

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

**Form 10-Q**

(Mark One)

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

For the quarterly period ended: **September 29, 2007**

or

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number: 0-2585



THE DIXIE GROUP

**THE DIXIE GROUP, INC.**

(Exact name of Registrant as specified in its charter)

**Tennessee**

(State or other jurisdiction of incorporation or organization)

**62-0183370**

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

**104 Nowlin Lane, Suite 101, Chattanooga, TN**

(Address of principal executive offices)

**37421**

(zip code)

**(423) 510-7000**

(Registrant's telephone number, including area code)

**Not Applicable**

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

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

Yes  No

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

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

Yes  No

The number of shares outstanding of each of the issuer's classes of Common Stock as of the latest practicable date.

| Class                               | Outstanding as of October 19, 2007 |
|-------------------------------------|------------------------------------|
| Common Stock, \$3 Par Value         | 12,154,110 shares                  |
| Class B Common Stock, \$3 Par Value | 877,539 shares                     |
| Class C Common Stock, \$3 Par Value | 0 shares                           |

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**PART I. FINANCIAL INFORMATION**  
**Item 1. Financial Statements**

**THE DIXIE GROUP, INC.**  
**CONSOLIDATED CONDENSED BALANCE SHEETS**  
(dollars in thousands)

|  | (Unaudited)<br>Sept. 29,<br>2007 | Dec. 30,<br>2006  |
|--|----------------------------------|-------------------|
| <b>ASSETS</b>  |                                  |                   |
| <b>CURRENT ASSETS</b>  |                                  |                   |
| Cash and cash equivalents  | \$ 317                           | \$ 538            |
| Accounts receivable (less allowance for doubtful accounts of \$660 for 2007 and \$651 for 2006)  | 37,837                           | 30,922            |
| Inventories  | 76,874                           | 69,600            |
| Other current assets   | 8,716                            | 7,652             |
| <b>TOTAL CURRENT ASSETS</b>  | <b>123,744</b>                   | <b>108,712</b>    |
| <b>PROPERTY, PLANT AND EQUIPMENT</b>   |                                  |                   |
| Land and improvements  | 6,075                            | 6,047             |
| Buildings and improvements   | 45,827                           | 45,407            |
| Machinery and equipment  | 124,587                          | 113,673           |
|  | 176,489                          | 165,127           |
| Less accumulated depreciation and amortization   | (75,953)                         | (66,729)          |
| <b>NET PROPERTY, PLANT AND EQUIPMENT</b>   | <b>100,536</b>                   | <b>98,398</b>     |
| <b>OTHER ASSETS</b>  |                                  |                   |
| Goodwill   | 56,797                           | 56,960            |
| Other long-term assets   | 13,798                           | 13,604            |
| <b>TOTAL OTHER ASSETS</b>  | <b>70,595</b>                    | <b>70,564</b>     |
| <b>TOTAL ASSETS</b>  | <b>\$ 294,875</b>                | <b>\$ 277,674</b> |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>  |                                  |                   |
| <b>CURRENT LIABILITIES</b>   |                                  |                   |
| Accounts payable   | \$ 12,245                        | \$ 8,382          |
| Accrued expenses   | 24,062                           | 19,541            |
| Current portion of long-term debt  | 8,299                            | 7,663             |
| <b>TOTAL CURRENT LIABILITIES</b>   | <b>44,606</b>                    | <b>35,586</b>     |
| <b>LONG-TERM DEBT</b>  |                                  |                   |
| Senior indebtedness  | 63,296                           | 57,780            |
| Capital lease obligations  | 2,904                            | 3,937             |
| Convertible subordinated debentures  | 17,162                           | 19,662            |
| <b>TOTAL LONG-TERM DEBT</b>  | <b>83,362</b>                    | <b>81,379</b>     |
| <b>DEFERRED INCOME TAXES</b>   | <b>11,654</b>                    | <b>11,697</b>     |
| <b>OTHER LONG-TERM LIABILITIES</b>   | <b>14,574</b>                    | <b>13,334</b>     |
| <b>COMMITMENTS AND CONTINGENCIES</b>   | <b>---</b>                       | <b>---</b>        |
| <b>STOCKHOLDERS' EQUITY</b>  |                                  |                   |
| Common Stock (\$3 par value per share): Authorized 80,000,000 shares, issued - 15,632,083 shares for 2007 and 15,506,664 shares for 2006 | 46,896                           | 46,520            |
| Class B Common Stock (\$3 par value per share): Authorized 16,000,000 shares, issued - 877,539 for 2007 and 829,825 shares for 2006      | 2,633                            | 2,489             |
| Additional paid-in capital   | 135,197                          | 134,469           |
| Retained earnings  | 11,154                           | 6,297             |
| Accumulated other comprehensive loss   | (275)                            | (8)               |
|  | 195,605                          | 189,767           |
| Less Common Stock in treasury at cost - 3,477,973 shares for 2007 and 3,398,845 shares for 2006  | (54,926)                         | (54,089)          |
| <b>TOTAL STOCKHOLDERS' EQUITY</b>  | <b>140,679</b>                   | <b>135,678</b>    |
| <b>TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY</b>  | <b>\$ 294,875</b>                | <b>\$ 277,674</b> |

See accompanying notes to the consolidated condensed financial statements.

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**THE DIXIE GROUP, INC.**  
**CONSOLIDATED CONDENSED STATEMENTS OF OPERATIONS**  
**(UNAUDITED)**  
(dollars in thousands, except per share data)

|  | Three Months Ended |                   | Nine Months Ended |                   |
|--|--------------------|-------------------|-------------------|-------------------|
|  | Sept. 29,<br>2007  | Sept. 30,<br>2006 | Sept. 29,<br>2007 | Sept. 30,<br>2006 |
| Net sales  | \$ 82,385          | \$ 83,606         | \$ 241,278        | \$ 250,825        |
| Cost of sales  | 57,878             | 58,761            | 168,690           | 179,031           |
| Gross profit   | 24,507             | 24,845            | 72,588            | 71,794            |
| Selling and administrative expenses                    | 19,371             | 19,097            | 59,691            | 57,108            |
| Other operating income                                 | (147)              | (29)              | (257)             | (599)             |
| Other operating expense                                | 149                | 171               | 418               | 458               |
| Defined benefit pension plan termination expenses      | ---                | ---               | ---               | 3,249             |
| Operating income                                       | 5,134              | 5,606             | 12,736            | 11,578            |
| Interest expense                                       | 1,613              | 1,795             | 4,839             | 5,506             |
| Other income   | (9)                | (14)              | (46)              | (122)             |
| Other expense  | 28                 | 53                | 59                | 107               |
| Income from continuing operations before taxes         | 3,502              | 3,772             | 7,884             | 6,087             |
| Income tax provision                                   | 1,263              | 1,069             | 2,852             | 1,430             |
| Income from continuing operations                      | 2,239              | 2,703             | 5,032             | 4,657             |
| Income (loss) from discontinued operations, net of tax | 9                  | (86)              | (175)             | (261)             |
| Net income   | \$ 2,248           | \$ 2,617          | \$ 4,857          | \$ 4,396          |
| <b>BASIC EARNINGS (LOSS) PER SHARE:</b>                |                    |                   |                   |                   |
| Continuing operations                                  | \$ 0.18            | \$ 0.21           | \$ 0.39           | \$ 0.37           |
| Discontinued operations                                | 0.00               | (0.00)            | (0.01)            | (0.02)            |
| Net income   | \$ 0.18            | \$ 0.21           | \$ 0.38           | \$ 0.35           |
| SHARES OUTSTANDING                                     | 12,817             | 12,736            | 12,805            | 12,685            |
| <b>DILUTED EARNINGS (LOSS) PER SHARE:</b>              |                    |                   |                   |                   |
| Continuing operations                                  | \$ 0.17            | \$ 0.21           | \$ 0.39           | \$ 0.36           |
| Discontinued operations                                | 0.00               | (0.01)            | (0.02)            | (0.02)            |
| Net income   | \$ 0.17            | \$ 0.20           | \$ 0.37           | \$ 0.34           |
| SHARES OUTSTANDING                                     | 12,985             | 12,982            | 12,990            | 12,953            |
| <b>DIVIDENDS PER SHARE:</b>                            |                    |                   |                   |                   |
| Common Stock   | ---                | ---               | ---               | ---               |
| Class B Common Stock                                   | ---                | ---               | ---               | ---               |

See accompanying notes to the consolidated condensed financial statements.

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**THE DIXIE GROUP, INC.**  
**CONSOLIDATED CONDENSED STATEMENTS OF CASH FLOWS**  
(dollars in thousands)

|   | Nine Months Ended |                   |
|---|-------------------|-------------------|
|   | Sept. 29,<br>2007 | Sept. 30,<br>2006 |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES</b>                                       |                   |                   |
| Income from continuing operations   | \$ 5,032          | \$ 4,657          |
| Loss from discontinued operations   | (175)             | (261)             |
| Net income  | 4,857             | 4,396             |
| Adjustments to reconcile net income to net cash provided by operating activities: |                   |                   |
| Depreciation and amortization   | 9,693             | 8,609             |
| Change in deferred income taxes   | (1,025)           | (1,445)           |
| Tax benefit from exercise of stock options  | (131)             | (258)             |
| Net loss on property, plant and equipment disposals                               | 12                | 31                |
| Stock-based compensation expense  | 911               | 482               |
| Changes in operating assets and liabilities:                                      |                   |                   |
| Accounts receivable   | (6,915)           | (3,519)           |
| Inventories   | (7,274)           | (3,553)           |
| Accounts payable and accrued expenses   | 7,259             | 159               |
| Other operating assets and liabilities  | 709               | 2,228             |
| <b>NET CASH PROVIDED BY OPERATING ACTIVITIES</b>                                  | <b>8,096</b>      | <b>7,130</b>      |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES</b>                                       |                   |                   |
| Net proceeds from sales of property, plant and equipment                          | 20                | 51                |
| Purchases of property, plant and equipment  | (11,641)          | (13,752)          |
| <b>NET CASH USED IN INVESTING ACTIVITIES</b>                                      | <b>(11,621)</b>   | <b>(13,701)</b>   |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES</b>                                       |                   |                   |
| Net borrowings on credit line   | 5,735             | 3,421             |
| Payments on term loan   | (1,282)           | (1,282)           |
| Borrowings from equipment financing   | 3,419             | 6,456             |
| Payments on equipment financing   | (1,617)           | (999)             |
| Payments on capitalized leases  | (963)             | (848)             |
| Payments on mortgage note payable   | (173)             | (161)             |
| Payments on subordinated indebtedness   | (2,500)           | (2,500)           |
| Common stock issued under stock option plans                                      | 266               | 854               |
| Common stock acquired for treasury  | (837)             | (45)              |
| Tax benefits from exercise of stock options                                       | 131               | 258               |
| Change in outstanding checks in excess of cash                                    | 1,125             | 2,031             |
| <b>NET CASH PROVIDED BY FINANCING ACTIVITIES</b>                                  | <b>3,304</b>      | <b>7,185</b>      |
| <b>(DECREASE) INCREASE IN CASH AND CASH EQUIVALENTS</b>                           | <b>(221)</b>      | <b>614</b>        |
| <b>CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD</b>                           | <b>538</b>        | <b>---</b>        |
| <b>CASH AND CASH EQUIVALENTS AT END OF PERIOD</b>                                 | <b>\$ 317</b>     | <b>\$ 614</b>     |
| Supplemental Cash Flow Information:   |                   |                   |
| Interest paid   | \$ 4,534          | \$ 5,022          |
| Income taxes paid, net of tax refunds   | 1,526             | 433               |
| Equipment purchased under capital leases  | ---               | 542               |

See accompanying notes to the consolidated condensed financial statements.

**THE DIXIE GROUP, INC.**  
**CONSOLIDATED CONDENSED STATEMENT OF STOCKHOLDERS' EQUITY AND COMPREHENSIVE INCOME**  
(dollars in thousands)

|   | Common<br>Stock<br>and<br>Class B<br>Common<br>Stock | Additional<br>Paid-in<br>Capital | Retained<br>Earnings | Accumulated<br>Other<br>Comprehensive<br>Loss | Common<br>Stock in<br>Treasury | Total<br>Stockholders'<br>Equity |
|---|--|----------------------------------|----------------------|---|--------------------------------|----------------------------------|
| <b>Balance at December 30, 2006</b>   | <b>\$ 49,009</b>                                     | <b>\$ 134,469</b>                | <b>\$ 6,297</b>      | <b>\$ (8)</b>                                 | <b>\$ (54,089)</b>             | <b>\$ 135,678</b>                |
| Common Stock and Class B issued under stock option plan - 64,782 net shares | 226  | 40                               | ---                  | ---   | ---                            | 266                              |
| Restricted stock grants issued - 109,620 shares                             | 329  | (329)                            | ---                  | ---   | ---                            | ---                              |
| Restricted stock grants forfeited -11,787 shares                            | (35)   | 35                               | ---                  | ---   | ---                            | ---                              |
| Common Stock acquired for treasury - 79,128 shares                          | ---  | ---                              | ---                  | ---   | (837)                          | (837)                            |
| Tax benefit from exercise of stock options                                  | ---  | 131                              | ---                  | ---   | ---                            | 131                              |
| Stock-based compensation expense  | ---  | 851                              | ---                  | ---   | ---                            | 851                              |
| <b>Comprehensive Income:</b>  |  |                                  |                      |   |                                |                                  |
| Net income  | ---  | ---                              | 4,857                | ---   | ---                            | 4,857                            |
| Unrealized loss on interest rate swap agreements, net of tax of \$167       | ---  | ---                              | ---                  | (272)   | ---                            | (272)                            |
| Pension and postretirement benefit plans:                                   |  |                                  |                      |   |                                |                                  |
| Recognition of net actuarial loss, net of tax of \$16                       | ---  | ---                              | ---                  | 27  | ---                            | 27                               |
| Amortization of prior service cost, net of tax of \$13                      | ---  | ---                              | ---                  | (22)  | ---                            | (22)                             |
| <b>Total Comprehensive Income</b>   | <b>---</b>   | <b>---</b>                       | <b>4,857</b>         | <b>(267)</b>                                  | <b>---</b>                     | <b>4,590</b>                     |
| <b>Balance at September 29, 2007</b>  | <b>\$ 49,529</b>                                     | <b>\$ 135,197</b>                | <b>\$ 11,154</b>     | <b>\$ (275)</b>                               | <b>\$ (54,926)</b>             | <b>\$ 140,679</b>                |

See accompanying notes to the consolidated condensed financial statements.

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**THE DIXIE GROUP, INC.**  
**NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS**  
**(UNAUDITED)**  
**(dollars in thousands, except per share data)**

**NOTE A - BASIS OF PRESENTATION**

The accompanying unaudited consolidated condensed financial statements have been prepared in accordance with U.S. generally accepted accounting principles for interim financial statements which do not include all the information and footnotes required by such accounting principles for annual financial statements. In the opinion of management, all adjustments (generally consisting of normal recurring accruals) considered necessary for a fair presentation have been included in the accompanying financial statements. The financial statements should be read in conjunction with the financial statements and notes thereto included in the Company's 2006 Annual Report on Form 10-K/A filed with the Securities and Exchange Commission, which includes consolidated financial statements for the fiscal year ended December 30, 2006. Operating results for the three month and nine month periods ended September 29, 2007 are not necessarily indicative of the results that may be expected for the entire 2007 year.

The Company is in one line of business, carpet manufacturing.

**NOTE B - RECENT ACCOUNTING PRONOUNCEMENTS**

In September 2006, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards ("SFAS") No. 157, "Fair Value Measurements". SFAS No. 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles and expands disclosures about fair value measurements. SFAS No. 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007 and interim periods within those fiscal years. The Company does not expect the adoption of this statement to have a material effect on its financial statements.

In February 2007, the FASB issued SFAS No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities", including an amendment of SFAS No. 115, "Accounting for Certain Investments in Debt and Equity Securities". SFAS No. 159 permits entities to choose to measure many financial instruments and certain other items at fair value. The objective of SFAS No. 159 is to improve financial reporting by providing entities with the opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. Eligible items for the measurement option include all recognized financial assets and liabilities except: investments in subsidiaries, interests in variable interest entities, obligations for pension benefits, assets and liabilities recognized under leases, deposit liabilities and financial instruments that are a component of shareholders' equity. Also included are firm commitments that involve only financial instruments, nonfinancial insurance contracts and warranties and host financial instruments.

The Statement permits all entities to choose the fair value measurement option at specified election dates, after which the entity shall report unrealized gains and losses on items for which the fair value option has been elected in earnings, at each subsequent reporting date. The fair value option may be applied instrument by instrument; however, the election is irrevocable and may apply only to entire instruments and not to portions of instruments. SFAS No. 159 is effective for fiscal years beginning after November 15, 2007. The Company is currently evaluating its options under this statement.

**NOTE C - SHARE-BASED PAYMENTS**

The Company recognizes compensation expense relating to share-based payments based on the fair value of the equity or liability instrument issued.

On March 2, 2007, the Company granted 108,720 shares of restricted stock to officers of the Company. The grant-date fair value of the awards was \$1,425, or \$13.11 per share. The shares will vest over terms ranging from 2 to 20 years. Each award is subject to a continued service condition. The fair value of each share of restricted stock awarded was equal to the market value of a share of the Company's Common Stock on the grant date.

The Company's stock compensation expense was \$283 and \$911 for the three and nine months ended September 29, 2007 and \$171 and \$482 for the three and nine months ended September 30, 2006, respectively.

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**THE DIXIE GROUP, INC.**  
**NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS**  
**(UNAUDITED)**

(dollars in thousands, except per share data) - Cont'd.

**NOTE D - ACCOUNTS RECEIVABLE**

Receivables are summarized as follows:

|                                      | Sept. 29,<br>2007 | Dec. 30,<br>2006 |
|--------------------------------------|-------------------|------------------|
| Customers, trade                     | \$ 35,996         | \$ 28,278        |
| Other                                | 2,501             | 3,295            |
| Gross receivables                    | 38,497            | 31,573           |
| Less allowance for doubtful accounts | (660)             | (651)            |
| Net receivables                      | <u>\$ 37,837</u>  | <u>\$ 30,922</u> |

The Company also had notes receivable in the amount of \$453 and \$589 at September 29, 2007 and December 30, 2006, respectively. The current portion of the notes receivable is included in accounts receivable and the long-term portion is included in other long-term assets in the Company's consolidated condensed balance sheets.

**NOTE E - INVENTORIES**

Inventories are stated at the lower of cost or market. Cost is determined using the last-in, first-out (LIFO) method, which generally matches current costs of inventory sold with current revenues, for substantially all inventories. Inventories are summarized as follows:

|                                  | Sept. 29,<br>2007 | Dec. 30,<br>2006 |
|----------------------------------|-------------------|------------------|
| Raw materials                    | \$ 27,140         | \$ 21,678        |
| Work-in-process                  | 15,602            | 15,210           |
| Finished goods                   | 44,684            | 41,107           |
| Supplies, repair parts and other | 419               | 410              |
| LIFO                             | (10,971)          | (8,805)          |
| Total inventories                | <u>\$ 76,874</u>  | <u>\$ 69,600</u> |

**NOTE F - DISCONTINUED OPERATIONS**

Following is a summary of the Company's discontinued operations:

|  | Three Months Ended |                   | Nine Months Ended |                   |
|--|--------------------|-------------------|-------------------|-------------------|
|  | Sept. 29,<br>2007  | Sept. 30,<br>2006 | Sept. 29,<br>2007 | Sept. 30,<br>2006 |
| Income (loss) from discontinued operations:            |                    |                   |                   |                   |
| Before income taxes                                    | \$ 14              | \$ (136)          | \$ (272)          | \$ (412)          |
| Income tax provision (benefit)                         | 5                  | (50)              | (97)              | (151)             |
| Income (loss) from discontinued operations, net of tax | <u>\$ 9</u>        | <u>\$ (86)</u>    | <u>\$ (175)</u>   | <u>\$ (261)</u>   |

The income (loss) from discontinued operations in 2007 and 2006 principally related to the settlement of contingencies that had been retained by the Company in connection with the sales of the Company's factory-built housing carpet, needlebond and carpet recycling businesses sold in 2003 and 2004 and the Company's textile operations in 1999 and prior years.

**NOTE G - ACCRUED EXPENSES**

Accrued expenses are summarized as follows:

|   | Sept. 29,<br>2007 | Dec. 30,<br>2006 |
|---|-------------------|------------------|
| Compensation and benefits                             | \$ 6,391          | \$ 5,768         |
| Provision for customer rebates, claims and allowances | 5,508             | 4,968            |
| Outstanding checks in excess of cash                  | 5,318             | 4,193            |
| Other   | 6,845             | 4,612            |
| Total accrued expenses                                | <u>\$ 24,062</u>  | <u>\$ 19,541</u> |

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**THE DIXIE GROUP, INC.**  
**NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS**  
**(UNAUDITED)**  
(dollars in thousands, except per share data) - Cont'd.

**NOTE H - PRODUCT WARRANTY RESERVES**

The Company warrants its products against manufacturing defects and failure to meet specific performance standards. At the time sales are recorded, the Company establishes reserves for the estimated costs of defective products and failure of its products to meet applicable performance standards. The levels of reserves are established based primarily upon historical experience and evaluation of known claims. Following is a summary of the Company's warranty activity:

|   | Three Months Ended |                   | Nine Months Ended |                   |
|---|--------------------|-------------------|-------------------|-------------------|
|   | Sept. 29,<br>2007  | Sept. 30,<br>2006 | Sept. 29,<br>2007 | Sept. 30,<br>2006 |
| Warranty reserve beginning of period          | \$ 1,496           | \$ 1,214          | \$ 1,276          | \$ 1,109          |
| Warranty liabilities accrued                  | 923                | 1,191             | 2,966             | 3,969             |
| Warranty liabilities settled                  | (786)              | (1,210)           | (2,752)           | (4,251)           |
| Changes for pre-existing warranty liabilities | (30)               | 57                | 113               | 425               |
| Warranty reserve end of period                | <u>\$ 1,603</u>    | <u>\$ 1,252</u>   | <u>\$ 1,603</u>   | <u>\$ 1,252</u>   |

**NOTE I - LONG-TERM DEBT AND CREDIT ARRANGEMENTS**

Long-term debt consists of the following:

|   | Sept. 29,<br>2007 | Dec. 30,<br>2006 |
|---|-------------------|------------------|
| Senior indebtedness                               |                   |                  |
| Credit line borrowings                            | \$ 33,556         | \$ 27,821        |
| Term loans  | 16,439            | 17,721           |
| Equipment financing                               | 11,138            | 9,336            |
| Capital lease obligations                         | 4,269             | 5,232            |
| Mortgage note payable                             | 6,597             | 6,770            |
| Total senior indebtedness                         | <u>71,999</u>     | <u>66,880</u>    |
| Convertible subordinated debentures               | 19,662            | 22,162           |
| Total long-term debt                              | <u>91,661</u>     | <u>89,042</u>    |
| Less current portion of long-term debt            | (6,934)           | (6,368)          |
| Less current portion of capital lease obligations | (1,365)           | (1,295)          |
| Total long-term debt, less current portions       | <u>\$ 83,362</u>  | <u>\$ 81,379</u> |

During the nine months ended September 29, 2007, the Company borrowed \$3,419 under equipment financing notes. The notes are secured by the equipment financed, bear interest at fixed rates ranging from 6.83% to 6.85% and are due in monthly installments over the five to seven year terms of the notes.

The Company's senior loan and security agreement, which matures on May 11, 2010, provides \$76,439 of credit, consisting of \$60,000 of revolving credit and a \$16,439 term loan. The Company's credit facilities do not contain ongoing financial covenants; however, these facilities contain covenants that generally limit dividends and repurchases of the Company's Common Stock to an aggregate of \$3,000 annually and could limit future acquisitions. The unused borrowing capacity under the senior loan and security agreement on September 29, 2007 was approximately \$24,029.

The Company's senior loan and security agreement was amended on July 16, 2007 and October 22, 2007. The July 16, 2007 amendment increased the level of "permitted purchase money debt" as defined in the loan agreement from \$10,000 to \$20,000. The October 22, 2007 amendment increased the agreement's limit on revolver loans from \$60,000 to \$70,000 and increased the amount the Company may expend for repurchases of its common stock or the payment of dividends by \$10,000, subject to certain limitations and conditions set forth in the agreement. The other provisions in the loan agreement remain unchanged.

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**NOTE J - DERIVATIVE FINANCIAL INSTRUMENTS**

The Company is a party to an interest rate swap agreement with a notional amount of \$30,000 through May 11, 2010. Under the interest rate swap agreement, the Company pays a fixed rate of interest of 4.79% times the notional amount and receives in return a specified variable rate of interest times the same notional amount. The interest rate swap is linked to the Company's variable rate debt and is considered a highly effective hedge. The fair value of the interest rate swap agreement is reflected on the Company's consolidated condensed balance sheets and related gains and losses are deferred in Accumulated Other Comprehensive Loss ("AOCL"). Net unrealized losses included in AOCL were \$117 at September 29, 2007.

The Company is also a party to an interest rate swap agreement through March 2013, which is linked to a mortgage note payable and considered a highly effective hedge. Under the interest rate swap agreement, the Company pays a fixed rate of interest times a notional amount equal to the outstanding balance of the mortgage note, and receives in return an amount equal to a specified variable rate of interest times the same notional amount. The fair value of the interest rate swap agreement is reflected on the Company's consolidated condensed balance sheets and related gains and losses are deferred in AOCL. As of September 29, 2007, the notional amount of the interest swap agreement was \$6,597. Under the terms of the swap agreement, the Company pays a fixed interest rate of 4.54% through March 2013, which effectively fixes interest on the mortgage note payable at 6.54%. Net unrealized gains included in AOCL were \$38 at September 29, 2007.

**NOTE K - EMPLOYEE BENEFIT PLANS**

The Company sponsors a 401(k) defined contribution plan covering substantially all associates. The Company matches participants' contributions, on a sliding scale, up to a maximum of 5% of the participant's earnings. The Company may make additional contributions to the plan if the Company attains certain performance targets.

The Company sponsors a non-qualified retirement savings plan that allows eligible associates to defer a specified percentage of their compensation. The obligations owed to participants under this plan were \$12,362 at September 29, 2007 and \$11,704 at December 30, 2006 and are included in other liabilities in the Company's consolidated condensed balance sheets. The obligations are unsecured general obligations of the Company and the participants do not have a right, interest or claim in the assets, except as unsecured general creditors. The Company utilizes a Rabbi Trust to hold, invest and reinvest deferrals and contributions under the plan. Assets invested in cash and company-owned life insurance in the Rabbi Trust were \$12,532 at September 29, 2007 and \$11,673 at December 30, 2006 and are included in cash and cash equivalents and other long-term assets in the Company's consolidated condensed balance sheets.

The Company also sponsors a defined benefit retirement plan that covers a limited number of the Company's active associates.

During June 2006, the Company terminated a defined benefit retirement plan and distributed the plan's assets to its participants. The plan had been frozen as to new benefits since 1993. The majority of participants covered by this plan had been employed by operations that were previously sold or discontinued. Settlement expenses for the plan termination recognized in the nine months ended September 30, 2006 were \$3,249, or \$2,057 net of tax. The funds required to terminate the plan were \$2,595.

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Costs charged to continuing operations for all retirement plans are summarized as follows:

|  | Three Months Ended |                    |               |                 |                    |               |
|--|--------------------|--------------------|---------------|-----------------|--------------------|---------------|
|  | Sept. 29, 2007     |                    |               | Sept. 30, 2006  |                    |               |
|  | Ongoing<br>Plan    | Terminated<br>Plan | Total<br>2007 | Ongoing<br>Plan | Terminated<br>Plan | Total<br>2006 |
| Components of net periodic benefit costs:              |                    |                    |               |                 |                    |               |
| Defined benefit plans                                  |                    |                    |               |                 |                    |               |
| Service cost   | \$ 51              | \$ ---             | \$ 51         | \$ 61           | \$ ---             | \$ 61         |
| Interest cost  | 43                 | ---                | 43            | 50              | ---                | 50            |
| Expected return on plan assets                         | (51)               | ---                | (51)          | (55)            | ---                | (55)          |
| Amortization of prior service cost                     | 2                  | ---                | 2             | 2               | ---                | 2             |
| Recognized net actuarial loss                          | 25                 | ---                | 25            | 27              | ---                | 27            |
| Settlement loss  | 89                 | ---                | 89            | ---             | ---                | ---           |
| Net periodic benefit cost - defined benefit plans      | 159                | ---                | 159           | 85              | ---                | 85            |
| Net periodic benefit cost - defined contribution plans | 243                | ---                | 243           | 261             | ---                | 261           |
| Net periodic benefit cost                              | <u>\$ 402</u>      | <u>\$ ---</u>      | <u>\$ 402</u> | <u>\$ 346</u>   | <u>\$ ---</u>      | <u>\$ 346</u> |

|  | Nine Months Ended |                    |                 |                 |                    |                 |
|--|-------------------|--------------------|-----------------|-----------------|--------------------|-----------------|
|  | Sept. 29, 2007    |                    |                 | Sept. 30, 2006  |                    |                 |
|  | Ongoing<br>Plan   | Terminated<br>Plan | Total<br>2007   | Ongoing<br>Plan | Terminated<br>Plan | Total<br>2006   |
| Components of net periodic benefit costs:              |                   |                    |                 |                 |                    |                 |
| Defined benefit plans                                  |                   |                    |                 |                 |                    |                 |
| Service cost   | \$ 153            | \$ ---             | \$ 153          | \$ 120          | \$ ---             | \$ 120          |
| Interest cost  | 129               | ---                | 129             | 99              | 117                | 216             |
| Expected return on plan assets                         | (153)             | ---                | (153)           | (108)           | (121)              | (229)           |
| Amortization of prior service cost                     | 5                 | ---                | 5               | 4               | ---                | 4               |
| Recognized net actuarial loss                          | 74                | ---                | 74              | 53              | 106                | 159             |
| Settlement loss  | 89                | ---                | 89              | ---             | 3,249              | 3,249           |
| Net periodic benefit cost - defined benefit plans      | 297               | ---                | 297             | 168             | 3,351              | 3,519           |
| Net periodic benefit cost - defined contribution plans | 752               | ---                | 752             | 787             | ---                | 787             |
| Net periodic benefit cost                              | <u>\$ 1,049</u>   | <u>\$ ---</u>      | <u>\$ 1,049</u> | <u>\$ 955</u>   | <u>\$ 3,351</u>    | <u>\$ 4,306</u> |

As a result of a prior acquisition, the Company sponsors a legacy postretirement benefit plan that provides life insurance to a limited number of associates. The Company also sponsors a postretirement benefit plan that provides medical and life insurance for a limited number of associates who retired prior to January 1, 2003.

Components of net periodic benefit costs for all postretirement plans are summarized as follows:

|   | Three Months Ended |                  | Nine Months Ended |                   |
|---|--------------------|------------------|-------------------|-------------------|
|   | Sept 29,<br>2007   | Sept. 30<br>2006 | Sept. 29<br>2007  | Sept. 30,<br>2006 |
| Components of net periodic benefit costs: |                    |                  |                   |                   |
| Defined benefit plans                     |                    |                  |                   |                   |
| Service cost                              | \$ 2               | \$ ---           | \$ 13             | \$ ---            |
| Interest cost                             | 16                 | ---              | 58                | ---               |
| Amortization of prior service cost        | (8)                | ---              | (40)              | ---               |
| Recognized net actuarial loss             | (10)               | ---              | (31)              | ---               |
| Net periodic benefit cost                 | <u>\$ ---</u>      | <u>\$ ---</u>    | <u>\$ ---</u>     | <u>\$ ---</u>     |

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Amounts contributed or expected to be contributed by the Company during the current fiscal year to its pension and postretirement plans are not anticipated to be significantly different from amounts disclosed in the Company's 2006 Annual Report filed on Form 10-K/A.

**NOTE L - INCOME TAXES**

The Company adopted the provisions of Financial Accounting Standards Board Interpretation No. 48, "Accounting for Uncertainty in Income Taxes - an interpretation of FASB Statement No. 109" ("FIN 48") on the first day of the Company's 2007 fiscal year. The Company's reserves for uncertain tax positions at December 30, 2006 were \$319 and did not change as a result of the implementation of FIN 48. Unrecognized tax benefits were \$356 at September 29, 2007, all of which, if recognized, would favorably affect the Company's effective tax rate. The Company does not expect its unrecognized tax benefits to change significantly during the next twelve months.

The Company recognizes interest and penalties related to uncertain tax positions in income tax expense. As of September 29, 2007, accrued interest related to uncertain tax positions was \$54.

The Company and its subsidiaries are subject to United States federal income taxes, as well as income taxes in a number of state jurisdictions. The Company's tax years 2004 through 2006 remain open to examination for U.S. federal income taxes and most state jurisdictions. A few state jurisdictions remain open to examination for tax years 2003 through 2006.

During the nine months ended September 30, 2006, the Company settled a federal income tax audit for the fiscal year 2003. As a result of the settlement of the audit, the Company reduced its tax contingency reserve and its income tax provision by \$460 to reflect the settlement of certain items previously included in the Company's tax contingency reserve. The Company also recognized federal and state income tax credits during these periods and received certain non-taxable life insurance benefits. As a result of these adjustments, income tax credits and non-taxable income, the Company's effective tax rate was reduced to 28.3% and 23.5%, respectively, for the three and nine months ended September 30, 2006.

**NOTE M - COMMON STOCK AND EARNINGS PER SHARE**

The following table sets forth the computation of basic and diluted earnings per share from continuing operations:

|  | Three Months Ended |                   | Nine Months Ended |                   |
|--|--------------------|-------------------|-------------------|-------------------|
|  | Sept. 29,<br>2007  | Sept. 30,<br>2006 | Sept. 29,<br>2007 | Sept. 30,<br>2006 |
| Income from continuing operations (1)  | \$ 2,239           | \$ 2,703          | \$ 5,032          | \$ 4,657          |
| Denominator for calculation of basic earnings per share - weighted-average shares (2)                                      | 12,817             | 12,736            | 12,805            | 12,685            |
| Effect of dilutive securities:   |                    |                   |                   |                   |
| Stock options (3)  | 112                | 196               | 142               | 233               |
| Restricted stock grants (3)  | 38                 | 20                | 34                | 7                 |
| Directors' stock performance units (3)   | 18                 | 30                | 9                 | 28                |
| Denominator for calculation of diluted earnings per share - weighted-average shares adjusted for potential dilution (2)(3) | <u>12,985</u>      | <u>12,982</u>     | <u>12,990</u>     | <u>12,953</u>     |
| Earnings per share:  |                    |                   |                   |                   |
| Basic  | \$ 0.18            | \$ 0.21           | \$ 0.39           | \$ 0.37           |
| Diluted  | 0.17               | 0.21              | 0.39              | 0.36              |

(1) No adjustments needed to the numerator for diluted calculations.

(2) Includes Common and Class B Common shares in thousands.

(3) Because their effects are anti-dilutive, shares issuable under stock option plans where the exercise price is greater than the average market price of Common Shares outstanding at the end of the relevant period and shares issuable on conversion of subordinated debentures into shares of Common Stock have been excluded. Aggregate shares excluded were 1,411 and 1,350 during the three and nine months of 2007 and 1,232 and 1,030 during the three and nine months of 2006.

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**NOTE N - COMPREHENSIVE INCOME**

Comprehensive income is summarized as follows:

|   | Three Months Ended |                   | Nine Months Ended |                   |
|---|--------------------|-------------------|-------------------|-------------------|
|   | Sept. 29,<br>2007  | Sept. 30,<br>2006 | Sept. 29,<br>2007 | Sept. 30,<br>2006 |
| Net income  | \$ 2,248           | \$ 2,617          | \$ 4,857          | \$ 4,396          |
| Other comprehensive income:   |                    |                   |                   |                   |
| Unrealized gain (loss) on interest rate swap agreements:                        |                    |                   |                   |                   |
| Before income taxes   | (737)              | (779)             | (439)             | 419               |
| Income taxes  | (280)              | (296)             | (167)             | 159               |
| Net of taxes  | (457)              | (483)             | (272)             | 260               |
| Recognition of net actuarial loss on pension and postretirement benefit plans:  |                    |                   |                   |                   |
| Before income taxes   | 14                 | ---               | 43                | ---               |
| Income taxes  | 5                  | ---               | 16                | ---               |
| Net of taxes  | 9                  | ---               | 27                | ---               |
| Amortization of prior service cost on pension and postretirement benefit plans: |                    |                   |                   |                   |
| Before income taxes   | (6)                | ---               | (35)              | ---               |
| Income taxes  | (2)                | ---               | (13)              | ---               |
| Net of taxes  | (4)                | ---               | (22)              | ---               |
| Change in additional minimum pension liability:                                 |                    |                   |                   |                   |
| Before income taxes   | ---                | ---               | ---               | 2,503             |
| Income taxes  | ---                | ---               | ---               | 951               |
| Net of taxes  | ---                | ---               | ---               | 1,552             |
| <b>Comprehensive income</b>   | <b>\$ 1,796</b>    | <b>\$ 2,134</b>   | <b>\$ 4,590</b>   | <b>\$ 6,208</b>   |

Components of accumulated other comprehensive income (loss), net of tax, are summarized as follows:

|  | Interest<br>Rate<br>Swaps | Pension and<br>Post-<br>Retirement<br>Benefit Plans | Total           |
|--|---------------------------|---|-----------------|
| Balance at December 30, 2006   | \$ 193                    | \$ (201)  | \$ (8)          |
| Unrealized loss on interest rate swap agreements, net of tax of \$167                              | (272)                     | ---   | (272)           |
| Recognition of net actuarial loss on pension and postretirement benefit plans, net of tax of \$16  | ---                       | 27  | 27              |
| Amortization of prior service cost on pension and postretirement benefit plans, net of tax of \$13 | ---                       | (22)  | (22)            |
| <b>Balance at September 29, 2007</b>   | <b>\$ (79)</b>            | <b>\$ (196)</b>                                     | <b>\$ (275)</b> |

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**NOTE O - OTHER (INCOME) EXPENSE**

Other (income) expense is summarized as follows:

|                                   | Three Months Ended  |                    | Nine Months Ended   |                     |
|-----------------------------------|---------------------|--------------------|---------------------|---------------------|
|                                   | Sept. 29,<br>2007   | Sept. 30,<br>2006  | Sept. 29,<br>2007   | Sept. 30,<br>2006   |
| Other operating income:           |                     |                    |                     |                     |
| Insurance settlements and refunds | \$       ---        | \$       ---       | \$       ---        | \$     (353)        |
| Miscellaneous income              | (147)               | (29)               | (257)               | (246)               |
| Other operating income            | <u>\$     (147)</u> | <u>\$     (29)</u> | <u>\$     (257)</u> | <u>\$     (599)</u> |
| Other operating expense:          |                     |                    |                     |                     |
| Retirement expenses               | \$     113          | \$     109         | \$     277          | \$     354          |
| Miscellaneous expense             | 36                  | 62                 | 141                 | 104                 |
| Other operating expense           | <u>\$     149</u>   | <u>\$     171</u>  | <u>\$     418</u>   | <u>\$     458</u>   |
| Other income:                     |                     |                    |                     |                     |
| Interest income                   | \$     (3)          | \$     (7)         | \$     (13)         | \$     (108)        |
| Miscellaneous income              | (6)                 | (7)                | (33)                | (14)                |
| Other income                      | <u>\$     (9)</u>   | <u>\$     (14)</u> | <u>\$     (46)</u>  | <u>\$     (122)</u> |
| Other expense:                    |                     |                    |                     |                     |
| Miscellaneous expense             | \$     28           | \$     53          | \$     59           | \$     107          |
| Other expense                     | <u>\$     28</u>    | <u>\$     53</u>   | <u>\$     59</u>    | <u>\$     107</u>   |

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## ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF RESULTS OF OPERATIONS AND FINANCIAL CONDITION

The following is presented to update the discussion of results of operations and financial condition included in our 2006 Annual Report on Form 10-K/A filed with the Securities and Exchange Commission.

### CRITICAL ACCOUNTING POLICIES

Our critical accounting policies were outlined in Management's Discussion and Analysis of Results of Operations and Financial Condition in our 2006 Annual Report on Form 10-K/A filed with the Securities and Exchange Commission. There have been no changes to those critical accounting policies subsequent to the date of that report.

### RESULTS OF OPERATIONS

The following table sets forth certain elements of our continuing operations as a percentage of net sales for the periods indicated:

|   | Three Months Ended |                   | Nine Months Ended |                   |
|---|--------------------|-------------------|-------------------|-------------------|
|   | Sept. 29,<br>2007  | Sept. 30,<br>2006 | Sept. 29,<br>2007 | Sept. 30,<br>2006 |
| Net sales   | 100.0 %            | 100.0 %           | 100.0 %           | 100.0 %           |
| Cost of sales                                     | 70.3 %             | 70.3 %            | 69.9 %            | 71.4 %            |
| Gross profit                                      | 29.7 %             | 29.7 %            | 30.1 %            | 28.6 %            |
| Selling and administrative expenses               | 23.5 %             | 22.8 %            | 24.7 %            | 22.8 %            |
| Other operating income                            | (0.2)%             | (0.0)%            | (0.1)%            | (0.3)%            |
| Other operating expense                           | 0.2 %              | 0.2 %             | 0.2 %             | 0.2 %             |
| Defined benefit pension plan termination expenses | 0.0 %              | 0.0 %             | 0.0 %             | 1.3 %             |
| Operating income                                  | 6.2 %              | 6.7 %             | 5.3 %             | 4.6 %             |

**Net Sales.** Net sales for the quarter ended September 29, 2007 were \$82.4 million, down 1.5% from net sales of \$83.6 million in the year-earlier quarter. Net sales for the first nine months of 2007 were \$241.3 million, down 3.8% from net sales of \$250.8 million in the prior year period. The decline in net sales is principally attributable to continued significant weakness in residential carpet markets that we began to experience in the third quarter of 2006.

Our net sales of residential carpet products declined 10.7% in the third quarter of 2007 and 10.1% for the first nine months of 2007, compared with the same periods in 2006. In addition to the general industry weakness, our residential carpet business was negatively affected by a significant decline in sales to one large home center customer. The carpet industry has reported that net sales of residential carpet declined 13.8% in the third quarter of 2007 and 13.7% for the first nine months of 2007, compared with the same periods in 2006. Although it is impossible to predict the future, the slowing housing market and tightening credit conditions are likely to continue to negatively impact demand for residential carpet products for the next several quarters.

Demand has remained strong in our commercial carpet business. Year-over-year sales of our commercial carpet products reflected net sales growth of 23.8% and 9.9%, respectively for the third quarter and first nine months of 2007, compared with the same periods in 2006. During 2007, the carpet industry reported year-over-year improvement in commercial carpet sales of 2.5% and 1.6%, respectively.

The new and differentiated residential products we are bringing to the market this year are well placed and beginning to generate sales. The outlook for our commercial business continues to be favorable. Our new modular/carpet tile products continue to gain momentum. We have also expanded our offering of commercial tile and broadloom products this year. The year-over-year order entry and sales comparisons of our commercial business continued to be positive in October of this year. The improvement we have seen in commercial business and the anticipated effect of our new residential and commercial products make us optimistic that our sales will continue to outpace the sales of the carpet industry.

**Cost of Sales.** Cost of sales, as a percentage of net sales, was 70.3% in the third quarter of 2007 and 2006. Higher raw material, utility and other costs were offset by higher selling prices and a more profitable mix of product sold.

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The 1.5 percentage point decrease in cost of sales as a percentage of sales for the first nine months of 2007, compared with the first nine months of 2006, is primarily a result of a higher selling prices, better product mix and improved operational performance. Quality, material utilization and manufacturing and distribution efficiencies also improved in 2007. The cost of our modular/carpet tile operation improved with higher sales and this new product line contributed to our operating results in September of this year.

**Gross Profit.** Gross profit declined \$338 thousand in the third quarter of 2007 compared with the third quarter of 2006 primarily due to lower sales of yarn and dyeing and finishing services. Despite lower sales volume, gross profit increased \$794 thousand for the first nine months of 2007, compared with the same period in 2006 due to the factors described above that reduced manufacturing cost as a percentage of net sales.

**Selling and Administrative Expenses.** Selling and administrative expenses increased \$274 thousand in the third quarter and \$2.6 million for the first nine months of 2007, compared with the same periods in 2006. The higher cost is principally the result of investments in our sales and marketing infrastructure, information systems and normal inflationary cost increases.

**Other Operating Income/Other Operating Expense.** Other operating income and other operating expense were not significant in the third quarter or first nine months of either 2007 or 2006. The decrease in other operating income in the first nine months of 2007 compared with the first nine months of 2006 was primarily a result of insurance proceeds received in the 2006 period.

**Defined Benefit Pension Plan Termination Expenses.** Results for the first nine months of 2006 included expenses of \$3.2 million to terminate our legacy defined benefit pension plan in the second quarter of 2006. Approximately \$2.9 million of these expenses related to the settlement of pension benefits for employees of our discontinued textile business segment that had been terminated in 1999 and prior years. The remaining expenses related to the settlement of pension benefits for employees of our ongoing floorcovering business segment.

**Operating Income.** Operating income was \$5.1 million, or 6.2% of sales, in the quarter ended September 29, 2007 and \$12.7 million, or 5.3% of sales, for the first nine months of 2007 compared with \$5.6 million, or 6.7% of sales, in the quarter ended September 30, 2006 and \$11.6 million, or 4.6% of sales, for the first nine months of 2006. Defined benefit pension plan termination expenses negatively affected operating income by 1.3 percentage points for the nine months ended September 30, 2006.

**Interest Expense.** Interest expense decreased in the third quarter and first nine months of 2007, compared with the same periods in 2006 principally due to lower levels of debt in 2007.

**Other Income/Other Expense.** Other income and other expense were not significant in the third quarter or first nine months of either 2007 or 2006.

**Income Tax Provision.** Our effective income tax rate was 36.1% and 36.2%, respectively for the three and nine months ended September 29, 2007 compared with 28.3% and 23.5%, respectively for the three and nine month periods ended September 30, 2006. Our 2006 income tax provision was reduced by the effect of non taxable life insurance benefits, a \$460 thousand adjustment to our tax contingency reserve as a result of a federal income tax examination concluded in the second quarter of 2006 and certain income tax credits recognized in the third quarter of 2006. Excluding the effects of these items, our effective income tax rate would have been 35.0% for the third quarter of 2006 and 36.0% for the nine months ended September 30, 2006.

**Income From Continuing Operations.** Income from continuing operations was \$2.2 million, or \$0.17 per diluted share, for the quarter ended September 29, 2007 compared with \$2.7 million, or \$0.21 per diluted share, for the quarter ended September 30, 2006. Income from continuing operations was \$5.0 million, or \$0.39 per diluted share, for the first nine months of 2007 compared with \$4.7 million, or \$0.36 per diluted share, for the first nine months of 2006. Income from continuing operations for the first nine months of 2006 was reduced by \$2.1 million, net of tax, or \$0.16 per diluted share, as a result of settlement expenses to terminate a defined benefit pension plan in the second quarter of 2006.

**Net Income.** Income from discontinued operations was \$9 thousand, or \$0.00 per diluted share for the third quarter of 2007, compared with a loss of \$86 thousand, or \$0.01 per diluted share for the third quarter of 2006. For the first nine months of 2007, the loss from discontinued operations was \$175 thousand, or \$0.01 per diluted share, compared with a loss of \$261 thousand, or \$0.02 per diluted share in the year earlier period.

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Including discontinued operations, net income was \$2.2 million, or \$0.17 per diluted share, for the third quarter of 2007, compared with net income of \$2.6 million, or \$0.20 per diluted share, for the third quarter of 2006. For the first nine months of 2007, net income was \$4.9 million, or \$0.38 per diluted share, compared with \$4.4 million, or \$0.34 per diluted share, in the year-earlier period.

## **LIQUIDITY AND CAPITAL RESOURCES**

During the nine-months ended September 29, 2007, we generated \$8.1 million of funds from operating activities, received \$397 thousand from the exercise of stock options, increased debt by \$2.6 million, increased outstanding checks in excess of cash by \$1.1 million and reduced cash on our balance sheet by \$221 thousand. These funds were used to finance our operations, purchase \$11.6 million of capital assets and acquire \$837 thousand of our outstanding Common Stock for treasury. The \$2.6 million net increase in debt included \$3.4 million of equipment financing notes, which bear interest at fixed rates ranging from 6.83% to 6.85%.

Working capital increased \$6.0 million for the first nine months of 2007 principally due to normal seasonal increases in accounts receivable, inventories and accounts payable and accrued expenses. Capital expenditures for the nine months ended September 29, 2007 were \$11.6 million while depreciation and amortization was \$9.7 million. We expect capital expenditures to be approximately \$16.0 million for fiscal 2007, while depreciation and amortization is expected to be slightly below \$13.0 million. Planned capital expenditures in 2007 primarily relate to new manufacturing technology and information systems.

On August 7, 2007, our Board of Directors authorized the repurchase of up to \$10.0 million of our Common Stock in the open market or through private transactions at such times and such prices as determined by management. We repurchased 79,128 shares of our Common Stock at an average price of \$10.53 per share pursuant to this authorization during the quarter ended September 29, 2007.

Our senior loan and security agreement was amended on July 16, 2007 and October 22, 2007. The July 16, 2007 amendment increased the level of "permitted purchase money debt" as defined in the loan agreement from \$10.0 million to \$20.0 million. The October 22, 2007 amendment increased the agreement's limit on revolver loans from \$60.0 million to \$70.0 million and increased the amount we may expend for repurchases of our Common Stock or the payment of dividends by \$10.0 million, subject to certain limitations and conditions set forth in the agreement. The other provisions in the loan agreement remain unchanged.

The unused borrowing capacity under our senior loan and security agreement was approximately \$24.0 million at September 29, 2007.

We believe our operating cash flows and existing credit facilities are adequate to finance our anticipated liquidity requirements.

## **RECENT ACCOUNTING PRONOUNCEMENTS**

In September 2006, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards ("SFAS") No. 157, "Fair Value Measurements". SFAS No. 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles and expands disclosures about fair value measurements. SFAS No. 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007 and interim periods within those fiscal years. We do not expect the adoption of this statement to have a material effect on our financial statements.

In February 2007, the FASB issued SFAS No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities", including an amendment of SFAS No. 115, "Accounting for Certain Investments in Debt and Equity Securities". SFAS No. 159 permits entities to choose to measure many financial instruments and certain other items at fair value. The objective of SFAS No. 159 is to improve financial reporting by providing entities with a means of mitigating volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. Eligible items for the measurement option include all recognized financial assets and liabilities except: investments in subsidiaries, interests in variable interest entities, obligations for pension benefits, assets and liabilities recognized under leases, deposit liabilities and financial instruments that are a component of shareholders' equity. Also included are firm commitments that involve only financial instruments, nonfinancial insurance contracts and warranties and host financial instruments.

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The Statement permits entities to choose the fair value measurement option at specified election dates, after which the entity shall report unrealized gains and losses on items for which the fair value option has been elected in earnings, at each subsequent reporting date. The fair value option may be applied instrument by instrument; however, the election is irrevocable and may apply only to entire instruments and not to portions of instruments. SFAS No. 159 is effective for fiscal years beginning after November 15, 2007. We are currently evaluating our options under this statement.

## **CERTAIN FACTORS AFFECTING THE COMPANY'S PERFORMANCE**

In addition to the other information provided in this Report, the risk factors included in Item 1A should be considered when evaluating results of our operations, future prospects and an investment in shares of our Common Stock. Any of these factors could cause our actual financial results to differ materially from our historical results, and could give rise to events that might have a material adverse effect on our business, financial condition and results of operations.

## **FORWARD-LOOKING INFORMATION**

This Report contains statements that may be considered forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended and Section 21E of the Securities Exchange Act of 1934, as amended. These statements include the use of terms or phrases that include such terms as "expects," "estimated," "projects," "believes," "anticipates," "intends," and similar terms and phrases. Such terms or phrases relate to, among other matters, our future financial performance, business prospects, growth strategies or liquidity. The following important factors may affect our future results and could cause those results to differ materially from our historical results. These factors include, in addition to those detailed under the heading "Certain Factors Affecting the Company's Performance", the cost and availability of capital and raw materials, transportation costs related to petroleum price levels, the cost and availability of energy supplies, the loss of a significant customer or group of customers, materially adverse changes in economic conditions generally in carpet, rug and floorcovering markets we serve and other risks detailed from time to time in our filings with the Securities and Exchange Commission.

### **ITEM 3. Quantitative and Qualitative Disclosures about Market Risk (Dollars in thousands)**

The Company's earnings, cash flows and financial position are exposed to market risks relating to interest rates. The Company minimizes its exposure to adverse changes in interest rates and manages interest rate risks inherent in funding the Company with debt through a risk management program that includes maintaining a mix of fixed and floating rate debt and the use of derivative financial instruments.

At September 29, 2007, the Company had an interest rate swap agreement applicable to its mortgage note payable. The agreement has a notional amount equal to the outstanding balance of the mortgage note (\$6,597 at September 29, 2007) which expires in March of 2013. Under the agreement, the Company pays a fixed rate of interest of 4.54% times the notional amount and receives in return an amount equal to a specified variable rate of interest times the same notional amount. The swap agreement effectively fixes the interest rate on the mortgage note payable at 6.54%.

On October 11, 2005, the Company entered into an interest rate swap agreement with a notional amount of \$30,000 through May 11, 2010. Under the interest rate swap agreement, the Company pays a fixed rate of interest of 4.79% times the notional amount and receives in return an amount equal to a specified variable rate of interest times the same notional amount. The interest rate swap agreement is linked to the Company's variable rate debt and is considered a highly effective hedge.

At September 29, 2007, \$19,995, or approximately 22% of the Company's total debt, was subject to floating interest rates. A 10% fluctuation in the variable interest rates applicable to this floating rate debt would have had an annual after-tax impact of approximately \$95.

### **ITEM 4 - Controls and Procedures**

We maintain disclosure controls and procedures to ensure that information required to be disclosed in the reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the commission's rules and forms and is accumulated and communicated to management, including our principal executive officer and principal financial officer, or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosure. Our management, under the supervision and with the participation of our Chief Executive Officer ("CEO") and Chief Financial Officer ("CFO") evaluated the effectiveness of the design and operation of our disclosure controls and procedures (as such terms are defined in Rules 13(a)-15(e) and 15(d)-15(e)) under the Securities Exchange Act of 1934, as amended (the "Exchange Act") as of September 29, 2007, the date of the financial statements included in this Form 10-Q (the "Evaluation Date"). Based on that evaluation, our CEO and CFO concluded that our disclosure controls and procedures were effective as of the Evaluation Date.

During the quarter ended September 29, 2007, we remediated a material weakness in our internal controls over financial reporting by amending and restating our Annual Report of on Form 10-K/A for the year ended December 30, 2006 and our Quarterly Reports on Form 10-Q/A for the quarterly periods ending July 1, 2006 and September 30, 2006 in response to comments from the Securities and Exchange Commission regarding our Annual Report on Form 10K for the fiscal year ended December 30, 2006. See Note Q – “Restatement of Consolidated Financial Statements”, of Notes to Consolidated Financial Statements in our Annual Report on Form 10-K/A for the fiscal year ended December 30, 2006, which fully describes the restatement of our previously issued financial statements to change the presentation of pension costs relating to our discontinued textile business in our Consolidated Statements of Operations and Consolidated Statements of Cash Flows for the years ended December 31, 2006 and December 31, 2005 and of income tax payments related to the sale of a business in our Consolidated Statement of Cash Flows for the year ended December 25, 2004. These changes in presentation had no impact on previously reported Net Income, Net Income per share, total cash flow, our Balance Sheets or stockholder’s equity. These changes in presentation also did not affect compliance with our loan covenants or financial rewards granted to our associates and officers. No other changes in our internal control over financial reporting occurred during the quarter covered by this report that materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Internal control over financial reporting cannot provide absolute assurance of achieving financial reporting objectives because of its inherent limitations. Internal control over financial reporting is a process that involves human diligence and compliance and is subject to lapses in judgment and breakdowns resulting from human failures, as well as diverse interpretation of U. S. Generally Accepted Accounting Principals by accounting professionals. Internal control over financial reporting also can be circumvented by collusion or improper management override. Because of such limitations, there is a risk that material misstatements may not be prevented or detected on a timely basis by internal control over financial reporting. 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. These inherent limitations are known features of the financial reporting process; therefore, it is not possible to design into the process safeguards to eliminate all risk.

## **PART II. OTHER INFORMATION**

### **Item 1 - Legal Proceedings**

None.

### **Item 1A - Risk Factors**

**In addition to the other information provided in this Report, the following risk factors should be considered when evaluating results of our operations, future prospects and an investment in shares of our Common Stock. Any of these factors could cause our actual financial results to differ materially from our historical results, and could give rise to events that might have a material adverse effect on our business, financial condition and results of operations.**

**The floorcovering industry is cyclical and prolonged declines in residential or commercial construction activity or corporate remodeling and refurbishment could have a material adverse effect on our business.**

The U.S. floorcovering industry is cyclical and is influenced by a number of general economic factors. The floorcovering industry in general is dependent on residential and commercial construction activity, including new construction as well as remodeling. New construction is cyclical in nature. To a somewhat lesser degree, this also is true with residential and commercial remodeling. A prolonged decline in any of these industries could have a material adverse effect on our business, financial condition and results of operations. The level of activity in these industries is significantly affected by numerous factors, all of which are beyond our control, including among others:

- consumer confidence;
- housing demand;
- financing availability;
- national and local economic conditions;
- interest rates;
- employment levels;
- changes in disposable income;
- commercial rental vacancy rates; and
- federal and state income tax policies.

Our product concentration in the higher-end of the residential and commercial markets could significantly affect the impact of these factors on our business.

**We face intense competition in our industry, which could decrease demand for our products and could have a material adverse effect on our profitability.**

The floorcovering industry is highly competitive. We face competition from a number of domestic manufacturers and independent distributors of floorcovering products and, in certain product areas, foreign manufacturers. Significant consolidation within the floorcovering industry during recent years has caused a number of our existing and potential competitors to be larger and have greater resources and access to capital than we do. Maintaining our competitive position may require us to make substantial additional investments in our product development efforts, manufacturing facilities, distribution network and sales and marketing activities, which may be limited by our access to capital, as well as restrictions set forth in our credit facilities. Competitive pressures may also result in decreased demand for our products and in the loss of market share. In addition, we face, and will continue to face, pressure on sales prices of our products from competitors. As a result of any of these factors, there could be a material adverse effect on our sales and profitability.

**Raw material prices may increase.**

The cost of raw materials has a significant impact on our profitability. In particular, our business requires the purchase of large volumes of nylon yarn, synthetic backing, latex, and dyes. Increases in the cost of these raw materials could materially adversely affect our business, results of operations and financial condition if we are unable to pass these increases through to our customers. We believe we are successful in passing along raw material and other costs as they may occur; however, there can be no assurance that we will successfully recover such increases in cost.

**Unanticipated termination or interruption of our arrangements with third-party suppliers of nylon yarn could have a material adverse effect on us.**

Nylon yarn is the principal raw material used in our floorcovering products. A significant portion of nylon yarn is purchased from one supplier. We believe there are other sources of nylon yarns; however, an unanticipated termination or interruption of our supply arrangements could adversely affect our supply arrangements and could be material.

**We may be responsible for environmental cleanup costs.**

Various federal, state and local environmental laws govern the use of our facilities. These laws govern such matters as:

- Discharges to air and water;
- Handling and disposal of solid and hazardous substances and waste; and
- Remediation of contamination from releases of hazardous substances in our facilities and off-site disposal locations.

Our operations also are governed by laws relating to workplace safety and worker health, which, among other things, establish noise standards and regulate the use of hazardous materials and chemicals in the workplace. We have taken, and will continue to take, steps to comply with these laws. If we fail to comply with present or future environmental or safety regulations, we could be subject to future liabilities. However, we cannot insure that complying with these environmental or health and safety laws and requirements will not adversely affect our business, results of operations and financial condition. Future laws, ordinances or regulations could give rise to additional compliance or remediation costs that could have a material adverse effect on our business, results of operations and financial condition.

**Acts of Terrorism.**

Our business could be materially adversely affected as a result of international conflicts or acts of terrorism. Terrorist acts or acts of war may cause damage or disruption to our facilities, employees, customers, suppliers, and distributors, which could have a material adverse effect on our business, results of operations or financial condition. Such conflicts also may cause damage or disruption to transportation and communication systems and to our ability to manage logistics in such an environment, including receipt of supplies and distribution of products.

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## Unanticipated Business Interruptions.

Our business could be adversely affected if a significant portion of our plant, equipment or operations were damaged or interrupted by a casualty, condemnation, utility service, work stoppage or other event beyond our control. Such an event could have a material adverse effect on our business, results of operations and financial condition.

### Item 2 - Unregistered Sales of Equity Securities and Use of Proceeds

The following table provides information regarding our repurchases of shares of our common stock during the three months ended September 29, 2007:

| Month Ending                    | Total Number of Shares Purchased | Average Price Paid Per Share | Maximum Number (or approximate dollar value) of Shares That May Yet Be Purchased Under Plans or Programs | Total Number of Shares Purchased As Part of Publicly Announced Plans or Programs (1) |
|---------------------------------|----------------------------------|------------------------------|--|--|
| August 4, 2007                  | ---                              | \$ N/A                       | \$ N/A   | ---  |
| September 1, 2007               | 64,728                           | 10.59                        | N/A  | 64,728   |
| September 29, 2007              | 14,400                           | 10.27                        | 9,162,605 (2)  | 14,400   |
| Three Months September 29, 2007 | 79,128                           | \$ 10.53                     |  | 79,128   |

(1) On August 8, 2007, we announced a stock repurchase program under which we would spend up to \$10 million to repurchase shares of our common stock.

(2) The balance of our authorization remaining after deducting the price paid, to date, plus all commissions paid, to date.

### Item 3 - Defaults Upon Senior Securities

None.

### Item 4 - Submission of Matters to a Vote of Security Holders

None.

### Item 5 - Other Information

None.

### Item 6 - Exhibits

(a) Exhibits

(i)

Exhibits Incorporated by Reference

10.1 Letter Agreement dated July 16, 2007, to the Amended and Restated Loan and Security Agreement. (Incorporated by reference to the Current Report on Form 8-K dated July 16, 2007)

99.1 On August 8 2007, The Dixie Group, Inc. issued a press release announcing that the Company's Board of Directors has authorized the repurchase of up to \$10 million of the Company's Common Stock. (Incorporated by reference to the Current Report on Form 8-K dated August 8, 2007)

(ii)

Exhibits Filed with this Report

31.1 CEO Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

31.2 CFO Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

32.1 CEO Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

32.2 CFO Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

## SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

THE DIXIE GROUP, INC.  
(Registrant)

Date: November 7, 2007

By: /s/ GARY A. HARMON  
Gary A. Harmon  
Vice President and Chief Financial Officer

Date: November 7, 2007

By: /s/ D. EUGENE LASATER  
D. Eugene Lasater  
Controller

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