ELMERS RESTAURANTS INC
Form 10-Q
September 05, 2002

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549
FORM 10-Q

[X] QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934

FOR THE QUARTERLY PERIOD ENDED JULY 22, 2002 OR

[_] TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934

FOR THE TRANSITION PERIOD FROM ________________ TO __________________

COMMISSION FILE NUMBER 0-14837

ELMER'S RESTAURANTS, INC.
(Exact name of registrant as specified in its charter)

OREGON	93-0836824
(STATE OR OTHER JURISDICTION OF INCORPORATION OR ORGANIZATION)	(I.R.S. EMPLOYER IDENTIFICATION NO.)
11802 S.E. Stark St. Portland, Oregon	97216
(ADDRESS OF PRINCIPAL EXECUTIVE OFFICES)	(ZIP CODE)

(503) 252-1485
(REGISTRANT'S TELEPHONE NUMBER, INCLUDING AREA CODE)

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

Securities registered pursuant to Section 12(g) of the Act:
Common Stock, no par value

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

Number of shares of Common Stock outstanding at September 3, 2002: 2,041,779

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Item 1

ELMER'S RESTAURANTS, INC., AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS

	July 22, 2002 (Unaudited)	April 1, (Audit
ASSETS		
Current assets:		
Cash and cash equivalents	$ 728,662	$ 654
Marketable securities	1,208,558	1,149
Accounts receivable	268,021	315
Notes receivable - related parties, current portion	350,092	372
Inventories	370,691	411

Prepaid expenses and other	467,488	133
Income taxes receivable	--	114
Total current assets	3,393,512	3,149
Notes receivable - related parties, net of current portion	264,732	
Property, buildings and equipment, net	7,214,053	7,654
Goodwill	4,873,121	4,699
Intangible assets	602,709	602
Principal debt service account for convertible debt	147,024	305
Other assets	330,417	274
Total assets	$ 16,825,568	$ 16,685

LIABILITIES AND SHAREHOLDERS' EQUITY

Current liabilities:		
Notes payable, current portion	$ 285,460	$ 277
Accounts payable	1,208,506	1,483
Accrued expenses	292,333	174
Accrued payroll and related taxes	442,184	403
Accrued income tax	201,376	
Total current liabilities	2,429,859	2,338
Notes payable, net of current portion	4,700,737	5,366
Deferred income taxes	692,858	691
Total liabilities	7,823,454	8,396
Commitments and contingencies		
Shareholders' equity		
Common stock, no par value; 10,000,000 shares authorized, 2,058,034 shares issued and outstanding	7,371,400	7,371
Retained earnings	1,642,348	929
Accumulated other comprehensive loss, net of taxes	(11,634)	(11
Total shareholders' equity	9,002,114	8,289
Total liabilities and shareholders' equity	$ 16,825,568	$ 16,685

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

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ELMER'S RESTAURANTS, INC., AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

	For the sixteen weeks ended	
	July 22, 2002	July 23, 2001
	(Unaudited)	(Unaudited)

REVENUES	$ 9,438,069	$ 10,267,510
COSTS AND EXPENSES:		
Cost of restaurant sales:		
Food and beverage	2,649,753	2,919,201
Labor and related costs	3,421,296	3,726,331
Restaurant operating costs	1,271,637	1,392,942
Occupancy costs	612,559	636,055
Depreciation and amortization	221,032	218,498
Restaurant opening and closing expenses	9,717	40,380
General and administrative expenses	687,328	705,628
	8,873,322	9,639,035
INCOME FROM OPERATIONS	564,747	628,475
OTHER INCOME (EXPENSE):		
Interest income	72,347	33,966
Interest expense	(134,151)	(181,858)
Loss on debt extinguishment	(97,500)	
Loss on sale of marketable securities	(55,934)	
Net gain on disposition of property	739,166	
Income before provision for income taxes	1,088,675	480,583
Income tax provision	(375,593)	(165,796)
Net Income	$ 713,082	$ 314,787
PER SHARE DATA:		
Net income per share - Basic	$ 0.35	$ 0.15
Weighted average number of common shares outstanding - Basic	2,058,003	2,060,103
Net income per share - Diluted	$ 0.32	$ 0.15
Weighted average number of common shares outstanding - Diluted	2,229,839	2,087,397

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

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ELMER'S RESTAURANTS, INC., AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

	For the sixteen weeks ended	
	July 22, 2002	July 23, 2001
	(Unaudited)	(Unaudited)
Cash flows from operating activities:		
Net income	$ 713,082	$ 314,787

Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	221,032	218,498
Net gain on disposition of property	(739,166)	
Loss on sale of marketable securities	55,934	
Loss on debt extinguishment	97,500	
Prepaid expenses and other	0	
Changes in assets and liabilities:		
Current assets	(202,380)	(80,388)
Other assets	102,166	(57,561)
Accounts payable and accrued expenses	(141,143)	173,485
Income taxes	316,627	39,386
Net cash provided by operating activities	423,652	608,207
Cash flows from investing activities:		
Acquisitions of property, buildings and equipment	(301,913)	(588,147)
Restaurant acquisitions	(314,263)	
Proceeds from restaurant dispositions	1,303,176	
Purchased goodwill		(40,730)
Net purchases of available for sale securities	(115,381)	
Issuance of note receivable	(129,488)	(74,620)
Principal collected on note receivables	37,893	22,737
Net cash provided by (used in) investing activities	480,024	(680,760)
Cash flows from financing activities:		
Repurchase of convertible notes	(747,500)	
Issuance of ten year term notes		2,806,944
Retirement of term debt		(2,789,231)
Payments on notes payable	(81,725)	(103,678)
Net cash used in financing activities	(829,225)	(85,965)
Net change in cash and cash equivalents	74,451	(158,518)
Cash and cash equivalents, beginning of period	654,211	1,141,016
Cash and cash equivalents, end of period	$ 728,662	$ 982,498
Supplemental disclosures of cash flow information:		
Cash paid during the period for:		
Interest	$ 134,151	$ 181,858
Income taxes	$ 60,100	$ 126,410
Supplemental disclosures of non cash transactions:		
Sale of property and equipment for notes receivable	$ 455,631	
Forgiveness of notes receivable as partial consideration for purchase of property, equipment and goodwill	$ 175,625	
Notes payable issued or assumed in conjunction with acquisition of certain restaurants	$ 74,538	

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

ELMER'S RESTAURANTS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(UNAUDITED)

1. BASIS OF PRESENTATION

The accompanying unaudited condensed financial statements have been prepared in accordance with the instructions to form 10-Q and Rule 10-01 of Regulation S-X. These interim financial statements do not include all the information and footnotes necessary for a fair presentation of financial position and results of operations and cash flows in conformity with generally accepted accounting principles in the United States of America. These condensed financial statements should be read in conjunction with the financial statements and related notes contained in the Company's Annual Report on Form 10-K for the year ended April 1, 2002. Operating results reflected in the interim consolidated financial statements are not necessarily indicative of the results that may be expected for the year ended March 31, 2003.

In the opinion of management, the accompanying unaudited financial statements contain all adjustments (consisting solely of normal recurring adjustments) necessary to present fairly the financial position of the Company and its subsidiaries, and their results of operations and cash flows.

The Company has included additional detail in the Statement of Operations. Restaurant operating expenses are now broken out on a separate line. These costs include such items as advertising, repairs and maintenance and credit card discounts. Historically, most of these items have been included under general and administrative. All information presented herein has been reclassified to conform to the new format. The Company believes that this new format will substantially improve comparability between the Company and its peers.

In July 2001, the Financial Accounting Standards Board issued SFAS No. 141, "Business Combinations" and SFAS No. 142, "Goodwill and Other Intangible Assets". SFAS No. 141 requires business combinations initiated after June 30, 2001, to be accounted for using the purchase method of accounting, and broadens the criteria for recording intangible assets separate from goodwill. Recorded goodwill and intangibles have been evaluated against this new criteria and no changes were considered necessary to the previously regorded intangibles. SFAS No. 142 requires the use of a nonamortization approach to account for purchased goodwill and certain intangibles. Under a nonamortization approach, goodwill and certain intangibles (those deemed to have an indefinate life) will be reviewed for impairment and written down and charged to results of operations only in the periods in which the recorded value of goodwill and certain intangibles are determined to be more than their fair value. The Company's intangible assets were tested for impairment in the third quarter of the fiscal year ended April 1, 2002 and no impairment was found.

Using the early application provision of SFAS No. 142 the Company adopted the provisions of SFAS No. 142 beginning April 3, 2001. These standards only permit prospective application of the new accounting; accordingly adoption of these standards will not affect previously reported financial information. The principal effect of implementing SFAS No. 142 was the cessation of the amortization of goodwill.

All net income per share amounts and weighted average number of common shares outstanding have been retroactively adjusted to reflect a 5% stock dividend, which had a record date in March 2002.

RECENT TRANSACTIONS

Sale of Southern Oregon Elmer's.

As previously reported on the Company's Form 8-K filed on May 17, 2002, effective May 7, 2002 Elmer's Restaurants, Inc. (the "Company") executed asset purchase and franchise agreements with Southern Oregon Elmer's LLC (the "Buyer"), refranchising three of the Company's Elmer's restaurants located in Grants Pass, Medford and Roseburg, Oregon. The Company sold substantially all the assets of those locations in consideration for $1,385,500 in cash and promissory notes valued at $349,500. The Buyer has signed 25-year franchise agreements for each location and will operate the locations under the Elmer's Breakfast. Lunch. Dinner.(TM) name.

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The Buyer has signed a development agreement to open an additional two units within five years. Conversion of the first unit, in Klamath Falls, Oregon, has begun and it is expected to open in early November 2002.

The principals of Southern Oregon Elmer's LLC, Robert Brutke and David Thomason, have substantial industry experience. They are both past-presidents of the Oregon Restaurant Association, Mr. Thomason operates a 10-unit Carl's Jr. franchise from Carl Karcher Enterprises and Mr. Brutke has operated a number of independent concepts in the southern Oregon market, including Brutke's Wagon Wheel in Roseburg, Oregon.

As a result of this transaction, the Company posted a one-time gain of approximately $504,000 or 25 cents per share, (net of tax effect) in the quarter ending July 22, 2002. For the year ended April 1, 2002, revenues from the three restaurants were $5.07 million, contributing $332,000 in earnings before taxes and interest expense. If these three restaurants had been franchised during the year ended April 1, 2002, pro forma franchise fee income would have been approximately $245,000.

The Company agreed to provide a limited amount of seller financing. The Company holds a $270,000 note bearing interest at 9% per year payable in 84 equal monthly payments; an approximately $79,500 note bearing interest at 9% payable in 24 equal monthly payments; an approximately $106,000 inventory note bearing interest at 12% and due in 90 days. To assist with the development of the Klamath Falls restaurant, the Company has granted an extension of the inventory note, which is now due in full by October 22, 2002.

In valuing the restaurants, the Company considered discounted historical cash flows, future capital spending requirements, as well as the impact on the Company's franchise program. The Company believes the consideration paid to be fair, from a financial point of view, to the Company's shareholders. The franchise agreements with the Buyer are comparable to other recent Company franchise agreements.

The Company has assigned its rights and obligations under the occupancy leases for the Medford and Roseburg locations. The Company remains a guarantor of the Medford lease until April 2007. The Company's guarantee of the Roseburg lease could extend until 2018 if the Buyer exercises its options in 2003, 2008 and 2013. The Company has subleased the Grants Pass location to the Buyer for five years under substantially the same terms and conditions as the underlying master lease. Provided all parties are in good standing under the lease at the end of the sublease, the Grants Pass landlord has agreed to lease directly to the Buyer under substantially similar terms.

The Buyer has indemnified the Company against all losses incurred as a result of the Company's obligations as a Guarantor. This indemnification is personally guaranteed by Mssrs. Brutke and Thomason and their spouses. However, in the event of default by the Buyer of the terms of the occupancy leases, and the failure of Mssrs. Brutke and Thomason to make good on their personal guarantees, the Company could be required to pay all rent and other amounts due under the terms of the lease for the remainder of the guarantee term. In the event of default, the Company expects it would exercise its right to reoccupy and continue to operate the restaurants as Elmer's Breakfast. Lunch. Dinner(TM).

The Buyer's obligations under the franchise agreements, promissory notes, lease assignments and sublease are guaranteed by the Buyer and personally by Mssrs. Brutke and Thomason.

Purchase of Vancouver Washington Elmer's

April 15, 2002 the Company acquired an Elmer's restaurant located in Vancouver, Washington from franchisee and former board member, Paul Welch for approximately $250,000 in cash and assumed liabilities. The Company has entered into a long-term occupancy lease at the same location, and will continue to operate the location as an Elmer's restaurant. The purchase price was allocated to the tangible assets of the restaurant.

Relocation of Richard's Deli & Pub

May 28, 2002 the Company relocated one of two Hillsboro Oregon units to a nearby retail mall. The prior landlord's bankruptcy, combined with the superiority of the new space, made the decision to move compelling. The Company terminated its occupancy lease and recorded a $77,000 loss on the surrender of leasehold

improvements. The Company entered into a five-year lease for approximately 4,000 sq. ft. at the new location. This is larger than the operating requirement, therefore the Company has subleased 1,900 sq. ft. of the new space to a non-competing use.

Repurchase of convertible debt

June 28, 2002 the Company repurchased half ($650,000) of its 10% convertible notes, paying a 15% premium over face value. As permitted by the early adoption provisions of SFAS No. 145 - Recission of FASB Statements No. 4, 44 and 64, Amendment of FASB Statement No. 13 and Technical Corrections, the total premium of $97,500 was recorded as a loss on extinguishment. In addition to reducing the Company's debt, this transaction eliminates the potential obligation to issue up to 105,000 shares of common stock upon conversion and reduces the Company's required balances in the debt service account by half.

Purchase of Cooper's Deli and Pub

July 1, 2002, the Company acquired three Cooper's Deli units located in Salem Oregon, from Cooper's Inc. The Cooper's units are substantially similar to the Company's existing deli operations. Purchase consideration included $100,000 cash, a $66,500, two-year promissory note, $11,500 assumed liabilities and the forgiveness of a $155,000 promissory note due to the Company. The acquisition cost of $333,000 included $120,000 in tangible assets and $213,000 in goodwill.

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS.

Elmer's Restaurants, Inc. (the "Company" or "Elmer's") (NASDAQ Small Cap Market symbol: ELMS), located in Portland, Oregon, is a franchisor and operator of full-service, family oriented restaurants under the names "Elmer's Breakfast. Lunch. Dinner." and "Mitzel's American Kitchen" and an operator of delicatessen restaurants under the names "Ashley's", "Cooper's" and "Richard's Deli and Pub." The Company is an Oregon corporation and was incorporated in 1983. Walter Elmer opened the first Elmer's restaurant in Portland, Oregon in 1960, and the first franchised restaurant opened in 1966. The Company acquired the Elmer's franchising operation in January 1984 from the Elmer family.

The Company currently owns and operates 10 Elmer's restaurants and is a party to franchise agreements for 21 Elmer's restaurants in six western states. The Company owns and operates five Mitzel's American Kitchen restaurants in the Puget Sound area of Washington state.

The Company franchises or operates a total of 36 full-service, family-oriented restaurants, with a warm, friendly atmosphere and comfortable furnishings. Most of the restaurants are decorated in a home style, with fireplaces in the dining rooms. The restaurants are primarily freestanding buildings, ranging in size from 4,600 to approximately 9,000 square feet with seating capacities ranging from 120 to 220. A portion of the dining room in most restaurants may also be used for private group meetings by closing it off from the public dining areas.

The menu offers an extensive selection of items for breakfast, lunch and dinner. The Elmer's breakfast menu, which is available all day, contains a wide variety of selections with particular emphasis on pancakes, omelets, crepes, country platters and other popular breakfast items.

CRITICAL ACCOUNTING POLICIES

The Company's reported results are affected by the application of certain accounting policies that require subjective or complex judgements. These judgements involve estimates that are inherently uncertain and may have a significant impact on our quarterly or annual results of operations and financial condition. Changes in these estimates and judgements could have significant effects on the Company's results of operations and financial condition in future years. We believe the Company's most critical accounting policies cover accounting for long-lived assets - specifically property, buildings and equipment depreciation thereon and the valuation of intangible assets. Additional critical accounting policies govern revenue recognition and accounting for stock options.

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Property, Buildings and Equipment

When the Company purchases fixed assets, those assets are recorded at cost. However, when the Company acquires an operating restaurant or business, the Company must allocate the purchase price between the fair market value of the tangible assets acquired and any excess to goodwill. The fair market value of restaurant equipment fixtures and furnishings in an operating restaurant is difficult to separate from the going concern value of the restaurant. Most of the value of the equipment is due to the fact that it is in the restaurant and working. The Company values in place equipment with reference to replacement cost, age and condition, and utility in its intended use.

Depreciation

Property, buildings and equipment are depreciated using the straight-line method over their estimated useful lives. Leasehold improvements are amortized on a straight-line method over their estimated useful lives or the term of the related lease, whichever is shorter. Differences between the realized lives and the estimated lives could result in changes to the Company's results from operations in future years, as well as changes in the rate of recurring capital expenditures.

Revenue Recognition

The Company's revenue is primarily from cash and credit card transactions. As such, restaurant revenue is generally recognized upon receipt of cash or credit cards receipts. Franchise fees based upon a percent of the franchisees gross sales are recognized as the franchisees' sales occur. Revenue from the lottery, which includes traditional ticket based games and video poker games is recorded on a commission basis, that is net of state regulated payouts. Expenses are record using accrual accounting based upon when goods and services are used.

Stock Options

The Company accounts for its stock-based compensation using the intrinsic value method prescribed in Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees, and related interpretations. Based on this methodology the Company has not recorded any compensation costs related to its stock options since all options have been issued at an exercise price equal to or greater than the market value of the Company's stock at the time of issuance.

HIGHLIGHTS OF HISTORICAL RESULTS. The Company reported net income of $713,082 or $.35 per share for the quarter ended July 22, 2002, on sales of $9.4 million as compared to reported net income of $314,787 or $.15 per share for the first quarter ended July 23, 2001. The $398,000 increase in net income is attributable gain on sale of the three Southern Oregon restaurants of $504,000 or 25 cents per share net of tax, partially offset by losses totaling seven cents per share from the debt repurchase, relocation and losses on investments. The Company's total assets as of July 22, 2002 were $16.8 million, which is an increase of $140,000 over total assets as of April 1, 2002. In the sixteen weeks ended July 22, 2002, working capital increased $152,000 while notes payable decreased $657,000. Cash provided by operating activities totaled $424,000 for the period ended July 22, 2002 compared to $608,000 for the period ended July 23, 2001. The decrease in cash provided from operations is primarily attributable to the paydown of negative working capital attributable to the sale of the three Southern Oregon units. The Company has also placed a $350,000 deposit with the Company's primary food vendor in exchange for improved pricing, resulting in increased prepaid expenses and reducing cash provided by operations.

COMPARISON OF RESULTS OF OPERATIONS. The following discussion and analysis presents the Company's results of operations for the 16 weeks ended July 22, 2002 and July 23, 2001.

For the period ended July 22, 2002, the Company's net income and earnings per share increased 127% over net income and earnings per share for the comparable period in 2001. Net income as a percentage of total revenue increased from 3.1% for the period ended July 23, 2001, to 7.6% for the period ended July 22, 2002. Excluding gains and losses, earnings before tax increased from 4.7% of sales to 5.3% of sales.

Dollar amounts in thousands except per share data (unaudited)	RESULTS OF OPERATIONS FOR THE SIXTEEN WEEKS ENDED JULY 22, 2002		RESULTS OF FOR THE SIXTE JULY 2
	Amount	Percent of Revenues	Amount
Revenues	$9,438	100.0%	$10,268
Restaurant costs and expenses	8,186	86.7	8,934
General and administrative expenses	687	7.3	706
Income from operations	565	6.0	628
Non operating income (expense)	524	5.6	(148)
Net income	713	7.6	315
Basic earnings per share	$0.35		$0.15
Weighted average shares outstanding	2,058,003		2,060,103

	REVENUE FOR THE SIXTEEN WEEKS ENDED JULY 22, 2002		REVENUE FOR THE SIXTEEN WEEKS ENDED JULY 23, 2001	
	Amount	Percent of Revenues	Amount	Percent of Revenues
Restaurant operations:				
Restaurant sales	$8,133	86.2%	$8,914	86.8%
Lottery	919	9.7	951	9.3
	9,052	95.9	9,865	96.1
Franchise operations	386	4.1	403	3.9
Total revenue	$9,438	100.0%	$10,268	100.0%

REVENUES. Revenues for the period ended July 22, 2002 were 8.1% less than comparable period in 2001, reflecting the sale of three and purchase of one Elmer's restaurants in April, 2002. Revenues from same store restaurant operations were up 1.4% compared to the sixteen weeks ended July 23, 2001. Same store sales at the Company's Elmer's restaurants were up 3.%. Revenue from franchise operations decreased 5% due to a decrease in administrative services fees of $70,000 earned in the current period, offset by increased franchise fees from the addition of franchised units to the system.

RESTAURANT COSTS AND EXPENSES. Restaurant costs and expenses, which consists of six categories including food, beverage and supply costs, labor and labor related costs, restaurant operating costs, occupancy costs, depreciation and amortization, and restaurant opening and closing expenses decreased to 86.7% of revenue for the quarter ended July 22, 2002 compared to 87.0% for the comparable period in 2001. Food, beverage and supply costs as a percentage of total revenues were 28.1% for the sixteen weeks ended July 22, 2002 compared to 28.4% for the comparable period ended July 23, 2001. Labor expenses totaled 36.2% of revenues for the quarter ended July 22, 2002 compared to 36.3% of revenues for the same period in 2001. Occupancy costs as a percentage of revenues increased from 6.2% for the sixteen weeks ended July 23, 2001 to 6.5% for the same period ended July 22, 2002. Depreciation and amortization expense as a percentage of revenues rose from 2.1% of revenues for the quarter ended July 23, 2001 to 2.3% of revenues for the quarter ended July 22, 2002.

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Restaurant opening and closing expenses decreased 0.3% of sales. The takeover cost of the Vancouver restaurant was significantly less than the startup cost for the Roseburg restaurant in the prior year. Generally the Company has seen improvements in controllable expenses (food, labor and operating expenses) partially offset by increases in other operating costs.

GENERAL AND ADMINISTRATIVE EXPENSES. General and administrative ("G&A") expenses increased from 6.9% to 7.3% of total revenue in each of the first quarter of 2001 and 2002 due to decreased revenues.

NON-OPERATING EXPENSES. Net non-operating income was 5.6% of total revenues in the first quarter of fiscal 2002 compared to an expense of 1.4% of total revenues in the comparable period in fiscal 2001. Increased interest income and decreased interest expense augmented the large gain on sale.

LIQUIDITY AND CAPITAL RESOURCES. As of July 22, 2002, the Company had cash and equivalents of approximately $729,000 representing an increase from April 1, 2002 of approximately $74,000. Cash used by financing activities was $829,000 primarily from the repurchase of 10% convertible notes. Cash provided by investing activities was $480,000. The 1.3 million received from the sale of the Southern Oregon restaurants was offset by $302,000 in capital expenditures and $314,000 used to acquire the Vancouver Elmer's and the Cooper's delis. Additional funds were used to purchase marketable securities and issue notes receivable.

The Company's primary liquidity needs arise from debt service on indebtedness, operating lease requirements and the funding of capital expenditures. The Company's primary source of liquidity during the year is the operation of its restaurants, franchise fees earned from its franchisees, cash on hand, and borrowings. As of July 22, 2002, the Company had outstanding indebtedness of $2.7 million with GE Capital, $1.6 million in real estate debt with Wells Fargo Bank and $650,000 in convertible notes.

In April 2002, the Company granted non-executive incentive stock options for 34,000 shares to employees of the Company. The options vest over five years and have a ten-year term. The exercise price of $5.00 was equal to the market value of the Company's stock on the grant date.

In August, 2002 the Company elected to fix the interest rate on the $925,000 portion of the GE Capital loan that had a variable interest rate. The new rate is 7.1% per annum.

The remaining Wells Fargo real estate debt has a weighted-average maturity of 7.5 years, bears interest at an average of 8.2%, requires monthly payments of principal and interest, and is collateralized by three real estate assets.

The $650,000 in convertible notes have a remaining maturity of approximately five and a half years, bear interest at 10%, requires monthly interest-only payments, straight line principal amortization into a Company-held sinking fund, and are subordinated to the other Company funded debt. The notes include a convertible feature that permits the holder to convert the principal of the note into common stock at any time at $6.19 per share. The Company may call the notes with a five percent premium beginning December 2003.

Certain of the Company's debt agreements require compliance with debt covenants. The most restrictive covenants require the Company to maintain a maximum ratio of total liabilities, excluding subordinated debt, to tangible net worth plus subordinated debt of 3.25 to 1.0, and a ratio of cash generation (defined as net income before taxes, interest expense, depreciation and amortization) to total interest expense plus the prior period current maturities of long-term debt of at least 2.25 to 1.0. Management believes that the Company is in compliance with such requirements. The Company obtained a waiver from Wells Fargo Bank permitting the repurchase of the convertible notes.

Elmer's Restaurants, Inc., like most restaurant businesses, is able to operate with nominal or deficit working capital because sales are for cash and inventory turnover is rapid. Renovation and/or remodeling of existing restaurants is either funded directly from available cash or, in some instances, is financed through outside lenders. Construction or acquisition of new restaurants is generally, although not always, financed by outside lenders.

The Company believes that it will continue to be able to obtain adequate financing on acceptable terms for new restaurant construction and acquisitions and that cash generated from operations will be adequate to meet its financial needs and to pay operating expenses for the foreseeable future, although no assurances can be given.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

SPECIAL NOTE REGARDING FORWARD-LOOKING STATEMENTS:

Certain statements in this form 10-Q constitute "forward-looking statements" which we believe are reasonable and within the meaning of the Securities Act of 1933, as amended and the Securities Exchange Act of 1934, as amended. Such forward-looking statements involve known and unknown risks, uncertainties, and other factors relating to the Company's business, financial condition, and operations which may cause the actual results, performance, or achievements of Elmer's Restaurants, Inc. (individually and collectively with its subsidiaries, herein the "Company") to be materially different from any future results, performance, or achievements expressed or implied by such forward-looking statements. Such factors include, among others, the following: general economic and business conditions; the ability to accomplish stated goals and objectives; successful integration of acquisitions; the impact of competitive products and pricing; success of operating initiatives; development and operating costs; advertising and promotional efforts; adverse publicity; acceptance of new product offerings; consumer trial and frequency; availability, locations, and terms of sites for restaurant development; changes in business strategy or development plans; changes in regulations effecting lottery commissions; quality of management; availability, terms and deployment of capital; the results of financing efforts; business abilities and judgment of personnel; availability of qualified personnel; food, labor and employee benefit costs; changes in, or the failure to comply with, government regulations; continued NASDAQ listing; weather conditions; construction and remodeling schedules; and other factors referenced in this Form 10-Q.

Market Risks

The Company invests excess cash beyond its working capital requirements in liquid marketable securities. These securities include corporate and government bond mutual funds focusing on issues with medium and short term maturities. The Company actively manages its portfolio to reduce interest rate risk. However, an increase in interest rate levels will tend to reduce the value of the portfolio.

Certain of the Company's outstanding financial instruments are subject to market risks, including interest rate risk. Such financial instruments are not currently subject to foreign currency risk or commodity price risk. A rise in prevailing interest rates could have adverse effects on the Company's financial condition and results of operations. The fair value of financial instruments approximate the book value at July 22, 2002.

PART II - OTHER INFORMATION

ITEM 5. OTHER INFORMATION

ITEM 6. EXHIBITS AND REPORTS OF FORM 8-K

a) Exhibits:

99.1 Certification of Chief Executive and Principal Financial Officer.
99.2 Certification of President
99.3 Certification of officers pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

Exhibits required to be attached by Item 601 of Regulation S-K are listed in the Index to Exhibits of this Form 10-Q and are incorporated herein by this reference.

b) Reports on Form 8-K:

The Company's Form 8-K filed on May 17, 2002, which discussed the sale of three Elmer's restaurants, is incorporated herein by reference.

SIGNATURES

Pursuant to the requirements of Section 13 of the Securities Exchange Act of 1934, Elmer's Restaurants, Inc. has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

Elmer's Restaurants, Inc.

By: /s/ WILLIAM W. SERVICE

William W. Service
Chief Executive Officer

Dated: September 3, 2002