MORGANS FOODS INC
Form 10-K
May 31, 2011

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549
FORM 10-K
Annual Report Pursuant to Section 13 or 15(d)
of the Securities Exchange Act of 1934
For the fiscal year ended February 27, 2011 Commission file number 1-08395
MORGAN S FOODS, INC.
(Exact name of registrant as specified in its charter)

Ohio	34-0562210
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification Number)

4829 Galaxy Parkway, Suite S, Cleveland, OH 44128

(Address of principal executive officers) (Zip Code)
Registrant s telephone number, including area code: (216) 359-9000
Securities registered pursuant to Section 12(b) of the Act: None

Title of each class	Name of each exchange on which registered
Common Shares, Without Par Value	

Securities registered pursuant to Section 12(g) of the Act: None
Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes o No þ
Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes o No þ
Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15 (d) of the Securities Exchange Act of 1934 during the preceding 12 months and (2) has been subject to such filing requirements for the past 90 days. Yes 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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. þ
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 definitions of large accelerated filer , accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

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 registration is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes o No þ

As of August 13, 2010, the aggregate market value of the common stock held by nonaffiliates of the Registrant was $6,800,700.

As of May 11, 2011, the Registrant had 2,934,995 common shares outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

Part III incorporates by reference certain information from the Definitive Proxy Statement for the 2011 annual meeting of shareholders to be held on June 24, 2011 and to be filed with the Securities and Exchange Commission about May 31, 2011.

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PART I

ITEM 1. BUSINESS

General

Morgan s Foods, Inc. (the Company), which was formed in 1925, operates through wholly-owned subsidiaries KFC restaurants under franchises from KFC Corporation, Taco Bell restaurants under franchises from Taco Bell Corporation, Pizza Hut Express restaurants under licenses from Pizza Hut Corporation and an A&W restaurant under a license from A&W Restaurants, Inc. As of May 20, 2011, the Company operates 56 KFC restaurants, 5 Taco Bell restaurants, 10 KFC/Taco Bell 2n1 s under franchises from KFC Corporation and franchises 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. See Subsequent Events for further discussion of the closing of 12 KFC restaurants. The Company s fiscal year is a 52 53 week year ending on the Sunday nearest the last day of February.

Restaurant Operations

The Company s KFC restaurants prepare and sell the distinctive KFC branded chicken products along with related food items. All containers and packages bear KFC trademarks. The Company s Taco Bell restaurants prepare and sell a full menu of quick service Mexican food items using the appropriate Taco Bell containers and packages. The KFC/Taco Bell 2n1 restaurants operated under franchise agreements from KFC Corporation and franchise agreements from Taco Bell Corporation prepare and sell a limited menu of Taco Bell items as well as the full KFC menu while those operated under franchise agreements from both KFC Corporation and Taco Bell Corporation offer a full menu of both KFC and Taco Bell items. The Taco Bell/Pizza Hut Express 2n1 restaurants prepare and sell a full menu of Taco Bell items and a limited menu of Pizza Hut items. The KFC/Pizza Hut Express 2n1 restaurant prepares and sells a full menu of KFC items and a limited menu of Pizza Hut items. The KFC/A&W 2n1 sells a limited menu of A&W items and a full menu of KFC items.

Of the 76 KFC, Taco Bell and 2n1 restaurants operated by the Company as of May 20, 2011, 13 are located in Ohio, 45 in Pennsylvania, nine in Missouri, one in Illinois, seven in West Virginia and one in New York. The Company was one of the first KFC Corporation franchisees and has operated in excess of 20 KFC franchises for more than 25 years. Operations relating to these units are seasonal to a certain extent, with higher sales generally occurring in the summer months.

Franchise Agreements

All of the Company s KFC and Taco Bell restaurants are operated under franchise agreements with KFC Corporation and Taco Bell Corporation, respectively. The Company s KFC/Taco Bell 2n1 restaurants are operated under franchises from KFC Corporation and franchises from Taco Bell Corporation. The Taco Bell/Pizza Hut Express 2n1 s are operated under franchises from Taco Bell Corporation and licenses from Pizza Hut Corporation. The KFC/Pizza Hut Express 2n1 restaurant is operated under a franchise from KFC Corporation and a license from Pizza Hut Corporation. The KFC/A&W 2n1 is operated under a franchise from KFC Corporation and a license from A&W Restaurants, Inc. The Company considers retention of these agreements to be important to the success of its restaurant business and believes that its relationships with KFC Corporation, Taco Bell Corporation, Pizza Hut Corporation and A&W Restaurants, Inc. are satisfactory. For further discussion of the requirements of the franchise and license agreements see Other Contractual Obligations and Commitments in Part II of this report.

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

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The Company has been in discussions with KFC Corporation for some time regarding its image enhancement obligations and has been in receipt of certain default and termination notices from KFC. For further discussion of these events, see the Subsequent Events section of this report as well as recent reports filed by the Company on Form 8-K.

Competition

The quick service restaurant business is highly competitive and is often affected by changes in consumer tastes; national, regional, or local economic conditions, demographic trends, traffic patterns; the type, number and locations of competing restaurants and disposable purchasing power. Each of the Company s KFC, Taco Bell and 2n1 restaurants competes directly or indirectly with a large number of national and regional restaurant operations, as well as with locally owned restaurants, drive-ins, diners and numerous other establishments which offer low- and medium-priced chicken, Mexican food, pizza, hamburgers and hot dogs to the public.

The Company s KFC, Taco Bell and 2n1 restaurants rely on innovative marketing techniques and promotions to compete with other restaurants in the areas in which they are located. The Company s competitive position is also enhanced by the national advertising programs sponsored by KFC Corporation, Taco Bell Corporation, Pizza Hut Corporation, A&W Restaurants, Inc. and their franchisees. Emphasis is placed by the Company on its control systems and the training of personnel to maintain high food quality and good service. The Company believes that its KFC, Taco Bell and 2n1 restaurants are competitive with other quick service restaurants on the basis of the important competitive factors in the restaurant business which include, primarily, restaurant location, product price, quality and differentiation, and also restaurant and employee appearance.

Government Regulation

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

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

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

Suppliers

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

Growth

The Company built no new restaurants in fiscal years 2011 or 2010. Two KFC restaurants in the St. Louis market were closed during fiscal 2011, one due to the expiration of the lease and the inability find a suitable replacement site in the trade area and the other due to lack of profitability and the property was disposed. Also in the Pittsburgh, PA market, a Taco Bell restaurant was closed due to lack of profitability and an agreement was reached with the landlord of the location to terminate the lease before its expiration and a KFC restaurant in a fee owned location was closed on the last day of fiscal 2011.

Employees

As of May 16, 2011, the Company employed approximately 1,722 persons, including 43 administrative and 201 managerial employees. The balance are hourly employees, most of whom are part-time. None of the Company s employees are represented by a labor union. The Company considers its employee relations to be satisfactory.

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ITEM 1A. RISK FACTORS

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

Image Enhancement and Capital Expenditure Requirements

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

Product and Marketing Success of Franchisors

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

Failure to Meet Loan Covenants

If the Company does not meet the periodic requirements of its loan covenants and is unable to obtain waivers of these deficiencies, its lenders could take actions which would have a material adverse impact on the Company s results of operations.

Contamination of the Food Supply

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

Litigation

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

Environmental Liabilities

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

Food and Labor Cost Increases

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

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Outbreak of Avian Flu or Mad Cow Disease

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

Governmental Laws and Regulations

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

Quick Service Restaurant Competition

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

ITEM 1B. UNRESOLVED STAFF COMMENTS

Not applicable.

ITEM 2. PROPERTIES

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

Of the 76 KFC, Taco Bell and 2n1 restaurants, the Company owns the land and building for 37 locations, owns the building and leases the land for 21 locations and leases the land and building for 18 locations. All of the owned properties are subject to mortgages. Additionally, the Company owns the land and building for nine closed locations, and is obligated for various terms under leases on three other closed locations. Remaining lease terms (including renewal options) range from 5 months to 37 years and average approximately 17 years. These leases generally require the Company to pay taxes and utilities, to maintain casualty and liability insurance, and to keep the property in good repair. The Company pays annual rent for each leased KFC, Taco Bell or 2n1 restaurant in amounts ranging from $24,000 to $134,000. In addition, four of these leases require payment of additional rentals based on a percentage of gross sales in excess of certain base amounts. Sales for four KFC, Taco Bell and 2n1 restaurants exceeded the respective base amounts in fiscal 2011.

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

ITEM 3. LEGAL PROCEEDINGS

None.

ITEM 4. (Removed and Reserved)

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

Name	Age	Position with Registrant	Officer Since
Executive Officers:			
Leonard R. Stein-Sapir	72	Chairman of the Board and Chief Executive Officer	April 1989
James J. Liguori	62	President and Chief Operating Officer	June 1979
Kenneth L. Hignett	64	Senior Vice President Chief Financial Officer & Secretary	May 1989
Other Officers:			
Barton J. Craig	62	Senior Vice President General Counsel	January 1994
Vincent J. Oddi	68	Vice President Restaurant Development	September 1979
Ramesh J. Gursahaney	62	Vice President Operations	January 1991

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

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PART II

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

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

	Price Range	
	High	**Low**
Year ended February 27, 2011:		
1st Quarter	$ 5.00	$ 3.30
2nd Quarter	4.00	2.11
3rd Quarter	4.00	2.65
4th Quarter	3.00	2.05
Year ended February 28, 2010:		
1st Quarter	$ 2.60	$ 1.01
2nd Quarter	3.00	1.75
3rd Quarter	3.00	2.05
4th Quarter	3.60	2.00

As of May 11, 2011, the Company had approximately 775 shareholders of record. The Company has paid no dividends since 1975 and does not expect to pay dividends in the foreseeable future.

Securities authorized for issuance under equity compensation plans are shown in the table below:

Plan Category	Number of securities to be issued upon exercise of outstanding options	Weighted average exercise price of outstanding options	Number of shares remaining for future issuance under equity compensation plans
Equity Compensation plans approved by security holders	148,650	$ 1.50	
Equity Compensation plans not approved by security holders	350	$ 1.50	
Total	149,000	$ 1.50	

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Shareholder Return Performance Graph

Set forth below is a line graph comparing the cumulative total return on the Company s Common Shares, assuming a $100 investment as of February 26, 2006, and based on the market prices at the end of each fiscal year, with the cumulative total return of the Standard & Poor s Midcap 400 Stock Index and a restaurant peer group index composed of 12 restaurant companies each of which has a market capitalization comparable to that of the Company.

Comparison Of Cumulative Five Year Total Return

	2006	2007	2008	2009	2010	2011
MORGANS FOODS INC	100	253	131	40	69	41
S&P MIDCAP 400 INDEX	100	113	104	60	100	133
RESTAURANT PEER GROUP	100	128	127	39	75	114

The companies in the peer group are Boston Restaurant Assoc. Inc., Brazil Fast Food Corp., Briazz Inc.(included through 2009), Einstein Noah Restaurant Grp, Flanigans Enterprises Inc., Good Times Restaurants Inc., Granite City Food & Brewery, Grill Concepts Inc., Mexican Restaurants Inc., Star Buffet Inc., Tumbleweed Inc. and Western Sizzlin Corp. The restaurant peer group index is weighted based on market capitalization. Some of the companies do not currently exist as independent publicly traded entities but are included in the calculation for the appropriate time periods. The companies included in the peer group index were selected by the Board of Directors.

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ITEM 6. SELECTED FINANCIAL DATA

The following selected financial information for each of the five fiscal years in the period ended February 27, 2011, is derived from, and qualified in its entirety by, the consolidated financial statements of the Company. The following selected financial information should be read in conjunction with Management s Discussion and Analysis of Financial Condition and Results of Operations and the consolidated financial statements and the notes thereto included elsewhere in this report.

			Years Ended		
$ in thousands, except per share amounts	February 27, 2011	February 28, 2010	March 1, 2009	March 2, 2008	February 25, 2007
Revenues	$ 89,891	$ 90,544	$ 92,485	$ 96,318	$ 91,248
Cost of sales:					
Food, paper and beverage	28,267	28,457	29,695	29,524	27,981
Labor and benefits	26,533	26,448	26,850	27,404	24,798
Restaurant operating expenses	23,748	23,931	24,068	24,415	22,765
Depreciation and amortization	2,831	3,026	3,224	2,953	2,950
General and administrative expenses	5,450	5,409	5,740	6,111	5,428
Loss on restaurant assets	841	75	417	112	5
Operating income	2,221	3,198	2,491	5,799	7,321
Provision for income taxes	637	340	391	349	136
Net income (loss)	(988)	396	(1,390)	414	3,527
Basic net income (loss) per comm. sh. (1)	(0.34)	0.13	(0.47)	0.14	1.29
Diluted net income (loss) per comm. sh. (1)	(0.34)	0.13	(0.47)	0.14	1.27
Working capital deficiency	(29,770)	(3,984)	(16,091)	(5,335)	(2,403)
Total assets	44,088	48,925	51,988	55,962	52,323
LT debt and capital lease current portion	27,097	3,209	16,514	3,224	2,941
Long-term debt less current maturities		29,725	19,738	35,789	34,445
Long-term capital lease obligations	1,013	1,061	1,105	1,144	1,299
Shareholders equity	635	1,623	1,171	2,473	1,839
Net cash flow operating activities	3,667	3,849	(98)	4,856	7,114
Net cash flow investing activities	1,047	(1,539)	1,727	(8,061)	(3,057)
Net cash flow financing activities	(5,885)	(3,362)	(2,800)	1,804	(2,643)

Certain amounts in prior periods have been reclassified to conform to the current period presentation

(1) Computed based upon the basic weighted average number of common shares outstanding during each year, which were 2,934,995 in 2011, 2010 and 2009, 2,911,448 in 2008, and 2,738,982 in 2007 and the diluted weighted average number of common and common equivalent shares outstanding during each year, which were 2,934,995 in 2011, 2,991,941 in 2010, 2,934,995 in 2009, 2,968,654 in 2008, and 2,767,478 in 2007.

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

Results of Operations

During fiscal 2010 through 2011 the Company operated KFC franchised restaurants, Taco Bell franchised restaurants and various 2n1 restaurants which include the KFC, Taco Bell, Pizza Hut and A&W concepts in the states of Illinois, Missouri, Ohio, Pennsylvania, West Virginia and New York. The average number of restaurants in operation during each fiscal year was 90 in 2011 and 92 in 2010.

Summary of Expenses and Operating Income as a Percentage of Revenues

	2011	2010
Cost of sales:		
Food, paper and beverage	31.4%	31.4%
Labor and benefits	29.5%	29.2%
Restaurant operating expenses	26.4%	26.4%
Depreciation and amortization	3.1%	3.3%
General and administrative expenses	6.1%	6.0%
Operating income	2.5%	3.5%

Revenues

Revenue was $89,891,000 in fiscal 2011, a decrease of $653,000, or 0.7%, compared to fiscal 2010. The $653,000 decrease in restaurant revenues during fiscal 2011 was primarily due to the permanent closing of four restaurants and the temporary closing during the current year of three restaurants for image enhancement; offset by the temporary closing during the previous year fourth quarter of one restaurant for image enhancement.

Revenues for the 16 weeks ended February 27, 2011, were $24,791,000, an increase of $1,025,000, or 4.3%, compared to the 16 weeks ended February 28, 2010 primarily resulting from a 4.7% or $1,093,000 increase in comparable restaurant revenues, $473,000 of lost revenue from three permanently closed restaurants, offset by the temporary closing of one location in the previous year quarter.

Cost of Sales Food, Paper and Beverage

Food, paper and beverage costs as a percent of revenue remained the same at 31.4%. There was an increase in commodity costs throughout fiscal 2011 causing food costs to rise throughout the year while the prior year food cost was negatively impacted by the cost of free chicken and excessive waste during the KGC (Kentucky Grilled Chicken) rollout during fiscal 2010.

For the fourth quarter of fiscal 2011, food, paper and beverage costs increased as a percentage of revenues to 32.5% from 30.8% in the fourth quarter fiscal 2010. The increase of 1.7% was primarily caused by an increase in commodity costs, higher cost promotional items and a decrease in vendor rebates in the current year quarter.

Cost of Sales Labor and Benefits

Labor and benefits increased slightly to 29.5% of revenues, or $26,533,000, in fiscal 2011 from 29.2% of revenues, or $26,448,000, in fiscal 2010. The increase was primarily the result of higher labor efficiency during the first two months of the Kentucky Grilled Chicken introduction during fiscal 2010.

Labor and benefit costs for the fourth quarter of fiscal 2011 decreased to 30.5% of revenues, or $7,566,000, compared to 32.3% of revenues, or $7,669,000, in fiscal 2010. This percentage decrease was primarily the result of increased efficiencies and reduced costs related to employee health and welfare during the current year quarter.

Restaurant Operating Expenses

Restaurant operating expenses remained the same as a percentage of revenues at 26.4%, in fiscal 2011and 2010. Restaurant operating expenses for the fourth quarter of fiscal 2011 decreased as a percentage of revenues to 26.7%, or $6,626,000, from 27.6% of revenues, or $6,566,000, in the year earlier quarter. This decrease reflects higher efficiencies due to higher sales volumes in the current year quarter. Notable decreases were realized in costs related to general insurance, real estate taxes, contract services and utilities with a slight offset from manager s bonuses.

Depreciation and Amortization

Depreciation and amortization for fiscal 2011 at $2,831,000 was a decrease from fiscal 2010 at $3,026,000. The decrease was primarily due to the greater volume of assets becoming fully depreciated than new assets being acquired. Depreciation and amortization for the fourth quarter of fiscal 2011 at $965,000 was comparable to the fourth quarter of fiscal 2010 at $913,000.

General and Administrative Expenses

General and administrative expenses increased to $5,450,000, or 6.1% of revenues, in fiscal 2011 from $5,409,000, or 6.0% of revenues, in fiscal 2010. The increase was primarily caused by costs related to the modification of certain loan documents and costs related to the retention of a financial advisory firm in the current year, partially offset by higher professional fees and compensation expense for stock options in the prior year.

For the fourth quarter of fiscal 2011, general and administrative expenses were $1,561,000, or 6.3% of revenues compared to $1,512,000, or 6.4% of revenues, in the fourth quarter of fiscal 2010. This increase of $49,000 is primarily a result of costs related to the retention a financial advisory firm.

Loss on Restaurant Assets

The Company had a loss on restaurant assets of $841,000 in fiscal 2011 compared to a loss of $75,000 in fiscal 2010. The fiscal 2010 loss consisted of $51,000 in tangible asset impairment while the fiscal 2011 loss had $406,000 of tangible asset impairment consisting primarily of reductions in the value of assets related to the restaurants closed April of 2011(see Subsequent Events for further discussion), a $125,000 reduction of assets held for sale, $152,000 of loss related to the permanent closing of three restaurants and $89,000 of goodwill write offs related to the sale of three restaurant locations.

In the fourth quarter of fiscal 2011 the Company had a loss on restaurant assets of $703,000 compared to a loss of $63,000 in the fourth quarter of fiscal 2010. The increase was primarily caused by the items discussed above.

Operating Income

Operating income in fiscal 2011 decreased to $2,221,000 from $3,198,000 in fiscal 2010 primarily as a result of the items discussed above.

Interest Expense

Prepayment and Deferred Financing Costs

During fiscal 2011, the Company incurred $138,000 of prepayment charges and the write-off of deferred financing costs relating to the early payment of debt to facilitate the disposal of a closed restaurant location and the sale/leaseback of two

operating restaurants. During fiscal 2010, the Company incurred $85,000 of prepayment charges and deferred financing cost write offs related to the early payoff of debt to facilitate the sale of a closed restaurant location. These charges were offset by the return, by a lender, of $98,000 of prepayment penalties which were charged in error.

Bank and Capitalized Lease Interest Expense

Interest expense on bank debt and notes payable decreased to $2,286,000 in fiscal 2011 from $2,558,000 in fiscal 2010. The decrease in interest expense for fiscal 2011 was the result of principal payments which reduced the outstanding debt balances. Interest expense from capitalized lease debt decreased slightly to $104,000 in fiscal 2011 from $108,000 in fiscal 2010 due to lower principal balances.

Other Income and Expense

Other expenses were $44,000 in fiscal 2011 compared to other income of $191,000 in fiscal 2010. The increase in expense of $235,000 consisted primarily of $111,000 in charitable contributions to the Susan G. Komen Foundation generated by KFC s Buckets for the Cure promotion, a $65,000 penalty related to the early termination of a Taco Bell franchise agreement and a $40,000 reduction in miscellaneous income and discounts.

For the current year quarter other expenses were $35,000 compared to other income of $62,000 in the previous year quarter. The increase in expense of $97,000 consisted primarily of a $65,000 penalty related to the early termination of a Taco Bell franchise agreement and a $30,000 reduction in miscellaneous income and discounts.

Provision for Income Taxes

There is no current federal tax provision for fiscal 2011 and 2010. The state and local tax provisions for fiscal 2011 and 2010 are a benefit of $1,000 and a provision of $4,000, respectively. The deferred tax provisions for fiscal 2011 and 2010 are $638,000 and $336,000, respectively and resulted from changes in the balance of net deferred tax assets, deferred tax liabilities associated with indefinite lived intangible assets and the valuation allowance for deferred tax assets.

There are no current federal tax provisions for the fourth quarter of fiscal 2011 and 2010. The state and local tax provisions for the quarter are a benefit of $3,000 compared to a benefit of $8,000 for the comparable prior quarter. The deferred tax provision for the quarter was $199,000 compared to a benefit of $294,000 for the comparable prior quarter. The fourth quarter of fiscal 2011 includes an increase in the deferred tax valuation allowance of $755,000 and fiscal 2010 includes a decrease in the deferred tax valuation allowance of $165,000.

Liquidity and Capital Resources

Cash flow activity for fiscal 2011 and 2010 is presented in the Consolidated Statements of Cash Flows. Cash provided by operating activities was $3,667,000 for the year ended February 27, 2011 compared to $3,849,000 for the year ended February 28, 2010. The decrease in fiscal 2011 in cash provided by operating activities resulted from the $988,000 net loss in fiscal 2011, offset by an increase of $758,000 of advance funding received on supply agreements and increases in the deferred income tax provision and loss on sale or impairment of restaurant assets, all as compared to fiscal 2010 amounts. In fiscal 2011 the Company was provided with cash of $1,047,000 in investing activities primarily because of proceeds from sale/leaseback transactions and the sale of three restaurant locations. Capital expenditures in fiscal 2011 were $1,763,000 compared to $1,648,000 in fiscal 2010, as the Company completed the image enhancement of three restaurant locations in fiscal 2011 compared to the image enhancement of one restaurant location in fiscal 2010 (see Required Capital Expenditures below). The Company paid long-term bank debt and capitalized lease debt of $5,903,000 in fiscal 2011, compared to payments of $3,362,000 in fiscal 2010. Proceeds from the issuance of long-term debt were $18,000 in fiscal 2011.

The Company s debt arrangements require the maintenance of a consolidated fixed charge coverage ratio of 1.2 to 1 regarding all of the Company s mortgage and equipment loans and the maintenance of individual restaurant fixed charge coverage ratios of between 1.2 and 1.5 to 1 on certain of the Company s mortgage loans. Fixed charge coverage ratios are calculated by dividing the cash flow before taxes, rent and debt service (EBITDAR) for the previous 12 months by the debt service and

rent due in the coming 12 months. Certain loans also require a consolidated funded debt (debt balance plus a calculation based on operating lease payments) to EBITDAR ratio of 5.5 or less. The consolidated and individual coverage ratios are computed quarterly. At the end of fiscal 2011, the Company was not in compliance with the consolidated fixed charge coverage ratio of 1.2 or with the funded debt to EBITDAR ratio of 5.5. As of the measurement date of February 27, 2011, the Company s consolidated fixed charge coverage ratio was 1.07 to 1 and funded debt to EBITDAR was 5.7. Also, at the end of fiscal 2011 the Company was not in compliance with the individual fixed charge coverage ratio on 20 of its restaurant properties. The Company has not obtained waivers with respect to the non-compliance from the applicable lenders.

The Company has engaged the services of a financial advisor to renegotiate its existing financing arrangements and to raise replacement capital to fund its required restaurant image enhancement obligations discussed in Note 6. As discussed below in Subsequent Events, the Company began deferring the payment of principal and paying interest only on substantially all of its debt as part of a strategy to engage in the negotiation of recapitalization of the Company s debt and in order to conserve operating cash while adjusting to the closure of twelve restaurants subsequent to February 27, 2011. As a result of this event of default, waivers of non-compliance were not obtained and all of the Company s debt is classified as current in the balance sheet as of February 27, 2011. The Company is continuing with its plan to recapitalize its current debt using a combination of new debt and sale/leaseback financing which structure contemplates the payment of the debt on which it has not met its loan covenants. If the Company does not comply with the covenants of its various debt agreements and if the recapitalization plan is not executed successfully, 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 could also trigger cross-default provisions contained in the respective agreements. See Note 5 to the consolidated financial statements for further discussion.

Subsequent Events

As previously reported in the Form 8-K filed by the Company on March 16, 2011, subsequent to the Company s fiscal year end of February 27, 2011, termination notices were received from KFC Corporation regarding 10 of the Company s KFC restaurant locations. After discussions with KFC Corporation, two of the restaurants were removed from the list of terminations and four more were added, bringing the total number of restaurants which the Company was required to close to twelve. The twelve restaurants were closed between March 30 and April 15, 2011. The restaurants which were closed were all of the older KFC image generally referred to as Series 38 and were terminated due to the Company s inability to remodel the restaurants to the current KFC image. The twelve restaurants had total sales of $8,342,000 and restaurant level income of $184,000 during the year preceding their closing. Of the twelve closed locations, the Company intends to sell the property from the six fee owned locations and sub-lease or terminate the leases on the six leased properties.

Beginning with the debt payments due April 1, 2011, as previously disclosed in a report on Form 8-K filed April 8, 2011, the Company began paying interest only on substantially all of its debt. The purpose of this strategic default was to begin negotiations with the lenders regarding the forgiveness of prepayment penalties to facilitate the refinancing of the debt and also to conserve operating cash while the closing of the twelve restaurants was conducted and trailing liabilities are paid off. The Company received on May 24, 2011 a notice of default from one of its lenders regarding debt secured by 28 of its restaurant properties. On the same date and from the same lender the Company also received and entered into a letter agreement which defines the terms under which the lender will engage in discussions regarding the possible restructuring of the debt covered by the default. Also, the Company has been engaged in discussions with its other primary lender regarding the possible restructuring of its debt. Nonetheless, given the level of the Company s indebtedness and other demands on its cash resources, there can be no assurance that the Company s lenders will consent to the restructuring, that the restructuring will be accomplished, or that other actions might not be taken by creditors that would impede the Company s ability to satisfy its obligations.

On May 3, 2011, subsequent to the Company s fiscal year end of February 27, 2011, the Company completed the sale and leaseback of its KFC restaurant property in Ashtabula, OH. The proceeds of the sale were used to pay off the mortgage debt on the property as well as certain other debt in the same trust and will also be used to fund the image enhancement of the Ashtabula, OH restaurant as well as contribute to the image enhancement of other properties. The

payoff of the debt related to the sale and leaseback of the Ashtabula, OH property reduced the Company s principal and interest payments by

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approximately $126,000 annually, the Company s debt balance by approximately $264,000 and will add approximately $62,000 in annual lease payments.

As previously reported in the Form 8-K filed by the Company on May 20, 2011, subsequent to the Company s fiscal year end of February 27, 2011, the Company has entered into a pre-negotiation agreement with KFC Corporation regarding its schedule for the image enhancement of its restaurants. In furtherance of its ongoing negotiations with KFC regarding the Company s required image enhancement obligations related to other restaurants, on May 19, 2011 the Company and KFC entered into a Pre-negotiation Agreement, similar to the Pre-negotiation Agreement entered into on November 10, 2010, as described in the Company s Form 8-K filed on the same date, outlining the conditions of reaching a final agreement related to the Company s required image enhancement obligations. Under the May 19, 2011 Pre-negotiation Agreement, KFC has agreed to forbear until August 31, 2011 from terminating the franchise agreements on the 13 operating restaurants on which KFC on May 2, 2011 delivered to the Company a notice of default (for failure to timely comply with required image enhancement obligations) provided that the Company is in compliance with certain forbearance conditions, which include, among others, that (i) the Company is paid up on amounts owing under the franchise agreements, (ii) the Company is not in default of its obligations under the franchise agreements (other than the image enhancement obligations), (iii) the Company submits to KFC a written proposal by June 20, 2011 detailing how the Company will obtain the necessary funds to enable it to comply with the Company s image enhancement obligations, (iv) the Company will establish a remodel escrow account, and (v) the Company will enter into a definitive remodel agreement with KFC by August 31, 2011.

Even though the Pre-negotiation Agreement outlines generally the mutually acceptable terms of a final agreement related to the Company s image enhancement obligations, there can be no assurance that the Company (i) will be able to reach an agreement with KFC regarding image enhancements that would extend the time periods for completion of the required image enhancements, or (ii) will complete the financial restructuring or that the restructuring will create the ability for the Company to complete a satisfactory number of image enhancements. If KFC exercises its termination rights, it is unclear, what, if any, action the Company s landlords and creditors may take under cross default provisions of the Company s agreements that would impede the Company s ability to satisfy its obligations. The termination of those franchise agreements would have a material adverse effect on the Company s financial condition and results of operations.

Market Risk Exposure

Certain of the Company s debt comprising approximately $12.2 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 $122,000 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 or caps if they are available and deemed to be advantageous to the Company. The Company s remaining borrowings are at fixed interest rates, and accordingly the Company does not have market risk exposure for fluctuations in interest rates relative to those loans. The Company does not enter into derivative financial investments for trading or speculation purposes. Also, the Company is subject to volatility in food costs as a result of market risk and we manage that risk through the use of a franchisee purchasing cooperative which uses longer term purchasing contracts. Our ability to recover increased costs through higher pricing is, at times, limited by the competitive environment in which we operate. The Company believes that its market risk exposure is not material to the Company s financial position, liquidity or results of operations.

Other Contractual Obligations and Commitments

For KFC products, the Company is required to pay royalties of 4% of gross revenues and to expend an additional 5.5% of gross revenues on national and local advertising pursuant to its franchise agreements. For Taco Bell products, the Company is required to pay royalties of 5.5% of gross revenues and to expend an additional 4.5% of gross revenues on national and local advertising. KFC/Taco Bell 2n1 restaurants are operated under separate KFC and Taco Bell franchise agreements. For Pizza Hut products in either Taco Bell or KFC/Pizza Hut Express 2n1 restaurants the Company is required to pay royalties of 8.0% of Pizza Hut gross revenues and to expend an additional 2.0% of Pizza Hut gross revenues on national and local advertising. For A&W products in 2n1 restaurants the Company is required to pay royalties of 7% of A&W gross revenues and to expend an additional 4% of A&W gross revenues on national and local

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advertising. Total royalties and advertising, which are included in the Consolidated Statements of Operations as part of restaurant operating expenses, were $9,298,000 and $9,391,000 in fiscal 2011 and 2010, respectively.

Contractual Obligations	2012	2013	2014	2015	2016	Thereafter
Long-term debt, including current (1)	$ 3,263	$ 11,810	$ 3,911	$ 1,706	$ 1,251	$ 5,108
Interest expense on long-term debt	$ 1,784	$ 1,499	$ 885	$ 662	$ 534	$ 852
Capital leases (2)	$ 148	$ 146	$ 147	$ 148	$ 149	$ 1,121
Operating leases (2)	$ 2,307	$ 2,139	$ 1,857	$ 1,544	$ 1,308	$ 11,452
Closed locations (3)	$ 333	$ 296	$ 213	$ 176	$ 178	$ 1,987

(1) All debt has been classified as current in the consolidated balance sheet. See Note 5 to the consolidated financial statements for further discussion regarding expected debt repayment

(2) Does not include contingent rental obligations based on sales performance

(3) Leases related to locations closed subsequent to February 27, 2011

Required Capital Expenditures

The Company is required by its franchise agreements to periodically bring its restaurants up to the required image of the franchisor. This typically involves a new dining room décor and seating package and exterior changes and related items but can, in some cases, require the relocation of the restaurant. If the Company deems a particular image enhancement expenditure to be inadvisable, it has the option to cease operations at that restaurant. Over time, the estimated cost and time deadline for each restaurant may change due to a variety of circumstances and the Company revises its requirements accordingly. Also, significant numbers of restaurants may have image enhancement deadlines that coincide, in which case, the Company will adjust the actual timing of the image enhancements in order to facilitate an orderly construction schedule. During the image enhancement process, each restaurant is normally closed for up 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. As discussed below, the Company has not met its obligations with respect to certain of its restaurants. As a result, the franchisor may terminate the franchise agreement for those restaurants. 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.

As mentioned elsewhere in this report, subsequent to February 27, 2011, the Company was required by KFC Corporation to close twelve KFC locations because they did not meet the franchisor s current image. Image enhancement requirements for these closed locations were formerly included in the capital requirements schedules published by the Company and have now been removed. As discussed in Note 12 to the consolidated financial statements, the Company has entered into a Pre-negotiation Agreement with KFC Corporation with the intention of arriving at a definitive schedule for the completion of the image enhancement of thirteen KFC restaurants which were the subject of default notices received on May 2, 2011, as well as other restaurant locations. The negotiations which are being conducted under the Pre-negotiation Agreement involve mainly restaurants with delinquent image enhancement requirement dates or dates that are two years or less in the future. The capital requirements for these

restaurants are included in the schedule in the time frame where management believes they are most likely to be when the definitive agreement is completed. A deposit toward the completion of the initial two image enhancements is shown on the Company s balance sheet at February 27,

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2011 as restricted cash. The Company will be required to place the restricted cash, as well as other amounts calculated to fund the first two image enhancements in an escrow account. The following schedule contains the capital requirements for image enhancements of restaurants for which the due dates are either estimated or definitive:

Number of Units	Period	Type	Capital Cost (1)
8	Fiscal 2012	Remodels	$ **2,425,000**
5	Fiscal 2013	Remodels	1,625,000
1	Fiscal 2013	Relo (2)	400,000
	Total 2013		**2,025,000**
3	Fiscal 2014	Remodels	625,000
3	Fiscal 2014	Relo (2)	1,200,000
	Total 2014		**1,825,000**
1	Fiscal 2015	Remodels	**150,000**
5	Fiscal 2018	Remodels	**750,000**
16	Fiscal 2020	Remodels	**3,650,000**
3	Fiscal 2021	Romodels	**450,000**
45	**Total**		**$ 11,275,000**

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

(2) Relocations of fee owned properties are shown net of expected recovery of capital from the sale of the former location. Relocation of leased properties assumes the capital cost of only equipment because it is not known until each lease is finalized whether the lease will be a capital or operating lease.

As mentioned elsewhere in this report and other reports, the Company has been utilizing the services of a financial advisor to renegotiate its existing financing arrangements and to raise replacement capital to fund its image enhancement requirements. While the Company believes it will be successful in these restructuring activities, no assurance can be given that all parties will cooperate in the financial restructuring which would cast doubt on its successful completion. Also, if the negotiations under the Pre-negotiation Agreement are not successful the franchisor will likely terminate the franchise agreements on the affected restaurants. The termination of those franchise agreements would have a material adverse effect on the Company s financial condition and results of operations.
Capital expenditures to meet the image requirements of the franchisors and additional capital expenditures on those same restaurants being image enhanced are a large portion of the Company s annual capital expenditures. However, the Company also has made and may make capital expenditures on restaurant properties not included on the foregoing schedule for upgrades or replacement of capital items appropriate for the continued successful operation of its restaurants. The Company may not be able to finance capital expenditures in the volume and time horizon required by the image enhancement deadlines solely from existing cash balances and existing cashflow and the Company expects that it will have to utilize financing for a portion of the capital expenditures. The Company may use both debt and sale/leaseback financing but has no commitments for either.
There can be no assurance that the Company will be able to accomplish the image enhancements and relocations required in the franchise agreements on terms acceptable to the Company. If the Company is unable to meet the requirements of a franchise agreement, the franchisor may choose to extend the time allowed for compliance or may terminate the franchise agreement.

Seasonality

The operations of the Company are affected by seasonal fluctuations. Historically, the Company s revenues and income have been highest during the summer months with the fourth fiscal quarter representing the slowest period. This seasonality is primarily attributable to weather conditions in the Company s marketplace, which consists of portions of Ohio, Pennsylvania, Missouri, Illinois, West Virginia and New York. Also, the fourth fiscal quarter contains the only two holidays for which the Company s restaurants are closed, contributing to lower sales in the period.

Critical Accounting Policies

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

Estimating future cash flows and fair value of assets associated with assessing potential impairment of long-lived tangible and intangible assets and projected compliance with debt covenants. See Notes 1 and 3 to the consolidated financial statements for further discussion of intangible assets.

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

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

Goodwill represents the cost of acquisitions in excess of the fair value of identifiable assets acquired. Goodwill is not amortized, but is subject to assessment for impairment whenever there is an indication of impairment or at least annually as of fiscal year end by applying a fair value based test. Goodwill is disaggregated by market area, as defined by the various advertising co-operatives in which the Company participates, for application of the impairment tests. Also, when a property is sold, the proportion that the proceeds of the property bears to the total fair value of the market is removed from the goodwill balance of that market.

New Accounting Standards

ASU 2010-06 January, 2010. Topic 820 Fair Value Measurements and Disclosures This update improves the disclosures regarding fair value measurements including information regarding the level of disaggregation of assets and liabilities and the valuation methods being employed. The provisions of this update are effective and have been adopted for the Company s fiscal year ending February 27, 2011. The Company has determined that the changes to the accounting standards required by this update do not have a material effect on the Company s financial position or results of operations.

ASU 2010-28 December, 2010. Topic 350 Intangibles Goodwill and Other This update defines when to perform step 2 of the goodwill impairment test and provides guidance for performing the test during interim periods in addition to the annual test. The provisions of this update are effective for the Company s fiscal year ending February 26, 2012 and early adoption is not permitted. The Company has determined that the changes to the accounting standards required by this update will not have a material effect on the Company s financial position or results of operations.

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Safe Harbor Statements

Portions of this document contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. Such statements include those identified by such words as may will expect anticipate believe plan and other similar terminolo forward-looking statements reflect the Company s current expectations, are based upon data available at the time of the statements and are subject to risks and uncertainties that could cause actual results or events to differ materially from those expressed in or implied by such statements. Such risks and uncertainties include both those specific to the Company and general economic and industry factors. Factors specific to the Company include, but are not limited to, its debt covenant compliance, actions that lenders may take with respect to any debt covenant violations, its ability to obtain waivers of any debt covenant violations, its ability to pay all of its current and long-term obligations and those factors described in Part I Item 1A.(Risk Factors).

Economic and industry risks and uncertainties include, but are not limited, to, franchisor promotions, business and economic conditions, legislation and governmental regulation, competition, success of operating initiatives and advertising and promotional efforts, volatility of commodity costs and increases in minimum wage and other operating costs, availability and cost of land and construction, consumer preferences, spending patterns and demographic trends.

ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Certain of the Company s debt comprising approximately $12.2 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 $122,000 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 or caps if they are available and deemed to be advantageous to the Company. The Company s remaining borrowings are at fixed interest rates, and accordingly the Company does not have market risk exposure for fluctuations in interest rates relative to those loans. The Company does not enter into derivative financial investments for trading or speculation purposes. Also, the Company is subject to volatility in food costs as a result of market risk and we manage that risk through the use of a franchisee purchasing cooperative which uses longer term purchasing contracts. Our ability to recover increased costs through higher pricing is, at times, limited by the competitive environment in which we operate. The Company believes that its market risk exposure is not material to the Company s financial position, liquidity or results of operations.

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

MORGAN S FOODS, INC.

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

Board of Directors and Shareholders
Morgan s Foods, Inc.

We have audited the accompanying consolidated balance sheets of Morgan s Foods, Inc. (an Ohio corporation) and subsidiaries (the Company) as of February 27, 2011 and February 28, 2010, and the related consolidated statements of operations, shareholders equity, and cash flows for each of the years then ended. These financial statements are the responsibility of the Company s management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Morgan s Foods, Inc. as of February 27, 2011 and February 28, 2010, and the results of its operations and its cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

The accompanying financial statements have been prepared assuming that the Company will continue as a going concern. As discussed in Notes 5 and 6 to the financial statements, as of February 27, 2011, the Company was in default and cross default of certain provisions of its most significant credit agreements and in default of the image enhancement requirements under franchise agreements for certain of its restaurants. The Company is attempting to restructure or refinance its existing credit agreements such that it can obtain capital sufficient to fund its image enhancement requirements under the affected franchise agreements. However, as of the date of this report, no such refinancing or restructuring has been completed, nor has the Company received waivers of the loan covenant violations from its lenders. The Company s ability to complete the debt refinancing or restructuring and to fund the image enhancement requirements, which may be necessary to permit the realization of assets and satisfaction of liabilities in the ordinary course of business, is uncertain and raises substantial doubt about its ability to continue as a going concern. The financial statements do not include any adjustments that might result from the outcome of this uncertainty.

/s/ GRANT THORNTON LLP
Cleveland, Ohio
May 31, 2011

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MORGAN S FOODS, INC.
Consolidated Balance Sheets
February 27, 2011 and February 28, 2010

	2011	2010
ASSETS		
Current assets:		
Cash and equivalents	$ 3,034,000	$ 4,205,000
Restricted cash	140,000	
Receivables	561,000	470,000
Inventories	715,000	682,000
Prepaid expenses	799,000	742,000
Deferred tax assets	2,000	15,000
Assets held for sale	545,000	678,000
	5,796,000	6,792,000
Property and equipment:		
Land	8,677,000	9,558,000
Buildings and improvements	18,861,000	20,960,000
Property under capital leases	1,314,000	1,314,000
Leasehold improvements	9,502,000	10,373,000
Equipment, furniture and fixtures	19,128,000	20,337,000
Construction in progress	19,000	626,000
	57,501,000	63,168,000
Less accumulated depreciation and amortization	29,663,000	31,941,000
	27,838,000	31,227,000
Other assets	410,000	546,000
Franchise agreements, net	906,000	1,133,000
Goodwill	9,138,000	9,227,000
	$ 44,088,000	$ 48,925,000
LIABILITIES AND SHAREHOLDERS EQUITY		
Current liabilities:		
Long-term debt, current	$ 27,049,000	$ 3,165,000
Current maturities of capital lease obligations	48,000	44,000
Accounts payable	4,331,000	3,683,000
Accrued liabilities	4,138,000	3,884,000
	35,566,000	10,776,000
Long-term debt		29,725,000
Long-term capital lease obligations	1,013,000	1,061,000
Other long-term liabilities	4,362,000	3,853,000
Deferred tax liabilities	2,512,000	1,887,000

SHAREHOLDERS EQUITY		
Preferred shares, 1,000,000 shares authorized, no shares outstanding		
Common stock, no par value		
Authorized shares - 25,000,000		
Issued shares - 2,969,405	30,000	30,000
Treasury shares - 34,410	(81,000)	(81,000)
Capital in excess of stated value	29,488,000	29,488,000
Accumulated deficit	(28,802,000)	(27,814,000)
Total shareholders equity	635,000	1,623,000
	$ 44,088,000	$ 48,925,000

See accompanying Notes to Consolidated Financial Statements.

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MORGAN S FOODS, INC.

Consolidated Statements of Operations

Years Ended February 27, 2011 and February 28, 2010

	2011	2010
Revenues	$ 89,891,000	$ 90,544,000
Cost of sales:		
Food, paper and beverage	28,267,000	28,457,000
Labor and benefits	26,533,000	26,448,000
Restaurant operating expenses	23,748,000	23,931,000
Depreciation and amortization	2,831,000	3,026,000
General and administrative expenses	5,450,000	5,409,000
Loss on restaurant assets	841,000	75,000
Operating income	2,221,000	3,198,000
Interest expense:		
Prepayment and deferred financing costs	(138,000)	13,000
Bank debt and notes payable	(2,286,000)	(2,558,000)
Capital leases	(104,000)	(108,000)
Other income and expense, net	(44,000)	191,000
Income (loss) before income taxes	(351,000)	736,000
Provision for income taxes	637,000	340,000
Net income (loss)	$ (988,000)	$ 396,000
Basic net income (loss) per common share:	$ (0.34)	$ 0.13
Diluted net income (loss) per common share:	$ (0.34)	$ 0.13

See accompanying Notes to Consolidated Financial Statements.

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MORGAN S FOODS, INC.
Consolidated Statements of Shareholders Equity
Years Ended February 27, 2011 and February 28, 2010

	Common Shares		Treasury Shares		Capital in excess of	Accumulated	Total Shareholders
	Shares	Amount	Shares	Amount	stated value	Deficit	Equity
Balance March 1, 2009	2,969,405	$ 30,000	(34,410)	$ (81,000)	$ 29,432,000	$ (28,210,000)	$ 1,171,000
Net income						396,000	396,000
Stock compensation expense					56,000		56,000
Balance February 28, 2010	2,969,405	30,000	(34,410)	(81,000)	29,488,000	(27,814,000)	1,623,000
Net loss						(988,000)	(988,000)
Balance February 27, 2011	2,969,405	$ 30,000	(34,410)	$ (81,000)	$ 29,488,000	$ (28,802,000)	$ 635,000

See accompanying Notes to Consolidated Financial Statements.

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MORGAN S FOODS, INC.
Consolidated Statements of Cash Flows
Years Ended February 27, 2011 and February 28, 2010

	2011	2010
Cash flows from operating activities:		
Net income (loss)	$ (988,000)	$ 396,000
Adjustments to reconcile to net cash provided by operating activities:		
Depreciation and amortization	2,831,000	3,026,000
Amortization of deferred financing costs	110,000	118,000
Amortization of supply agreement advances	(1,214,000)	(1,265,000)
Funding from supply agreements	962,000	204,000
Deferred income taxes	638,000	336,000
Stock compensation expense		56,000
Loss on restaurant assets	841,000	75,000
Changes in assets and liabilities:		
Deposit to restricted cash account	(140,000)	
Receivables	(7,000)	415,000
Inventories	(33,000)	49,000
Prepaid expenses	(57,000)	(118,000)
Other assets	26,000	12,000
Accounts payable	648,000	(226,000)
Accrued liabilities	50,000	771,000
Net cash provided by operating activities	3,667,000	3,849,000
Cash flows from investing activities:		
Capital expenditures	(1,763,000)	(1,648,000)
Purchase of franchise agreements	(5,000)	(10,000)
Proceeds from sale/leaseback transactions	2,205,000	
Proceeds from sale of fixed assets	610,000	119,000
Net cash provided by (used in) investing activities	1,047,000	(1,539,000)
Cash flows from financing activities:		
Proceeds from issuance of long-term debt	18,000	
Principal payments on long-term debt	(5,859,000)	(3,323,000)
Principal payments on capital lease obligations	(44,000)	(39,000)
Net cash used in financing activities	(5,885,000)	(3,362,000)
Net change in cash and equivalents	(1,171,000)	(1,052,000)
Cash and equivalents, beginning balance	4,205,000	5,257,000
Cash and equivalents, ending balance	$ 3,034,000	$ 4,205,000

Supplemental Cash Flow Information:
Interest paid on debt and capitalized leases was $2,399,000 and $2,721,000 in fiscal 2011 and 2010, respectively
Cash refunds for income taxes were $29,000 and $118,000 in fiscal 2011 and 2010, respectively

See accompanying Notes to Consolidated Financial Statements.

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MORGAN S FOODS, INC.

Notes to Consolidated Financial Statements

February 27, 2011 and February 28, 2010

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

Description of Business Morgan s Foods, Inc. and its subsidiaries (the Company) operate 56 KFC restaurants, 5 Taco Bell restaurants, 10 KFC/Taco Bell 2n1 restaurants, 3 Taco Bell/Pizza Hut Express 2n1 restaurants, 1 KFC/Pizza Hut Express 2n1 and 1 KFC/A&W 2n1 , in the states of Illinois, Missouri, Ohio, Pennsylvania, West Virginia and New York. The Company s fiscal year is a 52-53 week year ending on the Sunday nearest the last day of February. The Company operates as one business segment.

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

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

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

Advertising Costs The Company expenses advertising costs as incurred. Advertising expense was $5,493,000 and $5,553,000 for fiscal years 2011 and 2010, respectively.

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

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

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

Management assesses the carrying value of property and equipment whenever there is an indication of potential impairment, including quarterly assessments of any restaurant with negative cash flows. If the property and equipment of a restaurant on a held and used basis are not recoverable based upon forecasted, undiscounted cash flows, the assets are written down to their fair value. Management uses a valuation methodology to determine fair value, which is the sum of the restaurant s business value and real estate value. Business value is determined using a cash flow multiplier based upon market conditions and estimated cash flows of the restaurant. Real estate value is generally determined based upon the discounted market value of implied rent of the owned assets. Management believes the carrying value of property and equipment, after impairment write-downs, will be recovered from future cash flows. Assets held for sale are carried at estimated realizable value in a sale transaction.

Deferred Financing Costs Costs related to the acquisition of long-term debt are capitalized and expensed as interest over the term of the related debt. Amortization expense was $110,000 and $118,000 for fiscal years 2011 and 2010, respectively. The

balance of deferred financing costs was $303,000 at February 27, 2011 and $458,000 at February 28, 2010 and is included in other assets in the consolidated balance sheets.

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

Goodwill Goodwill represents the cost of acquisitions in excess of the fair value of identifiable assets acquired. Goodwill is not amortized, but is subject to assessment for impairment whenever there is an indication of impairment or at least annually as of fiscal year end by applying a fair value based test. Goodwill is disaggregated by market area, as defined by the various advertising co-operatives in which the Company participates, for application of the impairment tests. Also, when a property is sold, the proportion that the proceeds of the property sale bears to the total fair value of the restaurants in the related market area is removed from the goodwill balance of that market, and reflected in the gain or loss recorded on the sale of property.

Advance on Supply Agreements In conjunction with entering into contracts that require the Company to sell exclusively the specified beverage products for the term of the contract, the Company has received advances from the supplier. The Company amortizes advances on supply agreements as a reduction of food, paper and beverage cost of sales over the term of the related contract, using the straight-line method. These advances of $106,000 and $369,000 at February 27, 2011 and February 28, 2010, respectively, are included in other long-term liabilities in the consolidated balance sheets net of $236,000 and $263,000 included in accrued liabilities as of such dates.

Lease Accounting Operating lease expense is recognized on the straight-line basis over the term of the lease for those leases with fixed escalations. The difference between the scheduled amounts and the straight-line amounts is accrued. These accruals of $476,000 and $451,000 at February 27, 2011 and February 28, 2010, respectively, are included in other long-term liabilities in the consolidated balance sheets net of $60,000 and $63,000 included in accrued liabilities as of such dates.

Income Taxes - The provision for income taxes is based upon income or loss before tax for financial reporting purposes. Deferred tax assets or liabilities are recognized for the expected future tax consequences of temporary differences between the tax basis of assets and liabilities and their carrying values for financial reporting purposes. Deferred tax assets are also recorded for operating loss and tax credit carryforwards. A valuation allowance is recorded to reduce deferred tax assets to the amount more likely than not to be realized in the future, based on an evaluation of historical and projected profitability. The Company accounts for uncertain tax positions in accordance with the standards included in ASC Topic 740 Income Taxes . This accounting guidance 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. It is also required that changes in judgment that result in subsequent recognition, derecognition or change in a measurement of a tax position taken in a prior annual period (including any related interest and penalties) be recognized as a discrete item in the period in which the change occurs. It is the Company s policy to include any penalties and interest related to income taxes in its income tax provision, however, the Company currently has no penalties or interest related to income taxes. In general, the earliest year that the Company is subject to examination is the fiscal year ended February 25, 2007. However, net operating loss carryforwards generated from 2002 through 2004 remain subject to adjustment by taxing authorities.

Stock-Based Compensation For the fiscal year ended February 27, 2011 the Company reported no stock-based compensation expense and for the fiscal year ended February 28, 2010, $56,000 of compensation expense relating to stock options issued on November 6, 2008, the first stock options granted after the adoption of ASC Topic 718. See Note 9 for further discussion.

Reclassifications Certain prior period items are reclassified to conform to the current period presentations.

NOTE 2. LOSS ON RESTAURANT ASSETS

The Company had a loss on restaurant assets of $841,000 in fiscal 2011 compared to a loss of $75,000 in fiscal 2010. The fiscal 2010 loss included $51,000 in tangible asset impairment while the fiscal 2011 loss had $406,000 of tangible asset impairment consisting primarily of assets related to the restaurants closed in April of 2011, $125,000 of reduction in the value of assets held for sale and $152,000 of loss related to the permanent closing of three restaurants and $89,000 of goodwill write offs resulting from the sale of three locations.

NOTE 3. INTANGIBLE ASSETS

Intangible assets consisted of the following as of the indicated dates:

	Intangible Assets			
	As of February 27, 2011		As of February 28, 2010	
	Gross Carrying Amount	Accumulated Amortization	Gross Carrying Amount	Accumulated Amortization
Franchise Agreements	$ 2,291,000	$ (1,385,000)	$ 2,399,000	$ (1,266,000)
Goodwill	10,492,000	(1,354,000)	10,593,000	(1,366,000)
Total	$ 12,783,000	$ (2,739,000)	$ 12,992,000	$ (2,632,000)

Goodwill and intangibles with indefinite lives are not subject to amortization, but are subject to assessment for impairment whenever there is an indication of impairment or, at least annually as of the Company s fiscal year end by applying a fair value based test. The Company has five reporting units for the purpose of evaluating goodwill impairment which are based on the geographic market areas of its restaurants. These five reporting units are Youngstown, OH, West Virginia, Pittsburgh, PA, St Louis, MO and Erie, PA. The Company has performed the annual goodwill impairment tests during fiscal 2011 and 2010 and determined that the fair value of each reporting unit was greater than its carrying value at each date. When a property is sold, the proportion that the sales proceeds of the property bears to the total fair value of the restaurants in the related market area is removed from the goodwill balance of that market.

The Company s intangible asset amortization expense relating to its franchise agreements was $232,000 and $137,000 for fiscal 2011 and 2010, respectively. The estimated intangible amortization expense for each of the next five years is $109,000 per year.

The decrease in franchise agreements in fiscal 2011 resulted from the expiration of three licenses and the write off of agreements for four closed restaurants offset by $5,000 paid for a new agreement. The $89,000 decrease in goodwill resulted from the sale of three properties in the St. Louis market area.

NOTE 4. ACCRUED LIABILITIES

Accrued liabilities consist of the following at February 27, 2011 and February 28, 2010:

	2011	2010
Accrued compensation	$ 1,930,000	$ 1,854,000
Accrued taxes other than income taxes	899,000	955,000
Current portion of deferred gain on sale/leaseback	255,000	197,000
Current portion of supply agreement	236,000	263,000
Current portion of straight line rent	60,000	63,000
Other accrued expenses	758,000	552,000
	$ 4,138,000	$ 3,884,000

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NOTE 5. DEBT

Debt consists of the following at February 27, 2011 and February 28, 2010:

	2011	2010
Mortgage debt, interest at 8.3-10.6%, through 2019, collateralized by 42 restaurants in 2011 and 43 restaurants in 2010 having a net book value at February 27, 2011 of $15,707,000 and at February 28, 2010 of $16,510,000	$ 14,627,000	$ 16,982,000
Mortgage debt, interest at 7.2-7.3% fixed through 2018 and variable thereafter, collateralized by two restaurants having a net book value at February 27, 2011 of $0 and at February 28, 2010 of $1,805,000		2,101,000
Equipment loan, interest at 7.1% fixed through 2017, collateralized by equipment at two restaurants		363,000
Equipment loan, interest at 13.27% fixed through 2014, collateralized by equipment at two restaurants	200,000	
Mortgage debt, variable interest of 3.95% at February 27, 2011, amortization to 2028 with a term to 2013 collateralized by 13 restaurants in both 2011 and 2010 having a net book value at February 27, 2011 of $5,862,000 and at February 28, 2010 of $5,632,000	7,898,000	8,366,000
Equipment loan, variable interest of 4.7% at February 27, 2011, amortization to 2018 with a term to 2013 collateralized by the equipment at 17 restaurants	2,108,000	2,578,000
Equipment loan from franchisor for proprietary equipment, with variable interest rate of 2.26% as of February 27, 2011	16,000	
Equipment loan, variable interest rate of 5.05% at February 27, 2011, amortization to 2018 with a term to 2013 collateralized by the equipment at 10 restaurants	2,200,000	2,500,000
	27,049,000	32,890,000
Less long term debt		29,725,000
Long term debt, current portion	$ 27,049,000	$ 3,165,000

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The combined aggregate amounts of scheduled future maturities for all long-term debt, (as described below, all debt has been classified as current in the consolidated balance sheet), as of February 27, 2011:

2012	$ 3,263,000
2013	11,810,000
2014	3,911,000
2015	1,706,000
2016	1,251,000
Later years	5,108,000
	$ 27,049,000

The Company paid interest relating to long-term debt of approximately $2,295,000 and $2,612,000 in fiscal 2011 and 2010, respectively.

During fiscal 2011, the Company incurred $138,000 of prepayment charges and the write-off of deferred financing costs relating to the early payment of debt to facilitate the disposal of a closed restaurant location and the sale/leaseback of two operating restaurants. During fiscal 2010, the Company incurred $85,000 of prepayment charges and deferred financing cost write offs related to the early payoff of debt to facilitate the sale of a closed restaurant location. These charges were offset by the return, by a lender, of $98,000 of prepayment penalties which were charged in error.

The Company s debt arrangements require the maintenance of a consolidated fixed charge coverage ratio of 1.2 to 1 regarding all of the Company s mortgage and equipment loans and the maintenance of individual restaurant fixed charge coverage ratios of between 1.2 and 1.5 to 1 on certain of the Company s mortgage loans. Fixed charge coverage ratios are calculated by dividing the cash flow before taxes, rent and debt service (EBITDAR) for the previous 12 months by the debt service and rent due in the coming 12 months. Certain loans also require a consolidated funded debt (debt balance plus a calculation based on operating lease payments) to EBITDAR ratio of 5.5 or less. The consolidated and individual coverage ratios are computed quarterly. At the end of fiscal 2011, the Company was not in compliance with the consolidated fixed charge coverage ratio of 1.2 or with the funded debt to EBITDAR ratio of 5.5. As of the measurement date of February 27, 2011, the Company s consolidated fixed charge coverage ratio was 1.07 to 1 and funded debt to EBITDAR was 5.7. Also, at the end of fiscal 2011 the Company was not in compliance with the individual fixed charge coverage ratio on 20 of its restaurant properties. The Company has not obtained waivers with respect to the non-compliance from the applicable lenders.

The Company has engaged the services of a financial advisor to renegotiate its existing financing arrangements and to raise replacement capital to fund its required restaurant image enhancement obligations discussed in Note 6. As discussed below in Subsequent Events, the Company began deferring the payment of principal and paying interest only on substantially all of its debt as part of a strategy to engage in the negotiation of recapitalization of the Company s debt and in order to conserve operating cash while adjusting to the closure of twelve restaurants subsequent to February 27, 2011. As a result of this event of default, waivers of non-compliance were not obtained and all of the Company s debt is classified as current in the balance sheet as of February 27, 2011. The Company is continuing with its plan to recapitalize its current debt using a combination of new debt and sale/leaseback financing which structure contemplates the payment of the debt on which it has not met its loan covenants. If the Company does not comply with the covenants of its various debt agreements and if the recapitalization plan is not executed successfully, 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 could also trigger cross-default provisions contained in the respective agreements.

Management expects that it will be able to complete the financial restructuring successfully. Nonetheless, given the level of the Company s indebtedness and the cash requirements to fund image enhancement requirements under certain KFC restaurant franchise agreements, there can be no assurance that the Company s lenders will consent to the restructuring, that the restructuring will be accomplished, or that other actions might not be taken by lenders that

would impede the Company s ability to satisfy its obligations.

The Company s reduced debt payments and covenant violations discussed above could result in the exercise of certain remedies available to the lenders which may include calling of the debt, acceleration of payments or foreclosure on the Company s assets which secure the debt. The lenders have not initiated any of these remedies, and management believes, but

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cannot assure, that these actions will not be taken prior to the Company completing the financial restructuring described above. However, if the lenders initiate any of the remedies, the Company s ability to fulfill its obligations under its franchise agreements will be adversely affected, and there would be significant uncertainty as to the Company s ability to complete a financial restructuring. Consequently, there is substantial doubt that the Company will be able to continue as a going concern, and therefore, if applicable, the Company may be unable to realize its asset carrying values and discharge its liabilities in the normal course of business. The financial statements do not include any adjustments relating to recoverability and classification of recorded asset amounts and classification of liabilities that may be necessary if the Company is unable to continue as a going concern.

NOTE 6. LEASE OBLIGATIONS AND OTHER COMMITMENTS

Property under capital leases at February 27, 2011 and February 28, 2010 are as follows:

	2011	2010
Leased property:		
Buildings and land	$ 1,298,000	$ 1,298,000
Equipment, furniture and fixtures	16,000	16,000
Total	1,314,000	1,314,000
Less accumulated amortization	515,000	517,000
	$ 799,000	$ 797,000

Amortization of leased property under capital leases was $2,000 in fiscal 2011 and $83,000 in fiscal 2010.

Related obligations under capital leases at February 27, 2011 and February 28, 2010 are as follows:

	2011	2010
Capital lease obligations	$ 1,061,000	$ 1,105,000
Less current maturities	48,000	44,000
Long-term capital lease obligations	$ 1,013,000	$ 1,061,000

The Company paid interest of approximately $104,000 and $109,000 relating to capital lease obligations in fiscal 2011 and 2010, respectively.

Future minimum rental payments to be made under capital leases at February 27, 2011 are as follows:

2012	$ 148,000
2013	146,000
2014	147,000
2015	148,000
2015	149,000
Later years	1,121,000
	1,859,000
Less amount representing interest at 10%	798,000
Total obligations under capital leases	$ 1,061,000

The Company s operating leases for restaurant land and buildings are non-cancellable and expire on various dates through 2050. The leases have renewal options ranging from 5 to 20 years. Certain restaurant land and building leases require the payment of additional rent equal to an amount by which a percentage of annual sales exceeds annual minimum rentals.

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Total contingent rentals were $57,000 and $82,000 in fiscal 2011 and 2010, respectively. Future non-cancellable minimum rental payments under operating leases at February 27, 2011 are as follows: 2012 - $2,307,000; 2013 $2,139,000; 2014 $1,857,000; 2015 $1,544,000; 2016 $1,308,000 and an aggregate $11,452,000 for the years thereafter. Future non-cancellable minimum rental payments under operating leases of locations closed subsequent to fiscal year end at February 27, 2011 are as follows: 2012 $333,000; 2013 $296,000; 2014 $213,000; 2015 $176,000; 2016 $178,000 and an aggregate $1,987,000 for the years thereafter. Rental expense for all operating leases was $2,550,000 and $2,449,000 for fiscal 2011 and 2010, respectively, and is included in restaurant operating expenses in the consolidated statements of operations.

For KFC products, the Company is required to pay royalties of 4% of gross revenues and to expend an additional 5.5% of gross revenues on national and local advertising pursuant to its franchise agreements. For Taco Bell products, the Company is required to pay royalties of 5.5% of gross revenues and to expend an additional 4.5% of gross revenues on national and local advertising. KFC/Taco Bell 2n1 restaurants are operated under separate KFC and Taco Bell franchise agreements. For Pizza Hut products in either Taco Bell or KFC/Pizza Hut Express 2n1 restaurants the Company is required to pay royalties of 8.0% of Pizza Hut gross revenues and to expend an additional 2.0% of Pizza Hut gross revenues on national and local advertising. For A&W products in 2n1 restaurants the Company is required to pay royalties of 7% of A&W gross revenues and to expend an additional 4% of A&W gross revenues on national and local advertising. Total royalties and advertising, which are included in the Consolidated Statements of Operations as part of restaurant operating expenses, were $9,298,000 and $9,391,000 in fiscal 2011 and 2010, respectively.

The Company is required by its franchise agreements to periodically bring its restaurants up to the required image of the franchisor. This typically involves a new dining room décor and seating package and exterior changes and related items but can, in some cases, require the relocation of the restaurant. If the Company deems a particular image enhancement expenditure to be inadvisable, it has the option to cease operations at that restaurant. Over time, the estimated cost and time deadline for each restaurant may change due to a variety of circumstances and the Company revises its requirements accordingly. Also, significant numbers of restaurants may have image enhancement deadlines that coincide, in which case, the Company will adjust the actual timing of the image enhancements in order to facilitate an orderly construction schedule. During the image enhancement process, each restaurant is normally closed for up 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. As discussed below, the Company has not met its obligations with respect to certain of its restaurants. As a result, the franchisor may terminate the franchise agreement for those restaurants. 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.

As mentioned elsewhere in this report, subsequent to February 27, 2011, the Company was required by KFC Corporation to close twelve KFC locations because they did not meet the franchisor s current image. Image enhancement requirements for these closed locations were formerly included in the capital requirements schedules published by the Company and have now been removed. As discussed in Note 12 to the consolidated financial statements, the Company has entered into a Pre-negotiation Agreement with KFC Corporation with the intention of arriving at a definitive schedule for the completion of the image enhancement of thirteen KFC restaurants which were the subject of default notices received on May 2, 2011, as well as other restaurant locations. The negotiations which are being conducted under the Pre-negotiation Agreement involve mainly restaurants with delinquent image enhancement requirement dates or dates that are two years or less in the future. The capital requirements for these restaurants are included in the schedule in the time frame where management believes they are most likely to be when the definitive agreement is completed. A deposit toward the completion of the initial two image enhancements is

shown on the Company s balance sheet at February 27, 2011 as restricted cash. The Company will be required to place the restricted cash, as well as other amounts calculated to fund the first two image enhancements in an escrow account. The following schedule contains the capital requirements for image enhancements of restaurants for which the due dates are either estimated or definitive:

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Number of Units	Period	Type	Capital Cost (1)
8	Fiscal 2012	Remodels	$ **2,425,000**
5	Fiscal 2013	Remodels	1,625,000
1	Fiscal 2013	Relo (2)	400,000
	Total 2013		**2,025,000**
3	Fiscal 2014	Remodels	625,000
3	Fiscal 2014	Relo (2)	1,200,000
	Total 2014		**1,825,000**
1	Fiscal 2015	Remodels	**150,000**
5	Fiscal 2018	Remodels	**3,650,000**
16	Fiscal 2020	Remodels	**750,000**
3	Fiscal 2021	Romodels	**450,000**
45	**Total**		**$ 11,275,000**

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

(2) Relocations of fee owned properties are shown net of expected recovery of capital from the sale of the former location. Relocation of leased properties assumes the capital cost of only equipment because it is not known until each lease is finalized whether the lease will be a capital or operating lease.

As mentioned elsewhere in this report and other reports, the Company has been utilizing the services of a financial advisor to renegotiate its existing financing arrangements and to raise replacement capital to fund its image enhancement requirements. While the Company believes it will be successful in these restructuring activities, no assurance can be given that all parties will cooperate in the financial restructuring which would cast doubt on its successful completion. Also, if the negotiations under the Pre-negotiation Agreement are not successful the franchisor will likely terminate the franchise agreements on the affected restaurants. The termination of those franchise agreements would have a material adverse effect on the Company s financial condition and results of operations.

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

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

NOTE 7. NET INCOME (LOSS) PER COMMON SHARE

Basic net income (loss) per common share is computed by dividing net income (loss) by the weighted average number of common shares outstanding during the period which totaled 2,934,995 for both fiscal 2011 and 2010. Diluted net income (loss) per common share is based on the combined weighted average number of shares and dilutive stock options outstanding during the period which totaled 2,934,995 and 2,991,941 for fiscal 2011 and 2010, respectively. For the fiscal 2011 and fiscal 2010, zero stock options and 7,500 stock options respectively were excluded from the computation of diluted earnings per share because they were anti-dilutive. For the fourth quarter ended February 27,

2011 and the fourth quarter ended February 28, 2010, zero stock options and 7,500 stock options respectively were excluded from the computation of diluted earnings per share because they were anti-dilutive. No dilution was calculated for periods in which

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there was a loss. In computing diluted net income (loss) 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:

	Fiscal year ended February 27, 2011			Fiscal year ended February 28, 2010		
	Net income (Numerator)	Shares (Denominator)	Per Share Amount	Net loss (Numerator)	Shares (Denominator)	Per Share Amount
Basic EPS						
Income (loss) available to common shareholders	$ (988,000)	2,934,995	$ (0.34)	$ 396,000	2,934,995	$ 0.13
Effect of Dilutive Securities						
Weighted Average Stock Options					56,946	
Diluted EPS						
Income (loss) available to common shareholders	$ (988,000)	2,934,995	$ (0.34)	$ 396,000	2,991,941	$ 0.13

Options for 149,000 shares, exercisable at $1.50 per share expire on November 5, 2018.

NOTE 8. INCOME TAXES

There is no current federal tax provision for fiscal 2011 and 2010. The state and local tax provisions for fiscal 2011 and 2010 are a benefit of $1,000 and a provision of $4,000, respectively. The deferred tax provisions for fiscal 2011 and 2010 are $638,000 and $336,000, respectively and resulted from changes in the balance of net deferred tax assets, deferred tax liabilities associated with indefinite lived intangible assets and the valuation allowance for deferred tax assets.

There are no current federal tax provisions for the fourth quarter of fiscal 2011 and 2010. The state and local tax provisions for the quarter are a benefit of $3,000 compared to a benefit of $8,000 for the comparable prior quarter. The deferred tax provision for the quarter was $199,000 compared to a benefit of $294,000 for the comparable prior quarter. The fourth quarter of fiscal 2011 includes an increase in the deferred tax valuation allowance of $755,000 and fiscal 2010 includes a decrease in the deferred tax valuation allowance of $165,000.

A reconciliation of the provision for income taxes and income taxes calculated at the statutory tax rate of 34% is as follows:

	2011	2010
Tax provision (benefit) at statutory rate	$ (120,000)	$ 250,000
State and local taxes, net of federal benefit	(1,000)	2,000
Deferred tax provision-change in valuation allowance	745,000	(124,000)
Deferred tax provision-change in deferred state and local income taxes	(12,000)	54,000
Deferred tax provision-change in effective tax rate	11,000	44,000
Deferred tax provision-change in estimated deferred tax items	85,000	206,000
Employment tax credits	(68,000)	(73,000)
Other	(3,000)	(19,000)
	$ 637,000	$ 340,000

The components of deferred tax assets (liabilities) at February 27, 2011 and February 28, 2010 are as follows:

	2011	2010
Accrued expenses not currently deductible	$ 266,000	$ 244,000
Prepaid expenses	(224,000)	(174,000)
Inventory valuation	5,000	5,000
Current portion of advance payments	54,000	79,000
Current deferred tax valuation allowance	(99,000)	(139,000)
Current portion of deferred taxes	2,000	15,000
Operating loss carryforwards	2,078,000	1,688,000
Charitable contributions	43,000	

	2011	2010
Tax credit carryforwards	514,000	403,000
Stock options	55,000	55,000
Property and equipment	1,409,000	1,715,000
Deferred gain on sale/leaseback	1,476,000	1,224,000
Advance payments	88,000	125,000
Intangible assets	(161,000)	(112,000)
Deferred tax asset valuation allowance	(5,398,000)	(4,614,000)
Net non-current deferred tax asset	104,000	484,000
Deferred tax liabilities associated with indefinite lived intangible assets	(2,616,000)	(2,371,000)
Net total non-current deferred taxes	$ (2,512,000)	$ (1,887,000)

The valuation allowance increased $745,000 during fiscal 2011 and decreased $124,000 during fiscal 2010 from changes in projections regarding the future realization of deferred tax assets. The valuation allowance was calculated based on arriving at a net deferred tax asset equal to the deferred items expected to be realized using two years of projected income, which is more likely than not to be achieved.

At February 27, 2011, the Company has net operating loss carryforwards which, if not utilized, will expire as follows:

2023	$ 705,000
2024	383,000
2025	1,481,000
2028	1,022,000
2029	997,000
2030	232,000
2031	1,036,000
Total	$ 5,856,000

The net operating loss carryforwards include $438,000 attributable to stock options exercised where the tax benefit has not yet been realized. The tax benefit of $168,000 will be credited to equity if realized. The Company also has alternative minimum tax net operating loss carryforwards of $4,729,000 that will expire, if not utilized, in varying amounts through fiscal 2031. These carryforwards are available to offset up to 90% of alternative minimum taxable income that would otherwise be taxable. As of February 27, 2011, the Company has charitable contribution deduction carryforwards of $111,000, alternative minimum tax credit carryforwards of $108,000 and employment tax credit carryforwards of $406,000.

In connection with the provisions of ASC Topic 740, the Company has analyzed its filing positions in all of the federal, state and local jurisdictions where it is required to file income tax returns, as well as all open tax years in these jurisdictions. The earliest year that the Company is subject to federal, state and local examination is the fiscal year ended February 25, 2007. However, net operating loss carryforwards generated from 2002 through 2004 remain subject to adjustment by taxing authorities. The Company believes that its income tax filing positions would be sustained on audit and does not anticipate any adjustments that would result in a material change to its financial position. Therefore, no reserves for uncertain income tax positions have been recorded on the financial statements. Accordingly, the Company does not expect any material change in the next 12 months of the unrecognized tax benefits nor recognition of amounts that would affect the Company s annual effective tax rate.

NOTE 9. STOCK OPTIONS AND SHAREHOLDERS EQUITY

On April 2, 1999, the Board of Directors of the Company approved a Stock Option Plan for Executives and Managers. Under the plan 145,500 shares were reserved for the grant of options. The Stock Option Plan for Executives and Managers provides for grants to eligible participants of nonqualified stock options only. The exercise price for any option awarded under the Plan is required to be not less than 100% of the fair market value of the shares on the date that the option is granted. Options are granted by the Stock Option Committee of the Company. Options for 145,150 shares were granted to executives and managers of the Company on April 2, 1999 at an exercise price of $4.125 and options for 350 shares were granted on November 6, 2008 at an exercise price of $1.50. The plan provides that the options are exercisable after a waiting period of 6 months and that each option expires 10 years after its date of issue.

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At the Company s annual meeting on June 25, 1999 the shareholders approved the Key Employees Stock Option Plan. This plan allows the granting of options covering 291,000 shares of stock and has essentially the same provisions as the Stock Option Plan for Executives and Managers which was discussed above. Options for 129,850 shares were granted to executives and managers of the Company on January 7, 2000 at an exercise price of $3.00. Options for 11,500 shares were granted to executives on April 27, 2001 at an exercise price of $.85. Options for 149,650 shares were granted to executives on November 6, 2008 at an exercise price of $1.50. As of February 27, 2011, no options were available for grant under either plan.

For the fiscal year ended February 27, 2011 the Company reported no compensation expense and for the fiscal year ended February 28, 2010 the Company reported $56,000 of compensation expense related to the stock options granted in November 2008. The calculation of compensation expensed was made using the simplified method with volatility of 70% and risk free rate of 4.299%.

No options were granted during fiscal years 2011 or 2010. During fiscal 2011 and 2010 no options were exercised. As of February 27, 2011 and February 28, 2010 there were 149,000 options outstanding and exercisable at a weighted average exercise price of $1.50 per share. The table below summarizes the stock option activity for the fiscal year ended February 27, 2011:

	Shares
Balance February 28, 2010	149,000
Expired	
Balance February 27, 2011	149,000

The following table summarizes information about stock options outstanding at February 27, 2011:

Exercise Price	Outstanding 2-27-11	Average Life	Number Exercisable
$1.50	149,000	7.7	149,000

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

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

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

NOTE 10. 401(k) RETIREMENT PLAN

The Company has a 401(k) Retirement Plan in which employees age 21 or older are eligible to participate. The Company makes a 30% matching contribution on employee contributions of up to 6% of their salary. During fiscal 2011 and 2010, the Company incurred $71,000 and $65,000, respectively, in expenses for matching contributions to the plan.

NOTE 11. FAIR VALUE OF FINANCIAL INSTRUMENTS

The Company s debt is reported at historical cost, based upon stated interest rates which represented market rates at the time of borrowing. Due to subsequent declines in credit quality throughout the restaurant industry resulting from weak and volatile operating performance and related declines in restaurant values, the market for fixed rate mortgage debt for restaurant financing is currently extremely limited. The Company s debt is not publicly traded and there are few lenders or financing transactions for similar debt in the marketplace at this time. Consequently, management has not been able to identify a market for fixed rate restaurant mortgage debt with a similar risk profile, and has concluded that it is not practicable to estimate the fair value of the Company s debt as of February 27, 2011.

NOTE 12. SUBSEQUENT EVENTS

As previously reported in the Form 8-K filed by the Company on March 16, 2011, subsequent to the Company s fiscal year end of February 27, 2011, termination notices were received from KFC Corporation regarding 10 of the Company s KFC restaurant locations. After discussions with KFC Corporation, two of the restaurants were removed from the list of terminations and four more were added, bringing the total number of restaurants which the Company was required to close to twelve. The twelve restaurants were closed between March 30 and April 15, 2011. The restaurants which were closed were all of the older KFC image generally referred to as Series 38 and were terminated due to the Company s inability to remodel the restaurants to the current KFC image. The twelve restaurants had total sales of $8,342,000 and restaurant level income of $184,000 during the year preceding their closing. Of the twelve closed locations, the Company intends to sell the property from the six fee owned locations and sub-lease or terminate the leases on the six leased properties.

Beginning with the debt payments due April 1, 2011, as previously disclosed in a report on Form 8-K filed April 8, 2011, the Company began paying interest only on substantially all of its debt. The purpose of this strategic default was to begin negotiations with the lenders regarding the forgiveness of prepayment penalties to facilitate the refinancing of the debt and also to conserve operating cash while the closing of the twelve restaurants was conducted and trailing liabilities are paid off. The Company received on May 24, 2011 a notice of default from one of its lenders regarding debt secured by 28 of its restaurant properties. On the same date and from the same lender the Company also received and entered into a letter agreement which defines the terms under which the lender will engage in discussions regarding the possible restructuring of the debt covered by the default. Also, the Company has been engaged in discussions with its other primary lender regarding the possible restructuring of its debt. Nonetheless, given the level of the Company s indebtedness and other demands on its cash resources, there can be no assurance that the Company s lenders will consent to the restructuring, that the restructuring will be accomplished, or that other actions might not be taken by creditors that would impede the Company s ability to satisfy its obligations.

On May 3, 2011, subsequent to the Company s fiscal year end of February 27, 2011, the Company completed the sale and leaseback of its KFC restaurant property in Ashtabula, OH. The proceeds of the sale were used to pay off the mortgage debt on the property as well as certain other debt in the same trust and will also be used to fund the image enhancement of the Ashtabula, OH restaurant as well as contribute to the image enhancement of other properties. The payoff of the debt related to the sale and leaseback of the Ashtabula, OH property reduced the Company s principal and interest payments by approximately $126,000 annually, the Company s debt balance by approximately $264,000 and will add approximately $62,000 in annual lease payments.

As previously reported in the Form 8-K filed by the Company on May 20, 2011, subsequent to the Company s fiscal year end of February 27, 2011, the Company has entered into a pre-negotiation agreement with KFC Corporation regarding its schedule for the image enhancement of its restaurants. In furtherance of its ongoing negotiations with KFC regarding the Company s required image enhancement obligations related to other restaurants, on May 19, 2011 the Company and KFC entered into a Pre-negotiation Agreement, similar to the Pre-negotiation Agreement entered into on November 10, 2010, as described in the Company s Form 8-K filed on the same date, outlining the conditions of reaching a final agreement related to the Company s required image enhancement obligations. Under the May 19,

2011 Pre-negotiation Agreement, KFC has agreed to forbear until August 31, 2011 from terminating the franchise agreements on the 13 operating

restaurants on which KFC on May 2, 2011 delivered to the Company a notice of default (for failure to timely comply with required image enhancement obligations) provided that the Company is in compliance with certain forbearance conditions, which include, among others, that (i) the Company is paid up on amounts owing under the franchise agreements, (ii) the Company is not in default of its obligations under the franchise agreements (other than the image enhancement obligations), (iii) the Company submits to KFC a written proposal by June 20, 2011 detailing how the Company will obtain the necessary funds to enable it to comply with the Company s image enhancement obligations, (iv) the Company will establish a remodel escrow account, and (v) the Company will enter into a definitive remodel agreement with KFC by August 31, 2011.

Even though the Pre-negotiation Agreement outlines generally the mutually acceptable terms of a final agreement related to the Company s image enhancement obligations, there can be no assurance that the Company (i) will be able to reach an agreement with KFC regarding image enhancements that would extend the time periods for completion of the required image enhancements, or (ii) will complete the financial restructuring or that the restructuring will create the ability for the Company to complete a satisfactory number of image enhancements. If KFC exercises its termination rights, it is unclear, what, if any, action the Company s landlords and creditors may take under cross default provisions of the Company s agreements that would impede the Company s ability to satisfy its obligations. The termination of those franchise agreements would have a material adverse effect on the Company s financial condition and results of operations.

NOTE 13. NEW ACCOUNTING STANDARDS

ASU 2010-06 January, 2010. Topic 820 Fair Value Measurements and Disclosures This update improves the disclosures regarding fair value measurements including information regarding the level of disaggregation of assets and liabilities and the valuation methods being employed. The provisions of this update are effective and have been adopted for the Company s fiscal year ending February 27, 2011. The Company has determined that the changes to the accounting standards required by this update do not have a material effect on the Company s financial position or results of operations.

ASU 2010-28 December, 2010. Topic 350 Intangibles Goodwill and Other This update defines when to perform step 2 of the goodwill impairment test and provides guidance for performing the test during interim periods in addition to the annual test. The provisions of this update are effective for the Company s fiscal year ending February 26, 2012 and early adoption is not permitted. The Company has determined that the changes to the accounting standards required by this update will not have a material effect on the Company s financial position or results of operations.

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NOTE 14. SELECTED QUARTERLY FINANCIAL DATA (UNAUDITED)

	Fiscal 2011 Quarter Ended			
	May 23, 2010	August 15, 2010	November 7, 2010	February 27, 2011
Revenues	$ 22,170,000	$ 21,673,000	$ 21,257,000	$ 24,791,000
Operating costs and expenses, net	20,639,000	20,909,000	20,637,000	25,485,000
Operating income (loss)	1,531,000	764,000	620,000	(694,000)
Net income (loss)	575,000	163,000	(54,000)	(1,672,000)
Basic net income (loss) per share	0.20	0.06	(0.02)	(0.57)
Fully diluted net income (loss) per share	0.19	0.05	(0.02)	(0.57)

	Fiscal 2010 Quarter Ended			
	May 24, 2009	August 16, 2009	November 8, 2009	February 28, 2010
Revenues	$ 22,931,000	$ 23,202,000	$ 20,645,000	$ 23,766,000
Operating costs and expenses, net	21,846,000	21,928,000	19,533,000	24,039,000
Operating income (loss)	1,085,000	1,274,000	1,112,000	(273,000)
Net income (loss)	354,000	320,000	426,000	(704,000)
Basic net income (loss) per share	0.12	0.11	0.15	(0.24)
Fully diluted net income (loss) per share	0.12	0.11	0.14	(0.24)

Due to rounding, the per share amounts above may not add to the year end amounts.

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

None.

ITEM 9A. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures

The Principal Executive Officer (PEO) and Principal Financial Officer (PFO) carried out an evaluation 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. Disclosure controls and procedures are designed only to provide reasonable assurance that controls and procedures will meet their objectives. Based on that evaluation, the Company s PEO and PFO, concluded that our disclosure controls and procedures were effective as of February 27, 2011.

Changes in Internal Control Over Financial Reporting

The PEO and PFO also have concluded that in the fourth quarter of the fiscal year ended February 27, 2011, there were no changes in the Company s internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) of the Exchange Act) that materially affected, or are reasonably likely to materially affect, the Company s internal controls over financial reporting.

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Management s Report on Internal Control Over Financial Reporting

Our management is responsible for establishing and maintaining adequate internal control over financial reporting, as such term is defined in Exchange Act Rules 13a-15(f) and 15d-15(f). In evaluating the Company s internal control over financial reporting, management has adopted the framework in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission. Under the supervision and with the participation of our management, including the PEO and PFO, we conducted an evaluation of the effectiveness of our internal control over financial reporting as of February 27, 2011. Based on our evaluation under the framework in Internal Control-Integrated Framework, our management has concluded that our internal control over financial reporting was effective as of February 27, 2011.

The Company s internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external reporting purposes in accordance with generally accepted accounting principles. Internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the Company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the Company are being made only in accordance with authorizations of management and directors of the Company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company s assets that could have a material effect on the financial statements.

ITEM 9B. OTHER INFORMATION

None.

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PART III

ITEM 10. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE

Information on directors and corporate governance of the Company is incorporated herein by reference to the Definitive Proxy Statement for the 2011 annual meeting of shareholders to be held on June 24, 2011.

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

ITEM 11. EXECUTIVE COMPENSATION

Information on executive compensation is incorporated herein by reference to the Definitive Proxy Statement for the 2011 annual meeting of shareholders to be held on June 24, 2011.

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

Information on security ownership of certain beneficial owners and management and relate shareholder matters is incorporated herein by reference to the Definitive Proxy Statement for the 2011 annual meeting of shareholders to be held on June 24, 2011 and to Item 5 of Part II hereof.

ITEM 13. CERTAIN RELATIONSHIPS, RELATED TRANSACTIONS AND DIRECTOR INDEPENDENCE

Information on certain relationships and related transactions is incorporated herein by reference to the Definitive Proxy Statement for the 2011 annual meeting of shareholders to be held on June 24, 2011.

ITEM 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES

Information on Principal accountant fees and services is incorporated herein by reference to the Definitive Proxy Statement for the 2011 annual meeting of shareholders to be held on June 24, 2011.

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PART IV

ITEM 15. EXHIBITS AND FINANCIAL STATEMENT SCHEDULES

(a) Financial Statements and Financial Statement Schedules.

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

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

(b) Exhibits.

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

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SIGNATURES

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

Morgan s Foods, Inc.

Dated: May 31, 2011

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

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

By: /s/ Leonard R. Stein-Sapir
Leonard R. Stein-Sapir
Chairman of the Board,
Chief Executive Officer & Director
Dated: May 31, 2011

By: /s/ James J. Liguori
James J. Liguori
Director, President &
Chief Operating Officer
Dated: May 31, 2011

By: /s/ Kenneth L. Hignett
Kenneth L. Hignett
Director, Senior Vice President,
Chief Financial Officer & Secretary
also as Principal Accounting Officer
Dated: May 31, 2011

By: /s/ Bernard Lerner
Bernard Lerner
Director
Dated: May 31, 2011

By: /s/ Marilyn A. Eisele
Marilyn A. Eisele
Director
Dated: May 31, 2011

By: /s/ Bahman Guyuron
Bahman Guyuron
Director
Dated: May 31, 2011

By: /s/ Steven S. Kaufman
Steven S. Kaufman
Director
Dated: May 31, 2011

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INDEX TO EXHIBITS

Exhibit Number	Exhibit Description
3.1	Amended Articles of Incorporation, as amended (9)
3.2	Amended Code of Regulations (9)
4.1	Specimen Certificate for Common Shares (1)
4.2	Shareholder Rights Plan (2)
4.3	Amendment to Shareholder Rights Agreement (8)
10.1	Specimen KFC Franchise Agreements (3)
10.2	Specimen Taco Bell Franchise Agreement (4)
10.3	Executive and Manager Nonqualified Stock Option Plan (5)
10.4	Key Employee Nonqualified Stock Option Plan (5)
10.6	Form Mortgage Loan Agreement with Captec Financial Group, Inc. (6)
10.7	Pre-negotiation Agreement with KFC Corporation dated November 8, 2010
14	Code of Ethics for Senior Financial Officers (7)
19	Form of Indemnification Contract between Registrant and its Officers and Directors (5)
21	Subsidiaries
23.1	Consent of Independent Registered Public Accounting Firm Grant Thornton LLP
31.1	Certification of the Chairman and Chief Executive Officer pursuant to Rule 13a-14(a) of Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2	Certification of the Senior Vice President, Chief Financial Officer & Secretary pursuant to Rule 13a-14(a) of Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.1	Certification of the Chairman of the Board and Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
32.2	Certification of the Senior Vice President, Chief Financial Officer and Secretary pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

(1) Filed as an exhibit to the Registrant s Registration Statement (No. 33-35772) on Form S-2 and incorporated herein by reference.

(2) Filed as an exhibit to the Registrant s Form 8-A dated May 7, 1999 and incorporated herein by reference.

(3) Filed as an exhibit to the Registrant s Registration Statement (No. 2-78035) on Form S-1 and incorporated herein by reference.

(4) Filed as an exhibit to Registrant s Form 10-K for the 2000 fiscal year and incorporated herein by reference.

(5) Filed as an exhibit to the Registrant s Form S-8 filed November 17, 1999 and incorporated herein by reference.

(6) Filed as an exhibit to the Registrant s Form 10-K for the 1996 fiscal year and incorporated herein by reference.

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

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

(9) Filed as an exhibit to the Registrant s Form 10-K for the 2010 fiscal year and incorporated herein by reference.