

DIXIE GROUP INC  
Form 10-Q  
August 09, 2006

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

**Form 10-Q**

(Mark One)

**S**

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

For the quarterly period ended: **July 1, 2006**

or

**o**

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number: 0-2585

THE DIXIE GROUP, INC.

(Exact name of Registrant as specified in its charter)

**Tennessee**

(State or other jurisdiction of incorporation or organization)

**345-B Nowlin Lane, Chattanooga, TN**

(Address of principal executive offices)

**37421**

(zip code)

**Not Applicable**

(Former name, former address and former fiscal year, if changed since last report)

**62-0183370**

(I.R.S. Employer Identification No.)

**(423) 510-7000**

(Registrant's telephone number, including area code)

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Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer  Accelerated filer  Non-accelerated filer

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes  No

The number of shares outstanding of each of the issuer's classes of Common Stock as of the latest practicable date.

Class	Outstanding as of July 28, 2006
Common Stock, \$3 Par Value	12,048,887 shares
Class B Common Stock, \$3 Par Value	840,433 shares
Class C Common Stock, \$3 Par Value	0 shares

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**PART I. FINANCIAL INFORMATION****Item 1. Financial Statements**

**THE DIXIE GROUP, INC.**  
**CONSOLIDATED CONDENSED BALANCE SHEETS**  
**(dollars in thousands)**

	<b>(Unaudited)</b>	
	<b>July 1, 2006</b>	December 31, 2005
<b>ASSETS</b>		
<b>CURRENT ASSETS</b>		
Cash and cash equivalents	\$ 552	\$ ---
Accounts receivable (less allowance for doubtful accounts of \$553 for 2006 and \$595 for 2005)	38,296	31,633
Inventories	73,530	72,871
Other current assets	11,515	10,577
TOTAL CURRENT ASSETS	123,893	115,081
 <b>PROPERTY, PLANT AND EQUIPMENT</b>		
Land and improvements	6,100	6,047
Buildings and improvements	44,562	44,348
Machinery and equipment	110,735	107,993
	161,397	158,388
Less accumulated depreciation and amortization	(63,282)	(65,440)
NET PROPERTY, PLANT AND EQUIPMENT	98,115	92,948
 <b>OTHER ASSETS</b>		
Goodwill	57,068	57,177
Other long-term assets	12,962	11,797
TOTAL OTHER ASSETS	70,030	68,974
TOTAL ASSETS	\$ 292,038	\$ 277,003
 <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
<b>CURRENT LIABILITIES</b>		
Accounts payable	\$ 14,764	\$ 14,929
Accrued expenses	19,660	18,295
Current portion of long-term debt	7,460	6,341
TOTAL CURRENT LIABILITIES	41,884	39,565

LONG-TERM DEBT		
Senior indebtedness	<b>73,665</b>	60,987
Capital lease obligations	<b>4,139</b>	4,727
Convertible subordinated debentures	<b>19,662</b>	22,162
<b>TOTAL LONG-TERM DEBT</b>	<b>97,466</b>	87,876
DEFERRED INCOME TAXES	<b>10,691</b>	10,768
OTHER LONG-TERM LIABILITIES	<b>13,343</b>	15,310
COMMITMENTS AND CONTINGENCIES	<b>---</b>	---
STOCKHOLDERS' EQUITY		
Common Stock (\$3 par value per share): Authorized 80,000,000 shares, issued - 15,447,732 shares for 2006 and 15,347,589 shares for 2005	<b>46,343</b>	46,043
Class B Common Stock (\$3 par value per share): Authorized 16,000,000 shares, issued - 840,433 for 2006 and 714,560 shares for 2005	<b>2,521</b>	2,144
Additional paid-in capital	<b>134,098</b>	134,353
Unearned stock compensation	<b>---</b>	(719)
Retained earnings (accumulated deficit)	<b>373</b>	(1,406)
Accumulated other comprehensive loss	<b>(592)</b>	(2,887)
	<b>182,743</b>	177,528
Less Common Stock in treasury at cost - 3,398,845 shares for 2006 and 3,395,390 shares for 2005	<b>(54,089)</b>	(54,044)
<b>TOTAL STOCKHOLDERS' EQUITY</b>	<b>128,654</b>	123,484
<b>TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY</b>	<b>\$ 292,038</b>	\$ 277,003

See accompanying notes to the consolidated condensed financial statements.

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**THE DIXIE GROUP, INC.**  
**CONSOLIDATED CONDENSED STATEMENTS OF OPERATIONS**  
**(UNAUDITED)**  
**(dollars in thousands, except per share data)**

	Three Months Ended		Six Months Ended	
	July 1, 2006	June 25, 2005	July 1, 2006	June 25, 2005
Net sales	\$ 88,046	\$ 82,073	\$ 167,219	\$ 154,107
Cost of sales	63,582	55,925	120,557	105,916
Gross profit	24,464	26,148	46,662	48,191
Selling and administrative expenses	18,795	19,075	38,011	36,875
Other operating income	(228)	(139)	(570)	(224)
Other operating expense	130	277	286	313
Operating income	5,767	6,935	8,935	11,227
Interest expense	1,944	1,403	3,711	2,805
Other income	(95)	(141)	(108)	(233)
Other expense	50	27	54	46
Income from continuing operations before taxes	3,868	5,646	5,278	8,609
Income tax provision	964	2,062	1,449	3,153
Income from continuing operations	2,904	3,584	3,829	5,456
Loss from discontinued operations, net of tax	(1,960)	(95)	(2,050)	(507)
Income on disposal of discontinued operations, net of tax	---	---	---	834
Net income	\$ 944	\$ 3,489	\$ 1,779	\$ 5,783
<b>BASIC EARNINGS (LOSS) PER SHARE:</b>				
Continuing operations	\$ 0.23	\$ 0.29	\$ 0.30	\$ 0.44
Discontinued operations	(0.16)	(0.01)	(0.16)	(0.04)
	---	---	---	0.07

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Disposal of discontinued operations				
Net income	\$ <b>0.07</b>	\$ 0.28	\$ <b>0.14</b>	\$ 0.47
<b>SHARES OUTSTANDING</b>	<b>12,689</b>	12,326	<b>12,660</b>	12,298
<b>DILUTED EARNINGS (LOSS) PER SHARE:</b>				
Continuing operations	\$ <b>0.22</b>	\$ 0.28	\$ <b>0.30</b>	\$ 0.43
Discontinued operations	<b>(0.15)</b>	(0.01)	<b>(0.16)</b>	(0.04)
Disposal of discontinued operations	---	---	---	0.06
Net income	\$ <b>0.07</b>	\$ 0.27	\$ <b>0.14</b>	\$ 0.45
<b>SHARES OUTSTANDING</b>	<b>12,943</b>	12,805	<b>12,939</b>	12,829
<b>DIVIDENDS PER SHARE:</b>				
Common Stock	---	---	---	---
Class B Common Stock	---	---	---	---

See accompanying notes to the consolidated condensed financial statements.

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**THE DIXIE GROUP, INC.**  
**CONSOLIDATED CONDENSED STATEMENTS OF CASH FLOWS**  
**(UNAUDITED)**  
**(dollars in thousands)**

	Six Months Ended	
	July 1, 2006	June 25, 2005
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>		
Income from continuing operations	\$ 3,829	\$ 5,456
Loss from discontinued operations	(2,050)	(507)
Income on disposal of discontinued operations	---	834
Net income	1,779	5,783
Adjustments to reconcile net income to net cash (used in) provided by operating activities:		
Depreciation and amortization	5,731	5,291
Change in deferred income taxes	546	(1,296)
Net gain on property, plant and equipment disposals	(24)	(59)
Stock-based compensation expense	251	173
Changes in operating assets and liabilities:		
Accounts receivable	(6,663)	(1,942)
Inventories	(659)	(10,172)
Accounts payable and accrued expenses	1,200	4,605
Other operating assets and liabilities	(2,436)	3,526
<b>NET CASH (USED IN) PROVIDED BY OPERATING ACTIVITIES</b>	<b>(275)</b>	<b>5,909</b>
<b>CASH FLOWS FROM INVESTING ACTIVITIES</b>		
Net proceeds from sales of property, plant and equipment	26	716
Purchase of property, plant and equipment	(10,753)	(15,525)
<b>NET CASH USED IN INVESTING ACTIVITIES</b>	<b>(10,727)</b>	<b>(14,809)</b>
<b>CASH FLOWS FROM FINANCING ACTIVITIES</b>		
Net borrowings on credit line	8,987	13,320
Payments on term loan	(997)	(1,430)
Borrowings from equipment financing	6,456	---
Payments on equipment financing	(579)	(296)
Payments on capitalized leases	(552)	(973)

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Payments on mortgage note payable	<b>(106)</b>	(99)
Payments on subordinated indebtedness	<b>(2,500)</b>	(2,498)
Common stock issued under stock option plans	<b>699</b>	618
Common stock acquired for treasury	<b>(45)</b>	---
Tax benefits from exercise of stock options	<b>191</b>	258
<b>NET CASH PROVIDED BY FINANCING ACTIVITIES</b>	<b>11,554</b>	8,900
<b>INCREASE IN CASH AND CASH EQUIVALENTS</b>	<b>552</b>	---
<b>CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD</b>	<b>---</b>	---
<b>CASH AND CASH EQUIVALENTS AT END OF PERIOD</b>	<b>\$ 552</b>	<b>\$ ---</b>
Supplemental Cash Flow Information:		
Interest paid	<b>\$ 3,701</b>	<b>\$ 2,600</b>
Income taxes paid, net of tax refunds	<b>380</b>	3,224

See accompanying notes to the consolidated condensed financial statements.

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THE DIXIE GROUP, INC.  
 CONSOLIDATED CONDENSED STATEMENTS OF STOCKHOLDERS' EQUITY  
 (UNAUDITED)  
 (dollars in thousands)

	Common Stock and Class B Common Stock	Additional Paid-in Capital	Unearned Stock Compensation	Retained Earnings (Accumulated Deficit)	Accumulated Other Comprehensive Loss	Common Stock in Treasury	Total Stockhold Equity
<b>Balance at December 31, 2015</b>	<b>\$ 48,187</b>	<b>\$ 134,353</b>	<b>\$ (719)</b>	<b>\$ (1,406)</b>	<b>\$ (2,887)</b>	<b>\$ (54,044)</b>	<b>\$ 123,4</b>
Common Stock acquired for treasury - 155 shares	---	---	---	---	---	(45)	(
Common Stock Class B sold under stock option plan - 1,016 shares	302	397	---	---	---	---	6
Restricted Stock Grant issued - 1,000 shares	375	(375)	---	---	---	---	
Stock benefit from exercise of stock options	---	191	---	---	---	---	1
Stock-based compensation expense	---	251	---	---	---	---	2
Classification on adoption of AS No.	---	(719)	719	---	---	---	

23[R]

er prehensive ome	---	---	---	---	2,295	---	2,2
income	---	---	---	1,779	---	---	1,7
<b>alance at y 1, 2006</b>	<b>\$ 48,864</b>	<b>\$ 134,098</b>	<b>\$ ---</b>	<b>\$ 373</b>	<b>\$ (592)</b>	<b>\$ (54,089)</b>	<b>\$ 128,6</b>

accompanying notes to the consolidated condensed financial  
ements.

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**THE DIXIE GROUP, INC.**  
**NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS**  
**(UNAUDITED)**  
**(dollars in thousands, except per share data)**

**NOTE A - BASIS OF PRESENTATION**

The accompanying unaudited consolidated condensed financial statements have been prepared in accordance with U.S. generally accepted accounting principles for interim financial statements which do not include all the information and footnotes required by such accounting principles for annual financial statements. In the opinion of management, all adjustments (generally consisting of normal recurring accruals) considered necessary for a fair presentation have been included in the accompanying financial statements. The financial statements should be read in conjunction with the financial statements and notes thereto included in the Company's 2005 Annual Report on Form 10-K filed with the Securities and Exchange Commission, which includes consolidated financial statements for the fiscal year ended December 31, 2005. Operating results for the three month and six month periods ended July 1, 2006 are not necessarily indicative of the results that may be expected for the entire 2006 year.

The Company is in one line of business, Carpet Manufacturing.

The financial statements separately report discontinued operations and the results of continuing operations (See Note F). Disclosures included herein pertain to the Company's continuing operations unless noted otherwise.

**NOTE B - RECENT ACCOUNTING PRONOUNCEMENTS**

In July 2006, the Financial Accounting Standards Board ("FASB") issued FASB Interpretation No. 48, "Accounting for Uncertainty in Income Taxes" ("FIN 48"). FIN 48 clarified the treatment of uncertain income tax positions in accordance with FASB Statement No. 109, "Accounting for Income Taxes." The interpretation prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. It also provides guidance on adjustments of a previously recognized tax position, classification, interest and penalties, accounting for taxes in interim periods and disclosure requirements. FIN 48 is effective for fiscal years beginning after December 15, 2006. The Company is currently in the process of evaluating the impact of FIN 48 on its financial statements.

In June 2005, the FASB issued Statement of Financial Accounting Standards No. 154, "Accounting Changes and Error Corrections" ("SFAS No. 154"), a replacement of APB Opinion No. 20 and FASB Statement No. 3. The statement applies to all voluntary changes in accounting principles and changes the requirements for accounting and reporting a change in accounting principle. SFAS No. 154 requires retrospective application to prior periods' financial statements of voluntary changes in accounting principles unless such retrospective application is impracticable. SFAS No. 154 is effective for accounting changes and correction of errors made in fiscal years beginning after December 15, 2005. Earlier application is permitted for accounting changes and corrections of errors made in fiscal years beginning after June 1, 2005. The statement does not change the transition provisions of any existing accounting pronouncements, including those that are in a transition phase as of the effective date of this statement. The Company does not expect the adoption of SFAS No. 154 to have a material effect on its financial statements.

In February 2006, the FASB issued Statement of Financial Accounting Standards No. 155, "Accounting for Certain Hybrid Financial Instruments - an amendment of FASB Statements No. 133 and 140" ("SFAS No. 155") which is effective for fiscal years beginning after September 15, 2006. The statement was issued to clarify the application of FASB Statement No. 133 to beneficial interests in securitized financial assets and to improve the consistency of accounting for similar financial instruments, regardless of the form of the instruments. The Company does not expect the adoption of SFAS No. 155 to have a material effect on its financial statements.

In March 2006, the FASB issued Statement of Financial Accounting Standards No. 156, "Accounting for Servicing of Financial Assets - an amendment of FASB Statement No. 140" ("SFAS No. 156") which is effective for fiscal years beginning after September 15, 2006. This statement was issued to simplify the accounting for servicing rights and to reduce the volatility that results from using different measurement attributes. The Company does not expect the adoption of SFAS No. 156 to have a material effect on its financial statements.

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**THE DIXIE GROUP, INC.**  
**NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS**  
**(UNAUDITED)**  
**(dollars in thousands, except per share data) -- Cont'd.**

**NOTE C - SHARE-BASED PAYMENTS**

Effective January 1, 2006, the Company adopted Statement of Financial Accounting Standards No. 123(R), Share-Based Payment ("SFAS No. 123(R)"). SFAS No. 123(R) requires that compensation expense relating to share-based payments be recognized in financial statements based on the fair value of the equity or liability instrument issued. The Statement also requires that forfeitures be estimated over the vesting period of the instrument. Actual forfeitures prior to the adoption of SFAS 123(R) were considered by the Company. Accordingly, there was no cumulative effect on the Company's consolidated financial statements as a result of the adoption of SFAS 123(R).

The Company adopted SFAS No. 123(R) using the modified prospective method to account for stock options, restricted shares and stock performance units granted by the Company. Under the modified prospective method, compensation expense for share-based payments is recognized for periods after the date of adoption for (a) all unvested awards granted prior to January 1, 2006, based on the estimated grant-date fair value in accordance with the original provisions of SFAS No. 123, "Accounting for Stock-Based Compensation" ("SFAS No. 123"), and (b) all awards granted subsequent to January 1, 2006, based on the estimated grant-date fair value in accordance with the provisions of SFAS No. 123(R).

Prior to January 1, 2006, as permitted by SFAS No. 123, the Company accounted for share-based payments to employees using Accounting Principles Board (APB) Opinion No. 25, "Accounting for Stock Issued to Employees" ("APB No. 25") and accordingly, did not record compensation expense for stock options granted. Results for prior periods have not been retrospectively restated. Following is a pro forma summary of the Company's net income and earnings per share for the three and six months ended June 25, 2005, as if the Company had determined compensation expense for share-based payments based under the recognition provisions of SFAS No. 123(R).

	Three Months Ended June 25, 2005	Six Months Ended June 25, 2005
Net income, as reported	\$ 3,489	\$ 5,783
Stock compensation expense, net of taxes	(470)	(1,070)
Pro forma net income	3,019	4,713
Basic earnings per share, as reported	\$ 0.28	\$ 0.47
Stock compensation expense, net of taxes	(0.04)	(0.09)

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Pro forma basic earnings per share	\$	<b>0.24</b>	\$	0.38
Diluted earnings per share, as reported	\$	<b>0.27</b>	\$	0.45
Stock compensation expense, net of taxes		<b>(0.04)</b>		(0.08)
Pro forma diluted earnings per share	\$	<b>0.23</b>	\$	0.37

The pro forma effect of applying SFAS No. 123(R) on net income and earnings per share shown above is not necessarily indicative of future results.

SFAS No. 123(R) requires that the excess tax benefits relating to compensation expense be reported as a financing cash flow, rather than as an operating cash flow as required under prior guidance. Excess tax benefits of \$191 were included in cash used by financing activities for the six months ended July 1, 2006.

### **2006 Stock Awards Plan**

On May 3, 2006, the Company's shareholders' approved and adopted the Company's 2006 Stock Award Plan (the "2006 Plan") which provides for the issuance of a maximum of 800,000 shares of Common Stock and/or Class B Common Stock for the grant of options, and/or other stock-based or stock-denominated awards to directors of the Company, and to salaried employees of the Company and its participating subsidiaries. The 2006 Plan superseded and replaced The Dixie Group, Inc. Stock Incentive Plan (the "2000 Plan"), which was terminated with respect to the granting of new awards. Awards previously granted under the 2000 Plan will continue to be governed by the terms of that plan and will not be affected by its termination.

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**THE DIXIE GROUP, INC.**  
**NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS**  
**(UNAUDITED)**  
**(dollars in thousands, except per share data) -- Cont'd.**

**Restricted Stock Awards**

On June 6, 2006, the Company granted 125,000 shares of restricted stock to its Chief Executive Officer. The award is intended to retain and motivate the Company's Chief Executive Officer over the next several years and to bring his total compensation package closer to median levels for Chief Executive Officers of comparable companies. The fair value of the award was \$1,207, or \$9.6525 per share, equivalent to 71.5% of the market value of a share of the Company's Common Stock on the date the award was granted. Such value was determined using a lattice valuation model and will be expensed over the term of the award. Vesting of the shares is contingent on a 35% increase in the market value of the Company's Common Stock ("Market Condition") through June 5, 2011. Additionally, vesting of shares requires the Chief Executive Officer to meet a continued service condition during the term of the award, with a two year minimum vesting period. Shares subject to the award vest pro rata annually after the market condition is met on the anniversary date the award was granted.

In February 2005, the Company granted awards of 67,180 shares of restricted stock to officers and other key employees. The grant-date fair value of the awards was \$1,200, or \$17.86 per share. Vesting of the shares subject to the awards is subject to a continued service condition, with one-third of the awards vesting each year on the anniversary date the awards were granted. The fair value of the awards of restricted stock was equal to the market value of the Company's Common Stock on the grant date.

	Number of Shares
Outstanding at December 31, 2005	57,990
Granted	125,000
Vested	(19,330)
Forfeited	---
<b>Outstanding at July 1, 2006</b>	<b>163,660</b>

As of July 1, 2006, there was \$1,731 of unrecognized compensation cost related to unvested restricted stock. That cost is expected to be recognized over a period of 5.3 years. The total fair value of shares vested during the six months ended July 1, 2006 was approximately \$251.

**Stock Performance Units**

The Company's non-employee directors receive 50% of their annual retainer (\$12 in 2006) in Stock Performance Units under the Directors' Stock Plan. Upon retirement, the Stock Performance Units vest and the Company issues Common Stock equivalent to the number of Stock Performance Units held by non-employee directors. The fair value of the awards of Stock Performance Units was equal to the market value of the Company's Common Stock on the grant date. As of July 1, 2006, 36,442 Stock Performance Units were outstanding under this plan.

### **Stock Options**

All currently unvested stock options issued under the Company's 2000 Plan are generally exercisable at a cumulative rate 25% per year after the second year from the date the options were granted. Options under the Company's 2006 Plan will be exercisable for periods determined at the time awards may be issued. No options were issued under either of these plans during the six months ended July 1, 2006. The fair value of each option issued under the plans will be estimated on the date of grant using the Black-Scholes model. The assumptions used for grants prior to adoption of SFAS No. 123(R) are described more fully in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2005.

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**THE DIXIE GROUP, INC.**  
**NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS**  
**(UNAUDITED)**

(dollars in thousands, except per share data) -- Cont'd.

Stock option activity for the six months ended July 1, 2006 is summarized as follows:

	Number of Shares	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Life
Outstanding at December 31, 2005	1,189,312	\$ 10.78	
Granted	---	---	
Exercised	(101,016)	6.93	
Forfeited	(16,875)	14.71	
Outstanding at July 1, 2006	1,071,421	\$ 11.08	\$ 6.40
Exercisable at July 1, 2006	999,309	\$ 11.43	\$ 6.30

At July 1, 2006, the market value of the Company's Common Stock exceeded the exercise price of all outstanding stock options by \$2,364 and the exercise price of exercisable stock options by \$1,862. The market value of the Company's Common Stock exceeded the exercise price of stock options exercised during the six months ended July 1, 2006 and June 25, 2005 by \$722 and \$1,163, respectively. At July 1, 2006, unrecognized compensation cost related to unvested stock options was \$177. The remaining amounts expected to be recognized are \$58 in 2006, \$76 in 2007, \$35 in 2008 and \$8 in 2009.

**NOTE D - RECEIVABLES**

Receivables are summarized as follows:

	July 1, 2006	December 31, 2005
Customers, trade	\$ 36,003	\$ 30,174
Other	2,846	2,054
Gross receivables	38,849	32,228
Less allowance for doubtful accounts	(553)	(595)
Net receivables	\$ 38,296	\$ 31,633

The Company had notes receivables in the amount of \$636 and \$522 at July 1, 2006 and December 31, 2005, respectively. The notes receivable are included in accounts receivable and other long-term assets in the Company's

consolidated condensed balance sheets.

#### NOTE E - INVENTORIES

Inventories are stated at the lower of cost or market. Cost is determined using the last-in, first-out (LIFO) method, which generally matches current costs of inventory sold with current revenues, for substantially all inventories.

Inventories are summarized as follows:

	<b>July 1, 2006</b>	December 31, 2005
Raw materials	\$ 23,836	\$ 22,037
Work-in-process	17,995	17,498
Finished goods	39,337	40,959
Supplies, repair parts and other	456	480
LIFO	(8,094)	(8,103)
Total inventories	\$ 73,530	\$ 72,871

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**THE DIXIE GROUP, INC.**  
**NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS**  
**(UNAUDITED)**

(dollars in thousands, except per share data) -- Cont'd.

**NOTE F - DISCONTINUED OPERATIONS**

Following is a summary of the Company's discontinued operations:

	Three Months Ended		Six Months Ended	
	<b>July 1, 2006</b>	June 25, 2005	<b>July 1, 2006</b>	June 25, 2005
Net sales	\$ ---	\$ ---	\$ ---	\$ ---
Loss from discontinued operations:				
Before income taxes	<b>(3,101)</b>	(149)	<b>(3,239)</b>	(802)
Income tax benefit	<b>(1,141)</b>	(54)	<b>(1,189)</b>	(295)
Loss from discontinued operations, net of tax	<b>\$ (1,960)</b>	\$ (95)	<b>\$ (2,050)</b>	\$ (507)
Income on disposal of discontinued operations:				
Before income taxes	---	---	---	1,320
Income tax provision	---	---	---	486
Income on disposal of discontinued operations, net of tax	<b>\$ ---</b>	\$ ---	<b>\$ ---</b>	\$ 834

The losses from discontinued operations in 2006 principally consist of settlement expenses associated with the termination of one of the Company's defined benefit plans. The losses from discontinued operations in 2005 principally consists of additional workers' compensation costs associated with the Company's factory-built housing carpet, needlebond and carpet recycling businesses sold in 2003 and 2004. Income on disposal of discontinued operations in 2005 is the result of a recovery of a previously written-off note receivable associated with the cotton yarn and dyeing textile operations sold in 1999. Operating results associated with the businesses sold are classified as discontinued operations for all periods presented.

**NOTE G - ACCRUED EXPENSES**

Accrued expenses are summarized as follows:

	<b>July 1, 2006</b>	December 31, 2005
Compensation and benefits	\$ 5,869	\$ 6,076
Accrued income taxes	2,303	1,856
Provision for customer rebates, claims and allowances	4,442	4,160
Outstanding checks in excess of cash	2,780	1,918
Other	4,266	4,285
Total accrued expenses	\$ 19,660	\$ 18,295

#### **NOTE H - PRODUCT WARRANTY RESERVES**

The Company provides varying warranties related to its products against manufacturing defects and specific performance standards. The Company records reserves for the estimated costs of defective products and failure of its products to meet applicable performance standards at the time sales are recorded. The levels of reserves are established based primarily upon historical experience and evaluation of pending claims.

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Following is a summary of the Company's warranty activity:

	Three Months Ended		Six Months Ended	
	July 1, 2006	June 25, 2005	July 1, 2006	June 25, 2005
Warranty reserve beginning of period	\$ 1,091	\$ 867	\$ 1,109	\$ 922
Warranty liabilities accrued	1,476	957	2,778	1,989
Warranty liabilities settled	(1,593)	(1,207)	(3,041)	(2,317)
Changes for pre-existing warranty liabilities	240	275	368	298
Warranty reserve end of period	\$ 1,214	\$ 892	\$ 1,214	\$ 892

**NOTE I - LONG-TERM DEBT AND CREDIT ARRANGEMENTS**

Long-term debt consists of the following:

	July 1, 2006	December 31, 2005
Senior indebtedness		
Credit line borrowings	\$ 41,936	\$ 32,949
Term loans	18,433	19,430
Equipment financing	10,218	4,341
Capital lease obligations	5,296	5,848
Mortgage note payable	6,881	6,987
Total senior indebtedness	82,764	69,555
Convertible subordinated debentures	22,162	24,662
Total long-term debt	104,926	94,217
Less current portion of long-term debt	(6,303)	(5,221)
Less current portion of capital lease obligations	(1,157)	(1,120)
Total long-term debt, less current portion	\$ 97,466	\$ 87,876

During the six months ended July 1, 2006, the Company borrowed \$6,456 under equipment financing notes. The equipment financing notes are secured by the specific equipment financed, bear interest ranging from 6.19% to 6.83% and are due in monthly installments of principal and interest over five to seven year terms.

In May 2006, the Company amended its senior loan and security agreement to increase the revolving credit portion of the facility and change certain definitions in the agreement to facilitate the increase in revolving credit. As amended, the senior loan and security agreement matures on May 11, 2010 and provides the Company with \$80,000 of credit, consisting of \$60,000 of revolving credit and a \$20,000 term loan facility. The Company's long-term debt and capital lease facilities do not contain financial covenants; however, these facilities contain covenants that may limit dividends and repurchase of the Company's Common Stock to an aggregate of \$3,000 annually and could limit future acquisitions. Unused borrowing capacity under the senior loan and security agreement on July 1, 2006 was approximately \$15,507.

#### **NOTE J - DERIVATIVE FINANCIAL INSTRUMENTS**

The Company is a party to an interest rate swap agreement with a notional amount of \$30,000 through May 11, 2010. Under the interest rate swap agreement, the Company pays a fixed rate of interest of 4.79% and receives in return a specified variable rate of interest. The interest rate swap is linked to the Company's variable rate debt and is considered a highly effective hedge. The fair value of the interest rate swap agreement is reflected on the Company's balance sheet and related gains and losses are deferred in Accumulated Other Comprehensive Loss ("AOCL"). Net unrealized gains included in AOCL were \$452 at July 1, 2006.

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The Company is also a party to an interest rate swap agreement through March 2013, which is linked to a mortgage note payable and considered a highly effective hedge. Under the interest rate swap agreement, the Company pays a fixed rate of interest times a notional principal amount equal to the outstanding balance of the mortgage note, and receives in return an amount equal to a specified variable rate of interest times the same notional principal amount.

The fair value of the interest rate swap agreement is reflected on the Company's balance sheet and related gains and losses are deferred in other comprehensive income. As of July 1, 2006, the notional amount of the interest swap agreement was \$6,881. Under the terms of the swap agreement, the Company pays a fixed interest rate of 4.54% through March 2013, which effectively fixes interest on the mortgage note payable at 6.54%. Net unrealized gains included in AOCL were \$210 at July 1, 2006.

The Company was party to an interest rate swap agreement which expired March 11, 2005. Under the interest rate swap agreement, the Company paid a fixed rate of interest of 3.24% times a notional amount of \$70,000, and received in return an amount equal to a specified variable rate of interest times the same notional amount. The swap agreement was deemed highly effective as a cash flow hedge by the Company until a significant portion of the related debt was retired in 2003. At such time, the interest rate swap became ineffective and the Company wrote off the portion of interest expense in AOCL related to the debt retired. Changes in the fair value of the swap were marked to market through interest expense. Amounts that remained in AOCL at the time the interest rate swap agreement became ineffective were amortized into earnings through interest expense over the remaining life of the swap.

**NOTE K - EMPLOYEE BENEFIT PLANS**

The Company sponsors a 401(k) defined contribution plan covering substantially all associates. The Company matches associates' contributions up to a maximum of 5% on a sliding scale based on the level of the associate's contribution. The Company may make additional contributions to the plan if the Company attains certain performance targets.

The Company sponsors a non-qualified retirement savings plan that allows eligible associates to defer a specified percentage of their compensation. The obligations owed to participants under this plan were \$10,210 at July 1, 2006 and \$10,217 at December 31, 2005 and are included in other liabilities in the Company's balance sheet. Assets of the retirement savings plan were \$10,339 at July 1, 2006 and \$9,688 at December 31, 2005 and are included in cash and cash equivalents and other assets in the Company's balance sheets.

The Company also sponsors a defined benefit retirement plan that covers a limited number of the Company's active associates.

During June 2006, the Company completed the termination and distribution of assets of a defined benefit plan that had been frozen since 1993 as to new benefits. A significant number of associates covered by this plan were previously employed by operations that were sold and discontinued. Settlement expenses for the plan termination recognized in the quarter ended July 1, 2006 were \$3,249, or \$2,057 net of tax. \$1,829, net of tax, was recorded as a loss from discontinued operations and \$228, net of tax, was recorded as a expense in the Company's continuing operations. The funds required to terminate the plan were \$2,595.

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Costs charged to continuing operations for all retirement plans are summarized as follows:

	Three Months Ended					
	July 1, 2006			June 25, 2005		
	Terminated Plan	Ongoing Plan	<b>Total 2006</b>	Terminated Plan	Ongoing Plan	Total 2005
Components of net periodic benefit costs:						
Defined benefit plans						
Service cost	\$ ---	\$ 30	\$ 30	\$ ---	\$ 40	\$ 40
Interest cost	33	25	58	5	32	37
Expected return on plan assets	(34)	(27)	(61)	---	(30)	(30)
Amortization of prior service costs	---	1	1	---	2	2
Recognized net actuarial loss	30	13	43	2	17	19
Settlement loss	359	---	359	---	---	---
	388	42	430	7	61	68
Defined contribution plan	---	266	266	---	333	333
Net periodic benefit cost	\$ 388	\$ 308	696	7	394	401

	Six Months Ended					
	July 1, 2006			June 25, 2005		
	Terminated Plan	Ongoing Plan	<b>Total 2006</b>	Terminated Plan	Ongoing Plan	Total 2005
Components of net periodic benefit costs:						
Defined benefit plans						
Service cost	\$ ---	\$ 59	\$ 59	\$ ---	\$ 80	\$ 80

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Interest cost	33	49	<b>82</b>	9	64	73
Expected return on plan assets	(34)	(53)	<b>(87)</b>	---	(60)	(60)
Amortization of prior service costs	---	2	<b>2</b>	---	3	3
Recognized net actuarial loss	30	26	<b>56</b>	3	36	39
Settlement loss	359	---	<b>359</b>	---	---	---
	388	83	<b>471</b>	12	123	135
Defined contribution plan	---	534	<b>534</b>	---	485	485
Net periodic benefit cost	\$ 388	\$ 617	\$ <b>1,005</b>	\$ 12	\$ 608	\$ 620

The Company sponsors a postretirement benefit plan that provides life insurance to a limited number of associates as a result of a prior acquisition. The Company also sponsors a postretirement benefit plan that provides medical and life insurance for a limited number of associates who retired prior to January 1, 2003. There was no net periodic cost associated with these plans in the first six months of 2006.

Costs charged to continuing operations for all postretirement plans are summarized as follows:

	Three Months Ended		Six Months Ended	
	July 1, 2006	June 25, 2005	July 1, 2006	June 25, 2005
Components of net periodic benefit costs:				
Defined benefit plans				
Service cost	\$ ---	\$ 10	\$ ---	\$ 20
Interest cost	---	20	---	40
Amortization of prior service costs	---	(10)	---	(20)
Recognized net actuarial losses	---	---	---	---
Net periodic benefit cost	\$ ---	\$ 20	\$ ---	\$ 40

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Except for an additional \$845 required to fund the terminated defined benefit plan, amounts contributed or expected to be contributed by the Company during the current fiscal year to its pension and postretirement plans are not anticipated to be significantly different from amounts disclosed in the Company's 2005 Annual Report filed on Form 10-K.

**NOTE L - COMMON STOCK AND EARNINGS PER SHARE**

The following table sets forth the computation of basic and diluted earnings per share from continuing operations:

	Three Months Ended		Six Months Ended	
	<b>July 1, 2006</b>	June 25, 2005	<b>July 1, 2006</b>	June 25, 2005
Income from continuing operations (1)	\$ <b>2,904</b>	\$ 3,584	\$ <b>3,829</b>	\$ 5,456
Denominator for calculation of basic earnings per share - weighted-average shares (2)	<b>12,689</b>	12,326	<b>12,660</b>	12,298
Effect of dilutive securities:				
Stock options (3)	<b>224</b>	454	<b>251</b>	501
Restricted stock grants (3)	<b>1</b>	15	<b>1</b>	19
Directors' stock performance units (3)	<b>29</b>	10	<b>27</b>	11
Denominator for calculation of diluted earnings per share - weighted-average shares adjusted for potential dilution (2)(3)	<b>12,943</b>	12,805	<b>12,939</b>	12,829
Earnings per share:				
Basic	\$ <b>0.23</b>	\$ 0.29	\$ <b>0.30</b>	\$ 0.44
Diluted	<b>0.22</b>	0.28	<b>0.30</b>	0.43

(1)

No adjustments needed in the numerator for diluted calculations.

(2)

Includes Common and Class B Common shares in thousands.

(3)

Because their effects are anti-dilutive, excludes shares issuable under stock option plans whose grant price is greater than the average market price of Common Shares outstanding at the end of the relevant period and shares issuable on conversion of subordinated debentures into shares of Common Stock. Aggregate shares excluded were 893 and 929 during the three and six months of 2006 and 770 and 808 during the three and six months of 2005.

### NOTE M - COMPREHENSIVE INCOME

Comprehensive income is as follows:

	Three Months Ended		Six Months Ended	
	July 1, 2006	June 25, 2005	July 1, 2006	June 25, 2005
Net income	\$ 944	\$ 3,489	\$ 1,779	\$ 5,783
Other comprehensive income:				
Unrealized gains on interest rate swap agreement:				
Before income taxes	418	---	1,198	179
Income taxes	159	---	455	76
Net of taxes	259	---	743	103
Change in minimum pension liability:				
Before income taxes	2,503	---	2,503	---
Income taxes	951	---	951	---
Net of taxes	1,552	---	1,552	---
Comprehensive income	\$ 2,755	\$ 3,489	\$ 4,074	\$ 5,886

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Components of accumulated other comprehensive income (loss), net of tax, are as follows:

	Minimum Pension Liability	Interest Rate Swaps	Total
Balance at December 31, 2005	\$ (2,806)	\$ (81)	\$ (2,887)
Unrealized gains on interest rate swap agreements, net of tax of \$455	---	743	743
Change in additional minimum pension liability, net of tax of \$951	1,552	---	1,552
<b>Balance at July 1, 2006</b>	<b>\$ (1,254)</b>	<b>\$ 662</b>	<b>\$ (592)</b>

**NOTE N - OTHER (INCOME) EXPENSE**

Other (income) expense is summarized as follows:

	Three Months Ended		Six Months Ended	
	<b>July 1, 2006</b>	June 25, 2005	<b>July 1, 2006</b>	June 25, 2005
Other operating income:				
Insurance settlements and refunds	\$ (121)	\$ ---	\$ (353)	\$ ---
Miscellaneous income	(107)	(139)	(217)	(224)
Other operating income	\$ (228)	\$ (139)	\$ (570)	\$ (224)
Other operating expense:				
Retirement expenses	\$ 100	\$ 147	\$ 245	\$ 180
Miscellaneous expense	30	130	41	133
Other operating expense	\$ 130	\$ 277	\$ 286	\$ 313

Other income:

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Interest income	\$	<b>(88)</b>	\$	(18)	\$	<b>(101)</b>	\$	(102)
Dispute settlement		---		(107)		---		(107)
Miscellaneous income		<b>(7)</b>		(16)		<b>(7)</b>		(24)
Other income	\$	<b>(95)</b>	\$	(141)	\$	<b>(108)</b>	\$	(233)
Other expense:								
Miscellaneous expense	\$	<b>51</b>	\$	27	\$	<b>54</b>	\$	46
Other expense	\$	<b>51</b>	\$	27	\$	<b>54</b>	\$	46

**NOTE O - INCOME TAXES**

During the three months ended July 1, 2006, the Company settled a Federal income tax audit for the fiscal year 2003. As a result of the settlement of the audit, the Company reduced its tax contingency reserve and its income tax provision by \$460 to reflect the settlement of certain items previously included in the Company's tax contingency reserve. The effect on the Company's statement of operations was to reduce the effective tax rate to 24.9% and 27.5%, respectively for the three and six months periods ended July 1, 2006.

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## ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF RESULTS OF OPERATIONS AND FINANCIAL CONDITION

The following is presented to update the discussion of results of operations and financial condition included in our 2005 Annual Report on Form 10-K filed with the Securities and Exchange Commission.

### CRITICAL ACCOUNTING POLICIES

Our critical accounting policies were outlined in Management's Discussion and Analysis of Results of Operations and Financial Condition in our 2005 Annual Report on Form 10-K filed with the Securities and Exchange Commission. There have been no changes to those critical accounting policies subsequent to the date of that report.

### RESULTS OF OPERATIONS

The following table sets forth certain elements of our continuing operating results as a percentage of net sales for the periods indicated:

	Three Months Ended		Six Months Ended	
	July 1, 2006	June 25, 2005	July 1, 2006	June 25, 2005
Net sales	100.0 %	100.0 %	100.0 %	100.0 %
Cost of sales	72.2 %	68.1 %	72.1 %	68.7 %
Gross profit	27.8 %	31.9 %	27.9 %	31.3 %
Selling and administrative expenses	21.3 %	23.2 %	22.7 %	23.9 %
Other operating income	(0.2) %	(0.1) %	(0.3) %	(0.1) %
Other operating expense	0.2 %	0.3 %	0.2 %	0.2 %
Operating income	6.5 %	8.5 %	5.3 %	7.3 %

**Net Sales.** Net sales for the quarter ended July 1, 2006 were \$88.0 million, up 7.3% from net sales of \$82.1 million in the year-earlier quarter. Net sales for the first six months of 2006 were \$167.2 million, up 8.5% from net sales of \$154.1 million in the prior year period.

Net sales in our carpet operations increased by 8.1% in the second quarter of 2006 and 10.4% for the first six months of 2006, compared with the same periods in 2005. The 2006 revenue growth is primarily attributable to higher unit volume due to strong demand for our Dixie Home and Masland commercial products. On a product basis, net sales of commercial products grew 10.3% and 12.9%, respectively, during the three and six month periods ended July 1, 2006,

compared with the same periods in 2005. During these same periods, net sales of residential products grew 7.2% and 9.2%, respectively.

Unit sales of broadloom carpet rose 20% in the second quarter of 2006 and 16% for the first six months of 2006, compared with the same periods in 2005. Units sold increased at a higher rate than net sales dollars due to the significant growth in our Dixie Home and Masland commercial brands which have lower average selling prices than our Fabrica and Masland residential products. We also sold an unusually high level of products at promotional prices in the second quarter of 2006.

Net sales from our carpet yarn and carpet dyeing and finishing operations decreased year-over-year in both the second quarter and first six months of 2006. Sales from these operations only represent approximately 5% of our business and do not significantly affect the Company's total revenues.

**Cost of Sales.** The increase in cost of sales, as a percentage of net sales, in 2006 compared with prior year periods is primarily attributable to a less profitable product mix, start-up costs of our new tufting and modular/carpet tile operations, settlement expenses related to a defined benefit plan terminated in the second quarter of 2006 and higher levels of off-quality production. A significant portion of the quality issues were related to outsourcing of tufting production prior to June 2006 when our new North Georgia tufting operation began operating on a full schedule.

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Raw material costs were higher in the first six months of 2006 due to a number of increases in raw material prices in the fourth quarter of 2005. These increases were passed along to our customers through higher selling prices that were fully implemented by the end of the first quarter 2006. In July 2006, nylon yarn prices increased again. We have increased the selling prices of our products, which are generally effective with orders taken after July 2006 to offset these increases; however, we expect a normal two to three month lag between the time we incur higher raw material costs and the time the selling price increases are fully implemented.

**Gross Profit.** Gross profit declined \$1.7 million in the quarter ended July 1, 2006 and \$1.5 million during the first six months of 2006 compared with the same periods in 2005. The decrease in gross profit reflects the effect of the factors described above that increased cost of sales.

**Selling and Administrative Expenses.** Selling and administrative expenses, as a percentage of net sales, decreased in both the second quarter and first six months of 2006 compared with the same periods in 2005, principally as a result of the higher sales volume and lower sample expenses in the second quarter of 2006.

**Other Operating Income/Other Operating Expense.** Other operating income and other operating expense were not significant in the second quarter or first six months of either 2006 or 2005.

**Operating Income.** Operating income was \$5.8 million, or 6.5% of sales, in the quarter ended July 1, 2006 and \$8.9 million, or 5.3% of sales, for the first six months of 2006 compared with \$6.9 million, or 8.5% of sales, in the quarter ended June 25, 2005 and \$11.2 million, or 7.3% of sales, for the first six months of 2005. The lower levels of operating income reflect the higher cost of sales, which more than offset the positive effect of the higher net sales volume.

**Interest Expense.** Interest expense increased in the second quarter and first six months of 2006 compared with the same periods in 2005 principally due to higher levels of debt in 2006.

**Other Income/Other Expense.** Other income and other expense were not significant in the second quarter or first six months of either 2006 or 2005.

**Income Tax Provision.** Our effective income tax rate was 24.9% and 27.5%, respectively, for three and six months ended July 1, 2006, compared with 36.5% and 36.6%, respectively for the three and six months ended June 25, 2005. The decrease in the effective income tax rate in 2006 was principally due to reductions in our tax contingency reserve as a result of a federal income tax audit settled during the second quarter of 2006.

**Income From Continuing Operations.** Income from continuing operations was \$2.9 million, or \$0.22 per diluted share, for the quarter ended July 1, 2006 compared with \$3.6 million, or \$0.28 per diluted share, for the quarter ended June 25, 2005. Income from continuing operations was \$3.8 million, or \$0.30 per diluted share, for the first six months of 2006 compared with \$5.5 million, or \$0.43 per diluted share, for the first six months of 2005.

**Net Income.** Discontinued operations reflected a loss of \$2.0 million, or \$0.15 per diluted share, in the second quarter of 2006 and a loss of \$2.1 million, or \$0.16 per diluted share, for the first six months of 2006. Discontinued operations included settlement expenses of \$1.9 million, net of tax, or \$0.15 per diluted share, in the second quarter and first six

months of 2006 due to the termination of a defined benefit plan in the second quarter of 2006. Discontinued operations reflected a loss of \$95 thousand, or \$0.01 per diluted share, in the second quarter of 2005 and income of \$327 thousand, or \$0.02 per diluted share, for the first six months of 2005.

Including discontinued operations, net income was \$944 thousand, or \$0.07 per diluted share, in the quarter ended July 1, 2006 compared with net income of \$3.5 million, or \$0.27 per diluted share, for the quarter ended June 25, 2005. For the first six months of 2006, net income was \$1.8 million, or \$0.14 per diluted share, compared with \$5.8 million, or \$0.45 per diluted share, for the first six months of 2005.

## **LIQUIDITY AND CAPITAL RESOURCES**

During the six-months ended July 1, 2006, our debt increased \$10.7 million and \$0.9 million of funds were generated from Common Stock issued under stock option plans. These funds were used to purchase \$10.8 million of capital assets and to finance our operations, including \$2.6 million to funds required to terminate a defined benefit retirement plan. \$6.5 million of the capital expenditures were financed through equipment financing notes, which bear interest ranging from 6.19 to 6.83%, have terms of five to seven years and are due in monthly installments of principal and interest.

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Capital expenditures for the six month period ended July 1, 2006 were \$10.8 million while depreciation and amortization was \$5.7. We expect capital expenditures to be approximately \$16.0 million for fiscal 2006 while depreciation and amortization is expected to be approximately \$11.2 million. Capital expenditures in 2006 are primarily related to newer manufacturing technology, and to a lesser extent, new information systems.

In May 2006, we amended our senior loan and security agreement to increase the revolving credit portion of the facility by \$10.0 million, from \$50.0 million to \$60.0 million and change certain definitions in the agreement to facilitate the increase in the revolving credit facility. Other terms of the credit facility were not modified.

The unused borrowing capacity under the senior credit facility on July 1, 2006 was approximately \$15.5 million.

We believe our operating cash flows and credit availability under the senior credit facility are adequate to finance our anticipated liquidity requirements.

## **RECENT ACCOUNTING PRONOUNCEMENTS**

In July 2006, the Financial Accounting Standards Board ("FASB") issued FASB Interpretation No. 48, "Accounting for Uncertainty in Income Taxes" ("FIN 48"). FIN 48 clarified the treatment of uncertain income tax positions in accordance with FASB Statement No. 109, "Accounting for Income Taxes." The interpretation prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. It also provides guidance on adjustments of a previously recognized tax position, classification, interest and penalties, accounting for taxes in interim periods and disclosure requirements. FIN 48 is effective for fiscal years beginning after December 15, 2006. We are currently in the process of evaluating the impact of FIN 48 on our financial statements.

In June 2005, the FASB issued Statement of Financial Accounting Standards No. 154, "Accounting Changes and Error Corrections" ("SFAS No. 154"), a replacement of APB Opinion No. 20 and FASB Statement No. 3. The statement applies to all voluntary changes in accounting principles, and changes the requirements for accounting and reporting a change in accounting principle. SFAS No. 154 requires retrospective application to prior periods' financial statements of voluntary changes in accounting principles unless such retrospective application is impracticable. SFAS No. 154 is effective for accounting changes and correction of errors made in fiscal years beginning after December 15, 2005. Earlier application is permitted for accounting changes and corrections of errors made in fiscal years beginning after June 1, 2005. The statement does not change the transition provisions of any existing accounting pronouncements, including those that are in a transition phase as of the effective date of this statement. We do not expect the adoption of SFAS No. 154 to have a material effect on our financial statements.

In February 2006, the FASB issued Statement of Financial Accounting Standards No. 155, "Accounting for Certain Hybrid Financial Instruments - an amendment of FASB Statements No. 133 and 140" ("SFAS No. 155") which is effective for fiscal years beginning after September 15, 2006. The statement was issued to clarify the application of FASB Statement No. 133 to beneficial interests in securitized financial assets and to improve the consistency of

accounting for similar financial instruments, regardless of the form of the instruments. We do not expect the adoption of SFAS No. 155 to have a material effect on our financial statements.

In March 2006, the FASB issued Statement of Financial Accounting Standards No. 156, "Accounting for Servicing of Financial Assets - an amendment of FASB Statement No. 140" ("SFAS No. 156") which is effective for fiscal years beginning after September 15, 2006. This statement was issued to simplify the accounting for servicing rights and to reduce the volatility that results from using different measurement attributes. We do not expect the adoption of SFAS No. 156 to have a material effect on our financial statements.

#### **CERTAIN FACTORS AFFECTING THE COMPANY'S PERFORMANCE**

In addition to the other information provided in this Report, the risk factors included in Item 1A should be considered when evaluating results of our operations, future prospects and an investment in shares of our Common Stock. Any of these factors could cause our actual financial results to differ materially from our historical results, and could give rise to events that might have a material adverse effect on our business, financial condition and results of operations.

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## **FORWARD-LOOKING INFORMATION**

This Report contains statements that may be considered forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended and Section 21E of the Securities Exchange Act of 1934, as amended. These statements include the use of terms or phrases that include such terms as "expects," "estimated," "projects," "believes," "anticipates," "intends," and similar terms and phrases. Such terms or phrases relate to, among other matters, our future financial performance, business prospects, growth strategies or liquidity. The following important factors may affect our future results and could cause those results to differ materially from our historical results. These factors include, in addition to those detailed above under the heading "Certain Factors Affecting the Company's Performance", the cost and availability of capital and raw materials, transportation costs related to petroleum price levels, the cost and availability of energy supplies, the loss of a significant customer or group of customers, materially adverse changes in economic conditions generally in carpet, rug and floorcovering markets we serve and other risks detailed from time to time in our filings with the Securities and Exchange Commission.

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**Item 3 - Quantitative and Qualitative Disclosures about Market Risk (dollars in thousands)**

The Company's earnings, cash flows and financial position are exposed to market risks relating to interest rates. It is the Company's policy to minimize its exposure to adverse changes in interest rates and manage interest rate risks inherent in funding the Company with debt. The Company addresses this financial exposure through a risk management program that includes maintaining a mix of fixed and floating rate debt and the use of derivative financial instruments.

At July 1, 2006, the Company had an interest rate swap agreement linked to its mortgage note payable with a notional amount equal to the outstanding balance of the mortgage note (\$6,881 at July 1, 2006) which expires in March of 2013. Under the interest rate swap agreement, the Company pays interest at a fixed rate of 4.54% of interest times the notional amount and receives in return an amount equal to a specified variable rate of interest times the same notional amount. The swap agreement effectively fixes the interest rate on the mortgage note payable at 6.54%.

The Company is also a party to an interest rate swap agreement with a notional amount of \$30,000 through May 11, 2010. Under the interest rate swap agreement, the Company pays interest at a fixed rate of interest of 4.79% and receives in return a specified variable rate of interest. The interest rate swap agreement is linked to the Company's variable rate debt and is considered a highly effective hedge.

At July 1, 2006, \$30,369, or approximately 29%, of the Company's total debt was subject to floating interest rates. A 10% fluctuation in the variable interest rates applicable to this floating rate debt would have an annual after-tax impact on the Company's net income of approximately \$144.

**Item 4 - Controls and Procedures**

As of July 1, 2006, our management, under the supervision and with the participation of our Chief Executive Officer and the Chief Financial Officer, evaluated the effectiveness of the design and operation of our disclosure controls and procedures. Based on that evaluation, our management concluded that disclosure controls and procedures were effective.

No significant changes in our internal control over financial reporting occurred during the quarter covered by this report that materially adversely affected, or are reasonably likely to adversely affect, our internal control over financial reporting.

Internal control over financial reporting cannot provide absolute assurance of achieving financial reporting objectives because of its inherent limitations. Internal control over financial reporting is a process that involves human diligence and compliance and is subject to lapses in judgment and breakdowns resulting from human failures. Internal control over financial reporting also can be circumvented by collusion or improper management override. Because of such limitations, there is a risk that material misstatements may not be prevented or detected on a timely basis by internal control over financial reporting. These inherent limitations are known features of the financial reporting process; therefore, it is possible to design into the process safeguards to reduce, though not eliminate, this risk.

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## PART II. OTHER INFORMATION

### Item 1 - Legal Proceedings

None.

### Item 1A - Risk Factors

**In addition to the other information provided in this Report, the following risk factors should be considered when evaluating results of our operations, future prospects and an investment in shares of our Common Stock. Any of these factors could cause our actual financial results to differ materially from our historical results, and could give rise to events that might have a material adverse effect on our business, financial condition and results of operations.**

*The floorcovering industry is cyclical and prolonged declines in residential or commercial construction activity, or corporate remodeling and refurbishment could have a material adverse effect on our business.*

The U.S. floorcovering industry is cyclical and is influenced by a number of general economic factors. The floorcovering industry in general is dependent on residential and commercial construction activity, including new construction as well as remodeling. New construction activity is cyclical in nature. To a somewhat lesser degree, this also is true with residential and commercial remodeling. A prolonged decline in any of these industries could have a material adverse effect on our business, financial condition and results of operations. The level of activity in these industries is significantly affected by numerous factors, all of which are beyond our control, including:

- consumer confidence;
- housing demand;
- financing availability;
- national and local economic conditions;
- interest rates;
-

employment levels;

- 

changes in disposable income;

- 

commercial rental vacancy rates; and

- 

federal and state income tax policies.

Our product concentration in the higher-end of the residential and commercial markets could be a significant factor in the impact of these factors on our business.

***We face intense competition in our industry, which could decrease demand for our products and could have a material adverse effect on our profitability.***

The floorcovering industry is highly competitive. We face competition from a number of domestic manufacturers and independent distributors of floorcovering products and, in certain product areas, foreign manufacturers. There has been significant consolidation within the floorcovering industry during recent years that has caused a number of our existing and potential competitors to be larger and have greater resources and access to capital than we do.

Maintaining our competitive position may require us to make substantial investments in our product development efforts, manufacturing facilities, distribution network and sales and marketing activities, which may be limited by restrictions set forth in our credit facilities. Competitive pressures may also result in decreased demand for our products and in the loss of market share. In addition, we face, and will continue to face, pressure on sales prices of our products from competitors. As a result of any of these factors, there could be a material adverse effect on our sales and profitability.

***Raw material prices may increase.***

The cost of raw materials has a significant impact on our profitability. In particular, our business requires the purchase of large volumes of nylon yarn, synthetic backing, latex and dyes. Most of our raw materials are petroleum-based and their costs tend to fluctuate, over time, with the price of oil. Increases in the cost of these raw materials could materially adversely affect our business, results of operations and financial condition if we are unable to pass these increases through to our customers. We believe we will be successful in increasing our selling prices to pass along raw material and other cost as they may occur; however, there can be no assurance that we will successfully recover such increases in cost.

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*Unanticipated termination or interruption of our arrangements with third-party suppliers of nylon yarn could have a material adverse effect on us.*

Nylon yarn is the principal raw material used in our floorcovering products. A significant portion of our nylon yarn purchases is from one supplier. We believe there are other sources of nylon yarns; however, an unanticipated termination or interruption of our supply arrangements could adversely affect our supply arrangements and could be material.

*We may be responsible for environmental cleanup costs.*

Various federal, state and local environmental laws govern the use of our facilities. These laws govern such matters as:

- Discharges to air and water;
- Handling and disposal of solid and hazardous substances and waste; and
- Remediation of contamination from releases of hazardous substances in our facilities and off-site disposal locations.

Our operations also are governed by laws relating to workplace safety and worker health, which, among other things, establish noise standards and regulate the use of hazardous materials and chemicals in the workplace. We have taken, and will continue to take, steps to comply with these laws. If we fail to comply with present or future environmental or safety regulations, we could be subject to future liabilities. However, we cannot insure that complying with these environmental or health and safety laws and requirements will not adversely affect our business, results of operations and financial condition. Future laws, ordinances or regulations could give rise to additional compliance or remediation costs, which could have a material adverse effect on our business, results of operations and financial condition.

*Acts of Terrorism.*

Our business could be materially adversely affected as a result of international conflicts or acts of terrorism. Terrorist acts or acts of war may cause damage or disruption to our facilities, employees, customers, suppliers, and distributors, which could have a material adverse affect on our business, results of operations or financial condition. Such conflicts also may cause damage or disruption to transportation and communication systems and to our ability to manage logistics in such an environment, including receipt of supplies and distribution of products.

***Unanticipated Business Interruptions.***

Our business could be adversely affected if a significant portion of our plant, equipment or operations were damaged or interrupted by a casualty, condemnation, utility service, work stoppage or other event beyond our control. Such an event could have a material adverse effect on our business, results of operations and financial condition.

**Item 2 - Unregistered Sales of Equity Securities and Use of Proceeds**

None.

**Item 3 - Defaults Upon Senior Securities**

None.

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**Item 4 - Submission of Matters to a Vote of Security Holders**

- (a) The annual meeting of shareholders was held on May 3, 2006.
- (b) The meeting was held to consider and vote upon the following proposals: (1) to elect Directors for the following year (2) to approve the adoption of a new 2006 Stock Awards Plan and (3) approve material terms of the performance goals for awards under the Company's 2007 - 2011 Incentive Compensation Plan. All Directors were elected and all proposals were approved with the results of the vote summarized as follows:

Election of Directors:	FOR	AGAINST	ABSTAIN	TOTAL
J. Don Brock	24,390,334	825,285	1,009,704	26,225,323
Daniel K. Frierson	22,822,300	2,393,319	1,009,704	26,225,323
Paul K. Frierson	23,176,519	2,039,100	1,009,704	26,225,323
Walter W. Hubbard	25,212,302	3,317	1,009,704	26,225,323
Lowry F. Kline	25,081,503	134,116	1,009,704	26,225,323
John W. Murrey, III	24,641,526	574,093	1,009,704	26,225,323
Adoption of 2006 Stock Awards Plan	20,812,584	3,250,414	521,445	24,584,443
Adoption of material terms of performance goals for awards under the 2007 - 2011 Incentive Compensation Plan	22,947,336	1,068,522	502,665	24,518,523

**Item 5 - Other Information**

None.

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**Item 6 - Exhibits**

(a) Exhibits

(i) Exhibits Incorporated by Reference

- 10.30 Third Amendment dated May 3, 2006, to Amended and Restated Loan and Security Agreement, by and among The Dixie Group, Inc., each of its subsidiaries as guarantors, Bank of America, N.A., in its capacity as collateral and administrative agent for the Lenders for the Lenders, and the Lenders (as such term is defined in the Loan Agreement). (Incorporated by reference to Exhibit 10.1 to Current Report on Form 8-K dated May 4, 2006).
- 10.31 The Dixie Group, Inc., Form of Award of Career Shares under the 2006 Incentive Compensation Plan for Participants holding only shares of the Company's Common Stock. (Incorporated by reference to Current Report on Form 8-K dated June 6, 2006).
- 10.32 The Dixie Group, Inc., Form of Award of Career Shares under the 2006 Incentive Compensation Plan for Participants holding only shares of the Company's Class B Common Stock. (Incorporated by reference to Current Report on Form 8-K dated June 6, 2006).
- 10.33 The Dixie Group, Inc., Form of Award of Long Term Incentive Plan Shares under the 2006 Incentive Compensation Plan for Participants holding only share of the Company's Common Stock. (Incorporated by reference to Current Report on Form 8-K dated June 6, 2006).
- 10.34 The Dixie Group, Inc., Form of Award of Long Term Incentive Plan Shares under the 2006 Incentive Compensation Plan for Participants holding only share of the Company's Class B Common Stock. (Incorporated by reference to Current Report on Form 8-K dated June 6, 2006).
- 10.35 Award of 125,000 shares of Restricted Stock to Daniel K. Frierson. (Incorporated by reference to Current Report on Form 8-K dated June 7, 2006).

(ii) Exhibits Filed with this Report

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- 31.1 CEO Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2 CFO Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32.1 CEO Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 32.2 CFO Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

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**SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

THE DIXIE GROUP, INC.  
(Registrant)

Date: August 9, 2006

By: /s/ GARY A. HARMON  
Gary A. Harmon  
Vice President and Chief Financial Officer

Date: August 9, 2006

By: /s/ D. EUGENE LASATER  
D. Eugene Lasater  
Controller

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