

MORGANS FOODS INC  
Form 10-Q  
September 28, 2005

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**SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549  
FORM 10-Q  
QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15 (d)  
OF THE SECURITIES EXCHANGE ACT OF 1934**

**For the period ended August 14, 2005**

**Commission file number 1-08395**

**Morgan s Foods, Inc.**

(Exact name of registrant as specified in its charter)

Ohio

34-0562210

(State or other jurisdiction of  
incorporation or organization)

(I.R.S. Employer  
Identification Number)

24200 Chagrin Boulevard, Suite 126, Beachwood,  
Ohio

44122

(Address of principal executive offices)

(Zip Code)

Registrant s telephone number, including area code: (216) 360-7500

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

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

Yes  No

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Act).

Yes  No

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

As of September 23, 2005, the issuer had 2,718,495 shares of common stock outstanding.

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**Morgan s Foods, Inc.**  
**CONSOLIDATED STATEMENTS OF OPERATIONS**  
(unaudited)

	<b>Quarter Ended</b>	
	<b>August 14, 2005</b>	<b>August 15, 2004</b>
<b>Revenues</b>	<b>\$21,558,000</b>	<b>\$ 19,791,000</b>
<b>Cost of sales:</b>		
<b>Food, paper and beverage</b>	<b>6,621,000</b>	<b>6,303,000</b>
<b>Labor and benefits</b>	<b>5,511,000</b>	<b>5,359,000</b>
<b>Restaurant operating expenses</b>	<b>5,451,000</b>	<b>5,109,000</b>
<b>Depreciation and amortization</b>	<b>762,000</b>	<b>777,000</b>
<b>General and administrative expenses</b>	<b>1,316,000</b>	<b>1,122,000</b>
<b>(Gain) loss on restaurant assets</b>	<b>(142,000)</b>	<b>22,000</b>
<b>Operating income</b>	<b>2,039,000</b>	<b>1,099,000</b>
<b>Interest Expense:</b>		
<b>Bank debt and notes payable</b>	<b>(946,000)</b>	<b>(1,010,000)</b>
<b>Capital leases</b>	<b>(20,000)</b>	<b>(11,000)</b>
<b>Other income and expense, net</b>	<b>13,000</b>	<b>22,000</b>
<b>Income before income taxes</b>	<b>1,086,000</b>	<b>100,000</b>
<b>Provision for income taxes</b>	<b>2,000</b>	<b>1,000</b>
<b>Net income</b>	<b>\$ 1,084,000</b>	<b>\$ 99,000</b>
<b>Basic and diluted net income per common share</b>	<b>\$ .40</b>	<b>\$ .04</b>
<b>Basic weighted average number of shares outstanding</b>	<b>2,718,495</b>	<b>2,718,441</b>
<b>Diluted weighted average number of shares outstanding</b>	<b>2,725,865</b>	<b>2,722,928</b>

See notes to consolidated financial statements.

Table of Contents**PART I FINANCIAL INFORMATION****Item 1. Financial Statements.**

**Morgan s Foods, Inc.**  
**CONSOLIDATED STATEMENTS OF OPERATIONS**  
(unaudited)

	<b>Twenty-Four Weeks Ended</b>	
	<b>August 14, 2005</b>	<b>August 15, 2004</b>
<b>Revenues</b>	<b>\$42,318,000</b>	<b>\$ 38,134,000</b>
<b>Cost of sales:</b>		
<b>Food, paper and beverage</b>	<b>13,042,000</b>	<b>11,875,000</b>
<b>Labor and benefits</b>	<b>10,855,000</b>	<b>10,839,000</b>
<b>Restaurant operating expenses</b>	<b>10,566,000</b>	<b>9,891,000</b>
<b>Depreciation and amortization</b>	<b>1,512,000</b>	<b>1,560,000</b>
<b>General and administrative expenses</b>	<b>2,467,000</b>	<b>2,395,000</b>
<b>(Gain) loss on restaurant assets</b>	<b>(397,000)</b>	<b>292,000</b>
<b>Operating income</b>	<b>4,273,000</b>	<b>1,282,000</b>
<b>Interest Expense:</b>		
<b>Bank debt and notes payable</b>	<b>(1,941,000)</b>	<b>(2,046,000)</b>
<b>Capital leases</b>	<b>(31,000)</b>	<b>(22,000)</b>
<b>Other income and expense, net</b>	<b>42,000</b>	<b>39,000</b>
<b>Income (loss) before income taxes</b>	<b>2,343,000</b>	<b>(747,000)</b>
<b>Provision for income taxes</b>	<b>2,000</b>	<b>1,000</b>
<b>Net income (loss)</b>	<b>\$ 2,341,000</b>	<b>\$ (748,000)</b>
<b>Basic and diluted net income (loss) per common share</b>	<b>\$ .86</b>	<b>\$ (.28)</b>
<b>Basic weighted average number of shares outstanding</b>	<b>2,718,495</b>	<b>2,718,441</b>
<b>Diluted weighted average number of shares outstanding</b>	<b>2,724,505</b>	<b>2,718,441</b>

See notes to consolidated financial statements.

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**Morgan s Foods, Inc.**  
**CONSOLIDATED BALANCE SHEETS**  
**(unaudited)**

	August 14, 2005	February 27, 2005
<b>ASSETS</b>		
<b>Current assets:</b>		
Cash and equivalents	\$ 6,420,000	\$ 3,654,000
Receivables	288,000	392,000
Inventories	642,000	588,000
Prepaid expenses	356,000	589,000
	7,706,000	5,223,000
<b>Property and equipment:</b>		
Land	10,462,000	10,662,000
Buildings and improvements	19,415,000	19,423,000
Property under capital leases	1,298,000	435,000
Leasehold improvements	7,343,000	7,210,000
Equipment, furniture and fixtures	19,761,000	19,428,000
Construction in progress	50,000	189,000
	58,329,000	57,347,000
Less accumulated depreciation and amortization	27,106,000	25,740,000
	31,223,000	31,607,000
<b>Other assets</b>		
Franchise agreements	986,000	1,040,000
Goodwill	1,623,000	1,693,000
	9,227,000	9,227,000
	\$ 50,765,000	\$ 48,790,000
<b>LIABILITIES AND SHAREHOLDERS DEFICIENCY</b>		
<b>Current liabilities:</b>		
Current maturities of long-term debt	\$ 3,134,000	\$ 43,682,000
Current maturities of capital lease obligations	23,000	13,000
Accounts payable	4,193,000	4,034,000
Accrued liabilities	4,074,000	3,542,000
	11,424,000	51,271,000
Long-term debt	38,899,000	
Long-term capital lease obligations	1,212,000	368,000
Other long-term liabilities	1,463,000	1,725,000
<b>SHAREHOLDERS DEFICIENCY</b>		
Preferred shares, 1,000,000 shares authorized, no shares outstanding		
Common Stock		

<b>Authorized shares</b>	<b>25,000,000</b>		
<b>Issued shares</b>	<b>2,969,405</b>	<b>30,000</b>	<b>30,000</b>
<b>Treasury stock</b>	<b>250,910</b>	<b>(284,000)</b>	<b>(284,000)</b>
<b>Capital in excess of stated value</b>		<b>28,829,000</b>	<b>28,829,000</b>
<b>Accumulated deficit</b>		<b>(30,808,000)</b>	<b>(33,149,000)</b>
<b>Total shareholders' deficiency</b>		<b>(2,233,000)</b>	<b>(4,574,000)</b>
		<b>\$ 50,765,000</b>	<b>\$ 48,790,000</b>

See notes to consolidated financial statements.

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**Morgan s Foods, Inc.**  
**CONSOLIDATED STATEMENT OF SHAREHOLDERS DEFICIENCY**  
**(unaudited)**

	<b>Common Shares</b>		<b>Treasury Shares</b>		<b>Capital in</b>	<b>Accumulated</b>	<b>Total</b>
	<b>Shares</b>	<b>Amount</b>	<b>Shares</b>	<b>Amount</b>	<b>excess of</b>	<b>Deficit</b>	<b>Shareholders</b>
					<b>stated value</b>		<b>Deficiency</b>
Balance February 27, 2005	2,969,405	\$ 30,000	(250,910)	\$ (284,000)	\$ 28,829,000	\$ (33,149,000)	\$ (4,574,000)
Net income						2,341,000	2,341,000
Balance August 14, 2005	2,969,405	\$ 30,000	250,910	\$ (284,000)	\$ 28,829,000	\$ (30,808,000)	\$ (2,233,000)

**See notes to consolidated financial statements**

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**Morgan s Foods, Inc.**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**  
**(unaudited)**

	Twenty-Four Weeks Ended	
	August 14, 2005	August 15, 2004
<b>Cash flows from operating activities:</b>		
Net income (loss)	\$ 2,341,000	\$ (748,000)
<b>Adjustments to reconcile to net cash provided by operating activities:</b>		
Depreciation and amortization	1,512,000	1,560,000
Amortization of deferred financing costs	54,000	57,000
Amortization of supply agreement advances	(327,000)	(365,000)
Funding from supply agreements	52,000	63,000
(Gain) loss on restaurant assets	(397,000)	292,000
<b>Change in assets and liabilities:</b>		
Decrease in receivables	104,000	9,000
Increase in inventories	(54,000)	(126,000)
Decrease (increase) in prepaid expenses	233,000	(286,000)
Decrease in other assets		25,000
Increase in accounts payable	159,000	710,000
Increase in accrued liabilities	241,000	196,000
<b>Net cash provided by operating activities</b>	<b>3,918,000</b>	<b>1,387,000</b>
<b>Cash flows from investing activities:</b>		
Capital expenditures	(811,000)	(492,000)
Purchase of franchise agreement		(25,000)
Insurance Proceeds	405,000	
Redemption of certificate of deposit		300,000
<b>Net cash used in investing activities</b>	<b>(406,000)</b>	<b>(217,000)</b>
<b>Cash flows from financing activities:</b>		
Principal payments on long-term debt	(1,649,000)	(1,470,000)
Principal payments on capital lease obligations	(9,000)	(33,000)
Proceeds from sale leaseback	912,000	-
Proceeds from issuance of long-term debt, net of financing costs		29,000
<b>Net cash used in financing activities</b>	<b>(746,000)</b>	<b>(1,474,000)</b>
<b>Net change in cash and equivalents</b>	<b>2,766,000</b>	<b>(304,000)</b>
Cash and equivalents, beginning balance	3,654,000	4,353,000
<b>Cash and equivalents, ending balance</b>	<b>\$ 6,420,000</b>	<b>\$ 4,049,000</b>

See notes to consolidated financial statements.

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**Morgan s Foods, Inc.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**QUARTERS ENDED AUGUST 14, 2005 AND AUGUST 15, 2004**  
**(unaudited)**

**Note 1. Summary of Significant Accounting Policies.**

The interim consolidated financial statements of Morgan s Foods, Inc. ( the Company ) have been prepared without audit. In the opinion of Company Management, all adjustments have been included. Unless otherwise disclosed, all adjustments consist only of normal recurring adjustments necessary for a fair statement of results of operations for the interim periods. These unaudited financial statements have been prepared using the same accounting principles that were used in preparation of the Company s annual report on Form 10-K for the year ended February 27, 2005.

**Note 2. Income (Loss) Per Common Share.**

Basic net income (loss) per common share is computed by dividing net income by the weighted average number of common shares outstanding during the period. Diluted net income (loss) per common share is based on the combined weighted average number of shares outstanding, which includes the assumed exercise, or conversion of options. In computing diluted net income (loss) per common share, the Company has utilized the treasury stock method. For the quarter and twenty-four weeks ended August 14, 2005 and the quarter ended August 15, 2004, 275,000 shares were excluded from the computation of diluted earnings per share due to their antidilutive effect. For the twenty-four weeks ended August 15, 2004, 286,500 shares were excluded from the computation of diluted earnings per share due to their antidilutive effect.

**Note 3. (Gain) Loss on Restaurant Assets.**

The Company experienced a gain on restaurant assets of \$142,000 for the second quarter of fiscal 2006 compared to a loss of \$22,000 for the second quarter of fiscal 2005. The 2006 amount is primarily due to the receipt of \$144,000 of property damage and business interruption insurance proceeds. The second quarter fiscal 2005 amount includes an impairment loss of \$21,000 on one restaurant. The Company experienced a gain on restaurant assets of \$397,000 for the first twenty-four weeks of fiscal 2006 compared to a loss of \$292,000 for the first twenty-four weeks of fiscal 2005. The 2006 amount is primarily due to the receipt of \$405,000 of property damage and business interruption insurance proceeds. The insurance proceeds recognized in fiscal 2006 relate to restaurants damaged from the Hurricane Ivan storm system and one fire-damaged restaurant. Insurance proceeds which will result in a gain are recognized in the financial statements only when such gains are realized which is generally upon receipt of the proceeds. The 2005 loss on restaurant assets includes impairment losses of \$287,000 on four restaurants to reduce their carrying values to their estimated fair values. The impairment losses recorded in all periods presented were recognized as a result of management determining that the future operating cash flows of these restaurants would not fully recover the carrying value of the property and equipment.

**Table of Contents****Note 4. Long-Term Debt.**

The Company's debt arrangements require the maintenance of a consolidated fixed charge coverage ratio of 1.2 to 1 regarding all of its mortgage loans and individual restaurant coverage ratios between 1.2 and 1.5 to 1 on certain of its loans. The fixed charge coverage ratios are computed quarterly based upon financial results for the preceding twelve months. At the end of fiscal 2005 the Company was not in compliance with the consolidated ratio or with the individual restaurant ratios relating to a substantial portion of its debt and waivers of the fixed charge coverage ratio violations were not obtained from the lenders. Due to noncompliance with the fixed charge coverage ratios and as required by Emerging Issues Task Force No. 86-30, the Company classified all of its debt as current as of February 27, 2005. As of August 14, 2005, the Company was in compliance with the consolidated ratio of 1.2 to 1 on all of its debt but was not in compliance with the unit level ratios relating to \$12,929,000 of its debt. The Company has obtained waivers of the violations from the applicable lenders as of August 14, 2005, in which the lenders agree to forebear exercising their rights and remedies through the following twelve months. Based on projected operating results, the Company believes that it will comply with the terms of the waivers throughout the forbearance period and accordingly has classified its debt as long-term as of August 14, 2005. Based upon financial results for the twenty-four weeks ended August 14, 2005 management anticipates that the Company will continue to achieve the required consolidated fixed charge coverage ratio of 1.2 to 1 regarding all of its mortgage loans but may not achieve the individual restaurant coverage ratios between 1.2 to 1 and 1.5 to 1 on certain of its loans for the fiscal year ending February 26, 2006. If the Company does not comply with debt covenants in the future, and if future waivers are not obtained, the lenders will have certain remedies available to them which could include calling of the debt or acceleration of payments. Noncompliance with the requirements of the Company's mortgage debt, if not waived, could also trigger cross-default provisions of other debt agreements.

**Financial Restructuring.** Beginning in the second half of fiscal 2005, the Company engaged in discussions with its three primary lenders with the intent of securing short-term, temporary reductions in its debt service payments to conserve cash and to allow the Company to execute sale/leaseback financing which in order to be financially viable would require mortgage debt prepayment penalties to be waived on a number of its owned restaurant properties. On February 7, 2005, the Company reduced its debt service payments to interest only on loans with one lender representing approximately 50% of the principal balance of all of the Company's loans. The Company expected to continue this reduced payment schedule until the financial restructuring was completed. The Company had received a letter of understanding from this lender, acknowledging the financial restructuring and confirming its intent to negotiate a formal agreement of forbearance. During the second quarter of fiscal 2006, primarily as a result of the Company's substantially improved financial performance, the Company and its lender determined that the financial restructuring was no longer necessary and the forbearance agreement was not executed. As a result the Company paid past due principal payments of \$666,000, associated late fees of \$74,000 and legal fees of \$37,000 in order to cure its event of default with this lender. On June 13, 2005 a sale/leaseback transaction for one of its 2n1 restaurants that was unencumbered by debt was completed and the Company received net proceeds of \$912,000 on this transaction.

**Note 5. Lease Obligations and Other Commitments.**

During the second quarter of fiscal 2006, the Company completed a sale leaseback transaction for the land and building of one of its 2n1 restaurants. The Company recorded a deferred gain of \$359,000 which it will realize over the 20 year lease term. Lease commitments for this transaction are included in the capital lease obligations.

**Table of Contents****Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations.**

**Description of Business.** Morgan's Foods, Inc. operates through wholly-owned subsidiaries KFC restaurants under franchises from KFC Corporation and Taco Bell restaurants under franchises from Taco Bell Corporation. As of September 23, 2005, the Company operates 72 KFC restaurants, 7 Taco Bell restaurants, 14 KFC/Taco Bell restaurants under franchises from KFC Corporation and franchises or licenses from Taco Bell Corporation, 3 Taco Bell/Pizza Hut Express restaurants operated under franchisees from Taco Bell Corporation and licenses from Pizza Hut Corporation, 1 KFC/Pizza Hut Express restaurant operated under a franchise from KFC Corporation and a license from Pizza Hut Corporation and 1 KFC/A&W restaurant operated under a franchise from KFC Corporation and a license from A&W Restaurants, Inc. The Company's fiscal year is a 52-53 week year ending on the Sunday nearest the last day of February.

**Summary of Expenses and Operating Income as a Percentage of Revenues**

	Quarter Ended		Twenty-Four Weeks Ended	
	Aug. 14, 2005	Aug. 15, 2004	Aug. 14, 2005	Aug. 15, 2004
Cost of sales:				
Food, paper and beverage	30.7%	31.9%	30.8%	31.1%
Labor and benefits	25.6%	27.1%	25.7%	28.4%
Restaurant operating expenses	25.3%	25.8%	25.0%	25.9%
Depreciation and amortization	3.5%	3.9%	3.6%	4.1%
General and administrative expenses	6.1%	5.7%	5.8%	6.3%
Operating income	9.5%	5.6%	10.1%	3.4%

**Revenues.** Revenues for the quarter ended August 14, 2005 were \$21,558,000 compared to \$19,791,000 for the quarter ended August 15, 2004. This increase of \$1,767,000 was due mainly to a 10.3% increase in comparable restaurant revenues which was partially offset by \$253,000 in revenues lost due to the closing of three restaurants. The increase in comparable restaurant revenues was primarily the result of more effective product promotions by the franchisors during the current year quarter including the \$.99 KFC snacker sandwich. Revenues for the twenty-four weeks ended August 14, 2005 were \$42,318,000 compared to \$38,134,000 for the twenty-four weeks ended August 15, 2004. This increase was primarily due to a 12.8% increase in comparable restaurant revenues which was partially offset by \$538,000 in revenues lost due to the closing of three restaurants. The increase in comparable restaurant revenues for the twenty-four weeks was primarily the result of the reasons discussed above.

**Costs of Sales – Food, Paper and Beverages.** Food, paper and beverage costs for the second quarter decreased as a percentage of revenue from 31.9% in fiscal 2005 to 30.7% in fiscal 2006. This decrease was primarily the result of efficiencies generated from higher average restaurant volumes. Food, paper and beverage costs for the twenty-four weeks ended August 14, 2005 decreased to 30.8% of revenue compared to 31.1% in the year earlier period for the reason discussed above.

**Cost of Sales – Labor and Benefits.** Labor and benefits decreased as a percentage of revenue for the quarter ended August 14, 2005 to 25.6% compared to 27.1% for the year earlier quarter. The decrease was primarily due to lower workers' compensation and healthcare costs as well as efficiencies generated from higher average restaurant volumes. Labor and benefits for the twenty-four weeks ended August 14, 2005 decreased as a percentage of revenue to 25.7% from 28.4% in the year earlier period for the reasons discussed above.

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**Restaurant Operating Expenses.** Restaurant operating expenses decreased as a percentage of revenue to 25.3% in the second quarter of fiscal 2006 compared to 25.8% in the second quarter of fiscal 2005 primarily as a result of efficiencies generated from higher average restaurant volumes which were partially offset by increased restaurant management bonus expense resulting from the Company's substantially improved performance. Restaurant operating expenses for the twenty-four weeks ended August 14, 2005 decreased to 25.0% of revenue compared to 25.9% in the prior year period for the reasons discussed above.

**Depreciation and Amortization.** Depreciation and amortization was substantially unchanged at \$762,000 and \$777,000 for the second quarters of 2006 and 2005, respectively. Depreciation and amortization was substantially unchanged at \$1,512,000 and \$1,560,000 for the twenty-four weeks ended August 14, 2005 and August 15, 2004, respectively.

**General and Administrative Expenses.** General and administrative expenses increased to \$1,316,000 in the second quarter of fiscal 2006 from \$1,122,000 in the second quarter of fiscal 2005 due to increases in legal and professional expenses of \$234,000 associated with the attempted financial restructuring which were partially offset as a result of three senior officers of the Company reducing their salaries and other benefits to near zero while the remainder of the Company's executive team and some of its management took pay cuts during the fourth quarter of fiscal 2005 which continued into the second quarter of fiscal 2006. General and administrative expenses increased to \$2,467,000 for the twenty-four weeks ended August 14, 2005 from \$2,395,000 for the twenty-four weeks ended August 15, 2004 primarily for the reasons discussed above.

**(Gain) Loss on Restaurant Assets.** The Company experienced a gain on restaurant assets of \$142,000 for the second quarter of fiscal 2006 compared to a loss of \$22,000 for the second quarter of fiscal 2005. The 2006 amount is primarily due to the receipt of \$144,000 of property damage and business interruption insurance proceeds. The second quarter fiscal 2005 amount includes an impairment loss of \$21,000 on one restaurant. The Company experienced a gain on restaurant assets of \$397,000 for the first twenty-four weeks of fiscal 2006 compared to a loss of \$292,000 for the first twenty-four weeks of fiscal 2005. The 2006 amount is primarily due to the receipt of \$405,000 of property damage and business interruption insurance proceeds. The insurance proceeds recognized in fiscal 2006 relate to restaurants damaged from the Hurricane Ivan storm system and one fire-damaged restaurant. Insurance proceeds which will result in a gain are recognized in the financial statements only when such gains are realized which is generally upon receipt of the proceeds. The 2005 loss on restaurant assets includes impairment losses of \$287,000 on four restaurants to reduce their carrying values to their estimated fair values. The impairment losses recorded in all periods presented were recognized as a result of management determining that the future operating cash flows of these restaurants would not fully recover the carrying value of the property and equipment.

**Operating Income.** Operating income in the second quarter of fiscal 2006 increased to \$2,039,000 or 9.5% of revenues compared to \$1,099,000 or 5.6% of revenues for the second quarter of fiscal 2005 primarily as a result of efficiencies resulting from higher average restaurant volumes and the receipt of the property insurance proceeds discussed above. Operating income for the twenty-four weeks ended August 14, 2005 increased to \$4,273,000 or 10.1% of revenues compared to \$1,282,000 or 3.4% of revenues for the year earlier period for the reasons discussed above.

**Interest Expense.** Interest expense on bank debt decreased to \$946,000 in the second quarter of fiscal 2006 from \$1,010,000 in the second quarter of fiscal 2005 due to lower debt balances during the fiscal 2006 quarter.

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Interest expense on bank debt for the twenty-four weeks ended August 14, 2005 decreased to \$1,941,000 from \$2,046,000 for the year earlier period for the reason discussed above. Interest expense on capitalized leases increased to \$20,000 in the second quarter of fiscal 2006 from \$11,000 in the second quarter of fiscal 2005. Interest expense on capitalized leases increased to \$31,000 for the twenty-four weeks ended August 14, 2005 from \$22,000 for the year earlier period. The increases in both the quarter and twenty-four weeks were a result of the Company completing a sale/leaseback transaction for one of its restaurants.

**Other Income.** Other income was substantially unchanged relative to the comparable periods in fiscal 2005 at \$13,000 for the second quarter and \$42,000 for the first twenty-four weeks of fiscal 2006.

**Provision for Income Taxes.** The provision for income taxes was substantially unchanged in the second quarter and first twenty-four weeks of fiscal 2006 compared to the comparable periods in fiscal 2005. The low effective tax rate results from tax net operating loss carryforwards.

**Liquidity and Capital Resources.** Cash flow activity for the first twenty-four weeks of fiscal 2006 and fiscal 2005 is presented in the Consolidated Statements of Cash Flows. Cash provided by operating activities was \$3,918,000 for the twenty-four weeks ended August 14, 2005 compared to \$1,387,000 for the twenty-four weeks ended August 15, 2004. The improvement in operating cash flow resulted principally from the improved profitability of the Company in fiscal 2006. The Company paid scheduled long-term bank and capitalized lease debt of \$1,658,000 in the first twenty-four weeks of fiscal 2006 compared to payments of \$1,503,000 for the same period in fiscal 2005. Capital expenditures in the twenty-four weeks ended August 14, 2005 were \$811,000, compared to \$492,000 for the same period in fiscal 2005.

The Company's debt arrangements require the maintenance of a consolidated fixed charge coverage ratio of 1.2 to 1 regarding all of its mortgage loans and individual restaurant coverage ratios between 1.2 and 1.5 to 1 on certain of its loans. The fixed charge coverage ratios are computed quarterly based upon financial results for the preceding twelve months. At the end of fiscal 2005 the Company was not in compliance with the consolidated ratio or with the individual restaurant ratios relating to a substantial portion of its debt and waivers of the fixed charge coverage ratio violations were not obtained from the lenders. Due to noncompliance with the fixed charge coverage ratios and as required by Emerging Issues Task Force No. 86-30, the Company classified all of its debt as current as of February 27, 2005. As of August 14, 2005, the Company was in compliance with the consolidated ratio of 1.2 to 1 on all of its debt but was not in compliance with the unit level ratios relating to \$12,929,000 of its debt. The Company has obtained waivers of the violations from the applicable lenders as of August 14, 2005, in which the lenders agree to forebear exercising their rights and remedies through the following twelve months. Based on projected operating results, the Company believes that it will comply with the terms of the waivers throughout the forbearance period and accordingly has classified its debt as long-term as of August 14, 2005. Based upon financial results for the twenty-four weeks ended August 14, 2005 management anticipates that the Company will continue to achieve the required consolidated fixed charge coverage ratio of 1.2 to 1 regarding all of its mortgage loans but may not achieve the individual restaurant coverage ratios between 1.2 to 1 and 1.5 to 1 on certain of its loans for the fiscal year ending February 26, 2006. If the Company does not comply with debt covenants in the future, and if future waivers are not obtained, the lenders will have certain remedies available to them which could include calling of the debt or acceleration of payments. Noncompliance with the requirements of the Company's mortgage debt, if not waived, could also trigger cross-default provisions of other debt agreements.

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**Financial Restructuring.** Beginning in the second half of fiscal 2005, the Company engaged in discussions with its three primary lenders with the intent of securing short-term, temporary reductions in its debt service payments to conserve cash and to allow the Company to execute sale/leaseback financing which in order to be financially viable would require mortgage debt prepayment penalties to be waived on a number of its owned restaurant properties. On February 7, 2005, the Company reduced its debt service payments to interest only on loans with one lender representing approximately 50% of the principal balance of all of the Company's loans. The Company expected to continue this reduced payment schedule until the financial restructuring was completed. The Company had received a letter of understanding from this lender, acknowledging the financial restructuring and confirming its intent to negotiate a formal agreement of forbearance. During the second quarter of fiscal 2006, primarily as a result of the Company's substantially improved financial performance, the Company and its lender determined that the financial restructuring was no longer necessary and the forbearance agreement was not executed. As a result the Company agreed to pay past due principal payments of \$666,000 associated late fees of \$74,000 and legal fees of \$37,000 in order to cure its event of default with this lender. On June 13, 2005 a sale/leaseback transaction for one of its 2n1 restaurants that was unencumbered by debt was completed and the Company received net proceeds of \$912,000 on this transaction.

The Company's existing borrowings are at fixed interest rates, and accordingly the Company does not have market risk exposure for fluctuations in interest rates. The Company does not enter into derivative financial investments for trading or speculation purposes. As a result, the Company believes that its market risk exposure is not material to the Company's financial position, liquidity or results of operations.

**Contractual Obligations and Commitments.** During the second quarter of fiscal 2006, the Company completed a sale/leaseback transaction for the land and building of one of its 2n1 restaurants. The Company recorded a deferred gain of \$359,000 which it will realize over the 20 year lease term. Lease commitments for this transaction are included in the capital lease obligations.

**Seasonality.** The operations of the Company are affected by seasonal fluctuations. Historically, the Company's revenues and income have been highest during the summer months with the fourth fiscal quarter representing the slowest period. This seasonality is primarily attributable to weather conditions in the Company's marketplace, which consists of portions of Ohio, Pennsylvania, Missouri, Illinois, West Virginia and New York.

**Safe Harbor Statements.** This document contains 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. The statements include those identified by such words as may, will, expect, anticipate, believe, plan and other similar terminology. The forward-looking statements reflect the Company's current expectations and are based upon data available at the time of the statements. Actual results involve risks and uncertainties, including both those specific to the Company and general economic and industry factors. Factors specific to the Company include, but are not limited to, its debt covenant compliance and its ability to obtain waivers of any debt covenant violations.

Economic and industry risks and uncertainties include, but are not limited to, franchisor promotions, business and economic conditions, legislation and governmental regulation, competition, success of operating initiatives and advertising and promotional efforts, volatility of commodity costs and increases in minimum wage and other operating costs, availability and cost of land and construction, consumer preferences, spending patterns and demographic trends.

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**Item 3. Quantitative and Qualitative Disclosures About Market Risk.**

Information required by this item is included under Liquidity and Capital Resources .

**Item 4. Controls and Procedures.**

Management is responsible for the preparation, integrity and objectivity of the consolidated financial statements and other information presented in this report. The financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America and reflect certain estimates and adjustments by management. In preparing financial statements in conformity with accounting principles generally accepted in the United States of America, we must make a variety of decisions that affect the reported amounts and the related disclosures. Such decisions include the selection of accounting principles that reflect the economic substance of the underlying transactions and the assumptions on which to base accounting estimates. In reaching such decisions, we apply judgment based on our understanding and analysis of the relevant circumstances, including our historical experience, actuarial studies and other assumptions. We re-evaluate our estimates and assumptions on an ongoing basis. While actual results could, in fact, differ from those estimated at the time of preparation of the financial statements, we are committed to preparing financial statements incorporating accounting principles, assumptions and estimates that promote the representational faithfulness, verifiability, neutrality and transparency of the accounting information included in the financial statements.

We maintain a system of internal accounting controls and procedures, which we believe provide reasonable assurance that transactions are properly recorded and that assets are protected from loss or unauthorized use.

We maintain a system of disclosure controls and procedures to ensure timely collection and evaluation of information subject to disclosure, to ensure the selection of appropriate accounting policies, and to ensure compliance with our accounting policies and procedures. Our disclosure control systems and procedures include the certification of financial information provided from each of our key management personnel.

The integrity of our disclosure control systems are based on written policies and procedures, the careful selection and training of qualified financial personnel and direct management review. Our disclosure control committee meets periodically to review our systems and procedures and to review our financial statements and related disclosures.

Our independent auditors have direct and private access to the Audit Committee.

The effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rule 13a-14(c) under the Securities Exchange Act of 1934) was evaluated as of the date of the financial statements. This evaluation was carried out under the supervision of and with the participation of management, including the Chief Executive Officer and the Chief Financial Officer. Based upon that evaluation, the Chief Executive Officer and the Chief Financial Officer concluded that the design and operation of these disclosure controls and procedures are effective. There were no significant changes in internal controls or in other factors that could significantly affect these controls subsequent to the date of the most recent evaluation.



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**MORGAN S FOODS, INC.  
INDEX TO EXHIBITS**

Exhibit Number	Exhibit Description
31.1	Certification of the Chairman and Chief Executive Officer pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2	Certification of the Senior Vice President, Chief Financial Officer & Secretary pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.1	Certification of the Chairman of the Board and Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
32.2	Certification of the Senior Vice President, Chief Financial Officer and Secretary pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

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SIGNATURES

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

Morgan s Foods, Inc.

(Registrant)

Dated: September 28, 2005

By: /s/ Kenneth L. Hignett

Kenneth L. Hignett  
Senior Vice President,  
Chief Financial Officer & Secretary