TASTY BAKING CO
Form 10-Q
November 05, 2008

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

FORM 10-Q

(Mark One)

x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the thirteen weeks ended September 27, 2008

o 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 1-5084

TASTY BAKING COMPANY
(Exact name of Company as specified in its charter)

Pennsylvania	23-1145880
(State of Incorporation)	(IRS Employer Identification Number)

2801 Hunting Park Avenue, Philadelphia, Pennsylvania 19129
(Address of principal executive offices including Zip Code)

215-221-8500
(Company's telephone number, including area code)

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 o

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

Large accelerated filer	o	Accelerated filer	x
Non-accelerated filer	o	Smaller reporting company	x

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).
YES o NO x

There were 8,308,646 shares of Common Stock outstanding as of October 31, 2008.

TASTY BAKING COMPANY AND SUBSIDIARIES

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Part I. FINANCIAL INFORMATION
Item 1. Financial Statements

TASTY BAKING COMPANY AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS
(Unaudited)
(000's)

	September 27, 2008	December 29, 2007
Assets		
Current assets:		
Cash	$ 45	$ 57
Receivables, less allowance of $2,594 and $2,608, respectively	24,288	19,358
Inventories	7,401	7,719
Deferred income taxes	1,657	1,547
Prepayments and other	3,500	2,303
Total current assets	36,891	30,984
Property, plant and equipment:		
Land	1,433	1,433
Buildings and improvements	49,974	49,874
Machinery and equipment	130,754	126,132
Construction in progress	32,143	9,425
	214,304	186,864
Less accumulated depreciation	122,217	112,774
	92,087	74,090
Other assets:		
Long-term receivables from independent sales distributors	9,955	9,889
Deferred income taxes	8,075	6,396
Other	3,417	3,162
	21,447	19,447
Total assets	$ 150,425	$ 124,521
Liabilities		
Current liabilities:		
Accounts payable	$ 6,196	$ 6,210
Accrued payroll and employee benefits	2,732	4,080
Cash overdraft	3,853	890
Current obligations under capital leases	625	431
Current portion of long-term debt	1,000	-
Other accrued liabilities	4,427	5,343
Total current liabilities	18,833	16,954
Asset retirement obligation	6,954	6,676
Accrued pensions	14,823	16,502
Long-term obligations under capital leases, less current portion	1,087	1,003
Long-term debt, less current portion	53,364	25,697

Other accrued liabilities		2,844		2,888
Postretirement benefits other than pensions		7,460		7,365
Reserve for restructure		1,652		-
Total liabilities		107,017		77,085
Shareholders' equity				
Common stock, par value $0.50 per share and entitled to one vote per share: Authorized 30,000 shares, issued 9,116 shares		4,558		4,558
Capital in excess of par value of stock		28,742		28,683
Retained earnings		21,639		25,119
Accumulated other comprehensive income		9		634
Treasury stock, at cost		(11,540)		(11,558)
Total shareholders' equity		43,408		47,436
Total liabilities and shareholders' equity	$	150,425	$	124,521

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

TASTY BAKING COMPANY AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(Unaudited)
(000's, except per share amounts)

	For the Thirteen Weeks Ended		For the Thirty-Nine Weeks Ended	
	September 27, 2008	September 29, 2007	September 27, 2008	September 29, 2007
Gross sales	$ 69,147	$ 69,103	$ 210,620	$ 209,466
Less discounts and allowances	(26,342)	(26,584)	(80,401)	(78,817)
Net sales	42,805	42,519	130,219	130,649
Costs and expenses:				
Cost of sales, exclusive of depreciation shown below	28,367	27,457	86,353	82,494
Depreciation	3,484	2,866	9,583	6,909
Selling, general and administrative	11,168	11,745	35,172	37,946
Interest expense	545	467	1,509	907
Other (income) expense, net	1,484	(164)	1,091	(596)
	45,048	42,371	133,708	127,660
Income (loss) before provision for income taxes	(2,243)	148	(3,489)	2,989
Provision for (benefit from) income taxes	(891)	(62)	(1,253)	960
Net income (loss)	$ (1,352)	$ 210	$ (2,236)	$ 2,029
Average common shares outstanding:				
Basic	8,034	8,034	8,034	8,034
Diluted	8,034	8,173	8,034	8,148
Per share of common stock:				
Net income (loss):				
Basic	$ (0.17)	$ 0.03	$ (0.28)	$ 0.25
Diluted	$ (0.17)	$ 0.03	$ (0.28)	$ 0.25
Cash dividend	$ 0.05	$ 0.05	$ 0.15	$ 0.15

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

TASTY BAKING COMPANY AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOW
(Unaudited)
(000's)

	For the Thirty-Nine Weeks Ended	
	September 27, 2008	September 29, 2007
Cash flows from (used for) operating activities		
Net income (loss)	$ (2,236)	$ 2,029
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Depreciation	9,583	6,909
Amortization	253	239
Asset retirement obligation interest	278	-
Gain (loss) on sale of routes	(7)	57
Reserve for restructure	1,652	-
Defined benefit pension benefit	(282)	(377)
Pension contributions	(1,360)	(500)
Increase deferred taxes	(1,250)	(889)
Post retirement medical	(1,277)	(458)
Other	(1,159)	691
Changes in assets and liabilities:		
Increase in receivables	(4,866)	(2,999)
Decrease (increase) in inventories	318	(1,166)
Increase in prepayments and other	(1,450)	(1,685)
(Decrease) increase in accrued taxes	(26)	1,166
Decrease in accounts payable, accrued payroll and other current liabilities	(2,057)	(865)
Net cash (used for) from operating activities	(3,886)	2,152
Cash flows from (used for) investing activities		
Purchase of property, plant and equipment	(27,392)	(7,098)
Proceeds from independent sales distributor loan repayments	2,266	2,789
Loans to independent sales distributors	(2,484)	(2,123)
Other	(138)	(242)
Net cash used for investing activities	(27,748)	(6,674)
Cash flows from (used for) financing activities		
Dividends paid	(1,244)	(1,237)
Borrowings on long-term debt	98,729	40,768
Net increase (decrease) in notes-payable bank	1,000	(631)
Payment of long-term debt	(69,826)	(34,669)
Net increase in cash overdraft	2,963	391
Net cash from financing activities	31,622	4,622

Net (decrease) increase in cash		(12)		100
Cash, beginning of year		57		12
Cash, end of period	$	45	$	112
Supplemental Cash Flow Information				
Cash paid during the period for:				
Interest	$	610	$	940
Income taxes	$	84	$	5

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

Notes to Condensed Consolidated Financial Statements
(000's, except share, per share and square footage amounts, unless otherwise noted)
All disclosures are pre-tax, unless otherwise noted.

1. Summary of Significant Accounting Policies

Nature of the Business

Tasty Baking Company (the "Company") is a leading producer of sweet baked goods and one of the nation's oldest and largest independent baking companies, in operation since 1914. It has two manufacturing facilities, one in Philadelphia, PA, and a second in Oxford, PA.

Fiscal Year

The Company and its subsidiaries operate on a 52-53 week fiscal year, ending on the last Saturday of December. Fiscal year 2008 is a 52-week year. Fiscal year 2007 was a 52-week year.

Basis of Presentation

The condensed consolidated financial statements include the accounts of the Company and its subsidiaries. All significant intercompany accounts and transactions have been eliminated.

The condensed consolidated financial statements included herein have been prepared by the Company pursuant to the rules and regulations of the Securities and Exchange Commission. Certain information and footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles in the United States of America ("GAAP") have been condensed or omitted pursuant to such rules and regulations. In the opinion of the Company, the accompanying unaudited condensed consolidated interim financial statements reflect all adjustments, consisting of only normal recurring items, which are necessary for a fair statement of the results of operations for the periods shown. The results of operations for such periods are not necessarily indicative of the results expected for the full year or for any future period.

The preparation of condensed consolidated financial statements in conformity with GAAP requires management to make estimates, judgments and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses and related disclosure of contingent assets and liabilities. On an on-going basis, the Company evaluates its estimates, including those related to customer sales, discounts and allowances, long-lived asset impairment, pension and postretirement plan assumptions, workers' compensation expense and income taxes. Actual results may differ from these estimates.

Concentration of Credit

The Company encounters, in the normal course of business, exposure to concentrations of credit risk with respect to trade receivables. Ongoing credit evaluations of customers' financial conditions are performed and, generally, no collateral is required. The Company maintains reserves for potential credit losses and such losses have not exceeded management's expectations.

Revenue Recognition

Revenue is recognized when title and risk of loss pass, which is upon receipt of goods by the independent sales distributors, retailers or third-party distributors. For route area sales, the Company sells to independent sales distributors who, in turn, sell to retailers. Revenue for sales to independent sales distributors is recognized upon receipt of the product by the distributor. For sales made directly to a customer or a third-party distributor, revenue is recognized upon receipt of the products by the retailer or third-party distributor.

Sale of Routes

Sales distribution routes are primarily owned by independent sales distributors who purchase the exclusive right to sell and distribute Tastykake® products in defined geographical territories. When the Company sells routes to independent sales distributors, it recognizes a gain or loss on the sale. Routes sold by the Company are either existing routes that the Company has previously purchased from an independent sales distributor or newly established routes in new geographies. Any gain or loss recorded by the Company is based on the difference between the sales price and the carrying value of the route. Any potential impairment of net carrying value is reserved as identified. The Company recognizes gains or losses on sales of routes because all material services or conditions related to the sale have been substantially performed or satisfied by the Company as of the date of the sale. In most cases, the Company will finance a portion of the purchase price with interest bearing notes, which are required to be repaid in full. Interest rates on the notes are based on Treasury or LIBOR yields plus a spread. The Company has no obligation to later repurchase a route but may choose to do so to facilitate a change in route ownership.

Cash and Cash Equivalents

The Company considers all investments with an original maturity of three months or less on their acquisition date to be cash equivalents. Cash overdrafts are recorded within current liabilities. Cash flows associated with cash overdrafts are classified as financing activities.

Inventory Valuation

Inventories, which include material, labor and manufacturing overhead, are stated at the lower of cost or market, cost being determined using the first-in, first-out (“FIFO”) method. Inventory balances for raw materials, work in progress and finished goods are regularly analyzed and provisions for excess and obsolete inventory are recorded, as necessary, based on the forecast of product demand and production requirements.

Property and Depreciation

Property, plant and equipment are carried at cost. Depreciation is computed by the straight-line method over the estimated useful lives of the assets. Buildings and improvements, machinery and equipment, and vehicles are depreciated over thirty-nine years, seven to fifteen years, and five to ten years, respectively, except where a shorter useful life is necessitated by the Company’s decision to relocate its Philadelphia operations. Spare parts are capitalized as part of machinery and equipment and are expensed as utilized or capitalized as part of the relevant fixed asset. Spare parts are valued using a moving average method and are reviewed for potential obsolescence on a regular basis. Reserves are established for all spare parts that are no longer usable and have no fair market value. Capitalized computer hardware and software is depreciated over five years.

Costs of major additions, replacements and betterments are capitalized, while maintenance and repairs, which do not improve or extend the life of the respective assets, are expensed as incurred. For significant projects, the Company capitalizes interest and labor costs associated with the construction and installation of plant and equipment and significant information technology development projects.

In accordance with Statement of Financial Accounting Standards No.144, Accounting for the Impairment or Disposal of Long-Lived Assets, ("FAS 144") long-lived assets are reviewed for impairment at least annually or whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. In instances where the carrying amount may not be recoverable, the review for potential impairment utilizes estimates and assumptions of future cash flows directly related to the asset. For assets where there is no plan for future use, the review for impairment includes estimates and assumptions of the fair value of the asset, which is based on the best information available. These assets are recorded at the lower of their book value or fair value.

The Company has a conditional asset retirement obligation related to asbestos in its Philadelphia manufacturing facility. As a result of the Company’s decision in May 2007 to relocate its Philadelphia operations, it was able to estimate a settlement date for the asset retirement obligation and in accordance with FASB Interpretation No. 47, Accounting for Conditional Asset Retirement Obligations, recorded an obligation of $6.6 million which was the present value of the future obligation. This obligation will continue to accrete to the full value of the future obligation over the remaining period until settlement of the obligation, which is expected to occur in June 2010, while the capitalized asset retirement cost is depreciated through December 2044, the remaining useful life of the Philadelphia manufacturing facility. For the thirteen weeks and thirty-nine weeks ended September 27, 2008, the Company recorded $0.1 million and $0.3 million, respectively, in interest associated with the asset retirement obligation. As of September 27, 2008 and December 29, 2007, the asset retirement obligation totaled $7.0 million and $6.7 million, respectively.

Grants

The Company receives grants from various government agencies for employee training purposes. Expenses for the training are recognized in the Company’s income statement at the time the training takes place. When the proper approvals are given and funds are received from the government agencies, the Company records an offset to the training expense already recognized.

In 2007, in connection with the decision to relocate its Philadelphia manufacturing operations, the Company received a $0.6 million grant from the Department of Community and Economic Development of the Commonwealth of Pennsylvania (“DCED”). The opportunity grant has certain spending, job retention and nondiscrimination conditions with which the Company must comply. The Company accounted for this grant under the deferred income approach and will amortize the deferred income over the same period as the useful life of the asset acquired with the grant. The asset acquired with the grant is expected to be placed into service when the new manufacturing facility becomes fully operational in 2010.

In addition, in 2006, in conjunction with The Reinvestment Funds, Allegheny West Foundation and the DCED, the Company activated Project Fresh Start (the "Project"). The Project is an entrepreneurial development program that provides an opportunity for qualified minority entrepreneurs to purchase routes from independent sales distributors. The source of grant monies for this program is the DCED. The grants are used by minority applicants to partially fund their purchase of an independent sales distribution route.

Because the Project's grant funds merely pass through the Company in its role as an intermediary, the Company records an offsetting asset and liability for the total amount of grants as they relate to the project. There is no Statement of Operations impact related to the establishment of, or subsequent change to, the asset and liability amounts.

Marketing Costs
The Company expenses marketing costs, which include advertising and consumer promotions, as incurred or as required in accordance with Statement of Position 93-7, Reporting on Advertising Costs. Marketing costs are included as a part of selling, general and administrative expense.

Computer Software Costs
The Company capitalizes certain costs, such as software coding, installation and testing that are incurred to purchase or create and implement internal use computer software in accordance with Statement of Position 98-1, Accounting for Costs of Computer Software Development or Obtained for Internal Use. The majority of the Company's capitalized software relates to the implementation of the enterprise resource planning and handheld computer systems.

Freight, Shipping and Handling Costs
Outbound freight, shipping and handling costs are included as a part of selling, general and administrative expense. Inbound freight, shipping and handling costs are capitalized with inventory and expensed with cost of sales.

Pension Plan
The Company's funding policy for the pension plan is to contribute amounts deductible for federal income tax purposes plus such additional amounts, if any, as the Company's actuarial consultants advise to be appropriate. Effective January 1, 2008, the Company is required to make quarterly contributions under the Pension Protection Act of 2006. The Company will make three quarterly contributions in 2008. As of September 27, 2008, the Company had made two of the three required contributions. In 1987, the Company elected to immediately recognize all gains and losses in excess of the pension corridor, which is equal to the greater of ten percent of the accumulated pension benefit obligation or ten percent of the market-related value of plan assets.

The Company accrues normal periodic pension expense or income during the year based upon certain assumptions and estimates from its actuarial consultants. These estimates and assumptions include discount rate, rate of return on plan assets, mortality and employee turnover. In addition, the rate of return on plan assets is directly related to changes in the equity and credit markets, which can be and have recently been very volatile. The use of the above estimates and assumptions, including market volatility and the Company's election to immediately recognize all gains and losses in excess of its pension corridor in the current year may cause the Company to experience significant changes in its pension expense or income from year to year. Expense or income that falls outside the corridor is recognized only in the fourth quarter of each year.

In accordance with Financial Accounting Standards Board ("FASB") Statement No. 158, Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans, the Company maintains a liability on its balance sheet equal to the under-funded status of its defined benefit and other postretirement benefit plans.

Accounting for Derivative Instruments
The Company has entered into certain variable-to-fixed interest rate swap contracts to fix the interest rates on a portion of its variable interest rate debt. These contracts are accounted for as cash flow hedges in accordance with

FASB Statement No. 133, Accounting for Derivative Instruments and Hedging Activities ("FAS 133"). Accordingly, these derivatives are marked to market and the resulting gains or losses are recorded in other comprehensive income as an offset to the related hedged asset or liability. The actual interest expense incurred, inclusive of the effect of the hedge in the current period, is recorded in the Statement of Operations.

The Company has also entered into foreign currency forward contracts to hedge the future purchase of certain assets for its new facilities, which are denominated in Australian Dollars. These contracts are accounted for as fair value foreign currency hedges in accordance with FAS 133. Accordingly, the changes in fair value of both the commitment and the derivative instruments are recorded currently in the Statement of Operations, with the corresponding asset and liability recorded on the Balance Sheet.

Treasury Stock

Treasury stock is stated at cost. Cost is determined by the FIFO method.

Accounting for Income Taxes

The Company accounts for income taxes under the asset and liability method, in accordance with FASB Statement No. 109, Accounting for Income Taxes. Deferred tax assets and liabilities are determined based on differences between financial reporting and tax bases of assets and liabilities and are measured using the enacted tax rates in effect when the differences are expected to be recovered or settled.

Net Income Per Common Share

Net income per common share is presented as basic and diluted earnings per share. Net income per common share – Basic is based on the weighted average number of common shares outstanding during the period. Net income per common share – Diluted is based on the weighted average number of common shares and dilutive potential common shares outstanding during the period. Dilution is the result of outstanding stock options and restricted shares. For the thirteen weeks ended September 27, 2008 and September 29, 2007, 491,804 options to purchase common stock and restricted shares and 339,996 options to purchase common stock, respectively, were excluded from the calculation, as they were anti-dilutive. For the thirty-nine weeks ended September 27, 2008 and September 29, 2007, approximately 538,591options to purchase common stock and restricted shares and 367,263 options to purchase common stock, respectively, were excluded from the calculation, as they were anti-dilutive.

Share-based Compensation

The Company accounts for share-based compensation in accordance with FASB Statement No. 123(R), Share-Based Payment (“FAS 123(R)”). Share-based compensation expense, recognized during the current period, is based on the value of the portion of share-based payment awards that is ultimately expected to vest. The total value of compensation expense for restricted stock is equal to the closing market price of Tasty Baking Company shares on the date of grant. FAS 123(R) requires forfeitures to be estimated at the time of grant in order to estimate the amount of share-based awards that will ultimately vest. The forfeiture rate is based on the Company’s historical forfeiture experience. The Company calculated its historical pool of windfall tax benefits.

Recent Accounting Statements

In September 2006, the FASB issued Statement No. 157, Fair Value Measurements (“FAS 157”), which creates a single definition of fair value, along with a conceptual framework to measure fair value and to increase the consistency and the comparability in fair value measurements and in financial disclosure. The Company adopted the required provisions of FAS 157 effective December 30, 2007. The required provisions did not have a material impact on the Company’s financial statements. See Note 6 for additional information.

In February 2008, the FASB issued FASB Staff Position (“FSP”) No. FAS 157-2, Effective Date of FASB Statement No. 157. This FSP permits a delay in the effective date of FAS 157 to fiscal years beginning after November 15, 2008, for nonfinancial assets and nonfinancial liabilities, except for items that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually). The delay is intended to allow the Board and constituents additional time to consider the effect of various implementation issues that have arisen, or that may arise, from the application of FAS 157. The FASB also issued FSP FAS 157-1 to exclude SFAS 13, Accounting for Leases, and its related interpretive accounting pronouncements from the scope of FAS 157 in February 2008. The Company is currently assessing the potential impact that adoption of this statement would have on its financial statements.

In October 2008, the FASB issued FSP No. FAS 157-3, Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active. This FSP clarifies the application of FAS 157 in determining the fair values of assets or liabilities in a market that is not active. This FSP became effective upon issuance, including prior periods for which financial statements have not been issued. The Company adopted this FSP for the condensed consolidated financial statements contained within this Form 10-Q.

In February 2007, the FASB issued Statement No. 159, The Fair Value Option for Financial Assets and Financial Liabilities – Including an Amendment of FASB Statement No. 115 ("FAS 159"). This statement permits, but does not require entities to measure certain financial instruments and other assets and liabilities at fair value on an instrument-by-instrument basis and is irrevocable. At the adoption date, unrealized gains and losses on financial assets and liabilities for which the fair value option has been elected would be reported as a cumulative adjustment to beginning retained earnings. Unrealized gains and losses due to changes in their fair value must be recognized in earnings at each subsequent reporting date. This statement is effective for fiscal years beginning after November 15, 2007. Although FAS 159 was adopted December 30, 2007, the Company has not yet elected the fair value option for any items permitted under FAS 159.

In December 2007, the FASB issued Statement No. 141 (Revised 2007), Business Combinations ("FAS 141(R)"). FAS 141(R) significantly changes the accounting for business combinations in a number of areas including the treatment of contingent consideration, acquired contingencies, transaction costs, in-process research and development and restructuring costs. In addition, under FAS 141(R), changes in an acquired entity's deferred tax assets and uncertain tax positions after the measurement period will impact income tax expense. FAS 141(R) applies prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning after December 15, 2008. Earlier adoption is prohibited. The Company is currently evaluating the extent to which its current practices, financial statements and disclosures may change as a result of the adoption of FAS 141(R).

In December 2007, the FASB issued Statement No. 160, Noncontrolling Interests in Consolidated Financial Statements—An Amendment of ARB No. 51 ("FAS 160"), which establishes new accounting and reporting standards for the noncontrolling interest in a subsidiary, changes in a parent's ownership interest in a subsidiary and the deconsolidation of a subsidiary. FAS 160 is effective for fiscal years beginning after December 15, 2008. Earlier adoption is prohibited. The Company is currently evaluating the extent to which its current practices, financial statements and disclosures may change as a result of the adoption of FAS 160.

In March 2008, the FASB issued Statement of Financial Accounting Standards No. 161, Disclosures about Derivative Instruments and Hedging Activities—An Amendment of FASB Statement No. 133 ("FAS 161"). FAS 161 applies to all derivative instruments and related hedged items accounted for under FAS 133. It requires entities to provide greater transparency about (a) how and why an entity uses derivative instruments, (b) how derivative instruments and related hedged items are accounted for under FAS 133 and its related interpretations, and (c) how derivative instruments and related hedged items affect an entity's financial position, results of operations, and cash flows. FAS 161 is effective for fiscal years and interim periods beginning after November 15, 2008. Because FAS 161 applies only to financial statement disclosures, it will not have a material impact on the Company's consolidated financial position, results of operations or cash flows.

In May 2008, the FASB issued Statement of Financial Accounting Standards No. 162 ("FAS 162"), The Hierarchy of Generally Accepted Accounting Principles ("FAS 162"). FAS 162 identifies the sources of accounting principles and the framework for selecting the principles used in the preparation of financial statements that are presented in conformity with generally accepted accounting principles in the United States. FAS 162 will become effective 60 days following the SEC's approval of the Public Company Accounting Oversight Board amendments to AU Section 411, The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles. The Company does not expect the adoption of FAS 162 to have a material impact on the consolidated financial statements.

2. New Facilities

In May 2007, the Company announced that as part of its comprehensive operational review of strategic manufacturing alternatives, it entered into an agreement to relocate its Philadelphia operations to the Philadelphia Navy Yard. The bakery lease agreement provides for a 26-year lease for a 345,500 square foot bakery, warehouse and distribution

center located on approximately 25 acres. Construction of the facility is underway and is expected to be completed by the end of 2009. The Company expects the new facility to be fully operational in 2010. The lease provides for no rent payments in the first year of occupancy. Rental payments increase from $3.5 million in the second year of occupancy to $7.2 million in the final year of the lease.

As part of this initiative, the Company also entered into a 16-year agreement for $9.5 million in financing at a fixed rate of 8.54% to be used for leasehold improvements. This agreement provides for no principal or interest payments in the first year of occupancy and then requires equal monthly payments of principal and interest aggregating to $1.2 million annually over the remainder of the term.

The Company also entered into an agreement to relocate its corporate headquarters to the Philadelphia Navy Yard. This lease agreement provides for not less than 35,000 square feet of office space. It commences upon the later of substantial completion of the office space or April 2009, and ends coterminous with the new bakery lease. The lease provides for no rent payments in the first six months of occupancy. Rental payments increase from approximately $0.9 million in the second year of occupancy to approximately $1.6 million in the final year of the lease.

In connection with these agreements, the Company provided a $1.1 million letter of credit, which increases to $8.1 million by the beginning of 2009. The outstanding amount of the letter of credit will be reduced starting in 2026 and will be eliminated by the end of the lease term. As of September 27, 2008, the outstanding letter of credit under this arrangement totaled $3.6 million.

In connection with these agreements, the Company provided an additional $0.5 million letter of credit, which increases to $1.9 million by the beginning of 2009. The outstanding amount of the letter of credit will be eliminated in August 2009. As of September 27, 2008, the outstanding letter of credit under this arrangement totaled $1.0 million.

In addition to the facility leases, the Company is purchasing high-tech, modern baking equipment. This equipment is designed to increase product development flexibility and efficiency, while maintaining existing taste and quality standards. The investment for this project, in addition to any costs associated with the agreements described above, is projected to be approximately $75.0 million through 2010. In September 2007, the Company closed on a multi-bank credit facility and low-interest development loans provided in part by the Commonwealth of Pennsylvania and the Philadelphia Industrial Development Corporation to finance this investment and refinance the Company’s existing revolving credit facilities, as well as to provide for financial flexibility in running the ongoing operations and working capital needs.

The Company anticipates that long-lived assets utilized in the Philadelphia operations with an aggregate net book value of approximately $20.0 million at June 30, 2007 would not be relocated to the new facilities or sold as a result of the relocation. The Company accounts for disposal and exit activities in accordance with FASB Statement No. 146, Accounting for Costs Associated with Exit or Disposal Activities (“FAS 146”) and FAS 144. To date, the Company has not incurred any material obligations related to one-time termination benefits, contract termination costs or other associated costs as described in FAS 146.

The Company has evaluated the long-lived assets utilized in its Philadelphia operations for potential impairment or other treatment in accordance with FAS 144. Based on the commitment to the planned relocation, neither the assets to be relocated nor the assets to be left in place at the Philadelphia operations have suffered impairment. Therefore the estimated fair value of the asset groups continues to exceed the carrying amount of such asset groups. With respect to the group of assets not expected to be relocated or sold, certain of the assets included in the group had previously estimated useful lives that extended beyond the expected project completion in 2010. As such, in the quarter ended June 30, 2007, the Company changed its estimate of the remaining useful lives of such assets to be consistent with the time remaining until the end of the project, and accounted for such change in estimate in accordance with FASB Statement No. 154, Accounting Changes and Error Corrections, a replacement of APB Opinion No. 20 and FASB Statement No. 3. For the thirteen and thirty-nine week periods ended September 27, 2008, the change in estimated useful lives of these assets resulted in incremental depreciation of $1.3 million and $3.9 million, respectively. The after-tax impact of the incremental depreciation on net income, net income per common share-basic and net income per common share-diluted was $0.8 million, $0.10 per share, and $0.10 per share, respectively, for the thirteen weeks ended September 27, 2008 and $2.4 million, $0.30 per share, and $0.30 per share, respectively for the thirty-nine weeks ended September 27, 2008. For the thirteen and thirty-nine week periods ended September 29, 2007, the change in estimated useful lives of these assets resulted in incremental depreciation of $1.3 million and $2.0 million, respectively. The after-tax impact of the incremental depreciation on net income, net income per common share-basic, and net income per common share-diluted was $0.9 million, $0.11 per share, and $0.11 per share,

respectively, for the thirteen weeks ended September 29, 2007 and $1.3 million, $0.16 per share and $0.16 per share, respectively, for the thirty-nine weeks ended September 29, 2007. The Company expects that the future pre-tax impact of incremental depreciation resulting from the change in useful lives will be approximately $1.3 million per quarter through June 2010, when the new bakery is expected to be fully operational.

As part of the relocation of its Philadelphia operations, the Company expects to eliminate approximately 215 positions. While the Company hopes to achieve this result through normal attrition and the reduction of contract labor, it is probable that the Company will incur obligations related to postemployment benefits accounted for under FASB Statement No. 112, Employers' Accounting for Postemployment Benefits, an amendment of FASB Statements No. 5 and 43. During the quarter ended September 27, 2008, the Company recorded a reserve of $1.7 million, for estimated future obligations related to postemployment benefits associated with the relocation of its Philadelphia operations. The cost associated with this reserve was recorded in other (income)/expense.

3. Inventories

Inventories are classified as follows:

	Sep. 27, 2008	Dec. 29, 2007
Finished goods	$ 2,448	2,852
Work in progress	133	161
Raw materials and supplies	4,820	4,706
	$ 7,401	$ 7,719

The inventory balance has been reduced by reserves for obsolete and slow-moving inventories of $56 and $95 as of September 27, 2008 and December 29, 2007, respectively.

4. Credit Facilities

On September 6, 2007, the Company entered into a 5 year, $100.0 million secured credit facility with four banks, consisting of a $55.0 million fixed asset line of credit, a $35.0 million working capital revolver and a $10.0 million low-interest loan from the agent bank with the Commonwealth of Pennsylvania (the “Bank Credit Facility”). The Bank Credit Facility is secured by a blanket lien on the Company’s assets and contains various non-financial and financial covenants, including a fixed charge coverage covenant, a maximum operating leverage ratio covenant, a minimum liquidity ratio covenant and minimum level of earnings before interest, taxes, depreciation and amortization (“EBITDA”) covenant. Interest rates for the fixed asset line of credit and working capital revolver are indexed to LIBOR and as of September 27, 2008 included a spread above that index from 75 to 275 basis points based upon the Company’s ratio of debt to EBITDA. The fixed asset line of credit and the working capital revolver include commitment fees from 20 to 50 basis points based upon the Company’s ratio of debt to EBITDA. The $10.0 million low-interest loan bears interest at a fixed rate of 5.5% per annum. In October 2008, the Company amended its Bank Credit Facility to provide for additional flexibility and to change certain financial covenants, including the minimum EBITDA requirement as of December 27, 2008 and the maximum operating leverage ratio as of September 27, 2008 and December 27, 2008, which was necessary to eliminate an instance of non-compliance. As part of this amendment, the interest rates for the fixed asset line of credit and working capital revolver were changed to be indexed to LIBOR plus a credit spread from 125 to 325 basis points based upon the Company’s ratio of debt to EBITDA.

On September 6, 2007, the Company entered into a 10 year, $12.0 million secured credit agreement with the PIDC Local Development Corporation (“PIDC Credit Facility”). This credit facility bears interest at a blended fixed rate of 4.5% per annum, participates in the blanket lien on the Company’s assets and contains customary representations and warranties as well as customary affirmative and negative covenants essentially similar to those in the Bank Credit Facility, as amended in October 2008. Negative covenants include, among others, limitations on incurrence of liens and secured indebtedness by the Company and/or its subsidiaries, other than in connection with the Bank Credit Facility, the MELF Loan 1 and the MELF Loan 2, as defined below.

On September 6, 2007, the Company entered into a 10 year, $5.0 million Machinery and Equipment Loan Fund secured loan with the Commonwealth of Pennsylvania (“MELF Loan 1”). The Company borrowed $5.0 million under the MELF Loan 1 in September 2008. This loan bears interest at a fixed rate of 5.0% per annum and contains customary representations and warranties as well as customary affirmative and negative covenants, essentially similar to those in the Bank Credit Facility, as amended in October 2008. Negative covenants include among others, limitations on incurrence of liens and secured indebtedness by the Company, other than in connection with the Bank Credit Facility and the PIDC Credit Facility. In September 2008, the Company entered into a second 10 year, $5.0

million Machinery and Equipment Loan Fund secured loan with the Commonwealth of Pennsylvania ("MELF Loan 2"). The terms and conditions of the MELF Loan 2 are the same as the MELF Loan 1. The Company expects to borrow the $5.0 million under the MELF Loan 2 in the fourth quarter of 2008.

On September 6, 2007, the Company entered into an agreement which governs the shared collateral positions under the Bank Credit Facility, the PIDC Credit Facility, the MELF Loan 1 and the MELF Loan 2 (the "Intercreditor Agreement"), and establishes the priorities and procedures that each lender has in enforcing the terms and conditions of each of their respective agreements. The Intercreditor Agreement permits the group of banks and their agent bank in the Bank Credit Facility to have the initial responsibility to enforce the terms and conditions of the various credit agreements, subject to certain specific limitations, and allows such bank group to negotiate amendments and waivers on behalf of all lenders, subject to the approval of each lender.

The Company used a portion of the proceeds received under the Bank Credit Facility to terminate and repay outstanding indebtedness. The Company is currently utilizing proceeds from the Bank Credit Facility and MELF Loan 1 to finance the Company's relocation of its Philadelphia manufacturing facility and corporate headquarters to new facilities under construction at the Philadelphia Navy Yard, along with working capital needs. The Company will further utilize the proceeds from MELF Loan 2 and the PIDC Credit Facility, along with proceeds under the Bank Credit Facility for continued funding of its relocation to the Philadelphia Navy Yard.

5. Derivative Instruments

In order to hedge a portion of the Company's exposure to changes in interest rates on debt associated with the Company's new manufacturing facilities, the Company entered into certain variable-to-fixed interest rate swap contracts to fix the interest rates on a portion of its variable interest rate debt. In January 2008, the Company entered into an $8.5 million notional value interest rate swap contract that increases to $35.0 million by April 2010 with a fixed LIBOR rate of 3.835% that expires on September 5, 2012. As of September 27, 2008, the notional value of the swap was $8.5 million. As of September 27, 2008, the LIBOR rates were subject to an additional credit spread which could range from 75 basis points to 275 basis points and was equal to 225 basis points as of that date. The Company records as an asset or liability the cumulative change in the fair market value of the derivative instrument, and as of September 27, 2008, the Company recorded an asset of $0.3 million.

In May 2008, the Company entered into an $8.0 million notional value interest rate swap with a fixed LIBOR rate of 2.97% that expires on May 1, 2011. As of September 27, 2008, the LIBOR rates were subject to an additional credit spread which could range from 75 basis points to 275 basis points and was equal to 225 basis points as of that date. The Company records as an asset or liability the cumulative change in the fair market value of the derivative instrument, and as of September 27, 2008, the Company recorded an asset of $0.1 million.

During the third quarter of 2007, the Company entered into commitments to acquire assets denominated in a foreign currency. In order to hedge the Company's exposure to changes in foreign currency rates, the Company entered into foreign currency forward contracts with maturity dates ranging from July 2007 to April 2010. As of September 27, 2008, the notional principle of outstanding foreign currency forward contracts was $5.3 million Australian Dollar ($4.3 million USD). As of September 27, 2008, the change in fair value of both the commitment and the forward currency contracts was $0.1 million.

6. Fair Value Measurements

As described in Note 1, the Company adopted FAS 157 on December 30, 2007. FAS 157, among other things, defines fair value, establishes a consistent framework for measuring fair value and expands disclosure for each major asset and liability category measured at fair value on either a recurring or nonrecurring basis. FAS 157 clarifies that fair value is an exit price, representing the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. As such, fair value is a market-based measurement that should be determined based on assumptions that market participants would use in pricing an asset or liability. As a basis for considering such assumptions, FAS 157 establishes a three-tier fair value hierarchy, which prioritizes the inputs used in measuring fair value as follows:

Level 1.	Observable inputs such as quoted prices in active markets for identical assets or liabilities;
Level 2.	Inputs, other than quoted prices included within Level 1, that are observable either directly or indirectly; and
Level 3.	Unobservable inputs in which there is little or no market data, which require the reporting entity to develop its own assumptions.

The following table presents assets / (liabilities) measured at fair value on a recurring basis at September 27, 2008:

		Fair Value Measurement at Reporting Date Using		
Description	Balance as of Sep. 27, 2008	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Financial instruments owned:				
Interest rate swaps	$ 370	$ —	$ 370	$ —
Foreign currency hedges	107	—	107	—
Total financial instruments owned	$ 477	$ —	$ 477	$ —

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7. Defined Benefit Retirement Plans

The Company maintains a partially funded noncontributory Defined Benefit ("DB") Retirement Plan (the "DB Plan") providing retirement benefits. Benefits under this DB Plan generally are based on the employees' years of service and compensation during the years preceding retirement. In December 2004, the Company announced to its employees that it was amending the DB Plan to freeze benefit accruals effective March 26, 2005. The Company maintains a DB Supplemental Executive Retirement Plan ("SERP") for key employees designated by the Board of Directors (the "Board"), however, there are no current employees earning benefits under this plan. See Note 8 for more information. The Company also maintains a frozen unfunded Retirement Plan for Directors (the "Director Plan"). The benefit amount is the annual retainer in the year of retirement.

Effective February 15, 2007, benefit accruals under the Director Plan were frozen for current directors and future directors were precluded from participating in the plan. Participants are credited for service under the Director Plan after February 15, 2007 solely for vesting purposes. On February 15, 2007, the Board approved a Deferred Stock Unit Plan (the "DSU Plan"). The DSU Plan provides that for each fiscal quarter, the Company will credit deferred stock units to the director's account equivalent in value to $4 on the last day of such quarter, provided that he or she is a director on the last day of such quarter. Directors will be entitled to be paid in shares upon termination of Board service provided the director has at least five years of continuous service on the Board. The shares may be paid out in a lump sum or at the director's election, over a period of five years.

The components of the DB Plan, DB SERP, and DB Director Plan's costs / (benefits) are summarized as follows:

	Thirteen Weeks Ended		Thirty-nine Weeks Ended	
	9/27/08	9/29/07	9/27/08	9/29/07
Service cost-benefits earned during the quarter	$ -	$ -	$ -	$ 10
Interest cost on projected benefit obligation	1,252	1,247	3,757	3,735
Expected return on plan assets	(1,268)	(1,302)	(3,804)	(3,906)
Prior service cost amortization	(4)	(4)	(12)	(13)
Actuarial loss recognition	16	16	48	49
Net DB pension amount credited to income	$ (4)	$ (43)	$ (11)	$ (125)

Under the Pension Protection Act of 2006, the Company made a $0.7 million and $1.4 million cash contribution to the previously frozen DB Plan for the thirteen weeks and thirty-nine weeks ended September 27, 2008, respectively. There is a minimum required cash contribution to the DB Plan in fiscal 2008 of $2.0 million. The Company made a $0.5 million voluntary cash contribution in July 2007.

8. Defined Contribution Retirement Plans

The Company maintains a funded Defined Contribution ("DC") Retirement Plan (the "DC Plan"), which replaced the benefits provided in the DB Plan. Under the DC Plan, the Company makes weekly cash contributions into individual accounts for all eligible employees. These contributions are based on employees' point values which are the sum of age and years of service as of January 1 each year. All employees receive contributions that range from 2% to 5% of covered compensation relative to their point totals. Employees at March 27, 2005, who had 20 years of service or 10 years of service and 60 points, received an additional "grandfathered" contribution of between 1.5% and 3.5% of salary. The "grandfathered" contribution percentage was fixed as of March 27, 2005, and is paid weekly with the regular contribution until those covered employees retire or separate from the Company. These "grandfathered" contributions are being made to compensate older employees for the shorter earnings period that their accounts will have to appreciate in value relative to their normal retirement dates.

The Company also maintains the Tasty Baking Company 401(k) and Company Funded Retirement Plan (the "Retirement Plan"). In the Retirement Plan, all participants receive a company match of 50% of their elective deferrals that do not exceed 4% of their compensation as defined in the Retirement Plan. Under the Retirement Plan, the waiting period for participation has been eliminated and participants are offered a broad array of investment choices.

The Company also maintains an unfunded defined contribution SERP ("DC SERP") for one eligible active employee.

Components of DC pension amounts charged to income:

	Thirteen Weeks Ended		Thirty-nine Weeks Ended	
	9/27/08	9/29/07	9/27/08	9/29/07
Funded retirement plan	$ 419	$ 465	$ 1,223	$ 1,445
Defined contribution SERP	97	90	290	270
Net DC pension amount charged to income	$ 516	$ 555	$ 1,513	$ 1,715

9. Postretirement Benefits Other than Pensions

In addition to providing pension benefits, the Company also provides certain unfunded health care and life insurance programs for substantially all retired employees, or other postretirement benefits. These benefits are provided through contracts with insurance companies and health service providers. Coverage is maintained for all pre-65 retirees and for certain post-65 retirees who have qualifying dependents that are pre-65. Life insurance for incumbent retirees, as of January 1, 2006, at company group rates is capped at $20 of coverage. Incumbent retirees who purchase coverage in excess of $20 and all new retirees after January 1, 2006 pay age-based rates for their life insurance benefit.

Components of net periodic postretirement benefit cost / (benefit) are as follows:

	Thirteen Weeks Ended		Thirty-nine Weeks Ended	
	9/27/08	9/29/07	9/27/08	9/29/07
Service cost	$ 91	$ 67	$ 272	$ 201
Interest cost	115	92	347	277
Amortization of unrecognized prior service cost	(458)	(457)	(1,373)	(1,373)
Amortization of unrecognized gain	-	(29)	-	(87)
Total FAS 106 net postretirement benefit	$ (252)	$ (327)	$ (754)	$ (982)

Estimated company contributions for the thirty-nine weeks ended September 27, 2008 and September 29, 2007 were $524 and $453, respectively.

10. Stock Compensation

At the 2006 Annual Meeting of Shareholders of the Company held on May 11, 2006, the Company's shareholders approved the Tasty Baking Company 2006 Long-Term Incentive Plan (the "2006 Plan") as adopted by the Board on March 24, 2006. The aggregate number of shares available for grant under the Plan is 220,600 shares of the Company’s common stock as of September 27, 2008.

The 2006 Plan authorizes the Compensation Committee (the "Committee") of the Board to grant awards of stock options, stock appreciation rights, unrestricted stock, restricted stock (“RSA”) (including performance restricted stock) and performance shares to employees, directors and consultants or advisors of the Company. The option price is determined by the Committee and, in the case of incentive stock options, will be no less than the fair market value of the shares on the date of grant. Options lapse at the earlier of the expiration of the option term specified by the Committee (not more than ten years in the case of incentive stock options) or three months following the date on which employment with the Company terminates.

The Company also has active 2003 and 1997 Long-Term Incentive Plans (the "2003 Plan" and "1997 Plan," respectively). The aggregate number of shares available for grant under the 2003 Plan is 50,466 and under the 1997 Plan is 143,891 as of September 27, 2008. The terms and conditions of the 2003 and 1997 plans are generally the same as the 2006 Plan. A notable difference is that the 1997 Plan can award shares only to employees of the Company while the 2003 Plan can only award shares to employees and directors of the Company. The Company also has options outstanding under the 1994 Long-Term Incentive Plan, the terms and conditions of which are similar to the 1997 Plan.

Notwithstanding the vesting and termination provisions described above, under the terms of the Change of Control Agreements and Employment Agreements that the Company entered into with certain executive officers, upon a change of control, the shares granted as RSAs vest and any restrictions on outstanding stock options lapse immediately. Additionally, under the terms of those agreements, in certain change of control circumstances, shares granted as RSAs may vest after termination of employment.

A summary of stock options as of September 27, 2008 is presented below:

	Shares (000's)	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term	Aggregate Intrinsic Value (000s)
Outstanding at Dec. 29, 2007	439	$ 10.44		
Granted	-	-		
Forfeited	-			
Exercised	-			