

Edgar Filing: MORGANS FOODS INC - Form 10-K

MORGANS FOODS INC  
Form 10-K  
May 31, 2002

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-K

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

For the fiscal year ended March 3, 2002 Commission file number 0-3833  
-----

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)

24200 Chagrin Boulevard, Suite 126, Beachwood, Oh

44122

-----  
(Address of principal executive officers)

(Zip Code)

Registrant's telephone number, including area code: (216) 360-7500  
-----

Securities registered pursuant to Section 12 (b) of the Act:

Title of Each Class	Name of each exchange on which Registered
----- Common Shares, Without Par Value	----- American Stock Exchange

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

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 X No  
-----

Indicate by check mark if disclosure of delinquent filers pursuant to  
Item 405 of Regulation S-K is not contained herein, and will not be contained,  
to the best of registrant's knowledge, in definitive proxy or information  
statements incorporated by reference in Part III of this Form 10-K or any  
amendment to this Form 10-K. [X]

As of May 15, 2002, the aggregate market value of the common stock held  
by nonaffiliates of the Registrant was \$5,273,711.

As of May 15, 2002, the Registrant had 2,719,641 shares of common stock

# Edgar Filing: MORGANS FOODS INC - Form 10-K

outstanding.

## DOCUMENTS INCORPORATED BY REFERENCE

Part III incorporates by reference certain information from the definitive Proxy Statement to security holders for the 2002 annual meeting, to be filed with the Securities and Exchange Commission on or before June 21, 2002.

1

MORGAN'S FOODS, INC.

## PART I

### ITEM 1. BUSINESS.

GENERAL. Morgan's Foods, Inc. ("the Company") operates through wholly-owned subsidiaries KFC restaurants under franchises from KFC Corporation, Taco Bell restaurants under franchises from Taco Bell Corporation and Pizza Hut Express restaurants under licenses from Pizza Hut Corporation. As of May 23, 2002, the Company operates 76 KFC restaurants, 7 Taco Bell restaurants, 16 KFC/Taco Bell "2n1's" under franchises from KFC Corporation and franchises or licenses from Taco Bell Corporation, 3 Taco Bell/Pizza Hut Express "2n1's" under franchises from Taco Bell Corporation and licenses from Pizza Hut Corporation and 1 KFC/Pizza Hut Express "2n1's" under a franchise from KFC Corporation and a license from Pizza Hut Corporation. The Company formerly operated six East Side Mario's restaurants, a business segment which the Company had previously chosen to discontinue (see Note 2 to the consolidated financial statements). 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 license agreements from Taco Bell Corporation prepare and sell a limited menu of Taco Bell items as well as the full KFC menu while those operated under franchise agreements from both KFC Corporation and Taco Bell Corporation offer a full menu of both KFC and Taco Bell items. The Taco Bell/Pizza Hut Express "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 East Side Mario's restaurants were full service, mid-priced, casual family restaurants inspired by New York City's famous "Little Italy" district of the 1950's.

Of the 103 KFC, Taco Bell and "2n1" restaurants operated by the Company as of May 23, 2002, 16 are located in Ohio, 60 in Pennsylvania, 16 in Missouri, 2 in Illinois, 7 in West Virginia and 2 in New York. The Company was one of the first KFC Corporation franchisees and has operated in excess of 20 KFC franchises for more than 25 years. Operations relating to these units are seasonal to a certain extent, with higher sales generally occurring in the summer months.

FRANCHISE AGREEMENTS. All of the Company's KFC and Taco Bell restaurants are operated under franchise agreements with KFC Corporation and Taco Bell Corporation, respectively. The Company's KFC/Taco Bell "2n1" restaurants are operated under franchises from KFC Corporation and either

## Edgar Filing: MORGANS FOODS INC - Form 10-K

franchises or licenses 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 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 and Pizza Hut Corporation are satisfactory. For KFC products, the Company is required to pay royalties of 4% of gross revenues and to

2

MORGAN'S FOODS, INC.

PART I (CONT'D)

expend an additional 5.5% of gross revenues on national and local advertising pursuant to its franchise agreements. For Taco Bell products in KFC/Taco Bell "2n1" restaurants operated under license agreements from Taco Bell Corporation and franchise agreements from KFC Corporation the Company is required to pay royalties of 10% of Taco Bell gross revenues and to make advertising fund contributions of 1/2% of Taco Bell gross revenues. For Taco Bell product sales in restaurants operated under Taco Bell franchises the Company is required to pay royalties of 5.5% of gross revenues and to expend an additional 4.5% of gross revenues on national and local advertising.

For Pizza Hut products in "2n1" restaurants the Company is required to pay royalties of 5.5% of Pizza Hut gross revenues and to expend an additional 4.5% of Pizza Hut gross revenues on national and local advertising. In May 1997, the Company renewed substantially all of its 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 and Pizza Hut Express unit is to be inspected by KFC Corporation, Taco Bell Corporation and Pizza Hut Corporation, respectively, approximately three or four times per year. These inspections cover product preparation and quality, customer service, restaurant appearance and operation.

COMPETITION. The quick service restaurant business is highly competitive. 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 and pizza 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 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.

## Edgar Filing: MORGANS FOODS INC - Form 10-K

SUPPLIERS. The Company has been able to obtain sufficient supplies to carry on its business and believes it will be able to do so in the future.

GROWTH. During fiscal 2002 the Company added a Pizza Hut Express each to an existing KFC restaurant and an existing Taco Bell restaurant. During fiscal 2001, the Company completed construction of KFC/Taco Bell "2n1" restaurants in New Martinsville, WV and Lakewood, NY, added a concept to three restaurants located in Pennsylvania, closed 4 KFC restaurants and sold the one remaining former East Side

3

MORGAN'S FOODS, INC.

PART I (CONT'D)

Mario's location. On July 14, 1999 the Company acquired the assets of 54 existing KFC and Taco Bell restaurants and the land and building of a non-operating KFC restaurant from various subsidiaries of Tricon Global Restaurants, Inc. See Note 2 to the consolidated financial statements. As part of this acquisition, the Company was granted the rights to develop 20 KFC, Taco Bell or KFC/Taco Bell "2n1" restaurants in specific geographic areas. Under the agreement, five restaurants are required to be developed each year over a four year period. Also, during fiscal 2000, the Company acquired two KFC restaurants in the Erie, PA market area and completed construction of restaurants in Calcutta, OH and Troy, IL. On December 9, 1999 the Company sold four of the remaining five former East Side Mario's restaurant locations to Steak & Ale, a division of Metromedia Restaurants Group. See Note 2 to the consolidated financial statements for further details.

EMPLOYEES. As of May 23, 2002, the Company employed approximately 2,027 persons, including 56 administrative and 198 managerial employees. The balance are hourly employees, most of whom are part-time. None of the restaurant employees are represented by a labor union. The Company considers its employee relations to be satisfactory.

### ITEM 2. PROPERTIES.

The Company leases approximately 6,071 square feet of space for its headquarters in Cleveland, Ohio. The lease expires February 28, 2005 and the rent under the current term is \$8,120 per month. The lease also contains a renewal option of five years, which may be exercised by the Company. The Company also leases space for a regional office in Youngstown, OH, which is used to assist in the operation of the KFC, Taco Bell and "2n1" restaurants.

Of the 103 KFC, Taco Bell and "2n1" restaurants, the Company owns the land and building for 57 locations, owns the building and leases the land for 25 locations and leases the land and building for 21 locations. 56 of the owned properties are subject to mortgages. Additionally, the Company leases the land and building for two closed locations. Remaining lease terms (including renewal options) range from 3 to 27 years and average approximately 15 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 rental for each leased KFC, Taco Bell or "2n1" restaurant in amounts ranging from \$18,000 to \$86,000. In addition, 17 of these leases require payment of additional rentals based on a percentage of gross sales in excess of certain base amounts. Sales for 8 KFC and Taco Bell restaurants exceeded the

## Edgar Filing: MORGANS FOODS INC - Form 10-K

respective base amounts in fiscal 2002.

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

### ITEM 3. LEGAL PROCEEDINGS.

None.

4

## MORGAN'S FOODS, INC.

### PART I (CONT'D)

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

There were no matters submitted to security holders for a vote during the last quarter of the Company's fiscal year ended March 3, 2002.

### 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 Stein-Sapir	63	Chairman of the Board and Chief Executive Officer	April 198
James J. Liguori	53	President and Chief Operating Officer	June 1979
Kenneth L. Hignett	55	Senior Vice President- Chief Financial Officer & Secretary	May 1989
OTHER OFFICERS:			
Barton J. Craig	53	Senior Vice President - General Counsel	January 1
Vincent J. Oddi	59	Vice President- Restaurant Development	September
Ramesh J. Gursahaney	53	Vice President- Operations Services	January 1

Executive Officers of the Company serve for a term of one year and

## Edgar Filing: MORGANS FOODS INC - Form 10-K

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.

5

MORGAN'S FOODS, INC.

### PART II

#### ITEM 5. MARKET FOR THE COMPANY'S COMMON EQUITY AND RELATED STOCKHOLDER MATTERS.

The Company's Common Shares are traded on the American Stock Exchange under the symbol "MR". The following table sets forth, for the periods indicated, the high and low sales prices of the Common Shares as reported on the American Stock Exchange.

	PRICE RANGE	
	HIGH	LOW
-----		
YEAR ENDED MARCH 3, 2002:		
1st Quarter .....	\$1.40	\$ .70
2nd Quarter .....	1.10	.60
3rd Quarter .....	1.20	.80
4th Quarter .....	3.04	.70
YEAR ENDED FEBRUARY 25, 2001:		
1st Quarter .....	\$3.25	\$2.19
2nd Quarter .....	2.75	1.88
3rd Quarter .....	2.25	1.50
4th Quarter .....	1.75	.50

As of May 15, 2002, the Company had approximately 984 shareholders of record. The Company has paid no dividends since fiscal 1975.

#### ITEM 6. SELECTED FINANCIAL DATA.

The following selected financial information for each of the five fiscal years in the period ended March 3, 2002, 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.

6

MORGAN'S FOODS, INC.

# Edgar Filing: MORGANS FOODS INC - Form 10-K

## PART II (CONT'D)

Dollars in thousands except per share amounts.

	YEARS ENDED				
	MARCH 3, 2002	FEBRUARY 25, 2001	FEBRUARY 27, 2000	FEBRUARY 28, 1999	MARCH 3, 1998
Revenues.....	\$ 84,930	\$ 78,140	\$ 63,606	\$ 32,187	\$ 29,187
Cost of sales:					
Food, paper and beverage .....	25,987	24,378	19,955	10,510	9,875
Labor and benefits.....	22,155	20,702	16,978	7,894	7,894
Restaurant operating expenses....	21,805	19,795	15,523	7,633	7,633
Depreciation and amortization....	3,866	3,817	2,672	1,389	1,389
General and administrative expenses.....	5,209	5,516	4,420	2,810	2,810
Loss on restaurant assets.....	215	597	213	11	11
Operating income.....	5,693	3,335	3,845	1,940	1,940
Income (loss) from continuing operations before extraordinary items.....	602	(1,693)	283	913	913
Extraordinary loss on early extinguishment of debt (2).....	--	--	--	(287)	--
Gain (loss) from discontinued operations (3).....	--	150	(629)	(1,634)	(1,634)
Net income (loss).....	\$ 602	\$ (1,543)	\$ (346)	\$ (1,008)	\$ (1,008)
Basic and diluted income (loss) per common share (1):					
Income (loss) from continuing operations.....	\$ .21	\$ (.58)	\$ .10	\$ .31	\$ .31
Loss on early extinguishment of debt.....	--	--	--	(.10)	--
Gain (loss) from discontinued operations.....	--	.05	(.22)	(.56)	(.56)
Net income (loss).....	\$ .21	\$ (.53)	\$ (.12)	\$ (.35)	\$ (.35)
Working capital (deficiency).....	(1,312)	(2,454)	(4,228)	(2,182)	(2,182)
Total assets.....	60,253	61,554	62,188	24,011	20,011
Long-term debt.....	48,563	51,046	49,968	13,094	7,094
Long-term capital lease obligations.....	544	651	745	4,244	5,244
Shareholders' equity (deficit)...	(197)	(578)	930	1,248	2,248

(1) Computed based upon the basic weighted average number of common shares outstanding during each year, which were 2,851,160 in 2002, 2,931,227 in 2001, 2,912,894 in 2000, 2,910,839 in 1999 and 2,936,877 in 1998 and the diluted weighted average number of common and common equivalent shares outstanding during each year which were 2,853,789 in 2002, 2,931,227 in 2001, 2,912,894 in

## Edgar Filing: MORGANS FOODS INC - Form 10-K

2000, 2,910,839 in 1999 and 2,936,877 in 1998.

(2) Prepayment penalty, write off of deferred financing and early buy-out of capitalized leases costs related to early extinguishment of debt.

(3) The results of operations of the former East Side Mario's restaurant segment.

7

MORGAN'S FOODS, INC.

PART II (CONT'D)

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

RESULTS OF OPERATIONS. During fiscal 2000 through 2002 the Company operated KFC franchised restaurants, Taco Bell franchised restaurants and various "2n1" restaurants which include the KFC, Taco Bell and Pizza Hut concepts of which several also offer Taco Bell products, in the states of Illinois, Missouri, Ohio, Pennsylvania, West Virginia and New York. The average number of restaurants in operation during fiscal 2002 was 103 compared to 105 during fiscal 2001 and 77 during fiscal 2000. During fiscal 2002, the Company added a concept to two restaurants. During fiscal 2001, the Company opened two new KFC/Taco Bell "2n1" restaurants, added a concept to three restaurants and closed four restaurants. During fiscal 2000, the Company acquired fifty-six restaurants and built two new restaurants.

#### SUMMARY OF EXPENSES AS A PERCENTAGE OF REVENUES

	2002 -----	2001 -----	2000 -----
Cost of sales:			
Food, paper and beverage.....	30.6%	31.2%	31.4%
Labor and benefits.....	26.1%	26.5%	26.7%
Restaurant operating expenses.....	25.7%	25.3%	24.4%
Depreciation and amortization.....	4.6%	4.9%	4.2%
General and administrative expenses.....	6.1%	7.1%	6.9%
Operating income .....	6.7%	4.3%	6.0%

REVENUES. Revenue was \$84,930,000 in fiscal 2002, an increase of \$6,790,000 or 8.7% compared to an increase of \$14,534,000 or 22.9% in fiscal 2001.

The \$6,790,000 increase in restaurant revenues during fiscal 2002 was the result of an 8.2% increase in comparable restaurant revenues, \$1,641,000 in revenues generated from the extra week that occurred in fiscal 2002, and \$433,000 in revenues generated by locations where a concept was added or the location was remodeled. The increases were partially offset by lost revenues of \$952,000 due to restaurants being permanently or temporarily closed. The increase in comparable restaurant revenues was primarily the result of effective product promotions by the franchisors. The \$14,534,000 increase in restaurant



## Edgar Filing: MORGANS FOODS INC - Form 10-K

revenues during fiscal 2001 was the result of \$16,319,000 in revenues generated by newly built or acquired restaurants. This increase was offset by a 1.4% decrease in comparable restaurant revenues and lost revenues of \$1,364,000 due to restaurants being permanently closed or temporarily closed for image enhancements. The decline in comparable restaurant revenues was primarily the result of ineffective franchisor product promotions. The \$31,419,000 increase in restaurant revenues during fiscal 2000 was the result of a 5.1% decrease in comparable restaurant revenues, offset by \$34,577,000 in revenues generated by the 56 KFC's and Taco Bell's which were acquired and the two new KFC's which were built during fiscal 2000. The decline in comparable restaurant revenues was a result of several very effective promotions in the prior year and a somewhat ineffective chicken sandwich promotion in fiscal year 2000 which also decreased chicken on the bone sales.

Revenues for the 17 weeks ended March 3, 2002 were \$25,966,000, an increase of \$3,393,000 due to an 8.1% increase in comparable restaurant revenues and \$1,641,000 in revenues generated from the extra

8

MORGAN'S FOODS, INC.

PART II (CONT'D)

week that occurred during fiscal 2002. Revenues for the 16 weeks ended February 25, 2001 were \$22,573,000, a decrease of \$216,000 from the 16 weeks ended February 27, 2000. This decrease was due to a comparable restaurant decrease of 2.0% and lost sales of \$414,000 during the fiscal fourth quarter due to restaurants being permanently closed or temporarily closed for image enhancements, partially offset by \$625,000 in revenues generated by newly built or expanded restaurants.

**COST OF SALES - FOOD, PAPER AND BEVERAGE.** Food, paper and beverage costs were \$25,987,000 or 30.6% of sales in fiscal 2002 compared to \$24,378,000 or 31.2% in fiscal 2001. Food, paper and beverage costs declined by .6% as a result of several factors, including product promotions in fiscal 2002 having a lower food cost than those promoted during fiscal 2001 and by efficiencies gained due to higher average restaurant volumes. Food, paper and beverage costs were also reduced by \$259,000 received during fiscal 2002 as the result of a settlement negotiated by FRANMAC, the Taco Bell franchisee association, with certain system food suppliers. Food, paper and beverage costs were \$24,378,000 or 31.2% of sales in fiscal 2001 compared to \$19,955,000 or 31.4% in fiscal 2000. Food, paper and beverage costs declined by 0.2% of sales as a result of incentive payments received or amortized to cost of sales under the Company's beverage supply and marketing agreement which was partially offset by an increase in chicken prices and unfavorable pricing for certain other products.

For the fourth quarter of fiscal 2002, food, paper and beverage costs increased as a percentage of sales to 30.8% from 29.6% in fiscal 2001. The increase of 1.2% of sales was primarily due to the timing of incentive payments received or amortized to cost of sales under the Company's beverage supply and marketing agreement and product promotions in the fourth quarter of fiscal 2002 having a higher food cost than those promoted during fiscal 2001.

**COST OF SALES - LABOR AND BENEFITS.** Labor and benefits decreased to 26.1% of sales or \$22,155,000 in fiscal 2002 from 26.5% of sales or \$20,702,000 in fiscal 2001. The decrease was primarily due to higher average restaurant volumes, decreased benefit costs during the first three quarters of fiscal 2002

## Edgar Filing: MORGANS FOODS INC - Form 10-K

and improved operating efficiencies. Labor and benefits were substantially unchanged as a percentage of revenue for the year ended February 25, 2001 at 26.5% of sales compared to 26.7% of sales for the year earlier, even though they were expected to decline after digesting the 56 restaurant acquisitions from the prior year. This higher labor and benefit cost percentage was primarily the result of reduced labor efficiency caused by lower average restaurant volumes in fiscal 2001.

Labor and benefit costs for the fourth quarter of fiscal 2002 increased to 26.9% of sales or \$6,993,000 compared to 26.0% of sales or \$6,672,000 in fiscal 2001. This increase was a result of increased workers compensation and unemployment costs during the quarter.

RESTAURANT OPERATING EXPENSES. Restaurant operating expenses in fiscal 2002 increased to 25.7% of sales or \$21,805,000 compared to 25.3% of sales or \$19,795,000 in the prior year. This was due mainly to higher repair and maintenance costs and an increase in KFC national advertising expenses from 2.0% of KFC revenues to 2.5% of KFC revenues. The increased advertising was approved by the national advertising co-op

9

MORGAN'S FOODS, INC.

PART II (CONT'D)

and will continue in future periods. Restaurant operating expenses in fiscal 2001 increased to 25.3% of sales or \$19,795,000 compared to 24.4% of sales or \$15,523,000 in the prior year. This increase was mainly a result of increased utility and rent costs including an adjustment of \$357,000 in the fourth quarter of fiscal 2001 required to recognize fixed rent escalations on a straight-line basis over the terms of the leases.

Restaurant operating expenses for the fourth quarter of fiscal 2002 decreased to 25.7% of sales or \$6,683,000 from 27.0% of sales or \$6,090,000 in the year earlier quarter. As a percentage of sales, these expenses were less than the prior year fourth quarter primarily due to the prior year fourth quarter fixed escalation rent adjustment discussed above and higher average restaurant volumes in the fourth quarter of fiscal 2002.

DEPRECIATION AND AMORTIZATION. Depreciation and amortization in fiscal 2002 increased to \$3,866,000 from \$3,817,000 in fiscal 2001. Depreciation and amortization in fiscal 2001 increased to \$3,817,000 from \$2,672,000 in fiscal 2000. Both of these increases resulted from the Company's restaurant acquisitions, restaurant expansions and newly built restaurants.

GENERAL AND ADMINISTRATIVE EXPENSES. General and administrative expenses decreased to \$5,209,000 or 6.1% of revenues in fiscal 2002 from \$5,516,000 or 7.1% of revenues in fiscal 2001. The decrease of \$307,000 was mainly the result of improved cost control at both the Corporate and field operations levels as well as the fees that were paid to an advisor in fiscal year 2001. General and administrative expenses increased to \$5,516,000 or 7.1% of revenues in fiscal 2001 from \$4,420,000 or 6.9% of revenues in fiscal 2000. The increase of \$1,096,000 was the result of operating the acquired and newly built restaurants for the entire year, fees paid to an advisor to evaluate strategic alternatives for the Company, and increased salary and benefit costs.

LOSS ON RESTAURANT ASSETS. In fiscal 2002, the Company recorded losses

## Edgar Filing: MORGANS FOODS INC - Form 10-K

of \$215,000 as a result of an increase in the reserve for the costs necessary to dispose of previously closed restaurants and the write off of previously capitalized pre-construction costs related to projects which management has determined will not be undertaken. In fiscal 2001, the Company recorded a loss of \$597,000 which was the result of the costs necessary to dispose of four closed restaurants and an impairment loss of \$133,000 for the excess of net book value over fair value of a restaurant.

**OPERATING INCOME.** Operating income in fiscal 2002 increased \$2,358,000 to \$5,693,000 from \$3,335,000 in fiscal 2001. This increase was primarily the result of higher average restaurant volumes, improved operating efficiencies and the receipt of the settlement with certain Taco Bell system food suppliers mentioned earlier. Operating income in fiscal 2001 decreased \$510,000 to \$3,335,000 from \$3,845,000 in the prior fiscal year due to the reasons discussed previously.

**INTEREST EXPENSE.** Interest expense from bank debt and notes payable increased to \$5,174,000 in fiscal 2002 from \$5,072,000 in fiscal 2001 primarily as a result of the extra week that occurred during fiscal 2002. Interest expense from bank debt and notes payable increased to \$5,072,000 in fiscal 2001 from

10

MORGAN'S FOODS, INC.

PART II (CONT'D)

\$3,587,000 in fiscal 2000. The increase in fiscal 2001 was due to increased borrowings to fund the acquisition and expansion of KFC and Taco Bell restaurants. The Company opened two new restaurants and added a concept to three restaurants during fiscal 2001. Interest expense from capitalized lease debt decreased \$9,000 to \$72,000 in fiscal 2002 from \$81,000 in fiscal 2001. Interest expense from capitalized lease debt decreased \$11,000 to \$81,000 in fiscal 2001 from \$92,000 in fiscal 2000. Both of these fluctuations were due to lower principal balances during the years discussed.

**OTHER INCOME.** Other income was relatively unchanged at \$159,000 in fiscal 2002 compared to \$148,000 in fiscal 2001 and \$121,000 in fiscal 2000.

**DISCONTINUED OPERATIONS.** On September 3, 1999, management made the decision to discontinue the operation of its East Side Mario's restaurant segment. On December 9, 1999 the Company sold four of the remaining five former East Side Mario's restaurant locations. The Company sold the one remaining former East Side Mario's location and the liquor license and equipment during the third and fourth quarters of fiscal 2001 and recorded a gain on the disposal of the remaining assets of \$150,000. The cash received as a result of these transactions was used to pay off the capital lease obligations and other expenses of the transactions. The results of operations of the discontinued segment are shown in the Consolidated Statements of Operations as "Loss from discontinued operations". There is no tax effect of the loss.

**PROVISION FOR INCOME TAXES.** The provision for income taxes was \$4,000 in fiscal year 2002 compared to \$23,000 in fiscal 2001. This decrease was primarily due to changes in estimated alternative minimum tax payments.

**LIQUIDITY AND CAPITAL RESOURCES.** The Company, like others in the restaurant industry, operates on minimal working capital and relies on cash flow from operations, debt borrowings and lease financing for the construction and

## Edgar Filing: MORGANS FOODS INC - Form 10-K

refurbishment of restaurant properties and repayment of debt. Cash flow activity for fiscal 2002, 2001 and 2000 is presented in the Consolidated Statements of Cash Flows.

Capital expenditures for fiscal 2002 were \$883,000, substantially all of which related to the addition of concepts to restaurants, the addition of equipment necessary for new products and Home Office and restaurant computer equipment. In fiscal 2002 the Company made principal payments on long-term debt of \$2,264,000 and on capital lease obligations of \$96,000.

The quick service restaurant operations of the Company have historically provided sufficient cash flow to service the Company's debt, refurbish and upgrade restaurant properties and cover administrative overhead. Management believes that operating cash flow will provide sufficient capital to continue to operate and maintain the KFC, Taco Bell and "2n1" restaurants, service the Company's debt and support required corporate expenses.

Certain of the Company's debt arrangements require the maintenance of a consolidated fixed charge coverage ratio of 1.2 to 1 regarding all of its mortgage loans and individual restaurant coverage ratios of 1.4 to

11

MORGAN'S FOODS, INC.

PART II (CONT'D)

1 on certain of its loans. The Company was in compliance with the consolidated ratio of 1.2 to 1 applicable to its loans. The Company was not in compliance with the 1.4 to 1.0 unit level ratio on certain of its restaurants. The Company has obtained waivers of these violations from the applicable lender. Management expects to be in compliance with all financial covenants in future periods, or to obtain amendments or waivers of any covenants.

The Company is currently not in full compliance with the American Stock Exchange financial condition guidelines for continued listing. Specifically, the guidelines indicate that any company with shareholders' equity less than \$4,000,000 and losses in 3 of its last 4 fiscal years may be considered for delisting. This condition has been reviewed with representatives of the American Stock Exchange who indicated that the Company's performance would continue to be monitored by the Exchange.

The Company has been financing the expansion and image enhancement of its restaurants primarily through the use of fixed rate long-term debt on which the rate is fixed at the time of funding. At March 3, 2002 there was \$50,894,000 of such debt outstanding at rates ranging from 8.3% to 10.6%. The Company's market risk exposure is primarily due to possible fluctuations in interest rates as they relate to future borrowings. The Company has evaluated the potential effect of a 1.0% increase in these rates on future capital spending plans and believes that there would be no material effect. The Company does not enter into derivative financial investments for trading or speculation purposes. As a result, the Company believes that its market risk exposure is not material to the Company's financial position, liquidity or results of operations.

The Company expects to commit approximately \$2,000,000 to image enhancements and expansions of existing KFC restaurants during fiscal 2003.

SEASONALITY. The operations of the Company are affected by seasonal

## Edgar Filing: MORGANS FOODS INC - Form 10-K

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.

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. These judgments involve estimations about the effect of matters that are inherently uncertain and may significantly impact our 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 most significant policies require:

- Estimation of cash flows associated with the impairment of long-lived assets and projected compliance with debt covenants.
- Determination of 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.

12

MORGAN'S FOODS, INC.

PART II (CONT'D)

NEW ACCOUNTING STANDARDS. In June 2001, the FASB issued SFAS No. 141, Business Combinations. SFAS No. 141 requires that the purchase method of accounting be used for all business combinations initiated after June 30, 2001. As specified therein, intangible assets acquired that are obtained through contractual or legal right, or are capable of being separately sold, transferred, licensed, rented or exchanged are recognized as assets apart from goodwill. SFAS No. 141 is effective for all acquisitions subsequent to June 30, 2001.

In June 2001, the FASB issued SFAS No. 142, Goodwill and Other Intangible Assets. SFAS No. 142 changes the accounting for goodwill and certain intangible assets from an amortization method to an impairment only approach. Goodwill and intangibles with indefinite lives are no longer subject to amortization, but are subject to at least an annual assessment for impairment by applying a fair value based test. The Company is required to implement SFAS No. 142 for the fiscal year beginning March 4, 2002 and it has not yet completed its analysis of the effects of adopting this statement.

In June 2001, the FASB issued SFAS No. 143, Accounting for Asset Retirement Obligations, which addresses financial accounting and reporting for obligations associated with the retirement of tangible long-lived assets and associated asset retirement costs. The new rules apply to legal obligations associated with the retirement of long-lived assets that result from the acquisition, construction, development and/or normal operation of a long-lived assets. SFAS No. 143 is effective for the Company beginning in fiscal 2003. The Company believes, at this time, that the adoption of SFAS No. 143 will not have a material impact on its consolidated financial position or results of

## Edgar Filing: MORGANS FOODS INC - Form 10-K

operations.

In August 2001, the FASB issued SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets. SFAS No. 144 supersedes SFAS No. 121, Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of, and the accounting and reporting provisions of Accounting Principles Board Opinion ("APB") No. 30, Reporting the Results of Operations - Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions, for the disposal of a segment of a business (as previously defined in that opinion). SFAS No. 144 requires that one accounting model be used for long-lived assets to be disposed of by sale, whether previously held and used or newly acquired and broadens the presentation of discontinued operations to include more disposal transactions than were included under the previous standards. The Company will adopt SFAS No. 144 beginning in fiscal 2003, as required; however, adoption of the statement is not expected to have a material impact on its consolidated financial position or results of operations.

### ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK.

Information required by this item is included under "Liquidity and Capital Resources".

### ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA.

The Consolidated Financial Statements of the Company are set forth in Item 14 of this Report.

13

MORGAN'S FOODS, INC.

### PART III

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

None.

### ITEM 10. DIRECTORS AND EXECUTIVE OFFICERS OF THE REGISTRANT.

Information on Directors of the Company is incorporated herein by reference to the definitive Proxy Statement to security holders for the 2002 annual meeting to be filed with the Securities and Exchange Commission on or before June 21, 2002.

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 to security holders for the 2002 annual meeting to be filed with the Securities and Exchange Commission on or before June 21, 2002.

Edgar Filing: MORGANS FOODS INC - Form 10-K

ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT.

Information on security ownership of certain beneficial owners, officers and directors is incorporated herein by reference to the definitive Proxy Statement to security holders for the 2002 annual meeting to be filed with the Securities and Exchange Commission on or before June 21, 2002.

ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS.

Information on certain relationships and related transactions is incorporated herein by reference to the definitive Proxy Statement to security holders for the 2002 annual meeting to be filed with the Securities and Exchange Commission on or before June 21, 2002.

14

MORGAN'S FOODS, INC.

PART IV

ITEM 14. EXHIBITS, FINANCIAL STATEMENT SCHEDULES, AND REPORTS ON FORM 8-K.

- (a) 1 and 2. Financial Statements and Financial Statement Schedules.

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.

- (a) 3. Exhibits.

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

15

MORGAN'S FOODS, INC.  
INDEX TO FINANCIAL STATEMENTS AND  
FINANCIAL STATEMENT SCHEDULES  
ITEM 14 (A) 1 AND 2

ITEM 14 (a) 1  
-----

PAGE  
REFERENCE  
-----

Edgar Filing: MORGANS FOODS INC - Form 10-K

Independent Auditors' Report.....	17
Consolidated Balance Sheets at March 3, 2002 and February 25, 2001.....	18
Consolidated Statements of Operations for the years ended March 3, 2002, February 25, 2001 and February 27, 2000.....	19
Consolidated Statements of Shareholders' Equity (Deficit) for the years ended March 3, 2002, February 25, 2001 and February 27, 2000.....	20
Consolidated Statements of Cash Flows for the years ended March 3, 2002, February 25, 2001 and February 27, 2000.....	21
Notes to Consolidated Financial Statements.....	22

ITEM 14 (a) 2  
-----

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

INDEPENDENT AUDITORS' REPORT

To the Board of Directors and Shareholders  
Morgan's Foods, Inc.  
Cleveland, Ohio

We have audited the accompanying consolidated balance sheets of Morgan's Foods, Inc. and subsidiaries as of March 3, 2002 and February 25, 2001 and the related consolidated statements of operations, shareholders' equity (deficit), and cash flows for each of the three years in the period ended March 3, 2002. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on the financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial



## Edgar Filing: MORGANS FOODS INC - Form 10-K

statements. An audit also includes 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, such consolidated financial statements present fairly, in all material respects, the financial position of Morgan's Foods, Inc. and subsidiaries at March 3, 2002 and February 25, 2001 and the results of their operations and their cash flows for each of the three years in the period ended March 3, 2002 in conformity with accounting principles generally accepted in the United States of America.

/s/ Deloitte & Touche LLP

Deloitte & Touche LLP  
Cleveland, Ohio  
May 23, 2002

17

MORGAN'S FOODS, INC.  
CONSOLIDATED BALANCE SHEETS  
MARCH 3, 2002 AND FEBRUARY 25, 2001

ASSETS

	2002	2001
Current assets:		
Cash and equivalents .....	\$ 7,441,000	\$ 5,840,000
Receivables .....	232,000	78,000
Inventories .....	520,000	488,000
Prepaid expenses .....	301,000	222,000
	8,494,000	6,628,000
Property and equipment (Notes 5 and 6):		
Land .....	10,801,000	10,802,000
Buildings and improvements .....	17,949,000	17,701,000
Property under capital leases .....	1,006,000	1,006,000
Leasehold improvements .....	7,483,000	7,294,000
Equipment, furniture and fixtures .....	18,105,000	17,771,000
Construction in progress .....	108,000	110,000
	55,452,000	54,684,000
Less accumulated depreciation and amortization .....	17,304,000	14,130,000
	38,148,000	40,554,000
Other assets .....	1,521,000	1,621,000
Franchise agreements .....	2,119,000	2,241,000
Deferred taxes (Note 8) .....	600,000	600,000
Acquired franchise rights .....	9,371,000	9,910,000
	\$ 60,253,000	\$ 61,554,000

Edgar Filing: MORGANS FOODS INC - Form 10-K

	=====	=====
LIABILITIES AND SHAREHOLDERS' EQUITY (DEFICIT)		
Current liabilities:		
Current maturities of long-term debt (Note 5) .....	\$ 2,331,000	\$ 2,076,000
Current maturities of capital lease obligations (Note 6)	105,000	94,000
Accounts payable .....	3,761,000	3,590,000
Accrued liabilities (Note 4) .....	3,609,000	3,322,000
	-----	-----
	9,806,000	9,082,000
Long-term debt (Note 5) .....	48,563,000	51,046,000
Long-term capital lease obligations (Note 6) .....	544,000	651,000
Other long-term liabilities .....	1,537,000	1,353,000
Commitments and contingencies (Notes 5 and 6)		
SHAREHOLDERS' EQUITY (DEFICIT)		
Preferred shares, 1,000,000 shares authorized, no shares outstanding		
Common Stock:		
Authorized shares - 25,000,000		
Issued shares - 2,969,405 .....	30,000	30,000
Treasury shares - 241,564 in 2002 and 31,833 in 2001 ...	(251,000)	(76,000)
Capital in excess of stated value .....	28,829,000	28,875,000
Accumulated deficit .....	(28,805,000)	(29,407,000)
	-----	-----
Total shareholders' deficit .....	(197,000)	(578,000)
	-----	-----
	\$ 60,253,000	\$ 61,554,000
	=====	=====

See notes to consolidated financial statements.

MORGAN'S FOODS, INC.  
CONSOLIDATED STATEMENTS OF OPERATIONS  
YEARS ENDED MARCH 3, 2002, FEBRUARY 25, 2001 AND FEBRUARY 27, 2000

	2002	2001	2000
	-----	-----	-----
Revenues .....	\$ 84,930,000	\$ 78,140,000	\$ 63,606,000
Cost of sales:			
Food, paper and beverage .....	25,987,000	24,378,000	19,955,000
Labor and benefits .....	22,155,000	20,702,000	16,978,000
Restaurant operating expenses .....	21,805,000	19,795,000	15,523,000
Depreciation and amortization .....	3,866,000	3,817,000	2,672,000
General and administrative expenses .....	5,209,000	5,516,000	4,420,000
Loss on restaurant assets (Note 3) .....	215,000	597,000	213,000
	-----	-----	-----

Edgar Filing: MORGANS FOODS INC - Form 10-K

Operating income .....	5,693,000	3,335,000	3,845,000
Interest expense:			
Bank debt and notes payable .....	(5,174,000)	(5,072,000)	(3,587,000)
Capital leases .....	(72,000)	(81,000)	(92,000)
Other income and expense, net .....	159,000	148,000	121,000
	-----	-----	-----
Income (loss) from continuing operations before income taxes .....	606,000	(1,670,000)	287,000
Provision for income taxes (Note 8) .....	4,000	23,000	4,000
	-----	-----	-----
Income (loss) from continuing operations ..	602,000	(1,693,000)	283,000
Gain (loss) from discontinued operations (Note 2) .....	--	150,000	(629,000)
	-----	-----	-----
Net income (loss) .....	\$ 602,000	\$ (1,543,000)	\$ (346,000)
	=====	=====	=====
Basic and diluted income (loss) per common share:			
Income (loss) from continuing operations	\$ .21	\$ (.58)	\$ .10
Gain (loss) from discontinued operations	--	.05	(.22)
	-----	-----	-----
Net income (loss) per share .....	\$ .21	\$ (.53)	\$ (.12)
	=====	=====	=====

See notes to consolidated financial statements.

19

MORGAN'S FOODS, INC.  
CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY (DEFICIT)  
YEARS ENDED MARCH 3, 2002, FEBRUARY 25, 2001 AND FEBRUARY 27, 2000

	COMMON SHARES		TREASURY SHARES	
	SHARES	AMOUNT	SHARES	AMOUNT
	-----	-----	-----	-----
Balance, February 28, 1999 .	2,969,405	\$ 30,000	(58,566)	\$ (139,000)
Net loss .....	--	--	--	--
Issue of treasury shares for 401(k) contributions .....	--	--	11,888	28,000
	-----	-----	-----	-----
Balance, February 27, 2000 .	2,969,405	30,000	(46,678)	(111,000)
Net loss .....	--	--	--	--
Issue of treasury shares for 401(k) contributions .....	--	--	14,845	35,000
	-----	-----	-----	-----

Edgar Filing: MORGANS FOODS INC - Form 10-K

Balance, February 25, 2001 .	2,969,405	30,000	(31,833)	(76,000)
Net income .....	--	--	--	--
Issue of treasury shares for 401(k) contributions .....	--	--	31,833	76,000
Purchase of common shares ..	--	--	(241,564)	(251,000)
	-----	-----	-----	-----
Balance, March 3, 2002 .....	2,969,405	\$ 30,000	(241,564)	\$ (251,000)
	=====	=====	=====	=====

	CAPITAL IN EXCESS OF STATED VALUE	ACCUMULATED DEFICIT	TOTAL SHAREHOLDERS' EQUITY (DEFICIT)
	-----	-----	-----
Balance, February 28, 1999 .	\$ 28,875,000	\$ (27,518,000)	\$ 1,248,000
Net loss .....	--	(346,000)	(346,000)
Issue of treasury shares for 401(k) contributions .....	--	--	28,000
	-----	-----	-----
Balance, February 27, 2000 .	28,875,000	(27,864,000)	930,000
Net loss .....	--	(1,543,000)	(1,543,000)
Issue of treasury shares for 401(k) contributions .....	--	--	35,000
	-----	-----	-----
Balance, February 25, 2001 .	28,875,000	(29,407,000)	(578,000)
Net income .....	--	602,000	602,000
Issue of treasury shares for 401(k) contributions .....	(46,000)	--	30,000
Purchase of common shares ..	--	--	(251,000)
	-----	-----	-----
Balance, March 3, 2002 .....	\$ 28,829,000	\$ (28,805,000)	\$ (197,000)
	=====	=====	=====

See notes to consolidated financial statements.

20

MORGAN'S FOODS, INC.  
CONSOLIDATED STATEMENTS OF CASH FLOWS  
YEARS ENDED MARCH 3, 2002, FEBRUARY 25, 2001 AND FEBRUARY 27, 2000

	2002	2001	2000
	-----	-----	-----
CASH FLOWS FROM OPERATING ACTIVITIES:			
Net income (loss) .....	\$ 602,000	\$ (1,543,000)	\$ (3,866,000)
Adjustments to reconcile to net cash provided by operating activities:			
Depreciation and amortization .....	3,866,000	3,817,000	2,600,000
Amortization of deferred			

Edgar Filing: MORGANS FOODS INC - Form 10-K

financing costs .....	143,000	145,000	1
Amortization of supply agreement			
advances (Note 1) .....	(697,000)	(198,000)	
Funding from supply agreements (Note 1) .....	756,000	1,194,000	
Loss on restaurant assets .....	215,000	597,000	2
Changes in assets and liabilities:			
Decrease (Increase) in receivables .....	(154,000)	34,000	(
Decrease (Increase) in inventories .....	(32,000)	95,000	(2
Decrease (Increase) in prepaid expenses .....	(79,000)	135,000	(1
Increase in other assets .....	(44,000)	(18,000)	(8
Increase (Decrease) in accounts payable .....	171,000	(499,000)	2,0
Increase in accrued liabilities .....	322,000	329,000	1,3
	-----	-----	-----
Net cash provided by operating activities .....	5,069,000	4,088,000	4,7
	-----	-----	-----
CASH FLOWS FROM INVESTING ACTIVITIES:			
Proceeds from sale of restaurant assets .....	--	1,000	3,7
Capital expenditures .....	(883,000)	(3,144,000)	(28,7
Purchase of franchise agreements and			
acquired franchise rights .....	(10,000)	(173,000)	(12,4
Proceeds from sale of liquor licenses .....	--	33,000	1
	-----	-----	-----
Net cash used in investing activities .....	(893,000)	(3,283,000)	(37,4
	-----	-----	-----
CASH FLOWS FROM FINANCING ACTIVITIES:			
Proceeds from issuance of long-term debt,			
net of financing costs .....	36,000	3,254,000	39,1
Principal payments on long-term debt .....	(2,264,000)	(1,862,000)	(1,0
Principal payments on capital			
lease obligations .....	(96,000)	(136,000)	(3
Purchase of treasury shares .....	(251,000)	--	
Payments on capital lease obligations in			
advance of scheduled maturity .....	--	(833,000)	(3,0
	-----	-----	-----
Net cash (used in) provided by			
financing activities .....	(2,575,000)	423,000	34,6
	-----	-----	-----
Net change in cash and equivalents .....	1,601,000	1,228,000	1,9
Cash and equivalents, beginning balance .....	5,840,000	4,612,000	2,6
	-----	-----	-----
Cash and equivalents, ending balance .....	\$ 7,441,000	\$ 5,840,000	\$ 4,6
	=====	=====	=====
Noncash investing and financing activities:			
Capital leases .....	\$ --	\$ --	\$ 4
	=====	=====	=====

See notes to consolidated financial statements.

## Edgar Filing: MORGANS FOODS INC - Form 10-K

MARCH 3, 2002, FEBRUARY 25, 2001 AND FEBRUARY 27, 2000

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

**DESCRIPTION OF BUSINESS.** Morgan's Foods, Inc. and its subsidiaries ("the Company") operate 76 KFC restaurants, 7 Taco Bell restaurants, 16 KFC/Taco Bell "2n1" restaurants, 3 Taco Bell/Pizza Hut Express "2n1" restaurants and 1 KFC/Pizza Hut Express "2n1", in the states of Illinois, Missouri, Ohio, Pennsylvania, West Virginia and New York. The Company formerly operated six East Side Mario's ("ESM") restaurants. The Company's fiscal year is a 52-53 week year ending on the Sunday nearest the last day of February.

**USE OF ESTIMATES.** The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions pending completion of related events such as the recoverability of tangible and intangible asset values, projected compliance with covenants of financing agreements and the realization of the net deferred tax asset. 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. Certain prior year amounts have been reclassified to conform to their current year presentation.

**CASH AND EQUIVALENTS.** The Company considers all highly liquid debt instruments purchased with an initial maturity of three months or less to be cash equivalents.

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

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

Management evaluates the net carrying value of property and equipment periodically in light of both the estimated future cash flows resulting from the use of the assets as well as the estimated liquidation value of such assets. Management believes the carrying value of property and equipment at March 3, 2002 will be recovered from future cash flows.

**DEFERRED FINANCING COSTS.** Costs related to the acquisition of long-term debt are capitalized and expensed as interest over the term of the related debt. Amortization expense was \$143,000, \$145,000 and

## Edgar Filing: MORGANS FOODS INC - Form 10-K

MARCH 3, 2002, FEBRUARY 25, 2001 AND FEBRUARY 27, 2000

\$106,000 for fiscal years 2002, 2001 and 2000, respectively. The balance of deferred financing costs was \$1,261,000 at March 3, 2002 and \$1,405,000 at February 25, 2001 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. Amortization expense was \$132,000, \$129,000 and \$100,000 for fiscal years 2002, 2001 and 2000, respectively. Accumulated amortization was \$395,000 at March 3, 2002 and \$263,000 at February 25, 2001, respectively.

**ACQUIRED FRANCHISE RIGHTS.** Acquired franchise rights are amortized over the life of the franchise agreement on a straight-line basis. Amortization expense was \$539,000, \$538,000 and \$314,000 for fiscal 2002, 2001 and 2000, respectively. Accumulated amortization was \$1,391,000 at March 3, 2002 and \$852,000 at February 25, 2001. Management evaluates the carrying amount of acquired franchise rights periodically based upon past and projected cash flows from operations and the estimated fair value of related assets and believes the carrying value of the acquired franchise rights at March 3, 2002 will be recovered from future cash flows.

**ADVANCE ON SUPPLY AGREEMENTS.** 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 \$1,200,000 and \$996,000 at March 3, 2002 and February 25, 2001, respectively, are included in other long-term liabilities in the Consolidated Balance Sheets.

**LEASE ACCOUNTING.** Operating lease expense is recognized on the straight-line basis over the term of the lease for those leases with fixed escalations. These accruals of \$337,000 and \$357,000 at March 3, 2002 and February 27, 2001, respectively, are included in other long-term liabilities in the Consolidated Balance Sheets.

**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. A deferred tax asset is recorded for the benefits of future deductible temporary differences and 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.

**STOCK-BASED COMPENSATION.** The Company's outstanding stock options are accounted for using the intrinsic value method, under which compensation cost is measured as the excess, if any, of the quoted market price of the stock at the grant date over the amount an employee must pay to acquire the stock.

## Edgar Filing: MORGANS FOODS INC - Form 10-K

### NOTE 2. ACQUISITION AND DISPOSAL OF RESTAURANTS AND ASSETS.

On December 9, 1999 the Company sold four of the remaining five former East Side Mario's restaurant locations and recognized no gain or loss on this transaction. The Company sold the one remaining former East Side Mario's location and the liquor license and equipment during the third and fourth quarters of fiscal 2001 and recorded a gain on the disposal of the remaining assets of \$150,000. The cash received as a result of these transactions was used to pay off the capital lease obligations and other expenses of the transactions. The results of operations of the discontinued segment are shown in the Consolidated Statements of Operations as "Gain (loss) from discontinued operations". There is no tax effect of the gain (loss). The East Side Mario's restaurants formerly operated by the Company began in March 1993 and encompassed six locations by April 1995. Comparable restaurant revenues for the East Side Mario's segment had declined since fiscal 1996.

The results of operations for the East Side Mario's segment, reported separately as a loss from discontinued operations in the Consolidated Statement of Operations, are as follows:

	FIFTY-TWO WEEKS ENDED FEBRUARY 27, 2000 -----
Revenues.....	\$4,574,000 =====
Loss from operations of discontinued East Side Mario's restaurants.....	\$ (629,000) =====

In fiscal 2002 and 2001 there were no operations for the East Side Mario's segment.

On July 14, 1999 Morgan's Restaurants of Pennsylvania, Inc., Morgan's Restaurants of Ohio, Inc., Morgan's Restaurants of West Virginia, Inc. and Morgan's Foods of Missouri, Inc., all wholly owned subsidiaries of Morgan's Foods, Inc., acquired the assets of 54 existing KFC and Taco Bell restaurants and the land and building of a non-operating KFC restaurant from various subsidiaries of Tricon Global Restaurants, Inc. for cash in the amount of \$33,740,000. The acquisition was accounted for as a purchase and, accordingly, assets were recorded at fair value, and the operating results of these restaurants are included in the Company's consolidated financial statements from the date of acquisition.

### NOTE 3. LOSS ON RESTAURANT ASSETS.

During fiscal 2002, 2001 and 2000, the Company recognized losses totaling \$215,000, \$597,000 and \$213,000, respectively, from the sale or disposal of restaurant assets and the closing of unprofitable restaurants. These restaurants did not have a material effect upon the Company's consolidated results of operations or financial position.



# Edgar Filing: MORGANS FOODS INC - Form 10-K

MORGAN'S FOODS, INC.  
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
 MARCH 3, 2002, FEBRUARY 25, 2001 AND FEBRUARY 27, 2000

NOTE 4. ACCRUED LIABILITIES.

Accrued liabilities consist of the following at March 3, 2002 and February 25, 2001:

	2002	2001
	-----	-----
Accrued compensation .....	\$1,740,000	\$1,253,000
Accrued taxes other than income taxes .....	793,000	752,000
Accrued liabilities related to sold restaurants ..	274,000	293,000
Other accrued expenses .....	802,000	1,024,000
	-----	-----
	\$3,609,000	\$3,322,000
	=====	=====

NOTE 5. LONG-TERM DEBT

Long-term debt consists of the following at March 3, 2002 and February 25, 2001:

	2002
	-----
Mortgage debt, monthly payments of \$531,000 including interest at 8.3% to 10.6%, through 2021, collateralized by seventy-five restaurants having a net book value at March 3, 2002 of \$26,023,000 .....	\$48,264,000
Equipment loans, monthly payments of \$51,000 including interest at 10.1% to 11.0% through February 2007 collateralized by equipment at several KFC restaurants .....	2,379,000
Note payable at 8%, monthly interest payments of \$1,623 from October 2001 to June 2002.	
Monthly payments of \$7,627, including interest, from August 2002 to July 2005 ..	243,000
Note payable, monthly payments of \$500 including interest at 9.0%, through October 2003 .....	8,000
	-----
	50,894,000
Less current maturities .....	2,331,000
	-----
	\$48,563,000
	=====

The accompanying financial statements have been prepared on a going concern basis, which contemplates the realization of assets and the satisfaction of liabilities in the normal course of business. As noted above the Company has significant borrowings which require compliance with various terms and conditions including compliance with certain financial ratios, specifically a consolidated fixed charge coverage ratio of 1.2 to 1 regarding all of its

Edgar Filing: MORGANS FOODS INC - Form 10-K

mortgage loans and individual restaurant coverage ratios of 1.4 to 1 on certain of its loans. The Company was in compliance with the consolidated ratio of 1.2 applicable to its loans. As of March 3, 2002 the Company was not in compliance with the 1.4 to 1.0 unit level ratio on certain of its restaurants but has obtained waivers of these violations from the applicable lender. Management expects to be in compliance with all financial covenants in future periods, or to obtain amendments or waivers of any covenants. Management believes that operating cash flow will provide sufficient capital to continue to operate and maintain the KFC, Taco Bell and "2n1" restaurants, service the Company's debt and support required corporate expenses.

25

MORGAN'S FOODS, INC.  
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
 MARCH 3, 2002, FEBRUARY 25, 2001 AND FEBRUARY 27, 2000

The Company paid interest relating to long-term debt of approximately \$5,334,000, \$4,944,000 and \$3,169,000 in fiscal 2002, 2001 and 2000, respectively.

NOTE 6. LEASE OBLIGATIONS AND OTHER COMMITMENTS.

Property under capital leases at March 3, 2002 and February 25, 2001 are as follows:

	2002	2001
	-----	-----
Leased property:		
Buildings .....	\$ 435,000	\$ 435,000
Equipment, furniture and fixtures .....	571,000	571,000
	-----	-----
Total .....	1,006,000	1,006,000
Less accumulated amortization .....	406,000	301,000
	-----	-----
	\$ 600,000	\$ 705,000
	=====	=====

Amortization of leased property under capital leases was \$105,000, \$112,000 and \$119,000 in fiscal 2002, 2001 and 2000, respectively.

Related obligations under capital leases at March 3, 2002 and February 25, 2001 are as follows:

	2002	2001
	-----	-----
Capital lease obligations .....	\$649,000	\$745,000
Less current maturities .....	105,000	94,000
	-----	-----
Long-term capital lease obligations .....	\$544,000	\$651,000
	=====	=====

Edgar Filing: MORGANS FOODS INC - Form 10-K

The Company paid interest of approximately \$72,000, \$81,000 and \$92,000 relating to capital lease obligations in fiscal 2002, 2001 and 2000, respectively.

Future minimum rental payments to be made under capital leases at March 3, 2002 are as follows:

2003.....	\$	165,000
2004.....		157,000
2005.....		98,000
2006.....		50,000
2007.....		50,000
Later years		613,000
		-----
		1,133,000
Less amount representing interest at 9.5% to 13.0% .....		484,000
		-----
Total obligations under capital leases.....	\$	649,000
		=====

26

MORGAN'S FOODS, INC.  
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
 MARCH 3, 2002, FEBRUARY 25, 2001 AND FEBRUARY 27, 2000

The Company's operating leases for restaurant land and buildings are noncancellable and expire on various dates through 2019. The leases have renewal options ranging from 1 to 17 years. Certain restaurant land and building leases require the payment of additional rent equal to an amount by which a percentage of annual sales exceeds annual minimum rentals. Total contingent rentals were \$64,000, \$58,000 and \$82,000 in fiscal 2002, 2001 and 2000, respectively. Future noncancellable minimum rental payments under operating leases at March 3, 2002, are as follows: 2003 - \$2,021,000; 2004 - \$1,916,000; 2005 - \$1,735,000; 2006 - \$1,454,000; 2007 - \$1,260,000 and an aggregate \$6,674,000 for the years thereafter. Rental expense for all operating leases was \$2,188,000, \$2,465,000 and \$1,824,000 for fiscal 2002, 2001 and 2000, respectively.

For KFC products, the Company is required to pay royalties of 4% of gross revenues and to expend an additional 5% of gross revenues on national and local advertising pursuant to its franchise agreements. For Taco Bell products in KFC/Taco "2n1" restaurants operated under license agreements from Taco Bell Corporation and franchise agreements from KFC Corporation, the Company is required to pay royalties of 10% of Taco Bell gross revenues and to make advertising fund contributions of 1/2% of Taco Bell gross revenue. For Taco Bell product sales in restaurants operated under Taco Bell franchises the Company is required to pay royalties of 5.5% of gross revenues and to expend an additional 4.5% of gross revenues on national and local advertising. For Pizza Hut products in Taco Bell/Pizza Hut Express "2n1" restaurants the Company is required to pay royalties of 5.5% of Pizza Hut gross revenues and to expend an additional 4.5% of Pizza Hut gross revenues on national and local advertising. Total royalties and advertising which are included in the Statements of Operations as part of restaurant operating expenses were \$8,514,000, \$7,677,000 and \$6,297,000 in

## Edgar Filing: MORGANS FOODS INC - Form 10-K

fiscal 2002, 2001 and 2000 respectively.

In fiscal year 2000 the Company signed an agreement which granted it the rights to develop 20 KFC, Taco Bell or KFC "2n1" restaurants in specific geographic areas. Under the agreement five restaurants are required to be developed each year over a four year period. As of March 3, 2002 the Company has developed 5 restaurants under this agreement and as such is not currently in compliance with this agreement but does not believe that this will have a material impact on its financial position, results of operations or cash flows.

### 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 2,851,160, 2,931,227 and 2,912,894 for fiscal 2002, 2001 and 2000, respectively. Diluted net income (loss) per common share is based on the combined weighted average number of shares outstanding during the period which totaled 2,853,789, 2,931,227 and 2,912,894 for fiscal 2002, 2001 and 2000, respectively, which includes the assumed exercise, or conversion of 11,500 options for 2002. For fiscal years 2002, 2001 and 2000, 275,000 options were excluded from the computation of diluted earnings per share due to their antidilutive effect. In computing diluted net income (loss) per common share, the Company has utilized the treasury stock method.

27

MORGAN'S FOODS, INC.  
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
 MARCH 3, 2002, FEBRUARY 25, 2001 AND FEBRUARY 27, 2000

### NOTE 8. INCOME TAXES.

The current tax provision (benefit) consists of state and local taxes for fiscal 2002, 2001 and 2000 of \$4,000, \$23,000 and \$4,000, respectively. There was no deferred provision for income taxes during each of the fiscal years 2002, 2001 and 2000. There was no provision for income taxes from discontinued operations.

A reconciliation between the provision for income taxes and income taxes calculated at the statutory tax rate of 35% is as follows:

	2002	2001	2000
	-----	-----	-----
Tax provision (benefit)			
at statutory rate .....	\$ 212,000	\$ (532,000)	\$ (119,000)
State and local taxes, net of federal benefit .....	2,000	15,000	3,000
Utilization of net operating loss carryforwards .....	(212,000)		
Losses and temporary differences with no tax benefit .....	(3,000)	512,000	108,000
Other .....	5,000	28,000	12,000
	-----	-----	-----
	\$ 4,000	\$ 23,000	\$ 4,000

Edgar Filing: MORGANS FOODS INC - Form 10-K

=====

The components of deferred tax assets (liabilities) at March 3, 2002 and February 25, 2001 are as follows:

	2002	2001
	-----	-----
Operating loss carryforwards .....	\$ 2,932,000	\$ 3,300,000
Tax credit carryforwards .....	56,000	56,000
Property and equipment .....	1,547,000	1,254,000
Accrued expenses not currently deductible ....	366,000	311,000
Inventory valuation .....	5,000	5,000
Intangible assets .....	(225,000)	(143,000)
Deferred tax asset valuation allowance .....	(4,081,000)	(4,183,000)
	-----	-----
Net deferred tax asset .....	\$ 600,000	\$ 600,000
	=====	=====

The valuation allowance decreased \$102,000, \$1,049,000 and \$1,696,000 during fiscal 2002, 2001 and 2000, respectively, due to decreases in deferred tax assets, principally due to expiration or utilization of operating loss carryforwards.

At March 3, 2002, the Company has net operating loss carryforwards which, if not utilized, will expire as follows:

2005 .....	\$2,112,000
2008 .....	90,000
2009 .....	987,000
2012 .....	744,000
2013 .....	728,000
2019.....	268,000
2020.....	1,312,000
2021.....	1,090,000
	-----
Total .....	\$7,331,000
	=====

MORGAN'S FOODS, INC.  
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
 MARCH 3, 2002, FEBRUARY 25, 2001 AND FEBRUARY 27, 2000

The Company also has alternative minimum tax net operating loss carryforwards of \$5,296,000 which will expire, if not utilized, in varying amounts through fiscal 2021. Under the Job Creation and Worker Assistance Act of 2002, these carryforwards are available to offset up to 100% of any alternative minimum taxable income which would otherwise be taxable beginning with tax year ended March 3, 2002. As of March 3, 2002, the Company has alternative minimum tax credit carryforwards of \$56,000.

## Edgar Filing: MORGANS FOODS INC - Form 10-K

### 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 the 145,500 shares were granted to executives and managers of the Company on April 2, 1999 at an exercise price of \$4 1/8. As of March 3, 2002 the closing price of the Company's stock was \$2.15 per share. The plan provides that the options are exercisable after a waiting period of 6 months and that each option expires 10 years after its date of issue.

At the Company's annual meeting on June 25, 1999 the shareholders approved the Key Employees Stock Option Plan. This plan allows the granting of options covering 291,000 shares of stock and has essentially the same provisions as the Stock Option Plan for Executives and Managers which was discussed above. Options for 129,850 shares were granted to executives and managers of the Company on January 7, 2000 at an exercise price of \$3.00.

The Company applies APB No. 25 and related interpretations in accounting for its option grants for employees. Accordingly, no compensation cost has been recognized for options granted as the Company believes options were granted at fair market value at the date of grant. Had compensation cost for the options granted been determined based on the fair value at the grant dates for the awards under that plan consistent with the method of SFAS No. 123, Accounting for Stock-Based Compensation, the Company's net income (loss) and earnings (loss) per share would have been presented at the pro forma amounts indicated below:

		2002 -----	2001 -----	2000 -----
Net income (loss)	Pro forma	\$596,000	\$ (1,680,000)	\$ (774,000)
	As reported	602,000	(1,543,000)	(346,000)
Basic and diluted income (loss) per share	Pro forma	.21	(.57)	(.53)
	As reported	.21	(.53)	(.53)

In determining the pro forma amount of stock-based compensation on a basis consistent with SFAS No. 123, the fair value of each grant is estimated on the date of grant using the Black-Scholes option pricing model with the following weighted average assumptions used for grants in fiscal 2002: no dividend yield; expected volatility of 251%; risk free interest rate of 5.34%; and expected life of 10 years.

## Edgar Filing: MORGANS FOODS INC - Form 10-K

A summary of the status of the Company's options as of March 3, 2002, February 25, 2001, and February 2000, respectively; and changes during the years then ended is presented below:

	2002		2001		2000	
	Shares	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price
Outstanding at beginning of year	275,000	\$ 3.59	275,000	\$ 3.59	24,166	\$ 11.66
Granted	11,500	\$ 0.85			275,350	\$ 3.59
Forfeited					(24,516)	\$ 11.56
Outstanding at year-end	286,500	\$ 3.48	275,000	\$ 3.59	275,000	\$ 3.59
Options exercisable at year-end	286,500	\$ 3.48	275,000	\$ 3.59	145,150	\$ 4.13

The following table summarizes information about stock options outstanding at March 3, 2002.

Exercise Prices	Number Outstanding at 3/3/02	Average Remaining Life	Number Exercisable at 3/3/02
\$0.85	11,500	8.9	11,500
\$3.00	129,850	7.9	129,850
\$4.13	145,150	7.1	145,150
	286,500	7.5	286,500

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. The Rights will expire on April 7, 2009, 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

## Edgar Filing: MORGANS FOODS INC - Form 10-K

from the Common Shares if a person or group 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

30

MORGAN'S FOODS, INC.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
MARCH 3, 2002, FEBRUARY 25, 2001 AND FEBRUARY 27, 2000

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.

The dividend distribution was made on May 12, 1999, payable to shareholders of record on that date. The initial distribution of Rights is not taxable to shareholders.

The Company is currently not in full compliance with the American Stock Exchange financial condition guidelines for continued listing. Specifically, the guidelines indicate that any company with shareholders' equity less than \$4,000,000 and losses in 3 of its last 4 fiscal years may be considered for delisting. This condition has been reviewed with representatives of the American Stock Exchange who indicated that the Company's performance would continue to be monitored by the Exchange.

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 matches a percentage of employee contributions. During fiscal 2002, 2001 and 2000, the Company incurred \$73,000, \$64,000 and \$62,000, respectively, in expenses for matching contributions to the plan.

NOTE 11. FAIR VALUE OF FINANCIAL INSTRUMENTS.

Management believes that the fair value of the Company's debt at March 3, 2002 approximates carrying value, based upon interest rates obtained in recent financing transactions.

NOTE 12. NEW ACCOUNTING STANDARDS.

In June 2001, the FASB issued SFAS No. 141, Business Combinations. SFAS No. 141 requires that the purchase method of accounting be used for all business combinations initiated after June 30, 2001. As specified therein, intangible



## Edgar Filing: MORGANS FOODS INC - Form 10-K

assets acquired that are obtained through contractual or legal right, or are capable of being separately sold, transferred, licensed, rented or exchanged are recognized as assets apart from goodwill. SFAS No. 141 is effective for all acquisitions subsequent to June 30, 2001.

In June 2001, the FASB issued SFAS No. 142, Goodwill and Other Intangible Assets. SFAS No. 142 changes the accounting for goodwill and certain intangible assets from an amortization method to an impairment only approach. Goodwill and intangibles with indefinite lives are no longer subject to amortization, but are subject to at least an annual assessment for impairment by applying a fair value based test. The Company is required to implement SFAS No. 142 for its fiscal year beginning March 4, 2002 and has not yet completed its analysis of the effects of adopting this statement.

31

MORGAN'S FOODS, INC.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
MARCH 3, 2002, FEBRUARY 25, 2001 AND FEBRUARY 27, 2000

In June 2001, the FASB issued SFAS No. 143, Accounting for Asset Retirement Obligations, which addresses financial accounting and reporting for obligations associated with the retirement of tangible long-lived assets and associated asset retirement costs. The new rules apply to legal obligations associated with the retirement of long-lived assets that result from the acquisition, construction, development and/or normal operation of a long-lived assets that result from the acquisition, construction, development and/or normal operation of a long-lived asset. SFAS No. 143 is effective for the Company beginning in fiscal 2003. The Company believes, at this time, that the adoption of SFAS No. 143 will not have a material impact on its consolidated financial position or results of operations.

In August 2001, the FASB issued SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets. SFAS No. 144 supersedes SFAS No. 121, Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of, and the accounting and reporting provisions of Accounting Principles Board Opinion ("APB") No. 30, Reporting the Results of Operations - Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions, for the disposal of a segment of a business (as previously defined in that opinion). SFAS No. 144 requires that one accounting model be used for long-lived assets to be disposed of by sale, whether previously held and used or newly acquired and broadens the presentation of discontinued operations to include more disposal transactions than were included under the previous standards. The Company will adopt SFAS No. 144 beginning in fiscal 2003, as required; however, adoption of the statement is not expected to have a material impact on its consolidated financial position or results of operations.

NOTE 13. SELECTED QUARTERLY FINANCIAL DATA (UNAUDITED).

FISCAL 2002 QUARTER ENDED		
MAY 20, 2001	AUGUST 12, 2001	NOVEMBER 4, 2001
-----	-----	-----

Edgar Filing: MORGANS FOODS INC - Form 10-K

Revenues.....	\$18,607,000	\$19,939,000	\$20,418,000
Operating costs and expenses, net.....	17,505,000	18,348,000	18,709,000
Operating income.....	1,102,000	1,591,000	1,709,000
Net income (loss).....	(65,000)	435,000	552,000
Basic and diluted net income (loss) per share.....	(.02)	.15	.20

	FISCAL 2001 QUARTER ENDED		
	MAY 21, 2000	AUGUST 13, 2000	NOVEMBER 5, 2000
Revenues.....	\$17,566,000	\$19,282,000	\$18,719,000
Operating costs and expenses, net.....	16,859,000	18,035,000	18,248,000
Operating income.....	707,000	1,247,000	471,000
Income (loss) from continuing operations.....	(442,000)	105,000	(675,000)
Gain from discontinued operations.....	-	-	137,000
Net income (loss).....	(442,000)	105,000	(538,000)
Net income (loss) per share.....	(.15)	.04	(.18)

32

MORGAN'S FOODS, INC.  
INDEX TO EXHIBITS  
ITEM 14 (A) (3)

Exhibit Number	Exhibit Description
3.1	Amended Articles of Incorporation, as amended (1)
3.2	Amended Code of Regulations (1)
4.1	Specimen Certificate for Common Shares (2)
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)
10.5	Asset Purchase Agreements with Taco Bell Corp. and KFC Corporation and their Various Affiliated Companies (6)
10.6	Form of Mortgage Loan Agreement with Captec Financial Group, Inc. (7)
19	Form of Indemnification Contract between Registrant and its Officers and Directors (5)

Edgar Filing: MORGANS FOODS INC - Form 10-K

21 Subsidiaries  
23 Independent Auditors' Consent

- (1) Filed as an exhibit to Registrant's Form 10-K for the 1992 fiscal year and incorporated herein by reference.
- (2) Filed as an exhibit to the Registrant's Registration Statement (No. 33-35772) on Form S-2 and incorporated herein by reference.
- (3) Filed as an exhibit to the Registrant's 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 Registrant's Form 8-KA filed September 27, 1999 and incorporated herein by reference.
- (7) Filed as an exhibit to the Registrant's Form 10-K for the 1996 fiscal year and incorporated herein by reference.

33

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, 2002

/s/ Leonard R. Stein-Sapir

By: 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.

/s/ Leonard R. Stein-Sapir

/s/ Lawrence S. Dolin

By: Leonard R. Stein-Sapir  
Chairman of the Board,

By: Lawrence S. Dolin  
Director

Edgar Filing: MORGANS FOODS INC - Form 10-K

Chief Executive Officer & Director  
Dated: May 31, 2002

Dated: May 31, 2002

/s/ James J. Liguori  
-----

By: James J. Liguori  
Director, President &  
Chief Operating Officer  
Dated: May 31, 2002

/s/ Steven S. Kaufman  
-----

By: Steven S. Kaufman  
Director  
Dated: May 31, 2002

/s/ Kenneth L. Hignett  
-----

By: Kenneth L. Hignett  
Director, Senior Vice President,  
Chief Financial Officer & Secretary  
Dated: May 31, 2002

/s/ Richard A. Arons  
-----

By: Richard A. Arons  
Director  
Dated: May 31, 2002

/s/ BERNARD LERNER  
-----

By: Bernard Lerner  
Director  
Dated: May 31, 2002