

REGIS CORP
Form 10-Q/A
May 20, 2005

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

FORM 10-Q/A

(Amendment No. 1)

(Mark One)

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

For the quarterly period ended December 31, 2004

OR

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

For the transition period from _____ to _____

Commission file number 011230

Regis Corporation

(Exact name of registrant as specified in its charter)

Minnesota

41-0749934

(State or other jurisdiction of
incorporation or organization)

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

7201 Metro Boulevard, Edina, Minnesota

55439

(Address of principal executive offices)

(Zip Code)

(952)947-7777

(Registrant's telephone number, including area code)

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

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

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Yes No

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

Yes No

Indicate the number of shares outstanding of each of the issuer's classes of common stock as of January 31, 2005:

Common Stock, \$.05 par value

44,716,962

Class

Number of Shares

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EXPLANATORY NOTE

The Company's Quarterly Report on Form 10-Q for the quarter ended December 31, 2004 was filed with the SEC on February 9, 2005 (the Original Filing). The Company is filing this Amendment No. 1 to its Quarterly Report on Form 10-Q for the quarter ended December 31, 2004 (Form 10-Q/A) to reflect restatements of its Condensed Consolidated Balance Sheets at December 31, 2004 and June 30, 2004, its Condensed Consolidated Statement of Operations for the three and six months ended December 31, 2004 and 2003, its Condensed Consolidated Statement of Cash Flows for the six months ended December 31, 2004 and 2003, and the related notes thereto, as discussed below. For a more detailed description of these restatements, see Restatement of Financial Statements in Note 2 of the Notes to the Condensed Consolidated Financial Statements included in Item 1, Financial Statements, of this Form 10-Q/A. Information presented in the section entitled Item 2, Management's Discussion and Analysis of Financial Condition and Results of Operations has also been revised, as applicable, for the effects of the restatement of financial data.

During the third quarter of its fiscal year ending June 30, 2005 (fiscal year 2005), Regis Corporation (the Company) became aware that a number of retailers and restaurant operators had disclosed in their filings with the Securities and Exchange Commission (SEC) that they were reassessing their accounting related to leases and that some companies had restated their financial statements to reflect changes in their accounting for leases. In light of these disclosures and restatements, the Company conducted a review of its lease accounting policies and practices.

In its lease accounting review, the Company examined its leases to determine the appropriate lease term for each lease under generally accepted accounting principles (GAAP). Typically, the Company's operating leases do not require rental payments to begin until the salon is opened. The leased space is sometimes made available to the Company prior to the commencement of salon operations in order to allow time for installing normal leasehold improvements and equipment necessary to operate a salon. The Company historically began to recognize rental expense on a straight-line basis at the earlier of the commencement of operations or the commencement of rental payments. However, the Company did not include the rent holiday period in its straight-line rent calculation. A rent holiday is considered to be any period where the lessee has the right to control the use of the leased property but no rental payments are required under the lease during that period. FASB Technical Bulletin (FTB) 85-3, Accounting for Operating Leases with Scheduled Rent Increases, requires rent holiday periods in an operating lease to be recognized by the lessee on a straight-line basis over the lease term, which includes any rent holiday period.

Based on the review of the Company's accounting for operating leases, the Company determined that it would be appropriate to restate certain of its prior financial statements to appropriately account for rent holiday periods. On April 13, 2005, the Company determined that its previously filed financial statements included in its Annual Report on Form 10-K for fiscal year 2004 (ended June 30, 2004) and its previously filed financial statements included in its Quarterly Reports on Form 10-Q for the first two quarters of fiscal year 2005 should be restated. The restatement to appropriately account for rent holidays had no impact on the overall cash flows of the Company's business. The Company has completed its lease accounting review and has reflected all of the necessary adjustments in its restated Condensed Consolidated Financial Statements.

This Form 10-Q/A sets forth the content of the Original Filing in its entirety, with changes to Items 1, 2, and 4 of Part I and Item 6 of Part II of the Original Filing amended, in each case, solely as a result of, and to reflect, the restatement. No other information in the Original Filing has been amended in this Form 10-Q/A. Pursuant to the rules of the SEC, Item 6 of Part II of the Original Filing has been amended to contain the awareness letter of the Company's independent registered public accountants and currently-dated certifications from the Company's Chief Executive Officer (CEO) and Chief Financial Officer (CFO), as required by Sections 302 and 906 of the Sarbanes-Oxley Act of 2002. The awareness letter of the Company's independent registered public accountant is attached to this Form 10-Q/A as Exhibit 15. The certifications of the Company's CEO and CFO are attached to this form 10-Q/A as Exhibits 31.1, 31.2, 32.1 and 32.2.

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Except for the foregoing amended information, this Form 10-Q/A continues to describe conditions as of the date of the Original Filing, and the Company has not updated the disclosures contained herein to reflect events that have occurred subsequent to that date. Other events occurring after the date of the Original Filing or other information necessary to reflect subsequent events have been disclosed in reports filed with the SEC subsequent to the Original Filing and any other reports filed with the SEC subsequent to the date of this filing.

The Company has not amended and does not intend to amend its previously-filed Annual Reports on Form 10-K or Quarterly Reports on Form 10-Q for the periods affected by the restatement that ended prior to June 30, 2004. For this reason, the Consolidated Financial Statements, reports of independent accountants and related financial information for the affected periods contained in such reports should no longer be relied upon.

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PART I - FINANCIAL INFORMATION
Item 1. Condensed Consolidated Financial Statements

REGIS CORPORATION

CONDENSED CONSOLIDATED BALANCE SHEET (Unaudited)
as of December 31, 2004 and June 30, 2004
(Dollars in thousands, except per share amounts)

	December 31, 2004	June 30, 2004
	(as restated, see Note 2)	(as restated, see Note 2)
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 118,333	\$ 73,567
Receivables, net	45,771	35,033
Inventories	173,652	161,304
Deferred income taxes	14,373	15,285
Other current assets	28,370	28,253
Total current assets	380,499	313,442
Property and equipment, net	411,644	381,903
Goodwill	625,586	457,140
Other intangibles, net	210,751	79,174
Other assets	52,085	40,200
Total assets	\$ 1,680,565	\$ 1,271,859
LIABILITIES AND SHAREHOLDERS EQUITY		
Current liabilities:		
Long-term debt, current portion	\$ 6,368	\$ 19,128
Accounts payable	66,225	53,112
Accrued expenses	159,921	129,721
Total current liabilities	232,514	201,961
Long-term debt	513,295	282,015
Other noncurrent liabilities	170,969	105,863
Total liabilities	916,778	589,839
Commitments and contingencies		
Shareholders equity:		

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Preferred stock, authorized 250,000 shares at December 31, 2004 and June 30, 2004

Common stock, \$.05 par value; issued and outstanding 44,661,488 and 44,283,949 common shares at December 31, 2004 and June 30, 2004, respectively

Additional paid-in capital

Accumulated other comprehensive income

Retained earnings

2,228	2,214
230,550	220,204
62,442	40,615
468,567	418,987

Total shareholders equity

763,787	682,020
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Total liabilities and shareholders equity

\$	1,680,565	\$	1,271,859
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The accompanying notes are an integral part of the unaudited Condensed Consolidated Financial Statements.

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CONDENSED CONSOLIDATED STATEMENT OF OPERATIONS (Unaudited)
for the three months ended December 31, 2004 and 2003
(Dollars in thousands, except per share amounts)

	2004	2003
	(as restated, see Note 2)	(as restated, see Note 2)
Revenues:		
Service	\$ 357,147	\$ 306,630
Product	160,249	147,442
Royalties and fees	19,936	18,380
	537,332	472,452
Operating expenses:		
Cost of service	203,604	171,452
Cost of product	84,392	76,902
Site operating expenses	44,751	39,154
General and administrative	64,105	54,429
Rent	75,117	65,094
Depreciation and amortization	20,765	18,673
Total operating expenses	492,734	425,704
Operating income	44,598	46,748
Other income (expense):		
Interest	(5,467)	(3,851)
Other, net	1,024	331
Income before income taxes	40,155	43,228
Income taxes	(13,671)	(15,692)
Net income	\$ 26,484	\$ 27,536
Net income per share:		
Basic	\$ 0.59	\$ 0.63
Diluted	\$ 0.57	\$ 0.60

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Weighted average common and common equivalent shares outstanding:			
Basic		44,534	43,893
Diluted		46,468	45,973
Cash dividends declared per common share		\$ 0.04	\$ 0.03

The accompanying notes are an integral part of the unaudited Condensed Consolidated Financial Statements.

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CONDENSED CONSOLIDATED STATEMENT OF OPERATIONS (Unaudited)
for the six months ended December 31, 2004 and 2003
(Dollars in thousands, except per share amounts)

	2004	2003
	(as restated, see Note 2)	(as restated, see Note 2)
Revenues:		
Service	\$ 696,582	\$ 609,582
Product	308,368	287,102
Royalties and fees	38,604	36,489
	1,043,554	933,173
Operating expenses:		
Cost of service	396,190	341,853
Cost of product	161,976	151,215
Site operating expenses	88,052	77,701
General and administrative	121,806	107,873
Rent	147,625	128,620
Depreciation and amortization	40,560	36,299
Total operating expenses	956,209	843,561
Operating income	87,345	89,612
Other income (expense):		
Interest	(9,775)	(8,219)
Other, net	1,701	671
Income before income taxes	79,271	82,064
Income taxes	(27,595)	(29,879)
Net income	\$ 51,676	\$ 52,185
Net income per share:		
Basic	\$ 1.16	\$ 1.19
Diluted	\$ 1.11	\$ 1.14

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Weighted average common and common equivalent shares outstanding:			
Basic		44,423	43,795
Diluted		46,359	45,835
Cash dividends declared per common share	\$	0.08	\$ 0.06

The accompanying notes are an integral part of the unaudited Condensed Consolidated Financial Statements.

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CONDENSED CONSOLIDATED STATEMENT OF CASH FLOWS (Unaudited)
for the six months ended December 31, 2004 and 2003
(Dollars in thousands)

	2004	2003
	(as restated, see Note 2)	(as restated, see Note 2)
Cash flows from operating activities:		
Net income	\$ 51,676	\$ 52,185
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	38,137	34,888
Amortization	2,423	1,724
Deferred income taxes	4,125	5,604
Other	595	179
Changes in operating assets and liabilities:		
Receivables	(1,265)	(2,408)
Inventories	(8,407)	4,883
Other current assets	1,546	(1,950)
Other assets	(6,836)	(2,870)
Accounts payable	7,221	881
Accrued expenses	15,075	14,057
Other noncurrent liabilities	8,245	6,558
Net cash provided by operating activities	112,535	113,731
Cash flows from investing activities:		
Capital expenditures	(46,709)	(34,404)
Proceeds from sale of assets	602	95
Purchases of salon net assets, net of cash acquired	(244,743)	(33,611)
Net cash used in investing activities	(290,850)	(67,920)
Cash flows from financing activities:		
Borrowings on revolving credit facilities	890,315	385,175
Payments on revolving credit facilities	(760,633)	(396,150)
Proceeds from issuance of long-term debt	100,000	11,860
Repayment of long-term debt	(17,226)	(20,110)
Other, primarily increase (decrease) in negative book cash balances	2,672	(8,838)
Dividends paid	(3,555)	(2,631)
Repurchase of common stock	(442)	(3,373)
Proceeds from issuance of common stock	6,425	10,390
Net cash provided by (used in) financing activities	217,556	(23,677)

Effect of exchange rate changes on cash and cash equivalents	5,525	3,568
Increase in cash and cash equivalents	44,766	25,702
Cash and cash equivalents:		
Beginning of period	73,567	55,454
End of period	\$ 118,333	\$ 81,156

The accompanying notes are an integral part of the unaudited Condensed Consolidated Financial Statements.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

1. BASIS OF PRESENTATION OF UNAUDITED INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS:

The unaudited interim Condensed Consolidated Financial Information of Regis Corporation (the Company) as of December 31, 2004 and for the three and six months ended December 31, 2004 and 2003, reflect, in the opinion of management, all adjustments (all of which are normal and recurring in nature) necessary to fairly state the consolidated financial position of the Company as of December 31, 2004 and the consolidated results of its operations and its cash flows for the interim periods. The results of operations and cash flows for any interim period are not necessarily indicative of results of operations and cash flows for the full year.

The Consolidated Balance Sheet data for June 30, 2004 was derived from audited Consolidated Financial Statements, but does not include all disclosures required by accounting principles generally accepted in the United States of America (GAAP). The unaudited interim Condensed Consolidated Financial Statements should be read in conjunction with the Company's Annual Report on Form 10-K/A for the year ended June 30, 2004 and other documents filed or furnished with the Securities and Exchange Commission (SEC) during the current fiscal year.

With respect to the unaudited condensed financial information of the Company for the three and six month periods ended December 31, 2004 and 2003 included in this Form 10-Q/A, PricewaterhouseCoopers LLP reported that they have applied limited procedures in accordance with professional standards for a review of such information. However, their separate report dated January 26, 2005 appearing herein, states that they did not audit and they do not express an opinion on that unaudited financial information. Accordingly, the degree of reliance on their report on such information should be restricted in light of the limited nature of the review procedures applied. PricewaterhouseCoopers LLP is not subject to the liability provisions of Section 11 of the Securities Act of 1933 for their report on the unaudited financial information because that report is not a report or a part of the registration statement prepared or certified by PricewaterhouseCoopers LLP within the meaning of Sections 7 and 11 of the Act.

Cost of Product Used and Sold:

Product costs related to the sale of product or services to salon customers are determined by applying estimated gross profit margins to service and product revenues, which are based on historical factors including product pricing trends and estimated shrinkage. In addition, the estimated gross profit margin is adjusted based on the results of physical inventory counts performed at least semi-annually. During September of fiscal year 2005, the Company performed a physical inventory count which was finalized during the second quarter and resulted in changes in the Company's interim fiscal usage estimates, and a corresponding adjustment that increased second quarter cost of sales by approximately \$1.5 million. Significant changes in product costs, volumes or shrinkage could have a material impact on the Company's gross margin. Product costs related to the sale of product to franchisees are determined by weighted average cost.

Property and Equipment:

Property and equipment are carried at cost, less accumulated depreciation and amortization. Depreciation and amortization of property and equipment are computed on the straight-line method over estimated useful asset lives (30 to 39 years for buildings and improvements and five to ten years for equipment, furniture, software and

leasehold improvements). Leasehold improvements are amortized over the shorter of their estimated useful lives or the related lease term, generally ten years. For leases with renewal periods at the Company's option, management may determine at the inception of the lease that renewal is reasonably assured if failure to exercise a renewal option imposes an economic penalty to the Company. In such cases, the Company will include the renewal option period along with the original stated lease period in the determination of appropriate estimated useful lives.

The Company capitalizes both internal and external costs of developing or obtaining computer software for internal use. Costs incurred to develop internal-use software during the application development stage are capitalized, while data conversion, training and maintenance costs associated with internal-use software are expensed as incurred. Amortization expense related to capitalized software is determined based on an estimated useful life of five or seven years.

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**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (cont.)
(Unaudited)**

Expenditures for maintenance and repairs and minor renewals and betterments which do not improve or extend the life of the respective assets are expensed. All other expenditures for renewals and betterments are capitalized. The assets and related depreciation and amortization accounts are adjusted for property retirements and disposals with the resulting gain or loss included in operations. Fully depreciated/amortized assets remain in the accounts until retired from service.

Deferred Rent and Rent Expense:

The Company leases most salon, beauty school and hair restoration center locations under operating leases. Most lease agreements contain tenant improvement allowances funded by landlord incentives, rent holidays, rent escalation clauses and/or contingent rent provisions. Accounting principles generally accepted in the United States of America require rent expense to be recognized on a straight-line basis over the lease term. The difference between the rent due under the stated periods of the lease compared to that of the straight-line basis is recorded as deferred rent within other noncurrent liabilities in the Condensed Consolidated Balance Sheet.

For purposes of recognizing incentives and minimum rental expenses on a straight-line basis over the terms of the leases, the Company uses the date that it obtains the legal right to use and control the leased space to begin amortization, which is generally when the Company enters the space and begins to make improvements in preparation of intended use of the leased space.

For tenant improvement allowances funded by landlord incentives and rent holidays, the Company records a deferred rent liability in other noncurrent liabilities on the Condensed Consolidated Balance Sheet and amortizes the deferred rent as a reduction to rent expense on the Condensed Consolidated Statements of Operations over the term of the lease (including one renewal option period if renewal is reasonably assured based on the imposition of an economic penalty for failure to exercise the renewal option).

Certain lease agreements contain rent escalation clauses which provide for scheduled rent increases during the lease term or for rental payments commencing at a date other than the date of initial occupancy. Such stepped rent expense is recorded in the Condensed Consolidated Statements of Operations on a straight-line basis over the lease term (including one renewal option period if renewal is reasonably assured based on the imposition of an economic penalty for failure to exercise the renewal option).

Certain leases provide for contingent rents, which are determined as a percentage of revenues in excess of specified levels. The Company records a contingent rent liability in accrued expenses on the Condensed Consolidated Balance Sheet, along with the corresponding rent expense in the Condensed Consolidated Statement of Operations, when specified levels have been achieved or when management determines that achieving the specified levels during the fiscal year is probable.

Reclassifications:

Certain prior period amounts have been reclassified to conform to the current year presentation. These reclassifications had no effect on net income or shareholders' equity as previously presented.

Recent Accounting Pronouncements:

In December 2004, the Financial Accounting Standards Board (FASB) issued a revised FAS No. 123, Share-Based Payment (revised 2004) (FAS No. 123R), which supersedes APB No. 25 and amends FAS No. 123 to require

companies to expense the value of stock-based compensation plans. Additionally, FAS 123R, once adopted, disallows the use of the prospective transition method permitted by FAS No. 148. FAS 123R is effective as of the beginning of the first interim or annual reporting period that begins after June 15, 2005 (i.e., the beginning of the Company's fiscal year 2006).

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**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (cont.)
(Unaudited)**

As discussed in Note 1 in conjunction with stock-based employee compensation plans, the Company currently has three types of stock-based compensation: stock options, SARs and restricted stock. The Company adopted the fair value recognition provisions of FAS No. 123 using the prospective transition method as of the beginning of fiscal year 2004. No SRS or restricted stock were issued before fiscal year 2004; therefore, the adoption of FAS No. 123R has no effect with respect to these types of stock-based awards. However, in compliance with the prospective transition method under FAS No. 148, no compensation expense is currently recognized in the Company's Condensed Consolidated Statement of Operations with respect to stock options granted prior to fiscal year 2004 (the date upon which Company adopted the fair value recognition provisions under FAS No. 123). The Company will adopt FAS No. 123R on July 1, 2005. Under the provisions of FAS 123R, compensation expense will also be recognized in earnings over the vesting period for stock options which remain unvested as of the date of adoption (July 1, 2005), regardless of their grant date. The Company expects the adoption of FAS 123R to incrementally increase compensation expense by approximately \$2.6 million during fiscal year 2006.

In November, 2004, the FASB issued FAS No. 151, Inventory Costs, an Amendment of ARB No. 43, Chapter 4 (FAS No. 151). FAS No. 151 clarifies the accounting for abnormal amounts of idle facility expense, freight, handling costs and wasted material (spoilage) by requiring all such costs to be recognized as current period charges regardless of whether or not the costs meet the criterion of so abnormal. Additionally, the Statement requires that the allocation of fixed production overheads to the costs of conversion be based on the normal capacity of the production facilities. This Statement is effective prospectively for inventory costs incurred during fiscal years beginning after June 15, 2005. The Company is currently evaluating the impact of adopting this Statement on its Consolidated Financial Statements.

Also in December 2004, the FASB issued FAS No. 153, Exchanges of Nonmonetary Assets an Amendment of APB Opinion No. 29 (FAS No. 153). The guidance in APB Opinion No. 29 is based on the principle that exchanges of nonmonetary assets should be measured based on the fair value of the assets exchanged, with the exception that nonmonetary exchanges of similar productive assets should be recorded on a carryover basis. FAS No. 153 amends APB Opinion No. 29 to eliminate this exception for similar productive assets and replace it with the general exception for exchanges of nonmonetary assets that do not have commercial substance. A nonmonetary exchange has commercial substance if the future cash flows of the entity are expected to change significantly as a result of the exchange. The provisions of FAS No. 153 should be applied prospectively to nonmonetary asset exchanges occurring in fiscal periods beginning after June 15, 2005, with early application permitted. The Company does not expect the adoption of this Statement to have any impact on its Consolidated Financial Statements.

In October, 2004, the FASB ratified the consensus reached by the Emerging Issues Task Force (EITF) on EITF Issue No. 04-1 Accounting for Preexisting Relationships between the Parties to a Business Combination (EITF 04-1). This EITF requires, upon the acquisition of a business, acquiring companies to separately account for any pre-existing contractual relationships with the acquired entity. Amounts paid in settlement of any executory contracts must be expensed, measured at the lesser of (a) the amount by which the contract is favorable or unfavorable to market (from the acquiring company's perspective) or (b) any stated settlement provisions in the contract. The reacquisition of an acquired entity's contractual right to use the acquiring company's intangible assets must be recognized as an intangible asset apart from goodwill, measured at a value not to exceed any stated reacquisition amount included in the contract. If a business combination effectively settles a lawsuit or executory contract and that settlement results in a gain or loss for the acquiring company, that company must recognize a settlement gain or loss. The following disclosures are also required by EITF 04-1: (a) the nature of the pre-existing relationship; (b) the fair value of the acquired entity's assets and liabilities that were settled, including how fair value was determined; and (c) the amount of the settlement gain or loss recognized. This EITF must be applied to business combinations after October 13, 2004. The adoption of EITF

04-1 has not had, and the Company does not expect it to have in the future, a material impact on its Consolidated Financial Statements. When purchasing its franchisees, the fair value of any reacquired franchise right is estimated and considered in the purchase price allocation.

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**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (cont.)
(Unaudited)**

Also during October 2004, the FASB ratified the consensus reached by the EITF with respect to EITF Issue No. 04-10, Determining Whether to Aggregate Operating Segments That Do Not Meet the Quantitative Thresholds (EITF 04-10), which clarifies the guidance in paragraph 19 of FAS No. 131, Disclosures about Segments of an Enterprise and Related Information (FAS No. 131). According to EITF 04-10, operating segments that do not meet the quantitative thresholds can be aggregated under paragraph 19 only if aggregation is consistent with the objective and basic principle of FAS No. 131, the segments have similar economic characteristics, and the segments share a majority of the aggregation criteria listed in items (a)-(e) in paragraph 17 of FAS No. 131. The FASB staff is currently working on a FASB Staff Position (FSP) to provide guidance in determining whether two or more operating segments have similar economic characteristics. The effective date of EITF 04-10 has been delayed in order to coincide with the effective date of the anticipated FSP, with early application is permitted. The adoption of EITF 04-10 is not expected to have an impact on the Company's Consolidated Financial Statements.

On December 21, 2004, the FASB issued FASB Staff Position (FSP) No. FAS 109-2, Accounting and Disclosure Guidance for the Foreign Earnings Repatriation Provision within the American Jobs Creation Act of 2004. FSP No. FAS 109-2 provides accounting and disclosure guidance for the repatriation provision under the American Jobs Creation Act of 2004, and allows additional time for entities potentially impacted by the provision to determine whether any foreign earnings will be repatriated under those provisions. As discussed in Note 8, the Company has completed a preliminary evaluation of the repatriation provisions and Treasury guidance and has determined that there is no advantage to electing repatriation under the Act.

Stock-Based Employee Compensation Plans:

At December 31, 2004, the Company had the 2004 Long Term Incentive Plan (2004 Plan) and the 2000 Stock Option Plan. Additionally, the Company has outstanding stock options under its 1991 Stock Option Plan, although the Plan terminated in 2001. Prior to July 1, 2003, the Company accounted for its 2000 Stock Option Plan and 1991 Stock Option Plan using the intrinsic value method under the recognition and measurement principles of Accounting Principles Board (APB) Opinion No. 25, Accounting for Stock Issued to Employees (APB No. 25) and related Interpretations and applied Statement of Financial Accounting Standards (FAS) No. 123, Accounting for Stock-Based Compensation (FAS No. 123), as amended by FAS No. 148, Accounting for Stock-Based Compensation Transition and Disclosure (FAS No. 148), for disclosure purposes only. The FAS No. 123 disclosures include pro forma net income and earnings per share as if the fair value-based method of accounting had been used. Under the provisions of APB No. 25, no stock-based employee compensation cost is reflected in net income, as all options granted under those plans had an exercise price equal to the market value of the underlying stock on the date of grant.

Effective July 1, 2003, the Company adopted the fair value recognition provisions of FAS No. 123 using the prospective transition method. Under the prospective method of adoption, compensation cost is recognized related to options granted, modified or settled after the beginning of the fiscal year in which the fair value method is first adopted. Under this approach, fiscal year 2005 and 2004 compensation expense is less than it would have been had the fair value recognition provisions of FAS No. 123 been applied from its original effective date because the fair value of the options vesting during the year which were granted prior to fiscal year 2004 are not recognized under the prospective transition method in the Condensed Consolidated Statement of Operations. Options granted in fiscal years prior to the adoption of the fair value recognition provisions continue to be accounted for under APB Opinion No. 25 during fiscal year 2005. The adoption of the fair value recognition provisions for stock options increased the Company's second quarter and year-to-date fiscal year 2005 compensation expense by approximately \$0.2 million, and is expected to increase total fiscal year 2005 compensation expense by approximately \$0.3 million.

The 2004 Plan was approved by the Company's Board of Directors in May of 2004 and received shareholder approval on October 28, 2004. In June 2004 (prior to shareholder approval), 72,500 shares of restricted stock and 110,750 stock appreciation rights (SARs) were awarded under the 2004 Plan, pending shareholder approval. No stock options have been granted under the 2004 Plan. Since the 2004 Plan did not receive shareholder approval until the second quarter of fiscal year 2005, no compensation expense was recognized related to the 2004 Plan prior to this quarter. During the three months ended December 31, 2004, compensation expense of approximately \$0.1 million and less than \$0.1 million was recognized related to restricted stock and SARs, respectively.

Table of Contents**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (cont.)
(Unaudited)**

The Company's pro forma net income and pro forma earnings per share for the three and six months ended December 31, 2004 and 2003 was as follows:

	For the Periods Ended December 31,			
	Three Months		Six Months	
	2004	2003	2004	2003
(Dollars in thousands, except per share amounts)				
Net income, as reported (as restated, see Note 2)	\$ 26,484	27,536	\$ 51,676	\$ 52,185
Add: Stock-based employee compensation expense included in reported net income, net of related tax effects	164		214	
Deduct: Total stock-based employee compensation expense determined under fair value based methods for all awards, net of related tax effects	(1,588)	(1,652)	(3,157)	(3,327)
Pro forma net income (as restated, see Note 2)	\$ 25,060	\$ 25,884	\$ 48,733	\$ 48,858
Earnings per share:				
Basic as reported (as restated, see Note 2)	\$ 0.59	\$ 0.63	\$ 1.16	\$ 1.19
Basic pro forma (as restated, see Note 2)	\$ 0.56	\$ 0.59	\$ 1.10	\$ 1.12
Diluted as reported (as restated, see Note 2)	\$ 0.57	\$ 0.60	\$ 1.11	\$ 1.14
Diluted pro forma (as restated, see Note 2)	\$ 0.54	\$ 0.57	\$ 1.05	\$ 1.07

The fair value of options was calculated utilizing the Black-Scholes option-pricing model and the following key weighted average assumptions:

	2004	2003
Risk-free interest rate	4.16%	2.89%
Expected life in years	5.50	7.25
Expected volatility	30.0%	42.0%
Expected dividend yield	0.37%	0.45%

2. RESTATEMENT OF FINANCIAL STATEMENTS:

During the third quarter of its fiscal year ending June 30, 2005 (fiscal year 2005), the Company became aware that a number of retailers and restaurant operators had disclosed in their filings with the SEC that they were reassessing their accounting related to leases and that some companies had restated their financial statements to reflect changes in their accounting for leases. In light of these disclosures and restatements, the Company conducted a review of its lease accounting policies and practices.

In its lease accounting review, the Company examined its real estate leases to determine the appropriate lease term for each lease under GAAP. Typically, the Company's operating leases do not require rental payments to begin until the salon is opened. The leased space is sometimes made available to the Company prior to the commencement of salon operations in order to allow time for installing normal leasehold improvements and equipment necessary to operate a salon. The Company historically began to recognize rental expense on a straight-line basis at the earlier of the commencement of operations or the commencement of rental payments. However, the Company did not previously include the rent holiday period in its straight-line rent calculation. A rent holiday is considered to be any period where the lessee has the right to control the use of the leased property but no rental payments are required under the lease during that period. FASB Technical Bulletin (FTB) 85-3,

Accounting for Operating Leases with Scheduled Rent Increases, requires rent holiday periods in an operating lease to be recognized by the lessee on a straight-line basis over the lease term, which includes any rent holiday period.

Table of Contents**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (cont.)
(Unaudited)**

Based on the review of the Company's accounting for operating leases, the Company concluded that its previously reported rent expense amounts needed to be restated to reflect rent holidays on a straight-line basis over the appropriately defined lease term. This correction generally results in an increase of the total amount of rent expense recorded each fiscal year, with a corresponding adjustment to the deferred rent liability (within other noncurrent liabilities on the Condensed Consolidated Balance Sheet). The adjustment to lease expense is tax effected, which causes adjustments to income tax expense within the Condensed Consolidated Statement of Operations, as well as deferred income taxes (within other noncurrent liabilities) in the Condensed Consolidated Balance Sheet.

The Company restated its previously issued financial statements, including those in the Company's 2004 Annual Report on Form 10-K for the fiscal year ended June 30, 2004 and those in the Company's Quarterly Reports on Form 10-Q for the quarters ended September 30, 2004 and December 31, 2004. The restatement did not have any effect on the Company's previously reported consolidated revenues or cash flow from operations. Following is a summary of the effects of the lease accounting corrections on the Company's Condensed Consolidated Statements of Operations for the three and six months ended December 31, 2004 and 2003:

**Condensed Consolidated Statement of
Operations
For the Three Months Ended December 31,
2004**

	2004			2003		
	As Previously Reported	Adjustment	As Restated	As Previously Reported	Adjustment	As Restated
(Dollars in thousands)						
Rent	\$ 74,670	\$ 447	\$ 75,117	\$ 64,759	\$ 335	\$ 65,094
Operating income	45,045	(447)	44,598	47,083	(335)	46,748
Income before income taxes	40,602	(447)	40,155	43,563	(335)	43,228
Income taxes	(13,838)	167	(13,671)	(15,901)	209	(15,692)
Net income	26,764	(280)	26,484	27,662	(126)	27,536
Net income per share basic	\$ 0.60	\$ (0.01)	\$ 0.59	\$ 0.63	\$	\$ 0.63
Net income per share diluted	\$ 0.58	\$ (0.01)	\$ 0.57	\$ 0.60	\$	\$ 0.60

**Condensed Consolidated Statement of
Operations
For the Six Months Ended December 31,
2004**

	2004			2003		
	As Previously Reported	Adjustment	As Restated	As Previously Reported	Adjustment	As Restated
(Dollars in thousands)						
Rent	\$ 146,719	\$ 906	\$ 147,625	\$ 127,818	\$ 802	\$ 128,620
Operating income	88,251	(906)	87,345	90,414	(802)	89,612
Income before income taxes	80,177	(906)	79,271	82,866	(802)	82,064
Income taxes	(27,934)	339	(27,595)	(30,246)	367	(29,879)
Net income	52,243	(567)	51,676	52,620	(435)	52,185
Net income per share basic	\$ 1.18	\$ (0.02)	\$ 1.16	\$ 1.20	\$ (0.01)	\$ 1.19
Net income per share diluted	\$ 1.13	\$ (0.02)	\$ 1.11	\$ 1.15	\$ (0.01)	\$ 1.14

Following is a summary of the effects of the lease accounting corrections on the Company's Condensed Consolidated Balance Sheet as of December 31, 2004 and June 30, 2004:

	Condensed Consolidated Balance Sheet					
	December 31, 2004			June 30, 2004		
	As Previously Reported	Adjustment	As Restated	As Previously Reported	Adjustment	As Restated
(Dollars in thousands)						
Other noncurrent liabilities	\$ 164,828	\$ 6,141	\$ 170,969	\$ 100,322	\$ 5,541	\$ 105,863
Total liabilities	910,637	6,141	916,778	584,298	5,541	589,839
Accumulated other comprehensive income	62,502	(60)	62,442	40,642	(27)	40,615
Retained earnings	474,648	(6,081)	468,567	424,501	(5,514)	418,987
Total shareholders' equity	769,928	(6,141)	763,787	687,561	(5,541)	682,020

Table of Contents**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (cont.)
(Unaudited)****3. SHAREHOLDERS EQUITY AND COMPREHENSIVE INCOME:****Additional Paid-In Capital**

The increase in additional paid-in capital during the six months ended December 31, 2004 was due to the following:

(Dollars in thousands)	Increase (Decrease)
Exercise of stock options	\$ 6,412
Tax benefit realized upon exercise of stock options	3,785
Stock option compensation	341
Franchise stock incentive program	250
Stock repurchase plan	(442)
	\$ 10,346

Comprehensive Income

Components of comprehensive income for the Company include net income, changes in fair market value of financial instruments designated as hedges of interest rate exposures and changes in foreign currency translation, including the impact of the cross-currency swap, recorded in the cumulative translation account within shareholders' equity. Comprehensive income for the three and six months ended December 31, 2004 and 2003 were as follows:

(Dollars in thousands)	For the Periods Ended December 31,			
	Three Months		Six Months	
	2004	2003	2004	2003
Net income (as restated, see Note 2)	\$ 26,484	\$ 27,536	\$ 51,676	\$ 52,185
Other comprehensive income (loss):				
Changes in fair market value of financial instruments designated as cash flow hedges of interest rate exposure, net of taxes	24	61	23	106
Change in cumulative foreign currency translation, net of taxes	17,129	12,730	21,804	13,781
Total comprehensive income (as restated, see Note 2)	\$ 43,637	\$ 40,327	\$ 73,503	\$ 66,072

4. NET INCOME PER SHARE:

Stock options covering 106,701 and 661 shares for the six months ended December 31, 2004 and 2003, respectively, were excluded from the shares used in the computation of diluted earnings per share since they were anti-dilutive. There were no anti-dilutive shares during the three months ended December 31, 2004 or 2003.

The following table sets forth a reconciliation of shares used in the computation of basic and diluted earnings per share:

	For the Periods Ended December 31,			
	Three Months		Six Months	
	2004	2003	2004	2003
Weighted average shares for basic earnings per share	44,533,777	43,893,120	44,422,516	43,795,288
Effect of dilutive securities:				
Dilutive effect of stock-based compensation	1,894,154	2,079,748	1,896,367	2,004,612
Contingent shares issuable under contingent stock agreements (see Note 7)	39,678		39,678	35,017
Weighted average shares for diluted earnings per share	46,467,609	45,972,868	46,358,561	45,834,917

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**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (cont.)
(Unaudited)**

5. SEGMENT INFORMATION:

The Company operates or franchises 8,381 North American salons (located in the United States, Canada and Puerto Rico), 2,031 international salons and 15 beauty schools. Additionally, the Company purchased 91 hair restoration centers (42 company-owned and 49 franchise locations) in conjunction with its purchase of Hair Club for Men and Women during December 2004. The Company operates its North American salon operations through five primary concepts: Regis Salons, MasterCuts, Trade Secret, SmartStyle and Strip Center salons. Each of the concepts offer similar products and services, concentrates on the mass-market consumer marketplace and has consistent distribution channels. All of the company-owned and franchise salons within the North American salon concepts are located in high traffic, retail shopping locations that attract mass-market consumers, and the individual salons generally display similar economic characteristics. The salons share interdependencies and a common support base. The Company's international salon operations, which are primarily in Europe, are located in malls, leading department stores, mass merchants and high-street locations. The Company's beauty schools are located in the United States and the United Kingdom. The Company's newly acquired hair restoration centers are located in the United States and Canada.

Based on the way the Company manages its business, it has reported its North American salons, international salons, beauty schools and hair restoration centers as four separate segments. In the prior fiscal year, the Company reported two segments: North American and international operations. Salons and beauty schools were included within each of these segments due to the way in which the Company managed its business at that time. Management began reviewing the operations of the beauty schools separately from the salon operations during fiscal year 2005 in anticipation of further expansion into the beauty school business. Further, the acquisition of Hair Club for Men and Women allowed the Company to expand into a new line of business, and thereby created an additional segment (hair restoration centers). Segment information for the second quarter and first six months of fiscal year 2004 has been reclassified to conform to the current year presentation.

Financial information for the Company's reporting segments is shown in the following tables:

	For the Three Months Ended December 31, 2004 (as restated, see Note 2)					
	Salons		Beauty	Hair	Unallocated	
	North			Restoration		
(Dollars in thousands)	America	International	Schools	Centers	Corporate	Consolidated
Revenues:						
Service	\$ 309,545	\$ 33,745	\$ 7,597	\$ 6,260	\$	\$ 357,147
Product	145,854	12,463	435	1,497		160,249
Royalties and fees	9,919	9,389		628		19,936
	465,318	55,597	8,032	8,385		537,332
Operating expenses:						
Cost of service	180,850	18,095	2,143	2,516		203,604
Cost of product	75,425	7,816	363	788		84,392
Site operating expenses	41,085	2,389	797	480		44,751
General and administrative	24,992	10,714	1,471	1,818	25,110	64,105

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Rent	64,591	9,304	617	510	95	75,117
Depreciation and amortization	15,563	1,661	233	708	2,600	20,765
Total operating expenses	402,506	49,979	5,624	6,820	27,805	492,734
Operating income	62,812	5,618	2,408	1,565	(27,805)	44,598
Other income (expense):						
Interest					(5,467)	(5,467)
Other, net					1,024	1,024
Income before income taxes	\$ 62,812	\$ 5,618	\$ 2,408	\$ 1,565	\$ (32,248)	\$ 40,155

Table of Contents**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (cont.)
(Unaudited)****For the Three Months Ended December 31, 2003 (as restated, see Note 2)**

(Dollars in thousands)	Salons		Beauty	Hair		Consolidated
	North			Restoration	Unallocated	
	America	International	Schools	Centers	Corporate	
Revenues:						
Service	\$ 274,507	\$ 28,577	\$ 3,546	\$	\$	\$ 306,630
Product	136,382	10,902	158			147,442
Royalties and fees	10,049	8,331				18,380
	420,938	47,810	3,704			472,452
Operating expenses:						
Cost of service	156,609	13,760	1,083			171,452
Cost of product	69,406	7,398	98			76,902
Site operating expenses	36,717	1,939	498			39,154
General and administrative	22,921	9,007	315		22,186	54,429
Rent	56,222	8,520	255		97	65,094
Depreciation and amortization	14,586	1,764	59		2,264	18,673
Total operating expenses	356,461	42,388	2,308		24,547	425,704
Operating income	64,477	5,422	1,396		(24,547)	46,748
Other income (expense):						
Interest					(3,851)	(3,851)
Other, net					331	331
Income before income taxes	\$ 64,477	\$ 5,422	\$ 1,396	\$	\$ (28,067)	\$ 43,228

For the Six Months Ended December 31, 2004 (as restated, see Note 2)

(Dollars in thousands)	Salons		Beauty	Hair		Consolidated
	North			Restoration	Unallocated	
	America	International	Schools	Centers	Corporate	
Revenues:						
Service	\$ 611,411	\$ 65,753	\$ 13,158	\$ 6,260	\$	\$ 696,582
Product	282,192	23,749	930	1,497		308,368
Royalties and fees	20,143	17,833		628		38,604
	913,746	107,335	14,088	8,385		1,043,554

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Operating expenses:						
Cost of service	355,039	34,501	4,134	2,516		396,190
Cost of product	145,532	15,042	614	788		161,976
Site operating expenses	81,266	4,514	1,792	480		88,052
General and administrative	49,413	19,266	2,329	1,818	48,980	121,806
Rent	127,655	18,128	1,129	510	203	147,625
Depreciation and amortization	30,895	3,488	471	708	4,998	40,560
Total operating expenses	789,800	94,939	10,469	6,820	54,181	956,209
Operating income	123,946	12,396	3,619	1,565	(54,181)	87,345
Other income (expense):						
Interest					(9,775)	(9,775)
Other, net					1,701	1,701
Income before income taxes	\$ 123,946	\$ 12,396	\$ 3,619	\$ 1,565	\$ (62,255)	\$ 79,271

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (cont.)
(Unaudited)

For the Six Months Ended December 31, 2003 (as restated, see Note 2)

	Salons		Beauty	Hair	Unallocated		
	North		Schools	Restoration	Centers	Corporate	Consolidated
(Dollars in thousands)	America	International					
Revenues:							
Service	\$ 547,588	\$ 55,532	\$ 6,462	\$	\$	\$	\$ 609,582
Product	267,065	19,749	288				287,102
Royalties and fees	20,818	15,671					36,489
	835,471	90,952	6,750				933,173
Operating expenses:							
Cost of service	311,945	27,815	2,093				341,853
Cost of product	137,890	13,143	182				151,215
Site operating expenses	73,308	3,496	897				77,701
General and administrative	44,931	16,880	561			45,501	107,873
Rent	111,397	16,500	496			227	128,620
Depreciation and amortization	28,334	3,453	113			4,399	36,299
Total operating expenses	707,805	81,287	4,342			50,127	843,561
Operating income	127,666	9,665	2,408			(50,127)	89,612
Other income (expense):							
Interest						(8,219)	(8,219)
Other, net						671	671
Income before income taxes	\$ 127,666	\$ 9,665	\$ 2,408	\$	\$	\$ (57,675)	\$ 82,064

	Total Assets	
(Dollars in thousands)	December	June 30, 2004
	31, 2004	
North American salons	\$ 841,120	\$ 782,915
International salons	233,867	198,679
Beauty schools	46,984	38,665
Hair restoration centers	294,692	
Unallocated corporate	263,902	251,600
Consolidated	\$ 1,680,565	\$ 1,271,859

6. GOODWILL AND OTHER INTANGIBLES:

The table below presents other intangible assets as of December 31, 2004 and June 30, 2004:

(Dollars in thousands)	December 31, 2004			June 30, 2004		
	Cost	Accumulated Amortization	Net	Cost	Accumulated Amortization	Net
Amortized intangible assets:						
Trade names	\$ 111,271	\$ (2,937)	\$ 108,334	\$ 37,379	\$ (2,104)	\$ 35,275
Customer list	46,800	(390)	46,410			
Franchise agreements	25,386	(4,102)	21,284	16,513	(3,413)	13,100
Product license agreements	17,062	(1,555)	15,507	15,338	(1,144)	14,194
School-related licenses	5,700	(55)	5,645	4,700	(8)	4,692
Non-compete agreements	644	(536)	108	600	(460)	140
Other	15,027	(1,564)	13,463	12,902	(1,129)	11,773
	\$ 221,890	\$ (11,139)	\$ 210,751	\$ 87,432	\$ (8,258)	\$ 79,174

All intangible assets have been assigned an estimated finite useful life, and are amortized on a straight-line basis over the number of years that approximate their respective useful lives (ranging from four to 50 years). The straight-line method of amortization allocates the cost of the intangible assets to earnings in proportion to the amount of economic benefits obtained by the Company in that reporting period. The weighted average amortization periods, in total and by major intangible asset class, are as follows:

Table of Contents**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (cont.)
(Unaudited)**

	Weighted Average Amortization Period (in years)
(Dollars in thousands)	
Amortized intangible assets:	
Trade names	42
Customer list	10
Franchise agreements	20
Product license agreements	30
School-related licenses	50
Non-compete agreements	6
Other	19
Total	30

Total amortization expense related to amortizable intangible assets was approximately \$1.4 and \$0.7 million during the three months ended December 31, 2004 and 2003, respectively, and \$2.2 and \$1.4 million during the six months ended December 31, 2004 and 2003, respectively. As of December 31, 2004, future estimated amortization expense related to amortizable intangible assets is estimated to be:

(Dollars in thousands)

Fiscal Year

2006	\$ 10,324
2007	10,323
2008	10,292
2009	10,251
2010	10,237

Certain intangible assets are based on preliminary purchase price allocations associated with recent business acquisitions, and are subject to finalization and adjustment. Based upon the actual and preliminary purchase price allocations, the change in the carrying amount of the goodwill for the six months ended December 31, 2004 was as follows:

	Salons		Beauty	Hair Restoration	
	North America	International	Schools	Centers	Consolidated
(Dollars in thousands)					
Balance at June 30, 2004	\$ 370,347	\$ 71,421	\$ 15,372	\$	\$ 457,140
Goodwill acquired	19,266	1,341	5,439	132,079	158,125
Translation rate adjustments	3,544	6,777			10,321
Balance at December 31, 2004	\$ 393,157	\$ 79,539	\$ 20,811	\$ 132,079	\$ 625,586

7. ACQUISITIONS:

During the six months ended December 31, 2004 and 2003, the Company made numerous acquisitions and the purchase prices have been allocated to assets acquired and liabilities assumed based on their estimated fair values at the dates of acquisition. These acquisitions individually and in the aggregate are not material to the Company's operations. Operations of the acquired companies have been included in the operations of the Company since the date of the respective acquisition.

Table of Contents**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (cont.)
(Unaudited)**

Based upon purchase price allocations, which may have components representing preliminary allocations with respect to recent acquisitions, the components of the aggregate purchase prices of the acquisitions made during the six months ended December 31, 2004 and 2003, and the allocation of the purchase prices, were as follows:

	Six Months Ended December 31, 2004 2003	
(Dollars in thousands)		
Components of aggregate purchase prices:		
Cash	\$ 244,743	\$ 33,611
Allocation of the purchase price:		
Net tangible assets acquired, excluding deferred income taxes	\$ 9,412	\$ 5,222
Identifiable intangible assets	127,726	259
Goodwill	158,125	28,130
Deferred income tax liability	(50,520)	
	\$ 244,743	\$ 33,611

In a limited number of acquisitions, the Company has guaranteed that stock issued in conjunction with the acquisition will reach a certain market price. If the stock should not reach this price during an agreed-upon time frame (typically three years from the date of acquisition), the Company is obligated to issue additional shares to the sellers. Once the agreed-upon stock price is met or exceeded for a period of five consecutive days, the contingency is met and the Company is no longer liable. Based on the December 31, 2004 market price, the Company would be required to provide an additional 39,678 shares related to these acquisition contingencies if the agreed-upon time frames were all assumed to have expired December 31, 2004. These contingently issuable shares have been included in the calculation of diluted earnings per share for the three and six months ended December 31, 2004.

In December 2004, the Company purchased Hair Club for Men and Women (Hair Club) for approximately \$210 million, financed with debt. Hair Club offers a comprehensive menu of hair restoration solutions ranging from Extreme Hair Therapy to the non-surgical Bio-Matrix® Process and the latest advancements in hair transplantation, based on an analysis of what is best for each customer's situation. Hair Club operations have been included in the operations of the Company since the acquisition was completed on December 1, 2004, and are reported in Note 5 in the hair restoration centers segment. The hair restoration centers are expected to generate approximately \$100 to \$110 million in annual revenues, with an operating margin of approximately 20 percent of revenues.

The majority of the purchase price in salon acquisitions is accounted for as residual goodwill rather than identifiable intangible assets. This stems from the value associated with the walk-in customer base of the acquired salons, which is not recorded as an identifiable intangible asset under current accounting guidance, as well as the limited value and customer preference associated with the acquired hair salon brand. Key factors considered by consumers of hair salon services include personal relationships with individual stylists (driven by word-of-mouth referrals), service quality and price point competitiveness. These attributes represent the going concern value of the salon. While the value of the acquired customer base is the primary driver of any potential acquisition's cash flows (which determines the purchase price), it is neither known nor identifiable at the time of the acquisition. The cash flow history of a salon primarily

results from repeat walk-in customers driven by the existing personal relationship between the customer and the stylist(s). Under FAS No. 141, Business Combinations, a customer base does not meet the criteria for recognition apart from goodwill. As such, this portion of the purchase price is captured within goodwill and should not be attributed to any other contractual arrangement. Because we are acquiring the going concern value of the salon, driven primarily by the manner in which the salon has been operated and the existing walk-in customer base's relationship with the stylist(s), the value being acquired is subsumed into goodwill in accordance with FAS No. 141.

Residual goodwill further represents the Company's opportunity to strategically combine the acquired business with the Company's existing structure to serve a greater number of customers through its expansion strategies. In the acquisitions of international salons, beauty schools and hair restoration centers, the residual goodwill primarily represents the growth prospects that are not captured as part of acquired tangible or identified intangible assets. Generally the goodwill recognized in the North American salon transactions is expected to be fully deductible for tax purposes and the goodwill recognized in the international salon transactions is non-deductible for tax purposes. Goodwill generated in certain acquisitions, such as Hair Club, is generally not deductible for tax purposes due to the acquisition structure of the transaction.

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**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (cont.)
(Unaudited)**

In the Consolidated Financial Statements, the identifiable intangible assets are amortized over lives ranging from four to 50 years and, in accordance with FAS No. 142, Goodwill and Other Intangible Assets, goodwill has an unlimited useful life and is not amortized. However, in certain transactions, neither goodwill nor identifiable intangible assets are amortized for tax purposes. In these transactions, a deferred income tax liability is recognized at the date of acquisition in accordance with FAS No. 109, Accounting for Income Taxes, to account for the tax effect of the future amortization of the identifiable intangible assets which will be recognized in the Consolidated Financial Statements.

8. INCOME TAXES:

On October 4, 2004, President Bush signed an Act into law that included a provision reinstating the Work Opportunity and Welfare-to-Work Credits. The reinstatement is retroactive to January 1, 2004 and the credits will be available through December 31, 2005. For interim reporting purposes, the Company determines the best estimate of its annual effective tax rate and applies this rate in calculating income taxes on a year-to-date basis. Any immediate impact resulting from a change in tax law is recognized in the interim period in which the law change is enacted. Since the credits were reinstated (enacted) after September 30, 2004, they were not included in the Company's calculation of the estimated annual effective tax rate in the first quarter ended September 30. The Company remeasured its annual estimated tax rate in the second quarter, with consideration given to the reinstated tax credit for the full fiscal year. The resulting catch-up adjustment related to the first quarter was recognized in the second quarter, effectively reducing the second quarter's tax provision by less than \$0.1 million. The Company expects this change in tax law to have an annual impact of approximately \$0.9 million for fiscal year 2005.

Additionally, President Bush signed into law the American Jobs Creation Act of 2004 (Act) on October 22, 2004. The Act creates, among other things, a temporary incentive for United States (U.S.) multinational companies to repatriate accumulated income earned outside the U.S. at an effective U.S. income tax rate as low as 5.25 percent as long as the repatriated income is invested in the U. S. pursuant to a plan. On January 13, 2005, the Internal Revenue Service issued its guidelines for applying the repatriation provisions of the Act, including guidance on qualifying dividends and qualifying reinvestment plans. The Company has completed a preliminary evaluation of the repatriation provisions and Treasury guidance and has determined that there is no advantage to electing repatriation under the Act. However, no final decisions or plans regarding the repatriation of monies have been made to date.

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REVIEW REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Shareholders and Directors of Regis Corporation:

We have reviewed the accompanying restated condensed consolidated balance sheet of Regis Corporation as of December 31, 2004 and the related restated condensed consolidated statements of operations for the three and six month periods ended December 31, 2004 and 2003 and of cash flows for the six month periods ended December 31, 2004 and 2003. These interim financial statements are the responsibility of the Company's management.

We conducted our reviews in accordance with the standards of the Public Company Accounting Oversight Board (United States). A review of interim financial information consists principally of applying analytical procedures to financial data and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with the standards of the Public Company Accounting Oversight Board (United States), the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our reviews, we are not aware of any material modifications that should be made to the accompanying condensed consolidated interim financial statements for them to be in conformity with accounting principles generally accepted in the United States of America.

We previously audited in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheet as of June 30, 2004, and the related consolidated statements of operations, of changes in shareholders' equity and comprehensive income and of cash flows for the year then ended (not presented herein), and in our report dated August 24, 2004, except for Note 2, as to which the date is May 9, 2005, which contained explanatory paragraphs indicating (i) the Company changed its method of accounting for equity-based compensation arrangements to begin expensing new awards as of July 1, 2003 and (ii) the Company restated its financial statements as of June 30, 2004 and 2003 and for the three years ended June 30, 2004 to account for rent holidays on a straight-line basis, we expressed an unqualified opinion on those consolidated financial statements. In our opinion, the accompanying consolidated balance sheet information as of June 30, 2004, is fairly stated, in all material respects in relation to the consolidated balance sheet from which it has been derived.

As discussed in Note 2 to the accompanying condensed consolidated interim financial statements, the company restated its financial statements for the three and six month periods ended December 31, 2004 and 2003.

/s/ PricewaterhouseCoopers LLP

PRICEWATERHOUSECOOPERS LLP

Minneapolis, Minnesota
January 26, 2005, except for Note 2, as to
which the date is May 17, 2005

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**Item 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF
FINANCIAL CONDITION AND RESULTS OF OPERATIONS
RESTATEMENT OF FINANCIAL STATEMENTS**

During our quarter ending March 31, 2005 (third quarter of fiscal year 2005), we became aware that a number of retailers and restaurant operators had disclosed in their filings with the SEC that they were reassessing their accounting related to leases and that some companies had restated their financial statements to reflect changes in their accounting for leases. In light of these disclosures and restatements, we conducted a review of our lease accounting policies and practices.

In our lease accounting review, we examined our leases to determine the appropriate lease term for each lease under GAAP. Typically, our operating leases do not require rental payments to begin until the salon is opened. The leased space is sometimes made available to us prior to the commencement of salon operations in order to allow time for installing normal leasehold improvements and equipment necessary to operate a salon. We historically began to recognize rental expense on a straight-line basis at the earlier of the commencement of operations or the commencement of rental payments. However, we did not include the rent holiday period in our straight-line rent calculation. A rent holiday is considered to be any period where the lessee has the right to control the use of the leased property but no rental payments are required under the lease during that period. FASB Technical Bulletin (FTB) 85-3,

Accounting for Operating Leases with Scheduled Rent Increases, requires rent holiday periods in an operating lease to be recognized by the lessee on a straight-line basis over the lease term, which includes any rent holiday period. Therefore, we restated our financial statements for fiscal years 2004, 2003 and 2002 to appropriately account for rent holiday periods. The restatement to appropriately account for rent holidays had no impact on our consolidated revenues or cash flows from operations.

Based on the review of our accounting for operating leases, we have restated our previously issued financial statements in our Annual Report on Form 10-K for the fiscal year ended June 30, 2004, as well as those in our Quarterly Reports on Form 10-Q for the quarters ended September 30, 2004 and December 31, 2004. We filed a Form 10-K/A with restated Consolidated Financial Statements, and are filing a Form 10-Q/A for each of these interim reporting periods with restated Condensed Consolidated Financial Information.

See Note 2 to the Condensed Consolidated Financial Statements for a summary of the effect of this change on our Condensed Consolidated Balance Sheet as of December 31, 2004 and June 30, 2004 and the Condensed Consolidated Statement of Operations for the three and six month periods ended December 31, 2004 and 2003.

MANAGEMENT'S OVERVIEW

Regis Corporation (RGS) is the industry leader in the hair service business, which includes three distinct, but related, elements: beauty salons, hair restoration centers and beauty schools. As of December 31, 2004, our worldwide operations included 10,412 system-wide North American and international salons, 91 hair restoration centers and 15 beauty schools. Each of our salon concepts offer generally similar products and services and serves mass-market consumers. Our salon operations are organized to be managed based on geographical location. Our North American salon operations include 8,381 salons, including 2,324 franchise salons, operating in the United States, Canada and Puerto Rico primarily under the trade names of Regis Salons, MasterCuts, Trade Secret, SmartStyle, Supercuts and Cost Cutters. Our international salon operations include 2,031 salons, including 1,600 franchise salons, located throughout Europe, primarily in the United Kingdom, France, Italy and Spain. In December 2004, we purchased Hair Club for Men and Women. This enterprise includes 91 North American locations, including 42 corporate and 49 franchise locations. Our beauty schools are managed in aggregate, regardless of geographical location, and include eleven locations in the United States and four locations in the United Kingdom. During the second quarter of fiscal year 2005, we had an average of approximately 52,000 corporate employees worldwide.

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Our growth strategy consists of two primary, but flexible, building blocks. Through a combination of organic and acquisition growth, we seek to achieve our long-term objective of 10-to-14 percent annual revenue growth. We anticipate that going forward, the mix of organic and acquisition growth will be roughly equal. However, depending on several factors, including the ability of our salon development program to keep pace with the availability of real estate for new construction, student enrollment, hair restoration lead generation, the availability of attractive acquisition candidates and same-store sales trends, this mix will vary from year-to-year. We believe achieving revenue growth of 10-to-14 percent, including same-store sales increases in excess of two percent, will allow us to increase annual earnings at a low-to-mid teen percent growth rate. We anticipate expanding our presence in both North America and Europe. Additionally, we desire to enter the Asian market within the next five years.

Maintaining financial flexibility is a key element in continuing our successful growth. With strong operating cash flow and an investment grade credit rating, we are confident that we will be able to financially support our long-term growth objectives.

Salon Business

The strength of our salon business is in the fundamental similarity and broad appeal of our salon concepts that allow flexibility and multiple salon concept placements in shopping centers and neighborhoods. Each concept generally targets the middle market customer, however each attracts a different demographic. We anticipate expanding all of our salon concepts. In addition, we anticipate testing and developing new salon concepts to complement our existing concepts.

We execute our salon growth strategy by focusing on real estate. Our salon real estate strategy is to add new units in convenient locations with good visibility, strong customer traffic and appropriate trade demographics. Our various salon and product concepts operate in a wide range of retailing environments, including regional shopping malls, strip centers and Wal-Mart Supercenters. We believe that the availability of real estate will augment our ability to achieve the aforementioned long-term growth objectives. We anticipate that we will add approximately 1,000 net salons each year through a combination of organic, acquisition and franchise growth.

Organic salon revenue growth is achieved through the combination of new salon construction and salon same-store sales increases. Each fiscal year, we anticipate building several hundred corporate salons. We anticipate our franchisees will open several hundred salons as well. Older, unprofitable salons will be closed or relocated. Our long-term outlook for our salon business is for annual consolidated low single-digit same-store sales increases. Based on current fashion and economic cycles, we project our annual fiscal year 2005 consolidated same-store sales increase to be below the low end of our long-term outlook range.

Historically, our salon acquisitions have varied in size from as small as one salon to over one-thousand salons. The median acquisition size is approximately ten salons. From fiscal year 1994 to fiscal year 2004, we completed over 300 acquisitions, adding a net of nearly 7,000 salons. We anticipate adding several hundred corporate salons each year from acquisitions. Some of these acquisitions may include buying salons from our franchisees.

Hair Restoration Business

In December 2004, we acquired Hair Club for Men and Women. Hair Club for Men and Women is the industry leading provider of hair loss solutions with an estimated four to five percent share of the \$4.3 billion domestic market. This industry is comprised of approximately 4,000 locations domestically and is highly fragmented. As a result, we believe there is an opportunity to consolidate this industry through acquisition. Expanding the hair loss business organically and through acquisition would allow us to add incremental revenue which is neither dependent upon nor dilutive to our existing salon and school businesses.

Our organic growth plans for hair restoration include the construction of a modest number of new locations in untapped markets domestically and internationally. However, the success of our hair restoration business is not dependent on the same real estate criteria used for salon expansion. In an effort to provide confidentiality for their customers, hair restoration centers operate primarily in professional or medical office buildings. Further, the hair restoration business is more marketing intensive. As a result, organic growth at our hair restoration centers will be dependent on successfully generating new leads and converting them into hair restoration customers. Our growth expectations for our hair restoration business are not dependent on referral business from, or cross-marketing with, our hair salon business, but will be evaluated closely for additional growth opportunities.

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Beauty School Business

We have begun acquiring and are exploring the possibility of building beauty schools. The beauty school business is highly profitable, and often participates in governmental programs designed to encourage education. We believe there is an opportunity to place graduates in our various salon concepts which may provide us with another competitive advantage. Similar to the salon and hair loss industries, the beauty school industry is highly fragmented. As a result, we believe there is an opportunity to consolidate this industry through acquisition, as well. Expanding this business would allow us to add incremental revenue without cannibalizing our existing salon or hair restoration center businesses. Primarily through acquisition, we believe beauty schools could contribute over \$100 million in annual revenue within a few years.

Our organic growth plans for the beauty school business include the construction of new locations; however, due to Department of Education policies, we will be limited in the number of new schools we are able to construct in the immediate future. The success of a beauty school location is not dependent on good visibility or strong customer traffic; however, access to parking and/or public transportation is important. The success of existing and newly constructed schools is dependent on effective marketing and recruiting to attract new enrollees.

For a discussion of our near-term expectations, please refer to the Investor Information section of our website at www.regiscorp.com.

Table of Contents**CRITICAL ACCOUNTING POLICIES**

The Condensed Consolidated Financial Statements are prepared in conformity with accounting principles generally accepted in the United States of America. In preparing the Condensed Consolidated Financial Statements, we are required to make various judgments, estimates and assumptions that could have a significant impact on the results reported in the Condensed Consolidated Financial Statements. We base these estimates on historical experience and other assumptions believed to be reasonable under the circumstances. Changes in these estimates could have a material effect on our Condensed Consolidated Financial Statements.

Our significant accounting policies can be found in Note 1 to the Consolidated Financial Statements contained in Part II, Item 8 of the June 30, 2004 Annual Report on Form 10-K/A. We believe the accounting policies related to the valuation of goodwill, the valuation and estimated useful lives of long-lived assets, purchase price allocations, revenue recognition, the cost of product used and sold, self-insurance accruals, legal contingencies and estimates used in relation to tax liabilities and deferred taxes are most critical to aid in fully understanding and evaluating our reported financial condition and results of operations. Discussion of each of these policies is contained under **Critical Accounting Policies** in Part II, Item 7 of our June 30, 2004 Annual Report on Form 10-K/A. No changes have been made to these policies since June 30, 2004.

RESULTS OF OPERATIONS**Consolidated Results of Operations**

The following table sets forth, for the periods indicated, certain information derived from our Condensed Consolidated Statements of Operations, expressed as a percent of revenues. The percentages are computed as a percent of total consolidated revenues, except as noted.

	For the Periods Ended December 31,			
	Three Months		Six Months	
	2004	2003	2004	2003
Service revenues	66.5%	64.9%	66.8%	65.3%
Product revenues	29.8	31.2	29.5	30.8
Franchise royalties and fees	3.7	3.9	3.7	3.9
Operating expenses:				
Cost of service (1)	57.0	55.9	56.9	56.1
Cost of product (2)	52.7	52.2	52.5	52.7
Site operating expenses	8.3	8.3	8.4	8.3
General and administrative	11.9	11.5	11.7	11.6
Rent (as restated, see Note 2)	14.0	13.8	14.1	13.8
Depreciation and amortization	3.9	4.0	3.9	3.9
Operating income (as restated, see Note 2)	8.3	9.9	8.4	9.6
Income before income taxes (as restated, see Note 2)	7.5	9.1	7.6	8.8
Net income (as restated, see Note 2)	4.9	5.8	5.0	5.6

(1) Computed as a percent of service revenues.

(2) Computed as a percent of product revenues.

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Consolidated revenues include revenues of company-owned salons, product and equipment sales to franchisees, beauty school revenues, hair restoration center revenues, and franchise royalties and fees. During the second quarter and first half of fiscal year 2005, consolidated revenues increased 13.7 percent to \$537.3 million and 11.8 percent to \$1.0 billion, respectively, as compared to the corresponding periods of the prior fiscal year. The following table details our consolidated revenues by concept:

(Dollars in thousands)	For the Periods Ended December 31,			
	Three Months		Six Months	
	2004	2003	2004	2003
Revenues:				
North American salons:				
Regis Salons	\$ 118,870	\$ 118,731	\$ 235,327	\$ 236,686
MasterCuts	44,003	43,671	86,522	87,217
Trade Secret*	69,131	65,051	130,592	123,992
SmartStyle	84,400	69,964	166,683	138,411
Strip Center Salons*	148,914	123,521	294,622	249,165
Total North American Salons	465,318	420,938	913,746	835,471
International salons*	55,597	47,810	107,335	90,952
Beauty schools	8,032	3,704	14,088	6,750
Hair restoration centers*	8,385		8,385	
Consolidated revenues	\$ 537,332	\$ 472,452	\$ 1,043,554	\$ 933,173
Percent change from prior year	13.7%	13.9%	11.8%	14.6%
Same-store sales increase	0.4%	2.4%	0.7%	2.5%

* Includes aggregate franchise royalties and fees of \$19.9 and \$18.4 million for the three months ended December 31, 2004 and 2003, respectively, and \$38.6 and \$36.5 million for the six months ended December 31, 2004 and 2003, respectively. North American franchise revenues (including franchise revenues hair restoration centers) represented 52.9 and 54.7 percent of total franchise revenues in the three months ended December 31, 2004 and 2003, respectively, and 53.8 and 57.1 percent of total franchise revenues in the six months ended December 31, 2004 and 2003, respectively.

Salon same-store sales increases or decreases are calculated on a daily basis as the total change in sales for company-owned salons which were open on a specific day of the week during the current period and the corresponding prior period. Quarterly and year-to-date salon same-store sales increases are the sum of the same-store sales increases computed on a daily basis. Relocated salons are included in same-store sales as they are considered to have been open in the prior period. International same-store sales are calculated in local currencies so that foreign currency fluctuations do not impact the calculation. Management believes that same-store sales, a component of organic growth, are useful in order to help determine the increase in salon revenues attributable to its organic growth (new salon construction and same-store sales growth) versus growth from acquisitions.

The 13.7 and 11.8 percent increases in consolidated revenues during the three and six months ended December 31, 2004, respectively, were driven by the following:

	Percentage Increase (Decrease) in Revenues	
	For the Periods Ended December 31, 2004	
	Three Months	Six Months
Acquisitions (previous twelve months)	7.4%	6.5%
Organic growth	5.3	4.6
Foreign currency	1.5	1.4
Franchise revenues	0.1	
Closed salons	(0.6)	(0.7)
	13.7%	11.8%

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We acquired 416 company-owned salons (including 160 franchise salon buybacks), 42 company-owned hair restoration centers and ten company-owned beauty schools during the twelve months ended December 31, 2004. The organic growth stemmed from the construction of 511 company-owned salons during the twelve months ended December 31, 2004, as well as consolidated same-store sales increases. During the second quarter and first half of fiscal year 2005, the foreign currency impact was driven by the further weakening of the United States dollar against the British pound, Euro and Canadian dollar as compared to the prior periods exchange rates. The impact of foreign currency was calculated by multiplying current year revenues in local currencies by the change in the foreign currency exchange rate between the current fiscal year and the prior fiscal year.

Consolidated revenues are primarily comprised of service and product revenues, as well as franchise royalties and fees. Fluctuations in these three major revenue categories were as follows:

Service Revenues. Service revenues include revenues generated from company-owned salons, tuition and service revenues generated within our beauty schools, and service revenues generated by hair restoration centers. For the three and six months ended December 31, 2004 and 2003, total service revenues were as follows:

(Dollars in thousands) Periods Ended December 31, <i>Three Months</i>	Revenues	Increase Over Prior Fiscal Year	
		Dollar	Percentage
2004	\$ 357,147	\$ 50,517	16.5%
2003	306,630	35,942	13.3
<i>Six Months</i>			
2004	\$ 696,582	\$ 87,000	14.3%
2003	609,582	75,818	14.2

The growth in service revenues in the second quarter and first half of fiscal year 2005 were driven primarily by acquisitions and organic growth in our salons (new salon construction and same-store sales growth).

Product Revenues. Product revenues are primarily comprised of retail sales at company-owned salons, sales of product and equipment to franchisees, and retail product sales made by our beauty schools and hair restoration centers. Total product revenues for the three and six months ended December 31, 2004 and 2003 were as follows:

(Dollars in thousands) Periods Ended December 31, <i>Three Months</i>	Revenues	Increase Over Prior Fiscal Year	
		Dollar	Percentage
2004	\$ 160,249	\$ 12,807	8.7%
2003	147,442	20,651	16.3
<i>Six Months</i>			
2004	\$ 308,368	\$ 21,266	7.4%
2003	287,102	41,282	16.8

Fiscal year 2005 product revenue increases were not as robust as in the corresponding periods of the prior fiscal year primarily due to lower same-store product sales increases in our company-owned salons. The large increase in same-store product sales during fiscal year 2004 was primarily driven by a trend towards sales of higher priced beauty tools, such as flat irons.

Franchise Royalties and Fees. Total franchise revenues, which include royalties and franchise fees, were as follows:

(Dollars in thousands) Periods Ended December 31, <i>Three Months</i>	Revenues	Increase Over Prior Fiscal Year	
		Dollar	Percentage
2004	\$ 19,936	\$ 1,556	8.5%
2003	18,380	1,100	6.4
<i>Six Months</i>			
2004	\$ 38,604	\$ 2,115	5.8%
2003	36,489	2,091	6.1

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Total franchise locations open at December 31, 2004 and 2003 were 3,973 (including 49 franchise hair restoration centers) and 3,995, respectively. We purchased 160 of our franchise salons during the twelve months ended December 31, 2004, which drove the overall decrease in the number of franchise salons between periods.

The increase in consolidated franchise revenues during the three and six months ended December 31, 2004 was primarily due to favorable foreign currency exchange rate fluctuations, which caused franchise revenues to increase 5.0 and 4.2 percent, respectively. Exclusive of the effect of this favorable currency fluctuation, consolidated franchise revenues increased 3.5 and 1.6 percent in the quarter and six months ended December 31, 2004, respectively. These increases were primarily due to opening more new international franchise salons during the first half of fiscal year 2005 as compared to the first half of the prior fiscal year, as well as the acquisition of 49 franchise hair restoration centers.

Gross Margin

Our cost of revenues primarily includes labor costs related to salon employees, beauty school instructors and hair restoration center employees, the cost of product used in providing services and the cost of products sold to customers and franchisees. The resulting gross margin for the three and six months ended December 31, 2004 and 2003 was as follows:

(Dollars in thousands)	Total	Margin as % of Service and Product Revenues	Increase (Decrease) Over Prior Fiscal Year		Basis Point*
			Dollar	Percentage	
Periods Ended	Margin				
December 31, Three Months					
2004	\$ 229,400	44.3	\$ 23,682	11.5%	(100)
2003	205,718	45.3	23,815	13.1	(50)
Six Months					
2004	\$ 446,784	44.5	\$ 43,168	10.7%	(50)
2003	403,616	45.0	50,035	14.2	(40)

* Represents the basis point change in total margin as a percent of service and product revenues as compared to the corresponding periods of the prior fiscal year.

Service Margin. Service margin for the second quarter and first half of fiscal year 2005 and 2004 was as follows:

(Dollars in thousands)	Service	Margin as % of Service Revenues	Increase (Decrease) Over Prior Fiscal Year		Basis Point*
			Dollar	Percentage	
Periods Ended	Margin				
December 31, Three Months					
2004	\$ 153,543	43.0	\$ 18,365	13.6%	(110)
2003	135,178	44.1	17,173	14.6	50
Six Months					
2004	\$ 300,392	43.1	\$ 32,663	12.2%	(80)
2003	267,729	43.9	34,276	14.7	20

* Represents the basis point change in service margin as a percent of service revenues as compared to the corresponding periods of the prior fiscal year.

The basis point decrease in service margins during the three and six months ended December 31, 2004 was related to overstaffing due to lower than expected same-store sales during the latter half of December 2004, a shift in the mix of services provided to include a greater proportion of higher cost services, such as colorings, and our decision to compensate employees while salons were closed in the southeast United States during the first quarter due to the hurricanes.

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Product Margin. Product margin for the second quarter and first half of fiscal year 2005 and 2004 was as follows:

(Dollars in thousands)

Periods Ended	Product Margin	Margin as % of Product Revenues	Increase (Decrease) Over Prior Fiscal Year		Basis Point*
			Dollar	Percentage	
December 31, Three Months					
2004	\$ 75,857	47.3	\$ 5,317	7.5%	(50)
2003	70,540	47.8	6,642	10.4	(260)
Six Months					
2004	\$ 146,392	47.5	\$ 10,505	7.7%	20
2003	135,887	47.3	15,759	13.1	(160)

* Represents the basis point change in product margin as a percent of product revenues as compared to the corresponding periods of the prior fiscal year.

The decrease in product margins as a percent of product revenues during the second quarter of fiscal year 2005 was due to lower same-store product sales increases in the Trade Secret salons, which have fixed-cost payrolls, and changes in the mix of products carried and sold.

Site Operating Expenses

This expense category includes direct costs incurred by our salons, beauty schools and hair restoration centers, such as on-site advertising, workers compensation, insurance, utilities and janitorial costs. As a percent of consolidated revenues, site operating expenses were relatively consistent with the corresponding periods of the prior fiscal year.

General and Administrative

General and administrative (G&A) includes costs associated with our field supervision, salon training and promotions, product distribution centers and corporate offices (such as salaries and professional fees), including costs incurred to support franchise, beauty school and hair restoration center operations. During the three and six months ended December 31, 2004 and 2003, G&A costs were as follows:

Periods Ended	G&A	Expense as % of Total Revenues	Increase (Decrease) Over Prior Fiscal Year		Basis Point*
			Dollar	Percentage	
(Dollars in thousands)					
December 31, Three Months					
2004	\$ 64,105	11.9	\$ 9,676	17.8%	40
2003	54,429	11.5	5,997	12.4	(20)
Six Months					
2004	\$ 121,806	11.7	\$ 13,933	12.9%	10
2003	107,873	11.6	11,866	12.4	(20)

*

Represents the basis point change in G&A as a percent of total revenues as compared to the corresponding periods of the prior fiscal year.

The increase in G&A costs as a percent of total revenues during the second quarter and first half of fiscal year 2005 was primarily due to the addition of the hair restoration centers, which have slightly higher G&A costs due to the marketing-intensive nature of that business. Additionally, lower same-store sales increases in our salons contributed to the increase in these costs as a percent of revenues. For the six months ended December 31, 2004, the effect of these items was partially offset by a \$1.3 million expense during the first quarter of the prior fiscal year related to the write-off of loans associated with split dollar life insurance arrangements and \$0.6 million of expense related to the write-off of the cash surrender value of the related policies. The loans were written off due to final regulations issued by the IRS on the taxation of such split dollar arrangements.

Table of Contents**Rent**

Rent expense, which includes base and percentage rent, common area maintenance and real estate taxes, was as follows:

(Dollars in thousands)	Expense as % of Total	Increase (Decrease) Over Prior Fiscal Year		Basis Point*	
		Dollar	Percentage		
Periods Ended	Rent	Revenues			
December 31, Three Months					
2004 (as restated)	\$ 75,117	14.0	\$ 10,023	15.4%	20
2003 (as restated)	65,094	13.8	7,709	13.4	
Six Months					
2004 (as restated)	\$ 147,625	14.1	\$ 19,005	14.8%	30
2003 (as restated)	128,620	13.8	16,758	15.0	10

* Represents the basis point change in rent expense as a percent of total revenues as compared to the corresponding periods of the prior fiscal year.

The increase in this fixed-cost expense as a percent of total revenues during the three and six months ended December 31, 2004 was primarily due to rent expense increasing at a faster rate than salon same-store sales in the second quarter and first half of fiscal year 2005.

Interest

Interest expense was as follows:

(Dollars in thousands)	Expense as % of Total	Increase (Decrease) Over Prior Fiscal Year		Basis Point*	
		Dollar	Percentage		
Periods Ended	Interest	Revenues			
December 31, Three Months					
2004	\$ 5,467	1.0	\$ 1,616	42.0%	20
2003	3,851	0.8	(1,528)	(28.4)	(50)
Six Months					
2004	\$ 9,775	0.9	\$ 1,556	18.9%	
2003	8,219	0.9	(2,305)	(21.9)	(40)

* Represents the basis point change in interest expense as a percent of total revenues as compared to the corresponding periods of the prior fiscal year.

The increase in interest expense as a percent total revenues during the three months ended December 31, 2004 was primarily due to an increase in our debt level stemming from our second quarter acquisition activity, including the hair restoration centers.

Income Taxes

Our reported effective tax rate was as follows:

Periods Ended December 31, Three Months	Effective Rate	Basis Point Improvement
2004 (as restated)	34.0%	(230)
2003 (as restated)	36.3	(110)
Six Months		
2004 (as restated)	34.8%	(160)
2003 (as restated)	36.4	(100)

The improvement in our overall effective tax rate was primarily the result of the reinstated Work Opportunity Credit (refer to Note 8 of the Condensed Consolidated Financial Statements), as well a larger percentage of our income being generated in lower rate international tax jurisdictions.

Recent Accounting Pronouncements

Recent accounting pronouncements are discussed in Note 1 to the Condensed Consolidated Financial Statements.

Table of Contents**Effects of Inflation**

We compensate some of our salon employees with percentage commissions based on sales they generate, thereby enabling salon payroll expense as a percent of company-owned salon revenues to remain relatively constant. Accordingly, this provides us certain protection against inflationary increases, as payroll expense and related benefits (our major expense components) are variable costs of sales. In addition, we may increase pricing in our salons to offset any significant increases in wages. Therefore, we do not believe inflation has had a significant impact on the results of operations.

Constant Currency Presentation

The presentation below demonstrates the effect of foreign currency exchange rate fluctuations from year to year. In the second quarter and first half of fiscal year 2005, foreign currency translation had a positive impact on consolidated revenues and net income before income taxes due to the strengthening of the Canadian dollar, British pound and Euro. To present this information, current period results for entities reporting in currencies other than United States dollars are converted into United States dollars at the average exchange rates in effect during the corresponding period of the prior fiscal year, rather than the actual average exchange rates in effect during the current fiscal year. Therefore, the foreign currency impact is equal to current year results in local currencies multiplied by the change in the average foreign currency exchange rate between the current fiscal period and the corresponding period of the prior fiscal year.

Three Months Ended	Currency	Constant	Reported	Constant
December 31, 2004	Translation	Currency	%	Currency
(Dollars in thousands)	Benefit	Amount	Increase	% Increase
			(Decrease)*	(Decrease)*
Total revenues:				
North American salons	\$ 1,806	\$ 463,512	10.5%	10.1%
International salons	5,091	50,506	16.3	5.6
Beauty schools	297	7,735	116.8	108.8
Hair restoration centers		8,385	100.0	100.0
Total	\$ 7,194	\$ 530,138	13.7%	12.2%
Income before income taxes (as restated, see Note 2):				
North American salons	\$ 240	\$ 62,572	(2.6)%	(3.0)%
International salons	489	5,129	3.6	(5.4)
Beauty schools	146	2,262	72.5	62.0
Hair restoration centers		1,565	100.0	100.0
Corporate**	64	(32,312)	14.9	15.1
Total	\$ 939	\$ 39,216	(7.1)%	(9.3)%
Six Months Ended	Currency	Constant	Reported	Constant
December 31, 2004	Translation	Currency	%	Currency
			Increase	% Increase

(Dollars in thousands)	Amount	Benefit (Loss)	Amount	(Decrease)*	(Decrease)*
Total revenues:					
North American salons	\$ 913,746	\$ 2,702	\$ 911,044	9.4%	9.0%
International salons	107,335	9,939	97,396	18.0	7.1
Beauty schools	14,088	471	13,617	108.7	101.7
Hair restoration centers	8,385		8,385	100.0	100.0
Total	\$ 1,043,554	\$ 13,112	\$ 1,030,442	11.8%	10.4%
Income before income taxes (as restated, see Note 2):					
North American salons	\$ 123,946	\$ 370	\$ 123,576	(2.9)%	(3.2)%
International salons	12,396	1,124	11,272	28.3	16.6
Beauty schools	3,619	160	3,459	50.3	43.6
Hair restoration centers	1,565		1,565	100.0	100.0
Corporate**	(62,255)	(10)	(62,245)	7.9	7.9
Total	\$ 79,271	\$ 1,644	\$ 77,627	(3.4)%	(5.4)%

* represents the percentage increase (decrease) over reported amounts in the corresponding period of the prior fiscal year

** primarily general and administrative, corporate depreciation and amortization, and net interest expense

Table of Contents**Results of Operations by Segment**

Based on our internal management structure, we report four segments: North American salons, international salons, beauty schools and hair restoration centers. Significant results of operations are discussed below with respect to each of these segments.

North American Salons

North American Salon Revenues. Total North American salon revenues were as follows:

(Dollars in thousands)	Revenues	Increase Over Prior Fiscal Year		Same-Store Sales Increase
		Dollar	Percentage	
Periods Ended December 31,				
<i>Three Months</i>				
2004	\$ 465,318	\$ 44,380	10.5%	0.2%
2003	420,938	46,608	12.5	2.2
<i>Six Months</i>				
2004	\$ 913,746	\$ 78,275	9.4%	0.4%
2003	835,471	97,694	13.2	2.3

The percentage increases during the three and six months ended December 31, 2004 were due to the following factors:

	Percentage Increase (Decrease) in Revenues	
	For the Periods Ended December 31, 2004	
	Three Months	Six Months
Acquisitions (previous twelve months)	5.4%	5.3%
Organic growth	5.0	4.2
Foreign currency	0.4	0.4
Franchise revenues		(0.1)
Closed salons	(0.3)	(0.4)
	10.5%	9.4%

We acquired 385 company-owned North American salons during the twelve months ended December 31, 2004, including 160 franchise buybacks. The organic growth stemmed primarily from the construction of 487 company-owned salons in North America during the twelve months ended December 31, 2004. Revenues were negatively impacted during the first half of fiscal year 2005 by the hurricanes in the southeast United States, which caused nearly 650 of our company-owned salons to be closed for at least one day during the first quarter, as well as reduced customer visits to salons. The foreign currency impact during the second quarter and first half of fiscal years 2005 was driven by the weakening of the United States dollar against the Canadian dollar as compared to the prior periods exchange rates

North American Salon Operating Income. Operating income for the North American salons for the second quarter and first half of fiscal year 2005 and 2004 was as follows:

(Dollars in thousands)

Periods Ended	Operating Income	Operating Income as % of Total Revenues	Increase (Decrease) Over Prior Fiscal Year		Basis Point*
			Dollar	Percentage	
December 31, Three Months					
2004 (as restated)	\$ 62,812	13.5	\$ (1,665)	(2.6)%	(180)
2003 (as restated)	64,477	15.3	5,772	9.8	(40)
Six Months					
2004 (as restated)	\$ 123,946	13.6	\$ (3,720)	(2.9)%	(170)
2003 (as restated)	127,666	15.3	17,958	16.4	40

* Represents the basis point change in North American salon operating income as a percent of total North American salon revenues as compared to the corresponding periods of the prior fiscal year.

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The decrease in North American salon operating income during the three and six months ended December 31, 2004 was primarily related to lower same-store sales increases as compared to the prior fiscal year, overstaffing due to lower than expected same-store sales during the latter half of December 2004, changes in the mix of services provided and products carried and sold, and our decision to compensate employees while salons were closed in the southeast United States during the first quarter due to the hurricanes.

International Salons

International Salon Revenues. Total international salon revenues were as follows:

(Dollars in thousands)	Revenues	Increase Over Prior Fiscal Year		Same-Store Sales Increase
		Dollar	Percentage	
Periods Ended December 31,				
Three Months				
2004	\$ 55,597	\$ 7,787	16.3%	2.6%
2003	47,810	7,889	19.8	5.6
Six Months				
2004	\$ 107,335	\$ 16,383	18.0%	4.1%
2003	90,952	15,255	20.2	5.5

The percentage increases during the three and six months ended December 31, 2004 were due to the following factors:

	Percentage Increase (Decrease) in Revenues	
	For the Periods Ended December 31, 2004	
	Three Months	Six Months
Acquisitions (previous twelve months)	1.4%	1.2%
Organic growth	7.2	8.7
Foreign currency	10.7	10.9
Franchise revenues	0.3	0.8
Closed salons	(3.3)	(3.6)
	16.3%	18.0%

We acquired 31 company-owned international salons during the twelve months ended December 31, 2004. The organic growth stemmed from the construction of 24 company-owned international salons during the twelve months ended December 31, 2004, as well as international same-store sales increases. The foreign currency impact during the second quarter and first half of fiscal years 2005 was driven by the weakening of the United States dollar against the British pound and the Euro as compared to the prior periods' exchange rates

International Salon Operating Income. Operating income for the international salons for the second quarter and first half of fiscal year 2005 and 2004 was as follows:

(Dollars in thousands)

Periods Ended	Operating Income	Operating Income as % of Total Revenues	Increase (Decrease) Over Prior Fiscal Year		Basis Point*
			Dollar	Percentage	
December 31, Three Months					
2004	\$ 5,618	10.1	\$ 196	3.6%	(120)
2003	5,422	11.3	357	7.0	(140)
Six Months					
2004	\$ 12,396	11.5	\$ 2,731	28.3%	90
2003	9,665	10.6	(1,730)	(15.2)	(450)

* Represents the basis point change in international salon operating income as a percent of total international salon revenues as compared to the corresponding periods of the prior fiscal year.

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The basis point decrease in international salon operating income during the three months ended December 31, 2004 was primarily related to an adjustment to increase cost of sales by approximately \$1.0 million stemming from our September 2004 physical inventory count, as well as increased supply costs. For the six months ended December 31, 2004, this was offset by improved rent expense stemming from favorable rent negotiations, as well as lower depreciation expense as a percent of revenues due to the continuing maturation of the salon base in the United Kingdom.

Beauty Schools

Beauty School Revenues. Total beauty schools revenues were as follows:

(Dollars in thousands) Periods Ended December 31,	Revenues	Increase Over Prior Fiscal Year	
		Dollar	Percentage
<i>Three Months</i>			
2004	\$ 8,032	\$ 4,328	116.8%
2003	3,704	3,196	629.1
<i>Six Months</i>			
2004	\$ 14,088	\$ 7,338	108.7%
2003	6,750	6,242	1,228.7

The percentage increases during the three and six months ended December 31, 2004 were due to the following factors:

	Percentage Increase (Decrease) in Revenues For the Periods Ended December 31, 2004	
	Three Months	Six Months
	Acquisitions (previous twelve months)	97.3%
Organic growth	11.5	8.7
Foreign currency	8.0	7.0
	116.8%	108.7%

We acquired ten beauty schools during the twelve months ended December 31, 2004. The foreign currency impact during the second quarter and first half of fiscal years 2005 was driven by the weakening of the United States dollar against the British pound as compared to the prior periods' exchange rates.

Beauty School Operating Income. Operating income for our beauty schools for the second quarter and first half of fiscal year 2005 and 2004 was as follows:

(Dollars in thousands) Periods Ended	Operating	Operating Income as	Increase (Decrease) Over Prior Fiscal Year
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December 31, <i>Three Months</i>	Income	% of Total Revenues	Dollar	Percentage	Basis Point*
2004	\$ 2,408	30.0	\$ 1,012	72.5%	(770)
2003	1,396	37.7	1,218	684.3	270
<i>Six Months</i>					
2004	\$ 3,619	25.7	\$ 1,211	50.3%	(1,000)
2003	2,408	35.7	2,230	1,252.8	70
