



HOUSE OF BREAD FRANCHISING, INC.

INDEPENDENT AUDITORS' REPORT
AND
FINANCIAL STATEMENTS

For the Year Ended
December 31, 2005



CROSBY & CINDRICH, CERTIFIED PUBLIC ACCOUNTANTS
A PROFESSIONAL CORPORATION

1368 MARSH STREET - SAN LUIS OBISPO, CA 93401
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Independent Auditors' Report

To the Board of Directors and Shareholders
House of Bread Franchising, Inc.
San Luis Obispo, California

We have audited the accompanying balance sheet of House of Bread Franchising, Inc. (a California S-Corporation), as of December 31, 2005, and the related statements of operations, shareholders' equity, and cash flows for the year then ended. 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 audit.

We conducted our audit in accordance with U.S. generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of House of Bread Franchising, Inc., as of December 31, 2005, and the results of its operations and its cash flows for the year then ended in conformity with U.S. generally accepted auditing standards.

CROSBY & CINDRICH
Certified Public Accountants
A Professional Corporation

February 9, 2006

HOUSE OF BREAD FRANCHISING, INC.
INDEPENDENT AUDITORS' REPORT AND FINANCIAL STATEMENTS
For the Year Ended December 31, 2005

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HOUSE OF BREAD FRANCHISING, INC.

BALANCE SHEET

December 31, 2005

ASSETS

Current assets:

Cash	\$ 7,776
Accounts receivable	11,473
Shareholder advance	2,000
Total current assets	21,249

Fixed assets:

Fixed assets - less accumulated depreciation of \$14,645	1,691
Total assets	\$ 22,940

LIABILITIES AND SHAREHOLDERS' DEFICIT

Current liabilities:

Accounts payable	\$ 3,633
Credit card payable	607
Line of credit payable	31,624
Advance - House of Bread	1,274
Total current liabilities	37,138

Shareholders' deficit

Common stock, no par, 2,000 shares authorized, issued and outstanding	27,000
Accumulated deficit	(41,198)
Total shareholders' deficit	(14,198)
Total liabilities and shareholders' deficit	\$ 22,940

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

HOUSE OF BREAD FRANCHISING, INC.

STATEMENT OF OPERATIONS

For The Year Ended December 31, 2005

Revenue:

Franchise fee revenue	\$ 84,000
Royalty revenue	124,246
Total revenue	208,246

Operating expenses:

Advertising	3,461
Annual convention	3,374
Consulting expense	126,722
Depreciation expense	827
Dues and subscriptions	850
Franchise expense	8,400
Interest	3,006
Internet services	993
Marketing expense	14,077
Meal and entertainment	3,339
Miscellaneous	703
Office expense	1,059
Outside services	2,492
Printing	2,870
Professional fees	7,635
Taxes and licenses	619
Telephone	1,932
Training and education	4,470
Travel	13,397
Total operating expenses	200,226
Income before income taxes	8,020
Income tax expense	800
Net income	\$ 7,220

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

HOUSE OF BREAD FRANCHISING, INC.
STATEMENT OF CHANGES SHAREHOLDERS' DEFICIT
For The Year Ended December 31, 2005

Accumulated deficit - December 31, 2004

\$ (48,418)

Net income

7,220

Accumulated deficit - December 31, 2005

\$ (41,198)

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

HOUSE OF BREAD FRANCHISING, INC.

STATEMENT OF CASH FLOWS For The Year Ended December 31, 2005

<i>Cash flows from operating activities:</i>	
Net income	\$ 7,220
Adjustment to reconcile net income to net cash provided by operating activities:	
Depreciation	827
Increase in accounts receivable	(5,796)
Decrease in accounts payable	(135)
Decrease in credit card payable	(564)
Decrease in lease payable	(1,231)
Decrease in other current liabilities	(250)
Increase in advance	1,274
Total adjustments	(5,875)
Net cash provided by operating activities	1,345
<i>Cash flows from investing activities:</i>	
Purchase of fixed assets	(1,790)
Net cash used by investing activities	(1,790)
<i>Cash flows from financing activities:</i>	
Repayments on line of credit	(49,000)
Borrowing on line of credit	45,500
Net cash used in financing activities	(3,500)
<i>Net decrease in cash</i>	(3,945)
<i>Cash at beginning of year</i>	11,721
<i>Cash at end of year</i>	\$ 7,776

Supplemental information:

There was \$3,006 paid for interest for the year ended December 31, 2005.

There was \$800 paid in income taxes for the year ended December 31, 2005.

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

HOUSE OF BREAD FRANCHISING, INC.

NOTES TO FINANCIAL STATEMENTS

December 31, 2005

NOTE 1: HISTORY AND ORGANIZATION

House of Bread Franchising, Inc., a California S-Corporation, was incorporated on February 6, 1998. The Company has been approved by the California Department of Corporations to be a franchisor of bread stores, providing recipes, interior and exterior designs, and technical procedures and standards to the franchisees. The Company is based in San Luis Obispo, California.

NOTE 2: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Accounting

The financial statements are presented on the accrual basis of accounting, which recognizes revenue as gross income when earned and operating expenses as deductions from gross income when incurred.

Property and Equipment

Property and equipment are recorded at cost. Repairs and maintenance are charged to expense when incurred. Depreciation expense is calculated on the straight-line method over the useful life of the related asset.

Estimates

The preparation of financial statements in conformity with U.S. generally accepted accounting principles require management to make estimates and assumptions that affect certain reported amounts and disclosures. Accordingly, actual results could differ from those estimates.

Revenue Recognition

Revenue from the sales of individual franchises is recognized when the franchise agreement is signed by the franchisee and the initial services of the franchisor have been substantially performed. Payment of one-half the franchise fees are due and payable at the time of signing and the remainder is due and payable upon initial services of the franchisor being performed. The term of each franchise agreement is ten years, with the option to renew for successive ten year periods. Amounts collected in advance of substantial performance of the initial services of the franchisor are deferred until substantial performance has been achieved.

Franchisees pay the Company a 6% fee based upon its gross revenues. These fees are payable on or before the 10th day of each month for the prior month revenues.

Accounts Receivable

Accounts receivable is made up of royalty fees due from franchisees. A provision for doubtful accounts has not been established as management considers all accounts collectible based upon favorable history over a substantial period of time.

See accountants' report.

HOUSE OF BREAD FRANCHISING, INC.

NOTES TO FINANCIAL STATEMENTS

December 31, 2005

NOTE 2: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES - CONTINUED

Common stock

On March 27, 1998, the Company authorized and issued 2,000 shares of no par common stock to Sheila McCann for \$27,000. There are no additional shares authorized or outstanding as of December 31, 2005.

Income taxes

At inception, the Company elected to be taxed under provisions of subchapter S of the Internal Revenue Code. Under the provision, the Company does not pay federal corporate income taxes on its taxable income. Instead, the stockholders are liable for individual income taxes in the Company's taxable income. The Company is subject to California corporate income tax equal to 1.5% of its taxable income.

Advertising

Advertising and marketing costs are charged to operations when incurred and are included in operating expenses.

Concentration of Revenue Risk

The Company earns franchise fee revenue from new franchise agreements. For the year ended December 31, 2005, revenue from three new franchise agreements amounted to 40% of the Company's total revenue.

During the year the Company sold three franchises to three different licensees. Since the Company incorporated in 1998 thirty-six franchises have been sold to twenty-three different licensees.

Cash and Cash Equivalents

Cash and cash equivalents includes all liquid investments including money market accounts and certificates of deposits.

NOTE 3: PROPERTY AND EQUIPMENT

A summary of fixed assets by major classifications at December 31, 2005, is as follows:

Equipment	\$	16,336
Less: accumulated depreciation		<u>14,645</u>
Net fixed assets	\$	<u>1,691</u>

Depreciation for the year ended December 31, 2005 was \$827.

See accountants' report.

HOUSE OF BREAD FRANCHISING, INC.

NOTES TO FINANCIAL STATEMENTS

December 31, 2005

NOTE 4: LICENSING AGREEMENT

The Company has signed a licensing agreement with House of Bread, Inc., a related party. This licensing agreement permits the Company to use certain trademarked logos, emblems, service marks, recipes, systems and procedures owned by House of Bread, Inc. In exchange, the Company will pay House of Bread, Inc. a 10% franchise royalty fee on franchise license fees collected within 30 days of cash receipt from the franchisee. The agreement, which expires on May 27, 2006, automatically renews for one-year terms until canceled in writing by either party. The franchise royalty fees paid under this licensing agreement in 2005 were \$8,400.

NOTE 5: LINE OF CREDIT

The Company has available a \$75,000 line of credit, secured by all business assets. The line of credit expires August 3, 2006. The line of credit bears interest at 3.0 percentage points over the bank's index rate, 10.25% at December 31, 2005. The balance as of December 31, 2005 was \$31,624.

NOTE 6: COMMITMENTS

The Company has an exclusive management agreement with Chaisson Enterprises, Inc. (the "Contractor"). The Contractor will provide services related to the structuring, training and management of the franchise business. The contract, which expires May 1, 2006, automatically renews for one-year terms until canceled in writing by either party. The Contractor requires the Company to make payments of \$6,000 per month for management services. The contractor was paid \$72,000 in consulting fees for the year ended December 31, 2005.

The Company has an exclusive consulting agreement with K & J Marketing (the "Contractor"). The Contractor will provide training and development services and field supervision to new franchisees. The contract is for a one-year term from the date of execution. The agreement is automatically extended unless canceled by either party upon thirty days written notice, for an additional one-year term. The contract requires the Company to make payments under the current contract of approximately \$2,500 per month, plus reimbursement for expenses incurred. The Contractor was paid \$33,467 in training and development fees for the year ended December 31, 2005.

The Company has an exclusive marketing agreement with Hilary Kaye Associates, Inc. (the "Contractor"). The Contractor will provide marketing services for the franchisees on behalf of the Company. The contract is for a one-year term from the date of execution. The agreement is automatically extended unless canceled by either party upon thirty days written notice, for an additional one-year term. The contract requires the Company to make payments under the current contract of \$2,500 per month for training services plus reimbursement of expenses incurred. The Contractor was paid \$21,255 in training fees and reimbursed expenses for the year ended December 31, 2005.

House of Bread Franchising, Inc.

Financial Statements

December 31, 2004

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Accountancy Corporation

Independent Auditors' Report on the Financial Statements

To the Board of Directors and Shareholders
House of Bread Franchising, Inc.
San Luis Obispo, California

We have audited the accompanying balance sheet of House of Bread Franchising, Inc., (a California S-Corporation) as of December 31, 2004, and the related statements of operations, shareholders' equity and cash flows for the year then ended. These financial statements are the responsibility of House of Bread Franchising, Inc.'s management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatements. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as 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 financial position of House of Bread Franchising, Inc. as of December 31, 2004, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

Barbara Eugene Hooper & King

San Luis Obispo, California
January 14, 2005

House of Bread Franchising, Inc.

*Balance Sheet
December 31, 2004*

ASSETS

Current Assets

Cash	\$	11,721
Accounts receivable		5,677
Shareholder advance		<u>2,000</u>
		<u>19,398</u>

Property and Equipment

Register System		14,546
Less accumulated depreciation		<u>(13,819)</u>
		<u>727</u>
	\$	<u><u>20,125</u></u>

LIABILITIES AND SHAREHOLDERS' EQUITY

Current Liabilities

Credit line payable		35,124
Accounts payable		3,767
Unsecured borrowings		1,171
Current maturities of capital lease obligation		1,231
Other current liabilities		<u>250</u>
		<u>41,543</u>

Shareholders' Deficit

Common stock, no par, 2,000 shares authorized, issued and outstanding		27,000
Accumulated deficit		<u>(48,418)</u>
		<u>(21,418)</u>
	\$	<u><u>20,125</u></u>

See Accompanying Notes to Financial Statements.

House of Bread Franchising, Inc.

Statement of Operations
Year Ended December 31, 2004

Revenue	
Franchise fee revenue	\$ 150,000
Royalty revenue	<u>91,908</u>
	<u>241,908</u>
Operating expenses	
Advertising	1,043
Annual convention	6,461
Bad debt	6,000
Bank fees	437
Consulting expense	138,643
Depreciation expense	2,909
Dues & subscriptions	186
Franchise expense	12,600
Insurance	387
Internet services	2,960
Marketing expense	9,218
Miscellaneous expense	2,095
Office expense	1,146
Penalties	38
Printing	5,720
Professional fees	8,446
Taxes and licenses	2,175
Telephone	2,876
Training expense	976
Travel, meals and entertainment expense	<u>21,899</u>
	<u>226,215</u>
Operating income	<u>15,693</u>
Other income (expense)	
Interest expense	<u>(2,481)</u>
Income before taxes	13,212
Income tax expense	<u>800</u>
Net income	<u>\$ 12,412</u>

See Accompanying Notes to Financial Statements.

House of Bread Franchising, Inc.

*Statement of Shareholders' Deficit
Year Ended December 31, 2004*

<i>Beginning balance</i>	\$ (60,830)
Net income	<u>12,412</u>
Ending balance	<u>\$ (48,418)</u>

See Accompanying Notes to Financial Statements.

House of Bread Franchising, Inc.

*Statement of Cash Flows
Year Ended December 31, 2004*

Cash flows from operating activities:

Net income \$ 12,412

*Adjustments to reconcile net income to net cash
provided by operating activities:*

Depreciation expense 2,909
Decrease in accounts receivable 12,754
Increase in accounts payable 1,138
Decrease in other current liabilities (64)
Decrease in unearned revenue (12,000)

Net cash provided by operating activities 17,149

Cash flows from financing activities:

Capital lease payments (3,436)
Repayments of credit line borrowings (10,480)
Increase in unsecured borrowings 607

Net cash used in financing activities (13,309)

Net increase in cash and cash equivalents 3,840

Cash and cash equivalents, beginning of year 7,881

Cash and cash equivalents, end of year \$ 11,721

Supplemental disclosure of cash flow information:

Interest paid \$ 2,545

Income taxes paid \$ 800

See Accompanying Notes to Financial Statements.

House of Bread Franchising, Inc.

Notes to Financial Statements

Note 1. Summary of Significant Accounting Policies

Organization:

House of Bread Franchising, Inc., a California S-Corporation, was incorporated on February 6, 1998. The Company has been approved by the California Department of Corporations to be a franchisor of bread stores, providing recipes, interior and exterior designs, and technical procedures and standards to the franchisees. The Company is based in San Luis Obispo, California.

Basis of accounting:

The financial statements have been prepared on the accrual basis of accounting, which generally recognizes revenues as income when earned and expenses as deductions when incurred.

Use of estimates:

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the financial statements. Actual results could differ from those estimates.

Revenue Recognition:

Revenue from the sales of individual franchises is recognized when the franchise agreement is signed by the franchisee and the initial services of the franchisor have been substantially performed. Payment of one-half the franchise fees are due and payable at the time of signing and the remainder is due and payable upon initial services of the franchisor being performed. The term of each franchise agreement is ten years, with the option to renew for successive ten year periods. Amounts collected in advance of substantial performance of the initial services of the franchisor are deferred until substantial performance has been achieved.

Franchisees pay the Company a 6% fee based upon its gross revenues. These fees are payable on or before the 10th day of each month for the prior month revenues.

House of Bread Franchising, Inc.
Notes to Financial Statements

Cash and cash equivalents:

The Company considers cash and cash equivalents to be all highly liquid debt instruments purchased with a maturity of three months or less.

Accounts receivable:

Accounts receivable is made up of royalty fees due from franchises. A provision for doubtful accounts has not been established as management considers all accounts to be collectible based upon favorable history over a substantial period of time.

Property and equipment:

Property and equipment is carried at cost and is being depreciated over 5 years. Depreciation expense for the year ended December 31, 2004 is \$2,909.

Common stock:

On March 27, 1998, the Company authorized and issued 2,000 shares of no par common stock to Sheila McCann for \$27,000. There are no additional shares authorized or issued as of December 31, 2004.

Income taxes:

At inception, the Company elected to be taxed under the provisions of subchapter S of the Internal Revenue Code. Under the provisions, the Company does not pay federal corporate income taxes on its taxable income. Instead, the stockholders are liable for individual income taxes in the Company's taxable income. The Company is subject to California corporate income tax equal to 1.5% of its taxable income.

Advertising:

Advertising and marketing costs are charged to operations when incurred and are included in operating expenses. The amount charged in 2004 was \$1,043.

House of Bread Franchising, Inc.
Notes to Financial Statements

Note 2. Licensing Agreement

The Company has signed a licensing agreement with House of Bread, Inc., a related party. This licensing agreement permits the Company to use certain trademarked logos, emblems, service marks, recipes, systems and procedures owned by House of Bread, Inc. In exchange, the Company will pay to House of Bread, Inc. a 10% franchise royalty fee on franchise license fees collected within 30 days of cash receipt from the franchisee. The agreement, which expires on May 27, 2005, automatically renews for one-year terms until canceled in writing by either party. The franchise royalty fees paid under this licensing agreement in 2004 were \$12,600.

Note 3. Capital Lease Obligation

Capital lease obligation at December 31, 2004 consists of the following:

GE Capital, 11%, collateralized by equipment, payable \$315 , monthly including interest, due April 2005	\$ <u>1,231</u>
Less current maturities	<u>1,231</u>
	<u>\$ -0-</u>

All equipment included in property and equipment is subject to this capital lease. The cost of the equipment was \$14,546 and the related accumulated depreciation was \$13,819 at December 31, 2004. Depreciation expense for the year ended December 31, 2004 was \$2,909.

Future minimum payments of capital lease obligations are as follows:

<i>Year Ending</i> <u>December 31,</u> 2005	\$ 1,260
Less amounts attributable to interest	<u>(29)</u>
	<u>\$ 1,231</u>

House of Bread Franchising, Inc.
Notes to Financial Statements

Note 4. Line of Credit

The Company has available a \$75,000 line of credit, secured by all business assets. The line of credit expires August 3, 2005. Borrowings under the credit facility bear interest at the bank's index rate plus 3% (8.25% as of December 31, 2004). As of December 31, 2004, borrowings outstanding under this line of credit were \$35,124.

Note 5. Commitments

The Company has an exclusive management agreement with Chaisson Enterprises, Inc. (the "Contractor"). The Contractor will provide services related to the structuring, training and management of the franchise business. The contract, which expires May 1, 2005, automatically renews for one-year terms until canceled in writing by either party. The Contractor requires the Company to make payments of \$6,000 per month for management services and reimbursement of actual expenses incurred. The Contractor was paid \$71,000 in consulting fees for the year ended December 31, 2004.

The Company has an exclusive consulting agreement with K & J Marketing (the "Contractor"). The Contractor will provide training and development services and field supervision to new franchisees. The contract is for a one-year term from the date of execution. The agreement is automatically extended unless canceled by either party upon thirty days written notice, for additional one-year term. The contract requires the Company to make payments under the current contract of approximately \$2,500 per month, plus reimbursement for expenses incurred. The Contractor was paid \$33,319 in training and development fees for the year ended December 31, 2004.

On August 31, 2004, the Company entered into an exclusive marketing agreement with Hilary Kaye Associates, Inc. (the "Contractor"). The Contractor will provide marketing services for the franchisees on behalf of the Company. The contract is for a one-year term from the date of execution. The agreement is automatically extended unless canceled by either party upon thirty days written notice, for additional one-year term. The contract requires the Company to make payments under the current contract of \$2,500 per month for training services plus reimbursement of expenses incurred. The Contractor was paid \$34,324 in training fees and reimbursed expenses for the year ended December 31, 2004.

House of Bread Franchising, Inc.
Notes to Financial Statements

Note 7. Concentration of Revenues

The Company earns franchise fee revenue from new franchise agreements. For the year ended December 31, 2004, revenue from one specific franchise agreement amounted to 28% of the Company's total franchise fee revenue.

During the year the Company sold six franchises to five different licensees. Since the Company incorporated in 1998 thirty three franchises have been sold to twenty different licensees.

House of Bread Franchising, Inc.

Financial Statements

December 31, 2003

House of Bread Franchising, Inc.
Notes to Financial Statements

Note 5. ***Line of Credit***

The Company has available a \$75,000 line of credit, secured by all business assets. The line of credit expires August 3, 2004. Borrowings under the credit facility bear interest at the bank's index rate plus 3% (8.00% as of December 31, 2003). As of December 31, 2003, borrowings outstanding under this line of credit were \$45,604.

Note 6. ***Commitments***

The Company had a exclusive marketing management agreement with Douglas Matheson & Company, Inc. (the Contractor). The Contractor provided services related to the structuring, implementation, marketing, and management of the franchise business. The contract expired April 1, 2003, and was not extended. The contract required the Company to make payments of \$4,000 per month for management services and reimbursement of actual marketing expenses incurred. Additionally, the Contractor received a 30% commission on the initial franchise fee for each consummated franchise deal. The Contractor was paid \$34,000 in consulting fees and franchise commissions for the year ended December 31, 2003.

The Company has a exclusive management agreement with Chaisson Enterprises, Inc. (the Contractor). The Contractor will provide services related to the structuring, training and management of the franchise business. The contract, which expires May 1, 2004, automatically renews for one-year terms until canceled in writing by either party. The Contractor requires the Company to make payments of \$5,000 per month for management services. The Contractor was paid \$60,000 in consulting fees for the year ended December 31, 2003.

Note 7. ***Concentration of Revenues***

The Company earns franchise fee revenue from new franchise agreements. For the year ended December 31, 2003, revenue from on specific franchise agreement amounted to 21.36% of the Company's total franchise fee revenue.

House of Bread Franchising, Inc.
Notes to Financial Statements

Note 3. *Licensing Agreement*

The Company has signed a licensing agreement with House of Bread, Inc., a related party. This licensing agreement permits the Company to use certain trademarked logos, emblems, service marks, recipes, systems and procedures owned by House of Bread, Inc. In exchange, the Company will pay to House of Bread, Inc. a 10% franchise royalty fee on franchise license fees collected within 30 days of cash receipt from the franchisee. The agreement, which expires on May 27, 2004, automatically renews for one-year terms until canceled in writing by either party. The franchise royalty fees charged in 2003 were \$14,800.

Note 4. *Capital Lease Obligation*

Capital lease obligation at December 31, 2003 consists of the following:

GE Capital, 11%, collateralized by equipment, payable \$315 , monthly including interest, due April 2005	\$ <u>4,667</u>
Less current maturities	<u>3,436</u>
	<u>\$ 1,231</u>

All equipment included in property and equipment is subject to this capital lease. The cost of the equipment was \$14,546 and the related accumulated depreciation was \$10,910. Depreciation expense for the year ended December 31, 2003 was \$2,910.

Future minimum payments of capital lease obligations are as follows:

<i>Year Ending</i> <i>December 31,</i>	
2004	\$ 3,780
2005	<u>1,260</u>
	5,040
Less amounts attributable to interest	<u>(373)</u>
	<u>\$ 4,667</u>



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Independent Auditors' Report on the Financial Statements

To the Board of Directors and Shareholders
House of Bread Franchising, Inc.
San Luis Obispo, California

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We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatements. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as 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 financial position of House of Bread Franchising, Inc. as of December 31, 2003, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

Barbich Longcrier Hooper & King

San Luis Obispo, California
February 13, 2004

House of Bread Franchising, Inc.

*Balance Sheet
December 31, 2003*

ASSETS

Current Assets

Cash	\$ 7,881
Accounts receivable	431
Shareholder advance	2,000
Other receivables	<u>18,000</u>
	<u>28,312</u>

Property and Equipment

<i>Register System</i>	14,546
Less accumulated depreciation	<u>(10,910)</u>
	<u>3,636</u>
	<u>\$ 31,948</u>

LIABILITIES AND SHAREHOLDERS' EQUITY

Current Liabilities

Credit line payable	45,604
Accounts payable	2,629
Unsecured borrowings	564
Current maturities of capital lease obligation	3,436
Other current liabilities	314
Unearned revenue	<u>12,000</u>
	<u>64,548</u>

<i>Capital Lease Obligation, less current maturities</i>	<u>1,231</u>
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Shareholders' Deficit

Common stock, no par, 2,000 shares authorized, issued and outstanding	27,000
Accumulated deficit	<u>(60,830)</u>
	<u>(33,830)</u>
	<u>\$ 31,948</u>

See Accompanying Notes to Financial Statements.

House of Bread Franchising, Inc.

*Statement of Operations
Year Ended December 31, 2003*

Revenue	
Franchise fee revenue	\$ 168,553
Royalty revenue	<u>60,321</u>
	<u>228,874</u>
Operating expenses	
Advertising	3,795
Bank fees	424
Commissions expense	22,800
Consulting expense	88,266
Depreciation expense	2,909
Dues & subscriptions	516
Franchise expense	14,800
Insurance	4,931
Marketing expense	881
Miscellaneous expense	(309)
Office expense	3,881
Payroll expense	13,367
Professional fees	5,945
Taxes and licenses	3,557
Telephone	7,150
Training expense	3,373
Travel, meals and entertainment expense	<u>23,532</u>
	<u>199,818</u>
Operating income	<u>29,056</u>
Other income (expense)	
Interest income	837
Interest expense	<u>(5,697)</u>
	<u>(4,860)</u>
Income before taxes	24,196
Income tax expense	<u>966</u>
Net income	<u>\$ 23,230</u>

See Accompanying Notes to Financial Statements.

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House of Bread Franchising, Inc.

*Statement of Shareholders' Deficit
Year Ended December 31, 2003*

<i>Beginning balance</i>	\$ (84,060)
Net income	<u>23,230</u>
Ending balance	<u>\$ (60,830)</u>

See Accompanying Notes to Financial Statements.

House of Bread Franchising, Inc.

*Statement of Cash Flows
Year Ended December 31, 2003*

<i>Cash flows from operating activities:</i>	
Net income	\$ 23,230
<i>Adjustments to reconcile net income to net cash provided by operating activities:</i>	
Depreciation expense	2,910
Increase in accounts receivable	(3,314)
Decrease in prepaid expenses	4,000
Decrease in promissory notes receivable	15,163
Decrease in accounts payable	(2,171)
Decrease in other current liabilities	(648)
Decrease in unearned revenue	<u>(24,553)</u>
Net cash provided by operating activities	<u>14,617</u>
<i>Cash flows from financing activities:</i>	
Capital lease payments	(3,080)
Repayments of credit line borrowings	(14,250)
Increase in unsecured borrowings	<u>384</u>
Net cash used in financing activities	<u>(16,946)</u>
<i>Net decrease in cash and cash equivalents</i>	(2,329)
<i>Cash and cash equivalents, beginning of year</i>	<u>10,210</u>
<i>Cash and cash equivalents, end of year</i>	<u>\$ 7,881</u>
<i>Supplemental disclosure of cash flow information:</i>	
Interest paid	<u>\$ 5,697</u>
Income taxes paid	<u>\$ 800</u>

See Accompanying Notes to Financial Statements.

House of Bread Franchising, Inc.

Notes to Financial Statements

Note 1. Summary of Significant Accounting Policies

Organization:

House of Bread Franchising, Inc., a California S-Corporation, was incorporated on February 6, 1998. The Company has been approved by the California Department of Corporations to be a franchisor of bread stores, providing recipes, interior and exterior designs, and technical procedures and standards to the franchisees. The Company is based in San Luis Obispo, California.

Basis of accounting:

The financial statement have been prepared on the accrual basis of accounting, which generally recognizes revenues as income when earned and expenses as deductions when incurred.

Use of estimates:

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the financial statements. Actual results could differ from those estimates.

Revenue Recognition:

Revenue from the sales of individual franchises is recognized when the franchise agreement is signed by the franchisee and the initial services of the franchisor have been substantially performed. Payment of one-half the franchise fees are due and payable at the time of signing and the remainder is due and payable upon initial services of the franchisor being performed. The term of each franchise agreement is ten years, with the option to renew for successive ten year periods. Amounts collected in advance of substantial performance of the initial services of the franchisor are deferred until substantial performance has been achieved.

Franchisees pay the Company a 6% fee based upon its gross revenues. These fees are payable on or before the 10th day of each month for the prior month revenues.

House of Bread Franchising, Inc.
Notes to Financial Statements

Cash and cash equivalents:

The Company considers cash and cash equivalents to be all highly liquid debt instruments purchased with a maturity of three months or less.

Property and equipment:

Property and equipment is carried at cost and is being depreciated over 5 years. Depreciation expense for the year ended December 31, 2003 is \$2,909.

Common stock:

On March 27, 1998, the Company authorized and issued 2,000 shares of no par common stock to Sheila McCann for \$27,000. There are no additional shares authorized or issued, and no shares held in treasury as of December 31, 2003.

Income taxes:

At inception, the Company elected to be taxed under the provisions of subchapter S of the Internal Revenue Code. Under the provisions, the Company does not pay federal corporate income taxes on its taxable income. Instead, the stockholders are liable for individual income taxes in the Company's taxable income. The Company is subject to California corporate income tax equal to 1.5% of its taxable income.

Advertising:

Advertising and marketing costs are charged to operations when incurred and are included in operating expenses. The amount charged in 2003 was \$4,676.

Note 2. Other Receivables

As of December 31, 2003, the other receivable of \$18,000 represents the balance owed on two multi-unit franchising license agreement. The balance of \$6,000 is due upon the opening of the second franchise unit and the remaining \$12,000 is due upon completion of training, which was completed in January 2004.