

MORGANS FOODS INC  
Form 10-Q  
September 26, 2007

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

(Mark One)

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

**For the quarterly period ended August 12, 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 September 24, 2007, the issuer had 2,934,995 shares of common stock outstanding.

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

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

|   | <b>Quarter Ended</b>   |                        |
|---|------------------------|------------------------|
|   | <b>August 12, 2007</b> | <b>August 13, 2006</b> |
| Revenues  | \$22,877,000           | \$22,543,000           |
| Cost of sales:  |                        |                        |
| Food, paper and beverage                              | 6,977,000              | 6,910,000              |
| Labor and benefits                                    | 6,196,000              | 5,858,000              |
| Restaurant operating expenses                         | 5,727,000              | 5,582,000              |
| Depreciation and amortization                         | 661,000                | 722,000                |
| General and administrative expenses                   | 1,380,000              | 1,220,000              |
| (Gain) loss on restaurant assets                      | 8,000                  | (20,000)               |
| Operating income                                      | 1,928,000              | 2,271,000              |
| Interest expense:                                     |                        |                        |
| Bank debt and notes payable                           | 803,000                | 873,000                |
| Capital leases  | 29,000                 | 27,000                 |
| Other income and expense, net                         | (128,000)              | (78,000)               |
| Net income before income taxes                        | 1,224,000              | 1,449,000              |
| Provision for income taxes                            | 354,000                | 160,000                |
| Net income  | \$ 870,000             | \$ 1,289,000           |
| Basic net income per common share                     | \$ 0.30                | \$ 0.47                |
| Diluted net income per common share                   | \$ 0.29                | \$ 0.46                |
| Basic weighted average number of shares outstanding   | 2,888,999              | 2,718,495              |
| Diluted weighted average number of shares outstanding | 2,960,272              | 2,820,397              |

See notes to these consolidated financial statements.

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

|   | <b>Twenty-four Weeks Ended</b> |                        |
|---|--------------------------------|------------------------|
|   | <b>August 12, 2007</b>         | <b>August 13, 2006</b> |
| Revenues  | \$45,527,000                   | \$43,644,000           |
| Cost of sales:  |                                |                        |
| Food, paper and beverage                              | 13,916,000                     | 13,550,000             |
| Labor and benefits                                    | 12,247,000                     | 11,353,000             |
| Restaurant operating expenses                         | 11,300,000                     | 10,793,000             |
| Depreciation and amortization                         | 1,315,000                      | 1,445,000              |
| General and administrative expenses                   | 2,760,000                      | 2,355,000              |
| Gain on restaurant assets                             | (8,000)                        | (26,000)               |
| Operating income                                      | 3,997,000                      | 4,174,000              |
| Interest expense:                                     |                                |                        |
| Bank debt and notes payable                           | 1,650,000                      | 1,792,000              |
| Capital leases  | 58,000                         | 54,000                 |
| Other income and expense, net                         | (172,000)                      | (101,000)              |
| Net income before income taxes                        | 2,461,000                      | 2,429,000              |
| Provision for income taxes                            | 761,000                        | 241,000                |
| Net income  | \$ 1,700,000                   | \$ 2,188,000           |
| Basic net income per common share                     | \$ 0.59                        | \$ 0.80                |
| Diluted net income per common share                   | \$ 0.57                        | \$ 0.78                |
| Basic weighted average number of shares outstanding   | 2,884,997                      | 2,718,495              |
| Diluted weighted average number of shares outstanding | 2,962,399                      | 2,813,593              |

See notes to these consolidated financial statements.

MORGAN S FOODS, INC.  
CONSOLIDATED BALANCE SHEETS

|  | <b>August 12,<br/>2007<br/>(UNAUDITED)</b> | <b>February 25,<br/>2007<br/>(AUDITED)</b> |
|--|--|--|
| <b>ASSETS</b>  |  |  |
| Current assets:  |  |  |
| Cash and equivalents   | \$ 8,504,000                               | \$ 7,829,000                               |
| Receivables  | 400,000                                    | 345,000                                    |
| Inventories  | 743,000                                    | 684,000                                    |
| Prepaid expenses   | 415,000                                    | 600,000                                    |
|  | 10,062,000                                 | 9,458,000                                  |
| Property and equipment:  |  |  |
| Land   | 10,639,000                                 | 10,462,000                                 |
| Buildings and improvements   | 20,958,000                                 | 20,200,000                                 |
| Property under capital leases  | 1,433,000                                  | 1,433,000                                  |
| Leasehold improvements   | 8,001,000                                  | 7,841,000                                  |
| Equipment, furniture and fixtures                                    | 20,694,000                                 | 20,531,000                                 |
| Construction in progress   | 1,523,000                                  | 1,107,000                                  |
|  | 63,248,000                                 | 61,574,000                                 |
| Less accumulated depreciation and amortization                       | 31,785,000                                 | 31,104,000                                 |
|  | 31,463,000                                 | 30,470,000                                 |
| Other assets   | 756,000                                    | 824,000                                    |
| Franchise agreements   | 1,456,000                                  | 1,519,000                                  |
| Deferred tax asset   | 380,000                                    | 825,000                                    |
| Goodwill   | 9,227,000                                  | 9,227,000                                  |
|  | \$ 53,344,000                              | \$ 52,323,000                              |
| <b>LIABILITIES AND SHAREHOLDERS EQUITY</b>                           |  |  |
| Current liabilities:   |  |  |
| Long-term debt, current  | \$ 2,912,000                               | \$ 2,913,000                               |
| Current maturities of capital lease obligations                      | 33,000                                     | 28,000                                     |
| Accounts payable   | 4,842,000                                  | 4,291,000                                  |
| Accrued liabilities  | 4,530,000                                  | 4,629,000                                  |
|  | 12,317,000                                 | 11,861,000                                 |
| Long-term debt   | 32,958,000                                 | 34,445,000                                 |
| Long-term capital lease obligations                                  | 1,278,000                                  | 1,299,000                                  |
| Other long-term liabilities  | 1,244,000                                  | 1,302,000                                  |
| Deferred tax liabilities   | 1,788,000                                  | 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                        | (25,534,000)  | (27,234,000)  |
| Total shareholders equity                  | 3,759,000     | 1,839,000     |
|  | \$ 53,344,000 | \$ 52,323,000 |

See notes to these consolidated financial statements.

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

|                                   | <b>Common Shares</b> |               | <b>Treasury Shares</b> |                 | <b>Capital in<br/>excess of<br/>stated value</b> | <b>Accumulated<br/>Deficit</b> | <b>Total<br/>Shareholders<br/>Equity</b> |
|-----------------------------------|----------------------|---------------|------------------------|-----------------|--|--------------------------------|--|
|                                   | <b>Shares</b>        | <b>Amount</b> | <b>Shares</b>          | <b>Amount</b>   |  |                                |  |
| Balance<br>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                        |                      |               |                        |                 |  | 1,700,000                      | 1,700,000                                |
| <br>Balance<br>August 12,<br>2007 | <br>2,969,405        | <br>\$30,000  | <br>34,410             | <br>\$ (81,000) | <br>\$29,344,000                                 | <br>\$(25,534,000)             | <br>\$3,759,000                          |

See notes to these consolidated financial statements

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

|  | <b>Twenty-Four Weeks Ended</b> |                        |
|--|--------------------------------|------------------------|
|  | <b>August 12, 2007</b>         | <b>August 13, 2006</b> |
| <b>OPERATING ACTIVITIES</b>  |                                |                        |
| Net income   | \$ 1,700,000                   | \$ 2,188,000           |
| Adjustments to reconcile to net cash provided by operating activities: |                                |                        |
| Depreciation and amortization  | 1,315,000                      | 1,445,000              |
| Amortization of deferred financing costs                               | 48,000                         | 51,000                 |
| Amortization of supply agreement advances                              | (487,000)                      | (340,000)              |
| Funding from supply agreements   | 107,000                        | 41,000                 |
| Decrease in deferred tax assets  | 445,000                        |                        |
| Increase in deferred tax liabilities                                   | 211,000                        | 132,000                |
| Gain on restaurant assets  | (8,000)                        | (26,000)               |
| Change in assets and liabilities:                                      |                                |                        |
| (Increase) decrease in receivables                                     | (55,000)                       | 109,000                |
| Increase in inventories  | (59,000)                       | (81,000)               |
| Decrease in prepaid expenses   | 185,000                        | 421,000                |
| Increase (decrease) in accounts payable                                | 551,000                        | (523,000)              |
| Increase in accrued liabilities and other                              | 269,000                        | 168,000                |
| <b>NET CASH PROVIDED BY OPERATING ACTIVITIES</b>                       | <b>4,222,000</b>               | <b>3,585,000</b>       |
| <b>INVESTING ACTIVITIES</b>  |                                |                        |
| Capital expenditures   | (2,263,000)                    | (945,000)              |
| Purchase of franchise agreement  |                                | (36,000)               |
| <b>NET CASH USED FOR INVESTING ACTIVITIES</b>                          | <b>(2,263,000)</b>             | <b>(981,000)</b>       |
| <b>FINANCING ACTIVITIES</b>  |                                |                        |
| Principal payments on long-term debt                                   | (1,488,000)                    | (1,562,000)            |
| Principal payments on capital lease obligations                        | (16,000)                       | (11,000)               |
| Cash received for exercise of stock options                            | 220,000                        |                        |
| <b>NET CASH USED FOR FINANCING ACTIVITIES</b>                          | <b>(1,284,000)</b>             | <b>(1,573,000)</b>     |
| <b>NET CHANGE IN CASH AND EQUIVALENTS</b>                              | <b>675,000</b>                 | <b>1,031,000</b>       |
| Cash and equivalents, beginning balance                                | 7,829,000                      | 6,415,000              |
| <b>CASH AND EQUIVALENTS, ENDING BALANCE</b>                            | <b>\$ 8,504,000</b>            | <b>\$ 7,446,000</b>    |

Interest paid was \$1,725,000 and \$1,873,000 in the first 24 weeks of fiscal 2008 and 2007 respectively  
Cash payments for income taxes were \$171,000 and \$127,000 in the first 24 weeks of fiscal 2008 and 2007 respectively



See notes to these consolidated financial statements.

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 August 12, 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.

**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 August 12, 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 August 12, 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.

**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 145,500 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 August 12, 2007, options for a total of 150,000 shares were available for grant.

During the quarter ended August 12, 2007, options for 54,000 shares were exercised at a weighted average exercise price of \$4.07 and a weighted average market value of \$11.30. The exercise of these stock options resulted in \$390,258 of taxable compensation to the employees exercising the options, for which the Company is allowed a deduction for income tax purposes but for which it records no book expense. Under the provisions of SFAS No. 123R, the resulting tax benefit of approximately \$153,000 will be recorded when it is utilized which is expected to be after the use or expiration of the company's net operating loss carryforwards.

No options were granted during fiscal year 2007 and the twenty-four week period ended August 12, 2007. As of February 25, 2007 and August 12, 2007 there were 70,000 options outstanding, fully vested and exercisable at a weighted average exercise price of \$4.00 per share. During the twenty-four weeks ended August 12, 2007 there was no unrecognized compensation expense for financial reporting purposes.

The following table summarizes information about stock options outstanding at August 12, 2007:

| Exercise | Number<br>Outstanding at<br>August 12,<br>2007 | Average<br>Remaining<br>Life | Number<br>Exercisable at<br>August 12,<br>2007 |
|----------|--|------------------------------|--|
| Prices   |  |                              |  |
| \$3.00   | 7,500  | 2.3                          | 7,500  |
| \$4.13   | 62,500   | 1.6                          | 62,500   |
|          | 70,000   | 1.7                          | 70,000   |

**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 September 18, 2007, the Company operates 73 KFC restaurants, 6 Taco Bell restaurants, 13 KFC/Taco Bell restaurants under franchises from KFC Corporation and franchises or licenses from Taco Bell Corporation, 3 Taco Bell/Pizza Hut Express restaurants operated under franchises from Taco Bell Corporation and licenses from Pizza Hut Corporation, 1 KFC/Pizza Hut Express restaurant operated under a franchise from KFC Corporation and a license from Pizza Hut Corporation and 1 KFC/A&W restaurant operated under a franchise from KFC Corporation and a license from A&W Restaurants, Inc. The Company's fiscal year is a 52-53 week year ending on the Sunday nearest the last day of February.

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

|                                     | Quarter Ended   |                 | Twenty-four Weeks Ended |                 |
|-------------------------------------|-----------------|-----------------|-------------------------|-----------------|
|                                     | August 12, 2007 | August 13, 2006 | August 12, 2007         | August 13, 2006 |
| Cost of sales:                      |                 |                 |                         |                 |
| Food, paper and beverage            | 30.5%           | 30.7%           | 30.6%                   | 31.0%           |
| Labor and benefits                  | 27.1%           | 26.0%           | 26.9%                   | 26.0%           |
| Restaurant operating expenses       | 25.0%           | 24.8%           | 24.8%                   | 24.7%           |
| Depreciation and amortization       | 2.9%            | 3.2%            | 2.9%                    | 3.3%            |
| General and administrative expenses | 6.0%            | 5.4%            | 6.1%                    | 5.4%            |
| Operating income                    | 8.4%            | 10.1%           | 8.8%                    | 9.6%            |

**Revenues.** Revenues for the quarter ended August 12, 2007 were \$22,877,000 compared to \$22,543,000 for the quarter ended August 13, 2006. This increase of \$334,000 was due mainly to a 2.3% increase in comparable restaurant revenues partially offset by \$218,000 of revenues lost due to a permanent restaurant closing and three restaurants being closed for remodeling. 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 Biscuit Bowl at KFC and the Extreme Beef & Cheese Quesadilla at Taco Bell. Revenues for the twenty-four weeks ended August 12, 2007 increased to \$45,527,000 compared to \$43,644,000 for the twenty-four weeks ended August 13, 2006 due to a 5.0% comparable restaurant revenue increase offset by \$416,000 of revenues lost due to a permanent restaurant closing and four restaurants being closed for remodeling. Each restaurant being remodeled is generally closed from two to four weeks.

**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 August 12, 2007 compared to 30.7% for the quarter ended August 13, 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 twenty-four weeks ended August 12, 2007 decreased to 30.6% of revenue compared to 31.0% 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 August 12, 2007 to 27.1% compared to 26.0% for the year earlier quarter. The increase was primarily due to increases in the minimum wage. Labor and benefits for the twenty-four weeks ended August 12, 2007 were 26.9% compared to 26.0% for the comparable year earlier period also due to increases in the minimum wage.

**Restaurant Operating Expenses.** Restaurant operating expenses increased slightly as a percentage of revenue to 25.0% in the second quarter and 24.8% for the first twenty-four weeks of fiscal 2008 compared to 24.8% in the second quarter of fiscal 2007 and 24.7% for the first twenty-four 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 decreased to \$661,000 in the quarter ended August 12, 2007 compared to \$722,000 for the quarter ended August 13, 2006 primarily due to significant amounts of fixed assets

reaching the end of their useful lives and no longer being depreciated. Depreciation and amortization for the twenty-four weeks ended August 12, 2007 decreased to \$1,315,000 compared to \$1,445,000 in the comparable year earlier period for the reasons discussed above.

General and Administrative Expenses. General and administrative expenses increased to \$1,380,000 in the second quarter of fiscal 2008 and \$2,760,000 for the first twenty-four weeks of fiscal 2008 compared to \$1,220,000 in the second quarter of fiscal 2007 and \$2,355,000 for the first twenty-four weeks of fiscal 2007. These increases were caused by a variety of factors including salary increases and personnel additions both at the corporate office and in field management, field operations bonuses and increases in insurance rates.

(Gain)Loss on Restaurant Assets. The Company experienced a loss on restaurant assets of \$8,000 for the second quarter of fiscal 2008 compared to a gain of \$20,000 for the second quarter of fiscal 2007. The current year amounts were the result of losses on property disposed during restaurant remodeling partially offset by deferred gains on a sale/leaseback location. The prior year amounts contained very little disposed property. Gain on restaurant assets was \$8,000 for the twenty-four weeks ended August 12, 2007 and \$26,000 for the twenty-four weeks ended August 13, 2006 for the reasons discussed above.

Operating Income. Operating income in the second quarter of fiscal 2008 decreased to \$1,928,000 or 8.4% of revenues compared to \$2,271,000 or 10.1% of revenues for the second quarter of fiscal 2007 primarily due to increases in labor costs and operating expenses, partially offset by decreases in food and paper costs. Operating income for the twenty-four weeks ended August 12, 2007 decreased to \$3,997,000 or 8.8% of revenues from \$4,174,000 or 9.6% of revenues in the comparable prior year period for the reasons discussed above.

Interest Expense. Interest expense decreased to \$832,000 in the second quarter of fiscal 2008 and \$1,708,000 for the first twenty-four weeks of fiscal 2008 from \$900,000 in the second quarter of fiscal 2007 and \$1,846,000 for the first twenty-four weeks of fiscal 2007, due to lower debt balances during the fiscal 2008 periods.

Other Income. Other income increased to \$128,000 for the second quarter of fiscal 2008 and \$172,000 for the first twenty-four weeks of fiscal 2008 from \$78,000 for the second quarter of fiscal 2007 and \$101,000 for the first twenty-four 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 twenty-four week periods.

Provision for Income Taxes. The provision for income taxes increased to \$354,000 for the second quarter of fiscal 2008 compared to \$160,000 for the second quarter of fiscal 2007. The provision for income taxes is recorded at the Company's projected annual effective tax rate. For the first twenty-four weeks of fiscal 2008 the provision for income taxes increased to \$761,000 compared to \$241,000 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 which was offset by the use of net operating loss carryforwards in the prior 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 twenty-four weeks of fiscal 2008 and fiscal 2007 is presented in the Consolidated Statements of Cash Flows. Cash provided by operating activities was \$4,222,000 for the twenty-four weeks ended August 12, 2007 compared to \$3,585,000 for the twenty-four weeks ended August 13, 2006. The increase in operating cash flow resulted primarily from a decrease in the deferred tax assets and increases in accounts payable and accrued liabilities, primarily caused by more favorable vendor payment terms. The Company paid scheduled long-term bank and capitalized lease debt of \$1,504,000 in the first twenty-four weeks of fiscal 2008 compared to payments of \$1,573,000 for the same period in fiscal 2007. Capital expenditures in the twenty-four weeks ended August 12, 2007 were \$2,263,000, compared to \$945,000 for the same period in fiscal 2007 as the Company has increased its image enhancement activity to meet the requirements of its franchise agreements. The Company also received cash, in the amount of \$220,000, from the exercise of stock options in the second quarter of fiscal 2008.

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 August 12, 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 August 12, 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.

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 August 12, 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.

### **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 August 12, 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 August 12, 2007 and February 25, 2007 and the results of operations and cash flows for the quarters ended August 12, 2007 and August 13, 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.

**Item 5. Submission of Matters to vote of Security Holders**

The Company's annual meeting of shareholders was held on June 22, 2007 and voting was conducted on the following proposals:

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

| NAME                 | FOR       | WITHHOLD/<br>ABSTAIN |
|----------------------|-----------|----------------------|
| Leonard Stein-Sapir  | 2,240,621 | 151,147              |
| Lawrence S. Dolin    | 2,257,438 | 134,330              |
| Bahman Guyuron, M.D. | 2,257,371 | 134,397              |
| Kenneth L. Hignett   | 2,240,754 | 151,014              |
| Steven S. Kaufman    | 2,257,471 | 134,297              |
| Bernard Lerner       | 2,247,471 | 144,297              |
| James J. Liguori     | 2,240,705 | 151,063              |

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.   |

SIGNATURES

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

MORGAN S FOODS, INC.

/s/ Kenneth L. Hignett

Senior Vice President,

Chief Financial Officer and Secretary

September 26, 2007