

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

FORM 10-Q  
(Mark One)

QUARTERLY REPORT UNDER SECTION 13 OR 15(d)  
OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended October 2, 2011

TRANSITION REPORT UNDER SECTION 13 OR 15(d)  
OF THE EXCHANGE ACT

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

Commission File Number: 333-136167

**UFOOD RESTAURANT GROUP, INC.**  
(Exact name of registrant as specified in its charter)

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

**20-4463582**  
(I.R.S. Employer Identification No.)

**255 Washington Street, Suite 150**  
**Newton, MA 02458**  
(Address of principal executive offices)

**(617) 787-6000**  
(Registrant's telephone number, including area code)

Indicate by check mark whether the issuer (1) filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes  No

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

Large accelerated filer   
Non-accelerated filer  (Do not check if a smaller reporting company)

Accelerated filer   
Smaller reporting company

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes  No

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

Yes  No

As of November 15, 2011, there were 48,269,598 shares of the Registrant's common stock, par value \$0.001 per share, issued and outstanding.

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## PART I – FINANCIAL INFORMATION

### Item 1. Financial Statements

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UFOOD RESTAURANT GROUP, INC. AND SUBSIDIARY

Consolidated Balance Sheets  
October 2, 2011 and January 2, 2011

Assets

	<u>October 2, 2011</u>	<u>January 2, 2011</u>
	(unaudited)	(audited restated)
<b>Current assets:</b>		
Cash and cash equivalents	\$ 793,665	\$ 2,797,452
Restricted cash	40,129	40,041
Accounts receivable, net	27,908	8,334
Inventories	114,221	118,324
Prepaid expenses and other current assets	100,722	78,310
	<u>1,076,645</u>	<u>3,042,461</u>
<b>Property and equipment:</b>		
Equipment	1,100,031	1,006,238
Furniture and fixtures	303,570	210,251
Leasehold improvements	1,745,542	1,722,654
Website development costs	69,485	27,050
Total property and equipment	3,218,628	2,966,193
Accumulated depreciation and amortization	<u>2,135,429</u>	<u>1,863,148</u>
Net fixed assets	<u>1,083,199</u>	<u>1,103,045</u>
<b>Other assets:</b>		
Investment in APG JV, LLC	510	--
Deferred financing costs, net	3,083	7,717
Goodwill	75,363	75,363
Other	82,128	84,382
	<u>161,084</u>	<u>167,462</u>
<b>Total assets</b>	<u>\$ 2,320,928</u>	<u>\$ 4,312,968</u>

See accompanying notes.

UFOOD RESTAURANT GROUP, INC. AND SUBSIDIARY

Consolidated Balance Sheets  
October 2, 2011 and January 2, 2011

Liabilities and Stockholders' Equity (Deficit)

	<u>October 2, 2011</u>	<u>January 2, 2011</u>
	(unaudited)	(audited restated)
<b>Current liabilities:</b>		
Current portion of long-term debt	\$ 450,000	\$ 450,000
Current portion of capital lease obligations	13,117	27,496
Accounts payable	368,330	279,102
Franchisee deposits	122,500	80,000
Accrued dividends	690,456	225,779
Accrued expenses and other current liabilities	<u>169,577</u>	<u>165,632</u>
Total current liabilities	<u>1,813,980</u>	<u>1,228,009</u>
<b>Long-term liabilities:</b>		
Long-term debt	82,323	62,120
Warrant liability	388,798	1,451,669
Capital lease obligations, net of current portion	7,923	17,844
Other noncurrent liabilities	<u>75,956</u>	<u>83,716</u>
	<u>555,000</u>	<u>1,615,349</u>
Total liabilities	<u>2,368,980</u>	<u>2,843,358</u>
<b>Commitments and contingencies</b>		
<b>Stockholders' equity (deficit):</b>		
Preferred stock, \$0.001 par value, 10,000,000 shares authorized, Series "A" 51,925 and 56,925 shares issued and outstanding at October 2, 2011 and January 2, 2011 respectively.	52	57
Series "B" 33,785 and 39,400 shares issued and outstanding at October 2, 2011 and January 2, 2011 respectively.	34	39
Common stock, \$0.001 par value, 300,000,000 shares authorized, 47,640,810 and 40,487,294 shares issued and outstanding at October 2, 2011 and January 2, 2011 respectively.	47,641	40,487
Additional paid-in capital	43,455,378	42,845,625
Accumulated deficit	<u>(43,551,157)</u>	<u>(41,416,598)</u>
Total stockholders' equity (deficit)	<u>(48,052)</u>	<u>1,469,610</u>
<b>Total liabilities and stockholders' equity (deficit)</b>	<u><u>\$ 2,320,928</u></u>	<u><u>\$ 4,312,968</u></u>

See accompanying notes.

UFOOD RESTAURANT GROUP, INC. AND SUBSIDIARY

Consolidated Statements of Operations - Unaudited  
For the Three and Six Month Periods Ended October 2, 2011 and September 26, 2010

	Three Months Ended		Nine months Ended	
	October 2, 2011	September 26, 2010	October 2, 2011	September 26, 2010
<b>Revenues:</b>				
Store sales	\$ 1,057,986	\$ 1,178,874	\$ 3,044,199	\$ 3,447,118
Franchise royalties and fees	48,789	101,055	141,766	208,819
Other revenue	--	--	2,903	22,298
	<u>1,106,775</u>	<u>1,279,929</u>	<u>3,188,868</u>	<u>3,678,235</u>
<b>Costs and expenses:</b>				
Store operating expenses:				
Food and paper costs	343,408	356,628	945,409	1,016,192
Cost of nutritional products	65,908	70,787	214,662	255,140
Labor	333,222	332,455	951,182	957,840
Occupancy	112,996	74,847	329,700	309,571
Other store operating expenses	167,971	153,663	460,135	497,806
General and administrative expenses	667,240	2,104,249	2,490,645	3,760,979
Advertising, marketing and promotion expenses	38,753	44,472	157,246	158,345
Depreciation and amortization	91,060	80,636	272,281	244,711
Loss on disposal of assets	--	25,782	--	25,782
Total costs and expenses	<u>1,820,558</u>	<u>3,243,519</u>	<u>5,821,260</u>	<u>7,226,366</u>
Operating loss	<u>(713,783)</u>	<u>(1,963,590)</u>	<u>(2,632,392)</u>	<u>(3,548,131)</u>
<b>Other income (expense):</b>				
Interest income	858	672	4,803	4,829
Interest expense	(12,701)	(408,434)	(35,116)	(1,192,473)
Other income(expense)	253,479	(1,969,761)	1,062,871	(2,191,846)
Other income (expense), net	<u>241,636</u>	<u>(2,377,523)</u>	<u>1,032,558</u>	<u>(3,379,490)</u>
Loss before income taxes	(472,147)	(4,341,113)	(1,599,834)	(6,927,621)
Income taxes	<u>—</u>	<u>—</u>	<u>—</u>	<u>—</u>
Net loss	\$ (472,147)	\$ (4,341,113)	\$ (1,599,834)	\$ (6,927,621)
Dividends on preferred stock	<u>(168,420)</u>	<u>(19,778)</u>	<u>(534,724)</u>	<u>(19,778)</u>
Net loss attributable to common stockholders	\$ (640,567)	\$ (4,360,891)	\$ (2,134,559)	\$ (6,947,399)
Weighted average number of shares outstanding-basic and diluted				
	45,461,761	40,014,225	42,619,229	39,039,355
Basic and diluted loss per share	<u>\$ (0.01)</u>	<u>\$ (0.11)</u>	<u>\$ (0.05)</u>	<u>\$ (0.18)</u>

See accompanying notes.

UFOOD RESTAURANT GROUP, INC. AND SUBSIDIARY

Consolidated Statements of Cash Flows - Unaudited  
For the Nine months Ended October 2, 2011 and September 26, 2010

	Nine months Ended	
	October 2, 2011	September 26, 2010
<b>Cash flows from operating activities:</b>		
Net loss	\$ (1,599,834)	\$ (6,927,621)
<b>Adjustments to reconcile net loss to net cash used in operating activities:</b>		
Depreciation and amortization	272,281	244,711
Amortization of the beneficial conversion feature	20,203	569,090
Deferred financing costs	4,634	257,263
Provision for doubtful accounts	--	(66,322)
Stock-based compensation	406,717	853,083
Change in fair value of warrant liability	(1,062,871)	2,191,846
Loss on disposal of assets	--	25,782
Non-cash promotion expenses	149,592	1,178,545
Non-cash interest payments	--	312,884
<b>Increase (decrease) in cash from changes in assets and liabilities:</b>		
Accounts receivable	(19,574)	224,247
Inventories	4,103	(21,464)
Prepaid expenses and other current assets	(22,413)	46,798
Other assets and noncurrent liabilities	2,254	2,779
Accounts payable	89,228	64,236
Franchisee deposits	42,500	(46,079)
Accrued expenses and other current and non-current liabilities	(3,814)	(149,611)
<b>Net cash used in operating activities</b>	<b>(1,716,994)</b>	<b>(1,239,833)</b>
<b>Cash flows from investing activities:</b>		
Acquisition of property and equipment	(252,435)	(70,700)
Investment in APG JV, LLC	(510)	--
<b>Net cash used in investing activities</b>	<b>(252,945)</b>	<b>(70,700)</b>
<b>Cash flows from financing activities:</b>		
Proceeds from issuance of common stock, net	--	53,846
Payments for financing costs	(9,461)	(69,881)
Payments on long-term debt	--	(407,882)
Payments on capital lease obligations	(24,299)	(46,221)
(Increase) decrease in restricted cash	(88)	20,384
<b>Net cash used in financing activities</b>	<b>(33,848)</b>	<b>(449,754)</b>
Decrease in cash and cash equivalents	(2,003,787)	(1,760,287)
Cash and cash equivalents – beginning of year	2,797,452	2,278,427
<b>Cash and cash equivalents – end of period</b>	<b>\$ 793,665</b>	<b>\$ 518,140</b>

See accompanied notes.

**UFOOD RESTAURANT GROUP, INC.  
and SUBSIDIARY**  
Consolidated Statements of Changes in Stockholders' Equity (Deficit)  
For the nine months ended October 2, 2011

	Preferred Stock		Common Stock		Additional Paid-in Capital	Accumulated Deficit	Total
	Shares	Value	Shares	Value			
<b>Balance, January 2, 2011, restated</b>	96,325	\$ 96	40,487,294	\$ 40,487	\$ 42,845,625	\$ (41,416,598)	\$ 1,469,610
Conversion of Preferred Stock Series "A" into common stock	(5,000)	(5)	3,846,154	3,846	(3,841)	—	—
Conversion of Preferred Stock Series "B" into common stock	(5,615)	(6)	2,441,304	2,441	(2,436)	—	—
Common stock issued for consulting, marketing & promotional services	—	—	469,711	470	82,370	—	82,840
Common stock-based compensation for consulting, marketing and promotional expenses	—	—	—	—	66,752	—	66,752
Common stock-based compensation	—	—	—	—	406,717	—	406,717
Payments for financing costs	—	—	—	—	(9,461)	—	(9,461)
Payment of dividends to preferred stock converted into common stock	—	—	396,347	396	69,652	—	70,048
Dividends on preferred stock	—	—	—	—	—	(534,724)	(534,724)
Net loss for the nine months ended October 2, 2011	—	—	—	—	—	(1,599,834)	(1,599,834)
<b>Balance, October 2, 2011</b>	<u>85,710</u>	<u>\$ 86</u>	<u>47,640,810</u>	<u>\$ 47,641</u>	<u>\$ 43,455,378</u>	<u>\$ (43,551,157)</u>	<u>\$ (48,052)</u>

See accompanied notes.

UFOOD RESTAURANT GROUP, INC.  
Notes to Consolidated Financial Statements - Unaudited

**1. Nature of Operations and Basis of Presentation**

*Nature of Operations*

UFood Restaurant Group, Inc. was incorporated in the State of Nevada on February 8, 2006 as Axxent Media Corp. Prior to December 18, 2007, UFood was a development stage company headquartered in Vancouver, Canada. As Axxent Media Corp., the Company's business was to obtain reproduction and distribution rights to foreign films within North America and also to obtain the foreign rights to North American films for reproduction and distribution to foreign countries. On August 8, 2007, the Company changed its name to UFood Franchise Company, Inc., and on September 25, 2007, changed its name to UFood Restaurant Group, Inc. (UFood or the Company). Following the Merger described below, the Company abandoned its former plans with respect to film reproduction and distribution rights.

On December 18, 2007, (the Merger Date) pursuant to the terms of an Agreement and Plan of Merger and Reorganization, a wholly-owned subsidiary of the Company merged with and into KnowFat Franchise Company, Inc. (KnowFat). Following the merger (the Merger), UFood continued KnowFat's business operations as a franchisor and operator of fast-casual food service restaurants that capitalize on consumer demands for great tasting food with healthy attributes. On the Merger Date, each share of KnowFat common stock issued and outstanding immediately prior to the Merger was exchanged for 1.52350763 shares of UFood Common Stock. All share amounts have been adjusted to reflect the effect of the share exchange. As of October 2, 2011, the Company's operations consisted of four Company-owned restaurants and four franchisee owned restaurants.

*Basis of Presentation*

The accompanying consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information and with the rules and regulations of the Securities and Exchange Commission. They include the activity and balances of UFood and its subsidiaries but do not include all of the information and footnotes required by accounting principles generally accepted in the United States for complete financial statements. The interim consolidated financial statements are unaudited; however, they include all normal recurring accruals and adjustments that, in the opinion of management, are necessary to present fairly UFood's financial position at October 2, 2011, and the results of its operations and cash flows for the fiscal quarters ended October 2, 2011 and September 26, 2010. The results of operations for the three and nine months ended October 2, 2011 are not necessarily indicative of the results to be expected for future quarters or the full year. The interim consolidated financial statements should be read in conjunction with the audited consolidated financial statements and footnotes thereto for the fiscal year ended January 2, 2011 included in the Company's Annual Report as amended by Form 10-K/A filed on May 18, 2011.

As shown in the accompanying consolidated financial statements, the Company has incurred recurring net losses and negative cash flows from operations. Over the past few years, the Company's operations have been funded through a combination of private equity and debt financing. As of October 2, 2011, the Company had approximately \$794,000 of unrestricted cash. The Company is currently in the process of trying to raise additional equity capital necessary to enable the Company to meet its obligations as they become due without substantial disposition of assets outside the ordinary course of business, restructuring of debt, externally forced revisions of its operations, or similar actions. The accompanying consolidated financial statements do not include any adjustments that might be necessary if the Company is unable to continue as a going concern. The Company is subject to a number of risks similar to those of other companies in its industry, including dependence on key individuals, competition from substitute products, the successful attraction of franchisees, and the ability to obtain adequate additional financing necessary to fund continuing operations.

**2. Summary of Significant Accounting Policies**

*Fiscal Quarters*

In 2011, our fiscal quarters end on April 3<sup>rd</sup>, July 3<sup>rd</sup>, October 2<sup>nd</sup> of 2011, and January 1<sup>st</sup>, 2012. In 2010, our fiscal quarters ended on March 28<sup>th</sup>, June 27<sup>th</sup>, September 26<sup>th</sup>, 2010 and January 2<sup>nd</sup>, 2011.

### *Principles of Consolidation*

The consolidated financial statements include the assets, liabilities and results of operations of UFood Restaurant Group, Inc. and its subsidiaries. All significant intercompany balances and transactions have been eliminated.

### *Use of Estimates*

The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amount of revenues and expenses during the reporting period. Actual amounts could differ from those estimates.

### *Reclassifications*

Certain reclassifications have been made to conform previously reported data to the current presentation.

### *Investments in Companies Accounted for using the Equity Method*

The Company's invest in APG JV, LLC (see Note 6) is accounted for by the equity method as a result of the ownership percentage and/or the Company's ability to exercise significant influence over the operating and financial policies of the investee. Investments of this nature are recorded at original cost and adjusted periodically to recognize the Company's proportionate share of the investees' net income or losses after the date of the investment. When net losses from an investment accounted for under the equity method exceed its carrying amount, the investment balance is reduced to zero and additional losses are not provided for.

### *Deferred Financing Costs*

Deferred financing costs represent costs paid to third parties in order to obtain long-term financing and have been included in other assets. Deferred financing costs are amortized over the life of the related debt. Amortization expense related to these costs was \$4,634 and \$257,263 for the nine months ended October 2, 2011 and September 26, 2010, respectively, and is included in interest expense. The amortization expense recorded by the Company for the three months ended October 2, 2011 and September 26, 2010 was \$1,545 and \$83,435 respectively.

### *Valuation of Goodwill*

We account for goodwill and other intangible assets under ASC No. 805, *Business Combinations*, and ASC No. 350-20 to 30, *Goodwill and Other Intangible Assets*. ASC No. 805 requires that the purchase method of accounting be used for all business combinations initiated after June 30, 2001, and that certain intangible assets acquired in a business combination be recognized as assets apart from goodwill. Under ASC No. 350-20 to 30, purchased goodwill and intangible assets with indefinite lives are not amortized, but instead tested for impairment at least annually or whenever events or changes in circumstances indicate the carrying value may not be recoverable. Goodwill attributable to our franchise operations segment is evaluated by comparing the Company's fair market value, determined based upon quoted market prices of the Company's equity securities, to the carrying amount of goodwill. Goodwill attributable to our store operations segment is evaluated on a restaurant-by-restaurant basis by comparing the restaurant's estimated fair value to the carrying value of the restaurant's underlying net assets inclusive of goodwill. Fair value is determined based upon the restaurant's estimated future cash flows. Future cash flows are estimated based upon a restaurant's historical operating performance and management's estimates of future revenues and expenses over the period of time that the Company expects to operate the restaurant, which generally coincides with the initial term of the restaurant's lease but which may take into account the restaurant's first lease renewal period up to 5 years. The estimate of a restaurant's future cash flows may also include an estimate of the restaurant's terminal value, determined by applying a capitalization rate to the restaurant's estimated cash flows during the last year of the forecast period. The capitalization rate used by the Company was determined based upon the restaurant's location, cash flows and growth prospects. As of the first day of the fourth quarter of the year ended January 2, 2011 according to our policy we have tested the carrying value of the Goodwill attributable to our store operations and no impairment was necessary. The carrying amount of goodwill may be impaired in the future if our actual operating results and cash flows fall short of our expectations.

### *Impairment of Long-Lived Assets*

In accordance with ASC No. 360 *Property, Plant and Equipment*, when impairment indicators exist, the Company evaluates its long-lived assets for potential impairment. Potential impairment is assessed when there is evidence that events or changes in circumstances have occurred that indicate the carrying amount of an asset may not be recovered. When events or changes in circumstances have occurred that indicate a long-lived asset may be impaired, the Company uses estimates of future cash flows on a restaurant-by-restaurant basis to test the recoverability of its long-lived assets. Future cash flows are estimated based upon the restaurant's historical operating performance and management's projections of future revenues and expenses and may take into account the restaurant's estimated terminal value. Long-lived assets may be impaired in the future if our actual operating results and cash flows fall short of our expectations.

#### *Revenue Recognition*

The Company records revenue for Company-owned store sales upon the delivery of the related food and other products to the customer. The Company records a liability in the period in which a gift card is issued and proceeds are received. As gift cards are redeemed, this liability is reduced and revenue is recognized.

The Company follows the accounting guidance of ASC No. 952-605-25 and 952-340-25, *Franchisors*. Franchisee deposits represent advances on initial franchise fees prior to the opening of the franchisee location. We recognize initial franchise fee revenue when all material services we are required to perform and all material conditions we are required to satisfy have been substantially completed, which is generally the opening of the franchised location. The Company defers direct costs related to franchise sales until the related revenue is recognized; however, the deferred costs shall not exceed anticipated revenue less estimated additional related costs. Such costs include training, facilities design, menu planning and marketing. Franchise royalty revenues are recognized in the same period the relevant franchisee sales occur.

#### *Rent Expense*

The Company recognizes rent expense on a straight-line basis over the reasonably assured lease term as defined in ASC No. 840, *Leases*. The reasonably assured lease term on most of the Company's leases is the initial non-cancelable lease term, which generally equates to between 5 and 10 years. In addition, certain of the Company's lease agreements provide for scheduled rent increases during the lease terms or for rental payments commencing at a date other than the date of initial occupancy. The Company includes any rent escalations and other rent holidays in its determination of straight-line rent expense. Therefore, rent expense for new locations is charged to expense upon the commencement date of the lease.

#### *Earnings Per Share Data*

Earnings per share are based on the weighted average number of shares outstanding during the period after consideration of the dilutive effect, if any, for common stock equivalents, including stock options, restricted stock, and other stock-based compensation. Earnings per common share are computed in accordance with ASC No. 260, *Earnings Per Share*, which requires companies to present basic earnings per share and diluted earnings per share. Basic earnings per share are computed by dividing net income allocable to common stockholders by the weighted average number of shares of common stock outstanding during the year. Diluted earnings per common share are computed by dividing net income allocable to common stockholders by the weighted average number of shares of common stock outstanding and dilutive securities outstanding during the year.

#### *Fair Value of Financial Instruments*

The carrying amounts of the Company's financial instruments, which include cash and cash equivalents, accounts receivable, accounts payable and other accrued expenses and debt obligations approximate their fair values due to the short-term maturity of these instruments.

#### *Stock-Based Compensation*

The Company maintains two stock-based incentive plans. The Company grants options to purchase common stock at an option price equal to the market value of the stock at the date of grant. Options generally vest over a three year period beginning on the date of grant and have a ten year contractual term.

The Company applies the fair value recognition provisions of ASC No. 718, *Compensation-Stock Compensation*, which requires all stock-based compensation, including grants of employee stock options, to be recognized in the statement of operations based on their fair values. The Company uses the Black-Scholes option pricing model which requires extensive use of accounting

judgment and financial estimates, including estimates of the expected term participants will retain their vested stock options before exercising them and the estimated volatility of the Company's common stock price over the expected term.

Stock-based compensation expense recognized during the three months ended October 2, 2011 totaled approximately \$86,803 for stock options. Stock-based compensation expense recognized during the nine months ended October 2, 2011 totaled approximately \$406,716 for stock options. Stock-based compensation expense was included in general and administrative expenses in the accompanying Consolidated Statements of Operations.

### 3. Long Term Debt and Warrants

#### **2008 Investor Warrants**

On December 18 and 21, 2007, January 22, 2008, February 6, 2008, and March 30, 2008, the Company sold 5,720,000, 440,000, 863,000, 1,927,000, and 1,991,000 units (Units), respectively, of its securities at a price of \$1.00 per Unit, in connection with five separate closings (the Closings) of its private placement of securities (the Offering). Each Unit consists of one share of common stock of the Company, par value \$.001 per share (Common Stock), and a warrant to purchase one-half of one share of Common Stock (the 2008 Investor Warrants). A total of 5,470,500 2008 Investor Warrants were issued in conjunction with the closings.

The 2008 Investor Warrants provide for the purchase of shares of Common Stock for five years at an original exercise price of \$1.25 per share. The 2008 Investor Warrants, at the option of the holder, may be exercised by cash payment of the exercise price or by "cashless exercise" to the extent that a registration statement covering the shares of Common Stock underlying the 2008 Investor Warrants is not in effect following the one year anniversary of issuance. A "cashless exercise" means that in lieu of paying the aggregate purchase price for the shares being purchased upon exercise of the 2008 Investor Warrants in cash, the holder will forfeit a number of shares underlying the 2008 Investor Warrants with a "fair market value" equal to such aggregate exercise price. The Company will not receive additional proceeds to the extent that 2008 Investor Warrants are exercised by cashless exercise. As a result of the Company's recent private placement, the exercise price of the 2008 Investor Warrants was reduced to \$0.59 pursuant to the terms of such warrants.

The exercise price and number of shares of Common Stock issuable on exercise of the 2008 Investor Warrants may be adjusted in certain circumstances including in the event of a stock dividend, or our recapitalization, reorganization, merger or consolidation. The 2008 Investor Warrants are also subject to a weighted average price protection for the term of the 2008 Investor Warrants.

Through March of 2008, the Company paid the placement agent retained in connection with the Offering (the 2008 Placement Agent) a commission of 10% of the funds raised from the investors in connection with the Closings. In addition, the 2008 Placement Agent received warrants (the 2008 Placement Agent Warrants) to purchase a number of shares of Common Stock equal to 20% of the shares of Common Stock included in the Units sold to investors. As a result of the foregoing, the 2008 Placement Agent was paid commissions of \$1,294,100 and received warrants to purchase 2,988,200 shares of Common Stock. The terms of these warrants were similar to those of the 2008 Investor Warrants, except that they had a seven-year term and \$1.00 original exercise price. As a result of the Company's recent private placement, the exercise price of the 2008 Placement Agent Warrants was reduced to \$0.49 pursuant to the terms of such warrants.

The Company is subject to a derivative warrant liability instrument due to the fact that the related contract is not indexed to its own stock, as specified by ASC No. 815-40, *Derivatives and Hedging-Contracts in entity's Own Equity*. The derivative is accounted for and classified as a "warrant liability" within the liabilities section of the consolidated balance sheet. The change in the fair value of the derivative is included within "Other income (expenses)" in the consolidated statements of operations. The change in the fair value of the derivative instrument affects the "Change in fair value of warrant liability" line in the "Cash flows from operating activities" section of the consolidated statements of cash flows.

At the date of issuance of the 2008 Investor Warrants and 2008 Placement Agent Warrants, based upon evaluation under applicable ASC No. 815 Derivatives and Hedging guidance, the Company initially determined that the financial instrument did not constitute a derivative, and, accordingly, reflected the balance within additional paid-in capital as of December 28, 2008 in the Company's Form 10-K. During the fiscal quarter ended March 29, 2009, the Company re-assessed this categorization based upon the clarified "indexed to an entity's own stock" criteria specified within ASC No. 815-40, which was effective for fiscal years beginning after December 15, 2008, and concluded that the financial instrument constituted a derivative. The aggregate fair value of the derivative at inception was determined to be \$3,512,272, which was recorded as a derivative liability during the fiscal quarter ended March 29, 2009. At December 29, 2008, the aggregate fair value of the derivatives was \$353,248. The

decrease in the fair value of the derivative in the aggregate amount of \$3,159,024 upon adoption of ASC No. 815-40 was recorded in the consolidated statements of changes in stockholders' equity as a cumulative adjustment gain on derivative during the fiscal quarter ended March 29, 2009.

At October 2, 2011, the aggregate fair value of the derivative was \$388,798. The decrease in the fair value of the derivative was in the aggregate amount of \$253,479 and \$1,062,871 during the fiscal quarter and nine months ended October 2, 2011 respectively. The decrease in the fair value of the derivative was recorded in the consolidated statement of operations as other income(expense). As a result of the most recent financing during 2010 and pursuant to the terms of the 2008 Investor Warrants, the exercise price was changed to \$0.54 from \$0.59.

The derivative is not intended to hedge any specific risk exposures, such as fluctuating interest rates, exchange rates, commodity prices, etc. Therefore, the derivative constitutes neither a cash flow hedge, nor a fair value hedge. The volume of derivative activity relates solely to the derivative warrant liability instrument itself, and changes in fair value thereon.

Tabular disclosure of the fair value of the derivative instrument in the consolidated balance sheets, and the effect of the derivative instrument on the consolidated balance sheets follows:

	Liability Derivatives		
	Balance Sheet Location	Fair Value	
		As Of October 2, 2011	As of January 2, 2011
Derivatives designated as hedging instruments under ASC No. 815-10:			
None			
Derivatives not designated as hedging instruments under ASC No. 815-10:			
Derivative warrant liability	Long-term liabilities	\$388,798	\$1,451,669
Total derivatives		\$388,798	\$1,451,669

The effect of the derivative instrument on the consolidated statements of operations for the quarter and nine months ended October 2, 2011 and September 26, 2010 follows:

	Location of Gain (Loss) Recognized in Income on Derivative	Amount of Gain (Loss) Recognized in Income on Derivative			
		Fiscal quarter ended October 2, 2011	Fiscal quarter ended September 26, 2010	Nine months ended October 2, 2011	Nine months ended September 26, 2010
Derivatives not designated as hedging instruments under ASC No. 815-10:					
Derivative warrant liability	Other Income (Expense)	\$253,479	\$(1,969,761)	\$1,062,871	\$(2,191,846)
Total		\$253,479	\$(1,969,761)	\$1,062,871	\$(2,191,846)

The fair value of the warrant liability was determined using the Black Scholes Option Pricing method. The valuation methodology uses a combination of observable (Level 2) and unobservable (Level 3) inputs in calculating fair value. As required by ASC 820, assets are classified in their entirety based on the lowest level of input that is significant to the fair value measurement.

The fair value of the warrant liability was estimated on the date of issuance, as of January 2, 2011, and as of October 2, 2011,

using the following assumptions:

	At Issuance	January 2, 2011	October 2, 2011
Expected term (years)	5 - 7 Years	2 - 4 Years	1 - 3 Years
Expected volatility	32.34%	156.3%	121.22%
Risk-free interest rate	2.46%	0.61%	0.13%
Expected annual dividend	0.00%	0.00%	0.00%

The table below sets forth a summary of changes in the fair value of the Company's level 3 derivative at December 29, 2008, and for the nine months ended October 2, 2011:

Balance as of December 29, 2008	\$ --
Fair Value of warrant liability at issuance	3,512,272
Decrease in fair value at December 29, 2008	(3,159,024)
Decrease in fair value at December 27, 2009	(349,498)
Increase in fair value at January 2, 2011	1,447,919
Decrease in fair value during quarter ended April 3, 2011	(318,405)
Decrease in fair value during quarter ended July 3, 2011	(490,987)
Decrease in fair value during quarter ended October 2, 2011	(253,479)
Balance as of October 2, 2011	\$ 388,798

### **2009 Warrants**

On March 19, 2009, the Company sold 8% Senior Secured Convertible Debentures (the Debentures) to investors in the principal amount of \$3,315,000 and issued warrants (the 2009 Warrants and, collectively with the Debentures, the Securities) to purchase 12,750,000 shares of our Common Stock to such investors in connection with the first closing of our private placement of securities (the 2009 Offering). On April 20, 2009, the Company sold an additional \$2,559,000 of Debentures in connection with the final closing of its private offering to accredited investors. The addition of both closings is \$5,874,000 of Debentures. The Debentures bore interest at a rate of 8% and are due three years from the date they are issued. The Debentures were convertible into shares of Common Stock at \$0.13 per share. In addition, each investor will received 5-year detachable warrants to purchase a number of shares of Common Stock equal to 50% of the shares underlying the Investor's Debenture. Interest on the Debentures a rate of 8% per annum was payable on a quarterly basis. Subject to certain conditions, the Company had the right to pay interest on the Debentures in either cash or shares of Common Stock, or in a combination of cash and Common Stock. After the one year anniversary of the first closing of the 2009 Offering, the Company has the right to redeem the Debentures at a 20% premium, subject to certain conditions. Subject to certain conditions, the Company has the right to force conversion of the Debentures into shares of Common Stock. The Company has filed a registration statement with the Securities and Exchange Commission covering all shares of Common Stock issuable upon conversion of the Debentures and/or exercise of the 2009 Warrants.

The Company paid Garden State Securities, Inc., the placement agent retained in connection with the 2009 Offering (the 2009 Placement Agent), (i) a commission of 10% of the aggregate subscription amount of the Securities sold in the 2009 Offering, plus (ii) \$50,000 for its legal fees and expenses, plus (iii) a non-accountable expense allowance equal to 3% of the aggregate subscription amount of the Securities sold in the 2009 Offering. In addition, the 2009 Placement Agent (or its assigns) received warrants (the 2009 Placement Agent Warrants) to purchase a number of shares of Common Stock equal to twenty percent (20%) of the maximum number of shares of Common Stock underlying the Debentures and 2009 Warrants sold in the 2009 Offering. As a result of the foregoing, the 2009 Placement Agent was paid a commission of \$587,400 plus a non-accountable expense allowance of \$176,220 and received warrants to purchase 5,100,000 shares of Common Stock for March 2009 first closing, and 3,936,923 for April 2009 second and final closing in connection with the 2009 Offering. The terms of these warrants were similar to those of the 2009 Warrants.

In conjunction with the Debentures and the 2009 Warrants, the Company recorded a debt discount of \$3,130,200 associated with a beneficial conversion feature on the debt, which is being accreted using the effective interest method over the three year term of the debentures. Since the inception of the Debentures through the first fiscal quarter of 2011 ended on April 3, 2011 the Company has recorded interest expense of \$3,090,379 in connection with the debt discount on the warrants and the beneficial conversion feature. Of the \$3,130,200 in debt discount, \$571,200 had an effective interest rate of 15.18%, and

\$2,559,000 had an effective interest rate of 82.97%. The Company has undergone additional financing in order to fund future working capital requirements.

Since the issuance of the debentures through September 30, 2010, debentures holders converted their debentures into common stock in the amount of \$74,000. On October 1, 2010, the Company consummated the cancellation of ninety-eight percent (98%) of its outstanding 8% Senior Secured Convertible Debentures (the "Debentures") in exchange (the "Debenture Exchange") for shares of the Company Series A 8% Convertible Preferred Stock (the "Series A Preferred Stock"). An aggregate principal amount of \$5,692,500 of outstanding Debentures was cancelled in exchange for 56,925 shares of Series A Preferred Stock.

Effective immediately with respect to one-half of the shares of Series A Preferred Stock issued in connection with the Debenture Exchange, and effective January 1, 2011 with respect to the remaining shares of Series A Preferred Stock issued in connection with the Debenture Exchange, each holder of Series A Preferred Stock may convert his, her or its shares of Series A Preferred Stock into shares of Common Stock at a conversion price equal to \$0.13 ("Series A Conversion Price"). The number of shares of the common stock into which the Series A Preferred Stock is currently convertible is 39,942,308. However, the number of shares of Common Stock into which the Series A Preferred Stock is convertible is subject to adjustment to prevent dilution in the event of a stock split or stock dividend. The Series A Conversion Price is also subject to a weighted average price protection. Effective January 1, 2011, the Company may, at its election, require the conversion of the Series A Preferred Stock to shares of Common Stock at the Series A Conversion Price if the closing price of the Common Stock for 10 consecutive trading days equals or exceeds 300% of the Series A Conversion Price and the average daily volume of the shares of Common Stock for the same period exceeds 250,000 shares. The terms of the Series A Preferred Stock are more fully set forth in the Certificate of Designation attached hereto as Exhibit 3.2 and incorporated herein by reference.

In order to induce the conversion and extinguishment of debt, the exercise price of the Common Stock Purchase Warrants issued to the investors in connection with their Debentures was reduced from \$0.14 to \$0.09 per share of Common Stock, and the termination date of the Common Stock Purchase Warrants was extended to the six year anniversary of the initial exercise dates of the warrants. In addition, the Common Stock Purchase Warrants were modified so that such warrants are not exercisable until the one year anniversary of the closing of the Debenture Exchange.

#### **4. Stock-Based Compensation**

The Company has two share-based, shareholder approved employee compensation plans, the KnowFat 2004 Stock Option Plan (the 2004 Plan) and the UFood 2007 Equity Incentive Plan (the 2007 Plan, and together with the 2004 Plan, the Equity Plans), which are described below.

The Company estimates the fair value of stock options using a Black Scholes option pricing model. Key inputs used to estimate the fair value of stock options include the exercise price of the award, the expected option term, the expected volatility of the Company's stock over the option's expected term, the risk-free interest rate over the option's expected term, and the Company's expected annual dividend yield.

##### *The 2004 Plan*

Under the terms of the 2004 Plan, the Company was authorized to grant incentive stock options (ISO's), non-qualified stock options and restricted stock for up to 32,757 shares of common stock in the aggregate, to employees, officers, directors, consultants and agents of the Company. The Company believes that such awards align the interests of its employees with those of its shareholders. In general, stock option awards under the 2004 Plan are granted with an exercise price equal to the fair value of the Company's stock at the date of grant, vest over a three-year period and expire ten years from the date of grant. As a result of the Merger, no awards will be made under the 2004 Plan after December 18, 2007.

##### *The 2007 Plan*

There were no awards under the 2007 Plan prior to December 18, 2007. Awards of ISO's, non-qualified stock options, stock appreciation rights, restricted stock units, restricted stock or performance units may be made under the 2007 Plan of up to a maximum of 9,000,000 shares of Common Stock to employees, directors, consultants and agents of the Company. The Company believes awards under the 2007 Plan align the interests of its employees with those of its shareholders. On April 1<sup>st</sup>, 2010 the

Company's Board of Directors approved the grant of 2,070,000 options to purchase shares of the Company's common stock to Officers and employees, fully vested at grant. At October 2, 2011, there were 5,711,849 stock options outstanding under the 2007 Plan. At October 2, 2011, options to purchase 5,711,849 shares of Common Stock were exercisable at a weighted average exercise price of \$0.19.

Activity under the 2007 Plan for the nine months ended October 2, 2011 is presented below:

	Number of Options	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term	Aggregate Intrinsic Value
Outstanding at January 2, 2011	5,884,990	\$ 0.19	7.9	\$ --
Granted	—	-	-	-
Exercised	—	-	-	-
Forfeited	(173,141)			
Outstanding at October 2, 2011	<u>5,711,849</u>	<u>\$ 0.19</u>	<u>7.2</u>	<u>\$ --</u>
Exercisable at October 2, 2011	<u>5,711,849</u>	<u>\$ 0.19</u>	<u>7.2</u>	<u>\$ --</u>

At October 2, 2011 there were 3,288,151 options available for grant under the 2007 Plan. The aggregate intrinsic value in the table above represents the total intrinsic value, based on the Company's closing stock price of \$0.12 as of October 2, 2011 which would have been received by the options holders had all option holders exercise their options as of that date.

#### *Other Equity Awards*

On April 1<sup>st</sup>, 2010 the Company's Board of Directors approved the grant of non-qualified stock options to purchase 600,000 shares of the Company's common stock with an exercise price of \$0.19 and a vesting schedule of equal amounts over the next four months to Mr. Richard Fisher. This grant was pursuant to the terms of his consulting agreement with the Company. As a result of this grant the Company recognized an expense of \$39,853.

Also on June 12, 2010, the Board of Directors approved the grant of 10,000 Series "B" Preferred Shares to Summit Trading Limited according to its service agreement to provide investor relations and public relations services to the Company. These preferred shares were fully vested at the execution of the agreement. The face value of the preferred shares is \$100 per share and the conversion price to common stock is \$0.23. Pursuant to Section 3 of the Agreement, the Company terminated the agreement on December 8, 2010 which such cancellation reduced the number of preferred shares to be issued by one-half to 5,000 shares. As a result of this grant, the Company recorded an expense of \$500,000 of stock-based compensation expense. The Board of Directors have agreed to reinstate the Summit Trading Limited service agreement with a covenant of performance of 60 days after the Investor Relations campaign begins in November.

On June 30<sup>th</sup>, 2010 the Company's Board of Directors awarded to its vendors, executives, Board of Directors and employees, non-qualified stock options to purchase 7,703,673 shares of the Company's common stock with an exercise price of \$0.19. The vesting schedule varies from one year through three years. As a result of this grant, the Company will recognize an expense in the total amount of \$1,519,255 over the vesting period. At October 2, 2011 there was \$395,498 of total unrecognized compensation cost related to non-vested options granted outside of any Plan. This cost will be recognized over approximately 27 months.

On November 17, 2010 the Company's Board of Directors awarded to Jeffrey Bonasia, a marketing consultant, non-qualified stock options to purchase 250,000 shares of the Company's common stock with an exercise price of \$0.27. The vesting schedule is over a five month period pursuant to his consulting agreement with the Company. The Company recognized an expense in the total amount of \$55,631 over the vesting period.

On April 27, 2011 the Company's Board of Directors awarded the following grants:

<u>Name</u>	<u>Type</u>	<u>Number of Shares</u>	<u>Exercise Price</u>	<u>Termination</u>	<u>Vesting Schedule</u>
Charles Yelen	Warrant	10,000	\$0.16	5 years from the date of grant	All shares vest upon date of grant
Charles Yelen	Warrant	10,000 to be granted upon the opening of each of three stores	Market closing price at grant	5 years from the date of grant	All shares vest upon date of grant
Charles Yelen	Warrant	2,000 to be granted upon the opening of each of store after the third store	Market closing price at grant	5 years from the date of grant	All shares vest upon date of grant
Jeffrey Bonasia	Non-Qualified stock options	500,000	\$0.16	5 years from the date of grant	Equal monthly amounts for 24 months following the date of the grant.
Health Corp	Shares of common stock	20,000	None	None	None
MK3	Non-qualified stock options	69,625	\$0.16	10 years from the date of grant	All shares vest upon date of the grant
John Howell	Non-qualified stock options	25,000	\$0.16	5 years from the date of grant	Equal monthly amounts for 12 months following the date of the grant.
Raymund c. King	Non-qualified stock options	25,000	\$0.16	5 years from the date of grant	Equal monthly amounts for 12 months following the date of the grant
Paul W. Essex	Non-qualified stock options	25,000	\$0.16	5 years from the date of grant	Equal monthly amounts for 12 months following the date of the grant.
William A. Chatfield	Non-qualified stock options	25,000	\$0.16	5 years from the date of grant	Equal monthly amounts for 12 months following the date of the grant.
William J. Blalock	Non-qualified stock options	25,000	\$0.16	5 years from the date of grant	Equal monthly amounts for 12 months following the date of the grant.
Mark R. Milliken	Non-qualified stock options	25,000	\$0.16	5 years from the date of grant	Equal monthly amounts for 12 months following the date of the grant.
Stacey Bell	Non-qualified stock options	25,000	\$0.16	5 years from the date of grant	Equal monthly amounts for 12 months following the date of the grant.

Activity of Non-Qualified Stock Options outside of any plan from January 2, 2011 through October 2, 2011 is presented below:

	<u>Number of Options</u>	<u>Weighted Average Exercise Price</u>	<u>Weighted Average Remaining Contractual Term</u>	<u>Aggregate Intrinsic Value</u>
Outstanding at January 2, 2011	8,728,673	\$ 0.19	9.2	\$ 245,993
Granted	744,625	0.16	—	
Forfeited	(174,000)	0.19	—	
Outstanding at October 2, 2011	<u>9,299,298</u>	<u>\$ 0.19</u>	<u>7.4</u>	<u>\$ -0-</u>

Exercisable at October 2, 2011	6,775,815	\$	0.19	7.4	\$	-0-
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## 5. Capital Stock

### 2010 Private Placement

#### *Series "B" Preferred Stock*

On October 4 and October 29, 2010, the Company issued and sold 27,950 shares and 6,450 shares, respectively, of Series B 8% Convertible Preferred Stock, par value \$0.001 per share (the Series "B" Preferred Stock), at \$100.00 per share for a total of \$3,440,000. Effective January 1, 2011, each holder of the Series "B" Preferred Stock may convert his, her or its shares of Series "B" Preferred Stock into shares of Common Stock at a conversion price equal to \$0.23. The Series "B" Preferred Stock is convertible into 14,956,522 shares of Common Stock at the original conversion price. However, the number of shares is subject to adjustment to prevent dilution in the event of a stock split or stock dividend. The Series B conversion price is also subject to a weighted average price protection. Effective January 1, 2011, the Company may, at its election, require the conversion of the Series "B" Preferred Stock to shares of Common Stock at the Series B Conversion Price if the closing price of the Common Stock for 10 consecutive trading days equals or exceeds 300% of the Series B Conversion Price and the average daily volume of the shares of Common Stock for the same period exceeds 250,000 shares.

Each investor who participated in the Offering also received a warrant to purchase 100 shares of common stock of the Company, par value \$0.001 per share (the "Common Stock"), per share of Preferred Stock purchased (the "Investor Warrants"). The Company issued warrants to purchase an aggregate of 3,440,000 shares of Common Stock to investors who participated in the Offering.

The Company paid Garden State Securities, Inc., the exclusive placement agent retained in connection with the Offering (the "Placement Agent"), a commission of 10% of the funds raised from the investors in connection with each closing of the Offering. In addition, the Placement Agent received warrants (the "Placement Agent Warrants") to purchase a number of shares of Common Stock equal to 15% of the shares of Common Stock underlying the shares of Series "B" Preferred Stock sold to investors in connection with the each closing of the Offering. As a result of the foregoing, the Placement Agent was paid a commission of \$344,000 and received warrants to purchase 2,243,478 shares of Common Stock in connection with the both closings of the Offering.

The holders of Series "B" Preferred Stock will be entitled to receive, before any cash is paid out or set aside for any shares of the Company's Common Stock (but on an equal basis with the Company's Series A 8% Redeemable Convertible Preferred Stock) dividends at the annual rate of 8% of the Stated Value of the Preferred Shares, subject to adjustment for stock splits, etc. The dividends will be accruing and cumulative and will be paid upon the occurrence of a liquidation, deemed liquidation, dissolution or redemption if not previously declared and paid.

We evaluated the Series "B" Preferred Stock issued and have recorded the intrinsic value of the embedded beneficial conversion feature of \$1,793,428 as additional paid in capital. The embedded beneficial conversion feature was treated as a deemed dividend and, as such, has been expensed to retained earnings.

#### *Warrants*

As stated above, the Company issued to each investor who participated in the Offering a warrant to purchase 100 shares of common stock of the Company, par value \$0.001 per share (the "Common Stock"), per share of Preferred Stock purchased (the "Investor Warrants"). The Company issued warrants to purchase an aggregate of 3,440,000 shares of Common Stock to the participating investors. Also, the Company issued to the placement agent warrants to purchase an aggregate of 2,243,478 shares of common stock in connection with the most private placement.

The Investor Warrants provide for the purchase of shares of Common Stock for five years at an exercise price of \$0.29 per whole share. A "cashless exercise" means that in lieu of paying the aggregate purchase price for the shares being purchased upon exercise of the Investor Warrants in cash, the holder will forfeit a number of shares underlying the Investor Warrants with a "fair market value" equal to such aggregate exercise price. The Company will not receive additional proceeds to the extent that Investor Warrants are exercised by cashless exercise.

The exercise price and number of shares of Common Stock issuable on exercise of the Investor Warrants may be adjusted in certain circumstances including in the event of a stock dividend, or our recapitalization, reorganization, merger or consolidation.

The Investor Warrants are also subject to a weighted average price protection for the term of the Investor Warrants. The Placement Agent Warrants are substantially identical to the terms of the Investor Warrants except that the Placement Agent Warrants have cashless exercise rights to the extent that a registration statement covering the shares of Common Stock underlying the Placement Agent Warrants is not in effect nine months following the date of issuance.

Furthermore, we have calculated the relative fair value of the warrants on their date of grant, which was determined to be \$1,074,563 and was recorded as additional paid-in capital. The fair value of the warrants was computed using the Black-Scholes option pricing model. The fair value of the warrants was calculated on the dates of issuance, using the following assumptions:

	October 4, 2010	October 29, 2010
Expected term (years)	5 Years	5 Years
Expected volatility	118.45%	118.45%
Risk-free interest rate	1.26%	1.17%
Expected annual dividend	0.00%	0.00%

### **Debentures conversion into Series "A" Preferred Stock**

On October 1, 2010, the Company extinguished of approximately ninety-eight percent (98%) of the Debentures in exchange for shares of the Company's Series A 8% Convertible Preferred Stock (the "Series A Preferred Stock"). An aggregate principal amount of \$5,692,500 of outstanding Debentures was extinguished in exchange for 56,925 shares of Series A Preferred Stock. The face value of each preferred share is \$100 with an aggregate value of the transaction of \$5,692,500. The holders of Series A Preferred Stock will be entitled to receive, before any cash is paid out or set aside for any shares of the Company's Common Stock (but on an equal basis with the Company's Series B 8% Redeemable Convertible Preferred Stock) dividends at the annual rate of 8% of the Stated Value of the Preferred Shares, subject to adjustment for stock splits, etc. The dividends will be accruing and cumulative and will be paid upon the occurrence of a liquidation, deemed liquidation, dissolution or redemption if not previously declared and paid.

Each holder of Series A Preferred Stock may convert his, her or its shares of Series A Preferred Stock into shares of Common Stock at a conversion price equal to \$0.13. The number of shares of the common stock into which the Series A Preferred Stock is currently convertible is 39,922,308. However, the number of shares of Common Stock into which the Series A Preferred Stock is convertible is subject to adjustment to prevent dilution in the event of a stock split or stock dividend. The Series A Conversion Price is also subject to a weighted average price protection. Effective January 1, 2011, the Company may, at its election, require the conversion of the Series A Preferred Stock to shares of Common Stock at the Series A Conversion Price if the closing price of the Common Stock for 10 consecutive trading days equals or exceeds 300% of the Series A Conversion Price and the average daily volume of the shares of Common Stock for the same period exceeds 250,000 shares.

Approximately \$2,200,869 of the debt discount relating to the beneficial conversion option and the 2009 Warrants issued to the Debenture holders was recorded to interest expense as a result of the extinguishment of the Debentures. Furthermore, the intrinsic value of the beneficial conversion feature at the date of extinguishment was calculated to be approximately \$5,692,500 and, as such, we recorded a gain on extinguishment of debt for that amount.

We have evaluated the Series A Preferred Stock issued and have recorded the intrinsic value of the embedded beneficial conversion feature of \$5,692,443 as additional paid in capital. The embedded beneficial conversion feature was treated as a deemed dividend and, as such, has been recorded to retained earnings.

In conjunction with the extinguishment of debt, the Company modified the exercise price of the 2009 Warrants. The exercise price was reduced from \$0.14 to \$0.09 per share of Common Stock. As such, we have calculated the fair value of the warrants on the date of the modification to be approximately \$6,181,501 and recorded the increase in fair value of \$4,616,401 as an addition to additional paid-in capital. The fair value of the warrants was computed using the Black-Scholes option pricing model. The Company assumed a risk-free interest rate of 1.17%, no dividends, expected volatility of approximately 118.45%, which was calculated based on a combination of historical volatility and the history of comparable peer companies, and an expected warrant life of approximately 5 years.

## **6. Other investment**

On September 9, 2011, UFood Restaurant Group, Inc. (UFood Restaurant) entered into a (Delaware) limited liability company agreement of APG JV, LLC (the "LLC"), with: KFLG Watertown, Inc., a Massachusetts corporation and an indirect wholly-owned subsidiary of UFood Restaurant ("KFLG" and, collectively with UFood, "UFood" or the "Company"), and MBUF LLC, a Delaware limited liability company ("MBUF"). The purpose of the "LLC" is to build and operate 3 UFood Grill outlets at the Aberdeen Proving Ground (the Aberdeen units). The Company owns 51% of the membership units and the right to nominate two of the four Board of Managers (all decisions or actions requiring an affirmative vote by the majority).

UFood Restaurant will provide management services to the LLC (via separate management agreement), in exchange for a 5% (of LLC gross sales) management fee, paid quarterly by the LLC; conduct operations and affairs of the Aberdeen Units for the benefit of the LLC; grant and license to the LLC branding, materials and know-how, intellectual property rights, franchise rights, trademarks and service marks, etc.; and hold and operate under all leases, awards, contracts and rights re: Aberdeen Units for the benefit of the LLC.

A joint venture relationship must first be evaluated under the variable interest entity subsections of ASC 810-10, to determine if the joint venture is a variable interest entity ("VIE"), and whether one investor is the primary beneficiary required to consolidate the Joint Venture. Based on ASC 810-10-25-26, since APG JV, LLC (the LLC) is receiving financing (loan) from MBUF, the related liability creates variability, which is absorbed by MBUF. The LLC is the creator of variability.

Once the loan is repaid, UFood Restaurant and MBUF will share in the profits and distributions of the LLC in proportion to their respective interests (51% and 49%, respectively). As a result, both members absorb variability in terms of expected residual returns from the LLC's assets and operations.

Given that MBUF will absorb a majority of the VIE's expected losses and UFood Restaurant will receive a majority of the VIE's expected residual returns (51%), the reporting entity absorbing a majority of the losses (MBUF) should consolidate the VIE. As such, MBUF is the primary beneficiary in relation to the LLC VIE. UFood Restaurant would not have to consolidate the VIE. Instead, UFood Restaurant would need to include VIE disclosures within its financial statements, in relation to the counterparty (APG JV, LLC).

Although UFood Restaurant has a 51.0% membership unit interest, as far as initial membership units in APG JV, LLC, the Board of Managers, which makes decisions and actions based upon an affirmative vote of the majority, is comprised of two managers designated by UFood Restaurant, and two managers designated by MBUF. Thus, true voting power is split 50/50 between the two entities. Based upon this 50% voting interest, UFood Restaurant can exercise significant influence (but not control) over APG JV, LLC.

As a result, UFood Restaurant recorded for its investment in APG JV, LLC of 51,000 membership units for \$510 under the equity method of accounting.

## **7. Income Taxes**

The Company applies the provisions of ASC No. 740-10-25, *Accounting for Uncertainty in Income Taxes* which requires that the impact of tax positions taken by the Company be recognized in the financial statements if they are more likely than not of being sustained based upon the technical merits of the position. The Company has a valuation allowance against the full amount of its net deferred taxes. The Company currently provides a valuation allowance against deferred taxes when it is more likely than not that some portion, or all, of its deferred tax assets will not be realized.

No provision for current income taxes has been recorded for the three and nine months ended October 2, 2011 and September 26, 2010 due to the Company's cumulative net losses. Significant components of deferred tax assets are net operating loss carryforwards; start-up costs and organizational costs capitalized for tax purposes, and deferred revenue. Significant component of deferred tax liabilities is depreciation of property and equipment.

Management has evaluated the evidence bearing upon the realization of its deferred tax assets and has determined that it is more likely than not that the Company will not recognize the benefits of its federal and state deferred tax assets. As a result, the Company has recorded a full valuation allowance against its deferred tax assets. If the Company should generate sustained future taxable income against which these tax attributes might be applied, some portion or all of the valuation allowance would be reversed.

The Company's income tax returns have not been audited by the Internal Revenue Service (IRS) or any state taxing authority. The years 2008 through 2010 remain open to examination by the IRS and state taxing authority. The Company believes it is not subject to any tax exposure beyond the preceding discussion. The Company's policy is to recognize interest and penalties accrued on any unrecognized tax benefits as a component of income tax expense.

## 8. Commitments and Contingencies

We are subject to legal proceedings and claims which arise in the normal course of business. Although there can be no assurance as to the ultimate outcome, we generally have denied, or believe we have a meritorious defense and will deny, liability in all significant cases pending against us. Based on information currently available, we believe the amount, or range, of reasonably possible losses in connection with the actions against us, in excess of established reserves, in the aggregate, not to be material to our consolidated financial condition or cash flows. However, losses may be material to our operating results for any particular future period, depending on the level of our income for such period.

## 9. Supplemental Disclosures of Cash Flow Information

	Three Months Ended		Nine months Ended	
	October 2, 2011	September 26, 2010	October 2, 2011	September 26, 2010
Cash paid during the period for interest	\$ 3,409	\$ 15,174	\$ 7,112	\$ 51,993
Preferred stock dividends paid with common stock	\$ 42,078	\$ --	\$ 70,048	\$ --
Property and equipment acquired with capital lease	\$ --	\$ --	\$ --	\$ 8,163
	<u>                    </u>	<u>                    </u>	<u>                    </u>	<u>                    </u>

## 10. Loss Per Share

The amounts used for basic and diluted per share calculations are as follows:

	Three Months Ended		Nine months Ended	
	October 2, 2011	September 26, 2010	October 2, 2011	September 26, 2010
Net loss allocable to common stockholders	\$ (640,567)	\$ (4,360,891)	\$ (2,134,559)	\$ (6,947,399)
Weighted average number of shares outstanding – basic and diluted	45,461,761	40,014,225	42,619,229	39,039,355
Basic and diluted per common share	\$ (0.01)	\$ (0.11)	\$ (0.05)	\$ (0.18)

Diluted earnings (loss) per share are not presented since the effect of the assumed exercise of options and warrants to purchase common stock would have been anti-dilutive. A total of a 66,004,677 and 59,768,7150 potential common shares from the assumed exercise of options and warrants were excluded from the calculation of diluted net loss per share for the three and nine month periods ended October 2, 2011 and September 26, 2010 respectively, because their inclusion would have been anti-dilutive.

## 11. Segment Data

The Company operates two business segments; Store Operations and Franchise Operations. The Store Operations segment comprises the operating activities of restaurants owned or operated by the Company. The Franchise Operations segment is comprised of the operating activities of the franchise business unit which licenses qualified operators to conduct business under

the Knowfat and UFood Grill tradenames and also costs to monitor the operations of these business units. Under the terms of the franchise agreements, the licensed operators pay royalties and fees to the Company in return for the use of the Knowfat and UFood Grill tradenames.

The accounting policies of the segments are the same. Interest expense has been allocated based on operating results and total assets employed in each segment. Inter-segment transactions are uncommon and not material. Therefore, they have not been separately reflected in the financial table below. The totals of the reportable segments' revenues and net loss agree with the comparable amounts contained in the Company's consolidated financial statements.

Segment information for the Company's two business segments follows:

	Three Months Ended		Nine months Ended	
	October 2, 2011	September 26, 2010	October 2, 2011	September 26, 2010
<b>Revenues:</b>				
Store operations	\$ 1,057,986	\$ 1,178,874	\$ 3,044,199	\$ 3,477,118
Franchise operations	48,789	101,055	144,669	231,117
Total revenue	<u>\$ 1,106,775</u>	<u>\$ 1,279,929</u>	<u>\$ 3,188,868</u>	<u>\$ 3,678,235</u>
<b>Segment income (loss):</b>				
Store operations	\$ (44,881)	\$ 116,370	\$ (98,206)	\$ 178,774
Franchise operations	(114,521)	(498,277)	(441,730)	(820,520)
Total segment loss	<u>\$ (159,402)</u>	<u>\$ (381,907)</u>	<u>\$ (539,936)</u>	<u>\$ (641,746)</u>
Unallocated general and administrative expenses	\$ 424,568	\$ 1,456,575	\$ 1,662,931	\$ 2,503,329
Advertising, marketing and promotion	38,753	44,472	157,244	158,345
Depreciation and amortization	91,060	80,636	272,281	244,711
Interest expense, net	11,843	407,762	30,313	1,187,644
Other (income) expense	(253,479)	1,969,761	(1,062,871)	2,191,846
Net loss	<u>\$ (472,147)</u>	<u>\$ (4,341,113)</u>	<u>\$ (1,599,834)</u>	<u>\$ (6,927,621)</u>

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

The following discussion and analysis of financial condition and results of operations should be read in conjunction with our financial statements and related notes included elsewhere in this report. This discussion contains forward-looking statements that involve risks, uncertainties and assumptions. Our actual results could differ materially from those anticipated in the forward-looking statements as a result of certain factors discussed in "Risk Factors" in our Annual Report amended on Form 10-K/A filed with the Securities and Exchange Commission on May 18, 2011 and elsewhere in this report.

The information contained in this Report on Form 10-Q and in other public statements by the Company and Company Officers include or may contain forward-looking statements. All statements other than statements of historical facts contained in this Report on Form 10-Q, including statements regarding our future financial position, business strategy and plans and objectives of management for future operations, are forward-looking statements. The words "anticipate," "believe," "estimate," "will," "may," "future," "plan," "intend," and "expect" and similar expressions generally identify forward-looking statements. Although we believe that our plans, intentions and expectations reflected in the forward-looking statements are reasonable, we cannot be sure that they will be achieved. Actual results may differ materially from the forward-looking statements contained herein due to a number of factors.

### Overview

Our operations currently consist of eight restaurants in the Boston area and Dallas Forth Worth, TX and Cleveland, OH; comprising four Company-owned restaurants and four franchise-owned locations. We have entered into a total of four area development agreements and three franchise agreements covering 65 franchise units in five states (California, Florida, Texas, Ohio and Massachusetts) and the Washington, DC area; including four franchise locations currently open and operating, and requiring the construction by franchisees of 61 future UFood Grill outlets.

We view ourselves primarily as a franchisor and continually review our restaurant ownership mix (that is our mix among Company-owned, franchised and joint venture) in an endeavor to deliver a pleasant customer experience and drive profitability. In most cases, franchising is the best way to achieve both goals. In our Company-owned stores, and in collaboration with our franchisees, we further develop and refine operating standards, marketing concepts and product and pricing strategies, so that we introduce system-wide only initiatives that we believe are most beneficial.

We include in this discussion information on Company, franchisee, and/or system-wide comparable sales. System-wide sales are a non-GAAP financial measure that includes sales at all Company-owned and franchise-operated stores, as reported by franchisees. Management uses system-wide sales information internally in connection with store development decisions, planning and budgeting analysis. Management believes system-wide sales are useful in assessing customer acceptance of our brand and facilitating an understanding of financial performance as our franchisees pay royalties and contribute to marketing funds based on a percentage of their sales.

We derive revenues from three sources: (i) store sales which include sales of hot and cold prepared food in a fast casual dining environment as well as sales of health and nutrition related products; (ii) franchise royalties and fees represent amounts earned under franchise and area development agreements; and (iii) other revenues derived primarily from the sale of marketing materials to franchisees. Store operating expenses include the cost of goods, food and paper products sold in Company-owned stores as well as labor and other operating costs incurred to operate Company-owned stores. General and administrative expenses, advertising, marketing and promotion expenses and depreciation expense relate to all three revenue sources.

### Critical Accounting Policies and Estimates

The discussion and analysis of our financial condition and results of operations is based upon our consolidated financial statements for the three and nine months ended October 2, 2011 and September 26, 2010, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of the consolidated financial statements requires us to make estimates, judgments and assumptions, which we believe to be reasonable, based on the information available. These estimates and assumptions affect the reported amounts of assets, liabilities, revenues and expenses. Variances in the estimates or assumptions used could yield materially different accounting results. On an ongoing basis, we evaluate the continued appropriateness of our accounting policies and resulting estimates to make adjustments we consider appropriate under the facts and circumstances.

We have chosen accounting policies we believe are appropriate to report accurately and fairly our operating results and financial position, and we apply those accounting policies in a consistent manner.

### *Fiscal Quarters*

In 2011, our fiscal quarters end on April 3<sup>rd</sup>, July 3<sup>rd</sup>, October 2<sup>nd</sup> of 2011, and January 1<sup>st</sup>, 2012. In 2010, our fiscal quarters ended on March 28<sup>th</sup>, June 27<sup>th</sup>, September 26<sup>th</sup>, 2010 and January 2<sup>nd</sup>, 2011.

### *Principles of Consolidation*

The consolidated financial statements include the assets, liabilities and results of operations of UFood Restaurant Group, Inc. and its subsidiary. All significant intercompany balances and transactions have been eliminated.

### *Use of Estimates*

The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amount of revenues and expenses during the reporting period. Actual amounts could differ from those estimates.

### *Reclassifications*

Certain reclassifications have been made to conform previously reported data to the current presentation.

### *Investments in Companies Accounted for using the Equity Method*

The Company's invest in APG JV, LLC (see Note 6) is accounted for by the equity method as a result of the ownership percentage and/or the Company's ability to exercise significant influence over the operating and financial policies of the investee. Investments of this nature are recorded at original cost and adjusted periodically to recognize the Company's proportionate share of the investees' net income or losses after the date of the investment. When net losses from an investment accounted for under the equity method exceed its carrying amount, the investment balance is reduced to zero and additional losses are not provided for.

### *Deferred Financing Costs*

Deferred financing costs represent costs paid to third parties in order to obtain long-term financing and have been included in other assets. Deferred financing costs are amortized over the life of the related debt. Amortization expense related to these costs was \$4,634 and \$257,263 for the nine months ended October 2, 2011 and September 26, 2010, respectively, and is included in interest expense. The amortization expense recorded by the Company for the three months ended October 2, 2011 and September 26, 2010 was \$1,545 and \$83,435 respectively.

### *Valuation of Goodwill*

We account for goodwill and other intangible assets under ASC No. 805, *Business Combinations*, and ASC No. 350-20 to 30, *Goodwill and Other Intangible Assets*. ASC No. 805 requires that the purchase method of accounting be used for all business combinations initiated after June 30, 2001, and that certain intangible assets acquired in a business combination be recognized as assets apart from goodwill. Under ASC No. 350-20 to 30, purchased goodwill and intangible assets with indefinite lives are not amortized, but instead tested for impairment at least annually or whenever events or changes in circumstances indicate the carrying value may not be recoverable. Goodwill attributable to our franchise operations segment is evaluated by comparing the Company's fair market value, determined based upon quoted market prices of the Company's equity securities, to the carrying amount of goodwill. Goodwill attributable to our store operations segment is evaluated on a restaurant-by-restaurant basis by comparing the restaurant's estimated fair value to the carrying value of the restaurant's underlying net assets inclusive of goodwill. Fair value is determined based upon the restaurant's estimated future cash flows. Future cash flows are estimated based upon a restaurant's historical operating performance and management's estimates of future revenues and expenses over the period of time that the Company expects to operate the restaurant, which generally coincides with the initial term of the restaurant's lease but which may take into account the restaurant's first lease renewal period up to 5 years. The estimate of a restaurant's future cash flows may also include an estimate of the restaurant's terminal value, determined by applying a capitalization rate to the restaurant's estimated cash flows during the last year of the forecast period. The capitalization rate used by the Company was determined based upon the restaurant's location, cash flows and growth prospects. As of the first day of the fourth quarter of the year ended January 1, 2012 according to our policy we have tested the carrying value of the Goodwill attributable to our store operations and no impairment was necessary. The carrying amount of goodwill may be impaired in the future if our actual operating results and cash flows fall short of our expectations.

### *Impairment of Long-Lived Assets*

In accordance with ASC No. 360 *Property, Plant and Equipment*, when impairment indicators exist, the Company evaluates its long-lived assets for potential impairment. Potential impairment is assessed when there is evidence that events or changes in circumstances have occurred that indicate the carrying amount of an asset may not be recovered. When events or changes in circumstances have occurred that indicate a long-lived asset may be impaired, the Company uses estimates of future cash flows on a restaurant-by-restaurant basis to test the recoverability of its long-lived assets. Future cash flows are estimated based upon the restaurant's historical operating performance and management's projections of future revenues and expenses and may take into account the restaurant's estimated terminal value. Long-lived assets may be impaired in the future if our actual operating results and cash flows fall short of our expectations.

### *Revenue Recognition*

The Company records revenue for Company-owned store sales upon the delivery of the related food and other products to the customer. The Company records a liability in the period in which a gift card is issued and proceeds are received. As gift cards are redeemed, this liability is reduced and revenue is recognized.

The Company follows the accounting guidance of ASC No. 952-605-25 and 952-340-25, *Franchisors*. Franchisee deposits represent advances on initial franchise fees prior to the opening of the franchisee location. We recognize initial franchise fee revenue when all material services we are required to perform and all material conditions we are required to satisfy have been substantially completed, which is generally the opening of the franchised location. The Company defers direct costs related to franchise sales until the related revenue is recognized; however, the deferred costs shall not exceed anticipated revenue less estimated additional related costs. Such costs include training, facilities design, menu planning and marketing. Franchise royalty revenues are recognized in the same period the relevant franchisee sales occur.

### *Rent Expense*

The Company recognizes rent expense on a straight-line basis over the reasonably assured lease term as defined in ASC No. 840, *Leases*. The reasonably assured lease term on most of the Company's leases is the initial non-cancelable lease term, which generally equates to between 5 and 10 years. In addition, certain of the Company's lease agreements provide for scheduled rent increases during the lease terms or for rental payments commencing at a date other than the date of initial occupancy. The Company includes any rent escalations and other rent holidays in its determination of straight-line rent expense. Therefore, rent expense for new locations is charged to expense upon the commencement date of the lease.

### *Earnings Per Share Data*

Earnings per share are based on the weighted average number of shares outstanding during the period after consideration of the dilutive effect, if any, for common stock equivalents, including stock options, restricted stock, and other stock-based compensation. Earnings per common share are computed in accordance with ASC No. 260, *Earnings Per Share*, which requires companies to present basic earnings per share and diluted earnings per share. Basic earnings per share are computed by dividing net income allocable to common stockholders by the weighted average number of shares of common stock outstanding during the year. Diluted earnings per common share are computed by dividing net income allocable to common stockholders by the weighted average number of shares of common stock outstanding and dilutive securities outstanding during the year.

### *Fair Value of Financial Instruments*

The carrying amounts of the Company's financial instruments, which include cash and cash equivalents, accounts receivable, accounts payable and other accrued expenses and debt obligations approximate their fair values due to the short-term maturity of these instruments.

### *Stock-Based Compensation*

The Company maintains two stock-based incentive plans. The Company grants options to purchase common stock at an option price equal to the market value of the stock at the date of grant. Options generally vest over a three year period beginning on the date of grant and have a ten year contractual term.

The Company applies the fair value recognition provisions of ASC No. 718, *Compensation-Stock Compensation*, which requires all stock-based compensation, including grants of employee stock options, to be recognized in the statement of operations based on their fair values. The Company uses the Black-Scholes option pricing model which requires extensive use of accounting judgment and financial estimates, including estimates of the expected term participants will retain their vested stock options before exercising them and the estimated volatility of the Company's common stock price over the expected term.

Stock-based compensation expense recognized during the three months ended October 2, 2011 totaled approximately \$86,803 for stock options. Stock-based compensation expense recognized during the nine months ended October 2, 2011 totaled approximately \$406,716 for stock options. Stock-based compensation expense was included in general and administrative expenses in the accompanying Consolidated Statements of Operations.

#### Executive Summary of Results

The following table sets forth the percentage relationship to total revenues, except where otherwise indicated, of certain items included in our consolidated statements of operations for the periods indicated. Percentages may not add due to rounding:

	Three Months Ended		Nine months Ended	
	October 2, 2011	September 26, 2010	October 2, 2011	September 26, 2010
<b>Revenues:</b>				
Store sales	95.6%	92.1%	95.5%	93.7%
Franchise royalties and fees	4.4	7.9	4.4	5.7
Other revenue	0.0	0.0	0.1	0.6
	<u>100.0%</u>	<u>100.0%</u>	<u>100.0%</u>	<u>100.0%</u>
<b>Costs and expenses:</b>				
<b>Store operating expenses (1):</b>				
Food and paper costs	35.9%	33.7%	34.6%	33.3%
Cost of nutritional products	6.2	6.0	7.1	7.4
Labor	31.5	28.2	31.2	27.8
Occupancy	10.7	6.3	10.8	9.0
Other store operating expenses	15.9	13.0	15.1	14.4
General and administrative expenses	60.3	164.4	78.1	102.2
Advertising, marketing and promotion expenses	3.5	3.5	4.9	4.3
Depreciation and amortization	8.2	6.3	8.5	6.7
Loss on disposal of assets	—	2.0	—	0.7
Total costs and expenses	<u>164.5</u>	<u>253.4</u>	<u>182.5</u>	<u>196.5</u>
Operating loss	<u>(64.5)</u>	<u>(153.4)</u>	<u>(82.5)</u>	<u>(96.5)</u>
<b>Other income (expense):</b>				
Interest income	0.0	0.1	0.2	0.2
Interest expense	(1.1)	(31.9)	(1.1)	(32.4)
Other income	22.9	(153.9)	33.3	(59.6)
Other income (expense), net	<u>21.8</u>	<u>(185.8)</u>	<u>32.4</u>	<u>(91.9)</u>
Loss before income taxes	(42.7)	(185.8)	(50.2)	(188.3)
Income taxes	—	—	—	—
Net loss	<u>(42.7)%</u>	<u>(106.7)%</u>	<u>(50.2)%</u>	<u>(188.3)%</u>

- (1) Food and paper costs are shown as a percentage of food sales. Cost of nutritional products, labor, occupancy and other store operating expenses are shown as a percentage of total store sales.

The following table sets forth certain data relating to the number of Company-owned, franchise-operated and system-wide store locations:

	Three Months Ended		Nine months Ended	
	October 2, 2011	September 26, 2010	October 2, 2011	September 26, 2010
<b>Company-owned locations:</b>				
Locations at the beginning of the year	4	4	4	4
Locations opened	—	—	—	—
Locations closed	—	—	—	—
Locations sold	—	—	—	—
Locations transferred	—	—	—	—
Locations at the end of the period	<u>4</u>	<u>4</u>	<u>4</u>	<u>4</u>
<b>Franchise-owned locations:</b>				
Locations at the beginning of the year	4	4	4	4
Locations opened	—	1	—	2
Locations closed	—	(1)	—	(2)
Locations sold	—	—	—	—
Locations transferred	—	—	—	—
Locations at the end of the period	<u>4</u>	<u>4</u>	<u>4</u>	<u>4</u>
<b>System-wide locations</b>				
Locations at the beginning of the year	8	8	8	8
Locations opened	—	1	—	2
Locations closed	—	(1)	—	(2)
Locations sold	—	—	—	—
Locations transferred	—	—	—	—
Locations at the end of the period	<u>8</u>	<u>8</u>	<u>8</u>	<u>8</u>

### Three Months Ended October 2, 2011 Compared to Three Months Ended September 26, 2010

#### General

For the three months ended October 2, 2011, our comparable store sales for Company owned stores decreased by 10.3%. Comparable store sales of Company-owned and franchisee-owned locations were adversely impacted by the economic downturn and the corresponding slowdown in consumer spending. Comparable store sales are based on sales for stores that have been in operation for the entire period of comparison. Comparable store sales exclude closed locations.

#### Results of Operations

##### Revenues

Total revenues for the three months ended October 2, 2011 decreased by \$173,154 or 13.5% to \$1,106,775 from \$1,279,929 for the three months ended September 26, 2010. The decrease in total revenues for the three months ended October 2, 2011 as compared to the prior year was primarily due to lower same store sales and no openings of franchisee stores.

Sales at Company-operated stores for the three months ended October 2, 2011 decreased by \$120,888, or 10.3% to \$1,057,986 from \$1,178,874 for the three months ended September 26, 2010. As a percentage of total sales revenues, sales at Company-operated stores increased to 95.6% of the total revenues for the three months ended October 2, 2011 up from 92.1% of the total revenues for the three months ended September 26, 2010. The decrease in sales at Company-operated stores for the three

months ended October 2, 2011 was primarily due to a significant sales decline at our Logan Airport Terminal B location resulting from a reduction in customers caused by the decrease in airline passengers. Also, the decrease in sales is attributable to the fewer customers visiting our other stores locations slightly offset by a small increase of the average ticket.

During the three months ended October 2, 2011, franchise royalties and fees decreased by \$52,266, or 51.7 % to \$48,789 from \$101,055 for the three months ended September 26, 2010 due to the opening of a franchise store in 2010 and the associated franchise fee of \$35,000, compared to the same period this year with no openings.

#### *Costs and Expenses*

Food and paper costs for the three months ended October 2, 2011 decreased by \$13,220, or 3.7%, to \$343,408 from \$356,628 for the three months ended September 26, 2010. As a percentage of food sales, food and paper costs increased to 35.9% of food sales for the three months ended October 2, 2011 from 33.7% of food sales for the three months ended September 26, 2010. The increase in food and paper costs as a percentage of food sales was primarily attributable to the increase in promotional discounts which were 157% more than the same period last year.

The cost of nutritional products for the three months ended October 2, 2011 decreased by \$4,879, or 6.9%, to \$65,908 from \$70,787 for the three months ended September 26, 2010. As a percentage of store sales, the cost of nutritional products increased to 6.2% of store sales for the three months ended October 2, 2011 from 6% of store sales for the three months ended September 26, 2010. The decrease in the cost of nutritional products as a percentage of store sales was primarily attributable to the decline in sales of nutritional products.

Store labor expense for the three months ended October 2, 2011 increased by \$767, or 0.2%, to \$333,222 from \$332,455 for the three months ended September 26, 2010. As a percentage of store sales, labor expense increased to 31.5% of store sales for the three months ended October 2, 2011 from 28.2% of store sales for the three months ended September 26, 2010. The increase in the labor percentage as a percentage of sales was due to the decline in sales and pay rate increases to employees.

Store occupancy costs for the three months ended October 2, 2011 increased by \$38,149, or 51.0%, to \$112,996 from \$74,847 for the three months ended September 26, 2010. The increase in occupancy costs was primarily attributable to the rent relief we received for one of our locations, resulting in an adjustment to eliminate the rent accrual booked in the three months ended September 26, 2010. As a percentage of store sales, occupancy costs increased to 10.7% of store sales for the three months ended October 2, 2011 from 6.3% of store sales for the three months ended September 26, 2010.

Other store operating expenses for the three months ended October 2, 2011 increased by \$14,308, or 9.3%, to \$167,971 from \$153,663 for the three months ended September 26, 2010. The increase was primarily due an increase in maintenance expenses. As a percentage of store sales, other store operating expenses increased to 15.9% of store sales for the three months ended October 2, 2011 from 13% of store sales during the three months ended September 26, 2010, primarily due to the decline of same store sales.

General and administrative expenses for the three months ended October 2, 2011 decreased by \$1,437,009 or 68.3%, to \$667,240 from \$2,104,249 for the fiscal quarter ended September 26, 2010. The decrease in general and administrative expenses for the three months ended October 2, 2011 compared to the same period in the prior year is primarily due to non-cash transactions booked last year. The stock based compensation for employees was \$512,561 lower than last year during the same period. Also, the stock based compensation issued for Investor relations services was \$989,209 lower than last year during the same period. As a result of the foregoing, general and administrative expenses decreased to 60.3% of total revenues during the three months ended October 2, 2011 down from 164.4% of total revenues for the three months ended September 26, 2010.

Advertising, marketing and promotion expenses for the three months ended October 2, 2011 decreased by \$5,719 or 12.9%, to \$38,753 from \$44,472 for the three months ended September 26, 2010. The decrease in advertising, marketing and promotion expenses was primarily due to printing posters and promotional coupons in the prior year which were not incurred this year. As a percentage of total revenues, advertising, marketing and promotion expenses stayed at 3.5% for both years.

Depreciation and amortization expense for the three months ended October 2, 2011 increased by \$10,424, or 12.9%, to \$91,060 from \$80,636 for the three months ended September 26, 2010. As a percentage of total revenues, depreciation and amortization expense increased to 8.2% of total revenues for the three months ended October 2, 2011 up from 6.3% of total revenues for the three months ended September 26, 2010.

Net other income (expense) changed to \$241,636 of income for the three months ended October 2, 2011 from \$2,377,523 of expense for the three months ended September 26, 2010. The detail of the other expense is as follows:

	Three months ended <b>October 2, 2011</b>	Three months ended <b>September 26, 2010</b>	Variance
Other income (expense)	\$ 253,479	\$ (1,969,761)(1)	\$2,223,240
Interest income	858	672	186
Interest expense	(12,701)	(408,434)(2)	395,733
Total other income(expense)	<u>241,636</u>	<u>(2,377,523)</u>	<u>2,619,159</u>

- (1) *The Company is subject to a derivative warrant liability instrument due to the fact that the related contract is not indexed to its own stock, as specified by ASC No. 815-40, Derivatives and Hedging-Contracts in entity's Own Equity. At October 2, 2011, the aggregate fair value of the derivative was \$388,798. The decrease in the fair value of the derivative was in the aggregate amount of \$253,479 during the Fiscal quarter ended October 2, 2011.*
- (2) *On October 1, 2010, the Company extinguished 98% of the outstanding Debentures; consequently the payment of interest has diminished significantly. Furthermore, in connection with the Debentures and the 2009 Warrants, the Company recorded a debt discount of \$3,130,200 associated with a beneficial conversion feature on the debt, which was being accreted using the effective interest method over the three year term of the debentures. As a result of the extinguishment of the debentures the total unamortized amount at the time of the extinguishment was fully amortized.*

The net loss for the three months ended October 2, 2011 decreased by \$3,868,966, or 89.1% to \$472,147, from \$4,341,113 for the three months ended September 26, 2010. Our net loss decreased primarily due to the increase in other income and the decrease of General and Administrative expenses. Both variances were as a result of non-cash transactions such stock-based compensation and the valuation market-to-market of the outstanding 2008 Warrants as well as the beneficial conversion feature of the debentures extinguished last year. As a percentage of total revenues, our net loss decreased to 42.7% of total revenues for the three months ended October 2, 2011 down from 185.8% of total revenues for the three months ended September 26, 2010.

## **Nine months Ended October 2, 2011 Compared to Nine months Ended September 26, 2010**

### **General**

For the nine months ended October 2, 2011, our comparable store sales for Company owned stores decreased by 11.7%. The decrease in comparable store sales of Company-owned stores was primarily due to significant decline in passengers in Logan Airport Terminal B resulting in fewer customers at our store located within the food court in this terminal. Also, the decrease of sales was due to the closing of our stores for at least two days as a result of severe snow storms, the decrease of customer count slightly offset by a small increase of the average ticket. Comparable store sales are based on sales for stores that have been in operation for the entire period of comparison. Comparable store sales exclude closed locations.

### **Results of Operations**

#### *Revenues*

Our total revenues for the nine months ended October 2, 2011 decreased by \$489,367, or 13.3%, to \$ 3,188,868 from \$3,678,235 for the nine months ended September 26, 2010. The decrease in total revenues was primarily due to the decline in comparable store sales and less franchisee stores openings during the nine months ended October 2, 2011 compares to the same period last year.

Total store sales at Company-owned stores for the nine months ended October 2, 2011 decreased by \$402,919, or 11.7%, to \$3,044,199 from \$3,447,118 for the nine months ended September 26, 2010. As a percentage of total revenues, sales at Company-owned stores increased to 95.5% of total revenues for the nine months ended October 2, 2011 from 93.7 % of total revenues for the nine months ended September 26, 2010. The decrease in sales at Company-owned stores for the nine months ended October 2, 2011 was primarily due to a significant sales decline at our Logan Airport Terminal B location due to a

reduction in customers caused by the decrease of airline passengers and a decrease in customer counts at our Boston stores due to severe weather which forced the Company to close the Boston stores for several days during the first nine months of 2011.

During the nine months ended October 2, 2011, franchise royalties and fees decreased by \$67,053, or 32.1% to \$141,766 from \$208,819 for the nine months ended September 26, 2010 primarily due to a decrease in franchise fees from new store openings.

### *Costs and Expenses*

Food and paper costs for the nine months ended October 2, 2011 decreased by \$70,783, or 7.0%, to \$945,409 from \$1,016,192 for the nine months ended September 26, 2010. The decrease was primarily attributable to the decline in comparable sales. As a percentage of food sales, food and paper costs increased to 34.6% of food sales during the nine months ended October 2, 2011 up from 33.3% of food sales during the nine months ended September 26, 2010. The increase in food and paper costs as a percentage of food sales was primarily attributable to the significant increase in promotional discounts, an increase of wholesale costs partially offset by price increase in menu items that took place in the third week of May.

The cost of nutritional products for the nine months ended October 2, 2011 decreased by \$40,478, or 15.9%, to \$214,662 from \$255,140 for the nine months ended September 26, 2010. As a percentage of store sales, the cost of nutritional products decreased to 7.1% of store sales for the nine months ended October 2, 2011 down from 7.4% of store sales for the nine months ended September 26, 2010, the decrease was primarily due to lower total revenues.

Store labor expense for the nine months ended October 2, 2011 decreased by \$6,658, or 0.7%, to \$951,182 from \$957,840 for the nine months ended September 26, 2010. The decrease in labor expense was primarily attributable to a reduction in labor hours in response to the response of total store sales. As a percentage of store sales, labor expense increased to 31.2% of store sales for the nine months ended October 2, 2011 up from 27.8% of store sales for the nine months ended September 26, 2010. The increase in the labor percentage of store sales is primarily due the decline in stores sales and the general pay rate increases.

Store occupancy costs for the nine months ended October 2, 2011 increased by \$20,129, or 6.5%, to \$329,700 from \$309,571 for the nine months ended September 26, 2010. The increase in store occupancy costs was primarily attributable to the reversal of the accrual for the straight line basis rent due to the amendment of one of our Company-owned store leases with a reduction for the remaining period in the lease. As a percentage of store sales, occupancy costs increased to 10.8% of store sales for the nine months ended October 2, 2011 up from 9% of store sales for the nine months ended September 26, 2010.

Other store operating expenses for the nine months ended October 2, 2011 decreased by \$37,672, or 7.6%, to \$460,135 from \$497,807 for the nine months ended September 26, 2010. The decrease was primarily due to the reduction of utilities cost as a result of a charge back from prior years for utilities at one of our locations. As a percentage of store sales, other store operating expenses increased to 15.1% of store sales for the nine months ended October 2, 2011 from 14.4% of store sales for the nine months ended September 26, 2010, primarily due to the decrease in comparable store sales.

General and administrative expenses for the nine months ended October 2, 2011 decreased by \$1,270,334 or 33.8%, to \$2,490,645 from \$3,760,979 for the nine months ended September 26, 2010. The decrease in general and administrative expenses for the nine months ended October 2, 2011 compared to the same period in the prior year is primarily due to the following:

- The personnel cost decreased by \$467,536 due to the granting of stock options during the third quarter of 2010 and with vesting schedules from one year to three years.
- The Investor and public relations expenses were lower by \$933,233, due to the engagement of an investor relations firm in the third quarter of 2010 with fully vested shares.
- The above decreases were slightly offset by an increase in Consulting, leased equipment and Licenses fees.

As a result of the foregoing, general and administrative expenses decreased to 78.1% of total revenues during the nine months ended October 2, 2011 from 102.2% of total revenues for the nine months ended September 26, 2010.

Advertising, marketing and promotion expenses for the nine months ended October 2, 2011 decreased by \$1,099, or 0.7%, to \$157,246 from \$158,345 for the nine months ended September 26, 2010. As a percentage of total revenues, advertising, marketing and promotion expenses increased to 4.9% of total revenues during the nine months ended October 2, 2011 from 4.3% of total revenues during the nine months ended September 26, 2010.

Depreciation and amortization expense for the nine months ended October 2, 2011 increased by \$27,570, or 11.3%, to \$272,281 from \$244,711 for the nine months ended September 26, 2010. As a percentage of total revenues, depreciation and amortization expense increased to 8.5% of total revenues for the nine months ended October 2, 2011 from 6.7% of total revenues for the nine months ended September 26, 2010.

Net other expense changed from \$3,379,490 of expense for the nine months ended September 26, 2010 to \$1,032,558 of income for the nine months ended October 2, 2011. The detail of the other expense is as follows:

	Nine months ended <b>October 2, 2011</b>	Nine months ended <b>September 26, 2010</b>	Variance
Other income (expense)	\$ 1,062,871	\$ (2,191,846)(1)	\$3,254,717
Interest income	4,803	4,829	(26)
Interest expense	(35,116)	(1,192,473)(2)	1,157,357
Total other income(expense)	<u>1,032,558</u>	<u>(3,379,490)</u>	<u>4,412,048</u>

- (1) *The Company is subject to a derivative warrant liability instrument due to the fact that the related contract is not indexed to its own stock, as specified by ASC No. 815-40, Derivatives and Hedging-Contracts in entity's Own Equity. At October 2, 2011, the aggregate fair value of the derivative was \$388,798. The decrease in the fair value of the derivative was in the aggregate amount of \$1,062,871 during the nine months ended October 2, 2011.*
- (2) *On October 1, 2010, the Company extinguished 98% of the outstanding Debentures; consequently the payment of interest has diminished significantly. Furthermore, in connection with the Debentures and the 2009 Warrants, the Company recorded a debt discount of \$3,130,200 associated with a beneficial conversion feature on the debt, which was being accreted using the effective interest method over the three year term of the debentures. As a result of the extinguishment of the debentures the total unamortized amount at the time of the extinguishment was fully amortized.*

Our net loss for the nine months ended October 2, 2011 decreased by \$5,327,787, or 76.9%, to \$1,599,834, from \$6,927,621, for the nine months ended September 26, 2010. Our net loss decreased primarily due to the change in market-to-market value of warrants with derivative characteristics and the significant decrease in interest expenses due to the extinguishment of debt executed in October 2010 slightly offset by the increase in our operating loss due to the sales decline. As a percentage of total revenues, our net loss decreased to 50.2% of total revenues for the nine months ended October 2, 2011 from 188.3% of total revenues for the nine months ended September 26, 2010.

## Liquidity and Capital Resources

Cash and cash equivalents and restricted cash at October 2, 2011 were \$833,794 compared to \$2,837,493 at January 2, 2011. Cash is primarily used to fund our (i) capital expenditures for company-owned stores, (ii) working capital requirements and (iii) net operating losses.

At October 2, 2011, we had negative working capital of \$737,335 compared to positive working capital of \$1,814,452 at January 2, 2011. The decrease in working capital was primarily due to the use of cash to fund our operating loss, the accrual of preferred stock dividends and the acquisition of fixed assets.

We used \$1,716,994 of cash to fund our operating activities in the nine months ended October 2, 2011 compared with \$1,239,833 of cash used to fund our operating activities in nine months ended September 26, 2010. The increase in cash used to fund our operating activities was primarily due to increase in operating losses, reduction in collection of account receivables, and increase in account payable, partially offset by an increase in franchisee deposits.

During the nine months ended October 2, 2011, we spent \$252,435 for the acquisition of equipment compared with \$70,700 spent for the acquisition of equipment during the nine months ended September 26, 2010.

During the nine months ended October 2, 2011, financing activities used \$33,848 of cash, primarily due to payments capital lease obligations. During the nine months ended September 26, 2010, the financing activities used \$449,754 of cash, primarily due to payments on long-term debt.

Historically we have funded our operations, working capital requirements, acquisitions and capital expenditures with cash flow generated by operations and proceeds from the issuance of debt and equity securities. The Company is currently in the process of trying to raise additional equity capital necessary to enable the Company to meet its obligations as they become due without substantial disposition of assets outside the ordinary course of business, restructuring of debt, externally forced revisions of its operations, or similar actions.

### Debenture Conversion

On October 1, 2010, the Company extinguished of approximately ninety-eight percent (98%) of the Debentures in exchange for shares of the Company's Series A 8% Convertible Preferred Stock (the "Series A Preferred Stock"). An aggregate principal amount of \$5,692,500 of outstanding Debentures was extinguished in exchange for 56,925 shares of Series A Preferred Stock. The face value of each preferred share is \$100 with an aggregate value of the transaction of \$5,692,500. The holders of Series A Preferred Stock will be entitled to receive, before any cash is paid out or set aside for any shares of the Company's Common Stock (but on an equal basis with the Company's Series B 8% Redeemable Convertible Preferred Stock) dividends at the annual rate of 8% of the Stated Value of the Preferred Shares, subject to adjustment for stock splits, etc. The dividends will be accruing and cumulative and will be paid upon the occurrence of a liquidation, deemed liquidation, dissolution or redemption if not previously declared and paid.

Each holder of Series A Preferred Stock may convert his, her or its shares of Series A Preferred Stock into shares of Common Stock at a conversion price equal to \$0.13. The number of shares of the common stock into which the Series A Preferred Stock is currently convertible is 43,788,462. However, the number of shares of Common Stock into which the Series A Preferred Stock is convertible is subject to adjustment to prevent dilution in the event of a stock split or stock dividend. The Series A Conversion Price is also subject to a weighted average price protection. Effective January 1, 2011, the Company may, at its election, require the conversion of the Series A Preferred Stock to shares of Common Stock at the Series A Conversion Price if the closing price of the Common Stock for 10 consecutive trading days equals or exceeds 300% of the Series A Conversion Price and the average daily volume of the shares of Common Stock for the same period exceeds 250,000 shares.

Approximately \$2,200,869 of the debt discount relating to the beneficial conversion option and the 2009 Warrants issued to the Debenture holders was recorded to interest expense as a result of the extinguishment of the Debentures. Furthermore, the intrinsic value of the beneficial conversion feature at the date of extinguishment was calculated to be approximately \$5,692,500 and, as such, we recorded a gain on extinguishment of debt for that amount.

We have evaluated the Series A Preferred Stock issued and have recorded the intrinsic value of the embedded beneficial conversion feature of \$5,692,443 as additional paid in capital. The embedded beneficial conversion feature was treated as a deemed dividend and, as such, has been recorded to retained earnings.

In conjunction with the extinguishment of debt, the Company modified the exercise price of the 2009 Warrants. The exercise price was reduced from \$0.14 to \$0.09 per share of Common Stock. As such, we have calculated the fair value of the warrants on the date of the modification to be approximately \$6,181,501 and recorded the increase in fair value of \$4,616,401 as an addition to additional paid-in capital. The fair value of the warrants was computed using the Black-Scholes option pricing model. The Company assumed a risk-free interest rate of 1.17%, no dividends, expected volatility of approximately 118.45%, which was calculated based on a combination of historical volatility and the history of comparable peer companies, and an expected warrant life of approximately 5 years

The business reasons to execute the exchange of the debenture for preferred stock were:

- Eliminating the debt provides us with more operational flexibility in terms of allocating financial resources.
- We believe adding to our equity and reducing debt provides us with a stronger financial position and will allow us to more readily attract new capital to execute the operating plan and provide the time needed to reach profitability.
- Reducing debt in return for equity provides some assurance to potential franchisees of a longer term commitment from investors for us to reach profitability.

### Private Placement

On October 4 and October 29, 2010, the Company issued and sold 27,950 shares and 6,450 shares, respectively, of Series B 8% Convertible Preferred Stock, par value \$0.001 per share (the "Series B Preferred Stock"), at \$100.00 per share for a total of \$3,440,000. Effective January 1, 2011, each holder of the Series B Preferred Stock may convert his, her or its shares of

Series B Preferred Stock into shares of Common Stock at a conversion price equal to \$0.23. Each investor who participated in the Offering also received a warrant to purchase 100 shares of common stock of the Company, par value \$0.001 per share, per share of Preferred Stock purchased. Currently, the Series B is convertible into 14,956,522 shares of common stock. However, the number of shares of Common Stock into which the Series B Preferred Stock is convertible is subject to adjustment to prevent dilution in the event of a stock split or stock dividend. The Series B Conversion Price is also subject to a weighted average price protection. Effective January 1, 2011, the Company may, at its election, require the conversion of the Series “B” Preferred Stock to shares of common stock at the series B conversion price if the closing price of the common stock for 10 consecutive trading days equals or exceeds 300% of the Series “B” conversion price and the average daily volume of the shares of common stock for the same period exceeds 250,000 shares. The Company paid the placement agent retained in connection with the offering a commission of \$344,000 and granted warrants to purchase 2,243,478 shares of Common Stock in connection with the offering.

The holders of Series B Preferred Stock will be entitled to receive, before any cash is paid out or set aside for any shares of the Company’s Common Stock (but on an equal basis with the Company’s Series A 8% Redeemable Convertible Preferred Stock) dividends at the annual rate of 8% of the Stated Value of the Preferred Shares, subject to adjustment for stock splits, etc. The dividends will be accruing and cumulative and will be paid upon the occurrence of a liquidation, deemed liquidation, dissolution or redemption if not previously declared and paid.

Each investor who participated in the Offering also received a warrant to purchase 100 shares of Common Stock of the Company, par value \$0.001 per shares (the “Common Stock”), per share of Preferred Stock purchased (the “Investor Warrants”). The Company issued warrants to purchase an aggregate of 3,440,000 shares of Common Stock to investors who participated in the Offering.

The Investor Warrants provide for the purchase of shares of Common Stock for five years at an exercise price of \$0.29 per whole share. The Investor Warrants, at the option of the holder, may be exercised by cash payment of the exercise price or by “cashless exercise” to the extent that a registration statement covering the shares of Common Stock underlying the Investor Warrants is not in effect following the one year anniversary of issuance. A “cashless exercise” means that in lieu of paying the aggregate purchase price for the shares being purchased upon exercise of the Investor Warrants in cash, the holder will forfeit a number of shares underlying the Investor Warrants with a “fair market value” equal to such aggregate exercise price. The Company will not receive additional proceeds to the extent that Investor Warrants are exercised by cashless exercise.

The exercise price and number of shares of Common Stock issuable on exercise of the Investor Warrants may be adjusted in certain circumstances including in the event of a stock dividend, or our recapitalization, reorganization, merger or consolidation. The Investor Warrants are also subject to a weighted average price protection for the term of the Investor Warrants. The Placement Agent Warrants are substantially identical to the terms of the Investor Warrants except that the Placement Agent Warrants have cashless exercise rights to the extent that a registration statement covering the shares of Common Stock underlying the Placement Agent Warrants is not in effect nine months following the date of issuance.

We evaluated the Series B Preferred Stock issued and have recorded the intrinsic value of the embedded beneficial conversion feature of \$1,793,428 as additional paid in capital. The embedded beneficial conversion feature was treated as a deemed dividend and, as such, has been recorded to retained earnings.

Furthermore, we have calculated the relative fair value of the warrants on their date of grant, which was determined to be \$1,074,563 and was recorded as additional paid-in capital. The fair value of the warrants was computed using the Black-Scholes option pricing model. The Company assumed a risk-free interest rate of 1.26%, no dividends, expected volatility of approximately 118.45%, which was calculated based on a combination of historical volatility and the history of comparable peer companies, and an expected warrant life of approximately 5 years.

## **Contractual Obligations and Other Commitments**

In addition to our capital expenditures requirements, we have certain other contractual and committed cash obligations. Our contractual cash obligations primarily consist of non-cancelable operating leases for our stores and administrative offices. Lease terms for our stores and administrative offices are generally for seven to ten years with renewal options at most locations and generally require us to pay a proportionate share of real estate taxes, insurance, common area, and other operating costs. Some store leases provide for contingent rental (i.e. percentage rent) payments based on sales in excess of specified amount. Certain of our lease agreements provide for scheduled rent increases during the lease terms or for rental payments commencing at a date other than the date of initial occupancy.

The following table sets forth information as of October 2, 2011 with respect to our contractual obligations and the effect they are expected to have on our liquidity and cash flows in future periods:

	<u>Total</u>	<u>Less Than 1 Year</u>	<u>1 Year to 3 Years</u>	<u>4 Years to 5 Years</u>	<u>More than 5 Years</u>
Long-term debt	\$ 532,323	\$ 450,000(1)	\$ 82,323	\$ —	\$ —
Capital leases	21,040	13,117	7,923	—	—
Operating leases	1,809,000	234,000	943,000	596,000	36,000

(1) Long-term debt due in less than 1 year is \$450,000 that becomes due upon the sale of the Company's Landmark Center restaurant and store. The Company currently has no plans to sell its Landmark Center unit.

Our future capital requirements and the adequacy of available funds will depend on many factors, including the pace of expansion, real estate markets, site locations, and the nature of the arrangements negotiated with landlords. We have incurred significant operating losses since inception and expect to incur a significant operating loss in 2011.

### **Seasonality**

Although our business is not highly seasonal, it can be adversely affected by weather conditions.

### **Impact of Inflation**

In the past, we have been able to recover inflationary cost and commodity price increases through increased menu prices. There have been, and there may be in the future, delays in implementing such menu price increases, and competitive pressures may limit our ability to recover such cost increases in their entirety. Historically, the effects of inflation on our operations have not been materially adverse.

Many of our employees are paid hourly rates related to federal and state minimum wage laws. Although we have and will continue to attempt to pass along any increased labor costs through food price increases, there can be no assurance that all such increased labor costs can be reflected in our prices or that increased prices will be absorbed by consumers without diminishing to some degree consumer spending at our stores. However, we have not experienced to date a significant reduction in store profit margins as a result of changes in such laws, and management does not anticipate any related future significant reductions in gross profit margins.

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

Not applicable.

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

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

We have established disclosure controls and procedures to ensure that material information relating to the Company, including its consolidated subsidiaries is made known to the officers who certify our financial reports and to other members of management and the Board of Directors. Based on their evaluations as of October 2, 2011, our Chief Executive Officer (CEO) and Chief Financial Officer (CFO) have concluded that our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act) were not effective, due to our material weakness in internal control over financial reporting described below, in ensuring that the information required to be disclosed by us in the reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC rules and forms and that such information is accumulated and communicated to our management, including our CEO and CFO, as appropriate to allow timely decisions regarding required disclosures.

### **Management's Report on Internal Control Over Financial Reporting**

Our management is responsible for establishing and maintaining adequate internal control over financial reporting for our Company. Internal control over financial reporting is defined as a process designed by, or under the supervision of, a Company's principal executive and principal financial officers and effected by the Company's board of directors, management and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles and includes those policies and procedures that:

- pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the Company;
- provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the Company are being made in accordance with authorizations of management and directors of the Company; and
- provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the Company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. 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.

Our management, under the supervision of and with the participation of the Chief Executive Officer and Chief Financial Officer, assessed the effectiveness of our internal control over financial reporting as of October 2, 2011. In making this assessment, our management used the criteria set forth by the Committee of Sponsoring Organizations ("COSO") of the Treadway Commission in Internal Control — An Integrated Framework (September 1992). Because material weakness existed and continue to exist due to our inability to perform sufficient testing of internal controls over financial reporting, management concluded that, as of October 2, 2011, our internal controls over financial reporting were not effective.

### **Remediation Plans**

Management, in coordination with the input, oversight and support of our Audit Committee, has contracted with a Consultant to assist us in our controls re-design and testing and remediation efforts. As a result of the testing of Internal Controls over Financial Reporting, the Company may determine additional material weaknesses. We will continue to develop our remediation plans and implement additional measures into calendar year 2011. Management will actively address operational and internal control remediation efforts. Management will report quarterly to our Audit Committee on the status of the remediation efforts.

If the remedial measures described above are insufficient to address any of the identified material weaknesses or are not implemented effectively, or additional deficiencies arise in the future, material misstatements in our interim or annual financial statements may occur in the future. We are currently working to improve and simplify our internal processes and implement enhanced controls, as discussed above, to address the material weaknesses in our internal control over financial reporting and to remedy the ineffectiveness of our disclosure controls and procedures.

This quarterly report does not include an attestation report of our registered independent public accounting firm regarding internal control over financial reporting. Management's report was not subject to attestation by our registered independent public accounting firm pursuant to rules of the SEC that permit us to provide only management's report in this annual report.

### **Changes in internal control over financial reporting.**

There were no changes in our internal control over financial reporting that occurred during the most recent fiscal quarter that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

## **PART II – OTHER INFORMATION**

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

We are subject to legal proceedings and claims which arise in the normal course of business. Although there can be no assurance as to the ultimate outcome, we generally have denied, or believe we have a meritorious defense and will deny, liability in all significant cases pending against us, and we intend to defend vigorously each such case. Based on information currently available, we believe the amount, or range, of reasonably possible losses in connection with the actions against us, in excess of established reserves, in the aggregate, not to be material to our consolidated financial condition or cash flows. However, losses may be material to our operating results for any particular future period, depending on the level of our income for such period. In the opinion of management, the ultimate liabilities with respect to these actions will not have a material adverse effect on the Company's financial position, results of operations or cash flow.

**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds**

None

**Item 3. Defaults Upon Senior Securities**

None.

**Item 4. Removed and Reserved**

None.

**Item 5. Other Information**

None.

**Item 6. Exhibits**

<b>Exhibit No.</b>	<b>Description</b>
31.1	Certification of CEO required by Section 302 of the Sarbanes-Oxley Act of 2002*
31.2	Certification of CFO required by Section 302 of the Sarbanes-Oxley Act of 2002*
32.1	Certification of CEO required by Section 906 of the Sarbanes-Oxley Act of 2002*
32.2	Certification of CFO required by Section 906 of the Sarbanes-Oxley Act of 2002*
*	Filed herewith

## SIGNATURES

In accordance with the requirements of the Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

UFOOD RESTAURANT GROUP, INC.

Date: November 14, 2011

By: /s/ George Naddaff

George Naddaff  
Chairman and Chief Executive Officer  
(principal executive officer)

Date: November 14, 2011

By: /s/ Irma Norton

Irma Norton  
Chief Financial Officer  
(principal financial officer)

## CERTIFICATION

I, George Naddaff, certify that:

1. I have reviewed this Quarterly Report on Form 10-Q for the quarter ended October 2, 2011 of UFood Restaurant Group, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
  - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
  - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: November 14, 2011

/s/ George Naddaff

George Naddaff  
Chairman and Chief Executive Officer

## CERTIFICATION

I, Irma Norton certify that,

- 1 I have reviewed this Quarterly Report on Form 10-Q for the quarter ended October 2, 2011 of UFood Restaurant Group, Inc.;
- 2 Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
- 3 Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
- 4 The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
  - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
  - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: November 14, 2011

/s/ IrmaNorton

Irma Norton  
Chief Financial Officer

CERTIFICATION PURSUANT TO 18 U.S.C. SECTION 1350  
AS ADOPTED PURSUANT TO SECTION 906  
OF THE SARBANES-OXLEY ACT OF 2002

In connection with the Quarterly Report of UFood Restaurant Group, Inc. on Form 10-Q for the quarterly period ended October 2, 2011 (the "Report"), as filed with the Securities and Exchange Commission, I, George Naddaff, Chairman and Chief Executive Officer, certify, to the best of my knowledge and belief, pursuant to Rule 13a-14(b) and 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that:

1. The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
2. The information contained in this Report fairly presents, in all material respects, the financial condition and results of operation of UFood Restaurant Group, Inc.

Date: November 14, 2011

/s/ George Naddaff

George Naddaff  
Chairman and Chief Executive Officer

CERTIFICATION PURSUANT TO 18 U.S.C. SECTION 1350  
AS ADOPTED PURSUANT TO SECTION 906  
OF THE SARBANES-OXLEY ACT OF 2002

In connection with the Quarterly Report of UFood Restaurant Group, Inc. on Form 10-Q for the quarterly period ended October 2, 2011 (the "Report"), as filed with the Securities and Exchange Commission, I, Irma Norton, Acting Chief Financial Officer, certify, to the best of my knowledge and belief, pursuant to Rule 13a-14(b) and 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that:

1. The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
2. The information contained in this Report fairly presents, in all material respects, the financial condition and results of operation of UFood Restaurant Group, Inc.

Date: November 14, 2011

/s/ Irma Norton

Irma Norton  
Chief Financial Officer