

DIXIE GROUP INC  
Form 10-K  
March 05, 2009

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

**FORM 10-K**

(Mark One)

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

**For the fiscal year ended December 27, 2008**

**OR**

**o 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, 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 37421**

(Address of principal executive offices) (Zip code)

**(423) 510-7000**

(Registrant's telephone number, including area code)

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

Title of each class

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Name of each exchange on which  
registered

None

None

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

Title of class

Common Stock, \$3.00 Par Value

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

Yes

R

No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or 15(d) of the Act.

Yes

R

No

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or 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. R Yes  No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of the registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of the Form 10-K or any amendment to this Form 10-K. R

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

Large accelerated filer  Accelerated filer  R

Non-accelerated filer  Smaller reporting company

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

Yes

R

No

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

**FORM 10-K (Continued)**

The aggregate market value of the Common Stock held by non-affiliates of the registrant on June 28, 2008 (the last business day of the registrant's most recently completed fiscal second quarter) was approximately \$57,178,000. The aggregate market value was computed by reference to the closing price of the Common Stock on such date. In making this calculation, the registrant has assumed, without admitting for any purpose, that all executive officers, directors, and holders of more than 10% of a class of outstanding Common Stock, and no other persons, are affiliates. No market exists for the shares of Class B Common Stock, which is neither registered under Section 12 of the Act nor subject to Section 15(d) of the Act.

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

| Class                                  | Outstanding as of February 16, 2009 |
|--|-------------------------------------|
| Common Stock, \$3.00 Par Value         | 11,743,328 shares                   |
| Class B Common Stock, \$3.00 Par Value | 862,915 shares                      |
| Class C Common Stock, \$3.00 Par Value | 0 shares                            |

**DOCUMENTS INCORPORATED BY REFERENCE**

Specified portions of the following document are incorporated by reference:

Proxy Statement of the registrant for annual meeting of shareholders to be held April 28, 2009 (Part III).

## **PART I**

### **ITEM 1. BUSINESS**

#### **General**

Our business consists principally of marketing, manufacturing and selling carpet and rugs to high-end residential and commercial customers through the Fabrica International, Masland Carpets and the Dixie Home brands. A small portion of our manufacturing capacity is used to process yarns and provide carpet dyeing and finishing services to other carpet manufacturers.

Over the seven year period beginning in 1993, we made eight floorcovering business acquisitions and completed the disposal of the assets of our textile product's business. In 2001 through 2003, we disposed of our lower price point factory-built housing carpet, needlebond and carpet recycling businesses. The sale of these businesses and assets allowed us to substantially reduce our debt, diversify our customer base and focus on the upper-end of the soft floorcovering market where we believe we have strong brands and competitive advantages with our style and design capabilities and customer relationships.

Our business is now concentrated in areas of the soft floorcovering markets where innovative styling, design, color, quality and service, as well as limited distribution, are welcomed and rewarded. Through Masland, Fabrica, and Dixie Home, we have a significant presence in the high-end of the residential and commercial soft floorcovering markets.

Our brands are well known, highly regarded and complementary; by being differentiated, we offer meaningful alternatives to the discriminating customer.

#### **Our Business Units**

We are in one line of business, Carpet Manufacturing.

#### **Fabrica**

**Fabrica**, founded in 1974, markets and manufactures luxurious residential carpet and custom rugs, at selling prices that we believe are approximately five and one half times the average for the residential soft floorcovering industry. Its primary customers are interior decorators and designers, selected retailers and furniture stores, luxury home

builders and manufacturers of luxury motor coaches and yachts. Fabrica is among the leading premium brands in the domestic marketplace and is known for styling innovation and unique colors and patterns. Fabrica is viewed by the trade as a premier brand and resource for very high-end carpet and enjoys an established reputation as a styling trendsetter and a market leader in the very high-end residential sector. Fabrica accounted for approximately 17% of our sales in 2008.

## **Masland**

**Masland Carpets**, founded in 1866, markets and manufactures residential and commercial products.

**Masland Residential** markets and manufactures design-driven specialty carpets and rugs for the high-end residential marketplace. Its residential broadloom carpet products are marketed at selling prices that we believe are approximately four and one half times the average for the residential soft floorcovering industry. Its products are marketed through the interior design community, as well as to consumers through specialty floorcovering retailers. Masland Residential accounted for approximately 32% of our sales in 2008. Masland Residential has strong brand recognition within the upper-end residential market. Masland Residential competes through innovative styling, color, product design, quality and service.

**Masland Contract** markets and manufactures broadloom and modular carpet (carpet tiles) for the specified commercial marketplace. Its commercial products are marketed through the architectural and specifier community and directly to commercial end users, as well as to consumers through specialty floorcovering retailers. Masland Contract was started in 1993 and accounted for approximately 29% of our sales in 2008. Masland Contract has strong brand recognition within the upper-end contract market. Masland Contract competes through innovative styling, color, patterns, quality and service.

## **Dixie Home**

We introduced **Dixie Home** in 2003 as a brand to provide stylishly designed, differentiated products that offer affordable fashion to residential consumers. Dixie Home markets an array of tufted broadloom residential and commercial carpet to selected retailers and home centers under the Dixie Home and private label brands. Its objective is to make the Dixie Home brand the choice for styling, service and quality in the more moderately priced sector of the high-end broadloom residential carpet market. Its products are marketed at selling prices which we believe are approximately two times the average for the soft floorcovering industry. Dixie Home's products have been well received in the marketplace and are expected to have significant growth potential. Dixie Home accounted for approximately 19% of our sales in 2008.

## **Industry**

The carpet and rug industry has two primary markets, residential and commercial, with the residential market making up the largest portion of the industry's sales. A substantial portion of industry shipments is made in response to replacement demand. Residential products consist of broadloom carpets and rugs in a broad range of styles, colors and textures. Commercial products consist primarily of broadloom carpet and carpet tiles for a variety of institutional applications such as office buildings, restaurant chains, schools and other commercial establishments. The carpet industry also manufactures carpet for the automotive, recreational vehicle, small boat and other industries.

The Carpet and Rug Institute (the "CRI") is the national trade association representing carpet and rug manufacturers. Information compiled by the CRI suggests that the domestic carpet and rug industry is comprised of fewer than 100 manufacturers, with a significant majority of the industry's production concentrated in a limited number of manufacturers. The carpet industry has continued to consolidate in recent years. We believe that this consolidation provides us with opportunities to capitalize on our competitive strengths in selected markets where innovative styling, design, product differentiation, focused service and limited distribution can add value.

## **Competition**

The floorcovering industry is highly competitive. We compete with other carpet manufacturers and rug manufacturers and other types of floorcoverings. Despite the industry consolidation, a number of smaller manufacturers remain. We believe our products are among the leaders in styling and design in the high-end residential and high-end commercial carpet markets. However, a number of manufacturers produce competitive products and some of these manufacturers have greater financial resources than we do.

We believe the principal competitive factors in our primary floorcovering markets are innovative styling, color, product design, quality and service. In the high-end residential and high-end commercial markets, carpet competes

with various other types of floorcoverings.

Nevertheless, we believe we have competitive advantages in several areas. We have an attractive portfolio of brands that we believe are well known, highly regarded by customers and complementary; by being differentiated, we offer meaningful alternatives to the discriminating customer. In addition, we have established longstanding relationships with key suppliers in our industry and customers in most of our markets. Finally, our reputation for innovative design excellence and our experienced management team enhance our competitive position. See "Risk Factors" in Item 1A of this report.

### **Backlog**

Sales order backlog is not material to an understanding of our business, due to relatively short lead times for order fulfillment in the markets for the vast majority of our products.

### **Trademarks**

Our floorcovering businesses own a variety of trademarks under which our products are marketed. Among such trademarks, the names "Masland", "Fabrica" and "Dixie Home" are of greatest importance to our business. We believe that we have taken adequate steps to protect our interest in all significant trademarks.

### **Customer and Product Concentration**

No single customer accounts for more than 10 percent of our sales and we do not make a material amount of sales in foreign countries. We do not believe that we have any single class of products that accounts for more than 10 percent of our sales. However, our sales may be classified by significant markets, and such information for the past three years is summarized as follows:



|   | <b>2008</b> | 2007 | 2006 |
|---|-------------|------|------|
| Residential floorcovering products                              | <b>60%</b>  | 60%  | 65%  |
| Commercial floorcovering products                               | <b>37%</b>  | 35%  | 30%  |
| Carpet yarn processing and carpet dyeing and finishing services | <b>3%</b>   | 5%   | 5%   |

### **Seasonality**

Our sales volumes historically have normally reached their highest levels in the fourth quarter (approximately 28% of our annual sales) and their lowest levels in the first quarter (approximately 22% of our annual sales), with the remaining sales being distributed relatively equally between the second and third quarters. In 2008, only 22% of our sales occurred in the fourth quarter due to the softness of our markets in the last half of the year. Working capital requirements have normally reached their highest levels in the second and third quarters of the year.

### **Environmental**

Our operations are subject to federal, state and local laws and regulations relating to the generation, storage, handling, emission, transportation and discharge of materials into the environment. The costs of complying with environmental protection laws and regulations have not had a material adverse impact on our financial condition or results of operations in the past and are not expected to have a material adverse impact in the future. See "Risk Factors" in Item 1A of this report.

### **Raw Materials**

We obtain our raw materials from a number of domestic suppliers. Man-made yarns are purchased from major chemical companies and wool is purchased from a number of domestic and international sources. Where possible, we pass raw material price increases through to our customers; however, there can be no assurance that price increases can be passed through to customers and that increases in raw material prices will not have an adverse effect on our profitability. See "Risk Factors" in Item 1A of this report. We purchase a significant portion of our raw materials (nylon yarn) from one supplier. We believe there are other sources of nylon yarn; however, an unanticipated termination or interruption of our supply arrangements could adversely affect our supply arrangements and could be material. See "Risk Factors" in Item 1A of this report.

### **Utilities**

We use electricity as our principal energy source, with oil or natural gas used in some facilities for finishing operations as well as heating. We have not experienced any material problem in obtaining adequate supplies of electricity, natural gas or oil. Energy shortages of extended duration could have an adverse effect on our operations, and price volatility could negatively impact future earnings. See "Risk Factors" in Item 1A of this report.

### **Working Capital**

We are required to maintain significant levels of inventory in order to provide the enhanced service levels demanded by the nature of our business and our customers, and to ensure timely delivery of our products. Consistent and dependable sources of liquidity are required to maintain such inventory levels. Failure to maintain appropriate levels of inventory could materially adversely affect our relationships with our customers and adversely affect our business.

### **Employment Level**

We employ approximately 1,250 associates in our operations.

### **Available Information**

Our internet address is [www.thedixiegroup.com](http://www.thedixiegroup.com). We make the following reports filed by us with the Securities and Exchange Commission available, free of charge, on our website under the heading "Investor Relations":

1. annual reports on Form 10-K;
2. quarterly reports on Form 10-Q;
3. current reports on Form 8-K; and
4. amendments to the foregoing reports.

The contents of our website are not a part of this report.

**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. In general, the industry 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 new construction or remodeling activity could have a material adverse effect on our business, financial condition and results of operations; as well as, additional impairments of goodwill. The level of activity in these industries is significantly affected by numerous factors, all of which are beyond our control, including among others:

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consumer confidence;

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housing demand;

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financing availability;

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national and local economic conditions;

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interest rates;

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employment levels;

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changes in disposable income;

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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. There has been significant consolidation within the floorcovering industry during recent years that has caused a number of our existing and potential competitors to be significantly larger and have significantly 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, as well as wool yarns, 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 cost increases 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 such 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:

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Discharges to air and water;

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Handling and disposal of solid and hazardous substances and waste; and

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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 ensure 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.

**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 1B. UNRESOLVED STAFF COMMENTS

None.

## ITEM 2. PROPERTIES

The following table lists the Company's facilities according to location, type of operation and approximate total floor space as of February 20, 2009:

| Location                        | Type of Operation                         | Approximate Square Feet |
|---------------------------------|---|-------------------------|
| Administrative:                 |   |                         |
| Dalton, GA*                     | Administrative                            | 16,000                  |
| Saraland, AL                    | Administrative                            | 29,000                  |
| Santa Ana, CA*                  | Administrative                            | 10,500                  |
| Chattanooga, TN*                | Administrative                            | 3,500                   |
|                                 | Total Administrative                      | 59,000                  |
| Manufacturing and Distribution: |   |                         |
| Atmore, AL                      | Carpet Manufacturing, Distribution        | 610,000                 |
| Saraland, AL                    | Carpet Tile Manufacturing, Distribution   | 384,000                 |
| Saraland, AL*                   | Samples/Rug Manufacturing, Distribution   | 132,000                 |
| Roanoke, AL                     | Carpet Yarn Processing                    | 204,000                 |
| Santa Ana, CA*                  | Carpet/Rug Manufacturing                  | 98,000                  |
| Santa Ana, CA                   | Carpet Dyeing, Finishing and Distribution | 204,000                 |
| Eton, GA                        | Carpet Manufacturing, Distribution        | 408,000                 |
|                                 | Total Manufacturing and Distribution      | 2,040,000               |
|                                 | <b>TOTAL</b>                              | <b>2,099,000</b>        |

\* Leased properties



In addition to the facilities listed above, the Company leases a small amount of office space in various locations.

In our opinion, our manufacturing facilities are well maintained and our machinery is efficient and competitive. Operations of our facilities generally vary between 120 and 168 hours per week. Substantially all of our owned properties are subject to mortgages, which secure the outstanding borrowings under our senior credit facilities.

**ITEM 3. LEGAL PROCEEDINGS**

There are no material pending legal proceedings to which the Company or its subsidiaries are a party or of which any of its property is the subject.

**ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS**

There were no matters submitted to a vote of the shareholders during the fourth quarter 2008.

Pursuant to instruction G of Form 10-K the following is included as an unnumbered item to PART I.

## **EXECUTIVE OFFICERS OF THE REGISTRANT**

The names, ages, positions and offices held by the executive officers of the registrant as of February 20, 2009, are listed below along with their business experience during the past five years.

### **Name, Age and Position**

### **Business Experience During Past Five Years**

Daniel K. Frierson, 67  
Chairman of the Board, and  
Chief Executive Officer,  
Director

Director since 1973, Chairman of the Board since 1987 and Chief Executive Officer since 1980. He serves on the Company's Executive Committee and is Chairman of the Company's Retirement Plans Committee. He also serves as Director of Astec Industries, Inc. headquartered in Chattanooga, Tennessee; and Louisiana-Pacific Corporation headquartered in Nashville, TN.

Gary A. Harmon, 63  
Vice President and  
Chief Financial Officer

Vice President and Chief Financial Officer since January 2000. Treasurer 1993 to 2000. Director of Tax and Financial Planning, 1985 to 1993.

David E. Polley, 74  
Vice President Marketing

Vice President of Marketing since December 2006. Vice President of Marketing and President, Dixie Home from November of 2002 to 2006. President, Residential Division of Mohawk Industries, Inc. from 1998 to 2002. President of World Carpets from 1991 to 1998. Prior to 1991, President of Lee's Residential Carpet Business.

Paul B. Comiskey, 57  
Vice President and President,  
Dixie Home

Vice President and President, Dixie Home since February 2007. President, Dixie Home since December 2006. Senior Vice President of Residential Sales, Mohawk Industries, Inc. from 1998 to 2006. Executive Vice President of Sales and Marketing for World Carpets from 1996 to 1998.

Kenneth L. Dempsey, 50  
Vice President and President,  
Masland Contract

Vice President and President, Masland Contract since February 2005. Vice President and President, Masland Carpets, 1997 to 2005. Vice President of Marketing, Masland, 1991 to 1996.

D. Kennedy Frierson, Jr., 42  
Vice President and President,  
Masland Residential

Vice President and President Masland Residential since February 2006. President Masland Residential since December 2005. Executive Vice President and General

Manager, Dixie Home, 2003 to 2005. Business Unit  
Manager, Bretlin, 2002 to 2003.

Craig S. Lapeere, 59  
Vice President and President,  
Fabrica International

Vice President and President Fabrica International since  
December 2005. Vice President and President, Masland  
Residential, February 2005 to December 2005. Vice  
President of Sales, Masland Carpets, 1998 to 2005.

W. Derek Davis, 58  
Vice President, Human Resources

Vice President of Human Resources since January 1991.  
Corporate Employee Relations Director, 1990 to 1991.

Jon A. Faulkner, 48  
Vice President Planning and  
Development

Vice President of Planning and Development since February  
2002. Executive Vice President of Sales and Marketing for  
Steward, Inc. from 1997 to 2002.

Terry W. Clark, 58  
Vice President Manufacturing

Vice President of Manufacturing since June 2007. Group  
Plant Manager at Shaw Industries, Inc. from 2003 to 2007.  
Vice President of Manufacturing, The Dixie Group, Inc. from  
1972 to 2003.

D. Eugene Lasater, 58  
Controller

Controller since 1988.

Starr T. Klein, 66  
Secretary

Secretary since November 1992. Assistant Secretary, 1987 to  
1992.

The executive officers of the registrant are generally elected annually by the Board of Directors at its first meeting held after each annual meeting of the Company's shareholders.

**PART II****ITEM 5. MARKET FOR THE REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES**

The Company's Common Stock trades on the NASDAQ Global Market under the symbol DXYN. No market exists for the Company's Class B Common Stock.

As of February 20, 2009, the total number of holders of the Company's Common Stock was approximately 2,850 including an estimated 2,350 shareholders who hold the Company's Common Stock in nominee names, but excluding approximately 660 participants in the Company's 401(k) plan who may direct the voting of the shares allocated to their accounts. The total number of holders of the Company's Class B Common Stock was 15.

**Recent Sales of Unregistered Securities**

None.

**Issuer Purchases of Equity Securities**

The following table provides information regarding our repurchases of shares of our common stock during the three months ended December 27, 2008:

| Fiscal Month Ending                            | Total<br>Number of<br>Shares<br>Purchased | Average<br>Price Paid<br>Per Share | Maximum<br>Number (or<br>approximate<br>dollar value)<br>of Shares<br>That May Yet<br>Be Purchased<br>Under Plans<br>or Programs | Total<br>Number of<br>Shares<br>Purchased as<br>Part of<br>Publicly<br>Announced<br>Plans or<br>Programs (1) |
|--|---|------------------------------------|--|--|
| November 1, 2008                               | 516                                       | \$ 7.70                            | \$   | 516  |
| November 29, 2008                              | 16,207                                    | 3.47                               |  | 16,207   |
| December 27, 2008                              | 25,738                                    | 2.26                               |  | 25,738   |
| Three Fiscal Months Ended<br>December 27, 2008 | 42,461                                    | \$ 2.79                            | \$ 4,900,815   | 42,461   |

(1) On August 8, 2007, we announced a program to repurchase up to \$10 million of our Common Stock.

**Quarterly Financial Data, Dividends and Price Range of Common Stock**

Following are quarterly financial data, dividends and price range of Common Stock for the four quarterly periods in the years ended December 27, 2008 and December 29, 2007. Totals of the quarterly information for each of the years reflected below may not necessarily equal the annual totals. The discussion of restrictions on payment of dividends is included in Note F to the Consolidated Financial Statements included herein.

**THE DIXIE GROUP, INC.**  
**QUARTERLY FINANCIAL DATA, DIVIDENDS AND PRICE RANGE OF COMMON STOCK**  
**(unaudited)**  
**(dollars in thousands, except per share data)**

| <b>2008 QUARTER</b>                        | <b>1<sup>ST</sup></b> | <b>2<sup>ND</sup></b> | <b>3<sup>RD</sup></b> | <b>4<sup>TH</sup> (1)</b> |
|--|-----------------------|-----------------------|-----------------------|---------------------------|
| Net sales                                  | \$ 70,722             | \$ 77,155             | \$ 72,917             | \$ 61,916                 |
| Gross profit                               | 20,557                | 22,553                | 18,888                | 16,154                    |
| Operating income (loss)                    | 1,575                 | 3,382                 | 33                    | (33,387)                  |
| Income (loss) from continuing operations   | 82                    | 1,283                 | (732)                 | (31,761)                  |
| Income (loss) from discontinued operations | (69)                  | 3                     | (101)                 | (107)                     |
| Net income (loss)                          | 13                    | 1,286                 | (833)                 | (31,868)                  |
| Basic earnings (loss) per share:           |                       |                       |                       |                           |
| Continuing operations                      | 0.01                  | 0.10                  | (0.06)                | (2.59)                    |
| Discontinued operations                    | (0.01)                | 0.00                  | (0.01)                | (0.01)                    |
| Net income (loss)                          | 0.00                  | 0.10                  | (0.07)                | (2.60)                    |
| Diluted earnings (loss) per share:         |                       |                       |                       |                           |
| Continuing operations                      | 0.01                  | 0.10                  | (0.06)                | (2.59)                    |
| Discontinued operations                    | (0.01)                | 0.00                  | (0.01)                | (0.01)                    |
| Net income (loss)                          | 0.00                  | 0.10                  | (0.07)                | (2.60)                    |
| Dividends:                                 |                       |                       |                       |                           |
| Common Stock                               | ---                   | ---                   | ---                   | ---                       |
| Class B Common Stock                       | ---                   | ---                   | ---                   | ---                       |
| Common Stock Prices:                       |                       |                       |                       |                           |
| High                                       | 9.55                  | 8.50                  | 8.49                  | 8.83                      |
| Low  | 7.43                  | 6.29                  | 4.61                  | 1.50                      |

| <b>2007 QUARTER</b>                        | <b>1<sup>ST</sup></b> | <b>2<sup>ND</sup></b> | <b>3<sup>RD</sup></b> | <b>4<sup>TH</sup>(2)</b> |
|--|-----------------------|-----------------------|-----------------------|--------------------------|
| Net sales                                  | \$ 74,490             | \$ 84,403             | \$ 82,385             | \$ 79,517                |
| Gross profit                               | 21,819                | 26,263                | 24,507                | 24,646                   |
| Operating income                           | 1,944                 | 5,658                 | 5,134                 | 3,988                    |
| Income from continuing operations          | 237                   | 2,556                 | 2,239                 | 1,746                    |
| Income (loss) from discontinued operations | (66)                  | (118)                 | 9                     | (337)                    |
| Net income                                 | 171                   | 2,438                 | 2,248                 | 1,409                    |

|                                    |        |        |       |        |
|------------------------------------|--------|--------|-------|--------|
| Basic earnings (loss) per share:   |        |        |       |        |
| Continuing operations              | 0.02   | 0.20   | 0.18  | 0.14   |
| Discontinued operations            | (0.01) | (0.01) | 0.00  | (0.03) |
| Net income                         | 0.01   | 0.19   | 0.18  | 0.11   |
| Diluted earnings (loss) per share: |        |        |       |        |
| Continuing operations              | 0.02   | 0.20   | 0.17  | 0.14   |
| Discontinued operations            | (0.01) | (0.01) | 0.00  | (0.03) |
| Net income                         | 0.01   | 0.19   | 0.17  | 0.11   |
| Dividends:                         |        |        |       |        |
| Common Stock                       | ---    | ---    | ---   | ---    |
| Class B Common Stock               | ---    | ---    | ---   | ---    |
| Common Stock Prices:               |        |        |       |        |
| High                               | 13.99  | 13.86  | 13.22 | 10.68  |
| Low                                | 11.88  | 11.45  | 9.01  | 7.97   |

(1) Includes expenses of \$29,916, or \$27,684 net of tax, for the impairment of goodwill and long-lived assets and facility consolidation and severance costs in 2008.

(2) Includes expenses of \$1,518, or \$1,023 net of tax, to merge a defined benefit pension plan into a multi-employer pension plan in 2007.

## **Shareholder Return Performance Presentation**

The Company compares its performance to two different industry indexes published by Dow Jones, Inc. The first of these is the Dow Jones Furnishings Index, which is composed of publicly traded companies classified by Dow Jones in the furnishings industry. The second is the Dow Jones Building Materials & Fixtures Index, which is composed of publicly traded companies classified by Dow Jones in the building materials and fixtures industry.

In accordance with SEC rules, set forth below is a line graph comparing the yearly change in the cumulative total shareholder return on the Company's Common Stock against the total return of the Standard & Poor's 600 Stock Index, plus both the Dow Jones Furnishings Index and the Dow Jones Building Materials & Fixtures Index, in each case for the five year period ended December 27, 2008. The comparison assumes that \$100.00 was invested on December 27, 2003, in each of the Company's Common Stock, the S&P 600 Index, and each of the two Peer Groups, and assumes the reinvestment of dividends.

The foregoing shareholder performance presentation shall not be deemed "soliciting material" or to be "filed" with the Commission subject to Regulation 14A, or subject to the liabilities of Section 18 of the Exchange Act.





**ITEM 6. SELECTED FINANCIAL DATA****The Dixie Group, Inc.****Historical Summary***(dollars in thousands, except per share data)*

| <b>FISCAL YEARS</b>  | <b>2008 (1)</b> | <b>2007 (2)</b> | <b>2006 (3)</b> | <b>2005</b> | <b>2004 (4)</b> |
|--|-----------------|-----------------|-----------------|-------------|-----------------|
| <b>OPERATIONS</b>  |                 |                 |                 |             |                 |
| Net sales  | \$ 282,710      | \$ 320,795      | \$ 331,100      | \$ 318,526  | \$ 291,971      |
| Gross profit   | 78,152          | 97,234          | 95,838          | 96,510      | 99,479          |
| Operating income (loss)                                      | (28,396)        | 16,724          | 16,558          | 19,835      | 25,597          |
| Income (loss) from continuing operations before income taxes | (34,035)        | 10,471          | 9,672           | 14,411      | 21,891          |
| Income tax provision (benefit)                               | (2,907)         | 3,693           | 1,781           | 4,453       | 7,851           |
| Income (loss) from continuing operations                     | (31,128)        | 6,778           | 7,891           | 9,958       | 14,040          |
| Depreciation and amortization                                | 13,752          | 12,941          | 11,500          | 10,058      | 8,601           |
| Dividends  | ---             | ---             | ---             | ---         | ---             |
| Capital expenditures   | 10,044          | 16,659          | 16,992          | 27,175      | 13,611          |
| <b>FINANCIAL POSITION</b>                                    |                 |                 |                 |             |                 |
| Assets   | \$ 252,663      | \$ 290,238      | \$ 277,826      | \$ 278,089  | \$ 249,358      |
| Working capital  | 77,626          | 75,414          | 73,126          | 75,516      | 58,610          |
| Long-term debt:  |                 |                 |                 |             |                 |
| Senior indebtedness  | 70,355          | 62,666          | 61,717          | 65,714      | 42,077          |
| Convertible subordinated debentures                          | 14,662          | 17,162          | 19,662          | 22,162      | 24,737          |
| Stockholders' equity   | 107,588         | 142,114         | 135,678         | 123,484     | 110,837         |
| <b>PER SHARE</b>   |                 |                 |                 |             |                 |
| Income (loss) from continuing operations:                    |                 |                 |                 |             |                 |
| Basic  | \$ (2.50)       | \$ 0.53         | \$ 0.62         | \$ 0.80     | \$ 1.16         |
| Diluted  | (2.50)          | 0.52            | 0.61            | 0.77        | 1.12            |
| Dividends:   |                 |                 |                 |             |                 |
| Common Stock   | ---             | ---             | ---             | ---         | ---             |
| Class B Common Stock   | ---             | ---             | ---             | ---         | ---             |

|            |      |       |       |      |      |
|------------|------|-------|-------|------|------|
| Book value | 8.53 | 10.97 | 10.49 | 9.75 | 9.03 |
|------------|------|-------|-------|------|------|

**GENERAL**

## Weighted average common shares outstanding:

|                            |            |            |            |            |            |
|----------------------------|------------|------------|------------|------------|------------|
| Basic                      | 12,448,704 | 12,788,292 | 12,701,506 | 12,415,743 | 12,119,050 |
| Diluted                    | 12,448,704 | 12,967,212 | 12,958,610 | 12,878,886 | 12,574,695 |
| Number of shareholders (5) | 2,850      | 3,300      | 4,850      | 5,100      | 2,800      |
| Number of associates       | 1,250      | 1,500      | 1,500      | 1,500      | 1,400      |

(1) Includes expenses of \$29,916, or \$27,684 net of tax, for the impairment of goodwill and long-lived assets and facility consolidation and severance costs in 2008.

(2) Includes expenses of \$1,518, or \$1,023 net of tax, to merge a defined benefit pension plan into a multi-employer pension plan in 2007.

(3) Includes expenses of \$3,249, or \$2,057 net of tax, to terminate a defined benefit pension plan in 2006.

(4) Includes the results of operations of Chroma Systems Partners subsequent to November 7, 2004.

(5) The approximate number of record holders of the Company's Common Stock for 2004 through 2008 includes Management's estimate of shareholders who held the Company's Common Stock in nominee names as follows: 2004 - 2,100 shareholders; 2005 - 4,500 shareholders; 2006 - 4,300 shareholders; 2007 - 2,800 shareholders; 2008 - 2,350 shareholders.



## **ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF RESULTS OF OPERATIONS AND FINANCIAL CONDITION**

The following discussion and analysis should be read in conjunction with our consolidated financial statements and related notes appearing elsewhere in this report.

### **OVERVIEW**

Over the last three years, demand for products manufactured by the United States carpet industry and our business has been significantly affected by declining demand as tighter credit conditions, lower consumer confidence and other economic factors reduced the level of new residential housing construction, the sales and refurbishment of existing homes and more recently, the levels of business construction and refurbishment activity. As a result of the continuing market weakness, sales of our business declined in each of the last two years and over 11% for the three year period ended December 27, 2008. During this same three year period, sales for the carpet industry were down approximately 15%. In the third and fourth quarters of 2008, our sales began slowing at a greater rate than the sales of the carpet industry. We believe our recent results reflect the impact of the overall downturn as it reaches the higher end of the market where our business is concentrated. While it is difficult to predict the length of the current downturn and its impact on the markets we serve, we believe our position in the upper end of the market will permit us to benefit from improved conditions and grow our sales at a rate that will exceed the rate of growth of the carpet industry, as and when economic conditions improve.

### **FACILITY CONSOLIDATIONS AND COSTS REDUCTION PLAN**

In response to the continued difficult economic conditions, we developed plans to consolidate our North Georgia carpet tufting operation into our Atmore, Alabama tufting, dyeing and finishing facility, combine our two Santa Ana, California facilities and make organizational and other changes to reduce staff and expenses throughout our Company. The consolidation of our East Coast tufting operations was substantially completed in the first quarter of 2009. Expenses for the consolidation and organizational changes were \$2.3 million in 2008 and, included \$1.9 million for relocation of equipment and inventory and \$400 thousand for severance costs and employee relocation expenses. Approximately \$800 thousand of additional expenses are expected to complete the East Coast facilities consolidation and organizational changes. The East Coast facility consolidations and organizational changes are expected to reduce costs and expenses by approximately \$4.0 million annually. In addition, we suspended our match of certain 401(k) contributions for 2009 and lowered the compensation of our salaried associates effective March 1, 2009. These actions should reduce expenses by an additional \$1.7 million annually.

We are reviewing our alternatives for our West Coast operation and are considering the possibility of selling this business, or more likely, consolidating it into our East Coast facilities, beginning as early as the second half of 2009.

If implemented, such a consolidation would further reduce costs, headcount and allow us to sell or lease our California real estate. The costs to fully implement this consolidation should be approximately \$3.0 million to \$5.0 million, and we expect a payback of one year or less. The sale of our California real estate would permit the Company to significantly further reduce debt.

In 2008, we reduced total employment by approximately 17%. The sale or consolidation of our West Coast operations into our East Coast facilities should reduce employment by another 12% to 18%.

## **GOODWILL AND LONG-LIVED ASSET IMPAIRMENTS**

As a result of the effect of economic conditions on our business, we evaluated the recoverability of goodwill associated with our reporting units during the third quarter of 2008 and twice in the fourth quarter of 2008. The evaluation compares the carrying amount of our reporting units, including goodwill, to the fair value of the reporting unit using a discounted cash flow model. For these purposes, fair value is an estimate of the value of the reporting units' current and future cash flows, discounted at our weighted-average cost of capital ("WACC"). No potential goodwill impairment was indicated when we evaluated the recoverability of goodwill in the third quarter of 2008.

When our annual goodwill impairment evaluation was performed in October of 2008, we reduced our projections for the future sales and profitability of our reporting units, because economic conditions in the carpet industry had continued to deteriorate. In addition, higher interest rates for 20 year treasury constant maturities and Moody's Baa bonds increased our WACC. As a result of the decline in the cash flow projections for our reporting units and the higher WACC, goodwill was potentially impaired in the two reporting units that had goodwill associated with their operations.

Because our assessment indicated that goodwill may not be fully recoverable, we performed the second step in the goodwill evaluation process by comparing the implied fair value of our reporting units' goodwill with the carrying value of the reporting units' goodwill. For this purpose, the implied fair value of goodwill for each reporting unit that has goodwill

associated with its operations was determined in the same manner as the amount of goodwill is determined in a business combination. The measurement resulted in the impairment of all of the goodwill, or \$1.3 million, associated with the acquisition of Patrick Carpet Mills, Inc. in 1994 and \$21.8 million, or approximately 40% of the goodwill associated with the acquisition of Fabrica International, Inc in 2000. The total non-cash goodwill impairment loss recognized in the fourth quarter of 2008 was \$23.1 million. All remaining goodwill on our balance sheet at December 27, 2008 is associated with the acquisition of Fabrica International, Inc.

We retested goodwill for impairment at the end of the fourth quarter of 2008 and no additional impairment was indicated. Considering seasonal factors, economic conditions in the carpet industry at that date had not significantly changed and our future sales and profitability expectations were unchanged. Additionally, our WACC decreased from 12.4% to 11.0% by the end of the fourth quarter 2008 due to decreases in the rates for 20 year treasury constant maturities and Moody's Baa bonds.

Our facility consolidations and cost reduction plan identified certain assets, primarily computer software, which would not be utilized in our ongoing operations. As a result, the Company recorded \$4.5 million of non-cash asset impairments to reflect the loss in value of these assets in the fourth quarter of 2008.

## RESULTS OF OPERATIONS

Our discussion and analysis of financial condition and results of operations is based on our Consolidated Financial Statements that were prepared in accordance with U. S. generally accepted accounting principles. The following table sets forth certain elements of our continuing operations as a percentage of net sales for the periods indicated:

|  | Fiscal Year Ended    |                      |                      |
|--|----------------------|----------------------|----------------------|
|  | December 27,<br>2008 | December 29,<br>2007 | December 30,<br>2006 |
| Net sales  | 100.0 %              | 100.0 %              | 100.0 %              |
| Cost of sales  | 72.4 %               | 69.7 %               | 71.1 %               |
| Gross profit   | 27.6 %               | 30.3 %               | 28.9 %               |
| Selling and administrative expenses                      | 26.9 %               | 24.5 %               | 22.9 %               |
| Other operating income                                   | (0.2) %              | (0.1) %              | (0.2) %              |
| Other operating expense                                  | 0.3 %                | 0.2 %                | 0.2 %                |
| Facility consolidation and severance expense             | 0.8 %                | 0.0 %                | 0.0 %                |
| Impairment of assets                                     | 1.6 %                | 0.0 %                | 0.0 %                |
| Impairment of goodwill                                   | 8.2 %                | 0.0 %                | 0.0 %                |
| Defined benefit pension plan merger/termination expenses | 0.0 %                | 0.5 %                | 1.0 %                |

|                         |         |       |       |
|-------------------------|---------|-------|-------|
| Operating income/(loss) | (10.0)% | 5.2 % | 5.0 % |
|-------------------------|---------|-------|-------|

### Fiscal Year Ended December 27, 2008 Compared with Fiscal Year Ended December 29, 2007

**Net Sales.** Net sales for the year ended December 27, 2008 were \$282.7 million, down 11.9% from \$320.8 million in the year-earlier period. Continued weakness in residential carpet markets and softening commercial markets negatively affected the carpet industry and our business. The carpet industry reported a 7.4% decline in net sales in 2008, with residential carpet sales down 12.1% and commercial carpet relatively unchanged compared with the prior year. Our 2008 year-over-year carpet sales comparison reflected a 10.7% decline in total net carpet sales, with sales of residential carpet down 13.0% and sales of commercial carpet down 6.7%. Revenue from carpet yarn processing and carpet dyeing and finishing services decreased \$5.5 million, or 34.5% in 2008, compared with 2007.

**Cost of Sales.** Cost of sales, as a percentage of net sales, increased 2.7 percentage points in 2008 compared with 2007. This increase was principally attributable to unabsorbed fixed cost from lower production volume and a lag in passing higher raw material, energy and other costs through to our customers. LIFO inventory liquidations in 2008 reduced cost of sales by \$170 thousand.

**Gross Profit.** Gross profit declined \$19.0 million in 2008 compared with 2007 due to lower net sales and the higher cost of sales described above.

**Selling and Administrative Expenses.** Selling and administrative expenses were reduced \$2.7 million in 2008, compared with 2007. As a percent of net sales, these expenses increased 2.4 percentage points principally as a result of lower sales volume.

**Other Operating Income.** Other operating income did not significantly change, compared with the prior year.



**Other Operating Expense.** Other operating expense increased \$272 thousand in 2008, compared with 2007 principally due to higher retirement expenses.

**Facility Consolidation and Severance Expenses, Impairment of Assets and Goodwill.** During the fourth quarter of 2008, we recorded \$29.9 million of expenses related to the consolidation of facilities and severance cost, and impairments of assets and goodwill, of which \$27.6 million were non-cash. Facilities consolidation and severance costs were \$2.3 million, impairment of assets was \$4.5 million and the impairment of goodwill was \$23.1 million.

**Operating Income (Loss).** Our 2008 operating loss was \$28.4 million including \$29.9 million of principally non-cash costs related to the facility consolidation and severance expenses, and impairments of assets and goodwill, compared with \$16.7 million of operating income in 2007. Operating income in 2007 included \$1.5 million of expenses to merge a defined benefit pension plan into a multi-employer plan.

**Interest Expense.** Interest expense decreased \$382 thousand in 2008 principally due to lower interest rates.

**Other Income.** Other income increased \$216 thousand in 2008 principally as a result of the sale of available-for-sale securities.

**Other Expense.** Other expense was not significant in 2008 or 2007.

**Income Tax Provision (Benefit).** Our effective income tax benefit rate was 8.5% in 2008, compared with an effective income tax rate of 35.3% in 2007. The change in the effective income tax, or benefit rates was principally attributable to a \$23.1 non-deductible goodwill impairment.

**Net Income (Loss).** Continuing operations reflected a loss of \$31.1 million, or \$2.50 per diluted share in 2008, compared with income from continuing operations of \$6.8 million, or \$0.52 per diluted share in 2007. Our discontinued operations reflected a loss of \$275 thousand, or \$0.02 per diluted share in 2008, compared with a loss of \$512 thousand, or \$0.05 per diluted share in 2007. Including discontinued operations, the net loss was \$31.4 million, or \$2.52 per diluted share in 2008, compared with net income of \$6.3 million, or \$0.49 per diluted share in 2007.

**Fiscal Year Ended December 29, 2007 Compared with Fiscal Year Ended December 30, 2006**

**Net Sales.** Net sales for the year ended December 29, 2007 decreased 3.1% to \$320.8 million. Continued weakness in residential carpet markets had a negative impact on the sales of the carpet industry and our business. Nevertheless, our sales continued to significantly outpace the sales of the carpet industry, which reported that carpet sales declined 8.0%, with residential carpet sales down 13.1% and commercial carpet sales improving 1.6%, compared with the prior year. Our 2007 year-over-year carpet net sales comparison reflected a 2.8% decline, with net sales of residential carpet down 9.1% and net sales of commercial carpet growing 10.5%. In addition to difficult conditions in the industry, over 95% of the decline in our carpet sales was a result of lower sales of residential carpet to one large home center customer. Revenue from carpet yarn processing and carpet dyeing and finishing services decreased 8.2% in 2007, compared with 2006.

**Cost of Sales.** The 1.4 percentage point decrease in cost of sales as a percentage of sales in 2007, compared with 2006 was principally attributable to higher selling prices, improved product mix and operational performance. The year-over-year comparison was also affected by LIFO inventory liquidations that reduced cost of sales by \$297 thousand in 2006.

**Gross Profit.** Despite lower net sales and higher raw material and other costs, gross profit improved \$1.4 million in 2007, compared with 2006. The improved results of our modular/carpet tile operation and the items described above that decreased cost of sales as a percentage of sales, more than offset the effect of lower sales volume.

**Selling and Administrative Expenses.** Selling and administrative expenses increased \$2.9 million in 2007, compared with 2006. The higher level of these expenses is principally attributable to investments in our sales and marketing infrastructure, information systems and inflationary cost increases. As a percentage of net sales, these expenses also increased due to lower net sales volume.

**Other Operating Income.** Other operating income decreased \$171 thousand in 2007 primarily due to insurance settlements and refunds in 2006 that did not repeat in 2007 which more than offset higher levels of miscellaneous income in 2007.

**Other Operating Expense.** Other operating expense decreased \$60 thousand in 2007, compared with 2006, due to lower asset retirement and impairment losses and higher levels of miscellaneous expense.

**Defined Benefit Pension Plan Merger/Termination Expenses.** In 2007, \$1.5 million of expenses were incurred to merge our one remaining defined benefit pension plan into a multi-employer plan. These expenses principally consisted



of non-cash, previously unrecognized actuarial losses. In 2006, \$3.2 million of expenses were incurred to terminate our legacy defined benefit pension plan. Approximately \$2.9 million of these 2006 expenses related to the settlement of pension benefits for employees of our discontinued textile business segment and the remaining expenses related to the settlement of pension benefits for employees of our ongoing floorcovering business segment.

**Operating Income.** Operating income was \$16.7 million, or 5.2% of sales in 2007, compared with \$16.6 million, or 5.0% of sales in 2006.

**Interest Expense.** Interest expense decreased \$866 thousand in 2007 due to lower levels of debt, lower interest rates and higher levels of capitalized interest.

**Other Income.** Other income decreased \$291 thousand in 2007 principally as a result of a dispute settled in 2006 that did not repeat in 2007.

**Other Expense.** Other expense was not significant in 2007 or 2006.

**Income Tax Provision.** Our effective income tax rate was 35.3% in 2007, compared with 18.4% in 2006. The change in the effective tax rate is principally due to reductions in our tax contingency reserve in 2006 as a result of the resolution of federal and state tax examinations and expirations of tax statutes of limitations. We also were able to utilize more state and federal income tax credits in 2006.

**Net Income.** Income from continuing operations was \$6.8 million, or \$0.52 per diluted share in 2007, compared with \$7.9 million, or \$0.61 per diluted share in 2006. Our discontinued operations reflected a loss of \$512 thousand, or \$0.04 per diluted share in 2007, compared with a loss of \$188 thousand, or \$0.02 per diluted share in 2006. Including discontinued operations, net income was \$6.3 million, or \$0.48 per diluted share in 2007, compared with \$7.7 million, or \$0.59 per diluted share in 2006.

## LIQUIDITY AND CAPITAL RESOURCES

During the year ended December 27, 2008, cash generated from operating activities was \$8.4 million. These funds were supplemented by \$13.9 million of borrowings under our revolving credit line and capital leases and \$822 thousand of proceeds from the sale of property, plant and equipment and available-for-sale securities. These funds were used to support our operations, purchase \$10.0 million of property, plant and equipment, retire \$8.7 million of debt and capitalized leases, purchase \$3.5 million of our Common Stock and reduce outstanding checks in excess of cash by \$729 thousand. Working capital increased \$2.2 million in 2008 principally due to lower levels of accrued

expenses, which more than offset lower levels of current deferred income tax assets. Receivables increased slightly due to a \$5.3 million increase in income tax receivables, a \$1.2 million increase in other miscellaneous receivables and a \$6.1 million decrease in trade accounts receivable. We have developed an aggressive plan to improve our utilization of inventories in 2009. Depending on business activity levels, we could reduce inventories by as much as \$15.0 million by the end of 2009.

During the year ended December 29, 2007, cash generated from operating activities was \$19.8 million. These funds were supplemented by \$6.0 million of borrowings to finance equipment purchases and \$381 thousand of funds from the exercise of employee stock options. These funds were used to support our operations, purchase \$16.7 million of property, plant and equipment, retire \$6.4 million of debt, purchase \$1.6 million of our Common Stock and reduce outstanding checks in excess of cash by \$1.7 million. Working capital increased \$2.3 million in 2007 principally due to higher levels of inventories and accounts receivable in excess of the increase in the levels of accounts payable and accrued expenses. Accounts receivable increased \$1.8 million, inventories increased \$6.3 million and accounts payable and accrued expenses increased \$4.7 million. The increase in inventory is primarily due to higher levels of raw material.

During the year ended December 30, 2006, cash generated from operating activities was \$19.4 million. These funds were supplemented by \$6.5 million of borrowings to finance equipment purchases, \$1.1 million of funds received from the exercise of employee stock options and a \$2.3 million increase in outstanding checks in excess of cash. These funds were used to finance \$16.5 million of purchases of property, plant and equipment, retire \$12.2 million of debt and increase cash and cash equivalents by \$538 thousand. Working capital decreased \$2.4 million in 2006 principally as a result of lower levels of accounts receivable, inventories and income tax refunds receivable which more than offset lower levels of accounts payable and accrued expenses. Accounts receivable decreased by \$2.4 million, inventory decreased by \$3.3 million and accounts payable and accrued expenses decreased by \$6.2 million, due to softness in our business in the fourth quarter of the year. Other current assets decreased due principally to lower levels of income tax refunds receivable.

Capital expenditures were \$10.0 million in 2008, \$16.7 million in 2007 and \$16.5 million in 2006, while depreciation and amortization were \$13.8 million in 2008, \$12.9 million in 2007 and \$11.5 million in 2006. Capital expenditures in 2008, 2007 and 2006 were primarily for newly designed manufacturing technology and information systems. We expect capital

expenditures to be approximately \$7.0 million in 2009, while depreciation and amortization is expected to be approximately \$14.0 million. Capital expenditures in 2009 will be primarily for newly designed manufacturing technology.

In October 2008, we amended and restated our senior loan and security agreement to extend the term of the agreement. The amended and restated senior loan and security agreement matures on May 11, 2013 and provides \$84.3 million of credit, consisting of \$70.0 million of revolving credit and a \$14.3 million term loan. The term loan is payable in monthly principal installments of \$126 thousand and is due May 11, 2013.

Interest rates available under the amended and restated senior loan and security agreement may be selected from a number of options that effectively allow us to borrow at rates ranging from the lender's prime rate plus 1.50% to the lender's prime rate plus 2.75% for base rate loans, or at rates ranging from LIBOR plus 2.00% to LIBOR plus 3.25% for LIBOR loans. The weighted-average interest rate on borrowings outstanding under this agreement was 5.68% at December 27, 2008 and 6.68% at December 29, 2007. Commitment fees ranging from 0.25% to 0.375% per annum are payable on the average daily unused balance of the revolving credit facility. The interest rate on a portion of borrowings under the amended and restated senior loan and security agreement are fixed by an interest rate swap arrangement that effectively fixes the interest rate on \$30.0 million of such borrowings at 4.79% plus the applicable credit spreads. The levels of our accounts receivable and inventory limit the borrowing availability under the revolving credit facility. The facility is secured by a first priority lien on substantially all of our assets.

The amended and restated senior loan and security agreement does not contain ongoing financial covenants and permits payment of dividends and repurchases of our Common Stock in an aggregate annual amount of up to \$3.0 million and distributions in excess of \$3.0 million under conditions specified in the agreement. The agreement also contains covenants that could limit future acquisitions. Unused borrowing capacity under the amended and restated senior loan and security agreement on December 27, 2008 was \$11.4 million.

Effective January 1, 2009, the amended and restated senior loan and security agreement was further amended to modify certain interest rate definitions to change the relative relationship between base rates and LIBOR rates as used in the agreement and to reduce the applicable credit spreads for base rate loans by 0.50%.

Our equipment financing notes have terms ranging from five to seven years, are secured by the specific equipment financed, bear interest ranging from 5.55% to 6.94% and are due in monthly installments of principal and interest of \$311 through February 2010 and monthly installments of principal and interest ranging from \$263 thousand to \$38 thousand from March 2010 through May 2014. The notes do not contain financial covenants.

Our capitalized lease obligations have terms ranging from four to seven years, are secured by the specific equipment leased, bear interest ranging from 6.65% to 7.27% and are due in monthly installments of principal and interest of \$131 thousand through June 2010, monthly installments of principal and interest ranging from \$32 thousand to \$8 thousand from July 2010 through November 2015. The capitalized leases do not contain financial covenants.

Our \$6.3 million mortgage is secured by real property, is payable in monthly principal installments ranging from \$20 thousand to \$28 thousand during the remaining term and matures on March 2013. The mortgage bears interest at LIBOR plus 2.0% and its interest rate is fixed at 6.54% through March 13, 2013 by an interest rate swap.

Our convertible subordinated debentures bear interest at 7% per annum payable semi-annually, are due in 2012, and are convertible by their holders into shares of our Common Stock at an effective conversion price of \$32.20 per share, subject to adjustment under certain circumstances. Mandatory sinking fund payments, which commenced May 15, 1998, retire \$2.5 million principal amount of the debentures annually and approximately 86% of the debentures prior to maturity. The convertible debentures are subordinated in right of payment to all of our other indebtedness.

Interest payments were \$6.1 million in 2008, \$6.5 million in 2007, and \$7.2 million in 2006. Interest capitalized by the Company was \$367 thousand in 2008, \$457 thousand in 2007, and \$243 thousand in 2006.

The following table summarizes the Company's future minimum payments under contractual obligations as of December 27, 2008.

|                           | Payments Due By Period |         |         |         |         |            | Total    |
|---------------------------|------------------------|---------|---------|---------|---------|------------|----------|
|                           | 2009                   | 2010    | 2011    | 2012    | 2013    | Thereafter |          |
|                           | (dollars in millions)  |         |         |         |         |            |          |
| Debt                      | \$ 7.4                 | \$ 7.1  | \$ 6.4  | \$ 12.9 | \$ 56.7 | \$ 0.2     | \$ 90.7  |
| Interest - debt (1)       | 5.4                    | 5.0     | 4.6     | 4.0     | 1.6     | 0.1        | 20.7     |
| Capital leases            | 1.4                    | 1.1     | 0.3     | 0.2     | 0.1     | 0.2        | 3.3      |
| Interest - capital leases | 0.2                    | 0.1     | ---     | ---     | ---     | ---        | .3       |
| Operating leases          | 1.9                    | 1.7     | 1.5     | 1.0     | 0.1     | ---        | 6.2      |
| Purchase commitments      | 1.2                    | ---     | ---     | ---     | ---     | ---        | 1.2      |
|                           | \$ 17.5                | \$ 15.0 | \$ 12.8 | \$ 18.1 | \$ 58.5 | \$ 0.5     | \$ 122.4 |

(1) Interest rates used for variable rate debt were those in effect at December 27, 2008.





We may be required to make cash outlays related to our unrecognized tax benefits in the future; however, the timing of any such cash outlays cannot be determined. Accordingly, unrecognized tax benefits of \$332 thousand as of December 27, 2008, have been excluded from the summary of contractual obligations.

We believe our operating cash flows, credit availability under our senior loan and security agreement and other sources of financing are adequate to finance our normal liquidity requirements. However, significant additional cash expenditures above our normal liquidity requirements or significant further deterioration in economic conditions that affect our business could require supplemental financing or other funding sources. There can be no assurance that such supplemental financing or other sources of funding can be obtained or will be obtained on terms favorable to us.

**Income Tax Considerations.** Approximately \$5.3 million of income tax refunds are expected in 2009 due to overpayments of estimated income taxes and carrybacks of net operating loss to prior years. Other than these income tax refunds, we do not anticipate that cash outlays for income taxes will be materially different from our provision for income taxes during the next three fiscal years. Approximately \$500 thousand of state net operating loss and income tax credit carryforward benefits are expected to be utilized in the future. During 2008, we increased our tax valuation reserve related to future benefits for operating loss and tax credit carryforwards by \$1.1 million.

## CRITICAL ACCOUNTING POLICIES

Certain estimates and assumptions are made when preparing our financial statements. These estimates and assumptions affect various matters, including:

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Amounts reported for assets and liabilities in our Consolidated Balance Sheets at the dates of the financial statements, and

.

Amounts reported for revenues and expenses in our Consolidated Statements of Operations during the reporting periods presented.

Estimates involve judgments with respect to, among other things, future economic factors that are difficult to predict. As a result, actual amounts could differ from estimates made when our financial statements are prepared.

The Securities and Exchange Commission requires management to identify its most critical accounting policies, defined as those that are both most important to the portrayal of our financial condition and operating results and the application of which requires our most difficult, subjective, and complex judgments. Although our estimates have not differed materially from our experience, such estimates pertain to inherently uncertain matters that could result in material differences in subsequent periods.

We believe application of the following accounting policies require significant judgments and estimates and represent our critical accounting policies. Other significant accounting policies are discussed in Note A to our Consolidated Financial Statements.

•

**Revenue recognition.** Revenues, including shipping and handling amounts, are recognized when the following criteria are met: there is persuasive evidence that a sales agreement exists, delivery has occurred or services have been rendered, the price to the buyer is fixed or determinable, and collection is reasonably assured. Delivery is not considered to have occurred until the customer takes title to products shipped and assumes the risks and rewards of ownership, which is generally on the date of shipment. At the time revenue is recognized, we record a provision for the estimated amount of future returns based primarily on historical experience and any known trends or conditions.

•

**Accounts receivable.** We provide allowances for expected cash discounts, returns, claims and doubtful accounts based upon historical experience and periodic evaluations of the financial condition of our customers. If the financial conditions of our customers were to significantly deteriorate, or other factors impair their ability to pay their debts, credit losses could differ from allowances recorded in our Consolidated Financial Statements.

•

**Customer claims and product warranties.** We provide product warranties related to manufacturing defects and specific performance standards for our products. We record reserves for the estimated costs of defective products and failure to meet applicable performance standards. The levels of reserves are established based primarily upon historical experience and our evaluation of pending claims. Because our evaluations are based on historical experience and conditions at the time our financial statements are prepared, actual results could differ from the reserves in our Consolidated Financial Statements.

•

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



inventories. Reserves are also established to adjust inventories that are off-quality, aged or obsolete to their estimated net realizable value. Additionally, rates of recoverability per unit of off-quality, obsolete or excessive inventory are estimated based on historical rates of recoverability and other known conditions or circumstances that may affect future recoverability. Actual results could differ from assumptions used to value our inventory.

•

**Goodwill.** Goodwill is subject to annual impairment testing. This test is based on the fair value of the underlying assets and businesses to which the goodwill applies based on estimates of future cash flows, which require judgments and assumptions about future economic factors that are difficult to predict. Changes in our judgments and assumptions about future economic factors could materially change our estimate of values and could materially impact the value of goodwill and our Consolidated Financial Statements.

•

**Self-insured accruals.** We estimate costs required to settle claims related to our self-insured medical, dental and workers' compensation plans. These estimates include costs to settle known claims, as well as incurred and unreported claims. The estimated costs of known and unreported claims are based on historical experience. Actual results could differ from assumptions used to estimate these accruals.

•

**Deferred income tax assets and liabilities.** We recognize deferred income tax assets and liabilities for the future tax consequences of the differences between the financial statement carrying amounts of assets and liabilities and their respective tax bases. Deferred income tax assets and liabilities are measured using statutory income tax rates that are expected to be applicable in future periods when temporary differences are expected to be recovered or paid. The effect on deferred income tax assets and liabilities of changes in income tax rates is recognized in earnings in the period that a change in income tax rates is enacted. Taxing jurisdictions could disagree with our tax treatment of various items in a manner that could affect the tax treatment of such items in the future. Accounting rules require these future effects to be evaluated using existing laws, rules and regulations, each of which is subject to change.

## **STOCK-BASED AWARDS**

We recognize compensation expense related to share-based stock awards based on the fair value of the equity instrument over the period of vesting for the individual stock awards that were granted.

At December 27, 2008, the total unrecognized compensation expense related to non-vested restricted stock awards was \$2.8 million with a weighted-average vesting period of 3.7 years.

## RECENT ACCOUNTING PRONOUNCEMENTS

In September 2006, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards No. 157, "Fair Value Measurements" ("SFAS No. 157"). SFAS No. 157 defines fair value, establishes a framework for measuring fair value under 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 adoption of this statement did not have a material effect on our financial position or results of operations.

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"). 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 to such assets and liabilities.

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 shareholder's 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 unrealized gains and losses on items for which the fair value option has been elected must be reported 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. This statement did not have a material effect on our financial position or results of operations.

In December 2007, the FASB issued SFAS No. 141R, "Business Combinations" ("SFAS No. 141R"). SFAS No. 141R replaces SFAS No. 141 and establishes principles and requirements for how identifiable assets, liabilities assumed, any

non-controlling interest in an acquiree, and goodwill is recognized and measured in an acquirer's financial statements. SFAS No. 141R also establishes disclosure requirements to assist users in evaluating the nature and financial effects of business combinations. This statement is effective for fiscal years beginning after December 15, 2008. We do not expect the adoption of this statement to have a material effect on our financial position or results of operations.

In December 2007, the FASB issued SFAS No. 160, "Noncontrolling Interests in Consolidated Financial Statements" ("SFAS No. 160"). SFAS No. 160 establishes accounting and reporting standards for ownership interests in subsidiaries held by parties (other than the parent of such subsidiaries), the amount of consolidated net income attributable to the parent and to the holder of a non-controlling interest, changes in a parent's ownership interest and the valuation of retained non-controlling equity investments when a subsidiary is no longer consolidated. SFAS No. 160 also establishes reporting requirements to clearly identify, distinguish and disclose the interests of the parent and the interests of the non-controlling owners. This statement is effective for fiscal years beginning after December 15, 2008. We do not expect the adoption of this statement to have a material effect on our financial position or results of operations.

In March 2008, the FASB issued SFAS No. 161, "Disclosures about Derivative Instruments and Hedging Activities, an amendment of FASB Statement No. 133" ("SFAS No. 161"). SFAS No. 161 establishes, among other things, additional disclosure requirements for derivative instruments and for hedging activities. SFAS No. 161 is effective for fiscal years and interim periods beginning after November 15, 2008. We do not expect the adoption of this statement to have a material effect on its financial position or results of operations.

## **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. Such statements include the use of terms or phrases such as "expects," "estimated," "projects," "believes," "anticipates," "intends," and similar terms and phrases. Such forward-looking statements 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 "Risk Factors" detailed in Item 1A of this report, and described elsewhere in this document, the cost and availability of capital, raw material and 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 7A. 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. It is the Company's policy to minimize its exposure to adverse changes in interest rates and manage interest rate risks inherent in funding the Company with debt. The Company addresses this financial exposure through a risk management program that includes maintaining a mix of fixed and floating rate debt and the use of derivative financial instruments.

At December 27, 2008, the Company was a party to an interest rate swap agreement on its mortgage note payable with a notional amount equal to the outstanding balance of the mortgage note (\$6,288 at December 27, 2008) which expires in March of 2013. Under the interest rate swap 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 this 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 agreement is linked to the Company's variable rate debt and is considered a highly effective hedge.

At December 27, 2008, \$27,124, or approximately 29% 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 an annual after-tax impact of approximately \$73.

## **ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA**

The supplementary financial information required by ITEM 302 of Regulation S-K is included in PART II, ITEM 5 of this report and the Financial Statements is included in a separate section of this report.

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

None.

## **ITEM 9A. CONTROLS AND PROCEDURES**

(a)

Evaluation of Disclosure 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 and Chief Financial Officer, evaluated the effectiveness 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 December 27, 2008, the date of the financial statements included in this Form 10-K (the "Evaluation Date"). Based on that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective as of the Evaluation Date.

(b)

Changes in Internal Control over Financial Reporting. During the last fiscal quarter, there have not been any changes in our internal control over financial reporting that have materially affected or are reasonably likely to materially affect our internal controls over financial reporting.

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



Our management is responsible for establishing and maintaining adequate internal control over financial reporting, as such term is defined in Exchange Act Rules 13(a)-15(f) and 15(d)-15(f).

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 principles by accounting professionals. It is also possible that internal controls could 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. Furthermore, 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 possible to design into the reporting process safeguards to reduce, though not eliminate, this risk.

We conducted, under the supervision and with the participation of our management, including our principal executive officer and principal financial officer, an evaluation of the effectiveness of our internal control over financial reporting based on the framework in *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on our evaluation under such framework, our management concluded that our internal control over financial reporting was effective as of December 27, 2008.

Our independent auditor, Ernst & Young LLP, an independent registered public accounting firm, has audited and reported on our consolidated financial statements and has issued an attestation report on the effectiveness of our internal control over financial reporting.

## Report of Independent Registered Public Accounting Firm

The Board of Directors and Shareholders of The Dixie Group, Inc.

We have audited The Dixie Group, Inc.'s internal control over financial reporting as of December 27, 2008, based on criteria established in *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO criteria). The Dixie Group, Inc.'s management is responsible for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting included in the accompanying Management's Report on Internal Control over Financial Reporting. Our responsibility is to express an opinion on the company's internal control over financial reporting based on our audit.

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

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

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. 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.

In our opinion, The Dixie Group, Inc. maintained, in all material respects, effective internal control over financial reporting as of December 27, 2008, based on the COSO criteria.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of The Dixie Group, Inc. as of December 27, 2008 and December 29, 2007, and the related consolidated statements of operations, stockholders' equity and comprehensive income (loss), and cash flows for each of the three years in the period ended December 27, 2008. Our report dated March 5, 2009 expressed an unqualified opinion thereon.

/s/ Ernst & Young LLP

Atlanta, Georgia

March 4, 2009

**ITEM 9B. OTHER INFORMATION**

None.

**PART III**

**ITEM 10. DIRECTORS AND EXECUTIVE OFFICERS OF THE REGISTRANT**

The sections entitled "Information about Nominees for Director" and "Section 16(a) Beneficial Ownership Reporting Compliance" in the Proxy Statement of the registrant for the annual meeting of shareholders to be held April 28, 2009 is incorporated herein by reference. Information regarding the executive officers of the registrant is presented in PART I of this report.

The Company has adopted a Code of Business Conduct and Ethics (the "Code of Ethics") which applies to its principal executive officer, principal financial officer and principal accounting officer or controller, and any persons performing similar functions. A copy of the Code of Ethics is incorporated by reference as Exhibit 14 to this Report.

**Audit Committee Financial Expert**

The Board has determined that John W. Murrey, III is an audit committee financial expert as defined by Item 401(h) of Regulation S-K of the Securities Exchange Act of 1934, as amended, and is independent within the meaning of Item 7(d)(3)(iv) of Schedule 14A of the Securities Exchange Act of 1934. For a brief listing of Mr. Murrey's relevant experience, please refer to the "Election of Directors" section of the Company's Proxy Statement.

**Audit Committee**

The Company has a standing audit committee. At December 27, 2008, members of the Company's audit committee are John W. Murrey, III, Chairman, J. Don Brock, Walter W. Hubbard and Lowry F. Kline.

**ITEM 11. EXECUTIVE COMPENSATION**

The section entitled "Compensation Discussion and Analysis", "Executive Compensation Information" and "Director Compensation" in the Proxy Statement of the registrant for the annual meeting of shareholders to be held April 28, 2009 is incorporated herein by reference.

**ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT**

The section entitled "Principal Shareholders", as well as the beneficial ownership table (and accompanying notes) in the Proxy Statement of the registrant for the annual meeting of shareholders to be April 28, 2009 is incorporated herein by reference.

**Equity Compensation Plan Information as of December 27, 2008**

The following table sets forth information as to the Company's equity compensation plans as of the end of the Company's 2008 fiscal year:

| Plan Category  | (a)   |     | (b)   |     | (c)   |
|--|---|-----|---|-----|---|
|  | Number of securities to be issued upon exercise of the outstanding options, warrants and rights |     | Weighted-average exercise price of outstanding options, warrants and rights |     | 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     | 907,753   | (1) | \$ 11.45  | (2) | 364,364   |
| Equity Compensation Plans not approved by security holders | N/A   |     | N/A   |     | N/A   |

(1)

Does not include 56,604 shares of Common Stock issued pursuant to restricted stock grants under the Company's 2000 Stock Incentive Plan, with a weighted-average grant date value of \$17.86 per share or 435,636 shares of Common Stock issued pursuant to restricted stock grants under the Company's 2006 Stock Awards Plan, with a weighted-average grant date value of \$11.09 per share.

(2)

Includes the aggregate weighted-average of (i) the exercise price per share for outstanding options to purchase 858,941 shares of Common Stock under the Company's 2000 Stock Incentive Plan and (ii) the price per share of the Common Stock on the grant date for each of 48,812 Performance Units issued under the Directors' Stock Plan (each performance unit is equivalent to one share of Common Stock).

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

The section entitled "Certain Transactions Between the Company and Directors and Officers" in the Proxy Statement of the registrant for the annual meeting of shareholders to be held April 28, 2009 is incorporated herein by reference.

**ITEM 14. PRINCIPAL ACCOUNTING FEES AND SERVICES**

The section entitled "Audit Fees Discussion" in the Proxy Statement of the Registrant for the Annual Meeting of Shareholders to be held April 28, 2009 is incorporated herein by reference.

**PART IV.**

**ITEM 15. EXHIBITS, FINANCIAL STATEMENT SCHEDULES.**

(a)

(1) and (2) - The response to this portion of Item 15 is submitted as a separate section of this report.

(3) Please refer to the Exhibit Index which is attached hereto.

(b)

Exhibits - The response to this portion of Item 15 is submitted as a separate section of this report. See Item 15(a) (3) above.

(c)

Financial Statement Schedules - The response to this portion of Item 15 is submitted as a separate section of this report.





**SIGNATURES**

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

Date: March 3, 2009

The Dixie Group, Inc.

/s/ DANIEL K. FRIERSON

By: Daniel K. Frierson  
Chairman of the Board  
and Chief Executive Officer

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

/s/ DANIEL K. FRIERSON  
Daniel K. Frierson  
Chairman of the Board,  
Director and Chief Executive Officer  
March 3, 2009

/s/ GARY A. HARMON  
Gary A. Harmon  
Vice President,  
Chief Financial Officer  
March 3, 2009

/s/ D. EUGENE LASATER  
D. Eugene Lasater  
Controller  
March 3, 2009

/s/ J. DON BROCK  
J. Don Brock  
Director  
March 3, 2009

/s/ PAUL K. FRIERSON  
Paul K. Frierson  
Director  
March 3, 2009

/s/ WALTER W. HUBBARD  
Walter W. Hubbard  
Director  
March 3, 2009

/s/ LOWRY F. KLINE  
Lowry F. Kline  
Director  
March 3, 2009

/s/ JOHN W. MURREY, III  
John W. Murrey, III  
Director  
March 3, 2009



**ANNUAL REPORT ON FORM 10-K**

**ITEM 8, ITEM 15(a)(1) AND ITEM 15(d)**

**LIST OF FINANCIAL STATEMENTS AND FINANCIAL STATEMENT SCHEDULES**

**FINANCIAL STATEMENTS**

**FINANCIAL STATEMENT SCHEDULES**

**YEAR ENDED DECEMBER 27, 2008**

**THE DIXIE GROUP, INC.**

**CHATTANOOGA, TENNESSEE**

**FORM 10-K - ITEM 15(a)(1) and (2)**

**THE DIXIE GROUP, INC. AND SUBSIDIARIES**

**LIST OF FINANCIAL STATEMENTS AND FINANCIAL STATEMENT SCHEDULES**

The following consolidated financial statements of The Dixie Group, Inc. and subsidiaries are included in Item 8:

|  | Page    |
|--|---------|
| Table of Contents  |         |
| <u>Report of Independent Registered Public Accounting Firm</u>   | 29      |
| <u>Consolidated balance sheets - December 27, 2008 and December 29, 2007</u>   | 30      |
| <u>Consolidated statements of operations - Years ended December 27, 2008, December 29, 2007, and December 30, 2006</u>   | 31      |
| <u>Consolidated statements of cash flows - Years ended December 27, 2008, December 29, 2007, and December 30, 2006</u>   | 32      |
| <u>Consolidated statements of stockholders' equity and comprehensive income (loss) - Years ended December 27, 2008, December 29, 2007, and December 30, 2006</u> | 33      |
| <u>Notes to consolidated financial statements</u>  | 34 - 54 |

The following consolidated financial statement schedule of The Dixie Group, Inc. and subsidiaries is included in Item 15(d):

|  |    |
|--|----|
| <u>Schedule II - Valuation and qualifying accounts</u> | 55 |
|--|----|

All other schedules for which provision is made in the applicable accounting regulation of the Securities and Exchange Commission are not required under the related instructions, or are inapplicable, or the information is otherwise shown in the financial statements or notes thereto, and therefore such schedules have been omitted.

**Report of Independent Registered Public Accounting Firm**

The Board of Directors and Shareholders of The Dixie Group, Inc.

We have audited the accompanying consolidated balance sheets of The Dixie Group, Inc. as of December 27, 2008 and December 29, 2007, and the related consolidated statements of operations, stockholders' equity and comprehensive income (loss), and cash flows for each of the three years in the period ended December 27, 2008. Our audits also included the financial statement schedule listed in the Index at Item 15(a). These financial statements and schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and schedule based on our audits.

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of The Dixie Group, Inc. at December 27, 2008 and December 29, 2007, and the consolidated results of its operations and its cash flows for each of the three years in the period ended December 27, 2008, in conformity with U.S. generally accepted accounting principles. Also, in our opinion, the related financial statement schedule, when considered in relation to the basic financial statements taken as a whole, presents fairly in all material respects the information set forth therein.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), The Dixie Group, Inc.'s internal control over financial reporting as of December 27, 2008, based on criteria established in *Internal Control-Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated March 5, 2009 expressed an unqualified opinion thereon.

/s/ Ernst & Young LLP

Atlanta, Georgia

March 4, 2009

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

|  | <b>December 27,<br/>2008</b> | December 29,<br>2007 |
|--|------------------------------|----------------------|
| <b>ASSETS</b>  |                              |                      |
| <b>CURRENT ASSETS</b>  |                              |                      |
| Cash and cash equivalents  | \$ 113                       | \$ 427               |
| Receivables (less allowance for doubtful accounts<br>of \$961 for 2008 and \$676 for 2007) | 32,976                       | 32,868               |
| Inventories  | 75,167                       | 75,928               |
| Other current assets   | 5,893                        | 7,742                |
| TOTAL CURRENT ASSETS   | <b>114,149</b>               | 116,965              |
| <b>PROPERTY, PLANT AND EQUIPMENT</b>   |                              |                      |
| Land and improvements  | 6,088                        | 6,075                |
| Buildings and improvements   | 46,892                       | 45,890               |
| Machinery and equipment  | 131,297                      | 128,968              |
|  | <b>184,277</b>               | 180,933              |
| Less accumulated depreciation and amortization   | (90,217)                     | (78,555)             |
| NET PROPERTY, PLANT AND<br>EQUIPMENT   | <b>94,060</b>                | 102,378              |
| <b>OTHER ASSETS</b>  |                              |                      |
| Goodwill   | 33,406                       | 56,743               |
| Other long-term assets   | 11,048                       | 14,152               |
| TOTAL OTHER ASSETS   | <b>44,454</b>                | 70,895               |
| <b>TOTAL ASSETS</b>  | <b>\$ 252,663</b>            | \$ 290,238           |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>  |                              |                      |
| <b>CURRENT LIABILITIES</b>   |                              |                      |
| Accounts payable   | \$ 11,335                    | \$ 11,492            |
| Accrued expenses   | 16,356                       | 21,242               |
| Current portion of long-term debt  | 8,832                        | 8,817                |
| TOTAL CURRENT LIABILITIES  | <b>36,523</b>                | 41,551               |
| <b>LONG-TERM DEBT</b>  |                              |                      |
| Senior indebtedness  | 68,549                       | 60,119               |



|   |                   |            |
|---|-------------------|------------|
| Capital lease obligations   | <b>1,806</b>      | 2,547      |
| Convertible subordinated debentures   | <b>14,662</b>     | 17,162     |
| <b>TOTAL LONG-TERM DEBT</b>   | <b>85,017</b>     | 79,828     |
| <br>  |                   |            |
| DEFERRED INCOME TAXES   | <b>10,713</b>     | 11,726     |
| OTHER LONG-TERM LIABILITIES   | <b>12,822</b>     | 15,019     |
| COMMITMENTS AND CONTINGENCIES (Note N)  | ---               | ---        |
| <br>  |                   |            |
| <b>STOCKHOLDERS' EQUITY</b>   |                   |            |
| Common Stock (\$3 par value per share): Authorized<br>80,000,000 shares, issued - 15,840,374<br>shares<br>for 2008 and 15,673,714 shares for 2007 | <b>47,521</b>     | 47,021     |
| Class B Common Stock (\$3 par value per share):<br>Authorized 16,000,000 shares, issued - 862,915 shares for<br>2008 and 835,908 shares for 2007  | <b>2,589</b>      | 2,508      |
| Additional paid-in capital  | <b>136,015</b>    | 135,449    |
| Retained earnings (Accumulated deficit)   | <b>(18,840)</b>   | 12,563     |
| Accumulated other comprehensive income (loss)   | <b>(509)</b>      | 230        |
|   | <b>166,776</b>    | 197,771    |
| Less Common Stock in treasury at cost - 4,086,546 shares<br>for 2008 and 3,556,252 shares for 2007  | <b>(59,188)</b>   | (55,657)   |
| <b>TOTAL STOCKHOLDERS' EQUITY</b>   | <b>107,588</b>    | 142,114    |
| <b>TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY</b>   | <b>\$ 252,663</b> | \$ 290,238 |

See accompanying notes to the consolidated financial statements.

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

|  | Year Ended              |                         |                     |
|--|-------------------------|-------------------------|---------------------|
|  | December<br>27,<br>2008 | December<br>29,<br>2007 | December 30<br>2006 |
| Net sales  | \$ 282,710              | \$ 320,795              | \$ 331,100          |
| Cost of sales  | 204,558                 | 223,561                 | 235,262             |
| Gross profit   | 78,152                  | 97,234                  | 95,838              |
| Selling and administrative expenses                          | 76,115                  | 78,788                  | 75,938              |
| Other operating income                                       | (428)                   | (469)                   | (640)               |
| Other operating expense                                      | 945                     | 673                     | 733                 |
| Facility consolidation and severance<br>expenses             | 2,317                   | ---                     | ---                 |
| Impairment of assets   | 4,478                   | ---                     | ---                 |
| Impairment of goodwill                                       | 23,121                  | ---                     | ---                 |
| Defined benefit pension plan merger/<br>termination expenses | ---                     | 1,518                   | 3,249               |
| Operating income (loss)                                      | (28,396)                | 16,724                  | 16,558              |
| Interest expense   | 5,965                   | 6,347                   | 7,213               |
| Other income   | (379)                   | (163)                   | (454)               |
| Other expense  | 53                      | 69                      | 127                 |
| Income (loss) from continuing operations<br>before taxes     | (34,035)                | 10,471                  | 9,672               |
| Income tax provision (benefit)                               | (2,907)                 | 3,693                   | 1,781               |
| Income (loss) from continuing operations                     | (31,128)                | 6,778                   | 7,891               |
| Loss from discontinued operations, net of<br>tax             | (275)                   | (512)                   | (188)               |
| Net income (loss)  | \$ (31,403)             | \$ 6,266                | \$ 7,703            |
| <b>BASIC EARNINGS (LOSS) PER<br/>SHARE:</b>                  |                         |                         |                     |
| Continuing operations  | \$ (2.50)               | \$ 0.53                 | \$ 0.62             |
| Discontinued operations                                      | (0.02)                  | (0.04)                  | (0.01)              |
| Net income (loss)  | \$ (2.52)               | \$ 0.49                 | \$ 0.61             |

|                                    |               |         |         |
|------------------------------------|---------------|---------|---------|
| SHARES OUTSTANDING                 | <b>12,449</b> | 12,788  | 12,702  |
| DILUTED EARNINGS (LOSS) PER SHARE: |               |         |         |
| Continuing operations              | \$ (2.50)     | \$ 0.52 | \$ 0.61 |
| Discontinued operations            | (0.02)        | (0.04)  | (0.02)  |
| Net income (loss)                  | \$ (2.52)     | \$ 0.48 | \$ 0.59 |
| SHARES OUTSTANDING                 | <b>12,449</b> | 12,967  | 12,959  |
| DIVIDENDS PER SHARE:               |               |         |         |
| Common Stock                       | ---           | ---     | ---     |
| Class B Common Stock               | ---           | ---     | ---     |

See accompanying notes to the consolidated financial statements.

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

|  | <b>December<br/>27,<br/>2008</b> | Year Ended<br>December<br>29,<br>2007 | December 30,<br>2006 |
|--|----------------------------------|---------------------------------------|----------------------|
| <b>CASH FLOWS FROM OPERATING<br/>ACTIVITIES</b>  |                                  |                                       |                      |
| Income (loss) from continuing operations   | \$ (31,128)                      | \$ 6,778                              | \$ 7,891             |
| Loss from discontinued operations  | (275)                            | (512)                                 | (188)                |
| Net income (loss)  | <b>(31,403)</b>                  | 6,266                                 | 7,703                |
| Adjustments to reconcile net income (loss)<br>to net<br>cash provided by operating activities: |                                  |                                       |                      |
| Depreciation and amortization  | <b>13,752</b>                    | 12,941                                | 11,500               |
| Change in deferred income<br>taxes   | <b>797</b>                       | (990)                                 | 369                  |
| Excess tax benefit from<br>stock-based awards  | ---                              | (115)                                 | (202)                |
| Net (gain) loss on property,<br>plant and equipment disposals                                  | <b>(185)</b>                     | 14                                    | 191                  |
| Impairment of assets   | <b>4,478</b>                     | ---                                   | ---                  |
| Impairment of goodwill   | <b>23,121</b>                    | ---                                   | ---                  |
| Gain on sale of<br>available-for-sale securities   | <b>(222)</b>                     | ---                                   | ---                  |
| Stock-based compensation<br>expense  | <b>1,322</b>                     | 1,179                                 | 662                  |
| Changes in operating assets<br>and liabilities:  |                                  |                                       |                      |
| Receivables  | <b>(108)</b>                     | (1,794)                               | 2,408                |
| Inventories  | <b>761</b>                       | (6,328)                               | 3,271                |
| Other current assets   | <b>50</b>                        | 934                                   | 3,023                |
| Other assets   | <b>3,264</b>                     | (633)                                 | (1,889)              |
| Accounts payable and<br>accrued expenses   | <b>(4,455)</b>                   | 6,429                                 | (8,510)              |
| Other liabilities  | <b>(2,773)</b>                   | 1,863                                 | 842                  |
| <b>NET CASH PROVIDED BY OPERATING<br/>ACTIVITIES</b>   | <b>8,399</b>                     | 19,766                                | 19,368               |

CASH FLOWS FROM INVESTING  
ACTIVITIES

|  |                |          |          |
|--|----------------|----------|----------|
| Net proceeds from sales of property, plant and equipment | <b>598</b>     | 21       | 51       |
| Purchase of property, plant and equipment                | <b>(9,469)</b> | (16,659) | (16,450) |
| Net proceeds from sale of available-for-sale securities  | <b>222</b>     | ---      | ---      |
| <b>NET CASH USED IN INVESTING ACTIVITIES</b>             | <b>(8,649)</b> | (16,638) | (16,399) |

CASH FLOWS FROM FINANCING  
ACTIVITIES

|  |                |         |         |
|--|----------------|---------|---------|
| Net (payments) borrowings on credit line       | <b>13,336</b>  | 1,632   | (5,128) |
| Payments on term loan                          | <b>(1,675)</b> | (1,710) | (1,709) |
| Borrowings from equipment financing            | <b>---</b>     | 5,967   | 6,456   |
| Payments on equipment financing                | <b>(2,969)</b> | (2,258) | (1,461) |
| Payments on capitalized leases                 | <b>(1,313)</b> | (1,296) | (1,158) |
| Payments on subordinated indebtedness          | <b>(2,500)</b> | (2,500) | (2,500) |
| Payments on mortgage note payable              | <b>(250)</b>   | (232)   | (217)   |
| Common stock issued under stock option plans   | <b>25</b>      | 266     | 853     |
| Excess tax benefit from stock-based awards     | <b>---</b>     | 115     | 202     |
| Change in outstanding checks in excess of cash | <b>(729)</b>   | (1,655) | 2,275   |
| Common stock acquired for treasury             | <b>(3,531)</b> | (1,568) | (44)    |
| Payments for debt issuance costs               | <b>(458)</b>   | ---     | ---     |
| <b>NET CASH USED IN FINANCING ACTIVITIES</b>   | <b>(64)</b>    | (3,239) | (2,431) |

(DECREASE) INCREASE IN CASH AND  
CASH

|             |              |       |     |
|-------------|--------------|-------|-----|
| EQUIVALENTS | <b>(314)</b> | (111) | 538 |
|-------------|--------------|-------|-----|

CASH AND CASH EQUIVALENTS AT  
BEGINNING OF  
YEAR

|  |            |     |     |
|--|------------|-----|-----|
|  | <b>427</b> | 538 | --- |
|--|------------|-----|-----|

CASH AND CASH EQUIVALENTS AT END  
OF YEAR

|  |               |        |        |
|--|---------------|--------|--------|
|  | <b>\$ 113</b> | \$ 427 | \$ 538 |
|--|---------------|--------|--------|

|  |               |        |        |
|--|---------------|--------|--------|
| Equipment purchased under capital leases | <b>\$ 575</b> | \$ --- | \$ 542 |
|--|---------------|--------|--------|

See accompanying notes to the consolidated financial statements.

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**THE DIXIE GROUP, INC.**

**CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY AND COMPREHENSIVE INCOME  
(LOSS)**

(dollars in thousands)

|  | Common<br>Stock and<br>Class B<br>Common<br>Stock | Additional<br>Paid-In<br>Capital | Other    | (Accumulated<br>Deficit)<br>Retained<br>Earnings | Accumulated<br>Other<br>Comprehensive<br>Income (Loss) | Common<br>Stock in<br>Treasury | To<br>Stockh<br>Equ |
|--|---|----------------------------------|----------|--|--|--------------------------------|---------------------|
| <b>Balance at<br/>December 31,<br/>2005</b>  | \$ 48,187   | \$ 134,353                       | \$ (719) | \$ (1,406)                                       | \$ (2,887)   | \$ (54,044)                    | \$ 12               |
| Common Stock<br>acquired for<br>treasury<br>- 3,455 shares                                 | ---   | ---                              | ---      | ---  | ---  | (45)                           |                     |
| Common Stock<br>and Class B<br>issued<br>under stock<br>option plan -<br>125,340<br>shares | 375   | 478                              | ---      | ---  | ---  | ---                            |                     |
| Restricted stock<br>grants issued -<br>149,000 shares                                      | 447   | (447)                            | ---      | ---  | ---  | ---                            |                     |
| Tax benefit from<br>exercise of stock<br>options   | ---   | 202                              | ---      | ---  | ---  | ---                            |                     |
| Stock-based<br>compensation<br>expense   | ---   | 602                              | ---      | ---  | ---  | ---                            |                     |
| Reclassification<br>upon adoption of<br>SFAS No.<br>123{R}                                 | ---   | (719)                            | 719      | ---  | ---  | ---                            |                     |
| Adoption of<br>SFAS No. 158  | ---   | ---                              | ---      | ---  | 856  | ---                            |                     |
| Comprehensive<br>Income:   |   |                                  |          |  |  |                                |                     |
| Net income   | ---   | ---                              | ---      | 7,703  | ---  | ---                            |                     |

|   |                  |                   |               |                 |               |                    |
|---|------------------|-------------------|---------------|-----------------|---------------|--------------------|
| Unrealized gain on interest rate swap agreements, net of tax of \$45    | ---              | ---               | ---           | ---             | 274           | ---                |
| Change in minimum pension liability, net of tax of \$650                | ---              | ---               | ---           | ---             | 1,749         | ---                |
| Total Comprehensive Income  | ---              | ---               | ---           | 7,703           | 2,023         | ---                |
| <b>Balance at December 30, 2006</b>                                     | <b>\$ 49,009</b> | <b>\$ 134,469</b> | <b>\$ ---</b> | <b>\$ 6,297</b> | <b>\$ (8)</b> | <b>\$ (54,089)</b> |
| Common Stock acquired for treasury - 157,407 shares                     | ---              | ---               | ---           | ---             | ---           | (1,568)            |
| Common Stock and Class B issued under stock option plan - 75,300 shares | 226              | 40                | ---           | ---             | ---           | ---                |
| Restricted stock grants issued - 109,620 shares                         | 329              | (329)             | ---           | ---             | ---           | ---                |
| Restricted stock grants forfeited - 11,787 shares                       | (35)             | 35                | ---           | ---             | ---           | ---                |
| Tax benefit from exercise of stock options                              | ---              | 115               | ---           | ---             | ---           | ---                |
| Stock-based compensation expense  | ---              | 1,119             | ---           | ---             | ---           | ---                |
| Comprehensive Income (Loss):  |                  |                   |               |                 |               |                    |
| Net income  | ---              | ---               | ---           | 6,266           | ---           | ---                |
| Unrealized loss   | ---              | ---               | ---           | ---             | (748)         | ---                |



|  |                  |                   |           |           |               |           |            |           |                 |
|--|------------------|-------------------|-----------|-----------|---------------|-----------|------------|-----------|-----------------|
| on interest rate<br>swap<br>agreements,<br>net of tax of<br>\$459                        |                  |                   |           |           |               |           |            |           |                 |
| Pension and<br>postretirement<br>benefit plans:  |                  |                   |           |           |               |           |            |           |                 |
| Unrecognized<br>net actuarial<br>loss, net of<br>tax of \$76                             | ---              | ---               | ---       | ---       |               | (127)     |            | ---       |                 |
| Recognition<br>of net<br>actuarial<br>loss, net of<br>tax of \$685                       | ---              | ---               | ---       | ---       |               | 1,121     |            | ---       |                 |
| Amortization<br>of prior<br>service<br>credits, net<br>of tax of \$6                     | ---              | ---               | ---       | ---       |               | (8)       |            | ---       |                 |
| Total<br>Comprehensive<br>Income   | ---              | ---               | ---       | ---       | 6,266         | 238       |            | ---       |                 |
| <b>Balance at<br/>December 29,<br/>2007</b>  | <b>\$ 49,529</b> | <b>\$ 135,449</b> | <b>\$</b> | <b>\$</b> | <b>12,563</b> | <b>\$</b> | <b>230</b> | <b>\$</b> | <b>(55,657)</b> |
| Common Stock<br>acquired for<br>treasury<br>- 530,294<br>shares                          | ---              | ---               | ---       | ---       | ---           | ---       |            | (3,531)   |                 |
| Common Stock<br>and Class B<br>issued<br>under stock<br>option plan -<br>6,250<br>shares | 19               | 6                 | ---       | ---       | ---           | ---       |            | ---       |                 |
| Restricted stock<br>grants issued -<br>187,417<br>shares                                 | 562              | (562)             | ---       | ---       | ---           | ---       |            | ---       |                 |
| Tax expense<br>from exercise of<br>stock   | ---              | (140)             | ---       | ---       | ---           | ---       |            | ---       |                 |

|  |                  |                   |               |                    |                 |                    |                  |
|--|------------------|-------------------|---------------|--------------------|-----------------|--------------------|------------------|
| options  |                  |                   |               |                    |                 |                    |                  |
| Stock-based compensation expense   | ---              | 1,262             | ---           | ---                | ---             | ---                | ---              |
| Comprehensive Income (Loss):   |                  |                   |               |                    |                 |                    |                  |
| Net loss   | ---              | ---               | ---           | (31,403)           | ---             | ---                | (31,403)         |
| Unrealized loss on interest rate swap agreements, net of tax of \$493      | ---              | ---               | ---           | ---                | (804)           | ---                | (804)            |
| Unrealized gain on available-for-sale securities, net of tax of \$173      | ---              | ---               | ---           | ---                | 282             | ---                | 282              |
| Realized gain on sale of available-for-sale securities, net of tax of \$85 | ---              | ---               | ---           | ---                | (137)           | ---                | (137)            |
| Postretirement benefit plans:  |                  |                   |               |                    |                 |                    |                  |
| Unrecognized net actuarial loss, net of tax of \$8                         | ---              | ---               | ---           | ---                | 12              | ---                | 12               |
| Recognition of net actuarial loss, net of tax of \$23                      | ---              | ---               | ---           | ---                | (38)            | ---                | (38)             |
| Amortization of prior service credits, net of tax of \$34                  | ---              | ---               | ---           | ---                | (54)            | ---                | (54)             |
| Total Comprehensive Loss   | ---              | ---               | ---           | (31,403)           | (739)           | ---                | (32,142)         |
| <b>Balance at December 27, 2008</b>  | <b>\$ 50,110</b> | <b>\$ 136,015</b> | <b>\$ ---</b> | <b>\$ (18,840)</b> | <b>\$ (509)</b> | <b>\$ (59,188)</b> | <b>\$ 10,678</b> |

See accompanying notes to the consolidated financial statements.

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**THE DIXIE GROUP, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**(dollars in thousands, except per share data)**

**NOTE A - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

**Business:** The Company's business consists principally of marketing, manufacturing and selling finished carpet and rugs. The Company is in one line of business, Carpet Manufacturing.

**Principles of Consolidation:** The Consolidated Financial Statements include the accounts of The Dixie Group, Inc. and its wholly-owned subsidiaries (the "Company"). Significant intercompany accounts and transactions have been eliminated in consolidation.

**Use of Estimates in the Preparation of Financial Statements:** The preparation of financial statements in conformity with U. S. generally accepted accounting principles requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates.

**Fiscal Year:** The Company ends its fiscal year on the last Saturday of December. All references herein to "2008," "2007," and "2006," mean the fiscal years ended December 27, 2008, December 29, 2007, and December 30, 2006, respectively. All years presented contained 52 weeks.

**Discontinued Operations:** The financial statements separately report discontinued operations and the results of continuing operations (See Note Q). Disclosures included herein pertain to the Company's continuing operations unless noted otherwise.

**Cash and Cash Equivalents:** Highly liquid investments with original maturities of three months or less when purchased are reported as cash equivalents.

**Credit and Market Risk:** The Company sells carpet and supplies carpet yarn and carpet dyeing and finishing services to floorcovering retailers, the interior design, architectural and specifier communities, and certain manufacturers located principally throughout the United States. No customer accounted for more than 10% of net sales in 2008, 2007 or 2006, nor did the Company make a significant amount of sales to foreign countries during such periods.

The Company grants credit to its customers based on defined payment terms, performs ongoing evaluations of the credit worthiness of its customers and generally does not require collateral. Accounts receivable are carried at their outstanding principal amounts, less an anticipated amount for discounts and an allowance for doubtful accounts, which management believes is sufficient to cover potential credit losses based on historical experience and periodic evaluation of the financial condition of the Company's customers. Notes receivable are carried at their estimated fair values. The Company evaluates the fair value of its notes receivable based on its estimate of the financial condition of borrowers and collateral held by the Company. The Company invests its excess cash, if any, in short-term investments and has not experienced any losses on those investments.

**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. Reduction of inventory quantities in 2008 and 2006 resulted in liquidations of LIFO inventories carried at lower costs established in prior years and decreased cost of sales by \$170 in 2008 and \$297 in 2006.

Inventories are summarized as follows:

|                                  | <b>2008</b> | 2007      |
|----------------------------------|-------------|-----------|
| Raw materials                    | \$ 27,133   | \$ 26,148 |
| Work-in-process                  | 15,284      | 15,999    |
| Finished goods                   | 43,980      | 44,359    |
| Supplies, repair parts and other | 416         | 430       |
| LIFO reserve                     | (11,646)    | (11,008)  |
| Total inventories                | \$ 75,167   | \$ 75,928 |

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**THE DIXIE GROUP, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**(dollars in thousands, except per share data)**

**(Continued)**

**Property, Plant and Equipment:** Property, plant and equipment is stated at the lower of cost or impaired value. Provisions for depreciation and amortization of property, plant and equipment have been computed for financial reporting purposes using the straight-line method over the estimated useful lives of the related assets, ranging from 10 to 40 years for buildings and improvements, and 3 to 10 years for machinery and equipment. Applicable statutory depreciation methods are used for income tax purposes. Depreciation and amortization of property, plant and equipment, including amounts for capital leases, totaled \$13,460 in 2008, \$12,639 in 2007 and \$11,201 in 2006 for financial reporting purposes. Costs to repair and maintain the Company's equipment and facilities are expensed as incurred. Such costs typically include expenditures to maintain equipment and facilities in good repair and proper working condition.

**Impairment of Long-Lived Assets:** Long-lived assets are reviewed for impairment when circumstances indicate that the carrying value of an asset may not be fully recoverable. When the carrying value of the asset exceeds the value of its expected undiscounted future cash flows, an impairment charge is recognized equal to the difference between the asset's carrying value and its fair value.

**Goodwill:** Goodwill represents the excess of purchase price over the fair market value of identified net assets acquired in business combinations. Goodwill is tested for impairment annually or when an indication of impairment exists. The Company measures goodwill impairment by comparing the carrying value of its reporting units, including goodwill, with the present value of its reporting units' expected future cash flows (fair value). (See Note C)

**Customer Claims and Product Warranties:** The Company provides product warranties related to manufacturing defects and specific performance standards for its products. The Company records reserves for the estimated costs of defective products and failure of its products to meet applicable performance standards. The level of reserves is established based primarily upon historical experience and the Company's evaluation of pending claims.

**Self-Insured Accruals:** The Company records liabilities to reflect the cost of claims related to its self-insured medical and dental benefits and workers' compensation. The amounts of such liabilities are based on an analysis of the cost of known claims and estimates of the cost of unreported claims.

**Deferred Tax Assets and Liabilities:** The Company recognizes deferred income tax assets and liabilities for the future tax consequences of the differences between the financial statement carrying amounts of existing assets and

liabilities and their respective tax bases.

**Derivative Financial Instruments:** The Company does not hold speculative financial instruments, nor does it hold or issue financial instruments for trading purposes. The Company uses derivative instruments, currently interest rate swaps, to minimize interest rate volatility.

The Company recognizes all derivatives on its balance sheet at fair value. Derivatives that are designated as cash flow hedges are linked to specific liabilities on the Company's balance sheet. The Company assesses, both at inception and on an ongoing basis, whether the derivatives that are used in the hedging transaction are highly effective in offsetting changes in cash flows of the hedged items. When it is determined that a derivative is not highly effective or the derivative expires, is sold, terminated, or exercised, the Company discontinues hedge accounting for that specific hedge instrument. Changes in the fair value of cash flow hedges are deferred in accumulated other comprehensive income (loss) ("AOCIL"). Changes in the fair value of derivatives that are not effective cash flow hedges are recognized in income.

**Revenue Recognition:** Revenues, including shipping and handling amounts, are recognized when the following criteria are met: there is persuasive evidence that a sales agreement exists, delivery has occurred or services have been rendered, the price to the buyer is fixed or determinable, and collectability is reasonably assured. Delivery is not considered to have occurred until the customer takes title to the goods and assumes the risks and rewards of ownership, which is generally on the date of shipment. At the time revenue is recognized, the Company records a provision for the estimated amount of future returns based primarily on historical experience and any known trends or conditions that exist at the time revenue is recognized.

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**THE DIXIE GROUP, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**(dollars in thousands, except per share data)**

**(Continued)**

**Advertising Costs and Vendor Consideration:** The Company engages in promotional and advertising programs that include rebates, discounts, points and cooperative advertising programs. Expenses relating to these programs are charged to earnings during the period in which they are earned. These arrangements do not require significant estimates of costs. Substantially all such expenses are recorded as a deduction from sales. The cost of cooperative advertising programs is recorded as selling and administrative expenses when the Company can identify a tangible benefit associated with the program, and can reasonably estimate that the fair value of the benefit is equal to or greater than its cost. The amount of advertising and promotion expenses included in selling and administrative expenses was not significant for the years 2008, 2007 or 2006.

**Cost of Sales:** Cost of sales includes all costs related to manufacturing the Company's products, including purchasing and receiving costs, inspection costs, warehousing costs, freight costs, internal transfer costs or other costs of the Company's distribution network.

**Selling and Administrative Expenses:** Selling and administrative expenses include all costs, not included in cost of sales, related to the sale and marketing of the Company's products and general administration of the Company's business.

**Operating Leases:** Leasehold improvements are amortized over the shorter of their economic lives or the lease term, excluding renewal options. Rent is expensed over the lease period, including the effect of any rent holiday and rent escalation provisions, which effectively amortizes the rent holidays and rent escalations on a straight-line basis over the lease period. Any leasehold improvement made by the Company and funded by the lessor is treated as a leasehold improvement and amortized over the shorter of its economic life or the lease term. Any funding provided by the lessor for such improvements is treated as deferred costs and amortized over the lease period.

**Stock-Based Compensation:** Effective January 1, 2006, the Company adopted Statement of Financial Accounting Standards No. 123(R), "Share-Based Payment" ("SFAS No. 123(R)"). SFAS No. 123(R) requires that compensation expense relating to share-based payments be recognized in financial statements based on the fair value of the equity or liability instrument issued.

The Company adopted SFAS No. 123(R) using the modified prospective method to account for stock options, restricted shares, stock performance units, or other share-based payments made by the Company. Under the modified



prospective method, compensation expense for share-based payments is recognized for periods after the date of adoption for (a) all unvested share-based awards granted prior to January 1, 2006, based on the award's estimated grant-date fair value in accordance with the original provisions of SFAS No. 123, "Accounting for Stock-Based Compensation" ("SFAS No. 123"), and (b) all share-based awards granted after December 31, 2005, based on the award's estimated grant-date fair value in accordance with the provisions of SFAS No. 123(R). Because the Company used the modified prospective method and the estimated forfeiture method was used under SFAS No. 123 prior to the adoption of SFAS No. 123(R), there was no cumulative effect on the Company's Consolidated Financial Statements as a result of the adoption of SFAS No. 123(R).

Restricted stock grants with pro-rata vesting are expensed using the straight-line method.

**Recent Accounting Pronouncements:** In September 2006, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards No. 157, "Fair Value Measurements" ("SFAS No. 157"). SFAS No. 157 defines fair value, establishes a framework for measuring fair value under 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 adoption of this statement did not have a material effect on the Company's financial position or results of operations (See Note H).

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"). 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 to such assets and liabilities.

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 shareholder's equity. Also included are firm commitments that involve only financial instruments, nonfinancial insurance contracts and warranties and host financial instruments.

**THE DIXIE GROUP, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**(dollars in thousands, except per share data)**

**(Continued)**

The Statement permits all entities to choose the fair value measurement option at specified election dates, after which unrealized gains and losses on items for which the fair value option has been elected must be reported 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. This statement did not have a material effect on the Company's financial position or results of operations.

In December 2007, the FASB issued SFAS No. 141R, "Business Combinations" ("SFAS No. 141R"). SFAS No. 141R replaces SFAS No. 141 and establishes principles and requirements for how identifiable assets, liabilities assumed, any non-controlling interest in an acquiree, and goodwill is recognized and measured in an acquirer's financial statements. SFAS No. 141R also establishes disclosure requirements to assist users in evaluating the nature and financial effects of business combinations. This statement is effective for fiscal years beginning after December 15, 2008. The Company does not expect the adoption of this statement to have a material effect on its financial position or results of operations.

In December 2007, the FASB issued SFAS No. 160, "Noncontrolling Interests in Consolidated Financial Statements" ("SFAS No. 160"). SFAS No. 160 establishes accounting and reporting standards for ownership interests in subsidiaries held by parties (other than the parent of such subsidiaries), the amount of consolidated net income attributable to the parent and to the holder of a noncontrolling interest, changes in a parent's ownership interest and the valuation of retained noncontrolling equity investments when a subsidiary is no longer consolidated. SFAS No. 160 also establishes reporting requirements to clearly identify, distinguish and disclose the interests of the parent and the interests of the noncontrolling owners. This statement is effective for fiscal years beginning after December 15, 2008. The Company does not expect the adoption of this statement to have a material effect on its financial position or results of operations.

In March 2008, the FASB issued SFAS No. 161, "Disclosures about Derivative Instruments and Hedging Activities, an amendment of FASB Statement No. 133" ("SFAS No. 161"). SFAS No. 161 establishes, among other things, additional disclosure requirements for derivative instruments and for hedging activities. SFAS No. 161 is effective for fiscal years and interim periods beginning after November 15, 2008. The Company does not expect the adoption of this statement to have a material effect on its financial position or results of operations.

**NOTE B - RECEIVABLES**

Receivables are summarized as follows:

|                                      | <b>2008</b>      | 2007      |
|--------------------------------------|------------------|-----------|
| Customers, trade                     | \$ <b>23,805</b> | \$ 29,929 |
| Income taxes                         | <b>5,280</b>     | ---       |
| Other                                | <b>4,852</b>     | 3,615     |
| Gross receivables                    | <b>33,937</b>    | 33,544    |
| Less allowance for doubtful accounts | <b>(961)</b>     | (676)     |
| Net receivables                      | \$ <b>32,976</b> | \$ 32,868 |

The Company also had notes receivable in the amount of \$425 and \$542 at 2008 and 2007, respectively. The current portions of notes receivable are included in receivables and the non-current portions are included in other long-term assets in the Company's Consolidated Financial Statements.

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**THE DIXIE GROUP, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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**(Continued)**

**NOTE C - GOODWILL AND LONG-LIVED ASSET IMPAIRMENTS**

***Goodwill***

The Company's goodwill is tested for impairment annually in the fourth quarter of each year or more frequently if events or circumstances indicate that the carrying value of goodwill associated with a reporting unit, may not be fully recoverable. The first step in the goodwill assessment used to identify potential goodwill impairments involves a comparison of the carrying value of a reporting unit, including goodwill, to the fair value of the reporting unit. For these purposes, fair value is an estimate of the value of the reporting units' current and future cash flows discounted at the Company's weighted-average cost of capital ( WACC ). Such an estimate necessarily involves judgments and assumptions concerning, among other matters, future sales and profitability; as well as, interest rates and other financial factors used to calculate the Company's WACC. The Company tested goodwill for impairment in the third quarter of 2008 due to economic conditions and uncertainty that were impacting the Company and the markets it serves and its future expectations for the performance of its business. No potential goodwill impairment was indicated as a result of this evaluation. The Company's annual goodwill impairment test is performed in October of each year.

When the annual goodwill impairment test was performed, the Company reduced its projections for the future sales and profitability of its reporting units because economic conditions in the carpet industry had continued to deteriorate.

In addition, higher interest rates for 20 year treasury constant maturities and Moody's Baa bonds increased the Company's WACC. As a result of this decline in the cash flow projections for its reporting units, and the higher WACC, goodwill was potentially impaired in the Company's two reporting units that had goodwill associated with their operations.

Because our assessment indicated that goodwill may not be fully recoverable, the Company performed the second step in the goodwill evaluation process by comparing the implied fair value of our reporting units' goodwill with the carrying value of the reporting units' goodwill. For this purpose, the implied fair value of goodwill for each reporting unit that had goodwill associated with its operations was determined in the same manner as the amount of goodwill is determined in a business combination. The measurement resulted in the impairment of all of the goodwill, or \$1,341 associated with the acquisition of Patrick Carpet Mills, Inc. in 1994 and \$21,780, or approximately 40% of the goodwill associated with the acquisition of Fabrica International, Inc. in 2000. The total non-cash goodwill impairment loss recognized in the fourth quarter of 2008 was \$23,121.

The Company retested goodwill for impairment at the end of the fourth quarter 2008 and no additional impairment was indicated as a result of this evaluation. Considering seasonal factors, economic conditions in the carpet industry had not significantly changed and the Company's future sales and profitability expectations were unchanged.

Additionally, the Company's WACC decreased from 12.4% to 11.0% by the end of the fourth quarter 2008 due to

decreases in the rates for 20 year treasury constant maturities and Moody's Baa bonds.

The changes in the carrying amount of goodwill are summarized as follows:

|   | <b>2008</b>      | 2007      |
|---|------------------|-----------|
| Balance at beginning of year              | \$ <b>56,743</b> | \$ 56,960 |
| Reductions related to deferred tax assets | <b>(216)</b>     | (217)     |
| Impairment loss                           | <b>(23,121)</b>  | ---       |
| Balance at end of year                    | \$ <b>33,406</b> | \$ 56,743 |

All remaining goodwill on the Company's balance sheet at December 27, 2008 is associated with the acquisition of Fabrica International, Inc.

### *Long-lived Assets*

Long-lived assets are reviewed for impairment when circumstances indicate that the carrying value of an asset may not be fully recoverable. During the fourth quarter of 2008, the Company began consolidating certain of its operations and facilities and identified certain assets, primarily computer software, which would not be utilized in its ongoing operations. As a result, the Company recorded \$4,478 of non-cash asset impairments to reflect the loss in value of these assets. The impairment is included in "Impairment of Assets" in the Company's Consolidated Statements of Operations for the year ended December 27, 2008.

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**THE DIXIE GROUP, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****(dollars in thousands, except per share data)****(Continued)****NOTE D - ACCRUED EXPENSES**

Accrued expenses are summarized as follows:

|   | <b>2008</b>      | 2007      |
|---|------------------|-----------|
| Compensation and benefits                             | \$ <b>5,696</b>  | \$ 7,859  |
| Provision for customer claims, rebates and allowances | <b>5,057</b>     | 5,470     |
| Outstanding checks in excess of cash                  | <b>1,809</b>     | 2,538     |
| Other   | <b>3,794</b>     | 5,375     |
|   | <b>\$ 16,356</b> | \$ 21,242 |

The Company's self-insured Workers' Compensation program is collateralized by letters of credit in the aggregate amount of \$2,415.

**NOTE E - PRODUCT WARRANTY RESERVES**

The Company provides product warranties related to manufacturing defects and specific performance standards for its products. The Company records reserves for the estimated costs of defective products and failure of its products to meet applicable performance standards at the time sales are recorded. The level of reserves is established based primarily upon historical experience and evaluation of pending claims. Product warranty reserves are included in accrued expenses in the Company's Consolidated Financial Statements. Following is a summary of the Company's warranty activity.

|   | <b>2008</b>     | 2007     |
|---|-----------------|----------|
| Warranty reserve beginning of year            | \$ <b>1,515</b> | \$ 1,276 |
| Warranty liabilities accrued                  | <b>3,522</b>    | 3,934    |
| Warranty liabilities settled                  | <b>(3,329)</b>  | (3,464)  |
| Changes for pre-existing warranty liabilities | <b>(345)</b>    | (231)    |

|                              |    |              |    |       |
|------------------------------|----|--------------|----|-------|
| Warranty reserve end of year | \$ | <b>1,363</b> | \$ | 1,515 |
|------------------------------|----|--------------|----|-------|

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

|   |    | <b>2008</b>    |    | 2007    |
|---|----|----------------|----|---------|
| Senior indebtedness                               |    |                |    |         |
| Credit line borrowings                            | \$ | <b>42,789</b>  | \$ | 29,453  |
| Term loans  |    | <b>14,336</b>  |    | 16,011  |
| Equipment financing                               |    | <b>10,075</b>  |    | 13,045  |
| Capital lease obligations                         |    | <b>3,199</b>   |    | 3,936   |
| Mortgage note payable                             |    | <b>6,288</b>   |    | 6,538   |
| Total senior indebtedness                         |    | <b>76,687</b>  |    | 68,983  |
| Convertible subordinated debentures               |    | <b>17,162</b>  |    | 19,662  |
| Total long-term debt                              |    | <b>93,849</b>  |    | 88,645  |
| Less current portion of long-term debt            |    | <b>(7,439)</b> |    | (7,428) |
| Less current portion of capital lease obligations |    | <b>(1,393)</b> |    | (1,389) |
| Total long-term debt, less current portion        | \$ | <b>85,017</b>  | \$ | 79,828  |

In October 2008, the Company amended and restated its senior loan and security agreement to extend the agreement's maturity date from May 11, 2010 to May 11, 2013, decrease the monthly term loan principal installments and increase interest rates applicable to borrowings under the agreement to more current market interest rates. The amended and restated senior loan and security agreement provides \$84,336 of credit, consisting of \$70,000 of revolving credit and a \$14,336 term loan. The term loan is payable in monthly principal installments of \$126 and is due May 11, 2013.

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**THE DIXIE GROUP, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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**(Continued)**

Interest rates available under the amended and restated senior loan and security agreement may be selected from a number of options that effectively allow the Company to borrow at rates ranging from the lender's prime rate plus 1.50% to the lender's prime rate plus 2.75% for base rate loans, or at rates ranging from LIBOR plus 2.00% to LIBOR plus 3.25% for LIBOR loans. The weighted-average interest rate on borrowings outstanding under this agreement was 5.68% at December 27, 2008 and 6.68% at December 29, 2007. Commitment fees ranging from 0.25% to 0.375% per annum are payable on the average daily unused balance of the revolving credit facility. The interest rate on a portion of borrowings under the amended and restated senior loan and security agreement are fixed by an interest rate swap arrangement that effectively fixes the interest rate on \$30,000 of borrowings under the amended and restated senior loan and security agreement at 4.79% plus the applicable credit spreads. The levels of the Company's accounts receivable and inventory limit borrowing availability under the revolving credit facility. The facility is secured by a first priority lien on substantially all of the Company's assets.

Effective January 1, 2009, the amended and restated senior loan and security agreement was further amended to modify certain interest rate definitions to change the relative relationship between base rates and LIBOR rates as used in the agreement and to reduce the applicable credit spreads for base rate loans by .50%.

The Company's amended and restated senior loan and security agreement does not contain ongoing financial covenants and permits payment of dividends and repurchases of the Company's Common Stock in an aggregate annual amount of up to \$3,000 and distributions in excess of \$3,000 under conditions specified in the agreement. The agreement also contains covenants that could limit future acquisitions. Unused borrowing capacity under the amended and restated senior loan and security agreement on December 27, 2008 was \$11,443.

The Company's equipment financing notes have terms ranging from five to seven years, are secured by the specific equipment financed, bear interest ranging from 5.55% to 6.94% and are due in monthly installments of principal and interest of \$311 through February 2010 and monthly installments of principal and interest ranging from \$263 to \$38 from March 2010 through May 2014. The notes do not contain financial covenants.

The Company's capitalized lease obligations have terms ranging from four to seven years, are secured by the specific equipment leased, bear interest ranging from 6.65% to 7.27% and are due in monthly installments of principal and interest of \$131 through June 2010, monthly installments of principal and interest ranging from \$32 to \$8 from July 2010 through November 2015.



The Company's \$6,288 mortgage is secured by real property, is payable in monthly principal installments ranging from \$20 to \$28 during the remaining term and matures in March 2013. The mortgage bears interest at LIBOR plus 2.0% and the interest rate is fixed at 6.54% through March 13, 2013 by an interest rate swap.

The Company's convertible subordinated debentures bear interest at 7% payable semi-annually, are due in 2012, and are convertible by their holders into shares of the Company's Common Stock at an effective conversion price of \$32.20 per share, subject to adjustment under certain circumstances. Mandatory sinking fund payments, which commenced May 15, 1998, retire \$2,500 principal amount of the debentures annually and approximately 86% of the debentures prior to maturity. The convertible debentures are subordinated in right of payment to all of the Company's other indebtedness.

Interest payments were \$6,093 in 2008, \$6,469 in 2007, and \$7,152 in 2006. Interest capitalized by the Company was \$367 in 2008, \$457 in 2007, and \$243 in 2006.

Maturities of long-term debt for periods following December 27, 2008 are as follows:

|            | Long-Term<br>Debt | Capital Leases<br>(See Note N) | Total     |
|------------|-------------------|--------------------------------|-----------|
| 2009       | \$ 7,439          | \$ 1,393                       | \$ 8,832  |
| 2010       | 7,058             | 1,099                          | 8,157     |
| 2011       | 6,387             | 259                            | 6,646     |
| 2012       | 12,909            | 160                            | 13,069    |
| 2013       | 56,672            | 84                             | 56,756    |
| Thereafter | 185               | 204                            | 389       |
| Total      | \$ 90,650         | \$ 3,199                       | \$ 93,849 |

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**THE DIXIE GROUP, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

(dollars in thousands, except per share data)

(Continued)

**NOTE G - FINANCIAL INSTRUMENTS**

The Company's financial instruments are not held or issued for trading purposes. The carrying amounts and estimated fair value of the Company's financial instruments are summarized as follows:

|   | 2008               |               | 2007               |               |
|---|--------------------|---------------|--------------------|---------------|
|   | Carrying<br>Amount | Fair<br>Value | Carrying<br>Amount | Fair<br>Value |
| Financial assets:                               |                    |               |                    |               |
| Cash and cash equivalents                       | \$ 113             | \$ 113        | \$ 427             | \$ 427        |
| Notes receivable, including current<br>portion  | 425                | 425           | 542                | 542           |
| Available-for-sale securities                   | 235                | 235           | ---                | ---           |
| Financial liabilities:                          |                    |               |                    |               |
| Long-term debt and capital leases,<br>including |                    |               |                    |               |
| current portion                                 | 93,849             | 92,486        | 88,645             | 87,342        |
| Interest rate swaps                             | (2,248)            | (2,248)       | (885)              | (885)         |

The fair value of the Company's long-term debt and capital leases were estimated using market rates the Company believes are available for similar types of financial instruments.

**NOTE H - FAIR VALUE MEASUREMENTS**

The Company adopted SFAS No. 157 on the first day of fiscal year 2008. SFAS No. 157 defines fair value as the exchange value of an asset or a liability in an orderly transaction between market participants. The standard outlines a valuation framework and creates a fair value hierarchy in order to increase the consistency and comparability of fair value measurements and the related disclosures. The three broad fair value hierarchy levels are defined as follows:

Level 1 - Quoted market prices in active markets for identical assets or liabilities as of the reported date.

Level 2 - Other than quoted market prices in active markets for identical assets or liabilities, quoted prices for similar assets and liabilities in active markets, quoted prices for identical or similar assets or liabilities in markets that are not active, and other than quoted prices for assets or liabilities and prices that are derived principally from or corroborated by market data by correlation or other means.

Level 3 - Measurements using management's best estimate of fair value, where the determination of fair value requires significant management judgment or estimation.

The Company's available-for-sale securities and interest rate swaps are measured under the fair value standard. The following table summarizes the hierarchy level the Company used to determine fair value of its financial assets and liabilities as of December 27, 2008:

|                               | Balance at    | Fair Value Hierarchy Level |          |         |
|-------------------------------|---------------|----------------------------|----------|---------|
|                               | Dec. 27, 2008 | Level 1                    | Level 2  | Level 3 |
| Assets:                       |               |                            |          |         |
| Available-for-sale securities | \$ 235        | \$ 235                     | \$ ---   | \$ ---  |
| Liabilities:                  |               |                            |          |         |
| Interest rate swaps           | \$ 2,248      | \$ ---                     | \$ 2,248 | \$ ---  |

The fair value of available-for-sale securities was determined based on quoted market prices and the fair value of the interest rate swaps was obtained from external sources and was determined through the use of models that consider various assumptions and relevant economic factors.

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**THE DIXIE GROUP, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**(dollars in thousands, except per share data)**

**(Continued)**

Available-for-sale securities are reflected on the Company's consolidated balance sheet in other current assets and related gains and losses are deferred in AOCIL. Unrealized gains, net of taxes, included in AOCIL were \$145 at December 27, 2008. During 2008, the Company realized gains from the sale of available-for-sale securities of \$222, or \$137 net of tax. The basis on which the gains were reclassified out of AOCIL into earnings was determined by specific identification.

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 balance sheets in other long-term liabilities and related gains and losses are deferred in AOCIL. Unrealized losses, net of taxes, included in AOCIL were \$971 at December 27, 2008.

The Company is also a party to an interest rate swap agreement through March 2013, which is linked to a mortgage 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, and receives in return an amount equal to a specified variable rate of interest times the same notional amount. At December 27, 2008, the notional amount of the interest swap agreement was \$6,288. Under the terms of the interest rate swap agreement, the Company pays a fixed interest rate of 4.54% through March 2013, which effectively fixes the interest rate on the mortgage at 6.54%. The fair value of the interest rate swap agreement is reflected on the Company's consolidated balance sheets in other long-term liabilities and related gains and losses are deferred in AOCIL. Unrealized losses, net of taxes, included in AOCIL were \$388 at December 27, 2008.

**NOTE I - EMPLOYEE BENEFIT PLANS**

The Company sponsors two 401(k) defined contribution plans covering substantially all associates. The Company generally matches participants' contributions, on a sliding scale, up to a maximum of 5% of the participant's earnings. Matching contributions for the 401(k) plans was \$1,076 for the 2008 plan year. The Company does not expect to match participant's contribution for one of the two 401(k) plans for the 2009 plan year; accordingly, matching contributions for 401(k) plans for the 2009 plan year are expected to be approximately \$100. The Company may make additional contributions to the plan if the Company achieves 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 \$9,197 at December 27, 2008 and \$12,709 at December 29, 2007 and are included in other long-term liabilities in the Company's consolidated balance sheets. The obligations are unsecured general obligations of the Company and the participants have no right, interest or claim in the assets of the Company, except as unsecured general creditors. The Company utilizes a Rabbi Trust to hold, invest and reinvest deferrals and contributions under the plan. Amounts invested in company-owned life insurance in the Rabbi Trust were \$8,931 at December 27, 2008 and \$12,777 at December 29, 2007 and are included in other long-term assets in the Company's consolidated balance sheets.

On December 29, 2007, the Company merged its only remaining defined benefit pension plan into a multi-employer pension plan. As a result of the merger, the Company ceased to be a plan sponsor and became a contributing employer in the multi-employer pension plan. Expenses related to the merger in 2007 were \$1,518, or \$1,023 net of tax, and the Company contributed \$205 in January 2008 to complete its funding obligation for the defined benefit pension plan. Substantially all of the expenses were non-cash and principally consisted of previously unrecognized actuarial losses. The Company's expense related to the multi-employer pension plan during 2008 was \$186. Based on current employment and benefit levels, the Company's contributions to the multi-employer plan are expected to be approximately \$215 for 2009.

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 2006 were \$3,249, or \$2,057 net of tax. The funds required to terminate the plan were \$2,595.

The Company sponsors a legacy postretirement benefit plan that provides life insurance to a limited number of associates as a result of a prior acquisition. 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.

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

During 2006, the Company adopted the provisions of Financial Accounting Standards No. 158, "Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans - an amendment of FASB Statement No. 87, 88, 106 and 132(R)".

Information about the benefit obligation, assets and funded status of the Company's defined benefit pension plans is summarized as follows:

|  | <b>2008</b> | 2007     |
|--|-------------|----------|
| Change in benefit obligation:                  |             |          |
| Benefit obligation at beginning of year        | \$ ---      | \$ 2,845 |
| Service cost                                   | ---         | 169      |
| Interest cost                                  | ---         | 164      |
| Actuarial loss                                 | ---         | 76       |
| Benefits paid                                  | ---         | (15)     |
| Settlements                                    | ---         | (396)    |
| Liabilities transferred to multi-employer plan | ---         | (2,843)  |
| Benefit obligation at end of year              | ---         | ---      |
| Change in plan assets:                         |             |          |
| Fair value of plan assets at beginning of year | ---         | 2,542    |
| Actual return on plan assets                   | ---         | 22       |
| Employer contributions                         | ---         | 295      |
| Benefits paid                                  | ---         | (15)     |
| Settlements                                    | ---         | (396)    |
| Assets transferred to multi-employer plan      | ---         | (2,448)  |
| Fair value of plan assets at end of year       | ---         | ---      |
| Funded status                                  | \$ ---      | \$ ---   |

Information about the benefit obligation and funded status of the Company's postretirement benefit plans is summarized as follows:

|  | <b>2008</b>     | 2007     |
|--|-----------------|----------|
| Change in benefit obligation:                  |                 |          |
| Benefit obligation at beginning of year        | \$ <b>842</b>   | \$ 886   |
| Service cost                                   | <b>4</b>        | 5        |
| Interest cost                                  | <b>46</b>       | 46       |
| Participant contributions                      | <b>25</b>       | 27       |
| Actuarial (gain) loss                          | <b>(52)</b>     | (95)     |
| Benefits paid                                  | <b>(26)</b>     | (27)     |
| Medicare Part D subsidy                        | <b>14</b>       | ---      |
| Benefit obligation at end of year              | <b>853</b>      | 842      |
| Change in plan assets:                         |                 |          |
| Fair value of plan assets at beginning of year | ---             | ---      |
| Employer contributions                         | <b>(13)</b>     | ---      |
| Participant contributions                      | <b>25</b>       | 27       |
| Benefits paid                                  | <b>(26)</b>     | (27)     |
| Medicare Part D subsidy                        | <b>14</b>       | ---      |
| Fair value of plan assets at end of year       | ---             | ---      |
| Funded status                                  | \$ <b>(853)</b> | \$ (842) |

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

The balance sheet classification of the Company's liability for postretirement benefit plans is summarized as follows:

|                             | <b>2008</b>   | 2007   |
|-----------------------------|---------------|--------|
| Accrued expenses            | \$ <b>33</b>  | \$ 28  |
| Other long-term liabilities | <b>820</b>    | 814    |
| Total liability             | \$ <b>853</b> | \$ 842 |

Benefits expected to be paid on behalf of associates for postretirement benefit plans during the period 2009 through 2018 are summarized as follows:

| Years       | Postretirement<br>Plans |
|-------------|-------------------------|
| 2009        | \$ 33                   |
| 2010        | 35                      |
| 2011        | 26                      |
| 2012        | 27                      |
| 2013        | 28                      |
| 2014 - 2018 | 135                     |

Assumptions used to determine benefit obligations of the Company's postretirement benefit plans are summarized as follows:

|  | <b>2008</b>  | 2007  |
|--|--------------|-------|
| Weighted-average assumptions as of year-end: |              |       |
| Discount rate (benefit obligations)          | <b>5.68%</b> | 5.44% |

Assumptions used and related effects of health care cost are summarized as follows:

|  | <b>2008</b>   | 2007   |
|--|---------------|--------|
| Health care cost trend assumed for next year       | <b>10.00%</b> | 10.00% |
| Rate to which the cost trend is assumed to decline | <b>5.00%</b>  | 6.00%  |

Year that the rate reaches the ultimate trend rate

**2016**

2012

The effect of a 1% change in the health care cost trend on the Company's postretirement benefit plans is summarized as follows:

|   | <b>2008</b>            |                        | 2007           |                |
|---|------------------------|------------------------|----------------|----------------|
|   | <b>1%<br/>Increase</b> | <b>1%<br/>Decrease</b> | 1%<br>Increase | 1%<br>Decrease |
| Accumulated postretirement benefit obligation | \$ <b>3</b>            | \$ <b>(4)</b>          | \$ 3           | \$ (3)         |

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

|                                     | <b>2008</b>     | 2007     | 2006     |
|-------------------------------------|-----------------|----------|----------|
| Defined benefit plans:              |                 |          |          |
| Service cost                        | \$ ---          | \$ 169   | \$ 183   |
| Interest cost                       | ---             | 164      | 272      |
| Expected return on plan assets      | ---             | (200)    | (305)    |
| Amortization of prior service costs | ---             | 6        | 6        |
| Recognized net actuarial loss       | ---             | 78       | 196      |
| Settlement loss                     | ---             | 221      | 3,451    |
| Total - Defined pension plans       | ---             | 438      | 3,803    |
| Defined contribution plan           | <b>1,076</b>    | 1,025    | 1,022    |
| Net periodic benefit cost           | \$ <b>1,076</b> | \$ 1,463 | \$ 4,825 |

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

Costs charged for all postretirement plans are summarized as follows:

|                                       | <b>2008</b> | 2007     | 2006     |
|---------------------------------------|-------------|----------|----------|
| Defined benefit plans:                |             |          |          |
| Service cost                          | \$ 4        | \$ 5     | \$ 5     |
| Interest cost                         | 46          | 46       | 53       |
| Amortization of prior service credits | (88)        | (88)     | (88)     |
| Recognized net actuarial gain         | (61)        | (53)     | (67)     |
| Settlement gain                       | (32)        | (68)     | (28)     |
| Net periodic benefit credit           | \$ (129)    | \$ (158) | \$ (125) |

Pre-tax amounts included in AOCIL for the Company's postretirement benefit plans at December 27, 2008 are summarized as follows:

|                              | Postretirement Benefit Plans |                               |
|------------------------------|------------------------------|-------------------------------|
|                              | <b>2008</b>                  | 2009 Expected<br>Amortization |
| Prior service credits        | \$ (629)                     | \$ (88)                       |
| Unrecognized actuarial gains | (509)                        | (55)                          |
| Totals                       | \$ (1,138)                   | \$ (143)                      |

**NOTE J - INCOME TAXES**

The Company accounts for uncertainty in income tax positions under 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"). Unrecognized tax benefits at December 27, 2008 were \$332. Due to the Company's valuation allowances, such benefits, if recognized, would not affect the Company's effective tax rate. No interest or penalties have been accrued at December 27, 2008. 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, if any, in income tax expense.

Following is a summary of the change in the Company's unrecognized tax benefits:

|  | <b>2008</b>   | 2007   |
|--|---------------|--------|
| Balance at beginning of year                                       | \$ <b>419</b> | \$ 432 |
| Additions based on tax positions taken during a prior period       | <b>37</b>     | 59     |
| Reductions related to settlement of tax matters                    | <b>(15)</b>   | (51)   |
| Reductions related to a lapse of applicable statute of limitations | <b>(109)</b>  | (21)   |
| Balance at end of year   | \$ <b>332</b> | \$ 419 |

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 tax years subsequent to 2004 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 subsequent to 2003.

The provision (benefit) for income taxes on income (loss) from continuing operations consists of the following:

|                                | <b>2008</b>       | 2007     | 2006     |
|--------------------------------|-------------------|----------|----------|
| Current                        |                   |          |          |
| Federal                        | \$ <b>(4,740)</b> | \$ 4,079 | \$ 1,309 |
| State                          | <b>(194)</b>      | 308      | 103      |
| Total current                  | <b>(4,934)</b>    | 4,387    | 1,412    |
| Deferred                       |                   |          |          |
| Federal                        | <b>1,223</b>      | (645)    | 324      |
| State                          | <b>804</b>        | (49)     | 45       |
| Total deferred                 | <b>2,027</b>      | (694)    | 369      |
| Income tax provision (benefit) | \$ <b>(2,907)</b> | \$ 3,693 | \$ 1,781 |

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

Deferred income taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the tax basis of those assets and liabilities.

Significant components of the Company's deferred tax liabilities and assets are as follows:

|  | <b>2008</b>      | 2007      |
|--|------------------|-----------|
| Deferred tax liabilities:                      |                  |           |
| Property, plant and equipment                  | \$ <b>14,363</b> | \$ 13,397 |
| Intangible assets                              | <b>161</b>       | 121       |
| Other  | <b>3,340</b>     | 3,289     |
| Total deferred tax liabilities                 | <b>17,864</b>    | 16,807    |
| Deferred tax assets:                           |                  |           |
| Inventories                                    | <b>1,446</b>     | 1,686     |
| Retirement benefits                            | <b>4,050</b>     | 3,769     |
| Other employee benefits                        | <b>858</b>       | 882       |
| State net operating losses                     | <b>1,956</b>     | 1,095     |
| State tax credit carryforwards                 | <b>2,194</b>     | 2,079     |
| Allowances for bad debts, claims and discounts | <b>2,276</b>     | 2,385     |
| Other  | <b>1,512</b>     | 1,024     |
| Total deferred tax assets                      | <b>14,292</b>    | 12,920    |
| Valuation allowance                            | <b>(3,640)</b>   | (2,528)   |
| Net deferred tax asset                         | <b>10,652</b>    | 10,392    |
| Net deferred tax liabilities                   | \$ <b>7,212</b>  | \$ 6,415  |

At December 27, 2008, \$1,956 of deferred tax assets related to approximately \$48,500 of state tax net operating loss carryforwards and \$2,194 state tax credit carryforwards were available to the Company that will expire in five to twenty years. A valuation allowance of \$3,640 is recorded to reflect the estimated amount of deferred tax assets that may not be realized during the carryforward periods.

Differences between the provision (benefit) for income taxes and the amount computed by applying the statutory federal income tax rate of 34% to income (loss) from continuing operations are summarized as follows:

|  | <b>2008</b>       | 2007     | 2006     |
|--|-------------------|----------|----------|
| Statutory rate applied to income (loss) from continuing operations | \$ (11,572)       | \$ 3,560 | \$ 3,385 |
| Plus state income taxes net of federal tax effect                  | <b>581</b>        | 269      | 97       |
| Total statutory provision (benefit)                                | <b>(10,991)</b>   | 3,829    | 3,482    |
| Increase (decrease) attributable to:                               |                   |          |          |
| Impairment of goodwill   | <b>7,861</b>      | ---      | ---      |
| Tax contingency reserve  | <b>(71)</b>       | 33       | (1,221)  |
| Refunds from utilization of tax credits                            | <b>(93)</b>       | (114)    | (411)    |
| Other items  | <b>387</b>        | (55)     | (69)     |
| Total tax provision (benefit)                                      | \$ <b>(2,907)</b> | \$ 3,693 | \$ 1,781 |

During the fourth quarter of 2008, the Company recognized a non-deductible loss of \$23,121 from the impairment of goodwill. The Company's effective tax benefit rate was 8.5% for 2008, principally as a result of the goodwill impairment.

The settlement of federal and state income tax examinations and expiring tax statute of limitations reduced the Company's tax contingency reserve and its income tax provision by \$1,221 in 2006. The Company also recognized federal and state income tax credits and received certain non-taxable life insurance benefits in 2006. These adjustments and income tax credits and non-taxable income reduced the Company's effective tax rate to 18.4% for 2006.

Income tax payments, net of income tax refunds, for continuing and discontinued operations were \$1,368 in 2008, \$3,080 in 2007, and \$1,625 in 2006.

**THE DIXIE GROUP, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****(dollars in thousands, except per share data)****(Continued)****NOTE K - COMMON STOCK AND EARNINGS PER SHARE**

The Company's Charter authorizes 80,000,000 shares of Common Stock with a \$3 par value per share and 16,000,000 shares of Class B Common Stock with a \$3 par value per share. Holders of Class B Common Stock have the right to twenty votes per share on matters that are submitted to Shareholders for approval and to dividends in an amount not greater than dividends declared and paid on Common Stock. Class B Common Stock is restricted as to transferability and may be converted into Common Stock on a one share for one share basis. The Company's Charter also authorizes 200,000,000 shares of Class C Common Stock, \$3 par value per share, and 16,000,000 shares of Preferred Stock. No shares of Class C Common Stock or Preferred Stock have been issued.

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

|   | <b>2008</b>        | 2007     | 2006     |
|---|--------------------|----------|----------|
| Income (loss) from continuing operations (1)  | \$ <b>(31,128)</b> | \$ 6,778 | \$ 7,891 |
| Denominator for calculation of basic earnings (loss) per share - weighted-average shares outstanding (2)                                      | <b>12,449</b>      | 12,788   | 12,702   |
| Effect of dilutive securities:  |                    |          |          |
| Stock options (3)   | ---                | 129      | 222      |
| Restricted stock grants (2)(3)  | ---                | 14       | 6        |
| Directors' stock performance units  | ---                | 36       | 29       |
| Denominator for calculation of diluted earnings (loss) per share - weighted-average shares outstanding adjusted for potential dilution (2)(3) | <b>12,449</b>      | 12,967   | 12,959   |
| Earnings (loss) per share:  |                    |          |          |

|         |    |        |    |      |    |      |
|---------|----|--------|----|------|----|------|
| Basic   | \$ | (2.50) | \$ | 0.53 | \$ | 0.62 |
| Diluted |    | (2.50) |    | 0.52 |    | 0.61 |

(1)

No adjustments needed in the numerator for diluted calculations.

(2)

Includes Common and Class B Common shares, less shares held in treasury, 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, restricted stock grants where market conditions have not been met, and shares issuable on conversion of subordinated debentures into shares of Common Stock have been excluded. Aggregate shares excluded were 1,484 shares in 2008, 1,367 shares in 2007, and 995 shares in 2006.

## NOTE L - STOCK COMPENSATION EXPENSE AND STOCK PLANS

### Stock Compensation Expense

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

Stock-based compensation expense was \$1,322 for 2008, \$1,179 for 2007 and \$662 for 2006. No stock options were granted in 2008, 2007 or 2006.

At December 27, 2008, unrecognized compensation expense related to unvested stock options was \$7 and is expected to be recognized over a weighted-average period of 0.3 years.

Excess tax benefits of \$115 and \$202 were included in cash provided by financing activities for the years ended 2007 and 2006, respectively.



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**THE DIXIE GROUP, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**(dollars in thousands, except per share data)**

**(Continued)**

**2006 Stock Award Plan**

On May 3, 2006, the Company's shareholders' approved and adopted the Company's 2006 Stock Award Plan (the "2006 Plan") which provides for the issuance of up to 800,000 shares of Common Stock and/or Class B Common Stock as stock-based or stock-denominated awards to directors of the Company and to salaried employees of the Company and its participating subsidiaries. The 2006 Plan superseded and replaced The Dixie Group, Inc. Stock Incentive Plan (the "2000 Plan"), which was terminated with respect to the granting of new awards. Awards previously granted under the 2000 Plan will continue to be governed by the terms of that plan and will not be affected by its termination.

**Restricted Stock Awards**

During 2008, the Company granted 187,417 shares of restricted stock to officers of the Company. The grant-date fair value of the awards was \$1,643, or \$8.765 per share. The shares vest over terms ranging from 2 to 19 years from the date the awards were granted. 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.

During 2007, the Company granted 109,620 shares of restricted stock to officers and other key employees. The grant-date fair value of the awards was \$1,435, or \$13.09 per share. The shares will vest over terms ranging from 2 to 20 years from the date the awards were granted. 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.

On June 6, 2006, the Company granted 125,000 shares of restricted stock to its Chief Executive Officer. The award was intended to retain and motivate the Company's Chief Executive Officer over the term of the award and to bring his total compensation package closer to median levels for Chief Executive Officers of comparable companies. The fair value of the award was \$1,556, or \$12.45 per share, equivalent to 92% of the market value of a share of the Company's Common Stock on the date the award was granted. Such value was determined using a binomial model and will be expensed over the seven year term of the award. Vesting of the shares is contingent on a 35% increase in the market value of the Company's Common Stock (the "Market Condition") prior to June 5, 2011. Additionally, vesting of shares requires the Chief Executive Officer to meet a continued service condition during the term of the award, with a two year minimum vesting period. Shares subject to the award vest pro rata annually after the Market Condition and minimum vesting period are met on the anniversary date the award was granted.

During 2006, the Company also granted 24,000 shares of restricted stock to key employees. The grant-date fair value of the awards was \$333, or \$13.88 per share. Vesting of the share awards is subject to a continued service condition, with one-third to one-fifth of the awards vesting each year from the date the awards were granted. 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.

Restricted stock activity for the three years ended December 27, 2008 is summarized as follows:

|                                  | Number of<br>Shares | Weighted-Average<br>Fair Value of<br>Awards Granted<br>During the Year |
|----------------------------------|---------------------|--|
| Outstanding at December 31, 2005 | 57,990              | \$ ---   |
| Granted                          | 149,000             | 12.68  |
| Vested                           | (19,330)            | ---  |
| Forfeited                        | ---                 | ---  |
| Outstanding at December 30, 2006 | 187,660             | ---  |
| Granted                          | 109,620             | 13.09  |
| Vested                           | (29,369)            | ---  |
| Forfeited                        | (11,787)            | ---  |
| Outstanding at December 29, 2007 | 256,124             | ---  |
| Granted                          | 187,417             | 8.77   |
| Vested                           | (50,371)            | ---  |
| Forfeited                        | ---                 | ---  |
| Outstanding at December 27, 2008 | 393,170             | \$ ---   |

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**THE DIXIE GROUP, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**(dollars in thousands, except per share data)**

**(Continued)**

As of December 27, 2008, unrecognized compensation cost related to unvested restricted stock was \$2,827. That cost is expected to be recognized over a weighted-average period of 3.7 years. The total fair value of shares vested was approximately \$412, \$359 and \$261 during 2008, 2007 and 2006, respectively.

**Stock Performance Units**

The Company's non-employee directors receive 50% of their annual retainer (\$12 in 2008) in Stock Performance Units under the Directors' Stock Plan. Upon retirement, the Stock Performance Units vest and the Company issues a number of shares of Common Stock equivalent to the number of Stock Performance Units held by non-employee directors. The fair value of each Stock Performance Unit awarded was equal to the market value of a share of the Company's Common Stock on the grant date. As of December 27, 2008, 48,812 Stock Performance Units were outstanding under this plan.

**Stock Purchase Plan**

The Company has a stock purchase plan which authorizes 108,000 shares of Common Stock for purchase by supervisory associates at the market price prevailing at the time of purchase. At December 27, 2008, 27,480 shares remained available for issuance under the plan. Shares sold under this plan are held in escrow until paid for and are subject to repurchase agreements which give the Company a right of first refusal to purchase the shares if they are subsequently sold. No shares were sold under the plan in 2008, 2007 or 2006.

**Stock Options**

All unvested stock options issued under the Company's 2000 Plan are exercisable generally at a cumulative rate of 25% per year after the second year from the date the options are granted. Any options granted under the Company's 2006 Plan will be exercisable for periods determined at the time the awards are granted. No options were granted under either of these plans during 2008, 2007 and 2006.

During 2008, the Company modified 257,360 options by extending the life of certain options from 5 and 6 years to 10 years. The modification affected only 25 employees of the Company and resulted in an additional expense of approximately \$21.

Option activity for the three years ended December 27, 2008 is summarized as follows:

|                                  | Number of Shares |    | Weighted-Average<br>Exercise Price |
|----------------------------------|------------------|----|------------------------------------|
| Outstanding at December 31, 2005 | 1,189,312        | \$ | 10.78                              |
| Exercised                        | (125,340)        |    | 6.81                               |
| Forfeited                        | (34,375)         |    | 14.71                              |
| Outstanding at December 30, 2006 | 1,029,597        |    | 11.13                              |
| Exercised                        | (103,106)        |    | 6.16                               |
| Forfeited                        | (8,625)          |    | 12.90                              |
| Outstanding at December 29, 2007 | 917,866          |    | 11.68                              |
| Exercised                        | (6,250)          |    | 3.95                               |
| Forfeited                        | (52,675)         |    | 13.50                              |
| Outstanding at December 27, 2008 | 858,941          | \$ | 11.62                              |
| Options exercisable at:          |                  |    |                                    |
| December 30, 2006                | 976,635          |    | 11.36                              |
| December 29, 2007                | 904,054          |    | 11.71                              |
| December 27, 2008                | 854,691          |    | 11.62                              |

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

The following table summarizes information about stock options at December 27, 2008:

| Range of Exercise Prices | Options Outstanding |   |                                 |
|--------------------------|---------------------|---|---------------------------------|
|                          | Number of Shares    | Weighted-Average Remaining Contractual Life | Weighted-Average Exercise Price |
| \$3.21 - \$4.78          | 119,100             | 3.2 years                                   | \$ 4.26                         |
| 6.96 - 6.96              | 115,481             | 3.4 years                                   | 6.96                            |
| 11.85 - 17.58            | 624,360             | 6.4 years                                   | 13.89                           |
| \$3.21 - \$17.58         | 858,941             | 5.5 years                                   | \$ 11.62                        |

| Range of Exercise Prices | Options Exercisable |   |                                 |
|--------------------------|---------------------|---|---------------------------------|
|                          | Number of Shares    | Weighted-Average Remaining Contractual Life | Weighted-Average Exercise Price |
| \$3.21 - \$4.78          | 119,100             | 3.2 years                                   | \$ 4.26                         |
| 6.96 - 6.96              | 115,481             | 3.4 years                                   | 6.96                            |
| 11.85 - 17.58            | 620,110             | 6.4 years                                   | 13.90                           |
| \$3.21 - \$17.58         | 854,691             | 5.5 years                                   | \$ 11.62                        |

At December 27, 2008, the market value of all outstanding stock options was less than their exercise price by \$8,659 and the market value of exercisable stock options was less than their exercise price by \$8,613. The market value of stock options exercised exceeded their exercise price during the year ended 2008, 2007 and 2006 by \$13, \$682 and \$905, respectively.

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**THE DIXIE GROUP, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****(dollars in thousands, except per share data)****(Continued)****NOTE M - COMPREHENSIVE INCOME (LOSS)**

|   | <b>2008</b>        | 2007     | 2006     |
|---|--------------------|----------|----------|
| Net income (loss)   | <b>\$ (31,403)</b> | \$ 6,266 | \$ 7,703 |
| Other comprehensive income (loss):  |                    |          |          |
| Unrealized gain (loss) on interest rate swap agreements:                              |                    |          |          |
| Before income taxes   | <b>(1,297)</b>     | (1,207)  | 442      |
| Income taxes  | <b>(493)</b>       | (459)    | 168      |
| Net of taxes  | <b>(804)</b>       | (748)    | 274      |
| Unrealized gain on available-for-sale securities:                                     |                    |          |          |
| Before income taxes   | <b>455</b>         | ---      | ---      |
| Income taxes  | <b>173</b>         | ---      | ---      |
| Net of taxes  | <b>282</b>         | ---      | ---      |
| Realized gain on available-for-sale securities:                                       |                    |          |          |
| Before income taxes   | <b>(222)</b>       | ---      | ---      |
| Income taxes  | <b>(85)</b>        | ---      | ---      |
| Net of taxes  | <b>(137)</b>       | ---      | ---      |
| Unrecognized net actuarial gain (loss) on pension and postretirement benefit plans:   |                    |          |          |
| Before income taxes   | <b>20</b>          | (202)    | ---      |
| Income taxes  | <b>8</b>           | (75)     | ---      |
| Net of taxes  | <b>12</b>          | (127)    | ---      |
| Recognition of net actuarial (gain) loss on pension and postretirement benefit plans: |                    |          |          |
| Before income taxes   | <b>(61)</b>        | 1,806    | ---      |
| Income taxes  | <b>(23)</b>        | 685      | ---      |
| Net of taxes  | <b>(38)</b>        | 1,121    | ---      |



Amortization of prior service credits on pension and postretirement benefit plans:

|                     |      |      |     |
|---------------------|------|------|-----|
| Before income taxes | (88) | (14) | --- |
| Income taxes        | (34) | (6)  | --- |
| Net of taxes        | (54) | (8)  | --- |

Change in additional minimum pension liability:

|                     |     |     |       |
|---------------------|-----|-----|-------|
| Before income taxes | --- | --- | 2,789 |
| Income taxes        | --- | --- | 1,040 |
| Net of taxes        | --- | --- | 1,749 |

|                             |             |          |          |
|-----------------------------|-------------|----------|----------|
| Comprehensive income (loss) | \$ (32,142) | \$ 6,504 | \$ 9,726 |
|-----------------------------|-------------|----------|----------|

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

Components of accumulated other comprehensive income (loss) are as follows:

|  | Minimum<br>Pension<br>Liability | Interest<br>Rate<br>Swaps | Available-for-Sale<br>Securities | Pension &<br>Post-Retirement<br>Liabilities | Total      |
|--|---------------------------------|---------------------------|----------------------------------|---|------------|
| Balance at December 31,<br>2005  | \$ (2,806)                      | \$ (81)                   | \$ ---                           | \$ ---                                      | \$ (2,887) |
| Change in minimum<br>pension<br>liability, net of tax<br>of \$1,040                                      | 1,749                           | ---                       | ---                              | ---   | 1,749      |
| Unrealized gain on<br>interest rate<br>swap agreements,<br>net of tax of<br>\$168                        | ---                             | 274                       | ---                              | ---   | 274        |
| Reclassification upon<br>adoption of<br>SFAS No. 158, net<br>of tax of \$646                             | 1,057                           | ---                       | ---                              | (1,057)                                     | ---        |
| Reclassification of<br>unrecognized<br>gains upon adoption<br>of SFAS No.<br>158, net of tax of<br>\$525 | ---                             | ---                       | ---                              | 856   | 856        |
| Balance at December 30,<br>2006  | ---                             | 193                       | ---                              | (201)                                       | (8)        |
| Unrealized loss on<br>interest rate<br>swap agreements,<br>net of tax                                    | ---                             | (748)                     | ---                              | ---   | (748)      |

of \$459

|  |     |       |       |       |       |
|--|-----|-------|-------|-------|-------|
| Unrecognized net actuarial loss on pension and postretirement benefit plans, net of tax of \$75      | --- | ---   | ---   | (127) | (127) |
| Recognition of net actuarial loss on pension and postretirement benefit plans, net of tax of \$685   | --- | ---   | ---   | 1,121 | 1,121 |
| Amortization of prior service credits on pension and postretirement benefit plans, net of tax of \$6 | --- | ---   | ---   | (8)   | (8)   |
| Balance at December 29, 2007   | --- | (555) | ---   | 785   | 230   |
| Unrealized loss on interest rate swap agreements, net of tax of \$493                                | --- | (804) | ---   | ---   | (804) |
| Unrealized gain on available-for-sale securities, net of tax of \$173                                | --- | ---   | 282   | ---   | 282   |
| Realized gain on available-for-sale securities, net of tax of \$85                                   | --- | ---   | (137) | ---   | (137) |
| Unrecognized net actuarial loss on pension and postretirement benefit plans, net of tax of \$8       | --- | ---   | ---   | 12    | 12    |

|   |           |            |                   |           |            |           |            |           |              |
|---|-----------|------------|-------------------|-----------|------------|-----------|------------|-----------|--------------|
| Recognition of net actuarial loss on pension and postretirement benefit plans, net of tax of \$23     | ---       | ---        | ---               | (38)      | (38)       |           |            |           |              |
| Amortization of prior service credits on pension and postretirement benefit plans, net of tax of \$34 | ---       | ---        | ---               | (54)      | (54)       |           |            |           |              |
| <b>Balance at December 27, 2008</b>   | <b>\$</b> | <b>---</b> | <b>\$ (1,359)</b> | <b>\$</b> | <b>145</b> | <b>\$</b> | <b>705</b> | <b>\$</b> | <b>(509)</b> |

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**THE DIXIE GROUP, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

(dollars in thousands, except per share data)

(Continued)

**NOTE N - COMMITMENTS**

The Company had commitments of approximately \$1,179 at December 27, 2008, consisting primarily for purchases of machinery and equipment and, to a lesser extent, building additions.

The Company leases certain equipment under capital leases and certain buildings, machinery and equipment under operating leases. Commitments for minimum rentals under non-cancelable leases, including any applicable rent escalation clauses, are as follows:

|                                    | Capital<br>Leases | Operating<br>Leases |
|------------------------------------|-------------------|---------------------|
| 2009                               | \$ 1,575          | \$ 1,884            |
| 2010                               | 1,181             | 1,708               |
| 2011                               | 298               | 1,437               |
| 2012                               | 186               | 987                 |
| 2013                               | 102               | 134                 |
| Total commitments                  | 3,342             | 6,150               |
| Less amounts representing interest | (347)             | ---                 |
| Total                              | \$ 2,995          | \$ 6,150            |

Property, plant and equipment includes machinery and equipment under capital leases which have cost and accumulated depreciation of \$9,680 and \$6,199, respectively, at December 27, 2008, and \$9,104 and \$5,006, respectively, at December 29, 2007.

Rental expense was approximately \$2,641, \$2,422 and \$2,437 during the years 2008, 2007 and 2006, respectively.

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

Other income and expense is summarized as follows:

|  | 2008     | 2007     | 2006     |
|--|----------|----------|----------|
| Other operating income:                |          |          |          |
| Gain on sale of other operating assets | \$ (214) | \$ (13)  | \$ (27)  |
| Insurance settlements and refunds      | ---      | ---      | (353)    |
| Miscellaneous income                   | (214)    | (456)    | (260)    |
| Other operating income                 | \$ (428) | \$ (469) | \$ (640) |
| Other operating expense:               |          |          |          |
| Retirement expenses                    | \$ 546   | \$ 392   | \$ 453   |
| Miscellaneous expense                  | 399      | 281      | 280      |
| Other operating expense                | \$ 945   | \$ 673   | \$ 733   |
| Other income:                          |          |          |          |
| Interest income                        | \$ (20)  | \$ (20)  | \$ (32)  |
| Sale of available-for-sale securities  | (222)    | ---      | ---      |
| Dispute settlement                     | ---      | ---      | (294)    |
| Miscellaneous income                   | (137)    | (143)    | (128)    |
| Other income                           | \$ (379) | \$ (163) | \$ (454) |
| Other expense:                         |          |          |          |
| Miscellaneous expense                  | \$ 53    | \$ 69    | \$ 127   |
| Other expense                          | \$ 53    | \$ 69    | \$ 127   |

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**THE DIXIE GROUP, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

(dollars in thousands, except per share data)

(Continued)

**NOTE P - FACILITY CONSOLIDATION AND SEVERANCE EXPENSES**

In response to the continued difficult economic conditions, the Company developed plans to consolidate its North Georgia tufting operations into its Atmore, Alabama tufting, dyeing and finishing facility, combine its two Santa Ana, California facilities and make organizational and other changes to reduce staff and expenses throughout the Company. The Consolidation of our East Coast tufting operations was substantially completed early in the first quarter of 2009.

Cost of consolidation and administrative organizational changes made in 2008 were primarily related to the consolidation of the Company's East Coast Tufting operations and are summarized as follows:

|                                    | Accrued    | 2008     |            | Accrued    | As of December 27, 2008 |          |
|------------------------------------|------------|----------|------------|------------|-------------------------|----------|
|                                    | Balance at | Expenses | Cash       | Balance at | Total Costs             | Total    |
|                                    | 2007       | To Date  | Payments   | 2008       | Incurred To             | Expected |
|                                    |            |          |            |            | Date                    | Costs    |
| Equipment and inventory relocation | \$ ---     | \$ 1,855 | \$ (1,855) | \$ ---     | \$ 1,855                | \$ 2,500 |
| Severance pay                      | ---        | 462      | (181)      | 281        | 462                     | 600      |
| Totals                             | \$ ---     | \$ 2,317 | \$ (2,036) | \$ 281     | \$ 2,317                | \$ 3,100 |

These costs are classified in "Facility consolidation and severance expenses" in the Company's Consolidated Statements of Operations for the year ended December 27, 2008.

The Company is reviewing its alternatives for its two West Coast operations and is now considering the possibility of selling this business or, more likely, consolidating it into its East Coast facilities, beginning as early as the second half of 2009.

**NOTE Q - DISCONTINUED OPERATIONS**

Results associated with operations that have been sold or discontinued are generally classified as discontinued operations for all periods presented. Pension expenses associated with employees of the Company's discontinued textile operations are included in continuing operations in accordance with Statement of Financial Accounting Standards No. 88.

Discontinued operations are summarized as follows:

|   | <b>2008</b> | 2007     | 2006     |
|---|-------------|----------|----------|
| Loss on discontinued operations:              |             |          |          |
| Before income taxes                           | \$ (417)    | \$ (873) | \$ (321) |
| Income tax benefit                            | (142)       | (361)    | (133)    |
| Loss from discontinued operations, net of tax | \$ (275)    | \$ (512) | \$ (188) |

Discontinued operating losses in 2008, 2007 and 2006 primarily consisted of expenses for workers' compensation and sales tax expenses related to businesses sold in 2003 and 2004.

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**SCHEDULE II - VALUATION AND QUALIFYING ACCOUNTS****THE DIXIE GROUP, INC. AND SUBSIDIARIES****(dollars in thousands)**

| Description   | Balance at<br>Beginning<br>of Year | Additions<br>Charged to<br>Costs and<br>Expenses | Deductions | Balance<br>at End of<br>Year |
|---|------------------------------------|--|------------|------------------------------|
| Year ended December 27, 2008:                         |                                    |  |            |                              |
| Reserves deducted from asset accounts:                |                                    |  |            |                              |
| Allowance for doubtful<br>accounts                    | \$ 676                             | \$ 607   | \$ 322 (1) | \$ 961                       |
| Reduce inventories to net<br>realizable value         | 6,702                              | ---  | 1,119 (2)  | 5,583                        |
| Deferred income tax asset<br>valuation<br>allowance   | 2,528                              | 1,159  | 47 (3)     | 3,640                        |
| Reserves classified as liabilities:                   |                                    |  |            |                              |
| Provision for claims,<br>allowances and<br>warranties | 3,382                              | 6,080  | 6,331 (4)  | 3,131                        |
| Year ended December 29, 2007:                         |                                    |  |            |                              |
| Reserves deducted from asset accounts:                |                                    |  |            |                              |
| Allowance for doubtful<br>accounts                    | \$ 651                             | \$ 204   | \$ 179 (1) | \$ 676                       |
| Reduce inventories to net<br>realizable value         | 5,175                              | 1,527 (2)  | ---        | 6,702                        |
| Deferred income tax asset<br>valuation<br>allowance   | 2,410                              | 326  | 208 (3)    | 2,528                        |
| Reserves classified as liabilities:                   |                                    |  |            |                              |

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|   |       |       |           |       |
|---|-------|-------|-----------|-------|
| Provision for claims,<br>allowances and<br>warranties | 3,089 | 6,981 | 6,688 (4) | 3,382 |
|---|-------|-------|-----------|-------|

Year ended December 30, 2006:

Reserves deducted from asset accounts:

|   |        |        |            |        |
|---|--------|--------|------------|--------|
| Allowance for doubtful<br>accounts                  | \$ 595 | \$ 384 | \$ 328 (1) | \$ 651 |
| Reduce inventories to net<br>realizable value       | 6,705  | ---    | 1,530 (2)  | 5,175  |
| Deferred income tax asset<br>valuation<br>allowance | 1,627  | 1,002  | 219 (3)    | 2,410  |

Reserves classified as liabilities:

|   |       |       |           |       |
|---|-------|-------|-----------|-------|
| Provision for claims,<br>allowances and<br>warranties | 2,699 | 9,150 | 8,760 (4) | 3,089 |
|---|-------|-------|-----------|-------|

(1)

Uncollectible accounts written off, net of recoveries.

(2)

Current year net additions and deductions to the reserve.

(3)

Reductions resulting from settlement of federal and state income tax examinations and expiration of tax statute of limitations.

(4)

Reserve reductions for claims and allowances settled.

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**ANNUAL REPORT ON FORM 10-K**  
**ITEM 15(e)**  
**EXHIBITS**

YEAR ENDED DECEMBER 27, 2008  
THE DIXIE GROUP, INC.  
CHATTANOOGA, TENNESSEE

Exhibit Index

| <b>EXHIBIT<br/>NO.</b> | <b><u>EXHIBIT DESCRIPTION</u></b>   | <b><u>INCORPORATION BY REFERENCE</u></b>  |
|------------------------|---|---|
| (3.1)                  | Text of Restated Charter of The Dixie Group, Inc. as Amended - Blackline Version.   | Incorporated by reference to Exhibit (3.4) to Dixie's Annual Report on Form 10-K for the year ended December 27, 2003. *                      |
| (3.2)                  | Amended By-Laws of The Dixie Group, Inc. as of February 22, 2007.   | Incorporated by reference to Exhibit 3.1 to Dixie's Current Report on Form 8-K dated February 26 2007.*                                       |
| (4.1)                  | Form of Indenture, dated May 15, 1987 between Dixie Yarns, Inc. and Morgan Guaranty Trust Company of New York as Trustee.   | Incorporated by reference to Exhibit 4.2 to Amendment No. 1 of Dixie's Registration Statement No. 33-14078 on Form S-3, dated May 19, 1987. * |
| (4.2)                  | Master Lease Agreement for Synthetic Lease, dated October 14, 2003, between the Company and General Electric Capital Corporation.   | Incorporated by reference to Exhibit (10.28) to Dixie's Annual Report on Form 10-K for the year ended December 27, 2003. *                    |
| (4.3)                  | Amended and Restated Loan and Security Agreement dated April 14, 2004 by and among The Dixie Group, Inc. each of its subsidiaries as guarantors, and Fleet Capital Corporation. | Incorporated by reference to Exhibit (4.13) to Dixie's Current Report on Form 8-K dated April 14, 2004. *                                     |
| (4.4)                  | First Amendment to Amended and Restated Loan and Security Agreement, dated November 10, 2004 by and among The Dixie   | Incorporated by reference to Exhibit (4.1) to Dixie's Current Report on Form 8-K dated November 8, 2004. *                                    |

Group, Inc. each of its subsidiaries as guarantors, and Fleet Capital Corporation.

- |       |   |  |
|-------|---|--|
| (4.5) | Second Amendment, dated July 27, 2005, to Amended and Restated Loan and Security Agreement dated April 14, 2004 by and among The Dixie Group, Inc. each of its subsidiaries as guarantors, and Bank of America, N.A. (successor to Fleet Capital Corporation).  | Incorporated by reference to Exhibit (10.1) to Dixie's Current Report on Form 8-K dated July 27, 2005. * |
| (4.6) | Third Amendment dated May 3, 2006, to Amended and Restated Loan and Security Agreement, by and among The Dixie Group, Inc., each of its subsidiaries as guarantors, Bank of America, N.A., in its capacity as collateral and administrative agent for the Lenders, and the Lenders (as such term is defined in the Loan Agreement). | Incorporated by reference to Exhibit (10.1) to Dixie's Current Report on Form 8-K dated May 4, 2006. *   |

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|--------|---|---|
| (4.7)  | Fourth Amendment dated October 25, 2006, to Amended and Restated Loan and Security Agreement, by and among The Dixie Group, Inc., each of its subsidiaries as guarantors, Bank of America, N.A., in its capacity as collateral and administrative agent for the Lenders, and the Lenders (as such term is defined in the Loan Agreement).   | Incorporated by reference to Exhibit (10.1) to Dixie's Current Report on Form 8-K dated October 25, 2006. * |
| (4.8)  | Letter Agreement dated July 16, 2007 to the Fourth Amendment dated October 25, 2006, to Amended and Restated Loan and Security Agreement, by and among The Dixie Group, Inc., each of its subsidiaries as guarantors, Bank of America, N.A., in its capacity as collateral and administrative agent for the Lenders, and the Lenders (as such term is defined in the Loan Agreement). | Incorporated by reference to Exhibit (10.1) to Dixie's Current Report on Form 8-K dated July 16, 2007.*     |
| (4.9)  | Fifth Amendment dated October 23, 2007, to Amended and Restated Loan and Security Agreement, by and among The Dixie Group, Inc., each of its subsidiaries as guarantors, Bank of America, N.A., in its capacity as collateral and administrative agent for the Lenders, and the Lenders (as such term is defined in the Loan Agreement).  | Incorporated by reference to Exhibit (10.1) to Dixie's Current Report on Form 8-K dated October 23, 2007.*  |
| (4.10) | Note and Security Agreement with Bank of America Leasing & Capital, LLC   | Incorporated by reference to Exhibit (99.1) to Dixie's Current Report on Form 8-K dated November 9, 2007*   |
| (4.11) | Agreement by and between Stifel, Nicolaus & Company, Inc. dated August 18, 2008, to repurchase shares of The Dixie Group, Inc.'s Common Stock   | Incorporated by reference to Exhibit (99.1) to Dixie's Current Report on Form 8-K dated August 18, 2008.    |
| (4.12) | Second Amended and Restated Loan and Security Agreement dated October 24, 2008, by and among The Dixie Group, Inc., each of its subsidiaries as guarantors, Bank of America, N.A., in its capacity as collateral and administrative agent for the Lenders, and the Lenders (as such term is defined in the Loan Agreement)  | Incorporated by reference to Exhibit 4.1 to Dixie's Current Report on Form 8-K dated October 24, 2008.      |
| (4.14) | Agreement by and between Raymond James & Associates, Inc. dated November 6, 2008, to  | Incorporated by reference to Exhibit (99.1) to Dixie's Current Report on Form 8-K dated                     |

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|--------|--|---|
|        | repurchase shares of The Dixie Group, Inc.'s<br>Common Stock   | November 6, 2008.   |
| (4.13) | First Amendment to Second Amended and<br>Restated Loan and Security Agreement dated<br>October 24, 2008, by and among The Dixie<br>Group, Inc. each of its subsidiaries as<br>guarantors, and Bank of America, N.A.<br>(successor to Fleet Capital Corporation),<br>effective January 1, 2009. | Incorporated by reference to Exhibit (4.1) to<br>Dixie's Current Report on Form 8-K dated<br>December 23, 2008. |

- |        |  |   |
|--------|--|---|
| (10.1) | Dixie Yarns, Inc. Incentive Stock Plan as amended. **  | Incorporated by reference to ANNEX A to Dixie's Proxy Statement dated March 27, 1998 for its 1998 Annual Meeting of Shareholders. * |
| (10.2) | The Dixie Group, Inc. Director's Stock Plan. **  | Incorporated by reference to Exhibit (10y) to Dixie's Annual Report on Form 10-K for the year ended December 27, 1997. *            |
| (10.3) | The Dixie Group, Inc. New Non-qualified Retirement Savings Plan effective August 1, 1999. **   | Incorporated by reference to Exhibit (10.1) to Dixie's Quarterly Report on Form 10-Q for the quarter ended June 26, 1999. *         |
| (10.4) | The Dixie Group, Inc. Deferred Compensation Plan Amended and Restated Master Trust Agreement effective as of August 1, 1999. **                | Incorporated by reference to Exhibit (10.2) to Dixie's Quarterly Report on Form 10-Q for the quarter ended June 26, 1999. *         |
| (10.5) | Stock Purchase Agreement dated as of July 1, 2000, by and among the Company and the stockholders of Fabrica International, Inc. named therein. | Incorporated by reference to Exhibit (2.1) to Dixie's Current Report on Form 8-K dated July 1, 2000. *                              |
| (10.6) | Stock Purchase Agreement dated as of July 1, 2000, by and among the Company and all of the stockholders of Chroma Technologies, Inc.           | Incorporated by reference to Exhibit (2.2) to Dixie's Current Report on Form 8-K dated July 1, 2000. *                              |
| (10.7) | The Dixie Group, Inc. Stock Incentive Plan, as amended. **   | Incorporated by reference to Annex A to Dixie's Proxy Statement dated April 5, 2002 for its 2002 Annual Meeting of Shareholders. *  |
| (10.8) | Amended and restated stock purchase agreement by and among The Dixie Group,  | Incorporated by reference to Exhibit (10.1) to Dixie's Quarterly Report on Form 10-Q for the  |



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Inc., and Scott D. Guenther, Royce R. Renfroe, and the Albert A. Frink and Denise Frink Charitable Remainder Unitrust and the Albert A. Frink Loving Trust dated September 8, 2000.

quarter ended March 31, 2001. \*

- |         |  |  |
|---------|--|--|
| (10.9)  | Form of Stock Option Agreement under The Dixie Group, Inc. Stock Incentive Plan. **  | Incorporated by reference to Exhibit (10.23) to Dixie's Annual Report on Form 10-K for the year ended December 29, 2001. * |
| (10.10) | Form of Stock Rights and Restrictions Agreement for Restricted Stock Award under The Dixie Group, Inc. Stock Incentive Plan, as amended.** | Incorporated by reference to Exhibit (10.35) to Dixie's Annual Report on Form 10-K for the year ended December 25, 2004. * |
| (10.11) | Form of Stock Option Agreement under The Dixie Group, Inc. Stock Incentive Plan for Non-Qualified Options Granted December 20, 2005.**     | Incorporated by reference to Exhibit (10.1) to Dixie's Current Report on Form 8-K dated December 20, 2005. *               |

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|---------|--|--|
| (10.12) | Employment Agreement between The Dixie Group, Inc. and David E. Polley, dated November 20, 2002.**   | Incorporated by reference to Exhibit (10.1) to Dixie's Quarterly Report on Form 10-Q for the quarter ended March 29, 2003. * |
| (10.13) | First Amendment dated January 26, 2004 to Employment Agreement between The Dixie Group, Inc. and David E. Polley, dated November 20, 2002.**   | Incorporated by reference to Exhibit (10.29) to Dixie's Annual Report on Form 10-K for the year ended December 27, 2003. *   |
| (10.14) | Second Amendment, dated January 18, 2006, to Employment Agreement dated November 20, 2002 between The Dixie Group, Inc. and David E. Polley.** | Incorporated by reference to Exhibit (10.1) to Dixie's Current Report on Form 8-K dated January 18, 2006. *                  |
| (10.15) | Third Amendment, dated January 6, 2007, to Employment Agreement dated November 20, 2002 between The Dixie Group, Inc. and David E. Polley.**   | Incorporated by reference to Exhibit (10.1) to Dixie's Current Report on Form 8-K dated January 16, 2007. *                  |
| (10.16) | Summary Description of the 2004 Annual Incentive Plan for The Dixie Group, Inc.**  | Incorporated by reference to Exhibit (10.33) to Dixie's Annual Report on Form 10-K for the year ended December 25, 2004. *   |
| (10.17) | Summary Description of the Director Compensation Arrangements for The Dixie Group, Inc.**  | Incorporated by reference to Exhibit (10.34) to Dixie's Annual Report on Form 10-K for the year ended December 25, 2004. *   |
| (10.18) | Severance Agreement and Release Between Fabrica International and Royce Renfroe effective as of May 12, 2005.**                                | Incorporated by reference to Exhibit (10.1) to Dixie's Current Report on Form 8-K dated May 12, 2005. *                      |
| (10.19) | The Dixie Group, Inc. 2006 Stock Awards Plan. **   | Incorporated by reference to Annex A to the Company's Proxy Statement for its 2006 Annual                                    |

Meeting of Shareholders, filed March 20, 2006. \*

- |         |   |   |
|---------|---|---|
| (10.20) | The 2006 Incentive Compensation Plan, approved February 23, 2006.**   | Incorporated by reference to Current Report on Form 8-K dated March 1, 2006. *                          |
| (10.21) | Material terms of the performance goals for the period 2007-2011, pursuant to which incentive compensation awards may be made to certain key executives of the Company based on the results achieved by the Company during such years, approved March 14, 2006.** | Incorporated by reference to Current Report on Form 8-K dated March 20, 2006. *                         |
| (10.22) | Form of Award of Career Shares under the 2006 Incentive Compensation Plan for Participants holding only shares of the Company's Common Stock.**   | Incorporated by reference to Exhibit (10.1) to Dixie's Current Report on Form 8-K dated June 6, 2006. * |

- |         |  |   |
|---------|--|---|
| (10.23) | Form of Award of Career Shares under the 2006 Incentive Compensation Plan for Participants holding shares of the Company's Class B Common Stock.**                     | Incorporated by reference to Exhibit (10.2) to Dixie's Current Report on Form 8-K dated June 6, 2006. *     |
| (10.24) | Form of Award of Long Term Incentive Plan Shares under the 2006 Incentive Compensation Plan for Participants holding only shares of the Company's Common Stock.**      | Incorporated by reference to Exhibit (10.3) to Dixie's Current Report on Form 8-K dated June 6, 2006. *     |
| (10.25) | Form of Award of Long Term Incentive Plan Shares under the 2006 Incentive Compensation Plan for Participants holding shares of the Company's Class B Common Stock.**   | Incorporated by reference to Exhibit (10.4) to Dixie's Current Report on Form 8-K dated June 6, 2006. *     |
| (10.26) | Award of 125,000 shares of Restricted Stock under the 2006 Stock Awards Plan to Daniel K. Frierson.**  | Incorporated by reference to Exhibit (10.1) to Dixie's Current Report on Form 8-K dated June 7, 2006. *     |
| (10.27) | Summary description of The Dixie Group, Inc. 2007 Annual Compensation Plan.**  | Incorporated by reference to Exhibit (10.1) to Dixie's Current Report on Form 8-K dated February 26, 2007.* |
| (10.28) | Rule 10b5-1 and 10b-18 Repurchase Agreement by and between The Dixie Group, Inc. and Raymond James & Associates, Inc. dated December 11, 2007*                         | Incorporated by reference to Exhibit (99.1) to Dixie's Current Report on Form 8-K dated December 11, 2007*  |
| (10.29) | Merger agreement between The Dixie Group, Inc. and Unite Here National Retirement Fund regarding the Company's Masland Bargaining Unit Defined Benefit Pension Plan.** | Incorporated by reference to Exhibit (99.1) to Dixie's Current Report on Form 8-K dated December 28, 2007*  |
| (10.30) | Summary description of The Dixie Group, Inc. 2008 Annual Incentive Plan  | Incorporated by reference to Exhibit 10.1 to Dixie's Current Report on Form 8-K dated February 15, 2008*    |
| (14)    | Code of Ethics.  |   |

Incorporated by reference to Exhibit (14) to  
Dixie's Annual Report on Form 10-K for the year  
ended December 27, 2003. \*

- |        |   |                 |
|--------|---|-----------------|
| (21)   | Subsidiaries of the Registrant.                                       | Filed herewith. |
| (23)   | Consent of Independent Registered Public Accounting Firm.             | Filed herewith. |
| (31.1) | CEO Certification pursuant to Securities Exchange Act Rule 13a-14(a). | Filed herewith. |
| (31.2) | CFO Certification pursuant to Securities Exchange Act Rule 13a-14(a). | Filed herewith. |

- |        |   |                 |
|--------|---|-----------------|
| (32.1) | CEO Certification pursuant to Securities Exchange Act Rule 13a-14(b). | Filed herewith. |
| (32.2) | CFO Certification pursuant to Securities Exchange Act Rule 13a-14(b). | Filed herewith. |

\* Commission File No. 0-2585.

\*\* Indicates a management contract or compensatory plan or arrangement.

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