MORGANS FOODS INC
Form 10-Q
July 13, 2009

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

(Mark One)

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

For the quarterly period ended May 24, 2009

or

o **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 þ No o

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 o No o

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 accelerated filer , large accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act.

Large accelerated filer o	Accelerated filer o	Non-accelerated filer o (do not check if a smaller reporting company)	Smaller reporting company þ

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

As of July 6, 2009, the issuer had 2,934,995 shares of common stock outstanding.

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PART I FINANCIAL INFORMATION
Item 1. Financial Statements

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

	Quarter Ended	
	May 24, 2009	**May 25, 2008**
Revenues	$22,931,000	$21,753,000
Cost of sales:		
Food, paper and beverage	7,410,000	6,964,000
Labor and benefits	6,428,000	6,238,000
Restaurant operating expenses	5,876,000	5,487,000
Depreciation and amortization	717,000	773,000
General and administrative expenses	1,409,000	1,350,000
Loss on restaurant assets	6,000	5,000
Operating income	1,085,000	936,000
Interest expense:		
Bank debt and notes payable	625,000	824,000
Capital leases	25,000	26,000
Other income and expense, net	(44,000)	(90,000)
Income before income taxes	479,000	176,000
Provision for income taxes	125,000	82,000
Net income	$ 354,000	$ 94,000
Basic net income per common share:	$ 0.12	$ 0.03
Diluted net income per common share:	$ 0.12	$ 0.03

See accompanying Notes to Consolidated Financial Statements.

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MORGAN S FOODS, INC.
CONSOLIDATED BALANCE SHEETS

	May 24, 2009 (UNAUDITED)	March 1, 2009 (AS RESTATED)
ASSETS		
Current assets:		
Cash and equivalents	$ 7,634,000	$ 5,257,000
Receivables	447,000	806,000
Inventories	778,000	731,000
Prepaid expenses	511,000	624,000
Assets held for sale	828,000	828,000
	10,198,000	8,246,000
Property and equipment:		
Land	9,558,000	9,558,000
Buildings and improvements	20,702,000	20,692,000
Property under capital leases	1,314,000	1,314,000
Leasehold improvements	10,364,000	10,615,000
Equipment, furniture and fixtures	20,043,000	19,891,000
Construction in progress	308,000	316,000
	62,289,000	62,386,000
Less accumulated depreciation and amortization	30,028,000	29,827,000
	32,261,000	32,559,000
Other assets	647,000	676,000
Franchise agreements, net	1,224,000	1,260,000
Deferred tax asset	555,000	594,000
Goodwill	9,227,000	9,227,000
	$ 54,112,000	$ 52,562,000
LIABILITIES AND SHAREHOLDERS EQUITY		
Current liabilities:		
Long-term debt, current	$ 3,058,000	$ 16,475,000
Current maturities of capital lease obligations	40,000	39,000
Accounts payable	4,840,000	3,909,000
Accrued liabilities	4,608,000	3,934,000
	12,546,000	24,357,000
Long-term debt	32,429,000	19,738,000
Long-term capital lease obligations	1,095,000	1,105,000
Other long-term liabilities	4,254,000	4,061,000
Deferred tax liabilities	2,207,000	2,130,000

SHAREHOLDERS EQUITY		
Preferred shares, 1,000,000 shares authorized, no shares outstanding		
Common shares, 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	29,488,000	29,432,000
Accumulated deficit	(27,856,000)	(28,210,000)
Total shareholders equity	1,581,000	1,171,000
	$ 54,112,000	$ 52,562,000

See accompanying Notes to Consolidated Financial Statements.

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

	Common Shares		**Treasury Shares**		**Capital in excess of stated value**	**Accumulated Deficit**	**Total Shareholders Equity**
	Shares	**Amount**	**Shares**	**Amount**			
Balance March 1, 2009	2,969,405	30,000	(34,410)	(81,000)	29,432,000	(28,210,000)	1,171,000
Net Income						354,000	354,000
Stock compensation expense					56,000		56,000
Balance May 24, 2009	2,969,405	$30,000	(34,410)	$(81,000)	$29,488,000	$(27,856,000)	$1,581,000

See accompanying Notes to Consolidated Financial Statements.

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

	Quarter Ended	
	May 24, 2009	**May 25, 2008**
Cash flows from operating activities:		
Net income	$ 354,000	$ 94,000
Adjustments to reconcile to net cash provided by operating activities:		
Depreciation and amortization	717,000	773,000
Amortization of deferred financing costs	27,000	27,000
Amortization of supply agreement advances	(257,000)	(242,000)
Funding from supply agreements		37,000
Deferred income taxes	116,000	68,000
Stock compensation expense	56,000	
Loss on restaurant assets	6,000	5,000
Changes in assets and liabilities:		
Receivables	359,000	73,000
Inventories	(47,000)	(38,000)
Prepaid expenses	113,000	(121,000)
Other assets	2,000	
Accounts payable	931,000	(482,000)
Accrued liabilities	1,136,000	(431,000)
Net cash provided by (used in) operating activities	3,513,000	(237,000)
Cash flows from investing activities:		
Capital expenditures	(401,000)	(2,213,000)
Net cash used in investing activities	(401,000)	(2,213,000)
Cash flows from financing activities:		
Principal payments on long-term debt	(726,000)	(804,000)
Principal payments on capital lease obligations	(9,000)	(7,000)
Net cash used in financing activities	(735,000)	(811,000)
Net change in cash and equivalents	2,377,000	(3,261,000)
Cash and equivalents, beginning balance	5,257,000	6,428,000
Cash and equivalents, ending balance	$7,634,000	$ 3,167,000

Interest paid was $655,000 and $888,000 in the first 12 weeks of fiscal 2010 and 2009, respectively Cash payments for income taxes were $2,000 and $1,000 in the first 12 weeks of fiscal 2010 and 2009, respectively

See accompanying Notes to Consolidated Financial Statements.

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MORGAN S FOODS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

NOTE 1 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES AND RECENT ACCOUNTING PRONOUNCEMENTS

The interim consolidated financial statements of Morgan s Foods, Inc. (the Company) have been prepared without audit. In the opinion of Company management, all adjustments have been included. Unless otherwise disclosed, all adjustments consist only of normal recurring adjustments necessary for a fair statement of results of operations for the interim periods. These unaudited financial statements have been prepared using the same accounting principles that were used in preparation of the Company s annual report on Form 10-K for the year ended March 1, 2009. Certain prior period amounts have been reclassified to conform to current period presentations. The results of operations for the quarter ended May 24, 2009 are not necessarily indicative of the results to be expected for the full year. Although the Company believes that the disclosures are adequate to make the information presented not misleading, it is suggested that these condensed consolidated financial statements be read in conjunction with the audited consolidated financial statements and the notes thereto included in the Company s Form 10-K for the fiscal year ended March 1, 2009.

In March 2008, the FASB issued SFAS No. 161 Disclosure About Derivative Instruments and Hedging Activities-an amendment to FASB Statement 133 (SFAS 161). SFAS 161 requires enhanced disclosures about derivatives and hedging activities and the reasons for using them. SFAS 161 is effective for fiscal years beginning after November 15, 2008, the year beginning March 2, 2009 for the Company. We have adopted the provisions of SFAS 161 and have determined that the adoption has had no material effect on the results of operations of the Company.

In December 2007, the FASB issued SFAS 141R Business Combinations. SFAS No. 141R modifies the accounting for business combinations by requiring that acquired assets and assumed liabilities be recorded at fair value, contingent consideration arrangements be recorded at fair value on the date of the acquisition and preacquisition contingencies be accounted for in purchase accounting at fair value. The pronouncement also requires that transaction costs be expensed as incurred, acquired research and development be capitalized as an indefinite-lived intangible asset and the requirements of SFAS No. 146, Accounting for Costs Associated with Exit or Disposal Activities be met at the acquisition date in order to accrue for a restructuring plan in purchase accounting. SFAS No. 141R is required to be adopted prospectively effective for fiscal years beginning after December 15, 2008. We have adopted the provisions of SFAS 141R and have determined that the adoption has had no material effect on the results of operations of 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. The following table reconciles the difference between basic and diluted earnings per common share:

	For the Quarter ended May 24, 2009			For the Quarter ended May 25, 2008		
	Net income (Numerator)	Shares (Denominator)	Per Share Amount	Net income (Numerator)	Shares (Denominator)	Per Share Amount
Basic EPS						
Income available to common shareholders	$ 354,000	2,934,995	$ 0.12	$ 94,000	2,934,995	$ 0.03
Effect of Dilutive Securities						
		28,110			22,901	

Weighted Average Stock Options						
Diluted EPS						
Income available to common shareholders	$ 354,000	2,963,105	$ 0.12	$ 94,000	2,957,896	$ 0.03

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

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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. As of May 24, 2009, the Company entered into a loan modification agreement covering a portion of its debt which reduced the consolidated fixed charge coverage ratio to 1.15 to 1 from 1.20 to 1 and increased the funded debt to EBITDAR ratio to 6.15 from 5.5 for the first, second and third quarters of fiscal 2010 and was in compliance with those requirements. For certain other debt, the Company was not in compliance with the consolidated fixed charge coverage ratio of 1.20 to 1 but has obtained waivers of those requirements either for a period of longer than one year or for a period, after which management believes the Company will be in compliance with the requirements. In order to obtain the loan modification and the waivers, the Company paid certain fees. Also, as of May 24, 2009, the Company was not in compliance with the individual fixed charge coverage ratio on 19 of its restaurant properties and has also obtained waivers of these requirements covering a period of longer than one year. The debt obligations of the Company which contain fixed charge coverage ratio and funded debt to EBITDAR requirements are classified as long-term, except for the amounts due within one year. If the Company does not comply with the covenants of its various debt agreements in the future, and if future waivers are not obtained, the respective lenders will have certain remedies available to them which include calling the debt and the acceleration of payments. Noncompliance with the requirements of the Company s debt agreements, if not waived, could also trigger cross-default provisions contained in the respective agreements.

Restatement

As of March 1, 2009, the Company was not in compliance with the consolidated fixed charge coverage ratio of 1.20 to 1 or with the funded debt to EBITDAR ratio of 5.5 to 1 and waivers of the non-compliance were obtained with respect to an aggregate of $33,639,000 of debt. Of this amount, waivers with respect to $19,095,000 of debt continued through the end of fiscal 2010, and, therefore, such debt was classified as long-term at March 1, 2009. As the waiver related to the remaining $14,544,000 of debt did not continue through the end of fiscal 2010, such debt, which was incorrectly classified as long-term in the originally filed Form 10-K for the fiscal year ended March 1, 2009 was restated to be classified as a current liability in the balance sheet included in a Form 10-K/A filing.

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 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 vesting 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 150,000 common shares were granted on November 6, 2008 at the closing price on that day of $1.50 per share. The options vest six months after issue and expire ten years after issue.

As of May 24, 2009, 157,500 options were outstanding, fully vested and exercisable at a weighted average exercise price of $1.57 per share. As of May 24, 2009, no options were available for grant.

The following table summarizes information about stock options outstanding at May 24, 2009:

Exercise Prices	Outstanding 5-24-09	Average Life	Number Exercisable
$3.00	7,500	0.6	7,500
1.50	150,000	9.7	150,000
$1.57	157,500	9.2	157,500

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NOTE 5 CAPITAL EXPENDITURES

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

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

Number of Units	Period	Type	Total (1)	Required (2)	Additional (3)
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. Capital expenditures in the volume and time horizon required by the image enhancement deadlines cannot be financed solely from existing cash balances and existing cash flow and the Company expects that it will have to utilize financing for a portion of the capital expenditures. The Company may use both debt and sale leaseback financing but has no commitments for either.

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

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NOTE 6 ASSETS HELD FOR SALE

The Company owns the land and building of three closed KFC restaurants and the land and building adjacent to another of its restaurants, all of which are listed for sale and are shown on the Company s consolidated balance sheet as Assets Held for Sale as of May 24, 2009 and March 1, 2009.

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

Description of Business. Morgan s Foods, Inc. (the Company), which was formed in 1925, operates through wholly-owned subsidiaries KFC restaurants under franchises from KFC Corporation, Taco Bell restaurants under franchises from Taco Bell Corporation, Pizza Hut Express restaurants under licenses from Pizza Hut Corporation and an A&W restaurant under a license from A&W Restaurants, Inc. As of July 6, 2009, the Company operates 68 KFC restaurants, 6 Taco Bell restaurants, 13 KFC/Taco Bell 2n1 s under franchises from KFC Corporation and franchises or licenses from Taco Bell Corporation, 3 Taco Bell/Pizza Hut Express 2n1 s under franchises from Taco Bell Corporation and licenses from Pizza Hut Corporation, 1 KFC/Pizza Hut Express 2n1 under a franchise from KFC Corporation and a license from Pizza Hut Corporation and 1 KFC/A&W 2n1 operated under a franchise from KFC Corporation and a license from A&W Restaurants, Inc. The Company s fiscal year is a 52 53 week year ending on the Sunday nearest the last day of February.

Summary of Expenses and Operating Income as a Percentage of Revenues

	Quarter Ended	
	May 24, 2009	May 25, 2008
Cost of sales:		
Food, paper and beverage	32.3%	32.0%
Labor and benefits	28.0%	28.7%
Restaurant operating expenses	25.6%	25.2%
Depreciation and amortization	3.1%	3.6%
General and administrative expenses	6.1%	6.2%
Operating income	4.7%	4.3%

Revenues. The revenue increase of $1,178,000 in the quarter ended May 24, 2009 compared to the quarter ended May 25, 2008 was primarily the result of a 6.9% increase in comparable restaurant revenues. Most of the revenue increase took place in the company s third fiscal period which is the final period of the first quarter and was related to the national rollout of Kentucky Grilled Chicken®(KGC).

Cost of Sales Food, Paper and Beverage. Food, paper and beverage costs increased as a percentage of revenue to 32.3% for the quarter ended May 24, 2009 compared to 32.0% for the quarter ended May 25, 2008. The increase in the current year quarter was primarily the result of the national promotion of KGC which involved free single piece and free two piece dinner promotions.

Cost of Sales Labor and Benefits. Labor and benefits decreased to 28.0% of revenues for the twelve weeks ended May 24, 2009 compared to 28.7% in the comparable prior year period primarily due to increases in efficiencies caused by higher unit volumes.

Restaurant Operating Expenses. Restaurant operating expenses were relatively unchanged as a percentage of revenue at 25.6% in the first quarter of fiscal 2010 compared to 25.2% in the first quarter of fiscal 2009.

Depreciation and Amortization. Depreciation and amortization decreased to $717,000 in the quarter ended May 24, 2009 compared to $773,000 for the quarter ended May 25, 2008 primarily due to the permanent closure of 4 restaurants.

General and Administrative Expenses. General and administrative expenses increased slightly to $1,409,000 in the first quarter of fiscal 2010 compared to $1,350,000 in the first quarter of fiscal 2009, primarily due to the recording of compensation expense related to the granting of stock options.

Loss on Restaurant Assets. Loss on restaurant assets was substantially unchanged at $6,000 in the first quarter of fiscal 2010 compared to $5,000 in the first quarter of fiscal 2009.

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Operating Income. Operating income in the first quarter of fiscal 2010 increased to $1,085,000 or 4.7% of revenues compared to $936,000 or 4.3% of revenues for the first quarter of fiscal 2009 primarily due to the increase in revenues discussed above and the closure of poor performing restaurants.

Interest Expense. Interest expense on bank debt and notes payable decreased to $625,000 in the first quarter of fiscal 2010 from $824,000 in the first quarter of fiscal 2009 due to lower interest rates on debt which was refinanced during the fiscal 2009 second quarter.

Other Income. Other income decreased to $44,000 for the first quarter of fiscal 2010 from $90,000 for the first quarter of fiscal 2009. The decrease was primarily due to a lack of earnings on invested cash balances.

Provision for Income Taxes. The provision for income taxes for the quarter ended May 24, 2009 was $125,000 on pre-tax income of $479,000 compared to $82,000 on pre-tax income of $176,000 for the comparable prior year period. The provision for income taxes is recorded at the Company s projected annual effective tax rate and consists of a current tax provision of $9,000 and a deferred tax provision of $116,000. The effective tax rate for the current year quarter is lower than the comparable prior year period due to the effect of employment tax credits and deferred tax benefit as a result of a change in estimate of the future realization of various deferred items based on the Company s conclusion about the amount of projected taxable income within the carry forward period. The changes in deferred taxes are non-cash items and do not affect the Company s cash flow or cash balances.

Liquidity and Capital Resources. Cash flow activity for the twelve weeks ended May 24, 2009 is presented in the Consolidated Statements of Cash Flows. Cash provided by operating activities was $3,513,000 for the twelve weeks ended May 24, 2009 compared to cash used in operating activities of $237,000 for the twelve weeks ended May 25, 2008. The increase in operating cash flow resulted primarily from the increase in net income and changes in certain assets and liabilities. The Company paid scheduled long-term bank and capitalized lease debt of $735,000 in the first twelve weeks of fiscal 2010 compared to payments of $811,000 for the same period in fiscal 2009. Capital expenditures in the twelve weeks ended May 24, 2009 were $401,000, compared to $2,213,000 for the same period in fiscal 2009 as the Company had no image enhancement activity in the current year quarter. Capital expenditure activity is discussed in more detail in Note 5 to the consolidated financial statements.

The Company s debt arrangements require the maintenance of a consolidated fixed charge coverage ratio of 1.2 to 1 regarding all of the Company s mortgage loans and the maintenance of individual restaurant fixed charge coverage ratios of between 1.2 and 1.5 to 1 on certain of the Company s mortgage loans. Fixed charge coverage ratios are calculated by dividing the cash flow before rent and debt service for the previous 12 months by the debt service and rent due in the coming 12 months. The consolidated and individual coverage ratios are computed quarterly. As of May 24, 2009, the Company entered into a loan modification agreement covering a portion of its debt which reduced the consolidated fixed charge coverage ratio to 1.15 to 1 from 1.20 to 1 and increased the funded debt to EBITDAR ratio to 6.15 from 5.5 for the first, second and third quarters of fiscal 2010 and was in compliance with those requirements. For certain other debt, the Company was not in compliance with the consolidated fixed charge coverage ratio of 1.20 to 1 but has obtained waivers of those requirements either for a period of longer than one year or for a period, after which management believes the Company will be in compliance with the requirements. In order to obtain the loan modification and the waivers, the Company paid certain fees. Also, as of May 24, 2009, the Company was not in compliance with the individual fixed charge coverage ratio on 19 of its restaurant properties and has also obtained waivers of these requirements covering a period of longer than one year. The debt obligations of the Company which contain fixed charge coverage ratio and funded debt to EBITDAR requirements are classified as long-term, except for the amounts due within one year. If the Company does not comply with the covenants of its various debt agreements in the future, and if future waivers are not obtained, the respective lenders will have certain remedies available to them which include calling the debt and the acceleration of payments. Noncompliance with the requirements of the Company s debt agreements, if not waived, could also trigger cross-default provisions contained in the respective agreements.

New Accounting Pronouncements. In March 2008, the FASB issued SFAS No. 161 Disclosure About Derivative Instruments and Hedging Activities-an amendment to FASB Statement 133 (SFAS 161). SFAS 161 requires enhanced disclosures about derivatives and hedging activities and the reasons for using them. SFAS 161 is effective for fiscal years beginning after November 15, 2008, the year beginning March 2, 2009 for the Company. We have adopted the provisions of SFAS 161 and have determined that the adoption has had no material effect on the results of operations of the Company.

In December 2007, the FASB issued SFAS 141R Business Combinations. SFAS No. 141R modifies the accounting for business combinations by requiring that acquired assets and assumed liabilities be recorded at fair value, contingent consideration arrangements be recorded at fair value on the date of the acquisition and preacquisition contingencies be accounted for in purchase accounting at fair value. The pronouncement also requires that transaction costs be expensed as incurred, acquired research and development be capitalized as an indefinite-lived intangible asset and the requirements of SFAS No. 146, Accounting for Costs Associated with Exit or Disposal Activities be met at the acquisition date in order to accrue for a restructuring plan in purchase accounting. SFAS No. 141R is required to be adopted prospectively effective for fiscal years beginning after December 15, 2008. We have adopted the provisions of SFAS 141R and have determined that the adoption has had no material effect on the results of operations of 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 report contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. The statements include those identified by such words as may, will, expect anticipate, believe, plan and other sim terminology. Forward looking statements involve risks and uncertainties that could cause actual events or results to differ materially from those expressed or implied in this report. The forward-looking statements reflect the Company s current expectations and are based upon data available at the time of the statements. Actual results involve risks and uncertainties, including both those specific to the Company and general economic and industry factors. Factors specific to the Company include, but are not limited to, its debt covenant compliance, actions that lenders may take with respect to any debt covenant violations, its ability to obtain waivers of any debt covenant violations and its ability to pay all of its current and long-term obligations and those factors described in Part I Item 1A (Risk Factors) of the Company s annual report on Form 10-K filed with the SEC on June 3, 2009. Economic and industry risks and uncertainties include, but are not limited, to, franchisor promotions, business and economic conditions, legislation and governmental regulation, competition, success of operating initiatives and advertising and promotional efforts, volatility of commodity costs and increases in minimum wage and other operating costs, availability and cost of land and construction, consumer preferences, spending patterns and demographic trends.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

Certain of the Company s debt comprising approximately $14.3 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 $143,000 in additional annual interest costs. The Company may choose to offset all, or a portion of the risk through the use of interest rate swaps. The Company s remaining borrowings are at fixed interest rates, and accordingly the Company does not have market risk exposure for fluctuations in interest rates relative to those loans. The Company does not enter into derivative financial investments for trading or speculation purposes. Also, the Company is subject to volatility in food costs as a result of market risk and we manage that risk through the use of a franchisee purchasing cooperative which uses longer term purchasing contracts. Our ability to recover increased costs through higher pricing is, at times, limited by the competitive environment in which we operate. The Company believes that its market risk exposure is not material to the Company s financial position, liquidity or results of operations.

Item 4. Controls and Procedures.

Evaluation of Disclosure Controls and Procedures

As of 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 our disclosure controls and procedures were not effective at a reasonable assurance level as of May 24, 2009 because of the material weakness in our internal control over financial reporting discussed below. Notwithstanding the material weakness described below, our management has concluded that the Company s consolidated financial statements included in the report are fairly stated, in all material respects, in accordance with accounting principles generally accepted in the United States on America.

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 and also in the first quarter of the fiscal year ending February 28, 2010, there was a material weakness in the Company s internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) of the Exchange Act) which caused certain of the Company s debt to be classified as non-current when such debt should properly have been classified as current in the balance sheet as of March 1, 2009. As a result, for each subsequent reporting period, Management will prepare or cause to be prepared, a memo detailing the application of accounting principles relating to the classification of debt to each of its long term debt facilities and conclude as to proper balance sheet classification.

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PART II OTHER INFORMATION

Item 1. Legal Proceedings

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

Item 1A. Risk Factors

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

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

None

Item 3. Defaults Upon Senior Securities

None

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

None

Item 5. Other Information

None

Item 6. Exhibits

Reference is made to Index to Exhibits , filed herewith.

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
July 13, 2009

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MORGAN S FOODS, INC.
INDEX TO EXHIBITS

Exhibit 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.