



Unaudited Interim Consolidated Financial Statements and Footnotes

July 1, 2012

MEXICAN RESTAURANTS, INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS

	(unaudited)	
	Jul 1, 2012	Jan 1, 2012
ASSETS		
Current assets:		
Cash	\$ 1,127,283	\$ 804,816
Royalties receivable, net	75,546	99,722
Other receivables, net	102,711	120,910
Inventory	555,151	530,537
Prepaid expenses and other current assets	786,654	974,495
Assets related to discontinued operations, net	72,283	100,000
Total current assets	<u>2,719,628</u>	<u>2,630,480</u>
Property and equipment, net	12,587,149	12,939,426
Deferred tax assets	4,561,755	4,506,060
Other assets, net	98,183	107,706
Other assets related to discontinued operations	33,878	33,878
Total assets	<u>\$ 20,000,593</u>	<u>\$ 20,217,550</u>
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Current installments of long-term debt	\$ 2,500,000	\$ -
Accounts payable	2,382,434	2,350,811
Accrued sales and liquor taxes	120,991	107,036
Accrued payroll and related taxes	819,914	715,351
Accrued expenses	834,254	1,061,439
Income taxes payable	102,908	135,362
Current portion of liabilities associated with leasing and exit activities	104,934	117,050
Total current liabilities	<u>6,865,435</u>	<u>4,487,049</u>
Long-term debt	-	3,000,000
Liabilities associated with leasing and exit activities, net of current portion	56,496	115,899
Deferred gain	208,144	312,215
Deferred rent	<u>1,714,145</u>	<u>1,809,244</u>
Total liabilities	8,844,220	9,724,407
Commitments and contingencies	-	-
Stockholders' equity:		
Series A Convertible Preferred stock, \$.01 par value, 1,000,000 shares authorized, 872,585 and 838,790 shares issued and outstanding at 7/1/12 and 1/1/12, respectively	8,726	8,388
Additional paid-in capital-preferred stock	971,939	952,679
Common stock, \$.01 par value, 20,000,000 shares authorized, 4,732,705 shares issued, 3,473,099 and 3,463,099 shares outstanding at 7/1/2012 and 1/1/2012, respectively	47,327	47,327
Additional paid-in capital-common stock	18,439,386	18,471,716
Retained earnings	2,850,862	2,263,500
Treasury stock at cost, 1,259,606 and 1,269,606 common shares at 7/1/2012 and 1/1/2012, respectively	<u>(11,161,867)</u>	<u>(11,250,467)</u>
Total stockholders' equity	11,156,373	10,493,143
Total liabilities and stockholders' equity	<u>\$ 20,000,593</u>	<u>\$ 20,217,550</u>

MEXICAN RESTAURANTS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS
(Unaudited)

	13-Week Period Ended Jul 1, 2012	26-Week Period Ended Jul 1, 2012	13-Week Period Ended Jul 3, 2011	26-Week Period Ended Jul 3, 2011
Revenues:				
Restaurant sales	\$ 17,471,422	\$ 34,788,993	\$ 16,983,722	\$ 33,781,509
Franchise fees, royalties and other	<u>91,768</u>	<u>199,220</u>	<u>149,201</u>	<u>270,787</u>
	<u>17,563,190</u>	<u>34,988,213</u>	<u>17,132,923</u>	<u>34,052,296</u>
Costs and expenses:				
Cost of sales	5,151,332	10,020,614	5,028,976	9,960,019
Labor	6,054,951	11,876,939	5,897,558	11,691,248
Restaurant operating expenses	4,248,884	8,521,836	4,159,132	8,158,898
General and administrative	1,269,142	2,498,924	1,226,199	2,719,196
Depreciation and amortization	658,006	1,313,435	790,961	1,595,596
Restaurant closure expense	2,825	2,825	-	-
Loss on sale of property and equipment	<u>8,548</u>	<u>25,793</u>	<u>16,721</u>	<u>31,985</u>
	<u>17,393,688</u>	<u>34,260,366</u>	<u>17,119,547</u>	<u>34,156,942</u>
Operating income (loss)	<u>169,502</u>	<u>727,847</u>	<u>13,376</u>	<u>(104,646)</u>
Other income (expense):				
Interest income	1,085	1,619	535	1,065
Interest expense	(36,976)	(85,047)	(56,131)	(121,526)
Other, net	<u>8,442</u>	<u>12,095</u>	<u>5,968</u>	<u>5,001</u>
	<u>(27,449)</u>	<u>(71,333)</u>	<u>(49,628)</u>	<u>(115,460)</u>
Income (loss) before income taxes	142,053	656,514	(36,252)	(220,106)
Income tax (expense) benefit	<u>(31,678)</u>	<u>(49,554)</u>	<u>40,942</u>	<u>134,786</u>
Net income (loss)	<u>\$ 110,375</u>	<u>\$ 606,960</u>	<u>\$ 4,690</u>	<u>\$ (85,320)</u>

MEXICAN RESTAURANTS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY
(Unaudited)

	Preferred Stock	APIC-PS	Common Stock	APIC-CS	Retained Earnings	Treasury Stock	Total Stockholders' equity
Balances at January 1, 2012	\$8,388	\$952,679	\$47,327	\$18,471,716	\$2,263,500	\$(11,250,467)	\$10,493,143
Dividends on preferred stock	338	19,260			(19,598)		-
Issuance of common stock for vested restricted stock				(88,600)		88,600	-
Stock based compensation expense				56,270			56,270
Net income					606,960		606,960
Balances at July 1, 2012	\$8,726	\$971,939	\$47,327	\$18,439,386	\$2,850,862	\$(11,161,867)	\$11,156,373

MEXICAN RESTAURANTS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)

	26-Week Period Ended Jul 1, 2012	26-Week Period Ended Jul 3, 2011
Cash flows from operating activities:		
Net income (loss)	\$ 606,960	\$ (85,320)
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	1,313,435	1,595,596
Deferred gain amortization	(104,071)	(104,071)
Restaurant closure expense	2,825	-
Loss on sale of property & equipment	25,793	31,985
Stock based compensation expense	56,270	85,521
Deferred income tax benefit	(55,695)	(214,491)
Changes in operating assets and liabilities:		
Royalties receivable	24,176	(46,783)
Other receivables	18,199	(3,090)
Inventory	(24,614)	(33,807)
Income taxes payable	(32,454)	(45,735)
Prepaid and other current assets	187,841	166,792
Other assets	734	(50,581)
Accounts payable	28,798	106,364
Accrued expenses and other liabilities	(108,667)	(154,261)
Liabilities associated with leasing and exit activities	(71,519)	(128,679)
Deferred rent	(95,098)	(73,221)
Total adjustments	1,165,953	1,131,539
Net cash provided by continuing operations	1,772,913	1,046,219
Net cash provided by (used in) discontinued operations	27,717	(3,180)
Net cash provided by operating activities	1,800,630	1,043,039
Cash flows from investing activities:		
Purchase of property and equipment	(978,412)	(763,187)
Proceeds from sale of property and equipment	250	3,870
Net cash used in investing activities	(978,162)	(759,317)
Cash flows from financing activities:		
Borrowings under line of credit agreement	500,000	-
Payments under line of credit agreement	(1,000,000)	(850,000)
Proceeds from issuance of preferred stock and warrants, net of transaction fees	-	1,000,000
Net cash provided by (used in) financing activities	(500,000)	150,000
Net increase in cash	322,468	433,722
Cash at beginning of period	804,816	678,798
Cash at end of period	\$ 1,127,284	\$ 1,112,520
Supplemental disclosure of cash flow information:		
Cash paid during the period:		
Interest	\$ 77,176	\$ 117,276
Income taxes	\$ 138,000	\$ 136,000

MEXICAN RESTAURANTS, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

1. Basis of presentation

In the opinion of Mexican Restaurants, Inc. (the “Company”), the accompanying unaudited consolidated financial statements contain all adjustments (consisting only of normal recurring accruals and adjustments) necessary for a fair presentation of the consolidated financial position and stockholders’ equity as of July 1, 2012, and the consolidated statements of operations and cash flows for the 13-week and 26-week periods ended July 1, 2012 and July 3, 2011. The consolidated statements of operations for the 13-week and 26-week periods ended July 1, 2012 and July 3, 2011 are not necessarily indicative of the results to be expected for the full year or any other interim period. During the interim periods, the Company follows the accounting policies described in the notes to the consolidated financial statements in its “Audited Consolidated Financial Statements and Footnotes” for the year ended January 1, 2012. Reference should be made to such consolidated financial statements for information on such accounting policies and further financial detail.

The Company classifies as discontinued operations for all periods presented any component of the Company’s business that the Company believes is probable of being sold within the next 12 months and that has operations and cash flows that are clearly distinguishable operationally and for financial reporting purposes. For those components, the Company has no significant continuing involvement after disposal, and their operations and cash flows are eliminated from ongoing operations. Sales of significant components of the Company’s business not classified as discontinued operations are reported as a component of income from continuing operations.

2. Income taxes

In determining the provision for income taxes, the Company uses an estimated annual effective tax rate based on forecasted annual income and permanent items, statutory tax rates and tax planning opportunities in the various jurisdictions in which the Company operates. The impact of significant discrete items is separately recognized in the quarter in which they occur.

3. 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, 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. The Company’s stock-based compensation plans are described in more detail in Note 3 of the “Audited Consolidated Financial Statements and Footnotes” for the fiscal year ended January 1, 2012.

The Company receives a tax deduction for certain stock option exercises during the period in which the options are exercised. These deductions are generally for the excess of the price for which the options were sold over the exercise prices of the options. No stock options were exercised during the 13-week and 26-week periods ended July 1, 2012 and July 3, 2011.

4. Long term 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 July 1, 2012, the amended Agreement provided for a revolving loan of up to \$3.350 million 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. 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 July 1, 2012, the Company's outstanding debt to the financial institution was \$2.5 million and the entire balance 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 become due sooner than the stipulated maturity date. The Company was in compliance with all debt covenants of the agreement as of July 1, 2012. The Company is currently negotiating with its financial institution the extension of its revolving loan.

5. Related party transactions

The Company's Vice Chairman of the Board of Directors owns a Casa Olé franchise restaurant for which the Company receives royalties. For the 13-week and 26-week periods ended July 1, 2012, the Company recognized royalty income of \$5,499 and \$10,890, respectively, related to this restaurant. For the 13-week and 26-week periods ended July 3, 2011, the Company recognized royalty income of \$5,548 and \$11,180 respectively, related to this restaurant.

6. Discontinued operations and leasing exit activities

The results of operations, assets and liabilities for all units that have been disposed of that are material to the financial statements, either individually or in the aggregate, are reclassified to discontinued operations and to liabilities associated with leasing and exit activities in the consolidated statements of operations and balance sheets for all periods presented.

On May 3, 2012, the Company entered into a settlement agreement and promissory note receivable with a sublessee for past due rents totaling \$175,000. A down payment of \$25,000 was received along with a \$150,000 promissory note receivable to be paid over a period of four years. As of July 1, 2012, assets related to discontinued operations of \$72,283 (net of allowance) consisted of rent receivable related to the promissory note.

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 non-interest bearing note payable made in 2011 to exit a lease (see details below) and of rent differential for two other closed restaurants for which the Company has subleased the restaurants. Rent differential represents 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 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 beginning April 1, 2011 and contains a penalty clause that increases the principal to \$600,000, if the Company defaults on the note.

7. Company-operated restaurant activities

One underperforming company-operated Casa Ole restaurant was closed in June 2012 (the operating lease had expired). As of July 1, 2012, company-operated locations consisted of 52 restaurants.

8. Franchisee-operated restaurant activities

On April 3, 2012, the Company entered into a promissory note receivable with one of its franchisees for past due royalties of approximately \$56,000 to be paid over a period of three years.

As of July 1, 2012, the Company had seven Casa Ole franchisees operating a total of 13 restaurants.

9. Subsequent events

On July 26, 2012, the Company paid \$250,000 to its financial institution for principal on the line of credit agreement.

Management has evaluated subsequent events through August 10, 2012, the date which the financial statements were available to be issued.