

MORGANS FOODS INC  
Form 10-Q/A  
October 03, 2008

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

**(Mark One)**

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

**For the quarterly period ended August 17, 2008**

**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 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 29, 2008, the issuer had 2,934,995 shares of common stock outstanding.



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## Explanatory Note:

This amended report on Form 10-Q/A is being filed to correct certain language in the Liquidity and Capital Resources discussion in Part I, Item 2 dealing with cash provided by (used in) operations and capital expenditures.

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

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

|   | <b>Quarter Ended</b>   |                        |
|---|------------------------|------------------------|
|   | <b>August 17, 2008</b> | <b>August 12, 2007</b> |
| Revenues  | \$23,049,000           | \$22,877,000           |
| Cost of sales:  |                        |                        |
| Food, paper and beverage                              | 7,506,000              | 6,977,000              |
| Labor and benefits                                    | 6,557,000              | 6,196,000              |
| Restaurant operating expenses                         | 6,041,000              | 5,727,000              |
| Depreciation and amortization                         | 791,000                | 661,000                |
| General and administrative expenses                   | 1,364,000              | 1,380,000              |
| Loss (gain) on restaurant assets                      | (9,000)                | 8,000                  |
| Operating income                                      | 799,000                | 1,928,000              |
| Interest expense:                                     |                        |                        |
| Prepayment and deferred financing costs               | 428,000                |                        |
| Bank debt and notes payable                           | 734,000                | 803,000                |
| Capital leases  | 27,000                 | 29,000                 |
| Other income and expense, net                         | (79,000)               | (128,000)              |
| Income (loss) before income taxes                     | (311,000)              | 1,224,000              |
| Provision for income taxes                            | 330,000                | 354,000                |
| Net income (loss)                                     | \$ (641,000)           | \$ 870,000             |
| Basic net income (loss) per common share:             | \$ (0.22)              | \$ 0.30                |
| Diluted net income (loss) per common share:           | \$ (0.22)              | \$ 0.29                |
| Basic weighted average number of shares outstanding   | 2,934,995              | 2,888,999              |
| Diluted weighted average number of shares outstanding | 2,944,450              | 2,960,272              |

See notes to these consolidated financial statements.

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

|   | <b>Twenty-four Weeks Ended</b> |                        |
|---|--------------------------------|------------------------|
|   | <b>August 17, 2008</b>         | <b>August 12, 2007</b> |
| Revenues  | \$44,802,000                   | \$45,527,000           |
| Cost of sales:  |                                |                        |
| Food, paper and beverage                              | 14,470,000                     | 13,916,000             |
| Labor and benefits                                    | 12,795,000                     | 12,247,000             |
| Restaurant operating expenses                         | 11,528,000                     | 11,300,000             |
| Depreciation and amortization                         | 1,564,000                      | 1,315,000              |
| General and administrative expenses                   | 2,714,000                      | 2,760,000              |
| Gain on restaurant assets                             | (4,000)                        | (8,000)                |
| Operating income                                      | 1,735,000                      | 3,997,000              |
| Interest expense:                                     |                                |                        |
| Prepayment and deferred financing costs               | 428,000                        |                        |
| Bank debt and notes payable                           | 1,558,000                      | 1,650,000              |
| Capital leases  | 53,000                         | 58,000                 |
| Other income and expense, net                         | (169,000)                      | (172,000)              |
| Income (loss) before income taxes                     | (135,000)                      | 2,461,000              |
| Provision for income taxes                            | 412,000                        | 761,000                |
| Net income (loss)                                     | \$ (547,000)                   | \$ 1,700,000           |
| Basic net income (loss) per common share:             | \$ (0.19)                      | \$ 0.59                |
| Diluted net income (loss) per common share:           | \$ (0.19)                      | \$ 0.57                |
| Basic weighted average number of shares outstanding   | 2,934,995                      | 2,884,997              |
| Diluted weighted average number of shares outstanding | 2,951,173                      | 2,962,399              |

See notes to these consolidated financial statements.

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MORGAN S FOODS, INC.  
CONSOLIDATED BALANCE SHEETS

|   | <b>August 17,<br/>2008</b> | <b>March 02,<br/>2008</b> |
|---|----------------------------|---------------------------|
|   | <b>(UNAUDITED)</b>         |                           |
| <b>ASSETS</b>                                   |                            |                           |
| Current assets:                                 |                            |                           |
| Cash and equivalents                            | \$ 7,397,000               | \$ 6,428,000              |
| Receivables                                     | 405,000                    | 423,000                   |
| Inventories                                     | 787,000                    | 755,000                   |
| Prepaid expenses                                | 382,000                    | 679,000                   |
| Assets held for sale                            | 508,000                    |                           |
|   | 9,479,000                  | 8,285,000                 |
| Property and equipment:                         |                            |                           |
| Land  | 9,994,000                  | 10,798,000                |
| Buildings and improvements                      | 21,435,000                 | 22,588,000                |
| Property under capital leases                   | 1,314,000                  | 1,314,000                 |
| Leasehold improvements                          | 10,889,000                 | 10,110,000                |
| Equipment, furniture and fixtures               | 20,597,000                 | 21,047,000                |
| Construction in progress                        | 243,000                    | 1,193,000                 |
|   | 64,472,000                 | 67,050,000                |
| Less accumulated depreciation and amortization  | 30,099,000                 | 31,620,000                |
|   | 34,373,000                 | 35,430,000                |
| Other assets                                    |                            |                           |
| Other assets                                    | 712,000                    | 837,000                   |
| Franchise agreements, net                       | 1,362,000                  | 1,417,000                 |
| Deferred tax asset                              | 404,000                    | 766,000                   |
| Goodwill  | 9,227,000                  | 9,227,000                 |
|   | \$ 55,557,000              | \$ 55,962,000             |
| <b>LIABILITIES AND SHAREHOLDERS EQUITY</b>      |                            |                           |
| Current liabilities:                            |                            |                           |
| Long-term debt, current                         | \$ 3,086,000               | \$ 3,190,000              |
| Current maturities of capital lease obligations | 37,000                     | 34,000                    |
| Accounts payable                                | 4,878,000                  | 5,718,000                 |
| Accrued liabilities                             | 3,623,000                  | 4,678,000                 |
|   | 11,624,000                 | 13,620,000                |
| Deferred tax liabilities                        |                            |                           |
| Deferred tax liabilities                        | 1,963,000                  | 1,853,000                 |
| Long-term debt                                  | 34,910,000                 | 35,789,000                |
| Long-term capital lease obligations             | 1,128,000                  | 1,144,000                 |

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|  |               |               |
|--|---------------|---------------|
| Other long-term liabilities  | 4,006,000     | 1,083,000     |
| <b>SHAREHOLDERS EQUITY</b>   |               |               |
| 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  | 30,000        | 30,000        |
| Treasury shares - 34,410   | (81,000)      | (81,000)      |
| Capital in excess of stated value                                    | 29,344,000    | 29,344,000    |
| Accumulated deficit  | (27,367,000)  | (26,820,000)  |
| Total shareholders equity  | 1,926,000     | 2,473,000     |
|  | \$ 55,557,000 | \$ 55,962,000 |

See notes to these consolidated financial statements.



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MORGAN S FOODS, INC.  
 CONSOLIDATED STATEMENT OF SHAREHOLDERS EQUITY  
 (UNAUDITED)

|                               | <b>Common Shares</b> |               | <b>Treasury Shares</b> |               | <b>Capital in<br/>excess of<br/>stated value</b> | <b>Accumulated<br/>Deficit</b> | <b>Total<br/>Shareholders<br/>Equity</b> |
|-------------------------------|----------------------|---------------|------------------------|---------------|--|--------------------------------|--|
|                               | <b>Shares</b>        | <b>Amount</b> | <b>Shares</b>          | <b>Amount</b> |  |                                |  |
| Balance<br>March 2, 2008      | 2,969,405            | \$30,000      | (34,410)               | \$(81,000)    | \$29,344,000                                     | \$(26,820,000)                 | \$2,473,000                              |
| Net income<br>(loss)          |                      |               |                        |               |  | (547,000)                      | (547,000)                                |
| Balance<br>August 17,<br>2008 | 2,969,405            | \$30,000      | (34,410)               | \$(81,000)    | \$29,344,000                                     | \$(27,367,000)                 | \$1,926,000                              |

See notes to these consolidated financial statements.

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

|  | <b>Twenty-four Weeks Ended</b> |                        |
|--|--------------------------------|------------------------|
|  | <b>August 17, 2008</b>         | <b>August 12, 2007</b> |
| <b>Cash flows from operating activities:</b>                           |                                |                        |
| Net (loss) income  | \$ (547,000)                   | \$ 1,700,000           |
| Adjustments to reconcile to net cash provided by operating activities: |                                |                        |
| Depreciation and amortization  | 1,564,000                      | 1,315,000              |
| Amortization of deferred financing costs                               | 59,000                         | 48,000                 |
| Amortization of supply agreement advances                              | (473,000)                      | (487,000)              |
| Funding from supply agreements   | 38,000                         | 107,000                |
| Decrease in deferred tax assets  | 362,000                        | 445,000                |
| Increase in deferred tax liabilities                                   | 110,000                        | 211,000                |
| Gain on restaurant assets  | (4,000)                        | (8,000)                |
| Changes in assets and liabilities:                                     |                                |                        |
| Decrease (increase) in receivables                                     | 18,000                         | (55,000)               |
| Increase in inventories  | (32,000)                       | (59,000)               |
| Decrease in prepaid expenses   | 297,000                        | 185,000                |
| Increase (decrease) in accounts payable                                | (840,000)                      | 551,000                |
| Increase in accrued liabilities and other                              | (819,000)                      | 269,000                |
| Net cash provided by (used in) operating activities                    | (267,000)                      | 4,222,000              |
| <b>Cash flows from investing activities:</b>                           |                                |                        |
| Capital expenditures   | (2,956,000)                    | (2,263,000)            |
| Proceeds from sale/leasebacks  | 1,972,000                      |                        |
| Net cash used in investing activities                                  | (984,000)                      | (2,263,000)            |
| <b>Cash flows from financing activities:</b>                           |                                |                        |
| Proceeds from long-term borrowings                                     | 3,000,000                      |                        |
| Principal payments on long-term debt                                   | (1,532,000)                    | (1,488,000)            |
| Principal payments on capital lease obligations                        | (13,000)                       | (16,000)               |
| Bank debt repayment in advance   | (2,451,000)                    |                        |
| Cash received for exercise of stock options                            |                                | 220,000                |
| Deferred gain on sale/leaseback transactions                           | 3,216,000                      |                        |
| Net cash provided by (used in) financing activities                    | 2,220,000                      | (1,284,000)            |
| Net change in cash and equivalents                                     | 969,000                        | 675,000                |
| Cash and equivalents, beginning balance                                | 6,428,000                      | 7,829,000              |
| Cash and equivalents, ending balance                                   | \$ 7,397,000                   | \$ 8,504,000           |

Interest paid was \$1,604,000 and \$1,725,000 in the first 24 weeks of fiscal 2009 and 2008 respectively  
Cash payments for income taxes were \$34,000 and \$171,000 in the first 24 weeks of fiscal 2009 and 2008 respectively

See notes to these consolidated financial statements.

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MORGAN S FOODS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

**NOTE 1 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES AND RECENT ACCOUNTING PRONOUNCEMENTS**

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 2, 2008. Certain prior period amounts have been reclassified to conform to current period presentations. The results of operations for the quarter ended August 17, 2008 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 2, 2008.

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements. SFAS No. 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles and expands disclosures about fair value measurements. The provisions of SFAS No. 157 apply under other accounting pronouncements that require or permit fair value measurements. SFAS No. 157 is effective for fiscal years beginning after November 15, 2007 and interim periods within those years for financial assets and liabilities, and for fiscal years beginning after November 15, 2008 for nonfinancial assets and liabilities. The Company has determined that adoption of SFAS No. 157 did not have a material impact on its financial position, results of operations or related disclosures.

In February 2007, the FASB issued SFAS No. 159 The Fair Value Option for Financial Assets and Financial Liabilities (SFAS 159). SFAS 159 provides companies with an option to report selected financial assets and financial liabilities at fair value. Unrealized gains and losses on items for which the fair value option has been elected are reported in earnings at each subsequent reporting date. SFAS 159 is effective for fiscal years beginning after November 15, 2007, the year beginning March 3, 2008 for the Company. The Company did not elect the fair value option for any of its eligible financial assets or financial liabilities and the adoption of SFAS No. 159 did not have any material effect on the Company s financial position or results of operations.

In March 2008, the FASB issued SFAS No. 161 Disclosure About Derivative Instruments and Hedging Activities-an amendment to FASB Statement 133 (SFAS 161). SFAS 161 requires enhanced disclosures about derivatives and hedging activities and the reasons for using them. SFAS 161 is effective for fiscal years beginning after November 15, 2008, the year beginning March 2, 2009 for the Company. We are currently reviewing the provisions of SFAS 161 to determine any impact for the Company.

In December 2007, the FASB issued SFAS 141R Business Combinations. SFAS No. 141R modifies the accounting for business combinations by requiring that acquired assets and assumed liabilities be recorded at fair value, contingent consideration arrangements be recorded at fair value on the date of the acquisition and preacquisition contingencies be accounted for in purchase accounting at fair value. The pronouncement also requires that transaction costs be expensed as incurred, acquired research and development be capitalized as an indefinite-lived intangible asset and the requirements of SFAS No. 146, Accounting for Costs Associated with Exit or Disposal Activities be met at the acquisition date in order to accrue for a restructuring plan in purchase accounting. SFAS No. 141R is required to be adopted prospectively effective for fiscal years beginning after December 15, 2008.

**NOTE 2 NET INCOME (LOSS) 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.



**Table of Contents****NOTE 3 DEBT**

The Company's fixed rate debt arrangements require the maintenance of a consolidated fixed charge coverage ratio of 1.2 to 1 regarding all of the Company's loans, cross default and cross collateralization provisions and many require the maintenance of individual restaurant fixed charge coverage ratios of between 1.2 and 1.5 to 1. The Company's variable rate loans of which approximately \$15.1 million is outstanding at August 17, 2008, require the maintenance of a consolidated fixed charge coverage ratio of 1.2 and a funded debt (debt balance plus a calculation based on operating lease payments) to EBITDAR ratio of 5.5, contain cross default and cross collateralization provisions and do not contain either individual restaurant fixed charge ratio requirements or provisions for prepayment penalties beyond the second year. 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. The consolidated and individual coverage ratios are computed quarterly. As of August 17, 2008, the Company was in compliance with the consolidated fixed charge coverage ratio of 1.2. However, as of August 17, 2008, the Company was not in compliance with the individual fixed charge coverage ratio on certain of its restaurant properties and has obtained waivers of these violations.

On May 30, 2008, the Company completed a set of financing transactions involving: 1) the sale leaseback of five of its restaurant properties, 2) equipment debt supported by five additional restaurants and 3) the payment, before their maturity, of nine existing loans secured by certain of the properties. The Company retired approximately \$1,532,000 of debt, paid \$222,000 of prepayment charges and administrative fees and wrote off approximately \$31,000 of deferred financing costs associated with the loans being retired early. The Company received approximately \$5,188,000 of proceeds from the sale leasebacks, net of origination fees and costs, and approximately \$2,961,000 of net proceeds from the equipment loan. In order to facilitate the sale leaseback transaction, the Company also purchased, for \$350,000, a parcel, which it previously leased, adjacent to one of the restaurant locations. After restructuring the property, the Company intends to sell it. The leases are structured as operating leases and have a primary term of 18 years with annual rent ranging from approximately \$448,000 to \$577,000. The loan has a variable rate based on a spread over 90 day LIBOR, a term of five years and an amortization of ten years. The Company will use the remaining proceeds of the transactions for general corporate purposes, including funding of its image enhancement program. Additionally, the Company paid, before their maturity, four other fixed rate loans having a total principal balance of \$919,000. In doing so, the Company incurred \$165,000 of prepayment penalties and wrote off \$9,000 of deferred financing costs related to the loans.

**NOTE 4 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 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. As of August 17, 2008, options for a total of 150,000 shares were available for grant.

No options were granted during the twenty-four week period ended August 17, 2008. As of August 17, 2008, 70,000 options were outstanding, fully vested and exercisable at a weighted average exercise price of \$4.00 per share. During the twenty-four weeks ended August 17, 2008 there was no unrecognized compensation expense for financial reporting purposes.

The following table summarizes information about stock options outstanding at August 17, 2008:

| Exercise<br>Prices | Number<br>Outstanding<br>at<br>August<br>17, 2008 | Average<br>Remaining<br>Life | Number of<br>Shares<br>Exercisable at<br>August 17, 2008 |
|--------------------|---|------------------------------|--|
| \$3.000            | 7,500   | 1.4                          | 7,500  |
| \$4.125            | 62,500  | 0.6                          | 62,500   |
|                    | 70,000  | 0.7                          | 70,000   |

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The Company is required by its franchise agreements to periodically bring its restaurants into conformity with the franchisor's 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 franchisor's 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:

| Number of Units | Period           | Type     | Total (1)     | Required (2)  | Additional (3) |
|-----------------|------------------|----------|---------------|---------------|----------------|
| 3               | Fiscal 2009      | IE       | \$ 980,000    | \$ 860,000    | \$ 120,000     |
| 1               | Fiscal 2009      | Rebuild  | 450,000       | 450,000       |                |
| 1               | Fiscal 2009      | Relo (4) | 400,000       | 400,000       |                |
| 1               | Fiscal 2010      | IE       | 750,000       | 750,000       |                |
| 18              | Fiscal 2011      | IE       | 6,400,000     | 5,680,000     | 720,000        |
| 1               | Fiscal 2011      | Relo (4) | 1,400,000     | 1,400,000     |                |
| 1               | Fiscal 2012      | Relo (4) | 1,400,000     | 1,400,000     |                |
| 0               | Fiscal 2013      | IE       |               |               |                |
| 1               | Fiscal 2014      | Rebuild  | 1,000,000     | 1,000,000     |                |
| 4               | Fiscal 2015      | Relo (4) | 4,000,000     | 4,000,000     |                |
| 1               | Fiscal 2016      | Relo (4) | 500,000       | 500,000       |                |
| 0               | Fiscal 2017-2019 | IE       |               |               |                |
| 5               | Fiscal 2020      | Relo (4) | 7,000,000     | 7,000,000     |                |
| 2               | Fiscal 2020      | Rebuild  | 2,000,000     | 2,000,000     |                |
| 39              | Total            |          | \$ 26,280,000 | \$ 25,440,000 | \$ 840,000     |

(1) These amounts are based on 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) Relocations 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.

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The Company owns the land and building of a closed KFC restaurant and the land and building adjacent to another of its restaurants, both of which are listed for sale and are shown on the Company's consolidated balance sheets as Assets Held for Sale as of August 17, 2008.

**NOTE 7 SUBSEQUENT EVENTS**

On September 14, 2008, subsequent to the end of the Company's fiscal 2009 second quarter, we closed an unprofitable KFC restaurant in the Youngstown, Ohio area. The restaurant location is fee owned and unencumbered and has been listed for sale. The net book value of the land and building of the restaurant location is approximately \$115,000 and will be classified until sold as an Asset Held for Sale in subsequent financial statements.

**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 26, 2008, the Company operates 70 KFC restaurants, 6 Taco Bell restaurants, 13 KFC/Taco Bell units under franchises from KFC Corporation and franchises or licenses from Taco Bell Corporation, 3 Taco Bell/Pizza Hut Express units under franchises from Taco Bell Corporation and licenses from Pizza Hut Corporation, 1 KFC/Pizza Hut Express unit under a franchise from KFC Corporation and a license from Pizza Hut Corporation and 1 KFC/A&W unit operated under a franchise from KFC Corporation and a license from A&W Restaurants, Inc. The Company's fiscal year is a 52 to 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 |                    |
|-------------------------------------|--------------------|--------------------|-------------------------|--------------------|
|                                     | August<br>17, 2008 | August 12,<br>2007 | August<br>17, 2008      | August 12,<br>2007 |
| Cost of sales:                      |                    |                    |                         |                    |
| Food, paper and beverage            | 32.6%              | 30.5%              | 32.3%                   | 30.6%              |
| Labor and benefits                  | 28.4%              | 27.1%              | 28.6%                   | 26.9%              |
| Restaurant operating expenses       | 26.2%              | 25.0%              | 25.7%                   | 24.8%              |
| Depreciation and amortization       | 3.4%               | 2.9%               | 3.5%                    | 2.9%               |
| General and administrative expenses | 5.9%               | 6.0%               | 6.1%                    | 6.1%               |
| Operating income                    | 3.5%               | 8.4%               | 3.9%                    | 8.8%               |

**Revenues.** The revenue increase of \$172,000 in the quarter ended August 17, 2008 as compared to the comparable year earlier period was the result of a minor 0.2% increase in comparable restaurant revenues and the addition of a KFC/Taco Bell restaurant partially offset by the permanent closing of two restaurants, one of which was a Taco Bell restaurant that was replaced by the new KFC/Taco Bell. The comparable restaurant revenue decline of 2.2% in the twenty-four weeks ended August 17, 2008 from the twenty-four weeks ended August 12, 2007 was primarily the result of weak product promotions by the KFC system during the second quarter of the current fiscal year including the Toasted Wrap as well as difficult economic conditions for consumers in our market areas.

**Cost of Sales - Food, Paper and Beverage.** Food, paper and beverage costs increased as a percentage of revenue to 32.6% for the quarter ended August 17, 2008 compared to 30.5% for the quarter ended August 12, 2007. The increase in the current year quarter was primarily the result of rapidly increasing commodity costs and a reduction in operating efficiencies coupled with relatively flat average restaurant volumes. The Company was unable to implement menu price increases rapidly enough to offset the rising costs. Food, paper and beverage costs for the twenty-four weeks ended August 17, 2008 increased to 32.3% compared to 30.6% in the prior year period primarily for the reasons discussed above.

**Cost of Sales - Labor and Benefits.** Labor and benefits increased as a percentage of revenue for the quarter ended August 17, 2008 to 28.4% compared to 27.1% for the year earlier quarter. The increase was primarily due to increases

in the minimum wage in substantially all of the areas in which the Company operates coupled with relatively flat average restaurant volumes. Labor and benefits increased to 28.6% of revenues for the twenty-four weeks ended August 17, 2008 compared to 26.9% in the comparable prior year period primarily for the reasons discussed above.

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**Restaurant Operating Expenses.** Restaurant operating expenses increased as a percentage of revenue to 26.2% in the second quarter of fiscal 2009 compared to 25.0% in the second quarter of fiscal 2008 primarily due to increases in utilities and advertising expenses. For the twenty-four weeks ended August 17, 2008, restaurant operating expenses increased to 25.7% from 24.8% in the comparable prior year period primarily for the reasons discussed above.

**Depreciation and Amortization.** Depreciation and amortization increased to \$791,000 in the quarter and \$1,564,000 in the twenty-four weeks ended August 17, 2008 compared to \$661,000 for the quarter and \$1,315,000 for the twenty-four weeks ended August 12, 2007 primarily due to the additional depreciation related to capital additions made during the prior fiscal year.

**General and Administrative Expenses.** General and administrative expenses were largely unchanged at \$1,364,000 in the second quarter and \$2,714,000 for the first twenty-four weeks of fiscal 2009 compared to \$1,380,000 in the second quarter and \$2,760,000 for the first twenty-four weeks of fiscal 2008.

**Loss (gain) on Restaurant Assets.** The Company experienced a gain on restaurant assets of \$9,000 for the second quarter of fiscal 2009 compared to a loss of \$8,000 for the second quarter of fiscal 2008. The amounts contain reductions in the reserve for closed restaurant locations, offset by losses on property disposed during restaurant remodeling. The gain on restaurant assets was \$4,000 and \$8,000 for the first twenty-four weeks of fiscal 2009 and fiscal 2008 respectively, primarily reflecting the same elements as the quarter amounts discussed above.

**Operating Income.** Operating income in the second quarter of fiscal 2009 decreased to \$799,000, or 3.5% of revenues, compared to \$1,928,000, or 8.4% of revenues, for the second quarter of fiscal 2008 primarily due to increases in food costs, labor costs and operating expenses. Operating income for the twenty-four weeks ended August 17, 2008 declined to \$1,735,000, or 3.9% of revenues, from \$3,997,000, or 8.8% of revenues, for the twenty-four weeks ended August 12, 2007 primarily for the same reasons.

**Interest Expense.** Interest expense on bank debt and notes payable decreased to \$761,000 in the second quarter of fiscal 2009 from \$832,000 in the second quarter of fiscal 2008 due to lower interest rates on debt which was refinanced during the fiscal 2008 fourth quarter. Interest expense on bank debt and notes payable for the twenty-four weeks ended August 17, 2008 was \$1,611,000 compared to \$1,708,000 for the comparable prior year period primarily for the reasons discussed above.

**Other Income.** Other income decreased to \$79,000 for the second quarter and \$169,000 for the first twenty-four weeks of fiscal 2009 from \$128,000 for the second quarter and \$172,000 for the first twenty-four weeks of fiscal 2008. The decreases were primarily due to decreased interest on invested cash balances.

**Provision for Income Taxes.** The provision for income taxes for the quarter ended August 17, 2008 was \$330,000 on a pre-tax loss of \$311,000 compared to \$354,000 on a pre-tax profit of \$1,224,000 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 benefit of \$73,000 and a deferred tax provision of \$403,000. The current tax benefit is primarily a result of available employment tax credits that can be carried back to offset taxes previously paid. The deferred tax provision consists of \$579,000, which is primarily the result of a change in the estimate of the future realization of various deferred items, offset by a deferred tax benefit of \$176,000 associated with the prepayment and deferred financing costs incurred during the quarter ended August 17, 2008. The changes in deferred taxes are non-cash items and do not affect the Company's cash flow or cash balances. The components of the tax provision of \$412,000 for the twenty-four weeks ended August 17, 2008 were a current tax benefit of \$59,000 and a deferred tax provision of \$471,000. The current tax benefit is primarily the result of available employment tax credits that can be carried back to offset taxes previously paid. The deferred tax provision consists of \$647,000, primarily the result of a change in the estimate of the future realization of various deferred items offset by a deferred tax benefit of \$176,000 associated with the prepayment and deferred financing costs incurred during the twenty-four weeks ended August 17, 2008.

**Liquidity and Capital Resources.** Cash used in operating activities was \$267,000 for the twenty-four weeks ended August 17, 2008 compared to cash provided by operating activities of \$4,222,000 for the twenty-four weeks ended August 12, 2007. The decrease in operating cash flow resulted primarily from a decrease in net income which included refinancing costs. The Company paid scheduled long-term bank and capitalized lease debt of \$1,545,000 in the first twenty-four weeks of fiscal 2009 compared to payments of \$1,504,000 for the comparable period in fiscal 2008. Capital expenditures in the twenty-four weeks ended August 17, 2008 were \$2,956,000, compared to

\$2,263,000 for the comparable period in fiscal 2008 as the Company has continued its image enhancement activity into fiscal 2009 to meet the requirements of its franchise agreements. Capital expenditure activity is discussed in more detail in Note 5 to the consolidated financial statements. The Company owns the land and building of a closed KFC restaurant and the land and building adjacent to another of its restaurants, both of which are listed for sale and are shown on the Company's consolidated balance sheets as Assets Held for Sale as of August 17, 2008.

The Company's fixed rate debt arrangements require the maintenance of a consolidated fixed charge coverage ratio of 1.2 to 1 regarding all of the Company's loans, cross default and cross collateralization provisions and many require the maintenance of individual restaurant fixed charge coverage ratios of between 1.2 and 1.5 to 1. The Company's variable rate loans of which

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approximately \$15.1 million is outstanding at August 17, 2008, require the maintenance of a consolidated fixed charge coverage ratio of 1.2 and a funded debt (debt balance plus a calculation based on operating lease payments) to EBITDAR ratio of 5.5, contain cross default and cross collateralization provisions and do not contain either individual restaurant fixed charge ratio requirements or provisions for prepayment penalties beyond the second year. 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. The consolidated and individual coverage ratios are computed quarterly. As of August 17, 2008, the Company was in compliance with the consolidated fixed charge coverage ratio of 1.2. However, as of August 17, 2008, the Company was not in compliance with the individual fixed charge coverage ratio on certain of its restaurant properties and has obtained waivers of these violations.

On May 30, 2008, the Company completed a set of financing transactions involving: 1) the sale leaseback of five of its restaurant properties, 2) equipment debt supported by five additional restaurants and 3) the payment, before their maturity, of nine existing loans secured by certain of the properties. The Company retired approximately \$1,532,000 of debt, paid \$222,000 of prepayment charges and administrative fees and wrote off approximately \$31,000 of deferred financing costs associated with the loans being retired early. The Company received approximately \$5,188,000 of proceeds from the sale leasebacks, net of origination fees and costs, and approximately \$2,961,000 of net proceeds from the equipment loan. In order to facilitate the sale leaseback transaction, the Company also purchased, for \$350,000, a parcel, which it previously leased, adjacent to one of the restaurant locations. After restructuring the property, the Company intends to sell it. The leases are structured as operating leases and have a primary term of 18 years with annual rent ranging from approximately \$448,000 to \$577,000. The loan has a variable rate based on a spread over 90 day LIBOR, a term of five years and an amortization of ten years. The Company will use the remaining proceeds of the transactions for general corporate purposes, including funding of its image enhancement program. Additionally, the Company paid, before their maturity, four other fixed rate loans having a total principal balance of \$919,000. In doing so, the Company incurred \$165,000 of prepayment penalties and wrote off \$9,000 of deferred financing costs related to the loans.

The Company's image enhancement requirements have created an unusually active construction schedule in which there has been at least one restaurant closed in most weeks of the Company's recent and current fiscal periods. For each week that a restaurant is closed, the Company loses approximately \$20,000 in revenue and \$5,000 of profit. In addition, the management team of each closed restaurant either fills in at a restaurant nearby or engages in non-revenue generating activities to prepare for reopening and this has a negative impact on the overall labor cost of the Company. Also, in closing and reopening a restaurant, certain amounts of food and shortening are lost to waste, having a negative impact on the Company's food cost.

**New Accounting Pronouncements.** In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements. SFAS No. 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles and expands disclosures about fair value measurements. The provisions of SFAS No. 157 apply under other accounting pronouncements that require or permit fair value measurements. SFAS No. 157 is effective for fiscal years beginning after November 15, 2007 and interim periods within those years for financial assets and liabilities, and for fiscal years beginning after November 15, 2008 for nonfinancial assets and liabilities. The Company has determined that adoption of SFAS No. 157 did not have a material impact on its financial position, results of operations or related disclosures.

In February 2007, the FASB issued SFAS No. 159 The Fair Value Option for Financial Assets and Financial Liabilities (SFAS 159). SFAS 159 provides companies with an option to report selected financial assets and financial liabilities at fair value. Unrealized gains and losses on items for which the fair value option has been elected are reported in earnings at each subsequent reporting date. SFAS 159 is effective for fiscal years beginning after November 15, 2007, the year beginning March 3, 2008 for the Company. The Company did not elect the fair value option for any of its eligible financial assets or financial liabilities and the adoption of SFAS No. 159 did not have any material effect on the Company's financial position or results of operations.

In March 2008, the FASB issued SFAS No. 161 Disclosure About Derivative Instruments and Hedging Activities-an amendment to FASB Statement 133 (SFAS 161). SFAS 161 requires enhanced disclosures about derivatives and hedging activities and the reasons for using them. SFAS 161 is effective for fiscal years beginning after November 15,

2008, the year beginning March 2, 2009 for the Company. We are currently reviewing the provisions of SFAS 161 to determine any impact for the Company.

In December 2007, the FASB issued SFAS 141R Business Combinations. SFAS No. 141R modifies the accounting for business combinations by requiring that acquired assets and assumed liabilities be recorded at fair value, contingent consideration arrangements be recorded at fair value on the date of the acquisition and preacquisition contingencies be accounted for in purchase accounting at fair value. The pronouncement also requires that transaction costs be expensed as incurred, acquired research and development be capitalized as an indefinite-lived intangible asset and the requirements of SFAS No. 146, Accounting for Costs Associated with Exit or Disposal Activities be met at the acquisition date in order to accrue for a restructuring plan in purchase accounting. SFAS No. 141R is required to be adopted prospectively effective for fiscal years beginning after December 15, 2008.

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.



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**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 2, 2008. 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 \$15.1 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 \$151,000 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 17, 2008, 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 17, 2008.

**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 17, 2008 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 2, 2008 discusses the risk factors facing the Company. There has been no material change in the risk factors facing our business since March 2, 2008.

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



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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 27, 2008 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  | 2,171,540 | 132,784              |
| Lawrence S. Dolin    | 2,171,624 | 132,700              |
| Bahman Guyuron, M.D. | 2,171,540 | 132,784              |
| Kenneth L. Hignett   | 2,171,640 | 132,684              |
| Steven S. Kaufman    | 2,171,640 | 132,684              |
| Bernard Lerner       | 2,171,640 | 132,684              |
| James J. Liguori     | 2,171,640 | 132,684              |

**Item 5. Other Information**

None

**Item 6. Exhibits**

Reference is made to Index to Exhibits, filed herewith.

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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.

/s/ Kenneth L. Hignett

Senior Vice President,

Chief Financial Officer and Secretary

October 3, 2008

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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.   |