



A SERIOUS  
INVESTMENT  
IN fun.

.....

CEC ENTERTAINMENT, INC.

2006 ANNUAL REPORT

\$30 MILLION SPENT TO  
UPGRADE GAMES,  
rides & ATTRACTIONS!

FUN (FŪN) n. – a) merriment, playful action, to amuse or entertain. b) Chuck E. Cheese’s.

At Chuck E. Cheese’s, our business is all about fun, and it starts from the moment you step into one of our over-the-top entertainment centers. The music comes on, the lights go up, and almost magically you’re greeted by the ever-youthful “big cheese” himself, Chuck E. Cheese. What began 29 years ago as a pizza and playland arcade, has evolved into a national brand of 529 family-friendly dining and entertainment centers strategically located in major markets across the country.

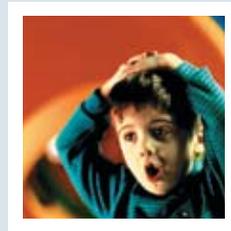
**Keeping pace with change**

Just as kids’ tastes change, so do our games, rides and shows. This year, we upgraded 152 company stores – about half of that investment went to enhancements with our games, rides and attractions. Games are higher quality and geared to today’s techno-savvy kids. Action-simulators

and rides such as the Mad Wave Motion Theater or Wasteland replace former, less exciting rides. In many of our locations, kids have the starring role at pretend television studios – complete with lights and camera – where they sing along to the latest pop tunes.

**Reinvesting in our future**

Updating existing stores continues to be an important part of our strategy that will promote long-term shareholder value. This year we continued our focus on growing sales in our existing store base and believe that our strong sales performances confirm that our strategies are gaining momentum. We completed 143 major remodels over the last six years where we reconfigured existing space – enlarging the game room, making stores brighter and with more open area. In the first year these remodeled stores have achieved average sales increases of approximately 9 percent.







FOCUSING ON  
SMART GROWTH  
IN *premier* LOCATIONS.

IN ADDITION, over the past five years we've increased the size of 37 stores by over 20 percent. We believe the remodels and capital improvements keep our stores fresh and exciting for our guests, and keep them coming back. Going forward, we plan to continue our existing store capital initiatives, as well as execute a targeted development plan that focuses on opening eight to 12 high-volume restaurants per year in densely-populated markets, ranging from 12,000 to 15,000 square feet and generating projected average unit volume of approximately \$2 million.

**Value counts**

When it comes to dining and entertainment, we realize families have many choices. We provide great value by offering families a safe, fun place to come, share a meal and spend time together. Another way we provide value is by periodically offering great package deals in our newspaper coupon program. This year we expanded the number of newspaper coupons from 13 to 16. As moms (and kids) spend more time on the computer, we update our database regularly to e-mail special offers to over 1 million customers each month. The plan is working. Our coupon redemptions in 2006 exceeded our

targets, and we believe the strong performance of our coupon program is one reason we've been successful in growing sales. In addition, this year we enhanced our cross-promotion programs to include partnerships with DreamWorks, Kraft and Carl Buddig lunch meats for kids, and will continue to look for more cross-promotional opportunities in years to come.

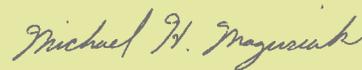
**Focus on people**

All the success we achieved this year was done so with the help of committed and involved employees and franchisees who have embraced our company's strategic initiatives. We extend our sincere appreciation for their dedication and contribution to the success at Chuck E. Cheese's and we look forward to another great year in 2007.

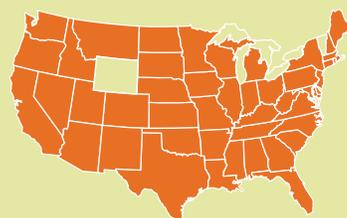
Sincerely,



RICHARD M. FRANK  
*Chairman, Chief Executive Officer*



MICHAEL H. MAGUSIAK  
*President*

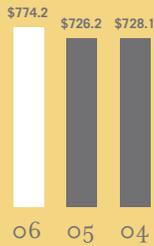


• States with CEC Restaurants

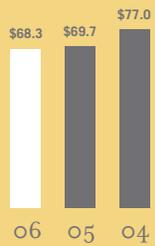




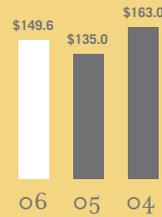
ADDING VALUE  
FOR SHAREHOLDERS,  
CUSTOMERS — AND kids.



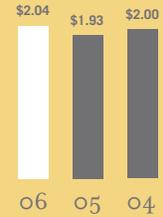
REVENUES  
(in millions)



NET INCOME  
(in millions)



CASH PROVIDED  
BY OPERATIONS  
(in millions)



DILUTED EARNINGS  
PER SHARE

CEC ENTERTAINMENT, INC.

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

**FORM 10-K**

**Annual report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 for the fiscal year ended December 31, 2006.**

**Transition report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934.**

**Commission File Number 0-15782**

**CEC ENTERTAINMENT, INC.**

(Exact name of registrant as specified in its charter)

**Kansas**  
(State or jurisdiction of  
incorporation or organization)

**48-0905805**  
(I.R.S. Employer  
Identification No.)

**4441 West Airport Freeway  
Irving, Texas**  
  
(Address of principal executive offices)

**75062**  
  
(Zip Code)

Registrant's telephone number, including area code: **(972) 258-8507**

**Securities registered pursuant to Section 12(b) of the Act:**

| Title of each class           | Name of each exchange on which registered |
|-------------------------------|---|
| Common Stock, \$.10 par value | New York Stock Exchange                   |

**Securities registered pursuant to Section 12(g) of the Act: None**

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes  No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Securities Exchange Act. Yes  No

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. Yes  No

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

Large accelerated filer  Accelerated filer  Non-accelerated filer

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes  No

At April 13, 2007, an aggregate of 32,241,703 shares of the registrant's common stock, par value of \$.10 each (being the registrant's only class of common stock), were outstanding.

At June 30, 2006, the aggregate market value of our common stock held by non-affiliates of the registrant was \$1,099,974,421.

**DOCUMENTS INCORPORATED BY REFERENCE**

Portions of the registrant's definitive Proxy Statement, to be filed pursuant to Section 14(a) of the Act in connection with the registrant's 2007 annual meeting of stockholders, have been incorporated by reference in Part III of this report.

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CEC ENTERTAINMENT, INC.  
FORM 10-K  
FISCAL YEAR ENDED DECEMBER 31, 2006  
INDEX

|   | <u>Page</u> |
|---|-------------|
| <br><b><u>Part I</u></b>  |             |
| Item 1. Business .....  | 3           |
| Item 1A. Risk Factors .....   | 7           |
| Item 1B. Unresolved Staff Comments .....  | 11          |
| Item 2. Properties .....  | 12          |
| Item 3. Legal Proceedings.....  | 13          |
| Item 4. Submission of Matters to a Vote of Security Holders.....  | 14          |
| <br><b><u>Part II</u></b>   |             |
| Item 5. Market for Registrant’s Common Equity, Related Stockholder Matters and<br>Issuer Purchases of Equity Securities ..... | 15          |
| Item 6. Selected Financial Data .....   | 17          |
| Item 7. Management’s Discussion and Analysis of Financial Condition and<br>Results of Operations.....                         | 18          |
| Item 7A. Quantitative and Qualitative Disclosures About Market Risk .....   | 26          |
| Item 8. Financial Statements and Supplementary Data .....   | 27          |
| Item 9. Changes in and Disagreements with Accountants on Accounting<br>and Financial Disclosure.....                          | 47          |
| Item 9A. Controls and Procedures .....  | 47          |
| Item 9B. Other Information .....  | 51          |
| <br><b><u>Part III</u></b>  |             |
| Item 10. Directors and Executive Officers of the Registrant.....  | 51          |
| Item 11. Executive Compensation .....   | 51          |
| Item 12. Security Ownership of Certain Beneficial Owners and Management and<br>Related Stockholder Matters .....              | 51          |
| Item 13. Certain Relationships and Related Transactions.....  | 51          |
| Item 14. Principal Accountant Fees and Services .....   | 51          |
| <br><b><u>Part IV</u></b>   |             |
| Item 15. Exhibits and Financial Statement Schedules.....  | 52          |
| Signatures .....  | 56          |

## PART I

### Item 1. Business

#### General

CEC Entertainment, Inc. (the "Company") was incorporated in the state of Kansas in 1980 and is engaged in the family restaurant/entertainment center business. The Company considers this to be its sole industry segment. Our principal executive offices are located at 4441 W. Airport Freeway, Irving, Texas 75062. The Company maintains a website at [www.chuckecheese.com](http://www.chuckecheese.com). Documents available on our website include the Company's (i) Code of Business Conduct and Ethics, (ii) Code of Ethics for the Chief Executive Officer and Senior Financial Officers, (iii) Corporate Governance Guidelines, and (iv) Charters for the Audit, Compensation, and Nominating/Corporate Governance Committees of the Board. These documents are also available in print to any stockholder who requests a copy. In addition, we make available free of charge through our website our annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and amendments to those reports as soon as reasonably practicable after electronic filing or furnishing of such material with the Securities and Exchange Commission.

The Company operated, as of December 31, 2006, 484 Chuck E. Cheese's® restaurants. In addition, as of December 31, 2006, franchisees of the Company operated 45 Chuck E. Cheese's restaurants.

#### Chuck E. Cheese's Restaurants

##### *Business Development*

Chuck E. Cheese's restaurants offer a variety of pizzas, a salad bar, sandwiches, appetizers and desserts and feature musical and comic entertainment by robotic and animated characters, family oriented games, rides and arcade-style activities. The restaurants are intended to appeal to families with children between the ages of two and 12. The Company opened its first restaurant in March 1980.

The Company and its franchisees operate in a total of 48 states and five foreign countries/territories. The Company owns and operates Chuck E. Cheese's restaurants in 44 states and Canada. See "Item 2. Properties."

The following table sets forth certain information with respect to the Chuck E. Cheese's restaurants owned by the Company (excludes franchised restaurants and one TJ Hartford's Grill and Bar).

|   | <u>2006</u> | <u>2005</u> | <u>2004</u> |
|---|-------------|-------------|-------------|
| Average annual revenues per restaurant (1)  | \$1,647,000 | \$1,633,000 | \$1,695,000 |
| Number of restaurants open at end of period | 484         | 475         | 449         |
| Percent of total restaurant revenues:       |             |             |             |
| Food and beverage sales                     | 63.4%       | 64.7%       | 66.1%       |
| Game sales                                  | 34.1%       | 32.5%       | 31.4%       |
| Merchandise sales                           | 2.5%        | 2.8%        | 2.5%        |

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(1) In computing these averages, only domestic restaurants that were open for a period greater than eighteen consecutive months at the beginning of each respective year, or twelve months for acquired restaurants, were included (416, 388 and 360 restaurants in 2006, 2005 and 2004, respectively). Fiscal year 2004 consisted of 53 weeks while each of fiscal years 2006 and 2005 consisted of 52 weeks.

The Company's sales volumes fluctuate seasonally and are generally higher during the first and third quarters of each fiscal year. Holidays, school operating schedules and weather conditions may affect sales volumes seasonally in some operating regions. Because of the seasonality of the Company's business, results for any quarter are not necessarily indicative of the results that may be achieved for the full fiscal year.

Each Chuck E. Cheese's restaurant typically employs a general manager, one or two managers, an electronic specialist who is responsible for repair and maintenance of the robotic characters and games, and 45 to 75 food preparation and service employees, most of whom work part-time.

To maintain a unique and exciting environment in the restaurants, the Company believes it is essential to reinvest capital through the evolution of its games, rides and entertainment packages and continuing enhancement of its facilities. The Company utilizes the following strategies to increase revenues and earnings in its restaurants over the long-term that require capital expenditures: (a) major remodels; (b) expansions of the square footage of existing restaurants; (c) a game enhancement initiative that includes new games and rides; and (d) small market remodels. The major remodel initiative typically includes expansion of the space allocated to the game room, an increase in the number of games and rides and in most cases may include a new exterior and interior identity. A new exterior identity includes a revised Chuck E. Cheese logo and signage, updating the exterior design of the buildings and, in some restaurants, colorful new awnings. The interior component includes painting, updating décor, a new menu board, enhanced lighting, remodeled restrooms and an upgraded salad bar. The average cost of major remodels in 2007 will approximate \$550,000 to \$650,000. In addition to expanding the square footage of existing restaurants, expansions typically include all components of a major remodel including an increase in the number of games and rides and range in cost from \$800,000 to \$900,000 per restaurant. The primary components of the game enhancement initiative are to provide new games and rides and the average capital cost is currently approximately \$100,000 to \$150,000 per restaurant. Small market remodels primarily include new games and rides and typically the removal of seating. Small market remodels are expected to range in cost from \$100,000 to \$150,000. The Company believes the evolution of its games, rides and entertainment packages and continuing enhancement of its facilities improve the guest experience and increase the attractiveness of its product.

In July 2006, the Company announced it had made enhancements to its strategic plan to increase focus on its existing restaurants and slow new restaurant development. The Company believes reducing the number of new restaurants opened will enable the Company to reallocate capital to its existing restaurants and enhance return on investment. The Company plans to increase its capital reinvestment in existing restaurants, primarily in the form of major remodels, expansions and game enhancement remodels, to approximately \$56 million in 2007 compared to an average of \$29 million per year over the last five years. Capital initiatives are expected to impact 155 existing restaurants in 2007. The Company plans to execute a more targeted new restaurant development focused on opening high volume stores in densely populated areas in the best performing geographic markets. The Company is expected to open approximately 10 new restaurants in 2007, including 3 relocations, and approximately 8 to 12 new restaurants per year thereafter.

The Company periodically reevaluates the site characteristics of its restaurants. The Company will consider relocating the restaurant to a more desirable site in the event certain site characteristics considered essential for the success of a restaurant deteriorate or the Company is unable to negotiate acceptable lease terms with the existing landlord.

The Company believes its ownership of trademarks in the names and character likenesses featured in the operation of its restaurants are an important competitive advantage.

#### *Restaurant Design and Entertainment*

Chuck E. Cheese's restaurants are typically located in shopping centers or in free-standing buildings near shopping centers and generally occupy 7,000 to 14,000 square feet in area. Chuck E. Cheese's restaurants are typically divided into three areas: a kitchen and related areas (cashier and prize area, salad bar, manager's office, technician's office, restrooms, etc.) occupies approximately 35% of the space, a dining area occupies approximately 25% of the space and a playroom area occupies approximately 40% of the space.

The dining area of each Chuck E. Cheese's restaurant features a variety of comic and musical entertainment by computer-controlled robotic characters, together with video monitors and animated props, located on various stage type settings. The dining area typically provides table and chair seating for 250 to 375 customers.

Each Chuck E. Cheese's restaurant typically contains a family oriented playroom area offering approximately 45 coin and token-operated attractions, including arcade-style games, kiddie rides, video games, skill oriented games and other similar entertainment. Most games dispense tickets that can be redeemed by guests for prize merchandise such as toys and dolls. Also included in the playroom area are tubes and tunnels suspended from or reaching to the ceiling known as SkyTubes® or other free attractions for young children, with booth and table seating for the entire family. The playroom area normally occupies approximately 60% of the restaurant's customer area. A limited number of free tokens are furnished with food orders or in connection with a sales promotion. Additional tokens may be purchased. Tokens are used to play the games and rides in the playroom.

### *Food and Beverage Products*

Each Chuck E. Cheese's restaurant offers a variety of pizzas, a salad bar, sandwiches, appetizers and desserts. Soft drinks, coffee and tea are also served, along with beer and wine where permitted by local laws. The Company believes that the quality of its food compares favorably with that of its competitors.

The majority of food, beverages and other supplies used in the Company-operated restaurants is currently distributed under a system-wide agreement with a major food distributor. The Company believes that this distribution system creates certain cost and operational efficiencies for the Company.

### *Marketing*

The primary customer base for the Company's restaurants consists of families having children between the ages of two and 12. The Company conducts advertising campaigns which are targeted at families with young children that feature the family entertainment experiences available at Chuck E. Cheese's restaurants and are primarily aimed at increasing the frequency of customer visits. The primary advertising medium continues to be television, due to its broad access to family audiences and its ability to communicate the Chuck E. Cheese's experience. The television advertising campaigns are supplemented by promotional offers in newspapers, cross promotions with companies targeting a similar customer base, the Company's website and direct e-mail.

### *Franchising*

The Company began franchising its restaurants in October 1981 and the first franchised restaurant opened in June 1982. At December 31, 2006, 45 Chuck E. Cheese's restaurants were operated by a total of 24 different franchisees, as compared to 44 of such restaurants at January 1, 2006. Currently, franchisees have expansion rights to open an additional six franchise restaurants.

The Chuck E. Cheese's standard franchise agreements grant to the franchisee the right to construct and operate a restaurant and use the associated trade names, trademarks and service marks within the standards and guidelines established by the Company. The franchise agreement presently offered by the Company has an initial term of 15 years and includes a 10-year renewal option. The standard agreement provides the Company with a right of first refusal should a franchisee decide to sell a restaurant. The earliest expiration dates of outstanding Chuck E. Cheese's franchises are in 2007.

The Company and its franchisees created The International Association of CEC Entertainment, Inc., (the "Association"), to discuss and consider matters of common interest relating to the operation of corporate and franchised Chuck E. Cheese's restaurants, to serve as an advisory council to the Company and to plan and approve contributions to and expenditures from the Advertising Fund, a fund established and managed by the Association that pays the costs of system-wide advertising, and the Entertainment Fund, a fund established and managed by the Association to further develop and improve entertainment attractions. Routine business matters of the Association are conducted by a Board of Directors of the Association, composed of five members appointed by the Company and five members elected by the franchisees. The Association is included in the Company's consolidated financial statements.

The franchise agreements governing existing franchised Chuck E. Cheese's restaurants in the United States currently require each franchisee to pay: (i) to the Company, in addition to an initial franchise fee of \$50,000, a continuing monthly royalty fee equal to 3.8% of gross sales; (ii) to the Advertising Fund an amount equal to 2.9% of gross sales; and (iii) to the Entertainment Fund an amount equal to 0.2% of gross sales. Under the Chuck E. Cheese's franchise agreements, the

Company is required, with respect to Company-operated restaurants, to spend for local advertising and to contribute to the Advertising Fund and the Entertainment Fund at the same rates as franchisees. The Company and its franchisees could be required to make additional contributions to the Association to fund any cash deficits that may be incurred by the Association.

### *Competition*

The restaurant and family entertainment industries are highly competitive, with a number of major national and regional chains operating in the restaurant or family entertainment business. Although other restaurant chains presently utilize the combined family restaurant/entertainment concept, these competitors primarily operate on a regional, market-by-market basis.

The Company believes that it will continue to encounter competition in the future. Major national and regional chains, some of which may have capital resources as great or greater than the Company, are competitors of the Company. The Company believes that the principal competitive factors affecting Chuck E. Cheese's restaurants are established brand recognition, the relative quality of food and service, quality and variety of offered entertainment, and location and attractiveness of the restaurants as compared to its competitors in the restaurant or entertainment industries.

### *TJ Hartford's Grill and Bar*

In 2001, the Company opened a full service casual dining restaurant with a game room area named TJ Hartford's Grill and Bar aimed at a broad demographic target offering medium priced, high quality food, including alcoholic beverages, in a relaxed entertaining atmosphere.

### *Trademarks*

The Company, through a wholly owned subsidiary, owns various trademarks, including "Chuck E. Cheese's" and "TJ Hartford's Grill and Bar" that are used in connection with the restaurants and have been registered with the appropriate patent and trademark offices. The duration of such trademarks is unlimited, subject to continued use. The Company believes that it holds the necessary rights for protection of the marks considered essential to conduct its present restaurant operations.

### *Government Regulation*

The development and operation of Chuck E. Cheese's restaurants are subject to various federal, state and local laws and regulations, including, but not limited to, those that impose restrictions, levy a fee or tax, or require a permit or license on the service of alcoholic beverages and the operation of games and rides. The Company is subject to the Fair Labor Standards Act, the Americans with Disabilities Act, and Family Medical Leave Act mandates. A significant portion of the Company's restaurant personnel are paid at rates related to the minimum wage established by federal and state law. Increases in such minimum wage result in higher labor costs to the Company, which may be partially offset by price increases and operational efficiencies.

### *Working Capital Practices*

The Company attempts to maintain only sufficient inventory of supplies in its restaurants to satisfy current operational needs. The Company's accounts receivable typically consist of credit card receivables, tax receivables, vendor rebates and leasehold improvement incentives.

### *Employees*

The Company's employment varies seasonally, with the greatest number of people being employed during the summer months. On December 31, 2006, the Company employed 18,395 employees, including 18,000 in the operation of Chuck E. Cheese's and TJ Hartford's Grill and Bar restaurants and 395 employed by the Company in its executive offices. None of the Company's employees are members of any union or collective bargaining group. The Company considers its employee relations to be good.

## *Item 1A. Risk Factors*

Our business operations and the implementation of our business strategy are subject to significant risks inherent in our business, including, without limitation, the risks and uncertainties described below. The occurrence of any one or more of the risks or uncertainties described below and elsewhere in this Form 10-K could have a material adverse effect on our financial condition, results of operations and cash flows. While we believe we have identified and discussed below the key risk factors affecting our business, there may be additional risks and uncertainties that are not presently known or that are not currently believed to be significant that may adversely affect our business, operations, industry, financial position and financial performance in the future. Because these forward-looking statements are based on estimates and assumptions that are subject to significant business, economic and competitive uncertainties, many of which are beyond our control or are subject to change, actual results could be materially different.

### **We may not be successful in the implementation of our growth strategies.**

Our continued growth depends, to a significant degree, on our ability to successfully implement our growth strategies. Among such strategies, we plan to continue to open new restaurants in selected markets and to enhance and upgrade the games and entertainment at existing restaurants. The opening and success of such new Chuck E. Cheese's restaurants will depend on various factors, including the availability of suitable sites, the negotiation of acceptable lease terms for such locations, store sales cannibalization, the ability to meet construction schedules, our ability to manage such expansion and hire and train personnel to manage the new restaurants, as well as general economic and business conditions. Our ability to successfully open new restaurants will also depend upon the availability of sufficient funds for such purpose, including funds from operations, our existing credit facility, future debt financings, future equity offerings or a combination thereof. There can be no assurance that we will be successful in opening and operating the number of anticipated new restaurants on a timely or profitable basis. There can be no assurance that we can continue to successfully upgrade the games and entertainment at existing restaurants. Our growth is also dependent on management's ability to continually evolve and update our business model to anticipate and respond to changing customer needs and competitive conditions. There can be no assurance that management will be able to successfully anticipate changes in competitive conditions or customer needs or that the market will accept our business model.

### **We may be unsuccessful in opening, closing and remodeling our restaurants.**

Our long-term growth is dependent on the success of strategic initiatives to increase the number of our restaurants and enhance the facilities of existing restaurants. We incur significant pre-opening expenses each time we open a new restaurant and other expenses when we close, relocate or remodel existing restaurants. The expenses of opening, closing, relocating or remodeling any of our restaurants, may be higher than anticipated. If we are unable to open or are delayed in opening new restaurants, we may incur significant costs which may adversely affect our financial results. If we are unable to remodel or are delayed in remodeling restaurants, we may incur significant costs which may adversely affect our financial results.

### **We are dependent on the service of certain key personnel.**

The success of our business will continue to be highly dependent upon the continued employment of Richard M. Frank, the Chairman of the Board and Chief Executive Officer of the Company, Michael H. Magusiak, the President of the Company, and other members of our senior management team. Although the Company has entered into employment agreements with each of Mr. Frank and Mr. Magusiak, the loss of the services of either of such individuals could have a material adverse effect upon our business and development. Our success will also depend upon our ability to retain and attract additional skilled management personnel to our senior management team and at our operational level. There can be no assurances that we will be able to retain the services of Messrs. Frank or Magusiak, senior members of our management team or the required operational support at the store level in the future.

**Our business is highly seasonal and quarterly results may fluctuate significantly as a result of this seasonality.**

We have experienced, and in the future could experience, quarterly variations in revenues as a result of a variety of factors, many of which are outside our control, including the timing and number of new store openings, the timing of capital investments in existing stores, the timing of school vacations and holidays, weather conditions and natural disasters. We typically experience lower net sales in the second and fourth quarters than in the first and third quarters. If revenues are below expectations in any given quarter, our operating results would likely be materially adversely affected for that quarter.

**We may be negatively affected by trends in the family restaurant/entertainment industry and national, regional and local economic conditions.**

The family restaurant/entertainment industry is affected by national, regional and local economic conditions, demographic trends and consumer tastes. The performance of individual restaurants may be affected by factors such as changes in consumer disposable income, demographic trends, weather conditions, traffic patterns and the type, number and location of competing restaurants. Dependence on frequent deliveries of fresh food products also subjects food service businesses, such as ours, to the risk that shortages or interruptions in supply caused by adverse weather or other conditions could adversely affect the availability, quality and cost of ingredients. In addition, factors such as inflation, increased food, labor and employee benefit costs, fluctuations in price of utilities, insurance costs and the availability of experienced management and hourly employees may also adversely affect the restaurant industry in general and our restaurants in particular. The entertainment industry is affected by many factors, including changes in customer preferences and increases in the type and number of entertainment offerings. Operating costs may also be affected by further increases in the minimum hourly wage, unemployment tax rates, sales taxes and similar matters over which we have no control.

**We are subject to intense competition in both the restaurant and entertainment industries.**

We believe that our combined restaurant and entertainment center concept puts us in a niche which combines elements of both the restaurant and entertainment industries. As a result, the Company, to some degree, competes with entities in both industries. Although other restaurant chains presently utilize the concept of combined family restaurant/entertainment operations, we believe these competitors operate primarily on a local or regional, market-by-market basis. Within the traditional restaurant sector, we compete with other casual restaurants on a nationwide basis with respect to price, service, personnel, type and quality of food, the number and location of restaurants, quality and speed of service, attractiveness of facilities, effectiveness of advertising and marketing programs, and new product development. Our high operating leverage may make the Company particularly susceptible to competition. Such competitive market conditions, including the effectiveness of our advertising and promotion and the emergence of significant new competition, could adversely affect our ability to successfully increase our results of operations.

**Changes in consumers' health, nutrition and dietary preferences could adversely affect our financial results.**

Our industry is affected by consumer preferences and perceptions. Changes in prevailing health or dietary preferences and perceptions may cause consumers to avoid certain products we offer in favor of alternative or healthier foods. If consumer eating habits change significantly and we are unable to respond with appropriate menu offerings, it could adversely affect our financial results.

**Negative publicity concerning food quality, health and other issues could adversely affect our financial results.**

Food service businesses can be adversely affected by litigation and complaints from guests, consumer groups or government authorities resulting from food quality, illness, injury or other health concerns or operating issues stemming from one restaurant or a limited number of restaurants. Publicity concerning food-borne illnesses and injuries caused by food tampering may negatively affect our operations, reputation and brand. Such publicity may have a significant adverse impact on the financial results of the Company. We could incur significant liabilities if a lawsuit or claim resulted in a judgment against us, or in significant litigation costs, regardless of the result.

**We may experience an increase in food, labor and other costs.**

An increase in food, labor, utilities, insurance and/or other operating costs, may adversely affect the financial results of the Company. Such an increase may adversely affect the Company directly or adversely affect the vendors, franchisees and others whose performance has a significant impact on our financial results.

Specifically, any increase in the prices for food commodities, including cheese, could adversely affect our financial results. The performance of our restaurants is also adversely affected by increases in the price of utilities on which the restaurants depend, such as natural gas, whether as a result of inflation, shortages or interruptions in supply, or otherwise. Our business also incurs significant costs for and including among other things, insurance, marketing, taxes, real estate, borrowing and litigation, all of which could increase due to inflation, changes in laws, competition, or other events beyond our control.

In addition, a number of our employees are subject to various minimum wage requirements. Several states in which we operate restaurants have established a minimum wage higher than the federally mandated minimum wage. There may be similar increases implemented in other jurisdictions in which we operate or seek to operate. These minimum wage increases may have an adverse effect on our financial results.

**We are subject to risks from disruption of our commodity distribution system**

Any disruption in our commodity distribution system could adversely affect our financial results. We use a single vendor to distribute most of the products and supplies used in our restaurants. Any failure by this vendor to adequately distribute products or supplies to our restaurants could increase our costs and have a material adverse effect on our financial results.

**Our restaurants may be adversely affected by local conditions, events and natural disasters.**

Certain regions in which our restaurants are located may be subject to adverse local conditions, events or natural disasters. A natural disaster may damage our stores or other operations which may adversely affect the financial results of the Company.

**Unanticipated conditions in foreign markets may adversely affect our ability to operate effectively in those markets.**

In addition to our restaurants in the United States, we currently own or franchise restaurants in Canada, Chile, Guatemala, Puerto Rico and Saudi Arabia. We may in the future expand into additional foreign markets. We are subject to the regulation and economic and political conditions of any foreign market in which we operate our restaurants and any change in the regulation or conditions of these foreign markets may adversely affect our financial results. Changes in foreign markets that may affect our financial results include, but are not limited to, taxation, inflation, currency fluctuations, increased regulations and quotas, tariffs and other protectionist measures.

**We are subject to risks in connection with owning and leasing real estate.**

As owner and lessor of the land and/or building for our restaurants we are subject to all of the risks generally associated with owning and leasing real estate, including changes in the supply and demand for real estate in general and the supply and demand for the use of the restaurants. Any obligation to continue making rental payments with respect to leases for closed restaurants could adversely affect our financial results.

**We may not be able to adequately protect our trademarks or other proprietary rights.**

We own certain common law trademark rights and a number of federal and international trademark and service mark registrations and proprietary rights relating to our operations. We believe that our trademarks and other proprietary rights are important to our success and our competitive position. We, therefore, devote appropriate resources to the protection of our trademarks and proprietary rights. The protective actions that we take, however, may not be enough to prevent unauthorized usage or imitation by others, which could harm our image, brand or competitive position and, if we commence litigation to enforce our rights, cause us to incur significant legal fees.

We cannot assure you that third parties will not claim that our trademarks or menu offerings infringe upon their proprietary rights. Any such claim, whether or not it has merit, could be time-consuming, result in costly litigation, cause delays in introducing new menu items in the future or require us to enter into royalty or licensing agreements. As a result, any such claim could have a material adverse effect on our business, results of operations, financial condition or liquidity.

**We are dependent on certain systems and technologies which may be disrupted.**

The Company's operations are dependent upon the successful functioning of our computer and information system. Damage, interruption or failure of our systems may result in additional development costs, loss of customers, loss of customer data, negative publicity, harm to our business and reputation and exposure to losses or other liabilities.

**We may be adversely affected by negative publicity relating to our target market.**

The Company's target market of two to twelve year old children and families with small children is potentially highly sensitive to adverse publicity. We are subject to risks of litigation and regulatory action regarding advertising to our target market. Any such litigation or regulatory action may adversely affect our financial results. There can be no assurance that the Company will not experience negative publicity regarding one or more of its restaurants. The occurrence of negative publicity regarding one or more of the Company's locations could materially and adversely affect the Company's image with its customers and its results of operations.

**We are subject to various government regulations.**

The Company and its franchisees are subject to various federal, state and local laws and regulations affecting operations, including those relating to the use of video and arcade games and rides, the preparation and sale of food and beverages, and those relating to building and zoning requirements. The Company and its franchisees are also subject to laws governing their relationship with employees, including minimum wage requirements, overtime, working and safety conditions, and citizenship requirements. In addition, the Company is subject to regulation by the Federal Trade Commission, Federal Communication Commission and must comply with certain state laws which govern the offer, sale and termination of franchises and the refusal to renew franchises. Difficulties or failures in obtaining required licenses or other regulatory approvals could delay or prevent the opening of a new restaurant, and the suspension of, or inability to renew, a license or permit could interrupt operations at an existing restaurant.

**We face litigation risks from customers, franchisees, employees and other third parties in the ordinary course of business.**

The Company's business is subject to the risk of litigation by employees, consumers, suppliers, shareholders or others through private actions, class actions, administrative proceedings, regulatory actions or other litigation. The outcome of litigation, particularly class action lawsuits and regulatory actions, is difficult to assess or quantify. Plaintiffs in these types of lawsuits may seek recovery of very large or indeterminate amounts, and the magnitude of the potential loss relating to such lawsuits may remain unknown for substantial periods of time. The cost to defend future litigation may be significant. There may also be adverse publicity associated with litigation that could decrease customer acceptance of our services, regardless of whether the allegations are valid or whether we are ultimately found liable.

Specifically, we are continually subject to risks from litigation and regulatory action regarding advertising to our market of two to twelve year old children. In addition, since certain of our restaurants serve alcoholic beverages, we are subject to "dram shop" statutes. These statutes generally allow a person injured by an intoxicated person to recover damages from an establishment that wrongfully served alcoholic beverages to the intoxicated person. Recent litigation against restaurant chains has resulted in significant judgments and settlements under dram shop statutes.

Under certain circumstances plaintiffs may seek punitive damages, which may not be covered by insurance. Any litigation the Company faces could have a material adverse effect on the Company's business, financial condition and results of operations.

**A failure to establish, maintain and apply adequate internal control over financial reporting could have a materially adverse affect on our business.**

The Company is subject to the ongoing internal control provisions of Section 404 of the Sarbanes-Oxley Act of 2002. These provisions provide for the identification of material weaknesses in internal control over financial reporting, which is a process to provide reasonable assurance regarding the reliability of financial reporting for external purposes in accordance with accounting principles generally accepted in the United States of America. We have identified a material weakness relating to our historical stock option granting process, and we have taken steps to improve our corporate governance process for equity compensation awards in the future. Should the Company identify other material weaknesses in internal control, there can be no assurance that the Company will be able to remediate any future material weaknesses that may be identified in a timely manner or maintain all of the controls necessary to remain in compliance. Any failure to maintain an effective system of internal control over financial reporting could limit the Company's ability to report financial results accurately and timely or to detect and/or prevent fraud.

**Our anti-takeover provisions may limit shareholder value.**

We have certain provisions in our corporate governance document which may make it difficult, discourage or otherwise prevent a third party from acquiring control of the Company without certain approvals. These provisions may result in shareholders receiving less in exchange for their stock than they otherwise would without the provisions. In addition, these provisions may delay, prevent or deter a merger, acquisition, tender offer, proxy contest or other transaction that might otherwise result in our shareholders receiving a premium over the market price for their common stock.

**Changes in financial accounting standards or interpretations of existing standards could affect reported results of operations.**

Generally accepted accounting principles and accompanying accounting pronouncements, implementation guidelines, and interpretations for many aspects of our business are highly complex and involve subjective judgments. Changes in these accounting standards, new accounting pronouncements and interpretations may occur that could adversely affect the Company's reported financial position, results of operations and/or cash flows.

**Other risk factors may adversely affect our financial performance.**

Other risk factors that could cause our actual results to differ materially from those indicated in the forward-looking statements by affecting, among many things, pricing, consumer spending and consumer confidence, include, without limitation, changes in economic conditions, increased fuel costs and availability for our employees, customers and suppliers, health epidemics or pandemics or the prospects of these events (such as recent reports on avian flu), consumer perceptions of food safety, changes in consumer tastes and behaviors, governmental monetary policies, changes in demographic trends, availability of employees, terrorist acts, energy shortages and rolling blackouts, and weather (including, major hurricanes and regional snow storms) and other acts of God.

*Item 1B. Unresolved Staff Comments.*

None.

*Item 2. Properties.*

The following table sets forth certain information regarding the Chuck E. Cheese's restaurants operated by the Company as of December 31, 2006.

| <u>Domestic</u>      | <u>Chuck E.<br/>Cheese's</u> |
|----------------------|------------------------------|
| Alabama              | 8                            |
| Alaska               | 1                            |
| Arizona              | 2                            |
| Arkansas             | 5                            |
| California           | 72                           |
| Colorado             | 9                            |
| Connecticut          | 6                            |
| Delaware             | 2                            |
| Florida              | 22                           |
| Georgia              | 16                           |
| Idaho                | 1                            |
| Illinois             | 22                           |
| Indiana              | 12                           |
| Iowa                 | 5                            |
| Kansas               | 4                            |
| Kentucky             | 3                            |
| Louisiana            | 9                            |
| Maine                | 1                            |
| Maryland             | 15                           |
| Massachusetts        | 11                           |
| Michigan             | 19                           |
| Minnesota            | 5                            |
| Mississippi          | 3                            |
| Missouri             | 8                            |
| Nebraska             | 2                            |
| Nevada               | 5                            |
| New Hampshire        | 2                            |
| New Jersey           | 15                           |
| New Mexico           | 3                            |
| New York             | 21                           |
| North Carolina       | 12                           |
| North Dakota         | 1                            |
| Ohio                 | 18                           |
| Oklahoma             | 3                            |
| Pennsylvania         | 22                           |
| Rhode Island         | 1                            |
| South Carolina       | 7                            |
| South Dakota         | 2                            |
| Tennessee            | 12                           |
| Texas                | 56                           |
| Virginia             | 11                           |
| Washington           | 6                            |
| West Virginia        | 1                            |
| Wisconsin            | <u>9</u>                     |
|                      | <u>470</u>                   |
| <u>International</u> |                              |
| Canada               | <u>14</u>                    |
|                      | <u>484</u>                   |

Of the 484 Chuck E. Cheese's restaurants owned by the Company as of December 31, 2006, 425 occupy leased premises and 59 occupy owned premises. The primary lease terms of these restaurants will expire at various times from

2007 to 2028 and available lease terms, including options to renew, expire at various times from 2007 to 2040, as described in the table below.

| <u>Year of Expiration</u> | <u>Number of Restaurants</u> | <u>Range of Renewal Options (Years)</u> |
|---------------------------|------------------------------|---|
| 2007                      | 36                           | None to 15                              |
| 2008                      | 38                           | None to 20                              |
| 2009                      | 50                           | None to 20                              |
| 2010                      | 32                           | None to 20                              |
| 2011                      | 32                           | None to 20                              |
| 2012 and thereafter       | 237                          | None to 25                              |

The leases of Chuck E. Cheese's restaurants contain terms that vary from lease to lease, although a typical lease provides for a primary term of 10 years, with two additional five-year options to renew, and provides for annual minimum rent payments of approximately \$2.99 to \$36.87 per square foot, subject to periodic adjustment. It is common for the Company to take possession of leased premises prior to the commencement of rents for the purpose of constructing leasehold improvements. The restaurant leases require the Company to pay the cost of repairs, insurance and real estate taxes and, in many instances, provide for additional rent equal to the amount by which a percentage (typically 6%) of gross revenues exceeds the minimum rent.

### *Item 3. Legal Proceedings.*

On July 25, 2006, the Company announced a review by its Audit Committee of stock option granting procedures. On July 27, 2006, the Company notified the SEC that the Audit Committee was conducting a review of the Company's stock option granting practices. The SEC notified the Company on August 1, 2006, that it was conducting an informal inquiry into various accounting matters related to the Company including its stock option practices. The Company has and will continue to fully cooperate with the SEC in the informal inquiry. Given the preliminary nature of the matter, the Company is not able to predict what impact, if any, this inquiry will have on the Company.

On January 23, 2007, a purported class action lawsuit against the Company, entitled *Blanco v. CEC Entertainment, Inc., et. al.*, Cause No. CV-07-0559 ("Blanco Litigation"), was filed in the United States District Court for the Central District of California. The Blanco Litigation was filed by an alleged customer of one of the Company's Chuck E. Cheese's restaurants purporting to represent all individuals in the United States who, on or after December 4, 2006, were knowingly and intentionally provided at the point of sale or transaction with an electronically-printed receipt by the Company that was in violation of U.S.C. Section 1681c(g) of the Fair and Accurate Credit Transactions Act ("FACTA"). The Blanco Litigation is not seeking actual damages, but is only seeking statutory damages for each willful violation under FACTA. The Blanco Litigation is still in its preliminary stages and discovery has not yet begun. Thus, its ultimate outcome, and any ultimate effect on the Company, cannot be precisely determined at this time. However, the Company believes that it has meritorious defenses to this lawsuit and intends to vigorously defend against it, including the Blanco plaintiffs' efforts to certify a nationwide class action.

On February 8, 2007, a purported class action lawsuit against the Company, entitled *Price v. CEC Entertainment, Inc., et. al.*, Cause No. CV-07-00923 ("Price Litigation"), was filed in the United States District Court for the Central District of California. The Price Litigation was filed by an alleged customer of one of the Company's Chuck E. Cheese's restaurants purporting to represent the following two classes of individuals in the United States: (i) all persons to whom, on or after January 1, 2005, the Company provided, through use of a machine that was first put into use by the Company on or after January 1, 2005, an electronically printed receipt which was in violation of U.S.C. Section 1681c(g) of the Fair and Accurate Credit Transactions Act ("FACTA"); and (ii) all persons to whom, on or after December 4, 2006, the Company provided, through use of a machine that was being used by the Company before January 1, 2005, an electronically printed receipt which was in violation of FACTA. The Price Litigation is not seeking actual damages, but is only seeking statutory damages for each willful violation under FACTA and a permanent injunction enjoining the Company from engaging in unlawful violations of FACTA. The Price Litigation is still in its preliminary stages and discovery has not yet begun. Thus,

its ultimate outcome, and any ultimate effect on the Company, cannot be precisely determined at this time. However, the Company believes that it has meritorious defenses to this lawsuit and intends to vigorously defend against it, including the Price plaintiffs' efforts to certify a nationwide class action.

*Item 4. Submission of Matters to a Vote of Security Holders.*

No matters were submitted to a vote of security holders during the fourth quarter of 2006.

## PART II

### *Item 5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchase of Equity Securities.*

As of April 13, 2007, there were an aggregate of 32,241,703 shares of the Company's common stock outstanding and approximately 2,220 stockholders of record.

The Company's common stock is listed on the New York Stock Exchange under the symbol "CEC." The following table sets forth the highest and lowest price per share of the common stock during each quarterly period within the two most recent years, as reported on the New York Stock Exchange:

|               | <u>High</u> | <u>Low</u> |
|---------------|-------------|------------|
| 2006          |             |            |
| - 1st quarter | \$ 38.46    | \$ 30.99   |
| - 2nd quarter | 36.26       | 30.95      |
| - 3rd quarter | 33.90       | 27.69      |
| - 4th quarter | 41.14       | 30.91      |
| 2005          |             |            |
| - 1st quarter | \$ 41.21    | \$ 35.80   |
| - 2nd quarter | 42.44       | 35.06      |
| - 3rd quarter | 43.14       | 29.50      |
| - 4th quarter | 36.92       | 30.39      |

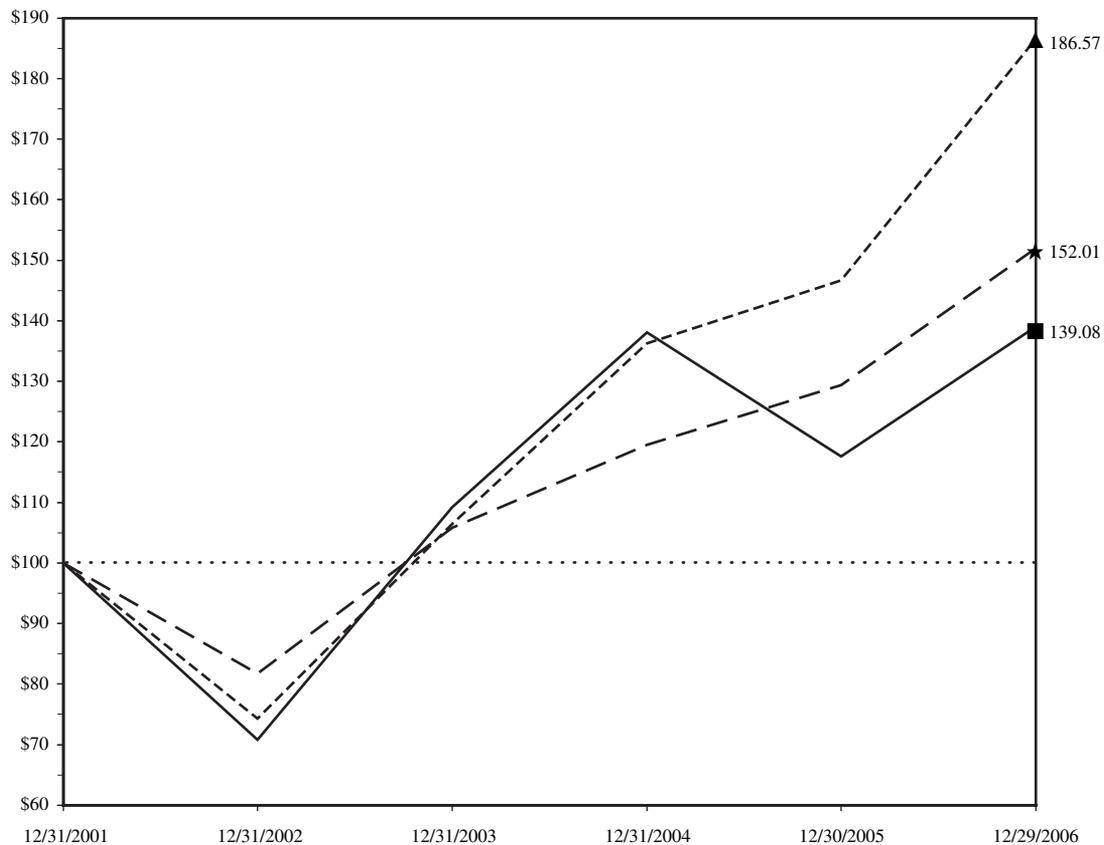
The Company has not paid any cash dividends on its common stock and has no present intention of paying cash dividends thereon in the future. The Company plans to retain any earnings to finance anticipated capital expenditures, repurchase the Company's common stock and reduce its long-term debt. The future dividend policy with respect to the common stock will be determined by the Board of Directors of the Company, taking into consideration factors such as future earnings, capital requirements, potential loan agreement restrictions and the financial condition of the Company.

From time to time, the Company repurchases shares of its common stock under a plan authorized by its Board of Directors. See the section titled Financial Condition, Liquidity and Capital Resources under Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations. There were no repurchases of common stock made by the Company during the fourth quarter of 2006.

## Performance Graph

The following graph compares the annual change in the Company's cumulative total stockholder return for the five fiscal years ended December 31, 2006 based upon the market price of the Company's common stock, compared with the cumulative total return on the NYSE Market Index and the NYSE Index for U.S. companies with a standard industrial classification for eating and drinking places assuming \$100 was invested.

### COMPARISON OF CUMULATIVE TOTAL RETURN OF ONE OR MORE COMPANIES, PEER GROUPS, INDUSTRY INDEXES AND/OR BROAD MARKETS



|         |  | Legend  |         |         |         |         |         |
|---------|--|---------|---------|---------|---------|---------|---------|
| Symbol  | CRSP Total Returns Index for:  | 12/2001 | 12/2002 | 12/2003 | 12/2004 | 12/2005 | 12/2006 |
| —■—     | CEC Entertainment, Inc.  | 100.0   | 70.75   | 109.22  | 138.11  | 117.62  | 139.08  |
| - - -★- | NYSE Stock Market (US Companies)                                       | 100.0   | 81.69   | 105.82  | 119.50  | 129.37  | 152.01  |
| - - -▲- | NYSE Stocks (SIC 5800-5899 US Companies)<br>Eating and drinking places | 100.0   | 74.26   | 106.46  | 136.27  | 146.68  | 186.57  |



Item 6. Selected Financial Data.

|  | <u>2006</u>                                  | <u>2005</u>      | <u>2004</u>      | <u>2003</u>      | <u>2002</u>      |
|--|--|------------------|------------------|------------------|------------------|
|  | (Thousands, except per share and store data) |                  |                  |                  |                  |
| Operating results (1):   |  |                  |                  |                  |                  |
| Revenues .....   | \$774,154                                    | \$726,163        | \$728,079        | \$654,598        | \$602,201        |
| Costs and expenses.....  | <u>662,777</u>                               | <u>613,382</u>   | <u>603,418</u>   | <u>554,589</u>   | <u>507,315</u>   |
| Income before income taxes .....   | 111,377                                      | 112,781          | 124,661          | 100,009          | 94,886           |
| Income taxes .....   | <u>43,120</u>                                | <u>43,110</u>    | <u>47,683</u>    | <u>39,425</u>    | <u>38,138</u>    |
| Net income .....   | <u>\$ 68,257</u>                             | <u>\$ 69,671</u> | <u>\$ 76,978</u> | <u>\$ 60,584</u> | <u>\$ 56,748</u> |
| Per share (2) (3):   |  |                  |                  |                  |                  |
| Basic:   |  |                  |                  |                  |                  |
| Net income .....   | \$ 2.09                                      | \$ 1.99          | \$ 2.07          | \$ 1.52          | \$ 1.36          |
| Weighted average shares outstanding .....  | 32,587                                       | 35,091           | 37,251           | 39,654           | 41,511           |
| Diluted:   |  |                  |                  |                  |                  |
| Net income .....   | \$ 2.04                                      | \$ 1.93          | \$ 2.00          | \$ 1.50          | \$ 1.34          |
| Weighted average shares outstanding .....  | 33,465                                       | 36,188           | 38,472           | 40,389           | 42,263           |
| Cash flow data:  |  |                  |                  |                  |                  |
| Cash provided by operating activities .....  | \$149,602                                    | \$134,998        | \$162,974        | \$155,588        | \$133,130        |
| Cash used in investing activities .....  | (115,516)                                    | (91,247)         | (80,327)         | (94,226)         | (112,686)        |
| Cash used in financing activities.....   | (27,962)                                     | (43,365)         | (78,916)         | (65,506)         | (11,912)         |
| Balance sheet data:  |  |                  |                  |                  |                  |
| Total assets.....  | \$704,185                                    | \$651,920        | \$612,129        | \$583,162        | \$537,251        |
| Long-term obligations (including current portion of<br>debt and capital leases) (4)..... | 190,364                                      | 163,671          | 100,808          | 84,258           | 77,212           |
| Shareholders' equity .....   | 359,206                                      | 343,183          | 365,978          | 373,374          | 368,112          |
| Number of restaurants at year end:   |  |                  |                  |                  |                  |
| Company operated .....   | 484  | 475              | 449              | 418              | 384              |
| Franchise.....   | <u>45</u>                                    | <u>44</u>        | <u>46</u>        | <u>48</u>        | <u>50</u>        |
|  | <u>529</u>                                   | <u>519</u>       | <u>495</u>       | <u>466</u>       | <u>434</u>       |

(1) Fiscal year 2004 was 53 weeks in length and all other fiscal years presented were 52 weeks in length.

(2) No cash dividends on common stock were paid in any of the years presented.

(3) Share and per share information reflect the effects of a 3 for 2 stock split effected in the form of a special stock dividend that was effective on March 15, 2004.

(4) Long-term obligations include long-term debt, capital lease obligations, accrued insurance and redeemable preferred stock.

## *Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations.*

### **General**

The Company operates on a 52 or 53 week fiscal year ending on the Sunday nearest December 31. The fiscal years are as follows:

| <u>Fiscal Year</u> | <u>Fiscal Year Ending</u> | <u>Number of Weeks</u> |
|--------------------|---------------------------|------------------------|
| 2006               | December 31, 2006         | 52                     |
| 2005               | January 1, 2006           | 52                     |
| 2004               | January 2, 2005           | 53                     |
| 2003               | December 28, 2003         | 52                     |
| 2002               | December 29, 2002         | 52                     |

### **Overview**

The Company and its subsidiaries develop, operate and franchise restaurants under the name “Chuck E. Cheese’s” in 48 states and five foreign countries/territories. The primary sources of the Company’s revenues are from Company restaurant sales (food, beverage, game and merchandise) and franchise royalties and fees.

Certain expenses relate only to Company operated restaurants. These include:

- Food, beverage and related supplies which includes, food and beverage costs less rebates from suppliers, paper and birthday supplies, cleaning supplies and kitchen utensils.
- Game and merchandise costs which include costs of merchandise sold to customers, prize costs and hourly game technician labor.
- Labor costs which include all direct restaurant labor costs and benefits with the exception of game technician labor included in game and merchandise cost.
- Other operating expenses which include utilities, repair costs, insurance, property taxes, restaurant rent expense, preopening expenses and gains and losses on property transactions.

Selling, general and administrative costs include both restaurant costs and corporate overhead costs including advertising.

Depreciation and amortization expense includes expense related to both restaurant assets and corporate overhead assets.

Comparable store sales (sales of domestic restaurants that were open for a period greater than eighteen consecutive months at the beginning of each respective year or twelve months for acquired restaurants) are a critical factor when evaluating the Company’s business. In order to positively impact comparable store sales and earnings per share, the Company plans to significantly increase its capital reinvestment in existing stores, slow new store development and enhance value to its guests with improved and increased distribution of coupons, cross promotions and e-marketing.

A critical component of the Company’s strategic plan to increase long-term shareholder value is through capital reinvestment. The Company projects that it will reinvest approximately \$56 million of capital impacting 155 stores in 2007. This plan includes 55 major remodels, 15 store expansions, 65 game enhancements and 20 small market remodels.

## Results of Operations

A summary of the results of operations of the Company as a percentage of revenues for the last three fiscal years is shown below.

|  | <u>2006</u>  | <u>2005</u>  | <u>2004</u>  |
|--|--------------|--------------|--------------|
| Revenues .....                               | 100.0%       | 100.0%       | 100.0%       |
| Costs and expenses:                          |              |              |              |
| Cost of sales                                |              |              |              |
| Food, beverage and related supplies.....     | 11.6%        | 12.0%        | 12.3%        |
| Games and merchandise .....                  | 4.3%         | 4.1%         | 4.2%         |
| Labor .....                                  | 27.4%        | 27.7%        | 27.5%        |
| Selling, general and administrative.....     | 13.8%        | 13.5%        | 13.1%        |
| Depreciation and amortization.....           | 8.4%         | 8.4%         | 7.7%         |
| Interest expense .....                       | 1.2%         | .6%          | .3%          |
| Other operating expenses .....               | <u>18.9%</u> | <u>18.1%</u> | <u>17.8%</u> |
|  | <u>85.6%</u> | <u>84.4%</u> | <u>82.9%</u> |
| Income before income taxes .....             | <u>14.4%</u> | <u>15.6%</u> | <u>17.1%</u> |
| Number of Company-owned restaurants:         |              |              |              |
| Beginning of period.....                     | 475          | 449          | 418          |
| New .....                                    | 14           | 25           | 29           |
| Company purchased franchise restaurants..... |              | 2            | 3            |
| Closed.....                                  | <u>(5)</u>   | <u>(1)</u>   | <u>(1)</u>   |
| End of period.....                           | <u>484</u>   | <u>475</u>   | <u>449</u>   |
| Number of franchise restaurants:             |              |              |              |
| Beginning of period.....                     | 44           | 46           | 48           |
| New .....                                    | 1            | 1            | 1            |
| Company purchased franchise store .....      |              | (2)          | (3)          |
| Closed.....                                  |              | <u>(1)</u>   |              |
| End of period.....                           | <u>45</u>    | <u>44</u>    | <u>46</u>    |

### 2006 Compared to 2005

#### Revenues

Revenues increased 6.6% to \$774.2 million in 2006 from \$726.2 million in 2005 primarily due to a 2.7% increase in comparable store sales. The Company opened 14 new restaurants and closed five restaurants in 2006. Average annual revenues per restaurant increased to approximately \$1,647,000 in 2006 from approximately \$1,633,000 in 2005. Fiscal years 2006 and 2005 both consisted of 52 weeks. Menu prices increased approximately 0.8% between the two years.

Revenues from franchise fees and royalties were \$2.9 million in both 2006 and 2005. During 2006, one new franchise restaurant opened. Domestic franchise comparable store sales increased 1.8% in 2006.

#### Costs and Expenses

Costs and expenses as a percentage of revenues increased to 85.6% in 2006 from 84.4% in 2005.

Cost of sales as a percentage of revenues decreased to 43.3% in 2006 from 43.8% in 2005. Costs of food, beverage, and related supplies as a percentage of revenues decreased to 11.6% in 2006 from 12.0% in 2005 due to a 15% reduction in average cheese prices paid during 2006 compared to 2005 and menu price increases. Costs of games and merchandise increased to 4.3% in 2006 from 4.1% in 2005 primarily due to the distribution of free tokens related to a marketing promotion in the first quarter of 2006. Restaurant labor expenses as a percentage of revenues decreased to 27.4% in 2006 from 27.7% in 2005 primarily due to the increase in comparable store sales and improved operational efficiencies.

Selling, general and administrative expenses as a percentage of revenues increased to 13.8% in 2006 from 13.5% in 2005. The increase was primarily due to \$2.1 million in professional service fees associated with the Company's review of its stock option granting practices.

Depreciation and amortization expense as a percentage of revenues remained consistent between years 2006 and 2005 at 8.4%.

Interest expense as a percentage of revenues increased to 1.2% in 2006 from 0.6% in 2005 primarily due to an increase in the average debt balance and an increase in interest rates.

Other operating expenses increased as a percentage of revenues to 18.9% in 2006 from 18.1% in 2005 primarily due to a 0.3% increase in utility expense as a percentage of revenues due to an 18% increase in the average electricity expense per store. In addition the Company recorded a \$3.9 million asset impairment loss for 4 small market stores and one large market store, a \$1.3 million loss related to the write-off of used games intended to be used in new stores and the write-off of development costs for abandoned sites where the decision was made to not develop the units. This was partially offset by an improvement in insurance expense of 0.2% between the years. Insurance expense decreased due to improved trends in workers' compensation and general liability claims and a reduction in insurance premiums.

The Company's effective income tax rate was 38.7% and 38.2% in 2006 and 2005, respectively.

#### Net Income

The Company had net income of \$68.3 million in 2006 compared to \$69.7 million in 2005 due to the changes in revenues and expenses discussed above. The Company's diluted earnings per share increased 5.7% to \$2.04 per share in 2006 compared to \$1.93 per share in 2005. Weighted average diluted shares outstanding decreased 7.5% to 33.5 million in 2006 from 36.2 million in 2005 primarily due to the Company's share repurchase program.

#### 2005 Compared to 2004

##### Revenues

Revenues decreased 0.3% to \$726.2 million in 2005 from \$728.1 million in 2004 primarily due to an additional week of operation in 2004 and a 2.3% decrease in comparable store sales. Excluding the benefit of the extra week in the prior year, comparable store sales would have decreased by 1.8%. Comparable store sales were negatively impacted by approximately 0.5% due to the loss of 711 operating days as a result of hurricane damage occurring in 2005. The Company opened 25 new restaurants, acquired two restaurants from franchisees and closed one restaurant in 2005. Average annual revenues per restaurant decreased to approximately \$1,633,000 in 2005 from approximately \$1,695,000 in 2004. Fiscal year 2005 consisted of 52 weeks while fiscal year 2004 consisted of 53 weeks. Menu prices increased approximately 2.2% between the two years.

Revenues from franchise fees and royalties were \$2.9 million in 2005 compared to \$3.2 million in 2004. During 2005, one new franchise restaurant opened, one franchise restaurant closed and two franchise restaurants were acquired by the Company. Domestic franchise comparable store sales decreased 1.6% in 2005.

##### Costs and Expenses

Costs and expenses as a percentage of revenues increased to 84.4% in 2005 from 82.9% in 2004.

Cost of sales as a percentage of revenues decreased to 43.8% in 2005 from 44.0% in 2004. Costs of food, beverage, and related supplies as a percentage of revenues decreased to 12.0% in 2005 from 12.3% in 2004 due to a 10% reduction in average cheese prices paid during 2005 compared to 2004, a beverage credit from our supplier and menu price increases. Costs of games and merchandise decreased to 4.1% in 2005 from 4.2% in 2004 primarily due to menu price increases. Restaurant labor expenses as a percentage of revenues increased to 27.7% in 2005 from 27.5% in 2004 primarily due to the decrease in comparable store sales.

Selling, general and administrative expenses as a percentage of revenues increased to 13.5% in 2005 from 13.1% in 2004 primarily due to the benefit of an extra week of revenue in the prior year and the decline in comparable store sales.

Depreciation and amortization expense as a percentage of revenues increased to 8.4% in 2005 from 7.7% in 2004 primarily due to capital invested in new and existing restaurants and the decline in comparable store sales.

Interest expense as a percentage of revenues increased to 0.6% in 2005 from 0.3% in 2004 primarily due to an increase in interest rates and outstanding debt.

Other operating expenses increased as a percentage of revenues to 18.1% in 2005 from 17.8% in 2004 primarily due to the benefit of the extra week of revenues in the prior year and the decline in comparable store sales. This was partially offset by an improvement in insurance expense of 1.0% between the years. Insurance expense decreased due to improved trends in workers' compensation and general liability claims and a reduction in insurance premiums.

The Company's effective income tax rate was 38.2% in both 2005 and 2004.

### Net Income

The Company had net income of \$69.7 million in 2005 compared to \$77.0 million in 2004 due to the changes in revenues and expenses discussed above. The Company's diluted earnings per share decreased 3.5% to \$1.93 per share in 2005 compared to \$2.00 per share in 2004 due to the 9.5% decrease in net income over the prior year and a 5.9% decrease in the Company's number of weighted average shares outstanding. In addition, the Company estimates that the additional week of operations in 2004 increased diluted earnings per share by approximately \$.11. Weighted average diluted shares outstanding decreased to 36.2 million in 2005 from 38.5 million in 2004 primarily due to the Company's share repurchase program.

## ***Critical Accounting Policies and Estimates***

The Company's significant accounting policies are disclosed in Note 1 to the consolidated financial statements. The following discussion addresses the Company's most critical accounting policies, which are those that require significant judgment.

### **Stock-Based Compensation Expense**

Prior to 2006, the Company accounted for stock-based compensation under the intrinsic value method of Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees," and related interpretations ("APB 25"), and had adopted the disclosure-only provisions of Financial Accounting Standards Board Statement No. 123, "Accounting for Stock-Based Compensation," ("SFAS 123"). In December 2004, the Financial Accounting Standards Board issued a revised and renamed standard regarding stock-based compensation, "Share-Based Payment," ("SFAS 123R"). The revised standard, which was adopted by the Company in the first quarter of 2006, eliminates the disclosure-only election under SFAS 123 and requires the recognition of compensation expense of stock options and all other forms of equity compensation generally based on the fair value of the instruments on the date of grant. In order to enhance comparability among all years presented and to provide the fullest understanding of the impact that expensing stock-based compensation has on the Company, the Company has retrospectively applied the new standard to prior period results.

The fair value of stock-based compensation is recognized in expense over the vesting period, and is determined on the measurement date. The measurement date is determined the first date on which both are known with finality (1) the number of shares an individual employee is entitled to receive and (2) the option or purchase price, if any. The Company uses all available evidence to determine the most likely measurement date.

The Company considers the date of a meeting to be the accounting measurement date if minutes of the meeting were recorded and provided sufficient specificity to determine the award price and the number of awards to be allocated to individuals.

For the instances when approval is obtained through unanimous written consent, the Company considers the measurement date to be the date when the last required approval was received by the Company from the Board of Directors or a special committee of the Board of Directors on the UWC. However in instances in which the Company

was unable to locate definitive and complete documentation evidencing the date on which the last required approval of a UWC was received by the Company, the Company formed a conclusion as to the most likely date that approval was received based on the timing of letters notifying employees of the stock award (if available) and the approval pattern of past stock awards approved through a UWC with evidence of the date on which the last required approval was received by the Company. More specifically, for these instances, the Company estimates the accounting measurement date to be the earlier of the date of the letter notifying the employee of the stock award (if available) or the average number of days lapsing from the stated “as of” date of a UWC to the date on which the last required approval of a UWC was received by the Company for other stock awards. For annual stock awards (in which the largest number of awards were granted to employees) and mid-year grants, the average number of days lapsing from the ‘as of’ date of the UWC to the date on which the last required approval of a UWC was received by the Company averaged 29 and 48 business days, respectively.

### **Self-Insurance**

The Company estimates its liability for incurred but unsettled general liability and workers’ compensation related claims under its self-insured retention programs, including reported losses in the process of settlement and losses incurred but not reported. The estimate is based on loss development factors determined through actuarial methods using the actual claim loss experience of the Company subject to adjustment for current trends. In addition, the Company uses a third-party actuary report obtained semi-annually to determine its required insurance reserves. Revisions to the estimated liability resulting from ongoing periodic reviews are recognized in the period in which a material difference is identified. Significant increases in general liability and workers’ compensation claim losses could have a material adverse impact on future operating results.

The Company also estimates its liability for claims related to a medical benefits program it provides to its employees. The estimated liability is based upon historical claims data.

### **Impairment of Long-Lived Assets**

The Company periodically reviews the estimated useful lives and recoverability of its depreciable assets based on factors including historical experience, the expected beneficial service period of the asset, the quality and durability of the asset and the Company’s maintenance policy including periodic upgrades. Changes in useful lives are made on a prospective basis, unless factors indicate the carrying amounts of the assets may not be recoverable from estimated future cash flows and an impairment write-down is necessary.

### **Lease Accounting**

The Company uses a consistent lease period (generally, the initial non-cancelable lease term plus renewal option periods provided for in the lease that can be reasonably assured) when calculating depreciation of leasehold improvements and in determining straight-line rent expense and classification of its leases as either an operating lease or a capital lease. The lease term and straight-line rent expense commences on the date when the Company takes possession and has the right to control use of the leased premises. Funds received from the lessor intended to reimburse the Company for the costs of leasehold improvements is recorded as a deferred credit resulting from a lease incentive and amortized over the lease term as a reduction to rent expense.

## **New Accounting Standards**

In May 2005, the Financial Accounting Standards Board issued SFAS No. 154, "Accounting Changes and Error Corrections" ("SFAS 154"), a Replacement of Accounting Principles Board Opinion No. 20, and Financial Accounting Standards Board Statement No. 3." SFAS 154 requires retrospective application to prior periods' financial statements for changes in accounting principles, unless it is not impracticable to determine either the period-specific effects or the cumulative effect of the change. SFAS 154 also requires that retrospective application of a change in accounting principle be limited to the direct effects of the change. Indirect effects of a change in accounting principle, such as a change in non-discretionary profit-sharing payments resulting from an accounting change, should be recognized in the period of the accounting change. SFAS 154 also requires that a change in depreciation, amortization, or deletion method for long-lived, non-financial assets be accounted for as a change in accounting estimate effected by a change in accounting principle. SFAS 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. The adoption of SFAS 154 did not have a material impact on the Company's consolidated financial statements. The Company's consolidated financial statements for the year ended December 31, 2006 comply with the provisions of FAS 154.

In March 2006, the Emerging Issues Task Force ("EITF") issued EITF Issue 06-3, "How Sales Taxes Collected from Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement." A consensus was reached that entities may adopt a policy of presenting sales taxes in the income statement on either a gross or net basis. If taxes are significant, an entity should disclose its policy of presenting taxes and the amounts of taxes. The guidance is effective for periods beginning after December 15, 2006. The Company presents sales net of sales taxes. This issue will not impact the method for recording sales taxes in the Company's consolidated financial statements.

In June 2006, the FASB issued FASB Interpretation No. 48 (FIN48), "Accounting for Uncertainty in Income Taxes, an Interpretation of FASB Statement No. 109." FIN 48 clarifies the accounting for uncertainty in income taxes recognized in a company's financial statements and prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in an income tax return. FIN 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosures and transition. FIN 48 is effective for fiscal years beginning after December 15, 2006. The Company is currently evaluating the impact of adopting FIN 48.

In September 2006, the Financial Accounting Standards Board issued SFAS No. 157, "Fair Value Measurements," ("SFAS 157"). This statement defines fair value and provides guidance for measuring fair value and the necessary disclosures. This statement does not require any new fair value measurements, but rather applies to all other accounting pronouncements that require or permit fair value measurements. SFAS No. 157 will be effective for fiscal years beginning after November 15, 2007. The Company has not determined the impact, if any, from adoption of this new accounting pronouncement on the financial statements.

In September 2006, the Securities and Exchange Commission issued Staff Accounting Bulletin No. 108, ("SAB 108"), which addresses how the effects of prior-year uncorrected misstatements should be considered when quantifying misstatements in the current-year financial statements. SAB 108 requires an entity to quantify misstatements using a balance sheet and income-statement approach and to evaluate whether either approach results in quantifying an error that is material in light of relevant quantitative and qualitative factors. The adoption of SAB 108 did not have a material impact on the Company's consolidated financial statements.

In February 2007, the FASB issued SFAS No. 159 ("FAS 159"), "The Fair Value Option for Financial Assets and Liabilities." This statement permits entities to choose to measure many financial instruments and certain other items at fair value. If the fair value option is elected, unrealized gains and losses will be recognized in earnings at each subsequent reporting date. FAS 159 is effective for fiscal years beginning after November 15, 2007. We are currently evaluating the impact of this adoption on our consolidated financial statements.

## ***Inflation***

The Company's cost of operations, including but not limited to labor, food products, supplies, utilities, financing and rental costs, are significantly affected by inflationary factors. The Company pays most of its part-time employees' rates that are related to federal and state mandated minimum wage requirements. Management anticipates that any increases in federally mandated minimum wage would result in higher costs to the Company, which the Company expects may be partially offset by menu price increases and increased efficiencies in operations.

## ***Financial Condition, Liquidity and Capital Resources***

Cash provided by operating activities increased to \$149.6 million in 2006 from \$135.0 million in 2005. Cash outflows from investing activities for 2006 were \$115.5 million, primarily related to capital expenditures. Net cash outflows from financing activities for 2006 were \$28.0 million, primarily related to the repurchase of the Company's common stock. The Company's primary requirements for cash relate to planned capital expenditures, the repurchase of the Company's common stock and debt service. The Company expects that it will satisfy such requirements from cash provided by operations and, if necessary, funds available under its line of credit.

Cash provided by operating activities is a significant source of liquidity for the Company. Since substantially all of the Company's sales are for cash and credit cards, and accounts payable are generally due in five to 30 days, the Company is able to carry current liabilities in excess of current assets. The net working capital deficit decreased from \$12.2 million at January 1, 2006 to \$9.6 million at December 31, 2006 due primarily to the timing of payments for various accrued expenses.

The Company has initiated several strategies to increase revenues and earnings over the long-term that require capital expenditures. These strategies include: (a) new restaurant development, (b) major remodels, (c) expansions of the square footage of existing restaurants, (d) a game enhancement initiative that includes new games and rides and (d) small market remodels.

In 2007, the Company plans to add approximately 10 restaurants, including relocating three restaurants. The Company currently anticipates its cost of opening such new restaurants will vary depending upon many factors including the size of the restaurants and whether the Company acquires land or the restaurant is an in-line or freestanding building. The average square footage of new stores in 2007 should approximate 12,500 square feet with projected average annual sales in excess of \$2 million. The average capital cost of all new restaurants expected to open in 2007 will approximate \$2.1 to \$2.2 million per restaurant.

The major remodel initiative typically includes expansion of the space allocated to the game room, an increase in the number of games and rides and in most cases may include a new exterior and interior identity. A new exterior identity includes a revised Chuck E. Cheese logo and signage, updating the exterior design of the buildings and, in some restaurants, colorful new awnings. The interior component includes painting, updating décor, a new menu board, enhanced lighting, remodeled restrooms and an upgraded salad bar. The average cost of major remodels in 2007 will approximate \$550,000 to \$650,000. In addition to expanding the square footage of existing restaurants, expansions typically include all components of a major remodel including an increase in the number of games and rides and range in cost from \$800,000 to \$900,000 per restaurant. The primary components of the game enhancement initiative are to provide new games and rides and the average capital cost is currently approximately \$100,000 to \$150,000 per restaurant. Small market remodels primarily include new games and rides and typically the removal of seating. Small market remodels are expected to range in cost from \$100,000 to \$150,000.

The Company expects the aggregate capital costs in 2007 of completing game enhancements, major remodels and expanding the square footage of existing restaurants to total approximately \$56 million and impact approximately 155 restaurants. This plan includes 65 game enhancements, 55 major remodels, 20 small market remodels and 15 store expansions.

During 2006, the Company opened 14 new restaurants and impacted a total of 152 existing restaurants with capital expenditures. The Company currently estimates that total capital expenditures in 2007 will be approximately \$90 to \$92 million, including the \$56 million the Company is expecting to invest in existing restaurants. The Company plans to fund its capital expenditures through cash flow from operations and, if necessary, borrowings under the Company's line of credit.

From time to time, the Company repurchases shares of its common stock under a plan authorized by its Board of Directors. The plan authorizes repurchases in the open market or in private transactions. Beginning in 1993, the Company has repurchased approximately 23.6 million shares of the Company's common stock, retroactively adjusted for all stock splits, at an aggregate purchase price of approximately \$505 million. During 2006, the Company repurchased 1,959,635 shares at an aggregate purchase price of approximately \$66.8 million. At the end of 2006, approximately \$280 million remained available for share repurchases under a \$400 million share repurchase authorization approved by the Company's Board of Directors in July 2005.

In July 2005, the Company amended its line of credit agreement to provide for borrowings of up to \$200 million for a term of five years. The credit facility replaces the Company's previous \$132.5 million credit facility that was scheduled to mature in December 2005. Interest under the line of credit is dependent on earnings and debt levels of the Company and ranges from prime or, at the Company's option, LIBOR plus 0.50% to 1.25%. Currently, any borrowings under this line of credit would be at the prime rate or LIBOR plus 0.75%. As of December 31, 2006, there were \$168.2 million in borrowings under this line of credit and outstanding letters of credit of \$11.2 million. The line of credit agreement contains certain restrictions and conditions as defined in the agreement that require the Company to maintain a fixed charge coverage ratio at a minimum of 1.5 to 1.0 and a maximum total debt to earnings before interest, taxes, depreciation, and amortization ratio of 3.0 to 1.0. Borrowings under the line of credit agreement are unsecured but the Company has agreed to not pledge any of its existing assets to secure future indebtedness. At December 31, 2006, the Company was in compliance with all of the above debt covenants. The Lenders under the line of credit agreement have agreed to waive any default or event of default resulting from the Company's failure to deliver certain documents, including its consolidated financial statements, as required by the line of credit agreement during the period beginning August 16, 2006 and ending May 15, 2007.

The following are contractual cash obligations of the Company as of December 31, 2006 (thousands):

|                                   | <u>Cash Obligations Due by Period</u> |                             |                        |                        |                              |
|-----------------------------------|---------------------------------------|-----------------------------|------------------------|------------------------|------------------------------|
|                                   | <u>Total</u>                          | <u>Less than 1<br/>Year</u> | <u>1 – 3<br/>Years</u> | <u>3 – 5<br/>Years</u> | <u>More than 5<br/>Years</u> |
| Operating leases (1) .....        | \$792,078                             | \$62,521                    | \$121,091              | \$121,635              | \$486,831                    |
| Revolving line of credit (2)..... | 168,200                               |                             |                        | 168,200                |                              |
| Purchase commitments (3).....     | 23,042                                | 6,272                       | 11,018                 | 5,752                  |                              |
| Capital lease obligations .....   | <u>21,475</u>                         | <u>1,679</u>                | <u>3,358</u>           | <u>3,358</u>           | <u>13,080</u>                |
|                                   | <u>\$1,004,795</u>                    | <u>\$70,472</u>             | <u>\$135,467</u>       | <u>\$298,945</u>       | <u>\$499,911</u>             |

- (1) Includes the initial non-cancelable term plus renewal option periods provided for in the lease that can be reasonably assured and excludes obligations to pay property taxes, insurance and maintenance on the leased assets.
- (2) The amount for the revolving credit facility excludes interest payments that are variable in nature.
- (3) The Company is required to purchase a minimum volume under a contract with its beverage supplier. Failure to purchase the minimum volume could result in a higher price paid by the Company. The Company is also required to purchase certain restaurant furniture totaling \$1 million that has been or will be manufactured to specifications by the Company.

In addition to the above, the Company estimates that the accrued liabilities for group medical, general liability and workers compensation claims of approximately \$12.7 million as of December 31, 2006 will be paid as follows: approximately \$4.2 million to be paid in 2007 and the remainder paid over the six year period from 2008 to 2013.

Under the terms of the respective employment agreements of the Company's Chief Executive Officer ("CEO) and president, if employment with the Company is terminated by the Company, other than as a result of death or permanent disability, as defined in the agreements, the CEO will be entitled to receive a severance amount of \$3 million and the president will be entitled to receive a severance amount equal to two times his then current base salary. Under the terms of the respective employment agreements, the CEO and president will receive their respective severance amount in the event there is a change of control, as defined in the agreements, and the CEO or president voluntarily terminates their employment within one year after such a change in control. If the severance payments had been due as of December 31, 2006, the Company would have been required to make aggregate payments totaling approximately \$4.2 million.

As of December 31, 2006, capital expenditures totaling \$7.3 million were outstanding and included in accounts payable. These amounts are expected to be paid in less than one year.

Certain statements in this report, other than historical information, may be considered forward-looking statements within the meaning of the “safe harbor” provisions of the Private Securities Litigation Reform Act of 1995, and are subject to various risks, uncertainties and assumptions. In some cases, you can identify forward-looking statements by terminology such as “may,” “should,” “could,” “predict,” “potential,” “continue,” “expect,” “anticipate,” “future,” “intend,” “plan,” “believe,” “estimate” and similar expressions (or the negative of such expressions). Should one or more of these risks or uncertainties materialize, or should underlying assumptions prove incorrect, actual results may differ from those anticipated, estimated or expected. Among the key factors that may have a direct bearing on the Company’s operating results, performance or financial condition are its ability to implement its growth strategies, national, regional and local economic conditions affecting the restaurant /entertainment industry, competition within each of the restaurant and entertainment industries, store sales cannibalization, success of its franchise operations, negative publicity, health epidemics or pandemics, acts of God, terrorist acts, litigation, demographic trends, fluctuations in quarterly results of operations, including seasonality, government regulations, weather, school holidays, increased commodity, utility, insurance, advertising and labor costs.

*Item 7A: Quantitative and Qualitative Disclosures about Market Risk.*

The Company is subject to market risk in the form of interest rate risk and foreign currency risk. Both interest rate risk and foreign currency risk are immaterial to the Company.

*Item 8. Financial Statements and Supplementary Data*

**CEC ENTERTAINMENT, INC.  
YEARS ENDED DECEMBER 31, 2006, JANUARY 1, 2006  
AND JANUARY 2, 2005**

**CONTENTS**

|  | <b><u>Page</u></b> |
|--|--------------------|
| Report of independent registered public accounting firm .....      | 28                 |
| Consolidated financial statements:                                 |                    |
| Consolidated balance sheets .....                                  | 29                 |
| Consolidated statements of earnings and comprehensive income ..... | 30                 |
| Consolidated statements of shareholders' equity .....              | 31                 |
| Consolidated statements of cash flows .....                        | 32                 |
| Notes to consolidated financial statements.....                    | 33                 |

## REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

Board of Directors and Shareholders  
CEC Entertainment, Inc.  
Irving, Texas

We have audited the accompanying consolidated balance sheets of CEC Entertainment, Inc. and subsidiaries (the “Company”) as of December 31, 2006 and January 1, 2006, and the related consolidated statements of earnings and comprehensive income, shareholders’ equity, and cash flows for each of the three years in the period ended December 31, 2006. These financial statements are the responsibility of the Company’s management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of CEC Entertainment, Inc. and subsidiaries as of December 31, 2006 and January 1, 2006, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2006, in conformity with accounting principles generally accepted in the United States of America.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of the Company’s internal control over financial reporting as of December 31, 2006, based on the criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated April 20, 2007 expressed an unqualified opinion on management’s assessment of the effectiveness of the Company’s internal control over financial reporting and an adverse opinion on the effectiveness of the Company’s internal control over financial reporting because of a material weakness.

Dallas, Texas  
April 20, 2007

**CEC ENTERTAINMENT, INC.**  
**CONSOLIDATED BALANCE SHEETS**  
(Thousands, except share data)

|  | <u>December 31,</u><br><u>2006</u> | <u>January 1,</u><br><u>2006</u> |
|--|------------------------------------|----------------------------------|
| <b>ASSETS</b>  |                                    |                                  |
| Current assets:  |                                    |                                  |
| Cash and cash equivalents .....  | \$ 18,308                          | \$ 12,184                        |
| Accounts receivable, net .....   | 17,556                             | 16,251                           |
| Inventories .....  | 18,296                             | 13,659                           |
| Prepaid expenses .....   | 8,210                              | 7,882                            |
| Deferred tax asset .....   | <u>2,394</u>                       | <u>1,824</u>                     |
| Total current assets .....   | <u>64,764</u>                      | <u>51,800</u>                    |
| Property and equipment, net .....  | <u>637,560</u>                     | <u>597,919</u>                   |
| Other assets .....   | <u>1,861</u>                       | <u>2,201</u>                     |
|  | <u>\$ 704,185</u>                  | <u>\$ 651,920</u>                |
| <br><b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>  |                                    |                                  |
| Current liabilities:   |                                    |                                  |
| Current portion of long-term debt .....  | \$ 693                             | \$ 594                           |
| Accounts payable .....   | 33,430                             | 36,210                           |
| Accrued liabilities .....  | <u>40,680</u>                      | <u>27,360</u>                    |
| Total current liabilities .....  | <u>74,803</u>                      | <u>64,164</u>                    |
| Long-term debt, less current portion .....   | <u>181,088</u>                     | <u>148,974</u>                   |
| Deferred rent .....  | <u>68,449</u>                      | <u>61,877</u>                    |
| Deferred tax liability .....   | <u>12,056</u>                      | <u>19,619</u>                    |
| Accrued insurance .....  | <u>8,583</u>                       | <u>14,103</u>                    |
| Commitments and contingencies (Note 6)   |                                    |                                  |
| Shareholders' equity:  |                                    |                                  |
| Common stock, \$.10 par value; authorized 100,000,000 shares;<br>56,619,300 and 56,115,658 shares issued, respectively ..... | 5,662                              | 5,612                            |
| Capital in excess of par value .....   | 325,212                            | 314,439                          |
| Retained earnings .....  | 531,435                            | 463,178                          |
| Accumulated other comprehensive income .....   | 2,368                              | 2,446                            |
| Less treasury shares of 24,359,450 and 22,499,815, respectively, at cost .....   | <u>(505,471)</u>                   | <u>(442,492)</u>                 |
|  | <u>359,206</u>                     | <u>343,183</u>                   |
|  | <u>\$ 704,185</u>                  | <u>\$ 651,920</u>                |

See notes to consolidated financial statements.

**CEC ENTERTAINMENT, INC.**  
**CONSOLIDATED STATEMENTS OF EARNINGS**  
**AND COMPREHENSIVE INCOME**  
(Thousands, except per share data)

|  | <b>Fiscal Year</b> |                  |                  |
|--|--------------------|------------------|------------------|
|  | <b>2006</b>        | <b>2005</b>      | <b>2004</b>      |
| Food and beverage revenues .....                   | \$ 490,464         | \$ 468,760       | \$ 479,741       |
| Games and merchandise revenues .....               | 280,770            | 254,422          | 245,088          |
| Franchise fees and royalties .....                 | 2,896              | 2,905            | 3,220            |
| Interest income .....                              | <u>24</u>          | <u>76</u>        | <u>30</u>        |
|  | <u>774,154</u>     | <u>726,163</u>   | <u>728,079</u>   |
| Costs and expenses:                                |                    |                  |                  |
| Cost of sales:                                     |                    |                  |                  |
| Food, beverage and related supplies .....          | 89,648             | 86,867           | 89,252           |
| Games and merchandise .....                        | 33,250             | 29,997           | 30,395           |
| Labor .....  | <u>211,782</u>     | <u>201,646</u>   | <u>200,554</u>   |
|  | 334,680            | 318,510          | 320,201          |
| Selling, general and administrative expenses ..... | 106,611            | 97,857           | 95,493           |
| Depreciation and amortization .....                | 65,392             | 61,310           | 55,771           |
| Interest expense .....                             | 9,532              | 4,608            | 2,544            |
| Other operating expenses .....                     | <u>146,562</u>     | <u>131,097</u>   | <u>129,409</u>   |
|  | <u>662,777</u>     | <u>613,382</u>   | <u>603,418</u>   |
| Income before income taxes .....                   | 111,377            | 112,781          | 124,661          |
| Income taxes .....                                 | <u>43,120</u>      | <u>43,110</u>    | <u>47,683</u>    |
| Net income .....                                   | 68,257             | 69,671           | 76,978           |
| Other comprehensive income (loss), net of tax:     |                    |                  |                  |
| Foreign currency translation .....                 | <u>(78)</u>        | <u>970</u>       | <u>781</u>       |
| Comprehensive income .....                         | <u>\$ 68,179</u>   | <u>\$ 70,641</u> | <u>\$ 77,759</u> |
| Earnings per share:                                |                    |                  |                  |
| Basic:   |                    |                  |                  |
| Net income .....                                   | <u>\$ 2.09</u>     | <u>\$ 1.99</u>   | <u>\$ 2.07</u>   |
| Weighted average shares outstanding .....          | <u>32,587</u>      | <u>35,091</u>    | <u>37,251</u>    |
| Diluted:   |                    |                  |                  |
| Net income .....                                   | <u>\$ 2.04</u>     | <u>\$ 1.93</u>   | <u>\$ 2.00</u>   |
| Weighted average shares outstanding .....          | <u>33,465</u>      | <u>36,188</u>    | <u>38,472</u>    |

See notes to consolidated financial statements.

**CEC ENTERTAINMENT, INC.**  
**CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY**  
(Thousands)

|  | <u>Fiscal Year - Amounts</u> |                   |                   | <u>Fiscal Year - Shares</u> |               |               |
|--|------------------------------|-------------------|-------------------|-----------------------------|---------------|---------------|
|  | <u>2006</u>                  | <u>2005</u>       | <u>2004</u>       | <u>2006</u>                 | <u>2005</u>   | <u>2004</u>   |
| Common stock and capital in excess of par value: |                              |                   |                   |                             |               |               |
| Balance, beginning of year.....                  | \$320,051                    | \$296,555         | \$265,652         | 56,116                      | 55,557        | 54,482        |
| Stock options exercised.....                     | 7,989                        | 11,224            | 18,853            | 349                         | 547           | 1,063         |
| Tax benefit from exercise                        |                              |                   |                   |                             |               |               |
| of stock options .....                           | 373                          | 3,854             | 2,818             |                             |               |               |
| Stock issued under 401(k) plan .....             | 456                          | 456               | 401               | 13                          | 12            | 13            |
| Stock-based compensation expense .....           | 5,801                        | 7,962             | 8,858             |                             |               |               |
| Restricted stock (unvested, net of forfeitures)  |                              |                   |                   | 241                         |               |               |
| Treasury stock reserved – 401(k) plan .....      | (3,796)                      |                   |                   | (100)                       |               |               |
| Payment for fractional shares.....               |                              |                   | (27)              |                             |               | (1)           |
| Balance, end of year.....                        | <u>330,874</u>               | <u>320,051</u>    | <u>296,555</u>    | <u>56,619</u>               | <u>56,116</u> | <u>55,557</u> |
| Retained earnings:                               |                              |                   |                   |                             |               |               |
| Balance, beginning of year.....                  | 463,178                      | 393,507           | 316,529           |                             |               |               |
| Net income .....                                 | <u>68,257</u>                | <u>69,671</u>     | <u>76,978</u>     |                             |               |               |
| Balance, end of year.....                        | <u>531,435</u>               | <u>463,178</u>    | <u>393,507</u>    |                             |               |               |
| Accumulated other comprehensive income (loss):   |                              |                   |                   |                             |               |               |
| Balance, beginning of year.....                  | 2,446                        | 1,476             | 695               |                             |               |               |
| Foreign currency translation .....               | <u>(78)</u>                  | <u>970</u>        | <u>781</u>        |                             |               |               |
| Balance, end of year.....                        | <u>2,368</u>                 | <u>2,446</u>      | <u>1,476</u>      |                             |               |               |
| Treasury shares:                                 |                              |                   |                   |                             |               |               |
| Balance, beginning of year.....                  | (442,492)                    | (325,560)         | (211,626)         | 22,500                      | 19,211        | 16,042        |
| Treasury stock acquired .....                    | (66,775)                     | (116,932)         | (113,934)         | 1,959                       | 3,289         | 3,169         |
| Treasury stock reserved – 401(k) plan .....      | <u>3,796</u>                 |                   |                   | <u>(100)</u>                |               |               |
| Balance, end of year.....                        | <u>(505,471)</u>             | <u>(442,492)</u>  | <u>(325,560)</u>  | <u>24,359</u>               | <u>22,500</u> | <u>19,211</u> |
| Total shareholders' equity.....                  | <u>\$ 359,206</u>            | <u>\$ 343,183</u> | <u>\$ 365,978</u> |                             |               |               |

See notes to consolidated financial statements.

**CEC ENTERTAINMENT, INC.**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**  
(Thousands)

|   | <b>Fiscal Year</b> |                  |                  |
|---|--------------------|------------------|------------------|
|   | <b>2006</b>        | <b>2005</b>      | <b>2004</b>      |
| <b>Operating activities:</b>  |                    |                  |                  |
| Net income .....  | \$ 68,257          | \$ 69,671        | \$ 76,978        |
| Adjustments to reconcile net income to cash provided by operating activities: |                    |                  |                  |
| Depreciation and amortization .....   | 65,392             | 61,310           | 55,771           |
| Deferred income tax expense (benefit) .....                                   | (8,085)            | (6,518)          | 2,148            |
| Share-based compensation expense .....  | 5,601              | 7,962            | 8,858            |
| Contributions from landlords .....  | 4,600              | 5,458            | 7,567            |
| Deferred lease rentals .....  | 1,972              | 2,992            | 3,042            |
| Provision for asset write-offs .....  | 10,254             | 2,389            | 1,576            |
| Changes in assets and liabilities:  |                    |                  |                  |
| Accounts receivable .....   | (666)              | (2,614)          | (355)            |
| Inventories .....   | (4,637)            | (1,488)          | 320              |
| Prepaid expenses .....  | (328)              | (438)            | 164              |
| Accounts payable .....  | (558)              | 6,360            | (4,920)          |
| Accrued liabilities .....   | 7,800              | (10,086)         | 11,825           |
| Cash provided by operating activities .....                                   | <u>149,602</u>     | <u>134,998</u>   | <u>162,974</u>   |
| <b>Investing activities:</b>  |                    |                  |                  |
| Purchases of property and equipment .....                                     | (115,810)          | (91,637)         | (80,088)         |
| Proceeds from dispositions of property and equipment .....                    | 66                 | 533              | 791              |
| Change in other assets .....  | 228                | (143)            | (1,030)          |
| Cash used in investing activities .....                                       | <u>(115,516)</u>   | <u>(91,247)</u>  | <u>(80,327)</u>  |
| <b>Financing activities:</b>  |                    |                  |                  |
| Proceeds from debt and line of credit .....                                   | 71,000             | 111,600          | 47,000           |
| Payments on debt and line of credit .....                                     | (40,522)           | (52,816)         | (34,227)         |
| Exercise of stock options .....   | 7,989              | 11,224           | 18,853           |
| Excess tax benefit from exercise of stock options .....                       | 373                | 3,854            | 2,818            |
| Treasury stock acquired .....   | (66,775)           | (116,932)        | (113,934)        |
| Other .....   | (27)               | (295)            | 574              |
| Cash used in financing activities .....                                       | <u>(27,962)</u>    | <u>(43,365)</u>  | <u>(78,916)</u>  |
| Increase in cash and cash equivalents .....                                   | 6,124              | 386              | 3,731            |
| Cash and cash equivalents, beginning of year .....                            | <u>12,184</u>      | <u>11,798</u>    | <u>8,067</u>     |
| Cash and cash equivalents, end of year .....                                  | <u>\$ 18,308</u>   | <u>\$ 12,184</u> | <u>\$ 11,798</u> |
| <b>Supplemental Cash Flow Information:</b>                                    |                    |                  |                  |
| Interest paid .....   | \$ 9,168           | \$ 4,189         | \$ 2,458         |
| Income taxes paid .....   | 45,106             | 52,665           | 40,248           |
| <b>Non-cash investing and financing activities:</b>                           |                    |                  |                  |
| Investment in capital leases .....  | \$ 1,735           | \$ 973           | \$ 786           |
| Modification of capital leases .....  | 0                  | (445)            | 0                |
| Accrued construction accounts payable .....                                   | 7,344              | 9,109            | 3,097            |
| Stock issued under 401(k) plan .....  | 456                | 456              | 401              |
| Restricted stock awards issued, net of forfeitures .....                      | 7,114              | 0                | 0                |
| Treasury stock retired and reserved for 401(k) plan .....                     | 3,796              | 0                | 0                |

See notes to consolidated financial statements.

**CEC ENTERTAINMENT, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**1. Description of business and summary of significant accounting policies:**

*Operations:* CEC Entertainment, Inc. and its subsidiaries (the "Company") operate and franchise Chuck E. Cheese's restaurants.

*Fiscal year:* The Company's fiscal year is 52 or 53 weeks and ends on the Sunday nearest December 31. References to 2006, 2005 and 2004 are for the fiscal years ended December 31, 2006, January 1, 2006, and January 2, 2005, respectively. Fiscal year 2004 consisted of 53 weeks, and 2006 and 2005 each consisted of 52 weeks.

*Basis of consolidation:* The consolidated financial statements include the accounts of the Company and its subsidiaries. The consolidated financial statements also include the accounts of the International Association of CEC Entertainment, Inc. (the "Association"); an entity in which the Company has variable interests and the Company is considered the primary beneficiary. The assets, liabilities and operating results of the Association are not material to the Company's consolidated financial statements. All significant intercompany accounts and transactions have been eliminated.

*Foreign currency translation:* The consolidated financial statements are presented in U.S. dollars. The assets and liabilities of the Company's Canadian subsidiary are translated to U.S. dollars at year-end exchange rates, while revenues and expenses are translated at average exchange rates during the year. Adjustments that result from translating amounts are reported as a component of other comprehensive income.

*Cash and cash equivalents:* Cash and cash equivalents of the Company are comprised of demand deposits with banks and short-term cash investments with remaining maturities of three months or less from the date of purchase by the Company.

*Inventories:* Inventories of food, paper products, merchandise and supplies are stated at the lower of cost on a first-in, first-out basis or market.

*Property and equipment, depreciation and amortization:* Property and equipment are stated at cost, net of accumulated depreciation and amortization. Depreciation and amortization are provided by charges to operations over the estimated useful lives of the assets by the straight-line method, generally ranging from four to 20 years for furniture, fixtures and equipment and 40 years for buildings. Leasehold improvements are amortized by the straight-line method over the lesser of the lease term, including renewal option periods provided for in the lease that are reasonably assured, or the estimated useful lives of the related assets. The Company uses a consistent lease period (generally, the initial non-cancelable lease term plus renewal option periods provided for in the lease that can be reasonably assured) when calculating depreciation of leasehold improvements and in determining straight-line rent expense and classification of its leases as either an operating lease or a capital lease. All pre-opening costs are expensed as incurred.

The Company evaluates long-lived assets held and used in the business for impairment whenever events or changes in circumstances indicate that the carrying amount of the assets may not be recoverable. Long-lived assets are grouped at the lowest level for which identifiable cash flows are largely independent of the cash flows of other groups of assets and liabilities. The carrying amount of long-lived assets is not recoverable if it exceeds the sum of associated undiscounted future cash flows. The amount of any impairment is measured as the excess of the carrying amount over associated discounted future operating cash flows. Assets held for sale are reported at the lower of carrying amount or the fair value less estimated costs to sell.

**CEC ENTERTAINMENT, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**1. Description of business and summary of significant accounting policies (continued):**

*Deferred rent:* The Company recognizes rent expense by the straight-line method over the lease term, including lease renewal option periods that can be reasonably assured at the inception of the lease. The lease term commences on the date when the Company takes possession and has the right to control use of the leased premises. Also, funds received from the lessor intended to reimburse the Company for the cost of leasehold improvements are recorded as a deferred credit resulting from a lease incentive and amortized over the lease term as a reduction of rent expense.

*Fair value of financial instruments:* The Company has certain financial instruments consisting primarily of cash equivalents, notes receivable and notes payable. The carrying amount of cash equivalents approximates fair value because of the short maturity of those instruments. The carrying amount of the Company's notes receivable and long-term debt approximates fair value based on the interest rates charged on instruments with similar terms and risks.

*Stock-based compensation:* In December 2004, the Financial Accounting Standards Board ("FASB") issued SFAS No. 123 (revised 2004), "Share-Based Payment." SFAS 123R is a revision of SFAS No. 123, "Accounting for Stock-Based Compensation" and supersedes APB Opinion No. 25, "Accounting for Stock Issued to Employees." SFAS 123R requires all share-based payments to employees including grants of employee stock options, to be recognized in the financial statements based on their fair values. SFAS 123R was effective at the beginning of the first annual period beginning after June 15, 2005. Under APB Opinion No. 25, compensation cost was reflected in the net income of the Company for grants of stock options to employees in instances where the stock price on the measurement date exceeded the exercise price. Beginning in the first quarter of 2006, the Company recognized compensation expense in its financial statements based on the fair value of all share-based payments to employees. SFAS No. 123R also changes the accounting for the tax effects of options, including the presentation of the tax effects on the consolidated statements of cash flows.

Prior to fiscal year 2006, the Company applied Accounting Principles Board Opinion (APB) No. 25, "Accounting for Stock Issued to Employees," and related interpretations in accounting for stock options. Compensation cost was recognized for option grants in periods prior to fiscal 2006 in instances where the stock price on the measurement date exceeded the exercise price.

Under SFAS 123R, the Company is required to select a valuation technique or option-pricing model that meets the criteria as stated in the standard, which includes a binomial model and the Black-Sholes model. At present, the Company is continuing to use the Black-Sholes model, which requires the input of subjective assumptions. These assumptions include estimating the length of time employees will retain their vested stock options before exercising them ("expected term"), the estimated volatility of the Company's common stock price over the expected term ("volatility"), the risk-free interest rate and the dividend yield. Changes in the subjective assumptions can materially affect the estimate of fair value of stock-based compensation.

The Company adopted SFAS 123R using the modified retrospective application method, which requires the Company to adjust financial statements for prior periods to give effect to the fair-value-based method of accounting for awards granted, modified, or settled in cash in fiscal years beginning after December 15, 1994, on a basis consistent with the pro forma disclosures required for those periods by SFAS 123R. Thus, compensation cost and related tax effects will be recognized in those financial statements as though they had been accounted for under SFAS 123R. See Note 10 for the effects of the adoption of SFAS 123.

**CEC ENTERTAINMENT, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**1. Description of business and summary of significant accounting policies (continued):**

The fair value of each option was estimated on the measurement date using the Black-Sholes option-pricing model with the following weighted average assumptions for years 2005 and 2004. No stock options were granted in 2006.

|   | <u>2005</u> | <u>2004</u> |
|---|-------------|-------------|
| Dividend yield .....                      | 0%          | 0%          |
| Expected volatility .....                 | 30.0%       | 30.0%       |
| Risk-free interest rate .....             | 4.1%        | 3.0%        |
| Expected life of options (in years) ..... | 3.2         | 4.8         |

The Company has adopted a restricted stock plan. The fair value of restricted stock is based on the closing price of the Company's common stock on the measurement date.

Prior to the adoption of SFAS 123R, the Company presented all tax benefits resulting from the exercise of stock options as operating cash inflows in the consolidated statement of cash flows, in accordance with the provision of the Emerging Issues Task Force (EITF) Issue No. 00-15, "Classification in the Statement of Cash Flows of the Income Tax Benefit Received by a Company upon Exercise of a Nonqualified Employee Stock Option." SFAS 123R requires the benefits of tax deductions in excess of the compensation cost recognized for those options to be classified as financing cash inflows rather than operating cash inflows. This amount is shown as excess tax benefit from exercise of stock options on the consolidated statement of cash flows.

*Franchise fees and royalties:* Franchise fees are recognized upon fulfillment of all significant obligations to the franchisee. At December 31, 2006, 45 Chuck E. Cheese's restaurants were operated by a total of 24 different franchisees. The standard franchise agreements grant to the franchisee the right to construct and operate a restaurant and use the associated trade names, trademarks and service marks within the standards and guidelines established by the Company. Royalties from franchisees are accrued as earned. Franchise fees included in revenues were \$60,000, \$85,000, and \$160,000 in 2006, 2005 and 2004, respectively.

*Cost of sales:* Cost of sales includes the cost of food, beverage, related supplies, prizes and merchandise sold during the period and restaurant labor expenses. These amounts exclude any allocation of other operating costs including depreciation and amortization expense.

*Advertising costs:* Production costs for commercials and coupons are expensed in the year in which the commercials are initially aired and the coupons are distributed. All other advertising costs are expensed as incurred. The total amounts charged to advertising expense were approximately \$31.4 million, \$27.9 million and \$26.1 million in 2006, 2005 and 2004, respectively.

*Self-insurance accruals:* The Company self-insures a significant portion of expected losses under its workers' compensation, employee medical and general liability programs. Accrued liabilities have been recorded based on the Company's estimates of the ultimate costs to settle incurred claims, both reported and unreported.

*Use of estimates and assumptions:* The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

**CEC ENTERTAINMENT, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**1. Description of business and summary of significant accounting policies (continued):**

*Recent accounting pronouncements:* In March 2006, the Emerging Issues Task Force (“EITF”) issued EITF Issue 06-3, “How Sales Taxes Collected from Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement.” A consensus was reached that entities may adopt a policy of presenting sales taxes in the income statement on either a gross or net basis. If taxes are significant, an entity should disclose its policy of presenting taxes and the amounts of taxes. The guidance is effective for periods beginning after December 15, 2006. The Company presents sales net of sales taxes. This issue will not impact the method for recording sales taxes in the Company’s consolidated financial statements.

In September 2006, the FASB issued SFAS No. 157, “Fair Value Measurements,” (“SFAS 157”). This statement defines fair value and provides guidance for measuring fair value and the necessary disclosures. This statement does not require any new fair value measurements, but rather applies to all other accounting pronouncements that require or permit fair value measurements. SFAS No. 157 will be effective for fiscal years beginning after November 15, 2007. The Company has not determined the impact, if any, from adoption of this new accounting pronouncement on its consolidated financial statements

In June 2006, the FASB issued Interpretation No. 48, “Accounting for Uncertainty in Income Taxes, an Interpretation of FASB Statement No. 109,” (“FIN 48”). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in a company’s financial statements and prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in an income tax return. FIN 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosures and transition. FIN 48 is effective for fiscal years beginning after December 15, 2006. The Company is currently evaluating the impact of adopting FIN 48 on its consolidated financial statements.

In September 2006, the Securities and Exchange Commission issued Staff Accounting Bulletin No. 108 (“SAB 108”), which addresses how the effects of prior-year uncorrected misstatements should be considered when quantifying misstatements in the current-year financial statements. SAB 108 requires an entity to quantify misstatements using a balance sheet and income-statement approach and to evaluate whether either approach results in quantifying an error that is material in light of relevant quantitative and qualitative factors. Application of the provisions of SAB 108 did not have a material impact on the Company’s consolidated financial statements.

In May 2005, the FASB issued SFAS No. 154, “Accounting Changes and Error Corrections, a Replacement of Accounting Principles Board Opinion No. 20, and FASB Statement No. 3,” (SFAS 154”). SFAS 154 requires retrospective application to prior periods’ financial statements for changes in accounting principles, unless it is not impracticable to determine either the period-specific effects or the cumulative effect of the change. SFAS 154 also requires that retrospective application of a change in accounting principle be limited to the direct effects of the change. Indirect effects of a change in accounting principle, such as a change in non-discretionary profit-sharing payments resulting from an accounting change, should be recognized in the period of the accounting change. SFAS 154 also requires that a change in depreciation, amortization, or deletion method for long-lived, non-financial assets be accounted for as a change in accounting estimate effected by a change in accounting principle. SFAS 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. The adoption of SFAS 154 did not have a material impact on the Company’s consolidated financial statements. The Company’s consolidated financial statements for the year ended December 31, 2006 comply with the provisions of FAS 154.

In February 2007, the FASB issued SFAS No. 159 (“FAS 159”), "The Fair Value Option for Financial Assets and Liabilities." This statement permits entities to choose to measure many financial instruments and certain other items at fair value. If the fair value option is elected, unrealized gains and losses will be recognized in earnings at each subsequent reporting date. FAS 159 is effective for fiscal years beginning after November 15, 2007. The Company is currently evaluating the impact of this adoption on its consolidated financial statements.

**CEC ENTERTAINMENT, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**2. Accounts receivable:**

|  | <u>2006</u>      | <u>2005</u>      |
|--|------------------|------------------|
|  | (Thousands)      |                  |
| Trade .....                            | \$ 6,215         | \$ 5,109         |
| Vendor rebates.....                    | 5,750            | 4,233            |
| Leasehold improvement incentives ..... | 1,435            | 4,210            |
| Other.....                             | <u>4,156</u>     | <u>2,699</u>     |
|  | <u>\$ 17,556</u> | <u>\$ 16,251</u> |

**3. Property and equipment:**

|   | <u>2006</u>       | <u>2005</u>       |
|---|-------------------|-------------------|
|   | (Thousands)       |                   |
| Land.....   | \$ 44,963         | \$ 43,489         |
| Leasehold improvements.....                                 | 403,706           | 349,461           |
| Buildings .....   | 88,582            | 83,286            |
| Game, restaurant and other equipment .....                  | 393,689           | 383,249           |
| Property leased under capital leases (Note 6).....          | <u>15,816</u>     | <u>14,081</u>     |
|   | 946,756           | 873,566           |
| Less accumulated depreciation and amortization .....        | <u>(332,808)</u>  | <u>(300,063)</u>  |
| Net property and equipment in service.....                  | 613,948           | 573,503           |
| Construction in progress.....                               | 14,325            | 17,036            |
| Game and restaurant equipment held for future service ..... | <u>9,287</u>      | <u>7,380</u>      |
|   | <u>\$ 637,560</u> | <u>\$ 597,919</u> |

**4. Accrued liabilities and accrued insurance:**

|                                | <u>2006</u>      | <u>2005</u>      |
|--------------------------------|------------------|------------------|
|                                | (Thousands)      |                  |
| Current:                       |                  |                  |
| Salaries and wages.....        | \$ 14,836        | \$ 9,892         |
| Insurance.....                 | 4,157            | 4,386            |
| Taxes, other than income ..... | 8,228            | 6,877            |
| Income taxes .....             | 5,977            | 0                |
| Other.....                     | <u>7,482</u>     | <u>6,205</u>     |
|                                | <u>\$ 40,680</u> | <u>\$ 27,360</u> |
| Long-term:                     |                  |                  |
| Insurance .....                | <u>\$ 8,583</u>  | <u>\$ 14,103</u> |

Accrued insurance liabilities represent estimated claims incurred but unpaid under the Company's self-insured retention programs for general liability, workers compensation, health benefits and certain other insured risks.

**CEC ENTERTAINMENT, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**5. Long-term debt:**

|  | <u>2006</u>       | <u>2005</u>       |
|--|-------------------|-------------------|
|  | (Thousands)       |                   |
| Revolving bank loan, prime or LIBOR plus 0.50% to 1.25%, due July 2010 ..... | \$ 168,200        | \$ 137,100        |
| Obligations under capital leases (Note 6).....                               | <u>13,581</u>     | <u>12,468</u>     |
|  | 181,781           | 149,568           |
| Less current portion.....  | <u>(693)</u>      | <u>(594)</u>      |
|  | <u>\$ 181,088</u> | <u>\$ 148,974</u> |

In July 2005, the Company amended its line of credit agreement to provide for borrowings of up to \$200 million for a term of five years. The credit facility replaces the Company's previous \$132.5 million credit facility that was scheduled to mature in December 2005. Interest under the line of credit is payable at rates which are dependent on earnings and debt levels of the Company. Currently, any borrowings under this line of credit would be at prime (8.25% at December 31, 2006) or, at the Company's option, LIBOR (5.85% at December 31, 2006) plus 0.75%. A 0.1% commitment fee is payable on any unused credit line.

The line of credit agreement contains certain restrictions and conditions as defined in the agreement that require the Company to maintain a fixed charge coverage ratio at a minimum of 1.5 to 1.0 and a maximum total debt to earnings before interest, taxes, depreciation, and amortization ratio of 3.0 to 1.0. At December 31, 2006, the Company was in compliance with these covenants. The Lenders under the line of credit agreement have waived any default or event of default resulting from the Company's failure to deliver certain documents, including its consolidated financial statements, as required by the line of credit agreement during the period beginning August 16, 2006 and ending May 15, 2007. The weighted average interest rate on the revolving bank loan was 5.6% and 4.2% in 2006 and 2005, respectively. The Company capitalized interest costs of \$140,763, \$109,000 and \$56,000 in 2006, 2005 and 2004, respectively, related to the construction of new restaurants.

**6. Commitments and contingencies:**

The Company leases certain restaurants and related property and equipment under operating and capital leases. All leases require the Company to pay property taxes, insurance and maintenance of the leased assets. The leases generally have initial terms of 10 to 20 years with various renewal options.

Scheduled annual maturities of the obligations for capital and operating leases as of December 31, 2006, are as follows:

| <u>Years</u>  | <u>Capital</u>   | <u>Operating</u> |
|---|------------------|------------------|
|   | (Thousands)      |                  |
| 2007 .....  | \$ 1,679         | \$ 62,521        |
| 2008 .....  | 1,679            | 61,199           |
| 2009 .....  | 1,679            | 59,892           |
| 2010 .....  | 1,679            | 61,858           |
| 2011 .....  | 1,679            | 59,777           |
| 2012-2028 (aggregate payments).....                 | <u>13,080</u>    | <u>486,831</u>   |
| Minimum future lease payments .....                 | 21,475           | <u>\$792,078</u> |
| Less amounts representing interest .....            | <u>(7,894)</u>   |                  |
| Present value of future minimum lease payments..... | 13,581           |                  |
| Less current portion .....                          | <u>(693)</u>     |                  |
| Long-term capital lease obligation.....             | <u>\$ 12,888</u> |                  |

**CEC ENTERTAINMENT, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**6. Commitments and contingencies (continued):**

The Company's rent expense, including contingent rent based on a percentage of sales when applicable, is comprised of the following:

|                 | <u>2006</u>      | <u>2005</u>      | <u>2004</u>      |
|-----------------|------------------|------------------|------------------|
|                 | (Thousands)      |                  |                  |
| Minimum .....   | \$ 69,453        | \$ 65,140        | \$ 62,191        |
| Contingent..... | <u>373</u>       | <u>240</u>       | <u>430</u>       |
|                 | <u>\$ 69,826</u> | <u>\$ 65,380</u> | <u>\$ 62,621</u> |

From time to time the Company is involved in litigation, most of which is incidental to its business. In the Company's opinion, no litigation to which the Company currently is a party is likely to have a material adverse effect on the Company's results of operations, financial condition or cash flows.

**7. Income taxes:**

The significant components of income tax expense are as follows:

|  | <u>2006</u>      | <u>2005</u>      | <u>2004</u>      |
|--|------------------|------------------|------------------|
|  | (Thousands)      |                  |                  |
| Current expense:                                 |                  |                  |                  |
| Federal .....                                    | \$ 44,086        | \$ 42,897        | \$ 33,999        |
| State .....                                      | 4,597            | 2,995            | 5,771            |
| Foreign.....                                     | 1,124            |                  | 200              |
| Tax benefit from exercise of stock options ..... | <u>1,398</u>     | <u>5,231</u>     | <u>7,801</u>     |
| Total current expense .....                      | 51,205           | 51,123           | 47,771           |
| Deferred expense (benefit):                      |                  |                  |                  |
| Federal .....                                    | (6,671)          | (6,867)          | (85)             |
| State .....                                      | (829)            | (845)            | (3)              |
| Foreign.....                                     | <u>(585)</u>     | <u>(301)</u>     | <u>0</u>         |
| Total deferred expense (benefit).....            | <u>(8,085)</u>   | <u>(8,013)</u>   | <u>(88)</u>      |
|  | <u>\$ 43,120</u> | <u>\$ 43,110</u> | <u>\$ 47,683</u> |

Deferred income tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of assets and liabilities and their respective tax basis. The income tax effects of temporary differences which give rise to deferred income tax assets and liabilities are as follows:

|                                  | <u>2006</u>     | <u>2005</u>     |
|----------------------------------|-----------------|-----------------|
|                                  | (Thousands)     |                 |
| Current deferred tax asset:      |                 |                 |
| Accrued vacation .....           | \$ 1,056        | \$ 997          |
| Unearned gift certificates ..... | 1,326           | 690             |
| Other .....                      | <u>12</u>       | <u>137</u>      |
|                                  | <u>\$ 2,394</u> | <u>\$ 1,824</u> |

**CEC ENTERTAINMENT, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**7. Income taxes (continued):**

|   |                    |                    |
|---|--------------------|--------------------|
| Non-current deferred tax asset (liability): |                    |                    |
| Deferred rent .....                         | \$ 26,021          | \$ 20,873          |
| Stock-based compensation .....              | 12,499             | 11,172             |
| Unearned franchise fees .....               | 247                | 269                |
| Depreciation .....                          | (57,188)           | (56,866)           |
| Foreign .....                               | 109                | (459)              |
| Insurance .....                             | 4,551              | 6,019              |
| Other .....                                 | 1,705              | (627)              |
|   | <u>\$ (12,056)</u> | <u>\$ (19,619)</u> |

A reconciliation of the statutory rate to taxes provided is as follows:

|  | <u>2006</u>  | <u>2005</u>  | <u>2004</u>  |
|--|--------------|--------------|--------------|
| Federal statutory rate .....                     | 35.0%        | 35.0%        | 35.0%        |
| State income taxes, net of federal benefit ..... | 3.5%         | 2.0%         | 3.2%         |
| Other .....                                      | <u>2%</u>    | <u>1.2%</u>  | <u>    </u>  |
| Effective tax rate .....                         | <u>38.7%</u> | <u>38.2%</u> | <u>38.2%</u> |

**8. Earnings per common share:**

Basic earnings per common share ("EPS") is computed by dividing earnings applicable to common shares by the weighted average number of common shares outstanding. Diluted EPS adjusts for the effect of potential common shares from dilutive stock options using the treasury stock method. Earnings per common and potential common shares (retroactively adjusted for a three-for-two stock split effective March 15, 2004) were computed as follows (thousands, except per share data):

|   | <u>2006</u>      | <u>2005</u>      | <u>2004</u>      |
|---|------------------|------------------|------------------|
| Net income applicable to common shares .....          | <u>\$ 68,257</u> | <u>\$ 69,671</u> | <u>\$ 76,978</u> |
| Basic:  |                  |                  |                  |
| Weighted average common shares outstanding .....      | <u>32,587</u>    | <u>35,091</u>    | <u>37,251</u>    |
| Earnings per common share .....                       | <u>\$ 2.09</u>   | <u>\$ 1.99</u>   | <u>\$ 2.07</u>   |
| Diluted:  |                  |                  |                  |
| Weighted average common shares outstanding .....      | 32,587           | 35,091           | 37,251           |
| Potential common shares for stock options .....       | <u>878</u>       | <u>1,097</u>     | <u>1,221</u>     |
| Weighted average shares outstanding .....             | <u>33,465</u>    | <u>36,188</u>    | <u>38,472</u>    |
| Earnings per common and potential common shares ..... | <u>\$ 2.04</u>   | <u>\$ 1.93</u>   | <u>\$ 2.00</u>   |

Anti-dilutive stock options to purchase 863,851; 946,680; and 5,175 common shares were not included in the EPS computations in 2006, 2005 and 2004, respectively, because the exercise prices of these options were greater than the average market price of the common shares.

**CEC ENTERTAINMENT, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**9. Benefit plans:**

The Company has benefit plans that include: a) incentive bonus compensation plans based on tenure or the performance of the Company, b) non-statutory stock option plans for its employees and non-employee directors, c) restricted stock plans for employees and non-employee directors, and d) a retirement and savings plan. Effective May 2005, the Company is restricted from issuing stock options to its non-employee directors and effective May 2006 resolved to discontinue issuing stock options to its employees and non-employee directors pursuant to the Company's stock option plans.

In 1997, the Company adopted an employee stock option plan under which 10,781,250 shares, as amended in 2004, may be granted before July 31, 2007. The exercise price for options granted under the plan may not be less than the fair market value of the Company's common stock at date of grant. Options may not be exercised until the employee has been continuously employed at least one year after the date of grant. Options which expire or terminate may be re-granted under the plan. Options which have been granted under the plan cannot be re-priced without shareholder approval. Shares granted generally vest over a period of one to four years. The Company issues new shares for stock option exercises.

In 1995, the Company adopted a stock option plan for its non-employee directors. Per an amendment to the plan in 2004, the number of shares of the Company's common stock that may be issued under this plan cannot exceed 437,500. Options which expire or terminate may be re-granted under the plan. Options may not be exercised until the non-employee director has served on the Board of Directors for at least two years after the date of grant. Shares granted generally vest over a period of one to four years. The Company issues new shares for stock option exercises.

In May 2004, the Company adopted an employee restricted stock plan under which 500,000 shares may be granted before December 31, 2014. All shares awarded shall provide for a vesting period of at least one year and no more than five years, and the full award may not vest in less than three years. Shares issued under a restricted stock award are nontransferable and subject to the forfeiture restrictions. Shares which expire or terminate may be re-granted under the plan.

In March 2005, the Company adopted a restricted stock plan for its non-employee directors under which 50,000 shares may be granted before March 1, 2020. The stockholders of the Company approved the plan in May 2005; and because of such approval, the Company has ceased issuing stock options to its non-employee directors. In January of each year, each non-employee director is entitled to a restricted stock award for the number of common shares having a fair market value, as defined in the plan, as of the date of grant equal to \$75,000. "Fair Market Value" is defined in the plan as the average of the closing prices of the Company's common stock as reported on the New York Stock Exchange for the five trailing day period ending on and including the date of a restricted stock award. All shares awarded shall provide for a vesting period of at least one year and no more than five years. Shares issued under a restricted stock award are nontransferable and subject to the forfeiture restrictions. Shares which expire or terminate may be re-granted under the plan.

**CEC ENTERTAINMENT, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**9. Benefit plans (continued):**

Stock option transactions are summarized as follows for all plans:

|  | <u>Number of Shares</u> |                  |                  | <u>Weighted Average Exercise Price per Share</u> |             |             |
|--|-------------------------|------------------|------------------|--|-------------|-------------|
|  | <u>2006</u>             | <u>2005</u>      | <u>2004</u>      | <u>2006</u>                                      | <u>2005</u> | <u>2004</u> |
| Options outstanding, beginning of year | 5,452,774               | 5,087,053        | 5,598,311        | \$25.69  | \$23.08     | \$21.09     |
| Granted .....                          | 0                       | 970,031          | 641,671          |  | 36.76       | 31.90       |
| Exercised .....                        | (349,323)               | (547,370)        | (1,063,029)      | 22.87  | 20.50       | 17.74       |
| Terminated .....                       | <u>(170,773)</u>        | <u>(56,940)</u>  | <u>(89,900)</u>  | 32.48  | 30.66       | 25.29       |
| Options outstanding, end of year       | <u>4,932,678</u>        | <u>5,452,774</u> | <u>5,087,053</u> | 25.66  | 25.69       | 23.08       |

Options outstanding at December 31, 2006:

| <u>Options Outstanding</u>      |  |   |  | <u>Options Exercisable</u>               |  |
|---------------------------------|--|---|--|--|--|
| <u>Range of Exercise Prices</u> | <u>Shares Outstanding as of 12/31/06</u> | <u>Weighted Avg. Remaining Life (Years)</u> | <u>Weighted Average Exercise Price</u> | <u>Shares Exercisable as of 12/31/06</u> | <u>Weighted Average Exercise Price</u> |
| \$11.67 - \$19.99               | 1,951,953                                | 2.3   | \$ 18.89                               | 1,586,228                                | \$18.64                                |
| \$20.83 - \$27.43               | 780,037                                  | 1.0   | 22.68                                  | 779,758                                  | 22.68                                  |
| \$29.00 - \$31.49               | 902,856                                  | 2.2   | 29.22                                  | 865,199                                  | 29.12                                  |
| \$31.64 - \$34.09               | 433,981                                  | 4.1   | 31.90                                  | 217,311                                  | 31.90                                  |
| \$35.04 - \$42.17               | <u>863,851</u>                           | 3.2   | 36.77                                  | <u>218,377</u>                           | 36.76                                  |
| \$11.67 - \$42.17               | <u>4,932,678</u>                         | 2.4   | 25.66                                  | <u>3,666,873</u>                         | 23.84                                  |

Stock options expire from five to seven years from the grant date. Stock options vest over various periods ranging from one to four years. There were 3,666,873 shares exercisable as of December 31, 2006 at a weighted average exercise price of \$23.84 and a weighted average remaining life of 2.4 years.

Pursuant to a plan approved by the Board of Directors, the Company's executive officers elected in December 2006 to modify the terms of certain outstanding stock options held by them totaling 1,903,450 shares in order to comply with the requirements of Internal Revenue Code 409A by setting a pre-determined fixed period in which such stock options would be exercised.

Non-vested share transactions are summarized as follows:

|   | <u>Restricted Share Awards</u> | <u>Weighted Avg. Fair Value Per Award</u> |
|---|--------------------------------|---|
| Non-vested shares outstanding, Jan. 1, 2006 ..... | 0                              |   |
| Granted .....                                     | 258,364                        | \$32.19                                   |
| Forfeited .....                                   | <u>(17,487)</u>                | 32.20                                     |
| Non-vested shares outstanding, Dec. 31, 2006...   | <u>240,877</u>                 | 32.18                                     |

No non-vested shares were granted in 2005.

Through March 23, 2007, the Company has granted an additional 24,078 shares under the non-employee directors' restricted stock plan.

**CEC ENTERTAINMENT, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**9. Benefit plans (continued):**

The Company has adopted the CEC 401(k) Retirement and Savings Plan, to which it may at its discretion make an annual contribution out of its current or accumulated earnings. Only non-highly compensated employees are eligible to participate in the plan. Contributions by the Company are made in the form of its common stock. At December 31, 2006, 112,289 shares remained available for grant under the plan. The Company made contributions of approximately \$456,000 in common stock for both the 2005 and 2004 plan years. The Company accrued \$506,000 for contributions for the 2006 plan year which will be paid in common stock in 2007.

In February 2006, the Company amended its incentive bonus plan to include the addition of a tenure-based element applicable to certain employees. The amendment also includes a change in one of the criteria used to determine the performance based element of the bonus plan, which is applicable to all employees of the Company eligible for a performance based bonus. Previously, the performance criteria were based upon comparable store sales and net income results for the applicable fiscal year of the bonus plan. The amendment to the bonus plan changes the net income component to an earnings per share component.

**10. Stock-based compensation:**

Prior to 2006, the Company accounted for stock-based compensation under the intrinsic value method of Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees," and related interpretations ("APB 25"), and had adopted the disclosure-only provisions of Financial Accounting Standards Board Statement No. 123, "Accounting for Stock-Based Compensation," ("FAS 123"). In December 2004, the Financial Accounting Standards Board issued a revised and renamed standard regarding stock-based compensation – FAS 123R. The revised standard, which was adopted by the Company in the first quarter of 2006, eliminates the disclosure-only election under FAS 123 and requires the recognition of compensation expense of stock options and all other forms of equity compensation generally based on the fair value of the instruments on the measurement date. In order to enhance comparability among all years presented and to provide the fullest understanding of the impact that expensing stock-based compensation has on the Company, the Company has retrospectively applied the new standard to prior period results.

The fair value of stock-based awards is determined on the date of grant and is recognized in expense over the vesting period. Stock option fair value is estimated using the Black-Scholes option pricing model. The estimated fair value of options granted was \$9.80 in the year ended January 1, 2006. There were no stock options granted during 2006. The fair value of restricted stock is measured at the closing market price of a common share on the grant date.

The consolidated statement of earnings and comprehensive income for the years ended December 31, 2006 and January 1, 2006, reflect pre-tax stock-based compensation cost of \$5.6 million and \$8.0 million, respectively. The impact on net income was \$3.5 million for fiscal year 2006 and \$4.9 million for fiscal year 2005. The amount expensed in 2006 includes the expense of restricted shares granted in 2006. Unrecognized pretax stock compensation cost as of December 31, 2006 was \$2.6 million related to stock options granted and \$5.6 million related to restricted shares issued which will be recognized over a weighted average period of 1.9 years. At December 31, 2006, the weighted average remaining contractual life of options outstanding and exercisable is 2.4 years and 2.0 years, respectively.

Cash proceeds from the exercise of stock options totaled \$8.0 million and \$11.2 million in the years ended December 31, 2006 and January 1, 2006, respectively. Stock options exercised in fiscal years 2006 and 2005, had an aggregate intrinsic value (amount by which the market price exceeded the exercise price on the date of exercise) of \$3.7 million and \$9.2 million, respectively. The income tax benefit related to the expense of employee stock options was \$1.4 million and \$3.5 million for fiscal years 2006 and 2005, respectively.

**CEC ENTERTAINMENT, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**10. Stock-based compensation (continued):**

The following tables present the effects of the retrospective application of FAS 123R on the consolidated balance sheets, statements of earnings and statements of cash flows as previously reported in the Company's annual report on Form 10-K/A for the year ended January 1, 2006.

|  | <u>Fiscal Year Ended January 1, 2006</u> |                 |                 |
|--|--|-----------------|-----------------|
|  | <u>As Previously</u>                     | <u>FAS 123R</u> | <u>As</u>       |
|  | <u>Reported</u>                          | <u>Adjust</u>   | <u>Adjusted</u> |
| Consolidated Balance Sheet:                        |  |                 |                 |
| Long-term deferred tax liability.....              | \$ 29,352                                | \$ (9,733)      | \$ 19,619       |
| Capital in excess of par value.....                | 271,332                                  | 43,107          | 314,439         |
| Retained earnings .....                            | 496,552                                  | (33,374)        | 463,178         |
| Total shareholders' equity .....                   | 333,450                                  | 9,733           | 343,183         |
|  |  |                 |                 |
|  | <u>Fiscal Year Ended January 1, 2006</u> |                 |                 |
|  | <u>As Previously</u>                     | <u>FAS 123R</u> | <u>As</u>       |
|  | <u>Reported</u>                          | <u>Adjust</u>   | <u>Adjusted</u> |
| Condensed Consolidated Statement of Earnings:      |  |                 |                 |
| Selling, general and administrative expenses ..... | \$ 90,223                                | \$ 7,634        | \$ 97,857       |
| Total costs and expenses .....                     | 605,748                                  | 7,634           | 613,382         |
| Income before income taxes .....                   | 120,415                                  | (7,634)         | 112,781         |
| Income taxes.....                                  | 45,714                                   | (2,604)         | 43,110          |
| Net income .....                                   | 74,701                                   | (5,030)         | 69,671          |
| Comprehensive income .....                         | 75,671                                   | (5,030)         | 70,641          |
| Basic earnings per share .....                     | 2.13                                     | (.14)           | 1.99            |
| Diluted earnings per share .....                   | 2.06                                     | (.13)           | 1.93            |
|  |  |                 |                 |
| Condensed Statement of Cash Flows:                 |  |                 |                 |
| Net income .....                                   | \$ 74,701                                | \$ (5,030)      | \$ 69,671       |
| Deferred income tax expense .....                  | (4,767)                                  | (1,751)         | (6,518)         |
| Share-based compensation expense.....              | 328                                      | 7,634           | 7,962           |
| Excess tax benefit from stock-based compensation.. | 4,707                                    | (4,707)         | 0               |
| Cash provided by operating activities.....         | 138,852                                  | (3,854)         | 134,998         |
| Excess tax benefit from stock-based compensation.. | 0  | 3,854           | 3,854           |
| Cash used in financing activities .....            | (47,219)                                 | 3,854           | (43,365)        |

**CEC ENTERTAINMENT, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**10. Stock-based compensation (continued):**

|  | <b>Fiscal Year Ended January 2, 2005</b> |                            |                        |
|--|--|----------------------------|------------------------|
|  | <b>As Previously<br/>Reported</b>        | <b>FAS 123R<br/>Adjust</b> | <b>As<br/>Adjusted</b> |
| <b>Condensed Consolidated Statement of Earnings:</b> |  |                            |                        |
| Selling, general and administrative expenses .....   | \$ 87,345                                | \$ 8,148                   | \$ 95,493              |
| Total costs and expenses .....                       | 595,270                                  | 8,148                      | 603,418                |
| Income before income taxes .....                     | 132,809                                  | (8,148)                    | 124,661                |
| Income taxes .....                                   | 50,553                                   | (2,870)                    | 47,683                 |
| Net income .....                                     | 82,256                                   | (5,278)                    | 76,978                 |
| Comprehensive income .....                           | 83,037                                   | (5,278)                    | 77,759                 |
| Basic earnings per share .....                       | 2.21                                     | (.14)                      | 2.07                   |
| Diluted earnings per share .....                     | 2.14                                     | (.14)                      | 2.00                   |
| <b>Condensed Statement of Cash Flows:</b>            |  |                            |                        |
| Net income .....                                     | \$ 82,256                                | \$ (5,278)                 | \$ 76,978              |
| Deferred income tax expense .....                    | 3,675                                    | (1,528)                    | 2,147                  |
| Share-based compensation expense .....               | 710                                      | 8,149                      | 8,859                  |
| Excess tax benefit from stock-based compensation..   | 4,161                                    | (4,161)                    | 0                      |
| Cash provided by operating activities .....          | 165,792                                  | (2,818)                    | 162,974                |
| Excess tax benefit from stock-based compensation..   | 0  | 2,818                      | 2,818                  |
| Cash used in financing activities .....              | (81,734)                                 | 2,818                      | (78,916)               |

**CEC ENTERTAINMENT, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**11. Quarterly results of operations (unaudited):**

The following summarizes the unaudited quarterly results of operations in 2006 and 2005 (thousands, except per share data), adjusted for the effects of the stock option investigation restatement and including adoption of SFAS 123R.

|                                  | <u>Fiscal year ended December 31, 2006</u> |               |               |                |
|----------------------------------|--|---------------|---------------|----------------|
|                                  | <u>April 2</u>                             | <u>July 2</u> | <u>Oct. 1</u> | <u>Dec. 31</u> |
| Revenues.....                    | \$226,992                                  | \$176,179     | \$194,671     | \$176,312      |
| Income before income taxes ..... | 47,077                                     | 16,576        | 28,050        | 19,674         |
| Net income.....                  | 28,853                                     | 10,159        | 17,192        | 12,053         |
| Earnings per Share:              |  |               |               |                |
| Basic .....                      | \$ .86                                     | \$ .31        | \$ .54        | \$ .38         |
| Diluted .....                    | .84  | .30           | .53           | .36            |

|                                  | <u>Fiscal year ended January 1, 2006</u> |               |               |               |
|----------------------------------|--|---------------|---------------|---------------|
|                                  | <u>April 3</u>                           | <u>July 3</u> | <u>Oct. 2</u> | <u>Jan. 1</u> |
| Revenues.....                    | \$214,086                                | \$168,401     | \$179,589     | \$164,087     |
| Income before income taxes ..... | 50,690                                   | 21,157        | 24,142        | 16,792        |
| Net income.....                  | 31,255                                   | 12,966        | 14,808        | 10,642        |
| Earnings per Share:              |  |               |               |               |
| Basic .....                      | \$ .86                                   | \$ .37        | \$ .42        | \$ .31        |
| Diluted .....                    | .83                                      | .36           | .41           | .31           |

## *Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure.*

None

### *Item 9A. Controls and Procedures*

#### **MANAGEMENT'S REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING**

##### **Background of Restatement**

Following an internal investigation into the Company's stock option accounting during the period from 1989 through 2005, the Company and its Audit Committee concluded that the Company's consolidated financial statements for each of the fiscal years during the three year period ended January 1, 2006, as well as the quarter ended April 2, 2006, should be restated to record additional stock-based compensation and related tax effects resulting from stock options granted during fiscal years 1989 through 2005 that were incorrectly accounted for under generally accepted accounting principles. The decision was based on the determination that the actual measurement dates for determining the accounting treatment of certain stock option grants differed from the measurement dates used by the Company in preparing its consolidated financial statements.

##### **Evaluation of Disclosure Controls and Procedures**

We have established and maintained disclosure controls and procedures that are designed to ensure that material information relating to the Company and our subsidiaries required to be disclosed by us in the reports that we file or submit under the Securities Exchange Act of 1934 is recorded, processed, summarized, and reported within the time periods specified in the SEC's rules and forms, and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure. In designing and evaluating the disclosure controls and procedures, management recognized that any control and procedures, no matter how well designed and operated, can provide only a reasonable assurance of achieving the desired control objectives, and management was necessarily required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures.

##### **Management's Annual Report on Internal Control over Financial Reporting**

Our management is responsible for establishing and maintaining adequate internal control over financial reporting. As defined in Exchange Act Rule 13a-15(f), internal control over financial reporting is a process designed by, or under the supervision of, our principal executive and principal financial officer and effected by our Board of Directors, management and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles and includes those policies and procedures that (i) pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the Company; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the Company are being made only in accordance with authorizations of management and directors of the Company; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the Company's assets that could have a material effect on the financial statements. Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements.

The management of the Company is responsible for establishing and maintaining adequate internal control over financial reporting, and for performing an assessment of the effectiveness of internal control over financial reporting as of December 31, 2006. Under the supervision and with the participation of management, including the Company's Chief Executive Officer and Chief Financial Officer, management assessed the effectiveness of the Company's internal control over financial reporting based on the criteria in *Internal Control — Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission.

The Public Company Accounting Oversight Board's Auditing Standard No. 2 defines a material weakness as a significant deficiency, or a combination of significant deficiencies, that results in there being a more than remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected. Management identified a material weakness in internal control over financial reporting in connection with this revised assessment.

Specifically, we did not design and implement controls necessary to provide reasonable assurance that the measurement date for stock option grants was appropriately determined. As a result, the measurement date used for certain option grants was not appropriate and such grants were not accounted for in accordance with GAAP. We previously reported the material weakness in our 2005 Form 10-K/A, filed on April 23, 2007. This material weakness continued to exist, as it was not remediated as of December 31 2006.

Deloitte & Touche LLP, an independent registered public accounting firm that audited our financial statements included in this Annual Report on Form 10-K, has issued an attestation report on management's assessment of our internal control over financial reporting as of December 31, 2006, which is included in this Item 9A under the caption "Report of Independent Registered Public Accounting Firm".

### **Changes in Internal Control over Financial Reporting**

No change in our internal control over financial reporting (as defined in rules 13a-15(f) and 15d-15(f) under the Exchange Act occurred during the quarter ended December 31, 2006 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

As of December 31, 2006, the Company adopted certain actions concerning corporate governance to enhance the process for equity-based compensation awards in the future and continues to implement additional remedies regarding the material weakness described above. However, we did not have sufficient time to assess operating effectiveness of the improved internal control over financial reporting. We expect our remediation efforts and testing to be completed prior to the filing of our June 2007 Form 10-Q. The actions taken to enhance the process for equity based compensation awards include:

- Engaging a compensation consultant to review existing equity based compensation plans to assist in compliance matters and to assist in development and implementation of a set of best practices with respect to its equity based compensation plans.
- The adoption of a formal written policy concerning equity-based compensation awards to employees, which includes, among other things, the following:
  - Equity based compensation awards will be made only at meetings, and not by unanimous written consents in lieu of a meeting;
  - The Board of Directors or committee thereof will meet between two and ten business days after each quarterly earnings release, and equity based compensation awards will be made only at these four meetings.

The Company is continuing to evaluate the recommendations of the Audit Committee and may take additional actions at a later date in response to these recommendations.

## REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

Board of Directors and Shareholders  
CEC Entertainment, Inc.  
Irving, Texas

We have audited management's assessment, included in the accompanying Management's Report on Internal Control over Financial Reporting, that CEC Entertainment, Inc. and subsidiaries (the "Company") did not maintain effective internal control over financial reporting as of December 31, 2006, based on criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (the "COSO control criteria"). The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assessment and an opinion on the effectiveness of the Company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinions.

A company's internal control over financial reporting is a process designed by, or under the supervision of, the company's principal executive and principal financial officers, or persons performing similar functions, and effected by the company's board of directors, management, and other personnel to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of the inherent limitations of internal control over financial reporting, including the possibility of collusion or improper management override of controls, material misstatements due to error or fraud may not be prevented or detected on a timely basis. Also, projections of any evaluation of the effectiveness of the internal control over financial reporting to future periods are subject to the risk that the controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected. The following material weakness has been identified and included in management's revised assessment: The Company did not design and implement controls necessary to provide reasonable assurance that the measurement date for stock option grants was appropriately determined. As a result, the measurement date used for certain option grants was not appropriate and such grants were not accounted for in accordance with generally accepted accounting principles. This material weakness was considered in determining the nature, timing, and extent of audit tests applied in our audit of the consolidated financial statements as of and for the year ended December 31, 2006, of the Company and this report does not affect our report on such financial statements.

In our opinion, management's assessment that the Company did not maintain effective internal control over financial reporting as of December 31, 2006, is fairly stated, in all material respects, based on the criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. Also in our opinion, because of the effect of the material weakness described above on the achievement of the objectives of the control criteria, the Company has not maintained effective internal control over financial reporting as of December 31, 2006, based on the criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated financial statements of the Company as of and for the year ended December 31, 2006, and our report dated April 20, 2007 expressed an unqualified opinion on those financial statements.

Dallas, Texas  
April 20, 2007

### *Item 9B. Other Information*

None.

## **PART III**

### *Item 10. Directors and Executive Officers of the Registrant*

The information required by this Item regarding the directors and executive officers of the Company is incorporated by reference to and will be included in the Company's definitive Proxy Statement to be filed pursuant to Regulation 14A in connection with the Company's 2007 annual meeting of stockholders. The Company has adopted a Code of Ethics for the Chief Executive Officer and Senior Financial Officers (the "Code of Ethics") that applies to the principal executive officer, principal financial officer and principal accounting officer. Changes to and waivers granted with respect to the Code of Ethics related to the above named officers required to be disclosed pursuant to applicable rules and regulations will also be posted on the Company's website at [www.chuckecheese.com](http://www.chuckecheese.com).

### *Item 11. Executive Compensation*

The information required by this Item regarding the directors and executive officers of the Company is incorporated by reference to and will be included in the Company's definitive Proxy Statement to be filed pursuant to Regulation 14A in connection with the Company's 2007 annual meeting of stockholders.

### *Item 12. Security Ownership of Certain Beneficial Owners and Management*

The information required by this Item is incorporated by reference to and will be included in the Company's definitive Proxy Statement to be filed pursuant to Regulation 14A in connection with Company's 2007 annual meeting of stockholders.

### *Item 13. Certain Relationships and Related Transactions*

The information required by this Item regarding the directors and executive officers of the Company is incorporated by reference to and will be included in the Company's definitive Proxy Statement to be filed pursuant to Regulation 14A in connection with the Company's 2007 annual meeting of stockholders.

### *Item 14. Principal Accountant Fees and Services*

The information required by this Item is incorporated by reference to and will be included in the Company's definitive Proxy Statement to be filed pursuant to Regulation 14A in connection with the Company's 2007 annual meeting of stockholders.

## PART IV

### *Item 15. Exhibits and Financial Statement Schedules.*

**(a) The following documents are filed as a part of this report:**

*(1) Financial Statements and Supplementary Data:*

Report of independent registered public accounting firm.

CEC Entertainment, Inc. consolidated financial statements:

Consolidated balance sheets as of December 31, 2006 and January 1, 2006.

Consolidated statements of earnings and comprehensive income for the years ended December 31, 2006, January 1, 2006, and January 2, 2005.

Consolidated statements of shareholders' equity for the years ended December 31, 2006, January 1, 2006, and January 2, 2005.

Consolidated statements of cash flows for the years ended December 31, 2006, January 1, 2006, and January 2, 2005.

Notes to consolidated financial statements.

*(2) Exhibits:*

| <u>Number</u> | <u>Description</u>   |
|---------------|--|
| 3(a)(1)       | Amended and Restated Articles of Incorporation of the Company (filed as Exhibit 3(a) to the Company's Quarterly Report on Form 10-Q for the quarter ended July 4, 1999, and incorporated herein by reference).   |
| 3(b)(1)       | Restated Bylaws of the Company, dated August 16, 1994 (filed as Exhibit 3 to the Company's Quarterly Report on Form 10-Q for the quarter ended September 30, 1994, and incorporated herein by reference).  |
| 3(b)(2)       | Amendment to the Bylaws, dated May 5, 1995 (filed as Exhibit 3 to the Company's Quarterly Report on Form 10-Q for the quarter ended June 30, 1995, and incorporated herein by reference).  |
| 4(a)          | Specimen form of certificate representing \$.10 par value Common Stock (filed as Exhibit 4(a) to the Company's Annual Report on Form 10-K for the year ended December 28, 1990, and incorporated herein by reference).   |
| 10(a)         | 2001 Employment Agreement dated November 13, 2000, between the Company and Richard M. Frank (filed as Exhibit 10(a) to the Company's Annual Report on Form 10-K for the year ended December 30, 2000, and incorporated herein by reference).   |
| 10(b)         | Employment Agreement, dated May 8, 2001, between Michael H. Magusiak and the Company (filed as Exhibit 10(a) to the Company's Quarterly Report on Form 10-Q for the quarter ended April 1, 2001, and incorporated herein by reference).  |
| 10(c)         | Amended and Restated Credit Agreement, in the stated amount of \$200,000,000, dated July 18, 2005, between CEC Entertainment Concepts, L.P., Company, Bank of America, N.A., JP Morgan Chase Bank, N.A., Suntrust Bank, and the other Lenders (filed as Exhibit 10(a)(1) to the Company's Form 8-K (No. 001-13687), and incorporated herein by reference). |
| 10(d)(1)      | 1997 Non-Statutory Stock Option Plan (filed as Exhibit 4.1 to the Company's Form S-8 (No. 333-41039), and incorporated herein by reference).   |
| 10(d)(2)      | Specimen form of Contract under the 1997 Non-Statutory Stock Option Plan of the Company, as amended to date (filed as Exhibit 10(o)(2) to the Company's Annual Report on Form 10-K for the year ended January 2, 1998, and incorporated herein by reference).  |
| 10(e)(1)      | Non-Employee Directors Stock Option Plan (filed as Exhibit B to the Company's Proxy Statement for Annual Meeting of Stockholders to be held on June 8, 1995, and incorporated herein by reference).  |
| 10(e)(2)      | Specimen form of Contract under the Non-Employee Directors Stock Option Plan of the Company, as amended to date (filed as Exhibit 10(s)(2) to the Company's Annual Report on Form 10-K for the year ended December 27, 1996, and incorporated herein by reference).  |
| 10(f)(1)      | 2004 Restricted Stock Plan (filed as Exhibit A to the Company's Form S-8 (No. 333-119232), and incorporated herein by reference).  |
| 10(f)(2)      | Specimen form of Contract under the 2004 Restricted Stock Plan of the Company, as amended to date (attached hereto, and incorporated herein by reference).   |

- 10(g)(1) Non-Employee Directors Restricted Stock Plan (filed as Exhibit A to the Company's Form S-8 (No.333-130142), and incorporated herein by reference).
- 10(g)(2) Specimen form of Contract under the Non-Employee Directors Restricted Stock Plan of the Company, as amended to date (attached hereto, and incorporated herein by reference).
- 10(h)(1) Specimen form of the Company's current Franchise Agreement (filed as Exhibit 10(a)(1) to the Company's Form 8-K (No. 001-13687) dated March 5, 2004, and incorporated herein by reference).
- 10(h)(2) Specimen form of the Company's current Development Agreement (filed as Exhibit 10(a)(2) to the Company's Form 8-K (No. 001-13687) dated March 5, 2004, and incorporated herein by reference).
- 10(i) Rights Agreement, dated as on November 19, 1997, by and between the Company and the Rights Agent (filed as Exhibit A to Exhibit 1 of the Company's Registration Statement on Form 8-A (No. 001-13687) and incorporated herein by reference).
- 23 Consent of Independent Registered Public Accounting Firm.
- 31.1 Certification of the Chief Executive Officer pursuant to Rule 13a-14(a)/15d-14(a).
- 31.2 Certification of the Acting Principal Financial Officer pursuant to Rule 13a-14(a)/15d-14(a).
- 32.1 Certification of Chief Executive Officer pursuant to 18 U.S.C.Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 32.2 Certification of Chief Financial Officer pursuant to 18 U.S.C.Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

**(b) Reports on Form 8-K:**

During the fourth quarter and to present, we filed or furnished the following reports on Form 8-K:

A current report on Form 8-K, dated October 31, 2006, announcing preliminary third quarter 2006 financial results and completion of Audit Committee's review of stock option granting practices.

A current report on Form 8-K, dated November 14, 2006, announcing non-reliance on previously issued financial statements.

A current report of Form 8-K/A, dated December 20, 2006, amending the Form 8-K filed on November 14, 2006.

A current report on Form 8-K, dated March 6, 2007, announcing preliminary financial results for the fourth quarter and year ended December 31, 2006.

A current report on Form 8-K, dated March 13, 2007, announcing unregistered sales of equity securities.

**(c) Exhibits pursuant to Item 601 of Regulation S-K:**

Pursuant to Item 601(b)(4) of Regulation S-K, there have been excluded from the exhibits filed pursuant to this report instruments defining the right of holders of long-term debt of the Company where the total amount of the securities authorized under each such instrument does not exceed 10% of the total assets of the Company. The Company hereby agrees to furnish a copy of any such instruments to the Commission upon request.

**(d) Financial Statements excluded from the annual report to shareholders by Rule 14A - 3(b):**

No financial statements are excluded from the annual report to the Company's shareholders by Rule 14a - 3(b).

## SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

Dated: April 23, 2007

CEC Entertainment, Inc.

By: /s/ Richard M. Frank

Richard M. Frank  
Chairman of the Board and  
Chief Executive Officer

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

| <u>Signature</u>  | <u>Title</u>  | <u>Date</u>    |
|---|---|----------------|
| <u>/s/ Richard M. Frank</u><br>Richard M. Frank           | Chairman of the Board,<br>Chief Executive Officer,<br>and Director (Principal<br>Executive Officer) | April 23, 2007 |
| <u>/s/ Christopher D. Morris</u><br>Christopher D. Morris | Executive Vice President,<br>Chief Financial Officer<br>(Principal Financial Officer)               | April 23, 2007 |
| <u>/s/ James Mabry</u><br>James Mabry                     | Vice President, Controller<br>and Treasurer<br>(Principal Accounting Officer)                       | April 23, 2007 |
| <u>/s/ Michael H. Magusiak</u><br>Michael H. Magusiak     | President and Director  | April 23, 2007 |
| <u>/s/ Richard T. Huston</u><br>Richard T. Huston         | Director  | April 23, 2007 |
| <u>/s/ Larry T. McDowell</u><br>Larry T. McDowell         | Director  | April 23, 2007 |
| <u>/s/ Tim T. Morris</u><br>Tim T. Morris                 | Director  | April 23, 2007 |
| <u>/s/ Louis P. Neeb</u><br>Louis P. Neeb                 | Director  | April 23, 2007 |
| <u>/s/ Cynthia I. Pharr Lee</u><br>Cynthia I. Pharr Lee   | Director  | April 23, 2007 |
| <u>/s/ Walter Tyree</u><br>Walter Tyree                   | Director  | April 23, 2007 |
| <u>/s/ Raymond E. Wooldridge</u><br>Raymond E. Wooldridge | Director  | April 23, 2007 |

## EXHIBIT INDEX

| <u>Exhibit No.</u> | <u>Description</u>   | <u>Page No.</u> |
|--------------------|--|-----------------|
| 23                 | Consent of Independent Registered Public Accounting Firm   | 58              |
| 31.1               | Certification of the Chief Executive Officer pursuant to Rule 13a-14(a)/15d-14(a).   | 59              |
| 31.2               | Certification of the Chief Financial Officer pursuant to Rule 13a-14(a)/15d-14(a)  | 60              |
| 32.1               | Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. | 61              |
| 32.2               | Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. | 62              |

## **CONSENT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

We consent to the incorporation by reference in Registration Statement No. 333-103572 of ShowBiz Pizza Time, Inc. on Form S-8 of our report relating to the consolidated financial statements of CEC Entertainment, Inc. dated April 20, 2007 and our report relating to management's report on the effectiveness of internal control over financial reporting dated April 20, 2007 (which report expresses an adverse opinion on the effectiveness of internal controls over financial reporting), appearing in this Annual Report on Form 10-K of CEC Entertainment, Inc. for the year ended December 31, 2006.

/a/ Deloitte & Touche LLP

Dallas, Texas  
April 20, 2007

EXHIBIT 31.1

CERTIFICATION PURSUANT TO RULE 13a – 14(a)/15d-14(a)  
(CHIEF EXECUTIVE OFFICER)

I, Richard M. Frank, certify that:

1. I have reviewed this annual report on Form 10-K of CEC Entertainment, Inc.;
2. Based on my knowledge, this annual report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
  - a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - b) designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - c) evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - d) disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
  - a) all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information and
  - b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

April 23, 2007

/s/ Richard M. Frank  
Richard M. Frank  
Chief Executive Officer

EXHIBIT 31.2

CERTIFICATION PURSUANT TO RULE 13a – 14(a)/15d-14(a)  
(CHIEF FINANCIAL OFFICER)

I, Christopher D. Morris, certify that:

1. I have reviewed this annual report on Form 10-K of CEC Entertainment, Inc.;
2. Based on my knowledge, this annual report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
  - a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - b) designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - c) evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - d) disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
  - a) all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information and
  - b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

April 23, 2007

/s/ Christopher D. Morris  
Christopher D. Morris  
Chief Financial Officer

EXHIBIT 32.1

CERTIFICATION PURSUANT TO  
18 U.S.C. SECTION 1350,  
AS ADOPTED PURSUANT TO  
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

In connection with the Annual Report of CEC Entertainment, Inc. (the “Company”) on Form 10-K for the year ended December 31, 2006 as filed with the Securities and Exchange Commission on the date hereof (the “Report”), the undersigned certifies, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that:

- (1) The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
- (2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company as of, and for, the periods presented in this Report.

/s/ Richard M. Frank  
Richard M. Frank  
Chief Executive Officer  
April 23, 2007

A signed original of this written statement required by Section 906 has been provided to CEC Entertainment, Inc. and will be retained by CEC Entertainment, Inc. and furnished to the Securities and Exchange Commission or its staff upon request.

EXHIBIT 32.2

CERTIFICATION PURSUANT TO  
18 U.S.C. SECTION 1350,  
AS ADOPTED PURSUANT TO  
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

In connection with the Annual Report of CEC Entertainment, Inc. (the "Company") on Form 10-K for the year ended December 31, 2006 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), the undersigned certifies, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that:

- (1) The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
- (2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company as of, and for, the periods presented in this Report.

/s/ Christopher D. Morris  
Christopher D. Morris  
Chief Financial Officer  
April 23, 2007

A signed original of this written statement required by Section 906 has been provided to CEC Entertainment, Inc. and will be retained by CEC Entertainment, Inc. and furnished to the Securities and Exchange Commission or its staff upon request.

# financial highlights

|  | 2006       | 2005       | 2004       |
|--|------------|------------|------------|
| <b>OPERATING RESULTS :</b>               |            |            |            |
| Revenues                                 | \$774,154  | \$726,163  | \$728,079  |
| Income before taxes                      | 111,377    | 112,781    | 124,661    |
| Net income                               | 68,257     | 69,671     | 76,978     |
| <b>EARNINGS PER SHARE :</b>              |            |            |            |
| Basic                                    | \$2.09     | \$1.99     | \$2.07     |
| Diluted                                  | \$2.04     | \$1.93     | \$2.00     |
| <b>OTHER INFORMATION :</b>               |            |            |            |
| Total assets                             | \$704,185  | \$651,920  | \$612,129  |
| Long-term obligations                    | 190,364    | 163,671    | 100,808    |
| Shareholders equity                      | 359,206    | 343,183    | 365,978    |
| <b>CHANGE IN COMPARABLE STORE SALES</b>  |            |            |            |
| Chuck E. Cheese's                        | 2.7%       | -2.3%      | 2.0%       |
| <b>NUMBER OF RESTAURANTS AT YEAR END</b> |            |            |            |
| Company operated                         | 484        | 475        | 449        |
| Franchise                                | 45         | 44         | 46         |
| <b>TOTAL</b>                             | <b>529</b> | <b>519</b> | <b>495</b> |

A SERIOUS  
INVESTMENT  
IN fun.

**CEC**  
entertainment, inc.

www.chuckecheese.com

## BOARD OF DIRECTORS

RICHARD M. FRANK  
RICHARD T. HUSTON  
MICHAEL H. MAGUSIAK  
LARRY T. MCDOWELL  
TIM T. MORRIS

LOUIS P. NEEB  
CYNTHIA I. PHARR LEE  
WALTER TYREE  
RAYMOND E. WOOLDRIDGE

## OFFICERS

RICHARD M. FRANK  
Chairman of the Board/  
Chief Executive Officer

MICHAEL H. MAGUSIAK  
President

JOHN R. CARDINALE  
Executive Vice President  
Development and Purchasing

GENE F. GRAMM  
Executive Vice President  
Games and Concept Evolution

RICHARD T. HUSTON  
Executive Vice President  
Marketing, Entertainment

CHRISTOPHER D. MORRIS  
Executive Vice President  
Chief Financial Officer

THOMAS W. OLIVER  
Executive Vice President  
General Counsel

RANDY G. FORSYTHE  
Senior Vice President  
Operations, Midwest Region

CATHERINE R. OLIVIERI  
Senior Vice President  
Human Resources,  
Risk Management, Benefits

MICHAEL R. BOYKO  
Vice President  
Operations, Western Region

SANDRA J. BROWN  
Vice President  
Payroll, Accounts Payable  
and Inventory

KENNY L. BULLOCK  
Vice President  
Real Estate

DANIEL A. DICKSON  
Vice President  
Operations, Southwest Region

JOE W. ELLIOTT  
Vice President  
Research and Development

MARSHALL R. FISCO, JR.  
Vice President  
Legal and Corporate Secretary

MICHAEL H. JOHNSON  
Vice President  
Purchasing

JAMES A. MABRY  
Vice President  
Controller  
Treasurer

DON L. MCKECHNIE  
Vice President  
Development, Construction

DONALD R. MAY  
Vice President  
Operations, Northern Region

AHMET M. ONER  
Vice President  
Management Information  
Systems

LOIS F. PERRY  
Vice President  
Advertising

MARK P. WALLACE  
Vice President  
Operations, Southeast Region

ALICE M. WINTERS  
Assistant Corporate Secretary

*The officers identified  
above are employed by  
CEC Entertainment, Inc.  
and its subsidiaries.*

## CORPORATE INFORMATION

EXECUTIVE OFFICES  
4441 West Airport Freeway  
P.O. Box 152077  
Irving, Texas 75015  
972/258-8507

ANNUAL SHAREHOLDER MEETING  
June 27, 2007  
9:00 A.M.  
Westin DFW Airport  
4545 W. John Carpenter Freeway  
Irving, Texas 75063

STOCK TRANSFER AGENT AND REGISTRAR  
Mailing Address:  
Compshare Investor Services  
P.O. Box 43078  
Providence, RI 02940-3078  
www.computershare.com

Shareholder Services:  
Telephone: 1/877-498-8865  
Internet: www.computershare.com

STOCK LISTING  
The Company's common stock is traded on the  
New York Stock Exchange under the symbol "CEC."

INDEPENDENT REGISTERED PUBLIC  
ACCOUNTING FIRM  
Deloitte & Touche, LLP  
2200 Ross Avenue  
Suite 1600  
Dallas, Texas 75201

10-K AVAILABILITY  
The company will furnish any shareholder, without  
charge, a copy of the Company's annual report filed  
with the Securities and Exchange Commission on  
Form 10-K for the 2006 fiscal year (including the  
financial statements and schedules thereto) upon  
written request from the shareholder addressed to:

Secretary  
CEC Entertainment, Inc.  
4441 West Airport Freeway  
P.O. Box 152077  
Irving, Texas 75015

CEO/CFO CERTIFICATIONS  
On April 23, 2007 the Company submitted its  
annual Section 303A CEO Certification to  
the New York Stock Exchange. The Company  
also filed the CEO and CFO certifications required  
under Section 302 of the Sarbanes-Oxley Act  
of 2002 with the Securities and Exchange  
Commission as exhibits to its Annual Report on  
Form 10-K for the year ended December 31, 2006.

ANNUAL REPORT DESIGN  
Squires & Company  
www.squirescompany.com