Audited Consolidated Financial Statements and Footnotes

For the fiscal years ended December 30, 2012 and January 1, 2012

INDEPENDENT AUDITORS' REPORT

The Board of Directors and Stockholders
Mexican Restaurants, Inc. and Subsidiaries
Houston, Texas

We have audited the accompanying consolidated financial statements of Mexican Restaurants, Inc. and its subsidiaries, which comprise the consolidated balance sheets as of December 30, 2012 and January 1, 2012, and the related consolidated statements of operations, changes in stockholders' equity, and cash flows for the years then ended, and the related notes to the consolidated financial statements.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

Auditors' Responsibility

Our responsibility is to express an opinion on these consolidated financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditors' judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Mexican Restaurants, Inc. and its subsidiaries as of December 30, 2012 and January 1, 2012, and the results of their operations and their cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

Briggs & Veselka Co.
Houston, Texas

March 27, 2013

MEXICAN RESTAURANTS, INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS
As of December 30, 2012 and January 1, 2012

ASSETS	Dec 30, 2012	Jan 1, 2012
Current assets:		
Cash and cash equivalents	$ 1,249,409	$ 804,816
Royalties receivable, net	57,605	99,722
Other receivables, net	115,859	120,910
Inventory	546,741	530,537
Prepaid expenses and other current assets	771,800	974,495
Assets related to discontinued operations, net	55,645	100,000
Total current assets	2,797,059	2,630,480
Property and equipment, net	10,959,831	12,939,426
Deferred tax assets	4,868,622	4,506,060
Other assets	88,659	107,706
Other assets related to discontinued operations	33,878	33,878
Total Assets	$ 18,748,049	$ 20,217,550
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 2,417,019	$ 2,350,811
Accrued sales and liquor taxes	107,404	107,036
Accrued payroll and related taxes	762,048	715,351
Accrued expenses	991,743	1,061,439
Income taxes payable	149,951	135,362
Current installments of long-term debt	2,000,000	-
Current portion of liabilities associated with leasing and exit activities	181,367	117,050
Total current liabilities	6,609,532	4,487,049
Long-term debt	-	3,000,000
Liabilities associated with leasing and exit activities, net of current portion	11,111	115,899
Deferred gain	93,352	312,215
Deferred rent	1,595,439	1,809,244
Total liabilities	8,309,434	9,724,407
Commitments and contingencies	-	-
Stockholders' equity:		
Series A convertible preferred stock, $0.01 par value, 1,000,000 shares authorized, 908,131 and 838,790 shares issued and outstanding at 12/30 and 1/1	9,081	8,388
Additional paid-in capital, preferred stock	1,003,628	952,679
Common stock, $0.01 par value, 20,000,000 shares authorized, 4,732,705 shares issued, 3,481,599 and 3,463,099 shares outstanding at 12/30 and 1/1	47,327	47,327
Additional paid-in capital, common stock	18,273,317	18,471,716
Retained earnings	2,191,819	2,263,500
Treasury stock at cost, 1,251,106 and 1,269,606 common shares at 12/30 and 1/1	(11,086,557)	(11,250,467)
Total stockholders' equity	10,438,615	10,493,143
Total Liabilities and Stockholders' Equity	$ 18,748,049	$ 20,217,550

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

MEXICAN RESTAURANTS, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF OPERATIONS
For the fiscal years ended December 30, 2012 and January 1, 2012

	Dec 30, 2012	Jan 1, 2012
Revenues:		
Restaurant sales, net	$ 67,730,211	$ 66,433,797
Franchise fees, royalties and other	407,486	458,060
	68,137,697	66,891,857
Costs and expenses:		
Cost of sales	19,690,277	19,661,984
Labor	23,167,877	22,884,700
Restaurant operating expenses	16,749,592	16,320,996
General and administrative	4,932,350	5,221,991
Depreciation and amortization	2,601,086	2,889,068
Impairment and restaurant closure expense	1,157,046	471,730
Bad debt expense	24,146	150,427
Loss on sale of property and equipment	57,838	43,184
	68,380,212	67,644,080
Operating loss	(242,515)	(752,223)
Other income (expense):		
Interest income	10,196	2,187
Interest expense	(144,486)	(222,326)
Other income, net	27,510	17,077
	(106,780)	(203,062)
Loss before income taxes	(349,295)	(955,285)
Income tax benefit	329,256	480,813
Net loss	$ (20,039)	$ (474,472)

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

MEXICAN RESTAURANTS, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY
For the fiscal years ended December 30, 2012 and January 1, 2012

	Preferred Stock	Additional Paid-in Capital-PS	Common Stock	Additional Paid-in Capital-CS	Retained Earnings	Treasury Stock	Total Stockholders' Equity
Balances at January 2, 2011	$ --	$ --	$47,327	$ 18,716,827	$ 2,771,215	$(11,693,467)	$ 9,841,902
Proceeds from issuance of preferred stock and warrants	8,000	919,824	--	72,176	--	--	1,000,000
Issuance of vested restricted stock from treasury	--	--	--	(443,000)	--	443,000	--
Dividends on preferred stock	388	32,855	--	--	(33,243)	--	--
Excess tax expense stock based compensation	--	--	--	(35,127)	--	--	(35,127)
Stock based compensation expense	--	--	--	160,840	--	--	160,840
Net loss	--	--	--	--	(474,472)	--	(474,472)
Balances at January 1, 2012	8,388	952,679	47,327	18,471,716	2,263,500	(11,250,467)	10,493,143
Issuance of vested restricted stock from treasury	--	--	--	(163,910)	--	163,910	--
Dividends on preferred stock	693	50,949	--	--	(51,642)	--	--
Excess tax expense stock based compensation	--	--	--	(114,256)	--	--	(114,256)
Stock based compensation expense	--	--	--	79,767	--	--	79,767
Net loss	--	--	--	--	(20,039)	--	(20,039)
Balances at December 30, 2012	$ 9,081	$ 1,003,628	$ 47,327	$ 18,273,317	$ 2,191,819	$(11,086,557)	$ 10,438,615

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

MEXICAN RESTAURANTS, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS
For the fiscal years ended December 30, 2012 and January 1, 2012

	Dec 30, 2012	Jan 1, 2012
Cash flows from operating activities:		
Net loss	$ (20,039)	$ (474,472)
Adjustments to reconcile net loss to net cash provided by operating activities:		
Depreciation and amortization	2,601,086	2,889,068
Deferred gain amortization	(218,861)	(208,142)
Impairment and restaurant closure expense	1,157,046	471,730
Bad debt expense	24,146	150,427
Loss on sale of property and equipment	57,838	43,184
Stock-based compensation expense	79,767	160,840
Excess tax expense stock based compensation	114,256	35,127
Deferred income tax benefit	(476,819)	(641,483)
Changes in operating assets and liabilities		
Royalties receivable	42,117	(98,174)
Other receivables	(19,095)	(37,209)
Inventory	(16,204)	8,099
Prepaid expenses and other current assets	202,695	(36,185)
Other assets	1,468	6,587
Accounts payable	(29,537)	(37,794)
Accrued expenses and other liabilities	(22,630)	89,451
Income taxes payable	14,589	32,559
Liabilities associated with leasing and exit activities	(40,471)	(237,636)
Deferred rent and other long-term liabilities	(213,806)	(142,555)
Total adjustments	3,257,582	2,447,894
Net cash provided by continuing operations	3,237,546	1,973,422
Net cash used in discontinued operations	44,355	(3,180)
Net cash provided by operating activities	3,281,901	1,970,242
Cash flows from investing activities:		
Purchase of property and equipment	(1,727,002)	(1,414,707)
Proceeds from sale of property and equipment	3,950	5,610
Net cash used in investing activities	(1,723,052)	(1,409,097)
Cash flows from financing activities:		
Borrowings under line of credit agreement	500,000	-
Payments under line of credit agreement	(1,500,000)	(1,400,000)
Proceeds from issuance of preferred stock and warrants	-	1,000,000
Excess tax expense-stock based compensation	(114,256)	(35,127)
Net cash used in financing activities	(1,114,256)	(435,127)
Net increase in cash and cash equivalents	444,593	126,018
Cash and cash equivalents at beginning of year	804,816	678,798
Cash and cash equivalents at end of year	$ 1,249,409	$ 804,816
Supplemental disclosure of cash flow information:		
Cash paid during the year:		
Interest	$ 119,200	$ 203,359
Income taxes	$ 159,792	$ 157,902

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

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 30, 2012 and January 1, 2012

(1) Organization and nature of business

General overview

Mexican Restaurants, Inc. (the "Company") was incorporated under the name "Casa Olé Restaurants, Inc." in the State of Texas in February 1996, and had its initial public offering of Common Stock in April 1996. In May 1999, the corporate name was changed to "Mexican Restaurants, Inc". In November 2010, the Company deregistered its common stock and suspended its reporting obligations under the Securities Exchange Act of 1934 (the "Exchange Act"). The Company maintains a market in its common shares by having the shares listed on the Pink Sheets, a quotation service that does not require an issuer to be registered with the Securities and Exchange Commission ("SEC"). The Company was eligible to deregister its common stock under the Exchange Act because it had fewer than 300 shareholders of record. The Company operates as a holding company and conducts substantially all of its operations through its subsidiaries. All references to the Company include the Company and its subsidiaries, unless otherwise stated.

The Company operates and franchises full-service Mexican-themed restaurants featuring various elements associated with the casual dining experience under the names Casa Olé®, Monterey's Little Mexico® ("Monterey"), Tortuga Coastal Cantina® ("Tortuga") and Crazy Jose's®. The Company also operates a burrito fast casual concept under the name Mission Burrito™. The Casa Olé, Monterey, Tortuga, Crazy Jose's and Mission Burrito concepts have been in business for 41, 58, 19, 26 and 16 years, respectively. Today, the Company operates 50 restaurants, franchises 11 restaurants and licenses one restaurant in various communities across Texas, Louisiana and Oklahoma. The Casa Olé, Monterey and Crazy Jose's restaurants are designed to appeal to a broad range of customers, and are located primarily in small and medium-sized communities and in middle-income areas of larger markets. The Tortuga and Mission Burrito restaurants, which are also designed to appeal to a broad range of customers, are located primarily in the Houston market. The restaurants offer fresh, quality food, affordable prices, friendly service and comfortable surroundings. The full-service menus feature a variety of traditional Mexican and Tex-Mex selections, complemented by the Company's own original Mexican-based recipes, designed to have broad appeal. The Mission Burrito restaurants offer freshly made burritos, tacos, quesadillas, soups, salads and chips with guacamole and/or chili con queso.

Company-operated restaurants

The Company's primary source of revenues is the sale of food and beverages at company-owned restaurants. All of the company-owned restaurant sites are leased. Real estate for company-owned restaurants is typically leased under triple net leases that require the Company to pay real estate taxes and utilities, to maintain insurance with respect to the premises and in certain cases to pay contingent rent based on sales in excess of specified amounts. Generally the non-mall locations for the company-owned restaurants have initial terms of 10 to 20 years with renewal options. Three underperforming company-operated locations were closed during fiscal year 2012.

Franchisee-operated restaurants

The Company also derives revenues from franchise fees, royalties and other franchise-related activities. The Company currently has six Casa Olé franchisees operating a total of 11 restaurants and one licensee operating one Monterey's restaurant. Two underperforming Casa Olé franchise locations were closed during fiscal year 2012.

(2) Significant accounting policies

Basis of presentation

The accompanying consolidated financial statements have been prepared in accordance with generally accepted accounting principles in the United States of America ("GAAP"). The Company maintains its accounting records on a 52/53 week fiscal year ending on the Sunday nearest December 31. References in this report to fiscal year 2012 and fiscal year 2011 relate to the periods ended December 30, 2012 and January 1, 2012, respectively. Fiscal years 2012 and 2011 presented herein each consisted of 52 weeks.

Basis of consolidation

The consolidated financial statements include the accounts of Mexican Restaurants, Inc. and its wholly-owned subsidiaries. All significant intercompany accounts and transactions have been eliminated in consolidation.

Use of estimates and assumptions

The preparation of consolidated financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the dates of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting periods. Actual results could differ from those estimates.

Significant estimates include, but are not limited to the estimates used in calculating depreciation and amortization, the estimates used when evaluating long-lived assets for impairment, estimates used when evaluating receivables for collectability, and the determination of valuation allowances related to income taxes and the utilization of net operating loss carryforwards in future periods. Because of the inherent uncertainties in these estimates, it is at least reasonably possible that the estimates used will change in the near term.

Revenue recognition

Revenue from the sale of food, soft beverages and alcoholic beverages are recognized as products are sold. Franchise fee revenue from an individual franchise sale is recognized when all services relating to the sale have been performed and the restaurant has commenced operations. Initial franchise fees relating to area franchise sales are recognized ratably in proportion to services that are required to be performed pursuant to the area franchise or development agreements and proportionately as the restaurants within the area are opened. The Company's current standard franchise agreement also provides for a royalty payment which is a percentage of gross sales. Royalty income is recognized when it is earned.

Revenues from gift card sales are recognized upon redemption. Prior to redemption, the outstanding balances of all gift cards are included in accounts payable in the consolidated balance sheets.

Concentration of credit risks

Financial instruments that potentially subject the Company to a significant concentration of credit risk consist primarily of cash and cash equivalents.

The Federal Deposit Insurance Corporation ("FDIC") provided unlimited insurance coverage of noninterest-bearing transaction accounts through December 31, 2012. Beginning January 1, 2013, FDIC protection on noninterest-bearing bank accounts (e.g. business operating accounts) reverted to $250,000. At times, the Company maintains deposits in federally insured financial institutions in excess of federally insured limits. Management monitors credit ratings and concentration of risk within these financial institutions on a continuing basis to safeguard cash deposits.

Cash and cash equivalents

The cash account includes restricted funds that are segregated from operating funds. The restricted funds are used at the discretion of the Company's employees and management for community relation purposes. The restricted fund balance was approximately $189,000 and $167,000 as of December 30, 2012 and January 1, 2012, respectively. Cash equivalents include credit card receivables because they are typically converted to cash within three to five days of the sales transaction.

Receivables and allowances for doubtful accounts

Receivables are stated at face value less an allowance for doubtful accounts. Company management evaluates the collectability of receivables and establishes an allowance for doubtful accounts based primarily upon collection history and the obligor's financial condition. All changes in the net carrying amount of the Company's contracts are recorded as adjustments to bad debt expense.

Uncollectible contracts are written off when it is determined that there is minimal chance of any kind of recovery, such as bankruptcy or other condition that severely impacts an obligor's ability to repay amounts owed. As of December 30, 2012 and January 1, 2012 the Company had $96,752 and $95,373, respectively, recorded within royalties receivable and $199,740 and $191,257, respectively, recorded within other receivables as an allowance for doubtful accounts on the consolidated balance sheets.

Sales taxes

Sales taxes collected from customers are excluded from revenues. The obligation is included in current liabilities until the taxes are remitted to the appropriate taxing authorities.

Pre-opening costs

Pre-opening costs primarily consist of hiring and training employees associated with the opening of a new restaurant and are expensed as incurred. No new restaurants were opened in fiscal years 2012 or 2011.

Discontinued operations and leasing exit activities

The assets and liabilities for all units that have been disposed of, either individually or in the aggregate, have been reclassified to assets related to discontinued operations, other assets related to discontinued operations or to liabilities associated with leasing and exit activities in the consolidated balance sheets.

As of December 30, 2012 and January 1, 2012, assets related to discontinued operations of $55,645 and $100,000 consisted of rents receivable from a subleased restaurant that ceased operations. Other assets related to discontinued operations of $33,878 consisted of security deposits for leases in the state of Michigan that were assigned to a third party in 2009 and which expire in 2019.

Current and long-term liabilities related to leasing and exit activities consisted primarily of accrued closure costs related to (a) two non-interest bearing notes payable made in 2011 to exit two leases (discussed in the following paragraphs), (b) the closure of an underperforming company-operated restaurant in December 2012 for which the lease expires in June 2013 and (c) rent differentials for two other closed restaurants for which the Company has subleased the restaurants. Rent differentials represent the difference between the Company's future contractual lease payment obligations for closed restaurants and contractual future rent payments to be received in accordance with the terms of the subleases.

On February 22, 2011, the Company entered into a "Promissory Note" along with a "Settlement and Release Agreement" to exit the lease related to a store that was closed in November 2010. This $150,000 non-interest bearing promissory note was included in liabilities associated with leasing and exit activities. A down payment of $40,000 was made on February 22, 2011 and the remaining balance of $110,000 was payable in twelve equal monthly installments. As of January 1, 2012, the Company owed $9,167 for this obligation. As of December 30, 2012, the obligation was paid in full.

On May 2, 2011, the Company entered into a promissory note along with a Compromise Settlement and Release Agreement to exit the lease related to a store that had been subleased. This $200,000 non-interest bearing promissory note is included in liabilities associated with leasing and exit activities. The principal balance is due in thirty-six equal monthly installments and contains a penalty clause that increases the principal to $600,000 if the Company defaults on the note. As of December 30, 2012 and January 1, 2012, the Company owed $77,778 and $144,445 for this obligation. The balance of the obligation matures in two years with $66,667 due in 2013 and $11,111 due in 2014.

Inventory

Inventory, which is mainly comprised of food and beverages, is stated at the lower of cost or market. Cost is determined using the first-in, first-out method. Miscellaneous restaurant supplies are included in inventory and valued on a specific identification basis.

Property and equipment

Property and equipment are stated at cost. Depreciation on equipment and vehicles is calculated on the straight-line method over the estimated useful lives of the assets. Leasehold improvements are amortized on a straight-line basis over the shorter of the lease term plus renewal options reasonably assured or the estimated useful life of the assets. The depreciable lives are as follows:

Leasehold improvements	2-18 years
Vehicles	5 years
Equipment	3-15 years

Upon opening a new restaurant, the initial purchase of smallwares is capitalized as restaurant equipment, but not depreciated. Subsequent purchases of smallwares are expensed as incurred.

Significant expenditures are capitalized if they extend the utility or useful life of the asset. All other maintenance and repair costs are charged to current operations. The cost and related accumulated depreciation of assets replaced, retired or otherwise disposed of are eliminated from the property accounts and any gain or loss is reflected in costs and expenses.

Property and equipment, net consist of the following:

	Dec 30, 2012	Jan 1, 2012
Land	$ 54,750	$ 60,750
Construction in process	29,753	-
Vehicles	16,874	16,874
Equipment and smallwares	19,314,622	22,179,419
Leasehold improvements	16,327,522	17,725,377
	35,743,521	39,982,420
Less: Accumulated depreciation and amortization	(24,783,690)	(27,042,994)
Property and equipment, net	$ 10,959,831	$ 12,939,426

Impairment and restaurant closure expense

Long-lived assets are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. If the carrying amount of the asset exceeds its estimated undiscounted net cash flow, excluding interest, an impairment charge is recognized for the amount by which the carrying amount of the asset exceeds its fair value.

Impairment expense of $1,061,302 during 2012 primarily related to asset impairments for four under-performing operating restaurants and to another restaurant that the company plans to relocate in fiscal year 2013. Impairment expense of $471,730 during 2011 primarily related to asset impairments for two under-performing operating restaurants one of which was closed during 2012.

Restaurant closure expense of $95,744 during 2012 primarily related to lease obligations related to the closure of an underperforming restaurant during 2012. There was no restaurant closure expense recorded for fiscal year 2011.

Advertising expense

Each year, management prepares a budget for advertising expenses to promote each restaurant brand. Prepaid advertising is deferred and amortized to expense based on estimates of usage. The Company recorded advertising expense in continuing operations of approximately $1,047,000 and $791,000 for fiscal years 2012 and 2011, respectively, and is recorded within restaurant operating expenses on the consolidated statements of operations.

Deferred rent

Lease rentals that have escalating rents are recorded as expense on a straight line basis over the life of each lease. Most of these lease agreements require minimum annual rent payments plus contingent rent payments based on a percentage of restaurant sales which exceed the minimum base rent. Contingent rent payments, to the extent they exceed minimum payments, are accrued during the periods in which the liability is incurred. Incentive allowances provided by landlords under leasing arrangements are deferred as a liability and amortized to income as an adjustment to rent expense over the life of the lease.

Deferred gain

On June 25, 1998, the Company completed a sale-leaseback transaction involving the sale and leaseback of land, building and improvements of 13 company-owned restaurants. The properties were sold for $11.5 million and resulted in a gain of approximately $3.5 million that was deferred and is amortized over the terms of the operating leases, which are 15 years each. The deferred gain at December 30, 2012 and January 1, 2012 was $93,352 and $312,215, respectively. Subsequent to the original transaction, two leases were sublet and two other leases were terminated. The remaining 9 leases have a total future minimum lease obligation of $3,059,918 and are included in the future minimum lease payment schedule below.

Commitments and contingencies

Restaurant operating space and equipment are leased by the Company under non-cancelable operating leases which expire at various dates through January 31, 2024. The restaurant operating space base agreements typically provide for a minimum lease rent plus common area maintenance, insurance, and real estate taxes, plus additional percentage rent based upon revenues of the restaurant (generally 2% to 7%) and may be renewed for periods ranging from one to twenty-five years.

Future minimum lease payments (which include two closed restaurants discussed below) under non-cancelable operating leases as of December 30, 2012 are as follows:

Fiscal year ending	
2013	$ 4,586,499
2014	4,154,834
2015	3,836,350
2016	3,471,208
2017	3,065,074
Thereafter	9,168,897
	$ 28,282,862

Two restaurants (as previously mentioned) have been subleased to third party restaurant operators. Each of the sublease terms corresponds with its underlying base lease term. Future minimum lease receipts under non-cancelable operating leases as of December 30, 2012 are $124,228 for the fiscal year ending 2013.

Total rent expense for restaurant operating space and equipment amounted to $5,499,535 and $5,502,242 for fiscal years 2012 and 2011, respectively, and is included with restaurant operating expenses in the consolidated statements of operations.

From time-to-time, the Company is subject to various litigation and other claims in the normal course of business. The Company establishes liabilities in connection with legal actions that management deems to be probable and estimable. No amounts have been accrued in the financial statements with respect to any matters.

Fair value measurements

The carrying value of cash and cash equivalents, accounts receivable, accounts payable and short-term borrowings, as reflected in the balance sheet, approximate fair value because of the short-term maturity of these instruments. The estimated fair value of long-term debt was determined by discounting future cash flows using rates currently available to the Company for debt with similar terms and remaining maturities. The Company calculated that the estimated fair value of the long-term debt is not significantly different than the carrying value of the debt.

Income taxes

Income taxes are provided based on the liability method for financial reporting purposes. Under this method deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to reverse. Valuation allowances are established when necessary to reduce deferred income tax assets to the amount expected to be realized.

Uncertain tax positions are recognized in the consolidated financial statements only if that position is more likely than not of being sustained upon examination by taxing authorities, based on the technical merits of the position. The Company recognizes interest and penalties related to uncertain tax positions in income tax expense.

The Company files income tax returns in the U.S. federal jurisdiction, and three state jurisdictions. The Company's periodic tax returns filed in 2008 and thereafter are subject to examination by taxing authorities in accordance with the normal statutes of limitations in the applicable jurisdictions.

The components of income tax benefit (expense) are as follows for fiscal years 2012 and 2011:

	2012	2011
Current:		
Federal	$ (7,951)	$ --
State and local	(139,612)	(160,670)
Deferred	476,819	641,483
	$ 329,256	$ 480,813

The actual income tax benefit differs from the expected income tax benefit calculated by applying the U.S. federal corporate tax rate to loss before income taxes as follows:

	2012	2011
Expected tax benefit	$ 118,760	$ 324,797
State tax expense	(93,720)	(105,535)
Tax credits	320,125	314,495
Other	(15,909)	(52,944)
	$ 329,256	$ 480,813

Deferred tax assets and liabilities consisted of the following at December 30, 2012 and January 1, 2012:

	Dec 30, 2012	Jan 1, 2012
Deferred tax assets:		
Sale-leaseback	$ 31,739	$ 106,153
Tax credit carryforwards	2,776,732	2,291,694
Stock compensation differences	58,095	56,755
Other	31,153	32,649
Capital losses	146,760	146,760
Bad debt expense	112,807	109,453
Goodwill amortization differences	590,614	683,538
Asset impairments	561,676	492,984
Depreciation differences	610,704	629,111
Net operating losses (NOL's)	527,569	522,594
Accrued expenses	127,533	141,129
	5,575,382	5,212,820
Valuation allowances	(706,760)	(706,760)
Net deferred tax assets	$4,868,622	$4,506,060

At December 30, 2012 and January 1, 2012, the Company had federal tax credit carryforwards of approximately $2.8 million and $2.3 million, respectively, and federal NOL carryforwards of approximately $1.6 million and $1.5 million, respectively all of which expire in years through 2032 and all of which are available to reduce future Federal regular income taxes. The Company also has a capital loss carryover in the amount of approximately $432,000 that expires in 2014.

Stock-based compensation

The Company accounts for share-based awards through the measurement and recognition of compensation expense for all share-based payment awards to employees, officers, directors, and consultants based on estimated fair values. Compensation expense is recognized for all stock-based compensation with future service requirements over the period that the recipient of the award provides service in exchange for the award. Stock options granted are recorded at estimated fair value using an option-pricing model or other applicable valuation technique. Restricted stock shares granted are recorded at estimated fair value based upon the quoted market value of the Company's common stock on the date of grant. The fair value of each share is expensed over the period during which the related restrictions lapse.

Recent accounting pronouncements

The Company has implemented all new accounting pronouncements and does not believe that there are any other new accounting pronouncements that have been issued that may have a material impact on the consolidated financial statements,

(3) Stock-based compensation plans

The Company has four stock-based compensation plans under which shares of common stock are issued to employees, officers, directors and consultants. The 2005 Long Term Incentive Plan was approved by stockholders and authorizes the granting of common stock in the form of incentive stock options, non-qualified stock options, and restricted stock. The 2005 Long Term Incentive Plan is the only plan with securities remaining available for future issuance. As of December 30, 2012 59,500 shares remain available for future issuance. The purpose of the 2005 Plan is to benefit and advance the interests of the Company by attracting and retaining qualified directors and key executive and managerial employees; motivate employees, by making appropriate awards, to achieve long-range goals; provide incentive compensation that is competitive with other corporations; and further align the interests of directors, employees and other participants with those of other shareholders.

The following table provides information about the shares of common stock that may be issued upon exercise and vesting of awards under these four plans as of December 30, 2012.

	Number of Securities to be Issued Upon Exercise of Stock Options and Vesting of Restricted Stock Shares	**Weighted Average Exercise Price of Stock Options (1)**	**Number of Securities Remaining Available for Future Issuance Under Stock-based Compensation Plans**
Stock-based compensation plans approved by shareholders	249,375	$10.60	59,500

(1) Grants of restricted stock are valued as of the date of vesting and have no exercise price. Consequently, they are not included in the calculation of weighted average exercise price.

(a) Stock Option Activity

The following table reflects the stock option activity during 2012 and 2011:

	Options Granted		**Options Exercisable**	
	Shares	**Weighted Average Exercise Price**	**Shares**	**Weighted Average Exercise Price**
Outstanding options at January 2, 2011	306,150	$ 8.73	267,150	$ 8.80
Canceled/forfeited	(67,550)	2.96	(50,550)	3.96
Outstanding options at January 1, 2012	238,600	10.36	216,600	10.57
Canceled/forfeited	(8,225)	3.80	(8,225)	3.80
Vested	-	-	22,000	8.28
Outstanding options at December 30, 2012	230,375	$10.60	230,375	$10.60

Information relating to significant option groups outstanding at December 30, 2012 is as follows:

	Options Granted			**Options Exercisable**		
Range of Exercise Prices	**Shares Outstanding**	**Weighted Average Remaining Contractual Life**	**Weighted Average Exercise Price**	**Shares Exercisable**	**Weighted Average Remaining Contractual Life**	**Weighted Average Exercise Price**
$3.00–6.00	10,375	0.18	$ 3.11	10,375	0.18	$ 3.11
$6.01–9.00	60,000	4.48	8.15	60,000	4.48	8.15
$12.00	160,000	2.92	12.00	160,000	2.92	12.00
$3.00–12.00	230,375	3.20	$ 10.60	230,375	3.20	$ 10.60

The Company receives a tax deduction for certain stock option exercises during the period the options are exercised, generally for the excess of the price at which the options were sold over the exercise prices of the options. During fiscal years 2012 and 2011, there were no stock options exercised. The 230,375 options outstanding at December 30, 2012 had exercise prices ranging from $3.10 to $12.00, of which 160,000 of the options had exercise prices of $12.00. As of December 30, 2012, 230,375 options were vested and exercisable.

The Company did not grant any stock options during fiscal years 2012 or 2011. As of December 30, 2012, all stock option awards were fully vested, therefore the Company had no unrecognized stock based compensation. As of January 1, 2012, the Company had unrecognized stock based compensation expense of $23,623 for all unvested stock option awards.

(b) Restricted Stock Activity

On May 22, 2007, the Board of Directors approved a restricted stock grant of 10,000 shares to the Company's President, with such grant vesting over a four year period. This award provided that the Company was to make additional restricted stock grants on the four following anniversary dates, for an aggregate of 40,000 shares. On May 22, 2011, restricted stock grants in the amount of 10,000 shares to the Company's President were granted pursuant to the May 22, 2007 agreement, with such shares vesting over a four-year period.

The following table reflects the restricted stock activity during 2012 and 2011:

	Shares	Weighted Average Grant-Date Fair Value	Weighted Average Remaining Contractual Term (years)
Unvested at beginning of 2011	50,000	$ 4.38	
Granted	10,000	1.35	
Vested	(22,500)	5.51	
Unvested at end of 2011	37,500	2.89	2.25
Vested	(18,500)		
Unvested at end of 2012	19,000	$ 2.01	1.18

The unvested restricted share awards were valued from $1.35 to $2.75 per share based on the grant date stock price and vest over 0.5 to 2.5 years. As of December 30, 2012, the unrecognized stock based compensation expense associated with unvested restricted shares was $27,830 and will be recognized over an average period of 1.18 years. During 2012, 18,500 treasury shares were issued for restricted stock which vested during 2012. During 2011, 50,000 treasury shares were issued for restricted stock which vested during 2010 and 2011.

(c) Performance units

Performance units have been granted under the 2005 Long Term Incentive Plan. The performance units vest upon a business combination (as defined in the plan) and are payable in cash in an amount equal to the product of the number of units vested and the average of the high and low prices of the common stock as of the last business day preceding the business combination, which average price must be in excess of $20.00 per share. As of December 30, 2012, there were 245,000 performance units available to be issued.

(4) Debt

The Company entered into a credit agreement (the "Agreement") with a financial institution in June 2007 which provided for a revolving loan of up to $10 million. Over the years, the available credit has been reduced in accordance with amendments to the Agreement. As of December 30, 2012, the amended Agreement provided for a revolving loan of up to $2,800,000 which will be reduced by $275,000 on the first day of each fiscal quarter.

At management's option, the revolving loan bears an interest rate equal to the Base Rate plus a stipulated percentage or LIBOR plus a stipulated percentage. Accordingly, the Company is impacted by changes in the Base Rate and LIBOR. At December 30, 2012 and January 1, 2012 the debt had an approximate interest rate of 5.00% and 5.25%, respectively. The Company is subject to a non-use fee of 0.50% on the unused portion of the revolver from the date of the Agreement. As of December 30, 2012 and January 1, 2012, the Company's outstanding debt to the financial institution was $2.0 million and $3.0 million, respectively, and the revolving loan matures on June 29, 2013.

Under the amended Agreement, the Company is subject to certain debt covenants that if violated would cause the loan to be called in advance of the stipulated maturity date. As of December 2012, the Company was in compliance with regard to financial covenants of the Agreement. Management believes funds will be sufficient to meet operating requirements and to finance routine capital expenditures through the next 12 months. Unless the Company violates a debt covenant, the Company's credit facility is not subject to triggering events that would cause the credit facility to become due in advance of the maturity date described in the previous paragraphs. As of the date hereof, management expects the Company will be in compliance with the debt covenants, as amended, during the next 12 months, although management continues to closely monitor the Company's operating results and cash flows.

On October 31, 2012, the Company obtained a "Limited Waiver and Consent" from the financial institution in order to secure financing from another financial institution to build a new Casa Ole restaurant. The waiver allows the Company to borrow up to $1.2 million for the project.

During November and December 2011, the Company was in default of the Agreement with regard to financial covenants. As a result, the Agreement was amended on February 23, 2012. Under this amendment, the financial institution agreed to waive the November 2011 and December 2011 defaults subject to amended terms and conditions to the Agreement. The amended terms and conditions primarily redefined certain financial ratio limits.

As of the fourth quarter of 2010, the Company was in default of the Agreement with regard to financial covenants. As a result, the Agreement was amended on April 8, 2011. Under this amendment, the financial institution agreed to waive the third and fourth quarter 2010 defaults subject to amended terms and conditions to the Agreement. The amended terms and conditions of the Agreement primarily include the following changes: (1) the loan maturity date was extended to June 29, 2013, (2) the maximum available credit was reduced to $4,725,000 and will continue to be reduced by $275,000 on the first day of each fiscal quarter beginning July 4, 2011, (3) the rate for borrowing was increased, (4) the calculation of certain financial ratios was redefined and a new financial ratio was added, (5) the measurement periods and certain financial ratio limits were redefined and, (6) a $1,000,000 capital contribution was required (see footnote 9 "Stockholders' equity-Issuance of preferred stock and warrants" for more details).

The Company repaid $1.0 million on the revolving loan during fiscal year 2012 from cash provided by operations. The Company repaid $1.4 million on the revolving loan during fiscal year 2011 of which $1.0 million was received from the sale of Series A convertible preferred stock and warrants (see footnote 9 "Stockholders' equity-Issuance of preferred stock and warrants" for more details).

The Agreement also allows up to $2.0 million in annual stock repurchases. Although the Agreement permits the Company to implement a share repurchase program for up to $2.0 million annually under certain conditions, the Company currently has no repurchase programs in effect. Shares previously acquired are being held for general corporate purposes, including the offset of the dilutive effect on shareholders from the exercise of stock options. The Company has pledged the stock of its subsidiaries, leasehold interests, patents and trademarks and furniture, fixtures and equipment as collateral for its credit facility with the financial institution.

(5) Related party transactions

In 2007, the Company sold a store to a director of the Company. The restaurant operations were taken over by Mr. Forehand after the close of business on July 1, 2007. This store currently operates under the Company's uniform franchise agreement and is subject to a monthly royalty fee. For the fiscal years ended December 30, 2012 and January 1, 2012, the Company recognized royalty income of $20,967 and $21,323, respectively, related to this site.

On April 11, 2011, the Company received $1,000,000 from executives and board members of the Company in cash in exchange for 800,000 Series A Convertible Preferred Stock ("Series A") shares and non-transferable share warrants to purchase up to 125,000 common stock shares. (See footnote 9 for more details regarding the sale of these securities.)

(6) Accrued expenses

Accrued expenses consist of the following:

	Dec 30, 2012	Jan 1, 2012
Property taxes	$ 486,017	$ 533,550
Group insurance	203,221	270,234
Contingent lease rent	95,880	86,922
Other	206,625	170,733
	$991,743	$1,061,439

(7) Prepaid expenses and other current assets

Prepaid expenses and other current assets consist of the following:

	Dec 30, 2012	Jan 1, 2012
Triple net lease rent	$ 485,490	$ 498,711
Property insurance	183,528	287,424
Licenses	62,152	133,762
Other	40,630	54,598
	$ 771,800	$ 974,495

(8) 401(k) Plan

Beginning in fiscal year 1998, the Company established a defined contribution 401(k) plan that covers substantially all full-time employees meeting certain age and service requirements. Participating employees may elect to defer a percentage of their qualifying compensation as voluntary employee contributions. The Company may contribute additional amounts at the discretion of management. The Company did not make any contributions to the plan in fiscal years 2012 and 2011.

(9) Stockholders' equity

Dividends

Since the Company's 1996 initial public offering, no cash dividends have been paid on the Company's Common Stock. Management intends to retain earnings of the Company to support operations and pay down debt, and does not intend to pay cash dividends on the Common Stock for the foreseeable future. In addition, the current credit agreement prohibits the payment of any cash dividends. Any payment of cash dividends in the future will be at the discretion of the Board of Directors and will depend upon such factors as earnings levels, capital requirements, the Company's financial condition and the ability to do so under then-existing credit agreements.

Issuance of preferred stock and warrants

On April 11, 2011, the Company received $1,000,000 in cash in exchange for 800,000 Series A shares and non-transferable share warrants to purchase up to 125,000 common stock shares. The equity contribution was made pursuant to resolutions adopted by the Board of Directors on February 4, 2011.

The Series A shares have a par value of $0.01 per share and a stated value of $1.25 per share and may be converted to Common Stock on a one-for-one basis. Dividends accrue at 8% per annum on the preferred stock with payment dates occurring on or before May 15, 2013 to be paid by issuing additional shares of Series A shares in lieu of cash. The holders of the Series A shares have voting rights provided by the Texas Business Organization Code as well as additional rights as defined in the designating resolutions. The non-transferable share warrants have an exercise price of $2.00 per share.

(10) Subsequent Events

On January 22, 2013 the Company purchased land in Texas for approximately $564,000 with plans to start building a new Casa Ole restaurant during 2013.

Management has evaluated subsequent events through March 27, 2013, the date which the consolidated financial statements were available to be issued.