FOOTSTAR INC
Form 10-K/A
December 01, 2006

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-K/A
AMENDMENT NO. 2

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

For the fiscal year ended December 31, 2005

Commission File Number 1-11681

FOOTSTAR, INC.
(Exact name of registrant as specified in its charter)

| | |
|---|---|
| DELAWARE | 22-3439443 |
| (State of incorporation) | (IRS Employer Identification No.) |

933 MACARTHUR BLVD., MAHWAH, NEW JERSEY 07430
(Address of principal executive offices)

Registrant's telephone number, including area code: (201) 934-2000

SECURITIES REGISTERED PURSUANT TO SECTION 12(b) OF THE ACT:

NONE

SECURITIES REGISTERED PURSUANT TO SECTION 12(g) OF THE ACT:

Common Stock (par value $.01 per share)
(Title of Class)

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

[ ] Yes [X] No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act

[ ] Yes [X] No

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

Yes X No
--- ---

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in the definitive proxy statement incorporated by reference in Part III of this Form 10-K, or any amendment to this Form 10-K. [ ]

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer (as defined in Rule 12b-2 of the Act).

Large accelerated filer ___ Accelerated filer X Non-accelerated filer ___

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

Yes ___ No X

The aggregate market value of the common stock held by non-affiliates of the registrant as of March 1, 2006, was approximately $86.9 million.

Number of shares outstanding of common stock, par value $.01 per share, as of March 1, 2006: 20,806,641.

DOCUMENTS INCORPORATED BY REFERENCE

None

2

EXPLANATORY NOTE

We are filing this Amendment No. 2 (this "Amendment") to our Annual Report on Form 10-K as amended by Amendment No. 1 to Annual Report on Form 10-K/A filed on March 16, 2006 (the "Original Filing"), in order to amend Item 9A. Item 9A in the Original Filing inadvertently omitted, and Item 9A in this Amendment includes, the conclusions of our principal executive and financial officers regarding the effectiveness of our disclosure controls and procedures.

Because the Item 9A changes relate to the entire Form 10-K, this Amendment sets forth the Original Filing in its entirety. This Amendment does not amend any portion of the Original Filing except for the Amendment to Item 9A, and the inclusion of updated certifications of our principal executive and financial officers and an updated consent from our independent accountants. This Amendment thus does not reflect events that have occurred after March 16, 2006, the filing date of the Original Filing, or modify or update the forward looking statements presented in the Original Filing. Accordingly, this Amendment should be read in conjunction with our periodic filings made with the SEC subsequent to the filing date of the Original Filing, including any amendments to those filings, as well as any Current Reports filed on Form 8-K subsequent to the filing date of the Original Filing. Any reference to facts and circumstances at a "current" date refer to such facts and circumstances as of the filing date of the Original Filing.

3

FOOTSTAR, INC.
ANNUAL REPORT ON FORM 10-K

TABLE OF CONTENTS



Footstar, the Footstar logo, Just For Feet, Thom McAn, Cobbie Cuddlers, Texas Steer and Cara Mia are, or were as of December 31, 2005, trademarks and/or service marks of Footstar, Inc.'s subsidiaries or affiliates. All other trademarks mentioned are the property of their respective owners.

4

PART I

INTRODUCTORY NOTE

Footstar, Inc., which may be referred to as "Footstar", the "Company", "we", "us" or "our", is today filing this Annual Report on Form 10-K for its fiscal year ended December 31, 2005.

On February 7, 2006, Footstar emerged from bankruptcy and made payments to creditors totaling $105.1 million, plus applicable interest, pursuant to our Plan of Reorganization (the "Plan"). These payments exclude approximately $14.2 million in claims which will be paid upon final resolution. Creditors were or will be paid in full, plus interest where applicable, from existing cash balances. This Introductory Note first describes the key events that led to our eventual emergence and then provides a chronology of events since November, 2002:

- The disposition of our Athletic segment which included the sale of 349 Footaction stores to FootLocker, Inc., and the subsequent liquidation of all Just for Feet and Uprise stores and the remaining 75 Footaction stores.

- The sale and monetization of our two distribution centers and subsequent agreement to utilize a third party provider, FMI, for all product distribution and warehousing services.

- The disposition of certain businesses in the Meldisco segment.

- The Kmart settlement agreement that allowed the Company to assume its agreement to operate the Kmart footwear departments until no later than December 31, 2008.

On November 13, 2002, we announced that management had discovered discrepancies in the reporting of our accounts payable balances. An investigation of the discrepancies was conducted under the oversight of the Audit Committee of the Board of Directors and the assistance of outside legal advisors and forensic accountants.

The investigation determined that a restatement of previously issued financial statements over a five-and-one-half year period from the beginning of fiscal year 1997 through June, 2002 was required. This restatement was included in our fiscal year 2002 Annual Report on Form 10-K that was filed on September 3, 2004. In addition, and as a result of the restatement, we were delayed in filing other periodic reports with the Securities and Exchange Commission (the "SEC"). Our 2003 Annual Report on Form 10-K was filed on April 8, 2005 and Amendment No. 1 on Form 10-K/A to our 2003 Annual Report on Form 10-K was filed on September 29, 2005. Our 2004 Annual Report on Form 10-K was filed on September 30, 2005. Our Quarterly Reports on Form 10-Q for our first two fiscal quarters ended April 2, 2005 and July 2, 2005 were filed on September 30, 2005, at which time we became current under the Securities Exchange Act of 1934, in filing our periodic reports with the SEC and we continue to be current in filing our periodic reports with the SEC.

Prior to the Company's November 13, 2002 announcement, we notified the Staff of the SEC of the discovery of the accounting discrepancies. Following that notification, the Staff of the SEC began an enforcement proceeding including an investigation into the facts and circumstances giving rise to the restatement and in February 2006, sent the Company a Wells Notice. The Company has been and intends to continue cooperating fully with the SEC. We cannot predict the outcome of this proceeding. For a further description of this and other restatement-related litigation, see "Restatement Related Proceedings" under Item 3 - Legal Proceedings.

On December 29, 2003, the New York Stock Exchange ("NYSE") suspended trading in our common stock and, at a later date, our common stock was delisted. The NYSE stated that it decided to take these actions in view of the overall uncertainty surrounding our previous announcement that a restatement of our results for 1997 through 2002 would be required and the continued delay in fulfilling our financial statement filing requirements.

Commencing March 2, 2004 ("Petition Date"), Footstar and substantially all of its subsidiaries (collectively, the "Debtors") filed voluntary petitions for relief under chapter 11 of title 11 of the United States Code ("Bankruptcy Code" or "Chapter 11") in the United States Bankruptcy Court for the Southern District of New York in White Plains ("Court"). The Chapter 11 cases were jointly administered under the caption "In re: Footstar, Inc., et al. Case No. 04-22350 (ASH)" (the "Chapter 11 Cases"). The Debtors operated their businesses and managed their properties as debtors-in-possession pursuant to Sections 1107(a) and 1108 of the Bankruptcy Code. As debtors-in-possession, we were authorized to continue to operate as an ongoing business but could not engage in transactions outside the ordinary course of business without the approval of the Court.

As of the Petition Date, our operations were comprised of two distinct business segments: the discount and family footwear segment ("Meldisco" or "Meldisco Segment") and the athletic footwear and apparel segment ("Athletic" or "Athletic Segment"). Meldisco sells family footwear through licensed footwear departments and wholesale arrangements. Athletic sold athletic footwear and apparel through various retail chains (for example, Footaction and Just For Feet), and via catalogues and the Internet.

Meldisco has operated licensed footwear departments in discount chains since 1961, and is the only major operator of licensed footwear departments in the United States today. As of December 31, 2005, Meldisco operated licensed footwear departments in all 1421 Kmart Corporation ("Kmart") stores and in 859 Rite Aid Corporation ("Rite Aid") stores located on the West Coast. Meldisco also supplies certain retail stores, including stores operated by Wal-Mart Stores, Inc. ("Wal-Mart") and Rite Aid, with family footwear on a wholesale basis.

Athletic specialized in the sale of branded athletic footwear, apparel and accessories through its three retail chains, Footaction, Just For Feet and Uprise. Each of the retail chains in Athletic sold footwear and apparel from all of the major brand-name vendors. Athletic's Consumer Direct operations conducted sales through catalogues and the Internet to support the Footaction and Just For Feet retail chains.

We sought bankruptcy protection after we determined we could not obtain necessary liquidity from our lending syndicate or additional debt or equity financing. This decline in liquidity primarily resulted from unprofitable results in the Athletic Segment, a reduction in trade credit by certain Athletic vendors, unprofitable results of operations from recent acquisitions and the effect of Kmart's own bankruptcy. Other factors included intense competition in the discount retailing industry, unsuccessful sales and marketing initiatives and capital market volatility.

Since the Petition Date, we exited the Athletic Segment entirely by closing certain underperforming stores and selling the remainder of the stores and the other assets. Our financial statements present the Athletic Segment as a discontinued operation for all periods presented.

In the initial stages of the Chapter 11 cases, we sought to streamline our Meldisco business by selling or exiting selected stores. As a result, we sold or liquidated all of our Shoe Zone stores ("Shoe Zone").We also exited the footwear departments in 44 Gordmans, Inc. ("Gordmans") stores and the footwear departments in 87 stores operated by subsidiaries of Federated Department Stores, Inc. ("Federated"). Our financial statements reflect these businesses as a discontinued operation for all periods presented.

We have sold other assets, including our distribution centers in Mira Loma, California ("Mira Loma") in July 2004 and Gaffney, South Carolina ("Gaffney") in September 2004. The purchaser of Mira Loma, Thrifty Oil Co. ("Thrifty") has leased Mira Loma to FMI International LLC ("FMI"), a logistics provider, which is obligated to provide us with warehousing and distribution services through June 30, 2012 under a receiving, warehousing and distribution services agreement (the "FMI Agreement"). Pursuant to the FMI Agreement, FMI is the Company's exclusive provider of receiving, warehousing and physical distribution services for (a) imported product where the Company or its subsidiaries are the importer of record or (b) landed or domestic shipments controlled within the Company's supply chain. In 2006, we are obligated to pay FMI a minimum of $15.1 million. Commencing with calendar year 2007, there are no specified minimum payments due under the FMI Agreement. The Company's obligation with respect to each calendar year commencing with 2007 through the end of the term of the FMI Agreement is to provide FMI with an estimated total unit volume, if any, prior to the start of such year. Such estimated unit volume, if any, will be the basis for any minimum quantity commitment for such year. If actual unit volume in any year is less than the estimated unit volume provided by the Company for such year, a payment will be due by the Company to FMI to make up for any such shortfall within 30 days after the end of each calendar quarter.

The business relationship between Meldisco and Kmart is extremely important to us. The licensed footwear departments in Kmart have historically provided a significant portion of our total sales and profits, and comprise substantially all of our sales and profits now that we have exited all of our Athletic Segment businesses and most of our other Meldisco businesses.

Our arrangement with Kmart was governed by the Master Agreement with Kmart effective July 1, 1995, as amended ("Master Agreement"). The Master Agreement provided us with the non-transferable, exclusive right and license to operate the footwear department in every Kmart store. The initial term of the Master Agreement would have expired on July 1, 2012, and was renewable for a 15 year term upon mutual agreement, unless either party gave notice of termination at least four years prior to the end of the applicable term.

On August 12, 2004, we filed a motion to assume the Master Agreement. On September 30, 2004, Kmart filed an objection to this motion (the "Assumption Objection") and cross-moved to lift the automatic stay to enable Kmart to terminate the Master Agreement (the "Cross Motion").

In the Assumption Objection, Kmart argued that the Master Agreement was non-assumable under section 365(c)(1) of the Bankruptcy Code because applicable law rendered the Master Agreement non-assignable. In addition, Kmart argued that the Master Agreement was non-assumable pursuant to section 365(b)(2)(D) of the Bankruptcy Code because we had defaulted under the Master Agreement and such defaults were incurable. Finally, Kmart disputed the amount of cure we would owe Kmart should we be authorized to assume the Master Agreement. In the Cross Motion, Kmart argued that, because the Master Agreement was non-assumable, Kmart should be entitled to exercise a termination provision pursuant to section 365(e)(2) of the Bankruptcy Code.

We contested the factual assertions and legal arguments contained in the Assumption Objection and Cross Motion. On December 17, 2004, a hearing was held to determine whether, as a matter of law, we could assume the Master Agreement. On February 16, 2005, the Court issued its decision on the Motion to Assume Executory Contracts (the "Assumption Decision"). In the Assumption Decision, the Court overruled the Assumption Objection and held that section 365(c)(1) did not prevent assumption of the Master Agreement because we did not intend to assign the Master Agreement.

Kmart moved for re-argument of the Assumption Decision and the Court held a hearing on the argument on March 31, 2005. At this hearing the Court affirmed the Assumption Decision. An additional hearing with respect to Kmart's Cross Motion was held and, on May 10, 2005, the Court denied the Cross Motion. The Court did not resolve the issue of whether the Master Agreement was assignable under applicable nonbankruptcy law and reserved its decision on the issue of section 365(b)(2)(D) until the completion of discovery. There continued to be no guarantee that the Court would authorize us to assume the Master Agreement or Kmart to terminate the Master Agreement under section 365(b)(2)(D) of the Bankruptcy Code. Additionally, we could not be sure what cure amounts the Court would find would be owing to Kmart if the Court authorized us to assume the Master Agreement.

In June 2004, Kmart announced the sale of 54 of its retail store locations to Sears, Roebuck and Co. ("Sears") but agreed that Kmart would continue to operate such stores until Sears could complete its conversion plans. Thereafter, in November 2004, Kmart announced plans to acquire Sears (the "Sears Acquisition"), which acquisition closed on March 24, 2005. Following the announcement of the Sears Acquisition, we received inconsistent information from Kmart regarding its plan to convert certain of its stores to a different retail format. Initially, Kmart advised us of its intent to convert approximately 25 of the 54 stores to Sears Essential stores, and that Kmart expected us to discontinue operating the footwear departments in those stores. Kmart then informed us that only 11 of these 25 stores were slated for a format conversion. After receiving this inconsistent information, we filed a motion with the Court on January 28, 2005 seeking to compel Kmart to produce certain documents relating to the proposed Sears Acquisition and Kmart's business plans relating to the operation of footwear departments in its stores.

When Kmart announced its plan to begin the reconfiguration of some of the stores slated for conversion to a new Sears format (the "Converting Stores"), we believed that the Master Agreement continued to grant us the exclusive right to operate footwear departments in the Converting Stores, whether or not Kmart converted or operated certain of those stores under a different name, such as the Sears Essentials name. Accordingly, after receiving notice of the reconfigurations from Kmart, we filed a motion (the "Enforcement Motion") requesting that the Court determine Kmart to be in contempt for violation of the automatic stay and assess damages. Kmart replied to the Enforcement Motion by arguing that the automatic stay did not prevent Kmart from converting stores to a different format because our rights under the Master Agreement to sell footwear in the Converting Stores expire upon conversion.

On February 24, 2005, the Court held a hearing with respect to the Enforcement Motion and ruled that the automatic stay barred Kmart from taking any actions to remove us from the Converting Stores absent relief from the automatic stay. Accordingly, on March 4, 2005, Kmart filed a motion seeking relief from the automatic stay. On April 6, 2005, the Court heard legal arguments



concerning our claim that we had the right to continue to operate in the Converting Stores. On May 10, 2005, the Court granted Kmart relief from the automatic stay to effect conversions of the Converting Stores. We filed a motion asking that the Court reconsider its ruling on this issue (the "Reconsideration Motion"). On June 6, 2005, the Court heard legal arguments on the Reconsideration Motion and, on June 24, 2005, the Court denied the Reconsideration Motion.

On July 2, 2005, the Company and Kmart entered into an agreement (the "Kmart Settlement") with respect to the assumption, interpretation and amendment of the Master Agreement. On August 25, 2005, the Court approved the Kmart Settlement. The Kmart Settlement, which took effect beginning January 2, 2005, allows us to continue operating the footwear departments in Kmart stores pursuant to the Master Agreement as amended by the Kmart Settlement (the "Amended Master Agreement"). The significant provisions of the Kmart Settlement are as follows:

- Elimination of all outstanding litigation between Kmart and us.

- Expiration of the Amended Master Agreement at the end of 2008 and the requirement that Kmart will purchase our Shoemart inventory (but not our brands) at book value, which will avoid the need to manage a complex liquidation of such inventory and the attendant costs.

  Kmart has agreed to purchase all of the inventory (excluding inventory that is damaged, unsaleable and seasonal inventory, as defined) that is in our remaining stores on December 31, 2008, or that is on order on that date pursuant to Kmart's written request, for an amount equal to the book value of the inventory, as defined. We will vacate those stores and the Amended Master Agreement will expire on December 31, 2008.

- Our cure obligation to Kmart was fixed at $45.0 million.

  The cure amount was inclusive of all claims of Kmart, including, without limitation, retained earnings and retained deficit of all stores that were no longer in operation as of January 1, 2005 and any dividend/excess fees. This entire amount was paid to Kmart on August 26, 2005.

- Elimination of all annual fees/payments, other than a weekly license fee, equal to 14.625% of gross sales and a miscellaneous expense fee of $23,500 per store per year; elimination of Kmart's equity interests in the Shoemart Corporations.

  Kmart's equity interests in the Shoemart Corporations were extinguished effective as of January 2, 2005 and accordingly Kmart no longer shares in the profits or losses of these entities for fiscal 2005 or subsequent years. Beginning on January 2, 2005, we were required to begin paying Kmart 14.625% of the gross sales of the footwear departments. Effective August 25, 2005, we are also required to pay Kmart a revised miscellaneous expense fee of $23,500 per store per year. These are the only material fees which we will be required to pay Kmart pursuant to the Kmart Settlement.

  Kmart will have a capital claim against us in the amount of $11,000 for each store that is an existing store, as defined, on August 25, 2005, which is generally payable by us to Kmart at the time a store closes or converts to another retail format in accordance with the 550 store



limitation described below. However, upon the expiration of the Amended Master Agreement or upon early termination of that agreement other than as a result of our breach, all capital claims not yet due and payable will be waived for any remaining stores. If the Amended Master Agreement is terminated as a result of our breach, capital claims for remaining stores will not be waived and will become immediately due and payable.

- Kmart must pay us the stipulated loss value if it reduces the number of stores in which we operate below specified levels.

  Kmart will be permitted to terminate our rights to operate footwear departments in up to 550 existing Kmart stores during the remaining term of the Amended Master Agreement by disposing of, closing or converting these stores without paying us the agreed upon stipulated loss value. The number of such terminations per year is capped at 85 in 2005, 150 in 2006 and 160 in each of 2007 and 2008, with any unused cap carried over to the following year. For each store that is closed or converted, Kmart must purchase all of our in-store inventory (excluding inventory that is damaged, unsaleable and seasonal inventory, as defined) at book value, as defined. In addition, for all closings and conversions above the annual cap or the 550 aggregate limit, Kmart must pay us a nonrefundable stipulated loss value per store equal to $100,000 for closings and conversions occurring in 2005, $60,000 for closings and conversions occurring in 2006, $40,000 for closings and conversions occurring in 2007 and $20,000 for closings and conversions occurring in 2008. A termination of the entire Amended Master Agreement in accordance with its terms does not trigger the obligation to make a stipulated loss value payment. Actual store closures during fiscal year 2005 were 61. In 2006, through February 25, 2006, 18 stores have been closed or converted with one store identified to be disposed of, closed or converted subsequent to February 25, 2006.

- Minimum staffing obligations.

  We must spend at least 10% of gross sales in the footwear departments on staffing costs for the stores; and we must schedule staffing in each store at a minimum of 40 hours per week. If we do not meet these staffing obligations termination of the Amended Master Agreement may occur prior to December 31, 2008.

- Elimination of performance standards in favor of a minimum sales test.

  The Company and Kmart will each have the right to terminate the Amended Master Agreement if the gross sales of the footwear departments are less than $550.0 million in any year, less $0.4 million for each store that is closed or converted after August 25, 2005. Twenty-two stores have been closed or converted from August 25, 2005 through February 25, 2006. We will also have a separate, unilateral right to terminate the Amended Master Agreement if either (i) the number of Kmart stores is less than 900 or (ii) the gross sales of the footwear departments in any four consecutive fiscal quarters is less than $450.0 million. Upon termination under either circumstance, Kmart must purchase all of the inventory at the stores, (including inventory that is on order but excluding inventory that is damaged, unsaleable and seasonal inventory, as defined) for an amount equal to the book value of the inventory, as defined. If we do not meet these sales tests or the number of Kmart stores is less than 900, termination of the Amended Master Agreement may occur prior to December



31, 2008.

- Kmart is required to allocate 52 weekend newspaper advertising insert pages per year to our products.

Effective March 4, 2004, we entered into a two year, $300.0 million senior secured Debtor-in-Possession Credit Agreement ("DIP Credit Agreement") with a syndicate of lenders co-led by Bank of America, N.A. (formerly Fleet National Bank ) and GECC Capital Markets Group, Inc. The DIP Credit Agreement was subsequently amended effective August 2, 2004 to reduce the amount of lending commitments available while operating as debtor-in-possession and provide for post-emergence financing ("DIP and Exit Facility").

Effective July 1, 2005, we entered into an amendment to the DIP and Exit Facility (the "Amended DIP and Exit Facility") which allowed for the consummation of our Amended Plan. The Amended DIP and Exit Facility was further amended effective January 6, 2006 and, as is currently constituted (the "Exit Facility"), provides for $100.0 million of revolving commitments (including a $40.0 million sub-limit for letters of credit), availability of which is subject to a borrowing base based upon eligible inventory and accounts receivable. The Exit Facility became effective upon consummation of the Amended Plan on February 7, 2006 as all conditions to be satisfied were met. The Exit Facility has a maturity date of the earlier of (a) November 30, 2008 and (b) thirty days prior to termination of the Amended and Restated Kmart Agreement. For further information on the Company's credit facilities, see "Liquidity and Capital Resources" under Item 7 - "Management's Discussion and Analysis of Financial Condition and Results of Operations."

Pursuant to Court orders, we were authorized to pay certain pre-petition operating liabilities incurred in the ordinary course of business and reject certain of our pre-petition obligations. We notified all known pre-petition creditors of the establishment of a bar date by which creditors must file a proof of claim, which date has now passed for all creditors. We reconciled our pre-petition liabilities to our actual claim payments along with estimated future claim payments and recorded a reduction of our pre-petition liabilities of $18.7 million, of which $1.5 million was recorded in reorganization expense in continuing operations, $9.2 million was recorded in discontinued operations and $8.0 million as a gain on disposal of discontinued operations.

On November 12, 2004, we filed a proposed joint plan of reorganization with the Court. On October 28, 2005, we filed an amended plan with the Court (the "October 2005 Plan"). The October 2005 Plan provided for a reorganization of the Company and cash distributions to creditors and was subject to a vote by eligible ballot holders. The October 2005 Plan provided that creditors in the bankruptcy would be paid in full, with interest at the federal judgment interest rate of 1.23%. The Creditors' Committee believed, however, that this interest rate was insufficient, and accordingly, sought to terminate the Debtors' exclusivity periods and have the Bankruptcy Court fix a higher rate of postpetition interest. On November 23, 2005, the Bankruptcy Court terminated the Debtors' exclusivity periods, but reserved judgment on appropriate rate of postpetition interest. The Creditors' Committee and the Equity Committee subsequently agreed to the terms of a consensual plan of reorganization, including a postpetition interest rate for unsecured claims at 4.25% per annum and to the filing on December 5, 2005, of further amendments to the October 2005 Plan to reflect such agreement (the "Amended Plan"). On January 25, 2006, the Bankruptcy Court confirmed our Amended Plan. On February 7, 2006, we successfully emerged from bankruptcy.



Pursuant to the guidance provided by the American Institute of Certified Public Accountants in Statement of Position 90-7, "Financial Reporting by Entities in Reorganization Under the Bankruptcy Code ("SOP 90-7"), the Company has not adopted fresh-start reporting because there was no change to the holders of existing voting shares and the reorganization value of the Company's assets is greater than its post petition liabilities and allowed claims.

## ITEM 1. BUSINESS

### GENERAL

We are a holding company and operate a retail business through Meldisco, which sells family footwear through licensed footwear departments and wholesale arrangements.

See "Introductory Note" for a description of certain important events which have occurred, including our restatement, our Chapter 11 filing and subsequent exit from bankruptcy, the exit from the footwear departments of Federated and Gordmans stores and the closing and sale of the Shoe Zone stores within the Meldisco Segment and the closing of certain stores, the sale of all remaining stores within the Athletic Segment and the Kmart Settlement.

### MELDISCO

Meldisco sells family footwear through licensed footwear departments and wholesale arrangements. Meldisco has operated licensed footwear departments since 1961 and is the only major operator of licensed footwear departments in the United States today.

As of December 31, 2005, Meldisco operated licensed footwear departments in 1,421 Kmart stores and in 859 Rite Aid drugstores. Meldisco's licensed footwear operation sells family footwear and lower-priced basic and seasonal footwear in Kmart and Rite Aid stores. In its licensed footwear departments, Meldisco generally sells a wide variety of family footwear, including men's, women's and children's dress, casual and athletic footwear, work shoes and slippers.

In October 2002, we began supplying Thom McAn family footwear on a wholesale basis to 300 Wal-Mart stores. In February 2003, we expanded our arrangement with Wal-Mart to supply Thom McAn family footwear on a wholesale basis to up to 1,500 Wal-Mart stores in the United States. As of December 31, 2005, we were supplying Thom McAn family footwear to 1,500 Wal-Mart stores in the United States and 13 stores in Puerto Rico. In 2005, we sold approximately $27 million of Thom McAn products to Wal-Mart stores. However, beginning in January 2006, Wal-Mart is no longer purchasing Thom McAn product for any of its stores in the United States, but, it will continue to buy Thom McAn footwear for Wal-Mart stores in Puerto Rico and will continue to source footwear from us for Wal-Mart stores under

Wal-Mart's proprietary brands.

In April 2003, the licensed footwear agreement between the Company and Rite Aid covering approximately 2,500 Rite Aid drugstores located in the eastern half of the United States changed to a wholesale arrangement. The remaining 859 Rite Aid drugstores are operated as licensed footwear departments.



COMPETITIVE ENVIRONMENT

The family footwear business, where the majority of Meldisco's business is generated, is highly competitive.

Competition is concentrated among a limited number of retailers and discount department stores, including Kmart, Wal-Mart, Payless ShoeSource, Kohl's, Target and Sears, with a number of traditional off-price and value retailers such as Shoe Carnival, Famous Footwear and Rack Room also selling lower-priced footwear. The events that caused us to seek bankruptcy and the terms of the Kmart Settlement put us at a disadvantage with respect to our competitors, many of which are growing rapidly and have substantial financial and marketing resources which are unavailable to us.

MERCHANDISING

Meldisco's merchandising strategy is to continue to build upon its position in family footwear. The essence of this strategy is to satisfy Meldisco's customers with high in-stock availability of its footwear products and a wide selection of well-known national brands such as Thom McAn and Cobbie Cuddlers (which are Company-owned). We offer a wide range of quality, value-priced footwear. Key strengths include style development, quality control, competitive pricing, planning and inventory management.

In its licensed footwear operations, Meldisco seeks to attract non-footwear shoppers into the footwear departments from other areas of the stores. Its branded products are also intended to differentiate Meldisco merchandise from that of its competitors. Brands currently available at Meldisco's operations include Thom McAn, Cobbie Cuddlers and Texas Steer (which are Company-owned) and Route 66, Basic Editions, Thalia and Joe Boxer. Meldisco conducts consumer research to gauge new opportunities for brand extensions and to determine price and positioning of new brands.

Meldisco's traditional strength has been in quality leather footwear which it currently offers under the Thom McAn brand, as well as seasonal, work, value-priced athletic, women's casual and children's shoes. Meldisco builds on its strength in these segments by focusing on customer satisfaction. Meldisco's "narrow and deep" merchandising strategy and its merchandise planning systems are designed to ensure that each store is well stocked in product lines that are particularly popular with Meldisco's core customers. Meldisco's demand-driven merchandise replenishment system has been designed to permit inventory management at the store, style and size levels.

MARKETING

Meldisco believes that the typical footwear customer in its licensed footwear departments in Kmart generally resembles the average Kmart softlines shopper: a 25 to 49 year-old woman who is employed at least part-time, has at least one child under the age of 18 and reports a total annual household income between $25,000 and $65,000. Meldisco's marketing initiatives are designed to support its overall business strategy of increasing purchases among traditional footwear shoppers, as well as appealing to the growing customer segments that include African Americans and Hispanics.

Meldisco's marketing strategy in its Kmart footwear departments is designed to convey to prospective customers that Kmart carries the right value combination of brands, product selection, quality, comfort and price to make Kmart footwear departments their footwear destination of



choice. This message is communicated primarily through weekly advertising in newspaper inserts and in-store presentations. Kmart's weekly newspaper inserts had a weekly circulation of approximately 43.9 million as of December 31, 2005.

TRADEMARKS AND SERVICE MARKS

Footstar or its subsidiaries own all rights in the United States to the marks Thom McAn, Cobbie Cuddlers and Cara Mia for use in connection with footwear and/or related products and services. The Company or its subsidiaries have registered or have common law rights in the United States to over 100 trademarks and/or service marks under which we market merchandise or services. The Company either has registered or is in the process of registering its trademarks and service marks in foreign countries in which it operates or may operate in the future. We vigorously protect our trademarks and service marks both domestically and internationally.

EMPLOYEES

As of December 31, 2005, we had 5,088 employees, of which 1,331 were full-time and 3,757 were part-time employees.

AVAILABLE INFORMATION

We make available free of charge through our web site, www.footstar.com, all materials that we file electronically with the SEC, including our Annual Report on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K, and amendments to those reports, filed or furnished pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934. During the period covered by this Form 10-K, we made all such materials available through our web site as soon as reasonably practicable after filing such materials with the SEC.

You may also read and copy any materials filed by us with the SEC at the SEC's Public Reference Room at 100 F Street, NE, Washington, DC 20549, and you may obtain information on the operation of the Public Reference Room by calling the SEC at 1-800-SEC-0330. In addition, the SEC maintains an Internet web site, www.sec.gov, which contains reports, proxy and information statements and other information which we file electronically with the SEC.

ITEM 1A. RISK FACTORS

Set forth below are certain important risks and uncertainties that could adversely affect our results of operations or financial condition and cause our actual results to differ materially from those expressed in forward-looking statements made by the Company or its management. See "Forward-Looking Statements" in Item 7 for additional risk factors.

MELDISCO IS OUR ONLY CONTINUING BUSINESS AND SUBSTANTIALLY ALL OF OUR CONTINUING NET SALES AND PROFITS RESULT FROM MELDISCO'S BUSINESS IN KMART STORES. THE KMART

SETTLEMENT WILL RESULT IN THE LIQUIDATION OF OUR KMART BUSINESS NO LATER THAN THE END OF DECEMBER 2008 OR EARLIER IF WE FAIL TO MEET THE MINIMUM SALES TESTS, STAFFING OBLIGATIONS OR OTHER PROVISIONS OF THE AMENDED MASTER AGREEMENT. IF WE FAIL TO DEVELOP VIABLE BUSINESS ALTERNATIVES TO OFFSET THIS BUSINESS WE WILL ALMOST CERTAINLY BE FORCED TO LIQUIDATE OUR BUSINESS WHEN THE KMART RELATIONSHIP ENDS.



WE MAY BE UNABLE TO ATTRACT AND RETAIN TALENTED PERSONNEL.

Our success is dependent upon our ability to attract and retain qualified and talented individuals. We have instituted several retention programs designed to retain key executives and employees and will seek to implement additional programs to retain key executives and employees as necessary. However, if we are unable to attract or retain key executives and employees, including senior management, and qualified accounting and finance, marketing, and merchandising personnel, or put in place additional retention programs, it could adversely affect our businesses. This risk is acute given the anticipated liquidation of our Kmart business no later than the end of 2008 as a result of the Kmart Settlement.

WE RELY ON KEY VENDORS AND THIRD PARTIES TO MANUFACTURE AND DISTRIBUTE OUR PRODUCTS.

Product sourcing in the family footwear business is driven by relationships with foreign manufacturers. If the terms under which these vendors deal with us, including payment terms, change adversely, there could be a material adverse impact on our operations and financial condition. Also, if these foreign manufacturers are unable to secure sufficient supplies of raw materials or maintain adequate manufacturing capacity, they may be unable to provide us with timely delivery of products of acceptable quality. In addition, if the prices charged by these manufacturers increase, our cost of acquiring merchandise would increase. A portion of our footwear product is comprised of petrochemical products which have risen in price dramatically over the past year. It is very possible that these raw material price increases will be passed on to us. Furthermore, higher product prices could result from the recent decision by the Chinese government to revalue their currency. Although we pay for finished goods in U.S. dollars, it is possible that higher labor costs due primarily to the currency revaluation could be passed on to us through higher product costs. If we cannot recover these cost increases with increased pricing to our customers, it could have a material adverse effect on our operations and financial condition. The Company is managing against possible product cost increases by shifting manufacturing production to lower cost regions of China. While the Company is exercising considerable diligence in selecting new factories, it is possible that the Company could experience lower product quality and/or late shipments from these new factories which could unfavorably impact the Company's financial results.

We also depend on third parties to receive, transport and deliver our products. If these third parties are unable to perform for any reason, or if they increase the price of their services as a result of increases in the cost of fuel, there could be a material adverse effect on our operations and financial performance.

WE ARE THE SUBJECT OF AN SEC ENFORCEMENT INVESTIGATION AND CANNOT YET DETERMINE WHETHER ANY FINES WILL BE IMPOSED ON US BY THE SEC AND IF SO, WHAT THE IMPACT OF ANY FINE OR SANCTION WILL BE ON OUR BUSINESS.

Prior to our November 13, 2002 announcement that management had discovered discrepancies in the reporting of our accounts payable balances, we notified the staff of the SEC concerning the discovery of the accounting discrepancies. Following that notification, the SEC began an enforcement proceeding, including an investigation into the facts and circumstances giving rise to the restatement. As we announced on February 10, 2006, the Company received a Wells notice



from the SEC Staff in connection with the enforcement investigation. Under SEC procedures, a Wells notice indicates that the Staff has made a preliminary decision to recommend that the SEC authorize the Staff to bring a civil or administrative action against the recipient of the notice. The Wells notice that Footstar received states that the SEC Staff, as a result of its investigation, is considering recommending that the SEC bring a civil injunctive action against the Company for alleged violations of provisions of the Securities Exchange Act of 1934 relating to the maintenance of books, records and internal accounting controls, the establishment of disclosure controls and procedures and the periodic filing requirements of Sections 10(b), 13(a) and 13(b)(2) of the Exchange Act and in SEC Rules 10b-5, 12b-20, 13a-1 and 13a-13. A recipient of a Wells notice can respond to the SEC Staff before the Staff makes a formal recommendation regarding whether the SEC should bring any action.

Footstar has been, and intends to continue, cooperating fully with the SEC Staff in connection with this matter and is in discussions with the Staff regarding the possible resolution of this matter. We cannot predict the outcome of this proceeding.

For a further description of our restatement related litigation, see "Restatement Related Proceedings" under Item 3 - Legal Proceedings.

WE HAVE HAD MATERIAL WEAKNESSES IN INTERNAL CONTROL OVER FINANCIAL REPORTING AND CANNOT ASSURE YOU THAT MATERIAL WEAKNESSES WILL NOT BE IDENTIFIED IN THE FUTURE. OUR FAILURE TO EFFECTIVELY MAINTAIN INTERNAL CONTROL OVER FINANCIAL REPORTING CAN RESULT IN MATERIAL MISSTATEMENTS IN OUR FINANCIAL STATEMENTS WHICH COULD REQUIRE US TO RESTATE FINANCIAL STATEMENTS, CAUSE INVESTORS TO LOSE CONFIDENCE IN OUR REPORTED FINANCIAL INFORMATION AND HAVE A NEGATIVE EFFECT ON OUR STOCK PRICE.

We and our independent registered public accounting firm determined that we had deficiencies in our internal control over financial reporting during fiscal 2004 that constitute "material weaknesses" as defined by the Public Company Accounting Oversight Board's Audit Standard No. 2.

Although these material weaknesses have been remediated, we cannot assure you that additional other weaknesses in our internal control over financial reporting will not be identified in the future. Any failure to maintain or implement required new or improved controls, or any difficulties we encounter in their implementation, could result in other material weaknesses, cause us to fail to meet our periodic reporting obligations or result in material misstatements in our financial statements. Any such failure could also adversely affect the results of periodic management evaluations and annual auditor attestation reports regarding the effectiveness of our internal control over financial reporting required under Section 404 of Sarbanes-Oxley and the rules promulgated under Section 404. The existence of a material weakness could also cause investors to lose confidence in our reported financial information, leading to a decline in our stock price.

DECLINES IN OUR SALES WILL HAVE A MAGNIFIED IMPACT ON PROFITABILITY BECAUSE OF

OUR FIXED COSTS.

A significant portion of our operating expenses are fixed costs that are not dependent on our sales performance, as opposed to variable costs, which vary proportionately with sales performance. These fixed costs include, among other things, the costs associated with operating as a public company and a substantial portion of our labor expenses. As our sales continue to decline with the



disposition, closing or conversion of Kmart stores, we will be unable to reduce our operating expenses proportionately. In accordance with the Kmart Settlement, if Kmart store sales fall below a certain threshold, as defined, the Amended Master Agreement may be terminated early.

WE OPERATE IN THE HIGHLY COMPETITIVE FOOTWEAR RETAILING INDUSTRY.

The family footwear industry, where our business is now concentrated, is highly competitive. Competition is concentrated among a limited number of retailers and discount department stores, including Payless ShoeSource, Kmart, Wal-Mart, Kohl's, Sears and Target, with a number of traditional mid-tier retailers such as Shoe Carnival, Famous Footwear and Rack Room also selling lower-priced footwear. The events that caused us to seek bankruptcy protection in 2004 and the terms of the Kmart Settlement put us at a disadvantage with respect to our competitors, many of which are growing rapidly and have substantial financial and marketing resources which are unavailable to us. If we are unable to overcome this disadvantage and respond effectively to our competitors, we may be forced to liquidate our operations.

THERE ARE RISKS ASSOCIATED WITH OUR IMPORTATION OF PRODUCTS.

Approximately 99% of Meldisco's products are manufactured in China. Substantially all of this imported merchandise is subject to customs duties and tariffs imposed by the United States. Penalties may be imposed for violations of labor and wage standards by foreign contractors.

In addition, China and other countries in which our merchandise is manufactured may, from time to time, impose additional new quotas, tariffs, duties, taxes or other restrictions on its merchandise or adversely change existing quotas, tariffs, duties, taxes or other restrictions. Any such changes could adversely affect our ability to import our products and, therefore, our results of operations.

Any deterioration in the trade relationship between the United States and China, issues regarding China's compliance with its agreements related to its entry into the World Trade Organization, or any other disruption in our ability to import products from China could adversely affect our business, financial condition or results of operations.

Other risks inherent in sourcing products from foreign countries include economic and political instability, social unrest and the threat of terrorism, each of which risks could adversely affect our business, financial condition or results of operations. In addition, we incur costs as a result of security programs designed to prevent acts of terrorism such as those imposed by government regulations and our participation in the Customs-Trade Partnership Against Terrorism implemented by the United States Bureau of Customs and Border Protection. Significant increases in such costs could adversely affect our business, financial condition or results of operations.

Our ability to successfully import merchandise into the United States from foreign sources is also dependent on stable labor conditions in the major ports of the United States. Any instability or deterioration of the domestic labor environment in these ports could result in increased costs, delays or disruption in merchandise deliveries that could cause loss of revenue, damage to customer relationships and have a material adverse effect on our business operations and financial condition.

THE FOOTWEAR RETAILING INDUSTRY IS HEAVILY INFLUENCED BY GENERAL ECONOMIC CYCLES.



Footwear retailing is a cyclical industry that is heavily dependent upon the overall level of consumer spending. Purchases of footwear, apparel and related goods tend to be highly correlated with the cycles of the levels of disposable income of our customers. As a result, any substantial deterioration in general economic conditions, including sustained increases in gasoline prices, could have a material adverse effect on our operations and financial condition.

WE MAY BE UNABLE TO ADJUST TO CONSTANTLY CHANGING FASHION TRENDS.

Our success depends, in large part, upon our ability to gauge the evolving fashion tastes of our customers and to provide merchandise that satisfies those fashion tastes in a timely manner. The retailing industry fluctuates according to changing fashion tastes and seasons, and merchandise usually must be ordered well in advance of the season, frequently before consumer fashion tastes are evidenced by consumer purchases. In addition, in order to ensure sufficient quantities of footwear in the desired size, style and color for each season, we are required to maintain substantial levels of inventory, especially prior to peak selling seasons when we build up our inventory levels.

As a result, if we fail to properly gauge the fashion tastes of consumers or to respond to changes in fashion tastes in a timely manner, this failure could adversely affect retail and consumer acceptance of our merchandise and leave us with substantial unsold inventory. If that occurs, we may be forced to rely on markdowns or promotional sales to dispose of excess, slow-moving inventory, which may harm our business and financial results.

WE MUST PROVIDE CONSUMERS WITH SEASONALLY APPROPRIATE MERCHANDISE, MAKING OUR SALES HIGHLY DEPENDENT ON SEASONAL WEATHER CONDITIONS.

If the weather conditions for a particular period vary significantly from those typical for that period, such as an unusually cold spring or an unusually warm winter, consumer demand for seasonally appropriate merchandise that we have available in our footwear departments will be lower, and our net sales and margins will be adversely affected. Lower sales may leave us with excess inventory of our basic products and seasonally appropriate products, forcing us to sell both types of our products at significantly discounted prices and, thereby, adversely affecting our net sales and margins.

ITEM 1 B. UNRESOLVED STAFF COMMENTS

None.

ITEM 2. PROPERTIES

As of December 31, 2005, we operated licensed footwear departments in 2,280 stores. The licensed footwear departments are located in 49 states, Guam, Puerto Rico and the U.S. Virgin Islands. Of the licensed departments operated as of December 31, 2005, 1,421 were located in Kmart discount stores and 859 were in Rite Aid drugstores on the West Coast.

Kmart and other retail host stores provide us with store space to sell footwear in exchange for certain payments. The footwear departments we operate in Kmart stores range from 1,200 to 4,400 square feet.



Our corporate headquarters is located in 129,000 square feet of owned office space in Mahwah, New Jersey. We also lease approximately 20,000 square feet of space in Mahwah, New Jersey for use by our footwear testing lab and for storage. Our corporate tax department is located in 3,500 square feet of leased office space in Worcester, Massachusetts.

ITEM 3. LEGAL PROCEEDINGS

In addition to the matters described below, we are involved in other legal proceedings, lawsuits and claims incidental to the conduct of our business. Estimates of the probable costs for resolution of these claims are accrued to the extent that they can be reasonably estimated. These estimates are based on an analysis of potential outcomes, assuming a combination of litigation and settlement strategies. These estimates also take into account any claim relating to events that occurred prior to our bankruptcy filing, which were required to be reported in a proof of claim filed with the Bankruptcy Court. However, legal proceedings are subject to significant uncertainties, the outcomes are difficult to predict, and assumptions and strategies may change. Consequently, except as specified below, we are unable to ascertain the ultimate financial impact of any legal proceedings.

RESTATEMENT RELATED PROCEEDINGS

Prior to our November 13, 2002 announcement that management had discovered discrepancies in the reporting of our accounts payable balances, we notified the Staff of the SEC concerning the discovery of the accounting discrepancies. Following that notification, the Staff of the SEC began an enforcement proceeding captioned, In the Matter of Footstar, Inc., MNY-7122, including an investigation into the facts and circumstances giving rise to the discrepancies. On November 25, 2003 the SEC issued a formal order in that enforcement proceeding, authorizing an investigation and empowering certain members of the SEC Staff to take certain actions in the course of the investigation, including requiring testimony and the production of documents.

The enforcement investigation includes determining whether the Company and certain of its present or former directors, officers and employees may have engaged in violations of the federal securities laws in connection with: the purchase or sale of the securities of the Company; required filings with the SEC; maintenance of our books, records and accounts; implementation and maintenance of internal accounting controls; making of false or misleading statements or omissions in connection with required audits or examinations of our consolidated financial statements or the preparation and filing of documents or reports we are required to file with the SEC.

As we announced on February 10, 2006, the Company received a Wells notice from the SEC Staff in connection with the enforcement investigation. Under SEC procedures, a Wells notice indicates that the Staff has made a preliminary decision to recommend that the SEC authorize the Staff to bring a civil or administrative action against the recipient of the notice. The Wells notice that Footstar received states that the SEC Staff, as a result of its investigation, is considering recommending that the SEC bring a civil injunctive action against the Company for alleged violations of provisions of the Securities Exchange Act of 1934 relating to the maintenance of books, records and internal accounting controls, the establishment of disclosure controls and procedures and the periodic filing requirements of Sections 10(b), 13(a) and 13(b)(2) of the Exchange Act and in SEC Rules 10b-5, 12b-20, 13a-1 and 13a-13. A recipient of a Wells notice can respond to the SEC Staff before the Staff makes a formal recommendation regarding whether



the SEC should bring any action. Footstar has been, and intends to continue, cooperating fully with the SEC Staff in connection with this matter and is in discussions with the Staff regarding the possible resolution of this matter. We cannot predict the outcome of this proceeding.

OTHER LITIGATION MATTERS

On or about March 3, 2005, a first amended complaint was filed against us in the U.S. District Court for the District of Oregon, captioned Adidas America, Inc. and Adidas-Solomon AG v. Kmart Corporation and Footstar, Inc. The complaint seeks injunctive relief and unspecified monetary damages for trademark infringement, trademark dilution, unfair competition, deceptive trade practices and breach of contract arising out of our use of four stripes as a design element on footwear which Adidas alleges infringes on its registered three stripe trademark. While it is too early in litigation to predict the outcome of this litigation, we believe that we have meritorious defenses to the claims asserted by Adidas and have filed an answer denying the allegations.

NAFTA Traders, Inc. ("NAFTA"), a salvage company which previously did business with our former Footaction division, filed a proof of claim in our bankruptcy proceeding alleging that NAFTA is owed $3.8 million. We have objected to this proof of claim on the basis that we do not owe any amounts to NAFTA and we are currently involved in an adversary proceeding in the bankruptcy court regarding resolution of this proof of claim. While it is too early to predict the outcome of this proceeding, we intend to continue to object and vigorously defend the proof of claim submitted by NAFTA.

Mr. Robinson's employment as our Chairman, President and Chief Executive Officer was terminated on September 12, 2003. Mr. Robinson had an employment agreement with us and initiated arbitration proceedings against us for benefits under that agreement. In July 2004, the parties agreed to settle that matter for $5.1 million. In January 2006, the final installment which was due to Mr. Robinson under the settlement was paid.

A former employee of the company filed a proof of claim in our bankruptcy proceeding alleging he is owed $2,000,000 based on services rendered and agreements entered into during his employment. We have objected to and intend to vigorously defend this proof of claim.

We are involved in other various claims and legal actions arising in the ordinary course of business. We do not believe that any of them will have a material adverse effect on our financial position.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

There were no matters submitted to a vote of security holders during fiscal year

2005 as no annual meeting was held.

Pursuant to Section 2 of Footstar's Amended and Restated By-Laws, our next annual meeting of shareholders is scheduled to be held in May, 2007.

20

PART II

ITEM 5. MARKET PRICES FOR THE REGISTRANT'S COMMON EQUITY AND RELATED STOCKHOLDER MATTERS

Since the delisting of our common stock from the NYSE on December 30, 2003, our common stock has been traded on the over-the-counter bulletin board ("OTCBB") under the symbol "FTSTQ:PK" (see "Introductory Note"). Effective March 13, 2006 our symbol changed to FTAR:PK. Prices shown below reflect the intraday high and low price ranges for the common stock as reported on the OTCBB System. The over-the-counter market quotations reflect inter-dealer prices, without retail mark-up, mark-down or commission, and may not necessarily reflect actual transactions. As of December 31, 2005, the closing price of our common stock was $3.45 and there were 2,332 shareholders of record. Information concerning the market prices of our common stock is set forth below:

| | MARKET PRICE | |
|---|---|---|
| | HIGH | LOW |
| 2004 | | |
| First Quarter | $6.02 | $0.95 |
| Second Quarter | $6.95 | $2.15 |
| Third Quarter | $5.75 | $2.00 |
| Fourth Quarter | $5.05 | $2.05 |
| 2005 | | |
| First Quarter | $6.35 | $3.50 |
| Second Quarter | $5.20 | $3.75 |
| Third Quarter | $6.90 | $4.85 |
| Fourth Quarter | $6.00 | $3.00 |

We have not paid dividends on our common stock at any time since we became a public company and we currently have no plans to pay dividends during 2006.

21

ITEM 6. SELECTED FINANCIAL DATA

FIVE-YEAR HISTORICAL FINANCIAL SUMMARY

| (dollars in millions) | 2005 | 2004 | 2003 | 2002 | 2001 |
|---|---|---|---|---|---|

| | | | | | |
|---|---|---|---|---|---|
| STATEMENT OF OPERATIONS DATA | | | | | |
| Net sales | $715.4 | $800.2 | $962.4 | $1,321.3 | $1,443.2 |
| Cost of sales | 490.4 | 535.8 | 650.3 | 899.8 | 986.2 |
| GROSS PROFIT | 225.0 | 264.4 | 312.1 | 421.5 | 457.0 |
| Store operating, selling, general and administrative expenses | 183.1 | 236.1 | 250.7 | 308.8 | 322.2 |
| Depreciation and amortization | 7.7 | 21.7 | 19.0 | 19.9 | 18.9 |
| Restructuring, asset impairment and other charges, net | -- | -- | 2.5 | 14.0 | 3.3 |
| Loss on Kmart Settlement (1) | -- | 6.3 | -- | -- | -- |
| Bad debt expense - Ames Department Stores | -- | -- | -- | 9.2 | -- |
| Other income | -- | (9.2) | (5.4) | -- | -- |
| Interest expense | 4.6 | 11.0 | 23.4 | 9.5 | 3.8 |
| Interest income | -- | -- | (1.1) | (1.1) | (1.6) |
| INCOME (LOSS) BEFORE REORGANIZATION ITEMS, INCOME TAXES, MINORITY INTERESTS, DISCONTINUED OPERATIONS AND CUMULATIVE EFFECT OF A CHANGE IN ACCOUNTING PRINCIPLE | 29.6 | (1.5) | 23.0 | 61.2 | 110.4 |
| Reorganization items(2) | (14.6) | (37.1) | -- | -- | -- |
| INCOME (LOSS) BEFORE INCOME TAXES, MINORITY INTERESTS, DISCONTINUED OPERATIONS AND CUMULATIVE EFFECT OF A CHANGE IN ACCOUNTING PRINCIPLE | 15.0 | (38.6) | 23.0 | 61.2 | 110.4 |
| (Provision) benefit for income taxes (3) | (4.2) | 2.9 | (10.0) | (70.9) | (28.8) |
| INCOME (LOSS) BEFORE MINORITY INTERESTS AND DISCONTINUED OPERATIONS | 10.8 | (35.7) | 13.0 | (9.7) | 81.6 |
| Minority interests in net loss (income) | -- | 11.0 | (17.3) | (37.1) | (44.8) |
| INCOME (LOSS) FROM CONTINUING OPERATIONS | 10.8 | (24.7) | (4.3) | (46.8) | 36.8 |
| Income (loss) from discontinued operations, net of tax (4) | 4.7 | (66.7) | (50.1) | (32.4) | (67.4) |
| Gain from disposal of Athletic Segment, net of tax | 8.9 | 21.4 | -- | -- | -- |
| INCOME (LOSS) FROM OPERATIONS BEFORE CUMULATIVE EFFECT OF A CHANGE IN ACCOUNTING PRINCIPLE | 24.4 | (70.0) | (54.4) | (79.2) | (30.6) |
| Cumulative effect of a change in accounting principle (5) | -- | -- | -- | (24.3) | -- |
| NET INCOME (LOSS) | $ 24.4 | $(70.0) | $(54.4) | $ (103.5) | $ (30.6) |
| BASIC INCOME (LOSS) PER SHARE FROM CONTINUING OPERATIONS | $ 0.53 | $(1.20) | $(0.21) | $ (2.29) | $ 1.82 |
| DILUTED INCOME (LOSS) PER SHARE FROM CONTINUING OPERATIONS | $ 0.53 | $(1.20) | $(0.21) | $ (2.29) | $ 1.78 |

22

ITEM 6. SELECTED FINANCIAL DATA, CONT.

FIVE-YEAR HISTORICAL FINANCIAL SUMMARY

| (dollars in millions) | 2005 | 2004 | 2003 | 2002 | 2001 |
|---|---|---|---|---|---|
| BALANCE SHEET DATA | | | | | |
| Current assets: | | | | | |
| Cash and cash equivalents | $196.1 | $189.6 | $ 1.1 | $ 13.4 | $ 12.5 |
| Inventories | 89.2 | 98.9 | 179.7 | 360.9 | 389.5 |
| Other | 30.3 | 50.5 | 39.7 | 87.5 | 123.7 |
| Assets related to discontinued operations | 0.1 | 6.2 | 284.5 | -- | -- |
| Total current assets | 315.7 | 345.2 | 505.0 | 461.8 | 525.7 |
| Property and equipment, net | 28.9 | 35.4 | 147.2 | 266.7 | 256.2 |
| Other assets | 12.1 | 13.5 | 12.5 | 46.8 | 116.9 |
| Total assets | 356.7 | 394.1 | 664.7 | 775.3 | 898.8 |
| Notes payable | -- | -- | 198.0 | 146.8 | 146.9 |
| Amount due under Kmart Settlement (1) | -- | 45.0 | -- | -- | -- |
| Other current liabilities | 107.8 | 98.0 | 133.2 | 319.0 | 322.4 |
| Liabilities related to discontinued operations | 7.4 | 3.5 | 110.5 | -- | -- |
| Liabilities subject to compromise | 125.5 | 152.3 | -- | -- | -- |
| Total current liabilities | 240.7 | 298.8 | 441.7 | 465.8 | 469.3 |
| Other long term liabilities | 35.0 | 38.5 | 58.9 | 72.8 | 81.5 |
| Amount due under Kmart Settlement (1) | 5.5 | 5.5 | -- | -- | -- |
| Minority interests in subsidiaries (1) | -- | -- | 42.2 | 61.9 | 70.1 |
| Total liabilities | 281.2 | 342.8 | 542.8 | 600.5 | 620.9 |
| Shareholders' equity | 75.5 | 51.3 | 121.9 | 174.8 | 277.9 |
| Total liabilities and shareholders equity | $356.7 | $394.1 | $664.7 | $775.3 | $898.8 |

(1) Represents additional charge incurred on Kmart Settlement and the elimination of the minority interests as part of the cure payment.

(2) Represents income and expenses associated with our bankruptcy. See Note 19 "Reorganization Items" of Notes to Consolidated Financial Statements.

(3) As a result of our historical losses and possible liquidation of our business in December, 2008, for accounting purposes we cannot rely on anticipated future profits to utilize certain of our deferred tax assets. As a result, we could not conclude that it is more likely than not that the deferred tax assets will be realized and have recorded in fiscal 2005 an additional non-cash valuation allowance of $1.9 million, $21.4 million in fiscal 2004, $24.7 million in fiscal 2003, $70.2 million in fiscal 2002.

(4) Loss from discontinued operations includes the losses from the disposition of our Athletic Segment in fiscal 2003 and the losses from the disposition of our Shoe Zone stores and the footwear departments of Gordmans and Federated, all part of our Meldisco business, in fiscal 2004. Shoe Zone commenced operations in fiscal 2001 and Gordmans and Federated commenced operations in fiscal 2002. The income (loss) from discontinued operations includes the following (in millions):

| | 2005 | 2004 | 2003 | 2002 | 2001 |
|---|---|---|---|---|---|
| Athletic Segment | $ 5.1 | $(38.9) | $(39.9) | $(30.8) | $(66.7) |
| Meldisco Businesses | (0.4) | (27.8) | (10.2) | (1.6) | (0.7) |
| Total | $ 4.7 | $(66.7) | $(50.1) | $(32.4) | $(67.4) |

See Note 3 "Discontinued Operations" of Notes to Consolidated Financial Statements.

(5) Represents write-off of goodwill recorded in connection with the acquisition of J. Baker assets upon the adoption of Statement of Financial Accounting Standards No. 142, "Goodwill and Other Intangible Assets". Amortization of goodwill in fiscal year 2001 was $2.3 million.



ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

FORWARD-LOOKING STATEMENTS

This report contains forward-looking statements made in reliance upon the safe harbor provisions 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 may be identified by the use of words such as "anticipate," "estimates," "should," "expect," "guidance," "project," "intend," "plan," "believe" and other words and terms of similar meaning, in connection with any discussion of our financial statements, business, results of operations, liquidity and future operating or financial performance. Factors that could affect our forward-looking statements include, among other things:

- The Company's ability to operate within the provisions of the Amended Master Agreement with Kmart through December 2008;

- the Company's ability to obtain and maintain normal terms with vendors and service providers;

- negative reactions from the Company's stockholders, creditors, licensors or vendors to the results of the investigation and restatement or the delay in providing financial information caused by the investigation;

- the Company's ability to successfully implement internal controls and procedures that ensure timely, effective and accurate financial reporting;

- the Company's ability to reduce overhead costs commensurate with any decline in sales;

- adverse results on the Company's business relating to increased review and scrutiny by regulatory authorities, media and others of financial reporting issues and practices or otherwise;

- the Company's compliance with the requirements of Sarbanes-Oxley;

- the ability to maintain contracts that are critical to the Company's operations;

- any adverse developments in existing commercial disputes or legal proceedings; and

- intense competition in the markets in which the Company competes.

Additionally, due to material uncertainties, it is not possible to predict the outcome of the ongoing SEC investigation, the Company's discussions with the SEC in response to the Wells notice it has received or the effect of the proceeding on the Company's businesses and the interests of various creditors and security holders. Also, the Company's Meldisco business is the Company's only continuing business and substantially all of the Company's continuing net sales and profits result from Meldisco's business in Kmart stores. The Kmart Settlement will result in the liquidation of the Company's Kmart business no later than the end of December 2008. If the Company fails to develop viable business alternatives to offset this business the Company will almost certainly be forced to liquidate our business when the Kmart relationship ends.

Because the information in this Annual Report on Form 10-K is based solely on data currently available, it is subject to change and should not be viewed as providing any assurance regarding our future performance. Actual results and performance may differ from our current projections, estimates and expectations and the differences may be material, individually or in the aggregate, to our business, financial condition, results of operations, liquidity or prospects. Additionally, we assume no obligation to update any of our forward looking statements based on changes in



assumptions, changes in results or other events subsequent to the date of this Annual Report on Form 10-K.

OVERVIEW

Management confronts major challenges in the emergence of the Company from the bankruptcy process and managing the business after the Kmart Settlement. Meldisco is our only continuing business and substantially all of our continuing net sales and profits result from Meldisco's business in Kmart stores. If we fail to develop viable business alternatives to offset the termination of the Kmart relationship, we will be forced to liquidate our business when the Kmart relationship ends which pursuant to the Kmart Settlement will be no later than December 31, 2008.

We decided to seek bankruptcy protection after management determined it was unable to obtain necessary liquidity from our lending syndicate or additional debt or equity financing. We suffered a decline in our liquidity primarily resulting from unprofitable results in our Athletic Segment, a reduction in trade credit by certain Athletic vendors, unprofitable results of operations from recent acquisitions and the effect of the Kmart bankruptcy. Other factors included intense competition in the discount retailing industry, unsuccessful sales and marketing initiatives and capital market volatility. As a debtor-in-possession, we were authorized to continue to operate as an ongoing business but could not engage in transactions outside the ordinary course of business without the approval of the Court.

On February 7, 2006, we successfully emerged from bankruptcy. Our creditors have been or will be paid in full, plus interest where applicable.

Although the process for the disposition of our Athletic Segment commenced in 2003, as part of our initial reorganization plans after filing for Chapter 11 we closed 166 underperforming stores within the Athletic Segment, comprised of all 88 Just For Feet stores, 75 Footaction stores and 3 Uprise stores.

After filing for bankruptcy protection, we received indications of significant interest from potential acquirers of the remaining Footaction retail stores comprising the Athletic Segment. We determined that a sale of these stores was the best way to maximize the value of that business. This decision was driven in part by the absence of a commitment from Nike USA, Inc., the largest supplier of the Athletic Segment, to supply the Athletic Segment for more than a limited period of time in accordance with past business practices. Accordingly, we decided to establish an orderly sale process for the remaining Footaction retail stores.

On April 21, 2004, we received Court approval to sell to Foot Locker 349 of the remaining Footaction stores (including all lease rights and inventory at these stores), along with the remaining inventory from the four remaining Footaction stores. Effective May 2, 2004, these assets were sold to Foot Locker for $225.0 million in cash, subject to adjustment. Approximately $13.0 million of the sales proceeds were placed in escrow with respect to 14 store locations that were leased on a month-to-month basis. If Foot Locker entered into a new lease for any of these store locations, the escrow amount related to that location was paid to us. The escrow amount related to any location for which Foot Locker did not enter into a new lease was paid to Foot Locker, thereby reducing the purchase price by such amount. As of December 31, 2005, no amounts were left in escrow as we



have been paid approximately $10 million from the escrow account and Foot Locker has been paid approximately $3 million. The Athletic Segment has been accounted for as discontinued operations in accordance with FASB Statement No. 144, "Accounting for the Impairment or Disposal of Long Lived Assets".

In the initial stages of our bankruptcy, we sought to streamline our Meldisco business by selling or exiting selected stores. As a result of our continued analysis of our businesses, we sold or liquidated all of our Shoe Zone stores. We also exited the footwear departments in 44 Gordmans stores and 87 Federated stores. Our financial statements reflect these Meldisco businesses as discontinued operations for all periods presented.

We have sold other assets, including our distribution centers in Mira Loma in July 2004 and Gaffney in September 2004. The purchaser of Mira Loma, Thrifty, has leased Mira Loma to FMI which has agreed to provide us with warehousing and distribution services through June 30, 2012 under the FMI Agreement. (See Introductory Note)

We previously operated a Shared Services Center in Dallas, Texas. The Shared Services Center administered accounts payable, loss prevention, payroll, benefits, store accounting and inventory control for the entire Company and also contained our information system's data center. In connection with our decision to sell the Athletic Segment and streamline our Meldisco business, we determined that, from both an internal control and cost perspective, the Shared Services Center was no longer a viable concept given our significantly reduced operating structure. Accordingly, during 2004 we transitioned all Shared Services Center functions to our headquarters in Mahwah, New Jersey.

KMART SETTLEMENT

Our business relationship between Meldisco and Kmart is extremely important to us. The licensed footwear departments in Kmart now provide substantially all of our sales and profits.

On July 2, 2005, the Company and Kmart entered into the Kmart Settlement and thereafter the Amended Master Agreement which dictates the structure of our relationship with Kmart. Under the Master Agreement before amendment, the Company and Kmart had formed in excess of 1,500 Shoemart Corporations in which we had a 51% ownership interest and Kmart had a 49% ownership interest, except for 23 Shoemart Corporations which were wholly-owned by us.

The Kmart Settlement provides that Kmart's equity interests in the Shoemart Corporations were extinguished effective January 2, 2005, and accordingly, Kmart does not share in the profits or losses of those entities for fiscal 2005 or subsequent years. The Kmart Settlement fixed the cure amount with respect to our assumption of the Amended Master Agreement at $45.0 million, which was paid on August 26, 2005. Effective January 2, 2005, we are required to pay Kmart 14.625% of the gross sales of the footwear departments, in lieu of the fees and dividends required under the Master Agreement. We made payments to Kmart of $15.5 million based on the revised percent of gross sales due under the Amended Master Agreement for the period beginning January 2, 2005 through August 27, 2005. Effective August 25, 2005, we are required to pay Kmart a miscellaneous expense fee of $23,500 per open store per year. The Amended Master Agreement expires at the end of 2008 at which time Kmart is obligated to purchase our Shoemart inventory (but not our brands)



at book value, as defined.

We and Kmart each have the right to terminate the Amended Master Agreement early if the gross sales of the footwear departments are less than $550.0 million in any year, provided that this gross sales minimum will be reduced by $0.4 million for each store that is closed or converted after August 25, 2005. Twenty-two stores have been closed or converted from August 25, 2005 through February 25, 2006. The Company also has the unilateral right to terminate the Amended Master Agreement if either (i) the number of Kmart stores is less than 900 or (ii) the gross sales of the footwear departments in any four consecutive quarters are less than $450.0 million. In the event of any such termination, Kmart is obligated to purchase all of the inventory (including inventory that is on order but excluding inventory that is damaged, unsaleable, and seasonal inventory, as defined) for an amount equal to the book value of the inventory, as defined.

Pursuant the Amended Master Agreement Kmart must pay us the stipulated loss value (as set forth below), if it terminates our licenses to operate shoe departments in up to 550 Kmart stores during the remaining term of the Amended Master Agreement by disposing of, closing or converting those stores. The number of stores it can dispose of, close or convert per year is capped at 85 in 2005, 150 in 2006 and 160 in each of 2007 and 2008, with any unused cap carried over to the following year. In 2005, 61 stores have been disposed of, closed or converted. In 2006, through February 25, 2006, 18 stores were disposed of, closed or converted and one additional store has been identified to be disposed of, closed or converted. For each store that is disposed of, closed or converted, Kmart must purchase all of our in-store inventory (excluding inventory that is damaged, unsaleable and seasonal inventory, as defined) at book value, as defined. In addition, to the extent Kmart exceeds the annual cap or the 550 aggregate limit, Kmart must pay us a non-refundable stipulated loss value per store equal to $100,000 for terminations occurring in 2005, $60,000 for terminations occurring in 2006, $40,000 for terminations occurring in 2007 and $20,000 for terminations occurring in 2008. If the entire Amended Master Agreement is terminated in accordance with its terms, Kmart is not obligated to make any stipulated loss value payments for such stores.

The Amended Master Agreement sets forth the parties' obligations with respect to staffing and advertising. Specifically, we must spend at least 10% of gross sales in the footwear departments on staffing costs, as defined, for the stores and we must schedule the staffing in each store at a minimum of 40 hours per week. In addition, Kmart is required to allocate at least 52 weekend newspaper advertising insert pages per year to our products.

Kmart has a capital claim against us in the amount of $11,000 for each store that is an existing store, as defined, on August 25, 2005, which is generally payable by us to Kmart at the time a store is disposed of, closed or converted to another retail format in accordance with the 550 store limitation described above. However, upon the expiration of the Amended Master Agreement or upon early termination of that agreement other than as a result of our breach, all capital claims not yet due and payable will be waived for any remaining stores. If the Amended Master Agreement is terminated as a result of our breach, capital claims for remaining stores will not be waived and will become immediately due and payable.



BUSINESS RELATIONSHIP WITH WAL-MART STORES

Although, as of December 31, 2005, we were supplying Thom McAn family footwear to 1,500 Wal-Mart stores in the United States and 13 stores in Puerto Rico, beginning in January 2006, Wal-Mart is no longer purchasing Thom McAn product for any of its stores in the United States; however, it will continue to buy Thom McAn footwear for Wal-Mart stores in Puerto Rico and will continue to source footwear from us for Wal-Mart stores under Wal-Mart's proprietary brands. In 2005, we sold approximately $27 million of Thom McAn products to Wal-Mart stores.

PRODUCT SOURCING

Product sourcing in the family footwear business is driven by relationships with foreign manufacturers. Approximately 99% of our products are manufactured in China. A portion of our footwear product is comprised of petrochemical products which have risen in price dramatically over the past year. It is possible that these raw material price increases will be passed on to us. Furthermore, higher product prices could result from the recent decision by the Chinese government to revalue their currency. Although we pay for finished goods in U.S. dollars, it is possible that higher labor costs due primarily to the currency revaluation could be passed on to us through higher product costs. As a result of these issues, the Company is beginning to shift manufacturing production to lower cost regions of China. While management is exercising considerable diligence in selecting new factories, it is possible that the Company could experience lower product quality and/or late shipments in these new factories which could unfavorably impact the Company's financial results.

RESULTS OF OPERATIONS

The following discussion and analysis should be read in conjunction with and is qualified in its entirety by our Consolidated Financial Statements and the Notes thereto that appear elsewhere in this report.

FISCAL 2005 VERSUS FISCAL 2004

Meldisco represents substantially all of our operations. Corporate (income) expenses (excluding other income, interest income and interest expense), net of royalties and commissions, were approximately $(10.0) million in fiscal 2005 and $22.1 million in fiscal 2004.

2005 VERSUS 2004 - CORPORATE

Royalties and commissions, which were approximately $12.9 million in fiscal 2005 and $14.4 million in fiscal 2004, consisted of the following:

- The royalties Footstar charges Meldisco on the corporate trademarks which we own and Meldisco utilizes on its products.

- Commissions on goods sourced to third parties.

- Fees associated with third party services, such as the testing lab.

Corporate expenses (excluding other income, interest income and interest expense) were



approximately $2.8 million in fiscal 2005 and $36.5 million in fiscal 2004 and consisted of the following:

- General expenses not allocated.

- Depreciation on assets located at our former headquarters in West Nyack, New York.

- Amortization of Company-owned trademarks.

MELDISCO

| (dollars in millions) | 2005 | 2004 |
|---|---|---|
| Net Sales | $715.4 | $800.2 |
| Gross Profit | 212.1 | 250.1 |
| SG&A Expenses | 180.6 | 204.8 |
| Depreciation/Amortization | 7.4 | 16.6 |
| Loss on Kmart Settlement | -- | 6.3 |
| Operating Profit | $ 24.1 | $ 22.4 |

Meldisco operates through our Shoemart subsidiaries primarily in the discount footwear market through its operation of 1,421 Kmart licensed footwear departments as of December 31, 2005, as well as other licensed footwear and wholesale businesses. Meldisco competes primarily with other discount department stores, discount footwear retailers, as well as off-price and value retailers. As a result, Meldisco is heavily dependent on the ability of its host retailers to attract traffic into their stores through their promotional and advertising programs. Our Shoemart Subsidiaries accounted for 93%, 94% and 94% of Meldisco's sales in 2005, 2004 and 2003, respectively.

As part of the Kmart Settlement, effective January 2, 2005 the fees paid to Kmart were revised and Kmart's equity interest in the Shoemart Corporations were eliminated. The effect of this change in payments made to Kmart in 2005 compared with 2004 is as follows:

| | |
|---|---|
| Increase in cost of sales | $32.8 million |
| Decrease in SG&A expenses | $17.3 million |

The increase in cost of sales was due to the 6.025% increase in the percentage of sales remitted to Kmart for license fees as a result of the Kmart Settlement ($45.3 million) offset by the reduction in sales ($12.5 million). The decrease in SG&A expenses was due to the elimination of the 2.3% of sales remitted to Kmart for advertising as a result of the Kmart Settlement ($15.3 million) in addition to the decrease in sales ($2.0 million).

Effective January 2, 2005, Kmart's equity interests in the Shoemart Corporations were eliminated. The minority interests share in 2004 losses was $11.0 million.



NET SALES

Net sales decreased $84.8 million, or 10.6%, in 2005, to $715.4 million compared with $800.2 million in 2004. A 7.5% comparable store sales decline in our Kmart stores during 2005 accounted for $53 million of this decrease and the reduction in open Kmart stores accounted for the remaining $32 million. There were 1,421 Kmart stores opened at the end of fiscal 2005 versus 1,482 at the end of fiscal 2004. Sales in our Rite Aid licensed footwear operation and wholesale operations were approximately the same in fiscal 2005 as they were in fiscal 2004.

As of the date of the filing of this 2005 Form 10-K, Kmart has not published comparable store data for fiscal 2005.

GROSS PROFIT

Gross profit decreased $38.0 million, or 15.2%, to $212.1 million in 2005 compared with $250.1 million in 2004. This decrease is primarily due to the aforementioned $32.8 million increase in the cost of sales as a result of the Kmart agreement. The overall gross margin rate declined to 29.7% in 2005 from 31.3% in 2004 primarily due to the Kmart settlement. Excluding the Kmart Settlement, the gross margin rate for 2005 would have been 34.2%. The higher gross margin rates in 2005 were due to a reduction in clearance sales in 2005 versus 2004 when the Company moved to aggressively sell aged inventory product at discounted prices in 2004. Such clearance sales were not necessary in 2005 as inventory levels contained a significantly lower level of aged merchandise.

SG&A EXPENSES

SG&A expenses decreased $24.2 million, or 11.8%, to $180.6 million in 2005 compared with $204.8 million in 2004. Approximately $17.3 million of this decrease was due to the elimination of the 2.3% advertising fee as a result of the Kmart settlement and reduction in sales and the remainder was due to reduction in store staffing and supervisory costs.

DEPRECIATION/AMORTIZATION

Depreciation/amortization decreased $9.2 million, or 55.4%, to $7.4 million in 2005 compared with $16.6 million in 2004 due to the significant disposal of assets during 2004.

KMART SETTLEMENT CHARGE

In connection with the Kmart Settlement, we recorded a charge of $6.3 million in fiscal 2004. This charge represents the amount of the $45.0 million cure payment to Kmart in excess of previously recorded amounts due Kmart, including minority interests.

OPERATING PROFIT

Operating profit increased $1.7 million, or 7.6%, to $24.1 million in 2005 compared with $22.4 million in 2004 due to the reasons noted above.

30

REORGANIZATION ITEMS

Reorganization items, which consist of income and expenses that are related to our bankruptcy were comprised of the following for 2005 and 2004 (in millions):

| | 2005 | 2004 |
|---|---|---|
| Store and distribution center closing and related asset impairment costs | $ 0.1 | $24.5 |
| Professional fees | 18.5 | 7.9 |
| Trustee fees | 3.1 | 5.8 |
| Gain on disposition of bankruptcy claims | (1.5) | -- |
| Interest income | (5.6) | (1.1) |
| Total | $14.6 | $37.1 |

The disposition of bankruptcy claims resulted in an increase of $1.5 million in income from continuing operations.

SOP 90-7 requires that interest income earned on cash accumulated during bankruptcy proceedings be included as a reorganization item. During fiscal 2005 and 2004, interest income of $5.6 million and $1.1 million, respectively, was earned on cash that would otherwise have been used to pay such pre-petition liabilities.

FISCAL 2004 VERSUS FISCAL 2003

Meldisco represents substantially all of our operations. Corporate expenses (excluding other income, interest income and interest expense), net of royalties and commissions, were approximately $22.1 million in fiscal 2004 and $19.1 million in fiscal 2003.

2004 VERSUS 2003 - CORPORATE

Royalties and commissions, which were approximately $14.4 million in fiscal 2004 and $19.5 million in fiscal 2003, consisted of the following:

- The royalties Footstar charges Meldisco on the corporate trademarks which we own and Meldisco utilizes on its products.
- Commissions on goods sourced to third parties.
- Fees associated with third party services, such as the testing lab.

Corporate expenses (excluding other income, interest income and interest expense), which were approximately $36.5 million in fiscal 2004 and $38.6 million in fiscal 2003, consisted of the following:

- General expenses not allocated.
- Depreciation on assets located at our former headquarters in West Nyack, New York.
- Amortization of Company-owned trademarks.



MELDISCO

| (dollars in millions) | 2004 | 2003 |
|---|---|---|
| Net Sales | $800.2 | $962.4 |
| Gross Profit | 250.1 | 292.7 |
| SG&A Expenses | 204.8 | 217.4 |
| Depreciation/Amortization | 16.6 | 14.0 |
| Loss on Kmart Settlement | 6.3 | -- |
| Restructuring, Asset Impairment and Other Charge | -- | 2.3 |
| Operating (Loss) Profit | $ 22.4 | $ 59.0 |

Meldisco operates through our Shoemart subsidiaries primarily in the discount footwear market through its operation of 1,482 Kmart licensed footwear departments as of January 1, 2005, as well as other licensed footwear and retail businesses. Meldisco competes primarily with other discount department stores, discount footwear retailers, as well as off-price and value retailers. As a result, Meldisco is heavily dependent on the ability of its host retailers to attract traffic into their stores through their promotional and advertising programs. Our Shoemart Subsidiaries accounted for 94%, 94% and 87% of Meldisco's sales in 2004, 2003 and 2002, respectively.

NET SALES

Net sales decreased $162.2 million, or 16.9%, in 2004, to $800.2 million compared with $962.4 million in 2003. This sales decrease was primarily due to

Shoemart comparable store sales declines ($80 million), a reduction in open Kmart stores ($58 million), one fewer week of sales results in the fiscal calendar year ($12 million) and lower sales to Wal-Mart ($9 million) as 2003 sales to Wal-Mart were higher due to initial shipment quantities.

Shoemart sales are largely dependent on the number of open Kmart stores and Kmart comparable store sales.

| | Open Kmart Stores | Kmart Store Comps (A) | Shoemart Store Comps |
|---|---|---|---|
| Full Year 2004 | 1,482 | (11.0)% | (9.8)% |
| Full Year 2003 | 1,511 | (8.1)% | (7.8)% |

(A) for periods ended January 26, 2005 and January 28, 2004, respectively.

GROSS PROFIT

Gross profit decreased $42.6 million, or 14.6%, to $250.1 million in 2004 compared with $292.7 million in 2003. This decrease was primarily due to the 16.9% decrease in sales. The increase in the overall gross margin rates to 31.3% in 2004 from 30.4% in 2003 was due to increasing the percentage of internally sourced purchases rather than using outside vendors and some price increases.

32

SG&A EXPENSES

SG&A expenses decreased $12.6 million, or 5.8%, to $204.8 million in 2004 compared with $217.4 million in 2003. This decrease was primarily attributable to a reduction in expenses to offset a portion of the sales declines in the Shoemart operation and the reduction of open Kmart stores. The overall SG&A rate as a percentage of sales increased to 25.6% in 2004 compared with 22.6% in 2003 as Shoemart was unable to reduce store selling, fixture and administrative costs commensurate with the overall sales decline due to a certain portion of these costs being fixed in nature.

DEPRECIATION/AMORTIZATION

Depreciation/amortization increased $2.6 million, or 18.6%, to $16.6 million in 2004 compared with $14.0 million in 2003. This increase is attributable to the acceleration of depreciation of our shared services center assets to coincide with the closing of the center in December 2004. This acceleration exceeded the reduction in depreciation associated with the disposition of Mira Loma and Gaffney distribution centers during 2004.

KMART SETTLEMENT CHARGE

In connection with the Kmart Settlement, we recorded a charge of $6.3 million in the fourth quarter of fiscal 2004. This charge represents the amount in excess of previously recorded amounts due Kmart, including minority interests.

RESTRUCTURING, ASSET IMPAIRMENT AND OTHER CHARGE

In 2003, we incurred approximately $18.2 million of restructuring and asset impairments relating to the closing of 321 Kmart stores. These charges included approximately $15.7 million for inventory write-downs which are included as a component of cost of sales. The other charges, which amounted to $2.5 million, included $1.9 million for severance costs and $0.6 million for asset impairments. These other charges were offset by $0.2 million of reserve reversals in the 2003 fourth quarter.

OPERATING PROFIT

Operating profit decreased $36.6 million, or 62.0%, to $22.4 million in 2004 compared with $59.0 million in 2003 due to the effect of the 16.9% decline in sales and the Kmart Settlement in 2004, which was offset by restructuring charges incurred in 2003.

LIQUIDITY AND CAPITAL RESOURCES

Our principal sources of liquidity used in funding short-term operations are our operating cash flows and our Exit Facility (previously our Amended DIP and Exit Facility). The Exit Facility is structured to support general corporate borrowing requirements. We also continue to benefit from improved payment terms obtained from our vendors and factories overseas beginning in December, 2004.



In accordance with the Amended Master Agreement, on August 26, 2005, we made the $45.0 million cure payment to Kmart. On August 29, 2005, we made an estimated payment to Kmart of $14.0 million based on the revised percent of gross sales due under the Amended Master Agreement for the period beginning January 2, 2005 through August 27, 2005. On September 6, 2005, we paid an additional $1.5 million to Kmart for the final payment of the amount due.

Upon emergence from Chapter 11 on February 7, 2006, we made payments to creditors totaling $105.1 million, plus interest where applicable. These payments exclude claims for approximately $14.2 million which will be paid upon final resolution. Creditors were and will be paid in full, plus interest. Such distributions were paid from existing cash balances and did not require us to incur borrowings under our Exit Facility.

Factors that could affect our liquidity include, among other things, maintaining the support of our key vendors and lenders, retaining key personnel, the impact of subsequent financial results, many of which are beyond our control. Also, the timing of the wind-down and ultimate liquidation of our Kmart business is outside our control (within certain parameters described under the "Kmart Settlement" above). If the Company does not develop viable business alternatives to offset the termination of its Kmart business by no later than the end of 2008, it is expected that the Company will liquidate its business when the Kmart relationship ends. Although we cannot reasonably assess the impact of these uncertainties on our long-term liquidity needs, we believe that our current cash, together with cash generated from operations and cash available under our Exit Facility, will be sufficient to fund our expected operating expenses, capital expenditures and working capital needs during the next 12 months.

THE CREDIT FACILITIES

Effective March 4, 2004, we entered into a two-year, $300.0 million senior-secured Debtor-in-Possession Credit Agreement (the "DIP Credit Agreement") with a syndicate of lenders co-led by Bank of America, N.A. (formerly Fleet National Bank) and GECC Capital Markets Group, Inc. Effective August 2, 2004, the DIP Credit Agreement was amended and restated (the "DIP and

Exit Facility"), which, among other things, provided for up to $160.0 million of post-emergence financing (containing a $75.0 million sub-limit for letters of credit) and reduced the amount of lending commitments available while operating as debtor-in-possession to $100.0 million (including a sub-limit for letters of credit).

Effective July 1, 2005, we amended certain terms and conditions of the DIP and Exit Facility (the "Amended DIP and Exit Facility") to, among other things, allow for the consummation of our Amended Plan and reduce the amount of revolving commitments available upon emergence from $160.0 million to $100.0 million. Accordingly, the letter of credit sub-limit was reduced from $75.0 million to $40.0 million. This amendment also included a change in the maturity date for the debtor-in-possession portion of the facility from the earlier of (a)(i) March 4, 2006 or (ii) 15 days following confirmation of the Amended Plan to the earlier of (b)(i) October 31, 2006 or (ii) emergence from Chapter 11. The maturity date of the exit portion of the Amended DIP and Exit Facility was modified to be, the earlier of 36 months after our emergence from Chapter 11 or March 4, 2009.

Effective January 6, 2006, we further amended our Amended DIP and Exit Facility. This amendment modified only certain terms and conditions related to the exit portion of the facility (the



"Exit Facility"). Debtor-in-possession financing continued to be provided under the Amended DIP and Exit Facility prior to the emergence date. The Exit Facility became effective upon consummation of the Plan on February 7, 2006 as all conditions to be satisfied were met. The Exit Facility has a maturity date of the earlier of (a) November 30, 2008 and (b) thirty days prior to the termination of the Amended and Restated Kmart Agreement. Prior to the amendment, the maturity date of the exit portion of the facility was the earlier of (a) thirty-six months after the Company's emergence from chapter 11 and (b) March 4, 2009. In addition, the Exit Facility reflects, among other things, temporary changes in certain advance rates and availability requirements which provide for incremental liquidity during the first twelve months following our emergence from chapter 11.

We may borrow up to $100.0 million through the Exit Facility, subject to a sufficient borrowing base (based upon eligible inventory and accounts receivable), and other terms of the facility. Revolving loans under the Exit Facility bear interest, at our option, either at the prime rate plus a variable margin of 0.0% to 0.5% or the London-Inter-Bank Offered Rate ("LIBOR") plus a variable margin of 1.75% to 2.50%. The variable margin is based upon quarterly excess availability levels specified in the Exit Facility. A quarterly fee of 0.3% per annum is payable to the lenders on the unutilized balance.

The Exit Facility is secured by substantially all of the assets of the Company and contains various affirmative and negative covenants, representations, warranties and events of default to which we are subject, including certain financial covenants and restrictions such as limitations on additional indebtedness, other liens, dividends, stock repurchases and capital expenditures. The Company is required to maintain minimum excess availability equal to at least 5% of the borrowing base for the first twelve months following the emergence date and 10% thereafter. In addition, if minimum excess availability falls below 20% of the borrowing base, we will be subject to a fixed charge coverage covenant. The Company is currently in compliance with all financial covenants.

The Exit Facility also includes representations and warranties, that, on an ongoing basis, there are no material adverse events affecting our business, operations, property, assets, or condition and that the Amended Master Agreement is in full force and effect and not in default. A failure by us to satisfy any of the covenants, representations or warranties would result in default or other adverse impact under the Exit Facility.

As of December 31, 2005, the Company had no loans outstanding and approximately $49.1 million of excess availability, as defined, under the Amended DIP and Exit Facility, net of outstanding letters of credit totaling $14.7 million (the majority of which were standby letters of credit) and minimum excess availability requirements.

CONTRACTUAL OBLIGATIONS

The following is a summary of our significant contractual obligations as of December 31, 2005 (in millions):



| | Payments Due By Period | | | | |
|---|---|---|---|---|---|
| | Total | Less than 1 Year | 1-3 Years | 4-5 Years | After 5 Years |
| Mortgage payable | $5.3 | $1.0 | $2.3 | $2.0 | -- |
| Operating leases | 3.4 | 1.5 | 1.6 | 0.3 | -- |
| Total | $8.7 | $2.5 | $3.9 | $2.3 | -- |

The above table does not include the Kmart license fees, as defined in the Amended Master Agreement, as such fees are based on sales. The Amended Master Agreement, however, requires the payment of a miscellaneous expense fee equal to $23,500 per open store per year.

In addition, pursuant to the FMI Agreement, we are obligated to pay to FMI a minimum of $15.1 million in 2006. (See Introductory Note)

CRITICAL ACCOUNTING ESTIMATES

Management's Discussion and Analysis of Financial Condition and Results of Operations is based in part upon the Consolidated Financial Statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America.

The preparation of these consolidated financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, expenses and related disclosure of contingent liabilities. On an ongoing basis, we evaluate these estimates, including those related to the valuation of inventory, deferred tax assets and the impairment of long-lived assets. We base these estimates on historical experience and on various other assumptions that are believed to be reasonable, the results of which form the bases for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may ultimately differ from these estimates. Our management has discussed with the Audit Committee of its

Board of Directors the development, selection and disclosure of our critical accounting estimates and the application of these estimates. We considered the following to be our critical accounting estimates in the preparation of the Consolidated Financial Statements included in this report.

Valuation and Aging of Inventory and Shrink Reserve

Merchandise inventory is a significant portion of our consolidated balance sheets, representing approximately 25% of total assets from continuing operations.

Inventories are valued using the lower of cost or market value, determined by the reverse mark-up or retail inventory method ("RIM"). Under the RIM, the valuation of inventories at cost and the resulting gross margins are calculated by applying a calculated cost-to-retail ratio to the retail value of inventories. RIM is an averaging method that is widely used in the retail industry due to its practicality. Also, it is recognized that the use of RIM will result in valuing inventories at the lower of cost or market if markdowns are currently taken as a reduction of the retail value of inventories.

The methodologies we utilize in our application of RIM are consistent for all periods presented. Such methodologies include the development of cost-to-retail ratios, the development of shrinkage reserves and the accounting for price changes. RIM calculations require management to make



estimates, such as merchandise mark-on, mark-ups, markdowns and shrinkage, which can significantly impact the ending inventory valuation at cost as well as resulting gross margins. These significant estimates, coupled with the fact that the RIM is an averaging process, may not, in all circumstances, reflect actual historical experience, and could result in significant differences to amounts recorded. Future events, such as store closings and liquidations, could result in an increase in the level of estimated markdowns which could result in lower inventory values and increases to cost of sales in future periods. In addition, failure to take markdowns currently can result in an overstatement of inventory value under the lower of cost or market principle.

As a supplement to the inventory values established under the RIM, we establish reserves for additional markdowns associated with shrink and aged product. The shrink expense reserve represents a reserve for the unidentified loss of inventory. Management uses historical percentages to accrue shrink expense. Physical inventory counts are performed at each store and distribution location throughout the year. At the completion of the inventory count, actual shrink expense is quantified and compared to the shrink reserve. Any difference between actual shrink expense and the reserve is recorded as a reduction or addition to inventory on the consolidated balance sheet and as a reduction or addition to cost of sales in the consolidated statements of operations.

The aged inventory reserve represents an estimate of the markdown required to liquidate aged inventory, which is generally defined as inventory that is aged 12 months or more. Management calculates a reserve for aged inventory by comparing the cost of the inventory to the estimated realizable value of the inventory. In order to accomplish this, we analyze the quantity and quality of all inventory in seasonal aging brackets (i.e., aged one season, two seasons, etc.). The expected markdowns necessary to liquidate each aging bracket are thus analyzed to determine if the related cost exceeds the net realizable value and a reserve, if necessary, is established.

Impairment of Long-Lived Assets

We evaluate the recoverability of our long-lived assets in accordance with Statement No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets to be Disposed Of, which generally requires us to assess these assets for recoverability whenever events or changes in circumstances indicate that the carrying amounts of long-lived tangible assets and intangible assets that are amortized may not be recoverable.

We consider historical performance and future estimated results in our evaluation of potential impairment and then compare the carrying amount of the asset to the estimated future undiscounted cash flows expected to result from the use of the asset. The ability to accurately predict future cash flows may impact the determination of fair value. Management's assessments of cash flows represent its best estimate as of the time of the impairment review and are based upon expected future results of operations. Management believes that its estimates of applicable cash flows in the current period are reasonable; however, if different cash flows had been estimated in the current period, the long-lived asset balances could have been materially impacted. Furthermore, estimates may change from period to period as new information is generated and as trends are identified, and this could materially impact results in future periods.

Factors that management must estimate when performing impairment tests include, among other items, possible liquidation of our business, sales volume, the related cost of product, markdowns,



shrink and estimated flow through or operating profit percentages. Actual results may ultimately differ from these estimates and, as a result, the fair values may be adjusted in the future.

As a result of the settlement with Kmart, effective during 2005 the useful lives of all long-lived assets except for land and building and improvement have been reduced so that long-lived assets will be fully depreciated or amortized as of December, 2008 to coincide with the expiration of our contract with Kmart.

Insurance and Self-Insurance Liabilities

We are primarily self-insured for medical costs and for fiscal year 2004 and prior we were primarily self-insured for worker's compensation, as our deductible under third party coverage was $250,000 per claim. We establish accruals for our insurance programs based on available claims data and historical trends and experience, as well as loss development factors prepared by third party actuaries. Loss development factors are estimates based on our actual historical data and other retail industry data. Commencing in 2005, the Company is no longer self-insured for workers' compensation insurance.

We evaluate the accrual and the underlying assumptions for workers compensation claims and for medical costs quarterly and make adjustments as needed based on third party actuarial assessments. The ultimate cost of these claims may be greater than or less than the established accrual. While we believe that the recorded amounts are adequate, there can be no assurance that changes to management's estimates will not occur due to limitations inherent in the estimating process. In the event we determine the accruals should be increased or reduced, we record such adjustments in the period in which such determination is made.

The accrued obligation for these self-insurance programs was approximately $5.7 million at the end of fiscal year 2005 and $10.1 million at the end of fiscal year 2004. Because loss development factors are estimates at a point in time, should unknown claim issues, such as adverse medical costs, occur, develop or become realized over the course of the claim, actual claim payments could materially differ from our accrued obligation.

Deferred Tax Assets

We currently have significant deferred tax assets resulting from net operating loss carryforwards and temporary differences, which should reduce taxable income in future periods.

As of December 31, 2005 we have recorded a deferred tax asset of $109.8 million and a related valuation allowance of $109.8 million. In connection with the audits of our fiscal years 2005, 2004, and 2003 consolidated financial statements, we reviewed the valuation of our deferred tax assets based on projections of our future taxable earnings. Primarily due to our historical losses and projected results, for accounting purposes we cannot rely on anticipated long-term future profits to utilize our deferred tax assets. As a result, we could not conclude that it is more likely than not that certain deferred tax assets will be realized and have recorded a non-cash valuation allowance on our net deferred tax asset.



Retiree Medical Benefits

The costs and obligations of our retiree medical plans (for current retirees and a "closed" group of active associates who meet certain eligibility requirements) are calculated by third party actuarial assessments using many assumptions to estimate the benefit that the employee earns while working, the amount of which cannot be completely determined until the benefit payments cease.

The most significant assumptions, as presented in Note 23 "Post Retirement Benefits" of Notes to the Consolidated Financial Statements, include discount rate and future trends in health care costs. The selection of assumptions is based on historical trends and known economic and market conditions at the time of valuation. Future health care costs may differ substantially from these assumptions. These differences may significantly impact future retiree medical expenses.

IMPACT OF RECENTLY ISSUED ACCOUNTING STANDARDS

In November 2004, FASB Statement No. 151, Inventory Costs, an Amendment of APB No. 43, Chapter 4 ("Statement No. 151"), was issued. Statement No. 151 requires certain abnormal expenditures to be recognized as expenses in the current period. It also requires that the amount of fixed production overhead allocated to inventory be based on the normal capacity of the production facilities. Statement No. 151 is effective for the fiscal year beginning January 1, 2006. The adoption of Statement No. 151 is not expected to have a material impact on our financial statements.

In December 2004, the FASB issued Statement No. 153, Exchanges of Nonmonetary Assets, an Amendment of APB Opinion No. 29 ("Statement No. 153"). Statement No. 153 is effective for nonmonetary asset exchanges occurring in our fiscal year beginning January 1, 2006. Statement No. 153 requires that exchanges of productive assets be accounted for at fair value unless fair value cannot be reasonably determined or the transaction lacks commercial substance. Statement

No. 153 is not expected to have a material impact on our financial statements.

In December 2004, the FASB issued Statement No. 123 (Revised 2004), Share-Based Payment, which is a revision of Statement No. 123. With limited exceptions, Statement No. 123 (Revised 2004) requires that the fair value of share-based payments to employees be expensed over the period service is received. This Statement is effective for us beginning with our first interim period subsequent to December 15, 2005. We intend to adopt this Statement using the modified prospective method. We expect to record approximately $0.6 million as a component of store operating, selling, general and administrative expenses in the 2006 Consolidated Statement of Operations.

In May 2005, the FASB issued SFAS No. 154 Accounting Changes and Error Corrections - A Replacement of APB Opinion No. 20 and FASB Statement No. 3. This Statement requires retrospective application to prior periods' financial statements of changes in accounting principle, unless it is impracticable to determine either the period-specific effects or the cumulative effect of the change. This Statement does not change the guidance for reporting the correction of an error in previously issued financial statements or a change in accounting estimate. The provisions of this Statement shall be effective for accounting changes and correction of errors made in fiscal years beginning after December 15, 2005. The adoption of Statement No. 154 is not expected to have a



material impact on our financial statements.

ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

DERIVATIVES

As of December 31, 2005, we were not materially exposed to changes in the underlying values of our assets or liabilities nor were we materially exposed to changes in the value of expected foreign currency cash flows. We historically have not entered into derivative instruments for any purpose other than to manage our interest rate exposure. That is, we do not hold derivative financial investments for trading or speculative purposes.

INTEREST RATES

Revolving loans under our Exit Facility bear interest at rates that are based upon the London-Inter-Bank Offered Rate ("LIBOR") and the Prime Rate and therefore, our consolidated financial statements will be exposed to changes in interest rates. As of December 31, 2005, we had no loans outstanding under the Amended DIP and Exit Facility and letters of credit issued thereunder totaled $14.7 million (the majority of which were standby letters of credit). We assess interest rate cash flow risk by identifying and monitoring changes in interest rate exposures that may adversely impact expected future cash flows and by evaluating hedging opportunities. The Company has engaged in interest rate hedging agreements in the past for purposes of limiting portions of interest rate expense in connection with outstanding variable rate debt.

FOREIGN EXCHANGE

A significant percentage of Meldisco's products are sourced or manufactured offshore, with China accounting for approximately 99% of all sources. Our offshore product sourcing and purchasing activities are currently, and have been historically, denominated in U.S. dollars, and, therefore, we do not currently have material exposure to cash flows denominated in foreign currencies nor have net foreign exchange gains or losses been material to operating results in the reporting periods presented in this report.



ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

The reports of independent registered public accounting firms, the consolidated financial statements of the Company, the notes to consolidated financial statements, and the supplementary financial information called for by this Item 8 are listed below. Specific financial statements and supplementary data can be found beginning on the page listed in the following index:

INDEX