Notes to Consolidated Financial Statements

August 31, 2006, 2005 and 2004
(In thousands, except per share data)

1. Summary of Significant Accounting Policies

Operations

Sonic Corp. (the "company") operates and franchises a chain of quick-service drive-ins in the United States and Mexico. It derives its revenues primarily from Partner Drive-In sales and royalty fees from franchisees. The company also leases signs and real estate, and owns a minority interest in several Franchise Drive-Ins.

From time to time, the company purchases existing Franchise Drive-Ins with proven track records in core markets from franchisees and other minority investors as a means to deploy excess cash generated from operating activities and provide a foundation for future earnings growth.

Principles of Consolidation

The accompanying financial statements include the accounts of the company, its wholly-owned subsidiaries and its majority-owned Partner Drive-Ins, organized as general partnerships and limited liability companies. All significant intercompany accounts and transactions have been eliminated.

Certain amounts have been reclassified in the Consolidated Financial Statements to conform to the fiscal year 2006 presentation.

Use of Estimates

The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the amounts reported and contingent assets and liabilities disclosed in the financial statements and accompanying notes. Actual results may differ from those estimates, and such differences may be material to the financial statements.

Cash Equivalents

Cash equivalents consist of highly liquid investments that mature in three months or less from date of purchase.

Inventories

Inventories consist principally of food and supplies that are carried at the lower of cost (first-in, first-out basis) or market.

Property, Equipment and Capital Leases

Property and equipment are recorded at cost, and leased assets under capital leases are recorded at the present value of future minimum lease payments. Depreciation of property and equipment and capital leases is computed by the straight-line method over the estimated useful lives or the lease term, including cancelable option periods when appropriate, and are combined for presentation in the financial statements

Accounting for Long-Lived Assets

In accordance with SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets," the company reviews long-lived assets whenever events or changes in circumstances indicate that the carrying amount of an asset might not be recoverable. Assets are grouped and evaluated for impairment at the lowest level for which there are identifiable cash flows that are largely independent of the cash flows of other groups of assets, which generally represents the individual drive-in. The company's primary test for an indicator of potential impairment is operating losses. If an indication of impairment is determined to be present, the company estimates the future cash flows expected to be generated from the use of the asset and its eventual disposal. If the sum of undiscounted future cash flows is less than the carrying amount of the asset, an impairment loss is recognized. The impairment loss is measured by comparing the fair value of the asset to its carrying amount. Calculating the present value of future cash flows is

typically not required. Rather, because drive-in buildings are typically single-purpose assets, the impairment provided is equal to the carrying amount of the building and any improvements. The equipment associated with a store can be easily relocated to another store, and therefore is not adjusted.

Surplus property assets are carried at the lower of depreciated cost or fair value less cost to sell. The majority of the value in surplus property is land. Fair values are estimated based upon appraisals or independent assessments of the assets' estimated sales values.

Goodwill and Other Intangible Assets

The company accounts for goodwill and other intangible assets in accordance with SFAS No. 142, "Goodwill and Other Intangible Assets". Intangible assets with lives restricted by contractual, legal, or other means are amortized over their useful lives. Goodwill and other intangible assets not subject to amortization are tested for impairment annually or more frequently if events or changes in circumstances indicate that the asset might be impaired. SFAS No. 142 requires a two-step process for testing impairment. First, the fair value of each reporting unit is compared to its carrying value to determine whether an indication of impairment exists. If an impairment is indicated, then the fair value of the reporting unit's goodwill is determined by allocating the unit's fair value to its assets and liabilities (including any unrecognized intangible assets) as if the reporting unit had been acquired in a business combination. The amount of impairment for goodwill and other intangible assets is measured as the excess of its carrying value over its fair value.

The company's intangible assets subject to amortization under SFAS No. 142 consist primarily of acquired franchise agreements, franchise fees, and other intangibles. Amortization expense is calculated using the straight-line method over the expected period of benefit, not exceeding 20 years. The company's trademarks and trade names were deemed to have indefinite useful lives and are not subject to amortization. See Note 5 for additional disclosures related to goodwill and other intangibles.

Ownership Program

The company's drive-in philosophy stresses an ownership relationship with drive-in supervisors and managers. Most supervisors and managers of Partner Drive-Ins own an equity interest in the drive-in, which is financed by third parties. Supervisors and managers are neither employees of the company nor of the drive-in in which they have an ownership interest.

The minority ownership interests in Partner Drive-Ins of the managers and supervisors are recorded as a minority interest liability on the Consolidated Balance Sheets, and their share of the drive-in earnings is reflected as Minority interest in earnings of Partner Drive-Ins in the Costs and expenses section of the Consolidated Statements of Income. The ownership agreements contain provisions, which give the company the right, but not the obligation, to purchase the minority interest of the supervisor or manager in a drive-in. The amount of the investment made by a partner and the amount of the buy-out are based on a number of factors, primarily upon the drive-in's financial performance for the preceding 12 months, and is intended to approximate the fair value of a minority interest in the drive-in.

The company acquires and sells minority interests in Partner Drive-Ins from time to time as managers and supervisors buy-out and buy-in to the partnerships or limited liability companies. If the purchase price of a minority interest that we acquire exceeds the net book value of the assets underlying the partnership interest, the excess is recorded as goodwill. The acquisition of a minority interest for less than book value is recorded as a reduction in purchased goodwill. Any subsequent sale of the minority interest to another minority partner is recorded as a pro-rata reduction of goodwill, and no gain or loss is recognized on the sale of the minority ownership interest. Goodwill created as a result of the acquisition of minority interests in Partner Drive-Ins is not amortized but is tested annually for impairment under the provisions of SFAS No. 142.

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Revenue Recognition, Franchise Fees and Royalties

Revenue from Partner Drive-In sales is recognized when food and beverage products are sold.

Initial franchise fees are nonrefundable and are recognized in income when all material services or conditions relating to the sale of the franchise have been substantially performed or satisfied by the company. Area development fees are nonrefundable and are recognized in income on a pro rata basis when the conditions for revenue recognition under the individual development agreements are met. Both initial franchise fees and area development fees are generally recognized upon the opening of a franchise drive-in or upon termination of the agreement between the company and the franchisee.

The company's franchisees are required under the provisions of the license agreements to pay the company royalties each month based on a percentage of actual net royalty sales. However, the royalty payments and supporting financial statements are not due until the 20th of the following month. As a result, the company accrues royalty revenue in the month earned based on estimates of Franchise Drive-In sales. These estimates are based on actual sales at Partner Drive-Ins and projections of average unit volume growth at Franchise Drive-Ins.

Operating Leases

Rent expense is recognized on a straight-line basis over the expected lease term, including cancelable option periods when it is deemed to be reasonably assured that we would incur an economic penalty for not exercising the options. Within the provisions of certain of our leases, there are rent holidays and/or escalations in payments over the base lease term, as well as renewal periods. The effects of the holidays and escalations have been reflected in rent expense on a straight-line basis over the expected lease term, which includes cancelable option periods when appropriate. The lease term commences on the date when we have the right to control the use of the leased property, which can occur before rent payments are due under the terms of the lease. Percentage rent expense is generally based on sales levels and is accrued at the point in time we determine that it is probable that such sales levels will be achieved.

Advertising Costs

Costs incurred in connection with the advertising and promotion of the company's products are included in other operating expenses and are expensed as incurred. Such costs amounted to $30,948, $28,216, and $23,664 for fiscal years 2006, 2005 and 2004, respectively.

Under the company's license agreements, both Partner-Drive-Ins and Franchise Drive-Ins must contribute a minimum percentage of revenues to a national media production fund (Sonic Advertising Fund) and spend an additional minimum percentage of gross revenues on local advertising, either directly or through company-required participation in advertising cooperatives. A portion of the local advertising contributions is redistributed to a System Marketing Fund, which purchases advertising on national cable and broadcast networks and other national media and sponsorship opportunities. As stated in the terms of existing license agreements, these funds do not constitute assets of the company and the company acts with limited agency in the administration of these funds. Accordingly, neither the revenues and expenses nor the assets and liabilities of the advertising cooperatives, the Sonic Advertising Fund, or the System Marketing Fund are included in the company's consolidated financial statements. However, all advertising contributions by Partner Drive-Ins are recorded as expense on the company's financial statements.

Stock-Based Compensation

Effective September 1, 2005, the company adopted the provisions of Statement of Financial Accounting Standards No. 123 (revised 2004), "Share-Based Payment" ("SFAS 123R"). Under the provisions of SFAS 123R, stock-based compensation is measured at the grant date, based on the calculated fair value of the award, and is recognized as an expense over the requisite employee service period (generally the vesting period of the grant). The company adopted SFAS 123R using the modified retrospective application method and, as a result, financial statement amounts for the prior periods presented have been adjusted to reflect the fair value method of expensing prescribed by SFAS 123R. The company believes that the modified retrospective application of this standard achieves the highest level of clarity and comparability among the presented periods.

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The following table shows total stock-based compensation expense and the tax benefit included in the Consolidated Statements of Income and the effect on basic and diluted earnings per share for the years ended August 31:

	2006	2005	2004
Selling, general and administrative	**$ 7,187**	$ 6,757	$ 6,495
Income tax benefit	**(2,266)**	(1,819)	(1,511)
Net stock-based compensation expense	**$ 4,921**	$ 4,938	$ 4,984
Impact on net income per share:			
Basic	**$ 0.06**	$ 0.05	$ 0.06
Diluted	**$ 0.06**	$ 0.05	$ 0.05

Many of the options granted by Sonic are incentive stock options, for which a tax benefit only results if the option holder has a disqualifying disposition. For grants of non-qualified stock options, the company expects to recognize a tax benefit on exercise of the option, so the full tax benefit is recognized on the related stock-based compensation expense. As a result of the limitation on the tax benefit for incentive stock options, the tax benefit for stock-based compensation will generally be less than the company's overall tax rate, and will vary depending on the timing of employees' exercises and sales of stock.

As a result of adopting SFAS 123R retrospectively, financial statements for the prior periods presented have been adjusted to reflect the fair value method of expensing stock options. The following table details the impact of retrospective application on previously reported results for the years ended August 31:

	2005		2004	
	Adjusted	As Previously Reported	Adjusted	As Previously Reported
Income Statement items:				
Income from operations	$ 117,449	$ 124,206	$ 99,619	$ 106,114
Income before income taxes	111,664	118,421	93,241	99,736
Net income	70,443	75,381	58,031	63,015
Net income per share - basic	$ 0.78	$ 0.84	$ 0.65	$ 0.71
Net income per share - diluted	0.75	0.80	0.63	0.68
Cash Flow items:				
Net cash provided by operating activities	$ 127,685	$ 132,280	$ 103,260	$ 106,658
Net cash used in financing activities	(51,297)	(55,892)	(61,755)	(65,153)
Balance Sheet items:				
Deferred income taxes	$ 7,786	$ 11,164		
Paid-in capital	153,776	121,982		
Retained earnings	397,989	426,783		
Total stockholders' equity	387,917	384,539		
Total liabilities and stockholders' equity	563,316	563,316		

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Income Taxes

Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date.

Income tax benefits credited to equity relate to tax benefits associated with amounts that are deductible for income tax purposes but do not affect earnings. These benefits are principally generated from employee exercises of non-qualified stock options and disqualifying dispositions of incentive stock options.

New Accounting Pronouncements

In May 2005, the FASB issued SFAS No. 154, "Accounting Changes and Error Corrections - a replacement of APB Opinion No. 20 and SFAS No. 3." SFAS No. 154 changes the requirements for the accounting for and reporting of a change in accounting principle and a change required by an accounting pronouncement when the pronouncement does not include specific transition provisions. SFAS No. 154 requires retrospective application of changes as if the new accounting principle had always been used. SFAS No. 154 is effective for fiscal years beginning after December 15, 2005, which is our fiscal year beginning September 1, 2006. The adoption of the pronouncement is not expected to have a material impact on the company's financial position or results of operations.

In June 2006, the EITF reached consensus on EITF 06-3, "Disclosure Requirements for Taxes Assessed by a Government Authority on Revenue-Producing Transactions." EITF 06-3 requires disclosure of a company's accounting policy with respect to presentation of taxes collected on a revenue producing transaction between a seller and a customer. For taxes that are reported on a gross basis (included in revenues and costs), EITF 06-3 also requires disclosure of the amount of taxes included in the financial statements. EITF 06-3 is effective for interim and annual reporting periods beginning after December 15, 2006, which will be our third fiscal quarter beginning March 1, 2007. The company does not expect the adoption of EITF 06-3 to have a material impact on the company's consolidated financial statements.

In June 2006, the FASB issued FIN 48, "Accounting for Uncertainty in Income Taxes - an interpretation of FASB Statement 109," which clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with FAS 109, "Accounting for Income Taxes." FIN 48 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 a tax return. FIN 48 is effective for fiscal years beginning after December 15, 2006, which will be our fiscal year beginning September 1, 2007. The company is currently evaluating the impact of adopting FIN 48.

On September 13, 2006, the Securities and Exchange Commission ("SEC") issued Staff Accounting Bulletin No. 108 ("SAB 108"), which provides interpretive guidance on how the effects of the carryover or reversal of prior year misstatements should be considered in quantifying a current year misstatement. SAB 108 is effective for the first fiscal year ending after November 15, 2006, which will be our fiscal year beginning September 1, 2007. The adoption of this statement is not expected to have a material impact on the company's financial position or results of operations.

Other accounting standards that have been issued or proposed by the FASB or other standards-setting bodies that do not require adoption until a future date are not expected to have a material impact on the consolidated financial statements upon adoption.

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2. Net Income Per Share

The following table sets forth the computation of basic and diluted earnings per share for the years ended August 31:

	2006	2005*	2004*
Numerator:			
Net income	**$ 78,705**	$ 70,443	$ 58,031
Denominator:			
Weighted average shares outstanding - basic	**86,260**	89,992	88,970
Effect of dilutive employee stock options	**2,979**	3,655	3,511
Weighted average shares - diluted	**89,239**	93,647	92,481
Net income per share - basic	**$ 0.91**	$ 0.78	$ 0.65
Net income per share - diluted	**$ 0.88**	$ 0.75	$ 0.63
Anti-dilutive employee stock options excluded	**1,378**	249	389

* Adjusted to include the impact of stock-based compensation expense and the three-for-two stock split in April 2006.

3. Impairment of Long-Lived Assets

During the fiscal years ended August 31, 2006, 2005 and 2004 the company identified impairments for certain drive-in assets and surplus property through regular quarterly reviews of long-lived assets. During fiscal year 2006, these analyses resulted in provisions for impairment totaling $264 to reduce the carrying amount of three surplus properties down to fair value. During fiscal year 2005, these analyses resulted in provisions for impairment totaling $387, including $286 to writedown the carrying amount of building and leasehold improvements on an underperforming drive-in, and $101 to reduce the carrying amount of a surplus property down to fair value. During fiscal year 2004, the regular quarterly reviews resulted in a provision of $675 to writedown the carrying amount of building and leasehold improvements for an underperforming drive-in.

4. Accounts and Notes Receivable

Accounts and notes receivable consist of the following at August 31, 2006 and 2005:

	2006	2005
Current Accounts and Notes Receivable:		
Royalties and other trade receivables	**$ 12,863**	$ 10,303
Notes receivable franchisees	**353**	104
Notes receivable from advertising funds	**3,681**	2,171
Other	**4,682**	6,446
	21,579	19,024
Less allowance for doubtful accounts and notes receivable	**308**	223
	$ 21,271	$ 18,801
Noncurrent Notes Receivable:		
Notes receivable franchisees	**$ 5,509**	$ 3,422
Less allowance for doubtful notes receivable	**327**	284
	$ 5,182	$ 3,138

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The company's receivables are primarily due from franchisees, all of whom are in the restaurant business. Substantially all of the notes receivable from franchisees are collateralized by real estate or equipment. The notes receivable from advertising funds represent transactions in the normal course of business. The company collects royalties from franchisees and provides for estimated losses for receivables that are not likely to be collected. General allowances for uncollectible receivables are estimated based on historical trends.

5. Goodwill, Trademarks, Trade Names and Other Intangibles

The gross carrying amount of franchise agreements, franchise fees and other intangibles subject to amortization was $5,245 and $749 at August 31, 2006 and 2005, respectively. Accumulated amortization related to these intangible assets was $543 and $359 at August 31, 2006 and 2005, respectively. The carrying amount of trademarks and trade names not subject to amortization was $6,044 at August 31, 2006 and 2005.

The changes in the carrying amount of goodwill for fiscal years ending August 31, 2006 and 2005 were as follows:

	2006	2005
Balance as of September 1,	**$ 88,471**	$ 87,420
Goodwill acquired during the year	**8,504**	468
Goodwill acquired (disposed of) related to the acquisitions and dispositions of minority interests in Partner Drive-Ins, net	**(26)**	733
Goodwill disposed of related to the sale of Partner Drive-Ins	**–**	(150)
Balance as of August 31,	**$ 96,949**	$ 88,471

6. Leases

Description of Leasing Arrangements

The company's leasing operations consist principally of leasing certain land, buildings and equipment (including signs) and subleasing certain buildings to franchise operators. The land and building portions of these leases are classified as operating leases and expire over the next 15 years. The equipment portions of these leases are classified principally as direct financing leases and expire principally over the next 10 years. These leases include provisions for contingent rentals that may be received on the basis of a percentage of sales in excess of stipulated amounts. Income is not recognized on contingent rentals until sales exceed the stipulated amounts. Some leases contain escalation clauses over the lives of the leases. Most of the leases contain one to four renewal options at the end of the initial term for periods of five years. The company classifies income from leasing operations as other revenue in the Consolidated Statements of Income.

Certain Partner Drive-Ins lease land and buildings from third parties. These leases, which expire over the next 18 years, include provisions for contingent rentals that may be paid on the basis of a percentage of sales in excess of stipulated amounts. For the majority of the leases, the land portions are classified as operating leases and the building portions are classified as capital leases.

Direct Financing Leases

Components of net investment in direct financing leases are as follows at August 31, 2006 and 2005:

	2006	2005
Minimum lease payments receivable	**$ 6,827**	$ 8,619
Less unearned income	**1,725**	2,412
Net investment in direct financing leases	**5,102**	6,207
Less amount due within one year	**1,287**	1,174
Amount due after one year	**$ 3,815**	$ 5,033

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Initial direct costs incurred in the negotiations and consummations of direct financing lease transactions have not been material. Accordingly, no portion of unearned income has been recognized to offset those costs.

Future minimum rental payments receivable as of August 31, 2006 are as follows:

	Operating	Direct Financing
Year ending August 31:		
2007	**$ 563**	**$ 1,920**
2008	**575**	**1,770**
2009	**571**	**1,284**
2010	**543**	**679**
2011	**543**	**442**
Thereafter	**2,960**	**732**
	5,755	**6,827**
Less unearned income	**–**	**1,725**
	$ 5,755	**$ 5,102**

Capital Leases

Components of obligations under capital leases are as follows at August 31, 2006 and 2005:

	2006	2005
Total minimum lease payments	**$ 54,437**	$ 58,960
Less amount representing interest averaging 8.0% in 2006 and 7.3% in 2005	**17,812**	20,435
Present value of net minimum lease payments	**36,625**	38,525
Less amount due within one year	**2,330**	2,266
Amount due after one year	**$ 34,295**	$ 36,259

Maturities of these obligations under capital leases and future minimum rental payments required under operating leases that have initial or remaining noncancelable lease terms in excess of one year as of August 31, 2006 are as follows:

	Operating	Capital
Year ending August 31:		
2007	**$ 10,513**	**$ 4,891**
2008	**10,431**	**4,767**
2009	**10,361**	**4,830**
2010	**10,210**	**4,853**
2011	**9,977**	**4,654**
Thereafter	**117,215**	**30,442**
	168,707	**54,437**
Less amount representing interest	**–**	**17,812**
	$168,707	**$ 36,625**

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Total rent expense for all operating leases and capital leases consists of the following for the years ended August 31:

	2006	2005	2004
Operating leases:			
Minimum rentals	**$ 12,731**	$ 11,355	$ 9,292
Contingent rentals	**199**	289	254
Sublease rentals	**(542)**	(536)	(596)
Capital leases:			
Contingent rentals	**1,123**	1,109	789
	$ 13,511	$ 12,217	$ 9,739

The aggregate future minimum rentals receivable under noncancelable subleases of operating leases as of August 31, 2006 was $2,767.

7. Property, Equipment and Capital Leases

Property, equipment and capital leases consist of the following at August 31, 2006 and 2005:

	Estimated Useful Life	2006	2005
Property and equipment:			
Home office:			
Leasehold improvements	Life of lease	**$ 3,066**	$ 3,046
Computer and other equipment	2 - 5 yrs	**28,842**	26,338
Drive-ins, including those leased to others:			
Land		**154,092**	134,695
Buildings	8 - 25 yrs	**275,924**	231,931
Equipment	5 - 7 yrs	**168,019**	146,116
Property and equipment, at cost		**629,943**	542,126
Less accumulated depreciation		**185,275**	154,269
Property and equipment, net		**444,668**	387,857
Capital Leases:			
Leased home office building	Life of lease	**9,321**	9,321
Leased drive-in buildings, equipment and other assets under capital leases, including those held for sublease	Life of lease	**35,844**	36,111
Less accumulated amortization		**12,779**	10,464
Capital leases, net		**32,386**	34,968
Property, equipment and capital leases, net		**$477,054**	$ 422,825

Land, buildings and equipment with a carrying amount of $33,836 at August 31, 2006 were leased under operating leases to franchisees or other parties. The accumulated depreciation related to these buildings and equipment was $7,507 at August 31, 2006. As of August 31, 2006, the company had drive-ins under construction with costs to complete which aggregated $3,430.

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8. Accrued Liabilities

Accrued liabilities consist of the following at August 31, 2006 and 2005:

	2006	2005
Wages and other employee benefits	**$ 9,707**	$ 6,153
Taxes, other than income taxes	**13,476**	12,618
Accrued interest	**389**	305
Minority interest in consolidated drive-ins	**2,610**	1,904
Other	**7,692**	5,387
	$ 33,874	$ 26,367

9. Long-Term Debt

Long-term debt consists of the following at August 31, 2006 and 2005:

	2006	2005
Borrowings under line of credit [A]	**$101,150**	$ 30,150
Senior unsecured notes [B]	**19,857**	24,428
Other	**1,392**	5,617
	122,399	60,195
Less long-term debt due within one year [C]	**5,227**	4,261
Long-term debt due after one year	**$117,172**	$ 55,934

(A) At August 31, 2006 the company had an agreement with a group of banks that provided for a $150,000 line of credit, including a $2,000 sub-limit for letters of credit, expiring in July 2010. In addition to the $101,150 borrowed under the line of credit as of August 31, 2006, there were $676 in letters of credit outstanding. The company's effective borrowing rate under this line of credit as of August 31, 2006 and 2005 was 6.1% and 5.1%, respectively. Subsequent to year-end, Sonic signed a credit agreement with a group of banks which provides for a $100,000 five-year revolving credit facility and a $486,000 seven-year term loan facility. The new facility was used to refinance the existing line of credit in September 2006. See Note 18 for additional information about the new credit agreement.

(B) At August 31, 2006 the company had $19,857 of senior unsecured notes with $2,000 of Series A notes maturing in August 2008 and $17,857 of Series B notes maturing in August 2011 with interest payable semi-annually at 6.58% for the Series A notes and 6.87% for the Series B notes. The related agreements required, among other things, the company to maintain equity of a specified amount, and maintain ratios of debt to equity and fixed charge coverage. Subsequent to year-end, Sonic utilized funds available from the new credit agreement to pay the remaining balance of the senior unsecured notes, incurring early payment penalties of approximately $794.

(C) As a result of the subsequent repayment of the line of credit and senior secured notes, the amount of long-term debt due within one year is reflective of the maturities of the new credit agreement, along with maturities of the other notes that were not repaid subsequent to year-end.

In February 2006, the company entered into an interest rate swap agreement to modify a portion of the variable rate line of credit to a fixed rate obligation, thereby reducing the exposure to market rate fluctuations. The interest rate swap agreement has been designated as a cash flow hedge, and effectiveness is determined by matching the principal balance and terms with that specific obligation. The effective portions of changes in fair value are recognized in accumulated other comprehensive income in the accompanying Consolidated Balance Sheets. Ineffective portions of changes in fair value are recognized as a charge or credit to earnings. Under the terms of the interest rate swap agreement, the company makes payments based on a fixed rate of 5.66% and receives interest payments based on 3-

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month LIBOR on a notional amount of $60,000. The differences to be paid or received under the interest rate swap agreement are recognized as an adjustment to interest expense. By its terms, the agreement would expire in May 2010 and settle quarterly, however, as a result of the repayment of the line of credit that was being hedged by this instrument, this derivative was terminated subsequent to August 31, 2006 resulting in an immaterial gain that will be reflected immediately in income in the first quarter of fiscal year 2007.

In August 2006, the company entered into a forward starting swap agreement with the same financial institution to hedge part of the exposure associated with the new debt related to the tender offer that is further discussed in Note 18. The forward starting swap has been designated as a cash flow hedge, and is expected to be settled at the time the debt refinancing is completed to provide us with an effective interest rate of 5.16% plus 90 to 110 basis points for $400 million of the amount financed. The effectiveness of the instrument will be assessed quarterly and at the time the financing closes and any ineffectiveness will be recorded as a charge or credit to earnings. As of August 31, 2006, there was no hedge ineffectiveness.

The following table presents the components of comprehensive income for the year ended August 31, 2006:

Net Income	**$ 78,705**
Unrealized gains on interest rate swap agreement, net of tax	**(484)**
Total comprehensive income	**$ 78,221**

Maturities of long-term debt, reflecting the impact of the debt refinancing further described in Note 18, for each of the five years after August 31, 2006 are $5,227 in 2007, $6,924 in 2008, $6,936 in 2009, $6,937 in 2010, $6,914 in 2011, and $89,461 thereafter.

10. Other Noncurrent Liabilities

Other noncurrent liabilities consist of the following at August 31, 2006 and 2005:

	2006	2005
Minority interest in consolidated drive-ins	**$ 4,566**	$ 4,182
Deferred area development fees	**2,385**	2,331
Other	**5,553**	3,565
	$ 12,504	$ 10,078

11. Income Taxes

The company's income before the provision for income taxes is classified by source as domestic income.

The components of the provision for income taxes consist of the following for the years ended August 31:

	2006	2005	2004
Current:			
Federal	**$ 42,629**	$ 37,572	$ 30,388
State	**4,163**	3,269	2,185
	46,792	40,841	32,573
Deferred:			
Federal	**(1,127)**	284	2,242
State	**(321)**	96	395
	(1,448)	380	2,637
Provision for income taxes	**$ 45,344**	$ 41,221	$ 35,210

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The provision for income taxes differs from the amount computed by applying the statutory federal income tax rate due to the following for the years ended August 31:

	2006	2005	2004
Amount computed by applying a tax rate of 35%	**$ 43,417**	$ 39,083	$ 32,634
State income taxes (net of federal income tax benefit)	**2,767**	2,481	1,678
Employment related and other tax credits, net	**(1,014)**	(1,092)	(337)
Other	**174**	749	1,235
Provision for income taxes	**$ 45,344**	$ 41,221	$ 35,210

Deferred tax assets and liabilities consist of the following at August 31, 2006 and 2005:

	2006	2005
Current deferred tax assets (liabilities):		
Allowance for doubtful accounts and notes receivable	**$ 83**	$ 83
Property, equipment and capital leases	**272**	194
Accrued litigation costs	**76**	76
Deferred income from franchisees	**(327)**	–
Deferred income from affiliated technology fund	**203**	468
Current deferred tax assets, net	**$ 307**	$ 821
Noncurrent deferred tax assets (liabilities):		
Net investment in direct financing leases including differences related to capitalization and amortization	**$ (2,390)**	$ (2,649)
Investment in partnerships, including differences in capitalization and depreciation related to direct financing leases and different year ends for financial and tax reporting purposes	**(8,764)**	(10,587)
Capital loss carryover	**–**	1,313
State net operating losses	**4,247**	3,939
Property, equipment and capital leases	**(1,150)**	(2,104)
Allowance for doubtful accounts and notes receivable	**160**	111
Deferred income from affiliated franchise fees	**1,830**	1,559
Accrued liabilities	**296**	1,125
Intangibles and other assets	**407**	93
Deferred income from franchisees	**877**	–
Stock compensation	**4,420**	3,378
Other	**55**	(25)
	(12)	(3,847)
Valuation allowance	**(4,247)**	(3,939)
Noncurrent deferred tax liabilities, net	**$ (4,259)**	$ (7,786)
Deferred tax assets and (liabilities):		
Deferred tax assets (net of valuation allowance)	**$ 8,679**	$ 8,400
Deferred tax liabilities	**(12,631)**	(15,365)
Net deferred tax liabilities	**$ (3,952)**	$ (6,965)

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State net operating loss carryforwards expire generally beginning in 2010. Management does not believe the company will be able to realize the state net operating loss carryforwards and therefore has provided a valuation allowance as of August 31, 2006 and 2005.

12. Stockholders' Equity

On April 30, 2004, the company's board of directors authorized a three-for-two stock split in the form of a stock dividend. A total of 24,845 shares of common stock were issued on May 21, 2004 in connection with the split, and an aggregate amount equal to the par value of the common stock issued of $248 was reclassified from paid-in capital to common stock.

On April 6, 2006, the company's board of directors authorized a three-for-two stock split in the form of a stock dividend. A total of 38,219 shares of common stock were issued in connection with the split, and an aggregate amount equal to the par value of the common stock issued of $382 was reclassified from paid-in capital to common stock.

All references in the accompanying consolidated financial statements to weighted average numbers of shares outstanding, per share amounts and Stock Purchase Plan and Stock Options share data have been adjusted to reflect the stock splits on a retroactive basis.

Stock Purchase Plan

The company has an employee stock purchase plan for all full-time regular employees. Employees are eligible to purchase shares of common stock each year through a payroll deduction not in excess of the lesser of 10% of compensation or $25. The aggregate amount of stock that employees may purchase under this plan is limited to 759,375 shares. The purchase price will be between 85% and 100% of the stock's fair market value and will be determined by the company's board of directors.

Stock-Based Compensation

Under the provisions of SFAS 123R, stock-based compensation is measured at the grant date, based on the calculated fair value of the award, and is recognized as an expense over the requisite employee service period (generally the vesting period of the grant). The company adopted SFAS 123R effective September 1, 2005, using the modified retrospective application method and, as a result, financial statement amounts for the prior periods presented have been adjusted to reflect the fair value method of expensing prescribed by SFAS 123R.

At Sonic's annual meeting of stockholders on January 31, 2006, the stockholders approved the Sonic Corp. 2006 Long-Term Incentive Plan and the authorization of 6,750 shares for awards to employees and non-employee directors. This omnibus plan provides flexibility to award various forms of equity compensation, such as stock options, stock appreciation rights, performance shares, restricted stock and other stock-based awards. Prior to approval of this plan, the company had two share-based compensation plans for employees and non-employee directors, which authorized the granting of stock options. No further awards will be granted under the previous plans now that the 2006 Long-Term Incentive Plan has been approved. The number of shares authorized for issuance under the company's existing plans as of August 31, 2006 totals 6,051, all of which were available for future issuance. Stock options historically granted under the company's plans have been granted with an exercise price equal to the market price of the company's stock at the date of grant, a contractual term of 10 years, and generally a vesting period of three years. The most recent options granted in April and August 2006 have a contractual term of seven years. The company's policy is to recognize compensation cost for these options on a straight-line basis over the requisite service period for the entire award. Additionally, the company's policy is to issue new shares of common stock to satisfy stock option exercises.

The company measures the compensation cost associated with share-based payments by estimating the fair value of stock options as of the grant date using the Black-Scholes option pricing model. The company believes that the valuation technique and the approach utilized to develop the underlying assumptions are appropriate in calculating the fair values of the company's stock options granted during 2006, 2005 and 2004. Estimates of fair value are not intended to predict actual future events or the value ultimately realized by the employees who receive equity awards.

The per share weighted average fair value of stock options granted during 2006, 2005 and 2004 was $7.90, $8.94 and $6.89, respectively. In addition to the exercise and grant date prices of the awards, certain weighted average

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assumptions that were used to estimate the fair value of stock option grants in the respective periods are listed in the table below:

	2006	2005	2004
Expected term (years)	**4.5**	5.1	5.8
Expected volatility	**34%**	41%	46%
Risk-free interest rate	**4.7%**	4.0%	3.8%
Expected dividend yield	**0%**	0%	0%

The company estimates expected volatility based on historical daily price changes of the company's common stock for a period equal to the current expected term of the options. The risk-free interest rate is based on the United States treasury yields in effect at the time of grant corresponding with the expected term of the options. The expected option term is the number of years the company estimates that options will be outstanding prior to exercise considering vesting schedules and our historical exercise patterns. The estimate of expected term for options granted in April 2006 was adjusted to consider the reduced contractual term from 10 years to 7 years, resulting in a lower expected term.

SFAS 123R requires the cash flows resulting from the tax benefits for tax deductions in excess of the compensation expense recorded for those options (excess tax benefits) to be classified as financing cash flows. These excess tax benefits were $4,645 for the year ended August 31, 2006 and are classified as a financing cash inflow in the company's Consolidated Statements of Cash Flows.

A summary of stock option activity under the company's share-based compensation plans for the year ended August 31, 2006 is presented in the following table:

	Options	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life (Yrs.)	Aggregate Intrinsic Value
Outstanding-beginning of year	**7,826**	**$ 9.91**		
Granted	**965**	**22.08**		
Exercised	**(1,339)**	**5.97**		
Forfeited or expired	**(221)**	**19.13**		
Outstanding August 31, 2006	**7,230**	**$ 11.98**	**5.42**	**$ 72,656**
Exercisable August 31, 2006	**5,415**	**$ 9.10**	**4.64**	**$ 69,445**

The total intrinsic value of options exercised during the years ended August 31, 2006, 2005 and 2004 was $19,567, $20,923 and $12,617, respectively. At August 31, 2006, total remaining unrecognized compensation cost related to unvested stock-based arrangements was $12,441 and is expected to be recognized over a weighted average period of 1.6 years.

Stockholder Rights Plan

The company has a stockholder rights plan which is designed to deter coercive takeover tactics and to prevent a potential acquirer from gaining control of the company without offering a fair price to all of the company's stockholders.

The plan provided for the issuance of one common stock purchase right for each outstanding share of the company's common stock. Each right initially entitles stockholders to buy one unit of a share of preferred stock for $85. The rights will be exercisable only if a person or group acquires beneficial ownership of 15% or more of the company's common stock or commences a tender or exchange offer upon consummation of which such person or group would beneficially own 15% or more of the company's common stock. At August 31, 2006, 1,000 shares of preferred stock have been reserved for issuance upon exercise of these rights.

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If any person becomes the beneficial owner of 15% or more of the company's common stock, other than pursuant to a tender or exchange offer for all outstanding shares of the company approved by a majority of the independent directors not affiliated with a 15%-or-more stockholder, then each right not owned by a 15%-or-more stockholder or related parties will then entitle its holder to purchase, at the right's then current exercise price, shares of the company's common stock having a value of twice the right's then current exercise price. In addition, if, after any person has become a 15%-or-more stockholder, the company is involved in a merger or other business combination transaction with another person in which the company does not survive or in which its common stock is changed or exchanged, or sells 50% or more of its assets or earning power to another person, each right will entitle its holder to purchase, at the right's then current exercise price, shares of common stock of such other person having a value of twice the right's then current exercise price. Unless a triggering event occurs, the rights will not trade separately from the common stock.

The company will generally be entitled to redeem the rights at $0.01 per right at any time until 10 days (subject to extension) following a public announcement that a 15% position has been acquired. The rights expire on June 16, 2007.

Stock Repurchase Program

The company has a stock repurchase program that is authorized by the Board of Directors. On April 7, 2006, the Board of Directors approved an increase in the company's share repurchase program from $34.6 million to $110.0 million and extended the program through August 31, 2007. Pursuant to this program, the company acquired 4,787 shares at an average price of $19.57 for a total cost of $93,682 during fiscal year 2006. As of August 31, 2006, the company had $89,413 available under the program.

13. Net Revenue Incentive Plan

The company has a Net Revenue Incentive Plan (the "Incentive Plan"), as amended, which applies to certain members of management and is at all times discretionary with the company's board of directors. If certain predetermined earnings goals are met, the Incentive Plan provides that a predetermined percentage of the employee's salary may be paid in the form of a bonus. The company recognized as expense incentive bonuses of $3,247, $2,997, and $3,070 during fiscal years 2006, 2005 and 2004, respectively.

14. Employment Agreements

The company has employment contracts with its Chairman and Chief Executive Officer and several members of its senior management. These contracts provide for use of company automobiles or related allowances, medical, life and disability insurance, annual base salaries, as well as an incentive bonus. These contracts also contain provisions for payments in the event of the termination of employment and provide for payments aggregating $8,608 at August 31, 2006 due to loss of employment in the event of a change in control (as defined in the contracts).

15. Contingencies

The company is involved in various legal proceedings and has certain unresolved claims pending. Based on the information currently available, management believes that all claims currently pending are either covered by insurance or would not have a material adverse effect on the company's business or financial condition.

The company has an agreement with GE Capital Franchise Finance Corporation ("GEC"), pursuant to which GEC made loans to existing Sonic franchisees who met certain underwriting criteria set by GEC. Under the terms of the agreement with GEC, the company provided a guarantee of 10% of the outstanding balance of loans from GEC to the Sonic franchisees, limited to a maximum amount of $5,000. As of August 31, 2006, the total amount guaranteed under the GEC agreement was $2,749. The company ceased guaranteeing new loans under the program during fiscal year 2002 and has not been required to make any payments under its agreement with GEC. Existing loans under guarantee will expire through 2012. In the event of default by a franchisee, the company has the option to fulfill the franchisee's obligations under the note or to become the note holder, which would provide an avenue of recourse with the franchisee under the notes.

The company has obligations under various lease agreements with third-party lessors related to the real estate for Partner Drive-Ins that were sold to franchisees. Under these agreements, the company remains secondarily liable

for the lease payments for which it was responsible as the original lessee. As of August 31, 2006, the amount remaining under the guaranteed lease obligations totaled $3,934.

Effective November 30, 2005, the company extended a note purchase agreement to a bank that serves to guarantee the repayment of a franchisee loan and also benefits the franchisee with a lower financing rate. In the event of default by the franchisee, the company would purchase the franchisee loan from the bank, thereby becoming the note holder and providing an avenue of recourse with the franchisee. As of August 31, 2006, the balance of the loan was $2,631.

The company has not recorded a liability for its obligations under the guarantees, other than an immaterial amount related to the fair value of the guarantee associated with the note purchase agreement, and has not been required to make any payments under any of these guarantees.

16. Selected Quarterly Financial Data (Unaudited)

	First Quarter		Second Quarter		Third Quarter		Fourth Quarter		Full Year	
	2006	2005*	**2006**	2005*	**2006**	2005*	**2006**	2005*	**2006**	2005*
Income statement data:										
Partner Drive-In sales	**$ 135,422**	$120,211	**$ 126,376**	$112,655	**$ 156,921**	$ 141,797	**$167,113**	$ 151,325	**$585,832**	$ 525,988
Other	**24,378**	22,016	**22,572**	19,958	**29,548**	25,856	**30,932**	29,248	**107,430**	97,078
Total revenues	**159,800**	142,227	**148,948**	132,613	**186,469**	167,653	**198,045**	180,573	**693,262**	623,066
Partner Drive-In operating expenses	**110,125**	97,784	**102,615**	91,682	**123,755**	111,691	**132,132**	120,749	**468,627**	421,906
Selling, general and administrative	**12,196**	10,833	**13,214**	11,785	**13,293**	12,096	**13,345**	12,789	**52,048**	47,503
Other	**9,897**	8,406	**9,997**	9,257	**10,361**	9,051	**10,705**	9,494	**40,960**	36,208
Total expenses	**132,218**	117,023	**125,826**	112,724	**147,409**	132,838	**156,182**	143,032	**561,635**	505,617
Income from operations	**27,582**	25,204	**23,122**	19,889	**39,060**	34,815	**41,863**	37,541	**131,627**	117,449
Interest expense, net	**1,307**	1,605	**2,096**	1,532	**2,215**	1,292	**1,960**	1,356	**7,578**	5,785
Income before income taxes	**26,275**	23,599	**21,026**	18,357	**36,845**	33,523	**39,903**	36,185	**124,049**	111,664
Provision for income taxes	**9,845**	8,485	**8,122**	7,084	**13,011**	12,248	**14,366**	13,404	**45,344**	41,221
Net income	**$ 16,430**	$ 15,114	**$ 12,904**	$ 11,273	**$ 23,834**	$ 21,275	**$ 25,537**	$ 22,781	**$ 78,705**	$ 70,443
Net income per share:										
Basic	**$ 0.19**	$ 0.17	**$ 0.15**	$ 0.12	**$ 0.28**	$ 0.24	**$ 0.30**	$ 0.26	**$ 0.91**	$ 0.78
Diluted	**$ 0.18**	$ 0.16	**$ 0.14**	$ 0.12	**$ 0.27**	$ 0.23	**$ 0.29**	$ 0.25	**$ 0.88**	$ 0.75
Weighted average shares outstanding:										
Basic	**87,415**	90,015	**86,227**	90,394	**85,993**	90,296	**85,405**	89,264	**86,260**	89,992
Diluted	**90,521**	93,578	**89,261**	94,182	**89,007**	94,074	**88,168**	92,755	**89,239**	93,647

* Prior years adjusted to include the impact of stock-based compensation expense and the three-for-two stock split in April 2006; see Note 1 and Note 12 for additional information.

17. Fair Values of Financial Instruments

The following discussion of fair values is not indicative of the overall fair value of the company's consolidated balance sheet since the provisions of SFAS No. 107, "Disclosures About Fair Value of Financial Instruments," do not apply to all assets, including intangibles.

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The following methods and assumptions were used by the company in estimating its fair values of financial instruments:

Cash and cash equivalents – Carrying value approximates fair value due to the short duration to maturity.

Notes receivable – For variable rate loans with no significant change in credit risk since the loan origination, fair values approximate carrying amounts. Fair values for fixed-rate loans are estimated using discounted cash flow analysis, using interest rates that would currently be offered for loans with similar terms to borrowers of similar credit quality and/or the same remaining maturities.

As of August 31, 2006 and 2005, carrying values approximate their estimated fair values.

Borrowed funds – Fair values for fixed rate borrowings are estimated using a discounted cash flow analysis that applies interest rates currently being offered on borrowings of similar amounts and terms to those currently outstanding. Carrying values for variable-rate borrowings approximate their fair values.

The carrying amounts, including accrued interest, and estimated fair values of the company's fixed-rate borrowings at August 31, 2006 were $19,857 and $19,925, respectively, and at August 31, 2005 were $24,526 and $25,123, respectively.

18. Subsequent Events

On August 15, 2006, we commenced a "modified Dutch auction" tender offer, initially offering to purchase 25,455 shares of our common stock at a price not less than $19.50 and not greater than $22.00 per share, for a maximum aggregate purchase price of $560 million. On September 25, 2006, we decreased the number of shares sought in the tender offer to 24,348, and increased the purchase price to not less than $19.50 and not greater than $23.00 per share. On October 13, 2006, we repurchased 15,918 shares of our common stock that were properly tendered and not withdrawn, at a purchase price of $23.00 per share for a total purchase price of $366,117.

We funded the repurchase of the shares of our common stock with the proceeds from new senior secured credit facilities with a syndicate of financial institutions led by Banc of America Securities LLC and Lehman Brothers Inc. The new senior secured credit facilities consist of a $100,000, five-year revolving credit facility and a $486,000, seven-year term loan facility. As of October 13, 2006, we had borrowed $486,000 under the term loan facility and no advances were outstanding under the revolving credit facility, to fund the purchase of the shares in the tender offer, as well as refinance certain of our existing indebtedness and pay related fees and expenses.

Interest on loans under the new senior secured credit facility will be payable at per annum rates equal to (1) in the case of the revolving credit facility, initially, LIBOR plus 175 basis points and adjusting over time based upon Sonic's leverage ratio and (2) in the case of the term loan facility, initially, LIBOR plus 200 basis points and adjusting over time based upon Sonic's credit ratings with Moody's Investors Service Inc.

We will pay a commitment fee on the unused portion of the revolving credit facility, starting at 0.375% and adjusting over time based upon our leverage ratio. Our ability to reserve funds from the revolving credit facility is conditioned upon various customary representations and warranties being true at the time of the borrowing, and upon no event of default existing or resulting from the receipt of such finds. We and all of our domestic subsidiaries have granted the lenders under the new senior secured credit facility valid and perfected first priority (subject to certain exceptions) liens and security interests in (1) all present and future shares of capital stock (or other ownership profit interests) in each of our present and future subsidiaries (subject to certain limitations), (2) all present and future property and assets, real and personal and (3) all proceeds and products of the property and assets described in clauses (1) and (2).

The credit agreement governing the new senior secured credit facilities contains certain affirmative covenants, certain negative covenants, certain financial covenants, certain conditions and events of default that are customarily required for similar financings. Such negative covenants include limitations on liens, consolidations and mergers, indebtedness, capital expenditures, asset dispositions, sale-leaseback transactions, stock repurchases, transactions with affiliates and other restrictions and limitations. Furthermore, the credit agreement requires us to maintain compliance with certain financial covenants such as a leverage ratio and fixed charge coverage ratio. Although management does not anticipate an event of default, if such an event occurred, the unpaid amounts outstanding could become immediately due and payable.