

MORGANS FOODS INC  
Form 10-K  
June 01, 2009

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549  
FORM 10-K**

**Annual Report Pursuant to Section 13 or 15(d)  
of the Securities Exchange Act of 1934**

**For the fiscal year ended March 1, 2009 Commission file number 1-08395  
**MORGAN S FOODS, INC.****

(Exact name of registrant as specified in its charter)

Ohio

34-0562210

(State or other jurisdiction of  
incorporation or organization)

(I.R.S. Employer  
Identification Number)

4829 Galaxy Parkway, Suite S, Cleveland, OH 44128

(Address of principal executive officers) (Zip Code)

Registrant's telephone number, including area code: (216) 359-9000

Securities registered pursuant to Section 12(b) of the Act: None

Title of each class  
Common Shares, Without Par Value

Name of each exchange on  
which registered

Securities registered pursuant to Section 12(g) of the Act: None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes  No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes  No

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15 (d) of the Securities Exchange Act of 1934 during the preceding 12 months 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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

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

Large accelerated filer  Accelerated filer  Non-accelerated filer  Smaller Reporting Company   
(Do not check if a smaller reporting company)

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

As of August 17, 2008, the aggregate market value of the common stock held by nonaffiliates of the Registrant was \$7,263,604.

As of May 13, 2009, the Registrant had 2,934,995 common shares outstanding.

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## DOCUMENTS INCORPORATED BY REFERENCE

Part III incorporates by reference certain information from the Definitive Proxy Statement for the 2009 annual meeting of shareholders to be held on June 26, 2009 and to be filed with the Securities and Exchange Commission about June 5, 2009.

### PART I

#### ITEM 1. BUSINESS

##### General

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 May 22, 2009, the Company operates 68 KFC restaurants, 6 Taco Bell restaurants, 13 KFC/Taco Bell restaurants under franchises from KFC Corporation and franchises or licenses from Taco Bell Corporation, 3 Taco Bell/Pizza Hut Express restaurants under franchises from Taco Bell Corporation and licenses from Pizza Hut Corporation, 1 KFC/Pizza Hut Express restaurant under a franchise from KFC Corporation and a license from Pizza Hut Corporation and 1 KFC/A&W restaurant operated under a franchise from KFC Corporation and a license from A&W Restaurants, Inc. The Company's fiscal year is a 52-53 week year ending on the Sunday nearest the last day of February.

##### Restaurant Operations

The Company's KFC restaurants prepare and sell the distinctive KFC branded chicken products along with related food items. All containers and packages bear KFC trademarks. The Company's Taco Bell restaurants prepare and sell a full menu of quick service Mexican food items using the appropriate Taco Bell containers and packages. The KFC/Taco Bell restaurants operated under franchise agreements from KFC Corporation and license agreements from Taco Bell Corporation prepare and sell a limited menu of Taco Bell items as well as the full KFC menu while those operated under franchise agreements from both KFC Corporation and Taco Bell Corporation offer a full menu of both KFC and Taco Bell items. The Taco Bell/Pizza Hut Express restaurants prepare and sell a full menu of Taco Bell items and a limited menu of Pizza Hut items. The KFC/Pizza Hut Express restaurant prepares and sells a full menu of KFC items and a limited menu of Pizza Hut items. The KFC/A&W restaurant sells a limited menu of A&W items and a full menu of KFC items.

Of the 92 KFC, Taco Bell and KFC/Taco Bell restaurants operated by the Company as of May 22, 2009, 15 are located in Ohio, 56 in Pennsylvania, 11 in Missouri, 1 in Illinois, 7 in West Virginia and 2 in New York. The Company was one of the first KFC Corporation franchisees and has operated in excess of 20 KFC franchises for more than 25 years. Operations relating to these units are seasonal to a certain extent, with higher sales generally occurring in the summer months.

##### Franchise Agreements

All of the Company's KFC and Taco Bell restaurants are operated under franchise agreements with KFC Corporation and Taco Bell Corporation, respectively. The Company's KFC/Taco Bell restaurants are operated under franchises from KFC Corporation and either franchises or licenses from Taco Bell Corporation. The Taco Bell/Pizza Hut Express restaurants are operated under franchises from Taco Bell

Corporation and licenses from Pizza Hut Corporation. The KFC/Pizza Hut Express restaurant is operated under a franchise from KFC Corporation and a license from Pizza Hut Corporation. The KFC/A&W is operated under a franchise from KFC Corporation and a license from A&W Restaurants, Inc. The Company considers retention of these agreements to be important to the success of its restaurant business and believes that its relationships with KFC Corporation, Taco Bell Corporation, Pizza Hut Corporation and A&W Restaurants, Inc. are satisfactory. For further discussion of the requirements of the franchise and license agreements see Other Contractual Obligations and Commitments in Part II of this report.

In May 1997, the Company renewed substantially all of its then existing franchise agreements for twenty years. New 20 year franchise agreements were obtained for all 54 restaurants acquired in July 1999. Subject to satisfying KFC and Taco Bell requirements for restaurant image and other matters, franchise agreements are renewable at the Company's option for successive ten year periods. The franchise and license agreements provide that each KFC, Taco Bell, Pizza Hut Express and A&W unit is to be inspected by KFC Corporation, Taco Bell Corporation, Pizza Hut Corporation and A&W Restaurants, Inc., respectively, approximately three or four times per year. These inspections cover product preparation and quality, customer service, restaurant appearance and operation.

### **Competition**

The quick service restaurant business is highly competitive and is often affected by changes in consumer tastes; national, regional, or local economic conditions, demographic trends, traffic patterns; the type, number and locations of competing restaurants and disposable purchasing power. Each of the Company's KFC, Taco Bell and restaurants competes directly or indirectly with a large number of national and regional restaurant operations, as well as with locally owned restaurants, drive-ins, diners and numerous other establishments which offer low- and medium-priced chicken, Mexican food, pizza, hamburgers and hot dogs to the public.

The Company's KFC, Taco Bell and restaurants rely on innovative marketing techniques and promotions to compete with other restaurants in the areas in which they are located. The Company's competitive position is also enhanced by the national advertising programs sponsored by KFC Corporation, Taco Bell Corporation, Pizza Hut Corporation, A&W Restaurants, Inc. and their franchisees. Emphasis is placed by the Company on its control systems and the training of personnel to maintain high food quality and good service. The Company believes that its KFC, Taco Bell and restaurants are competitive with other quick service restaurants on the basis of the important competitive factors in the restaurant business which include, primarily, restaurant location, product price, quality and differentiation, and also restaurant and employee appearance.

### **Government Regulation**

The Company is subject to various federal, state and local laws affecting its business. Each of the Company's restaurants must comply with licensing and regulation by a number of governmental authorities, which include health, sanitation, safety and fire agencies in the state or municipality in which the restaurant is located.

The Company is also subject to federal and state laws governing such matters as employment and pay practices, overtime and working conditions. The bulk of the Company's employees are paid on an hourly basis at rates not less than the federal and state minimum wages.

The Company is also subject to federal and state child labor laws which, among other things, prohibit the use of certain hazardous equipment by employees 18 years of age or younger.

**Suppliers**

The Company's food is sourced from suppliers approved by its franchisors. Much of this purchasing is done through a franchisee owned cooperative and the Company contracts for the distribution of the goods to its restaurants primarily through McLane Foodservice, Inc.

**Growth**

The Company built a new KFC restaurant and relocated an existing KFC to that facility in fiscal 2009, and built a new KFC/Taco Bell 2n1 and relocated an existing Taco Bell to that facility in fiscal 2008.

**Employees**

As of May 13, 2009, the Company employed approximately 2,294 persons, including 51 administrative and 240 managerial employees. The balance are hourly employees, most of whom are part-time. None of the Company's employees are represented by a labor union. The Company considers its employee relations to be satisfactory.

**ITEM 1A. RISK FACTORS**

The Company faces a variety of risks inherent in general business and in the restaurant industry specifically, including operational, legal, regulatory and product risks. Certain significant factors that could adversely affect the operations and results of the Company are discussed below. Other risk factors that the Company cannot anticipate may develop, including risk factors that the Company does not currently consider to be significant.

**Outbreak of Avian Flu or Mad Cow Disease**

Due to the Company's reliance on poultry in its menu items, an outbreak of the Avian Flu in the United States could cause a shortage of chicken or could cause unreasonable panic in the public related to the consumption of chicken products, either of which would likely have a significant adverse impact on the Company's business. To a lesser extent the Company also uses beef in certain of its menu items and the conditions discussed above could apply to an outbreak of Mad Cow disease.

**Image Enhancement and Capital Expenditure Requirements**

The Company faces significant image enhancement and relocation requirements in future fiscal years as described under "Required Image Enhancements" in Part II of this report. There is no assurance that the Company will be able to obtain sale/leaseback or debt financing on terms which it finds reasonably acceptable to fund these obligations when due. Lack of acceptable financing could have a material adverse affect on the operations of the Company, including the loss of restaurants subject to enhancement or relocation requirements under applicable franchise agreements.

**Contamination of the Food Supply**

The food supply in general is subject to the accidental or intentional introduction of contaminants which can cause illness or death in humans. To the extent that the Company's food supplies become impacted by any of these contaminants, the Company's revenue could be significantly reduced and the Company could be subjected to related liability claims.

**Litigation**

The Company is involved in various commercial activities in the operation of its restaurants. These activities may generate the potential for legal claims against the Company. While many of these risks are covered by insurance, the costs of litigating large claims and any potential resulting uninsured liability could have a material adverse effect on the Company's results of operations.

**Environmental Liabilities**

In operating its restaurants, the Company is the owner of many real estate parcels. Environmental problems at any of these sites could cause significant costs and liabilities for the Company.

**Food and Labor Cost Increases**

The Company is exposed to numerous cost pressures in the operation of its restaurants including food, fuel and minimum wage increases. To the extent that the business environment prohibits the Company from passing on these increased costs in its selling prices, there could be a material negative impact on the results of operations.

**Product and Marketing Success of Franchisors**

The Company relies heavily on the success of its franchisors in developing products and marketing programs which support its revenues. Failure of the franchisors to provide appropriate support could have a significant negative impact on the Company's financial performance.

**Governmental Laws and Regulations**

The operations of the Company are subject to many federal, state and local regulations governing health, sanitation, workplace safety, public access, wages and benefits among other things. We are also subject to various privacy and security regulations. Changes to any of these regulations can have a significant adverse impact on the operations of the Company.

**Quick Service Restaurant Competition**

The quick service restaurant industry in which the Company operates is highly competitive and consumers have many choices other than the Company's restaurants. Changes in consumer tastes or preferences could have a significant adverse impact on the operations of the Company.

**ITEM 1B. UNRESOLVED STAFF COMMENTS**

Not applicable.

**ITEM 2. PROPERTIES**

The Company leases approximately 6,000 square feet of space for its corporate headquarters in Cleveland, Ohio. The lease expires December 31, 2011 and the rent under the current term is \$6,300 per month. The Company also leases space for a regional office in Youngstown, Ohio, which is used to assist in the operation of the KFC, Taco Bell and 2n1 restaurants.

Of the 92 KFC, Taco Bell and 2n1 restaurants, the Company owns the land and building for 48 locations, owns the building and leases the land for 22 locations and leases the land and building for 22 locations. 47 of the owned properties are subject to mortgages. Additionally, the Company leases the land and building for one closed location and owns the land and building for four closed locations, two of which are subject to mortgages. Two of the closed locations are leased to an operator of an independent local restaurant concept. Remaining lease terms (including renewal options) range from 1 to 40 years and average approximately 13 years. These leases generally require the Company to pay taxes and utilities, to maintain casualty and liability insurance, and to keep the property in good repair. The Company pays annual rent for each leased KFC, Taco Bell or 2n1 restaurant in amounts ranging from \$21,000 to \$130,000. In addition, nine of these leases require payment of additional rentals based on a percentage of gross sales in excess of certain base amounts. Sales for eight KFC, Taco Bell and 2n1 restaurants exceeded the respective base amounts in fiscal 2009.

The Company believes that its restaurants are generally efficient, well equipped and maintained and in good condition.

**ITEM 3. LEGAL PROCEEDINGS**

None.

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

None.

**Executive Officers of the Company**

The Executive Officers and other Officers of the Company are as follows:

| <b>Name</b>                | <b>Age</b> | <b>Position with Registrant</b>                            | <b>Officer Since</b> |
|----------------------------|------------|--|----------------------|
| <b>Executive Officers:</b> |            |  |                      |
| Leonard R. Stein-Sapir     | 70         | Chairman of the Board and Chief Executive Officer          | April 1989           |
| James J. Liguori           | 60         | President and Chief Operating Officer                      | June 1979            |
| Kenneth L. Hignett         | 62         | Senior Vice President- Chief Financial Officer & Secretary | May 1989             |
| <b>Other Officers:</b>     |            |  |                      |
| Barton J. Craig            | 60         | Senior Vice President- General Counsel                     | January 1994         |
| Vincent J. Oddi            | 66         | Vice President- Restaurant Development                     | September 1979       |
| Ramesh J. Gursahaney       | 60         | Vice President- Operations                                 | January 1991         |

Officers of the Company serve for a term of one year and until their successors are elected and qualified, unless otherwise specified by the Board of Directors. Any officer is subject to removal with or without cause, at any time, by a vote of a majority of the Board of Directors.



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

The Company's Common Shares are traded over-the-counter under the symbol MRFD. The following table sets forth, for the periods indicated, the high and low sale prices of the Common Shares as reported.

|                                  | <b>Price Range</b> |            |
|----------------------------------|--------------------|------------|
|                                  | <b>High</b>        | <b>Low</b> |
| <b>Year ended March 1, 2009:</b> |                    |            |
| 1st Quarter                      | \$ 6.55            | \$ 5.30    |
| 2nd Quarter                      | 5.51               | 4.10       |
| 3rd Quarter                      | 5.00               | 1.50       |
| 4th Quarter                      | 2.00               | 0.52       |

**Year ended March 2, 2008:**

|             |          |          |
|-------------|----------|----------|
| 1st Quarter | \$ 12.90 | \$ 11.40 |
| 2nd Quarter | 12.40    | 10.95    |
| 3rd Quarter | 10.99    | 9.45     |
| 4th Quarter | 10.95    | 6.55     |

As of May 13, 2009, the Company had approximately 809 shareholders of record. The Company has paid no dividends since fiscal 1975 and does not expect to have the ability to pay dividends in the foreseeable future. Securities authorized for issuance under equity compensation plans are shown in the table below:

## Equity Compensation Plan Information as of March 1, 2009

| Plan Category  | Number of securities to be issued upon exercise of outstanding options | Weighted average exercise price of outstanding options | Number of shares remaining for future issuance under equity compensation plans |
|--|--|--|--|
| Equity Compensation plans approved by security holders     | 157,150  | \$ 1.63  |  |
| Equity Compensation plans not approved by security holders | 62,850   | \$ 2.99  |  |
| Total  | 220,000  | \$ 2.016   |  |

**Shareholder Return Performance Graph**

Set forth below is a line graph comparing the cumulative total return on the Company's Common Shares, assuming a \$100 investment as of February 29, 2004, and based on the market prices at the end of each fiscal year, with the cumulative total return of the Standard & Poor's Midcap 400 Stock Index and a restaurant peer group index composed of 19 restaurant companies each of which has a market capitalization comparable to that of the Company.

**Comparison of Cumulative Five Year Total Return**

|                                 | <b>2004</b> | <b>2005</b> | <b>2006</b> | <b>2007</b> | <b>2008</b> | <b>2009</b> |
|---------------------------------|-------------|-------------|-------------|-------------|-------------|-------------|
| <b>MORGANS FOODS INC</b>        | 100         | 46          | 250         | 633         | 328         | 100         |
| <b>S&amp;P MIDCAP 400 INDEX</b> | 100         | 113         | 133         | 149         | 137         | 80          |
| <b>RESTAURANT PEER GROUP</b>    | 100         | 110         | 156         | 200         | 197         | 60          |

The companies in the peer group are AM-CH Inc., Avado Brands Inc., Boston Restaurant Assoc. Inc., Brazil Fast Food Corp., Briazz Inc., Chefs International Inc., Creative Host Services Inc., Eateries Inc., Einstein Noah Restaurant Grp, Elmer's Restaurants Inc., Flanigans Enterprises Inc., Good Times Restaurants Inc., Granite City Food & Brewery, Grill Concepts Inc., Health Express USA Inc., Mexican Restaurants Inc., Star Buffet Inc., Tumbleweed Inc. and Western Sizzlin Corp. The restaurant peer group index is weighted based on market capitalization. Some of the companies do not currently exist as independent publicly traded entities but are included in the calculation for the appropriate time periods. The companies included in the peer group index were selected by the Board of Directors.

**ITEM 6. SELECTED FINANCIAL DATA**

The following selected financial information for each of the five fiscal years in the period ended March 1, 2009, is derived from, and qualified in its entirety by, the consolidated financial statements of the Company. The following selected financial information should be read in conjunction with Management's Discussion and Analysis of Financial Condition and Results of Operations and the consolidated financial statements and the notes thereto included elsewhere in this report.

|   | <b>Years Ended</b>       |                          |                                  |                                  |                                  |
|---|--------------------------|--------------------------|----------------------------------|----------------------------------|----------------------------------|
|   | <b>March 1,<br/>2009</b> | <b>March 2,<br/>2008</b> | <b>February<br/>25,<br/>2007</b> | <b>February<br/>26,<br/>2006</b> | <b>February<br/>27,<br/>2005</b> |
| \$ in thousands, except per share amounts   |                          |                          |                                  |                                  |                                  |
| Revenues                                    | \$92,485                 | \$96,318                 | \$91,248                         | \$87,457                         | \$ 80,960                        |
| Cost of sales:                              |                          |                          |                                  |                                  |                                  |
| Food, paper and beverage                    | 29,695                   | 29,524                   | 27,981                           | 27,146                           | 25,222                           |
| Labor and benefits                          | 26,850                   | 27,404                   | 24,798                           | 23,186                           | 22,803                           |
| Restaurant operating expenses               | 24,068                   | 24,415                   | 22,765                           | 22,190                           | 21,015                           |
| Depreciation and amortization               | 3,224                    | 2,953                    | 2,950                            | 3,254                            | 3,419                            |
| General and administrative expenses         | 5,740                    | 6,111                    | 5,428                            | 5,133                            | 4,870                            |
| Loss (gain) on restaurant assets            | 417                      | 112                      | 5                                | (715)                            | 574                              |
| Operating income                            | 2,491                    | 5,799                    | 7,321                            | 7,263                            | 3,057                            |
| Net income (loss)                           | (1,390)                  | 414                      | 3,527                            | 3,437                            | (2,141)                          |
| Basic net income (loss) per comm. sh. (1)   | (0.47)                   | 0.14                     | 1.29                             | 1.26                             | (0.79)                           |
| Diluted net income (loss) per comm. sh. (1) | (0.47)                   | 0.14                     | 1.27                             | 1.24                             | (0.79)                           |
| Working capital (deficiency)                | (2,667)                  | (5,335)                  | (2,403)                          | (3,178)                          | (46,048)                         |
| Total assets                                | 52,562                   | 55,962                   | 52,323                           | 50,751                           | 48,790                           |
| LT debt and capital lease (current portion) | 3,070                    | 3,224                    | 2,941                            | 3,140                            | 43,695                           |
| Long-term debt (less current maturities)    | 33,182                   | 35,789                   | 34,445                           | 37,357                           |                                  |
| Long-term capital lease obligations         | 1,105                    | 1,144                    | 1,299                            | 1,194                            | 368                              |
| Shareholders' equity (deficiency)           | 1,171                    | 2,473                    | 1,839                            | (2,186)                          | (5,623)                          |

(1) Computed based upon the basic weighted average number of common shares outstanding during each year, which

were 2,934,995  
in 2009,  
2,911,448 in  
2008, 2,738,982  
in 2007,  
2,718,495 in  
2006 and  
2,718,495 in  
2005 and the  
diluted weighted  
average number  
of common and  
common  
equivalent  
shares  
outstanding  
during each  
year, which  
were 2,943,415  
in 2009,  
2,968,654 in  
2008, 2,767,478  
in 2007,  
2,778,524 in  
2006 an  
2,718,495 in  
2005.

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

**Results of Operations**

During fiscal 2008 through 2009 the Company operated KFC franchised restaurants, Taco Bell franchised restaurants and various 2n1 restaurants which include the KFC, Taco Bell, Pizza Hut and A&W concepts in the states of Illinois, Missouri, Ohio, Pennsylvania, West Virginia and New York. The average number of restaurants in operation during each fiscal year was 95 in 2009 and 97 in 2008.

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

|                                     | 2009  | 2008  |
|-------------------------------------|-------|-------|
| Cost of sales:                      |       |       |
| Food, paper and beverage            | 32.1% | 30.7% |
| Labor and benefits                  | 29.0% | 28.5% |
| Restaurant operating expenses       | 26.0% | 25.3% |
| Depreciation and amortization       | 3.5%  | 3.1%  |
| General and administrative expenses | 6.2%  | 6.3%  |
| Operating income                    | 2.7%  | 6.0%  |

**Revenues**

Revenue was \$92,485,000 in fiscal 2009, a decrease of \$3,833,000, or 4.0%, compared to fiscal 2008. The \$3,833,000 decrease in restaurant revenues during fiscal 2009 was due mainly to a 2.6% decrease in comparable restaurant revenues, \$1,830,000 in revenues in the fifty-third week of the Company's 2008 fiscal year and \$1,201,000 of revenue lost from restaurants either temporarily or permanently closed, partially offset by \$1,019,000 of additional revenue from new restaurants. The decrease in comparable restaurant revenue resulted from difficult economic conditions in the Company's geographic markets and the lack of effective new products and promotions from our franchisors. Revenues for the 16 weeks ended March 1, 2009, were \$25,716,000, a decrease of \$2,793,000 compared to the 17 weeks ended March 2, 2008 primarily resulting from a 3.0% decrease in comparable restaurant revenues, \$1,830,000 in revenues for the seventeenth week in the fourth quarter of the Company's 2008 fiscal year and \$515,000 of lost revenue from restaurants either temporarily or permanently closed, partially offset by \$321,000 of revenue from a new restaurant.

**Cost of Sales – Food, Paper and Beverage**

Food, paper and beverage costs were \$29,695,000, or 32.1% of revenues, in fiscal year 2009 compared to \$29,524,000, or 30.7% of revenues, in fiscal year 2008. These results reflect the historically high levels of commodity prices during most of fiscal 2009 causing unusually high food costs compounded by lower average restaurant volumes resulting in reduced efficiency.

For the fourth quarter of fiscal 2009, food, paper and beverage costs increased as a percentage of revenues to 31.1% from 30.9% in the fourth quarter fiscal 2008. The increase of 0.2% was primarily caused by inefficiencies due to lower average restaurant volumes during the fiscal 2009 period.

**Cost of Sales – Labor and Benefits**

Labor and benefits increased to 29.0% of revenues or \$26,850,000 in fiscal 2009 from 28.5% of revenues or \$27,404,000 in fiscal 2008 primarily due to lower efficiency caused by lower average restaurant volumes.

Labor and benefit costs for the fourth quarter of fiscal 2009 decreased to 30.2% of revenues or \$7,754,000 compared to 30.9% of revenues or \$8,801,000 in fiscal 2008. This percentage decrease was primarily the result of more aggressive labor scheduling creating a reduction in hours worked.

**Restaurant Operating Expenses**

Restaurant operating expenses increased to 26.0% as a percentage of revenues or \$24,068,000 in fiscal 2009 from 25.3% of revenues or \$24,415,000 in fiscal 2008. The increase was primarily caused by higher rent due to the conversion of 5 previously owned locations to leased locations through sale/leaseback transactions as well as increases in operating supplies.

Restaurant operating expenses for the fourth quarter of fiscal 2009 increased as a percentage of revenues to 27.0% or \$6,945,000 from 26.0% of revenues or \$7,399,000 in the year earlier quarter. This increase was primarily caused by the items discussed above.

**Depreciation and Amortization**

Depreciation and amortization for fiscal 2009 at \$3,224,000 was an increase from fiscal 2008 at \$2,953,000. The increase was the result of \$8,215,000 of capital additions in fiscal 2008 related primarily to the Company's image enhancement program having a full year of depreciation expense during the 2009 fiscal year, as well as an additional \$3,626,000 of capital additions in fiscal 2009.

Depreciation and amortization for the fourth quarter of fiscal 2009 was \$871,000 compared to \$960,000 for the fourth quarter of fiscal 2008. The decrease was primarily due to \$57,000 of additional expense in the 2008 fiscal quarter because it contained 17 weeks compared to 16 for the current year quarter as well as lower depreciation from the movement of certain assets to assets held for sale and the sale of one location in the current year period.

**General and Administrative Expenses**

General and administrative expenses decreased to \$5,740,000, or 6.2% of revenues, in fiscal 2009 from \$6,111,000, or 6.3% of revenues, in fiscal 2008 primarily as a result of decreases in the number of salaried positions, lower bonuses paid out and lower field training expenses.

For the fourth quarter of fiscal 2009, general and administrative expenses were \$1,838,000, or 7.2% of revenues compared to \$1,829,000 or 6.4% of revenues in the fourth quarter of fiscal 2008. The results include \$108,000 of additional expense for the seventeenth week in the 2008 quarter offset by \$88,000 of stock based compensation expense and other minor expense increases in the 2009 quarter.

**Loss on Restaurant Assets**

The Company had a loss on restaurant assets of \$417,000 in fiscal 2009 compared to \$112,000 in fiscal 2008. The fiscal 2009 loss primarily reflects losses recognized for movements of fixed assets to assets held for sale and a charge of \$245,000 for asset impairment write downs.

In the fourth quarter of fiscal 2009 the Company had a loss on restaurant assets of \$430,000 compared to \$36,000 in the fourth quarter of fiscal 2008. The increase is due to asset impairment write downs partially offset by the proceeds of the sale of one restaurant.

### **Operating Income**

Operating income in fiscal 2009 decreased to \$2,491,000 from \$5,799,000 in fiscal 2008 primarily as a result of the items discussed above.

### **Interest Expense**

#### **Prepayment and Deferred Financing Costs**

During the second quarter of fiscal 2009, 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 unamortized 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 has listed it for sale. 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 equipment loan has a variable rate based on a spread over 90 day LIBOR, a term of five years and an amortization period of ten years. 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 unamortized deferred financing costs related to the loans. In the fourth quarter of fiscal 2009 the Company sold a property and paid the debt before maturity to facilitate the sale. The debt balance was \$298,000, prepayment and administrative expenses were \$93,000 and unamortized deferred financing costs were \$4,000. All of the deferred financing costs are non-cash charges.

During the fourth quarter of fiscal 2008 the Company completed the funding of two loan agreements totaling \$12,600,000, the proceeds of which were used to retire \$10,901,000 of debt before its scheduled maturity. This transaction is described in more detail in Note 5 to the consolidated financial statements. As a result of the early payment, the Company was required to pay prepayment penalties and administrative fees of \$1,718,000 and write off \$154,000 of unamortized deferred financing costs remaining from the origination of the loans in fiscal 2000. The deferred financing costs are a non-cash charge.

#### **Bank and Capitalized Lease Interest Expense**

Interest expense on bank debt and notes payable decreased to \$3,190,000 in fiscal 2009 from \$3,472,000 in fiscal 2008. The decrease in interest expense for fiscal 2009 was the result of principal payments which reduced the outstanding debt balances and a reduction in the Company's average interest rate due to the refinancing transactions in late fiscal 2008 and early fiscal 2009. Interest expense from capitalized lease debt

decreased slightly to \$111,000 in fiscal 2009 from \$125,000 in fiscal 2008 as a result of the removal of a capitalized lease during the fourth quarter of fiscal 2008.

**Other Income**

Other income decreased to \$336,000 in fiscal 2009 compared to \$433,000 in fiscal 2008 primarily due to the reduced rate of return on the investment of available cash balances.

**Provision for Income Taxes**

The current tax provision consists of federal tax benefit of \$(63,000) for fiscal 2009 and state and local taxes for fiscal 2009 and 2008 of \$6,000 and \$14,000, respectively. The current federal tax benefit is a result of employment tax credits that have been carried back to offset taxes previously paid. The deferred tax provision for fiscal 2009 and 2008 is \$448,000 and \$335,000, respectively and resulted from a change in the valuation allowance for deferred tax assets and an increase in deferred tax liabilities associated with indefinite lived intangible assets for book purposes.

**Liquidity and Capital Resources**

Cash flow activity for fiscal 2009 and 2008 is presented in the Consolidated Statements of Cash Flows. Cash used in operating activities was \$98,000 for the year ended March 1, 2009 compared to cash provided by operating activities of \$4,856,000 for the year ended March 2, 2008. The decrease in operating cash flow was primarily the result of lower net income, an increase in receivables and a decrease in accounts payable. The Company paid long-term bank debt of \$5,769,000 in fiscal 2009, compared to payments of \$13,691,000 in fiscal 2008, which included the refinancing of approximately \$10,901,000 of existing debt. Proceeds from the issuance of long-term debt were \$3,003,000 during fiscal 2009. There were no proceeds from stock option exercises in fiscal 2009, compared to \$220,000 in fiscal 2008. Capital expenditures in fiscal 2009 were \$3,626,000 compared to \$8,215,000 in fiscal 2008. This decrease is primarily a result of 16 fewer restaurants being image enhanced during the current year. Capital expenditures for fiscal 2010 are expected to be approximately \$1,500,000.

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 and equipment 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. Certain loans also require a consolidated funded debt (debt balance plus a calculation based on operating lease payments) to earnings before interest, taxes, depreciation, amortization and rent ratio of 5.5 or less. 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. At the end of fiscal 2009, the Company was not in compliance with the consolidated fixed charge coverage ratio of 1.2 or with the funded debt to EBITDAR ratio of 5.5 but has obtained waivers of the non-compliance. Also, at the end of fiscal 2009 the Company was not in compliance with the individual fixed charge coverage ratio on 19 of its restaurant properties and has obtained waivers with respect to the non-compliance.



**Market Risk Exposure**

Certain of the Company's debt comprising approximately \$14.5 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 \$145,000 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 if they are available. 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.

**Other Contractual Obligations and Commitments**

For KFC products, the Company is required to pay royalties of 4% of gross revenues and to expend an additional 5.5% of gross revenues on national and local advertising pursuant to its franchise agreements. For Taco Bell products in KFC/Taco 2n1 restaurants operated under license agreements from Taco Bell Corporation and franchise agreements from KFC Corporation, the Company is required to pay royalties of 10% of Taco Bell gross revenues and to make advertising fund contributions of 1/2% of Taco Bell gross revenues. For Taco Bell product sales in restaurants operated under Taco Bell franchises the Company is required to pay royalties of 5.5% of gross revenues and to expend an additional 4.5% of gross revenues on national and local advertising. For Pizza Hut products in Taco Bell/Pizza Hut Express 2n1 restaurants the Company is required to pay royalties of 5.5% of Pizza Hut gross revenues and to expend an additional 4.5% of Pizza Hut gross revenues on national and local advertising. For A&W products in 2n1 restaurants the Company is required to pay royalties of 7% of A&W gross revenues and to expend an additional 4% of A&W gross revenues on national and local advertising. Total royalties and advertising, which are included in the Consolidated Statements of Operations as part of restaurant operating expenses, were \$9,433,000 and \$9,569,000 in fiscal 2009 and 2008, respectively.

| <b>Contractual Obligations</b>     | <b>2010</b> | <b>2011</b> | <b>2012</b> | <b>2013</b> | <b>2014</b> | <b>Thereafter</b> |
|------------------------------------|-------------|-------------|-------------|-------------|-------------|-------------------|
| Long-term debt, including current  | \$3,031     | \$3,188     | \$3,388     | \$12,087    | \$4,070     | \$10,449          |
| Interest expense on long-term debt | \$2,582     | \$2,347     | \$2,089     | \$1,780     | \$1,084     | \$2,695           |
| Capital leases (1)                 | \$147       | \$148       | \$148       | \$146       | \$147       | \$1,419           |
| Operating leases (1)               | \$2,434     | \$2,237     | \$2,107     | \$1,867     | \$1,506     | \$12,155          |

(1) does not include contingent rental obligations based on sales performance

### **Required Capital Expenditures**

The Company is required by its franchise agreements to periodically bring its restaurants up to the required image of the franchisor. 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 which are unaudited:

| <b>Number<br/>of<br/>Units</b> | <b>Period</b> | <b>Type</b> | <b>Total (1)</b> | <b>Required (2)</b> | <b>Additional<br/>(3)</b> |
|--------------------------------|---------------|-------------|------------------|---------------------|---------------------------|
| 1                              | Fiscal 2010   | IE          | \$ 390,000       | 350,000             | \$ 40,000                 |
| 1                              | Fiscal 2011   | Relo (4)    | 1,400,000        | 1,400,000           |                           |
| 8                              | Fiscal 2011   | IE          | 2,560,000        | 2,240,000           | 320,000                   |
| 1                              | Fiscal 2012   | Relo (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                              | Fiscal 2015   | Relo (4)    | 5,600,000        | 5,600,000           |                           |
| 1                              | Fiscal 2016   | Relo (4)    | 1,400,000        | 1,400,000           |                           |
| 4                              | Fiscal 2020   | Relo (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. The Company may not be able to finance capital expenditures in the volume and time horizon required by the image enhancement deadlines 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.

#### **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. Also, the

fourth fiscal quarter contains the only two holidays for which the Company's restaurants are closed, contributing to lower sales in the period.

### **Critical Accounting Policies**

The Company's reported results are impacted by the application of certain accounting policies that require it to make subjective or complex judgments or to apply complex accounting requirements. These judgments include estimations about the effect of matters that are inherently uncertain and may significantly impact its quarterly or annual results of operations, financial condition or cash flows. Changes in the estimates and judgments could significantly affect results of operations, financial condition and cash flows in future years. The Company believes that its critical accounting policies are as follows:

Estimating future cash flows and fair value of assets associated with assessing potential impairment of long-lived tangible and intangible assets and projected compliance with debt covenants.

Determining the appropriate valuation allowances for deferred tax assets and reserves for potential tax exposures. See Note 8 to the consolidated financial statements for a discussion of income taxes.

Applying complex lease accounting requirements to the Company's capital and operating leases of property and equipment. The Company leases the building or land, or both, for nearly one-half of its restaurants. See Note 6 to the consolidated financial statements for a discussion of lease accounting.

### **New Accounting Standards**

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's adoption of SFAS No. 157 with respect to financial assets and liabilities has not had a material impact on its financial position, results of operations or related disclosures. The Company is evaluating the impact of adoption of SFAS No. 157 with respect to non-financial assets and liabilities on its financial position, results of operations and related disclosures.

In February 2007, the FASB issued SFAS No. 159 The Fair Value Option for Financial Assets and Financial Liabilities (SFAS No. 159). SFAS No. 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 No. 159 is effective for fiscal years beginning after November 15, 2007, the year beginning March 3, 2008 for the Company. The Company has determined not to utilize the fair value option provided in SFAS No. 159 for any of its financial assets or financial liabilities.

In March 2008, the FASB issued SFAS No. 161 Disclosure About Derivative Instruments and Hedging Activities-an amendment to FASB Statement 133 (SFAS No. 161). SFAS No. 161 requires enhanced disclosures about derivatives and hedging activities and the reasons for using them. SFAS No. 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 No. 161 to determine any impact for the Company. In December 2007, the FASB issued SFAS No. 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 will generally 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.

#### **Safe Harbor Statements**

Portions of this document contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. Such statements include those identified by such words as may, will, expect anticipate, believe, plan and other similar terminology. The forward-looking statements reflect the Company's current expectations, are based upon data available at the time of the statements and are subject to risks and uncertainties that could cause actual results or events to differ materially from those expressed in or implied by such statements. Such risks and uncertainties include 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, its ability to pay all of its current and long-term obligations and those factors described in Part I Item 1.A. ( Risk Factors ).

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 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

Certain of the Company's debt comprising approximately \$14.5 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 \$145,000 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 if they are available. 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 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA**  
**MORGAN S FOODS, INC.**  
**INDEX TO FINANCIAL STATEMENTS AND**  
**FINANCIAL STATEMENT SCHEDULES**

|  | Page<br>Reference |
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| <u>Consolidated Balance Sheets at March 1, 2009 and March 2, 2008</u>                                      | 22                |
| <u>Consolidated Statements of Operations for the years ended March 1, 2009 and March 2, 2008</u>           | 23                |
| <u>Consolidated Statements of Shareholders' Equity for the years ended March 1, 2009 and March 2, 2008</u> | 24                |
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**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

Board of Directors and Shareholders of  
Morgan's Foods, Inc.

We have audited the accompanying consolidated balance sheets of Morgan's Foods, Inc. (an Ohio corporation) and subsidiaries (the Company) as of March 1, 2009 and March 2, 2008, and the related consolidated statements of operations, shareholders' equity, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Morgan's Foods, Inc. and subsidiaries as of March 1, 2009 and March 2, 2008, and the results of their operations and their cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

/s/ GRANT THORNTON LLP

Cleveland, Ohio

June 1, 2009



**MORGAN S FOODS, INC.**  
Consolidated Balance Sheets  
March 1, 2009 and March 2, 2008

|   | <b>2009</b>   | <b>2008</b>   |
|---|---------------|---------------|
| <b>ASSETS</b>                                   |               |               |
| Current assets:                                 |               |               |
| Cash and equivalents                            | \$ 5,257,000  | \$ 6,428,000  |
| Receivables                                     | 806,000       | 423,000       |
| Inventories                                     | 731,000       | 755,000       |
| Prepaid expenses                                | 624,000       | 679,000       |
| Assets held for sale                            | 828,000       |               |
|   | 8,246,000     | 8,285,000     |
| Property and equipment:                         |               |               |
| Land  | 9,558,000     | 10,798,000    |
| Buildings and improvements                      | 20,692,000    | 22,588,000    |
| Property under capital leases                   | 1,314,000     | 1,314,000     |
| Leasehold improvements                          | 10,615,000    | 10,110,000    |
| Equipment, furniture and fixtures               | 19,891,000    | 21,047,000    |
| Construction in progress                        | 316,000       | 1,193,000     |
|   | 62,386,000    | 67,050,000    |
| Less accumulated depreciation and amortization  | 29,827,000    | 31,620,000    |
|   | 32,559,000    | 35,430,000    |
| Other assets                                    |               |               |
| Other assets                                    | 676,000       | 837,000       |
| Franchise agreements, net                       | 1,260,000     | 1,417,000     |
| Deferred tax asset                              | 594,000       | 766,000       |
| Goodwill  | 9,227,000     | 9,227,000     |
|   | \$ 52,562,000 | \$ 55,962,000 |
| <b>LIABILITIES AND SHAREHOLDERS EQUITY</b>      |               |               |
| Current liabilities:                            |               |               |
| Long-term debt, current                         | \$ 3,031,000  | \$ 3,190,000  |
| Current maturities of capital lease obligations | 39,000        | 34,000        |
| Accounts payable                                | 3,909,000     | 5,718,000     |
| Accrued liabilities                             | 3,934,000     | 4,678,000     |
|   | 10,913,000    | 13,620,000    |
| Long-term debt                                  |               |               |
| Long-term debt                                  | 33,182,000    | 35,789,000    |
| Long-term capital lease obligations             | 1,105,000     | 1,144,000     |
| Other long-term liabilities                     | 4,061,000     | 1,083,000     |
| Deferred tax liabilities                        | 2,130,000     | 1,853,000     |

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           | 30,000        | 30,000        |
| Treasury shares 34,410            | (81,000)      | (81,000)      |
| Capital in excess of stated value | 29,432,000    | 29,344,000    |
| Accumulated deficit               | (28,210,000)  | (26,820,000)  |
| Total shareholders equity         | 1,171,000     | 2,473,000     |
|                                   | \$ 52,562,000 | \$ 55,962,000 |

See accompanying Notes to Consolidated Financial Statements.

**MORGAN S FOODS, INC.**  
 Consolidated Statements of Operations  
 Years Ended March 1, 2009 and March 2, 2008

|   | <b>2009</b>    | <b>2008</b>  |
|---|----------------|--------------|
| Revenues                                    | \$92,485,000   | \$96,318,000 |
| Cost of sales:                              |                |              |
| Food, paper and beverage                    | 29,695,000     | 29,524,000   |
| Labor and benefits                          | 26,850,000     | 27,404,000   |
| Restaurant operating expenses               | 24,068,000     | 24,415,000   |
| Depreciation and amortization               | 3,224,000      | 2,953,000    |
| General and administrative expenses         | 5,740,000      | 6,111,000    |
| Loss on restaurant assets                   | 417,000        | 112,000      |
| Operating income                            | 2,491,000      | 5,799,000    |
| Interest expense:                           |                |              |
| Prepayment and deferred financing costs     | (525,000)      | (1,872,000)  |
| Bank debt and notes payable                 | (3,190,000)    | (3,472,000)  |
| Capital leases                              | (111,000)      | (125,000)    |
| Other income and expense, net               | 336,000        | 433,000      |
| Income (loss) before income taxes           | (999,000)      | 763,000      |
| Provision for income taxes                  | 391,000        | 349,000      |
| Net income (loss)                           | \$ (1,390,000) | \$ 414,000   |
| Basic net income (loss) per common share:   | \$ (0.47)      | \$ 0.14      |
| Diluted net income (loss) per common share: | \$ (0.47)      | \$ 0.14      |

See accompanying Notes to Consolidated Financial Statements.

**MORGAN S FOODS, INC.**  
 Consolidated Statements of Shareholders Equity  
 Years Ended March 1, 2009 and March 2, 2008

|                                  | Common Shares |           | Treasury Shares |             | Capital in<br>excess of<br>stated value | Accumulated<br>Deficit | Total<br>Shareholders<br>Equity |
|----------------------------------|---------------|-----------|-----------------|-------------|---|------------------------|---------------------------------|
|                                  | Shares        | Amount    | Shares          | Amount      |   |                        |                                 |
| Balance<br>February 25, 2007     | 2,969,405     | \$ 30,000 | (88,410)        | \$(131,000) | \$ 29,174,000                           | \$(27,234,000)         | \$ 1,839,000                    |
| Net income                       |               |           |                 |             |   | 414,000                | 414,000                         |
| Exercise of stock<br>options     |               |           | 54,000          | 50,000      | 170,000                                 |                        | 220,000                         |
| Balance March 2,<br>2008         | 2,969,405     | 30,000    | (34,410)        | (81,000)    | 29,344,000                              | (26,820,000)           | 2,473,000                       |
| Net loss                         |               |           |                 |             |   | (1,390,000)            | (1,390,000)                     |
| Stock<br>compensation<br>expense |               |           |                 |             | 88,000                                  |                        | 88,000                          |
| Balance March 1,<br>2009         | 2,969,405     | \$ 30,000 | (34,410)        | \$(81,000)  | \$ 29,432,000                           | \$(28,210,000)         | \$ 1,171,000                    |

See accompanying Notes to Consolidated Financial Statements.

**MORGAN S FOODS, INC.**  
Consolidated Statements of Cash Flows  
Years Ended March 1, 2009 and March 2, 2008

|  | <b>2009</b>   | <b>2008</b>  |
|--|---------------|--------------|
| <b>Cash flows from operating activities:</b>                           |               |              |
| Net income (loss)  | \$(1,390,000) | \$ 414,000   |
| Adjustments to reconcile to net cash provided by operating activities: |               |              |
| Depreciation and amortization  | 3,224,000     | 2,953,000    |
| Amortization of deferred financing costs                               | 122,000       | 100,000      |
| Amortization of supply agreement advances                              | (1,165,000)   | (1,071,000)  |
| Funding from supply agreements   | 457,000       | 951,000      |
| Deferred income taxes  | 449,000       | 59,000       |
| Stock compensation expense   | 88,000        |              |
| Loss on restaurant assets  | 417,000       | 112,000      |
| Changes in assets and liabilities:                                     |               |              |
| Receivables  | (383,000)     | (78,000)     |
| Inventories  | 24,000        | (68,000)     |
| Prepaid expenses   | 55,000        | (79,000)     |
| Other assets   | 39,000        | (138,000)    |
| Accounts payable   | (1,809,000)   | 1,427,000    |
| Accrued liabilities  | (226,000)     | (2,000)      |
| Net cash provided by (used in) operating activities                    | (98,000)      | 4,856,000    |
| <b>Cash flows from investing activities:</b>                           |               |              |
| Capital expenditures   | (3,626,000)   | (8,215,000)  |
| Purchase of franchise agreement, net of disposals                      | (9,000)       | (24,000)     |
| Proceeds from sale/leaseback transactions                              | 5,188,000     |              |
| Proceeds from sale of fixed assets                                     | 174,000       | 178,000      |
| Net cash provided by (used in) investing activities                    | 1,727,000     | (8,061,000)  |
| <b>Cash flows from financing activities:</b>                           |               |              |
| Proceeds from issuance of long-term debt, net of financing costs       | 3,003,000     | 15,312,000   |
| Principal payments on long-term debt                                   | (5,769,000)   | (13,691,000) |
| Principal payments on capital lease obligations                        | (34,000)      | (37,000)     |
| Cash received for exercise of stock options                            |               | 220,000      |
| Net cash provided by (used in) financing activities                    | (2,800,000)   | 1,804,000    |
| Net change in cash and equivalents                                     | (1,171,000)   | (1,401,000)  |
| Cash and equivalents, beginning balance                                | 6,428,000     | 7,829,000    |
| Cash and equivalents, ending balance                                   | \$ 5,257,000  | \$ 6,428,000 |

Interest paid was \$3,262,000 and \$3,436,000 in fiscal 2009 and 2008, respectively

Cash payments (refunds) for income taxes were \$(27,000) and \$240,000 in fiscal 2009 and 2008, respectively



**MORGAN S FOODS, INC.**

Notes to Consolidated Financial Statements

March 1, 2009, March 2, 2008

**NOTE 1. DESCRIPTION OF BUSINESS AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES.**

*Description of Business* Morgan s Foods, Inc. and its subsidiaries ( the Company ) operate 68 KFC restaurants, 6 Taco Bell restaurants, 13 KFC/Taco Bell 2n1 restaurants, 3 Taco Bell/Pizza Hut Express 2n1 restaurants, 1 KFC/Pizza Hut Express 2n1 and 1 KFC/A&W 2n1 , in the states of Illinois, Missouri, Ohio, Pennsylvania, West Virginia and New York. The Company s fiscal year is a 52-53 week year ending on the Sunday nearest the last day of February.

*Use of Estimates* The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions pending completion of related events. These estimates and assumptions include the recoverability of tangible and intangible asset values, the probability of receiving insurance proceeds, projected compliance with financing agreements and the realizability of deferred tax assets. These estimates and assumptions affect the amounts reported at the date of the financial statements for assets, liabilities, revenues and expenses and the disclosure of contingencies. Actual results could differ from those estimates.

*Principles of Consolidation* The consolidated financial statements include the accounts of the Company. All significant intercompany transactions and balances have been eliminated.

*Revenue Recognition* The Company recognizes revenue as customers pay for products at the time of sale. Taxes collected from customers and remitted to governmental agencies, such as sales taxes, are not included in revenue.

*Advertising Costs* The Company expenses advertising costs as incurred. Advertising expense was \$5,521,000 and \$5,483,000 for fiscal years 2009 and 2008, respectively.

*Cash and Cash Equivalents* The Company considers all highly liquid debt instruments purchased with an initial maturity of three months or less to be cash equivalents. The Company generally carries cash balances at financial institutions which are in excess of the FDIC insurance limits.

*Inventories* Inventories, principally food, beverages and paper products, are stated at the lower of aggregate cost (first-in, first-out basis) or market.

*Property and Equipment* Property and equipment are stated at cost. Depreciation is computed using the straight-line method over the estimated useful lives of the related assets as follows: buildings and improvements 3 to 20 years; equipment, furniture and fixtures 3 to 10 years. Leasehold improvements are amortized over 3 to 15 years, which is the shorter of the life of the asset or the life of the lease. The asset values of the capitalized leases are amortized using the straight-line method over the lives of the respective leases which range from 5 to 20 years.

Management assesses the carrying value of property and equipment whenever there is an indication of potential impairment, including quarterly assessments of any restaurant with negative cash flows. If

the property and equipment of a restaurant on a held and used basis are not recoverable based upon forecasted, undiscounted cash flows, the assets are written down to their fair value. Management uses a valuation methodology to determine fair value, which is the sum of the restaurant's business value and real estate value. Business value is determined using a cash flow multiplier based upon market conditions and estimated cash flows of the restaurant. Real estate value is generally determined based upon the discounted market value of implied rent of the owned assets. Management believes the carrying value of property and equipment, after impairment write-downs, will be recovered from future cash flows.

*Deferred Financing Costs* Costs related to the acquisition of long-term debt are capitalized and expensed as interest over the term of the related debt. Amortization expense was \$122,000 and \$100,000 for fiscal years 2009 and 2008, respectively. The balance of deferred financing costs was \$580,000 at March 1, 2009 and \$711,000 at March 2, 2008 and is included in other assets in the consolidated balance sheets.

*Franchise Agreements* Franchise agreements are recorded at cost. Amortization is computed on the straight-line method over the term of the franchise agreement. The Company's franchise agreements are predominantly 20 years in length.

*Goodwill* Goodwill represents the cost of acquisitions in excess of the fair value of identifiable assets. In accordance with Statement of Financial Accounting Standards (SFAS) No. 142, Goodwill and Other Intangible Assets, goodwill is not amortized, but is subject to assessment for impairment whenever there is an indication of impairment or at least annually as of fiscal year end by applying a fair value based test.

*Advance on Supply Agreements* In conjunction with entering into contracts that require the Company to sell exclusively the specified beverage products for the term of the contract, the Company has received advances from the supplier. The Company amortizes advances on supply agreements as a reduction of food, paper and beverage cost of sales over the term of the related contract using the straight-line method. These advances of \$662,000 and \$345,000 at March 1, 2009 and March 2, 2008, respectively, are included in other long-term liabilities in the consolidated balance sheets net of \$201,000 and \$787,000 included in accrued liabilities as of such date.

*Lease Accounting* Operating lease expense is recognized on the straight-line basis over the term of the lease for those leases with fixed escalations. The difference between the scheduled amounts and the straight-line amounts is accrued. These accruals of \$426,000 and \$395,000 at March 1, 2009 and March 2, 2008, respectively, are included in other long-term liabilities in the consolidated balance sheets net of \$65,000 and \$55,000 included in accrued liabilities as of such date.

*Income Taxes* The provision for income taxes is based upon income or loss before tax for financial reporting purposes. Deferred tax assets or liabilities are recognized for the expected future tax consequences of temporary differences between the tax basis of assets and liabilities and their carrying values for financial reporting purposes. Deferred tax assets are also recorded for operating loss and tax credit carryforwards. A valuation allowance is recorded to reduce deferred tax assets to the amount more likely than not to be realized in the future, based on an evaluation of historical and projected profitability. Effective February 26, 2007, we adopted FASB Interpretation 48 (FIN 48), Accounting for Uncertainty in Income Taxes—An Interpretation of Statement of Financial Accounting Standards No. 109. FIN 48 requires that a position taken or expected to be taken in a tax return be recognized in the financial statements when it is more likely than not (i.e., a likelihood of more than fifty percent) that the position would be sustained upon examination by tax authorities. A recognized tax position is then measured at the largest amount of benefit that is greater than fifty percent likely of being realized upon ultimate settlement. Upon adoption, we determined that the provisions of FIN 48



did not have a material effect on prior financial statements and therefore no change was made to the opening balance of retained earnings. FIN 48 also requires that changes in judgment that result in subsequent recognition, derecognition or change in a measurement of a tax position taken in a prior annual period (including any related interest and penalties) be recognized as a discrete item in the period in which the change occurs. It is the Company's policy to include any penalties and interest related to income taxes in its income tax provision, however, the Company currently has no penalties or interest related to income taxes. The earliest year that the Company is subject to examination is the fiscal year ended February 29, 2004.

*Stock-Based Compensation* In December 2004, the FASB issued SFAS No. 123R, *Share-Based Payment*. The Company adopted these provisions effective February 27, 2006 utilizing the modified prospective application method, and determined that there was no effect on options outstanding at the time of adoption as all options issued and outstanding at February 27, 2006 were fully vested. For the fiscal year ended March 1, 2009 the Company reported \$88,000 of compensation expense relating to stock options issued on November 6, 2008, the first stock options granted after the adoption of SFAS No. 123R. See Note 9 for further discussion.

#### **NOTE 2. LOSS ON RESTAURANT ASSETS**

The Company had a loss on restaurant assets of \$417,000 in fiscal 2009 compared to \$112,000 in fiscal 2008. The fiscal 2009 loss primarily reflects loss realized from movements of fixed assets to assets held for sale, and a \$245,000 charge for asset impairment write downs.

#### **NOTE 3. INTANGIBLE ASSETS**

In accordance with SFAS No. 142, *Goodwill and Other Intangible Assets*, goodwill and intangibles with indefinite lives are not subject to amortization, but are subject to assessment for impairment whenever there is an indication of impairment or, at least annually as of the Company's yearend by applying a fair value based test. The Company has five reporting units for the purpose of evaluating goodwill impairment which are based on the geographic market areas of its restaurants. These five reporting units are Youngstown, OH, West Virginia, Pittsburgh, PA, St Louis, MO and Erie, PA. The Company has performed the annual goodwill impairment tests during fiscal 2009 and 2008 and determined that the fair value of each reporting unit was greater than its carrying value at each date.

|                      | <b>Intangible Assets</b> |                             |                          |                             |
|----------------------|--------------------------|-----------------------------|--------------------------|-----------------------------|
|                      | As of March 1, 2009      |                             | As of March 2, 2008      |                             |
|                      | Gross Carrying<br>Amount | Accumulated<br>Amortization | Gross Carrying<br>Amount | Accumulated<br>Amortization |
| Franchise Agreements | \$ 2,418,000             | \$(1,158,000)               | \$ 2,489,000             | \$(1,072,000)               |
| Goodwill             | 10,593,000               | (1,366,000)                 | 10,593,000               | (1,366,000)                 |
| Total                | \$13,011,000             | \$(2,524,000)               | \$13,082,000             | \$(2,438,000)               |

The Company's intangible asset amortization expense relating to its franchise agreements was \$166,000 and \$151,000 for fiscal 2009 and 2008, respectively. The estimated intangible amortization expense for each of the next five years is \$145,000 per year.

The decrease in franchise agreements in fiscal 2009 resulted from \$9,000 in new agreements offset by the write off of agreements for closed restaurants.

**NOTE 4. ACCRUED LIABILITIES**

Accrued liabilities consist of the following at March 1, 2009 and March 2, 2008:

|   | <b>2009</b>        | <b>2008</b>        |
|---|--------------------|--------------------|
| Accrued compensation                              | \$1,911,000        | \$2,277,000        |
| Accrued taxes other than income taxes             | 896,000            | 873,000            |
| Accrued liabilities related to closed restaurants | 51,000             | 57,000             |
| Deferred gain on sale/leaseback                   | 197,000            | 18,000             |
| Current portion of supply agreement               | 201,000            | 787,000            |
| Current portion rent smoothing                    | 65,000             | 55,000             |
| Other accrued expenses                            | 613,000            | 611,000            |
|   | <b>\$3,934,000</b> | <b>\$4,678,000</b> |

**NOTE 5. DEBT**

Debt consists of the following at March 1, 2009 and March 2, 2008:

|  | 2009          | 2008          |
|--|---------------|---------------|
| Mortgage debt, interest at 8.3-10.6%, through 2019, collateralized by 44 restaurants in 2009 and 48 restaurants in 2008 having a net book value at March 1, 2009 of \$17,287,000 and at March 2, 2008 of \$17,781,000  | \$ 19,095,000 | \$ 23,678,000 |
| Mortgage debt, interest at 7.2-7.3% fixed through 2018 and variable thereafter, collateralized by two restaurants having a net book value at March 1, 2009 of \$1,483,000 and at March 2, 2008 of \$1,136,000  | 2,155,000     | 2,205,000     |
| Equipment loan, interest at 7.1% fixed through 2017, collateralized by equipment at two restaurants  | 397,000       | 428,000       |
| Mortgage debt, variable interest of 4.08% at March 1, 2009, amortization to 2028 with a term to 2013 collateralized by 13 restaurants in 2009 and 10 restaurants in 2008 having a net book value at March 1, 2009 of \$5,902,000 and at March 2, 2008 of \$5,371,000 | 8,834,000     | 6,250,000     |
| Equipment loan, variable interest of 4.83% at March 1, 2009, amortization to 2018 with a term to 2013 collateralized by the equipment at 17 restaurants  | 2,910,000     | 6,350,000     |
| Equipment loan from franchisor for proprietary equipment, variable interest of 3.11% at March 1, 2009 through 2010   | 22,000        | 68,000        |
| Equipment loan, variable interest rate of 5.18% at March 1, 2009, amortization to 2018 with a term to 2013 collateralized by the equipment at 10 restaurants   | 2,800,000     |               |
|  | 36,213,000    | 38,979,000    |
| Less long term debt  | 33,182,000    | 35,789,000    |
| Long term debt, current portion  | \$ 3,031,000  | \$ 3,190,000  |

The combined aggregate amounts of scheduled future maturities for all long-term debt as of March 1, 2009:

|             |               |
|-------------|---------------|
| 2010        | \$ 3,031,000  |
| 2011        | 3,188,000     |
| 2012        | 3,388,000     |
| 2013        | 12,087,000    |
| 2014        | 4,070,000     |
| Later years | 10,449,000    |
|             | \$ 36,213,000 |

The Company paid interest relating to long-term debt of approximately \$3,262,000 and \$3,436,000 in fiscal 2009 and 2008, respectively.

During the second quarter of fiscal 2009, 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 unamortized 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 has listed it for sale. 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 period of ten years. 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 unamortized deferred financing costs related to the loans. In the fourth quarter of fiscal 2009 the Company sold a property and paid the debt before maturity to facilitate the sale. The debt balance was \$298,000, prepayment and administrative expenses were \$93,000 and unamortized deferred financing costs were \$4,000. All of the write offs of deferred financing costs are non-cash charges.

During the fourth quarter of fiscal 2008 the Company completed the funding of two loan agreements totaling \$12,600,000, the proceeds of which were used to retire \$10,901,000 of debt before its scheduled maturity. As a result of the early payment, the Company was required to pay prepayment penalties and administrative fees of \$1,718,000 and write off \$154,000 of unamortized deferred financing costs remaining from the origination of the loans in fiscal 2000. The write offs of deferred financing costs are a non-cash charge.

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 and equipment 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. Certain loans also require a consolidated funded debt (debt balance plus a calculation based on operating lease payments) to earnings before interest, taxes, depreciation, amortization and rent ratio of 5.5 or less. 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. At the end of fiscal 2009, the Company was not in

compliance with the consolidated fixed charge coverage ratio of 1.2 or with the funded debt to EBITDAR ratio of 5.5 but has obtained waivers of the non-compliance. Also, at the end of fiscal 2009 the Company was not in compliance with the individual fixed charge coverage ratio on 19 of its restaurant properties and has obtained waivers with respect to the non-compliance.

**NOTE 6. LEASE OBLIGATIONS AND OTHER COMMITMENTS**

Property under capital leases at March 1, 2009 and March 2, 2008 are as follows:

|                                   | <b>2009</b>  | <b>2008</b>  |
|-----------------------------------|--------------|--------------|
| Leased property:                  |              |              |
| Buildings and land                | \$ 1,298,000 | \$ 1,298,000 |
| Equipment, furniture and fixtures | 16,000       | 16,000       |
| Total                             | 1,314,000    | 1,314,000    |
| Less accumulated amortization     | 434,000      | 351,000      |
|                                   | \$ 880,000   | \$ 963,000   |

Amortization of leased property under capital leases was \$83,000 and \$89,000 in fiscal 2009 and 2008, respectively. Related obligations under capital leases at March 1, 2009 and March 2, 2008 are as follows:

|                                     | <b>2009</b>  | <b>2008</b>  |
|-------------------------------------|--------------|--------------|
| Capital lease obligations           | \$ 1,144,000 | \$ 1,178,000 |
| Less current maturities             | 39,000       | 34,000       |
| Long-term capital lease obligations | \$ 1,105,000 | \$ 1,144,000 |

The Company paid interest of approximately \$111,000 and \$125,000 relating to capital lease obligations in fiscal 2009 and 2008, respectively.

Future minimum rental payments to be made under capital leases at March 1, 2009 are as follows:

|  |              |
|--|--------------|
| 2010                                     | \$ 147,000   |
| 2011                                     | 148,000      |
| 2012                                     | 148,000      |
| 2013                                     | 146,000      |
| 2014                                     | 147,000      |
| Later years                              | 1,419,000    |
|  | 2,155,000    |
| Less amount representing interest at 10% | 1,011,000    |
| Total obligations under capital leases   | \$ 1,144,000 |

The Company's operating leases for restaurant land and buildings are noncancellable and expire on various dates through 2028. The leases have renewal options ranging from 1 to 40 years. Certain restaurant land and building leases require the payment of additional rent equal to an amount by which a percentage of annual sales exceeds annual minimum rentals. Total contingent rentals were \$91,000 and \$118,000 in fiscal 2009 and 2008, respectively. Future noncancellable minimum rental payments under operating leases at March 1, 2009 are as follows: 2010 - \$2,434,000; 2011 - \$2,237,000; 2012 - \$2,107,000; 2013 - \$1,867,000; 2014 - \$1,506,000 and an aggregate \$12,155,000 for the years thereafter. Rental expense for all operating leases was \$2,349,000 and \$2,126,000 for fiscal 2009 and 2008, respectively, and is included in restaurant operating expenses in the consolidated statements of operations.

For KFC products, the Company is required to pay royalties of 4% of gross revenues and to expend an additional 5.5% of gross revenues on national and local advertising pursuant to its franchise agreements. For Taco Bell products in KFC/Taco Bell restaurants operated under license agreements from Taco Bell Corporation and franchise agreements from KFC Corporation, the Company is required to pay royalties of 10% of Taco Bell gross revenues and to make advertising fund contributions of 1/2% of Taco Bell gross revenues. For Taco Bell product sales in restaurants operated under Taco Bell franchises the Company is required to pay royalties of 5.5% of gross revenues and to expend an additional 4.5% of gross revenues on national and local advertising. For Pizza Hut products in Taco Bell/Pizza Hut Express restaurants the Company is required to pay royalties of 5.5% of Pizza Hut gross revenues and to expend an additional 4.5% of Pizza Hut gross revenues on national and local advertising. For A&W products in restaurants the Company is required to pay royalties of 7% of A&W gross revenues and to expend an additional 4% of A&W gross revenues on national and local advertising. Total royalties and advertising, which are included in the consolidated statements of operations as part of restaurant operating expenses, were \$9,433,000 and \$9,569,000 in fiscal 2009 and 2008, respectively.

The Company is required by its franchise agreements to periodically bring its restaurants up to the required image of the franchisor. 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 which are unaudited:

| <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                      | Fiscal 2011   | Relo (4)    | 1,400,000        | 1,400,000           |                       |
| 8                      | Fiscal 2011   | IE          | 2,560,000        | 2,240,000           | 320,000               |
| 1                      | Fiscal 2012   | Relo (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                      | Fiscal 2015   | Relo (4)    | 5,600,000        | 5,600,000           |                       |
| 1                      | Fiscal 2016   | Relo (4)    | 1,400,000        | 1,400,000           |                       |
| 4                      | Fiscal 2020   | Relo (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. The Company may not be able to finance capital expenditures in the volume and time horizon required by the image enhancement deadlines 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. 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 which totaled 2,934,995 and 2,911,448 for fiscal 2009 and 2008, respectively. Diluted net income (loss) per common share is based on the combined weighted average number of shares and dilutive stock options outstanding during the period which totaled 2,943,415 and 2,968,654 for fiscal 2009 and 2008, respectively. In computing diluted net income (loss) per common share, the Company has utilized the treasury stock method.

**NOTE 8. INCOME TAXES**

The current tax provision consists of federal tax benefit of \$63,000 for fiscal 2009 and state and local tax provisions for fiscal 2009 and 2008 of \$6,000 and \$14,000, respectively. The current federal tax benefit is a result of employment tax credits that have been carried back to offset taxes previously paid. The deferred tax provision for fiscal 2009 and 2008 is \$448,000 and \$335,000, respectively and resulted from a change in the valuation allowance for deferred tax assets and an increase in deferred tax liabilities associated with indefinite lived intangible assets for book purposes. A reconciliation of the provision for income taxes and income taxes calculated at the statutory tax rate of 34% is as follows:

|  | 2009        | 2008      |
|--|-------------|-----------|
| Tax provision (benefit) at statutory rate                              | \$(340,000) | \$260,000 |
| State and local taxes, net of federal benefit                          | 4,000       | 9,000     |
| Deferred tax provision-change in valuation allowance                   | 846,000     | 11,000    |
| Deferred tax provision-change in deferred state and local income taxes | (60,000)    | 42,000    |
| Employment tax credits   | (86,000)    |           |
| Other  | 27,000      | 27,000    |
|  | \$ 391,000  | \$349,000 |

The components of deferred tax assets (liabilities) at March 1, 2009 and March 2, 2008 are as follows:

|   | 2009           | 2008           |
|---|----------------|----------------|
| Operating loss carryforwards  | \$ 1,620,000   | \$ 1,113,000   |
| Tax credit carryforwards  | 284,000        | 171,000        |
| Stock Options   | 34,000         |                |
| Property and equipment  | 2,049,000      | 3,121,000      |
| Deferred gain on sale/leaseback   | 1,319,000      | 121,000        |
| Accrued expenses not currently deductible                                   | 302,000        | 342,000        |
| Prepaid expenses  | (176,000)      | (168,000)      |
| Inventory valuation   | 6,000          | 7,000          |
| Advance payments  | 135,000        | 182,000        |
| Intangible assets   | (102,000)      | (92,000)       |
| Deferred tax asset valuation allowance                                      | (4,877,000)    | (4,031,000)    |
| Net deferred tax asset  | \$ 594,000     | \$ 766,000     |
| Deferred tax liabilities associated with indefinite lived intangible assets | (2,130,000)    | (1,853,000)    |
| Net total deferred taxes  | \$ (1,536,000) | \$ (1,087,000) |

The valuation allowance increased \$846,000 and \$11,000 during fiscal years 2009 and 2008, respectively from a change in judgment regarding the future realization of deferred tax assets.

At March 1, 2009, the Company has net operating loss carryforwards which, if not utilized, will expire as follows:

|       |              |
|-------|--------------|
| 2023  | \$ 705,000   |
| 2024  | 383,000      |
| 2025  | 1,481,000    |
| 2028  | 1,022,000    |
| 2029  | 990,000      |
| Total | \$ 4,581,000 |

The net operating loss carryforwards include \$438,000 attributable to stock options exercised where the tax benefit has not yet been realized. The tax benefit of \$171,000 will be credited to equity if realized. The Company also has alternative minimum tax net operating loss carryforwards of \$3,309,000 that will expire, if not utilized, in varying amounts through fiscal 2029. These carryforwards are available to offset up to 90% of alternative minimum taxable income that would otherwise be taxable. As of March 1, 2009, the Company has alternative minimum tax credit carryforwards of \$108,000 and employment tax credit carryforwards of \$176,000.

In connection with the provisions of FIN 48, the Company has analyzed its filing positions in all of the federal and state jurisdictions where it is required to file income tax returns, as well as all open tax years in these jurisdictions. The earliest year that the Company is subject to federal and state examination is the fiscal year ended February 29, 2004.

Upon adopting the provisions of FIN 48, the Company believed that its income tax filing positions and deductions would be sustained on audit and did not anticipate any adjustments that would result in a material

change to its financial position. Therefore, no reserves for uncertain income tax positions were recorded and the Company did not record a cumulative effect adjustment related to the adoption of FIN 48. In addition, the Company has not recorded a reserve related to FIN 48 during fiscal year 2009 and does not expect a material change in the next 12 months of unrecognized tax benefits. There are also no amounts that if recognized would affect the Company's annual effective tax rate.

It is the Company's policy to include any interest and penalties related to income taxes in its income tax provision, however, the Company currently has no interest or penalties related to income taxes.

#### **NOTE 9. STOCK OPTIONS AND SHAREHOLDERS' EQUITY**

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 145,150 shares were granted to executives and managers of the Company on April 2, 1999 at an exercise price of \$4.125 and options for 350 shares were granted on November 6, 2008 at an exercise price of \$1.50. 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. Options for 149,650 shares were granted to executives on November 6, 2008 at an exercise price of \$1.50. As of March 1, 2009, no options were available for grant under either plan.

Prior to February 27, 2006, the Company applied APB No. 25 and related interpretations in accounting for its option grants for employees. In December 2004, the FASB issued SFAS No. 123R, "Share-Based Payment". The Company has adopted these provisions effective February 27, 2006 utilizing the modified prospective application method, and has determined that there is no effect on options outstanding at the time of adoption as all options issued and outstanding at February 27, 2006 were fully vested. For the fiscal year ended March 1, 2009 the Company reported \$88,000 of compensation expense relating to stock options issued on November 6, 2008, the first stock options granted after the adoption of SFAS No. 123R. The calculation of compensation expense was made using the simplified method with a volatility of 70 percent and a risk free rate of 4.299 percent and resulted in total compensation expense of \$143,000 to be recognized over the vesting period of the options. The remainder of the compensation expense of \$55,000 will be recorded in the first quarter of fiscal 2010.

No options were granted during fiscal year 2008. During fiscal 2009 no options were exercised. During fiscal 2008 options covering 54,000 shares were exercised at various prices. As of March 1, 2009, there were 70,000 options outstanding and exercisable at a weighted average exercise price of \$4.00 per share and 150,000 options outstanding but not exercisable. At March 2, 2008, there were 124,000 options outstanding and exercisable at a weighted average exercise price of \$4.03 per share.

The following table summarizes information about stock options outstanding at March 1, 2009:

| <b>Exercise<br/>Prices</b> | <b>Outstanding<br/>3-1-09</b> | <b>Average<br/>Life</b> | <b>Number<br/>Exercisable</b> |
|----------------------------|-------------------------------|-------------------------|-------------------------------|
| 3.000                      | 7,500                         | 0.8                     | 7,500                         |
| 4.125                      | 62,500                        | 0.1                     | 62,500                        |
| 1.500                      | 150,000                       | 9.7                     |                               |
|                            | 220,000                       | 6.6                     | 70,000                        |

On April 8, 1999, the Company adopted a Shareholder Rights Plan in which the Board of Directors declared a distribution of one Right for each of the Company's outstanding Common Shares. Each Right entitles the holder to purchase from the Company one one-thousandth of a Series A Preferred Share (a Preferred Share) at a purchase price of \$30.00 per Right, subject to adjustment. One one-thousandth of a Preferred Share is intended to be approximately the economic equivalent of one Common Share. During fiscal 2008 the Board of Directors voted to extend the term of its Shareholder Rights Plan to April 7, 2014 and to make several technical amendments to the Plan. Previously the Plan had an expiration date of April 7, 2009. The Rights will expire on April 7, 2014, unless redeemed by the Company as described below.

The Rights are neither exercisable nor traded separately from the Common Shares. The Rights will become exercisable and begin to trade separately from the Common Shares if a person or group, unless approved in advance by the Company Board of Directors, becomes the beneficial owner of 21% or more of the then-outstanding Common Shares or announces an offer to acquire 21% or more of the then-outstanding Common Shares.

If a person or group acquires 21% or more of the outstanding Common Shares, then each Right not owned by the acquiring person or its affiliates will entitle its holder to purchase, at the Right's then-current exercise price, fractional Preferred Shares that are approximately the economic equivalent of Common Shares (or, in certain circumstances, Common Shares, cash, property or other securities of the Company) having a market value equal to twice the then-current exercise price. In addition, if, after the Rights become exercisable, the Company is acquired in a merger or other business combination transaction with an acquiring person or its affiliates or sells 50% or more of its assets or earnings power to an acquiring person or its affiliates, each Right will entitle its holder to purchase, at the Right's then-current exercise price, a number of shares of the acquiring person's common stock having a market value of twice the Right's exercise price. The Board of Directors may redeem the Rights in whole, but not in part, at a price of \$.01 per Right, subject to certain limitations.

#### **NOTE 10. 401(k) RETIREMENT PLAN**

The Company has a 401(k) Retirement Plan in which employees age 21 or older are eligible to participate. The Company makes a 30% matching contribution on employee contributions of up to 6% of their salary. During fiscal 2009 and 2008, the Company incurred \$67,000 and \$90,000, respectively, in expenses for matching contributions to the plan.

#### **NOTE 11. FAIR VALUE OF FINANCIAL INSTRUMENTS**

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 March 1, 2009.

**NOTE 12. NEW ACCOUNTING STANDARDS**

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's adoption of SFAS No. 157 with respect to financial assets and liabilities has not had a material impact on its financial position, results of operations or related disclosures. The Company is evaluating the impact of adoption of SFAS No. 157 with respect to non-financial assets and liabilities on its financial position, results of operations and related disclosures.

In February 2007, the FASB issued SFAS No. 159 The Fair Value Option for Financial Assets and Financial Liabilities (SFAS No. 159). SFAS No. 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 No. 159 is effective for fiscal years beginning after November 15, 2007, the year beginning March 3, 2008 for the Company. The Company has determined not to utilize the fair value option provided in SFAS No. 159 for any of its financial assets or financial liabilities.

In March 2008, the FASB issued SFAS No. 161 Disclosure About Derivative Instruments and Hedging Activities-an amendment to FASB Statement 133 (SFAS No. 161). SFAS No. 161 requires enhanced disclosures about derivatives and hedging activities and the reasons for using them. SFAS No. 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 No. 161 to determine any impact for the Company.

In December 2007, the FASB issued SFAS No. 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 will generally 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 13. SELECTED QUARTERLY FINANCIAL DATA (UNAUDITED)**

|   |                         | <b>Fiscal 2009 Quarter Ended</b> |                             |                          |  |
|---|-------------------------|----------------------------------|-----------------------------|--------------------------|--|
|   | <b>May 25,<br/>2008</b> | <b>August 17,<br/>2008</b>       | <b>November 9,<br/>2008</b> | <b>March 1,<br/>2009</b> |  |
| Revenues                                  | \$ 21,753,000           | \$ 23,049,000                    | \$ 21,967,000               | \$ 25,716,000            |  |
| Operating costs and expenses, net         | 20,817,000              | 22,250,000                       | 21,100,000                  | 25,827,000               |  |
| Operating income                          | 936,000                 | 799,000                          | 867,000                     | (111,000)                |  |
| Net income (loss)                         | 94,000                  | (641,000)                        | (67,000)                    | (776,000)                |  |
| Basic net income (loss) per share         | 0.03                    | (0.22)                           | (0.02)                      | (0.26)                   |  |
| Fully diluted net income (loss) per share | 0.03                    | (0.22)                           | (0.02)                      | (0.26)                   |  |

|   |                         | <b>Fiscal 2008 Quarter Ended</b> |                             |                          |  |
|---|-------------------------|----------------------------------|-----------------------------|--------------------------|--|
|   | <b>May 20,<br/>2007</b> | <b>August 12,<br/>2007</b>       | <b>November 4,<br/>2007</b> | <b>March 2,<br/>2008</b> |  |
| Revenues                                  | \$ 22,650,000           | \$ 22,877,000                    | \$ 22,282,000               | \$ 28,509,000            |  |
| Operating costs and expenses, net         | 20,581,000              | 20,949,000                       | 21,162,000                  | 27,827,000               |  |
| Operating income                          | 2,069,000               | 1,928,000                        | 1,120,000                   | 682,000                  |  |
| Net income (loss)                         | 830,000                 | 870,000                          | 161,000                     | (1,447,000)              |  |
| Basic net income (loss) per share         | 0.29                    | 0.30                             | 0.05                        | (0.50)                   |  |
| Fully diluted net income (loss) per share | 0.28                    | 0.29                             | 0.05                        | (0.49)                   |  |

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

None.

**ITEM 9A. CONTROLS AND PROCEDURES****Evaluation of Disclosure Controls and Procedures**

As of the end of the period covered by this report, the Chief Executive Officer ( CEO ) and Chief Financial Officer ( CFO ) carried out an evaluation, which included inquiries made to certain other of our employees, of the Company s disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended ( the Exchange Act )) as of the end of the period covered by this report. 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 March 1, 2009.

**Changes in Internal Control Over Financial Reporting**

The CEO and CFO also have concluded that in the fourth quarter of the fiscal year ended March 1, 2009, there were no changes in the Company s internal control over financial reporting (as defined in Rules 13a-

15(f) and 15d-15(f) of the Exchange Act) that materially affected, or are reasonably likely to materially affect, the Company's internal controls over financial reporting.

**Management's Report on Internal Control Over Financial Reporting**

Our management is responsible for establishing and maintaining adequate internal control over financial reporting, as such term is defined in Exchange Act Rules 13a-15(f) and 15d-15(f). In evaluating the Company's internal control over financial reporting, management has adopted the framework in Internal Control-Integrated Framework issued by the Committee of Sponsoring organizations of the Treadway Commission. Under the supervision and with the participation of our management, including the principal executive officer and principal financial officer, we conducted an evaluation of the effectiveness of our internal control over financial reporting as of March 1, 2009. Based on our evaluation under the framework in Internal Control-Integrated Framework, our management has concluded that our internal control over financial reporting was effective as of March 1, 2009.

The Company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external reporting purposes in accordance with generally accepted accounting principles. The Company's internal control system was designed to provide reasonable assurance to the Company's management and directors regarding the reliability of financial reporting and the preparation of financial statements for the external purposes in accordance with generally accepted accounting principles. Internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the Company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the Company are being made only in accordance with authorizations of management and directors of the Company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements. However, because of inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

This annual report does not include an attestation report of the Company's registered public accounting firm regarding internal control over financial reporting. The Company's evaluation of effectiveness of internal control over financial reporting was not subject to attestation by the Company's registered public accounting firm pursuant to temporary rules of the Securities and Exchange Commission that permit the Company to provide only this report.

**ITEM 9B. OTHER INFORMATION**

None.

**PART III**

**ITEM 10. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE**

Information on directors and corporate governance of the Company is incorporated herein by reference to the Definitive Proxy Statement for the 2009 annual meeting of shareholders to be held on June 26, 2009 and to be filed with the Securities and Exchange Commission about June 5, 2009.

Information regarding the executive officers of the Company is reported in a separate section captioned Executive Officers of the Company included in Part I hereof.

**ITEM 11. EXECUTIVE COMPENSATION**

Information on executive compensation is incorporated herein by reference to the Definitive Proxy Statement for the 2009 annual meeting of shareholders to be held on June 26, 2009 and to be filed with the Securities and Exchange Commission about June 5, 2009.

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

Information on security ownership of certain beneficial owners and management and relate shareholder matters is incorporated herein by reference to the Definitive Proxy Statement for the 2009 annual meeting of shareholders to be held on June 26, 2009 and to be filed with the Securities and Exchange Commission about June 5, 2009 and to Item 5 of Part II hereof.

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

Information on certain relationships and related transactions is incorporated herein by reference to the Definitive Proxy Statement for the 2009 annual meeting of shareholders to be held on June 26, 2009 and to be filed with the Securities and Exchange Commission about June 5, 2009.

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

Information on Principal accountant fees and services is incorporated herein by reference to the Definitive Proxy Statement for the 2009 annual meeting of shareholders to be held on June 26, 2009 and to be filed with the Securities and Exchange Commission about June 5, 2009.



**PART IV**

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

(a) Financial Statements and Financial Statement Schedules.

All schedules normally required by Form 10-K are not required under the related instructions or are inapplicable, and therefore are not presented.

The Financial Statements and Financial Statement Schedules listed on the accompanying Index to Financial Statements and Financial Statement Schedules are filed as part of this Annual Report on Form 10-K.

(b) Exhibits.

The Exhibits listed on the accompanying Index to Exhibits are filed as part of this Annual Report on Form 10-K.

**SIGNATURES**

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

Morgan's Foods, Inc.

Dated: June 1, 2009

By: /s/ Leonard R. Stein-Sapir  
Leonard R. Stein-Sapir  
Chairman of the Board,  
Chief Executive Officer & Director

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

By: /s/ Leonard R. Stein-Sapir

Leonard R. Stein-Sapir  
Chairman of the Board,  
Chief Executive Officer & Director  
Dated: June 1, 2009

By: /s/ Lawrence S. Dolin

Lawrence S. Dolin  
Director  
Dated: June 1, 2009

By: /s/ James J. Liguori

James J. Liguori  
Director, President &  
Chief Operating Officer  
Dated: June 1, 2009

By: /s/ Bahman Guyuron

Bahman Guyuron  
Director  
Dated: June 1, 2009

By: /s/ Kenneth L. Hignett

Kenneth L. Hignett  
Director, Senior Vice President,  
Chief Financial Officer & Secretary  
Dated: June 1, 2009

By: /s/ Steven S. Kaufman

Steven S. Kaufman  
Director  
Dated: June 1, 2009

By: /s/ Bernard Lerner

Bernard Lerner  
Director  
Dated: June 1, 2009

**INDEX TO EXHIBITS**

| Exhibit<br>Number | Exhibit Description   |
|-------------------|---|
| 3.1               | Amended Articles of Incorporation, as amended (1)   |
| 3.2               | Amended Code of Regulations (1)   |
| 4.1               | Specimen Certificate for Common Shares (2)  |
| 4.2               | Shareholder Rights Plan (3)   |
| 4.3               | Amendment to Shareholder Rights Agreement (9)   |
| 10.1              | Specimen KFC Franchise Agreements (4)   |
| 10.2              | Specimen Taco Bell Franchise Agreement (5)  |
| 10.3              | Executive and Manager Nonqualified Stock Option Plan (6)  |
| 10.4              | Key Employee Nonqualified Stock Option Plan (6)   |
| 10.6              | Form Mortgage Loan Agreement with Captec Financial Group, Inc. (7)  |
| 14                | Code of Ethics for Senior Financial Officers (8)  |
| 19                | Form of Indemnification Contract between Registrant and its Officers and Directors (6)  |
| 21                | Subsidiaries  |
| 23.1              | Consent of Independent Registered Public Accounting Firm Grant Thornton LLP   |
| 31.1              | Certification of the Chairman 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 & 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   |
| (1)               | Filed as an exhibit to Registrant's Form 10-K for the 1992 fiscal year and incorporated herein by reference.  |
| (2)               | Filed as an exhibit to the Registrant's Registration Statement (No. 33-35772) on Form S-2 and incorporated herein by  |

reference.

- (3) Filed as an exhibit to the Registrant's Form 8-A dated May 7, 1999 and incorporated herein by reference.
- (4) Filed as an exhibit to the Registrant's Registration Statement (No. 2-78035) on Form S-1 and incorporated herein by reference.
- (5) Filed as an exhibit to Registrant's Form 10-K for the 2000 fiscal year and incorporated herein by reference.
- (6) Filed as an exhibit to the Registrant's Form S-8 filed November 17, 1999 and incorporated herein by reference.
- (7) Filed as an exhibit to the Registrant's Form 10-K for the 1996 fiscal year and incorporated

herein by  
reference.

(8) Filed as an  
exhibit to the  
Registrant's  
Form 10-K for  
the 2004 fiscal  
year and  
incorporated  
herein by  
reference.

(9) Filed as an  
exhibit to the  
Registrant's  
Form 8-A/A  
filed June 9,  
2003 and  
incorporated  
herein by  
reference