



**GLACIER WATER SERVICES, INC.**

Consolidated Financial Statements

December 31, 2006 and January 1, 2006

(With Independent Auditors' Report Thereon)

# GLACIER WATER SERVICES, INC.

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**KPMG LLP**  
Suite 1500  
750 B Street  
San Diego, CA 92101

## **Independent Auditors' Report**

The Board of Directors  
Glacier Water Services, Inc.:

We have audited the accompanying consolidated balance sheets of Glacier Water Services, Inc. and subsidiaries as of December 31, 2006 and January 1, 2006, and the related consolidated statements of operations, stockholders' deficit and comprehensive loss, and cash flows for each of the fiscal years then ended. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with the auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. An audit includes 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 consolidated financial statements, 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 consolidated financial statements referred to above present fairly, in all material respects, the financial position of Glacier Water Services, Inc. and subsidiaries as of December 31, 2006 and January 1, 2006, and the results of their operations and their cash flows for each of the years then ended in conformity with U.S. generally accepted accounting principles.

**KPMG LLP**

San Diego, California  
March 20, 2007

**GLACIER WATER SERVICES, INC.**

Consolidated Balance Sheets

(In thousands, except share data)

Assets	December 31, 2006	January 1, 2006
Current assets:		
Cash and cash equivalents	\$ 3,841	3,563
Accounts receivable, net of allowance for doubtful accounts of \$96 and \$182 as of December 31, 2006 and January 1, 2006, respectively	2,119	2,034
Repair parts	2,180	2,261
Prepaid expenses and other	1,099	1,050
Total current assets	9,239	8,908
Property and equipment, net	54,459	61,962
Goodwill	7,080	7,080
Intangible assets, net of accumulated amortization of \$1,178 and \$925 as of December 31, 2006 and January 1, 2006, respectively	151	409
Investment in Glacier Water Trust I Common Securities	2,629	2,629
Investment in Glacier Water Trust I Preferred Securities	3,357	3,357
Other assets	5,213	5,702
Total assets	\$ 82,128	90,047
<b>Liabilities and Stockholders' Deficit</b>		
Current liabilities:		
Accounts payable	\$ 1,016	1,112
Accrued commissions	2,353	2,044
Accrued liabilities	4,237	2,431
Bank overdraft	1,750	—
Current portion of long-term notes payable	112	104
Current portion of deferred rent	52	26
Current portion of obligations under capital lease	404	661
Total current liabilities	9,924	6,378
Long-term debt	87,629	87,629
Long-term notes payable	19,599	27,166
Long-term portion of deferred rent	111	142
Total liabilities	117,263	121,315
Commitments and contingencies		
Stockholders' deficit:		
Common stock, \$0.01 par value. Authorized 10,000,000 shares, issued and outstanding 2,590,405 and 2,322,766 shares at December 31, 2006 and January 1, 2006, respectively	43	39
Additional paid-in capital	22,379	21,529
Retained deficit	(24,999)	(20,291)
Treasury stock, at cost, 1,587,606 shares at December 31, 2006 and January 1, 2006	(32,562)	(32,562)
Accumulated other comprehensive income	4	17
Total stockholders' deficit	(35,135)	(31,268)
Total liabilities and stockholders' deficit	\$ 82,128	90,047

See accompanying notes to consolidated financial statements.

**GLACIER WATER SERVICES, INC.**

## Consolidated Statements of Operations

(In thousands, except share and per share data)

	<b>Fiscal years ended</b>	
	<b>December 31, 2006</b>	<b>January 1, 2006</b>
Revenues	\$ 87,154	78,718
Operating costs and expenses:		
Operating expenses	53,871	49,971
Depreciation and amortization	15,829	14,493
Cost of goods sold	69,700	64,464
Selling, general, and administrative expenses	12,877	12,729
Total operating costs and expenses	82,577	77,193
Income from operations	4,577	1,525
Interest expense	9,285	8,765
Loss before income taxes	(4,708)	(7,240)
Income tax benefit	—	—
Net loss applicable to common stockholders	\$ (4,708)	(7,240)
Basic and diluted loss per share:		
Net loss applicable to common stockholders	\$ (1.93)	(3.21)
Weighted average shares used in calculation	2,434,114	2,255,200
Cash dividend per common share	\$ 0.80	—

See accompanying notes to consolidated financial statements.

**GLACIER WATER SERVICES, INC.**

Consolidated Statements of Stockholders' Deficit and Comprehensive Loss

December 31, 2006, and January 1, 2006

(In thousands, except share data)

	Preferred stock		Common stock		Additional paid-in capital	Retained deficit	Treasury stock	Accumulated other comprehensive income	Total
	Shares	Amount	Shares	Amount					
Balance, January 2, 2005	—	\$ —	2,160,218	\$ 38	18,948	(13,051)	(32,562)	—	(26,627)
Exercise of stock options	—	—	162,548	1	2,581	—	—	—	2,582
Comprehensive income:									
Net loss	—	—	—	—	—	(7,240)	—	—	(7,240)
Foreign currency translation adjustment	—	—	—	—	—	—	—	17	17
Total comprehensive loss									<u>(7,223)</u>
Balance, January 1, 2006	—	—	2,322,766	39	21,529	(20,291)	(32,562)	17	(31,268)
Exercise of stock options	—	—	267,639	4	2,907	—	—	—	2,911
Stock compensation	—	—	—	—	12	—	—	—	12
Dividends on common stock	—	—	—	—	(2,069)	—	—	—	(2,069)
Comprehensive income:									
Net loss	—	—	—	—	—	(4,708)	—	—	(4,708)
Foreign currency translation adjustment	—	—	—	—	—	—	—	(13)	(13)
Total comprehensive loss									<u>(4,721)</u>
Balance, December 31, 2006	<u>—</u>	<u>\$ —</u>	<u>2,590,405</u>	<u>\$ 43</u>	<u>22,379</u>	<u>(24,999)</u>	<u>(32,562)</u>	<u>4</u>	<u>(35,135)</u>

See accompanying notes to consolidated financial statements.

**GLACIER WATER SERVICES, INC.**

Consolidated Statements of Cash Flows

(In thousands)

	<b>Fiscal years ended</b>	
	<b>December 31, 2006</b>	<b>January 1, 2006</b>
	<hr/>	<hr/>
Cash flows from operating activities:		
Net loss	\$ (4,708)	(7,240)
Adjustments to reconcile net loss to net cash provided by operating activities:		
Depreciation and amortization	15,829	14,493
Stock option compensation expense	12	1,142
Loss on disposal of assets	81	82
Changes in operating assets and liabilities:		
Accounts receivable	(85)	721
Repair parts	81	344
Prepaid expenses and other	(49)	(95)
Cash paid for prepaid contract rights	(1,473)	(2,872)
Other assets	58	958
Accounts payable, accrued liabilities, and accrued commissions	2,019	(1,810)
Net cash provided by operating activities	<hr/> 11,765	<hr/> 5,723
Cash flows from investing activities:		
Investment in property and equipment	(6,245)	(20,138)
Cash paid in acquisitions, net of cash acquired	—	(1,177)
Net cash used in investing activities	<hr/> (6,245)	<hr/> (21,315)
Cash flows from financing activities:		
Dividends	(2,069)	—
Principal payments on line of credit and long-term notes payable	(16,694)	(5,960)
Proceeds from long-term notes payable	9,135	21,608
Bank overdraft	1,750	—
Principal payments under capital lease obligations	(257)	(262)
Increase (decrease) in deferred rent	(5)	56
Proceeds from issuance of common stock	2,911	1,440
Net cash provided by (used in) financing activities	<hr/> (5,229)	<hr/> 16,882
Net increase in cash and cash equivalents	291	1,290
Effect of exchange rate changes on cash and cash equivalents	(13)	17
Cash and cash equivalents, beginning of year	<hr/> 3,563	<hr/> 2,256
Cash and cash equivalents, end of year	<hr/> <hr/> \$ 3,841	<hr/> <hr/> 3,563

**GLACIER WATER SERVICES, INC.**

## Consolidated Statements of Cash Flows

(In thousands)

	<b>Fiscal years ended</b>	
	<b>December 31, 2006</b>	<b>January 1, 2006</b>
Supplemental disclosure of cash flow information:		
Cash paid for interest	\$ 9,556	8,528
Cash paid for income taxes	12	33
Noncash investing and financing activities:		
Business acquisitions:		
Assets acquired:		
Accounts receivable	\$ —	279
Repair parts	—	202
Prepaid expenses and other	—	5
Property and equipment	—	1,857
Intangible assets	—	178
Goodwill	—	212
Total assets acquired	—	2,733
Liabilities assumed:		
Accounts payable and accrued liabilities	—	(434)
Notes payable	—	(1,122)
Cash paid in acquisitions, net of cash acquired	\$ —	1,177

See accompanying notes to consolidated financial statements.

## GLACIER WATER SERVICES, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

December 31, 2006 and January 1, 2006

### (1) The Company and a Summary of Significant Accounting Policies

#### (a) *Business*

Glacier Water Services, Inc., a Delaware corporation (Glacier or Company), is primarily engaged in the operation of self-service vending machines that dispense drinking water to consumers. The machines are placed at supermarkets and other retail outlets under commission arrangements with the retailers. The Company's revenues are subject to seasonal fluctuations, with decreased revenues during rainy or cold weather months and increased revenues during dry or hot weather months. The Company's machines are primarily located throughout the Sunbelt and Midwest regions of the United States. On October 3, 2005, Glacier acquired Gestion Bi-Eau Pure, Inc. (Bi-Eau Pure), a privately held water vending company headquartered in Quebec, Canada. The transaction was accounted for as a purchase and, accordingly, the results of operations have been included in the consolidated statements of operations from the date of acquisition. As of December 31, 2006, the Company operated approximately 15,900 machines in 41 states and Canada.

#### (b) *Principles of Consolidation*

The accompanying consolidated financial statements include the accounts of Glacier Water Services, Inc. and its wholly owned subsidiaries. All significant intercompany accounts and transactions have been eliminated.

#### (c) *Use of Estimates*

The preparation of consolidated financial statements in conformity with U.S. generally accepted accounting principles requires that management make certain estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting periods. Actual results could differ from those estimates. These estimates and assumptions include, but are not limited to, assessing the following: the recoverability of accounts receivable, repair parts, property and equipment, goodwill and intangible assets, accrued liabilities, deferred tax assets, and the ability to estimate accrued revenues.

#### (d) *Fiscal Year*

The Company utilizes a fiscal year of 52 or 53 weeks ending on the Sunday closest to December 31. Fiscal year 2006 ended December 31, 2006 and fiscal year 2005 ended January 1, 2006 and consisted of 52 weeks or 364 days.

#### (e) *Other Comprehensive Loss*

Components of other comprehensive loss include net loss and foreign currency translation adjustments.

#### (f) *Cash and Cash Equivalents*

The Company considers all highly liquid investments with an original maturity of three months or less to be cash equivalents. As of December 31, 2006, cash equivalents consist primarily of cash held

## GLACIER WATER SERVICES, INC. AND SUBSIDIARIES

### Notes to Consolidated Financial Statements

December 31, 2006 and January 1, 2006

in money market accounts and/or certificates of deposit. The Company's policy is to place its cash with high credit quality financial institutions in order to limit the amount of credit exposure.

**(g) Investments**

The Company holds investments in Trust Common Securities of \$2,629,000 and Trust Preferred Securities of \$3,357,000 as long-term assets at December 31, 2006 and January 1, 2006 as discussed in note 4(a). Investments are accounted for in accordance with Financial Accounting Standards Board (FASB) Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, which requires that the Company determine the appropriate classification of investments at the time of purchase based on management's intent and reevaluate such designation as of each balance sheet date. The Trust Preferred Securities are classified as investments being held to maturity and are therefore stated at amortized cost as the Company has the ability and intent to hold the debt securities to the maturity date in 2028.

**(h) Fair Value of Financial Instruments**

The carrying amounts of cash and cash equivalents, accounts receivable, other current assets, and all current liabilities approximate their fair value because of the short-term nature of those instruments. The Company's long-term debt at December 31, 2006 consists of the Trust Preferred Securities and the long-term notes payable, which consist of amounts due in connection with the Bi-Eau Pure acquisition and amounts outstanding under the Company's credit facility (note 4). The market value of the Trust Preferred Securities at December 31, 2006 and January 1, 2006 was approximately \$84,500,000 and \$81,600,000, respectively. The carrying value of the Company's Trust Preferred Securities was approximately \$85,000,000 at December 31, 2006 and January 1, 2006. The carrying value of the Company's long-term notes payable, including any current portion, was approximately \$19,711,000 and \$27,270,000 at December 31, 2006 and January 1, 2006, respectively. The carrying value of the long-term notes payable approximates the fair value since their terms are equivalent to those generally available in the market place. The Company also has long-term obligations under capital leases with a carrying value of \$404,000 and \$661,000 as of December 31, 2006 and January 1, 2006, respectively.

**(i) Repair Parts**

Repair parts consist of machine parts used to maintain vending machines in operation and are stated at cost (moving weighted average). Repair parts consist of operating components that are used to replace or refurbish components installed in vending machines, thereby maintaining the overall life of the vending machine at its estimated useful life.

**(j) Long-Lived Assets**

The Company evaluates and assesses its long-lived assets for impairment under the guidelines of Statement of Financial Accounting Standards (SFAS) No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*. SFAS No. 144 addresses financial accounting and reporting for the impairment or disposal of long-lived assets. SFAS No. 144 supersedes SFAS No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of*, and the accounting and reporting provisions of Accounting Principles Board Opinion No. 30, *Reporting the Results of Operations—Reporting the Effects of a Disposal of a Segment of a Business, and*

## GLACIER WATER SERVICES, INC. AND SUBSIDIARIES

### Notes to Consolidated Financial Statements

December 31, 2006 and January 1, 2006

*Extraordinary, Unusual, and Infrequently Occurring Events and Transactions*, for the disposal of a segment of a business (as previously defined in that opinion). The Company periodically assesses triggering events for the impairment of long-lived assets. The impairment analysis requires the use of assumptions and judgments regarding the carrying value and estimated lives of these assets. For the years ended December 31, 2006 and January 1, 2006, there has been no impairment of long-lived assets recorded.

**(k) *Property and Equipment and Depreciation***

Property and equipment are recorded at cost and consist of the following (in thousands):

	<b>December 31, 2006</b>	<b>January 1, 2006</b>
Vending equipment	\$ 138,382	134,269
Equipment, furniture, and fixtures	4,440	4,453
Land	69	69
Building	655	655
Leasehold improvements	73	69
Capital lease assets	1,225	1,225
	144,844	140,740
Less accumulated depreciation and amortization	(90,385)	(78,778)
	\$ 54,459	61,962

Depreciation is provided using the straight-line method over the estimated useful lives of the assets as follows:

Vending equipment	13 years
Equipment, furniture, and fixtures	3 to 10 years
Leasehold improvements	Shorter of life of asset or remaining lease term
Capital leases	Shorter of life of asset or remaining lease term

The Company's vending equipment was depreciated using a 10% estimated salvage value during fiscal years 2006 and 2005. Costs associated with installing vending equipment are capitalized and depreciated over five years, which is the normal contractual period with the retailers. All maintenance, repair, and minor refurbishment costs are charged to operations as incurred. Additions and major improvements are capitalized. Certain long-term repair parts are classified as vending equipment and are depreciated over a 3-, 5-, or 10-year estimated useful life. Costs associated with the assembly of vending machines are accumulated until finished machines are ready for installation at a retail location, at which time the costs are transferred to property and equipment. As of December 31, 2006 and January 1, 2006, there were no new vending machines in the process of assembly. The Company currently has sufficient machines in storage available for deployment in fiscal year 2007. Machines that have been previously installed and are in storage awaiting redeployment are currently being depreciated.

## GLACIER WATER SERVICES, INC. AND SUBSIDIARIES

### Notes to Consolidated Financial Statements

December 31, 2006 and January 1, 2006

**(l) Other Assets**

Included in other assets are prepaid contract rights, which consist of fees paid to retailers for future benefits associated with the ongoing placement of the Company's vending equipment at those locations. These fees are amortized over the life of the contract, generally ranging from three to five years. At December 31, 2006, prepaid contract rights in the amount of \$347,000 were included in other assets as compared to \$769,000 at January 1, 2006. For the years ended December 31, 2006 and January 1, 2006, \$1,895,000 and \$1,937,000, respectively, is included in depreciation and amortization.

Also included in other assets are net deferred financing costs for the years ended December 31, 2006 and January 1, 2006 of \$2,665,000 and \$2,705,000, respectively, which were incurred in connection with the original issue of the Trust Preferred Securities discussed in note 4 and are amortized using the effective interest method over the period ending January 2028, the date of the mandatory redemption of the securities. Additional net deferred financing costs for the years ended December 31, 2006 and January 1, 2006 of \$2,074,000 and \$2,106,000, respectively, associated with the Exchange Offer discussed in note 4 are also included in other assets and are also amortized using the effective interest method thru the period ending January 2028.

**(m) Revenue Recognition**

The Company recognizes revenue from the sale of its product at the point of purchase, which occurs when the customer vends the water and pays for the product. Due to the fact that the Company has approximately 15,900 vending machines, it is impractical to visit all machines at the end of each reporting period. Consequently, the Company estimates the revenue from the last time each machine was serviced until the end of the reporting period, based on the most current daily volume of each machine. For the years ended December 31, 2006 and January 1, 2006, the Company recorded approximately \$2,115,000 and \$1,892,000, respectively, of such estimated revenues, which represents an average of approximately 10 days per machine in both years.

**(n) Segment and Geographic Reporting**

Glacier operates in a single-business segment providing high-quality, low-priced drinking water dispensed to consumers through self-service vending machines and containers sold to retailers for resale. As of December 31, 2006, the Company operated 15,900 machines in 41 states and Canada.

**(o) Income Taxes**

Deferred tax liabilities and assets reflect the net tax effects, using enacted tax rates in effect for the year in which the differences are expected to reverse, of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. Valuation allowances are established, when necessary, to reduce deferred tax assets to the amount expected to be realized.

## GLACIER WATER SERVICES, INC. AND SUBSIDIARIES

### Notes to Consolidated Financial Statements

December 31, 2006 and January 1, 2006

(p) ***Stock-Based Compensation***

The Company had an employee stock-based compensation plan, which is described more fully in note 8. The Company's Stock Option Program expired in March 2004 and no options have been issued since that time.

Effective January 2, 2006, the Company adopted the provisions of SFAS No. 123R, *Share-Based Payment* which replaces SFAS No. 123, *Accounting for Stock-Based Compensation*, and supersedes Accounting Principles Board (APB) Opinion No. 25, *Accounting for Stock Issued to Employees*. Under the fair value recognition provisions of SFAS No. 123R, stock-based compensation cost is measured at the grant date based on the fair value of the award and is recognized as an expense over the requisite service period or the vesting period. The Company elected the modified-prospective method in implementing SFAS No. 123R, which does not require a revision to prior period financial statements for comparative purposes. The adoption of SFAS No. 123R had no material impact on the Company's consolidated financial statements.

Prior to adoption of SFAS No. 123R, the Company measured compensation expense for the employee stock-based compensation awards using the intrinsic value method and provided pro forma disclosures of net loss and loss per share as if a fair value method had been applied. Therefore, compensation cost for employee stock awards is measured as the excess, if any, of the fair value of the common stock at the grant date over the amount an employee must pay to acquire the stock and is amortized over the related service periods using the straight-line method. During fiscal year 2005, the Company recorded a one-time noncash stock compensation charge of \$1,142,000 associated with cashless stock option exercises by two company executives. These shares were subsequently repurchased by some of the Company's directors.

The Company calculated the fair value of the stock options included in the prior period pro forma stock compensation disclosures as required by SFAS No. 123 using the Black-Scholes option pricing model, consistent with the provisions of SFAS No. 123R. For the fair value calculation, the Company used historical stock price volatility. The expected term of the stock options represents the period over which time options are expected to be outstanding and is based on observed historical exercise patterns, which the Company believes are indicative of future exercise behavior. For the risk-free interest rate the Company used the then currently available rate on zero-coupon U.S. Government issues with a remaining period commensurate with the expected term for valuing options.

The fair value of the stock options granted is recognized to expense over the requisite service period. There were no stock options granted after the SFAS No. 123R effective date of January 2, 2006. For stock options granted prior to January 2, 2006, and which are continuing to vest, the Company will continue to record expenses using the straight-line method. During fiscal year 2006, the Company recorded stock compensation expenses of \$12,000.

## GLACIER WATER SERVICES, INC. AND SUBSIDIARIES

### Notes to Consolidated Financial Statements

December 31, 2006 and January 1, 2006

The following pro forma disclosures represent what the Company's net loss and loss per common share would have been had the Company recorded compensation cost for these plans in accordance with the provisions of SFAS No. 123 for fiscal year 2005:

	<b>Fiscal year ended January 1, 2006</b>
Net loss applicable to common stockholders, as reported	\$ (7,240)
Add total stock-based employee compensation expense for cashless options included in net loss	1,142
Deduct total stock-based employee compensation expense determined under the fair value method for all awards	1,233
Pro forma net loss applicable to common stockholders	<u>\$ (7,331)</u>
Basic and diluted loss per common share:	
As reported	\$ (3.21)
Pro forma	(3.25)

**(q) Recent Accounting Pronouncements**

In June 2006, the FASB issued FASB Interpretation (FIN) No. 48, *Accounting for Uncertainty in Income Taxes, an Interpretation of FASB No. 109*. FIN No. 48 applies to all tax positions accounted for under SFAS No. 109, including tax positions acquired in a business combination. FIN No. 48 is effective at the beginning of 2007. The impact of adopting FIN No. 48 is not expected to have a material effect on the financial position or results of operations.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements*. SFAS No. 157 sets out a framework for measuring fair value, and requires additional disclosures about fair-value measurements. SFAS No. 157 becomes effective at the beginning of 2008. Adopting SFAS No. 157 is not expected to have a material effect on the financial position or results of operations.

**(r) Loss Per Common Share**

Basic earnings per share are computed based upon the weighted average number of common shares outstanding during the period. Diluted earnings per share are based upon the weighted average number of common shares outstanding and potentially dilutive securities during the period.

## GLACIER WATER SERVICES, INC. AND SUBSIDIARIES

### Notes to Consolidated Financial Statements

December 31, 2006 and January 1, 2006

Potentially dilutive securities include shares issuable in connection with options granted under the Company's stock option plans using the treasury stock method. For fiscal years 2006 and 2005, a total of 235,728 and 336,596 potentially dilutive securities, respectively, were not used to calculate diluted loss per share because of their antidilutive effect.

	<b>December 31, 2006</b>	<b>January 1, 2006</b>
	(In thousands, except share and per share data)	
Numerator for basic earnings per share – net loss applicable to common shareholders	\$ (4,708)	(7,240)
Denominator – shares:		
Weighted average common shares for basic loss per share	2,434,114	2,255,200
Dilutive potential shares for diluted loss per share	\$ 2,434,114	2,255,200
Loss per share:		
Basic and dilutive loss applicable to common shareholders	\$ (1.93)	(3.21)

### (2) Acquisitions

On February 8, 2002, Glacier acquired substantially all of the assets of the Pure Fill Corporation, and its wholly owned subsidiaries, National Water Services, Pure Fill Finance Corporation and Pure Fill Container Corporation, (collectively, Pure Fill) for a purchase price of \$6,064,000. The excess of purchase price over acquired net assets was \$4,129,000 and is classified as goodwill.

On October 7, 2003, Glacier acquired Water Island, Inc. (Water Island) for a purchase price of \$6,068,000. The excess of purchase price over acquired net assets was \$2,739,000 and is classified as goodwill.

On October 3, 2005, the Company acquired 100% of the outstanding common stock of Gestion Bi-Eau Pure Management, Inc. for a purchase price (subject to adjustment) of approximately \$1,179,000 in cash and \$65,000 payable on each of the first and second anniversaries of the acquisition and \$43,000 payable on January 1, 2007 and January 1, 2008 for a total purchase price of \$1,395,000. Gestion Bi-Eau Pure Management, Inc. was a privately held company headquartered in Montreal, Canada. This acquisition was consummated principally to expand the Company's water vending operations and customer base in Canada. The transaction was accounted for as a purchase and, accordingly, the results of operations have been included in the consolidated statements of operations from the date of acquisition. The allocation of fair values of assets and liabilities was based upon a third-party appraisal. The excess of purchase price over acquired net assets was \$212,000 and is classified as goodwill. Intangible assets of \$99,000 and \$79,000 were assigned to registered trademarks and contracts, respectively (collectively, Bi-Eau Pure Intangible Assets). The Bi-Eau Pure Intangible Assets are subject to amortization and have a weighted average useful life of 4 years. For the year ended December 31, 2006, the Company recorded amortization

## GLACIER WATER SERVICES, INC. AND SUBSIDIARIES

### Notes to Consolidated Financial Statements

December 31, 2006 and January 1, 2006

of \$56,000 related to the Bi-Eau Pure Intangible Assets. The transaction was financed with cash on hand and borrowings under the Company's credit facility.

The Company estimates that amortization expense related to Pure Fill, Water Island, and Bi-Eau Pure Intangible Assets to be \$74,000, \$31,000, \$16,000, \$16,000, and \$12,000 for the fiscal years 2007 thru 2011.

### (3) Supplementary Balance Sheet Information

#### (a) Other Assets

Other assets consist of the following (in thousands):

	<b>December 31, 2006</b>	<b>January 1, 2006</b>
Prepaid contract rights, net	\$ 347	769
Deferred financing costs, net	4,739	4,811
Other	127	122
Total other assets	\$ 5,213	5,702

#### (b) Accrued Liabilities

Accrued liabilities consist of the following (in thousands):

	<b>December 31, 2006</b>	<b>January 1, 2006</b>
Accrued compensation, benefits, and related taxes	\$ 2,340	1,580
Accrued property, sales, income, and other taxes	221	207
Accrued interest	464	518
Accrued dividends	1,038	—
Other accrued liabilities	174	126
Total accrued liabilities	\$ 4,237	2,431

### (4) Long-Term Debt, Line of Credit, and Notes Payable

#### (a) Company Obligated Mandatorily Redeemable Preferred Securities

On January 27, 1998, Glacier Water Trust I (the Trust), a newly created Delaware business trust and a wholly owned subsidiary of the Company, issued 105,154 common securities to the Company and completed a public offering of 3,400,000 of 9.0625% Cumulative Trust Preferred Securities with a liquidation amount of \$25.00 per security (the Trust Preferred Securities and, together with the common securities, the Trust Securities). The Subordinated Debentures mature on January 31, 2028, but may be redeemed at the option of the Company at any time since January 31, 2003. The Trust exists for the sole purpose of issuing Trust Securities and purchasing Subordinated Debentures. Concurrent with the issuance of such securities, the Trust invested the proceeds therefrom in an

## GLACIER WATER SERVICES, INC. AND SUBSIDIARIES

### Notes to Consolidated Financial Statements

December 31, 2006 and January 1, 2006

aggregate principal amount of \$85,000,000 of 9.0625% Junior Subordinated Debentures (the Subordinated Debentures) issued by the Company.

Pursuant to an Exchange Offer, which commenced on February 26, 2003 and expired on April 11, 2003, a total of 983,880 shares of Common Stock were exchanged for a total of 787,105 Trust Preferred Securities at a ratio of one share of Common Stock for eight-tenths of a Trust Preferred Security. The Exchange Offer increased long-term debt by approximately \$19,678,000, which represents the total liquidation value of the 787,105 Trust Preferred Securities.

The Trust is considered a variable interest entity under FIN 46R. Prior to FIN 46R, variable interest entities were generally consolidated by an enterprise when the enterprise had a controlling financial interest through ownership of a majority voting interest in the entity. Under FIN 46R, a variable interest entity should be consolidated by its primary beneficiary. Because the Company is not the primary beneficiary of the Trust, the financial statements of the Trust are no longer included in the consolidated financial statements of the Company. FIN 46R may be adopted either by recording a cumulative effect adjustment as of the date of the adoption or restating prior period financial statements. The Company opted to restate prior period financial statements. As a result of the deconsolidation, the Company has recorded its ownership of 105,154 Common Trust Securities of the Trust and its ownership of 134,295 shares of Trust Preferred Securities as long-term assets and has recorded the Junior Subordinated Debentures as long-term debt at a face value of \$87,629,000. At December 31, 2006 and January 1, 2006, there were 3,265,705 Trust Preferred Securities outstanding (other than the 134,295 held by the Company).

**(b) *Line of Credit and Notes Payable***

On June 30, 2005, City National Bank increased the availability on the credit facility to \$30,000,000. The revised credit facility requires monthly interest payments at City National Bank's prime rate less 0.25% (8.00% per annum at December 31, 2006). The revolving credit facility requires a quarterly unused facility fee of 0.125% per annum and continues to contain certain customary financial covenants, which restrict indebtedness and capital expenditures. The Company pledged certain assets such as repair parts and equipment as collateral for its obligations under the credit facility. The credit availability on the revised revolving credit facility is reduced by \$1,500,000 every three months beginning January 1, 2007 until its maturity in December 2010. The Company was in compliance at December 31, 2006 with all covenants under this credit facility. As of December 31, 2006, there was \$19,550,000 outstanding on the credit facility, which is included in long-term notes payable. Availability under the \$30,000,000 revolving credit facility was \$10,450,000 as of December 31, 2006.

**(5) *Commitments and Contingencies***

**(a) *Leases***

The Company leases certain vehicles, warehouse, and office facilities under noncancelable operating leases that expire on various dates through 2011. The Company leases the corporate office located in Vista, California and other facilities that have terms that include annual rate increases and, as such, the Company has recorded a deferred rent liability of \$163,000 as of December 31, 2006. The Company also leased certain equipment under a capital lease, which expired in November 2006.

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Future minimum lease payments under noncancelable operating and capital leases with initial terms of one or more years are as follows (in thousands):

	<u>Operating</u>	<u>Capital</u>
Fiscal year:		
2007	\$ 941	404
2008	620	—
2009	521	—
2010	93	—
2011	—	—
	<u>2,175</u>	<u>404</u>
Total minimum lease payments	\$ <u>2,175</u>	404
Less amount representing interest		<u>—</u>
Present value of minimum lease payments		\$ <u>404</u>

Total lease expense for the years ended December 31, 2006 and January 1, 2006 was \$1,767,000 and \$1,769,000, respectively.

**(b) Contingencies**

The Company is involved in various legal proceedings and claims arising in the ordinary course of business, none of which, in the opinion of management, is expected to have a material effect on the Company's consolidated financial position, results of operations, or liquidity.

**(6) Income Taxes**

Deferred tax liabilities and assets result from the following (in thousands):

	<u>December 31, 2006</u>	<u>January 1, 2006</u>
Deferred tax liabilities:		
Property and equipment	\$ 8,890	9,339
Deferred tax assets:		
Alternative minimum tax credit	(1,070)	(1,070)
Net operating loss	(17,059)	(15,718)
Manufacturer's investment credit	(654)	(654)
Accruals and reserves	(295)	(267)
Other, net	<u>(84)</u>	<u>(91)</u>
Total gross deferred tax assets	(19,162)	(17,800)
Valuation allowance	<u>10,272</u>	<u>8,461</u>
Total deferred tax assets, net	<u>(8,890)</u>	<u>(9,339)</u>
Net deferred tax assets	\$ <u>—</u>	<u>—</u>

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The Company's effective income tax rate differs from the federal statutory rate as follows:

	Fiscal year ended	
	December 31, 2006	January 1, 2006
Federal statutory rate	(34.0)%	(34.0)%
State and local taxes, net of federal benefit	0.2	0.3
Other, net	0.5	0.1
Change in valuation allowance	33.3	33.6
Effective rate	—%	—%

The realization of deferred tax assets is dependent upon the Company's ability to generate taxable income in future years. Based on risk factors and net operating loss carryforwards, realization cannot be assured. Management believes it is not more likely than not that the deferred tax assets will be realized and, therefore, has recorded a valuation allowance for the net balance as of December 31, 2006.

At December 31, 2006, the Company had federal and California income tax net operating loss carryforwards of \$45,479,000 and \$12,160,000, respectively, which will begin to expire in 2012 and 2007 for U.S. federal and state income tax purposes, respectively.

#### (7) Stockholders' Equity

The board of directors has authorized the purchase of up to 750,000 shares of the Company's common stock in the open market. As of December 31, 2006, 603,726 shares had been repurchased under this program. No shares were acquired in 2006. As of December 31, 2006, there were 1,587,606 shares of common stock held in treasury. As of December 31, 2006, the Company is authorized to repurchase an additional 146,274 shares, approximately 5.6% of the Company's total shares outstanding.

The Company declared a cash dividend of \$0.40 per share on September 25, 2006 to holders of the Company's common stock on record as of October 16, 2006. The payment of the dividend occurred on October 30, 2006. The Company recorded the dividend of \$1,032,000 as a reduction of additional paid-in capital.

The Company declared a cash dividend of \$0.40 per share on November 29, 2006 to holders of the Company's common stock on record as of January 16, 2007. The payment of the dividend is to occur on January 30, 2007. The Company recorded the dividend of \$1,038,000 as a reduction of additional paid-in capital.

The Company declared a cash dividend of \$0.40 per share on March 20, 2007 to holders of the Company's common stock on record as of April 16, 2007. The payment of the dividend is to occur on April 30, 2007.

#### (8) Stock Option Plans

The Company has options outstanding under the 1994 Stock Compensation Program (the Program). The Program was terminated in 2004. For the fiscal year ended January 1, 2006, the Company accounted for this plan under APB Opinion No. 25 under which no compensation cost was recognized, since the exercise

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price of the option was not less than the market price of the stock on the grant date. Effective January 2, 2006, the Company adopted SFAS No. 123R under which compensation cost is measured at the grant date based on the fair value of the award and is recognized as an expense over the requisite service period or the vesting period, as described in note 1(p).

The Program provided for the issuance of incentive and nonqualified stock options to key employees, including directors and consultants. Incentive stock options were granted at no less than the fair market value on the date of the grant. Nonqualified options were granted at prices determined by the board of directors, but at no less than 85% of the fair market value on the date of the grant. Options generally have a term of 10 years and become exercisable at a rate of 25% per annum. Supplemental Options granted to directors for their services in lieu of cash fees have a term of five years and become exercisable one year following the date of the grant.

A summary of the status of the Company's stock option plans and activities is as follows:

	<b>Shares</b>	<b>Weighted average exercise price</b>
Balance as of January 2, 2005	787,772	\$ 11.47
Exercised	(162,548)	11.27
Cashless exercised	(39,272)	9.78
Canceled	(4,150)	22.41
Outstanding at January 1, 2006	581,802	11.47
Exercised	(267,639)	10.88
Canceled	(1,500)	18.62
Outstanding at December 31, 2006	312,663	12.07

There are 312,663 options outstanding under the 1994 Stock Option Plan at December 31, 2006 with exercise prices between \$7.95 and \$31.25, a weighted average exercise price of \$12.07, and a weighted average remaining contractual life of four years. At December 31, 2006, 305,536 of these options are exercisable and their weighted average exercise price is \$12.00.

The Company granted a one-time performance-based restricted stock grant to members of management on January 26, 2007. The grant consists of 85,000 restricted shares of common stock, the vesting of which being subject to achieving specific earning targets in 2011. The grant of the restricted stock has to be accounted for under SFAS No. 123R under which the Company estimated compensation cost of \$1,732,000, which is to be recognized as an expense over the requisite service period of five years.

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#### (9) 401(k) Savings Plan

The Company has a 401(k) Savings Plan (the Plan), which allows eligible employees to contribute a percentage of their pretax compensation (subject to annual limitations of the lesser of 60% of eligible compensation or \$15,000 in calendar year 2006), with the Company making discretionary matching contributions as determined each year by the plan administrator. Employees vest immediately in their contributions and vest in the Company discretionary matching contributions over a five-year period of service. The Company's discretionary matching contributions were approximately \$93,000 and \$90,000 for fiscal years 2006 and 2005, respectively.

#### (10) Significant Customers

The following table sets forth the customers that represent 10% or more of the Company's total revenues in fiscal years 2006 and 2005 after the effect of any consolidations that occurred as a result of any acquisition or mergers by the retailers:

	Fiscal year ended	
	December 31, 2006	January 1, 2006
Company A	13.08%	12.84%
Company B	10.67	11.40

#### (11) Related-Party Transactions

The Company has used Kayne Anderson Capital Advisors, L.P. to manage the Company's investments during fiscal 2006 and 2005. One board member is currently employed as a senior executive of Kayne Anderson Capital Advisors, L.P. and is a shareholder of the Company. The Company incurred no costs during fiscal 2006 and 2005 to Kayne Anderson Capital Advisors, L.P. in connection with investment management fees. During fiscal year 2005, the Company recorded a one-time noncash stock compensation charge of \$1,142,000 associated with cashless stock option exercises by two company executives. These shares were subsequently repurchased by some of the Company's directors.