
**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, DC 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 SEPTEMBER 26, 2006**
- TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

Commission File Number 000-29643

GRANITE CITY FOOD & BREWERY LTD.

(Exact Name of Registrant as Specified in Its Charter)

Minnesota
(State or Other Jurisdiction
of Incorporation or Organization)

41-1883639
(I.R.S. Employer
Identification No.)

**5402 Parkdale Drive, Suite 101
Minneapolis, Minnesota 55416
(952) 215-0660**

(Address of Principal Executive Offices and Issuer's
Telephone Number, including Area Code)

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

Yes No

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

Large accelerated filer Accelerated filer Non-accelerated filer

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

Yes No

As of November 6, 2006, the issuer had outstanding 13,253,642 shares of common stock.

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PART I FINANCIAL INFORMATION**ITEM 1 Financial Statements**

GRANITE CITY FOOD & BREWERY LTD.
CONDENSED CONSOLIDATED BALANCE SHEETS
(Unaudited)

	<u>September 26, 2006</u>	<u>December 27, 2005</u>
ASSETS:		
Current assets:		
Cash	\$ 2,761,706	\$ 9,836,231
Inventory	377,006	243,180
Prepays and other	664,864	218,960
Total current assets	<u>3,803,576</u>	<u>10,298,371</u>
Prepaid rent, net of current portion	491,808	—
Property and equipment, net	46,501,376	33,767,282
Intangible assets and other	695,478	416,937
Total assets	<u>\$51,492,238</u>	<u>\$44,482,590</u>
LIABILITIES AND SHAREHOLDERS' EQUITY:		
Current liabilities:		
Accounts payable	\$ 3,529,635	\$ 1,007,437
Accrued expenses	3,269,525	3,156,455
Deferred rent, current portion	105,116	76,437
Long-term debt, current portion	257,455	241,747
Capital lease obligations, current portion	771,670	679,738
Total current liabilities	<u>7,933,401</u>	<u>5,161,814</u>
Deferred rent, net of current portion	1,617,437	1,119,458
Long-term debt, net of current portion	2,068,565	2,262,180
Capital lease obligations, net of current portion	<u>25,734,759</u>	<u>18,585,630</u>
Total liabilities	<u>37,354,162</u>	<u>27,129,082</u>
Commitments and contingencies		
Shareholders' equity:		
Common stock, \$0.01 par value, 90,000,000 shares authorized; 13,253,642 and 13,226,526 shares issued and outstanding at September 26, 2006 and December 27, 2005, respectively	132,536	132,265
Additional paid-in capital	28,422,223	27,881,089
Accumulated deficit	<u>(14,416,683)</u>	<u>(10,659,846)</u>
Total shareholders' equity	<u>14,138,076</u>	<u>17,353,508</u>
Total liabilities and shareholders' equity	<u>\$51,492,238</u>	<u>\$44,482,590</u>

See notes to condensed consolidated financial statements.

GRANITE CITY FOOD & BREWERY LTD.
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(Unaudited)

	<u>Thirteen Weeks Ended</u>		<u>Thirty-nine Weeks Ended</u>	
	<u>September 26, 2006</u>	<u>September 27, 2005</u>	<u>September 26, 2006</u>	<u>September 27, 2005</u>
Restaurant revenues	\$ 15,028,065	\$ 9,705,060	\$41,337,502	\$26,109,648
Cost of sales:				
Food, beverage and retail	4,522,565	2,975,397	12,295,648	7,863,715
Labor	5,404,636	3,540,867	14,662,268	9,291,407
Direct restaurant operating	1,856,222	1,199,186	5,103,711	3,192,631
Occupancy	850,788	478,898	2,328,316	1,338,683
Total cost of sales	<u>12,634,211</u>	<u>8,194,348</u>	<u>34,389,943</u>	<u>21,686,436</u>
Pre-opening	866,193	297,509	1,940,567	525,620
General and administrative (includes non-cash compensation of \$143,364, \$0, \$550,848 and \$12,780)	1,650,862	1,312,890	4,722,296	3,447,934
Depreciation and amortization	<u>877,988</u>	<u>560,600</u>	<u>2,444,933</u>	<u>1,496,384</u>
Operating loss	<u>(1,001,189)</u>	<u>(660,287)</u>	<u>(2,160,237)</u>	<u>(1,046,726)</u>
Interest:				
Income	16,803	23,284	72,967	92,630
Expense	<u>(607,890)</u>	<u>(364,319)</u>	<u>(1,669,567)</u>	<u>(1,009,202)</u>
Net interest expense	<u>(591,087)</u>	<u>(341,035)</u>	<u>(1,596,600)</u>	<u>(916,572)</u>
Net loss	<u>\$ (1,592,276)</u>	<u>\$ (1,001,322)</u>	<u>\$ (3,756,837)</u>	<u>\$ (1,963,298)</u>
Loss per common share, basic and diluted	<u>\$ (0.12)</u>	<u>\$ (0.09)</u>	<u>\$ (0.28)</u>	<u>\$ (0.17)</u>
Weighted average shares outstanding, basic and diluted	<u>13,242,173</u>	<u>11,653,538</u>	<u>13,231,742</u>	<u>11,629,651</u>

See notes to condensed consolidated financial statements.

GRANITE CITY FOOD & BREWERY LTD.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)

	Thirty-nine Weeks Ended	
	September 26, 2006	September 27, 2005
Cash flows from operating activities:		
Net loss	\$(3,756,837)	\$(1,963,298)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	2,444,933	1,496,384
Stock option compensation expense	550,848	12,780
Loss on disposal of asset	2,746	50,475
Deferred rent	356,168	(64,224)
Changes in operating assets and liabilities:		
Inventory	(133,826)	(46,000)
Prepays and other	(937,712)	(80,570)
Accounts payable	900,277	(176,136)
Accrued expenses	132,740	(78,672)
Net cash used in operating activities	(440,663)	(849,261)
Cash flows from investing activities:		
Purchase of:		
Property and equipment	(5,673,006)	(4,135,825)
Intangible assets and other	(131,419)	(19,136)
Net cash used in investing activities	(5,804,425)	(4,154,961)
Cash flows from financing activities:		
Payments on capital lease obligations	(642,087)	(445,544)
Payments on long term-debt	(177,907)	(168,554)
Payment of dividends	—	(41,068)
(Cost incurred)/proceeds from issuance of stock	(9,443)	230,094
Net cash used in financing activities	(829,437)	(425,072)
Net decrease in cash	(7,074,525)	(5,429,294)
Cash, beginning of period	9,836,231	9,297,247
Cash, end of period	\$ 2,761,706	\$ 3,867,953
Supplemental disclosure of non-cash investing and financing activities:		
Land and buildings acquired under capital lease agreements	\$ 8,053,638	\$ 5,715,333
Equipment and intangibles purchased and included in accounts payable and accrued expenses	\$ 1,602,251	\$ 174,068

See notes to condensed consolidated financial statements.

GRANITE CITY FOOD & BREWERY LTD.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

Thirteen and thirty-nine weeks ended September 26, 2006 and September 27, 2005

1. General

Background:

Granite City Food & Brewery Ltd. (the "Company") develops and operates casual dining restaurants known as Granite City Food & Brewery®. The restaurant theme is upscale casual dining with a wide variety of menu items that are prepared fresh daily, combined with freshly brewed hand-crafted beers finished on-site. The first Granite City restaurant opened in St. Cloud, Minnesota in July 1999 and the Company subsequently expanded to other Midwest markets while pursuing its national expansion plans. The Company opened restaurants in Omaha, Nebraska and Roseville, Minnesota in October 2006 and November 2006, respectively, bringing the total number of restaurants it operates to 17. The Company also operates a beer production facility which is used to provide raw material support to its restaurants to create consistent quality and operational efficiencies.

The Company's expansion strategy focuses on development of restaurants in markets where management believes the Company's concept will have broad appeal and attractive restaurant-level economics.

Basis of Presentation:

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America and regulations of the Securities and Exchange Commission. Accordingly, they do not include all the information and footnotes required by U.S. generally accepted accounting principles for complete financial statements. In the opinion of management, all adjustments, consisting of normal recurring adjustments, which are necessary for a fair statement of its financial position as of September 26, 2006 and the results of operations for the interim periods ended September 26, 2006 and September 27, 2005 have been included.

The balance sheet at December 27, 2005 has been derived from the audited financial statements at that date, but does not include all of the information and notes required by generally accepted accounting principles for complete financial statements. Certain information and note disclosures normally included in the Company's annual financial statements have been condensed or omitted. These condensed financial statements should be read in conjunction with the financial statements and notes thereto included in the Company's Annual Report on Form 10-KSB for the fiscal year ended December 27, 2005, filed with the Securities and Exchange Commission on March 27, 2006.

The results of operations for the thirteen and thirty-nine weeks ended September 26, 2006 are not necessarily indicative of the results to be expected for the entire year.

2. Summary of Significant Accounting Policies

Stock-Based Compensation:

On December 16, 2004, the FASB issued Statement of Financial Accounting Standards ("SFAS") No. 123 (revised 2004) ("SFAS 123(R)"), *Share-Based Payment*, which is a revision of SFAS 123, *Accounting for Stock-Based Compensation*. SFAS 123(R) supersedes Accounting Principles Board ("APB") Opinion No. 25, *Accounting for Stock Issued to Employees*, and amends SFAS No. 95, *Statement of Cash Flows*. Generally, SFAS 123(R) requires all share-based payments to employees, including grants of employee stock options, to be recognized in the income statement based on their fair values determined at the date of grant. On April 14, 2005, the Securities and Exchange Commission adopted a new rule that amended the compliance dates for

SFAS 123(R). The Company adopted SFAS 123(R) using the modified prospective method effective December 28, 2005, the first day of its 2006 fiscal year.

In all prior periods, the Company accounted for stock-based compensation awards to employees using the intrinsic value method prescribed by APB Opinion No. 25 and, as such, generally recognized no compensation cost for employee stock options. Accordingly, the adoption of SFAS 123(R)'s fair value method affects the Company's reported results of operations, although it does not affect the Company's overall financial position. If the Company had been accounting for stock-based compensation under SFAS 123(R) during the third quarter of fiscal year 2005, the impact of that standard would have approximated the impact of SFAS 123 as described in the pro forma disclosure set forth below:

	<u>Thirteen Weeks Ended</u> <u>September 27,</u> <u>2005</u>	<u>Thirty-nine Weeks Ended</u> <u>September 27,</u> <u>2005</u>
Net income (loss):		
As reported	\$ (1,001,322)	\$ (1,963,298)
Less: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects	\$ (446,552)	\$ (828,097)
Pro forma	\$ (1,447,874)	\$ (2,791,395)
Net income (loss) per common share		
Basic and diluted as reported	\$ (0.09)	\$ (0.17)
Basic and diluted pro forma	\$ (0.12)	\$ (0.24)

The fair value of options at date of grant was estimated using the Black-Scholes option-pricing model with the following assumptions for the third quarter of 2005: (a) no dividend yield, (b) 47.5% expected volatility, (c) expected life of options of five to ten years and (d) a risk-free interest rate of 4.1% to 4.3%.

During the third quarter of 2006, the Company granted an aggregate of 190,000 options, estimating the fair value of such options using the Black-Scholes option-pricing model with the following assumptions: (a) no dividend yield, (b) 24.5% to 36.4% expected volatility, (c) expected life of options of five to ten years and (d) a risk-free interest rate of 4.78% to 5.00%. The Company recorded total stock-based compensation expense of \$143,364 and \$550,848 in the first thirteen and thirty-nine weeks of fiscal year 2006, respectively. See Note 7 for further discussion of the Company's stock-based compensation.

Accounting for Leases:

On October 6, 2005, the FASB issued Staff Position No. FAS 13-1, *Accounting for Rental Costs Incurred During a Construction Period*. Generally, the staff position requires companies to expense rental costs incurred during a construction period. The Company was required to adopt FASB Staff Position No. FAS 13-1 beginning in fiscal year 2006, and as a result, included \$263,881 and \$531,290 of such rental costs in pre-opening expense during the third quarter and first three quarters of fiscal year 2006, respectively. The non-cash portion of such pre-opening rent expense was \$197,931 and \$420,086 in the third quarter of 2006 and first three quarters of 2006, respectively. Prior to the adoption of FASB Staff Position No. FAS 13-1, the Company did not expense rental costs during the construction period, but rather capitalized such costs as then permitted under GAAP. The Company believes the adoption of the staff position will increase average per-unit pre-opening costs by \$50,000 to \$250,000 depending upon the lease term and length of construction period.

Principles of consolidation and presentation:

The Company's consolidated financial statements include the accounts and operations of the Company and its subsidiary corporations under which its Kansas locations are operated. Fifty-one percent of the stock of each of the subsidiary corporations is owned by a Granite City restaurant manager and the Company owns the

remainder of the stock of each corporation. Each manager-owner of the stock of these entities has entered into a buy-sell agreement with each corporation providing, among other things, that transfer of the shares is restricted and that the shareholder must sell his shares to the corporation upon certain events, including termination of employment or any event which disqualifies the manager from owning the shares under applicable laws and regulations of the state. The Company has entered into a master agreement with each separate corporation that permits the operation of the restaurants and leases to each corporation the Company's property and facilities. Each corporation pays all of its operating expenses and obligations, and the Company retains, as consideration for the operating arrangements and the lease of property and facilities, the net profit from its operations. The Company has determined that the foregoing ownership structure will cause these separate corporations to be treated as variable interest entities in which the Company has a controlling financial interest for the purpose of FASB Interpretation 46 (R), *Consolidation of Variable Interest Entities* (FIN46R). As such, the corporations are consolidated with the Company's financial statements and the Company's financial statements do not reflect a minority ownership in those separate corporations. All references to the Company in these financial statements relate to the consolidated entity.

Reclassification:

Certain reclassifications have been made to the financial statements for the third quarter and first three quarters of 2005 in order for them to conform to the presentation of the financial statements for the third quarter and first three quarters of 2006. These reclassifications have no effect on the accumulated deficit or net loss previously reported.

Recent accounting pronouncements:

In July 2006, the Financial Accounting Standards Board ("FASB") issued FASB Interpretation No. 48, "Accounting for Uncertainty in Income Taxes," ("FIN 48,") which clarifies the accounting and disclosures for uncertainty in income taxes recognized in the financial statements in accordance with SFAS No. 109, "Accounting for Income Taxes." FIN 48 also provides guidance on the de-recognition of uncertain tax positions, financial statement classification, accounting for interest and penalties, accounting for interim periods and adds new disclosure requirements. FIN 48 is effective for fiscal years beginning after December 15, 2006. We are evaluating the impact the adoption of FIN 48 will have on our consolidated financial statements.

3. Property and Equipment

The cost of property and equipment is depreciated over the estimated useful lives of the related assets. The cost of leasehold improvements is depreciated over the initial term of the related lease. Depreciation is computed on the straight-line method for financial reporting purposes and accelerated methods for income tax purposes. Amortization of assets acquired under capital lease is included in depreciation expense. The following is a summary of the Company's property and equipment at September 26, 2006 and December 27, 2005:

	<u>September 26, 2006</u>	<u>December 27, 2005</u>
Land	\$ 18,000	\$ 18,000
Buildings	27,145,648	19,718,797
Leasehold improvements	7,283,857	6,204,704
Equipment and furniture	17,177,839	11,921,513
Construction in progress*	3,290,462	1,893,731
	<u>54,915,806</u>	<u>39,756,745</u>
Less accumulated depreciation	8,414,430	5,989,463
	<u>\$ 46,501,376</u>	<u>\$ 33,767,282</u>

*Construction in progress includes the following approximate amounts for items yet to be placed in service:

St. Louis Park equipment	\$ 428,000
Madison equipment	\$ 441,000
Omaha equipment	\$ 844,000
Roseville equipment	\$ 978,000
St. Cloud leasehold improvements	\$ 547,000
Future locations' architecture fees	\$ 33,000
Corporate furniture and office equipment	\$ 19,000

Included in property and equipment are the following assets held under capital leases:

	<u>September 26, 2006</u>	<u>December 27, 2005</u>
Land	\$ 18,000	\$ 18,000
Buildings	27,145,648	19,718,797
Equipment	1,546,657	1,546,657
	<u>28,710,305</u>	<u>21,283,454</u>
Less accumulated depreciation	3,312,994	2,307,298
	<u>\$ 25,397,311</u>	<u>\$ 18,976,156</u>

4. Capital Leases

Minimum future lease payments under all capital leases as of September 26, 2006 are:

<u>Year ended:</u>	<u>Capital Leases</u>
2006	\$ 756,148
2007	3,024,591
2008	2,947,837
2009	2,892,902
2010	2,897,709
Thereafter	39,815,601
Total minimum lease payments	<u>52,334,788</u>
Less amount representing interest	25,828,359
Present value of net minimum lease payments	26,506,429
Less current portion	771,670
Long-term portion of obligations	<u>\$ 25,734,759</u>

Amortization expense related to the assets held under capital leases is included with depreciation expense on the Company's statements of operations.

5. Commitments and Contingencies

The following commitments and contingencies commenced or will commence subsequent to the quarter ended September 26, 2006:

Omaha, Nebraska Lease:

In October 2006, the Company commenced leasing its Omaha, Nebraska restaurant under a 20-year net lease agreement based on the terms specified in its development agreement with Dunham Capital Management L.L.C. ("Dunham") for the development of restaurants. The restaurant was constructed for the Company on a build-to-suit basis. The annual rent is \$315,500 of which \$220,500 is classified as a capital lease and \$95,000 plus percentage rent is classified as an operating lease. The Company will be responsible for any real-estate

