FOOTSTAR INC
Form 10-Q
May 10, 2006

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

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

For the quarterly period ended April 1, 2006
Commission File Number 1-11681

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

DELAWARE	22-3439443
(State or other jurisdiction of incorporation for organization)	(IRS Employer Identification No.)

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

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

Indicate by check mark whether registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities and 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 whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer" in Rule 12b-2 of the Exchange Act. (Check one):

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

Number of shares outstanding of common stock, par value $.01 per share, as of April 29, 2006: 20,922,614.

Indicated by check mark whether the registrant has filed all documents and reports required to be filed by Sections 12, 13 or 15(d) of the Securities Exchange Act of 1934 subsequent to the distribution of securities under a plan confirmed by a court (the registrant did not distribute new securities under the plan confirmed by the court; there was no change to the holders of securities as a result of the registrant's reorganization). Yes X No

1

FOOTSTAR, INC.
QUARTERLY REPORT ON FORM 10-Q
TABLE OF CONTENTS

PART 1. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

FOOTSTAR, INC. AND SUBSIDIARY COMPANIES
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
FOR THE THREE MONTHS ENDED APRIL 1, 2006 AND APRIL 2, 2005
(Unaudited)
(amounts in millions, except per share amounts)

	Three Months Ended	
	APRIL 1, 2006	April 2, 2005
Net sales	$133.9	$154.8
Cost of sales	94.8	110.5
GROSS PROFIT	39.1	44.3
Store operating, selling, general and administrative expenses	39.4	47.6
Depreciation and amortization	2.3	1.8
Interest expense	0.5	0.8
Interest income	(0.7)	--
LOSS BEFORE REORGANIZATION ITEMS	(2.4)	(5.9)
Reorganization items	(0.1)	3.7
LOSS BEFORE INCOME TAXES AND DISCONTINUED OPERATIONS	(2.3)	(9.6)
Income tax provision (benefit)	0.3	(8.2)
LOSS FROM CONTINUING OPERATIONS	(2.6)	(1.4)
Loss from discontinued operations	(0.8)	(0.1)
Gain from disposal of discontinued operations	--	0.1
NET LOSS	$ (3.4)	$ (1.4)
LOSS PER SHARE:		
Basic and diluted:		
Loss from continuing operations	$(0.12)	$(0.07)
Loss from discontinued operations	(0.04)	--
Net loss	$(0.16)	$(0.07)
Average common shares outstanding:		
Basic and diluted	20.8	20.5

See accompanying notes to condensed consolidated financial statements.

3

FOOTSTAR, INC. AND SUBSIDIARY COMPANIES
CONDENSED CONSOLIDATED BALANCE SHEETS
(in millions, except share amounts)

	APRIL 1, 2006 (UNAUDITED)	December 31, 2005
ASSETS		
Current Assets:		
Cash and cash equivalents	$ 47.6	$196.1
Accounts receivable, net	12.8	8.8
Inventories	109.4	89.2
Prepaid expenses and other current assets	19.7	21.5
Assets of discontinued operations	0.1	0.1
Total current assets	189.6	315.7
Property and equipment, net	27.8	28.9
Intangible assets, net	9.2	10.0
Deferred charges and other assets	1.9	2.1
Total assets	$228.5	$356.7
LIABILITIES AND SHAREHOLDERS' EQUITY		
Liabilities not subject to compromise:		
Accounts payable	$ 67.2	$ 60.0
Accrued expenses	30.2	45.9
Income taxes payable	0.9	1.9
Liabilities of discontinued operations	2.5	7.4
Liabilities subject to compromise	10.9	125.5
Total current liabilities	111.7	240.7
Other long-term liabilities	38.9	35.0
Amount due under Kmart Settlement	5.3	5.5
Total liabilities	$155.9	$281.2
Shareholders' Equity:		
Common stock $.01 par value: 100,000,000 shares authorized, 31,632,372 and 31,084,647 shares issued	0.3	0.3
Additional paid-in capital	342.9	342.6
Treasury stock: 10,711,569 shares at cost	(310.6)	(310.6)
Unearned compensation	--	(0.1)
Retained earnings	40.0	43.3
Total shareholders' equity	72.6	75.5
Total liabilities and shareholders' equity	$228.5	$356.7

See accompanying notes to condensed consolidated financial statements.

FOOTSTAR, INC. AND SUBSIDIARY COMPANIES
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
FOR THE THREE MONTHS ENDED APRIL 1, 2006 AND APRIL 2, 2005
(Unaudited)
(amounts in millions)

	Three Months Ended	
	APRIL 1, 2006	April 2, 2005
Net cash (used in) provided by operating activities	$ (60.4)	$ 2.6
Cash flows (used in) provided by investing activities:		
Additions to property and equipment	(0.4)	(0.3)
Proceeds from sale of furniture and equipment	--	0.3
Net cash used in investing activities	(0.4)	--
Cash flows used in financing activities:		
Payments on mortgage note	(0.2)	--
Net cash used in financing activities	(0.2)	--
Cash flows from discontinued operations (REVISED):		
Net cash (used in) provided by operating activities of discontinued operations	(87.5)	6.7
Net (decrease) increase in cash and cash equivalents	(148.5)	9.3
Cash and cash equivalents, beginning of period	196.1	189.6
Cash and cash equivalents, end of period	$ 47.6	$198.9

See accompanying notes to condensed consolidated financial statements.

FOOTSTAR, INC. AND SUBSIDIARY COMPANIES
NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(UNAUDITED)

THE COMPANY

Footstar, Inc., ("Footstar", the "Company", "we", "us", or "our") is a holding company that operates its businesses through its subsidiaries. We are principally a retailer conducting business through our Meldisco Division ("Meldisco"). Meldisco sells family footwear through licensed footwear departments and wholesale arrangements.

1. EMERGENCE FROM BANKRUPTCY

Commencing March 2, 2004 ("Petition Date"), Footstar and most of its subsidiaries (collectively, the "Debtors") filed voluntary petitions for reorganization 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 business 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.

On July 2, 2005, the Company and Kmart Corporation ("Kmart") entered into an agreement (the "Kmart Settlement") with respect to the assumption of the Master Agreement with Kmart, effective July 1, 1995, as amended (the "Master Agreement"), which was effective as of January 2, 2005, and allowed us to continue operating the footwear departments in Kmart stores pursuant to an Amended and Restated Master Agreement (the "Amended Master Agreement"). See Note 5 "Meldisco's Relationship with Kmart".

On November 12, 2004, we filed a proposed joint plan of reorganization with the Court which was amended on October 28, 2005, and amended again on December 5, 2005, (the "Amended Plan"). On January 25, 2006, the Bankruptcy Court confirmed our Amended Plan. On February 7, 2006, we successfully emerged from bankruptcy and paid substantially all our creditors in full with interest. 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.

2. BASIS OF PRESENTATION

Our consolidated financial statements contained herein have been prepared in accordance with the provisions of SOP 90-7. Pursuant to SOP 90-7, our pre-petition liabilities that were subject to compromise are reported separately in the accompanying balance sheet as an estimate of the amount that will ultimately be allowed by the Court. SOP 90-7 also requires separate reporting of certain expenses, realized gains and losses and provisions for losses related to the bankruptcy filing as reorganization items.

The accompanying consolidated financial statements are unaudited but, in the opinion of management, contain all adjustments (which are of a normal recurring nature) necessary to present fairly the financial position, results of operations and cash flows for the periods presented. All significant intercompany accounts and transactions have been eliminated.

Detailed footnote information is not included in this report. The financial information set forth herein should be read in conjunction with the Notes to Consolidated Financial Statements contained in our fiscal 2005 Annual Report on

Form 10-K/A for the period ended December 31, 2005 filed with the SEC.

The results of operations for the three months ended April 1, 2006 are not necessarily indicative of results to be expected for the entire fiscal year ended December 30, 2006.

3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

As of April 1, 2006, there have been no material changes to any of the significant accounting policies, except for the accounting for stock compensation, described in our Annual Report on Form 10-K/A for the fiscal year ended December 31, 2005. Effective January 1, 2006, the company adopted FASB Statement No. 123 (R), "Share Based Payment," revising FAS 123 and requiring that all share-based payments to employees be recognized in the financial statements. See Note 9 "Stock-Based Compensation Plans."

4. DISCONTINUED OPERATIONS

The disposition of our Athletic Segment and certain operations within our Meldisco Segment in fiscal year 2004, have been accounted for as discontinued operations in accordance with FASB Statement No. 144, "Accounting for the Impairment or Disposal of Long Lived Assets". Accordingly, we have reported our results of the discontinued operations as a separate component of operations. In addition, we applied the provisions of SFAS No. 144 to the stores closed by Kmart during the first quarter of 2006 and 2005 and determined that these stores either did not meet the criteria to be accounted for as discontinued operations or were not considered material to our consolidated results of operations.

Net sales and operating loss from discontinued operations for the three months ended April 1, 2006 and April 2, 2005 were as follows (in millions):

	2006	2005
Net sales	$ --	$ --
Operating loss from discontinued operations	$(0.2)	$(0.1)

5. MELDISCO'S RELATIONSHIP WITH KMART

The business relationship between Meldisco and Kmart is extremely important to us. The Kmart licensed footwear departments account for substantially all of our sales and operating profit from continuing operations. The loss of Meldisco's Kmart operation, a significant reduction in customer

traffic in Kmart stores or the closing or conversation of a significant number of additional Kmart stores would have a material adverse effect on us.

We operated the footwear departments in 1,402 Kmart stores (the "Shoemart Corporations") as of April 1, 2006.

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, other than 23 of the 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. The Amended Master Agreement provides that effective January 2, 2005, we pay Kmart 14.625% of the gross sales of the footwear departments, in lieu of almost all of the fees and dividends required under the Master Agreement. The Amended Master Agreement further provides that effective August 25, 2005, we pay Kmart a miscellaneous expense fee of $23,500 each year per open store. 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 in any four consecutive fiscal quarters are less than $550.0 million, 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. Thirty-seven stores have been closed or converted from August 25, 2005 through April 1, 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 fiscal 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 to the Amended Master Agreement, Kmart must pay us the stipulated loss value (as set forth below), if it terminates our licenses to operate a certain number of shoe departments in Kmart stores by disposing of, closing or converting those stores. The number of stores it can dispose of, close or convert per year before having to pay us the stipulated loss value, 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 were disposed of, closed or converted. In 2006, through April 1, 2006, 19 stores were 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 $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, 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. 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.

As set forth in the Amended Master Agreement, Kmart collects proceeds from the sale of our inventory and remits those sales proceeds to us on a weekly basis less any applicable fees outlined in the Kmart Settlement. Such fees were $27.0 million and $29.1 million for the three months ended April 1, 2006 and April 2, 2005, respectively. As of April 1, 2006 and December 31, 2005, we had outstanding accounts receivable due from Kmart of $9.8 million and $5.2 million, respectively, which were subsequently collected in April 2006 and January 2006, respectively.

6. ASSETS AND LIABILITIES RELATED TO DISCONTINUED OPERATIONS

Assets and liabilities related to discontinued operations consisted of the following (in millions):

	APRIL 1, 2006	December 31, 2005
ASSETS		
Prepaid expenses and other current assets	$0.1	$0.1
	$0.1	$0.1
LIABILITIES		
Accrued expenses	$2.2	$7.4
Other long-term liabilities	0.3	--
	$2.5	$7.4

7. LIABILITIES SUBJECT TO COMPROMISE

Liabilities subject to compromise represent our current estimate of the amount of the pre-petition claims that are subject to restructuring in the Chapter 11 Cases. Pursuant to Court orders, we were authorized to pay certain pre-petition operating liabilities incurred in the ordinary course of business

FOOTSTAR, INC. AND SUBSIDIARY COMPANIES
NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(UNAUDITED)

and reject certain of our pre-petition obligations. We notified all known pre-petition creditors of the establishment of a bar date by which pre-petition creditors must file a proof of claim, which bar date has now passed for all such creditors. Differences between liability amounts recorded by us and claims filed by pre-petition creditors have been substantially reconciled and paid upon our emergence on February 7, 2006 (see Note 1 - Emergence from Bankruptcy). The Court will make a final determination of allowable claims on remaining disputed amounts.

Liabilities subject to compromise consisted of the following (in millions):

	APRIL 1, 2006	DECEMBER 31, 2005
Accounts payable	$ --	$ 56.0
Accrued expenses	10.9	64.4
Long-term liabilities	--	5.1
Total	$10.9(a)	$125.5(a)

(a) Includes approximately $10.0 and $92.3 of liabilities subject to compromise from discontinued operations as of April 1, 2006 and December 31, 2005, respectively.

8. REORGANIZATION ITEMS

Reorganization items, which consist of income and expenses that are related to our bankruptcy, were comprised of the following for the three months ended April 1, 2006 and April 2, 2005 (in millions):

	2006	2005
Professional fees	$ 1.3	$ 3.9
Trustee fees	--	1.0
Gain on disposition of bankruptcy claims	(0.7)	--
Interest income	(0.7)	(1.2)
Total	$(0.1)	$ 3.7

9. STOCK-BASED COMPENSATION PLANS

In December 2004, the Financial Accounting Standards Board issued Statement No. 123(R) (FAS 123R), Share-Based Payment, revising FAS 123 and requiring that all share-based payments to employees be recognized in the financial statements. We adopted the new statement effective January 1, 2006, using the modified-prospective transition method described in the statement, which requires measurement of compensation cost of all stock-based awards at fair value on the date of grant and recognition of compensation over the service periods for awards expected to vest. Under this method, we are required to recognize compensation expense for all awards granted after the adoption and for the unvested portion of previously granted options that remain outstanding as of the adoption date. We recorded compensation expense in the period ended April 1, 2006 of $0.4 million. Prior amounts have not been restated.

Prior to adopting FAS 123R, we applied the intrinsic value-based method of accounting prescribed in APB Opinion No. 25 and, accordingly, did not recognize compensation expense for stock option

grants made at an exercise price equal to or in excess of the fair market value of the stock at the date of grant.

The following table details the effect on the Company's net income and basic and diluted net income per share had compensation expense for stock-based awards been recorded in the three months ended April 2, 2005 based on the fair-value method under SFAS 123.

	Three Months Ended April 2, 2005
Net loss:	
Reported	$(1.4)
Add: Non-cash employee compensation, as reported	--
Deduct: Stock-based employee compensation expense determined under fair value based method for all awards, net of taxes	(0.4)
Pro forma, net loss	$(1.8)
Basic and diluted net loss per share, as reported	$(0.07)
Basic and diluted net loss per share, pro forma	$(0.09)

There were no options granted in the three months ended April 1, 2006 and April 2, 2005.

As of April 1, 2006 there was $0.3 million of total unrecognized compensation costs related to stock options. These costs are expected to be recognized over a weighted average period of 7 months.

FOOTSTAR, INC. AND SUBSIDIARY COMPANIES
NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(UNAUDITED)

	RESTRICTED STOCK, RESTRICTED STOCK UNITS AND PERFORMANCE BASED STOCK AWARDS	WEIGHTED AVERAGE GRANT DATE FAIR VALUE
Outstanding, January 1, 2006	115,645	$20
Granted	328,953	$ 4
Cancelled	(15,474)	$38
Shares issued	(346,926)	$ 6
Outstanding, April 1, 2006	82,198	$12

As of April 1, 2006 there was $1.5 million of unrecognized compensation costs related to restricted stock, restricted stock units and performance-based stock awards. These costs are expected to be recognized over a weighted average period of 32 months.

2006 NON-EMPLOYEE DIRECTOR STOCK PLAN

On our emergence from bankruptcy on February 7, 2006, the 2006 Director Stock Plan became effective and the 1996 Director Stock Plan was frozen. The 2006 Director Stock Plan allows for the grant of up to 458,044 shares of common stock of the Company (the "Common Stock").

The 2006 Director Stock Plan provides for an automatic initial grant of 10,000 shares of restricted Common Stock to each eligible director. Beginning with the 2007 annual meeting of the Company, the Company shall make additional grants to each eligible director of 10,000 shares of restricted Common Stock, or such other amount determined by the Board of Directors of the Company (the "Board"), subject to the provisions of the 2006 Director Stock Plan.

Unless the Board shall determine otherwise at the time of grant, each award of restricted Common Stock shall vest with respect to 50% of the shares on the first anniversary of the date of grant, an additional 25% of the shares on the second anniversary of the date of grant, and with respect to the remaining 25% of the shares on the third anniversary of the date of grant. In the event of a participant's retirement, all unvested shares of restricted Common Stock shall become vested as of the effective date of such retirement. In the event of a change in control (as specified in the 2006 Director Stock Plan), all unvested shares of restricted Common Stock shall become vested as of the effective date of such change in control.

A participant's termination of service as a director of the Company for any reason other than retirement shall result in the immediate forfeiture of all shares of restricted Common Stock that have not yet vested as of the date of such termination of service. To effect such forfeiture, the participant shall transfer such shares of Common Stock to the Company promptly following such termination of service in accordance with procedures established by the Board from time to time

and the Company shall reimburse such participant for the shares of Common Stock in an amount equal to the lesser of (i) the fair market value of the shares of Common Stock transferred on the date service terminated, and (ii) the cash price, if any, paid by the participant for such shares of Common Stock. In addition, the participant shall forfeit all dividends paid on the shares of restricted Common Stock, which forfeiture shall be effected by termination of any escrow arrangement under which such dividends are held, or, if paid directly to the participant by the participant's repayment of dividends received directly, or by such other method established by the Board from time to time.

The following table provides information relating to the status of, and changes in, stock units granted under the 2006 Director Stock Plan:

2006 Director Stock Plan Units

	Stock Units	Weighted Average Grant Date Fair Value
Outstanding, January 1, 2006	--	--
Granted	80,000	$ 5
Shares Issued	(80,000)	$ 5
Outstanding, April 1, 2006	--	--

As of April 1, 2006 there was $0.3 million of unrecognized compensation costs related to Director Stock units. These costs are expected to be recognized over a weighted average period of 18 months.

10. EARNINGS PER SHARE

Basic EPS is computed by dividing net income available for common stockholders by the weighted average number of common shares outstanding for the period. Diluted EPS is computed by dividing net income available to common stockholders by the weighted average shares outstanding, after giving effect to the potential dilution that could occur if outstanding options or other contracts or obligations to issue common stock were exercised or converted.

The following table reflects average shares outstanding used to compute basic and diluted loss per share (in millions):

	APRIL 1, 2006	April 2, 2005

Average shares outstanding	20.7	20.3
Contingently issuable shares (1)	0.1	0.2
Average shares outstanding - basic	20.8	20.5
Average shares outstanding - diluted (2)	20.8	20.5

(1) Represents shares earned under our stock incentive plans

(2) The computation of diluted EPS does not assume conversion, exercise or issuance of shares that would have an anti-dilutive effect on EPS. During the three months ended April 1, 2006 and April 2, 2005, we had a net loss; as a result, any assumed conversions would result in reducing the loss per share and, therefore, are not included in the calculation. There were no assumed shares having an anti-dilutive effect on EPS in either period.

11. INCOME TAXES

Upon our emergence from bankruptcy on February 7, 2006, the Company realized approximately $51 million of tax deductible expenses thereby creating a loss for tax purposes in excess of the book loss which will increase our net operating loss carryforwards. In addition, we have recorded a non-cash valuation allowance on the net deferred tax asset. The 2006 income tax provision relates to the estimated income tax obligation of our stores located in Puerto Rico, Guam and the Virgin Islands.

Although the Kmart Settlement was effective as of January 2, 2005, the effective date for tax purposes was August 25, 2005, the date the Kmart Settlement was approved by the Court. As a result, two tax periods were required for fiscal 2005. Due to the minority interests in each Shoemart store for the period January 2, 2005 through August 25, 2005, we could not file a consolidated federal tax return. As losses from stores could not therefore be offset against profits from other stores, this resulted in an unusually high estimated effective tax rate of approximately 85% for 2005. As the minority interests are eliminated as of August 25, 2005, subsequent federal tax returns will be filed on a consolidated basis.

12. COMMITMENTS AND CONTINGENCIES

Kmart Relationship

In connection with the Kmart Settlement, all outstanding litigation between Kmart and us has been settled. See Note 5 "Meldisco's Relationship with Kmart." The Amended Master Agreement expires at the end of 2008.

If we fail to develop viable business alternatives to offset the termination of our Amended Master Agreement, we will almost certainly be forced to liquidate our business at the end of December, 2008. In addition, should we fail to meet the minimum sales tests, staffing requirements or other provisions provided in the Amended Master Agreement, termination of our business could occur prior to December 31, 2008.

Restatement Related Litigation

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. We cannot predict the outcome of this proceeding.

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.

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 -Salomon AG v. Kmart Corporation and Footstar, Inc. The first amended 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 the claims against us, 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 the amount of $3.8 million. On May 1, 2006, NAFTA advised us that they are in the process of amending this claim to provide that the Company owes them at least $9.1 million plus legal fees and expenses. We have objected to this proof of claim, and will object to any amendment, 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 adversary proceeding, we intend to continue to

object and vigorously defend the proof of claims 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 such agreement. In July 2004, the parties agreed to settle such matter for $5.1 million. This amount was accrued in fiscal 2003, and was offset by the reversal of his $7.2 million Supplemental Executive Retirement Plan liability. 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.

FMI Agreement

During our bankruptcy, we sold certain assets, including, among other things, our distribution center in Mira Loma, California ("Mira Loma"). We sold Mira Loma to Thrifty Oil Co. ("Thrifty") for approximately $28.0 million. 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.

ITEM 1A. RISK FACTORS

The Risk Factors included in the Company's Annual Report on Form 10-K/A for the fiscal year ended December 31, 2005, have not materially changed, but given the termination of the Company's principal business relationship with Kmart no later than December 31, 2008 and the difficulty of the Company's ability to manage and plan for the disposal of, conversion, or closing of additional Kmart stores, we are repeating these factors below.

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 2. 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;

- the Company's ability to successfully implement and maintain 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;

- the Company's ability to manage and plan for the disposal of, closing or conversion of Kmart stores; and

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

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 Quarterly Report on Form 10-Q 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 Quarterly Report on

Form 10-Q.

OVERVIEW

As of April 1, 2006, Footstar operated licensed footwear departments in 1,402 Kmart stores, compared with 1,479 stores on April 2, 2005. See Note 5 "Meldisco's Relationship with Kmart" for further discussion of the agreement. Footstar also operated licensed footwear departments in 854 Rite Aid stores in the western region of the United States, compared with 861 stores on April 2, 2005.

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. See Note 5 "Meldisco's Relationship with Kmart" in the Notes to the Consolidated Financial Statements.

BUSINESS RELATIONSHIP WITH WAL-MART STORES

Until 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 stopped purchasing Thom McAn product for any of its stores in the United States. However, Wal-Mart has continued to buy Thom McAn footwear for Wal-Mart stores in Puerto Rico and has continued to source footwear from us for Wal-Mart stores under Wal-Mart's proprietary brands. For the three months ending April 2, 2005, we had sales of approximately $10.2 million to Wal-Mart stores in the United States and Puerto Rico. For the three months ending April 1, 2006, we had sales of approximately $1.6 million to Wal-Mart stores in the United States and Puerto Rico.

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 could be passed on to us through higher product costs. As a result of these issues, the Company has begun to shift manufacturing production to lower cost regions of China. 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 is a discussion of the results of operations for the three months ended April 1, 2006 compared with the three months ended April 2, 2005.

22

FOOTSTAR, INC. AND SUBSIDIARY COMPANIES

2006 VERSUS 2005 (dollars in millions)	2006	2005	% SALES - 2006	% Sales - 2005
Net Sales	$133.9	$154.8		
Gross Profit	39.1	44.3	29.2%	28.6%
SG&A Expenses	39.4	47.6	29.4%	30.7%
Depreciation/Amortization	2.3	1.8	1.7%	1.2%
Operating Loss	$ (2.6)	$ (5.1)	(1.9%)	(3.3%)

NET SALES

Net sales decreased $20.9 million, or 13.5%, to $133.9 million in 2006 compared with $154.8 million in 2005. Shoemart sales were approximately $128.4 million in 2006 and $140.9 million in 2005. The Shoemart sales decrease was due to a 4.9% comparable store sales decline in 2006 as a result of weaker winter product sales and the shift of Easter out of first quarter. Furthermore, the sales decrease at Shoemart was also a result of operating in 1,402 stores at the end of first quarter 2006 versus 1,479 stores in 2005. The balance of the sales decrease during first quarter 2006 was the result of no longer selling Thom McAn product within Wal-Mart domestic stores effective at the beginning of 2006.

GROSS PROFIT

Gross profit decreased $5.2 million to $39.1 million in 2006 compared with $44.3 million in 2005 due to the lower sales in 2006. The gross margin rate increased in 2006 as a result of improved margins on clearance sales in 2006 compared with 2005.

SG&A EXPENSES

SG&A expenses decreased $8.2 million, or 17.2%, to $39.4 million in 2006 compared with $47.6 million in 2005. The overall SG&A rate as a percentage of sales decreased to 29.4% in 2006 compared with 30.7% in 2005. The company incurred less corporate overhead related to the bankruptcy and has continued to reduce expenses in conjunction with sales declines.

DEPRECIATION AND AMORTIZATION

Depreciation and amortization increased $0.5 million to $2.3 million in 2006 compared with $1.8 million in 2005 due to higher trademark amortization expense recorded in 2006.

OPERATING LOSS

Operating loss decreased by $2.5 million to $(2.6) million in 2006 compared with $(5.1) million in 2005 primarily due to the reasons noted above.

REORGANIZATION ITEMS

Reorganization items, which consist of income and expenses that are related to our bankruptcy were comprised of the following for 2006 and 2005 (in millions):

	2006	2005
Professional fees	$ 1.3	$ 3.9
Trustee fees	--	1.0
Gain on disposition of bankruptcy claims	(0.7)	--
Interest income	(0.7)	(1.2)
Total	$(0.1)	$ 3.7

Reorganization items decreased by $3.6 million to $(0.1) million in 2006 compared with $3.7 million in 2005 primarily because we emerged from bankruptcy on February 7, 2006.

The disposition of bankruptcy claims resulted in an increase of $0.7 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 2006 and 2005, interest income of $0.7 million and $1.2 million, respectively, was earned on cash that would otherwise have been used to pay such pre-petition liabilities.

LIQUIDITY AND CAPITAL RESOURCES

Our principal sources of liquidity used in funding short-term operations are our operating cash flows and our Credit Facility (as hereinafter defined). The Credit 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.

Subsequent to our emergence from Chapter 11 through April 29, 2006, we made payments to creditors totaling $121.2 million, plus interest where applicable. These payments exclude claims for approximately $9.6 million which will be paid, with interest where applicable, upon final resolution. Creditors were and are expected to be paid in full, plus interest where applicable. Such distributions were and are expected to be paid from existing cash balances and will not require us to incur borrowings under our Credit Facility.

Factors that could affect our short and long term 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 are 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 or other uncertainties, we believe that our current cash, together with cash generated from operations and cash available under our Credit Facility, will be sufficient to fund our expected operating expenses, capital expenditures and working capital needs during the next 12 months.

THE CREDIT FACILITY

On February 7, 2006, upon our emergence from Chapter 11 we entered into a new $100 million senior-secured revolving credit facility (the "Credit Facility") (containing a sub-limit for letters of credit). We may borrow up to $100.0 million through the Credit Facility subject to a sufficient borrowing base (based upon eligible inventory and accounts receivable), and other terms of the facility. Revolving loans under the Credit 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 Credit Facility. A quarterly fee of 0.3% per annum is payable to the lenders on the unutilized balance. The Credit Facility has a maturity date of the earlier of (a) November 30, 2008 and (b) thirty days prior to the termination of the Amended Master Agreement.

The Credit 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 (a) 5% of the borrowing base for the first twelve months following the Company's emergence from bankruptcy (i.e., February 7, 207) and (b) 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 the Credit Facility.

The Credit 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 Credit Facility.

As of April 29, 2006, the Company had no loans outstanding and approximately $67.4 million of availability under the Credit Facility, net of outstanding letters of credit totaling $10.8 million (the majority of which were standby letters of credit commitments) and minimum excess availability requirements.

CRITICAL ACCOUNTING ESTIMATES

Our discussion of results of operations and financial condition relies on our consolidated financial statements that are prepared based on certain critical accounting estimates that require management to make judgments and estimates that are subject to varying degrees of uncertainty. We believe that investors need to be aware of these policies and how they impact our financial statements as a whole, as well as our related discussion and analysis presented herein. While we believe that these accounting estimates are based on sound measurement criteria, actual future events can and often do result in outcomes that can be materially different from these estimates or forecasts.

The accounting estimates and related risks described in our fiscal 2005 Annual Report on Form 10-K/A for the year ended December 31, 2005 are those that depend most heavily on these judgments and estimates. As of April 1, 2006, there have been no material changes to any of the critical accounting estimates contained therein.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

DERIVATIVES

As of April 29, 2006, 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. We do not hold derivative financial investments for trading or speculative purposes.

INTEREST RATES

Revolving loans under our Credit Facility bear interest at rates that are based upon the LIBOR and the Prime Rate and therefore, our consolidated financial statements could be exposed to changes in interest rates. As of April 29, 2006, we had no loans outstanding under the Credit Facility and letters of credit issued thereunder totaled $10.8 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 4. CONTROLS AND PROCEDURES

Under the supervision of our Chief Executive Officer and Senior Vice President, Chief Financial Officer, management conducted an evaluation of the effectiveness of the design and operation of our disclosure controls and procedures (as such term is defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the "Exchange Act")) as of the end of the period covered by this report (the "Evaluation Date"). There are inherent limitations to the effectiveness of any system of disclosure controls and procedures, including the possibility of human error and the circumvention or overriding of the controls and procedures. Accordingly, even effective disclosure controls and procedures can only provide reasonable assurance of achieving their control objectives. Based on such evaluation, the Chief Executive Officer and Senior Vice President, Chief Financial Officer concluded that, as of the Evaluation Date, our disclosure controls and procedures were effective at a reasonable assurance level.

There were no changes in our internal control over financial reporting during the quarterly period covered by this report that have materially affected, or are reasonably likely to materially affect, our internal controls over financial reporting.

PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

The information set forth on page 12 with respect to the NAFTA litigation under the caption "Other Litigation Matters" in Note 11 to the Consolidated Financial Statements is incorporated herein by reference.

ITEM 6. EXHIBITS

Exhibit 31.1 Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes Oxley Act of 2002.

Exhibit 31.2 Certification of Senior Financial Officer and Chief Financial Officer pursuant to Section 302 of the Sarbanes Oxley Act of 2002.

Exhibit 32 Certifications pursuant to Section 906 of the Sarbanes Oxley Act of 2002.

SIGNATURES

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

Footstar, Inc.

Date: May 10, 2006

By: /s/ Jeffrey A. Shepard

Jeffrey A. Shepard
Chief Executive Officer and President

Date: May 10, 2006

By: /s/ Michael J. Lynch

Michael J. Lynch
Senior Vice President, Chief Financial Officer

Date: May 10, 2006

By: /s/ Craig M. Haines

Craig M. Haines
Vice President, Controller, Principal Accounting Officer