

COMBINED FINANCIAL STATEMENTS  
Curves International, Inc. and Curves for Women II, L.C.  
*Three years ended December 31, 2005*

Curves International, Inc. and Curves for Women II, L.C.

Combined Financial Statements

Three years ended December 31, 2005

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## Report of Independent Auditors

Board of Directors

Curves International, Inc. and Curves for Women II, L.C.

We have audited the accompanying combined balance sheets of Curves International, Inc. and Curves for Women II, L.C. (together the Company) as of December 31, 2005 and 2004, and the related combined statements of income, owners' equity, and cash flows for each of the three years in the period ended December 31, 2005. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. We were not engaged to perform an audit of the Company's internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the combined financial position of Curves International, Inc. and Curves for Women II, L.C. at December 31, 2005 and 2004, and the combined results of their operations and their cash flows for each of the three years in the period ended December 31, 2005, in conformity with accounting principles generally accepted in the United States.

*Ernst & Young LLP*

March 24, 2006

Curves International, Inc. and Curves for Women II, L.C.

Combined Balance Sheets

Assets	December 31,	
	2005	2004
<b>Current Assets</b>		
Cash and cash equivalents	\$ 20,349,663	\$ 27,505,694
Short-term investments	2,880,181	5,855,629
Accounts and notes receivable, net	3,378,012	1,277,889
Inventories	11,423,176	6,409,434
Deferred income taxes	204,521	197,050
Advertising fund assets, restricted	1,511,270	1,387,897
Prepaid expenses	3,765,581	4,522,054
Total current assets	43,512,404	47,155,647
Notes receivable, less current portion	579,891	191,846
Other assets, net	933,401	7,246
Property and equipment, less accumulated depreciation	9,787,611	10,169,332
<b>Total assets</b>	<b>\$ 54,813,307</b>	<b>\$ 57,524,071</b>
<b>Liabilities and Owners' Equity</b>		
<b>Current Liabilities</b>		
Accounts payable	\$ 4,610,612	\$ 4,060,409
Amounts due to owners, net	742,255	1,552,104
Accrued expenses and other	3,563,188	12,501,944
Federal, state, and foreign taxes	7,217,774	7,696,283
Advertising fund liabilities	1,511,270	1,387,897
Deferred revenue	13,747,905	16,038,264
Total current liabilities	31,393,004	43,236,901
<b>Commitments and Contingencies</b>		
<b>Owners' Equity</b>		
Common stock	23,939	23,939
Member interests	20,632	20,632
Retained earnings	23,236,344	13,924,264
Accumulated other comprehensive income	139,388	318,335
Total owners' equity	23,420,303	14,287,170
<b>Total liabilities and owners' equity</b>	<b>\$ 54,813,307</b>	<b>\$ 57,524,071</b>

See accompanying notes.

Curves International, Inc. and Curves for Women II, L.C.

Combined Statements of Income

	Years ended December 31		
	2005	2004	2003
Revenues			
Sales of franchises	\$ 33,601,781	\$ 48,771,504	\$ 55,745,168
Royalties	43,010,253	37,086,182	25,368,248
Product sales	60,566,666	68,383,451	53,206,747
Other	8,820,319	5,292,404	1,560,889
Total revenues	145,999,019	159,533,541	135,881,052
Cost of revenues			
Sales of franchises and royalties	16,256,891	42,878,778	34,199,720
Product sales and other	35,738,777	38,142,214	28,757,039
Total costs of revenues	51,995,668	81,020,992	62,956,759
Gross profit	94,003,351	78,512,549	72,924,293
Operating expenses and costs			
General and administrative expenses	31,249,028	33,513,138	19,999,218
Depreciation and amortization	1,454,288	1,112,190	671,824
	32,703,316	34,625,328	20,671,042
Income from operations	61,300,035	43,887,221	52,253,251
Other income			
Interest income	668,231	330,665	273,430
Other income (expense), net	(1,392)	(3,576)	107,094
	666,839	327,089	380,524
Income before income taxes	61,966,874	44,214,310	52,633,775
Income tax expense	1,466,027	3,463,626	1,920,329
Net income	\$ 60,500,847	\$ 40,750,684	\$ 50,713,446

See accompanying notes.

Curves International, Inc. and Curves for Women II, L.C.

Combined Statements of Owners' Equity

	Common Stock	Member Interests	Accumulated Other Comprehensive Income	Retained Earnings	Total
Balances, January 1, 2003	\$ 23,939	\$ 20,632	\$ 4,440	\$ 22,058,323	\$ 22,107,334
Net income	-	-	-	50,713,446	50,713,446
Foreign currency translation	-	-	82,306	-	82,306
Comprehensive income	-	-	-	-	50,795,752
Distributions to owners	-	-	-	(48,003,589)	(48,003,589)
Balances, December 31, 2003	23,939	20,632	86,746	24,768,180	24,899,497
Net income	-	-	-	40,750,684	40,750,684
Foreign currency translation	-	-	130,158	-	130,158
Unrealized gain on available-for-sale securities	-	-	101,431	-	101,431
Comprehensive income	-	-	-	-	40,982,273
Distributions to owners	-	-	-	(51,594,600)	(51,594,600)
Balances, December 31, 2004	23,939	20,632	318,335	13,924,264	14,287,170
Net income	-	-	-	60,500,847	60,500,847
Foreign currency translation	-	-	(227,109)	-	(227,109)
Unrealized gain on available-for-sale securities	-	-	48,162	-	48,162
Comprehensive income	-	-	-	-	60,321,900
Distributions to owners	-	-	-	(51,188,767)	(51,188,767)
Balances, December 31, 2005	\$ 23,939	\$ 20,632	\$ 139,388	\$ 23,236,344	\$ 23,420,303

See accompanying notes.

Curves International, Inc. and Curves for Women II, L.C.

Combined Statements of Cash Flows

	Year ended December 31		
	2005	2004	2003
<b>Operating Activities</b>			
Net income	\$ 60,500,847	\$ 40,750,684	\$ 50,713,446
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	1,454,288	1,112,190	671,824
Losses from foreign currency transactions, net	51,610	106,613	65,016
Deferred income taxes	(55,558)	(58,735)	2,296
Provision for doubtful accounts	277,258	467,455	206,935
Changes in operating assets and liabilities:			
Accounts and notes receivable, net	(2,847,926)	251,746	562,644
Inventories	(5,013,742)	(2,639,953)	(2,024,872)
Prepaid expenses and other assets	760,679	1,726,189	(3,288,412)
Accounts payable, accrued expenses, and other	(8,303,721)	11,397,392	3,657,404
Amounts due to owners	(1,281,752)	5,456	1,765,265
Federal, state, and foreign taxes	(478,509)	3,672,592	1,930,510
Deferred revenue	(2,229,633)	(6,631,272)	12,768,393
Net cash provided by operating activities	42,833,841	50,160,357	(67,030,449)
<b>Investing Activities</b>			
Purchase of property and equipment	(1,131,519)	(2,680,569)	(5,334,881)
Sale of property and equipment	207,644	66,055	313,325
Purchase of short-term investments	(319,989)	(9,881,871)	—
Sale of short-term investments	3,272,192	4,200,000	—
Purchase of other assets	(1,050,000)	—	—
Net cash provided by (used in) investing activities	978,328	(8,296,385)	(5,021,556)
<b>Financing Activities</b>			
Distributions paid to owners	(50,769,324)	(50,859,600)	(48,003,589)
Payments of capital lease obligations	(60,224)	(39,963)	(19,869)
Net cash used in financing activities	(50,829,548)	(50,899,563)	(48,023,458)
<b>Exchange rate effects on cash balances held in foreign currencies</b>	(138,652)	95,927	121,934
<b>Net (decrease) increase in cash and cash equivalents</b>	<b>(7,156,031)</b>	<b>(8,939,664)</b>	<b>14,107,369</b>
<b>Cash and cash equivalents, beginning of year</b>	<b>27,505,694</b>	<b>36,445,358</b>	<b>22,337,989</b>
<b>Cash and cash equivalents, end of year</b>	<b>\$ 20,349,663</b>	<b>\$ 27,505,694</b>	<b>\$ 36,445,358</b>
<b>Supplemental Cash Flow Information</b>			
Taxes paid	\$ 507,498	\$ 421,142	\$ 315,919
Interest paid	\$ 6,073	\$ 3,810	\$ 6,081
<b>Noncash Investing and Financing Activity</b>			
Distribution of property and equipment to owners	\$ —	\$ 735,000	\$ —

See accompanying notes.

# Curves International, Inc. and Curves for Women II, L.C.

## Notes to Combined Financial Statements

December 31, 2005

### **1. Organization, Basis of Accounting and Summary of Significant Accounting Principles**

Curves International, Inc. and Curves for Women II, L.C. (together with their subsidiaries and affiliates, the Company or Curves) is a franchisor of fitness clubs designed specifically for women. At December 31, 2005, there were approximately 9,500 Curves franchisees, operating under the name *Curves* and *Curves for Women*. These franchises are located in every state in the United States and over 40 foreign countries, including Canada, Australia, England, Ireland, Mexico, Spain, and Japan. In addition to selling franchises and providing a base level of operating support to franchisees, the Company sells promotional and retail products and equipment to franchisees. Curves International, Inc., is a Texas corporation with authorized capital of 100,000 shares of no par value common stock, of which 10,002 shares are outstanding at December 31, 2005. Curves for Women II, L.C., is a limited liability company with two 50% membership interests outstanding, which was organized in the state of Texas with a finite term of existence ending on May 15, 2014.

#### **Principles of Combination**

The accompanying combined financial statements include the accounts of the Company and its direct or indirect wholly owned subsidiaries as of December 31, 2005. Through June 1, 2005, these subsidiaries, with the exception of Heavin Ideas in Action, Inc., (Ideas), were wholly owned, directly or indirectly, by the Company's Chief Executive Officer (CEO), Gary Heavin and his wife, Diane Heavin. On June 1, 2005, the Company purchased Ideas, which has served as the marketing/logistics provider of fitness-related products and equipment to the Curves franchisees. Prior to the acquisition, Ideas was owned 100% by the brother and sister-in-law of Gary Heavin. Because of the nature of the relationship between the companies, the Company has combined the historical operations of Ideas with its operations for all periods prior to the acquisition with no adjustment to the historical cost basis of Ideas resulting from the acquisition. In connection with the acquisition of Ideas, the former stockholders of Ideas received 2.6% of the outstanding shares of Curves International, Inc., and \$6.0 million in cash. The cash payment has been presented as a distribution in the combined statements of owners' equity. The former stockholders of Ideas have indemnified the Company for all pre-acquisition contingencies.



## Curves International, Inc. and Curves for Women II, L.C.

### Notes to Combined Financial Statements (continued)

#### **1. Organization, Basis of Accounting and Summary of Significant Accounting Policies (continued)**

All significant intercompany accounts and transactions have been eliminated in the combined financial statements.

#### **Revenue Recognition**

The Company's revenues consist primarily of franchise sales, continuing monthly royalty fees (royalties) from franchisees, and promotional and retail product sales to franchisees.

**Sales of Franchises** – Revenues recognized from the sales of franchises are derived from two different franchising methods: direct sales and master franchise agreements.

- **Direct Sales** – The Company recognizes revenues from the initial franchise fee received from a franchisee when it has performed substantially all initial services required by the franchise agreement, which is generally upon the opening of the club. Until such time, the initial fees received are reflected as deferred revenue on the balance sheet. In consideration for the initial franchise fee, the Company provides a specified number of units of circuit equipment, initial training, operational materials and manuals, and other operational support and training prior to and during the opening. At the time of the franchise sale, the Company pays a commission to independent contracted salesmen of approximately 20% of the initial franchise fee. The costs associated with the commissions, which are not earned by salesmen until the clubs open, and circuit equipment are deferred and included in prepaid expenses until the date the club opens.
- **Master Franchise Agreements** – The Company has entered into master franchise agreements for the marketing and development of franchises in South America, Japan, and the Netherlands. In consideration of the rights granted, the Company receives license fees and a portion of all income derived from the sales of franchises, royalty fees and other associated revenues. The Company has limited specific obligations as defined within these agreements, which include training the master licensee and providing developmental guidance. Revenues are recognized over the period, generally one to two years, over which the Company is required to perform the services specified in the agreements.

Curves International, Inc. and Curves for Women II, L.C.

Notes to Combined Financial Statements (continued)

**1. Organization, Basis of Accounting and Summary of Significant Accounting Policies (continued)**

**Royalties** – Under the terms of the direct sales franchise agreements, franchisees pay a monthly royalty fee to the Company, which may be a fixed rate per month or a percentage of the franchisee's gross club sales subject to a minimum and maximum amount. The royalties are recognized in revenue as earned.

**Promotional and Retail Product Sales** – The Company also sells promotional products to franchisees for use primarily as workout incentives for members, retail products for resale to members, and extra equipment for replacement or expansion. The Company recognizes revenues and costs associated with such sales at the time of shipment.

**Other** – The Company receives revenues from commissions under licensing agreements for the use of the *Curves* brand name on products produced and sold by third parties and commissions on sales of third-party club management software to franchisees; sales of advertising in Company publications; and fees paid by franchisees in connection with the resale of franchises. The Company recognizes these revenues as earned. Other revenues are summarized as follows:

	2005	2004	2003
Commissions	\$ 2,152,773	\$ 1,645,862	\$ 439,211
Advertising	1,635,393	450,135	–
Franchise resale fees	4,590,226	2,865,547	1,121,678
Other	441,927	330,860	–
	<u>\$ 8,820,319</u>	<u>\$ 5,292,404</u>	<u>\$ 1,560,889</u>

**Income Taxes**

The Company, except for certain subsidiaries, is treated as a flow-through entity for federal income tax purposes. Accordingly, a large portion of the Company's income and deductions is reported on the tax returns of its stockholders and members for federal income tax purposes. Certain subsidiaries are subject to federal or foreign income taxes. In addition, the Company is subject to income taxes in various states.

## Curves International, Inc. and Curves for Women II, L.C.

### Notes to Combined Financial Statements (continued)

#### **1. Organization, Basis of Accounting and Summary of Significant Accounting Policies (continued)**

The Company accounts for income taxes under the liability method. Deferred income taxes result from differences in the bases of assets and liabilities for financial reporting and income tax purposes.

#### **Concentrations**

Substantially all accounts and notes receivable are from franchisees. One account represented 37% of total accounts receivable at December 31, 2005, and was substantially collected after December 31, 2005. No other franchisee account or note accounted for more than 2% of total accounts and notes receivable at December 31, 2005 or 2004. The Company performs ongoing credit evaluations of its franchisees and generally does not require collateral. Historically, credit losses have been insignificant.

The Company's revenues in 2005 were primarily in North America (86%); Central and South America (1%); Europe (6%); Oceania (5%); and Asia (2%).

The Company purchases all of the equipment sold to franchisees from one supplier.

#### **Foreign Currency Translation**

All balance sheet accounts of the Company's subsidiary in Spain are translated from its functional currency, the euro, into United States dollars at the year-end rate of exchange, and income statement items are translated at the weighted average exchange rate for the year. Foreign currency translation adjustments are included as a component of other comprehensive income for each period.

#### **Cash Equivalents**

Cash equivalents consist of highly liquid investments with maturities of three months or less at the date of purchase. Cash equivalents consist primarily of money market funds and are carried at cost, which approximates fair value.

## Curves International, Inc. and Curves for Women II, L.C.

### Notes to Combined Financial Statements (continued)

#### **1. Organization, Basis of Accounting and Summary of Significant Accounting Policies (continued)**

##### **Notes Receivable**

The Company provides partial financing to certain franchisees for the initial franchise fee. In addition, working capital advances were occasionally made to the Company's primary equipment manufacturer. The terms of the related notes generally require monthly payments of principal and interest at rates ranging from 5% to 15%. The terms of the notes varied from 24 to 36 months. Interest income on notes receivable recognized during the years ended December 31, 2005, 2004, and 2003, approximated \$42,000, \$38,000, and \$62,000, respectively. As of December 31, 2005, the Company has recorded an allowance for doubtful notes of approximately \$78,000 to reduce the carrying amount of notes receivable to their estimated collectible amounts.

##### **Allowance for Doubtful Accounts**

The allowance for doubtful accounts represents the Company's estimate of potential accounts receivable write-offs associated with recognized revenue, based on historical trends and factors surrounding the credit risk of specific franchisees. The Company writes off accounts receivable when franchises are terminated and other means for collection have been exhausted. Allowances for doubtful accounts were approximately \$499,000 and \$407,000 as of December 31, 2005 and 2004, respectively.

##### **Property and Equipment**

Property and equipment are recorded at cost. Repairs and maintenance costs are expensed as incurred. Depreciation expense is provided using the straight-line method over the estimated useful lives of the related assets. Equipment recorded under capital leases is amortized over the estimated useful life of the asset or the term of the lease, whichever is shorter. Estimated useful lives (in years) are as follows:

Building and improvements	15-39
Furniture, fixtures, and equipment	3-5
Vehicles	5
Software	3

## Curves International, Inc. and Curves for Women II, L.C.

### Notes to Combined Financial Statements (continued)

#### **1. Organization, Basis of Accounting and Summary of Significant Accounting Policies (continued)**

##### **Impairment of Long-Lived Assets**

Finite-lived intangible assets and property and equipment are evaluated for impairment whenever the Company identifies indicators of impairment. An asset is considered to be impaired if the related future undiscounted cash flows are less than the carrying value of the asset, at which time the asset is written down to fair value based on the discounted cash flows. The Company is aware of no impairment indicators in 2005, 2004, and 2003.

##### **Comprehensive Income**

Comprehensive income includes net income and all items of other comprehensive income, including unrealized gains and losses on available-for-sale marketable securities and foreign currency translation adjustments.

##### **Use of Estimates**

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates.

#### **2. Short-Term Investments**

The Company's investments include marketable securities classified as available for sale and certificates of deposit. Available-for-sale securities are stated at fair value with any unrealized gains or losses included as a component of accumulated other comprehensive income until realized. Realized gains and losses on sales are computed based upon initial cost, using the specific identification method, adjusted for other than temporary declines in fair value. Unrealized losses are recognized in income when a decline in value is considered to be other than temporary. Municipal debt securities consist of auction rate securities with interest reset dates every 30-90 days, resulting in a fair value approximately equal to cost.

Curves International, Inc. and Curves for Women II, L.C.

Notes to Combined Financial Statements (continued)

**2. Short-Term Investments (continued)**

Marketable securities and other short-term investments at December 31 were as follows:

	<b>Cost</b>	<b>Unrealized Gains</b>	<b>Unrealized Losses</b>	<b>Fair Value</b>
<b>2005</b>				
Equity mutual fund	\$ 1,030,588	\$ 149,593	\$ —	\$ 1,180,181
Municipal debt securities	1,700,000	—	—	1,700,000
	<u>\$ 2,730,588</u>	<u>\$ 149,593</u>	<u>\$ —</u>	<u>\$ 2,880,181</u>
<b>2004</b>				
Equity mutual fund	\$ 1,011,048	\$ 101,431	\$ —	\$ 1,112,479
Municipal debt securities	2,925,000	—	—	2,925,000
U.S. Treasury securities	999,510	—	—	999,510
Certificates of deposit	818,640	—	—	818,640
	<u>\$ 5,754,198</u>	<u>\$ 101,431</u>	<u>\$ —</u>	<u>\$ 5,855,629</u>

Realized gains on short-term investments were less than \$5,000 for the year ended December 31, 2005.

**3. Accounts and Notes Receivable**

Accounts and notes receivable, net, at December 31 were as follows:

	<b>2005</b>	<b>2004</b>
Accounts receivable:		
Franchisee	\$ 2,773,809	\$ 1,042,839
Other	1,069,081	471,747
	<u>3,842,890</u>	<u>1,514,586</u>
Notes receivable:		
Franchisee	364,131	362,199
Other	328,000	—
	<u>692,131</u>	<u>362,199</u>
Total accounts and notes receivable	4,535,021	1,876,785
Less long-term portion of notes receivable	(579,891)	(191,846)
	<u>3,955,130</u>	<u>1,684,939</u>
Less allowance for doubtful accounts and notes	(577,118)	(407,050)
Accounts and notes receivable, net	<u>\$ 3,378,012</u>	<u>\$ 1,277,889</u>

Curves International, Inc. and Curves for Women II, L.C.

Notes to Combined Financial Statements (continued)

**4. Inventories**

Inventories are stated at the lower of cost (on a first-in, first-out basis) or market. Inventories, net of estimated reserves for excess, slow-moving, and obsolete inventory, at December 31 were as follows:

	<u>2005</u>	<u>2004</u>
Retail products	\$ 4,831,934	\$ 842,256
Equipment	1,974,127	1,247,079
Promotional and other	4,617,115	4,320,099
	<u>\$ 11,423,176</u>	<u>\$ 6,409,434</u>

Retail products are products sold to franchisees for resale, generally consisting of vitamins, supplements, and *Curves* brand-name apparel, while promotional products generally include those items sold to franchisees for use as rewards and incentives for club members.

**5. Prepaid Expenses**

Prepaid expenses at December 31 were as follows:

	<u>2005</u>	<u>2004</u>
Prepaid commissions	\$ 1,907,245	\$ 2,910,407
Cost of equipment provided to franchisees	398,269	436,971
Advances on purchases	916,093	1,045,081
Other	543,974	129,595
	<u>\$ 3,765,581</u>	<u>\$ 4,522,054</u>

**6. Other Assets**

Other assets consist primarily of amounts paid in 2005 to register the Company's Internet address and a 2005 license agreement related to the production of charts and other aids. The cost of the Internet address registration is amortized over seven years. The license agreement is amortized ratably over the 15-year term of the agreement. Amortization expense was approximately \$119,000 for 2005. Annual amortization expense for each of the years 2006 through 2010 is expected to be approximately \$144,000.

Curves International, Inc. and Curves for Women II, L.C.

Notes to Combined Financial Statements (continued)

**7. Property and Equipment**

Property and equipment, net, at December 31 were as follows:

	<u>2005</u>	<u>2004</u>
Land	\$ 322,271	\$ 325,084
Buildings and improvements	7,601,475	7,680,350
Furniture, fixtures, and equipment	3,492,495	2,985,737
Vehicles	688,942	679,374
Software	1,423,203	998,928
	<u>13,528,386</u>	<u>12,669,473</u>
Less accumulated depreciation and amortization	<u>(3,740,775)</u>	<u>(2,500,141)</u>
Property and equipment, net	<u>\$ 9,787,611</u>	<u>\$ 10,169,332</u>

Office equipment under capital leases of \$266,993 and \$205,219 as of December 31, 2005 and 2004, respectively, is amortized using the straight-line method over the term of the lease, generally three years.

Depreciation and amortization expense on property and equipment was \$1.3 million, \$1.1 million, and \$672,000 in 2005, 2004, and 2003, respectively.

**8. Advertising**

The Company has the right under the franchise agreements to charge a monthly advertising fee to franchisees, which may be a fixed rate per month or a monthly amount based on a percentage (generally 3%) of the franchisee's gross club sales. As fees are collected, they are deposited and maintained in a separate account called the National Advertising Fund (the Fund). The funds are used by the Company, with consideration of the input and direction of a franchisee advisory council, for market research, direct advertising occurring primarily through television, radio and print, sales promotions and public relations, and internal administrative costs associated with marketing and advertising. Any excess not spent for the agreed upon purposes in any given year is carried forward to subsequent years. Franchisees currently charged for advertising are those in the United States, Canada, and, beginning the fall of 2005, Ireland. Balances in the Fund, net of costs incurred but not reimbursed by the Fund, are restricted for the use and benefit of franchisees. Restricted cash balances on hand at the end of each year are recorded as advertising fund assets, restricted, with a corresponding liability in



Curves International, Inc. and Curves for Women II, L.C.

Notes to Combined Financial Statements (continued)

**8. Advertising (continued)**

advertising fund liabilities. Payments of advertising costs out of the Fund, and therefore not included in the combined statements of income, totaled \$20.5 million, \$17.0 million, and \$11.8 million in 2005, 2004, and 2003, respectively.

Advertising costs, excluding amounts paid from the Fund, primarily relating to advertising incurred, placed, and paid for by the Company for the benefit of the franchisees, are expensed as incurred and were \$1.2 million, \$1.0 million, and \$673,000 for 2005, 2004, and 2003, respectively.

**9. Income Taxes**

The differences between the tax provision computed based on the United States federal statutory income tax rate of 35% and the Company's combined provision for income taxes are summarized as follows:

	2005	2004	2003
Federal income tax provision based on the statutory rate	\$ 21,688,406	\$ 15,475,009	\$ 18,421,821
Effect of income taxable directly to stockholders and members	(20,786,371)	(12,409,513)	(16,771,969)
State and local income taxes, net of related federal benefit	565,635	397,361	271,232
Other	(1,643)	769	(755)
	<u>\$ 1,466,027</u>	<u>\$ 3,463,626</u>	<u>\$ 1,920,329</u>

The components of the combined provision for income taxes are as follows:

	2005	2004	2003
Federal income taxes	\$ 476,923	\$ 2,681,312	\$ 1,330,785
State and local income taxes	588,012	523,734	333,948
Foreign income taxes	401,092	258,580	255,596
	<u>\$ 1,466,027</u>	<u>\$ 3,463,626</u>	<u>\$ 1,920,329</u>

Curves International, Inc. and Curves for Women II, L.C.

Notes to Combined Financial Statements (continued)

**9. Income Taxes (continued)**

The significant components of net deferred income tax assets and liabilities are as follows at December 31:

	<b>2005</b>	<b>2004</b>
Deferred tax assets:		
Deferred revenue	<b>\$ 161,162</b>	<b>\$ 147,100</b>
Allowance for doubtful accounts	<b>43,359</b>	<b>49,950</b>
Total deferred tax assets	<b>204,521</b>	<b>197,050</b>
Deferred income tax liabilities:		
Property and equipment	<b>25,785</b>	<b>46,153</b>
Total deferred tax liabilities	<b>25,785</b>	<b>46,153</b>
Net deferred tax assets	<b>\$ 178,736</b>	<b>\$ 150,897</b>

Deferred tax liabilities are included with accrued expenses and other liabilities in the accompanying combined balance sheets.

Income tax expense is presented net of deferred tax benefits of approximately \$56,000 and \$59,000 for the years ended December 31, 2005 and 2004, respectively, and includes deferred tax expense of approximately \$2,000 for the year ended December 31, 2003.

**10. Commitments and Contingencies**

The Company leases equipment under operating and capital leases, which are generally for terms of 3 to 4 years. Future minimum rental commitments on all leases are as follows: 2006 – \$63,000; 2007 – \$53,000; and 2008 – \$25,000.

The Company obtains letters of credit from a bank primarily to collateralize payments to certain vendors. Outstanding letters of credit issued at December 31, 2005 and 2004, approximated \$1,026,000 and \$34,000, respectively.

The Company has contracted with a university for a period ending in January 2009 to develop more advanced training equipment and to further study the impact of exercise and diet on weight loss and enhancing fitness and health. Total costs to the Company under the contract are not to exceed \$5.0 million and the contract is cancelable by the Company at any time prior to December 31, 2006. The agreement provides for the

## Curves International, Inc. and Curves for Women II, L.C.

### Notes to Combined Financial Statements (continued)

#### 10. Commitments and Contingencies (continued)

university to license any intellectual property developed under the contract to the Company in return for a royalty on net sales of products covered by the license. During the years ended December 31, 2005, 2004, and 2003, the Company recognized expenses of approximately \$1.5 million, \$1.1 million, and \$614,000, respectively, related to these research studies.

The Company is a party to litigation and claims as well as examinations by taxing authorities arising in the normal course of operations. In many instances, the Company is named in claims made by customers of franchisees. Franchisees are required to maintain a specified level of insurance to cover claims and to indemnify the Company from such claims. The Company also maintains insurance to cover certain types of claims. In management's opinion, these matters, individually, and in the aggregate, will not have a significant adverse impact on the financial condition of the Company.

#### 11. Related Party Transactions

In addition to the distributions to owners summarized in the combined statements of owners' equity, the combined statements of income include compensation expense related to owners, all of whom are employees, totaling approximately \$1.4 million, \$1.5 million, and \$1.4 million for 2005, 2004, and 2003, respectively.

In 2004, general and administrative costs include payments of \$10.0 million made in connection with the departure of the former president of the Company.

The Company utilizes aircraft owned by HAALO, Ltd., a company owned by the CEO. For the years ended December 31, 2005, 2004, and 2003, the Company paid approximately \$577,000, \$353,000, and \$296,000, respectively, for use of the aircraft. Amounts due to related parties, net, includes amounts owed to HAALO of \$125,000 and \$188,000 at December 31, 2005 and 2004, respectively.

Ideas uses office and warehouse space in a building owned personally by the CEO. Ideas pays for all operational costs associated with the building, including taxes, insurance, utilities, and maintenance, and recognized rent expense of approximately \$255,000, \$193,000, and \$180,000 during the years ended December 31, 2005, 2004, and 2003, respectively.

## Curves International, Inc. and Curves for Women II, L.C.

### Notes to Combined Financial Statements (continued)

#### **11. Related Party Transactions (continued)**

Amounts due to owners, net, at December 31, 2005, includes approximately \$419,000 of accrued distributions to owners.

#### **12. Royalty Residual Buyout**

Prior to December 31, 2004, in addition to the commission paid on sales of franchises, the Company paid commissions on subsequent royalties to the independent contracted salesmen, the amount of which was generally 20% of the monthly royalty. In December 2004, the Company exercised its contractual buyout provision related to commissions on future royalties and recorded a charge of approximately \$15.0 million related to the settlement of these obligations, which is included in cost of sales of franchises and royalties.

#### **13. Defined Contribution Plan**

The Company offers a 401(k) profit sharing and savings plan which covers substantially all employees, other than Ideas. Under the plan the Company has the discretion to make an annual contribution (up to 3%) to a participant's account, based on base salary. The 401(k) plan allows participants to make pre-tax contributions that are matched up to a specified amount. Ideas offers its employees a simple IRA plan that matches contributions up to a specified contribution rate. The Company recognized expense related to these plans for the years December 31, 2005, 2004, and 2003 of approximately \$323,000, \$253,000, and \$223,000, respectively.