KISSNER CHARLES
Form 4
November 15, 2010

FORM 4

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

Check this box if no longer subject to Section 16. Form 4 or Form 5 obligations may continue. *See* Instruction 1(b).

STATEMENT OF CHANGES IN BENEFICIAL OWNERSHIP OF SECURITIES

Filed pursuant to Section 16(a) of the Securities Exchange Act of 1934, Section 17(a) of the Public Utility Holding Company Act of 1935 or Section 30(h) of the Investment Company Act of 1940

OMB APPROVAL
OMB Number: 3235-0287
Expires: January 31, 2005
Estimated average burden hours per response... 0.5

(Print or Type Responses)

1. Name and Address of Reporting Person *
KISSNER CHARLES

(Last) (First) (Middle)

5200 GREAT AMERICA PARKWAY

(Street)

SANTA CLARA, CA 95054

(City) (State) (Zip)

2. Issuer Name **and** Ticker or Trading Symbol
AVIAT NETWORKS, INC. [AVNW]

3. Date of Earliest Transaction (Month/Day/Year)
11/11/2010

4. If Amendment, Date Original Filed(Month/Day/Year)

5. Relationship of Reporting Person(s) to Issuer

(Check all applicable)

__X__ Director _____ 10% Owner
__X__ Officer (give title below) _____ Other (specify below)
Chairman and CEO

6. Individual or Joint/Group Filing(Check Applicable Line)
_X_ Form filed by One Reporting Person
___ Form filed by More than One Reporting Person

Table I - Non-Derivative Securities Acquired, Disposed of, or Beneficially Owned

1.Title of Security (Instr. 3)	2. Transaction Date (Month/Day/Year)	2A. Deemed Execution Date, if any (Month/Day/Year)	3. Transaction Code (Instr. 8)		4. Securities Acquired (A) or Disposed of (D) (Instr. 3, 4 and 5)			5. Amount of Securities Beneficially Owned Following Reported Transaction(s) (Instr. 3 and 4)	6. Ownership Form: Direct (D) or Indirect (I) (Instr. 4)	7. Nature of Indirect Beneficial Ownership (Instr. 4)
			Code	V	Amount	(A) or (D)	Price			
Common Stock	11/11/2010		A		67,500 (1)	A	$ 0	162,376	D	
Common Stock	11/11/2010		A		67,500 (2)	A	$ 0	229,876	D	

Reminder: Report on a separate line for each class of securities beneficially owned directly or indirectly.

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SEC 1474 (9-02)

Table II - Derivative Securities Acquired, Disposed of, or Beneficially Owned
(*e.g.*, puts, calls, warrants, options, convertible securities)

1. Title of Derivative Security (Instr. 3)	2. Conversion or Exercise Price of Derivative Security	3. Transaction Date (Month/Day/Year)	3A. Deemed Execution Date, if any (Month/Day/Year)	4. Transaction Code (Instr. 8)		5. Number of Derivative Securities Acquired (A) or Disposed of (D) (Instr. 3, 4, and 5)		6. Date Exercisable and Expiration Date (Month/Day/Year)		7. Title and Amou Underlying Secur (Instr. 3 and 4)	
				Code	V	(A)	(D)	Date Exercisable	Expiration Date	Title	Am Nu Sha
Non-Qualified Stock Option (right to buy)	$ 4.36	11/11/2010		A		135,000		(3)	11/11/2017	Common Stock	13

Reporting Owners

Reporting Owner Name / Address	Relationships			
	Director	10% Owner	Officer	Other
KISSNER CHARLES 5200 GREAT AMERICA PARKWAY SANTA CLARA, CA 95054	X		Chairman and CEO	

Signatures

/s/ Meena Elliott, VP, General Counsel and Secretary, on behalf of Charles Kissner	11/15/2010
**Signature of Reporting Person	Date

Explanation of Responses:

* If the form is filed by more than one reporting person, *see* Instruction 4(b)(v).

** Intentional misstatements or omissions of facts constitute Federal Criminal Violations. *See* 18 U.S.C. 1001 and 15 U.S.C. 78ff(a).

(1) Performance shares, which are subject to vesting. Vesting requires both (a) continuing employment with the Corporation through the end of the Corporation's fiscal year 2013 (approximately June 30, 2013), and (b) achievement of at least the minimum cumulative performance result for the three-year period set forth in the Specific Terms and Conditions. Unvested performance shares are subject to repurchase by the Corporation at $0.01 per share if eligible employment ends or, following the determination of actual Corporation performance versus metrics, to the extent such performance shares do not vest.

(2) Restricted shares, which are subject to vesting. Vesting requires continuing employment with the Corporation as of the vesting dates. Restricted shares will vest as follows: 33.3% on November 11, 2011, 33.3% on November 11, 2012 and 33.3% on November 11, 2013. Unvested shares are subject to repurchase by the Corporation at $0.01 per share if eligible employment ends before the vesting date.

(3) Stock options to purchase shares become exercisable if employment with the Corporation continues through the vesting dates. The options will vest as follows: 50% on November 11, 2011, 25% on November 11, 2012 and 25% on November 11, 2013.

Note: File three copies of this Form, one of which must be manually signed. If space is insufficient, *see* Instruction 6 for procedure.
Potential persons who are to respond to the collection of information contained in this form are not required to respond unless the form displays a currently valid OMB number.

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250,343

Total equity (deficit)

124,236

130,213

156,325

Explanation of Responses:

153,273

(168,728

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(1) The fiscal year ended December 30, 2012 included a $16.9 million tax benefit related to the release of a valuation allowance against substantially all of our deferred tax assets. The fiscal year ended December 29, 2013 included a $0.6 million benefit related to increasing the federal statutory rate to measure our deferred tax assets.
(2) Non-controlling interests represent a non-controlling partner's share of the assets, liabilities and operations related to five joint venture investments. We have ownership interests ranging from 51-80% in these consolidated joint ventures.
(3) Net income (loss) per common share attributable to common stockholders is calculated using the weighted average number of common shares outstanding for the period. For fiscal year ending December 30, 2012, net income (loss) per common share attributable to common stockholders was calculated under the two-class method as our redeemable convertible preferred stock participated in the undistributed earnings of the company. Earnings of the company were allocated between the common and preferred stockholders to account for the accretion of the redeemable convertible preferred stock to its maximum redemption value, thereby reducing the earnings of the company attributable to common stockholders. Upon completion of the initial public offering on October 9, 2013, the redeemable convertible preferred stock was automatically converted to common stock.
(4) Income from operations as a percentage of total revenues.
(5) Shop-level profit is not required by, or presented in accordance with, GAAP, and is defined as income (loss) from operations less franchise royalties and fees, general and administrative expenses, depreciation expense, pre-opening costs and impairment and loss on disposal of property and equipment. Shop-level profit is a supplemental measure of operating performance of our shops and our calculation thereof may not be comparable to that reported by other companies. Shop-level profit margin represents shop-level profit expressed as a percentage of net company-operated sandwich shop sales. Shop-level profit and shop-level profit margin have limitations as analytical tools, and you should not consider them in isolation or as a substitute for analysis of our results as reported under GAAP. Management believes shop-level profit margin is an important tool for investors because it is a widely used metric within the restaurant industry to evaluate restaurant-level productivity, efficiency and performance. Management uses shop-level profit margin as a key metric to evaluate the profitability of incremental sales at our shops, to evaluate our shop performance across periods and to evaluate our shop financial performance compared with our

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competitors. See "Management's Discussion and Analysis of Financial Condition and Results of Operations" in Item 7 for a discussion of shop-level profit margin and other key performance indicators. A reconciliation of shop-level profit to income (loss) from operations and a calculation of shop-level profit margin is provided below:

	Fiscal Year Ended December 25, 2016	December 27, 2015	December 28, 2014	December 29, 2013	December 30, 2012
	($ in thousands)				
Income from operations	$13,013	$9,429	$7,271	$1,475	$8,565
Less: Franchise royalties and fees	2,257	1,895	1,515	1,138	844
General and administrative expenses	40,411	37,322	32,420	39,656	29,624
Depreciation expense	22,734	21,476	19,615	17,875	16,219
Pre-opening costs	1,786	2,160	1,634	1,437	2,051
Impairment and loss on disposal of property and equipment	4,141	3,589	3,128	1,135	994
Shop-level profit [Y]	$79,828	$72,081	$62,553	$60,440	$56,609
Total revenues	$407,131	$372,849	$326,979	$299,712	$274,914
Less: Franchise royalties and fees	2,257	1,895	1,515	1,138	844
Sandwich shop sales, net [X]	$404,874	$370,954	$325,464	$298,574	$274,070
Shop-level profit margin [Y÷X]	19.7 %	19.4 %	19.2 %	20.2 %	20.7 %

(6) Adjusted EBITDA is a supplemental measure of financial performance that is not required by, or presented in accordance with, GAAP. We define adjusted EBITDA as net income (loss) before depreciation and amortization expense, interest expense, provision for income taxes and pre-opening costs, adjusted to eliminate the impact of other items set forth in the reconciliation below, including certain non-cash as well as certain other items that we do not consider representative of our ongoing operating performance. Adjusted EBITDA margin is calculated by dividing adjusted EBITDA by total revenues. Adjusted EBITDA has limitations as an analytical tool and our calculation thereof may not be comparable to that reported by other companies; accordingly, you should not consider it in isolation or as a substitute for analysis of our results as reported under GAAP. Adjusted EBITDA is included in this Annual Report because it is a key metric used by management. Additionally, adjusted EBITDA is frequently used by analysts, investors and other interested parties to evaluate companies in our industry. We use adjusted EBITDA, alongside GAAP measures such as operating income (loss) and net income (loss), to measure profitability, as a key profitability target in our annual and other budgets, and to compare our performance against that of peer companies. We believe that adjusted EBITDA provides useful information facilitating operating performance comparisons from period to period and company to company. A reconciliation of adjusted EBITDA to net income attributable to Potbelly Corporation is provided below:

	Fiscal Year Ended December 25, 2016	December 27, 2015	December 28, 2014	December 29, 2013	December 30, 2012
	($ in thousands)				
Net income attributable to Potbelly Corporation	$8,212	$5,628	$4,358	$1,258	$24,046
Depreciation expense	22,734	21,476	19,615	17,875	16,219

Interest expense, net	134	221	179	387	541
Income tax expense (benefit)	4,443	3,466	2,748	(204)	(15,994)
EBITDA	$35,523	$ 30,791	$ 26,900	$ 19,316	$24,812
Impairment and closures (a)	4,265	4,006	3,885	1,132	1,181
Pre-opening costs (b)	1,786	2,160	1,634	1,437	2,051
Stock-based compensation (c)	3,057	2,399	2,542	11,610	2,825
Legal settlement (d)	1,300	—	—	—	—
Public company costs (e)	2,069	2,281	1,888	1,727	582
Adjusted EBITDA	$48,000	$ 41,637	$ 36,849	$ 35,222	$31,451

(a) This adjustment includes costs related to impairment of long-lived assets, gain or loss on disposal of property and equipment and shop closure expenses. Additionally, fiscal years 2014 and 2015 reflects costs associated with our plans to move our corporate headquarters.

(b) This adjustment includes expenses directly associated with the opening of new shops and are incurred prior to the opening of the shop.

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(c) This adjustment includes non-cash stock-based compensation. As a result of the consummation of our initial public offering, we recorded one-time charges of $10.0 million in fiscal year 2013 related to stock-based compensation, which primarily consist of a $7.6 million charge related to the cumulative expense for the periods in which the performance conditions were not met.

(d) This adjustment relates to a one-time, non-recurring legal expense incurred to establish an accrual related to a Fair Labor Standards claim.

(e) This adjustment includes on-going public company costs. Additionally, fiscal years 2012, 2013 and 2014 include one-time costs associated with our initial public offering. Both these costs primarily consist of legal and accounting fees.

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ITEM 7.MANAGEMENT’S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion of our financial condition and results of operations should be read in conjunction with “Selected Financial Data” in Item 6 and our consolidated financial statements and the related notes to those statements included in Item 8. The discussion contains forward-looking statements involving risks, uncertainties and assumptions that could cause our results to differ materially from expectations. Our actual results may differ materially from those anticipated in these forward-looking statements as a result of certain factors, including those described in “Risk Factors” in Item 1A and elsewhere in this report.

Overview

Potbelly is a fast-growing neighborhood sandwich concept offering toasty warm sandwiches, signature salads and other fresh menu items served by engaging people in an environment that reflects the Potbelly brand. Our combination of product, people and place is how we deliver on our passion to be “The Best Place for Lunch.” Our sandwiches, salads and hand-dipped milkshakes are all made fresh to order and our cookies are baked fresh each day. Our employees are trained to engage with our customers in a genuine way to provide a personalized experience. Our shops feature vintage design elements and locally-themed décor inspired by the neighborhood that we believe create a lively atmosphere. Through this combination, we believe we are creating a devoted base of Potbelly fans that return again and again and that we are expanding one sandwich shop at a time.

We believe that a key to our past and future success is our culture. It is embodied in The Potbelly Advantage, which is an expression of our Vision, Mission, Passion and Values, and the foundation of everything we do. Our Vision is for our customers to feel that we are their “Neighborhood Sandwich Shop” and to tell others about their great experience. Our Mission is to make people really happy, to make more money and to improve every day. Our Passion is to be “The Best Place for Lunch.” Our Values embody both how we lead and how we behave, and form the cornerstone of our culture. We use simple language that resonates from the frontline associate to the most senior levels of the organization, creating shared expectations and accountabilities in how we approach our day-to-day activities. We strive to be a fun, friendly and hardworking group of people who enjoy taking care of our customers, while at the same time taking care of each other.

We own and operate Potbelly Sandwich Works sandwich shops in the United States. We also have domestic and international franchise operations of Potbelly Sandwich Works sandwich shops. Our chief operating decision maker is our Chief Executive Officer. Based on how our Chief Executive Officer reviews financial performance and allocates resources on a recurring basis, the company has one operating segment and one reportable segment.

The table below sets forth a rollforward of company-operated and franchise-operated activities:

	Company-Operated	Franchise-Operated Domestic	International	Total	Total Company
Shops as of December 29, 2013	296	11	12	23	319
Shops opened	39	6	1	7	46
Shops closed	(1)	—	(1)	(1)	(2)
Shops as of December 28, 2014	334	17	12	29	363
Shops opened	43	8	2	10	53
Shop purchased from franchisee	1	(1)	—	(1)	—
Shops closed	(6)	—	(2)	(2)	(8)

Shops as of December 27, 2015	372	24	12	36	408
Shops opened	40	7	3	10	50
Shop purchased from franchisee	1	(1)	—	(1)	—
Shops closed	(2)	—	(2)	(2)	(4)
Shops as of December 25, 2016	411	30	13	43	454

Fiscal Year

Operating results are reported on a 52-week fiscal year calendar, with a 53-week year occurring every fifth or sixth year. Our fiscal year ends on the last Sunday of each calendar year. Fiscal years 2016, 2015 and 2014 were 52-week years. The first three quarters of our fiscal year consist of 13 weeks and our fourth quarter consists of 13 weeks for 52-week fiscal years and 14 weeks for 53-week fiscal years.

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Outlook

Potbelly operates in a highly competitive segment of the restaurant industry. We compete with sandwich concepts that have significant scale and presence, as well as with the multitude of locally-owned sandwich shops. Additionally, we compete with many non-sandwich concepts that fall into the limited-service restaurants category. However, we believe that we will continue to succeed in the marketplace based on our combination of excellent product, people and place. The following competitive strengths provide a platform for us to achieve continued growth:

- Simple, Made-to-Order Food. Our menu features items made from high quality ingredients such as fresh vegetables, hearth-baked bread, and all-natural white-meat chicken. Our sandwiches are made fresh to order and served toasty warm on our signature multigrain or regular bread or on our multigrain Flats, all of which are delivered to our shops. Our menu also features a variety of cookies baked fresh daily in each shop, and our hand-dipped shakes, malts and smoothies are made from real ingredients. We believe the unique Potbelly experience encourages repeat customer visits and drives increased sales.

- Differentiated Customer Experience That Delivers a Neighborhood Feel. We strive to provide a positive customer experience that is driven by both our employees and the atmosphere of our shops. We look to hire employees that are outgoing people and train them to interact with our customers in a genuine way while providing fast service. We believe our atmosphere is enhanced by live, local musicians that perform weekly in the majority of our shops. Every Potbelly location strives to be “The Neighborhood Sandwich Shop,” creating devoted fans who tell others about their experience.

- Attractive Shop Economics. Our shop model is designed to generate, and has generated, strong cash flow, with above 20% shop-level profit margins, a non-GAAP measure, and targeted cash-on-cash returns, on new company-operated shops, above 25% after two full years of operation. Our ability to maintain such margins and returns depends on a number of factors. For example, we face increasing labor and commodity costs, which we have partially offset by increasing menu prices. Although there is no guarantee that we will be able to maintain these returns, we believe our shop economics support our ability to profitably grow our brand in new and existing markets.

- Management Team with Substantial Operating Experience. Our senior management team has extensive operating experience across disciplines in the restaurant and retail sectors. Our senior team led by our CEO, Aylwin Lewis, averages 15 years of restaurant industry experience and embraces the daily intensity needed to deliver growth in existing shops as well as growing the business in new neighborhoods. We believe our experienced leadership team is a key driver of our success and positions us to execute our long-term growth strategy.

- Distinct, Deep-Rooted Culture: The Potbelly Advantage. We believe our culture is a key to our success. It is embodied in The Potbelly Advantage, which is an expression of our Vision, Mission, Passion and Values. The Potbelly Advantage is a statement of our intentions and is the foundation of everything we do, including how we plan and manage our business. It allows us to deliver operational excellence and grow our business and our base of devoted fans.

We believe the combination of these strengths provides a competitive advantage in the marketplace. Continuing to execute at a high level across all aspects of our business is imperative to realize the growth potential for Potbelly. We are confident in our strategies, our people and the opportunity to make Potbelly a “Global Iconic Brand.”

Key Performance Indicators

In assessing the performance of our business, we consider a variety of performance and financial measures. The key measures for determining how our business is performing are comparable store sales, number of shop openings, shop-level profit margins and adjusted EBITDA.

Company-Operated Comparable Store Sales

Comparable store sales reflect the change in year-over-year sales for the comparable company-operated store base. We define the comparable store base to include those shops open for 15 months or longer. As of the fiscal years ended December 28, 2014, December 27, 2015 and December 25, 2016, there were 286, 312 and 355 shops, respectively, in our comparable company-operated store base. Comparable store sales growth can be generated by an increase in entree counts and/or by increases in the average check amount resulting from a shift in menu mix and/or increase in price. This measure highlights performance of existing shops as the impact of new shop openings is excluded. Entrees are defined as sandwiches, salads and bowls of soup.

Number of Company-Operated Shop Openings

The number of company-operated shop openings reflects the number of shops opened during a particular reporting period. Before we open new shops, we incur pre-opening costs, which are defined below. Often, new shops open with an initial start-up period of higher than normal sales volumes, which subsequently decrease to stabilized levels. While sales volumes are generally higher during the initial opening period, new shops typically experience normal inefficiencies in the form of higher cost of sales, labor and other direct operating expenses and as a result, shop-level profit margins are generally lower during the start-up period of operation. The average start-up period is 10 to 13 weeks. The number and timing of shop openings has had, and is expected to continue to have, an impact on our results of operations.

Shop-Level Profit Margin

Shop-level profit margin is defined as net company-operated sandwich shop sales less company-operated sandwich shop operating expenses, including cost of goods sold, labor and related expenses, other operating expenses and occupancy expenses, as a percentage of net company-operated sandwich shop sales. Shop-level profit margin is not required by, or presented in accordance with, GAAP. We believe shop-level profit margin is important in evaluating shop-level productivity, efficiency and performance.

Adjusted EBITDA

We define adjusted EBITDA as net income before depreciation and amortization, interest expense and provision for income taxes, adjusted for the impact of the following items that we do not consider representative of our ongoing operating performance: stock-based compensation expense, impairment and shop closure expenses, gain or loss on disposal of property and equipment, pre-opening expenses and public company costs as well as costs associated with our plans to move our corporate headquarters and other one-time, non-recurring charges. We believe that adjusted EBITDA is a more appropriate measure of operating performance, as it provides a clearer picture of operating results by eliminating expenses that are not reflective of underlying business performance.

Key Financial Definitions

Revenues

We generate revenue from net company-operated sandwich shop sales and our franchise operations. Net company-operated shop sales consist of food and beverage sales, net of promotional allowances and employee meals. Company-operated shop sales are influenced by new shop openings, shop closures and comparable store sales. Franchise royalties and fees consist of an initial franchise fee, a franchise development agreement fee and royalty income from the franchisee.

Cost of Goods Sold

Cost of goods sold consists primarily of food and beverage related costs. The components of cost of goods sold are variable in nature, change with sales volume, are influenced by menu mix and are subject to increases or decreases based on fluctuations in commodity costs.

Labor and Related Expenses

Labor and related expenses include all shop-level management and hourly labor costs, including salaries, wages, benefits and performance incentives, labor taxes and other indirect labor costs.

Occupancy Expenses

Occupancy expenses include fixed and variable portions of rent, common area maintenance and real estate taxes.

Other Operating Expenses

Other operating expenses include all other shop-level operating costs, the major components of which are credit card fees, operating supplies, utilities, repair and maintenance costs, shop-level marketing costs and musician expense.

General and Administrative Expenses

General and administrative expenses is comprised of expenses associated with corporate and administrative functions that support the development and operations of shops, including compensation and benefits, travel expenses, stock-based compensation

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costs, legal and professional fees, advertising costs, costs related to abandoned new shop development sites and other related corporate costs.

Depreciation Expense

Depreciation expense includes the depreciation of fixed assets and capitalized leasehold improvements.

Pre-Opening Costs

Pre-opening costs consist of costs incurred prior to opening a new shop and are made up primarily of travel, employee payroll and training costs incurred prior to the shop opening, as well as occupancy costs incurred from when we take site possession to shop opening. Shop pre-opening costs are expensed as incurred.

Impairment and Loss on Disposal of Property and Equipment

We review long-lived assets, such as property and equipment and intangibles, for impairment when events or circumstances indicate the carrying value of the assets may not be recoverable and record an impairment charge when appropriate. The impairment loss recognized is the excess of the carrying value of the asset over its fair value. Typically, the fair value of the asset is determined by estimating undiscounted future cash flows associated with the asset. Loss on disposal of property and equipment represents the net book value of property and equipment less proceeds received, if applicable, on assets abandoned or sold. These losses are related to normal disposals in the ordinary course of business, along with disposals related to shop closures and selected shop remodeling activities.

Interest Expense

Interest expense consists of interest on the note payable, unused commitment fees and deferred financing fees.

Non-controlling Interests

Non-controlling interests represent a non-controlling partner's share of the assets, liabilities and operations related to five joint venture investments. We have ownership interests ranging from 51-80% in these consolidated joint ventures.

Results of Operations

Fiscal Year 2016 (52 Weeks) Compared to Fiscal Year 2015 (52 Weeks)

The following table presents information comparing the components of net income for the periods indicated (dollars in thousands):

	Fiscal Year 2016	% of Revenues	2015	% of Revenues	Increase (Decrease)	Percent Change
Revenues						
Sandwich shop sales, net	$404,874	99.4 %	$370,954	99.5 %	$ 33,920	9.1 %
Franchise royalties and fees	2,257	0.6	1,895	0.5	362	19.1
Total revenues	407,131	100.0	372,849	100.0	34,282	9.2
Expenses						
Sandwich shop operating expenses						
Cost of goods sold, excluding depreciation	111,026	27.3	105,614	28.3	5,412	5.1
Labor and related expenses	117,838	28.9	106,628	28.6	11,210	10.5
Occupancy expenses	52,444	12.9	46,762	12.5	5,682	12.2
Other operating expenses	43,738	10.7	39,869	10.7	3,869	9.7
General and administrative expenses	40,411	9.9	37,322	10.0	3,089	8.3
Depreciation expense	22,734	5.6	21,476	5.8	1,258	5.9
Pre-opening costs	1,786	0.4	2,160	0.6	(374)	(17.3)
Impairment and loss on disposal of property and equipment	4,141	1.0	3,589	1.0	552	15.4
Total expenses	394,118	96.8	363,420	97.5	30,698	8.4
Income from operations	13,013	3.2	9,429	2.5	3,584	38.0
Interest expense, net	134	*	221	0.1	(87)	(39.4)
Income before income taxes	12,879	3.2	9,208	2.5	3,671	39.9
Income tax expense	4,443	1.1	3,466	0.9	977	28.2
Net income	8,436	2.1	5,742	1.5	2,694	46.9
Net income attributable to non-controlling interests	224	*	114	*	110	96.5
Net income attributable to Potbelly Corporation	$8,212	2.0 %	$5,628	1.5 %	$ 2,584	45.9 %

* Amount is less than 0.1%

Revenues

Revenues increased by $34.3 million, or 9.2%, to $407.1 million for fiscal year 2016, from $372.8 million for fiscal year 2015. Company-operated non-comparable store sales contributed $32.7 million, or 95%, of the total revenue increase, company-operated comparable store sales contributed $5.1 million, or 15%, of the total revenue increase and franchise shops contributed $0.4 million, or 1%, of the total revenue increase. This is partially offset by a decrease in revenues of $3.9 million, or 11%, related to closed stores. The increase in company-operated comparable store sales resulted from certain menu price increases and menu mix.

In February 2017, the City of Chicago's Department of Aviation approved the award of the Midway International Airport dining concessions to a development group whose proposal does not include an extension of our lease at the airport. The winning bidders must still sign a contract which is subject to final approval by the Chicago City Council. We are currently advocating to city officials to retain our shop at Midway; we can give no assurance that we will succeed. For the year ended December 25, 2016, our Midway shop represented approximately $7.8 million in revenue and approximately $2.0 million in income before income taxes.

Cost of Goods Sold

Cost of goods sold increased by $5.4 million, or 5.1%, to $111.0 million for fiscal year 2016, compared to $105.6 million for fiscal year 2015, primarily due to the increase in revenues. As a percentage of revenues, cost of goods sold decreased to 27.3% for fiscal year 2016, from 28.3% for fiscal year 2015, primarily driven by certain menu price increases, as well as decreases in certain food commodity costs.

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Labor and Related Expenses

Labor and related expenses increased by $11.2 million, or 10.5%, to $117.8 million for fiscal year 2016, from $106.6 million for fiscal year 2015, primarily due to new shop openings. As a percentage of revenues, labor and related expenses increased to 28.9% for fiscal year 2016, from 28.6% for fiscal year 2015, primarily due to wage inflation in certain states as a result of statutory minimum wage increases. These increases were partially offset by improvements in labor productivity and certain menu price increase.

Occupancy Expenses

Occupancy expenses increased by $5.6 million, or 12.2%, to $52.4 million for fiscal year 2016, from $46.8 million for fiscal year 2015, primarily due to new shop openings. As a percentage of revenues, occupancy expenses increased to 12.9% for fiscal year 2016, from 12.5% for fiscal year 2015, primarily due to rent renewals and inflation on common area maintenance and real estate taxes.

Other Operating Expenses

Other operating expenses increased by $3.8 million, or 9.7%, to $43.7 million for fiscal year 2016, from $39.9 million for fiscal year 2015, primarily due to new shop openings as well as increased fees associated with credit card usage in our shops. As a percentage of revenues, other operating expenses remained consistent at 10.7% for fiscal year 2016 and fiscal year 2015.

General and Administrative Expenses

General and administrative expenses increased by $3.1 million, or 8.3%, to $40.4 million for fiscal year 2016, from $37.3 million for fiscal year 2015. The increase is primarily driven by increased headcount for our field management and a one-time legal settlement, partially offset by decreases in our performance-based incentives. As a percentage of revenues, general and administrative expenses decreased to 9.9% for fiscal year 2016, from 10.0% for fiscal year 2015, driven by leverage of the primarily fixed Support Center cost.

Depreciation Expense

Depreciation expense increased by $1.2 million, or 5.9%, to $22.7 million for fiscal year 2016, from $21.5 million for fiscal year 2015, primarily due to a higher depreciable base resulting from new shops. As a percentage of revenues, depreciation decreased to 5.6% for fiscal year 2016, from 5.8% for fiscal year 2015, driven by lower depreciation associated with new shops with lower build-out costs and longer expected useful lives for leasehold improvements, as well as leasehold improvements at legacy shops with higher build-out costs and shorter expected useful lives being fully depreciated.

Pre-Opening Costs

Pre-opening costs decreased by $0.4 million, or 17.3%, to $1.8 million for fiscal year 2016, from $2.2 million for fiscal year 2015, primarily due to four fewer new company-operated shops opening in 2016 as compared to fiscal year 2015, as well as pre-opening rent for the new corporate office location of $0.2 million incurred during fiscal year 2015.

Impairment and Loss on Disposal of Property and Equipment

Impairment and loss on disposal of property and equipment increased by $0.5 million, or 15.4%, to $4.1 million for fiscal year 2016, from $3.6 million for fiscal year 2015. As a result of performing a periodic review of our shops during each fiscal quarter of 2016, it was determined that indicators of impairment were present for certain shops as a result of underperformance of shop profitability. We performed an impairment analysis related to these shops and recorded an impairment charge of $4.0 million related to the excess of the carrying amounts recorded on our balance sheet over the estimated fair values, as compared to $3.4 million in fiscal year 2015.

Interest Expense

Interest expense decreased by $0.1 million, or 39.4%, to $0.1 million for fiscal year 2016, from $0.2 million for fiscal year 2015. Interest expense for the fiscal year ended December 25, 2016 is attributable to unused commitment fees and deferred financing fees.

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Income Tax Expense

Income tax expense increased by $0.9 million to $4.4 million for fiscal year 2016, from $3.5 million for fiscal year 2015, driven by higher taxable income. Our effective tax rate was 34.5% for fiscal year 2016, compared to 37.6% for fiscal year 2015. The decrease in the effective tax rate primarily relates to recognizing more federal tax credits in fiscal year 2016 as compared to the prior year.

Results of Operations

Fiscal Year 2015 (52 Weeks) Compared to Fiscal Year 2014 (52 Weeks)

The following table presents information comparing the components of net income for the periods indicated (dollars in thousands):

	Fiscal Year								
		% of			% of		Increase	Percent	
	2015	Revenues		2014	Revenues		(Decrease)	Change	
Revenues									
Sandwich shop sales, net	$370,954	99.5	%	$325,464	99.5	%	$ 45,490	14.0	%
Franchise royalties and fees	1,895	0.5		1,515	0.5		380	25.1	
Total revenues	372,849	100.0		326,979	100.0		45,870	14.0	
Expenses									
Sandwich shop operating expenses									
Cost of goods sold, excluding depreciation	105,614	28.3		93,688	28.7		11,926	12.7	
Labor and related expenses	106,628	28.6		93,165	28.5		13,463	14.5	
Occupancy expenses	46,762	12.5		41,389	12.7		5,373	13.0	
Other operating expenses	39,869	10.7		34,669	10.6		5,200	15.0	
General and administrative expenses	37,322	10.0		32,420	9.9		4,902	15.1	
Depreciation expense	21,476	5.8		19,615	6.0		1,861	9.5	
Pre-opening costs	2,160	0.6		1,634	0.5		526	32.2	
Impairment and loss on disposal of property and equipment	3,589	1.0		3,128	1.0		461	14.7	
Total expenses	363,420	97.5		319,708	97.8		43,712	13.7	
Income from operations	9,429	2.5		7,271	2.2		2,158	29.7	
Interest expense, net	221	0.1		179	0.1		42	23.5	
Income before income taxes	9,208	2.5		7,092	2.2		2,116	29.8	
Income tax expense	3,466	0.9		2,748	0.8		718	(26.1	)
Net income	5,742	1.5		4,344	1.3		1,398	32.2	
Net income (loss) attributable to non-controlling interests	114	*		(14)	*		128	(914.3	)
Net income attributable to	$5,628	1.5	%	$4,358	1.3	%	$ 1,270	29.1	%

Potbelly Corporation

* Amount is less than 0.1%

Revenues

Revenues increased by $45.9 million, or 14.0%, to $372.8 million for fiscal year 2015, from $327.0 million for fiscal year 2014. Company-operated non-comparable store sales contributed $31.9 million, or 69.6%, of the total revenue increase, company-operated comparable store sales contributed $13.6 million, or 29.5%, of the total revenue increase and franchise shops contributed $0.4 million, or 0.9%, of the total revenue increase. The increase in company-operated comparable store sales resulted from certain menu price increases and menu mix, and an increase in traffic.

Cost of Goods Sold

Cost of goods sold increased by $11.9 million, or 12.7%, to $105.6 million for fiscal year 2015, compared to $93.7 million for fiscal year 2014, primarily due to the increase in revenues. As a percentage of revenues, cost of goods sold decreased to 28.3% for

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fiscal year 2015, from 28.7% for fiscal year 2014, primarily driven by certain menu price increases, as well as increased volume-based rebates from certain vendors.

Labor and Related Expenses

Labor and related expenses increased by $13.5 million, or 14.5%, to $106.6 million for fiscal year 2015, from $93.2 million for fiscal year 2014, primarily due to new shop openings. As a percentage of revenues, labor and related expenses increased to 28.6% for fiscal year 2015, from 28.5% for fiscal year 2014, primarily due to wage inflation in certain states as a result of statutory minimum wage increases as well as an additional incentive program to reward employees for tenure and development, which began in fiscal year 2015. These increases were partially offset by improvements in labor productivity.

Occupancy Expenses

Occupancy expenses increased by $5.4 million, or 13.0%, to $46.8 million for fiscal year 2015, from $41.4 million for fiscal year 2014, primarily due to new shop openings. As a percentage of revenues, occupancy expenses decreased to 12.5% for fiscal year 2015, from 12.7% for fiscal year 2014, primarily due to sales leverage (i.e., the ability to spread certain expenses over a higher revenue base).

Other Operating Expenses

Other operating expenses increased by $5.2 million, or 15.0%, to $39.9 million for fiscal year 2015, from $34.7 million for fiscal year 2014, primarily due to new shop openings as well as increased fees associated with credit card usage in our shops. As a percentage of revenues, other operating expenses increased to 10.7% for fiscal year 2015, from 10.6% for fiscal year 2014, primarily due to the $0.2 million cumulative adjustment recorded during the 39 weeks ended September 28, 2014, for the change in accounting estimate related to gift card breakage.

General and Administrative Expenses

General and administrative expenses increased by $4.9 million, or 15.1%, to $37.3 million for fiscal year 2015, from $32.4 million for fiscal year 2014. The increase is primarily driven by increases in our performance-based incentives, advertising and rent associated with our new office. As a percentage of revenues, general and administrative expenses increased to 10.0% for fiscal year 2015, from 9.9% for fiscal year 2014, primarily driven by the increase in performance-based incentives.

Depreciation Expense

Depreciation expense increased by $1.9 million, or 9.5%, to $21.5 million for fiscal year 2015, from $19.6 million for fiscal year 2014, primarily due to a higher depreciable base resulting from new shops. As a percentage of revenues, depreciation decreased to 5.8% for fiscal year 2015, from 6.0% for fiscal year 2014, driven by lower depreciation associated with new shops with lower build-out costs and longer expected useful lives for leasehold improvements, as well as leasehold improvements at legacy shops with higher build-out costs and shorter expected useful lives being fully depreciated.

Pre-Opening Costs

Pre-opening costs increased by $0.5 million to $2.2 million for fiscal year 2015, from $1.6 million for fiscal year 2014, primarily due to four more new company-operated shops opening in 2015 as compared to fiscal year 2014 and a transition of a franchise shop to a company-operated shop in 2015, as well as pre-opening rent for the new corporate office location of $0.2 million.

Impairment and Loss on Disposal of Property and Equipment

Impairment and loss on disposal of property and equipment increased by $0.5 million, or 14.7%, to $3.6 million for fiscal year 2015, from $3.1 million for fiscal year 2014. As a result of performing a periodic review of our shops during each fiscal quarter of 2015, it was determined that indicators of impairment were present for certain shops as a result of underperformance of shop profitability. We performed an impairment analysis related to these shops and recorded an impairment charge of $3.4 million related to the excess of the carrying amounts recorded on our balance sheet over the estimated fair values, as compared to $2.9 million in fiscal year 2014.

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Interest Expense

Interest expense remained consistent at $0.2 million for fiscal year 2015 as compared to fiscal year 2014. Interest expense for the fiscal year ended December 27, 2015 is attributable to interest on the note payable, unused commitment fees and deferred financing fees.

Income Tax Expense (Benefit)

Income tax expense increased by $0.7 million to $3.5 million for fiscal year 2015, from $2.7 million for fiscal year 2014, driven by higher taxable income. Our effective tax rate was 37.6% for fiscal year 2015, compared to 38.7% for fiscal year 2014. The decrease in the effective tax rate primarily relates to recognizing more federal tax credits in fiscal year 2015 as compared to the prior year.

Quarterly Results and Seasonality

The following table sets forth certain unaudited financial and operating data in each fiscal quarter during fiscal year 2015 and 2016. The quarterly information includes all normal recurring adjustments that we consider necessary for a fair presentation of the information shown. This information should be read in conjunction with our consolidated financial statements and the related notes to those statements included Part II, Item 8, "Financial Statements and Supplementary Data" of this Annual Report on Form 10-K.

	2016 Fiscal Quarters Ended (1)			
	March 27, 2016	June 26, 2016	September 25, 2016	December 25, 2016
	(unaudited; dollars in thousands)			
Total revenues	$95,955	$105,036	$103,782	$102,358
Income from operations	1,889	5,512	2,842	2,770
Net income attributable to Potbelly Corporation	1,088	3,373	1,795	1,956
Total company-operated shops (end of period)	377	382	387	411
Change in company-operated comparable store sales	3.7 %	1.7 %	0.6 %	0.1 %

	2015 Fiscal Quarters Ended (1)			
	March 29, 2015	June 28, 2015	September 27, 2015	December 27, 2015
	(unaudited; dollars in thousands)			
Total revenues	$85,768	$95,949	$ 96,039	$ 95,093
Income from operations	948	4,084	2,379	2,018
Net income attributable to Potbelly Corporation	531	2,461	1,401	1,235
Total company-operated shops (end of period)	339	349	358	372
Change in company-operated comparable store sales	5.4 %	4.9 %	3.7 %	3.7 %

(1) Fiscal years 2016 and 2015 each consisted of 52 weeks. Each quarter of such fiscal years consisted of 13 weeks.

Historically, customer spending patterns for our established shops are lowest in the first quarter of the year. Our quarterly results have been and will continue to be affected by the timing of new shop openings and their associated pre-opening costs. As a result of these and other factors, our financial results for any quarter may not be indicative of the results that may be achieved for a full fiscal year.

Liquidity and Capital Resources

General

Our on-going primary sources of liquidity and capital resources are cash provided from operating activities, existing cash and cash equivalents and our credit facility. Our primary requirements for liquidity and capital are new shop openings, existing shop capital investments (maintenance and improvements), repurchases of our common stock, lease obligations, principal and interest payments on our debt, purchases of existing franchise-operated shops, and working capital and general corporate needs. Our requirement for working capital is not significant since our customers pay for their food and beverage purchases in cash or payment cards (credit or debit) at the time of sale. Thus, we are able to sell certain inventory items before we have to pay our suppliers for such items. Our shops do not require significant inventories or receivables. We believe that these sources of liquidity and capital will be sufficient to finance our continued operations and expansion plans for at least the next twelve months.

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The following table presents summary cash flow information for the periods indicated (in thousands):

	Fiscal Year		
	2016	2015	2014
Operating activities	$45,969	$40,320	$26,554
Investing activities	(37,820)	(36,058)	(29,209)
Financing activities	(16,776)	(35,261)	(3,919)
Net decrease in cash	$(8,627)	$(30,999)	$(6,574)

Operating Activities

Net cash provided by operating activities increased to $46.0 million for fiscal year 2016, from $40.3 million for fiscal year 2015. The $5.7 million increase is primarily attributable to an increase of $7.7 million in net shop-level profits. The remainder of the change is primarily driven by changes in certain working capital accounts mainly due to timing.

Net cash provided by operating activities increased to $40.3 million for fiscal year 2015, from $26.6 million for fiscal year 2014. The $13.7 million increase is primarily attributable to an increase of $9.5 million in net shop-level profits, a decrease of approximately $1.0 million in payments for performance-based incentives as well as a $1.6 million cash outflow for prepaid expenses related to change in terms with certain vendors incurred in the prior year with no comparable item in the current year. The remainder of the change is primarily driven by changes in certain working capital accounts mainly due to timing.

Investing Activities

Net cash used in investing activities increased to $37.8 million for fiscal year 2016, from $36.1 million for fiscal year 2015. The increase was primarily due to construction costs for 40 new company-operated shops opened for the 52 weeks ended December 25, 2016, compared to 43 new company-operated shops opened for the 52 weeks ended December 27, 2015, at a higher average cost per shop in 2016, as well as capital expenditures for future shop openings, maintaining our existing shops and certain other projects. In addition, in April 2016, we purchased a franchise shop, converting it into a company-operated shop at a cost of $1.1 million.

Net cash used in investing activities increased to $36.1 million for fiscal year 2015, from $29.2 million for fiscal year 2014. The increase was primarily due to construction costs for 43 new company-operated shops opened for the 52 weeks ended December 27, 2015, compared to 39 new company-operated shops opened for the 52 weeks ended December 28, 2014, at a lower average cost per shop in 2015, as well as capital expenditures for future shop openings, maintaining our existing shops and certain other projects. In addition, in July 2015, we purchased a franchise shop, converting it into a company-operated shop at a cost of $0.3 million.

Financing Activities

Net cash used in financing activities decreased to $16.8 million for fiscal year 2016, from $35.3 million for fiscal year 2015. The decrease in net cash used was mainly driven by $22.3 million of treasury stock repurchased during fiscal year 2016 compared to $39.8 million during fiscal year 2015.

Net cash used in financing activities increased to $35.3 million for fiscal year 2015, from $3.9 million for fiscal year 2014. The increase in net cash used was mainly driven by $39.8 million of treasury stock repurchased during fiscal year 2015 compared to $10.2 million during fiscal year 2014.

Initial Public Offering

On October 9, 2013, we completed an IPO of 8,625,000 shares of common stock at a price of $14.00 per share, which included 1,125,000 shares of common stock issued upon the exercise in full of the underwriters' option to purchase additional shares. We sold 8,474,869 shares of common stock and certain stockholders sold 150,131 shares of common stock. We received net proceeds from the offering of approximately $108.8 million, after deducting the underwriting discount and other estimated offering expenses. We used a portion of the net proceeds received from the sale of the shares in the IPO to pay a previously declared one-time cash dividend of approximately $49.9 million on shares outstanding on October 8, 2013 as well as to repay $14.0 million outstanding under the senior credit facility on October 24, 2013. During fiscal year 2014, we used approximately $10.2 million of the net proceeds to repurchase common stock pursuant to the share repurchase program authorized by our Board of Directors on August 1, 2014. The remaining proceeds were used in fiscal year 2015 for share repurchases, working capital, and general corporate purposes.

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Stock Repurchase Program

On September 8, 2016, we announced that our Board of Directors authorized a share repurchase program of up to $30.0 million of the Company’s common stock. Our previous $35.0 million share repurchase program, authorized in September 2015, was completed in July 2016. The new program permits us, from time to time, to purchase shares in the open market (including in pre-arranged stock trading plans in accordance with the guidelines specified in Rule 10b5-1 under the Exchange Act) or in privately negotiated transactions. During fiscal year 2016, we repurchased 1,719,502 shares of common stock for approximately $22.3 million, including cost and commission, in open market transactions. At December 25, 2016, the remaining dollar value of authorization under the share repurchase program was $27.7 million, which does not include commission.

Credit Facility

On December 9, 2015, we entered into an amended and restated five-year revolving credit facility agreement that expires in November 2020. The credit agreement provides, among other things, for a revolving credit facility in a maximum principal amount of $50 million, with possible future increases to $75 million under an expansion feature. Borrowings under the credit facility generally bear interest at our option at either (i) a eurocurrency rate determined by reference to the applicable LIBOR rate plus a margin ranging from 1.00% to 1.75% or (ii) a prime rate as announced by JP Morgan Chase plus a margin ranging from 0.00% to 0.50%. The applicable margin is determined based upon our consolidated total leverage ratio. On the last day of each calendar quarter, we are required to pay a commitment fee ranging from 0.125% to 0.20% per annum in respect of any unused commitments under the credit facility, with the specific rate determined based upon our consolidated total leverage ratio. So long as certain total leverage ratios are met, there is no limit on the “restricted payments” (primarily distributions and equity repurchases) that we may make. As of December 25, 2016, we had no amounts outstanding under the credit facility.

Off-Balance Sheet Arrangements

We do not have any off-balance sheet arrangements, synthetic leases, investments in special purpose entities or undisclosed borrowings or debt that would be required to be disclosed pursuant to Item 303 of Regulation S-K under the Exchange Act.

Contractual Obligations

The following table presents contractual obligations and commercial commitments as of December 25, 2016 (in thousands):

	Payments Due By Period				
	Total	Less than 1 year	1-3 years	3-5 years	More than 5 years
Operating leases (a)	$293,372	$46,035	$81,530	$69,729	$96,078
Capital leases	215	91	124	—	—
Total	$293,587	$46,126	$81,654	$69,729	$96,078

(a)

Includes base lease terms and certain optional renewal periods that are included in the lease term in accordance with accounting guidance related to leases. Certain of these options are subject to escalation based on various market-based factors.

Impact of Inflation

Our profitability is dependent, among other things, on our ability to anticipate and react to changes in the costs of key operating resources, including food and beverages, labor, energy and other services. Substantial increases in costs and expenses could impact our operating results to the extent such increases cannot be passed along to our customers. Apart from the commodity effects discussed above, in general, we have been able to substantially offset shop and operating cost increases resulting from inflation by altering our menu items, increasing menu prices, making productivity improvements or other adjustments. However, certain areas of costs, notably labor and utilities, can be significantly volatile or subject to significant changes due to changes in laws or regulations, such as the minimum wage laws. There can be no assurance that we will continue to generate increases in comparable store sales in amounts sufficient to offset inflationary or other cost pressures.

Critical Accounting Policies and Estimates

Our discussion and analysis of our financial condition and results of operations are based on our consolidated financial statements, which have been prepared in accordance with GAAP. The preparation of our consolidated financial statements requires us 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. Critical accounting policies are those that management believes are both most important to the portrayal of our financial condition and operating results, and require management's most difficult, subjective or complex judgments, often as a result of the need to make estimates about the effect of matters that are inherently uncertain. We base our estimates on historical experience and other factors that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying value of assets and liabilities that are not readily apparent from other sources. Judgments and uncertainties affecting the application of those policies may result in materially different amounts being reported under different conditions or using different assumptions. Our significant accounting policies can be found in Note 2 to our consolidated financial statements in Item 8. We consider the following policies to be the most critical in understanding the judgments that are involved in preparing our consolidated financial statements.

Impairment of Long-Lived Assets and Disposal of Property and Equipment

We assess potential impairments to long-lived assets, which includes property and equipment, on a quarterly basis or whenever events or circumstances indicate that the carrying amount of an asset may not be recoverable. Shop-level assets are grouped together for the purpose of the impairment assessment. Recoverability of an asset is measured by a comparison of the carrying amount of an asset to its estimated undiscounted future cash flows expected to be generated by the asset. If the carrying amount of the asset exceeds its estimated undiscounted future cash flows, an impairment charge is recognized as the amount by which the carrying amount of the asset exceeds the fair value of the asset. The fair value of the shop assets is determined using the discounted future cash flow method of anticipated cash flows through the shop's lease-end date using fair value measurement inputs classified as Level 3. Level 3 inputs are derived from valuation techniques in which one or more significant inputs or significant value drivers are unobservable. We used a weighted average cost of capital to discount the future cash flows. A 100 basis point change in weighted average cost of capital would not have a material impact on the calculation of an impairment charge. After performing a periodic review of our shops as of December 25, 2016, December 27, 2015 and December 28, 2014, it was determined that indicators of impairment were present for certain shops as a result of continued underperformance of shop profitability. We recorded an impairment charge of $2.9 million, $3.4 million and $4.0 million for the fiscal years 2014, 2015 and 2016, respectively, which is included in impairment and loss on disposal of property and equipment in the consolidated statements of operations.

ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Interest Rate Risk

We are subject to interest rate risk in connection with borrowings under our credit facility, which bear interest at variable rates. As of December 25, 2016, we had no amounts outstanding under our credit facility or our note payable. A 100 basis point change in the interest rate would not have a material impact on our financial condition or results of operations. We did not have any material exposure to interest rate market risks for fiscal year 2016.

Commodity Price Risk

We are also exposed to commodity price risks. Many of the food products we purchase are subject to changes in the price and availability of food commodities, including among other things beef, poultry, grains, dairy and produce. Prices may be affected due to market changes, increased competition, the general risk of inflation, shortages or interruptions in supply due to weather, disease or other conditions beyond our control, or other reasons. We work with our suppliers and use a mix of forward pricing protocols for certain items under which we agree with our supplier on fixed prices for deliveries at some time in the future, fixed pricing protocols under which we agree on a fixed price with our supplier for the duration of that protocol, and formula pricing protocols under which the prices we pay are based on a specified formula related to the prices of the goods, such as spot prices. Our use of any forward pricing arrangements varies substantially from time to time and these arrangements tend to cover relatively short periods (i.e., typically twelve months or less). We do not enter into futures contracts or other derivative instruments. Increased prices or shortages could generally affect the cost and quality of the items we buy or may require us to further raise prices or limit our menu options. These events, combined with other general economic and demographic conditions, could impact our pricing and negatively affect our sales and profit margins.

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

Report of Independent Registered Public Accounting Firm

To the Stockholders and Board of Directors of

Potbelly Corporation and subsidiaries

Chicago, Illinois

We have audited the accompanying consolidated balance sheets of Potbelly Corporation and subsidiaries (the "Company") as of December 25, 2016 and December 27, 2015, and the related consolidated statements of operations, equity, and cash flows for each of the three years in the period ended December 25, 2016. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated 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. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, 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 the Company as of December 25, 2016 and December 27, 2015, and the results of their operations and their cash flows for each of the three years in the period ended December 25, 2016, in conformity with accounting principles generally accepted in the United States of America.

/s/ Deloitte & Touche LLP

Chicago, Illinois

February 22, 2017

Explanation of Responses:

POTBELLY CORPORATION AND SUBSIDIARIES

Consolidated Balance Sheets

(amounts in thousands, except share and par value data)

	December 25, 2016	December 27, 2015
ASSETS		
Current assets		
Cash and cash equivalents	$23,379	$32,006
Accounts receivable, net of allowances of $78 and $14 as of December 25, 2016 and December 27, 2015, respectively	3,787	4,461
Inventories	3,365	3,159
Prepaid expenses and other current assets	8,020	10,155
Total current assets	38,551	49,781
Property and equipment, net	107,074	97,434
Indefinite-lived intangible assets	3,404	3,404
Goodwill	2,222	1,428
Deferred income taxes, non-current	19,410	18,439
Deferred expenses, net and other assets	4,784	4,021
Total assets	$175,445	$174,507
LIABILITIES AND EQUITY		
Current liabilities		
Accounts payable	$3,111	$5,762
Accrued expenses	23,082	19,277
Accrued income taxes	1,622	143
Total current liabilities	27,815	25,182
Deferred rent and landlord allowances	21,076	17,820
Other long-term liabilities	2,318	1,292
Total liabilities	51,209	44,294
Equity		
Common stock, $0.01 par value—authorized, 200,000,000 shares; outstanding 25,139,127 and 26,304,261 shares as of December 25, 2016 and December 27, 2015, respectively	309	303
Warrants	909	909
Additional paid-in-capital	407,622	399,458
Treasury stock, held at cost, 5,753,412 and 4,033,910 shares as of December 25, 2016, and December 27, 2015, respectively	(72,321)	(50,000)
Accumulated deficit	(213,034)	(221,246)
Total stockholders’ equity	123,485	129,424
Non-controlling interest	751	789

Total equity	124,236	130,213
Total liabilities and equity	$175,445	$174,507

See accompanying notes to the consolidated financial statements.

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POTBELLY CORPORATION AND SUBSIDIARIES

Consolidated Statements of Operations

(amounts in thousands, except share and per share data)

	Fiscal Year 2016	2015	2014
Revenues			
Sandwich shop sales, net	$404,874	$370,954	$325,464
Franchise royalties and fees	2,257	1,895	1,515
Total revenues	407,131	372,849	326,979
Expenses			
Sandwich shop operating expenses			
Cost of goods sold, excluding depreciation	111,026	105,614	93,688
Labor and related expenses	117,838	106,628	93,165
Occupancy expenses	52,444	46,762	41,389
Other operating expenses	43,738	39,869	34,669
General and administrative expenses	40,411	37,322	32,420
Depreciation expense	22,734	21,476	19,615
Pre-opening costs	1,786	2,160	1,634
Impairment and loss on disposal of property and equipment	4,141	3,589	3,128
Total expenses	394,118	363,420	319,708
Income from operations	13,013	9,429	7,271
Interest expense	134	221	179
Income before income taxes	12,879	9,208	7,092
Income tax expense	4,443	3,466	2,748
Net income	8,436	5,742	4,344
Net income (loss) attributable to non-controlling interest	224	114	(14)
Net income attributable to Potbelly Corporation	$8,212	$5,628	$4,358
Net income per common share attributable to common stockholders:			
Basic	$0.32	$0.20	$0.15
Diluted	$0.31	$0.20	$0.14
Weighted average shares outstanding:			
Basic	25,623,809	28,002,005	29,209,298
Diluted	26,231,367	28,634,396	30,275,061

See accompanying notes to the consolidated financial statements.

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POTBELLY CORPORATION AND SUBSIDIARIES

Consolidated Statements of Equity

(amounts in thousands, except share data)

	Common Stock Shares	Amount	Treasury Stock	Warrants	Additional Paid-In-Capital	Accumulated Deficit	Non-Controlling Interest	Total Equity
Balance at December 29, 2013	29,148,029	$ 291	$—	$ 909	$ 383,077	$ (231,232)	$ 228	$ 153,273
Net income	—	—	—	—	—	4,358	(14)	4,344
Issuance of unrestricted common stock	28,240	—	—	—	432	—	—	432
Exercise of stock options	585,521	7	—	—	5,052	—	—	5,059
Excess tax benefits associated with exercise of stock options	—	—	—	—	1,300	—	—	1,300
Repurchases of common stock	(827,090)	—	(10,246)	—	—	—	—	(10,246)
Distributions to non-controlling interest	—	—	—	—	—	—	(46)	(46)
Contributions from non-controlling interest	—	—	—	—	—	—	98	98
Amortization of stock-based compensation	—	—	—	—	2,111	—	—	2,111
Balance at December 28, 2014	28,934,700	$ 298	$ (10,246)	$ 909	$ 391,972	$ (226,874)	$ 266	$ 156,325
Net income	—	—	—	—	—	5,628	114	5,742
Exercise of stock options	576,381	5	—	—	4,779	—	—	4,784
Excess tax benefits associated with exercise of stock options	—	—	—	—	308	—	—	308
Repurchases of common stock	(3,206,820)	—	(39,754)	—	—	—	—	(39,754)
Distributions to non-controlling interest	—	—	—	—	—	—	(198)	(198)

Contributions from non-controlling interest	—	—	—	—	—	—	607	607
Amortization of stock-based compensation	—	—	—	—	2,399	—	—	2,399
Balance at December 27, 2015	26,304,261	$ 303	$ (50,000)	$ 909	$ 399,458	$ (221,246)	$ 789	$ 130,213
Net income	—	—	—	—	—	8,212	224	8,436
Exercise of stock options	536,332	6	—	—	5,770	—	—	5,776
Common stock issued for stock-based compensation plans	18,036	—	—	—	—	—	—	—
Excess tax deficiencies associated with exercise of stock options	—	—	—	—	(663)	—	—	(663)
Repurchases of common stock	(1,719,502)	—	(22,321)	—	—	—	—	(22,321)
Distributions to non-controlling interest	—	—	—	—	—	—	(413)	(413)
Contributions from non-controlling interest	—	—	—	—	—	—	151	151
Amortization of stock-based compensation	—	—	—	—	3,057	—	—	3,057
Balance at December 25, 2016	25,139,127	$ 309	$ (72,321)	$ 909	$ 407,622	$ (213,034)	$ 751	$ 124,236

See accompanying notes to the consolidated financial statements.

POTBELLY CORPORATION AND SUBSIDIARIES

Consolidated Statements of Cash Flows

(amounts in thousands)

	Fiscal Year		
	2016	2015	2014
CASH FLOWS FROM OPERATING ACTIVITIES:			
Net income	$8,436	$5,742	$4,344
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation	22,734	21,476	19,615
Deferred income tax	(1,659)	(72)	(289)
Deferred rent and landlord allowances	3,256	3,808	1,787
Amortization of stock-based compensation	3,057	2,399	2,543
Excess tax benefit from stock-based compensation	(31)	(308)	(1,300)
Asset impairment, store closure and disposal of property and equipment	4,243	3,818	3,679
Amortization of debt issuance costs	34	11	70
Changes in operating assets and liabilities:			
Accounts receivable, net	674	(445)	(1,013)
Inventories	(188)	(388)	(505)
Prepaid expenses and other assets	3,204	(1,155)	(4,216)
Accounts payable	(1,899)	1,876	1,301
Accrued and other liabilities	4,108	3,558	538
Net cash provided by operating activities	45,969	40,320	26,554
CASH FLOWS FROM INVESTING ACTIVITIES:			
Acquisition of franchise shop	(1,108)	(333)	—
Purchases of property and equipment	(36,712)	(35,725)	(29,209)
Net cash used in investing activities	(37,820)	(36,058)	(29,209)
CASH FLOWS FROM FINANCING ACTIVITIES:			
Payments on note payable	—	(1,008)	(84)
Proceeds from exercise of stock options	6,165	5,825	6,137
Payment of payroll taxes related to stock-based compensation awards	(389)	(1,041)	(1,078)
Excess tax benefit from stock-based compensation	31	308	1,300
Treasury stock repurchase	(22,321)	(39,754)	(10,246)
Contributions from non-controlling interest	151	607	98
Distributions to non-controlling interest	(413)	(198)	(46)
Net cash used in financing activities	(16,776)	(35,261)	(3,919)
NET DECREASE IN CASH AND CASH EQUIVALENTS	(8,627)	(30,999)	(6,574)
CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD	32,006	63,005	69,579
CASH AND CASH EQUIVALENTS AT END OF PERIOD	$23,379	$32,006	$63,005
Supplemental cash flow information :			
Income taxes paid	$3,663	$2,376	$3,232
Interest paid	108	183	179
Supplemental non-cash investing and financing activities :			
Unpaid liability for purchases of property and equipment	$2,727	$3,395	$2,690

See accompanying notes to the consolidated financial statements.

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POTBELLY CORPORATION AND SUBSIDIARIES

Notes to the Consolidated Financial Statements

(1) Organization and Other Matters

Business

Potbelly Corporation (the "Company" or "Potbelly"), through its wholly-owned subsidiaries, operates Potbelly Sandwich Works sandwich shops in 29 states and the District of Columbia. The Company also sells and administers franchises of Potbelly Sandwich Works sandwich shops. The first franchise locations administered by the Company opened during February 2011. In July 2015, the Company opened its first franchise shop in the United Kingdom, and in October 2016, the Company opened its first franchise shop in Canada. Additionally, during each of July 2015 and April 2016, the Company transitioned one franchise shop into a company-operated shop for a purchase price of $0.3 million and $1.1 million, respectively. The Company did not record any goodwill related to the July 2015 transaction and recorded $0.8 million of goodwill related to the April 2016 transaction. The Company believes both acquisitions are immaterial.

Initial Public Offering

On October 9, 2013, the Company completed an initial public offering ("IPO") of 8,625,000 shares of common stock, which included 1,125,000 shares of common stock issued upon the exercise in full of the underwriters' option to purchase additional shares. The Company sold 8,474,869 shares of common stock and certain stockholders sold 150,131 shares of common stock. The Company received net proceeds from the offering of approximately $108.8 million, after deducting the underwriting discount and other offering expenses. The Company did not receive any proceeds from the shares sold by the selling stockholders.

The Company used the net proceeds received from the sale of its shares to pay a previously-declared one-time cash dividend of $49.9 million on shares outstanding on October 8, 2013 and also to repay borrowings of approximately $14.0 million under its senior credit facility. During fiscal year 2014, the Company used approximately $10.2 million of the net proceeds to repurchase common stock pursuant to the share repurchase program authorized by the Company's Board of Directors on August 1, 2014. The remaining proceeds were used in fiscal year 2015 for share repurchases, working capital, and general corporate purposes.

(2) Summary of Significant Accounting Policies

(a) Principles of Consolidation

The consolidated financial statements include the accounts of Potbelly Corporation; its wholly owned subsidiary, Potbelly Illinois, Inc. ("PII"); PII's wholly owned subsidiaries, Potbelly Franchising, LLC and Potbelly Sandwich Works LLC ("LLC"); eight of LLC's wholly owned subsidiaries and LLC's five joint ventures, collectively, the "Company." All significant intercompany balances and transactions have been eliminated in consolidation. For consolidated joint ventures, non-controlling interest represents a non-controlling partner's share of the assets, liabilities and operations related to the five joint venture investments. The Company has ownership interests ranging from 51-80% in these consolidated joint ventures.

The Company does not have any components of other comprehensive income (loss) recorded within its consolidated financial statements, and, therefore, does not separately present a statement of comprehensive income (loss) in its consolidated financial statements.

(b) Reporting Period

The Company uses a 52/53-week fiscal year that ends on the last Sunday of the calendar year. Approximately every five or six years a 53rd week is added. Fiscal years 2014, 2015 and 2016 each consisted of 52 weeks.

(c) Segment Reporting

The Company owns and operates Potbelly Sandwich Works sandwich shops in the United States. The Company also has domestic and international franchise operations of Potbelly Sandwich Works sandwich shops. The Company’s chief operating decision maker (the “CODM”) is its Chief Executive Officer. As the CODM reviews financial performance and allocates resources at a consolidated level on a recurring basis, the Company has one operating segment and one reportable segment.

(d) Use of Estimates

The preparation of financial statements in conformity with generally accepted accounting principles in the United States (“GAAP”) requires management to make estimates and assumptions, primarily related to the long-lived assets and income taxes, that affect the

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POTBELLY CORPORATION AND SUBSIDIARIES

Notes to the Consolidated Financial Statements

reported amounts of assets and liabilities and disclosure of contingent assets and liabilities as of 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.

(e) Fair Value Measurements

The Company applies fair value accounting for all financial assets and liabilities and nonfinancial assets and liabilities that are recognized or disclosed at fair value in the financial statements on a recurring basis. Fair value is defined as the price that would be received from selling an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. When determining the fair value measurements for assets and liabilities that are required to be recorded at fair value, the Company assumes the highest and best use of the asset by market participants in which the Company would transact and the market-based risk measurements or assumptions that market participants would use in pricing the asset or liability, such as inherent risk, transfer restrictions, and credit risk.

The Company applies the following fair value hierarchy, which prioritizes the inputs used to measure fair value into three levels, and bases the categorization within the hierarchy upon the lowest level of input that is available and significant to the fair value measurement:

- Level 1—Quoted prices in active markets for identical assets or liabilities.
- Level 2—Observable inputs other than quoted prices in active markets for identical assets or liabilities, quoted prices for identical or similar assets or liabilities in inactive markets, or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities.
- Level 3—Inputs that are both unobservable and significant to the overall fair value measurement reflect an entity’s estimates of assumptions that market participants would use in pricing the asset or liability.

(f) Financial Instruments

The Company records all financial instruments at cost, which is the fair value at the date of transaction. The amounts reported in the consolidated balance sheets for cash and cash equivalents, accounts receivable, accounts payable and all other current liabilities approximate their fair value because of the short-term maturities of these instruments.

(g) Cash and Cash Equivalents

The Company considers all highly liquid investment instruments with an original maturity of three months or less when purchased to be cash equivalents. The Company maintains its cash in bank deposit accounts that, at times, may exceed federally insured limits; however, the Company has not experienced any losses in these accounts. The Company believes it is not exposed to any significant credit risk. These are valued within the fair value hierarchy as Level 1 measurements.

(h) Accounts Receivable, net

Accounts receivable, net consists of credit card receivables, amounts owed from vendors and miscellaneous receivables. The Company had credit card receivables of $2.0 million and $1.6 million as of December 27, 2015 and December 25, 2016, respectively.

(i) Inventories

Inventories, which consist of food products, paper goods and supplies, and promotional items, are valued at the lower of cost (first-in, first-out) or market. No adjustment is deemed necessary to reduce inventory to the lower of cost or market value due to the rapid turnover and high utilization of inventory.

(j) Property and Equipment

Property and equipment acquired is recorded at cost less accumulated depreciation. Property and equipment is depreciated based on the straight-line method over the estimated useful lives, generally ranging from three to five years for furniture and fixtures, computer equipment, computer software, and machinery and equipment. Leasehold improvements are depreciated over the shorter of their estimated useful lives or the related lease life, generally 10 to 15 years. For leases with renewal periods at the Company’s option,

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Notes to the Consolidated Financial Statements

the Company determines the expected lease period based on whether the renewal of any options are reasonably assured at the inception of the lease.

Direct costs and expenditures for refurbishments and improvements that significantly add to the productive capacity or extend the useful life of an asset are capitalized, whereas the costs of repairs and maintenance are expensed when incurred. The Company capitalizes certain internal costs associated with the development, design, and construction of new shop locations as these costs have a future benefit to the Company. The Company capitalized costs of $0.9 million, $0.6 million and $0.6 million for the fiscal years ended December 28, 2014, December 27, 2015 and December 25, 2016, respectively. Capitalized costs are recorded as part of the asset to which they relate, primarily to leasehold improvements, and such costs are amortized over the asset's useful life. When assets are retired or sold, the asset cost and related accumulated depreciation are removed from the consolidated balance sheet and any gain or loss is recorded in the consolidated statement of operations.

The Company assesses potential impairments to its long-lived assets, which includes property and equipment, on a quarterly basis or whenever events or circumstances indicate that the carrying amount of an asset may not be recoverable. Shop-level assets are grouped at the individual shop-level for the purpose of the impairment assessment. Recoverability of an asset is measured by a comparison of the carrying amount of an asset to its estimated undiscounted future cash flows expected to be generated by the asset. If the carrying amount of the asset group exceeds its estimated undiscounted future cash flows, an impairment charge is recognized as the amount by which the carrying amount of the asset exceeds the fair value of the asset. The fair value of the shop assets is determined using the discounted future cash flow method of anticipated cash flows through the shop's lease-end date using fair value measurement inputs classified as Level 3. Level 3 inputs are derived from valuation techniques in which one or more significant inputs or significant value drivers are unobservable. The Company used a weighted average cost of capital to discount the future cash flows. After performing periodic reviews of the company-operated shops during each quarter of 2014, 2015 and 2016, it was determined that indicators of impairment were present for certain shops as a result of continued underperformance. The Company performed an impairment analysis related to these shops and recorded impairment charges of $2.9 million, $3.4 million and $4.0 million for the fiscal years 2014, 2015 and 2016, respectively, which is included in impairment and loss on disposal of property and equipment in the consolidated statements of operations.

(k) Intangible Assets

The Company reviews indefinite-lived intangible assets, which includes goodwill and tradenames, annually at fiscal year-end for impairment or more frequently if events or circumstances indicate that the carrying value may not be recoverable. An impaired asset is written down to its estimated fair value based on the most recent information available. The Company assesses the fair values of its intangible assets, and its reporting unit for goodwill testing purposes, using both an income-based approach and a market approach. Under the income approach, fair value is based on the present value of estimated future cash flows. The income approach is dependent on a number of factors, including forecasted revenues and expenses, appropriate discount rates and other variables. The market approach measures fair value by comparison to the observed fair values of comparable companies, adjusted for the relative size and profitability of these comparable companies. The annual impairment review utilizes the estimated fair value of the intangible assets and the overall reporting unit and compares the estimated fair values to the carrying values as of the testing date. If the carrying value of these intangible assets or the reporting unit exceeds the fair values, the Company would then use the fair values to measure the amount of any required impairment charge. No impairment charge was recognized for intangible assets for any of the fiscal periods presented.

(l) Pre-opening Costs

Pre-opening costs consist of costs incurred prior to opening a new shop and are made up primarily of travel, employee payroll and training costs incurred prior to the shop opening, as well as occupancy costs incurred from when the Company takes site possession to shop opening. Shop pre-opening costs are expensed as incurred.

(m) Advertising Expenses

Advertising costs are expensed as incurred and are included in general and administrative expenses in the consolidated statements of operations. Advertising expenses were $2.2 million, $2.9 million and $3.0 million in fiscal years 2014, 2015 and 2016, respectively.

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POTBELLY CORPORATION AND SUBSIDIARIES

Notes to the Consolidated Financial Statements

(n) Income Taxes

Income taxes are accounted for under the asset and liability method. Deferred tax assets and liabilities are attributable to differences between financial statement and income tax reporting. Deferred tax assets, net of any valuation allowances, represent the future tax return consequences of those differences and for operating loss and tax credit carryforwards, which will be deductible when the assets are recovered. Deferred tax assets are reduced by a valuation allowance if it is deemed more likely than not that some or all of the deferred tax assets will not be realized. In making this assessment of realizability of deferred tax assets, the Company considers whether it is more likely than not that some portion or all of the deferred tax assets will not be realized. The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income during the periods in which those temporary differences become deductible. The Company considers the scheduled reversal of deferred tax liabilities, projected future taxable income, and tax planning strategies in making this assessment. Deferred tax liabilities are recognized for temporary differences that will be taxable in future years' tax returns.

The Company accounts for uncertain tax positions under current accounting guidance, which prescribes a minimum probability threshold that a tax position must meet before a financial statement benefit is recognized. The minimum threshold is defined as a tax position that is more likely than not to be sustained upon examination by tax authorities, based on the technical merits of the position. The tax benefit to be recognized is measured as the largest amount of benefit that is greater than fifty percent likely of being realized upon ultimate settlement.

(o) Stock-Based Compensation

The Company has granted stock options under its 2001 Equity Incentive Plan (the "2001 Plan"), 2004 Equity Incentive Plan (the "2004 Plan") and 2013 Long-Term Incentive Plan, as amended (the "2013 Plan" and together with the 2004 Plan and 2001 Plan, the "Plans"). The Plans permit the granting of awards to employees and non-employee officers, consultants, agents, and independent contractors of the Company in the form of stock appreciation rights, stock awards, and stock options. The Plans give broad powers to the Company's board of directors to administer and interpret the Plans, including the authority to select the individuals to be granted options and rights and to prescribe the particular form and conditions of each option to be granted. In September 2011, the 2001 Plan expired with options outstanding under the plan still available for exercise. On July 31, 2013, the Company's board of directors approved the adoption of the 2013 Plan, which replaced the 2004 Plan in conjunction with the Company's IPO. Upon approval of the 2013 Plan, the Company no longer issued awards under the 2004 Plan. The 2004 Plan expired in February 2014, but will continue to govern outstanding awards granted prior to its termination.

The Company accounts for its stock-based employee compensation in accordance with Accounting Standards Codification ("ASC") 718, Stock Based Compensation. The Company records stock compensation expense on a straight-line basis over the vesting period based on the grant-date fair value of the option, determined using the Black-Scholes option pricing valuation model.

(p) Leases

The Company leases retail shops, warehouse and office space under operating leases. Most lease agreements contain tenant improvement allowances, rent holidays, lease premiums, rent escalation clauses, and/or contingent rent provisions. For purposes of recognizing incentives, premiums, and minimum rental expenses on a straight-line basis over the terms of the leases, the Company uses the date it takes possession of the leased space for construction purposes as the beginning of the term, which is generally two to three months prior to a shop's opening date. For leases with renewal periods at the Company's option, the Company determines the expected lease period based on whether the renewal of any options are reasonably assured at the inception of the lease. In addition to rental expense, certain leases require the Company to pay a portion of real estate taxes, utilities, building operating expenses, insurance and other charges in addition to rent.

For tenant improvement allowances, rent escalations, and rent holidays, the Company records a deferred rent liability in its consolidated balance sheets and amortizes the deferred rent over the terms of the leases as reductions to occupancy expense in the consolidated statements of operations.

(q) Revenue Recognition

Revenue from retail shops are presented net of discounts and recognized when food and beverage products are sold. Sales taxes collected from customers are excluded from revenues and the obligation is included in accrued liabilities until the taxes are remitted to the appropriate taxing authorities.

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Revenues from the Company’s gift cards are deferred and were previously recognized upon redemption or after a period of 36 months of inactivity on gift card balances (“gift card breakage”) and the Company does not have a legal obligation to remit the value of the unredeemed gift cards to the relevant jurisdictions. The Company monitors its actual patterns of redemption and updates its estimates and assumptions regarding redemption as the actual pattern changes. The Company estimates and records gift card breakage income based on its historical redemption pattern. The Company recognized an immaterial amount of gift card breakage income for the fiscal years ended 2014, 2015 and 2016, which is recorded within other operating expenses in the consolidated statements of operations.

The Company earns an initial franchise fee, a franchise development agreement fee and ongoing royalty fees under the Company’s franchise agreements. Initial franchise fee revenue is recognized at the point a franchise shop opens for business to the public, as this is the point in time when the Company has substantially performed all initial services required under the franchise agreement. The Company recognized franchise fee revenue of $0.3 million, $0.4 million and $0.4 million in fiscal year 2014, 2015 and 2016, respectively. Initial franchise fee payments received by the Company before the shop opens are recorded as deferred revenue in the consolidated balance sheet. The Company had deferred revenue related to initial franchise fees of $0.5 million and $0.7 million included in accrued expenses as of December 27, 2015 and December 25, 2016, respectively. Franchise development agreement fee represents the exclusivity rights for a geographical area paid by a third party to develop Potbelly shops for a certain period of time. Franchise development agreement fee payments received by the Company are recorded as deferred revenue in the consolidated balance sheet and amortized over the life of the franchise development agreement. The Company had deferred revenue related to franchise development agreement fees of $0.4 million recorded as accrued expenses as of December 27, 2015 and December 25, 2016. Royalty fees are based on a percentage of sales and are recorded as revenue as the fees are earned and become receivable from the franchisee. The Company recognized royalty fees revenue of $1.2 million, $1.5 million and $1.9 million for fiscal years 2014, 2015, and 2016, respectively.

(r) Recent Accounting Pronouncements

In May 2014, the FASB issued ASU No. 2014-09, “Revenue from Contracts with Customers.” The pronouncement was issued to clarify the principles for recognizing revenue and to develop a common revenue standard and disclosure requirements for U.S. GAAP and IFRS. The FASB has approved a one-year deferral of the effective date of ASU 2014-09, such that it will become effective for the annual period beginning after December 15, 2017. In addition, the FASB issued ASU 2016-08, ASU 2016-10, ASU 2016-12, and ASU 2016-20 in March 2016, April 2016, May 2016, and December 2016, respectively, to help provide interpretive clarifications on the new guidance in ASC Topic 606. The Company is currently evaluating the overall impact that ASU 2014-09 will have on the Company's consolidated financial statements, as well as the expected timing and method of adoption. Based on a preliminary assessment, the Company has determined that the adoption will not have a material impact on sandwich shop sales, but may impact gift card breakage income. The Company is continuing its assessment, which may identify additional impacts this standard will have on its consolidated financial statements and related disclosures.

In February 2016, the FASB issued ASU No. 2016-02, “Leases”, which will replace the existing guidance in ASC 840, “Leases”. The pronouncement requires a dual approach for lessee accounting under which a lessee would account for leases as finance leases or operating leases. Both finance leases and operating leases will result in the lessee recognizing a right-of-use asset and a corresponding lease liability. For finance leases, the lessee would recognize interest expense and amortization of the right-of-use asset, and for operating leases, the lessee would recognize a straight-line total lease expense. The pronouncement is effective for fiscal years beginning after December 15, 2018, including annual and interim periods thereafter. In addition, the pronouncement requires the use of the modified retrospective method, which will require adjustment to all comparative periods presented in the consolidated financial statements. The Company is currently evaluating the impact ASU 2016-02 will have on its financial position, results of operations and cash flows but expect that it will result in a material increase in its long-term assets and liabilities given the Company has a significant number of leases.

In March 2016, the FASB issued ASU No. 2016-04, “Recognition of Breakage for Certain Prepaid Stored-Value Products”. This pronouncement clarifies when it is acceptable to recognize the unredeemed portion of prepaid gift cards into income. This pronouncement is effective for fiscal years beginning after December 15, 2017, and interim periods within those fiscal years. The Company is evaluating the impact this standard will have on its financial statements and disclosures.

In March 2016, the FASB issued ASU No. 2016-09, “Compensation – Stock Compensation (Topic 718)”. The pronouncement simplifies the accounting for the taxes related to stock-based compensation, including the accounting for income taxes, forfeitures, and statutory tax withholding requirements, as well as classification within the statement of cash flows. The pronouncement is effective for

POTBELLY CORPORATION AND SUBSIDIARIES

Notes to the Consolidated Financial Statements

annual periods beginning after December 15, 2016, including annual and interim periods thereafter. If the Company would have adopted this standard for fiscal 2016, it would have had the effect of increasing income tax expense by $0.7 million for the year.

In August 2016, the FASB issued ASU No. 2016-15, “Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments”. The objective of this pronouncement is to eliminate the diversity in practice related to the classification of certain cash receipts and payments in the statement of cash flows, by adding or clarifying guidance on eight specific cash flow issues. The pronouncement is effective for annual periods beginning after December 15, 2017, including annual and interim periods thereafter. Early adoption is permitted. The adoption of ASU 2016-15 is not expected to have a material effect on the Company’s financial statements and disclosures.

(s) Commitments and Contingencies

As previously disclosed in prior reports filed with the SEC, the Company received notice of a potential claim alleging that the Company violated the Fair Labor Standards Act by not paying overtime to its assistant managers, whom the Company has classified as exempt employees. Although the Company has always believed that its assistant managers are properly classified as exempt under both federal and state laws, and have always intended to defend any such lawsuits vigorously, the Company agreed to mediate the matter. On February 20, 2017, the parties entered into a Settlement Agreement and Release whereby participating assistant managers will release the Company from all federal and/or state wage and hour claims in exchange for a gross settlement amount of $1.3 million. As part of the settlement process, a complaint was filed on February 17, 2017 in the Circuit Court of the Fifteenth Judicial Circuit in and for Palm Beach County, Florida, and a motion seeking the Court's preliminary approval of the settlement was filed on February 21, 2017. As of December 25, 2016, the Company recorded a liability of $1.3 million for this matter. The settlement of this action did not have a material adverse effect on our financial position or results of operations and cash flows.

The Company is subject to legal proceedings, claims and liabilities, such as employment-related claims and slip and fall cases, which arise in the ordinary course of business and are generally covered by insurance. In the opinion of management, the amount of ultimate liability with respect to those actions should not have a material adverse impact on the Company’s financial position, results of operations or cash flows.

Many of the food products the Company purchases are subject to changes in the price and availability of food commodities, including, among other things, beef, poultry, grains, dairy and produce. The Company works with its suppliers and uses a mix of forward pricing protocols for certain items including agreements with its supplier on fixed prices for deliveries at some time in the future and agreements on a fixed price with its supplier for the duration of that protocol. The Company also utilizes formula pricing protocols under which the prices the Company pays are based on a specified formula related to the prices of the goods, such as spot prices. The Company’s use of any forward pricing arrangements varies substantially from time to time and these arrangements tend to cover relatively short periods (i.e., typically twelve months or less). Such contracts are used in the normal purchases of the Company’s food products and not for speculative purposes, and as such are not required to be evaluated as derivative instruments. The Company does not enter into futures contracts or other derivative instruments.

(3) Fair Value Measurement

The carrying amounts of cash and cash equivalents, accounts receivable, accounts payable and all other current liabilities approximate fair values due to the short maturities of these balances.

The Company assesses potential impairments to its long-lived assets, which includes property and equipment, on a quarterly basis, or whenever events or circumstances indicate that the carrying amount of an asset may not be recoverable. Shop-level assets are grouped at the individual shop-level for the purpose of the impairment assessment. Recoverability of an asset is measured by a comparison of the carrying amount of an asset to its estimated undiscounted future cash flows expected to be generated by the asset. If the carrying amount of the asset group exceeds its estimated undiscounted future cash flows, an impairment charge is recognized as the amount by which the carrying amount of the asset exceeds the fair value of the asset. The fair value of the shop assets was determined using the discounted future cash flow method of anticipated cash flows through the shop’s lease-end date using fair value measurement inputs classified as Level 3. Level 3 inputs are derived from valuation techniques in which one or more significant inputs or significant value drivers are unobservable. After performing a periodic review of the Company’s shops during each quarter of 2014, 2015 and 2016, it was determined that indicators of impairment were present for certain shops as a result of continued underperformance of shop profitability. The Company performed an impairment analysis related to these shops and recorded impairment charges of $2.9 million, $3.4 million and $4.0 million for the fiscal years 2014, 2015 and 2016, respectively, related to the excess of the carrying amounts recorded on the Company’s consolidated balance sheet over the identified shops’ estimated fair values.

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(4) Earnings per share

Basic and diluted income per common share attributable to common stockholders are calculated using the weighted average number of common shares outstanding for the period. Diluted income per common share attributable to common stockholders is computed by dividing the income allocated to common stockholders by the weighted average number of fully diluted common shares outstanding.

	Fiscal Year		
	2016	2015	2014
Net income attributable to Potbelly Corporation	$8,212	$5,628	$4,358
Weighted average common shares outstanding-basic	25,623,809	28,002,005	29,209,298
Plus: Effect of potential stock options exercise	549,578	577,156	949,142
Plus: Effect of potential warrant exercise	57,980	55,235	116,621
Weighted average common shares outstanding-diluted	26,231,367	28,634,396	30,275,061
Income per share available to common stockholders-basic	$0.32	$0.20	$0.15
Income per share available to common stockholders-diluted	$0.31	$0.20	$0.14
Potentially dilutive shares that are considered anti-dilutive:			
Common share options	1,164,047	898,966	622,879
Warrants	—	—	—

(5) Property and Equipment

Property and equipment, net consisted of the following (in thousands):

	December 25, 2016	December 27, 2015
Leasehold improvements	$170,196	$157,556
Machinery and equipment	47,668	42,840
Furniture and fixtures	32,561	28,605
Computer equipment and software	23,162	20,077
Construction in progress	5,601	3,074
	279,188	252,152
Less: Accumulated depreciation	(172,114)	(154,718)
	$107,074	$97,434

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POTBELLY CORPORATION AND SUBSIDIARIES

Notes to the Consolidated Financial Statements

(6) Accrued Expenses

Accrued expenses consisted of the following (in thousands):

	December 25, 2016	December 27, 2015
Accrued labor and related expenses	$ 6,120	$ 7,482
Deferred gift card revenue	2,292	1,843
Accrued occupancy expenses	1,538	672
Deferred rent—current	706	813
Accrued corporate and shop expenses	2,255	1,961
Accrued utilities	1,094	1,035
Accrued sales and use tax	1,857	1,820
Accrued construction	2,329	2,271
Accrued contract termination costs (a)	28	21
Accrued legal and professional fees	1,756	136
Accrued other	3,107	1,223
Total	$ 23,082	$ 19,277

(a) The Company incurs expenses associated with exit activity for certain signed lease agreements, which are recognized in general and administrative expenses. Accrued contract termination costs consisted of the following (in thousands):

	December 25, 2016	December 27, 2015
Accrued contract termination costs—beginning balance	$ 21	$ 801
Contract termination costs incurred	24	—
Contract termination costs settled and paid	(17)	(780)
Accrued contract termination costs—ending balance	$ 28	$ 21

(7) Income Taxes

Income before income taxes for the Company’s domestic and foreign operations was as follows (in thousands):

	Fiscal Year		
	2016	2015	2014
Domestic operations	$ 12,411	$ 8,660	$ 6,627
Foreign operations	468	548	465

Total	$12,879	$9,208	$7,092

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POTBELLY CORPORATION AND SUBSIDIARIES

Notes to the Consolidated Financial Statements

Income tax expense consisted of the following (in thousands):

	Fiscal Year		
	2016	2015	2014
Federal:			
Current	$4,652	$2,450	$2,386
Deferred	(1,386)	209	(467)
	3,266	2,659	1,919
State and Local:			
Current	1,426	1,047	622
Deferred	(273)	(281)	178
	1,153	766	800
Foreign:			
Current	24	41	29
Deferred	—	—	—
	24	41	29
Income tax expense	$4,443	$3,466	$2,748

Income tax expense differed from the amounts computed by applying the U.S. federal income tax rates to income before income taxes as a result of the following (in thousands):

	Fiscal Year		
	2016	2015	2014
Computed "expected" tax expense	$4,508	$3,223	$2,411
Increase (reduction) resulting from:			
Minority interest	(89)	(45)	—
Permanent differences	131	51	97
State and local income taxes, net of federal income tax effect	673	533	460
FICA and other tax credits	(556)	(392)	(222)
Rate change and true-ups (a)	(224)	164	2
Change in valuation allowance	—	(68)	—
	$4,443	$3,466	$2,748

(a) The $(224) of rate changes and true-ups relates primarily to a favorable provision-to-return adjustment related to WOTC credits.

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POTBELLY CORPORATION AND SUBSIDIARIES

Notes to the Consolidated Financial Statements

The tax effects of temporary differences that give rise to significant portions of the deferred tax assets and liabilities reflected in the consolidated balance sheets are presented below (in thousands):

	December 25, 2016	December 27, 2015
Deferred tax assets:		
Accrued liabilities	$ 1,848	$ 2,074
Deferred revenue on gift certificates and gift cards	323	141
Stock-based compensation	8,104	8,261
Property and equipment depreciation	6,293	5,805
Deferred rent and start-up amortization	5,656	4,650
Other timing differences	234	273
FICA and other tax credits	—	43
Total deferred tax assets	22,458	21,247
Less: valuation allowance	—	—
Net deferred tax assets	22,458	21,247
Deferred tax liabilities:		
Prepaids	(635)	(547)
Intangible asset	(1,351)	(1,226)
Smallwares	(801)	(733)
Other timing differences	(261)	(302)
Total gross deferred tax liabilities	(3,048)	(2,808)
Net deferred tax assets	$ 19,410	$ 18,439

As of December 27, 2015 and December 25, 2016, the Company has no valuation allowances recorded based on management's assessment of the amount of its deferred tax assets that are more likely than not to be realized.

In accordance with its accounting policy, the Company recognizes accrued interest and penalties related to unrecognized tax benefits as a component of income tax expense. As of December 27, 2015 and December 25, 2016, the Company had no interest or penalties accrued.

The tax years prior to 2013 are generally closed for examination by the United States Internal Revenue Service. However, certain of these tax years are open for examination as a result of net operating losses generated in these years and utilized in subsequent years. The Company is currently under examination with the IRS for the 2014 tax year; no other IRS audits are currently ongoing. State statutes are generally open for audit for the 2012 to 2016 tax years. Additionally, certain tax years through 2016 are open for examination by certain state tax authorities.

(8) Long-term debt

Note payable

On March 15, 2007, the Company entered into a long-term note payable associated with the acquisition of certain assets of Pot Belly Deli, Inc., an unrelated California company, including the Pot Belly trade name, certain design marks, and other related assets. The Company records interest on the note payable under the effective interest method at an annual interest rate of 6.2% and recorded interest expense of $0.1 million in fiscal year 2014. The Company recorded an immaterial amount of interest expense on the note payable in fiscal year 2015. Payment of interest and principal is made monthly. The final repayment of the note was made on April 1, 2015.

Credit facility

JPMorgan Chase Bank, N.A.

On December 9, 2015, the Company entered into an amended and restated five-year revolving credit facility agreement that expires in November 2020. The credit agreement provides, among other things, for a revolving credit facility in a maximum principal amount of $50 million, with possible future increases to $75 million under an expansion feature. Borrowings under the credit facility generally bear interest at the Company’s option at either (i) a eurocurrency rate determined by reference to the applicable LIBOR rate

POTBELLY CORPORATION AND SUBSIDIARIES

Notes to the Consolidated Financial Statements

plus a margin ranging from 1.00% to 1.75% or (ii) a prime rate as announced by JP Morgan Chase plus a margin ranging from 0.00% to 0.50%. The applicable margin is determined based upon the Company's consolidated total leverage ratio. On the last day of each calendar quarter, the Company is required to pay a commitment fee ranging from 0.125% to 0.20% per annum in respect of any unused commitments under the credit facility, with the specific rate determined based upon the Company's consolidated total leverage ratio. So long as certain total leverage ratios are met, there is no limit on the "restricted payments" (primarily distributions and equity repurchases) that the Company may make. As of December 25, 2016, the Company has no amounts outstanding under the credit facility. As of and for the year ended December 25, 2016, the Company has $49.3 million available for borrowing under the credit facility after reductions for outstanding letters of credit.

(9) Capital Stock and Warrants

As of December 25, 2016 and December 27, 2015, the Company had authorized an aggregate of 210,000,000 shares of capital stock, of which 200,000,000 shares were designated as common stock and 10,000,000 shares were designated as preferred stock. As of December 25, 2016, the Company had issued and outstanding 30,892,539 and 25,139,127 shares of common stock, respectively. As of December 27, 2015, the Company had issued and outstanding 30,338,171 and 26,304,261 shares of common stock, respectively.

Common Stock

As of December 25, 2016, each share of common stock has the same relative rights and was identical in all respects to each other share of common stock. Each holder of shares of common stock is entitled to one vote for each share held by such holder at all meetings of stockholders.

On September 8, 2016, the Company announced that its Board of Directors authorized a share repurchase program of up to $30.0 million of the Company's common stock. The Company's previous $35.0 million share repurchase program, authorized in September 2015, was completed in July 2016. The new program permits the Company, from time to time, to purchase shares in the open market (including in pre-arranged stock trading plans in accordance with the guidelines specified in Rule 10b5-1 under the Securities Exchange Act of 1934, as amended) or in privately negotiated transactions. During the fiscal year ended December 25, 2016, the Company repurchased 1,719,502 shares of its common stock for approximately $22.3 million, including cost and commission, in open market transactions. As of December 25, 2016, the remaining dollar value of authorization under the share repurchase program was $27.7 million, which does not include commission. Repurchased shares are included as treasury stock in the consolidated balance sheets and the consolidated statements of equity.

Warrants

As of December 27, 2015 and December 25, 2016, the Company had 241,704 warrants outstanding. During 2013, the Company modified 241,704 of warrants issued to Oxford Capital Partners, Inc. that were set to expire upon the consummation of an IPO to extend the expiration date of such warrants to five years from the date of the consummation of an IPO. In accordance with ASC Topic 718, Compensation—Stock Compensation, the Company recorded a charge of approximately $0.1 million related to the incremental value associated with the extension of the expiration date.

(10) Operating Leases

The Company leases office space for its corporate office and commercial spaces for its shops under various long-term operating lease agreements. The leases for the Company's shop locations generally have initial terms of 10 years and typically provide for two renewal options in five-year increments as well as for rent escalations. These leases expire or become subject to renewal clauses at various dates from 2017 to 2029. Some of the leases provide for base rent, plus additional rent based on gross sales, as defined in each lease agreement. The Company is also generally obligated to pay certain real estate taxes, utilities, building operating expenses, insurance, and various other expenses related to properties.

POTBELLY CORPORATION AND SUBSIDIARIES

Notes to the Consolidated Financial Statements

Rental expense under operating lease agreements were as follows (in thousands):

	Fiscal Year		
	2016	2015	2014
Minimum rentals	$40,252	$36,955	$33,032
Contingent rentals	1,755	1,827	1,765
Less: sublease rentals	(94)	(94)	(94)
Total	$41,913	$38,688	$34,703

A schedule by year of future minimum rental payments required under operating leases, excluding contingent rent, that have initial or remaining non-cancelable lease terms in excess of one year, as of December 25, 2016, is as follows (in thousands):

Years Ending	Minimum
2017	$46,035
2018	42,583
2019	38,947
2020	36,818
2021	32,911
Thereafter	96,078
Total minimum payments required*	$293,372

*Minimum payments have not been reduced by minimum sublease rentals of $0.2 million due in the future.
Certain leases have outstanding letters of credit in lieu of rent deposits expiring at various dates through September 2017. The letters of credit were $0.6 million in aggregate for each of the years ended December 28, 2014 and December 27, 2015, and $0.7 million in aggregate for the year ended December 25, 2016. Under the credit facility, outstanding letters of credit are subject to an annual fee of 1.50% and reduce the available borrowing to the Company.

(11) Employee Benefit Plan

The Company sponsors a 401(k) profit sharing plan for all employees who are eligible based upon age and length of service. The Company made matching contributions of $0.3 million for fiscal year 2014 and $0.4 million for fiscal years 2015 and 2016.

(12) Stock Based Compensation

Stock Based Compensation Granted Under the 2001 and 2004 Equity Incentive Plans and 2013 Long-Term Incentive Plan

The Company has granted stock options under its 2001 Equity Incentive Plan (the “2001 Plan”), 2004 Equity Incentive Plan (the “2004 Plan”) and 2013 Long-Term Incentive Plan, as amended (the “2013 Plan” and together with the 2004 Plan and 2001 Plan, the “Plans”). The Plans permit the granting of awards to employees and non-employee officers, consultants, agents, and independent contractors of the Company in the form of stock appreciation rights, stock awards, and stock options. The Plans give broad powers to the Company’s board of directors to administer and interpret the Plans, including the authority to select the individuals to be granted options and rights and to prescribe the particular form and conditions of each option to be granted.

Under the 2001 Plan, the Company had 746,749 shares reserved for issuance. In 2007, the Company entered into a Stock Option Agreement (the “Agreement”), which granted a certain key executive 500,000 options of non-voting common stock. In September 2011, the 2001 Plan expired with options outstanding under the plan still available for exercise. As a result of the IPO, all shares of the non-voting common stock converted into voting common stock on a 1:1 basis upon exercise.

On July 31, 2013, the Company’s board of directors approved the adoption of the 2013 Plan, which replaced the 2004 Plan in conjunction with the Company’s IPO. Upon approval of the 2013 Plan, the Company no longer issued awards under the 2004 Plan. The 2004 Plan expired in February 2014, but will continue to govern outstanding awards granted prior to its termination. As of December 25, 2016, there have been 1,646,991 options, 28,240 shares of unrestricted common stock and 88,635 shares of restricted stock units (“RSUs”) granted under the 2013 Plan and 1,099,191 shares are reserved for future issuance.

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POTBELLY CORPORATION AND SUBSIDIARIES

Notes to the Consolidated Financial Statements

Under the Plans, the number of shares and exercise price of each option are determined by the committee designated by the Company's board of directors. The options granted are generally exercisable within a 10-year period from the date of grant. Certain options have been issued to key executives. Options issued and outstanding expire on various dates through the year 2026. The range of exercise prices of options outstanding as of December 25, 2016, is $7.00 to $20.53 per option, and the options vest over a range of immediately to five-year periods.

Activity under the Plans and the Agreement is as follows:

Options	Shares (Thousands)	Weighted Average Exercise Price	Aggregate Intrinsic Value (Thousands)	Weighted Average Remaining Term (Years)
Outstanding—December 29, 2013	5,030	$ 9.41	$ 78,575	6.31
Granted	318	19.16		
Exercised	(586)	8.67		
Canceled	(149)	11.68		
Outstanding—December 28, 2014	4,613	$ 10.10	$ 12,731	5.62
Granted	565	13.21		
Exercised	(576)	8.30		
Canceled	(234)	13.89		
Outstanding—December 27, 2015	4,368	$ 10.53	$ 9,742	5.10
Granted	369	13.65		
Exercised	(536)	10.77		
Canceled	(188)	14.40		
Outstanding—December 25, 2016	4,013	$ 10.61	$ 13,455	4.78
Vested and expected to vest—December 25, 2016	2,965	9.62	$ 10,182	3.54
Exercisable—December 25, 2016	2,989	$ 9.61	$ 12,675	3.60

The following table reflects the average assumptions utilized in the Black-Scholes option-pricing model to value the options granted for each year:

	2016	2015	2014
Risk-free interest rate	1.7 %	1.9 %	1.3 %
Expected life (years)	7.00	7.00	7.00
Expected dividend yield	—	—	—
Volatility	49.4 %	45.3 %	49.2 %
Weighted average common stock fair value	$13.65	$13.21	$19.16

The risk-free rate is based on U.S. Treasury rates in effect at the time of the grant with a similar duration of the expected life of the options. The expected life of options granted is derived from the average of the vesting period and the term of the option. The Company has not paid dividends to date (with exception to the one-time dividend paid to stockholders prior to the initial public offering) and does not plan to pay dividends in the near future. Beginning October 2015, expected volatility of the options was calculated using the Company's historical data since its initial public offering. Prior to October 2015, the Company calculated expected volatility of the options based on historical data from selected peer public company restaurants.

During fiscal year 2014, the Company issued 28,240 shares of unrestricted common stock to certain non-employee members of its Board of Directors. The unrestricted stock had a weighted average grant-date share price of $15.29 upon issuance. The Company recorded $0.4 million in stock-based compensation expense, with a corresponding increase to additional paid-in capital, related to the issuance of the common stock.

In May 2015, the Company issued 30,856 shares of "RSUs" to certain non-employee members of its Board of Directors. The RSUs had a grant-date fair value of $14.26 upon issuance. In August 2015, the Company issued 5,221 shares of RSUs to the new non-employee member of its Board of Directors. The RSUs had a grant-date fair value of $11.88 upon issuance. In May 2016, the Company issued 52,558 shares of RSUs to certain non-employee members of its Board of Directors. The RSUs had a grant-date fair

POTBELLY CORPORATION AND SUBSIDIARIES

Notes to the Consolidated Financial Statements

value of $13.27 upon issuance. All issued RSUs have a vesting schedule of 50% on the first anniversary of the grant date and 50% on the second anniversary of the grant date.

Stock-based Compensation Expense

In accordance with ASC Topic 718, Compensation—Stock Compensation, 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 recognized $2.5 million, $2.4 million and $3.1 million for the fiscal years 2014, 2015 and 2016, respectively, with a corresponding increase to additional paid-in-capital. Fiscal year 2014 stock-based compensation expense includes $0.4 million related to unrestricted common stock granted during 2014. As of December 25, 2016, the unrecognized stock-based compensation expense was $5.2 million, which will be recognized through fiscal year 2020. The Company records stock-based compensation expense within general and administrative expenses in the consolidated statements of operations.

(13) Quarterly Financial Data (Unaudited)

The unaudited quarterly information includes all normal recurring adjustments that the Company considers necessary for a fair presentation of the information shown. The Company’s quarterly results have been and will continue to be affected by the timing of new shop openings and their associated pre-opening costs. As a result of these and other factors, the financial results for any quarter may not be indicative of the results for any future period.

The following table presents selected unaudited quarterly financial data for periods indicated (in thousands, except per share data):

	Fiscal Year 2016 (1)			
	March 27	June 26	September 25	December 25
Total revenues	$95,955	$105,036	$103,782	$102,358
Income from operations	1,889	5,512	2,842	2,770
Net income attributable to Potbelly Corporation	1,088	3,373	1,795	1,956
Income per share available to common stockholders-basic	0.04	0.13	0.07	0.08
Income per share available to common stockholders-diluted	0.04	0.13	0.07	0.08

	Fiscal Year 2015 (1)			
	March 29	June 28	September 27	December 27
Total revenues	$85,768	$95,949	$ 96,039	$ 95,093
Income from operations	948	4,084	2,379	2,018
Net income attributable to Potbelly Corporation	531	2,461	1,401	1,235
Income per share available to common stockholders-basic	0.02	0.09	0.05	0.05
Income per share available to common stockholders-diluted	0.02	0.08	0.05	0.05

(1) Fiscal years 2016 and 2015 were 52-week years. Each quarter of the fiscal year consists of 13 weeks.

(14) Commitments and Contingencies

As previously disclosed in prior reports filed with the SEC, the Company received notice of a potential claim alleging that the Company violated the Fair Labor Standards Act by not paying overtime to its assistant managers, whom the Company has classified as exempt employees. Although the Company has always believed that its assistant managers are properly classified as exempt under both federal and state laws, and have always intended to defend any such lawsuits vigorously, the Company agreed to mediate the matter. On February 20, 2017, the parties entered into a Settlement Agreement and Release whereby participating assistant managers will release the Company from all federal and/or state wage and hour claims in exchange for a gross settlement amount of $1.3 million. As part of the settlement process, a complaint was filed on February 17, 2017 in the Circuit Court of the Fifteenth Judicial Circuit in and for Palm Beach County, Florida, and a motion seeking the Court's preliminary approval of the settlement was filed on February 21, 2017. As of December 25, 2016, the Company recorded a liability of $1.3 million for this matter. The settlement of this action did not have a material adverse effect on our financial position or results of operations and cash flows.

POTBELLY CORPORATION AND SUBSIDIARIES

Notes to the Consolidated Financial Statements

The Company is subject to legal proceedings, claims and liabilities, such as employment-related claims and slip and fall cases, which arise in the ordinary course of business and are generally covered by insurance. In the opinion of management, the amount of ultimate liability with respect to those actions should not have a material adverse impact on the Company’s financial position or results of operations and cash flows.

ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

None.

ITEM 9A. CONTROLS AND PROCEDURES

Disclosure Controls and Procedures

Our management, with the participation of our Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended ("Exchange Act")) as of December 25, 2016. Based upon that evaluation, our Chief Executive Officer and Chief Financial Officer have concluded that, as of December 25, 2016, our disclosure controls and procedures were effective in ensuring that information required to be disclosed in reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the rules and forms of the Securities and Exchange Commission (the "SEC") and 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.

Changes in Internal Control over Financial Reporting

There have been no changes in our internal control over financial reporting (as defined in Rule 13a-15(f) under the Exchange Act) that occurred during our fiscal quarter ended December 25, 2016 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Management's Report on Internal Control over Financial Reporting

Management, including our Chief Executive Officer and Chief Financial Officer, is responsible for establishing and maintaining adequate internal control over financial reporting (as defined in Rule 13a-15(f) and 15d-15(f) under the Exchange Act). Our internal control over financial reporting is a process 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. Our internal control over financial reporting 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 our assets; (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 our receipts and expenditures are being made only in accordance with authorizations of our management and directors; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of our assets that could have a material effect on our financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Therefore, even those systems determined to be effective can provide only reasonable assurance with respect to financial statement preparation and presentation. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions or that the degree of compliance with the policies or procedures may deteriorate.

Management assessed the effectiveness of our internal control over financial reporting as of December 25, 2016. In making this assessment, management used the criteria established by the Committee of Sponsoring Organizations of the Treadway Commission ("COSO") in Internal Control-Integrated Framework (2013). Based on this assessment, management has concluded that, as of December 25, 2016, our internal control over financial reporting was effective, at a reasonable assurance level.

Because we are an "emerging growth company" under the Jumpstart Our Business Startups Act of 2012, this Annual Report on Form 10-K does not include an attestation report of our independent registered public accounting firm.

ITEM 9B. OTHER INFORMATION

None.

PART III

ITEM 10. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE

Except as set forth below, the information required by this item will be contained in our definitive proxy statement for the 2016 Annual Meeting (our “Proxy Statement”) and is incorporated herein by reference.

We have adopted an ethics code of conduct applicable to our directors, officers and employees. A copy of that code is available on our corporate website at www.potbelly.com, which does not form a part of this Annual Report on Form 10-K. Any amendments to such code, or any waivers of its requirements, will be posted on our website.

ITEM 11. EXECUTIVE COMPENSATION

The information required by this item will be contained in our Proxy Statement and is incorporated herein by reference.

ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS

Except as set forth below, the information required by this item will be contained in our Proxy Statement and is incorporated herein by reference.

Equity Compensation Plan Information

The following table presents certain information related to our equity incentive plans under which our equity securities are authorized for issuance as of December 25, 2016:

Plan Category	(a) Number of Securities to be issued upon exercise of outstanding options, warrants and rights	(b) Weighted-average exercise price of outstanding options, warrants and rights	(c) Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a))

Equity compensation plans approved by security holders (1)	4,012,520	$ 10.61	1,099,191	(2)
Equity compensation plans not approved by security holders	—	—	—	
Total	4,012,520	$ 10.61	1,099,191	

(1) Consists of the 2001 Equity Incentive Plan, the 2004 Equity Incentive Plan and the 2013 Long-Term Incentive Plan. No further awards may be made under the 2001 Equity Incentive Plan or the 2004 Equity Incentive Plan.
(2) The total amount reported consists only of shares available for future issuance under the 2013 Long-Term Incentive Plan, which may be issued in connection with awards of stock options, stock appreciation rights, restricted stock, restricted stock units, deferred stock units, performance stock and performance stock units.

ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS, AND DIRECTOR INDEPENDENCE

The information required by this item will be contained in our Proxy Statement and is incorporated herein by reference.

ITEM 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES

The information required by this item will be contained in our Proxy Statement and is incorporated herein by reference.

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PART IV

ITEM 15. EXHIBITS AND FINANCIAL STATEMENT SCHEDULES
(a) Financial Statements

(1) The financial statements filed as part of this Annual Report on Form 10-K are listed in the index to the financial statements.

(2) Any financial statement schedules required to be filed as part of this Annual Report on Form 10-K are set forth in section (c) below.

(b) Exhibits

See the Exhibit Index at the end of this Annual Report on Form 10-K, which is incorporate by reference.

(c) Financial Statement Schedules

No financial statement schedules are provided because the information called for is not applicable or is shown in the financial statements or notes thereto.

SIGNATURES

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

POTBELLY CORPORATION

By: /s/ Aylwin Lewis
Aylwin Lewis
Chief Executive Officer and President

Date: February 22, 2017

POWER OF ATTORNEY

KNOW ALL MEN BY THESE PRESENTS, that each person whose signature appears below constitutes and appoints Aylwin Lewis, Michael Coyne and Matthew Revord and each of them, his or her true and lawful attorneys-in-fact, each with full power of substitution, for him or her in any and all capacities, to sign any amendments to this report on Form 10-K and to file the same, with exhibits thereto and other documents in connection therewith, with the Securities and Exchange Commission, hereby ratifying and confirming all that each of said attorneys-in-fact or their substitute or substitutes may do or cause to be done by virtue hereof. 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.

Signature	Title	Date
/s/ Aylwin Lewis Aylwin Lewis	Chairman, Chief Executive Officer and President (Principal Executive Officer)	February 22, 2017
/s/ Michael Coyne Michael Coyne	Senior Vice President and Chief Financial Officer (Principal Financial and Principal Accounting Officer)	February 22, 2017
/s/ Peter Bassi Peter Bassi	Director	February 22, 2017
/s/ Ann-Marie Campbell Ann-Marie Campbell	Director	February 22, 2017
/s/ Susan Chapman-Hughes	Director	February 22, 2017

Susan Chapman-Hughes		
/s/ Daniel Ginsberg Daniel Ginsberg	Director	February 22, 2017
/s/ Marla Gottschalk Marla Gottschalk	Director	February 22, 2017
/s/ Harvey Kanter Harvey Kanter	Director	February 22, 2017
/s/ Carl Warschausky Carl Warschausky	Director	February 22, 2017

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EXHIBIT INDEX

Exhibit Number	Description of Exhibit
3.1	Seventh Amended and Restated Certificate of Incorporation of Potbelly Corporation (filed as Exhibit 3.1 to Form S-1 (File No. 333-190893) filed on August 29, 2013 and incorporated herein by reference)
3.2	Amended and Restated By-laws of Potbelly Corporation (filed as Exhibit 3.2 to Form S-1 (File No. 333-190893) filed on August 29, 2013 and incorporated herein by reference)
4.1	Fifth Amended and Restated Registration Rights Agreement (filed as Exhibit 4.1 to Form S-1 (File No. 333-190893) filed on August 29, 2013 and incorporated herein by reference)

10.1	Potbelly Corporation 2004 Equity Incentive Plan, as amended (filed as Exhibit 10.1 to Form S-1 (File No. 333-190893) filed on August 29, 2013 and incorporated herein by reference) †
10.2	Amended and Restated Potbelly Corporation 2013 Long-Term Incentive Plan (filed as Exhibit 10.1 to Form 8-K (File No. 001-36104) filed August 4, 2016 and incorporated herein by reference) †
10.3	Amended and Restated Credit Agreement, dated as of December 9, 2015, among Potbelly Sandwich Works, LLC, Potbelly Corporation, the other Loan Parties party thereto, the Lenders party thereto, JPMorgan Chase Bank, N.A., as Administrative Agent, and J.P. Morgan Securities, LLC, as Sole Bookrunner and

	Sole Lead Arranger (filed as Exhibit 10.1 to Form 8-K (File No. 001-36104) filed December 11, 2015 and incorporated herein by reference)
10.4	Executive Employment Contract between Potbelly Corporation and Aylwin Lewis dated August 8, 2013 (filed as Exhibit 10.6 to Form S-1 (File No. 333-190893) filed August 29, 2013 and incorporated herein by reference) †
10.5	Executive Employment Agreement, dated July 25, 2013, between Potbelly Corporation and Matthew Revord †
10.6	Amendment to Executive Employment Agreement, dated April 22, 2015, between Potbelly Corporation and Matthew Revord †
10.7	Executive Employment Agreement, dated April 3, 2015, effective May 1,

	2015, between Potbelly Corporation and Michael Coyne (filed as Exhibit 10.1 to Form 8-K (File No. 001-36104) filed April 8, 2015 and incorporated herein by reference) †
10.8	Executive Employment Agreement, dated May 1, 2015, between Potbelly Corporation and Julie Younglove-Webb (filed as Exhibit 10.1 to Form 8-K (File No. 001-36104) filed May 4, 2015 and incorporated herein by reference) †
10.9	Form of stock option agreement for grants prior to January 1, 2011 for named executive officers other than Aylwin Lewis pursuant to 2004 Equity Incentive Plan (including any replacement options granted after such date for expired grants) (filed as Exhibit 10.9 to Form S-1(File No. 333-190893) filed August 29,

	2013 and incorporated herein by reference) †
10.10	Form of stock option agreement for grants prior to January 1, 2011 for Aylwin Lewis pursuant to 2004 Equity Incentive Plan (filed as Exhibit 10.10 to Form S-1(File No. 333-190893) filed August 29, 2013 and incorporated herein by reference) †
10.11	Form of stock option agreement for grants during year 2011 for named executive officers other than Aylwin Lewis pursuant to 2004 Equity Incentive Plan (filed as Exhibit 10.11 to Form S-1(File No. 333-190893) filed August 29, 2013 and incorporated herein by reference) †
10.12	Form of stock option agreement for grants for directors other than Aylwin Lewis pursuant to 2004 Equity Incentive Plan (filed as Exhibit

	10.13 to Form S-1(File No. 333-190893) filed August 29, 2013 and incorporated herein by reference) †
10.13	Form of stock option agreement (other than for Aylwin Lewis) pursuant to 2013 Long-Term Incentive Plan (filed as Exhibit 10.14 to Form S-1(File No. 333-190893) filed August 29, 2013 and incorporated herein by reference) †
10.14	Form of stock option agreement for Aylwin Lewis pursuant to 2013 Long-Term Incentive Plan (filed as Exhibit 10.15 to Form S-1(File No. 333-190893) filed August 29, 2013 and incorporated herein by reference) †
10.15	Form of Restricted Stock Unit Award Agreement pursuant to 2013 Long-Term Incentive Plan (filed as Exhibit 10.16 to Form

S-1(File
No. 333-190893)
filed August 29,
2013 and
incorporated
herein by
reference) †

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Exhibit Number	Description of Exhibit
10.16	Form of Director Restricted Stock Unit Award Agreement for directors other than Aylwin Lewis pursuant to 2013 Long-Term Incentive Plan †
10.17	Form of Indemnification Agreement between Potbelly Corporation and each of its directors and executive officers (filed as Exhibit 10.17 to Form S-1 (File No. 333-190893) filed August 29, 2013 and incorporated herein by reference)
10.18	Director Compensation Plan (filed as Exhibit 10.20 to Form 10-K (File No. 001-36104) filed February 25, 2015 and incorporated herein by reference)†
10.19	Potbelly Director Compensation Plan (filed as Exhibit 10.23 to Form 10-K (File

	No. 001-36104) filed February 24, 2016 and incorporated herein by reference) †
10.20	Potbelly Non-Qualified Deferred Compensation Plan (filed as Exhibit 10.21 to Form 10-K (File No. 001-36104) filed February 25, 2015 and incorporated herein by reference)†
21.1	Subsidiaries of the Registrant
23.1	Consent of Deloitte & Touche LLP
24.1	Power of Attorney (included on signature page)
31.1	Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2	Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.1	Certification of Chief Executive

	Officer and Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
101.INS	XBRL Instance Document
101.SCH	XBRL Taxonomy Extension Schema
101.CAL	XBRL Taxonomy Extension Calculation Linkbase
101.DEF	XBRL Taxonomy Extension Definition Linkbase
101.LAB	XBRL Taxonomy Extension Label Linkbase
101.PRE	XBRL Taxonomy Extension Presentation Linkbase

† Management contract or compensatory plan

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