) and a director who owned stock options based on a pro rata basis in proportion to the number of shares of common stock issuable upon exercise of the options owned by such persons. The bonus payment was made in January 2005 and, including applicable payroll taxes of \$0.6 million, totaled \$20.9 million.

**12. Stockholders' Deficit**

*Stock Split.* On November 21, 2006, the Company authorized an 11.288-for-one stock split of the Company's common stock. The stock split became effective on December 8, 2006 upon the filing by the Company of its Restated Certificate of Incorporation with the Secretary of State of Delaware. All 2005 and 2004 share and per share information included in the accompanying consolidated financial statements have been adjusted to retroactively reflect the stock split.



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*Initial Public Offering ( IPO ).* In December 2006, the Company and certain selling stockholders completed an IPO of 5,666,666 and 5,333,334 (including 1,000,000 shares sold upon the underwriters' exercise of its over-allotment option) shares of common stock, respectively, at \$13.00 per share. The Company received net proceeds of approximately \$65.4 million from the sale of shares of its common stock in the offering after deducting underwriting discounts and commissions and offering expenses. The Company contributed the net proceeds from the IPO to Carrols, which used all of such funds to repay principal amounts of term loan borrowings under Carrols senior credit facility.

*Stock Awards.* Effective May 3, 2005, the Company issued an aggregate of 2,941,521 shares of common stock in exchange for the cancellation and termination of an identical number of outstanding options to purchase shares of common stock. As a consequence of the exchange, all outstanding stock options were cancelled and terminated, and the option plans (described below) were subsequently terminated. In 2005, the Company issued an additional 61,406 shares of common stock in separate awards.

All shares were issued pursuant to stock award agreements, which provide that such shares are fully vested and non-forfeitable upon issuance, but may not be sold or otherwise disposed of for a period of two years from the date of issuance. The fair market value of a share of the Company's common stock on the date of these awards was estimated to be \$5.45. The Company recorded a pre-tax compensation charge of \$16.4 million in 2005 relative to these stock awards.

In 2006, the Company also granted stock awards of 1,120 shares to certain of its employees.

Prior to October 27, 2004, the Company's authorized common stock consisted of three series comprised of 33,864,000 shares of Carrols Stock, par value \$0.01 per share, 2,000,000 shares of Pollo Tropical Stock, par value \$0.01 per share, and 2,000,000 shares of Taco Cabana Stock, par value \$0.01 per share. The Pollo Tropical and Taco Cabana classes of the Company's stock were considered tracking stocks, a class of stock which tracked the separate performance of Pollo Tropical and Taco Cabana, respectively. On October 27, 2004, the Company eliminated this tracking stock by combining all of its authorized series of common stock into one series of common stock. The Company's Pollo Tropical class of common stock and Taco Cabana class of common stock were each converted into the series of common stock known as Carrols Stock, which at the time of the combination, was renamed and is now referred to as common stock.

Prior to October 27, 2004, no shares of the Company's Pollo Tropical or Taco Cabana classes of common stock were outstanding. However, as a result of the combination, each outstanding option to purchase a share of the Company's Pollo Tropical class of common stock pursuant to the 1998 Pollo Tropical Long-Term Incentive Plan was converted on October 27, 2004 into an option to purchase 0.4144 shares (pre-stock split) of common stock. Similarly, each outstanding option to purchase a share of the Company's Taco Cabana class of common stock pursuant to the 2001 Taco Cabana Long-Term Incentive Plan was converted on October 27, 2004 into an option to purchase 0.0522 shares (pre-stock split) of common stock.

*Stock Options.* In 1996, the Company adopted a stock option plan entitled the 1996 Long-Term Incentive Plan ( 1996 Plan ) and reserved and authorized a total of 1,199,350 shares of common stock for grant thereunder. The number of shares reserved and authorized under this plan was increased to 1,255,790 in 2001 and to 2,137,100 in 2002. Options under this plan generally vested over a four-year period. In 1998, the Company adopted the 1998 Directors' Stock Option Plan ( 1998 Directors' Plan ) authorizing the grant of up to 112,880 options to non-employee directors. Options under this plan were exercisable over four years. Also, options for 366,036 shares of common stock not covered under any plan ( Non Plan Options ) were granted in

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1997 at a price of \$9.01 with vesting over a five-year period. On February 26, 2002, the Compensation Committee of the Company extended the expiration date for the Non Plan Options and the 1996 Plan options granted prior to March 1, 2002 to February 29, 2012 for all executive officers and certain other officers of the Company. All outstanding options related to these plans were cancelled in 2005.

The Company also adopted the 1998 Pollo Tropical Long-Term Incentive Plan (the 1998 Pollo Plan ) authorizing the grant of options to purchase up to 41,440 shares of the Company s common stock (100,000 shares of the Company s Pollo Tropical class of common stock prior to the conversion). The Company also adopted the 2001 Taco Cabana Long-Term Incentive Plan (the 2001 Taco Plan ) authorizing to grant of options to purchase up to 26,100 shares of the Company s common stock (500,000 shares of the Company s Taco Cabana class of common stock prior to the conversion). Options under both of these plans generally vested over a five-year period. All outstanding options related to these plans were cancelled in 2005.

*2006 Stock Incentive Plan.* In 2006, the Company adopted a stock plan entitled the 2006 Stock Incentive Plan (the 2006 Plan ) and reserved and authorized a total of 3,300,000 shares of common stock for grant thereunder. Prior to and in connection with the IPO, the Company granted options to purchase 1,241,750 shares of its common stock, consisting of 395,000 shares of non-qualified stock options and 846,750 shares of incentive stock options ( ISO ), and issued 75,800 shares of restricted stock, 55,700 to certain of its employees and 20,100 to outside directors. As of December 31, 2006, 1,982,450 shares are available for future issuance.

The non-qualified stock options and ISO s granted under the 2006 Plan are exercisable for up to one-fifth of the total number of option shares on or after the first anniversary of the grant date and as of the first day of each month that commences subsequent to the first anniversary of the grant date, the option is exercisable for up to an additional one-sixtieth of the total number of option shares until fully exercisable. The options expire seven years from the date of the grant and 50% were issued with an exercise price equal to the fair market value of the stock price, or \$13.00 per share of common stock on the date of grant, and the remaining 50% were issued with an exercise price equal to 120% of the fair market value of the stock price, or \$15.60 per share of common stock, on the date of grant. The restricted stock awards issued to certain employees vest one-third on the first anniversary of the award date, an additional one-third on the second anniversary of the award date and the remaining one-third on the third anniversary of the award date. The restricted stock awards issued to outside directors vest one-fifth on the first anniversary of the award date and an additional one-fifth on each subsequent anniversary of the award date, provided that, the participant has continuously remained a director of the Company. Forfeiture rates are based on a stratification of employees by expected exercise behavior and range from 0 to 15%.

Stock based compensation expense for 2006 totaled \$0.1 million. A portion of the Company s granted options qualify as ISO s for income tax purposes. As such, a tax benefit is not recorded at the time the compensation cost related to the options is recorded for financial reporting purposes because an ISO does not ordinarily result in a tax benefit unless there is a disqualifying disposition. Stock option grants of non-qualified options result in the creation of a deferred tax asset until the time that the option is exercised.

The total non-vested stock-based compensation expense relating to the options and restricted shares is approximately \$5.4 million and approximately \$1.5 million will be recorded as compensation expense in 2007. The remaining weighted average vesting period for such options and restricted shares is 4.38 years at December 31, 2006.



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A summary of all option activity under the Company's 2006 Plan was as follows:

|  | Number<br>of<br>Options | Weighted<br>Average<br>Exercise<br>Price | 2006 Plan<br>Average<br>Remaining<br>Contractual<br>Life | Aggregate<br>Intrinsic<br>Value (in<br>thousands)(1) |
|--|-------------------------|--|--|--|
| Options outstanding at January 1, 2006   |                         | \$                                       |  | \$   |
| Granted                                  | 1,241,750               | \$ 14.30                                 | 7.0  | \$ 733   |
| Options outstanding at December 31, 2006 | 1,241,750               | \$ 14.30                                 | 7.0  | \$ 733   |
| Expected to vest at December 31, 2006    | 1,224,886               | \$ 14.30                                 | 7.0  | \$ 723   |
| Options exercisable at December 31, 2006 |                         |  |  |  |

(1) The aggregate intrinsic value was calculated using the difference between the market price of the Company's common stock at December 31 and the grant price for only those awards that have a grant price that is less than the market price of the Company's common stock at December 31.

The restricted stock activity related to the Company's 2006 plan is as follows:

|                                | Shares | Weighted<br>Average<br>Fair<br>Value |
|--------------------------------|--------|--------------------------------------|
| Nonvested at January 1, 2006   |        | \$                                   |
| Shares granted                 | 75,800 | \$ 13.00                             |
| Nonvested at December 31, 2006 | 75,800 | \$ 13.00                             |

A summary of all option activity under the Company's prior stock option plans for the years ended December 31, 2005 and 2004 is as follows:

|                                | NonPlan<br>Options | 1996<br>Plan | Directors<br>Plan | Pollo<br>Plan | Taco<br>Plan |
|--------------------------------|--------------------|--------------|-------------------|---------------|--------------|
| Outstanding at January 1, 2004 | 366,036            | 2,073,019    | 39,508            | 90,775        | 339,000      |
| Granted                        |                    | 34,993       | 5,644             | 8,725         | 85,500       |
| Canceled                       |                    | (7,326)      |                   | (750)         | (15,724)     |
| Redeemed                       |                    | (5,667)      |                   | (22,470)      |              |

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|   |           |             |          |           |           |
|---|-----------|-------------|----------|-----------|-----------|
| Merger of tracking stock to common stock                              |           |             |          | (56,777)  | (387,967) |
| Adjust tracking stock for common stock split                          |           |             |          | 200,647   | 214,083   |
| Outstanding at December 31, 2004                                      | 366,036   | 2,095,019   | 45,152   | 220,150   | 234,892   |
| Canceled  | (366,036) | (2,095,019) | (45,152) | (220,150) | (234,892) |
| Outstanding at December 31, 2005                                      |           |             |          |           |           |
| Grant Prices (in whole dollars) in 2004                               | \$        | \$ 11.25    | \$ 11.25 | \$ 183.00 | \$ 14.50  |
| Weighted Average Option Price (in whole dollars) at December 31, 2004 | \$ 9.01   | \$ 9.76     | \$ 10.49 | \$ 13.59  | \$ 13.86  |
| Options Exercisable at December 31, 2004                              | 366,036   | 2,022,640   | 36,686   | 151,620   | 124,495   |

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**Table of Contents****CARROLS RESTAURANT GROUP, INC. AND SUBSIDIARY****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****Years Ended December 31, 2006, 2005 and 2004**

(in thousands of dollars, except share and per share amounts)

**13. Business Segment Information**

The Company is engaged in the quick-service and quick-casual restaurant industry, with three restaurant concepts: Burger King operating as a franchisee, Pollo Tropical and Taco Cabana, both Company owned concepts. The Company's Burger King restaurants are all located in the United States, primarily in the Northeast, Southeast and Midwest. Pollo Tropical is a quick-casual restaurant chain featuring grilled marinated chicken and authentic made from scratch side dishes. Pollo Tropical's core markets are located in south and central Florida. Taco Cabana is a quick-casual restaurant chain featuring Mexican style food, including, flame-grilled beef and chicken fajitas, quesadillas and other Tex-Mex dishes. Taco Cabana's core markets are primarily located in Texas.

The accounting policies of each segment are the same as those described in the summary of significant accounting policies. The following table includes Segment EBITDA which is the measure of segment profit or loss reported to the chief operating decision maker for purposes of allocating resources to the segments and assessing their performance. Segment EBITDA is defined as earnings before interest, income taxes, depreciation and amortization, impairment losses, stock-based compensation expense, bonus to employees and a director in connection with the Company's December 2004 refinancing, other expense (income) and loss on extinguishment of debt.

The Other column includes corporate related items not allocated to reportable segments, including stock-based compensation expense. Other identifiable assets consist primarily of cash, certain other assets, corporate property and equipment, goodwill and deferred income taxes.

|  | Pollo<br>Tropical | Taco<br>Cabana | Burger<br>King | Other   | Consolidated |
|--|-------------------|----------------|----------------|---------|--------------|
| <b>Year ended December 31, 2006</b>          |                   |                |                |         |              |
| Revenues                                     | \$ 154,207        | \$ 228,304     | \$ 368,915     | \$      | \$ 751,426   |
| Cost of sales                                | 49,430            | 66,061         | 95,745         |         | 211,236      |
| Restaurant wages and related expenses        | 38,625            | 64,976         | 115,190        | 6       | 218,797      |
| General and administrative expense (1)       | 8,951             | 11,649         | 29,082         | 74      | 49,756       |
| Depreciation and amortization                | 5,050             | 8,742          | 18,028         | 1,714   | 33,534       |
| Segment EBITDA                               | 28,422            | 33,494         | 34,177         |         |              |
| Identifiable assets                          | 46,617            | 71,601         | 155,272        | 179,369 | 452,859      |
| Capital expenditures, including acquisitions | 18,175            | 17,051         | 8,327          | 1,586   | 45,139       |
| <b>Year ended December 31, 2005</b>          |                   |                |                |         |              |
| Revenues                                     | \$ 136,983        | \$ 209,831     | \$ 360,096     | \$      | \$ 706,910   |
| Cost of sales                                | 45,185            | 60,368         | 99,067         |         | 204,620      |
| Restaurant wages and related expenses        | 31,956            | 58,932         | 113,404        |         | 204,292      |
| General and administrative expense (1)       | 7,502             | 10,154         | 24,852         | 16,432  | 58,940       |
| Depreciation and amortization                | 4,881             | 7,951          | 18,988         | 1,276   | 33,096       |
| Segment EBITDA                               | 28,684            | 31,927         | 31,767         |         |              |
| Identifiable assets                          | 59,761            | 70,883         | 182,902        | 183,399 | 496,945      |
| Capital expenditures, including acquisitions | 14,124            | 16,792         | 6,614          | 1,319   | 38,849       |
| <b>Year ended December 31, 2004</b>          |                   |                |                |         |              |
| Revenues                                     | \$ 125,101        | \$ 202,941     | \$ 369,837     | \$      | \$ 697,879   |
| Cost of sales                                | 38,986            | 60,435         | 103,203        |         | 202,624      |
| Restaurant wages and related expenses        | 31,380            | 57,702         | 117,650        |         | 206,732      |

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|  |        |        |         |         |         |
|--|--------|--------|---------|---------|---------|
| General and administrative expense (1)       | 7,314  | 11,061 | 23,392  | 1,818   | 43,585  |
| Depreciation and amortization                | 4,460  | 9,884  | 22,078  | 2,099   | 38,521  |
| Segment EBITDA                               | 27,884 | 30,082 | 36,582  |         |         |
| Identifiable assets                          | 50,177 | 63,655 | 198,015 | 204,399 | 516,246 |
| Capital expenditures, including acquisitions | 6,636  | 6,555  | 4,811   | 1,071   | 19,073  |

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**Table of Contents****CARROLS RESTAURANT GROUP, INC. AND SUBSIDIARY****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****Years Ended December 31, 2006, 2005 and 2004**

(in thousands of dollars, except share and per share amounts)

- (1) For the Pollo Tropical and Taco Cabana segments, such amounts include general and administrative expenses related directly to each segment. For the Burger King segment such amounts include general and administrative expenses related directly to the Burger King segment as well as expenses associated with administrative support to all three of the Company's segments including executive management, information systems and certain accounting, legal and other administrative functions.

A reconciliation of segment EBITDA to consolidated net income (loss) is as follows:

|                                      | Year ended December 31, |            |            |
|--------------------------------------|-------------------------|------------|------------|
|                                      | 2006                    | 2005       | 2004       |
| Segment EBITDA:                      |                         |            |            |
| Pollo Tropical                       | \$ 28,422               | \$ 28,684  | \$ 27,884  |
| Taco Cabana                          | 33,494                  | 31,927     | 30,082     |
| Burger King                          | 34,177                  | 31,767     | 36,582     |
| Subtotal                             | 96,093                  | 92,378     | 94,548     |
| Less:                                |                         |            |            |
| Depreciation and amortization        | 33,534                  | 33,096     | 38,521     |
| Impairment losses                    | 1,019                   | 1,468      | 1,544      |
| Interest expense                     | 44,262                  | 42,972     | 35,383     |
| Provision (benefit) for income taxes | 6,561                   | 2,760      | (6,720)    |
| Bonus to employees and a director    |                         |            | 20,860     |
| Stock-based compensation expense     | 80                      | 16,432     | 1,818      |
| Loss on extinguishment of debt       |                         |            | 8,913      |
| Other expense (income)               | (2,787)                 |            | 2,320      |
| Net income (loss)                    | \$ 13,424               | \$ (4,350) | \$ (8,091) |

**14. Commitments and Contingencies**

On November 16, 1998, the Equal Employment Opportunity Commission ( EEOC ) filed suit in the United States District Court for the Northern District of New York (the Court ), under Title VII of the Civil Rights Act of 1964, as amended, against Carrols. The complaint alleged that Carrols engaged in a pattern and practice of unlawful discrimination, harassment and retaliation against former and current female employees. The EEOC identified approximately 450 individuals (which was subsequently increased to 511 individuals) that it believed represented the class of claimants and was seeking monetary and injunctive relief from Carrols.

On April 20, 2005, the Court issued a decision and order granting Carrols' Motion for Summary Judgment that Carrols filed in January 2004. Subject to possible appeal by the EEOC, the case is dismissed, however the Court noted that it was not ruling on the claims, if any, that individual employees might have against Carrols. The Company does not believe that any individual claim, if any, would have a material adverse impact on its consolidated financial statements.

On February 27, 2006, Carrols filed a motion for summary judgment to dismiss all but between four and 17 of the individual claims. On July 10, 2006, in its response to that motion, the EEOC has asserted that, notwithstanding the Court's dismissal of the case as a class action, the EEOC may still maintain some kind of collective action on behalf of these claimants. Oral argument before the Court was held on October 4, 2006 and the Company is awaiting the Court's decision on Carrols' summary judgment motion. Although the Company believes that the EEOC's continued class litigation argument is without merit, it is not possible to predict the outcome of the pending motion.



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**CARROLS RESTAURANT GROUP, INC. AND SUBSIDIARY**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**Years Ended December 31, 2006, 2005 and 2004**

(in thousands of dollars, except share and per share amounts)

On November 30, 2002, four former hourly employees commenced a lawsuit against Carrols in the United States District Court for the Western District of New York entitled Dawn Seever, et al. v. Carrols Corporation. The lawsuit alleges, in substance, that Carrols violated certain minimum wage laws under the Federal Fair Labor Standards Act and related state laws by requiring employees to work without recording their time and by retaliating against those who complained. The plaintiffs seek damages, costs and injunctive relief. They also seek to notify, and eventually certify, a class consisting of current and former employees who, since 1998, have worked, or are working, for Carrols. As a result of the July 21, 2005 Status Conference, the parties agreed to withdraw Plaintiff's Motions to Certify and for National Discovery, and Defendant's Motion to Disqualify Counsel and related motions, to allow both sides limited additional discovery. Carrols has since filed a Motion for Summary Judgment as to the existing plaintiffs that the Court has under consideration. On January 19, 2007, plaintiffs re-filed the Motion to certify and for National Discovery and Carrols intends to oppose such Motion. It is too early to evaluate the likelihood of an unfavorable outcome or estimate the amount or range of potential loss. Consequently, it is not possible to predict what adverse impact, if any, this case could have on the Company's consolidated financial statements. Carrols intends to continue to contest this case vigorously.

The Company is a party to various other litigation matters incidental to the conduct of business. The Company does not believe that the outcome of any of these other matters will have a material adverse effect on its consolidated financial statements.

**15. Retirement Plans**

The Company offers its salaried employees the option to participate in the Carrols Corporation Retirement Savings Plan (the Retirement Plan). The Retirement Plan includes a savings option pursuant to section 401(k) of the Internal Revenue Code in addition to a post tax savings option. The Company may elect to contribute to the Retirement Plan on an annual basis. The Company's contributions are equal to 50% of the employee's contribution to a maximum Company contribution of \$520 annually for any plan year that the Company participates in an employee match. Under the Retirement Plan, the Company's contributions begin to vest after one year and fully vest after five years of service. A year of service is defined as a plan year during which an employee completes at least 1,000 hours of service. Participating employees may contribute up to 18% of their salary annually to either of the savings options, subject to other limitations. The employees have various investment options available under a trust established by the Retirement Plan. Contributions to the Retirement Plan were \$404 and \$403 for the years ended December 31, 2006 and 2005, respectively. For the 2004 plan year, the Company did not make any matching contributions.

The Company also has a Deferred Compensation Plan which permits employees not eligible to participate in the Retirement Plan because they have been excluded as highly compensated employees (as so defined in the Retirement Plan), to voluntarily defer portions of their base salary and annual bonus. All amounts deferred by the participants earn interest at 8% per annum. There is no Company matching on any portion of the funds. At December 31, 2006 and 2005, a total of \$2,034 and \$870, respectively, was deferred under this plan, including accrued interest. Liabilities related to the Deferred Compensation Plan are included in other long-term liabilities in the consolidated balance sheet.

**Table of Contents****CARROLS RESTAURANT GROUP, INC. AND SUBSIDIARY****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****Years Ended December 31, 2006, 2005 and 2004**

(in thousands of dollars, except share and per share amounts)

**16. Postretirement Benefits**

The Company provides postretirement medical and life insurance benefits covering substantially all Burger King administrative and restaurant management salaried employees. A December 31 measurement date is used for the postretirement benefits. The following is the plan status and accumulated postretirement benefit obligation (APBO) at December 31, 2006 and 2005:

|   | 2006     | 2005     |
|---|----------|----------|
| <b>Change in benefit obligation:</b>                      |          |          |
| Benefit obligation at beginning of year                   | \$ 6,075 | \$ 4,943 |
| Service cost  | 485      | 395      |
| Interest cost   | 335      | 280      |
| Plan participants' contributions                          | 9        | 8        |
| Actuarial loss  | (288)    | 598      |
| Benefits paid   | (246)    | (149)    |
| <br>  |          |          |
| Benefit obligation at end of year                         | \$ 6,370 | \$ 6,075 |
| <b>Change in plan assets:</b>                             |          |          |
| Fair value of plan assets at beginning of year            |          |          |
| Employer contributions                                    | 237      | 141      |
| Plan participants' contributions                          | 9        | 8        |
| Benefits paid   | (246)    | (149)    |
| <br>  |          |          |
| Fair value of plan assets at end of year                  |          |          |
| <br>  |          |          |
| Funded status   | 6,370    | 6,075    |
| Unrecognized prior service credit                         |          | 73       |
| Unrecognized net actuarial net loss                       |          | (2,080)  |
| <br>  |          |          |
| Funded status at end of year                              | \$ 6,370 | \$ 4,068 |
| <b>Weighted average assumptions:</b>                      |          |          |
| Discount rate used to determine benefit obligations       | 5.90%    | 5.55%    |
| <br>  |          |          |
| Discount rate used to determine net periodic benefit cost | 5.55%    | 6.15%    |

The incremental effect of applying SFAS No. 158 on the individual line items in the consolidated balance sheet is as follows at December 31, 2006:

Adjustments



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|                                      | <b>Before</b>       |                | <b>After</b>        |
|--------------------------------------|---------------------|----------------|---------------------|
|                                      | <b>SFAS No. 158</b> |                | <b>SFAS No. 158</b> |
| Postretirement benefit obligation    | \$ 4,715            | \$ 1,655       | \$ 6,370            |
| Deferred income taxes                | 16,329              | (654)          | 15,675              |
| <b>Total liabilities</b>             | <b>477,625</b>      | <b>1,001</b>   | <b>478,626</b>      |
| Accumulated other comprehensive loss |                     | (1,001)        | (1,001)             |
| <b>Total stockholders' deficit</b>   | <b>(24,766)</b>     | <b>(1,001)</b> | <b>(25,767)</b>     |

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**Table of Contents****CARROLS RESTAURANT GROUP, INC. AND SUBSIDIARY****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****Years Ended December 31, 2006, 2005 and 2004**

(in thousands of dollars, except share and per share amounts)

The amounts recognized on the consolidated balance sheet of \$6,370 and \$4,068 at December 31, 2006 and 2005, respectively, are included as a non-current liability. Amounts recognized in accumulated other comprehensive loss, consist of:

|                                      | <b>2006</b> |
|--------------------------------------|-------------|
| Prior service cost                   | \$ (44)     |
| Net gain                             | 1,699       |
| Income tax benefit                   | (654)       |
| Accumulated other comprehensive loss | \$ 1,001    |

The discount rate is determined based on high-quality fixed income investments that match the duration of expected retiree medical and life insurance benefits. The Company has typically used the corporate AA/Aa bond rate for this assumption.

Assumed health care cost trend rates at December 31:

|   | <b>2006</b> | <b>2005</b> | <b>2004</b> |
|---|-------------|-------------|-------------|
| Medical benefits cost trend rate assumed for the following year                   | 8.00%       | 8.00%       | 8.25%       |
| Prescription drug benefit cost trend rate assumed for the following year          | 10.00%      | 11.00%      | 12.00%      |
| Rate to which the cost trend rate is assumed to decline (the ultimate trend rate) | 5.00%       | 5.00%       | 5.00%       |
| Year that the rate reaches the ultimate trend rate                                | 2012        | 2012        | 2012        |

During 2007, the Company expects to contribute approximately \$132 to its postretirement benefit plan. The benefits expected to be paid in each year from 2007 through 2011 are \$118, \$116, \$135, \$158 and \$193, respectively, and for the years 2012-2016 the aggregate amount of \$1,434. Components of net period postretirement benefit cost are:

|  | <b>Year ended December 31,</b> |             |             |
|--|--------------------------------|-------------|-------------|
|  | <b>2006</b>                    | <b>2005</b> | <b>2004</b> |
| Net periodic postretirement benefit cost |                                |             |             |
| Service cost                             | \$ 485                         | \$ 395      | \$ 381      |
| Interest cost                            | 335                            | 280         | 251         |
| Amortization of net gains and losses     | 92                             | 61          | 46          |
| Amortization of prior service credit     | (29)                           | (30)        | (30)        |
| Net periodic postretirement benefit cost | \$ 883                         | \$ 706      | \$ 648      |

The estimated net loss and prior service credit for the postretirement benefit plan that will be amortized from accumulated other comprehensive loss into net periodic benefit cost over the next fiscal year are \$68 and (\$30), respectively.

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Assumed health care cost trend rates have a significant effect on the amounts reported for the health care plans. A one-percentage-point change in the health care cost trend rates would have the following effects:

|   | <b>1%<br/>Increase</b> | <b>1%<br/>Decrease</b> |
|---|------------------------|------------------------|
| Effect on total of service and interest cost components | \$ 180                 | \$ (146)               |
| Effect on postretirement benefit obligation             | 1,248                  | (1,021)                |

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**Table of Contents****CARROLS RESTAURANT GROUP, INC. AND SUBSIDIARY****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****Years Ended December 31, 2006, 2005 and 2004**

(in thousands of dollars, except share and per share amounts)

**17. Income (loss) per share**

Basic income (loss) per share is computed by dividing net income (loss) for the period by the weighted average number of common shares outstanding during the period. Diluted income (loss) per share is computed by dividing net income (loss) for the period by the weighted average number of common shares outstanding plus the dilutive effect of outstanding stock options using the treasury stock method. For the year ended December 31, 2004, diluted income (loss) per share is computed by dividing the net income (loss) allocated to Carrols class of common stock by the weighted average number of the Carrols class common shares outstanding plus the dilutive effect of outstanding stock options of the Carrols class common stock using the treasury stock method. The computation of diluted income (loss) per share excludes options to purchase 620,875, 388 and 144,384 shares of common stock in 2006, 2005 and 2004 because the exercise price of these options was greater than the average market price of the common shares in the periods and therefore, they were antidilutive. In addition, options to purchase 620,875 shares of common stock are excluded from the computation of diluted income (loss) per share excludes in 2006 as they were antidilutive under the treasury stock method.

In connection with the IPO, the Company authorized an 11.288 for-one stock split on November 21, 2006 which became effective on December 8, 2006 (see Note 12). Accordingly, basic and diluted shares for all periods presented have been calculated based on the average shares outstanding, as adjusted for the stock split.

The following table is a reconciliation of the income (loss) and share amounts used in the calculation of basic income (loss) per share and diluted income (loss) per share:

|   | Year ended December 31, |            |            |
|---|-------------------------|------------|------------|
|   | 2006                    | 2005       | 2004       |
| Basic income (loss) per share:                            |                         |            |            |
| Net income (loss)   | \$ 13,424               | \$ (4,350) | \$ (8,091) |
| Weighted average common shares outstanding                | 16,152,060              | 14,905,750 | 12,915,095 |
| Basic net income (loss) per share                         | \$ 0.83                 | \$ (0.29)  | \$ (0.63)  |
| Diluted income (loss) per share:                          |                         |            |            |
| Net income (loss) for diluted income (loss) per share (1) | \$ 13,424               | \$ (4,350) | \$ (8,200) |
| Shares used in computing basic income (loss) per share    | 16,152,060              | 14,905,750 | 12,915,095 |
| Dilutive effect of stock options treasury stock method    | 270                     |            |            |
| Shares used in computing diluted income (loss) per share  | 16,152,330              | 14,905,750 | 12,915,095 |
| Diluted income (loss) per share                           | \$ 0.83                 | \$ (0.29)  | \$ (0.63)  |

(1) Net income (loss) for diluted income (loss) per share was adjusted \$109 in 2004 for the allocation of income to the Company's authorized Pollo Tropical class of common stock.

**Table of Contents****CARROLS RESTAURANT GROUP, INC. AND SUBSIDIARY****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****Years Ended December 31, 2006, 2005 and 2004**

(in thousands of dollars, except share and per share amounts)

**18. Selected Quarterly Financial and Earnings Data (Unaudited)**

|  | 2006             |                   |                  |                   |
|--|------------------|-------------------|------------------|-------------------|
|  | First<br>Quarter | Second<br>Quarter | Third<br>Quarter | Fourth<br>Quarter |
| Revenue  | \$ 182,543       | \$ 190,581        | \$ 189,597       | \$ 188,705        |
| Gross profit (1)   | 26,514           | 29,773            | 29,127           | 28,535            |
| Income from operations                                   | 13,673           | 17,589            | 17,924           | 15,061            |
| Net income   | 1,525            | 3,089             | 5,128(4)         | 3,682(5)          |
| Basic and diluted net income per common share            | 0.10(3)          | 0.19(3)           | 0.32(3)          | 0.22              |
|  |                  |                   |                  |                   |
|  | 2005             |                   |                  |                   |
|  | First<br>Quarter | Second<br>Quarter | Third<br>Quarter | Fourth<br>Quarter |
| Revenue  | \$ 169,516       | \$ 181,800        | \$ 181,286       | \$ 174,308        |
| Gross profit (1)   | 22,930           | 27,280            | 28,716           | 24,140            |
| Income from operations                                   | 11,576           | (932)             | 18,016           | 12,722            |
| Net income (loss)  | 871              | (11,356)(2)       | 5,261            | 874               |
| Basic and diluted net income (loss) per common share (3) | 0.07             | (0.76)            | 0.34             | 0.06              |

- (1) Gross profit is defined as total revenues less cost of sales, restaurant wages and related expenses, restaurant rent expense, other restaurant operating expenses, advertising expense and depreciation expense allocated to the Company's restaurants.
- (2) In the second quarter of 2005, the Company recorded stock-based compensation expense of \$16.4 million in connection with stock awards issued in the second quarter of 2005 (See Note 12).
- (3) Earnings (loss) per share calculations by quarter do not reflect the additional shares issued in the Company's initial public offering.
- (4) In the third quarter of 2006, the Company recorded \$1.4 million of other income related to a reduction of exit cost reserves (See Note 5).
- (5) In the fourth quarter of 2006, the Company recorded \$1.4 million of other income related to a lease termination gain (See Note 9).

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**CARROLS RESTAURANT GROUP, INC. AND SUBSIDIARY**  
**SCHEDULE I CONDENSED FINANCIAL INFORMATION OF**

**CARROLS RESTAURANT GROUP, INC.**

**(PARENT COMPANY ONLY)**

**CONDENSED BALANCE SHEETS**

(in thousands of dollars except share and per share amounts)

|  | December 31,       |                     |
|--|--------------------|---------------------|
|  | 2006               | 2005                |
| <b>ASSETS</b>  |                    |                     |
| Investment in and advances from unconsolidated subsidiary  | \$ (25,735)        | \$ (103,511)        |
| <b>Total assets</b>  | <b>\$ (25,735)</b> | <b>\$ (103,511)</b> |
| <b>LIABILITIES AND STOCKHOLDERS DEFICIT</b>  |                    |                     |
| Due to unconsolidated subsidiary   | \$ 32              | \$ 26               |
| Total current liabilities  | 32                 | 26                  |
| <b>Total liabilities</b>   | <b>32</b>          | <b>26</b>           |
| Stockholders' deficit:   |                    |                     |
| Preferred stock, par value \$.01; authorized 20,000,000 shares, issued and outstanding none  |                    |                     |
| Voting common stock, par value \$.01; authorized 100,000,000 shares, issued and outstanding 21,550,827 and 15,917,176 shares, respectively | 216                | 159                 |
| Additional paid-in capital   | (3,108)            | (68,539)            |
| Accumulated deficit  | (21,733)           | (35,157)            |
| Accumulated other comprehensive loss   | (1,001)            |                     |
| Treasury stock, at cost  | (141)              |                     |
| <b>Total stockholders' deficit</b>   | <b>(25,767)</b>    | <b>(103,537)</b>    |
| <b>Total liabilities and stockholders' deficit</b>   | <b>\$ (25,735)</b> | <b>\$ (103,511)</b> |

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

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**CARROLS RESTAURANT GROUP, INC. AND SUBSIDIARY**  
**SCHEDULE I CONDENSED FINANCIAL INFORMATION OF**  
**CARROLS RESTAURANT GROUP, INC.**  
**(PARENT COMPANY ONLY)**  
**CONDENSED STATEMENTS OF OPERATIONS**

(in thousands of dollars)

|   | Year Ended December 31, |            |            |
|---|-------------------------|------------|------------|
|   | 2006                    | 2005       | 2004       |
| Income (loss):  |                         |            |            |
| Investment income (loss) from unconsolidated subsidiary | \$ 13,430               | \$ (4,343) | \$ (8,084) |
| Expenses:   |                         |            |            |
| General and administrative                              | 6                       | 7          | 7          |
| Net income (loss)                                       | \$ 13,424               | \$ (4,350) | \$ (8,091) |

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

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**CARROLS RESTAURANT GROUP, INC. AND SUBSIDIARY**  
**SCHEDULE I CONDENSED FINANCIAL INFORMATION OF**  
**CARROLS RESTAURANT GROUP, INC.**  
**(PARENT COMPANY ONLY)**  
**CONDENSED STATEMENTS OF CASH FLOWS**

(in thousands of dollars)

|  | Year Ended December 31, |            |                  |
|--|-------------------------|------------|------------------|
|  | 2006                    | 2005       | 2004             |
| Cash flows from operating activities:  |                         |            |                  |
| Net income (loss)  | \$ 13,424               | \$ (4,350) | \$ (8,091)       |
| Adjustments to reconcile net income (loss) to net cash provided from operating activities: |                         |            |                  |
| Decrease (increase) in investment in unconsolidated subsidiary                             | (13,430)                | 4,343      | 8,084            |
| Dividends from subsidiary  |                         |            | 116,794          |
| Increase in due to unconsolidated subsidiary   | 6                       | 7          | 7                |
| <b>Net cash provided from operating activities</b>   |                         |            | <b>116,794</b>   |
| Cash flows used for financing activities:  |                         |            |                  |
| Dividends paid   |                         |            | (116,794)        |
| <b>Net cash used for financing activities</b>  |                         |            | <b>(116,794)</b> |
| <b>Net increase (decrease) in cash and cash equivalents</b>                                |                         |            |                  |
| Cash and cash equivalents, beginning of year   |                         |            |                  |
| <b>Cash and cash equivalents, end of year</b>  | <b>\$</b>               | <b>\$</b>  | <b>\$</b>        |

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



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**CARROLS RESTAURANT GROUP, INC. AND SUBSIDIARY**  
**SCHEDULE I CONDENSED FINANCIAL INFORMATION OF**  
**CARROLS RESTAURANT GROUP, INC.**  
**(PARENT COMPANY ONLY)**  
**NOTES TO CONDENSED FINANCIAL STATEMENTS**

**Note 1 Basis of Presentation**

Carrols Restaurant Group, Inc.'s (formerly known as Carrols Holdings Corporation) (the "Company") investment in subsidiary is stated at cost plus equity in the undistributed earnings of its subsidiary. The Company's share of net income (loss) of its unconsolidated subsidiary is included in consolidated income using the equity method. This condensed financial information of the parent company only should be read in conjunction with the Consolidated Financial Statements of the Company included elsewhere in this annual report.

**Note 2 Dividend Payment**

On December 22, 2004, the Board of Directors of the Company approved the payment of a cash dividend of \$116.8 million to its stockholders from the net proceeds of the December 2004 Transactions. The cash dividend was paid on December 28, 2004.

**Note 3 Stock Awards**

On May 3, 2005, the Company issued an aggregate of 2,941,521 shares of common stock in exchange for the cancellation and termination of an identical number of outstanding options to purchase shares of common stock. See Note 12 to the Company's Consolidated Financial Statements included elsewhere in this annual report.

**Note 4 Initial Public Offering and Stock Split**

*Initial Public Offering.* In December 2006, the Company and certain selling stockholders completed an IPO of 5,666,666 and 5,333,334 (including 1,000,000 shares sold upon the underwriters' exercise of its over-allotment option) shares of common stock, respectively, at \$13.00 per share. The Company received net proceeds of approximately \$65.4 million from the sale of shares of its common stock in the offering after deducting underwriting discounts and commissions and offering expenses. The Company contributed the net proceeds from the IPO to Carrols, which used all of such funds to repay principal amounts of term loan borrowings under Carrols' senior credit facility.

*Stock Split.* On November 21, 2006, the Company authorized an 11.288-for-one stock split of the Company's common stock. The stock split became effective on December 8, 2006 upon the filing by the Company of its Restated Certificate of Incorporation with the Secretary of State of Delaware. All 2005 and 2004 share and per share information included in the financial statements have been adjusted to retroactively reflect the stock split.

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**CARROLS RESTAURANT GROUP, INC. AND SUBSIDIARY**  
**SCHEDULE II VALUATION AND QUALIFYING ACCOUNTS**

**Years Ended December 31, 2006, 2005 and 2004**

(in thousands of dollars)

| Column A<br>Description                        | Column B<br>Balance at<br>Beginning<br>of Period | Col. C<br>Charged<br>to<br>Costs<br>and<br>Expenses | Col. D<br>Charged<br>to<br>other<br>accounts | Col. D<br>Deductions | Col. E<br>Balance<br>at End<br>of<br>Period |
|--|--|---|--|----------------------|---|
| Year ended December 31, 2006:                  |  |   |  |                      |   |
| Reserve for note receivable                    | \$ 1,094   | \$  | \$   | \$ (1,094)(a)        | \$  |
| Deferred income tax valuation allowance        | 1,119  | (97)  |  |                      | 1,022                                       |
| Year ended December 31, 2005:                  |  |   |  |                      |   |
| Reserve for doubtful trade accounts receivable | \$ 81  | \$  | \$   | \$ (81)(b)           | \$  |
| Reserve for note receivable                    | 1,159  |   |  | (65)(a)              | 1,094                                       |
| Deferred income tax valuation allowance        |  | 1,119(c)  |  |                      | 1,119                                       |
| Year ended December 31, 2004:                  |  |   |  |                      |   |
| Reserve for doubtful trade accounts receivable | \$ 94  | \$  | \$   | \$ (13)(b)           | \$ 81                                       |
| Reserve for note receivable                    | 1,184  |   |  | (25)(a)              | 1,159                                       |

- (a) Represents payments received on this fully reserved note (See Note 5 to the consolidated financial statements).  
(b) Represents write-offs of accounts.  
(c) Represents the establishment of a valuation allowance on certain deferred tax assets.

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**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

To the Board of Directors and Stockholder of

Carrols Corporation

Syracuse, New York

We have audited the accompanying consolidated balance sheets of Carrols Corporation and subsidiaries (the Company) as of December 31, 2006 and January 1, 2006, and the related consolidated statements of operations, changes in stockholders' equity (deficit), and cash flows for each of the two years in the period ended December 31, 2006. Our audits also included the 2006 and 2005 financial statement schedule listed in the index at Item 15 (a)(2). These financial statements and financial statement schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on the financial statements and financial statement schedule based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of the Company as of December 31, 2006 and January 1, 2006, and the results of its operations and its cash flows for each of the two years in the period ended December 31, 2006, in conformity with accounting principles generally accepted in the United States of America. Also, in our opinion, such 2006 and 2005 financial statement schedule, when considered in relation to the basic 2006 and 2005 financial statements taken as a whole presents fairly in all material respects the information set forth therein.

/s/ Deloitte & Touche

Rochester, New York

March 21, 2007

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**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

To the Board of Directors and Stockholder of

Carrols Corporation:

In our opinion, the consolidated statements of operations, changes in stockholder's equity (deficit), and of cash flows for the year ended December 31, 2004, present fairly, in all material respects, the results of operations and cash flows of Carrols Corporation and its subsidiaries for the year ended December 31, 2004, in conformity with accounting principles generally accepted in the United States of America. In addition, in our opinion, the accompanying financial statement schedule for the year ended December 31, 2004, presents fairly, in all material respects, the information set forth therein when read in conjunction with the related consolidated financial statements. These financial statements and financial statement schedule are the responsibility of the Carrols Corporation's management. Our responsibility is to express an opinion on these financial statements and financial statement schedule based on our audit. We conducted our audit of these statements in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

As discussed in Note 2 to the consolidated financial statements included in the 2004 Form 10K/A of Carrols Corporation (not separately presented herein), the consolidated financial statements for the year ended December 31, 2004 have been restated.

/s/ PricewaterhouseCoopers LLP

Syracuse, New York

July 27, 2005, except for the current restatement section of Note 2 to the consolidated financial statements included in the 2004 Form 10K/A of Carrols Corporation (not separately presented herein) as to which the date is June 29, 2006.

**Table of Contents****CARROLS CORPORATION AND SUBSIDIARIES****CONSOLIDATED BALANCE SHEETS****December 31, 2006 and 2005**

(in thousands of dollars except share and per share amounts)

|  | <b>December 31,</b> |             |
|--|---------------------|-------------|
|  | <b>2006</b>         | <b>2005</b> |
| <b>ASSETS</b>  |                     |             |
| Current assets:  |                     |             |
| Cash and cash equivalents  | \$ 3,939            | \$ 9,331    |
| Trade and other receivables (Note 9)   | 5,364               | 3,017       |
| Inventories  | 4,677               | 5,333       |
| Prepaid rent   | 4,130               | 4,476       |
| Prepaid expenses and other current assets  | 5,367               | 4,635       |
| Refundable income taxes  | 2,806               | 593         |
| Deferred income taxes (Note 10)  | 4,539               | 4,867       |
| Total current assets   | 30,822              | 32,252      |
| Property and equipment, net (Note 2)   | 182,742             | 217,506     |
| Franchise rights, net (Note 3)   | 83,268              | 86,490      |
| Goodwill (Note 3)  | 124,934             | 124,934     |
| Intangible assets, net (Note 3)  | 1,175               | 1,465       |
| Franchise agreements, at cost less accumulated amortization of \$5,431 and \$5,208, respectively | 5,793               | 5,869       |
| Deferred income taxes (Note 10)  | 11,136              | 13,279      |
| Other assets   | 12,989              | 15,150      |
| Total assets   | \$ 452,859          | \$ 496,945  |
| <b>LIABILITIES AND STOCKHOLDER S DEFICIT</b>   |                     |             |
| Current liabilities:   |                     |             |
| Current portion of long-term debt (Note 7)   | \$ 2,477            | \$ 2,588    |
| Accounts payable   | 17,860              | 19,022      |
| Accrued interest   | 7,861               | 7,615       |
| Accrued payroll, related taxes and benefits  | 18,445              | 15,703      |
| Accrued real estate taxes  | 4,102               | 3,933       |
| Other liabilities  | 10,623              | 8,832       |
| Total current liabilities  | 61,368              | 57,693      |
| Long-term debt, net of current portion (Note 7)  | 297,432             | 391,108     |
| Lease financing obligations (Note 8)   | 58,571              | 110,898     |
| Deferred income sale-leaseback of real estate  | 31,391              | 10,660      |
| Accrued postretirement benefits (Note 16)  | 6,370               | 4,068       |
| Other liabilities (Note 5)   | 23,462              | 26,029      |
| Total liabilities  | 478,594             | 600,456     |
| Commitments and contingencies (Notes 6 and 14)   |                     |             |
| Stockholder s deficit (Note 12):   |                     |             |
| Common stock, par value \$1; authorized 1,000 shares, issued and outstanding 10 shares           |                     |             |
| Additional paid-in capital   | (10,601)            | (75,948)    |
| Accumulated deficit  | (14,133)            | (27,563)    |
| Accumulated other comprehensive loss (Note 16)   | (1,001)             |             |

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|   |            |            |
|---|------------|------------|
| Total stockholders' deficit                 | (25,735)   | (103,511)  |
| Total liabilities and stockholders' deficit | \$ 452,859 | \$ 496,945 |

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

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**CARROLS CORPORATION AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF OPERATIONS**  
**Years Ended December 31, 2006, 2005 and 2004**

(in thousands of dollars except share and per share amounts)

|   | 2006             | 2005              | 2004              |
|---|------------------|-------------------|-------------------|
| <b>Revenues:</b>  |                  |                   |                   |
| Restaurant sales  | \$ 750,069       | \$ 705,422        | \$ 696,343        |
| Franchise royalty revenues and fees   | 1,357            | 1,488             | 1,536             |
| <b>Total revenues</b>   | <b>751,426</b>   | <b>706,910</b>    | <b>697,879</b>    |
| <b>Costs and expenses:</b>  |                  |                   |                   |
| Cost of sales   | 211,236          | 204,620           | 202,624           |
| Restaurant wages and related expenses   | 218,797          | 204,292           | 206,732           |
| Restaurant rent expense   | 37,768           | 34,668            | 34,606            |
| Other restaurant operating expenses   | 110,164          | 102,921           | 92,891            |
| Advertising expense   | 27,692           | 25,523            | 24,711            |
| General and administrative (including stock-based compensation expense of \$74, \$16,432 and \$1,818, respectively) | 49,750           | 58,933            | 43,578            |
| Depreciation and amortization   | 33,534           | 33,096            | 38,521            |
| Impairment losses (Note 4)  | 1,019            | 1,468             | 1,544             |
| Bonus to employees and a director (Note 11)   |                  |                   | 20,860            |
| Other expense (income) (Notes 5 and 9)  | (2,787)          |                   | 2,320             |
| <b>Total operating expenses</b>   | <b>687,173</b>   | <b>665,521</b>    | <b>668,387</b>    |
| <b>Income from operations</b>   | <b>64,253</b>    | <b>41,389</b>     | <b>29,492</b>     |
| Interest expense  | 44,262           | 42,972            | 35,383            |
| Loss on extinguishment of debt (Note 7)   |                  |                   | 8,913             |
| <b>Income (loss) before income taxes</b>  | <b>19,991</b>    | <b>(1,583)</b>    | <b>(14,804)</b>   |
| Provision (benefit) for income taxes (Note 10)  | 6,561            | 2,760             | (6,720)           |
| <b>Net income (loss)</b>  | <b>\$ 13,430</b> | <b>\$ (4,343)</b> | <b>\$ (8,084)</b> |

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

**Table of Contents****CARROLS CORPORATION AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDER S EQUITY (DEFICIT)****Years Ended December 31, 2006, 2005 and 2004**

(in thousands of dollars)

|  | <b>Common<br/>Stock</b> | <b>Additional<br/>Paid-In<br/>Capital</b> | <b>Accumulated<br/>Deficit</b> | <b>Accumulated<br/>Other<br/>Comprehensive<br/>Loss</b> | <b>Total<br/>Stockholder s<br/>Equity (Deficit)</b> |
|--|-------------------------|---|--------------------------------|---|---|
| Balance at January 1, 2004                             | \$                      | \$ 24,485                                 | \$ (15,136)                    | \$  | \$ 9,349  |
| Net loss   |                         |   | (8,084)                        |   | (8,084)   |
| Dividends declared (Note 11)                           |                         | (116,794)                                 |                                |   | (116,794)   |
| Balance at December 31, 2004                           |                         | (92,309)                                  | (23,220)                       |   | (115,529)   |
| Net loss   |                         |   | (4,343)                        |   | (4,343)   |
| Equity contributions from parent (Note 12)             |                         | 16,361                                    |                                |   | 16,361  |
| Balance at December 31, 2005                           |                         | (75,948)                                  | (27,563)                       |   | (103,511)   |
| Net income   |                         |   | 13,430                         |   | 13,430  |
| Equity contribution from parent                        |                         | 65,347                                    |                                |   | 65,347  |
| Adjustment to adopt SFAS No. 158, net of tax (Note 16) |                         |   |                                | (1,001)   | (1,001)   |
| Balance at December 31, 2006                           | \$                      | \$ (10,601)                               | \$ (14,133)                    | \$ (1,001)  | \$ (25,735)   |

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



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**CARROLS CORPORATION AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**

**Years Ended December 31, 2006, 2005 and 2004**

(in thousands of dollars)

|  | 2006            | 2005            | 2004            |
|--|-----------------|-----------------|-----------------|
| <b>Cash flows provided from operating activities:</b>                                      |                 |                 |                 |
| Net income (loss)  | \$ 13,430       | \$ (4,343)      | \$ (8,084)      |
| Adjustments to reconcile net income (loss) to net cash provided from operating activities: |                 |                 |                 |
| Gain on disposal of property and equipment   | (1,398)         | (620)           | (176)           |
| Stock-based compensation   | 69              | 16,310          | 1,818           |
| Depreciation and amortization  | 33,534          | 33,096          | 38,521          |
| Amortization of deferred financing costs   | 1,449           | 1,529           | 1,527           |
| Amortization of unearned purchase discounts  | (2,155)         | (2,156)         | (2,154)         |
| Amortization of deferred gains from sale-leaseback transactions                            | (1,303)         | (481)           | (458)           |
| Accretion of interest on lease financing obligations                                       | 412             | 344             | 406             |
| Impairment losses  | 1,019           | 1,468           | 1,544           |
| Loss on extinguishment of debt   |                 |                 | 8,913           |
| Gain on settlements of lease financing obligations   | (120)           |                 |                 |
| Deferred income taxes  | 3,123           | 1,036           | (6,466)         |
| Changes in other operating assets and liabilities:   |                 |                 |                 |
| Refundable income taxes  | (2,213)         | 2,435           | (4,162)         |
| Accounts payable   | (670)           | 1,140           | (2,427)         |
| Accrued payroll, related taxes and benefits  | 2,742           | (9,186)         | 9,666           |
| Accrued bonus to employees and director  |                 | (20,860)        | 20,860          |
| Other liabilities current  | 1,960           | (931)           | 1,762           |
| Accrued interest   | 246             | 6,659           | (593)           |
| Other liabilities long-term  | (580)           | (603)           | (428)           |
| Other  | (790)           | (2,829)         | (858)           |
| <b>Net cash provided from operating activities</b>   | <b>48,755</b>   | <b>22,008</b>   | <b>59,211</b>   |
| <b>Cash flows used for investing activities:</b>   |                 |                 |                 |
| <b>Capital expenditures:</b>   |                 |                 |                 |
| New restaurant development   | (28,132)        | (20,613)        | (9,654)         |
| Restaurant remodeling  | (6,372)         | (4,018)         | (845)           |
| Other restaurant capital expenditures  | (9,049)         | (8,684)         | (7,503)         |
| Corporate and restaurant information systems   | (1,586)         | (1,319)         | (1,071)         |
| Acquisition of Taco Cabana restaurants   |                 | (4,215)         |                 |
| <b>Total capital expenditures</b>  | <b>(45,139)</b> | <b>(38,849)</b> | <b>(19,073)</b> |
| Properties purchased for sale-leaseback  | (3,413)         | (1,091)         | (1,574)         |
| Proceeds from sale-leaseback transactions  | 36,313          | 5,237           | 10,984          |
| Proceeds from sales of other properties  | 1,800           | 795             | 1,174           |
| <b>Net cash used for investing activities</b>  | <b>(10,439)</b> | <b>(33,908)</b> | <b>(8,489)</b>  |
| <b>Cash flows used for financing activities:</b>   |                 |                 |                 |
| Payments on revolving credit facility, net   |                 |                 | (600)           |
| Scheduled principal payments on term loans   | (2,200)         | (2,200)         | (10,125)        |
| Principal pre-payments on term loans   | (91,200)        | (6,000)         |                 |
| Proceeds from initial public offering, net of expenses                                     | 65,419          |                 |                 |
| Proceeds from issuance of debt   |                 |                 | 400,000         |
| Tender and redemption of 9 1/2% senior subordinated notes                                  |                 |                 | (175,756)       |
| Repayments of borrowings under previous credit facility                                    |                 |                 | (113,375)       |
| Financing costs associated with issuance of debt and lease financing obligations           |                 | (542)           | (9,013)         |

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|  |                 |                 |                 |
|--|-----------------|-----------------|-----------------|
| Proceeds from lease financing obligations  |                 |                 | 4,500           |
| Dividends paid to parent   | (141)           |                 | (116,794)       |
| Settlement of lease financing obligations  | (15,199)        | (1,074)         |                 |
| Payments on other notes payable  |                 |                 | (117)           |
| Principal payments on capital leases   | (387)           | (419)           | (390)           |
| <b>Net cash used for financing activities</b>  | <b>(43,708)</b> | <b>(10,235)</b> | <b>(21,670)</b> |
| Net increase (decrease) in cash and cash equivalents                                   | (5,392)         | (22,135)        | 29,052          |
| Cash and cash equivalents, beginning of year   | 9,331           | 31,466          | 2,414           |
| <br>   |                 |                 |                 |
| Cash and cash equivalents, end of year   | \$ 3,939        | \$ 9,331        | \$ 31,466       |
| <b>Supplemental disclosures:</b>   |                 |                 |                 |
| Interest paid on long-term debt  | \$ 32,302       | \$ 23,763       | \$ 23,368       |
| Interest paid on lease financing obligations   | \$ 9,974        | \$ 10,677       | \$ 10,626       |
| Income taxes paid (refunded), net  | \$ 5,630        | \$ (824)        | \$ 3,905        |
| Increase (decrease) in accruals for capital expenditures                               | \$ (870)        | \$ 301          | \$ 1,153        |
| Capital lease obligations acquired and incurred  | \$              | \$ 1,090        | \$              |
| Non-cash reduction of assets under lease financing obligations due to lease amendments | \$ 24,707       | \$              | \$              |
| Non-cash reduction of lease financing obligations due to lease amendments              | \$ 37,544       | \$              | \$              |

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

**Table of Contents****CARROLS CORPORATION AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****Years Ended December 31, 2006, 2005 and 2004**

(in thousands of dollars, except share and per share amounts)

**1. Description of Business and Summary of Significant Accounting Policies**

*Basis of Consolidation.* The consolidated financial statements presented herein include the accounts of Carrols Corporation and its subsidiaries ( the Company ). All intercompany transactions have been eliminated in consolidation. The Company is a wholly-owned subsidiary of Carrols Restaurant Group, Inc. ( Carrols Restaurant Group ).

The difference between the consolidated financial statements of Carrols Corporation and Carrols Restaurant Group is primarily due to additional rent expense of approximately \$6 per year for Carrols Restaurant Group and the composition of stockholder s deficit.

*Business Description.* At December 31, 2006, the Company operated, as franchisee, 328 quick-service restaurants under the trade name Burger King in 12 Northeastern, Midwestern and Southeastern states. At December 31, 2006, the Company also owned and operated 76 Pollo Tropical restaurants, of which 74 were located in Florida, one located in the New York City metropolitan area in northern New Jersey and one located in Brooklyn, New York and franchised a total of 27 Pollo Tropical restaurants, 23 in Puerto Rico, two in Ecuador and two on college campuses in Florida. At December 31, 2006, the Company owned and operated 143 Taco Cabana restaurants located primarily in Texas and franchised two Taco Cabana restaurants in New Mexico and one in Georgia.

*Use of Estimates.* The preparation of the consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the dates of the financial statements. Estimates also affect the reported amounts of revenues and expenses during the reporting periods. Significant items subject to such estimates and assumptions include: accrued occupancy costs, insurance liabilities, legal obligations, income taxes, evaluation for impairment of goodwill, impairment of long-lived assets and impairment of Burger King franchise rights, lease accounting and stock-based compensation. Actual results could differ from those estimates.

*Fiscal Year.* The Company uses a 52-53 week fiscal year ending on the Sunday closest to December 31. All references herein to fiscal years ended January 2, 2005, January 1, 2006 and December 31, 2006 will be referred to as fiscal years ended December 31, 2004, 2005 and 2006, respectively. The fiscal years ended December 31, 2006 and 2005 each contained 52 weeks. The fiscal year ended December 31, 2004 contained 53 weeks.

*Cash and Cash Equivalents.* The Company considers all highly liquid investments with an original maturity of three months or less when purchased to be cash equivalents. At December 31, 2005 the Company had \$2.0 million invested in money market funds.

*Inventories.* Inventories are stated at the lower of cost (first-in, first-out) or market. Inventories are primarily comprised of food and paper.

*Property and Equipment.* The Company capitalizes all direct costs incurred to construct and substantially improve its restaurants. These costs are depreciated and charged to expense based upon their property classification when placed in service. Property and equipment is recorded at cost. Repair and maintenance activities are expensed as incurred. Depreciation and amortization is provided using the straight-line method over the following estimated useful lives:

|                                  |                                      |
|----------------------------------|--------------------------------------|
| Owned buildings                  | 5 to 30 years                        |
| Equipment                        | 3 to 15 years                        |
| Computer hardware and software   | 3 to 7 years                         |
| Assets subject to capital leases | Shorter of useful life or lease term |

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**CARROLS CORPORATION AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**Years Ended December 31, 2006, 2005 and 2004**

(in thousands of dollars, except share and per share amounts)

Leasehold improvements are depreciated over the shorter of their estimated useful lives or the underlying lease term. In circumstances where an economic penalty, as defined under Statement of Financial Accounting Standards ( SFAS ) No. 13, Accounting for Leases , would be presumed by the non exercise of one or more renewal options under the lease, the Company includes those renewal option periods when determining the lease term. For significant leasehold improvements made during the latter part of the lease term, the Company amortizes those improvements over the shorter of their useful life or an extended lease term. The extended lease term would consider the exercise of renewal options if the value of the improvements would cause an economic penalty to be presumed incurred without the renewal of the option. Building costs incurred for new restaurants on leased land are depreciated over the lease term, which is generally a twenty year period.

*Burger King Franchise Rights.* For its Burger King restaurant acquisitions, the Company has generally allocated a portion of the purchase price to franchise rights, an intangible asset. Amounts allocated to franchise rights for each acquisition are amortized using the straight-line method over the average remaining term of the acquired franchise agreements at January 1, 2002 plus one twenty year renewal period.

*Burger King Franchise Agreements.* Fees for initial franchises and renewals are amortized using the straight-line method over the term of the agreement, which is generally twenty years.

*Goodwill.* Goodwill represents the excess of purchase price and related costs over the value assigned to the net tangible and identifiable intangible assets of businesses acquired. Goodwill is not amortized but is tested at least annually for impairment. The Company performs its impairment evaluation annually as of December 31.

*Long-Lived Assets.* The Company assesses the recoverability of property and equipment, franchise rights and intangible assets by determining whether the carrying value of these assets, over their respective remaining lives, can be recovered through undiscounted future operating cash flows. Impairment is reviewed whenever events or changes in circumstances indicate the carrying amounts of these assets may not be fully recoverable.

*Deferred Financing Costs.* Financing costs, that are included in other assets and were incurred in obtaining long-term debt and lease financing obligations, are capitalized and amortized over the life of the related obligation as interest expense using the effective interest method.

*Leases.* Leases are accounted for in accordance with SFAS 13 and other related authoritative guidance. Rent expense for leases that contain scheduled rent increases is recognized on a straight-line basis over the lease term, including any option period included in the determination of the lease term. Contingent rentals are generally based upon a percentage of sales or a percentage of sales in excess of stipulated amounts and are generally not considered minimum rent payments but are recognized as rent expense when incurred.

*Lease Financing Obligations.* Lease financing obligations pertain to real estate transactions accounted for under the financing method as required by SFAS No. 98, Accounting for Leases ( SFAS 98 ). The assets (land and building) subject to these obligations remain on the Company's consolidated balance sheet at their historical costs and such assets (excluding land) continue to be depreciated over their remaining useful lives. The proceeds received by the Company from these transactions are recorded as lease financing obligations and the lease payments are applied as payments of principal and interest. The selection of the interest rate on lease financing obligations is evaluated at inception of the lease based on the Company's incremental borrowing rate adjusted to the rate required to prevent recognition of a non-cash loss or negative amortization of the obligation through the end of the primary lease term. In addition, if a purchase option exists for any properties subject to a lease financing obligation, the purchase option is evaluated for its probability of exercise on an ongoing basis. This

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evaluation considers many factors including, without limitation, the Company's intentions, the fair value of the underlying properties, the Company's ability to acquire the property, economic circumstances and other available alternatives to the Company for the continued use of the property. At December 31, 2006 and 2005, no purchase options were considered probable of exercise by the Company.

*Revenue Recognition.* Revenues from Company owned and operated restaurants are recognized when payment is tendered at the time of sale. Franchise royalty revenues associated with Pollo Tropical and Taco Cabana restaurants are based on a percent of gross sales and are recorded as income when earned.

*Income Taxes.* The Company provides for income taxes in accordance with the provisions of SFAS No. 109, Accounting for Income Taxes (SFAS 109). Under the liability method specified by SFAS 109, deferred tax assets and liabilities are based on the difference between the financial statement and tax bases of assets and liabilities as measured by the tax rates that are anticipated to be in effect when those differences reverse. The deferred tax provision generally represents the net change in deferred tax assets and liabilities during the period. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in the results of operations in the period that includes the enactment date. A valuation allowance is established when it is necessary to reduce deferred tax assets to amounts for which realization is more likely than not. The Company also records a reserve for uncertain tax positions when it is probable and estimable. The Company and its subsidiary file a consolidated federal income tax return.

*Advertising Costs.* All advertising costs are expensed as incurred.

*Cost of Sales.* The Company includes the cost of food, beverage and paper, net of any purchase discounts, in cost of sales.

*Insurance.* The Company is insured for workers' compensation, general liability and medical insurance claims under policies where it pays all claims, subject to annual stop-loss limitations both for individual claims and claims in the aggregate. Losses are accrued based upon the Company's estimates of the aggregate liability for claims based on Company experience and certain actuarial methods used to measure such estimates. The Company does not discount any of its self-insurance obligations.

*Fair Value of Financial Instruments.* The following methods were used to estimate the fair value of each class of financial instruments for which it is practicable to estimate the fair value:

*Current Assets and Liabilities.* The carrying value cash and cash equivalents and accrued liabilities approximates fair value because of the short maturity of those instruments.

*Senior Subordinated Notes.* The fair values of outstanding senior subordinated notes are based on quoted market prices. The fair values at December 31, 2006 and 2005 were approximately \$184.1 million and \$174.6 million, respectively.

*Revolving and Term Loan Facilities.* Rates currently available to the Company for debt with similar terms and remaining maturities are used to estimate fair value. The recorded amounts, as of December 31, 2006 and 2005, approximated fair value.

*Earnings Per Share Presentation.* The guidance of SFAS No. 128, Earnings Per Share, requires presentation of earnings per share by all entities that have issued common stock or potential common stock if those securities trade in a public market either on a stock exchange (domestic or foreign) or in the over-the-counter market. The Company's common stock is not publicly traded and therefore, earnings per share amounts are not presented.



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*Stock-Based Compensation.* Effective January 3, 2006, the Company adopted SFAS No. 123(R), Share-Based Payment ( SFAS 123R ) using the modified prospective transition method and, as a result, did not retroactively adjust results from prior periods. The Company applies the Black-Scholes valuation model in determining the fair value of stock options granted to employees, which is then amortized on a straight-line basis to compensation expense over the requisite service period. For restricted stock awards, the fair market value of the award, determined based upon the closing value of the Carrols Restaurant Group s stock price on the grant date, is recorded to compensation expense on a straight-line basis over the vesting period.

Carrols Restaurant Group adopted an incentive stock plan in 2006 under which incentive stock options, non-qualified stock options and restricted shares may be granted to employees and non-employee directors. In 2006, Carrols Restaurant Group granted incentive stock options, non-qualified stock options and restricted shares under this plans. The stock options granted generally vest at 20% per year and expire seven years from the date of grant. Restricted shares granted to employees generally vest 33% per year for three years and restricted shares granted to non-employee directors vest generally vest at 20% per year and the fair value of shares granted is determined based on Carrols Restaurant Group s closing stock price on the date of grant. Stock-based compensation related to these grants totaled \$0.1 million in 2006.

Prior adoption of SFAS No. 123R in 2006, Share-Based Payment ( SFAS 123R ), the Company accounted for stock-based compensation using the intrinsic value method prescribed in Accounting Principles Board ( APB ) Opinion No. 25, Accounting for Stock Issued to Employees , ( APB 25 ) and, as permitted by SFAS 123, Accounting for Stock-Based Compensation ( SFAS 123 ), the Company provided pro forma net income disclosures for employee stock option grants as if the fair-value-based method defined in SFAS 123 has been applied in 2005 and 2004. Certain provisions of the Carrols Restaurant Group s option plans caused the Company to account for stock options using a variable accounting treatment. Under variable accounting, compensation expense was remeasured each balance sheet date based on the difference between the current market price of the Carrols Restaurant Group s stock and the option s exercise price. An accrual for compensation expense is determined based on the proportionate vested amount of each option as prescribed by Financial Interpretation No. 28, Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans. Each period, adjustments to the accrual are recognized in the income statement. Stock-based compensation expense for the Carrols Restaurant Group s options was \$75 in 2005 and \$1,818 in 2004.

Effective May 3, 2005, Carrols Restaurant Group issued an aggregate of 2,941,521 shares of common stock in exchange for the cancellation and termination of an identical number of outstanding options to purchase shares of Carrols Restaurant Group common stock. During the second quarter of 2005 Carrols Restaurant Group issued an additional 61,406 shares of its common stock in separate awards. As a consequence of the exchange, all outstanding stock options were cancelled and terminated. The Company recorded a pre-tax compensation charge, including applicable payroll taxes, of \$16.4 million in the second quarter of 2005 due to these stock awards. See Note 12 for a complete discussion of the stock awards.

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Pro forma disclosures for 2006 are not presented because the amounts are recognized in the consolidated financial statements. The following table presents the Company's pro forma net loss for 2005 and 2004, had compensation cost been determined based upon the fair value of the stock options at the grant date consistent with the fair-value based method of SFAS No. 123:

|  | <b>Year Ended December 31,</b> |             |
|--|--------------------------------|-------------|
|  | <b>2005</b>                    | <b>2004</b> |
| Net loss, as reported  | \$ (4,343)                     | \$ (8,084)  |
| Add: Stock-based compensation expense included in reported net loss, net of related tax effects (1)(2)                               | 13,188                         | 13,279      |
| Deduct: Stock-based compensation expense determined under the fair-value based method for all awards, net of related tax effects (2) | (12,011)                       | (5,656)     |
| Pro forma net loss   | \$ (3,166)                     | \$ (461)    |

- (1) The amount of stock-based compensation expense included in reported net loss includes certain stock options requiring variable accounting (see Note 12) and for the year ended December 31, 2005, includes \$13.1 million of expense related to stock awards granted in the second quarter of 2005, net of tax. This expense, net of tax, has also been included in the determination of compensation expense determined under the fair-value based method for the year ended December 31, 2005.
- (2) For the year ended December 31, 2004, the equity value of the Company was reduced as a result of the December 2004 refinancing (See Note 7) in which a non-recurring dividend of \$116.8 million was paid by the Company to Carrols Restaurant Group, its sole stockholder, which Carrols Restaurant Group in turn paid to its stockholders. In conjunction with this, the Company also approved a compensatory bonus payment of approximately \$20.3 million to a number of employees (including management) and an outside director who owned stock options, on a pro rata basis in proportion to the number of shares of Carrols Restaurant Group common stock issuable upon exercise of the options owned by such persons. Carrols Restaurant Group did not modify its outstanding stock options to reflect the reduction in equity value. Therefore for the year ended December 31, 2004, this reduction has been offset against the \$20.3 million bonus payment recorded for the determination of compensation expense under SFAS 123. The \$20.3 million bonus payment, net of tax, has also been included in stock-based employee compensation expense included in reported net loss for the year ended December 31, 2004 in the above table.

Carrols Restaurant Group did not grant any options in 2005. The fair value of each option grant in 2004 was estimated using the minimum value option-pricing model. The weighted average fair-value of options granted in 2006 was \$4.02 which was estimated using the Black-Scholes option pricing model with the following weighted-average assumptions:

|                         | <b>2006</b> | <b>2004</b> |
|-------------------------|-------------|-------------|
| Risk-free interest rate | 4.58%       | 3.38%       |
| Annual dividend yield   | 0%          | 0%          |
| Expected life           | 5 years     | 5 years     |
| Expected volatility     | 30%         | n/a         |

The assumptions include the risk-free rate of interest, expected dividend yield, expected volatility, and the expected term of the award. The risk-free rate of interest is based on the zero coupon U.S. Treasury rates appropriate for the expected term of the award. There are no expected dividends as Carrols Restaurant Group does not currently plan to pay dividends on its common stock. Expected stock price volatility is based on the





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implied volatility of a peer group that had actively traded stock during the period immediately preceding the share-based award grant. This period is equal in length to the award's expected term as Carrols Restaurant Group does not have its own historical stock price data. The expected term was estimated using the simplified method, as prescribed by SAB No. 107, for options granted in 2006. Compensation expense is recognized only for those options expected to vest, with forfeitures estimated based on our historical experience and future expectations. Prior to the adoption of SFAS 123R, the effect of forfeitures on the pro forma expense amounts was recognized as the forfeitures occurred. See also Note 12 to the consolidated financial statements.

*Recent Accounting Pronouncements.*

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

In July 2006, the Financial Accounting Standards Board ( FASB ) issued FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes an Interpretation of FASB Statement No. 109 ( FIN 48 ). FIN 48 prescribes a comprehensive recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 requires that only income tax benefits that meet the more likely than not recognition threshold be recognized or continue to be recognized on the effective date. For those benefits to be recognized, a tax position must also be sustained upon examination by taxing authorities. Initial derecognition amounts would be reported as a cumulative effect of a change in accounting principle. The provisions of FIN 48 are effective for fiscal years beginning after December 15, 2006, with the cumulative effect of the change in accounting principle recorded as an adjustment to opening retained earnings. This interpretation will be effective for the Company beginning January 1, 2007. The Company has completed its initial review of the interpretation and does not expect that the adoption of FIN 48 will have a significant impact on its consolidated financial statements.

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements ( SFAS 157 ). This statement defines fair value, establishes a framework for using fair value to measure assets and liabilities and expands disclosures about fair value measurements. The statement applies whenever other pronouncements require or permit assets or liabilities to be measured at fair value. SFAS 157 is effective for the Company's fiscal year beginning January 1, 2008. The Company is evaluating the impact the adoption of SFAS 157 will have on the Company's consolidated financial statements.

In September 2006, the FASB issued SFAS No. 158, Employers Accounting for Defined Benefit Pension and Other Postretirement Benefits, an amendment of FAS 87, 88, 106 and 132(R) ( SFAS 158 ) which is effective for fiscal years ending after December 15, 2006. SFAS No. 158 requires an employer that sponsors postretirement plans to recognize an asset or liability on its balance sheet for the overfunded or underfunded status of the plan and to recognize changes in that funded status in the year in which the changes occur through comprehensive income. SFAS 158 does not change the amount of actuarially determined expense that is recorded in the Company's consolidated statement of operations. SFAS 158 also requires an employer to measure plan assets and benefit obligations as of the date of the employer's balance sheet, which is consistent with the Company's historical measurement date. Adoption of SFAS 158 resulted in recording a liability and a charge to

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accumulated other comprehensive income, a component of stockholder's deficit, at December 31, 2006 equal to the difference between the Company's accrued benefit cost and the Company's projected benefit obligation which was \$1.7 million. See Note 16.

In September 2006, the Securities and Exchange Commission issued Staff Accounting Bulletin No. 108, "Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements" (SAB 108) to address diversity in practice in quantifying financial statement misstatements. SAB 108 requires that the Company quantify misstatements based on their impact on each of its financial statements and related disclosures. The application of SAB 108 in the fourth quarter of 2006 did not have any impact on the Company's consolidated financial statements.

In February 2007, the FASB issued SFAS No. 159, "The Fair Value Option for Financial Assets and Liabilities Including an amendment of FASB Statement No. 115" (SFAS 159). This statement permits entities to choose to measure many financial instruments and certain other items at fair value. SFAS 159 is effective for the Company's fiscal year beginning January 1, 2008. The Company is currently evaluating the impact of adopting SFAS No. 159.

**2. Property and Equipment**

Property and equipment at December 31 consisted of the following:

|  | December 31, |            |
|--|--------------|------------|
|  | 2006         | 2005       |
| Land   | \$ 37,971    | \$ 61,112  |
| Owned buildings                                | 43,855       | 76,502     |
| Leasehold improvements                         | 143,969      | 129,015    |
| Equipment                                      | 186,143      | 183,670    |
| Assets subject to capital leases               | 7,716        | 8,106      |
|  | 419,654      | 458,405    |
| Less accumulated depreciation and amortization | (236,912)    | (240,899)  |
|  | \$ 182,742   | \$ 217,506 |

Assets subject to capital leases pertain to buildings leased for certain restaurant locations and had accumulated amortization at December 31, 2006 and 2005 of \$6,613 and \$6,872, respectively. At December 31, 2006 and 2005, land of \$23,972 and \$45,077, respectively, and owned buildings of \$28,547 and \$56,580, respectively, were subject to lease financing obligations accounted for under the lease financing method (See Note 8). Accumulated depreciation pertaining to owned buildings subject to lease financing obligations at December 31, 2006 and 2005 was \$11,420 and \$24,416, respectively.

Depreciation expense for all property and equipment for the years ended December 31, 2006, 2005 and 2004 was \$29,234, \$29,110 and \$34,462, respectively.

**3. Goodwill, Franchise Rights and Intangible Assets**

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*Goodwill.* In accordance with SFAS No. 142, the Company reviews goodwill for impairment annually, or more frequently when events and circumstances indicate that the carrying amounts may be impaired. The Company performs its annual impairment assessment as of December 31 and has determined its reporting units

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to be at the operating segment level: its Burger King restaurants, operating as a franchisee; Pollo Tropical and Taco Cabana at the brand level. No impairment losses have been recognized as a result of these tests since January 1, 2002. The Company recorded \$2.7 million of goodwill associated with the acquisition of four Taco Cabana restaurants in July of 2005. Changes in goodwill for the years ended December 31, 2006 and 2005 are summarized below:

|                            | <b>Pollo<br/>Tropical</b> | <b>Taco<br/>Cabana</b> | <b>Burger<br/>King</b> | <b>Total</b> |
|----------------------------|---------------------------|------------------------|------------------------|--------------|
| Balance, December 31, 2004 | \$ 56,307                 | \$ 64,484              | \$ 1,450               | \$ 122,241   |
| Goodwill acquired in 2005  |                           | 2,693                  |                        | 2,693        |
| Balance, December 31, 2005 | 56,307                    | 67,177                 | 1,450                  | 124,934      |
| Changes in goodwill        |                           |                        |                        |              |
| Balance, December 31, 2006 | \$ 56,307                 | \$ 67,177              | \$ 1,450               | \$ 124,934   |

*Burger King Franchise Rights.* Amounts allocated to franchise rights for each Burger King acquisition are amortized using the straight-line method over the average remaining term of the acquired franchise agreements at January 1, 2002 plus one twenty year renewal period. Following is a summary of the Company's Burger King franchise rights as of the respective balance sheet dates:

|                  | <b>December 31, 2006</b> |                     | <b>December 31, 2005</b> |                     |
|------------------|--------------------------|---------------------|--------------------------|---------------------|
|                  | <b>Gross</b>             |                     | <b>Gross</b>             |                     |
|                  | <b>Carrying</b>          | <b>Accumulated</b>  | <b>Carrying</b>          | <b>Accumulated</b>  |
|                  | <b>Amount</b>            | <b>Amortization</b> | <b>Amount</b>            | <b>Amortization</b> |
| Franchise rights | \$ 139,131               | \$ 55,863           | \$ 139,139               | \$ 52,649           |

Amortization expense related to Burger King franchise rights for the years ended December 31, 2006, 2005 and 2004 was \$3,214, \$3,215 and \$3,233, respectively. Estimated annual amortization is \$3,216 for each of the years ending 2007 through 2011.

*Intangible Assets.* In July 2005, the Company acquired four Taco Cabana restaurants from a franchisee for a cash purchase price of approximately \$4.2 million. Under EITF Issue No. 04 -1 Accounting for Preexisting Relationships between the Parties to a Business Combination, certain reacquired rights, including the right to the acquirer's trade name, are required to be recognized as intangible assets apart from goodwill. The Company has allocated \$1.6 million of the purchase price to this intangible asset and determined its weighted average life to be approximately seven years, based on the remaining terms of the acquired franchise agreements. The Company recorded amortization expense relating to the intangible asset of approximately \$290 and \$145 for the years ended December 31, 2006 and 2005 and expects the annual expense for each of the next five years ending 2007 through 2011 to be \$289, \$211, \$133, \$125 and \$117, respectively.

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|                   | December 31, 2006           |                             | December 31, 2005           |                             |
|-------------------|-----------------------------|-----------------------------|-----------------------------|-----------------------------|
|                   | Gross<br>Carrying<br>Amount | Accumulated<br>Amortization | Gross<br>Carrying<br>Amount | Accumulated<br>Amortization |
| Intangible assets | \$ 1,610                    | \$ 435                      | \$ 1,610                    | \$ 145                      |

**4. Impairment of Long-Lived Assets**

The Company reviews its long-lived assets, principally property and equipment, for impairment at the restaurant level. If an indicator of impairment exists for any of the assets, an estimate of undiscounted future cash

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flows produced by each restaurant is compared to that long-lived asset's carrying value. If the carrying value is greater than the undiscounted cash flow, the Company then determines the fair value of the asset. If an asset is determined to be impaired, the loss is measured by the excess of the carrying amount of the asset over its fair value.

The Company assesses the potential impairment of Burger King franchise rights whenever events or changes in circumstances indicate that the carrying value may not be recoverable. If an indicator of impairment exists, an estimate of the aggregate undiscounted cash flows from the acquired restaurants is compared to the respective carrying value of franchise rights for each Burger King acquisition. If an asset is determined to be impaired, the loss is measured by the excess of the carrying amount of the asset over its fair value. No impairment charges were recorded related to the Company's Burger King franchise rights for the year ended December 31, 2006. The Company recorded impairment charges related to its Burger King franchise rights of \$316 and \$283 for the years ended December 31, 2005 and 2004, respectively.

The Company recorded impairment losses on long-lived assets, including Burger King franchise rights, for its segments as follows:

|             | <b>Year Ended December 31,</b> |                 |                 |
|-------------|--------------------------------|-----------------|-----------------|
|             | <b>2006</b>                    | <b>2005</b>     | <b>2004</b>     |
| Burger King | \$ 276                         | \$ 1,373        | \$ 1,544        |
| Taco Cabana | 743                            | 95              |                 |
|             | <b>\$ 1,019</b>                | <b>\$ 1,468</b> | <b>\$ 1,544</b> |

**5. Other Liabilities, Long-Term**

Other liabilities, long-term, at December 31, consisted of the following:

|                                     | <b>At December 31,</b> |                  |
|-------------------------------------|------------------------|------------------|
|                                     | <b>2006</b>            | <b>2005</b>      |
| Unearned purchase discounts         | \$ 4,526               | \$ 6,686         |
| Accrued occupancy costs             | 8,683                  | 10,674           |
| Accrued workers' compensation costs | 4,595                  | 4,615            |
| Other                               | 5,658                  | 4,054            |
|                                     | <b>\$ 23,462</b>       | <b>\$ 26,029</b> |

Unearned purchase discounts are amortized as a reduction of cost of sales either over the life of the supplier contract or the estimated purchase commitment period. In 2000, Burger King Corporation arranged for the Coca-Cola Company and Dr. Pepper/Seven-Up, Inc. to provide funding to franchisees in connection with certain initiatives to upgrade restaurants. The Company received approximately \$19.8 million in 2000 and \$1.6 million in 2001 under this arrangement with these suppliers. The total amount of these purchase discounts amortized for each of the years ended December 31, 2006, 2005 and 2004 was \$2.2 million.

Accrued occupancy costs include obligations pertaining to closed restaurant locations, contingent rent, accruals to expense operating lease rental payments on a straight-line basis over the lease term, and acquired leases with above market rentals.





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In 2001, management made the decision to close seven Taco Cabana restaurants in the Phoenix, Arizona market and discontinue restaurant development underway in that market. At December 31, 2006 and 2005, the Company had \$0.7 million and \$1.1 million in lease liability reserves, respectively, included in accrued occupancy costs. The following table presents the activity in the exit cost reserve included in accrued occupancy costs:

|  | Year ended December 31, |          |        |
|--|-------------------------|----------|--------|
|  | 2006                    | 2005     | 2004   |
| Beginning Balance                          | \$ 1,083                | \$ 756   | \$ 847 |
| Changes in estimates of accrued costs, net | (295)                   | 467      |        |
| Payments                                   | (132)                   | (140)    | (91)   |
| Balance, end of period                     | \$ 656                  | \$ 1,083 | \$ 756 |

In 2005, the exit cost reserve was increased by \$0.5 million due to a change in circumstances affecting the Company's estimates of future sub-lease revenue for one restaurant property. In 2006, the Company reduced its exit cost reserve by \$0.3 million due to an increase in the Company's estimates for future sublease income at certain locations. In addition, the Company reduced collection reserves previously established for a \$1.1 million note receivable that was paid in full in the fourth quarter of 2006 related to the sale of leasehold improvements at two of the closed locations that were written off as part of the restructuring charge in 2001. Other income in 2006 includes \$1.4 million as a result of these transactions.

**6. Leases**

The Company utilizes land and buildings in operation under various lease agreements. The Company does not consider any of these individual leases material to the Company's operations. Initial lease terms are generally for twenty years and, in many cases, provide for renewal options and in some cases rent escalations. Certain leases require contingent rent, determined as a percentage of sales as defined by the terms of the applicable lease agreement. For most locations, the Company is obligated for occupancy costs including payment of property taxes, insurance and utilities.

In the years ended December 31, 2006, 2005 and 2004, the Company sold twenty-four, four and eight restaurant properties in sale-leaseback transactions for net proceeds of \$36,313, \$5,237 and \$10,984, respectively. Deferred gains of \$22,034, \$2,556 and \$2,391 for the years ended December 31, 2006, 2005 and 2004, respectively, have been recorded as a result of these sale-leaseback transactions and are being amortized over the lives of the related leases. These related leases have been classified as operating leases and generally contain a twenty-year initial term with renewal options. The amortization of deferred gains related to these sale-leaseback transactions was \$1,303, \$481 and \$458 for the years ended December 31, 2006, 2005 and 2004, respectively.

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Minimum rent commitments under capital and non-cancelable operating leases at December 31, 2006 were as follows:

| <b>Years Ending December 31,</b>                  | <b>Capital</b>  | <b>Operating</b>  |
|---|-----------------|-------------------|
| 2007  | \$ 409          | \$ 40,743         |
| 2008  | 234             | 38,370            |
| 2009  | 199             | 36,406            |
| 2010  | 158             | 34,381            |
| 2011  | 114             | 32,161            |
| Thereafter  | 1,606           | 269,856           |
| <b>Total minimum lease payments</b>               | <b>2,720</b>    | <b>\$ 451,917</b> |
| Less amount representing interest                 | (1,211)         |                   |
| <b>Total obligations under capital leases</b>     | <b>1,509</b>    |                   |
| Less current portion                              | (277)           |                   |
| <b>Long-term obligations under capital leases</b> | <b>\$ 1,232</b> |                   |

Total rent expense on operating leases, including percentage rent on both operating and capital leases, for the past three fiscal years was as follows:

|  | <b>Year ended December 31,</b> |                  |                  |
|--|--------------------------------|------------------|------------------|
|  | <b>2006</b>                    | <b>2005</b>      | <b>2004</b>      |
| Minimum rent on real property                | \$ 34,978                      | \$ 32,416        | \$ 32,509        |
| Additional rent based on percentage of sales | 2,790                          | 2,252            | 2,097            |
| <b>Restaurant rent expense</b>               | <b>37,768</b>                  | <b>34,668</b>    | <b>34,606</b>    |
| Administrative rent                          | 875                            | 822              | 783              |
| Equipment rent                               | 731                            | 739              | 526              |
|  | <b>\$ 39,374</b>               | <b>\$ 36,229</b> | <b>\$ 35,915</b> |

**7. Long-Term Debt**

Long-term debt at December 31 consisted of the following:

**December 31,**

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|   | 2006       | 2005       |
|---|------------|------------|
| Collateralized:                             |            |            |
| Senior Credit Facility-Term loan B facility | \$ 118,400 | \$ 211,800 |
| Unsecured:                                  |            |            |
| 9% Senior Subordinated Notes                | 180,000    | 180,000    |
| Capital leases (Note 6)                     | 1,509      | 1,896      |
|   | 299,909    | 393,696    |
| Less: current portion                       | (2,477)    | (2,588)    |
|   | \$ 297,432 | \$ 391,108 |

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**CARROLS CORPORATION AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**Years Ended December 31, 2006, 2005 and 2004**

(in thousands of dollars, except share and per share amounts)

*December 2004 Refinancing*

On December 15, 2004, the Company completed the private placement of \$180.0 million of 9% Senior Subordinated Notes due 2013. Concurrently, the Company repaid all outstanding borrowings under its prior senior secured credit facility and amended and restated that credit facility with a new syndicate of lenders. The Company received \$400.0 million in total proceeds that included the issuance of the 9% senior subordinated notes and \$220.0 million principal amount of term loan B borrowings under the senior credit facility. Those proceeds were primarily utilized to repay borrowings outstanding under the prior senior credit facility of \$74.4 million, to retire all unsecured 9 1/2% senior subordinated notes due 2008 outstanding in the amount, including redemption premiums, of \$175.9 million, to pay a dividend to Carrols Restaurant Group (which Carrols Restaurant Group in turn paid to its stockholders) in the amount of \$116.8 million, to pay fees and expenses related to the refinancing of \$8.8 million, and to pay a bonus to employees and a director totaling \$20.9 million including payroll taxes of \$0.6 million. See discussion of the bonus and dividend payments in Note 11. The Company also recorded an \$8.9 million loss on early extinguishment of debt from the write-off of previously deferred financing costs and premiums in conjunction with the retirement of the 9 1/2% senior subordinated notes.

*Senior Secured Credit Facility:*

On December 15, 2004, the Company entered into a senior secured credit facility with a syndicate of lenders. The senior secured credit facility provides for a revolving credit facility under which the Company may borrow up to \$50.0 million (including a sub limit of up to \$20.0 million for letters of credit and up to \$5.0 million for swingline loans), a term loan B facility of \$220.0 million and incremental borrowing facilities, at the Company's option, of up to \$100.0 million, subject to the satisfaction of certain conditions.

There were no borrowings outstanding on the revolving credit facility at December 31, 2006 or 2005. After reserving \$15.0 million for letters of credit guaranteed by the facility, \$35.0 million was available for borrowings under the revolving credit facility at December 31, 2006.

Borrowings under the revolving credit facility bear interest at a per annum rate, at the Company's option, of either:

- 1) the sum of (a) the greater of (i) the prime rate or (ii) the federal funds rate plus .50%, plus (b) a margin ranging from .50% to 1.50% based on the Company's total leverage ratio (as defined in the senior credit facility); or
- 2) LIBOR plus a margin ranging from 2.0% to 3.0% based on total leverage ratio.

Borrowings under the term loan B bear interest at a per annum rate, at the Company's option, of either:

- 1) the sum of (a) the greater of (i) the prime rate or (ii) the federal funds rate plus .50%, plus (b) a margin ranging from .75% to 1.0% based on the Company's total leverage ratio; or
- 2) LIBOR plus a margin ranging from 2.25% to 2.50% based on the Company's total leverage ratio.

The revolving credit facility expires on December 31, 2009 and the term loan B facility matures on December 31, 2010. During 2006, the Company made prepayments of \$91.2 million on outstanding borrowings under the term loan B facility, from, in part, the use of proceeds of

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\$68.0 million Carrols Restaurant Group received in its initial public offering.

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Amounts under the term loan B facility are repayable as follows:

- 1) four quarterly installments of \$0.55 million in each of fiscal years 2007 through 2009; and
- 2) two quarterly installments of \$52.25 million beginning with last day of the first fiscal quarter in 2010 and a final installment of \$7.3 million on the last day of the third fiscal quarter of 2010.

Under the senior credit facility, the Company is also required to make mandatory prepayments of principal on term loan B facility borrowings (a) annually in an initial amount equal to 50% of Excess Cash Flow (as defined in the senior credit facility), (b) in the event of certain dispositions of assets (all subject to certain exceptions) and insurance proceeds, in an amount equal to 100% of the net proceeds received by the Company therefrom, and (c) in an amount equal to 100% of the net proceeds from any subsequent issuance of debt.

In general, the Company's obligations under the senior credit facility are guaranteed by Carrols Restaurant Group and all of the Company's material subsidiaries and are collateralized by all of the Company's and its subsidiaries' assets, a pledge of the Company's common stock and the stock of each of the Company's subsidiaries. The senior credit facility contains certain covenants, including, without limitation, those limiting the Company's and its subsidiaries' ability to incur indebtedness, incur liens, sell or acquire assets or businesses, change the nature of its business, engage in transactions with related parties, make certain investments or pay dividends. In addition, the Company is required to meet certain financial ratios, including fixed charge coverage, senior leverage, and total leverage ratios (all as defined under the senior credit facility). As of December 31, 2006 the Company was in compliance with these covenants in its senior credit facility.

*Senior Subordinated Notes:*

On December 15, 2004, the Company issued \$180.0 million of 9% Senior Subordinated Notes due 2013. The senior subordinated notes bear interest at a rate of 9% payable semi-annually on January 15 and July 15 (commencing July 15, 2005) and mature on January 15, 2013. The notes are redeemable at the option of the Company in whole or in part on or after January 15, 2009 at a price of 104.5% of the principal amount if redeemed before January 15, 2010, 102.25% of the principal amount if redeemed after January 15, 2010 but before January 15, 2011 and at 100% of the principal amount after January 15, 2011.

Restrictive covenants under the 9% senior subordinated notes include limitations with respect to the Company's ability to incur additional debt, incur liens, sell or acquire assets or businesses, pay dividends and make certain investments. The Company was in compliance as of and for the years ended December 31, 2006 and 2005 with the restrictive covenants in the indenture governing the senior subordinated notes. At December 31, 2006, principal payments required on all long-term debt are as follows:

|            |          |
|------------|----------|
| 2007       | \$ 2,477 |
| 2008       | 2,324    |
| 2009       | 2,300    |
| 2010       | 111,870  |
| 2011       | 32       |
| Thereafter | 180,906  |

The weighted average interest rate on all debt, excluding lease financing obligations, for the years ended December 31, 2006, 2005 and 2004 was 8.3%, 7.3% and 7.8%, respectively. Interest expense on the Company's long-term debt was \$33,852, \$31,728 and \$24,122 for the years ended December 31, 2005, 2004 and 2003, respectively.

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**Years Ended December 31, 2006, 2005 and 2004**

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*New Senior Credit Facility.* On March 9, 2007, the Company terminated its existing senior credit facility and entered into a new senior credit facility with a syndicate of lenders. The Company's new credit facility totals approximately \$185 million, consisting of \$120 million principal amount of term loan A borrowings maturing on March 8, 2013 (or earlier on September 30, 2012 if the Senior Subordinated Notes are not refinanced by June 30, 2012) and a \$65.0 million revolving facility (including a sub limit of up to \$25.0 million for letters of credit and up to \$5.0 million for swingline loans), maturing on March 8, 2012. The term loan A borrowings and an additional \$4.3 million of revolver borrowings from this facility were used to repay all outstanding borrowings and other obligations under the Company's existing senior credit facility and to pay certain fees and expenses incurred in connection with the new senior credit facility.

Both term loan and revolving credit borrowings under the new senior credit facility bear interest at a per annum rate, at the Company's option, of either:

- 1) the applicable margin ranging from 0% to 0.25% based on the Company's senior leverage ratio (as defined in the new credit facility) plus the greater of (i) the prime rate or (ii) the federal funds rate for that day plus 0.5%; or
- 2) Adjusted LIBOR plus the applicable margin percentage in effect ranging from 1.0% to 1.5% based on the Company's senior leverage ratio.

Term loan A borrowings shall be due and payable in quarterly installments, beginning on June 30, 2008 as follows:

- 1) four quarterly installments of \$1.5 million beginning on June 30, 2008;
- 2) eight quarterly installments of \$3.0 million beginning on June 30, 2009;
- 3) four quarterly installments of \$4.5 million beginning on June 30, 2011; and
- 4) four quarterly installments of \$18.0 million beginning on June 30, 2012.

Under the senior credit facility, the Company is also required to make mandatory prepayments of principal on term loan A facility borrowings (a) annually in an initial amount equal to 50% of Excess Cash Flow (as defined in the senior credit facility), (b) in the event of certain dispositions of assets (all subject to certain exceptions) and insurance proceeds, in an amount equal to 100% of the net proceeds received by the Company therefrom, and (c) in an amount equal to 100% of the net proceeds from any subsequent issuance of debt.

In general, the Company's obligations under the senior credit facility are guaranteed by Carrols Restaurant Group and all of the Company's material subsidiaries and are collateralized by a pledge of the Company's common stock and the stock of each of its material subsidiaries. The new senior credit facility contains certain covenants, including, without limitation, those limiting the Company's ability to incur indebtedness, incur liens, sell or acquire assets or businesses, change the nature of its business, engage in transactions with related parties, make certain investments or pay dividends. In addition, the Company is required to meet certain financial ratios, including fixed charge coverage, senior leverage, and total leverage ratios (all as defined under the new senior credit facility).



**8. Lease Financing Obligations**

The Company entered into sale-leaseback transactions in various years involving certain restaurant properties that did not qualify for sale-leaseback accounting and as a result have been classified as financing transactions under SFAS No. 98, Accounting For Leases . Under the financing method, the assets remain on the

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consolidated balance sheet and proceeds received by the Company from these transactions are recorded as a financing liability. Payments under these leases are applied as payments of imputed interest and deemed principal on the underlying financing obligations.

These leases generally provide for an initial term of 20 years plus renewal options. The rent payable under such leases includes a minimum rent provision and in some cases, includes rent based on a percentage of sales provision. These leases also require payment of property taxes, insurance and utilities.

Purchase options related to certain properties sold in real estate transactions accounted for under the financing method were held by an entity wholly-owned by the nephew of the Chairman and Chief Executive Officer of the Company and such entity was deemed a related party for accounting purposes. In the fourth quarter of 2006, these purchase options were assigned to the Company for nominal consideration.

During 2006, the Company exercised its right of first refusal under the leases for 14 restaurant properties following the exercise of purchase options previously held by the related party and the Company purchased these 14 restaurant properties from the respective lessors. Concurrently with these purchases, the properties were sold in qualified sale-leaseback transactions. The Company recorded deferred gains representing the amounts by which the sales prices exceeded the net book value of the underlying assets. Deferred gains are being amortized as an adjustment to rent expense over the term of the leases, which is generally 20 years.

The Company also amended lease agreements for 21 restaurant properties and amended a master lease agreement covering 13 restaurant properties in 2006, all of which were previously accounted for as lease financing obligations, to eliminate or otherwise cure the provisions that precluded the original sale-leaseback accounting under SFAS No. 98. As a result of such amendments, the Company recorded these sale-leaseback transactions as sales, removed all of the respective assets under lease financing obligations and related liabilities from its consolidated balance sheet and recognized gains from the sales, which were generally deferred and are being amortized as an adjustment to rent expense over the remaining term of the underlying leases.

As a result of the above transactions, in 2006 the Company reduced its lease financing obligations by \$52.8 million, reduced its assets under lease financing obligations by \$36.2 million and recorded deferred gains of \$18.3 million. The Company also recorded interest expense of \$2.0 million which represents the net amount by which the purchase price for the restaurant properties sold exceeded the lease financing obligations. Of these amounts, \$37.5 million of lease financing obligations and \$24.7 million of assets under lease financing obligations have been reflected as non-cash transactions in the consolidated statements of cash flows.

At December 31, 2006, payments required on lease financing obligations are as follows:

|  |                  |
|--|------------------|
| 2007                                     | \$ 5,299         |
| 2008                                     | 5,629            |
| 2009                                     | 5,646            |
| 2010                                     | 5,696            |
| 2011                                     | 5,796            |
| Thereafter, through 2023                 | 107,740          |
| <b>Total minimum lease payments</b>      | <b>135,806</b>   |
| Less: Interest implicit in obligations   | (77,235)         |
| <b>Total lease financing obligations</b> | <b>\$ 58,571</b> |



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The interest rates on lease financing obligations range from 8.5% to 12.4% at December 31, 2006. Interest expense on lease financing obligations totaled \$10,411, \$11,244 and \$11,261 for the years ended December 31, 2006, 2005 and 2004, respectively.

**9. Other Expense (Income)**

In the fourth quarter of 2006, the Company entered into a lease termination agreement for one of its Pollo Tropical restaurants resulting in a gain of \$1.4 million that is presented in other income in the consolidated statements of operations. The lease termination amount payable to the Company of \$1.8 million is included in trade and other receivables on the consolidated balance sheet at December 31, 2006. The Company subsequently received this amount in January 2007.

During 2004, the Company's parent company, Carrols Restaurant Group, filed a registration statement on Form S-1 to register an initial public offering of Enhanced Yield Securities (EYSs) comprised of its common stock and senior subordinated notes. On October 25, 2004, Carrols Restaurant Group withdrew and terminated its registration of such securities and expensed the costs incurred for this offering of \$2.3 million in 2004.

**10. Income Taxes**

The income tax provision (benefit) was comprised of the following:

|                     | Year ended December 31, |          |            |
|---------------------|-------------------------|----------|------------|
|                     | 2006                    | 2005     | 2004       |
| Current:            |                         |          |            |
| Federal             | \$ 2,952                | \$ 1,426 | \$ (1,250) |
| Foreign             | 305                     | 295      | 306        |
| State               | 181                     | 3        | 690        |
|                     | 3,438                   | 1,724    | (254)      |
| Deferred (prepaid): |                         |          |            |
| Federal             | 3,136                   | 661      | (3,981)    |
| State               | 84                      | (744)    | (2,485)    |
|                     | 3,220                   | (83)     | (6,466)    |
| Valuation allowance | (97)                    | 1,119    |            |
|                     | \$ 6,561                | \$ 2,760 | \$ (6,720) |

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The components of deferred income tax assets and liabilities are as follows:

|  | December 31,     |                  |
|--|------------------|------------------|
|  | 2006             | 2005             |
| Current deferred tax assets:                                   |                  |                  |
| Inventory and other reserves                                   | \$ 117           | \$ 124           |
| Accrued vacation benefits                                      | 2,193            | 2,084            |
| Other accruals   | 2,229            | 2,659            |
| <b>Current deferred tax assets</b>                             | <b>4,539</b>     | <b>4,867</b>     |
| Long term deferred tax assets/(liabilities):                   |                  |                  |
| Deferred income on sale-leaseback of certain real estate       | 11,657           | 5,784            |
| Lease financing obligations                                    | 6,387            | 10,317           |
| Postretirement benefit expenses                                | 1,864            | 1,609            |
| Accumulated other comprehensive income postretirement benefits | 654              |                  |
| Property and equipment depreciation                            | 3,357            | 387              |
| Net state operating loss carry forwards                        | 2,189            | 2,331            |
| Amortization of other intangibles, net                         | 1,625            | 2,294            |
| Amortization of franchise rights                               | (23,232)         | (22,542)         |
| Occupancy costs  | 3,443            | 4,128            |
| Tax credit carry forwards                                      | 896              | 5,786            |
| Unearned purchase discounts                                    | 2,617            | 3,489            |
| Other  | 701              | 815              |
| <b>Long-term net deferred tax assets</b>                       | <b>12,158</b>    | <b>14,398</b>    |
| Less: Valuation allowance                                      | (1,022)          | (1,119)          |
| <b>Total long-term deferred tax assets</b>                     | <b>11,136</b>    | <b>13,279</b>    |
| <b>Carrying value of net deferred tax assets</b>               | <b>\$ 15,675</b> | <b>\$ 18,146</b> |

The Company's state net operating loss carryforwards expire in varying amounts beginning in 2007 through 2026. In addition, the Company has available Federal alternative minimum tax credit carryforwards of \$0.5 million with no expiration date.

The Company establishes a valuation allowance to reduce the carrying amount of deferred tax assets when it is more likely than not that it will not realize some portion or all of the tax benefit of its deferred tax assets. The Company evaluates whether its deferred tax assets are probable of realization on a quarterly basis. In performing this analysis, the Company considers all available evidence, both positive and negative, including historical operating results, the estimated timing of future reversals of existing taxable temporary differences and estimated future taxable income exclusive of reversing temporary differences and carryforwards. As of December 31, 2006, the Company has a valuation allowance of \$1,022 against net deferred tax assets due primarily to state net operating loss carryforwards where realization of the related deferred tax asset amounts was not more likely than not. The estimation of future taxable income for federal and state purposes and the Company's resulting ability to realize deferred tax assets pertaining to state net operating loss carryforwards and tax credit carryforwards can significantly change based on

future events and operating results. Thus, recorded valuation allowances may be subject to future changes that could be material.

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A reconciliation of the statutory federal income tax provision (benefit) to the effective tax provision for the years ended December 31, 2006, 2005 and 2004 is as follows:

|  | 2006     | 2005     | 2004       |
|--|----------|----------|------------|
| Statutory federal income tax provision     | \$ 6,994 | \$ (538) | \$ (5,036) |
| State income taxes, net of federal benefit | 172      | (500)    | (1,366)    |
| Stock based compensation expense           | 9        | 3,302    |            |
| Change in valuation allowance              | (97)     | 1,119    |            |
| Non-deductible expenses                    | 56       | 56       | 5          |
| Foreign taxes                              | 305      | 295      | 306        |
| Employment tax credits                     | (423)    | (552)    | (287)      |
| Foreign tax credits                        | (305)    | (295)    | (306)      |
| Miscellaneous                              | (150)    | (127)    | (36)       |
|  | \$ 6,561 | \$ 2,760 | \$ (6,720) |

On May 18, 2006, the state of Texas enacted House Bill 3, which replaces the state's current franchise tax with a margin tax. This legislation significantly affects the tax system for most corporate taxpayers. The margin tax, which is based on revenues less certain allowed deductions, will be accounted for as an income tax, following the provisions of SFAS No. 109, *Accounting for Income Taxes*. The Company has reviewed the provisions of this legislation and has concluded that the impact on its deferred taxes is immaterial.

On June 30, 2005, tax legislation in the state of Ohio was enacted that significantly restructured the state's tax system for most corporate taxpayers. Included in the legislation is a multi-year phase-out of the state franchise tax and tangible personal property tax. These taxes have been replaced with a Commercial Activity Tax that will be phased-in over a five-year period. In 2005, the Company recorded a tax expense of \$0.5 million related to the impact of this legislation due to the reduction of deferred tax assets associated with the future utilization of Ohio net operating loss carryforwards.

**11. Dividend and Bonus Payments**

On December 22, 2004, the Board of Directors of the Company approved the payment of a cash dividend of \$116.8 million to Carrols Restaurant Group from the net proceeds of the December 2004 refinancing. The cash dividend was paid on December 28, 2004 and was concurrently distributed by Carrols Restaurant Group in a dividend to the stockholders of Carrols Restaurant Group.

In conjunction with the December 2004 refinancing, the Company also approved a compensatory bonus payment of approximately \$20.3 million to a number of employees (including management) and a director who owned stock options based on a pro rata basis in proportion to the number of shares of Carrols Restaurant Group common stock issuable upon exercise of the options owned by such persons. The bonus payment was made in January 2005, and including applicable payroll taxes of \$0.6 million, totaled \$20.9 million.

**12. Stockholder's Deficit**

*The Company.* The Company which is 100% owned by Carrols Restaurant Group, has 1,000 shares of common stock authorized of which 10 shares are issued and outstanding. Dividends on the Company's common stock are restricted to amounts permitted by the senior secured credit facility and indenture governing the 9% senior subordinated notes.





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*Stock Split.* On November 21, 2006, Carrols Restaurant Group authorized an 11.288-for-one stock split of its common stock. The stock split became effective on December 8, 2006 upon the filing by the Carrols Restaurant Group of its Restated Certificate of Incorporation with the Secretary of State of Delaware. All 2005 and 2004 share information related to the stock awards discussed below have been adjusted to retroactively reflect the stock split.

*Initial Public Offering. ( IPO )* In December 2006, the Company's parent company, Carrols Restaurant Group and certain selling stockholders completed an IPO of 5,666,666 and 5,333,334 (including 1,000,000 shares sold upon the underwriters' exercise of its over-allotment option) shares of Carrols Restaurant Group common stock, respectively, at \$13.00 per share. Carrols Restaurant Group received net proceeds of approximately \$65.4 million from the sale of shares of its common stock in the offering after deducting underwriting discounts and commissions and offering expenses. Carrols Restaurant Group contributed the net proceeds from the IPO to the Company, which used all of such funds to repay principal amounts of term loan borrowings under the Company's senior credit facility.

*Stock Awards.* Effective May 3, 2005, Carrols Restaurant Group issued an aggregate of 2,941,521 shares of its common stock in exchange for the cancellation and termination of an identical number of outstanding options to purchase shares of its common stock. As a consequence of the exchange, all outstanding stock options were cancelled and terminated, and the option plans (described below) were subsequently terminated. In 2005, Carrols Restaurant Group issued an additional 61,406 shares of its common stock in separate awards.

All shares were issued pursuant to stock award agreements, which provide that such shares are fully vested and non-forfeitable upon issuance, but may not be sold or otherwise disposed of for a period of two years from the date of issuance. The fair market value of a share of the Carrols Restaurant Group's common stock on the date of these awards was estimated to be \$5.45. The Company recorded a pre-tax compensation charge of \$16.4 million in 2005 relative to these stock awards.

In 2006, Carrols Restaurant Group also granted stock awards of 1,120 shares to certain of its employees.

Prior to October 27, 2004, Carrols Restaurant Group's authorized common stock consisted of three series comprised of 33,864,000 shares of Carrols Stock, par value \$0.01 per share, 2,000,000 shares of Pollo Tropical Stock, par value \$0.01 per share, and 2,000,000 shares of Taco Cabana Stock, par value \$0.01 per share. The Pollo Tropical and Taco Cabana classes of the Company's stock were considered tracking stocks, a class of stock which tracked the separate performance of Pollo Tropical and Taco Cabana, respectively. On October 27, 2004, Carrols Restaurant Group eliminated this tracking stock by combining all of its authorized series of common stock into one series of common stock. Carrols Restaurant Group's Pollo Tropical class of common stock and Taco Cabana class of common stock were each converted into the series of common stock known as Carrols Stock, which at the time of the combination, was renamed and is now referred to as common stock.

Prior to October 27, 2004, no shares of Carrols Restaurant Group's Pollo Tropical or Taco Cabana classes of common stock were outstanding. However, as a result of the combination, each outstanding option to purchase a share of the Carrols Restaurant Group's Pollo Tropical class of common stock pursuant to the 1998 Pollo Tropical Long-Term Incentive Plan was converted on October 27, 2004 into an option to purchase 0.4144 shares (pre-stock split) of common stock. Similarly, each outstanding option to purchase a share of Carrols Restaurant Group's Taco Cabana class of common stock pursuant to the 2001 Taco Cabana Long-Term Incentive Plan was converted on October 27, 2004 into an option to purchase 0.0522 shares (pre-stock split) of common stock.

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*Stock Options.* In 1996, Carrols Restaurant Group adopted a stock option plan entitled the 1996 Long-Term Incentive Plan ( 1996 Plan ) and reserved and authorized a total of 1,199,350 shares of common stock for grant thereunder. The number of shares reserved and authorized under this plan was increased to 1,255,790 in 2001 and to 2,137,100 in 2002. Options under this plan generally vested over a four-year period. In 1998, Carrols Restaurant Group adopted the 1998 Directors Stock Option Plan ( 1998 Directors Plan ) authorizing the grant of up to 112,880 options to non-employee directors. Options under this plan were exercisable over four years. Also, options for 366,036 shares of common stock not covered under any plan ( Non Plan Options ) were granted in 1997 at a price of \$9.01 with vesting over a five-year period. On February 26, 2002, the Compensation Committee of Carrols Restaurant Group extended the expiration date for the Non Plan Options and the 1996 Plan options granted prior to March 1, 2002 to February 29, 2012 for all executive officers and certain other officers of Carrols Restaurant Group. All outstanding options related to these plans were cancelled in 2005.

Carrols Restaurant Group also adopted the 1998 Pollo Tropical Long-Term Incentive Plan ( 1998 Pollo Plan ) authorizing the grant of options to purchase up to 41,440 shares of Carrols Restaurant Group s common stock (100,000 shares of the Carrols Restaurant Group s Pollo Tropical class of common stock prior to the conversion). Carrols Restaurant Group also adopted the 2001 Taco Cabana Long-Term Incentive Plan (the 2001 Taco Plan ) authorizing the grant of options to purchase up to 26,100 shares of Carrols Restaurant Group s common stock (500,000 shares of Carrols Restaurant Group s Taco Cabana class of common stock prior to the conversion). Options under both of these plans generally vested over a five-year period. All outstanding options related to these plans were cancelled in 2005.

*2006 Stock Incentive Plan.* In 2006, Carrols Restaurant Group adopted a stock plan entitled the 2006 Stock Incentive Plan (the 2006 Plan ) and reserved and authorized a total of 3,300,000 shares of common stock for grant thereunder. Prior to and in connection with its IPO, Carrols Restaurant Group granted options to purchase 1,241,750 shares of its common stock, consisting of 395,000 shares of non-qualified stock options and 846,750 shares of incentive stock options ( ISO ), and issued 75,800 shares of restricted stock, 55,700 to certain of its employees and 20,100 to outside directors. As of December 31, 2006, 1,982,450 shares are available for future issuance.

The non-qualified stock options and ISO s granted under the 2006 Plan are exercisable for up to one-fifth of the total number of option shares on or after the first anniversary of the grant date and as of the first day of each month that commences subsequent to the first anniversary of the grant date, the option is exercisable for up to an additional one-sixtieth of the total number of option shares until fully exercisable. The options expire seven years from the date of the grant and 50% were issued with an exercise price equal to the fair market value of Carrols Restaurant Group s stock price, or \$13.00 per share of common stock on the date of grant and the remaining 50% were issued with an exercise price equal to 120% of the fair market value of Carrols Restaurant Group s stock price, or \$15.60 per share of common stock, on the date of grant. The restricted stock awards issued to certain employees vest one-third on the first anniversary of the award date, an additional one-third on the second anniversary of the award date and the remaining one-third on the third anniversary of the award date. The restricted stock awards issued to outside directors vest one-fifth on the first anniversary of the award date and an additional one-fifth on each subsequent anniversary of the award date, provided that, the participant has continuously remained a director of Carrols Restaurant Group. Forfeiture rates are based on a stratification of employees by expected exercise behavior and range from 0 to 15%.

Stock based compensation expense for 2006 totaled \$0.1 million. A portion of Carrols Restaurant Group s granted options qualify as ISO s for income tax purposes. As such, a tax benefit is not recorded at the time the compensation cost related to the options is recorded for financial reporting purposes because an ISO does not ordinarily result in a tax benefit unless there is a disqualifying disposition. Stock option grants of non-qualified options result in the creation of a deferred tax asset, until the time that the option is exercised.

**Table of Contents****CARROLS CORPORATION AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****Years Ended December 31, 2006, 2005 and 2004**

(in thousands of dollars, except share and per share amounts)

The total non-vested stock-based compensation expense relating to the options and restricted shares is approximately \$5.4 million and approximately \$1.5 million will be recorded as compensation expense in 2007. The remaining weighted average vesting period for such options and restricted shares is 4.38 years at December 31, 2006.

A summary of all option activity under Carrols Restaurant Group's 2006 Plan was as follows:

|  |                         | 2006 Plan<br>Average                     |                                  | Aggregate<br>Intrinsic<br>Value (in<br>thousands)(1) |
|--|-------------------------|--|----------------------------------|--|
|  | Number<br>of<br>Options | Weighted<br>Average<br>Exercise<br>Price | Remaining<br>Contractual<br>Life |  |
| Options outstanding at January 1, 2006   |                         | \$                                       |                                  | \$   |
| Granted                                  | 1,241,750               | \$ 14.30                                 | 7.0                              | \$ 733   |
| Options outstanding at December 31, 2006 | 1,241,750               | \$ 14.30                                 | 7.0                              | \$ 733   |
| Expected to vest at December 31, 2006    | 1,224,886               | \$ 14.30                                 | 7.0                              | \$ 723   |
| Options exercisable at December 31, 2006 |                         |  |                                  |  |

(1) The aggregate intrinsic value was calculated using the difference between the market price of Carrols Restaurant Group's stock at December 31 and the grant price for only those awards that have a grant price that is less than the market price of Carrols Restaurant Group's stock at December 31.

The restricted stock activity related to Carrols Restaurant Group's 2006 plan is as follows:

|                                | Shares | Weighted<br>Average<br>Fair Value |
|--------------------------------|--------|-----------------------------------|
| Nonvested at January 1, 2006   |        | \$                                |
| Shares granted                 | 75,800 | \$ 13.00                          |
| Nonvested at December 31, 2006 | 75,800 | \$ 13.00                          |

**Table of Contents****CARROLS CORPORATION AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****Years Ended December 31, 2006, 2005 and 2004**

(in thousands of dollars, except share and per share amounts)

A summary of all option activity under Carrols Restaurant Group's prior stock option plans for the years ended December 31, 2005 and 2004 is as follows:

|   | NonPlan<br>Options | 1996<br>Plan | Directors<br>Plan | Pollo<br>Plan | Taco<br>Plan |
|---|--------------------|--------------|-------------------|---------------|--------------|
| Outstanding at January 1, 2004  | 366,036            | 2,073,019    | 39,508            | 90,775        | 339,000      |
| Granted   |                    | 34,993       | 5,644             | 8,725         | 85,500       |
| Canceled  |                    | (7,326)      |                   | (750)         | (15,724)     |
| Redeemed  |                    | (5,667)      |                   | (22,470)      |              |
| Merger of tracking stock to common stock                              |                    |              |                   | (56,777)      | (387,967)    |
| Adjust tracking stock for common stock split                          |                    |              |                   | 200,647       | 214,083      |
| Outstanding at December 31, 2004                                      | 366,036            | 2,095,019    | 45,152            | 220,150       | 234,892      |
| Canceled  | (366,036)          | (2,095,019)  | (45,152)          | (220,150)     | (234,892)    |
| <b>Outstanding at December 31, 2005</b>                               |                    |              |                   |               |              |
| Grant Prices (in whole dollars) in 2004                               | \$                 | \$ 11.25     | \$ 11.25          | \$ 183.00     | \$ 14.50     |
| Weighted Average Option Price (in whole dollars) at December 31, 2004 | \$ 9.01            | \$ 9.76      | \$ 10.49          | \$ 13.59      | \$ 13.86     |
| Options Exercisable at December 31, 2004                              | 366,036            | 2,022,640    | 36,686            | 151,620       | 124,495      |

**13. Business Segment Information**

The Company is engaged in the quick-service and quick-casual restaurant industry, with three restaurant concepts: Burger King operating as a franchisee, Pollo Tropical and Taco Cabana, both Company owned concepts. The Company's Burger King restaurants are all located in the United States, primarily in the Northeast, Southeast and Midwest. Pollo Tropical is a quick-casual restaurant chain featuring grilled marinated chicken and authentic made from scratch side dishes. Pollo Tropical's core markets are located in south and central Florida. Taco Cabana is a quick-casual restaurant chain featuring Mexican style food, including, flame-grilled beef and chicken fajitas, quesadillas and other Tex-Mex dishes. Taco Cabana's core markets are primarily located in Texas.

The accounting policies of each segment are the same as those described in the summary of significant accounting policies. The following table includes Segment EBITDA which is the measure of segment profit or loss reported to the chief operating decision maker for purposes of allocating resources to the segments and assessing their performance. Segment EBITDA is defined as earnings before interest, income taxes, depreciation and amortization, impairment losses, stock-based compensation expense, bonus to employees and a director in connection with the Company's December 2004 refinancing, other expense (income) and loss on extinguishment of debt.

**Table of Contents****CARROLS CORPORATION AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****Years Ended December 31, 2006, 2005 and 2004**

(in thousands of dollars, except share and per share amounts)

The Other column includes corporate related items not allocated to reportable segments, including stock-based compensation expense. Other identifiable assets consist primarily of cash, certain other assets, corporate property and equipment, goodwill and deferred income taxes.

|  | <b>Pollo<br/>Tropical</b> | <b>Taco<br/>Cabana</b> | <b>Burger<br/>King</b> | <b>Other</b> | <b>Consolidated</b> |
|--|---------------------------|------------------------|------------------------|--------------|---------------------|
| <b>Year ended December 31, 2006</b>          |                           |                        |                        |              |                     |
| Revenues                                     | \$ 154,207                | \$ 228,304             | \$ 368,915             | \$           | \$ 751,426          |
| Cost of sales                                | 49,430                    | 66,061                 | 95,745                 |              | 211,236             |
| Restaurant wages and related expenses        | 38,625                    | 64,976                 | 115,190                | 6            | 218,797             |
| General and administrative expense (1)       | 8,945                     | 11,649                 | 29,082                 | 74           | 49,750              |
| Depreciation and amortization                | 5,050                     | 8,742                  | 18,028                 | 1,714        | 33,534              |
| Segment EBITDA                               | 28,428                    | 33,494                 | 34,177                 |              |                     |
| Identifiable assets                          | 46,617                    | 71,601                 | 155,272                | 179,369      | 452,859             |
| Capital expenditures, including acquisitions | 18,175                    | 17,051                 | 8,327                  | 1,586        | 45,139              |
| <b>Year ended December 31, 2005</b>          |                           |                        |                        |              |                     |
| Revenues                                     | \$ 136,983                | \$ 209,831             | \$ 360,096             | \$           | \$ 706,910          |
| Cost of sales                                | 45,185                    | 60,368                 | 99,067                 |              | 204,620             |
| Restaurant wages and related expenses        | 31,956                    | 58,932                 | 113,404                |              | 204,292             |
| General and administrative expense (1)       | 7,495                     | 10,154                 | 24,852                 | 16,432       | 58,933              |
| Depreciation and amortization                | 4,881                     | 7,951                  | 18,988                 | 1,276        | 33,096              |
| Segment EBITDA                               | 28,691                    | 31,927                 | 31,767                 |              |                     |
| Identifiable assets                          | 59,761                    | 70,883                 | 182,902                | 183,399      | 496,945             |
| Capital expenditures, including acquisitions | 14,124                    | 16,792                 | 6,614                  | 1,319        | 38,849              |
| <b>Year ended December 31, 2004</b>          |                           |                        |                        |              |                     |
| Revenues                                     | \$ 125,101                | \$ 202,941             | \$ 369,837             | \$           | \$ 697,879          |
| Cost of sales                                | 38,986                    | 60,435                 | 103,203                |              | 202,624             |
| Restaurant wages and related expenses        | 31,380                    | 57,702                 | 117,650                |              | 206,732             |
| General and administrative expense (1)       | 7,307                     | 11,061                 | 23,392                 | 1,818        | 43,578              |
| Depreciation and amortization                | 4,460                     | 9,884                  | 22,078                 | 2,099        | 38,521              |
| Segment EBITDA                               | 27,891                    | 30,082                 | 36,582                 |              |                     |
| Identifiable assets                          | 50,177                    | 63,655                 | 198,015                | 204,399      | 516,246             |
| Capital expenditures, including acquisitions | 6,636                     | 6,555                  | 4,811                  | 1,071        | 19,073              |

- (1) For the Pollo Tropical and Taco Cabana segments, such amounts include general and administrative expenses related directly to each segment. For the Burger King segment such amounts include general and administrative expenses related directly to the Burger King segment as well as expenses associated with administrative support to all three of the Company's segments including executive management, information systems and certain accounting, legal and other administrative functions.

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(in thousands of dollars, except share and per share amounts)

A reconciliation of segment EBITDA to consolidated net income (loss) is as follows:

|                                      | Year ended December 31, |            |            |
|--------------------------------------|-------------------------|------------|------------|
|                                      | 2006                    | 2005       | 2004       |
| Segment EBITDA:                      |                         |            |            |
| Pollo Tropical                       | \$ 28,428               | \$ 28,691  | \$ 27,891  |
| Taco Cabana                          | 33,494                  | 31,927     | 30,082     |
| Burger King                          | 34,177                  | 31,767     | 36,582     |
| Subtotal                             | 96,099                  | 92,385     | 94,555     |
| Less:                                |                         |            |            |
| Depreciation and amortization        | 33,534                  | 33,096     | 38,521     |
| Impairment losses                    | 1,019                   | 1,468      | 1,544      |
| Interest expense                     | 44,262                  | 42,972     | 35,383     |
| Provision (benefit) for income taxes | 6,561                   | 2,760      | (6,720)    |
| Bonus to employees and a director    |                         |            | 20,860     |
| Stock-based compensation expense     | 80                      | 16,432     | 1,818      |
| Loss on extinguishment of debt       |                         |            | 8,913      |
| Other expense (income)               | (2,787)                 |            | 2,320      |
| Net income (loss)                    | \$ 13,430               | \$ (4,343) | \$ (8,084) |

**14. Commitments and Contingencies**

On November 16, 1998, the Equal Employment Opportunity Commission ( EEOC ) filed suit in the United States District Court for the Northern District of New York (the Court ), under Title VII of the Civil Rights Act of 1964, as amended, against the Company. The complaint alleged that the Company engaged in a pattern and practice of unlawful discrimination, harassment and retaliation against former and current female employees. The EEOC identified approximately 450 individuals (which was subsequently increased to 511 individuals) that it believed represented the class of claimants and was seeking monetary and injunctive relief from the Company.

On April 20, 2005, the Court issued a decision and order granting Carrols Motion for Summary Judgment that the Company filed in January 2004. Subject to possible appeal by the EEOC, the case is dismissed, however the Court noted that it was not ruling on the claims, if any, that individual employees might have against the Company. The Company does not believe that any individual claim, if any, would have a material adverse impact on its consolidated financial statements.

On February 27, 2006, the Company filed a motion for summary judgment to dismiss all but between four and 17 of the individual claims. On July 10, 2006, in its response to that motion, the EEOC has asserted that, notwithstanding the Court s dismissal of the case as a class action, the EEOC may still maintain some kind of collective action on behalf of these claimants. Oral argument before the Court was held on October 4, 2006 and the Company is awaiting the Court s decision on the Company s summary judgment motion. Although the Company believes that the EEOC s continued class litigation argument is without merit, it is not possible to predict the outcome of the pending motion.

On November 30, 2002, four former hourly employees commenced a lawsuit against the Company in the United States District Court for the Western District of New York entitled Dawn Seever, et al. v. Carrols Corporation. The lawsuit alleges, in substance, that the Company violated

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certain minimum wage laws under the Federal Fair Labor Standards Act and related state laws by requiring employees to work without recording their time and by retaliating against those who complained. The plaintiffs seek damages, costs and injunctive relief.

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They also seek to notify, and eventually certify, a class consisting of current and former employees who, since 1998, have worked, or are working, for the Company. As a result of the July 21, 2005 Status Conference, the parties agreed to withdraw Plaintiff's Motions to Certify and for National Discovery, and Defendant's Motion to Disqualify Counsel and related motions, to allow both sides limited additional discovery. The Company has since filed a Motion for Summary Judgment as to the existing plaintiffs that the Court has under consideration. On January 19, 2007, plaintiffs re-filed the Motion to certify and for National Discovery and the Company intends to oppose such Motion. It is too early to evaluate the likelihood of an unfavorable outcome or estimate the amount or range of potential loss. Consequently, it is not possible to predict what adverse impact, if any, this case could have on the Company's consolidated financial statements. The Company intends to continue to contest this case vigorously.

The Company is a party to various other litigation matters incidental to the conduct of business. The Company does not believe that the outcome of any of these other matters will have a material adverse effect on its consolidated financial statements.

**15. Retirement Plans**

The Company offers its salaried employees the option to participate in the Carrols Corporation Retirement Savings Plan (the Retirement Plan). The Retirement Plan includes a savings option pursuant to section 401(k) of the Internal Revenue Code in addition to a post tax savings option. The Company may elect to contribute to the Retirement Plan on an annual basis. The Company's contributions are equal to 50% of the employee's contribution to a maximum Company contribution of \$520 annually for any plan year that the Company participates in an employee match. Under the Retirement Plan, the Company's contributions begin to vest after one year and fully vest after five years of service. A year of service is defined as a plan year during which an employee completes at least 1,000 hours of service. Participating employees may contribute up to 18% of their salary annually to either of the savings options, subject to other limitations. The employees have various investment options available under a trust established by the Retirement Plan. Contributions to the Retirement Plan were \$404 and \$403 for the years ended December 31, 2006 and 2005, respectively. For the 2004 plan year, the Company did not make any matching contributions.

The Company also has a Deferred Compensation Plan which permits employees not eligible to participate in the Retirement Plan because they have been excluded as highly compensated employees (as so defined in the Retirement Plan), to voluntarily defer portions of their base salary and annual bonus. All amounts deferred by the participants earn interest at 8% per annum. There is no Company matching on any portion of the funds. At December 31, 2006 and 2005, a total of \$2,034 and \$870, respectively, was deferred under this plan, including accrued interest. Liabilities related to the Deferred Compensation Plan are included in other long-term liabilities in the consolidated balance sheet.



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(in thousands of dollars, except share and per share amounts)

**16. Postretirement Benefits**

The Company provides postretirement medical and life insurance benefits covering substantially all Burger King administrative and restaurant management salaried employees. A December 31 measurement date is used for the postretirement benefits. The following is the plan status and accumulated postretirement benefit obligation (APBO) at December 31, 2006 and 2005:

|   | 2006     | 2005     |
|---|----------|----------|
| Change in benefit obligation:                             |          |          |
| Benefit obligation at beginning of year                   | \$ 6,075 | \$ 4,943 |
| Service cost  | 485      | 395      |
| Interest cost   | 335      | 280      |
| Plan participants contributions                           | 9        | 8        |
| Actuarial loss  | (288)    | 598      |
| Benefits paid   | (246)    | (149)    |
| <br>  |          |          |
| Benefit obligation at end of year                         | \$ 6,370 | \$ 6,075 |
| Change in plan assets:                                    |          |          |
| Fair value of plan assets at beginning of year            |          |          |
| Employer contributions                                    | 237      | 141      |
| Plan participants contributions                           | 9        | 8        |
| Benefits paid   | (246)    | (149)    |
| <br>  |          |          |
| Fair value of plan assets at end of year                  |          |          |
| <br>  |          |          |
| Funded status   | 6,370    | 6,075    |
| Unrecognized prior service credit                         |          | 73       |
| Unrecognized net actuarial net loss                       |          | (2,080)  |
| <br>  |          |          |
| Funded status at end of year                              | \$ 6,370 | \$ 4,068 |
| Weighted average assumptions:                             |          |          |
| Discount rate used to determine benefit obligations       | 5.90%    | 5.55%    |
| <br>  |          |          |
| Discount rate used to determine net periodic benefit cost | 5.55%    | 6.15%    |

The incremental effect of applying SFAS No. 158 on the individual line items in the consolidated balance sheet is as follows at December 31, 2006:

| Before | Adjustments | After |
|--------|-------------|-------|
|--------|-------------|-------|

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|                                      | SFAS No. |          | SFAS No. |  |
|--------------------------------------|----------|----------|----------|--|
|                                      | 158      |          | 158      |  |
| Postretirement benefit obligation    | \$ 4,715 | \$ 1,655 | \$ 6,370 |  |
| Deferred income taxes                | 16,329   | (654)    | 15,675   |  |
| Total liabilities                    | 477,593  | 1,001    | 478,594  |  |
| Accumulated other comprehensive loss |          | (1,001)  | (1,001)  |  |
| Total stockholders deficit           | (24,734) | (1,001)  | (25,735) |  |

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The amounts recognized on the consolidated balance sheet of \$6,370 and \$4,068 at December 31, 2006 and 2005, respectively, are included as a non-current liability. Amounts recognized in accumulated other comprehensive loss, consist of:

|                                      | <b>2006</b> |
|--------------------------------------|-------------|
| Prior service cost                   | \$ (44)     |
| Net gain                             | 1,699       |
| Income tax benefit                   | (654)       |
| Accumulated other comprehensive loss | \$ 1,001    |

The discount rate is determined based on high-quality fixed income investments that match the duration of expected retiree medical and life insurance benefits. The Company has typically used the corporate AA/Aa bond rate for this assumption.

Assumed health care cost trend rates at December 31:

|   | <b>2006</b> | <b>2005</b> | <b>2004</b> |
|---|-------------|-------------|-------------|
| Medical benefits cost trend rate assumed for the following year                   | 8.00%       | 8.00%       | 8.25%       |
| Prescription drug benefit cost trend rate assumed for the following year          | 10.00%      | 11.00%      | 12.00%      |
| Rate to which the cost trend rate is assumed to decline (the ultimate trend rate) | 5.00%       | 5.00%       | 5.00%       |
| Year that the rate reaches the ultimate trend rate                                | 2012        | 2012        | 2012        |

During 2007, the Company expects to contribute approximately \$132 to its postretirement benefit plan. The benefits expected to be paid in each year from 2007 through 2011 are \$118, \$116, \$135, \$158 and \$193, respectively, and for the years 2012-2016 the aggregate amount of \$1,434. Components of net period postretirement benefit cost are:

|  | <b>Year ended December 31,</b> |             |             |
|--|--------------------------------|-------------|-------------|
|  | <b>2006</b>                    | <b>2005</b> | <b>2004</b> |
| Net periodic postretirement benefit cost |                                |             |             |
| Service cost                             | \$ 485                         | \$ 395      | \$ 381      |
| Interest cost                            | 335                            | 280         | 251         |
| Amortization of net gains and losses     | 92                             | 61          | 46          |
| Amortization of prior service credit     | (29)                           | (30)        | (30)        |
| Net periodic postretirement benefit cost | \$ 883                         | \$ 706      | \$ 648      |

The estimated net gain and prior service cost for the postretirement benefit plan that will be amortized from accumulated other comprehensive income into net periodic benefit cost over the next fiscal year are \$68 and (\$30), respectively.



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Assumed health care cost trend rates have a significant effect on the amounts reported for the health care plans. A one-percentage-point change in the health care cost trend rates would have the following effects:

|   | <b>1%</b><br><b>Increase</b> | <b>1%</b><br><b>Decrease</b> |
|---|------------------------------|------------------------------|
| Effect on total of service and interest cost components | \$ 180                       | \$ (146)                     |
| Effect on postretirement benefit obligation             | 1,248                        | (1,021)                      |

**17. Guarantor Financial Statements**

The Company's obligation under the \$180.0 million 9% senior subordinated notes are, and the \$170.0 million 9/2% senior subordinated notes of the Company were, jointly and severally guaranteed in full on an unsecured senior subordinated basis by certain of the Company's subsidiaries (Guarantor Subsidiaries), all of which are directly or indirectly wholly-owned by the Company. These subsidiaries are:

Cabana Beverages, Inc.

Cabana Bevco LLC

Carrols Realty Holdings

Carrols Realty I Corp.

Carrols Realty II Corp.

Carrols J.G. Corp.

Quanta Advertising Corp.

Pollo Franchise, Inc.

Pollo Operations, Inc.

Taco Cabana, Inc.

TP Acquisition Corp.

TC Bevco LLC

T.C. Management, Inc.

TC Lease Holdings III, V and VI, Inc.

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Get Real, Inc.

Texas Taco Cabana, L.P.

TPAQ Holding Corporation

The following supplemental financial information sets forth on a condensed consolidating basis, consolidating balance sheets, statements of operations and statements of cash flows for the Parent Company only, Guarantor Subsidiaries and for the Company as of December 31, 2006 and 2005 and for the years ended December 31, 2006, 2005 and 2004.

For certain of the Company's sale-leaseback transactions, the Parent Company has guaranteed on an unsecured basis the rental payments of its subsidiaries. In accordance with Emerging Issues Task Force Issue No. 90-14, "Unsecured Guarantee by Parent of Subsidiary's Lease Payments in a Sale-Leaseback Transaction", the Company has included in the following Guarantor Financial Statements amounts pertaining to these leases as if they were accounted for as financing transactions of the Guarantor subsidiaries. These adjustments are eliminated in consolidation.

For purposes of the guarantor financial statements, the Company and its subsidiaries determine the applicable tax provision for each entity generally using the separate return method. Under this method, current and deferred taxes are allocated to each reporting entity as if it were to file a separate tax return. The rules

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**Years Ended December 31, 2006, 2005 and 2004**

(in thousands of dollars, except share and per share amounts)

followed by the reporting entity in computing its tax obligation or refund, including the effects of the alternative minimum tax, would be the same as those followed in filing a separate return with the Internal Revenue Service. However, for purposes of evaluating an entity's ability to realize its tax attributes, the Company assesses whether it is more likely than not that those assets will be realized at the consolidated level. Any differences in the total of the income tax provision (benefit) for the Parent Company Only and the Guarantor Subsidiaries, as calculated on the separate return method, and the consolidated income tax provision (benefit) are eliminated in consolidation.

The Company provides some administrative support to its subsidiaries related to executive management, information systems and certain accounting, legal and other administrative functions. For purposes of the guarantor financial statements, the Company allocates such corporate costs on a specific identification basis, where applicable, or based on revenues or the number of restaurants for each subsidiary. Management believes that these allocations are reasonable based on the nature of costs incurred.

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(in thousands of dollars)

|   | Parent<br>Company<br>Only | Guarantor<br>Subsidiaries | Eliminations       | Consolidated<br>Total |
|---|---------------------------|---------------------------|--------------------|-----------------------|
| <b>ASSETS</b>   |                           |                           |                    |                       |
| Current assets:                                       |                           |                           |                    |                       |
| Cash and cash equivalents                             | \$ 1,182                  | \$ 2,757                  | \$                 | \$ 3,939              |
| Trade and other receivables, net                      | 783                       | 4,581                     |                    | 5,364                 |
| Inventories   | 2,997                     | 1,680                     |                    | 4,677                 |
| Prepaid rent  | 2,203                     | 1,927                     |                    | 4,130                 |
| Prepaid expenses and other current assets             | 1,920                     | 3,447                     |                    | 5,367                 |
| Refundable income taxes                               | 2,806                     |                           |                    | 2,806                 |
| Deferred income taxes                                 | 2,653                     | 1,886                     |                    | 4,539                 |
| <b>Total current assets</b>                           | <b>14,544</b>             | <b>16,278</b>             |                    | <b>30,822</b>         |
| Property and equipment, net                           | 62,978                    | 171,369                   | (51,605)           | 182,742               |
| Franchise rights, net                                 | 83,268                    |                           |                    | 83,268                |
| Goodwill  | 1,450                     | 123,484                   |                    | 124,934               |
| Intangible assets, net                                |                           | 1,175                     |                    | 1,175                 |
| Franchise agreements, net                             | 5,793                     |                           |                    | 5,793                 |
| Intercompany receivable (payable)                     | 151,907                   | (152,204)                 | 297                |                       |
| Investment in subsidiaries                            | 35,396                    |                           | (35,396)           |                       |
| Deferred income taxes                                 | 5,215                     | 6,619                     | (698)              | 11,136                |
| Other assets  | 8,703                     | 6,008                     | (1,722)            | 12,989                |
| <b>Total assets</b>                                   | <b>\$ 369,254</b>         | <b>\$ 172,729</b>         | <b>\$ (89,124)</b> | <b>\$ 452,859</b>     |
| <b>LIABILITIES AND STOCKHOLDER S EQUITY (DEFICIT)</b> |                           |                           |                    |                       |
| Current liabilities:                                  |                           |                           |                    |                       |
| Current portion of long-term debt                     | \$ 2,295                  | \$ 182                    | \$                 | \$ 2,477              |
| Accounts payable                                      | 7,783                     | 10,077                    |                    | 17,860                |
| Accrued interest                                      | 7,861                     |                           |                    | 7,861                 |
| Accrued payroll, related taxes and benefits           | 11,034                    | 7,411                     |                    | 18,445                |
| Accrued real estate taxes                             | 1,754                     | 2,348                     |                    | 4,102                 |
| Other liabilities                                     | 7,123                     | 3,500                     |                    | 10,623                |
| <b>Total current liabilities</b>                      | <b>37,850</b>             | <b>23,518</b>             |                    | <b>61,368</b>         |
| Long-term debt, net of current portion                | 296,397                   | 1,035                     |                    | 297,432               |
| Lease financing obligations                           | 19,419                    | 103,060                   | (63,908)           | 58,571                |
| Deferred income sale-leaseback of real estate         | 18,548                    | 4,812                     | 8,031              | 31,391                |
| Accrued postretirement benefits                       | 6,370                     |                           |                    | 6,370                 |
| Other liabilities                                     | 16,405                    | 6,799                     | 258                | 23,462                |
| <b>Total liabilities</b>                              | <b>394,989</b>            | <b>139,224</b>            | <b>(55,619)</b>    | <b>478,594</b>        |
| Commitments and contingencies                         |                           |                           |                    |                       |



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|  |            |            |             |            |
|--|------------|------------|-------------|------------|
| Stockholder s equity (deficit)                       | (25,735)   | 33,505     | (33,505)    | (25,735)   |
| Total liabilities and stockholder s equity (deficit) | \$ 369,254 | \$ 172,729 | \$ (89,124) | \$ 452,859 |

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**Table of Contents****CARROLS CORPORATION AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****CONSOLIDATING BALANCE SHEET****December 31, 2005**

(in thousands of dollars)

|   | Parent     |              | Eliminations | Consolidated |
|---|------------|--------------|--------------|--------------|
|   | Company    | Guarantor    |              |              |
|   | Only       | Subsidiaries |              | Total        |
| <b>ASSETS</b>   |            |              |              |              |
| Current assets:                                       |            |              |              |              |
| Cash and cash equivalents                             | \$ 7,493   | \$ 1,838     | \$           | \$ 9,331     |
| Trade and other receivables, net                      | 608        | 2,409        |              | 3,017        |
| Inventories   | 3,767      | 1,566        |              | 5,333        |
| Prepaid rent  | 2,600      | 1,876        |              | 4,476        |
| Prepaid expenses and other current assets             | 1,292      | 3,343        |              | 4,635        |
| Refundable income taxes                               | 593        |              |              | 593          |
| Deferred income taxes                                 | 3,081      | 2,225        | (439)        | 4,867        |
| Total current assets                                  | 19,434     | 13,257       | (439)        | 32,252       |
| Property and equipment, net                           | 85,999     | 155,078      | (23,571)     | 217,506      |
| Franchise rights, net                                 | 86,490     |              |              | 86,490       |
| Goodwill  | 1,450      | 123,484      |              | 124,934      |
| Intangible assets, net                                |            | 1,465        |              | 1,465        |
| Franchise agreements, net                             | 5,869      |              |              | 5,869        |
| Intercompany receivable (payable)                     | 159,161    | (159,735)    | 574          |              |
| Investment in subsidiaries                            | 21,478     |              | (21,478)     |              |
| Deferred income taxes                                 | 5,611      | 7,668        |              | 13,279       |
| Other assets  | 10,231     | 5,968        | (1,049)      | 15,150       |
| Total assets  | \$ 395,723 | \$ 147,185   | \$ (45,963)  | \$ 496,945   |
| <b>LIABILITIES AND STOCKHOLDER S EQUITY (DEFICIT)</b> |            |              |              |              |
| Current liabilities:                                  |            |              |              |              |
| Current portion of long-term debt                     | \$ 2,340   | \$ 248       | \$           | \$ 2,588     |
| Accounts payable                                      | 7,327      | 11,695       |              | 19,022       |
| Accrued interest                                      | 7,615      |              |              | 7,615        |
| Accrued payroll, related taxes and benefits           | 8,940      | 6,763        |              | 15,703       |
| Accrued real estate taxes                             | 1,362      | 2,571        |              | 3,933        |
| Other liabilities                                     | 6,571      | 2,261        |              | 8,832        |
| Total current liabilities                             | 34,155     | 23,538       |              | 57,693       |
| Long-term debt, net of current portion                | 389,892    | 1,216        |              | 391,108      |
| Lease financing obligations                           | 48,817     | 90,613       | (28,532)     | 110,898      |
| Deferred income sale-leaseback of real estate         | 5,664      | 2,327        | 2,669        | 10,660       |
| Accrued postretirement benefits                       | 4,068      |              |              | 4,068        |
| Other liabilities                                     | 16,638     | 9,222        | 169          | 26,029       |

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|  |            |            |             |            |
|--|------------|------------|-------------|------------|
| Total liabilities                                    | 499,234    | 126,916    | (25,694)    | 600,456    |
| Commitments and contingencies                        |            |            |             |            |
| Stockholder s equity (deficit)                       | (103,511)  | 20,269     | (20,269)    | (103,511)  |
| Total liabilities and stockholder s equity (deficit) | \$ 395,723 | \$ 147,185 | \$ (45,963) | \$ 496,945 |

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**Table of Contents****CARROLS CORPORATION AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****CONSOLIDATED STATEMENT OF OPERATIONS****FOR THE YEAR ENDED DECEMBER 31, 2006**

(in thousands of dollars)

|   | <b>Parent<br/>Company<br/>Only</b> | <b>Guarantor<br/>Subsidiaries</b> | <b>Eliminations</b> | <b>Consolidated<br/>Total</b> |
|---|------------------------------------|-----------------------------------|---------------------|-------------------------------|
| <b>Revenues:</b>  |                                    |                                   |                     |                               |
| Restaurant sales  | \$ 368,915                         | \$ 381,154                        | \$                  | \$ 750,069                    |
| Franchise royalty revenues and fees   |                                    | 1,357                             |                     | 1,357                         |
| <b>Total revenues</b>   | <b>368,915</b>                     | <b>382,511</b>                    |                     | <b>751,426</b>                |
| <b>Costs and expenses:</b>  |                                    |                                   |                     |                               |
| Cost of sales   | 95,745                             | 115,491                           |                     | 211,236                       |
| Restaurant wages and related expenses   | 115,196                            | 103,601                           |                     | 218,797                       |
| Restaurant rent expense   | 22,150                             | 11,791                            | 3,827               | 37,768                        |
| Other restaurant operating expenses   | 56,732                             | 53,432                            |                     | 110,164                       |
| Advertising expense   | 15,839                             | 11,853                            |                     | 27,692                        |
| General and administrative (including stock-based compensation expense of \$74) | 25,835                             | 23,915                            |                     | 49,750                        |
| Depreciation and amortization   | 18,677                             | 15,746                            | (889)               | 33,534                        |
| Impairment losses   | 276                                | 743                               |                     | 1,019                         |
| Other income  |                                    | (2,787)                           |                     | (2,787)                       |
| <b>Total operating expenses</b>   | <b>350,450</b>                     | <b>333,785</b>                    | <b>2,938</b>        | <b>687,173</b>                |
| Income from operations  | 18,465                             | 48,726                            | (2,938)             | 64,253                        |
| Interest expense  | 37,909                             | 10,509                            | (4,156)             | 44,262                        |
| Intercompany interest allocations   | (18,226)                           | 18,226                            |                     |                               |
| Income (loss) before income taxes   | (1,218)                            | 19,991                            | 1,218               | 19,991                        |
| Provision (benefit) for income taxes  | (730)                              | 6,584                             | 707                 | 6,561                         |
| Equity income from subsidiaries   | 13,918                             |                                   | (13,918)            |                               |
| <b>Net income</b>   | <b>\$ 13,430</b>                   | <b>\$ 13,407</b>                  | <b>\$ (13,407)</b>  | <b>\$ 13,430</b>              |

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**Table of Contents****CARROLS CORPORATION AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****CONSOLIDATED STATEMENT OF OPERATIONS****FOR THE YEAR ENDED DECEMBER 31, 2005**

(in thousands of dollars)

|   | Parent<br>Company<br>Only | Guarantor<br>Subsidiaries | Eliminations      | Consolidated<br>Total |
|---|---------------------------|---------------------------|-------------------|-----------------------|
| <b>Revenues:</b>  |                           |                           |                   |                       |
| Restaurant sales  | \$ 360,096                | \$ 345,326                | \$                | \$ 705,422            |
| Franchise royalty revenues and fees   |                           | 1,488                     |                   | 1,488                 |
| <b>Total revenues</b>   | <b>360,096</b>            | <b>346,814</b>            |                   | <b>706,910</b>        |
| <b>Costs and expenses:</b>  |                           |                           |                   |                       |
| Cost of sales   | 99,067                    | 105,553                   |                   | 204,620               |
| Restaurant wages and related expenses   | 113,404                   | 90,888                    |                   | 204,292               |
| Restaurant rent expense   | 21,200                    | 11,126                    | 2,342             | 34,668                |
| Other restaurant operating expenses   | 55,599                    | 47,322                    |                   | 102,921               |
| Advertising expense   | 14,206                    | 11,317                    |                   | 25,523                |
| General and administrative (including stock-based compensation expense of \$16,432) | 33,184                    | 25,749                    |                   | 58,933                |
| Depreciation and amortization   | 19,649                    | 13,926                    | (479)             | 33,096                |
| Impairment losses   | 1,373                     | 95                        |                   | 1,468                 |
| <b>Total operating expenses</b>   | <b>357,682</b>            | <b>305,976</b>            | <b>1,863</b>      | <b>665,521</b>        |
| <b>Income from operations</b>   | <b>2,414</b>              | <b>40,838</b>             | <b>(1,863)</b>    | <b>41,389</b>         |
| Interest expense  | 36,220                    | 9,346                     | (2,594)           | 42,972                |
| Intercompany interest allocations   | (18,225)                  | 18,225                    |                   |                       |
| <b>Income (loss) before income taxes</b>  | <b>(15,581)</b>           | <b>13,267</b>             | <b>731</b>        | <b>(1,583)</b>        |
| Provision (benefit) for income taxes  | (3,860)                   | 6,361                     | 259               | 2,760                 |
| Equity income from subsidiaries   | 7,378                     |                           | (7,378)           |                       |
| <b>Net income (loss)</b>  | <b>\$ (4,343)</b>         | <b>\$ 6,906</b>           | <b>\$ (6,906)</b> | <b>\$ (4,343)</b>     |

**Table of Contents****CARROLS CORPORATION AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****CONSOLIDATED STATEMENT OF OPERATIONS****FOR THE YEAR ENDED DECEMBER 31, 2004**

(in thousands of dollars)

|  | Parent<br>Company<br>Only | Guarantor<br>Subsidiaries | Eliminations      | Consolidated<br>Total |
|--|---------------------------|---------------------------|-------------------|-----------------------|
| <b>Revenues:</b>   |                           |                           |                   |                       |
| Restaurant sales   | \$ 369,837                | \$ 326,506                | \$                | \$ 696,343            |
| Franchise royalty revenues and fees  |                           | 1,536                     |                   | 1,536                 |
| <b>Total revenues</b>  | <b>369,837</b>            | <b>328,042</b>            |                   | <b>697,879</b>        |
| <b>Costs and expenses:</b>   |                           |                           |                   |                       |
| Cost of sales  | 103,203                   | 99,421                    |                   | 202,624               |
| Restaurant wages and related expenses  | 117,650                   | 89,082                    |                   | 206,732               |
| Restaurant rent expense  | 21,809                    | 10,455                    | 2,342             | 34,606                |
| Other restaurant operating expenses  | 52,712                    | 40,179                    |                   | 92,891                |
| Advertising expense  | 14,489                    | 10,222                    |                   | 24,711                |
| General and administrative (including stock-based compensation expense of \$1,818) | 21,033                    | 22,545                    |                   | 43,578                |
| Depreciation and amortization  | 23,186                    | 15,810                    | (475)             | 38,521                |
| Impairment losses  | 1,544                     |                           |                   | 1,544                 |
| Bonus to employees and director  | 14,817                    | 6,043                     |                   | 20,860                |
| Other expense  | 2,320                     |                           |                   | 2,320                 |
| <b>Total operating expenses</b>  | <b>372,763</b>            | <b>293,757</b>            | <b>1,867</b>      | <b>668,387</b>        |
| <b>Income from operations</b>  | <b>(2,926)</b>            | <b>34,285</b>             | <b>(1,867)</b>    | <b>29,492</b>         |
| Interest expense   | 28,615                    | 9,370                     | (2,602)           | 35,383                |
| Loss on extinguishment of debt   | 8,913                     |                           |                   | 8,913                 |
| Intercompany interest allocations  | (18,225)                  | 18,225                    |                   |                       |
| <b>Income (loss) before income taxes</b>   | <b>(22,229)</b>           | <b>6,690</b>              | <b>735</b>        | <b>(14,804)</b>       |
| Provision (benefit) for income taxes   | (8,857)                   | 2,253                     | (116)             | (6,720)               |
| Equity income from subsidiaries  | 5,288                     |                           | (5,288)           |                       |
| <b>Net income (loss)</b>   | <b>\$ (8,084)</b>         | <b>\$ 4,437</b>           | <b>\$ (4,437)</b> | <b>\$ (8,084)</b>     |

**Table of Contents****CARROLS CORPORATION AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****CONSOLIDATING STATEMENT OF CASH FLOWS****Year Ended December 31, 2006**

(in thousands of dollars)

|  | <b>Parent<br/>Company<br/>Only</b> | <b>Guarantor<br/>Subsidiaries</b> | <b>Eliminations</b> | <b>Consolidated<br/>Total</b> |
|--|------------------------------------|-----------------------------------|---------------------|-------------------------------|
| Net income (loss)  | \$ 13,430                          | \$ 13,407                         | \$ (13,407)         | \$ 13,430                     |
| Adjustments to reconcile net income (loss) to net cash provided from operating activities: |                                    |                                   |                     |                               |
| Gain on disposal of property and equipment   |                                    | (1,398)                           |                     | (1,398)                       |
| Stock-based compensation   | 69                                 |                                   |                     | 69                            |
| Depreciation and amortization  | 18,677                             | 15,746                            | (889)               | 33,534                        |
| Amortization of deferred financing costs   | 1,362                              | 276                               | (189)               | 1,449                         |
| Amortization of unearned purchase discounts  | (2,155)                            |                                   |                     | (2,155)                       |
| Amortization of deferred gains from sale-leaseback transactions                            | (746)                              | (183)                             | (374)               | (1,303)                       |
| Accretion of interest on lease financing obligations                                       | (35)                               | 477                               | (30)                | 412                           |
| Impairment losses  | 276                                | 743                               |                     | 1,019                         |
| Gain on settlement of lease financing obligations, net                                     | (309)                              |                                   | 189                 | (120)                         |
| Deferred income taxes  | 1,476                              | 1,217                             | 430                 | 3,123                         |
| Changes in other operating assets and liabilities  | (580)                              | (12,995)                          | 14,270              | 695                           |
| Net cash provided from operating activities  | 31,465                             | 17,290                            |                     | 48,755                        |
| Cash flows provided from (used for) investing activities:                                  |                                    |                                   |                     |                               |
| Capital expenditures:  |                                    |                                   |                     |                               |
| New restaurant development   | (324)                              | (27,808)                          |                     | (28,132)                      |
| Restaurant remodeling  | (4,557)                            | (1,815)                           |                     | (6,372)                       |
| Other restaurant capital expenditures  | (3,446)                            | (5,603)                           |                     | (9,049)                       |
| Corporate and restaurant information systems   | (1,149)                            | (437)                             |                     | (1,586)                       |
| Total capital expenditures   | (9,476)                            | (35,663)                          |                     | (45,139)                      |
| Properties purchased for sale-leaseback  | (1,008)                            | (2,405)                           |                     | (3,413)                       |
| Proceeds from sale-leaseback transactions  | 9,614                              | 16,155                            | 10,544              | 36,313                        |
| Proceeds from sales of other properties  |                                    | 1,800                             |                     | 1,800                         |
| Net cash provided from (used for) investing activities                                     | (870)                              | (20,113)                          | 10,544              | (10,439)                      |
| Cash flows provided from (used for) financing activities:                                  |                                    |                                   |                     |                               |
| Scheduled principal payments on term loans   | (2,200)                            |                                   |                     | (2,200)                       |
| Principal pre-payments on term loans   | (91,200)                           |                                   |                     | (91,200)                      |
| Proceeds from initial public offering, net of expenses                                     | 65,419                             |                                   |                     | 65,419                        |
| Dividend paid to parent  | (141)                              |                                   |                     | (141)                         |
| Financing costs associated with issuance of debt and lease financing obligations           |                                    | (586)                             | 586                 |                               |
| Settlement of lease financing obligations  | (8,644)                            | (6,555)                           |                     | (15,199)                      |
| Proceeds from lease financing obligations  |                                    | 11,130                            | (11,130)            |                               |
| Principal payments on capital leases   | (140)                              | (247)                             |                     | (387)                         |

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|  |          |          |          |          |
|--|----------|----------|----------|----------|
| Net cash provided from (used for) financing activities | (36,906) | 3,742    | (10,544) | (43,708) |
| Decrease in cash and cash equivalents                  | (6,311)  | 919      |          | (5,392)  |
| Cash and cash equivalents, beginning of period         | 7,493    | 1,838    |          | 9,331    |
| Cash and cash equivalents, end of period               | \$ 1,182 | \$ 2,757 | \$       | \$ 3,939 |

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**Table of Contents****CARROLS CORPORATION AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****CONSOLIDATING STATEMENT OF CASH FLOWS****Year Ended December 31, 2005**

(in thousands of dollars)

|   | Parent<br>Company<br>Only | Guarantor<br>Subsidiaries | Eliminations | Consolidated<br>Total |
|---|---------------------------|---------------------------|--------------|-----------------------|
| Cash flows provided from (used for) operating activities:   |                           |                           |              |                       |
| Net income (loss)   | \$ (4,343)                | \$ 6,906                  | \$ (6,906)   | \$ (4,343)            |
| Adjustments to reconcile net income (loss) to net cash provided from (used for) operating activities: |                           |                           |              |                       |
| Gain on sales of properties   | (35)                      | (585)                     |              | (620)                 |
| Stock based compensation  | 10,883                    | 5,427                     |              | 16,310                |
| Depreciation and amortization   | 19,649                    | 13,926                    | (479)        | 33,096                |
| Amortization of deferred financing costs  | 1,395                     | 257                       | (123)        | 1,529                 |
| Amortization of unearned purchase discounts   | (2,156)                   |                           |              | (2,156)               |
| Amortization of deferred gains from sale-leaseback transactions                                       | (213)                     | (115)                     | (153)        | (481)                 |
| Accretion of interest on lease financing obligations  | (75)                      | 461                       | (42)         | 344                   |
| Impairment losses   | 1,373                     | 95                        |              | 1,468                 |
| Deferred income taxes   | (1,876)                   | 2,660                     | 252          | 1,036                 |
| Changes in payroll and related accounts   | (27,996)                  | (2,050)                   |              | (30,046)              |
| Changes in other operating assets and liabilities   | (5,388)                   | 3,808                     | 7,451        | 5,871                 |
| <b>Net cash provided from (used for) operating activities</b>   | <b>(8,782)</b>            | <b>30,790</b>             |              | <b>22,008</b>         |
| Cash flows used for investing activities:   |                           |                           |              |                       |
| Capital expenditures:   |                           |                           |              |                       |
| New restaurant development  | (1,234)                   | (19,379)                  |              | (20,613)              |
| Restaurant remodeling   | (2,634)                   | (1,384)                   |              | (4,018)               |
| Other restaurant capital expenditures   | (2,745)                   | (5,939)                   |              | (8,684)               |
| Corporate and restaurant information systems  | (791)                     | (528)                     |              | (1,319)               |
| Acquisition of Taco Cabana restaurants  |                           | (4,215)                   |              | (4,215)               |
| <b>Total capital expenditures</b>   | <b>(7,404)</b>            | <b>(31,445)</b>           |              | <b>(38,849)</b>       |
| Properties purchased for sale-leaseback   | (275)                     | (816)                     |              | (1,091)               |
| Proceed from sale-leaseback transactions  | 3,519                     | 1,718                     |              | 5,237                 |
| Proceeds from sales of other properties   | 126                       | 669                       |              | 795                   |
| <b>Net cash used for investing activities</b>   | <b>(4,034)</b>            | <b>(29,874)</b>           |              | <b>(33,908)</b>       |
| Cash flows used for financing activities:   |                           |                           |              |                       |
| Scheduled principal payments on term loans  | (2,200)                   |                           |              | (2,200)               |
| Purchase of properties under lease financing obligations  |                           | (1,074)                   |              | (1,074)               |
| Principal payments on capital leases  | (144)                     | (275)                     |              | (419)                 |
| Principal pre-payments on term loans  | (6,000)                   |                           |              | (6,000)               |
| Financing costs associated with issuance of debt  | (542)                     |                           |              | (542)                 |
| <b>Net cash used for financing activities</b>   | <b>(8,886)</b>            | <b>(1,349)</b>            |              | <b>(10,235)</b>       |

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|  |          |          |          |
|--|----------|----------|----------|
| Net decrease in cash and cash equivalents    | (21,702) | (433)    | (22,135) |
| Cash and cash equivalents, beginning of year | 29,195   | 2,271    | 31,466   |
| Cash and cash equivalents, end of year       | \$ 7,493 | \$ 1,838 | \$ 9,331 |

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**Table of Contents****CARROLS CORPORATION AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****CONSOLIDATING STATEMENT OF CASH FLOWS****Year Ended December 31, 2004**

(in thousands of dollars)

|   | Parent<br>Company<br>Only | Guarantor<br>Subsidiaries | Eliminations | Consolidated<br>Total |
|---|---------------------------|---------------------------|--------------|-----------------------|
| Cash flows provided from operating activities:  |                           |                           |              |                       |
| Net income (loss)   | \$ (8,084)                | \$ 4,437                  | \$ (4,437)   | \$ (8,084)            |
| Adjustments to reconcile net income (loss) to net cash provided from (used for) operating activities: |                           |                           |              |                       |
| (Gain)/loss on disposal of property and equipment   | (288)                     | 112                       |              | (176)                 |
| Stock-based compensation expense  | 35                        | 1,783                     |              | 1,818                 |
| Depreciation and amortization   | 23,186                    | 15,810                    | (475)        | 38,521                |
| Amortization of deferred financing costs  | 1,396                     | 265                       | (134)        | 1,527                 |
| Amortization of unearned purchase discounts   | (2,154)                   |                           |              | (2,154)               |
| Amortization of deferred gains from sale-leaseback transactions                                       | (205)                     | (100)                     | (153)        | (458)                 |
| Accretion of interest on lease financing obligations  | (33)                      | 478                       | (39)         | 406                   |
| Impairment losses   | 1,544                     |                           |              | 1,544                 |
| Loss on extinguishment of debt  | 8,913                     |                           |              | 8,913                 |
| Deferred income taxes   | (7,898)                   | 1,259                     | 173          | (6,466)               |
| Changes in other operating assets and liabilities   | 36,954                    | (18,199)                  | 5,065        | 23,820                |
| <b>Net cash provided from operating activities</b>  | <b>53,366</b>             | <b>5,845</b>              |              | <b>59,211</b>         |
| Cash flows used for investing activities:   |                           |                           |              |                       |
| Capital expenditures:   |                           |                           |              |                       |
| New restaurant development  | (1,053)                   | (8,601)                   |              | (9,654)               |
| Restaurant remodeling   | (845)                     |                           |              | (845)                 |
| Other restaurant capital expenditures   | (2,913)                   | (4,590)                   |              | (7,503)               |
| Corporate and restaurant information systems  | (734)                     | (337)                     |              | (1,071)               |
| <b>Total capital expenditures</b>   | <b>(5,545)</b>            | <b>(13,528)</b>           |              | <b>(19,073)</b>       |
| Properties purchased for sale-leaseback transactions  | (1,574)                   |                           |              | (1,574)               |
| Proceeds from sale-leaseback transactions   | 6,263                     | 4,721                     |              | 10,984                |
| Proceeds from dispositions of property and equipment  | 488                       | 686                       |              | 1,174                 |
| <b>Net cash used for investing activities</b>   | <b>(368)</b>              | <b>(8,121)</b>            |              | <b>(8,489)</b>        |
| Cash flows provided from (used for) financing activities:   |                           |                           |              |                       |
| Payment on revolving credit facility, net   | (600)                     |                           |              | (600)                 |
| Scheduled principal payments on term loans  | (10,125)                  |                           |              | (10,125)              |
| Proceeds from issuance of debt  | 400,000                   |                           |              | 400,000               |
| Tender and redemption of 9 <sup>1</sup> / <sub>2</sub> % senior subordinated notes                    | (175,756)                 |                           |              | (175,756)             |
| Repayment of borrowings under previous credit facility  | (113,375)                 |                           |              | (113,375)             |
| Financing costs associated with issuance of debt and lease financing obligations                      | (8,853)                   | (160)                     |              | (9,013)               |
| Proceeds from lease financing obligations   | 1,250                     | 3,250                     |              | 4,500                 |

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|  |           |          |           |
|--|-----------|----------|-----------|
| Dividends paid   | (116,794) |          | (116,794) |
| Payments on other notes payable                        | (117)     |          | (117)     |
| Principal payments on capital leases                   | (141)     | (249)    | (390)     |
| Net cash provided from (used for) financing activities | (24,511)  | 2,841    | (21,670)  |
| Net increase in cash and cash equivalents              | 28,487    | 565      | 29,052    |
| Cash and cash equivalents, beginning of year           | 708       | 1,706    | 2,414     |
| Cash and cash equivalents, end of year                 | \$ 29,195 | \$ 2,271 | \$ 31,466 |

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**Table of Contents****CARROLS CORPORATION AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****Years Ended December 31, 2006, 2005 and 2004**

(in thousands of dollars, except share and per share amounts)

**18. Selected Quarterly Financial Data (Unaudited)**

|                        | 2006             |                   |                  |                   |
|------------------------|------------------|-------------------|------------------|-------------------|
|                        | First<br>Quarter | Second<br>Quarter | Third<br>Quarter | Fourth<br>Quarter |
| Revenue                | \$ 182,543       | \$ 190,581        | \$ 189,597       | \$ 188,705        |
| Gross profit (1)       | 26,514           | 29,773            | 29,127           | 28,535            |
| Income from operations | 13,673           | 17,589            | 17,924           | 15,061            |
| Net income             | 1,527            | 3,090             | 5,130(3)         | 3,683(4)          |
|                        | 2005             |                   |                  |                   |
|                        | First<br>Quarter | Second<br>Quarter | Third<br>Quarter | Fourth<br>Quarter |
| Revenue                | \$ 169,516       | \$ 181,800        | \$ 181,286       | \$ 174,308        |
| Gross profit (1)       | 22,930           | 27,280            | 28,716           | 24,140            |
| Income from operations | 11,576           | (932)             | 18,016           | 12,722            |
| Net income (loss)      | 873              | (11,354)(2)       | 5,262            | 876               |

- (1) Gross profit is defined as total revenues less cost of sales, restaurant wages and related expenses, restaurant rent expense, other restaurant operating expenses, advertising expense and depreciation expense allocated to the Company's restaurants.
- (2) In the second quarter of 2005, the Company recorded stock-based compensation expense of \$16.4 million in connection with stock awards issued in the second quarter of 2005 (See Note 12).
- (3) In the third quarter of 2006, the Company recorded \$1.4 million of other income related to a reduction of exit cost reserves (See Note 5).
- (4) In the fourth quarter of 2006, the Company recorded \$1.4 million of other income related to a lease termination gain (See Note 9).

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## CARROLS CORPORATION AND SUBSIDIARIES

## SCHEDULE II VALUATION AND QUALIFYING ACCOUNTS

Years Ended December 31, 2006, 2005 and 2004

(in thousands of dollars)

| Column A                                       | Column<br>B | Col. C   |            | Col. D        | Col. E  |
|--|-------------|----------|------------|---------------|---------|
| Description                                    | Balance at  | Charged  | Charged    | Deductions    | Balance |
| Year ended December 31, 2006:                  | Beginning   | to Costs | to other   |               | at End  |
| Year ended December 31, 2005:                  | of Period   | and      | accounts   | of Period     | of      |
| Year ended December 31, 2004:                  | Expenses    | Expenses | Deductions | of Period     | of      |
| Reserve for note receivable                    | \$ 1,094    | \$       | \$         | \$ (1,094)(a) | \$      |
| Deferred income tax valuation allowance        | 1,119       | (97)     |            |               | 1,022   |
| Year ended December 31, 2005:                  |             |          |            |               |         |
| Reserve for doubtful trade accounts receivable | \$ 81       | \$       | \$         | \$ (81)(b)    | \$      |
| Reserve for note receivable                    | 1,159       |          |            | (65)(a)       | 1,094   |
| Deferred income tax valuation allowance        |             | 1,119(c) |            |               | 1,119   |
| Year ended December 31, 2004:                  |             |          |            |               |         |
| Reserve for doubtful trade accounts receivable | \$ 94       | \$       | \$         | \$ (13)(b)    | \$ 81   |
| Reserve for note receivable                    | 1,184       |          |            | (25)(a)       | 1,159   |

(a) Represents payments received on this fully reserved note. (See Note 5 to the consolidated financial statements)

(b) Represents write-offs of accounts.

(c) Represents the establishment of a valuation allowance on certain deferred tax assets.

**Table of Contents****SIGNATURES**

Pursuant to the requirements of Section 13 or 15 (d) of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized on the 22<sup>nd</sup> day of March 2007.

CARROLS RESTAURANT GROUP, INC.

By: /s/ ALAN VITULI  
Alan Vituli,

**Chairman of the Board and**

**Chief Executive Officer**

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

| <b>Signature</b>                                      | <b>Title</b>  | <b>Date</b>    |
|---|---|----------------|
| /s/ ALAN VITULI<br><b>Alan Vituli</b>                 | Director, Chairman of the Board and Chief Executive Officer | March 22, 2007 |
| /s/ DANIEL T. ACCORDINO<br><b>Daniel T. Accordino</b> | President, Chief Operating Officer and Director             | March 22, 2007 |
| /s/ PAUL R. FLANDERS<br><b>Paul R. Flanders</b>       | Vice President Chief Financial Officer and Treasurer        | March 22, 2007 |
| /s/ TIMOTHY J. LALONDE<br><b>Timothy J. LaLonde</b>   | Vice President Controller                                   | March 22, 2007 |
| /s/ JACK A. SMITH<br><b>Jack A. Smith</b>             | Director  | March 22, 2007 |
| /s/ ROBIN P. SELATI<br><b>Robin P. Selati</b>         | Director  | March 22, 2007 |
| /s/ CLAYTON E. WILHITE<br><b>Clayton E. Wilhite</b>   | Director  | March 22, 2007 |
| /s/ JOEL M. HANDEL<br><b>Joel M. Handel</b>           | Director  | March 22, 2007 |

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/s/ OLASENI ADEYEMI SONUGA

Director

March 22, 2007

**Olaseni Adeyemi Sonuga**



**Table of Contents****SIGNATURES**

Pursuant to the requirements of Section 13 or 15 (d) of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized on the 22nd day of March 2007.

CARROLS CORPORATION

By: /s/ ALAN VITULI  
Alan Vituli,

**Chairman of the Board and**

**Chief Executive Officer**

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

| <b>Signature</b>                                      | <b>Title</b>  | <b>Date</b>    |
|---|---|----------------|
| /s/ ALAN VITULI<br><b>Alan Vituli</b>                 | Director, Chairman of the Board and Chief Executive Officer | March 22, 2007 |
| /s/ DANIEL T. ACCORDINO<br><b>Daniel T. Accordino</b> | President, Chief Operating Officer and Director             | March 22, 2007 |
| /s/ PAUL R. FLANDERS<br><b>Paul R. Flanders</b>       | Vice President Chief Financial Officer and Treasurer        | March 22, 2007 |
| /s/ TIMOTHY J. LALONDE<br><b>Timothy J. LaLonde</b>   | Vice President Controller                                   | March 22, 2007 |
| /s/ JACK A. SMITH<br><b>Jack A. Smith</b>             | Director  | March 22, 2007 |
| /s/ ROBIN P. SELATI<br><b>Robin P. Selati</b>         | Director  | March 22, 2007 |
| /s/ CLAYTON E. WILHITE<br><b>Clayton E. Wilhite</b>   | Director  | March 22, 2007 |
| /s/ JOEL M. HANDEL<br><b>Joel M. Handel</b>           | Director  | March 22, 2007 |

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/s/ OLASENI ADEYEMI SONUGA

Director

March 22, 2007

**Olaseni Adeyemi Sonuga**