

MORGANS FOODS INC  
Form 10-Q  
September 30, 2009

**Table of Contents**

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, DC 20549  
FORM 10-Q**

(Mark One)

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

**For the quarterly period ended August 16, 2009**

**or**

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

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

**Commission File Number 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 No.)

4829 Galaxy Parkway, Suite S, Cleveland, Ohio

44128

(Address of principal executive offices)

(Zip Code)

(216) 359-9000

(Registrant s telephone number, including area code)

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 has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

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 the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer  Accelerated filer  Non-accelerated filer  Smaller reporting company

(Do not check if a smaller reporting company)

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 28, 2009, the issuer had 2,934,995 shares of common stock outstanding.



**TABLE OF CONTENTS**

**PART I FINANCIAL INFORMATION**

Item 1. Financial Statements

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

Item 3. Quantitative and Qualitative Disclosures About Market Risk

Item 4. Controls and Procedures

**PART II OTHER INFORMATION**

Item 1. Legal Proceedings

Item 1A. Risk Factors

Item 2. Unregistered Sale of Equity Securities and Use of Proceeds

Item 3. Defaults Upon Senior Securities

Item 4. Submission of Matters to a Vote of Security Holders

Item 5. Other Information

Item 6. Exhibits

**SIGNATURES**

**INDEX TO EXHIBITS**

EX-31.1

EX-31.2

EX-32.1

EX-32.2

---

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

MORGAN S FOODS, INC.  
CONSOLIDATED STATEMENTS OF OPERATIONS  
(UNAUDITED)

|   | <b>Quarter Ended</b>   |                        |
|---|------------------------|------------------------|
|   | <b>August 16, 2009</b> | <b>August 17, 2008</b> |
| Revenues  | \$23,202,000           | \$23,049,000           |
| Cost of sales:  |                        |                        |
| Food, paper and beverage                              | 7,356,000              | 7,506,000              |
| Labor and benefits                                    | 6,405,000              | 6,557,000              |
| Restaurant operating expenses                         | 6,004,000              | 6,041,000              |
| Depreciation and amortization                         | 711,000                | 791,000                |
| General and administrative expenses                   | 1,437,000              | 1,364,000              |
| Loss (gain) on restaurant assets                      | 15,000                 | (9,000)                |
| Operating income                                      | 1,274,000              | 799,000                |
| Interest expense:                                     |                        |                        |
| Prepayment and deferred financing costs               | 82,000                 | 428,000                |
| Bank debt and notes payable                           | 591,000                | 734,000                |
| Capital leases  | 25,000                 | 27,000                 |
| Other income and expense, net                         | (43,000)               | (79,000)               |
| Income (loss) before income taxes                     | 619,000                | (311,000)              |
| Provision for income taxes                            | 299,000                | 330,000                |
| Net income (loss)                                     | \$ 320,000             | \$ (641,000)           |
| Basic net income (loss) per common share:             | \$ 0.11                | \$ (0.22)              |
| Diluted net income (loss) per common share:           | \$ 0.11                | \$ (0.22)              |
| Basic weighted average number of shares outstanding   | 2,934,995              | 2,934,995              |
| Diluted weighted average number of shares outstanding | 2,990,361              | 2,944,450              |

See notes to these consolidated financial statements.

**Table of Contents**

MORGAN S FOODS, INC.  
CONSOLIDATED STATEMENTS OF OPERATIONS  
(UNAUDITED)

|   | <b>Twenty-four Weeks Ended</b> |                        |
|---|--------------------------------|------------------------|
|   | <b>August 16, 2009</b>         | <b>August 17, 2008</b> |
| Revenues  | \$46,133,000                   | \$44,802,000           |
| Cost of sales:  |                                |                        |
| Food, paper and beverage                              | 14,766,000                     | 14,470,000             |
| Labor and benefits                                    | 12,833,000                     | 12,795,000             |
| Restaurant operating expenses                         | 11,880,000                     | 11,528,000             |
| Depreciation and amortization                         | 1,428,000                      | 1,564,000              |
| General and administrative expenses                   | 2,846,000                      | 2,714,000              |
| Loss (gain) on restaurant assets                      | 21,000                         | (4,000)                |
| Operating income                                      | 2,359,000                      | 1,735,000              |
| Interest expense:                                     |                                |                        |
| Prepayment and deferred financing costs               | 82,000                         | 428,000                |
| Bank debt and notes payable                           | 1,216,000                      | 1,558,000              |
| Capital leases  | 50,000                         | 53,000                 |
| Other income and expense, net                         | (87,000)                       | (169,000)              |
| Income (loss) before income taxes                     | 1,098,000                      | (135,000)              |
| Provision for income taxes                            | 424,000                        | 412,000                |
| Net income (loss)                                     | \$ 674,000                     | \$ (547,000)           |
| Basic net income (loss) per common share:             | \$ 0.23                        | \$ (0.19)              |
| Diluted net income (loss) per common share:           | \$ 0.23                        | \$ (0.19)              |
| Basic weighted average number of shares outstanding   | 2,934,995                      | 2,934,995              |
| Diluted weighted average number of shares outstanding | 2,976,733                      | 2,951,173              |

See notes to these consolidated financial statements

**Table of Contents**

MORGAN S FOODS, INC.  
CONSOLIDATED BALANCE SHEETS  
(UNAUDITED)

|   | <b>August 16, 2009</b> | <b>March 1, 2009</b> |
|---|------------------------|----------------------|
| <b>ASSETS</b>                                   |                        |                      |
| Current assets:                                 |                        |                      |
| Cash and equivalents                            | \$ 6,875,000           | \$ 5,257,000         |
| Receivables                                     | 461,000                | 806,000              |
| Inventories                                     | 710,000                | 731,000              |
| Prepaid expenses                                | 322,000                | 624,000              |
| Assets held for sale                            | 678,000                | 828,000              |
|   | 9,046,000              | 8,246,000            |
| Property and equipment:                         |                        |                      |
| Land  | 9,558,000              | 9,558,000            |
| Buildings and improvements                      | 20,886,000             | 20,692,000           |
| Property under capital leases                   | 1,314,000              | 1,314,000            |
| Leasehold improvements                          | 10,444,000             | 10,615,000           |
| Equipment, furniture and fixtures               | 20,115,000             | 19,891,000           |
| Construction in progress                        | 372,000                | 316,000              |
|   | 62,689,000             | 62,386,000           |
| Less accumulated depreciation and amortization  | 30,708,000             | 29,827,000           |
|   | 31,981,000             | 32,559,000           |
| Other assets                                    |                        |                      |
| Other assets                                    | 614,000                | 676,000              |
| Franchise agreements, net                       | 1,198,000              | 1,260,000            |
| Deferred tax asset                              | 398,000                | 594,000              |
| Goodwill  | 9,227,000              | 9,227,000            |
|   | \$ 52,464,000          | \$ 52,562,000        |
| <b>LIABILITIES AND SHAREHOLDERS EQUITY</b>      |                        |                      |
| Current liabilities:                            |                        |                      |
| Long-term debt, current                         | \$ 3,066,000           | \$ 16,475,000        |
| Current maturities of capital lease obligations | 41,000                 | 39,000               |
| Accounts payable                                | 4,105,000              | 3,909,000            |
| Accrued liabilities                             | 4,408,000              | 3,934,000            |
|   | 11,620,000             | 24,357,000           |
| Long-term debt                                  |                        |                      |
| Long-term debt                                  | 31,363,000             | 19,738,000           |
| Long-term capital lease obligations             | 1,085,000              | 1,105,000            |
| Other long-term liabilities                     | 4,152,000              | 4,061,000            |
| Deferred tax liabilities                        | 2,343,000              | 2,130,000            |

SHAREHOLDERS' EQUITY

Preferred shares, 1,000,000 shares authorized, no shares outstanding

Common stock, no par value

Authorized shares - 25,000,000

Issued shares - 2,969,405

Treasury shares - 34,410

Capital in excess of stated value

Accumulated deficit

Total shareholders' equity

|               |               |
|---------------|---------------|
| 30,000        | 30,000        |
| (81,000)      | (81,000)      |
| 29,488,000    | 29,432,000    |
| (27,536,000)  | (28,210,000)  |
| 1,901,000     | 1,171,000     |
| \$ 52,464,000 | \$ 52,562,000 |

See notes to these consolidated financial statements.



**Table of Contents**

MORGAN S FOODS, INC.  
CONSOLIDATED STATEMENT OF SHAREHOLDERS EQUITY  
(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>Equity</b>       |
| Balance         |                      |               |                        |               |                     |                    |                     |
| March 1, 2009   | 2,969,405            | \$30,000      | (34,410)               | \$(81,000)    | \$29,432,000        | \$(28,210,000)     | \$1,171,000         |
| Net income      |                      |               |                        |               |                     | 674,000            | 674,000             |
| Stock           |                      |               |                        |               |                     |                    |                     |
| compensation    |                      |               |                        |               |                     |                    |                     |
| expense         |                      |               |                        |               | 56,000              |                    | 56,000              |
| Balance May 24, |                      |               |                        |               |                     |                    |                     |
| 2009            | 2,969,405            | \$30,000      | (34,410)               | \$(81,000)    | \$29,488,000        | \$(27,536,000)     | \$1,901,000         |

See notes to these consolidated financial statements.

**Table of Contents**

MORGAN S FOODS, INC.  
CONSOLIDATED STATEMENTS OF CASH FLOWS  
(UNAUDITED)

|  | <b>Twenty-four Weeks Ended</b> |                        |
|--|--------------------------------|------------------------|
|  | <b>August 16, 2009</b>         | <b>August 17, 2008</b> |
| <b>Cash flows from operating activities:</b>                           |                                |                        |
| Net income (loss)  | \$ 674,000                     | \$ (547,000)           |
| Adjustments to reconcile to net cash provided by operating activities: |                                |                        |
| Depreciation and amortization  | 1,428,000                      | 1,564,000              |
| Amortization of deferred financing costs                               | 57,000                         | 59,000                 |
| Amortization of supply agreement advances                              | (563,000)                      | (473,000)              |
| Funding from supply agreements   |                                | 38,000                 |
| Deferred income taxes  | 409,000                        | 472,000                |
| Stock compensation expense   | 56,000                         |                        |
| Disposal of restaurant assets  | 21,000                         | (4,000)                |
| Changes in assets and liabilities:                                     |                                |                        |
| Receivables  | 395,000                        | 18,000                 |
| Inventories  | 21,000                         | (32,000)               |
| Prepaid expenses   | 302,000                        | 297,000                |
| Other assets   | 5,000                          |                        |
| Accounts payable   | 196,000                        | (840,000)              |
| Accrued liabilities  | 1,106,000                      | (819,000)              |
| Net cash provided by (used in) operating activities                    | 4,107,000                      | (267,000)              |
| <b>Cash flows from investing activities:</b>                           |                                |                        |
| Proceeds from sale of restaurant                                       | 119,000                        |                        |
| Capital expenditures   | (802,000)                      | (2,956,000)            |
| Proceeds from sale/leasebacks  |                                | 1,972,000              |
| Purchase of license and other investments                              | (4,000)                        |                        |
| Net cash used in investing activities                                  | (687,000)                      | (984,000)              |
| <b>Cash flows from financing activities:</b>                           |                                |                        |
| Proceeds from long-term borrowings                                     |                                | 3,000,000              |
| Principal payments on long-term debt                                   | (1,478,000)                    | (1,532,000)            |
| Principal payments on capital lease obligations                        | (18,000)                       | (13,000)               |
| Bank debt repayment in advance   | (306,000)                      | (2,451,000)            |
| Deferred gain on sale/leaseback transactions                           |                                | 3,216,000              |
| Net cash provided by (used in) financing activities                    | (1,802,000)                    | 2,220,000              |
| Net change in cash and equivalents                                     | 1,618,000                      | 969,000                |
| Cash and equivalents, beginning balance                                | 5,257,000                      | 6,428,000              |
| Cash and equivalents, ending balance                                   | \$ 6,875,000                   | \$ 7,397,000           |

Edgar Filing: MORGANS FOODS INC - Form 10-Q

Interest paid was \$1,311,000 and \$1,697,000 in the first 24 weeks of fiscal 2010 and 2009 respectively

Cash payments for income taxes were \$3,000 and \$34,000 in the first 24 weeks of fiscal 2010 and 2009 respectively

See notes to these consolidated financial statements.

**Table of Contents**

MORGAN S FOODS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (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 March 1, 2009. Certain prior period amounts have been reclassified to conform to current period presentations. The results of operations for the twenty-four weeks ended August 16, 2009 are not necessarily indicative of the results to be expected for the full year. Although the Company believes that the disclosures are adequate to make the information presented not misleading, it is suggested that these condensed consolidated financial statements be read in conjunction with the audited consolidated financial statements and the notes thereto included in the Company s Form 10-K for the fiscal year ended March 1, 2009. Management has considered events occurring through September 30, 2009 for possible disclosure as subsequent events.

The Company s debt is reported at historical cost, based upon stated interest rates which represented market rates at the time of borrowing. Due to subsequent declines in credit quality throughout the restaurant industry resulting from weak and volatile operating performance and related declines in restaurant values, the market for fixed rate mortgage debt for restaurant financing is currently extremely limited. The Company s debt is not publicly traded and there are few lenders or financing transactions for similar debt in the marketplace at this time. Consequently, management has not been able to identify a market for fixed rate restaurant mortgage debt with a similar risk profile, and has concluded that it is not practicable to estimate the fair value of the Company s debt as of August 16, 2009.

**NOTE 2 RECENT ACCOUNTING PRONOUNCEMENTS**

Effective July 1, 2009, the FASB (Financial Accounting Standards Board) Accounting Standards Codification (ASC) (Topic 105, Generally Accepted Accounting Principles ), became the single source for authoritative nongovernmental U.S. generally accepted accounting principles. During fiscal 2010, four new accounting standards became effective. These new standards are included in Topic 820 Fair Value Measurements and Disclosures as it relates to non-financial assets and liabilities, Topic 805 Disclosures About Derivative Investments and Hedging Activities , Topic 815 Business Combinations and Topic 855 Subsequent Events of the FASB ASC. The Company has determined that the changes to the accounting standards in fiscal 2010 do not have a material effect on the Company s financial position or results of operations.

**NOTE 3 NET INCOME PER COMMON SHARE**

Basic net income (loss) per common share is computed by dividing net income (loss) 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. The following table reconciles the difference between basic and diluted earnings per common share:

**Table of Contents**

|   | For the Quarter ended August 16,<br>2009 |                         |                        | For the Quarter ended August 17,<br>2008 |                         |                        |
|---|--|-------------------------|------------------------|--|-------------------------|------------------------|
|   | Net<br>income<br>(Numerator)             | Shares<br>(Denominator) | Per<br>Share<br>Amount | Net loss<br>(Numerator)                  | Shares<br>(Denominator) | Per<br>Share<br>Amount |
| <b>Basic EPS</b>                        |  |                         |                        |  |                         |                        |
| Income available to common shareholders | \$ 320,000                               | 2,934,995               | \$ 0.11                | \$ (641,000)                             | 2,934,995               | \$ (0.22)              |

**Effect of Dilutive Securities**

|                                |  |        |  |  |       |  |
|--------------------------------|--|--------|--|--|-------|--|
| Weighted Average Stock Options |  | 55,366 |  |  | 9,455 |  |
|--------------------------------|--|--------|--|--|-------|--|

**Diluted EPS**

|   |            |           |         |              |           |           |
|---|------------|-----------|---------|--------------|-----------|-----------|
| Income available to common shareholders | \$ 320,000 | 2,990,361 | \$ 0.11 | \$ (641,000) | 2,944,450 | \$ (0.22) |
|---|------------|-----------|---------|--------------|-----------|-----------|

|   | Twenty-four weeks ended August<br>16, 2009 |                         |                        | Twenty-four weeks ended August<br>17, 2008 |                         |                        |
|---|--|-------------------------|------------------------|--|-------------------------|------------------------|
|   | Net<br>income<br>(Numerator)               | Shares<br>(Denominator) | Per<br>Share<br>Amount | Net loss<br>(Numerator)                    | Shares<br>(Denominator) | Per<br>Share<br>Amount |
| <b>Basic EPS</b>                        |  |                         |                        |  |                         |                        |
| Income available to common shareholders | \$ 674,000                                 | 2,934,995               | \$ 0.23                | \$ (547,000)                               | 2,934,995               | \$ (0.19)              |

**Effect of Dilutive Securities**

|                                |  |        |  |  |        |  |
|--------------------------------|--|--------|--|--|--------|--|
| Weighted Average Stock Options |  | 41,738 |  |  | 16,178 |  |
|--------------------------------|--|--------|--|--|--------|--|

**Diluted EPS**

|   |            |           |         |              |           |           |
|---|------------|-----------|---------|--------------|-----------|-----------|
| Income available to common shareholders | \$ 674,000 | 2,976,733 | \$ 0.23 | \$ (547,000) | 2,951,173 | \$ (0.19) |
|---|------------|-----------|---------|--------------|-----------|-----------|

Options to purchase 157,500 common shares were outstanding during the 2010 fiscal year but were included in the computation only for the time during which their exercise price was greater than the average market price of the common shares. Options for 7,500 shares, exercisable at \$3.00 per share expire on January 7, 2010 and options for 150,000 shares, exercisable at \$1.50 per share expire on November 5, 2018.

**NOTE 4 DEBT**

The Company's debt arrangements require the maintenance of a consolidated fixed charge coverage ratio of 1.2 to 1 regarding all of the Company's mortgage loans and the maintenance of individual restaurant fixed charge coverage ratios of between 1.2 and 1.5 to 1 on certain of the Company's mortgage loans. A portion of the Company's debt also contains a funded debt to EBITDAR (earnings before interest, taxes, depreciation, amortization and rent) requirement of 5.5. Fixed charge coverage ratios are calculated by dividing the cash flow before rent and debt service for the previous 12 months by the debt service and rent due in the coming 12 months. In the calculation of funded debt to EBITDAR, funded debt is the next twelve month operating lease obligation times eight plus the debt balance at the measurement date. The funded debt is then divided by the prior twelve month EBITDAR to obtain the calculated ratio. The consolidated and individual ratios are all computed quarterly. As of May 24, 2009, the Company entered into a loan modification agreement covering a portion of its debt which reduced the consolidated fixed charge coverage ratio to 1.15 to 1 from 1.20 to 1 and increased the funded debt to EBITDAR ratio to 6.15 from 5.5 for the first, second and third quarters of fiscal 2010 and was in compliance with those requirements. With respect to its other

debt, the Company was in compliance with the consolidated fixed charge coverage ratio of 1.20 to 1. As of the measurement date of August 16, 2009, the Company's consolidated fixed charge coverage ratio was 1.21 to 1, funded debt to EBITDAR was 5.6 and management projects that the Company will be in compliance with its consolidated debt covenants at future measurement dates. In order to obtain the loan modification, the Company paid certain fees. As of August 16, 2009, the Company was not in compliance with the individual fixed charge coverage ratio on 18 of its restaurant properties and has obtained waivers of these requirements covering a period of longer than one year. The debt obligations of the Company which contain fixed charge coverage ratio and funded debt to EBITDAR requirements are classified as long-term, except for the amounts due within one year. If the Company does not comply with the covenants of its various debt agreements in the future, and if future waivers are not obtained, the respective lenders will have certain remedies available to them which include calling the debt, increasing the interest rates and the acceleration of payments. Noncompliance with the requirements of the Company's debt agreements, if not waived, could also trigger cross-default provisions contained in the respective agreements.

**NOTE 5 STOCK OPTIONS**

On April 2, 1999, the Board of Directors of the Company approved a Stock Option Plan for Executives and Managers. Under the plan 145,500 shares were reserved for the grant of options. The Stock Option Plan for Executives and Managers provides for grants to eligible participants of nonqualified stock options only. The exercise price for any option awarded under the Plan is required to be not less than 100% of the fair market value of the shares on the date that the option is granted. Options are granted by the Stock Option Committee of the Company. Options for the 145,150 shares were granted to executives and managers of the Company on April 2, 1999 at an exercise price of \$4.125. The plan provides that the options are exercisable after a waiting period of 6 months and that each option expires 10 years after its date of issue.

At the Company's annual meeting on June 25, 1999 the shareholders approved the Key Employees Stock Option Plan. This plan allows the granting of options covering 291,000 shares of stock and has essentially the same provisions as the Stock Option Plan

**Table of Contents**

for Executives and Managers which was discussed above. Options for 129,850 shares were granted to executives and managers of the Company on January 7, 2000 at an exercise price of \$3.00. Options for 11,500 shares were granted to executives on April 27, 2001 at an exercise price of \$.85. Options for 150,000 common shares were granted on November 6, 2008 at the closing price on that day of \$1.50 per share. The options vest six months after issue and expire ten years after issue.

As of August 16, 2009, 157,500 options were outstanding, fully vested and exercisable at a weighted average exercise price of \$1.57 per share. As of August 16, 2009, no options were available for grant.

The following table summarizes information about stock options outstanding at August 16, 2009:

| <b>Exercise</b> | <b>Outstanding</b> | <b>Average</b> | <b>Number</b>      |
|-----------------|--------------------|----------------|--------------------|
| <b>Prices</b>   | <b>8-16-09</b>     | <b>Life</b>    | <b>Exercisable</b> |
| \$3.00          | 7,500              | 0.5            | 7,500              |
| \$1.50          | 150,000            | 9.2            | 150,000            |
| \$1.57          | 157,500            | 8.8            | 157,500            |

**NOTE 6 CAPITAL EXPENDITURES**

The Company is required by its franchise agreements to periodically bring its restaurants into conformity with the franchisors' required image. This typically involves a new dining room décor and seating package and exterior changes and related items but can, in some cases, require the relocation of the restaurant. If the Company deems a particular image enhancement expenditure to be inadvisable, it has the option to cease operations at that restaurant. Over time, the estimated cost and time deadline for each restaurant may change due to a variety of circumstances and the Company revises its requirements accordingly. Also, significant numbers of restaurants may have image enhancement deadlines that coincide, in which case, the Company will adjust the actual timing of the image enhancements in order to facilitate an orderly construction schedule. During the image enhancement process, each restaurant is closed for one to two weeks, which has a negative impact on the Company's revenues and operating efficiencies. At the time a restaurant is closed for a required image enhancement, the Company may deem it advisable to make other capital expenditures in addition to those required for the image enhancement.

The franchise agreements with KFC and Taco Bell Corporation require the Company to upgrade and remodel its restaurants to comply with the franchisors' current standards within agreed upon timeframes. In the case of a restaurant containing two concepts, even though only one is required to be remodeled, additional costs will be incurred because the dual concept restaurant is generally larger and contains more equipment and signage than the single concept restaurant. If a property is of usable size and configuration, the Company can perform an image enhancement to bring the building to the current image of the franchisor. If the property is not large enough to fit a drive-thru or has some other deficiency, the Company would need to relocate the restaurant to another location within the trade area to meet the franchisor's requirements. In four of the Company's restaurants, one of the franchisors may have the ability to accelerate the deadline for image enhancements. In order to meet the terms and conditions of the franchise agreements, the Company has the following obligations:

**Table of Contents**

| <b>Number of Units</b> | <b>Period</b> | <b>Type</b> | <b>Total (1)</b> | <b>Required (2)</b> | <b>Additional (3)</b> |
|------------------------|---------------|-------------|------------------|---------------------|-----------------------|
| 1                      | Fiscal 2010   | IE          | \$ 390,000       | 350,000             | \$ 40,000             |
| 1                      |               | Relo        |                  |                     |                       |
|                        | Fiscal 2011   | (4)         | 1,400,000        | 1,400,000           |                       |
| 8                      | Fiscal 2011   | IE          | 2,560,000        | 2,240,000           | 320,000               |
| 1                      |               | Relo        |                  |                     |                       |
|                        | Fiscal 2012   | (4)         | 750,000          | 750,000             |                       |
| 8                      | Fiscal 2012   | IE          | 2,560,000        | 2,240,000           | 320,000               |
| 5                      | Fiscal 2013   | IE          | 1,600,000        | 1,400,000           | 200,000               |
| 1                      | Fiscal 2015   | Rebuild     | 1,000,000        | 1,000,000           |                       |
| 4                      |               | Relo        |                  |                     |                       |
|                        | Fiscal 2015   | (4)         | 5,600,000        | 5,600,000           |                       |
| 1                      |               | Relo        |                  |                     |                       |
|                        | Fiscal 2016   | (4)         | 1,400,000        | 1,400,000           |                       |
| 4                      |               | Relo        |                  |                     |                       |
|                        | Fiscal 2020   | (4)         | 5,600,000        | 5,600,000           |                       |
| 2                      | Fiscal 2020   | Rebuild     | 2,000,000        | 2,000,000           |                       |
| 36                     | Total         |             | \$24,860,000     | \$23,980,000        | \$ 880,000            |

(1) These amounts are based on estimates of current construction costs and actual costs may vary.

(2) These amounts include only the items required to meet the franchisor's image requirements.

(3) These amounts are for capital upgrades performed on or which may be performed on the image enhanced



restaurants  
which were or  
may be deemed  
by the Company  
to be  
advantageous to  
the operation of  
the units and  
which may be  
done at the time  
of the image  
enhancement.

- (4) Relocation of  
fee owned  
properties are  
shown net of  
expected  
recovery of  
capital from the  
sale of the  
former location.  
Relocation of  
leased  
properties  
assumes the  
capital cost of  
only equipment  
because it is not  
known until  
each lease is  
finalized  
whether the  
lease will be a  
capital or  
operating lease.

Capital expenditures  
to meet the image  
requirements of the  
franchisors and  
additional capital  
expenditures on  
those same  
restaurants being  
image enhanced are  
a large portion of the  
Company's annual  
capital expenditures.  
However, the  
Company also has

made and may make capital expenditures on restaurant properties not included on the foregoing schedule for upgrades or replacement of capital items appropriate for the continued successful operation of its restaurants. Capital expenditures in the volume and time horizon required by the image enhancement deadlines cannot be financed solely from existing cash balances and existing cashflow and the Company expects that it will have to utilize financing for a portion of the capital expenditures. The Company may use both debt and sale leaseback financing but has no commitments for either.

There can be no assurance that the Company will be able to accomplish the image enhancements and relocations required in the franchise agreements on terms acceptable to the Company. If the Company is unable to meet the requirements of a franchise agreement, the franchisor may choose to extend the time allowed for compliance or may terminate the franchise agreement.

**NOTE 7 ASSETS HELD FOR SALE**

The Company owns the land and building of two closed KFC restaurants and the land and building adjacent to another of its restaurants, all of which are listed for sale and are shown on the Company's consolidated balance sheet as Assets Held for Sale as of August 16, 2009.

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

Description of Business. Morgan's Foods, Inc. (the Company), which was formed in 1925, operates through wholly-owned subsidiaries KFC restaurants under franchises from KFC Corporation, Taco Bell restaurants under franchises from Taco Bell Corporation, Pizza Hut Express restaurants under licenses from Pizza Hut Corporation and an A&W restaurant under a license from A&W Restaurants, Inc. As of September 28, 2009, the Company operates 68 KFC restaurants, 6 Taco Bell restaurants, 13 KFC/Taco Bell 2n1 s under franchises from KFC Corporation and franchises or licenses from Taco Bell Corporation, 3 Taco Bell/Pizza Hut Express 2n1 s under franchises from Taco Bell Corporation and licenses from Pizza Hut Corporation, 1 KFC/Pizza Hut Express 2n1 under a franchise from KFC Corporation and a license from Pizza Hut Corporation and 1 KFC/A&W 2n1 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.

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

|                                     | Quarter Ended      |                    | Twenty-four Weeks Ended |                    |
|-------------------------------------|--------------------|--------------------|-------------------------|--------------------|
|                                     | August<br>16, 2009 | August 17,<br>2008 | August<br>16, 2009      | August 17,<br>2008 |
| Cost of sales:                      |                    |                    |                         |                    |
| Food, paper and beverage            | 31.7%              | 32.6%              | 32.0%                   | 32.3%              |
| Labor and benefits                  | 27.6%              | 28.4%              | 27.8%                   | 28.6%              |
| Restaurant operating expenses       | 25.9%              | 26.2%              | 25.8%                   | 25.7%              |
| Depreciation and amortization       | 3.1%               | 3.4%               | 3.1%                    | 3.5%               |
| General and administrative expenses | 6.2%               | 5.9%               | 6.2%                    | 6.1%               |
| Operating income                    | 5.5%               | 3.5%               | 5.1%                    | 3.9%               |

**Revenues.** The revenue increase of \$153,000 in the quarter ended August 16, 2009 as compared to the prior year quarter was primarily the result of a 2.6% increase in comparable restaurant revenues and the relocation of a KFC restaurant to a higher volume location, partially offset by the permanent closing of four restaurants. The increase in comparable revenues was largely attributable to the introduction of Kentucky Grilled Chicken® ( KGC ) which took place during the first quarter of fiscal 2010. The increase of \$1,331,000 in revenue for the twenty-four weeks ended August 16, 2009 compared to the twenty-four weeks ended August 17, 2008 was primarily the result of a comparable restaurant revenue increase of 5.0% and the factors discussed above.

**Cost of Sales Food, Paper and Beverage.** Food, paper and beverage costs decreased as a percentage of revenue to 31.7% for the quarter ended August 16, 2009 compared to 32.6% for the quarter ended August 17, 2008. The decrease in the current year quarter was primarily the result of higher vendor rebates due to an early extension of a beverage contract that included a retroactive pricing adjustment offset by the national promotion of KGC which involved a free two piece dinner promotion. Food, paper and beverage costs for the twenty-four weeks ended August 16, 2009 decreased to 32.0% compared to 32.3% in the prior year period primarily for the reasons discussed above.

**Cost of Sales Labor and Benefits.** Labor and benefits decreased as a percentage of revenue for the quarter ended August 16, 2009 to 27.6% compared to 28.4% for the year earlier quarter. The decrease was primarily due to increased efficiencies caused by higher unit volumes. Labor and benefits decreased to 27.8% of revenues for the twenty-four weeks ended August 16, 2009 compared to 28.6% in the comparable prior year period primarily due to increases in efficiencies mainly caused by higher unit volumes during the KGC rollout.

**Restaurant Operating Expenses.** Restaurant operating expenses declined slightly to 25.9% percent of revenue in the second quarter of fiscal 2010 compared to 26.2% in the second quarter of fiscal 2009 primarily due to lower utility rates in the current year period. For the twenty-four weeks ended August 16, 2009, restaurant operating expenses were relatively unchanged as a percentage of revenue at 25.8% from 25.7% in the comparable prior year period.

**Depreciation and Amortization.** Depreciation and amortization decreased to \$711,000 in the quarter and \$1,428,000 in the twenty-four weeks ended August 16, 2009 compared to \$791,000 for the quarter and \$1,564,000 for the twenty-four weeks ended August 17, 2008 primarily due to the permanent closure of 4 restaurants.

**General and Administrative Expenses.** General and administrative expenses increased to \$1,437,000 in the second quarter of fiscal 2010 compared to \$1,364,000 in the prior year quarter primarily due to higher bonuses for operations management personnel. General and administrative expenses for the twenty-four weeks ended August 16, 2009 increased to \$2,846,000 from \$2,714,000 for the comparable prior year period primarily due to the bonuses mentioned above and compensation expense related to the granting of stock options on November 6, 2008.

**Loss (gain) on Restaurant Assets.** The Company experienced a loss on restaurant assets of \$15,000 for the second quarter of fiscal 2010 compared to a gain of \$9,000 for the second quarter of fiscal 2009. The amounts contain reductions in the reserve for closed restaurant locations and the sale of one restaurant. The loss on restaurant assets of \$21,000 the first twenty-four weeks of fiscal 2010 compared to a gain of \$4,000 for the first twenty-four weeks of fiscal 2009, primarily reflect the same factors as the quarter amounts discussed above.

Operating Income. Operating income in the second quarter of fiscal 2010 increased to \$1,274,000, or 5.5% of revenues, compared to \$799,000, or 3.5% of revenues, for the second quarter of fiscal 2009 primarily due to the increase in revenues in the current year period discussed above and the closure of poor performing restaurants. Operating income for the twenty-four weeks ended August 16, 2009 increased to \$2,359,000, or 5.1% of revenues, from \$1,735,000, or 3.9% of revenues, for the twenty-four weeks ended August 17, 2008 primarily for the same reasons.

Interest Expense. The second quarter of fiscal 2010 contained \$82,000 of prepayment penalties and the write off of deferred financing costs related to the early payment of the debt on a closed restaurant location which was sold while the comparable prior year period contained \$428,000 related to the early payment of the debt on several locations in a refinancing transaction. Interest expense on bank debt and notes payable including capitalized leases decreased to \$616,000 in the second quarter of fiscal 2010

**Table of Contents**

from \$761,000 in the second quarter of fiscal 2009 due to lower debt balances. Interest expense on bank debt and notes payable including capitalized leases for the twenty-four weeks ended August 16, 2009 was \$1,266,000 compared to \$1,611,000 for the comparable prior year period primarily for the reasons discussed above.

**Other Income.** Other income decreased to \$43,000 for the second quarter and \$87,000 for the first twenty-four weeks of fiscal 2010 from \$79,000 for the second quarter and \$169,000 for the first twenty-four weeks of fiscal 2009. The decreases were primarily due to the lack of earnings on invested cash balances in the current fiscal periods.

**Provision for Income Taxes.** The provision for income taxes for the quarter ended August 16, 2009 was \$299,000 on pre-tax income of \$619,000 compared to \$330,000 on a pre-tax loss of (\$311,000) for the comparable prior year period. The provision for income taxes is recorded at the Company's projected annual effective tax rate and consists of a current tax expense of \$7,000 and a deferred tax provision of \$292,000 compared to a current income tax benefit of \$73,000 and a deferred tax provision of \$403,000 for the comparable prior year period.

The provision for income taxes for the twenty-four weeks ended August 16, 2009 was \$424,000 on pre-tax income of \$1,098,000 compared to \$412,000 on a pre-tax loss of (\$135,000) for the comparable prior year period. The components of the tax provision for the twenty-four weeks ended August 16, 2009 were a current tax expense of \$16,000 and deferred tax provision of \$408,000 compared to a current income tax benefit of \$59,000 and a deferred tax provision of \$471,000 for the comparable prior year period. The comparable prior year quarter and twenty-four week period include a current tax benefit of \$63,000 as a result of available employment tax credits that can be carried back to offset taxes previously paid.

The deferred tax provision for the current quarter and for the twenty-four weeks ended August 16, 2009 includes a \$48,000 increase in the deferred tax asset valuation allowance from a change in projection of income that would allow the future realization of deferred tax assets. The comparable quarter and twenty-four weeks ended August 17, 2008 include a \$501,000 increase in the deferred tax asset valuation allowance from a change in projection of income that would allow the future realization of deferred tax assets. A valuation allowance is recorded to reduce the deferred tax assets to the amount more likely than not to be realized in the future. During the quarter the Company increased the valuation allowance as a result of the Company's conclusion about the amount of projected taxable income within the carry forward period that was more likely than not based on recent actual operating results and other current economic factors. The deferred tax provision for the quarter and twenty-four weeks ended August 16, 2009 also include a deferred tax benefit of \$32,000 associated with prepayment and deferred financing costs incurred during the quarter. The comparable quarter and twenty-four weeks ended August 17, 2008 include a deferred tax benefit of \$176,000 associated with prepayment and deferred financing costs. The changes in deferred taxes are non-cash items and do not affect the Company's cash flow or cash balances.

**Liquidity and Capital Resources.** Cash flow activity for the twenty-four weeks ended August 16, 2009 is presented in the Consolidated Statements of Cash Flows. Cash provided by operating activities was \$4,107,000 for the twenty-four weeks ended August 16, 2009 compared to cash used in operating activities of \$267,000 for the twenty-four weeks ended August 17, 2008. The increase in operating cash flow resulted primarily from the increase in net income and decreases of \$395,000 in accounts receivable and increases of \$196,000 in accounts payable and \$1,106,000 in accrued liabilities compared to decreases of \$840,000 in accounts payable and \$819,000 in accrued liabilities in the comparable prior year period. The current year changes in receivables, payables and accrued liabilities were caused primarily by the recording of vendor rebates and incentives relating to the extension of a beverage contract. The Company paid scheduled long-term bank and capitalized lease debt of \$1,496,000 in the first twenty-four weeks of fiscal 2010 compared to payments of \$1,545,000 for the same period in fiscal 2009. Capital expenditures in the twenty-four weeks ended August 16, 2009 were \$802,000, compared to \$2,956,000 for the same period in fiscal 2009 as the Company had no image enhancement activity in the current fiscal year. Capital expenditure activity is discussed in more detail in Note 6 to the consolidated financial statements.

The Company's debt arrangements require the maintenance of a consolidated fixed charge coverage ratio of 1.2 to 1 regarding all of the Company's mortgage loans and the maintenance of individual restaurant fixed charge coverage ratios of between 1.2 and 1.5 to 1 on certain of the Company's mortgage loans. A portion of the Company's debt also contains a funded debt to EBITDAR (earnings before interest, taxes, depreciation, amortization and rent) requirement of 5.5. Fixed charge coverage ratios are calculated by dividing the cash flow before rent and debt service for the

previous 12 months by the debt service and rent due in the coming 12 months. In the calculation of funded debt to EBITDAR, funded debt is the next twelve month operating lease obligation times eight plus the debt balance at the measurement date. The funded debt is then divided by the prior twelve month EBITDAR to obtain the calculated ratio. The consolidated and individual ratios are all computed quarterly. As of May 24, 2009, the Company entered into a loan modification agreement covering a portion of its debt which reduced the consolidated fixed charge coverage ratio to 1.15 to 1 from 1.20 to 1 and increased the funded debt to EBITDAR ratio to 6.15 from 5.5 for the first, second and third quarters of fiscal 2010 and was in compliance with those requirements. With respect to its other debt, the Company was in compliance with the consolidated fixed charge coverage ratio of 1.20 to 1. As of the measurement date of August 16, 2009, the Company's consolidated fixed charge coverage ratio was 1.21 to 1, funded debt to EBITDAR was 5.6 and management projects that the Company will be in compliance with its consolidated debt covenants at future measurement dates. In order to obtain the loan modification, the Company paid certain fees. As of August 16, 2009, the Company was not in compliance with the individual

**Table of Contents**

fixed charge coverage ratio on 18 of its restaurant properties and has obtained waivers of these requirements covering a period of longer than one year. The debt obligations of the Company which contain fixed charge coverage ratio and funded debt to EBITDAR requirements are classified as long-term, except for the amounts due within one year. If the Company does not comply with the covenants of its various debt agreements in the future, and if future waivers are not obtained, the respective lenders will have certain remedies available to them which include calling the debt, increasing the interest rates and the acceleration of payments. Noncompliance with the requirements of the Company's debt agreements, if not waived, could also trigger cross-default provisions contained in the respective agreements.

**Recent Accounting Pronouncements.** Effective July 1, 2009, the FASB (Financial Accounting Standards Board) Accounting Standards Codification (ASC) (Topic 105, Generally Accepted Accounting Principles), became the single source for authoritative nongovernmental U.S. generally accepted accounting principles. During fiscal 2010, four new accounting standards became effective. These new standards are included in Topic 820 Fair Value Measurements and Disclosures as it relates to non-financial assets and liabilities, Topic 805 Disclosures About Derivative Investments and Hedging Activities, Topic 815 Business Combinations and Topic 855 Subsequent Events of the FASB ASC. The Company has determined that the changes to the accounting standards in fiscal 2010 do not have a material effect on the Company's financial position or results of operations.

**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 report 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. Forward looking statements involve risks and uncertainties that could cause actual events or results to differ materially from those expressed or implied in this report. 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, actions that lenders may take with respect to any debt covenant violations, its ability to obtain waivers of any debt covenant violations and its ability to pay all of its current and long-term obligations and those factors described in Part I Item 1A (Risk Factors) of the Company's annual report on Form 10-K filed with the SEC on June 3, 2009. 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.

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

Certain of the Company's debt comprising approximately \$14.0 million of principal balance has a variable rate which is adjusted monthly. A one percent increase in variable rate base (90 day LIBOR) of the loans at the beginning of the year would cost the Company approximately \$140,000 in additional annual interest costs. The Company may choose to offset all, or a portion of the risk through the use of interest rate swaps. The Company's remaining borrowings are at fixed interest rates, and accordingly the Company does not have market risk exposure for fluctuations in interest rates relative to those loans. The Company does not enter into derivative financial investments for trading or speculation purposes. Also, the Company is subject to volatility in food costs as a result of market risk and we manage that risk through the use of a franchisee purchasing cooperative which uses longer term purchasing contracts. Our ability to recover increased costs through higher pricing is, at times, limited by the competitive environment in which we operate. The Company believes that its market risk exposure is not material to the Company's financial position, liquidity or results of operations.

**Item 4. Controls and Procedures.**

Evaluation of Disclosure Controls and Procedures



As of August 16, 2009, an evaluation was performed under the supervision and with the participation of the Company's management, including the chief executive officer (CEO) and chief financial officer (CFO), of the effectiveness of the design and operation of the Company's disclosure controls and procedures (as defined in Rules 13a-15(e) under the Securities Exchange Act of 1934, as amended (the Exchange Act)). Based on that evaluation, the Company's management, including the CEO and CFO, concluded that the Company's disclosure controls and procedures were effective as of August 16, 2009.

**Table of Contents****Changes in Internal Control Over Financial Reporting**

There were no changes in the Company's internal control over financial reporting (as defined in Rule 13a-15(f) and a5d-15(f) of the Exchange Act) during the quarter ended August 16, 2009 that materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

**PART II OTHER INFORMATION****Item 1. Legal Proceedings**

The Company is a party to various legal proceedings and claims arising in the ordinary course of its business. The Company believes that the outcome of these matters will not have a material adverse affect on its consolidated financial position, results of operations or liquidity.

**Item 1A. Risk Factors**

The Company's annual report on Form 10-K for the fiscal year ended March 1, 2009 discusses the risk factors facing the Company. There has been no material change in the risk factors facing our business since March 1, 2009.

**Item 2. Unregistered Sale of Equity Securities and Use of Proceeds**

None

**Item 3. Defaults Upon Senior Securities**

None

**Item 4. Submission of Matters to a Vote of Security Holders**

The Company's annual meeting of shareholders was held on June 26, 2009 and voting was conducted on the following proposals:

Proposal 1 The election of seven Directors. The following seven Directors were elected:

| NAME                 | FOR       | WITHHOLD/<br>ABSTAIN |
|----------------------|-----------|----------------------|
| Leonard Stein-Sapir  | 2,273,335 | 372,085              |
| Lawrence S. Dolin    | 2,282,622 | 362,798              |
| Bahman Guyuron, M.D. | 2,282,622 | 362,798              |
| Kenneth L. Hignett   | 2,273,405 | 372,015              |
| Steven S. Kaufman    | 2,161,560 | 483,860              |
| Bernard Lerner       | 2,282,614 | 362,806              |
| James J. Liguori     | 2,273,405 | 372,015              |

**Item 5. Other Information**

None

**Item 6. Exhibits**

Reference is made to Index to Exhibits, filed herewith.

**Table of Contents**

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.

/s/ Kenneth L. Hignett  
Senior Vice President,  
Chief Financial Officer and Secretary  
September 30, 2009  
15

---

**Table of Contents**

MORGAN S FOODS, INC.  
INDEX TO EXHIBITS

| Exhibit<br>Number | Exhibit Description  |
|-------------------|--|
| 31.1              | Certification of the Chairman of the Board and Chief Executive Officer pursuant to Rule 13a-14(a) of 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 and Secretary pursuant to Rule 13a-14(a) of 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.   |