

MORGANS FOODS INC  
Form 10-Q  
December 19, 2007

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

(Mark One)

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

**For the quarterly period ended November 4, 2007**

**or**

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

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

**Commission File Number 1-08395**

**Morgan s Foods, Inc.**

(Exact name of registrant as specified in its charter)

Ohio

34-0562210

(State or other jurisdiction of incorporation or organization)

(I.R.S. Employer Identification No.)

4829 Galaxy Parkway, Suite S, Cleveland, Ohio

44128

(Address of principal executive offices)

(Zip Code)

(216) 359-9000

(Registrant s telephone number, including area code)

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

No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Securities Exchange Act of 1934.

Large accelerated filer

Accelerated filer

Non-accelerated filer

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

As of December 17, 2007, the issuer had 2,934,995 shares of common stock outstanding.

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MORGAN S FOODS, INC.

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

|   | <b>Quarter Ended</b>        |                             |
|---|-----------------------------|-----------------------------|
|   | <b>November 4,<br/>2007</b> | <b>November 5,<br/>2006</b> |
| Revenues  | \$22,282,000                | \$ 21,782,000               |
| Cost of sales:  |                             |                             |
| Food, paper and beverage                              | 6,806,000                   | 6,697,000                   |
| Labor and benefits                                    | 6,356,000                   | 5,777,000                   |
| Restaurant operating expenses                         | 5,716,000                   | 5,347,000                   |
| Depreciation and amortization                         | 678,000                     | 636,000                     |
| General and administrative expenses                   | 1,522,000                   | 1,313,000                   |
| Loss on restaurant assets                             | 84,000                      | 22,000                      |
| Operating income                                      | 1,120,000                   | 1,990,000                   |
| Interest expense:                                     |                             |                             |
| Bank debt and notes payable                           | 787,000                     | 863,000                     |
| Capital leases  | 29,000                      | 27,000                      |
| Other income and expense, net                         | (123,000)                   | (39,000)                    |
| Net income before income taxes                        | 427,000                     | 1,139,000                   |
| Provision for income taxes                            | 266,000                     | 137,000                     |
| Net income  | \$ 161,000                  | \$ 1,002,000                |
| Basic net income per common share                     | \$ 0.05                     | \$ 0.37                     |
| Diluted net income per common share                   | \$ 0.05                     | \$ 0.35                     |
| Basic weighted average number of shares outstanding   | 2,934,995                   | 2,720,430                   |
| Diluted weighted average number of shares outstanding | 2,977,260                   | 2,833,889                   |

See notes to these consolidated financial statements.

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

|   | <b>Thirty-six Weeks Ended</b> |                             |
|---|-------------------------------|-----------------------------|
|   | <b>November 4,<br/>2007</b>   | <b>November 5,<br/>2006</b> |
| Revenues  | \$67,809,000                  | \$ 65,426,000               |
| Cost of sales:  |                               |                             |
| Food, paper and beverage                              | 20,722,000                    | 20,247,000                  |
| Labor and benefits                                    | 18,603,000                    | 17,130,000                  |
| Restaurant operating expenses                         | 17,016,000                    | 16,140,000                  |
| Depreciation and amortization                         | 1,993,000                     | 2,081,000                   |
| General and administrative expenses                   | 4,282,000                     | 3,667,000                   |
| (Gain) loss on restaurant assets                      | 76,000                        | (4,000)                     |
| Operating income                                      | 5,117,000                     | 6,165,000                   |
| Interest expense:                                     |                               |                             |
| Bank debt and notes payable                           | 2,437,000                     | 2,655,000                   |
| Capital leases  | 87,000                        | 81,000                      |
| Other income and expense, net                         | (295,000)                     | (139,000)                   |
| Net income before income taxes                        | 2,888,000                     | 3,568,000                   |
| Provision for income taxes                            | 1,027,000                     | 378,000                     |
| Net income  | \$ 1,861,000                  | \$ 3,190,000                |
| Basic net income per common share                     | \$ 0.64                       | \$ 1.17                     |
| Diluted net income per common share                   | \$ 0.62                       | \$ 1.13                     |
| Basic weighted average number of shares outstanding   | 2,916,995                     | 2,719,140                   |
| Diluted weighted average number of shares outstanding | 2,982,685                     | 2,821,006                   |

See notes to these consolidated financial statements.

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MORGAN S FOODS, INC.  
CONSOLIDATED BALANCE SHEETS

|  | November 04,<br>2007<br>(UNAUDITED) | February 25,<br>2007<br>(AUDITED) |
|--|-------------------------------------|-----------------------------------|
| <b>ASSETS</b>  |                                     |                                   |
| Current assets:  |                                     |                                   |
| Cash   | \$ 5,339,000                        | \$ 7,829,000                      |
| Receivables  | 510,000                             | 345,000                           |
| Inventories  | 706,000                             | 684,000                           |
| Prepaid expenses   | 624,000                             | 600,000                           |
| Assets held for sale (Note 6)  | 175,000                             |                                   |
|  | 7,354,000                           | 9,458,000                         |
| Property and equipment:  |                                     |                                   |
| Land   | 10,489,000                          | 10,462,000                        |
| Buildings and improvements   | 22,351,000                          | 20,200,000                        |
| Property under capital leases  | 1,433,000                           | 1,433,000                         |
| Leasehold improvements   | 8,811,000                           | 7,841,000                         |
| Equipment, furniture and fixtures                                    | 20,643,000                          | 20,531,000                        |
| Construction in progress   | 563,000                             | 1,107,000                         |
|  | 64,290,000                          | 61,574,000                        |
| Less accumulated depreciation and amortization                       | 31,189,000                          | 31,104,000                        |
|  | 33,101,000                          | 30,470,000                        |
| Other assets:  |                                     |                                   |
| Franchise agreements   | 728,000                             | 824,000                           |
| Deferred tax asset   | 1,463,000                           | 1,519,000                         |
| Goodwill   | 146,000                             | 825,000                           |
|  | 9,227,000                           | 9,227,000                         |
|  | \$ 52,019,000                       | \$ 52,323,000                     |
| <b>LIABILITIES AND SHAREHOLDERS EQUITY</b>                           |                                     |                                   |
| Current liabilities:   |                                     |                                   |
| Long-term debt, current  | \$ 2,972,000                        | \$ 2,913,000                      |
| Current maturities of capital lease obligations                      | 33,000                              | 28,000                            |
| Accounts payable   | 4,780,000                           | 4,291,000                         |
| Accrued liabilities  | 3,835,000                           | 4,629,000                         |
|  | 11,620,000                          | 11,861,000                        |
| Long-term debt   | 32,184,000                          | 34,445,000                        |
| Long-term capital lease obligations                                  | 1,271,000                           | 1,299,000                         |
| Other long-term liabilities  | 1,171,000                           | 1,302,000                         |
| Deferred tax liabilities   | 1,853,000                           | 1,577,000                         |
| <b>SHAREHOLDERS EQUITY</b>   |                                     |                                   |
| Preferred shares, 1,000,000 shares authorized, no shares outstanding |                                     |                                   |

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|  |               |               |
|--|---------------|---------------|
| Common Stock, 25,000,000 shares authorized |               |               |
| Issued shares 2,969,405                    | 30,000        | 30,000        |
| Treasury shares 34,410 and 88,410          | (81,000)      | (131,000)     |
| Capital in excess of stated value          | 29,344,000    | 29,174,000    |
| Accumulated deficit                        | (25,373,000)  | (27,234,000)  |
| Total shareholders equity                  | 3,920,000     | 1,839,000     |
|  | \$ 52,019,000 | \$ 52,323,000 |

See notes to these consolidated financial statements.

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

|                                 | 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,<br>2007 | 2,969,405     | \$ 30,000 | 88,410          | \$(131,000) | \$29,174,000                            | \$(27,234,000)         | \$ 1,839,000                    |
| Exercise of<br>Stock Options    |               |           | (54,000)        | 50,000      | 170,000                                 |                        | 220,000                         |
| Net income                      |               |           |                 |             |   | 1,861,000              | 1,861,000                       |
| Balance<br>November 4,<br>2007  | 2,969,405     | \$ 30,000 | 34,410          | \$( 81,000) | \$29,344,000                            | \$(25,373,000)         | \$3,920,000                     |

See notes to these consolidated financial statements

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

|  | <b>Thirty-six Weeks Ended</b> |                             |
|--|-------------------------------|-----------------------------|
|  | <b>November 4,<br/>2007</b>   | <b>November 5,<br/>2006</b> |
| <b>OPERATING ACTIVITIES</b>  |                               |                             |
| Net income   | \$ 1,861,000                  | \$ 3,190,000                |
| Adjustments to reconcile to net cash provided by operating activities: |                               |                             |
| Depreciation and amortization  | 1,993,000                     | 2,081,000                   |
| Amortization of deferred financing costs                               | 71,000                        | 75,000                      |
| Amortization of supply agreement advances                              | (487,000)                     | (510,000)                   |
| Funding from supply agreements   | 107,000                       | 41,000                      |
| Decrease in deferred tax assets  | 679,000                       |                             |
| Increase in deferred tax liabilities                                   | 276,000                       | 198,000                     |
| (Gain) loss on restaurant assets                                       | 76,000                        | (4,000)                     |
| Change in assets and liabilities:                                      |                               |                             |
| (Increase) decrease in receivables                                     | (165,000)                     | 34,000                      |
| Increase in inventories  | (22,000)                      | (38,000)                    |
| Increase in prepaid expenses   | (24,000)                      | 104,000                     |
| Decrease in other assets   | 30,000                        |                             |
| Increase (decrease) in accounts payable                                | 489,000                       | (45,000)                    |
| (Increase) decrease in accrued liabilities and other                   | (507,000)                     | (17,000)                    |
| <b>NET CASH PROVIDED BY OPERATING ACTIVITIES</b>                       | <b>4,377,000</b>              | <b>5,109,000</b>            |
| <b>INVESTING ACTIVITIES</b>  |                               |                             |
| Capital expenditures   | (4,821,000)                   | (1,857,000)                 |
| Proceeds from sale of fixed assets                                     | 3,000                         |                             |
| Purchase of franchise agreement  | (44,000)                      | (74,000)                    |
| <b>NET CASH USED FOR INVESTING ACTIVITIES</b>                          | <b>(4,862,000)</b>            | <b>(1,931,000)</b>          |
| <b>FINANCING ACTIVITIES</b>  |                               |                             |
| Principal payments on long-term debt                                   | (2,202,000)                   | (2,352,000)                 |
| Principal payments on capital lease obligations                        | (23,000)                      | (17,000)                    |
| Cash received from exercise of stock options                           | 220,000                       | 35,000                      |
| <b>NET CASH USED FOR FINANCING ACTIVITIES</b>                          | <b>(2,005,000)</b>            | <b>(2,334,000)</b>          |
| <b>NET CHANGE IN CASH AND EQUIVALENTS</b>                              | <b>(2,490,000)</b>            | <b>844,000</b>              |
| Cash and equivalents, beginning balance                                | 7,829,000                     | 6,415,000                   |
| <b>CASH AND EQUIVALENTS, ENDING BALANCE</b>                            | <b>\$ 5,339,000</b>           | <b>\$ 7,259,000</b>         |

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Interest paid was \$2,522,000 and \$2,781,000 in the first 36 weeks of fiscal 2008 and 2007 respectively. Cash payments for income taxes were \$270,000 and \$121,000 in the first 36 weeks of fiscal 2008 and 2007 respectively.

See notes to these consolidated financial statements.

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MORGAN S FOODS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

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

The interim consolidated financial statements of Morgan s Foods, Inc. ( the Company ) have been prepared without audit. In the opinion of Company management, all adjustments have been included. Unless otherwise disclosed, all adjustments consist only of normal recurring adjustments necessary for a fair statement of results of operations for the interim periods. These unaudited financial statements have been prepared using the same accounting principles that were used in preparation of the Company s annual report on Form 10-K for the year ended February 25, 2007. Certain prior period amounts have been reclassified to conform to current period presentations.

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. This change will not impact the manner in which we record income taxes on an annual basis and did not significantly impact our recorded income tax provision in the quarter and year to date periods ended November 4, 2007.

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.

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 fiscal years. The Company does not believe that adoption of SFAS No. 157 will have a material impact on its financial position, results of operations or related disclosures.

In February 2007, the FASB issued SFAS No. 159 The Fair Value Option for Financial Assets and Financial Liabilities (SFAS 159). SFAS 159 provides companies with an option to report selected financial assets and financial liabilities at fair value. Unrealized gains and losses on items for which the fair value option has been elected are reported in earnings at each subsequent reporting date. SFAS 159 is effective for fiscal years beginning after November 15, 2007, the year beginning March 3, 2008 for the Company. We are currently reviewing the provisions of SFAS 159 to determine any impact for the Company.

**NOTE 2 NET INCOME PER COMMON SHARE**

Basic net income per common share is computed by dividing net income by the weighted average number of common shares outstanding during the period. Diluted net income per common share is based on the combined weighted average number of shares outstanding, which includes the assumed exercise, or conversion of options. In computing diluted net income per common share, the Company has utilized the treasury stock method.

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

The Company's debt arrangements require the maintenance of a consolidated fixed charge coverage ratio of 1.2 to 1 regarding all of the Company's mortgage loans and the maintenance of individual restaurant fixed charge coverage ratios of between 1.2 and 1.5 to 1 on certain of the Company's mortgage loans. 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 2007 and as of November 4, 2007, the Company was in compliance with the consolidated fixed charge coverage ratio of 1.2. However, at the end of fiscal 2007 and as of November 4, 2007, the Company was not in compliance with the individual fixed charge coverage ratio on certain of its restaurant properties and has obtained waivers of these violations. Certain of the Company's debt arrangements also contain cross default and cross collateralization provisions.

**NOTE 4 STOCK OPTIONS**

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

At the Company's annual meeting on June 25, 1999 the shareholders approved the Key Employees Stock Option Plan. This plan allows the granting of options covering 291,000 shares of stock and has essentially the same provisions as the Stock Option Plan for Executives and Managers which was discussed above. Options for 129,850 shares were granted to executives and managers of the Company on January 7, 2000 at an exercise price of \$3.00. Options for 11,500 shares were granted to executives on April 27, 2001 at an exercise price of \$.85. As of February 25, 2007 and November 4, 2007, options for a total of 150,000 shares were available for grant.

No options were granted during fiscal year 2007 and the thirty-six week period ended November 4, 2007. As of February 25, 2007 and November 4, 2007 there were 124,000 and 70,000 options respectively outstanding, fully vested and exercisable at a weighted average exercise price of \$4.03 and \$4.00 per share respectively. During the thirty-six weeks ended November 4, 2007 there was no unrecognized compensation expense for financial reporting purposes.

The following table summarizes information about stock options outstanding at November 4, 2007:

| Exercise Prices | Number Outstanding<br>at November 4, 2007 | Average<br>Remaining Life | Number Exercisable<br>at November 4, 2007 |
|-----------------|---|---------------------------|---|
| \$3.00          | 7,500                                     | 2.1                       | 7,500                                     |
| \$4.13          | 62,500                                    | 1.4                       | 62,500                                    |
|                 | 70,000                                    | 1.5                       | 70,000                                    |

**NOTE 5 CAPITAL EXPENDITURES**

The Company is required by its franchise agreements to periodically bring its restaurants up to the franchisors required image. This typically involves a new dining room décor and seating package and exterior changes and related items but can, in some cases, require the relocation of the restaurant. If the Company deems a particular image enhancement (IE) 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 chart below shows both actual and estimated required image enhancement expenditures as well as other capital expenditures either made or expected to be made in those same restaurants for the listed time periods:

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| <b>Number of<br/>Units</b> | <b>Period</b>       | <b>Type</b> | <b>Total (1)</b> | <b>Required (2)</b> | <b>Additional<br/>(3)</b> |
|----------------------------|---------------------|-------------|------------------|---------------------|---------------------------|
| 6                          | Fiscal 2008 3Q YTD  | IE          | \$ 2,249,000     | \$ 1,500,000        | \$ 749,000                |
| 1                          | Fiscal 2008 3Q YTD  | Relo (4)    | 1,264,000        | 1,264,000           |                           |
| 7                          | Total 3Q YTD        |             | 3,513,000        | 2,764,000           | 749,000                   |
| 12                         | Fiscal 2008 4Q Est. | IE          | 3,360,000        | 3,120,000           | 240,000                   |
| 19                         | Full FYE 3-2-2008   |             | 6,873,000        | 5,884,000           | 989,000                   |
| 7                          | Fiscal 2009         | IE          | 2,220,000        | 1,820,000           | 400,000                   |
| 1                          | Fiscal 2009         | Rebuild     | 400,000          | 400,000             |                           |
| 1                          | Fiscal 2009         | Relo (4)    | 750,000          | 750,000             |                           |
| 0                          | Fiscal 2010         | IE          |                  |                     |                           |
| 19                         | Fiscal 2011         | IE          | 5,510,000        | 4,940,000           | 570,000                   |
| 1                          | Fiscal 2012         | Relo (4)    | 1,300,000        | 1,300,000           |                           |
| 0                          | Fiscal 2013         | IE          |                  |                     |                           |
| 1                          | Fiscal 2014         | Rebuild     | 1,000,000        | 1,000,000           |                           |
| 4                          | Fiscal 2015         | Relo (4)    | 4,000,000        | 4,000,000           |                           |
| 1                          | Fiscal 2016         | Relo (4)    | 500,000          | 500,000             |                           |
| 0                          | Fiscal 2017-2019    | IE          |                  |                     |                           |
| 5                          | Fiscal 2020         | Relo (4)    | 6,500,000        | 6,500,000           |                           |
| 2                          | Fiscal 2020         | Rebuild     | 2,000,000        | 2,000,000           |                           |
| 61                         | Total               |             | \$31,053,000     | \$29,094,000        | \$ 1,959,000              |

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

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

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

enhanced  
restaurants  
which were or  
may be deemed  
by the Company  
to be  
advantageous to  
the operation of  
the units and  
which were or  
may be done at  
the time of th

- (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 wh

Capital expenditures to meet the image requirements of the franchisors and additional capital expenditures on those same restaurants being image enhanced are a large portion of the Company's annual capital expenditures. However, the Company also has made and may make capital expenditures on restaurant properties not included on the foregoing schedule for upgrades or replacement of capital items appropriate for the continued successful operation of its restaurants. Capital expenditures in the volume and time horizon required by the image enhancement deadlines cannot be financed solely from existing cash balances and existing cashflow and the Company expects that it will have to utilize financing for a portion of the capital expenditures. The Company may use both debt and sale leaseback financing but has no commitments for either except for the financing completed subsequent to the end of the fiscal third quarter as discussed in Note 6 to the financial statements.

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 6-SUBSEQUENT EVENTS**

During the fiscal third quarter, the Company closed a Taco Bell restaurant and replaced it with a new built KFC/Taco Bell 2n1. On November 21, 2007, the Company executed a fee mortgage loan in the amount of \$846,000 and an equipment loan in the amount of \$432,000 to finance the new restaurant. As of November 4, 2007, the former Taco Bell restaurant property was shown as an asset held for sale and the sale was completed on December 6, 2007. On December 14, 2007 the Company completed a mortgage loan in the amount of \$1,360,000 on a previously

unencumbered restaurant property.



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

**Description of Business.** Morgan's Foods, Inc. (the Company) operates, through wholly-owned subsidiaries, KFC restaurants under franchises from KFC Corporation and Taco Bell restaurants under franchises from Taco Bell Corporation. As of December 12, 2007, the Company operates 73 KFC restaurants, 5 Taco Bell restaurants, 14 KFC/Taco Bell units under franchises from KFC Corporation and franchises or licenses from Taco Bell Corporation, 3 Taco Bell/Pizza Hut Express units operated under franchises from Taco Bell Corporation and licenses from Pizza Hut Corporation, 1 KFC/Pizza Hut Express unit operated under a franchise from KFC Corporation and a license from Pizza Hut Corporation and 1 KFC/A&W unit operated under a franchise from KFC Corporation and a license from A&W Restaurants, Inc. The Company's fiscal year is a 52-53 week year ending on the Sunday nearest the last day of February.

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

|                                     | Quarter Ended    |                  | Thirty-six Weeks Ended |                  |
|-------------------------------------|------------------|------------------|------------------------|------------------|
|                                     | November 4, 2007 | November 5, 2006 | November 4, 2007       | November 5, 2006 |
| Cost of sales:                      |                  |                  |                        |                  |
| Food, paper and beverage            | 30.5%            | 30.7%            | 30.6%                  | 30.9%            |
| Labor and benefits                  | 28.5%            | 26.5%            | 27.4%                  | 26.2%            |
| Restaurant operating expenses       | 25.7%            | 24.5%            | 25.1%                  | 24.7%            |
| Depreciation and amortization       | 3.0%             | 2.9%             | 2.9%                   | 3.2%             |
| General and administrative expenses | 6.8%             | 6.0%             | 6.3%                   | 5.6%             |
| Operating income                    | 5.0%             | 9.1%             | 7.5%                   | 9.4%             |

**Revenues.** Revenues for the quarter ended November 4, 2007 were \$22,282,000 compared to \$21,782,000 for the quarter ended November 5, 2006. This increase of \$500,000 was due mainly to a 2.1% increase in comparable restaurant revenues with one restaurant permanently closed, one relocated and four closed for short periods for remodeling which adjustments substantially offset each other. For 9 of the 12 weeks in the current year quarter at least one restaurant per week was closed for remodeling, representing lost revenue of approximately \$180,000 in the aggregate. The increase in comparable restaurant revenues was primarily the result of modestly successful product promotions by the franchisors during the current year quarter including the Build Your Own Variety Bucket at KFC and the Nacho Crunch Grilled Stuft Burrito at Taco Bell. Revenues for the thirty-six weeks ended November 4, 2007 increased to \$67,809,000 compared to \$65,426,000 for the thirty-six weeks ended November 5, 2006 due to a 3.9% comparable restaurant revenue increase including various offsetting adjustments as in the quarter comparison above.

**Cost of Sales – Food, Paper and Beverage.** Food, paper and beverage costs declined slightly as a percentage of revenue to 30.5% for the quarter ended November 4, 2007 compared to 30.7% for the quarter ended November 5, 2006. The improvement in the current year quarter was primarily the result of improved operating efficiencies due to higher average restaurant volumes. Food, paper and beverage costs for the thirty-six weeks ended November 4, 2007 decreased to 30.6% of revenue compared to 30.9% for the comparable prior year period primarily for the reasons discussed above.

**Cost of Sales – Labor and Benefits.** Labor and benefits increased as a percentage of revenue for the quarter ended November 4, 2007 to 28.5% compared to 26.5% for the year earlier quarter. The increase was primarily due to increases in the minimum wage in substantially all of the areas in which the Company operates. Labor and benefits for the thirty-six weeks ended November 4, 2007 were 27.4% compared to 26.2% for the comparable year earlier period also due to increases in the minimum wage.

**Restaurant Operating Expenses.** Restaurant operating expenses increased as a percentage of revenue to 25.7% in the third quarter and 25.1% for the first thirty-six weeks of fiscal 2008 compared to 24.5% in the third quarter of fiscal 2007 and 24.7% for the first thirty-six weeks of fiscal 2007 primarily due to increases in utilities and advertising expenses in both the quarter and year-to-date periods.

Depreciation and Amortization. Depreciation and amortization increased to \$678,000 in the quarter ended November 4, 2007 compared to \$636,000 for the quarter ended November 5, 2006 primarily due to the additional depreciation of capital additions made during the current fiscal year. Depreciation and amortization for the thirty-six weeks ended November 4, 2007 decreased to \$1,993,000 compared to \$2,081,000 in the comparable year earlier period due to significant amounts of fixed assets reaching the end of their useful lives earlier in fiscal 2008 and no longer being depreciated.

General and Administrative Expenses. General and administrative expenses increased to \$1,522,000 in the third quarter of fiscal 2008 and \$4,282,000 for the first thirty-six weeks of fiscal 2008 compared to \$1,312,000 in the third quarter of fiscal 2007 and \$3,667,000 for the first thirty-six weeks of fiscal 2007. These increases were caused by a variety of factors including salary

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increases and personnel additions both at the corporate office and in field management, increases in insurance rates and additional professional fees related to the Company's documentation of internal controls for compliance with Sarbanes-Oxley Section 404.

**(Gain)Loss on Restaurant Assets.** The Company experienced a loss on restaurant assets of \$84,000 for the third quarter of fiscal 2008 compared to a loss of \$22,000 for the third quarter of fiscal 2007. The current year amounts were the result of losses on property disposed during restaurant remodeling and the write down of a closed restaurant property to the value at which it is under contract for sale. The prior year amounts are primarily losses on property disposed during restaurant remodeling. Loss on restaurant assets was \$76,000 for the thirty-six weeks ended November 4, 2007 compared to a gain of \$4,000 for the thirty-six weeks ended November 5, 2006. The current year period represents losses on property disposed during restaurant remodeling and the prior year amount reflects gain on restaurant assets from an insured loss.

**Operating Income.** Operating income in the third quarter of fiscal 2008 decreased to \$1,120,000 or 5.0% of revenues compared to \$1,990,000 or 9.1% of revenues for the third quarter of fiscal 2007 primarily due to increases in labor costs and operating expenses. Operating income for the thirty-six weeks ended November 4, 2008 decreased to \$5,117,000 or 7.5% of revenues from \$6,165,000 or 9.4% of revenues in the comparable prior year period for the reasons discussed above.

**Interest Expense.** Interest expense decreased to \$787,000 in the third quarter of fiscal 2008 and \$2,437,000 for the first thirty-six weeks of fiscal 2008 from \$863,000 in the third quarter of fiscal 2007 and \$2,655,000 for the first thirty-six weeks of fiscal 2007, due to lower debt balances during the fiscal 2008 periods.

**Other Income.** Other income increased to \$123,000 for the third quarter of fiscal 2008 and \$295,000 for the first thirty-six weeks of fiscal 2008 from \$38,000 for the third quarter of fiscal 2007 and \$139,000 for the first thirty-six weeks of fiscal 2007. The increase was primarily due to revenue from various sub-leased properties and increased earnings on cash balances in both the most recent quarter and thirty-six week periods.

**Provision for Income Taxes.** The provision for income taxes increased to \$266,000 for the third quarter of fiscal 2008 compared to \$137,000 for the third quarter of fiscal 2007. The provision for income taxes is recorded at the Company's projected annual effective tax rate, currently 35% compared to an estimated 32% at the end of the second quarter of fiscal 2008. This change in projected annual effective tax rate caused a disproportionate part of the annual tax provision to fall into the third quarter of fiscal 2008. For the first thirty-six weeks of fiscal 2008 the provision for income taxes increased to \$1,027,000 compared to \$378,000 in the comparable year earlier period. The increases in both periods were primarily due to the Company having recognized during fiscal 2007 the benefits of its remaining net operating loss carryforwards, therefore requiring a provision for taxes in the current year period. This change did not affect the Company's cash balances or cashflow for the period as the provision related to deferred taxes.

**Liquidity and Capital Resources.** Cash flow activity for the first thirty-six weeks of fiscal 2008 and fiscal 2007 is presented in the Consolidated Statements of Cash Flows. Cash provided by operating activities was \$4,377,000 for the thirty-six weeks ended November 4, 2007 compared to \$5,109,000 for the thirty-six weeks ended November 5, 2006. The decrease in operating cash flow resulted primarily from a decrease in net income, partially offset by increases in the net tax liabilities. The Company paid scheduled long-term bank and capitalized lease debt of \$2,225,000 in the first thirty-six weeks of fiscal 2008 compared to payments of \$2,369,000 for the same period in fiscal 2007. Capital expenditures in the thirty-six weeks ended November 4, 2007 were \$4,821,000, compared to \$1,857,000 for the same period in fiscal 2007 as the Company has increased its image enhancement activity to meet the requirements of its franchise agreements. Capital expenditure activity is discussed in more detail in Note 5 to the financial statements. The Company also received cash, in the amount of \$220,000, from the exercise of stock options during the first thirty-six weeks of fiscal 2008 compared to \$35,000 in the comparable prior year period.

The Company's debt arrangements require the maintenance of a consolidated fixed charge coverage ratio of 1.2 to 1 regarding all of the Company's mortgage loans and the maintenance of individual restaurant fixed charge coverage ratios of between 1.2 and 1.5 to 1 on certain of the Company's mortgage loans. 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 2007 and as of the quarter ended November 4, 2007, the Company was in compliance with the consolidated

fixed charge coverage ratio of 1.2. However, at the end of fiscal 2007 and as of the quarter ended November 4, 2007, the Company was not in compliance with the individual fixed charge coverage ratio on certain of its restaurant properties and has obtained waivers of these violations. Certain of the Company's debt arrangements also contain cross default and cross collateralization provisions.

The Company's image enhancement requirements have created an unusually active construction schedule in which there has been at least one restaurant closed in most weeks of the Company's recent and current fiscal periods and this pace is expected to continue through the first half of fiscal 2009. For each week that a restaurant is closed, the Company loses approximately \$20,000 in revenue and \$5,000 of profit. In addition, the management team of each closed restaurant either fills in at a restaurant nearby or engages in non-revenue generating activities to prepare for reopening and this has a negative impact on the overall labor cost of the

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Company. Also, in closing and reopening a restaurant, certain amounts of food and shortening are lost to waste, having a negative impact on the Company's food cost.

**New Accounting Pronouncements.** 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. This change will not impact the manner in which we record income taxes on an annual basis and did not significantly impact our recorded income tax provision in the quarter and year to date periods ended November 4, 2007.

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.

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 fiscal years. The Company does not believe that adoption of SFAS No. 157 will have a material impact on its financial position, results of operations or related disclosures.

In February 2007, the FASB issued SFAS No. 159 The Fair Value Option for Financial Assets and Financial Liabilities (SFAS 159). SFAS 159 provides companies with an option to report selected financial assets and financial liabilities at fair value. Unrealized gains and losses on items for which the fair value option has been elected are reported in earnings at each subsequent reporting date. SFAS 159 is effective for fiscal years beginning after November 15, 2007, the year beginning March 3, 2008 for the Company. We are currently reviewing the provisions of SFAS 159 to determine any impact for the Company.

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

**Safe Harbor Statements.** This document contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. The statements include those identified by such words as may, will, expect, anticipate, believe, plan and other similar terminology. The forward-looking statements reflect the Company's current expectations and are based upon data available at the time of the statements. Actual results involve risks and uncertainties, including both those specific to the Company and general economic and industry factors. Factors specific to the Company include, but are not limited to, its debt covenant compliance, actions that lenders may take with respect to any debt covenant violations, its ability to obtain waivers of any debt covenant violations and its ability to pay all of its current and long-term obligations. Economic and industry risks and uncertainties include, but are not limited, to, franchisor promotions, business and economic conditions, legislation and governmental regulation, competition, success of operating initiatives and advertising and promotional efforts, volatility of commodity costs and increases in minimum wage and other operating costs, availability and cost of land and construction, consumer preferences, spending patterns and demographic trends.

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

The Company's existing borrowings are at fixed interest rates, and accordingly the Company does not have market risk exposure for fluctuations in interest rates. The Company does not enter into derivative financial investments for trading or speculation purposes. 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 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.

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**Item 4. Controls and Procedures.**

The effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rule 13a-14(c) under the Securities Exchange Act of 1934) was evaluated as of the date of the financial statements. This evaluation was carried out under the supervision of and with the participation of management, including the Chief Executive Officer and the Chief Financial Officer. Based on that evaluation, management concluded that as of November 4, 2007 the Company maintained effective internal controls over financial reporting. Management has concluded that the consolidated financial statements included in this Form 10-Q fairly present in all material respects the Company's financial condition as of November 4, 2007 and February 25, 2007 and the results of operations and cash flows for the quarters and thirty-six weeks ended November 4, 2007 and November 5, 2006.

**PART II OTHER INFORMATION**

**Item 1. Legal Proceedings**

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

**Item 1A. Risk Factors**

The Company's annual report on Form 10-K for the fiscal year ended February 25, 2007 discusses the risk factors facing the Company. There has been no material change in the risk factors facing our business since February 25, 2007.

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MORGAN S FOODS, INC.  
INDEX TO EXHIBITS

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



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SIGNATURES

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

MORGAN S FOODS, INC.

/s/ Kenneth L. Hignett  
Senior Vice President,  
Chief Financial Officer and Secretary  
December 19, 2007

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