

DIXIE GROUP INC  
Form 10-Q  
November 04, 2009

**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: September 26, 2009

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**

**62-0183370**

(State or other jurisdiction of incorporation or organization)

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

**104 Nowlin Lane, Suite 101, Chattanooga, TN**

**37421**

**(423) 510-7000**

(Address of principal executive offices)

(zip code)

(Registrant's telephone number, including area code)

**Not Applicable**

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

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. S Yes o No

Indicate by check mark whether the registrant has submitted electronically and posted on its Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (Section 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). o Yes o No

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

|                         |                       |   |                                  |
|-------------------------|-----------------------|---|----------------------------------|
| Large accelerated filer | <input type="radio"/> | Accelerated filer                             | <input checked="" type="radio"/> |
|                         |                       |   | S                                |
|                         |                       | (Do not check if a smaller reporting company) |                                  |
| Non-accelerated filer   | <input type="radio"/> | Smaller reporting company                     | <input type="radio"/>            |

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act.) o Yes S 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 October 23, 2009 |
| Common Stock, \$3 Par Value | 11,920,483 shares                  |

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|                                     |                |
|-------------------------------------|----------------|
| Class B Common Stock, \$3 Par Value | 858,447 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)

|   | Sept. 26,<br>2009  | Dec. 27,<br>2008 |
|---|--------------------|------------------|
| <b>ASSETS</b>   | <b>(Unaudited)</b> |                  |
| <b>CURRENT ASSETS</b>   |                    |                  |
| Cash and cash equivalents   | \$ 102             | \$ 113           |
| Receivables (less allowance for doubtful accounts<br>of \$1,213 for 2009 and<br>\$961 for 2008) | 25,102             | 32,976           |
| Inventories   | 59,153             | 75,167           |
| Other current assets  | 5,063              | 5,893            |
| <b>TOTAL CURRENT ASSETS</b>   | <b>89,420</b>      | 114,149          |
| <b>PROPERTY, PLANT AND EQUIPMENT</b>  |                    |                  |
| Land and improvements   | 6,088              | 6,088            |
| Buildings and improvements  | 47,536             | 46,892           |
| Machinery and equipment   | 128,742            | 131,297          |
|   | 182,366            | 184,277          |
| Less accumulated depreciation and amortization  | (98,179)           | (90,217)         |
| <b>NET PROPERTY, PLANT AND EQUIPMENT</b>  | <b>84,187</b>      | 94,060           |
| <b>OTHER ASSETS</b>   |                    |                  |
| Goodwill  | ---                | 33,406           |
| Other long-term assets  | 12,672             | 11,048           |
| <b>TOTAL OTHER ASSETS</b>   | <b>12,672</b>      | 44,454           |
| <b>TOTAL ASSETS</b>   | <b>\$ 186,279</b>  | \$ 252,663       |
| <b>LIABILITIES AND STOCKHOLDERS'<br/>EQUITY</b>   |                    |                  |
| <b>CURRENT LIABILITIES</b>  |                    |                  |
| Accounts payable  | \$ 10,026          | \$ 11,335        |
| Accrued expenses  | 13,389             | 16,356           |
| Current portion of long-term debt   | 8,959              | 8,832            |
| <b>TOTAL CURRENT LIABILITIES</b>  | <b>32,374</b>      | 36,523           |

|   |                   |                   |
|---|-------------------|-------------------|
| LONG-TERM DEBT                                    |                   |                   |
| Senior indebtedness                               | <b>55,303</b>     | 68,549            |
| Capital lease obligations                         | <b>791</b>        | 1,806             |
| Convertible subordinated debentures               | <b>12,162</b>     | 14,662            |
| <b>TOTAL LONG-TERM DEBT</b>                       | <b>68,256</b>     | 85,017            |
| <br>  |                   |                   |
| DEFERRED INCOME TAXES                             | <b>3,450</b>      | 10,713            |
| OTHER LONG-TERM LIABILITIES                       | <b>11,660</b>     | 12,822            |
| COMMITMENTS AND CONTINGENCIES                     | ---               | ---               |
| <br>  |                   |                   |
| STOCKHOLDERS' EQUITY                              |                   |                   |
| Common Stock (\$3 par value per share):           |                   |                   |
| Authorized 80,000,000 shares,                     |                   |                   |
| issued - 15,843,942 shares for 2009 and           |                   |                   |
| 15,840,374 shares for 2008                        | <b>47,532</b>     | 47,521            |
| Class B Common Stock (\$3 par value per share):   |                   |                   |
| Authorized 16,000,000                             |                   |                   |
| shares, issued - 858,447 shares for 2009 and      |                   |                   |
| 862,915 shares for 2008                           | <b>2,575</b>      | 2,589             |
| Additional paid-in capital                        | <b>136,405</b>    | 136,015           |
| Accumulated deficit                               | <b>(57,458)</b>   | (18,840)          |
| Accumulated other comprehensive loss              | <b>(186)</b>      | (509)             |
|   | <b>128,868</b>    | 166,776           |
| <br>  |                   |                   |
| Less Common Stock in treasury at cost - 3,923,459 |                   |                   |
| shares for 2009 and 4,086,546 shares for 2008     | <b>(58,329)</b>   | (59,188)          |
| <b>TOTAL STOCKHOLDERS' EQUITY</b>                 | <b>70,539</b>     | 107,588           |
| <br>  |                   |                   |
| <b>TOTAL LIABILITIES AND STOCKHOLDERS'</b>        |                   |                   |
| <b>EQUITY</b>                                     | <b>\$ 186,279</b> | <b>\$ 252,663</b> |

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        |                   | Nine Months Ended         |                   |
|--|---------------------------|-------------------|---------------------------|-------------------|
|  | <b>Sept. 26,<br/>2009</b> | Sept. 27,<br>2008 | <b>Sept. 26,<br/>2009</b> | Sept. 27,<br>2008 |
| Net sales  | <b>\$ 50,487</b>          | \$ 72,917         | <b>\$ 150,698</b>         | \$ 220,794        |
| Cost of sales  | <b>36,911</b>             | 54,029            | <b>113,166</b>            | 158,796           |
| Gross profit   | <b>13,576</b>             | 18,888            | <b>37,532</b>             | 61,998            |
| Selling and administrative expenses                    | <b>14,857</b>             | 18,733            | <b>45,338</b>             | 56,754            |
| Other operating income                                 | <b>(212)</b>              | (56)              | <b>(560)</b>              | (292)             |
| Other operating expense                                | <b>79</b>                 | 178               | <b>384</b>                | 546               |
| Facility consolidation and severance expenses          | <b>563</b>                | ---               | <b>2,295</b>              | ---               |
| Impairment of goodwill                                 | ---                       | ---               | <b>31,406</b>             | ---               |
| Operating income (loss)                                | <b>(1,711)</b>            | 33                | <b>(41,331)</b>           | 4,990             |
| Interest expense                                       | <b>1,347</b>              | 1,483             | <b>4,243</b>              | 4,414             |
| Other income   | <b>(20)</b>               | (165)             | <b>(339)</b>              | (348)             |
| Other expense  | <b>146</b>                | 5                 | <b>167</b>                | 31                |
| Income (loss) from continuing operations before taxes  | <b>(3,184)</b>            | (1,290)           | <b>(45,402)</b>           | 893               |
| Income tax provision (benefit)                         | <b>(1,167)</b>            | (558)             | <b>(6,960)</b>            | 260               |
| Income (loss) from continuing operations               | <b>(2,017)</b>            | (732)             | <b>(38,442)</b>           | 633               |
| Income (loss) from discontinued operations, net of tax | <b>23</b>                 | (101)             | <b>(176)</b>              | (167)             |
| Net income (loss)                                      | <b>\$ (1,994)</b>         | \$ (833)          | <b>\$ (38,618)</b>        | \$ 466            |



**BASIC EARNINGS  
(LOSS) PER SHARE:**

|                         |    |               |    |        |    |               |    |        |
|-------------------------|----|---------------|----|--------|----|---------------|----|--------|
| Continuing operations   | \$ | <b>(0.16)</b> | \$ | (0.06) | \$ | <b>(3.13)</b> | \$ | 0.05   |
| Discontinued operations |    | <b>0.00</b>   |    | (0.01) |    | <b>(0.01)</b> |    | (0.01) |
| Net income (loss)       | \$ | <b>(0.16)</b> | \$ | (0.07) | \$ | <b>(3.14)</b> | \$ | 0.04   |

**BASIC SHARES  
OUTSTANDING**

|               |        |               |        |
|---------------|--------|---------------|--------|
| <b>12,325</b> | 12,345 | <b>12,283</b> | 12,515 |
|---------------|--------|---------------|--------|

**DILUTED EARNINGS  
(LOSS) PER SHARE:**

|                         |    |               |    |        |    |               |    |        |
|-------------------------|----|---------------|----|--------|----|---------------|----|--------|
| Continuing operations   | \$ | <b>(0.16)</b> | \$ | (0.06) | \$ | <b>(3.13)</b> | \$ | 0.05   |
| Discontinued operations |    | <b>0.00</b>   |    | (0.01) |    | <b>(0.01)</b> |    | (0.01) |
| Net income (loss)       | \$ | <b>(0.16)</b> | \$ | (0.07) | \$ | <b>(3.14)</b> | \$ | 0.04   |

**DILUTED SHARES  
OUTSTANDING**

|               |        |               |        |
|---------------|--------|---------------|--------|
| <b>12,325</b> | 12,345 | <b>12,283</b> | 12,625 |
|---------------|--------|---------------|--------|

**DIVIDENDS PER  
SHARE:**

|                      |     |     |     |     |
|----------------------|-----|-----|-----|-----|
| 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)

|  | Nine Months Ended |                   |
|--|-------------------|-------------------|
|  | Sept. 26,<br>2009 | Sept. 27,<br>2008 |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES</b>  |                   |                   |
| Income (loss) from continuing operations   | \$ (38,442)       | \$ 633            |
| Loss from discontinued operations  | (176)             | (167)             |
| Net income (loss)  | (38,618)          | 466               |
| Adjustments to reconcile net income (loss) to net cash provided by operating activities: |                   |                   |
| Depreciation and amortization  | 10,467            | 10,385            |
| Change in deferred income taxes  | (4,996)           | (751)             |
| Net gain on property, plant and equipment disposals                                      | (185)             | (97)              |
| Gain on sale of available-for-sale securities  | (292)             | (222)             |
| Stock-based compensation expense   | 928               | 975               |
| Impairment of goodwill   | 31,406            | ---               |
| Write-off of deferred financing costs  | 133               | ---               |
| Changes in operating assets and liabilities:   |                   |                   |
| Receivables  | 7,874             | (1,081)           |
| Inventories  | 16,014            | (1,387)           |
| Accounts payable and accrued expenses  | (2,943)           | (1,865)           |
| Other operating assets and liabilities   | (2,215)           | (2,865)           |
| <b>NET CASH PROVIDED BY OPERATING ACTIVITIES</b>   | <b>17,573</b>     | <b>3,558</b>      |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES</b>  |                   |                   |
| Net proceeds from sales of property, plant and equipment                                 | 1,924             | 306               |
| Purchase of property, plant and equipment  | (2,163)           | (6,275)           |
| Proceeds from sale of available-for-sale securities                                      | 292               | 222               |

|  |           |         |
|--|-----------|---------|
| NET CASH PROVIDED BY (USED IN)<br>INVESTING ACTIVITIES | <b>53</b> | (5,747) |
|--|-----------|---------|

CASH FLOWS FROM FINANCING  
ACTIVITIES

|  |                 |         |
|--|-----------------|---------|
| Net (payments) borrowings on credit line               | <b>(9,807)</b>  | 12,471  |
| Payments on term loan                                  | <b>(1,130)</b>  | (1,282) |
| Payments on equipment financing                        | <b>(2,356)</b>  | (2,208) |
| Payments on capitalized leases                         | <b>(1,034)</b>  | (991)   |
| Payments on mortgage note payable                      | <b>(198)</b>    | (186)   |
| Payments on subordinated indebtedness                  | <b>(2,500)</b>  | (2,500) |
| Borrowings on note payable                             | <b>466</b>      | ---     |
| Payments on note payable                               | <b>(75)</b>     | ---     |
| Change in outstanding checks in excess of<br>cash      | <b>(959)</b>    | 109     |
| Common stock issued under stock option<br>plans        | ---             | 25      |
| Common stock acquired for treasury                     | <b>(29)</b>     | (3,411) |
| Payments for debt issuance cost                        | <b>(15)</b>     | ---     |
| NET CASH (USED IN) PROVIDED BY<br>FINANCING ACTIVITIES | <b>(17,637)</b> | 2,027   |

|   |             |       |
|---|-------------|-------|
| DECREASE IN CASH AND CASH<br>EQUIVALENTS            | <b>(11)</b> | (162) |
| CASH AND CASH EQUIVALENTS AT<br>BEGINNING OF PERIOD | <b>113</b>  | 427   |

|   |               |        |
|---|---------------|--------|
| CASH AND CASH EQUIVALENTS AT<br>END OF PERIOD | <b>\$ 102</b> | \$ 265 |
|---|---------------|--------|

Supplemental Cash Flow Information:

|   |                 |          |
|---|-----------------|----------|
| Interest paid                                       | <b>\$ 3,875</b> | \$ 4,258 |
| Income taxes paid, net of tax refunds<br>(received) | <b>(4,750)</b>  | 1,337    |

See accompanying notes to the consolidated condensed financial statements.

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**THE DIXIE GROUP, INC.**  
**CONSOLIDATED CONDENSED STATEMENTS OF STOCKHOLDERS' EQUITY AND**  
**COMPREHENSIVE INCOME (LOSS)**  
**(UNAUDITED)**  
**(dollars in thousands)**

|  | Common<br>Stock<br>and<br>Class B<br>Common<br>Stock | Additional<br>Paid-In<br>Capital | Accumulated<br>Deficit | Accumulated<br>Other<br>Comprehensive<br>Income (Loss) | Common<br>Stock in<br>Treasury | Total<br>Stockholders'<br>Equity |
|--|--|----------------------------------|------------------------|--|--------------------------------|----------------------------------|
| <b>Balance at<br/>December 27,<br/>2008</b>  | <b>\$ 50,110</b>                                     | <b>\$ 136,015</b>                | <b>\$ (18,840)</b>     | <b>\$ (509)</b>  | <b>\$ (59,188)</b>             | <b>\$ 107,588</b>                |
| Common Stock<br>acquired for<br>treasury -<br>18,146 shares                                | ---  | ---                              | ---                    | ---  | (29)                           | (29)                             |
| Re-issuance of<br>Common Stock<br>in<br>Treasury -<br>181,233 shares                       | ---  | (337)                            | ---                    | ---  | 888                            | 551                              |
| Restricted stock<br>grants forfeited<br>-<br>900 shares                                    | (3)  | (6)                              | ---                    | ---  | ---                            | (9)                              |
| Tax expense<br>from vesting of<br>stock awards   | ---  | (178)                            | ---                    | ---  | ---                            | (178)                            |
| Stock-based<br>compensation<br>expense   | ---  | 911                              | ---                    | ---  | ---                            | 911                              |
| Comprehensive<br>Income (Loss):  |  |                                  |                        |  |                                |                                  |
| Net loss   | ---  | ---                              | (38,618)               | ---  | ---                            | (38,618)                         |
| Unrealized<br>loss on<br>interest<br>rate swap<br>agreements,<br>net<br>of tax of<br>\$119 | ---  | ---                              | ---                    | (194)  | ---                            | (194)                            |

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|  |                  |                   |                    |                 |                    |                  |
|--|------------------|-------------------|--------------------|-----------------|--------------------|------------------|
| Reclassification<br>into earnings<br>on interest<br>rate swap<br>agreements,<br>net of tax of<br>\$447 | ---              | ---               | ---                | 729             | ---                | 729              |
| Unrealized<br>gain on<br>available<br>for-sale<br>securities, net<br>of<br>tax of \$22                 | ---              | ---               | ---                | 35              | ---                | 35               |
| Realized gain<br>on sale of<br>available-for-sale<br>securities,<br>net of tax of<br>\$111             | ---              | ---               | ---                | (181)           | ---                | (181)            |
| Postretirement<br>benefit plans:   |                  |                   |                    |                 |                    |                  |
| Recognition<br>of net<br>actuarial<br>gain, net of<br>tax<br>of \$16                                   | ---              | ---               | ---                | (25)            | ---                | (25)             |
| Amortization<br>of prior<br>service<br>credits, net<br>of<br>tax of \$25                               | ---              | ---               | ---                | (41)            | ---                | (41)             |
| Total<br>Comprehensive<br>Income<br>(Loss)   | ---              | ---               | (38,618)           | 323             | ---                | (38,295)         |
| <b>Balance at<br/>September 26,<br/>2009</b>   | <b>\$ 50,107</b> | <b>\$ 136,405</b> | <b>\$ (57,458)</b> | <b>\$ (186)</b> | <b>\$ (58,329)</b> | <b>\$ 70,539</b> |

See accompanying notes to the consolidated condensed financial statements.

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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 2008 Annual Report on Form 10-K filed with the Securities and Exchange Commission, which includes consolidated financial statements for the fiscal year ended December 27, 2008. Operating results for the three month and nine month periods ended September 26, 2009 are not necessarily indicative of the results that may be expected for the entire 2009 year.

The Company evaluated subsequent events through November 4, 2009, which represents the date the financial statements were issued.

The Company is in one line of business, carpet manufacturing.

**NOTE B - RECENT ACCOUNTING PRONOUNCEMENTS**

In December 2007, the Financial Accounting Standards Board ("FASB") Accounting Standards Codification ("ASC") 805 (formerly SFAS 141R), "Business Combinations" ("FASB ASC 805") was issued. FASB ASC 805 establishes principles and requirements for how identifiable assets, liabilities assumed, non-controlling interests in an acquiree, and goodwill are recognized and measured in an acquirer's financial statements. FASB ASC 805 also establishes disclosure requirements to assist users in evaluating the nature and financial effects of business combinations. This standard is effective for fiscal years beginning after December 15, 2008. The adoption of this statement did not have a material effect on the Company's financial position or results of operations.



In December 2007, the FASB issued FASB ASC 810 (formerly SFAS 160) "Consolidations" ("FASB ASC 810"). FASB ASC 810 establishes accounting and reporting standards for ownership interests in subsidiaries held by parties (other than the parent of such subsidiaries), the amount of consolidated net income attributable to the parent and to the holder of a noncontrolling interest, changes in a parent's ownership interest and the valuation of retained noncontrolling equity investments when a subsidiary is no longer consolidated. FASB ASC 810 also establishes reporting requirements to clearly identify, distinguish and disclose the interests of the parent and the interests of the noncontrolling owners. This standard is effective for fiscal years beginning after December 15, 2008. The adoption of this statement did not have a material effect on the Company's financial position or results of operations.

In March 2008, the FASB issued FASB ASC 815 (formerly SFAS 161) "Derivatives and Hedging" ("FASB ASC 815"). FASB ASC 815 establishes, among other things, additional disclosure requirements for derivative instruments and for hedging activities. FASB ASC 815 is effective for fiscal years and interim periods beginning after November 15, 2008. The adoption of this statement did not have a material effect on the Company's financial position or results of operations.

In April 2009, the FASB issued FASB ASC 825 (formerly FSP No. SFAS 107-1 and APB 28-1) "Financial Instruments" ("FASB ASC 825"), which requires quarterly disclosure of information about the fair value of financial instruments within the scope of FASB ASC 825. FASB ASC 825 is effective for interim periods ending after June 15, 2009. The adoption of this statement did not have a material effect on the Company's financial position or results of operations.

In May 2009, the FASB issued FASB ASC 855 (formerly SFAS 165) "Subsequent Events" ("FASB ASC 855"), which sets forth general standards of accounting for and disclosure of events that occur after the balance sheet date but before financial statements are issued or are available to be issued. FASB ASC 855 is effective for interim or annual periods ending after June 15, 2009. The adoption of this statement did not have a material effect on the Company's financial position or results of operations.

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**THE DIXIE GROUP, INC.**

**NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS**

**(UNAUDITED)**

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

In June 2009, the FASB issued SFAS No. 166, "Accounting for Transfers of Financial Assets - an amendment of FASB Statement No. 140" ("SFAS No. 166"). SFAS No. 166 was issued to improve the relevance, representational faithfulness, and comparability of the information that a reporting entity provides in its financial statements about a transfer of financial assets; the effects of a transfer on its financial position, financial performance, and cash flows; and a transferor's continuing involvement, if any, in transferred financial assets. SFAS No. 166 is effective as of the beginning of each reporting entity's first annual reporting period that begins after November 15, 2009, for interim periods within that first annual reporting period and for interim and annual reporting periods thereafter. The Company does not expect the adoption of this statement to have a material effect on its financial position or results of operations.

In June 2009, the FASB issued SFAS No. 167, "Amendments to FASB Interpretation No. 46R" ("SFAS No. 167"), which amends FASB Interpretation No. 46 (revised December 2003) to address the elimination of the concept of a qualifying special purpose entity. SFAS No. 167 also replaces the quantitative-based risks and rewards calculation for determining which enterprise has a controlling financial interest in a variable interest entity with an approach focused on identifying which enterprise has the power to direct the activities of a variable interest entity and the obligation to absorb losses of the entity or the right to receive benefits from the entity. SFAS No. 167 is effective as of the beginning of each reporting entity's first annual reporting period that begins after November 15, 2009, for interim periods within that first annual reporting period, and for interim and annual reporting periods thereafter. The Company does not expect the adoption of this statement to have a material effect on its financial position or results of operations.

In June 2009, the FASB issued Accounting Standards Update ("ASU") 2009-01 "Generally Accepted Accounting Principles" ("ASU 2009-01") which establishes the FASB Accounting Standards Codification as the source of authoritative accounting principles recognized by the FASB to be applied in the preparation of financial statements in conformity with generally accepted accounting principles. ASU 2009-01 explicitly recognizes rules and interpretive releases of the Securities and Exchange Commission ("SEC") under federal securities laws as authoritative GAAP for SEC registrants. ASU 2009-01 is effective for financial statements issued for interim and annual periods ending after September 15, 2009. The adoption of this statement did not have a material effect on the Company's financial position or results of operations.

**NOTE C - SHARE-BASED PAYMENTS**

The Company recognizes compensation expense relating to share-based payments based on the fair value of the equity or liability instrument issued.

The Company's stock compensation expense was \$293 and \$928, respectively for the three and nine months ended September 26, 2009 and \$325 and \$975, respectively for the three and nine months ended September 27, 2008.

On March 20, 2009, the Company extended the life of 234,081 options held by 27 of the Company's employees by an additional three years. The modification increased stock compensation expense by \$9 in the first quarter of 2009.

On May 20, 2009, the Company amended and restated a Restricted Stock Award granted to the Company's Chief Executive Officer. The amended and restated Award consists of 125,000 shares of Restricted Stock, initially granted on June 6, 2006. The award was amended to extend the term of the Award by one year to June 6, 2014, and to extend the time during which the award's market condition may be met by three years to June 6, 2014. The modification resulted in incremental stock compensation expense of \$41 in the second quarter of 2009 which will be amortized over the award's remaining vesting period.

#### NOTE D - RECEIVABLES

Receivables are summarized as follows:

|   | <b>Sept. 26,<br/>2009</b> | Dec. 27,<br>2008 |
|---|---------------------------|------------------|
| Customers,<br>trade                           | \$ <b>22,094</b>          | \$ 23,805        |
| Income taxes                                  | <b>2,258</b>              | 5,280            |
| Other   | <b>1,963</b>              | 4,852            |
| Gross<br>receivables                          | <b>26,315</b>             | 33,937           |
| Less<br>allowance<br>for doubtful<br>accounts | <b>(1,213)</b>            | (961)            |
| Net<br>receivables                            | \$ <b>25,102</b>          | \$ 32,976        |

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

Notes receivable were \$419 and \$425 at September 26, 2009 and December 27, 2008. The current portions of notes receivable are included in receivables and the non-current portions are included in 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.

Reduction of inventory quantities in 2009 resulted in liquidations of LIFO inventories carried at lower costs established in prior years, which decreased cost of sales by \$116 and \$1,136 for the three and nine month periods ended September 26, 2009, respectively.

Inventories are summarized as follows:

|                                  | <b>Sept. 26,<br/>2009</b> | Dec. 27,<br>2008 |
|----------------------------------|---------------------------|------------------|
| Raw materials                    | <b>\$ 19,152</b>          | \$ 27,133        |
| Work-in-process                  | <b>10,446</b>             | 15,284           |
| Finished goods                   | <b>38,272</b>             | 43,980           |
| Supplies, repair parts and other | <b>363</b>                | 416              |
| LIFO reserve                     | <b>(9,080)</b>            | (11,646)         |
| Total inventories                | <b>\$ 59,153</b>          | \$ 75,167        |

**NOTE F - GOODWILL**

The Company's goodwill is tested for impairment annually in the fourth quarter of each year or more frequently if events or circumstances indicate that the carrying value of goodwill associated with a reporting unit may not be fully recoverable. The first step in the goodwill assessment process, used to identify potential goodwill impairments, involves a comparison of the carrying value of a reporting unit, including goodwill, to the fair value of the reporting

unit. For this purpose, fair value is an estimate of the value of the reporting unit's current and future cash flows discounted at the Company's weighted-average cost of capital ("WACC"). Such an estimate necessarily involves judgments and assumptions concerning, among other matters, future sales and profitability, as well as interest rates and other financial factors used to calculate the WACC. Because economic conditions in the carpet industry deteriorated significantly in the first quarter of 2009, the Company reduced its expectations for the future sales and profitability of its reporting unit ("Fabrica") that had goodwill and tested such goodwill for impairment. As a result of the decline in the cash flow expectations for Fabrica, goodwill was potentially impaired.

Because goodwill was potentially impaired, the Company performed the second step in the goodwill evaluation process by comparing the "implied fair value" of Fabrica's goodwill with the carrying value of its goodwill. For this purpose, the "implied fair value" of goodwill for Fabrica was determined in the same manner as the amount of goodwill that would have been determined in a business combination. The measurement resulted in the impairment of the remaining goodwill associated with the acquisition of Fabrica International, Inc., which occurred in 2000; accordingly, the Company recorded a non-cash goodwill impairment loss of \$31,406 in the first quarter of 2009.

The changes in the carrying amount of goodwill during the nine months ended September 26, 2009 are summarized as follows:

|   |                  |
|---|------------------|
| Balance at December 27, 2008            | <b>\$ 33,406</b> |
| Reclassification to deferred tax assets | <b>(2,000)</b>   |
| Impairment loss                         | <b>(31,406)</b>  |
| Balance at September 26, 2009           | <b>\$ ---</b>    |

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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 G - ACCRUED EXPENSES**

Accrued expenses are summarized as follows:

|   | <b>Sept. 26,<br/>2009</b> | Dec. 27,<br>2008 |
|---|---------------------------|------------------|
| Compensation and benefits                             | <b>\$ 4,128</b>           | \$ 5,696         |
| Provision for customer rebates, claims and allowances | <b>3,581</b>              | 5,057            |
| Outstanding checks in excess of cash                  | <b>850</b>                | 1,809            |
| Other   | <b>4,830</b>              | 3,794            |
| Total accrued expenses                                | <b>\$ 13,389</b>          | \$ 16,356        |

**NOTE H - PRODUCT WARRANTY RESERVES**

The Company generally provides product warranties related to manufacturing defects and specific performance standards for its products. At the time sales are recorded, the Company records reserves for the estimated costs of defective products and failure of its products to meet applicable performance standards. The level of reserves the Company establishes is based primarily upon historical experience and evaluation of pending claims. Product warranty reserves are included in accrued expenses in the Company's consolidated condensed balance sheets. The following is a summary of the Company's warranty activity:

Three Months Ended

Nine Months Ended

|   | <b>Sept. 26,<br/>2009</b> | Sept. 27,<br>2008 | <b>Sept. 26,<br/>2009</b> | Sept. 27,<br>2008 |
|---|---------------------------|-------------------|---------------------------|-------------------|
| Warranty reserve beginning of period          | \$ <b>1,030</b>           | \$ 1,473          | \$ <b>1,363</b>           | \$ 1,515          |
| Warranty liabilities accrued                  | <b>605</b>                | 1,016             | <b>1,960</b>              | 2,698             |
| Warranty liabilities settled                  | <b>(540)</b>              | (879)             | <b>(1,847)</b>            | (2,502)           |
| Changes for pre-existing warranty liabilities | <b>(278)</b>              | (115)             | <b>(659)</b>              | (216)             |
| Warranty reserve end of period                | \$ <b>817</b>             | \$ 1,495          | \$ <b>817</b>             | \$ 1,495          |

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

Long-term debt consists of the following:

|                                     | <b>Sept. 26,<br/>2009</b> | Dec. 27,<br>2008 |
|-------------------------------------|---------------------------|------------------|
| Senior indebtedness:                |                           |                  |
| Credit line borrowings              | \$ <b>32,982</b>          | \$ 42,789        |
| Term loan                           | <b>13,206</b>             | 14,336           |
| Equipment financing                 | <b>7,719</b>              | 10,075           |
| Capital lease obligations           | <b>2,164</b>              | 3,199            |
| Mortgage note payable               | <b>6,090</b>              | 6,288            |
| Note payable                        | <b>392</b>                | ---              |
| Total senior indebtedness           | <b>62,553</b>             | 76,687           |
| Convertible subordinated debentures | <b>14,662</b>             | 17,162           |



|  |                  |           |
|--|------------------|-----------|
| Total long-term debt                               | <b>77,215</b>    | 93,849    |
| Less: current portion of long-term debt            | <b>(7,586)</b>   | (7,439)   |
| Less: current portion of capital lease obligations | <b>(1,373)</b>   | (1,393)   |
| Total long-term debt, less current portion         | <b>\$ 68,256</b> | \$ 85,017 |

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**THE DIXIE GROUP, INC.**

**NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS**

**(UNAUDITED)**

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

Effective July 31, 2009, the Company reduced its revolving credit facility from \$70,000 to \$55,000 to better align the size of the revolving credit facility with the Company's anticipated levels of accounts receivable and inventory.

Reduction of the facility will reduce unused borrowing capacity fees. The Company's senior loan and security agreement matures on May 11, 2013 and provides \$68,206 of credit, consisting of \$55,000 of revolving credit and a \$13,206 term loan. The Company's credit facilities do not contain ongoing financial covenants. The level of accounts receivable and inventory limit the borrowing availability under the agreement's revolving credit facility. The unused borrowing capacity under the senior loan and security agreement on September 26, 2009 was \$7,356.

**NOTE J - FAIR VALUE MEASUREMENTS AND FINANCIAL INSTRUMENTS**

FASB ASC 820 (formerly SFAS 157) defines fair value as the exchange value of an asset or a liability in an orderly transaction between market participants. The standard outlines a valuation framework and establishes a fair value hierarchy in order to increase the consistency and comparability of fair value measurements and disclosures. The hierarchy consists of three levels as follows:

Level 1 - Quoted market prices in active markets for identical assets or liabilities as of the reported date;

Level 2 - Other than quoted market prices in active markets for identical assets or liabilities, quoted prices for similar assets and liabilities in active markets, quoted prices for identical or similar assets or liabilities in markets that are not active, and other than quoted prices for assets or liabilities and prices that are derived principally from or corroborated by market data by correlation or other means; and

Level 3 - Measurements using management's best estimate of fair value, where the determination of fair value requires significant management judgment or estimation.

The Company's available-for-sale securities and interest rate swaps are measured under the fair value standard. The following table summarizes the hierarchy level the Company used to determine fair value of its financial assets and liabilities as of September 26, 2009:

|                                       | Fair Value Hierarchy<br>Level |         |            |        |
|---------------------------------------|-------------------------------|---------|------------|--------|
| Balance<br>at<br>Sept.<br>26,<br>2009 | Level<br>1                    | Level 2 | Level<br>3 |        |
| <b>Assets:</b>                        |                               |         |            |        |
| Available-for-sale securities         | \$ ---                        | \$ ---  | \$ ---     | \$ --- |
| <b>Liabilities:</b>                   |                               |         |            |        |
| Interest rate swaps                   | \$ 1,331                      | \$ ---  | \$ 1,331   | \$ --- |

The fair value of the interest rate swaps was obtained from external sources and was determined through the use of models that consider various assumptions and relevant economic factors.

Available-for-sale securities, if any, are reflected on the Company's consolidated condensed balance sheets in other current assets and related gains and losses are deferred in accumulated other comprehensive income (loss) ("AOCIL"). During the nine months ended September 26, 2009, the Company sold its remaining available-for-sale securities and realized gains from the sale of such securities of \$292, or \$181 net of tax.

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

The Company's financial instruments are not held or issued for trading purposes. The carrying amounts and estimated fair values of the Company's financial instruments are summarized as follows:

|  | <b>Sept. 26, 2009</b>      |                       | Dec. 27, 2008      |               |
|--|----------------------------|-----------------------|--------------------|---------------|
|  | <b>Carrying<br/>Amount</b> | <b>Fair<br/>Value</b> | Carrying<br>Amount | Fair<br>Value |
| Financial assets:  |                            |                       |                    |               |
| Cash and cash equivalents                                    | \$ 102                     | \$ 102                | \$ 113             | \$ 113        |
| Notes receivable, including current portion                  | 419                        | 419                   | 425                | 425           |
| Available-for-sale securities                                | ---                        | ---                   | 235                | 235           |
| Financial Liabilities:                                       |                            |                       |                    |               |
| Long-term debt and capital leases, including current portion | 77,215                     | 76,115                | 93,849             | 92,486        |
| Interest rate swaps  | 1,331                      | 1,331                 | 2,194              | 2,194         |

The fair values of the Company's long-term debt and capital leases were estimated using market rates the Company believes are available for similar types of financial instruments. The fair values of cash and cash equivalents and notes receivable approximate their carrying amounts.

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 interest rate swaps, to minimize interest rate volatility. The Company does not hold speculative financial instruments, nor does it hold or issue financial instruments for trading purposes.

Derivatives designated as cash flow hedges are linked to specific liabilities on the Company's balance sheet. The Company assesses, both at inception and on an ongoing basis, whether the derivatives that are used in the hedging transaction are highly effective in offsetting changes in cash flows of the hedged items. When it is determined that a derivative is not highly effective or the derivative expires, is sold, terminated, or exercised, the Company discontinues hedge accounting for that specific hedge instrument. The Company recognizes all derivatives on its consolidated condensed balance sheet at fair value. Changes in the fair value of cash flow hedges are deferred in AOCIL. Changes in the fair value of derivatives that are not effective cash flow hedges are recognized in income.

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

The Company is also a party to an interest rate swap agreement through March 2013, which is linked to a mortgage and considered a highly effective hedge. Under the interest rate swap agreement, the Company pays a fixed rate of interest times a notional amount equal to the outstanding balance of the mortgage, and receives in return an amount equal to a specified variable rate of interest times the same notional amount. At September 26, 2009, the notional amount of the interest rate swap agreement was \$6,090. Under the terms of the interest rate swap agreement, the Company pays a fixed rate of interest through March 2013, which effectively fixes the interest rate on the mortgage at 6.54%.

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## THE DIXIE GROUP, INC.

## NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

(UNAUDITED)

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

The following table summarizes the fair values of derivative instruments included in the Company's consolidated condensed balance sheets as of September 26, 2009 and December 27, 2008:

|  | Liability Derivatives |                  |
|--|-----------------------|------------------|
|  | Sept. 26,<br>2009     | Dec. 27,<br>2008 |
| Cash flow<br>hedges -<br>interest rate<br>swaps: |                       |                  |
| Accrued<br>expenses                              | \$ 841                | \$ ---           |
| Other<br>long-term<br>liabilities                | 490                   | 2,194            |
| Total  | \$ 1,331              | \$ 2,194         |

The following table summarizes the pre-tax impact of derivative instruments on the Company's financial statements for the three months ending September 26, 2009 and September 27, 2008:

|   | Amount of Gain or (Loss)<br>Recognized in AOCIL on<br>Derivative (effective portion) |                | Amount of Gain or (Loss)<br>Reclassified from AOCIL into<br>Income (effective portion) (1) (2) |                |
|---|--|----------------|--|----------------|
|   | Sept. 26, 2009   | Sept. 27, 2008 | Sept. 26, 2009   | Sept. 27, 2008 |
| Cash<br>flow<br>hedges -<br>interest<br>rate<br>swaps | \$ (177)   | \$ (196)       | \$ (406)   | \$ (209)       |

The following table summarizes the pre-tax impact of derivative instruments on the Company's financial statements for the nine months ending September 26, 2009 and September 27, 2008:

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|   | Amount of Gain or (Loss)<br>Recognized in AOCIL on<br>Derivative (effective portion) |                | Amount of Gain or (Loss)<br>Reclassified from AOCIL into<br>Income (effective portion) (1) (2) |                |
|---|--|----------------|--|----------------|
|   | Sept. 26, 2009   | Sept. 27, 2008 | Sept. 26, 2009   | Sept. 27, 2008 |
| Cash<br>flow<br>hedges -<br>interest<br>rate<br>swaps | \$ (313)   | \$ (520)       | \$ (1,176)   | \$ (486)       |

(1) The amount of loss reclassified from AOCIL is included in interest expense on the Company's consolidated condensed statements of operations.

(2) The amount of AOCIL expected to be reclassified into earnings during the next 12 months is \$1,114.

**NOTE K - EMPLOYEE BENEFIT PLANS**

The Company sponsors two 401(k) defined contribution plans covering substantially all associates. The Company generally matches participants' contributions, on a sliding scale, up to a maximum of 5% of the participant's earnings. The Company does not intend to match participants' contributions for one of the two 401(k) plans for the 2009 plan year; accordingly, matching contributions for the 401(k) plans were \$28 and \$272, respectively for the three months ended September 26, 2009 and September 27, 2008 and \$75 and \$832, respectively for the nine months ended September 26, 2009 and September 27, 2008.

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 \$9,663 at September 26, 2009 and \$9,197 at December 27, 2008 and are included in other long-term liabilities in the Company's consolidated condensed balance sheets. The obligations are unsecured general obligations of the Company and the participants have no right, interest or claim in the assets of the Company, except as unsecured general creditors. The Company utilizes a Rabbi Trust to hold, invest and reinvest deferrals and contributions under the plan. Amounts invested in company-owned life insurance in the Rabbi Trust were \$9,931 at September 26, 2009 and \$8,931 at December 27, 2008 and are included in other long-term assets in the Company's consolidated condensed balance sheets.

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

The Company is a contributing employer in a multi-employer pension plan. Expenses related to the multi-employer pension plan were \$56 and \$44, respectively for the three months ended September 26, 2009 and September 27, 2008 and \$164 and \$142, respectively for the nine months ended September 26, 2009 and September 27, 2008.

The Company sponsors a legacy 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.

Components of net periodic benefit cost for all postretirement plans are summarized as follows:

|   | Three Months<br>Ended |                      | Nine Months<br>Ended |                      |
|---|-----------------------|----------------------|----------------------|----------------------|
|   | Sept.<br>26,<br>2009  | Sept.<br>27,<br>2008 | Sept.<br>26,<br>2009 | Sept.<br>27,<br>2008 |
| Amortization<br>of prior<br>service credits | \$ (22)               | \$ (17)              | \$ (66)              | \$ (52)              |
| Recognized<br>net actuarial<br>gains        | (14)                  | (12)                 | (41)                 | (35)                 |
| Net periodic<br>benefit credit              | \$ (36)               | \$ (29)              | \$ (107)             | \$ (87)              |

Amounts contributed or expected to be contributed by the Company during the current fiscal year to its postretirement plans are not anticipated to be significantly different from amounts disclosed in the Company's 2008 Annual Report filed on Form 10-K.

**NOTE L - INCOME TAXES**

The Company accounts for uncertainty in income tax positions under the provisions of FASB ASC 740 (formerly FIN 48) "Income Taxes" ("FASB ASC 740"). Unrecognized tax benefits were \$82 at September 26, 2009. Due to the Company's valuation allowances, such benefits, if recognized, would not affect the Company's effective tax rate. No interest or penalties have been accrued as of September 26, 2009. The Company does not expect its unrecognized tax benefits to change significantly during the next twelve months. The Company recognizes interest and penalties related to uncertain tax positions, if any, in income tax expense.

The Company and its subsidiaries are subject to United States federal income taxes, as well as income taxes in a number of state jurisdictions. The tax years subsequent to 2005 remain open to examination for U.S. federal income taxes and most state jurisdictions. A few state jurisdictions remain open to examination for tax years subsequent to 2004.

The Company's income tax benefit for the nine months ended September 26, 2009 includes a \$2,992 benefit from the write-off of the tax deductible component of the Company's \$31,406 goodwill impairment.

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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 M - COMMON STOCK AND EARNINGS (LOSS) PER SHARE**

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

|   | Three Months Ended        |                   | Nine Months Ended         |                   |
|---|---------------------------|-------------------|---------------------------|-------------------|
|   | <b>Sept. 26,<br/>2009</b> | Sept. 27,<br>2008 | <b>Sept. 26,<br/>2009</b> | Sept. 27,<br>2008 |
| Income (loss) from continuing operations (1)  | \$ <b>(2,017)</b>         | \$ (732)          | \$ <b>(38,442)</b>        | \$ 633            |
| Denominator for calculation of basic earnings (loss) per share - weighted-average shares (2)            | <b>12,325</b>             | 12,345            | <b>12,283</b>             | 12,515            |
| Effect of dilutive securities:  |                           |                   |                           |                   |
| Stock options (3)   | ---                       | ---               | ---                       | 59                |
| Restricted stock grants (2)(3)  | ---                       | ---               | ---                       | 48                |
| Directors' stock performance units  | ---                       | ---               | ---                       | 3                 |
| Denominator for calculation of diluted earnings (loss) per share - weighted-average shares adjusted for | <b>12,325</b>             | 12,345            | <b>12,283</b>             | 12,625            |

potential dilution

(2)(3)

Earnings (loss) per  
share:

|         |    |               |    |        |    |               |    |      |
|---------|----|---------------|----|--------|----|---------------|----|------|
| Basic   | \$ | <b>(0.16)</b> | \$ | (0.06) | \$ | <b>(3.13)</b> | \$ | 0.05 |
| Diluted |    | <b>(0.16)</b> |    | (0.06) |    | <b>(3.13)</b> |    | 0.05 |

(1)

No adjustments needed to the numerator for diluted calculations.

(2)

Includes Common and Class B Common shares, less shares held in treasury and unvested restricted stock, in thousands.

(3)

Because their effects are anti-dilutive, shares issuable under stock option plans where the exercise price is greater than the average market price of the Company's Common Stock at the end of the relevant period, restricted stock grants where market conditions have not been met, and shares issuable on conversion of subordinated debentures into shares of Common Stock have been excluded. Aggregate shares excluded were 1,575 and 1,612, respectively during the three and nine months of 2009 and 1,534 and 1,457, respectively during the three and nine months of 2008.

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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 N - COMPREHENSIVE INCOME (LOSS)

Comprehensive income (loss) is as follows:

|   | Three Months Ended |                   | Nine Months Ended |                      |
|---|--------------------|-------------------|-------------------|----------------------|
|   | Sept. 26,<br>2009  | Sept. 27,<br>2008 | Sept. 26,<br>2009 | Sept.<br>27,<br>2008 |
| Net income (loss)   | \$ (1,994)         | \$ (833)          | \$ (38,618)       | \$ 466               |
| Other comprehensive<br>income (loss):                                     |                    |                   |                   |                      |
| Unrealized loss on<br>interest rate swap<br>agreements:                   |                    |                   |                   |                      |
| Before income taxes   | (177)              | (196)             | (313)             | (520)                |
| Income taxes  | (67)               | (75)              | (119)             | (198)                |
| Net of taxes  | (110)              | (121)             | (194)             | (322)                |
| Reclassification into<br>earnings on interest<br>rate swap<br>agreements: |                    |                   |                   |                      |
| Before income taxes   | 406                | 209               | 1,176             | 486                  |
| Income taxes  | 154                | 80                | 447               | 185                  |
| Net of taxes  | 252                | 129               | 729               | 301                  |
| Unrealized gain on<br>available-for-sale<br>securities:                   |                    |                   |                   |                      |
| Before income taxes   | 2                  | 110               | 57                | 861                  |
| Income taxes  | 1                  | 43                | 22                | 328                  |
| Net of taxes  | 1                  | 67                | 35                | 533                  |

|   |                   |          |                    |        |
|---|-------------------|----------|--------------------|--------|
| Realized gain on sale<br>of available-for-<br>sale securities:                  |                   |          |                    |        |
| Before income taxes   | <b>(9)</b>        | (110)    | <b>(292)</b>       | (222)  |
| Income taxes  | <b>(3)</b>        | (43)     | <b>(111)</b>       | (85)   |
| Net of taxes  | <b>(6)</b>        | (67)     | <b>(181)</b>       | (137)  |
| Recognition of net<br>actuarial gain on<br>postretirement<br>benefit plans:     |                   |          |                    |        |
| Before income taxes   | <b>(14)</b>       | (12)     | <b>(41)</b>        | (34)   |
| Income taxes  | <b>(6)</b>        | (5)      | <b>(16)</b>        | (13)   |
| Net of taxes  | <b>(8)</b>        | (7)      | <b>(25)</b>        | (21)   |
| Amortization of prior<br>service credits on<br>postretirement<br>benefit plans: |                   |          |                    |        |
| Before income taxes   | <b>(22)</b>       | (17)     | <b>(66)</b>        | (52)   |
| Income taxes  | <b>(8)</b>        | (6)      | <b>(25)</b>        | (20)   |
| Net of taxes  | <b>(14)</b>       | (11)     | <b>(41)</b>        | (32)   |
| Comprehensive income<br>(loss)  | <b>\$ (1,879)</b> | \$ (843) | <b>\$ (38,295)</b> | \$ 788 |

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## THE DIXIE GROUP, INC.

## NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

(UNAUDITED)

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

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

|   | Interest<br>Rate<br>Swaps | Available-<br>for-Sale<br>Securities | Post-<br>Retirement<br>Liabilities | Total    |
|---|---------------------------|--------------------------------------|------------------------------------|----------|
| Balance at December<br>27, 2008   | \$ (1,360)                | \$ 146                               | \$ 705                             | \$ (509) |
| Unrealized loss on<br>interest rate swap<br>agreements, net<br>of tax of \$119                      | (194)                     | ---                                  | ---                                | (194)    |
| Reclassification<br>into earnings on<br>interest rate<br>swap agreements,<br>net of tax of<br>\$447 | 729                       | ---                                  | ---                                | 729      |
| Unrealized gain on<br>available-for-sale<br>securities, net of<br>tax of \$22                       | ---                       | 35                                   | ---                                | 35       |
| Realized gain on<br>sale of available-<br>for-sale<br>securities, net of<br>tax of<br>\$111         | ---                       | (181)                                | ---                                | (181)    |
| Recognition of net<br>actuarial gain on<br>postretirement<br>benefit plans,<br>net of tax of \$16   | ---                       | ---                                  | (25)                               | (25)     |

|   |     |     |      |      |
|---|-----|-----|------|------|
| Amortization of<br>prior service<br>credits<br>on<br>postretirement<br>benefit plans,<br>net of tax of \$25 | --- | --- | (41) | (41) |
|---|-----|-----|------|------|

**Balance at September  
26, 2009**                    \$   **(825)**   \$            ---   \$            **639**   \$   **(186)**

#### NOTE O - OTHER (INCOME) EXPENSE

Other (income) expense is summarized as follows:

|   | Three Months Ended |                   | Nine Months Ended |                   |
|---|--------------------|-------------------|-------------------|-------------------|
|   | Sept. 26,<br>2009  | Sept. 27,<br>2008 | Sept. 26,<br>2009 | Sept. 27,<br>2008 |
| Other operating<br>income:                  |                    |                   |                   |                   |
| Gain on sale of<br>operating assets         | \$    (15)         | \$    ---         | \$   (188)        | \$   (116)        |
| Insurance<br>proceeds                       | (62)               | ---               | (62)              | ---               |
| Miscellaneous<br>income                     | (135)              | (56)              | (310)             | (176)             |
| Other operating<br>income                   | \$   (212)         | \$    (56)        | \$   (560)        | \$   (292)        |
| Other operating<br>expense:                 |                    |                   |                   |                   |
| Retirement<br>expenses                      | \$     72          | \$     96         | \$    236         | \$    346         |
| Miscellaneous<br>expense                    | 7                  | 82                | 148               | 200               |
| Other operating<br>expense                  | \$     79          | \$    178         | \$    384         | \$    546         |
| Other income:                               |                    |                   |                   |                   |
| Sale of<br>available-for-sale<br>securities | \$     (9)         | \$ (109)          | \$   (292)        | \$   (222)        |
|   | (11)               | (56)              | (47)              | (126)             |



|  |    |      |    |       |           |
|--|----|------|----|-------|-----------|
| Miscellaneous income                               |    |      |    |       |           |
| Other income                                       | \$ | (20) | \$ | (165) | \$ (348)  |
| Other expense:                                     |    |      |    |       |           |
| Write-off deferred financing costs                 | \$ | 133  | \$ | ---   | \$ ---    |
| Miscellaneous expense                              |    | 13   |    | 5     | 34 31     |
| Other expense                                      | \$ | 146  | \$ | 5     | \$ 167 31 |
| <u><a href="#">Return to Table of Contents</a></u> |    |      |    |       |           |

**THE DIXIE GROUP, INC.****NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS****(UNAUDITED)****(dollars in thousands, except per share data) - Cont'd.****NOTE P - FACILITY CONSOLIDATION AND SEVERANCE EXPENSES**

In response to the difficult economic conditions, the Company developed plans in the fourth quarter of 2008 to consolidate its Eton, Georgia carpet tufting operation into its Atmore, Alabama tufting, dyeing and finishing facility. This consolidation was substantially completed in the first quarter of 2009. The Company also developed plans to make organizational and other changes to reduce staff and expenses throughout the Company. In addition, the plan included consolidation of its Santa Ana, California tufting plant into its Santa Ana, California dyeing, finishing and distribution facility. The consolidation is substantially complete and is expected to be completed during the fourth quarter of this year. The Company expects to record additional costs related to the exit of its Santa Ana, California leased facility during the fourth quarter of 2009. The Company cannot currently estimate such exit cost.

During the first nine months of 2009, the Company further reduced the size of its operations and made additional staffing reductions as economic conditions within the carpet industry significantly weakened. The Company's staff was reduced by 15% in the first nine months of 2009. The Company's total employment is down by 28% since the beginning of 2008.

Costs related to the facility consolidations and organizational changes under the 2008 restructuring plan are summarized as follows:

|   |   |                            |                  | As of September 26,<br>2009                    |                            |                                |
|---|---|----------------------------|------------------|--|----------------------------|--------------------------------|
|   | Accrued<br>Balance at<br>December<br>27, 2008 | 2009<br>Expense<br>To Date | Cash<br>Payments | Accrued<br>Balance at<br>September<br>26, 2009 | Total<br>Costs<br>Incurred | Total<br>Expected<br>Costs (1) |
| Equipment<br>and<br>inventory<br>relocation | \$ ---  | \$ 1,292                   | \$ (1,292)       | \$ ---   | \$ 3,147                   | \$ 3,284                       |
| Severance<br>pay                            | 281   | 618                        | (854)            | 45   | 1,080                      | 1,080                          |
| Total                                       | \$ 281  | \$ 1,910                   | \$ (2,146)       | \$ 45  | \$ 4,227                   | \$ 4,364                       |

(1)

Excludes additional exit costs related to leased facility.

In August 2009, the Company developed and began implementing a plan to realign its organizational structure in the third and fourth quarters of 2009. Under this plan, the Company will combine its three residential carpet units into one business with three distinct brands. As a result, the Company's residential business will be organized much like its commercial carpet business and more like the rest of the industry and will further reduce costs. Costs related to the organization realignment include severance costs, associate relocation expenses and costs related to the migration of certain computer applications necessary to support the realignment.

Costs related to the 2009 organization restructuring plan are summarized as follows:

|  | Accrued<br>Balance<br>at<br>June 27,<br>2009 | 2009<br>Expenses<br>To Date | Cash<br>Payments | Accrued<br>Balance at<br>September<br>26, 2009 | As of September<br>26,<br>2009<br>Total<br>Costs<br>Incurred | Total<br>Expected<br>Costs |
|--|--|-----------------------------|------------------|--|--|----------------------------|
| Severance<br>pay and<br>employee<br>relocation | \$ ---                                       | \$ 364                      | \$ (95)          | \$ 269   | \$ 364   | \$ 636                     |
| Computer<br>systems<br>conversion<br>cost      | ---  | 21                          | (21)             | ---  | 21   | 132                        |
| Total  | \$ ---                                       | \$ 385                      | \$ (116)         | \$ 269   | \$ 385   | \$ 768                     |

Expenses incurred under these plans are classified in "facility consolidation and severance expenses" in the Company's consolidated condensed statements of operations for the three and nine months ended September 26, 2009.

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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 Q - DISCONTINUED OPERATIONS**

Results associated with operations that have been sold or discontinued are generally classified as discontinued operations for all periods presented. Discontinued operations are summarized as follows:

|  | Three Months Ended |                   | Nine Months Ended |                   |
|--|--------------------|-------------------|-------------------|-------------------|
|  | Sept. 26,<br>2009  | Sept. 27,<br>2008 | Sept. 26,<br>2009 | Sept. 27,<br>2008 |
| Income (loss)<br>from<br>discontinued<br>operations:               |                    |                   |                   |                   |
| Before<br>income<br>taxes  | \$ 32              | \$ (130)          | \$ (264)          | \$ (234)          |
| Income<br>tax<br>provision<br>(benefit)                            | 9                  | (29)              | (88)              | (67)              |
| Income (loss)<br>from<br>discontinued<br>operations,<br>net of tax | \$ 23              | \$ (101)          | \$ (176)          | \$ (167)          |

Results for discontinued operations in 2009 and 2008 reflected primarily workers' compensation expense related to businesses sold in 2003 and 2004.

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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 2008 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 2008 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.

**OVERVIEW**

The carpet industry and our business continued to be negatively affected by weak demand as tight credit conditions, low consumer confidence and other economic factors depressed the level of new residential and business construction and refurbishment activity. We believe our results reflect the impact of the overall economic downturn as it reached the higher end of the market where our business is concentrated. We have aggressively been reducing costs and conserving capital in an effort to return our Company to profitability at current sales levels.

**FACILITY CONSOLIDATIONS AND COST REDUCTION PLANS**

In response to the difficult economic conditions, we developed plans in the fourth quarter of 2008 to consolidate our Eton, Georgia carpet tufting operation into our Atmore, Alabama tufting, dyeing and finishing facility and make organizational and other changes to reduce staff and expenses throughout our Company. The consolidation of our East Coast tufting operations was substantially completed in the first quarter of 2009. During the nine months of 2009, we further reduced the size of our operations and made additional staffing reductions as economic conditions in our industry continued to significantly weaken.

Following our evaluation of Fabrica's business, we decided to consolidate our Santa Ana, California tufting plant into our Santa Ana, California dyeing, finishing, and distribution facility. The consolidation is substantially complete and is expected to be completed during the fourth quarter of this year. This will better align our operations with business activity levels and reduce cost.

Expenses for the consolidation and organizational changes associated were \$178 thousand and \$1.9 million, respectively in the third quarter and first nine months of 2009, bringing the total costs for the cost reduction plan to \$4.2 million since the third quarter of 2008. The first nine months of 2009 included \$1.3 million of costs to consolidate facilities and \$618 thousand of severance expenses. The expenses to complete the cost reduction plan, excluding any expenses that may be incurred to exit a leased facility, are expected to be approximately \$137 thousand.

During the third quarter of 2009, we developed and began implementing a plan to realign our organizational structure to further reduce cost and streamline operations. Under the plan, we are combining our three residential carpet units into one business with three distinct brands. As a result, our residential business will be organized much like our commercial carpet business and more like the rest of the industry. Costs of this realignment include severances, limited employee relocation expenses, and computer systems conversion expenses required to support the realignment. The total cost of this initiative is expected to approximate \$800 thousand. Costs incurred under this realignment plan were \$385 in the third quarter of 2009.

In addition to the facility consolidations and employee reductions, we suspended our match of certain 401(k) contributions for 2009 and lowered the compensation of our exempt salaried associates in March 2009. We have lowered our total number of associates by 28% since the beginning of 2008 and reduced annual cost significantly. These actions have had a positive impact on our second and third quarter results; however, at current business activity levels we must reduce cost further in order to become profitable.

## **GOODWILL IMPAIRMENT**

Our goodwill is tested for impairment annually in the fourth quarter of each year or more frequently if events or circumstances indicate that the carrying value of goodwill associated with a reporting unit may not be fully recoverable. The first step in the goodwill assessment process, used to identify potential goodwill impairments, involves a comparison of the carrying value of a reporting unit, including goodwill, to the fair value of the reporting unit. For this purpose, fair value is an estimate of the value of the reporting unit's current and future cash flows discounted at our weighted-average cost of capital ( WACC ). Such an estimate necessarily involves judgments and assumptions concerning, among other matters, future sales and profitability, as well as interest rates and other financial factors used to calculate our WACC. Because economic conditions in the carpet industry deteriorated significantly in the first quarter of 2009, we reduced our expectations for the future sales and profitability of the



reporting unit ("Fabrica") that had goodwill and tested goodwill for impairment. As a result of the decline in the cash flow expectations for Fabrica, the test indicated that goodwill was potentially impaired.

Because goodwill was potentially impaired, we performed the second step in the evaluation process by comparing the implied fair value of Fabrica's goodwill with the carrying value of its goodwill. For this purpose, the implied fair value of goodwill for Fabrica was determined in the same manner as the amount of goodwill that would have been determined in a business combination. The measurement resulted in the impairment of the remaining goodwill associated with the 2000 acquisition of Fabrica International, Inc.; accordingly, we recorded a non-cash goodwill impairment loss of \$31.4 million in the first quarter of 2009.

## RESULTS OF OPERATIONS

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

|   | Three Months Ended |                   | Nine Months Ended |                   |
|---|--------------------|-------------------|-------------------|-------------------|
|   | Sept. 26,<br>2009  | Sept. 27,<br>2008 | Sept. 26,<br>2009 | Sept. 27,<br>2008 |
| Net sales                                     | 100.0 %            | 100.0 %           | 100.0 %           | 100.0 %           |
| Cost of sales                                 | 73.1 %             | 74.1 %            | 75.1 %            | 71.9 %            |
| Gross profit                                  | 26.9 %             | 25.9 %            | 24.9 %            | 28.1 %            |
| Selling and administrative expense            | 29.4 %             | 25.7 %            | 30.1 %            | 25.7 %            |
| Other operating income                        | (0.4) %            | (0.0) %           | (0.4) %           | (0.1) %           |
| Other operating expense                       | 0.1 %              | 0.2 %             | 0.3 %             | 0.2 %             |
| Facility consolidation and severance expenses | 1.1 %              | 0.0 %             | 1.5 %             | 0.0 %             |
| Impairment of goodwill                        | 0.0 %              | 0.0 %             | 20.8 %            | 0.0 %             |
| Operating income (loss)                       | (3.3) %            | 0.0 %             | (27.4) %          | 2.3 %             |

**Net Sales.** Net sales for the quarter ended September 26, 2009 were \$50.5 million, down 30.8%, compared with sales of \$72.9 million for the year-earlier quarter. Net sales for the first nine months of 2009 were \$150.7 million, down 31.7%, compared with sales of \$220.8 million for the first nine months of 2008. Continued weak demand in residential carpet markets and further deterioration in commercial carpet markets negatively affected the carpet industry and our business. Our year-over-year sales comparison reflected a 29.4% decline in net carpet sales for the third quarter of 2009, with net sales of residential carpet down 23.7% and net sales of commercial carpet down 38.3%. For the first nine months of 2009, the sales comparison reflected a 31.1% decline in net carpet sales, with net sales of residential carpet down 26.8% and net sales of commercial carpet down 37.8%.

**Cost of Sales.** Cost of sales as a percentage of net sales decreased 1.0% in the third quarter of 2009 and increased 3.2% for the first nine months of 2009 compared with the same periods in 2008. Production declined significantly in

the third quarter and first nine months of 2009, compared with the 2008 periods, reflecting lower sales levels and a 21% reduction in inventories from the end of 2008. The lower production levels resulted in higher costs which more than offset lower raw material and energy costs and the effect of our cost reduction initiatives. LIFO inventory liquidations reduced cost of sales \$116 thousand in the third quarter of 2009 and \$1.1 million in the first nine months of 2009.

**Gross Profit.** Gross profit dollars declined \$5.3 million in the third quarter of 2009 compared with the third quarter 2008; however, gross profit increased 1%, as a percent of sales, primarily reflecting the effects of the cost reduction initiatives. Gross profit declined \$24.5 million for the first nine months of 2009 compared with the same period in 2008 due primarily to the lower sales volume.

**Selling and Administrative Expenses.** Selling and administrative expenses decreased \$3.9 million in the third quarter of 2009 and \$11.4 million in the first nine months of 2009, compared with the same periods in 2008. The lower selling and administrative expenses reflect the effect of our cost reduction initiatives and lower variable selling expenses. However, these expenses increased as a percentage of net sales due to the decline in net sales.

**Other Operating Income.** Other operating income increased \$156 thousand in the third quarter of 2009 and \$268 thousand for the first nine months of 2009 compared with the same periods in 2008. The increases were primarily a result of the receipt of insurance proceeds in the third quarter and the effect of the receipt of such insurance proceeds and higher gains from the sale of operating assets in the nine month 2009 comparison.

**Other Operating Expense.** Other operating expense decreased \$99 thousand in the third quarter of 2009 and \$162 thousand for the first nine months of 2009 compared with the same periods of 2008. The decrease is primarily due to a lower level of miscellaneous expenses in the third quarter of 2009 and a reduction in retirement expenses for the nine months of 2009.

**Operating Income (Loss).** Our operating loss was \$1.7 million, or 3.3% of net sales, in the third quarter of 2009 compared with operating income of \$33 thousand, or 0.0% of net sales, in the third quarter of the prior year. For the first nine months of 2009, our operating loss was \$41.3 million, compared with operating income of \$5.0 million, in the first nine months of 2008. The third quarter 2009 operating loss included \$563 thousand of expenses for facility consolidations and severance. For the first nine months of 2009, the operating loss included \$31.4 million of non-cash expenses related to impairment of goodwill and \$2.3 million for facility consolidations and severance.

**Interest Expense.** Interest expense decreased \$136 thousand in the third quarter of 2009 and \$171 thousand for the first nine months of 2009 compared with the same periods in 2008, principally as a result of lower levels of debt and lower interest rates in 2009.

**Other Income.** Other income decreased \$145 thousand in the third quarter of 2009 compared with the same period in 2008 principally due to higher gains from the sale of available-for-sale securities in 2008.

**Other Expense.** Other expense increased \$141 thousand and \$136 thousand in the third quarter and first nine months of 2009, respectively compared to the same periods in 2008, principally as a result of deferred financing costs that were written off in 2009 associated with the modification of our revolving credit facility.

**Income Tax Provision (Benefit).** Our effective income tax rate was a benefit of 36.7% in the third quarter of 2009 and 15.3% for the first nine months of 2009, compared with an effective income tax rate of 43.3% for the third quarter of 2008 and 29.1% for the first nine months of 2008. The decrease in the effective tax rate for the first nine months of 2009 was principally due to the non-deductible portion of the impairment of goodwill. The effective tax rate in the third quarter and first nine months of 2008 differed from statutory rates primarily as a result of the effects of permanent differences and tax credits on pre-tax earnings utilized in the tax calculations.

**Income (Loss) from Continuing Operations.** The loss from continuing operations was \$2.0 million, or \$0.16 per diluted share in the third quarter of 2009 and \$38.4 million, or \$3.13 per diluted share, for the first nine months of 2009 compared with a loss from continuing operations of \$732 thousand, or \$0.06 per diluted share in the third quarter of 2008 and income from continuing operations of \$633 thousand, or \$0.05 per diluted share for the first nine months of 2008. The loss from continuing operations in the third quarter of 2009 included \$407 thousand of losses, or \$0.03 per diluted share for consolidation and severance expenses. The loss from continuing operations for the first nine months of 2009 included \$29.9 million, or \$2.44 per diluted share of losses associated with the impairment of goodwill and consolidation and severance expenses.

**Net Income (Loss).** Discontinued operations reflected income of \$23 thousand, or \$0.00 per diluted share, in the third quarter of 2009 compared with a loss of \$101 thousand, or \$0.01 per diluted share, in the same period in 2008. Discontinued operations reflected a loss of \$176 thousand, or \$0.01 per diluted share, for the first nine months of 2009

compared with a loss of \$167 thousand, or \$0.01 per diluted share, for the first nine months of 2008. Including discontinued operations, the net loss was \$2.0 million, or \$0.16 per diluted share, in the third quarter of 2009 compared with a net loss of \$833 thousand, or \$0.07 per diluted share, in the third quarter of 2008. The first nine months of 2009 reflected a net loss of \$38.6 million, or \$3.14 per diluted share, compared with net income of \$466 thousand, or \$0.04 per diluted share, in the same period in 2008.

## **LIQUIDITY AND CAPITAL RESOURCES**

During the nine months ended September 26, 2009, we generated \$17.6 million of funds through operating activities and \$1.9 million from the sale of operating assets. These funds were used primarily to finance our operations, invest \$2.2 million in capital assets, reduce outstanding checks in excess of cash by \$1.0 million and reduce debt by \$16.6 million.

Working capital was reduced \$20.6 million in the first nine months of 2009, principally as a result of lower levels of receivables and inventories. Receivables and inventories declined \$7.9 million and \$16.0 million; respectively, other current assets decreased \$830 thousand and accounts payable and accrued expenses decreased \$4.3 million. The lower levels of receivables reflected reductions of \$2.0 million in trade receivables, \$3.0 million in income taxes receivable and \$2.9 million in other receivables. Inventories were reduced in all categories commensurate with the lower levels of business activity.

Capital expenditures for the nine months ended September 26, 2009 were \$2.2 million, while depreciation and amortization was \$10.5 million. We expect capital expenditures to be approximately \$3.0 million for fiscal 2009, while depreciation and amortization is expected to be approximately \$13.6 million. Planned 2009 capital expenditures relate primarily to expenditures to maintain our facilities and equipment. Earlier capital expenditure plans for 2009 included equipment for new manufacturing technology with a value of approximately \$3.2 million. The equipment was subsequently obtained under an operating lease.

We believe our operating cash flows, credit availability under our senior loan and security agreement and other sources of financing are adequate to finance our normal liquidity requirements. However, unforeseen cash expenditures above our normal liquidity requirements, or significant further deterioration in economic conditions that affect our business, could require supplemental financing or other funding sources. There can be no assurance that such supplemental financing or other sources of funding can be obtained or will be obtained on terms favorable to us. The levels of our accounts receivable and inventory limit the borrowing availability under our revolving credit facility. Unused borrowing capacity under our revolving credit facility was \$7.4 million at September 26, 2009.

Effective July 31, 2009, we reduced our revolving credit facility from \$70.0 million to \$55.0 million. This adjustment will better align the size of the facility with our anticipated levels of accounts receivable and inventory. Reduction of the facility will reduce unused borrowing capacity fees. The lower revolving credit facility did not affect, and is not anticipated to materially affect, our available borrowing capacity under the senior loan and security agreement.

## **RECENT ACCOUNTING PRONOUNCEMENTS**

In December 2007, the Financial Accounting Standards Board ("FASB") Accounting Standards Codification ("ASC") 805 (formerly SFAS 141R), "Business Combinations" ("FASB ASC 805") was issued. FASB ASC 805 establishes principles and requirements for how identifiable assets, liabilities assumed, non-controlling interests in an acquiree, and goodwill are recognized and measured in an acquirer's financial statements. FASB ASC 805 also establishes disclosure requirements to assist users in evaluating the nature and financial effects of business combinations. This standard is effective for fiscal years beginning after December 15, 2008. The adoption of this statement did not have a material effect on our financial position or results of operations.

In December 2007, the FASB issued FASB ASC 810 (formerly SFAS 160) "Consolidations" ("FASB ASC 810"). FASB ASC 810 establishes accounting and reporting standards for ownership interests in subsidiaries held by parties (other than the parent of such subsidiaries), the amount of consolidated net income attributable to the parent and to the holder of a noncontrolling interest, changes in a parent's ownership interest and the valuation of retained noncontrolling equity investments when a subsidiary is no longer consolidated. FASB ASC 810 also establishes reporting requirements to clearly identify, distinguish and disclose the interests of the parent and the interests of the noncontrolling owners. This standard is effective for fiscal years beginning after December 15, 2008. The adoption of this statement did not have a material effect on our financial position or results of operations.

In March 2008, the FASB issued FASB ASC 815 (formerly SFAS 161) "Derivatives and Hedging" ("FASB ASC 815"). FASB ASC 815 establishes, among other things, additional disclosure requirements for derivative instruments and for hedging activities. FASB ASC 815 is effective for fiscal years and interim periods beginning after November 15, 2008. The adoption of this statement did not have a material effect on our Company's financial position or results of operations.

In April 2009, the FASB issued FASB ASC 825 (formerly FSP No. SFAS 107-1 and APB 28-1) "Financial Instruments" ("FASB ASC 825"), which requires quarterly disclosure of information about the fair value of financial instruments within the scope of FASB ASC 825. FASB ASC 825 is effective for interim periods ending after June 15, 2009. The adoption of this statement did not have a material effect on our financial position or results of operations.

In May 2009, the FASB issued FASB ASC 855 (formerly SFAS 165) "Subsequent Events" ("FASB ASC 855"), which sets forth general standards of accounting for and disclosure of events that occur after the balance sheet date but before financial statements are issued or are available to be issued. FASB ASC 855 is effective for interim or annual periods ending after June 15, 2009. The adoption of this statement did not have a material effect on our financial position or results of operations.

In June 2009, the FASB issued SFAS No. 166, "Accounting for Transfers of Financial Assets - an amendment of FASB Statement No. 140" ("SFAS No. 166"). SFAS No. 166 was issued to improve the relevance, representational faithfulness, and comparability of the information that a reporting entity provides in its financial statements about a transfer of financial assets; the effects of a transfer on its financial position, financial performance, and cash flows; and a transferor's continuing involvement, if any, in transferred financial assets. SFAS No. 166 is effective as of the beginning of each reporting entity's first annual reporting period that begins after November 15, 2009, for interim periods within that first annual reporting period and for interim and annual reporting periods thereafter. We do not expect the adoption of this statement to have a material effect on our financial position or results of operations.

In June 2009, the FASB issued SFAS No. 167, "Amendments to FASB Interpretation No. 46R" ("SFAS No. 167"), which amends FASB Interpretation No. 46 (revised December 2003) to address the elimination of the concept of a qualifying special purpose entity. SFAS No. 167 also replaces the quantitative-based risks and rewards calculation for determining which enterprise has a controlling financial interest in a variable interest entity with an approach focused on identifying which enterprise has the power to direct the activities of a variable interest entity and the obligation to absorb losses of the

entity or the right to receive benefits from the entity. SFAS No. 167 is effective as of the beginning of each reporting entity's first annual reporting period that begins after November 15, 2009, for interim periods within that first annual reporting period, and for interim and annual reporting periods thereafter. We do not expect the adoption of this statement to have a material effect on our financial position or results of operations.

In June 2009, the FASB issued Accounting Standards Update ("ASU") 2009-01 "Generally Accepted Accounting Principles" ("ASU 2009-01") which establishes the FASB Accounting Standards Codification as the source of authoritative accounting principles recognized by the FASB to be applied in the preparation of financial statements in conformity with generally accepted accounting principles. ASU 2009-01 explicitly recognizes rules and interpretive releases of the Securities and Exchange Commission ("SEC") under federal securities laws as authoritative GAAP for SEC registrants. ASU 2009-01 is effective for financial statements issued for interim and annual periods ending after September 15, 2009. The adoption of this statement did not have a material effect on our financial position or results of operations.

## **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.

## **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 forward looking statements 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 Risk Factors detailed in item 1A of this report and described elsewhere in this document, the cost and availability of capital, raw material and 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 floor covering markets we serve and other risks detailed from time to time in our filings with the Securities and Exchange Commission.

### **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, among other factors. 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 September 26, 2009, the Company was a party to an interest rate swap agreement on its mortgage note payable with a notional amount equal to the outstanding balance of the mortgage note (\$6,090 at September 26, 2009) which expires in March of 2013. Under the interest rate swap agreement, the Company pays a fixed rate 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%.

On October 11, 2005, the Company entered into an interest rate swap agreement with a notional amount of \$30,000 through May 11, 2010. Under this agreement, the Company pays a fixed rate of interest of 4.79% times the notional amount and receives in return a specified variable rate of interest times the same notional amount. The interest rate swap agreement is linked to the Company's variable rate debt and is considered a highly effective hedge.

At September 26, 2009, \$16,188, or approximately 21% 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 of approximately \$33.

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#### **Item 4 - Controls and Procedures**

We maintain disclosure controls and procedures to ensure that information required to be disclosed in the reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the Commission's rules and forms and is accumulated and communicated to management, including our principal executive officer and principal financial officer, or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosure. Our management, under the supervision and with the participation of our Chief Executive Officer ( CEO ) and Chief Financial Officer ( CFO ) evaluated the effectiveness of the design and operation of our disclosure controls and procedures (as such terms are defined in Rules 13(a)-15(e) and 15(d)-15(e)) under the Securities Exchange Act of 1934, as amended (the Exchange Act ) as of September 26, 2009, the date of the financial statements included in this Form 10-Q (the Evaluation Date ). Based on that evaluation, our CEO and CFO concluded that our disclosure controls and procedures were effective as of the Evaluation Date.

No changes in our internal control over financial reporting occurred during the quarter covered by this report that materially affected, or are reasonably likely to 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, as well as diverse interpretation of U. S. Generally Accepted Accounting Principles by accounting professionals. It is also possible that internal control over financial reporting 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. Furthermore, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate. These inherent limitations are known features of the financial reporting process; therefore, while it is possible to design into the process safeguards to reduce such risk, it is not possible to eliminate all risk.

## **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. In general the industry is dependent on residential and commercial construction activity, including new construction as well as remodeling. New construction is cyclical in nature. To a somewhat lesser degree, this also is true with residential and commercial remodeling. A prolonged decline in new construction or remodeling activity 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 among others:

- .
- 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 policies.

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Our product concentration in the higher-end of the residential and commercial markets could significantly affect 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 significantly larger and have significantly greater resources and access to capital than we do. Maintaining our competitive position may require us to make substantial additional investments in our product development efforts, manufacturing facilities, distribution network and sales and marketing activities, which may be limited by our access to capital, as well as 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.

**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 and other yarn, synthetic backing, latex, and dyes. Continued 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. Other costs which could adversely affect our business include energy and transportation. We believe we have been generally successful in passing along raw material and other costs as they may occur; however, there can be no assurance that we will successfully recover such increases in cost, as they occur in the future.

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

Yarn is the principal raw material used in our floorcovering products. A significant portion of nylon yarn is purchased from one supplier. We believe there are other sources of 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/government regulation.**

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

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Discharges to air and water;

.

Handling and disposal of solid and hazardous substances and waste; and

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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 that 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 effect 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.

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**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 disruption, 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**

The following table provides information regarding our repurchases of shares of our Common Stock during the three months ended September 26, 2009:

| Month Ending                          | Total<br>Number of<br>Shares<br>Purchased | Average<br>Price<br>Paid Per<br>Share | Maximum<br>Number (or<br>approximate<br>dollar value)<br>of Shares<br>That May<br>Yet Be<br>Purchased<br>Under Plans<br>or Programs | Total<br>Number of<br>Shares<br>Purchased<br>as Part of<br>Publicly<br>Announced<br>Plans or<br>Programs<br>(1) |
|---------------------------------------|---|---------------------------------------|---|---|
| August 1, 2009                        | ---                                       | \$ ---                                | \$  | ---   |
| August 29, 2009                       | ---                                       | ---                                   |   | ---   |
| September 26, 2009                    | 417                                       | 3.02                                  |   | 417   |
| Three Months Ended September 26, 2009 | 417                                       | \$ 3.02                               | \$ 4,871,438  | 417   |

(1) On August 8, 2007, we announced a program to repurchase up to \$10 million of our Common Stock.

**Item 3 -  
Defaults  
Upon Senior  
Securities**

None.

**Item 4 -  
Submission of**

**Matters to a  
Vote of  
Security  
Holders**

None.

**Item 5 -  
Other  
Information**

None.

**Item 6 -  
Exhibits**

(a) Exhibits

(i) Exhibits Incorporated by Reference

- 10.1 Consulting agreement and non-compete agreement by and between Gary A. Harmon and The Dixie Group, Inc. dated July 27, 2009, (Incorporated by reference to the Current Report on Form 8-K filed July 30, 2009.)
- 10.1 Letter dated July 28, 2009, voluntarily reducing The Dixie Group, Inc.'s revolving credit facility under the Second Amended and Restated Loan and Security Agreement, dated October 24, 2008, (Incorporated by reference to the Current Report on Form 8-K filed July 30, 2009).
- 10.1 Master Lease Agreement by and between Masland Carpets, LLC and General Electric Capital Corporation dated as of August 21, 2009, relating to certain manufacturing equipment, (Incorporated by reference to the Current Report on Form 8-K filed on August 25, 2009).
- 10.2 Schedule to the Master Lease Agreement dated August 21, 2009, between Masland Carpets, LLC and General Electric Capital Corporation dated August 21, 2009, relating to certain manufacturing equipment, (Incorporated by reference to the Current Report on Form 8-K filed on August 25, 2009)
- 10.3 Corporate Guaranty of The Dixie Group, Inc. dated August 21, 2009, to General Electric Capital Corporation, related to the Master Lease Agreement executed August 21, 2009. (Incorporated by reference to the Current Report on Form 8-K filed on August 25, 2009)

(ii) Exhibits Filed with this Report

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.

**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: November 4, 2009

By: /s/ JON A. FAULKNER  
Jon A. Faulkner  
Vice President and Chief Financial Officer

Date: November 4, 2009

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



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