

MORGANS FOODS INC
Form 10-Q
December 21, 2011

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, DC 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended November 6, 2011

or

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

For the transition period from _____ to _____

Commission File Number 1-08395

Morgan's Foods, Inc.

(Exact name of registrant as specified in its charter)

Ohio
(State or other jurisdiction of incorporation or organization)

34-0562210
(I.R.S. Employer Identification No.)

4829 Galaxy Parkway, Suite S, Cleveland, Ohio
(Address of principal executive offices)

44128
(Zip Code)

(216) 359-9000

(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15 (d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark whether the registrant 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 No

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

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

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

As of December 16, 2011, the issuer had 2,934,995 common shares outstanding.

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PART I – FINANCIAL INFORMATION

Item 1. Financial Statements

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

| | Quarter Ended | |
|---|---------------------|---------------------|
| | November 6, 2011 | November 7, 2010 |
| Revenues | \$19,278,000 | \$21,257,000 |
| Cost of sales: | | |
| Food, paper and beverage | 6,285,000 | 6,718,000 |
| Labor and benefits | 5,540,000 | 6,330,000 |
| Restaurant operating expenses | 5,011,000 | 5,663,000 |
| Depreciation and amortization | 610,000 | 571,000 |
| General and administrative expenses | 1,259,000 | 1,316,000 |
| Loss on restaurant assets | 267,000 | 39,000 |
| Operating income | 306,000 | 620,000 |
| Interest expense: | | |
| Prepayment and deferred financing costs | - | - |
| Bank debt and notes payable | 440,000 | 516,000 |
| Capital leases | 23,000 | 24,000 |
| Other income and expense, net | (141,000) | (63,000) |
| Income (loss) before income taxes | (16,000) | 143,000 |
| Provision for income taxes | 77,000 | 197,000 |
| Net loss | \$(93,000) | \$(54,000) |
| Basic net loss per common share: | \$(0.03) | \$(0.02) |
| Diluted net loss per common share: | \$(0.03) | \$(0.02) |
| Basic weighted average number of shares outstanding | 2,934,995 | 2,934,995 |
| Diluted weighted average number of shares outstanding | 2,934,995 | 2,934,995 |

See notes to these consolidated financial statements.

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

| | Thirty-six Weeks Ended | |
|---|------------------------|---------------------|
| | November 6, 2011 | November 7, 2010 |
| Revenues | \$58,353,000 | \$65,100,000 |
| Cost of sales: | | |
| Food, paper and beverage | 19,386,000 | 20,203,000 |
| Labor and benefits | 16,768,000 | 18,967,000 |
| Restaurant operating expenses | 14,971,000 | 17,122,000 |
| Depreciation and amortization | 1,800,000 | 1,866,000 |
| General and administrative expenses | 3,732,000 | 3,889,000 |
| Loss on restaurant assets | 626,000 | 138,000 |
| Operating income | 1,070,000 | 2,915,000 |
| Interest expense: | | |
| Prepayment and deferred financing costs | 33,000 | 98,000 |
| Bank debt and notes payable | 1,354,000 | 1,611,000 |
| Capital leases | 69,000 | 72,000 |
| Other income and expense, net | (137,000) | 9,000 |
| Income (loss) before income taxes | (249,000) | 1,125,000 |
| Provision for income taxes | 318,000 | 441,000 |
| Net income (loss) | \$(567,000) | \$684,000 |
| Basic net income (loss) per common share: | \$(0.19) | \$0.23 |
| Diluted net income (loss) per common share: | \$(0.19) | \$0.23 |
| Basic weighted average number of shares outstanding | 2,934,995 | 2,934,995 |
| Diluted weighted average number of shares outstanding | 2,934,995 | 3,023,611 |

See notes to these consolidated financial statements

MORGAN'S FOODS, INC.
CONSOLIDATED BALANCE SHEET

| | November 6, 2011 (UNAUDITED) | February 27, 2011 |
|---|------------------------------------|----------------------|
| ASSETS | | |
| Current assets: | | |
| Cash and equivalents | \$ 2,010,000 | \$3,034,000 |
| Restricted cash | - | 140,000 |
| Receivables | 474,000 | 561,000 |
| Inventories | 686,000 | 715,000 |
| Prepaid expenses | 780,000 | 799,000 |
| Deferred tax asset | - | 2,000 |
| Assets held for sale | 1,206,000 | 545,000 |
| Total current assets | 5,156,000 | 5,796,000 |
| Property and equipment: | | |
| Land | 7,832,000 | 8,677,000 |
| Buildings and improvements | 17,057,000 | 18,861,000 |
| Property under capital leases | 1,298,000 | 1,314,000 |
| Leasehold improvements | 10,039,000 | 9,502,000 |
| Equipment, furniture and fixtures | 18,293,000 | 19,128,000 |
| Construction in progress | 11,000 | 19,000 |
| Total property and equipment | 54,530,000 | 57,501,000 |
| Less accumulated depreciation and amortization | 28,546,000 | 29,663,000 |
| Net book value of property and equipment | 25,984,000 | 27,838,000 |
| Other assets | | |
| Other assets | 343,000 | 410,000 |
| Franchise agreements, net | 854,000 | 906,000 |
| Goodwill | 9,072,000 | 9,138,000 |
| Total assets | \$ 41,409,000 | \$44,088,000 |
| LIABILITIES AND SHAREHOLDERS' EQUITY | | |
| Current liabilities: | | |
| Long-term debt, current | \$ 25,891,000 | \$27,049,000 |
| Current maturities of capital lease obligations | 49,000 | 48,000 |
| Accounts payable | 3,405,000 | 4,331,000 |
| Accrued liabilities | 3,813,000 | 4,138,000 |
| Total current liabilities | 33,158,000 | 35,566,000 |
| Long-term debt | | |
| Long-term debt | - | - |
| Long-term capital lease obligations | 978,000 | 1,013,000 |
| Other long-term liabilities | 4,405,000 | 4,362,000 |
| Deferred tax liabilities | 2,800,000 | 2,512,000 |
| 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) |

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| | | |
|--|---------------|---------------|
| Capital in excess of stated value | 29,488,000 | 29,488,000 |
| Accumulated deficit | (29,369,000) | (28,802,000) |
| Total shareholders' equity | 68,000 | 635,000 |
| Total liabilities & shareholders' equity | \$ 41,409,000 | \$44,088,000 |

See notes to these consolidated financial statements

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

| | Common Shares | | Treasury Shares | | Capital in | Accumulated | Total |
|------------------------------|---------------|-----------|-----------------|-------------|---------------------------|----------------|-------------------------|
| | Shares | Amount | Shares | Amount | Excess of Stated Value | Deficit | Shareholders' Equity |
| Balance February 27, 2011 | 2,969,405 | \$ 30,000 | (34,410) | \$(81,000) | \$29,488,000 | \$(28,802,000) | \$ 635,000 |
| Net loss | | | | | | (567,000) | (567,000) |
| Balance November 6, 2011 | 2,969,405 | \$ 30,000 | (34,410) | \$(81,000) | \$29,488,000 | \$(29,369,000) | \$ 68,000 |

See notes to these consolidated financial statements.

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

| | Thirty-six Weeks Ended | |
|--|------------------------|---------------------|
| | November 6, 2011 | November 7, 2010 |
| Cash flows from operating activities: | | |
| Net income (loss) | \$(567,000) | \$684,000 |
| Adjustments to reconcile to net cash provided by operating activities: | | |
| Depreciation and amortization | 1,800,000 | 1,866,000 |
| Amortization of deferred financing costs | 69,000 | 77,000 |
| Amortization of supply agreement advances | (723,000) | (840,000) |
| Funding from supply agreements | 783,000 | 803,000 |
| Deferred income taxes | 290,000 | 439,000 |
| Disposal and gains/losses on restaurant assets | 626,000 | 138,000 |
| Changes in assets and liabilities: | | |
| Use of restricted cash | 140,000 | - |
| Receivables | 48,000 | (16,000) |
| Inventories | 29,000 | (83,000) |
| Prepaid expenses | 19,000 | (60,000) |
| Other assets | (2,000) | (14,000) |
| Accounts payable | (1,169,000) | 466,000 |
| Accrued liabilities | (781,000) | 279,000 |
| Net cash provided by operating activities | 562,000 | 3,739,000 |
| Cash flows from investing activities: | | |
| Proceeds from sale of restaurant | 352,000 | 234,000 |
| Capital expenditures | (1,439,000) | (1,603,000) |
| Proceeds from sale/leaseback transactions | 717,000 | - |
| Purchase of franchise agreements | (24,000) | - |
| Net cash used in investing activities | (394,000) | (1,369,000) |
| Cash flows from financing activities: | | |
| Principal payments on long-term debt | (553,000) | (2,300,000) |
| Principal payments on capital lease obligations | (34,000) | (31,000) |
| Bank debt repayment in advance | (605,000) | (451,000) |
| Net cash used in financing activities | (1,192,000) | (2,782,000) |
| Net change in cash and equivalents | (1,024,000) | (412,000) |
| Cash and equivalents, beginning balance | 3,034,000 | 4,205,000 |
| Cash and equivalents, ending balance | \$2,010,000 | \$3,793,000 |
| Interest paid on debt and capitalized lease | \$1,534,000 | \$1,823,000 |
| Cash payments (refunds) for income taxes | \$1,000 | \$(30,000) |

See notes to these consolidated financial statements.

MORGAN'S FOODS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The interim consolidated financial statements of Morgan's Foods, Inc. (the "Company") have been prepared without audit. In the opinion of Company management, all adjustments have been included. Unless otherwise disclosed, all adjustments consist only of normal recurring adjustments necessary for a fair statement of results of operations for the interim periods. These unaudited financial statements have been prepared using the same accounting principles that were used in preparation of the Company's annual report on Form 10-K for the year ended February 27, 2011. Certain prior period amounts have been reclassified to conform to current period presentations. The results of operations for the thirty-six weeks ended November 6, 2011 are not necessarily indicative of the results to be expected for the full year. Although the Company believes that the disclosures are adequate to make the information presented not misleading, it is suggested that these condensed consolidated financial statements be read in conjunction with the audited consolidated financial statements and the notes thereto included in the Company's Form 10-K for the fiscal year ended February 27, 2011.

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 November 6, 2011.

NOTE 2 – RECENT ACCOUNTING PRONOUNCEMENTS

ASU 2011-04 May, 2011 - Topic 820 "Fair Value Measurement"

This update creates comparability in fair value measurement between GAAP and IFRS. The update enhances the disclosures required for entities presenting assets at fair value. This update is effective for interim and annual periods beginning after December 15, 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 2011-05 June, 2011 - Topic 220 "Comprehensive Income"

This update facilitates the convergence of GAAP and IFRS by eliminating certain options for presenting comprehensive income that are inconsistent with IFRS. This update is effective for interim and annual periods beginning after December 15, 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 2011-08 September, 2011 – Topic 350 "Intangibles – Goodwill and Other"

This update simplifies the previous two step process for goodwill impairment testing by allowing a qualitative analysis to determine if it is more likely than not that an impairment exists before being required to complete the two step impairment calculation. This update is effective for interim and annual periods beginning after December 15, 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.

NOTE 3 – NET INCOME (LOSS) PER COMMON SHARE

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

| | Quarter ended November 6, 2011 | | | Quarter ended November 7, 2010 | | |
|--|--------------------------------|---------------|------------------------|--------------------------------|---------------|------------------------|
| | Net income | Shares | Per Share Amount | Net income | Shares | Per Share Amount |
| | (Numerator) | (Denominator) | | (Numerator) | (Denominator) | |
| Basic EPS | | | | | | |
| Income (loss) available to common shareholders | \$ (93,000) | 2,934,995 | \$ (0.03) | \$ (53,000) | 2,934,995 | \$ (0.02) |
| Effect of Dilutive Securities | | | | | | |
| Weighted Average Stock Options | - | - | | - | - | |
| Diluted EPS | | | | | | |
| Income (loss) available to common shareholders | \$ (93,000) | 2,934,995 | \$ (0.03) | \$ (53,000) | 2,934,995 | \$ (0.02) |

| | Thirty-six weeks ended November 6, 2011 | | | Thirty-six weeks ended November 7, 2010 | | |
|--|---|---------------|------------------------|---|---------------|------------------------|
| | Net income | Shares | Per Share Amount | Net income | Shares | Per Share Amount |
| | (Numerator) | (Denominator) | | (Numerator) | (Denominator) | |
| Basic EPS | | | | | | |
| Income (loss) available to common shareholders | \$ (567,000) | 2,934,995 | \$ (0.19) | \$ 684,000 | 2,934,995 | \$ 0.23 |
| Effect of Dilutive Securities | | | | | | |
| Weighted Average Stock Options | - | - | | - | 88,616 | |
| Diluted EPS | | | | | | |
| Income (loss) available to common shareholders | \$ (567,000) | 2,934,995 | \$ (0.19) | \$ 684,000 | 3,023,611 | \$ 0.23 |

NOTE 4 – DEBT

The Company's debt arrangements require the maintenance of a consolidated fixed charge coverage ratio of 1.20 to 1 regarding all of the Company's loans and the maintenance of individual restaurant fixed charge coverage ratios of between 1.20 and 1.50 to 1 on certain of the Company's individual restaurant loans. A portion of the Company's debt also contains a funded debt to EBITDAR (earnings before interest, taxes, depreciation, amortization and rent) requirement of 5.5. Fixed charge coverage ratios are calculated by dividing the cash flow before rent and debt service for the previous 12 months by the debt service and rent due in the coming 12 months. In the calculation of funded debt to EBITDAR, funded debt is the next twelve month operating lease obligation times eight plus the debt balance at the measurement date. The funded debt is then divided by the prior twelve month EBITDAR to obtain the calculated ratio. The consolidated and individual ratios are all computed quarterly. As of November 6, 2011, the Company was not in compliance with the consolidated fixed charge coverage ratio of 1.20 or with the funded debt to EBITDAR ratio of 5.5. As of the measurement date of November 6, 2011, the Company's consolidated fixed charge

coverage ratio was 1.0 to 1 and funded debt to EBITDAR was 6.2. Also, at the end of the fiscal third quarter of 2012 the Company was not in compliance with the individual fixed charge coverage ratio on 22 of its restaurant properties including five closed locations. The Company has not obtained waivers with respect to the non-compliance from the applicable lenders at November 6, 2011, August 14, 2011, May 22, 2011 and at February 27, 2011.

The Company engaged the services of a financial advisor to renegotiate its financing arrangements and to raise replacement capital to fund its required restaurant image enhancement obligations discussed in Note 6. As disclosed previously in its public filings, in April 2011 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 its debt and in order to conserve operating cash while adjusting to the closure of twelve restaurants during April 2011. As a result of this event of default, all of the Company's debt is classified as current in the balance sheets as of November 6, 2011 and February 27, 2011 since waivers of non-compliance were not obtained. As previously disclosed in Form 8-K's, the Company was granted, by its lenders, a waiver of the prepayment penalties on substantially all of its debt that contains prepayment provisions through December 31, 2011 and forbearance on the payment of principal until December 31, 2011 for one lender and December 30, 2011 for the other, in order to pursue its plan to recapitalize its existing 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.

As of December 13, 2011, subsequent to the balance sheet date, the Company completed the refinancing of substantially all of the debt shown on the balance sheet as of November 6, 2011. The replacement financing involved the sale and leaseback of 29 restaurant properties for approximately \$22,000,000 and a new term loan in the amount of approximately \$8,250,000. The term loan has a floating interest rate based on 30 day LIBOR with a minimum rate of 9.0% and has a five year term with a 10 year amortization and principal payments beginning in the thirteenth month of the term. The term loan has graduated covenants with fixed charge coverage ratio beginning at 1.15, debt to EBITDAR of 2.75 and minimum EBITDA of \$2,500K. The Company's completion of the refinancing eliminates the forbearance agreements that had been in effect with lenders which are now paid off. The financing also required the consent of KFC Corporation, the Company's primary franchisor and the entry, by the Company into a definitive remodel agreement with KFC Corporation. See Note 8 - Subsequent Events, and Note 6 – Capital Expenditures, for further discussion of both the refinancing and the remodel agreement.

NOTE 5 - STOCK OPTIONS

On April 2, 1999, the Board of Directors of the Company approved a Stock Option Plan for Executives and Managers. Under the plan 145,500 shares were reserved for the grant of options. The Stock Option Plan for Executives and Managers provides for grants to eligible participants of nonqualified stock options only. The exercise price for any option awarded under the Plan is required to be not less than 100% of the fair market value of the shares on the date that the option is granted. Options are granted by the Stock Option Committee of the Company. Options for 145,150 shares were granted to executives and managers of the Company on April 2, 1999 at an exercise price of \$4.125, all of which have either expired or been exercised. Options for 350 common shares were granted on November 6, 2008 at the closing price on that day of \$1.50 per share all of which are currently outstanding. The options vested in six months and expire ten years after date of issue.

At the Company's annual meeting on June 25, 1999 the shareholders approved the Key Employees Stock Option Plan. This plan allows the granting of options covering 291,000 shares of stock and has essentially the same provisions as the Stock Option Plan for Executives and Managers which was discussed above. Options for 129,850 shares were granted to executives and managers of the Company on January 7, 2000 at an exercise price of \$3.00. Options for 11,500 shares were granted to executives on April 27, 2001 at an exercise price of \$.85, all of which have either expired or been exercised. Options for 149,650 common shares were granted on November 6, 2008 at the closing price on that day of \$1.50 per share of which 146,650 are currently outstanding. The options vested in six months and expire ten years after date of issue.

As of November 6, 2011, a total of 147,000 options were outstanding, fully vested and exercisable at a weighted average exercise price of \$1.50 per share. No options are available for grant.

The following table summarizes information about stock options outstanding at November 6, 2011:

| Exercise Prices | Outstanding 11-6-11 | Average Life | Number Exercisable |
|-----------------|---------------------|--------------|--------------------|
| 1.50 | 147,000 | 7.0 | 147,000 |

NOTE 6 – 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 has a deficiency which would render it unsuitable, the Company would need to relocate the restaurant to another location within the trade area to meet the franchisor's requirements.

During April 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 its report on Form 8-K filed December 15, 2011, the Company has entered into a Remodel Agreement dated December 9, 2011 with KFC Corporation covering all of its KFC and KFC branded 2 in 1 restaurants. The Remodel Agreement terminates the May 19, 2011 Pre-negotiation Agreement with KFC Corporation and also the default notices on thirteen KFC restaurants received on May 2, 2011, which were the primary subject of the Pre-negotiation Agreement.

As discussed in Note 4, in connection with the image enhancement program and negotiations, the Company had retained a financial advisor, Brookwood Associates, LLC, to evaluate alternatives for providing the capital necessary for its capital improvements. That financing was obtained and a fee of approximately \$442,500 has been paid to Brookwood by the Company. Brookwood's engagement began on November 23, 2010.

The capital requirements for the KFC branded restaurants are included in the schedule based on the requirements of the Remodel Agreement and the Taco Bell restaurants are shown at the time management believes they will be done so that all of them can comfortably be completed before the due date for the group. The Company has completed the image enhancement of three of its KFC restaurants during the second quarter of the current fiscal year. Unless otherwise indicated on the schedule, the facility is either a KFC or KFC Branded 2 in 1. The following schedule contains the capital requirements for the image enhancement of restaurants:

| Number of Units | Period | Type | Capital Cost (1) |
|-----------------|-------------|-------------|------------------|
| 1 | Fiscal 2012 | Remodels | \$ 350,000 |
| 6 | Fiscal 2013 | Remodels | 2,100,000 |
| 2 | Fiscal 2014 | Remodels | 700,000 |
| 3 | Fiscal 2014 | Relo (2) | 1,200,000 |
| | Total 2014 | | 1,900,000 |
| 4 | Fiscal 2015 | Remodels | 760,000 |
| 7 | Fiscal 2016 | Remodels | 1,330,000 |
| 4 | Fiscal 2017 | Remodels | 760,000 |
| 1 | Fiscal 2017 | Refresh (3) | 75,000 |
| 2 | Fiscal 2017 | Taco Bell | 800,000 |
| | Total 2017 | | 1,635,000 |
| 3 | Fiscal 2018 | Remodels | 570,000 |
| 1 | Fiscal 2018 | Refresh (3) | 75,000 |
| 2 | Fiscal 2018 | Taco Bell | 800,000 |
| | Total 2018 | | 1,445,000 |
| 2 | Fiscal 2019 | Remodels | 380,000 |
| 2 | Fiscal 2019 | Remodels | 320,000 |
| 2 | Fiscal 2019 | Taco Bell | 800,000 |
| | Total 2019 | | 1,500,000 |
| 7 | Fiscal 2020 | Refresh (3) | 525,000 |
| 2 | Fiscal 2020 | Taco Bell | 800,000 |
| | Total 2020 | | 1,325,000 |
| 7 | Fiscal 2021 | Refresh (3) | 525,000 |
| 7 | Fiscal 2022 | Refresh (3) | 525,000 |
| 8 | Fiscal 2023 | Refresh (3) | 600,000 |
| 1 | Fiscal 2025 | Refresh (3) | 75,000 |
| 74 | Total | | \$ 14,070,000 |

(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.

(3) Reflects the estimated cost of dining room update and exterior paint and refurbishment on restaurants previously remodeled to the current image. This is a cost that may be incurred at the time of renewal of the franchise agreement for that location.

In addition to the various facilities actions listed on the table above, the Company expects to spend approximately \$800,000 in each of the fiscal years 2013 through 2015 to install the KFC operations platform consisting of a new point of sale system and related reporting and management systems, new food holding cabinets that improve the quality of product held for sale and a new drive-thru speed of service system in all of its KFC and KFC/Taco Bell "2n1" restaurants.

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 cash flow and the Company expects that it will have to utilize financing for a portion of the capital expenditures. The Company may use both debt and sale/leaseback financing but has no commitments for either.

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

NOTE 7 – ASSET ACTIVITIES

The Company owns the land and building of eight closed KFC restaurants and the land and building adjacent to another of its restaurants, all of which are listed for sale and are shown on the Company's consolidated balance sheet as Assets Held for Sale as of November 6, 2011. Three of the locations are under contract to be sold and the Company incurred a write down of value of \$210,000 on those properties. During the third quarter of the current fiscal year, the Company sold one of its closed former KFC restaurant properties for \$350,000, the proceeds of which went to reduce the outstanding debt to one of its lenders. The sale generated a gain on the disposal of \$111,000 and a charge to goodwill related to the property of \$66,000.

On May 3, 2011 the Company completed the sale and leaseback of its KFC restaurant property in Ashtabula, Ohio. 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 were also used to fund the image enhancement of the Ashtabula, Ohio 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, Ohio 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.

Additionally, on December 9, 2011, the Company sold 29 of its restaurant properties in a sale/leaseback transaction valued at \$22.0M. See Note 8 for further discussion of this transaction.

NOTE 8 – SUBSEQUENT EVENTS

On December 9, 2011, the Company entered into a definitive Remodel Agreement with KFC Corporation covering the schedule for remodeling its KFC and KFC Branded "2n1" restaurants. The agreement outlines the schedule for remodeling certain restaurants to meet the franchisor's image requirements through the Company's 2015 fiscal year and specifies a certain number of remodel activities during each year thereafter through fiscal 2023. The Remodel Agreement also required the establishment of an escrow account in the amount of \$1,500,000 to be used only for the required remodels and the account has been established through the refinancing described below.

On December 9, 2011, the Company also entered into a Purchase and Sale Agreement and Joint Escrow Instructions with, and completed the sale of 29 restaurant properties to, DBMFI LLC, a Delaware limited liability company and an affiliate of Fortress Credit Corp., in order to lease the properties back. The sale generated gross proceeds of approximately \$22 million to the Company, less normal expenses such as title work, environmental and valuation reports, surveys, and legal fees. In connection with the sale the Company also entered into two Master Land and

Building Leases to lease the 29 properties back from DBMFI LLC under a 20 year lease with 4 five year extension options. Under the leases the Company will pay annual rent of \$2,140,000 with increases of 1.5% for each of the first five years and 10% each five years thereafter.

Simultaneously, on December 9, 2011, the Company entered into a Credit and Security Agreement with Fortress Credit Corp. which provides for a term loan in the amount of \$8,250,000 having a term of five years with payments based on a 10 year amortization and principal payments beginning in the thirteenth month. Interest on the term loan is calculated at 7.25% over 30 day LIBOR with a minimum rate of 9.0%.

The sale and leaseback arrangement and the term loan both described above, funded the advisory fee due to Brookwood Associates of approximately \$442,500 and the payoff and termination of the Company's long term debt in the amount approximately \$9,886,000 of fixed rate, securitized debt with BNY Mellon and approximately \$15,837,000 of fixed and variable rate debt from GE Capital Corp. The Company's engagement of Brookwood Associates as advisor for the financial restructuring extended from November 23, 2010 to the closing of the loan and sale/leaseback transactions on December 9, 2011. Early payment of these debt obligations caused the Company to incur approximately \$40,000 of prepayment fees and approximately \$167,000 of administrative fees.

As a direct result of the Company entering into the Remodel Agreement dated December 9, 2011 discussed above, the May 19, 2011 Pre-negotiation Agreement between the Company and KFC Corporation was terminated. Also, the thirteen default notices which were rendered to the Company on May 2, 2011 by KFC Corporation and which KFC refrained from enforcing under the Pre-negotiation Agreement and extensions thereof have also been terminated.

The Company had also entered into forbearance agreements with both BNY Mellon and GE Capital Corp. allowing the Company to defer principal payments until December 30, 2011 while the refinance program was negotiated. The payoff of the debt to both entities resulted in the termination of the forbearance agreements and no further fees are due or payable under the forbearance agreements.

The accounting for all of the aforementioned subsequent event transactions will be included in the financial statements of the Company for the fourth quarter of Fiscal 2012.

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

Description of Business. Morgan's Foods, Inc., 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 December 16, 2011, the Company operates 57 KFC restaurants, five Taco Bell restaurants, ten KFC/Taco Bell "2n1's" under franchises from KFC Corporation and franchises or licenses from Taco Bell Corporation, three Taco Bell/Pizza Hut Express "2n1's" under franchises from Taco Bell Corporation and licenses from Pizza Hut Corporation, and one KFC/A&W "2n1" operated under a franchise from KFC Corporation and a license from A&W Restaurants, Inc. The Company's fiscal year is a 52 - 53 week year ending on the Sunday nearest the last day of February.

Summary of Expenses and Operating Income as a Percentage of Revenues

| | Quarter Ended | | Thirty-six Weeks Ended | | | |
|-------------------------------|---------------------|---------------------|------------------------|---------------------|---|---|
| | November 6, 2011 | November 7, 2010 | November 6, 2011 | November 7, 2010 | | |
| Cost of sales: | | | | | | |
| Food, paper and beverage | 32.6 | 31.6 | 33.2 | 31.0 | % | % |
| Labor and benefits | 28.7 | 29.8 | 28.7 | 29.1 | % | % |
| Restaurant operating expenses | 26.0 | 26.6 | 25.7 | 26.3 | % | % |
| Depreciation and amortization | 3.2 | 2.7 | 3.1 | 2.9 | % | % |
| | 6.5 | 6.2 | 6.4 | 6.0 | % | % |

General and administrative expenses

| | | | | | | | | |
|------------------|-----|---|-----|---|-----|---|-----|---|
| Operating income | 1.6 | % | 2.9 | % | 1.8 | % | 4.5 | % |
|------------------|-----|---|-----|---|-----|---|-----|---|

Revenues. The revenue decrease of \$1,979,000 in the quarter ended November 6, 2011 as compared to the prior year quarter was primarily the result of the permanent closing of 15 restaurants prior to this quarter, including the 12 for which the franchise agreements were terminated, causing a reduction in revenues of approximately \$2,382,000. Also, the removal of the Taco Bell concept from two locations caused a reduction of \$91,000. These decreases were partially offset by an increase in comparable restaurant revenues of 2.5% or \$471,000 and an increase of \$24,000 due to the temporary closing of one location in the prior year quarter for image enhancement. The revenue decrease of \$6,747,000 in the thirty-six weeks ended November 6, 2011 as compared to the thirty-six weeks ended November 7, 2010 was primarily the result of the permanent closing of 16 restaurants causing a reduction in revenues of approximately \$6,512,000. Also, the removal of the Taco Bell concept from three locations caused a reduction of \$454,000, partially offset by the temporary closing of three locations this year and three last year for image enhancement resulting in an increase of \$48,000 and a comparable sales increase of 0.3% or \$171,000.

Cost of Sales - Food, Paper and Beverage. Food, paper and beverage costs increased as a percentage of revenue to 32.6% for the quarter ended November 6, 2011 compared to 31.6% for the quarter ended November 7, 2010. The increase in the current year quarter was primarily the result of higher commodity costs as well as higher food costs related to promotional items. Food, paper and beverage costs for the thirty-six weeks ended November 6, 2011 increased to 33.2% compared to 31.0% in the comparable prior year period primarily due to the reasons discussed above.

Cost of Sales - Labor and Benefits. Labor and benefits decreased as a percentage of revenue for the quarter ended November 6, 2011 to 28.7% compared to 29.8% for the comparable year earlier quarter. The decrease was primarily the result of improved efficiencies due to the closing of 15 lower efficiency restaurant locations and the tight operational control of labor hours. Labor and benefits decreased slightly to 28.7% of revenues for the thirty-six weeks ended November 6, 2011 compared to 29.1% in the comparable prior year period as the result of lower labor costs in the first fiscal quarter partially offset by higher labor costs in the second and third fiscal quarters.

Restaurant Operating Expenses. The decrease in restaurant operating expenses to 26.0% of revenue in the third quarter of fiscal 2012 compared to 26.6% in the third quarter of fiscal 2011 was primarily the result of improved efficiencies due to the closing of 15 restaurant locations. For the thirty-six weeks ended November 6, 2011, restaurant operating expenses were 25.7% compared to 26.3% in the comparable prior year period primarily due to the reasons discussed above.

Depreciation and Amortization. Depreciation and amortization increased to \$610,000 for the quarter ended November 6, 2011 compared to \$571,000 in the prior year quarter as the result of asset additions due to three recent image enhancements. Depreciation and amortization decreased to \$1,800,000 for the thirty-six weeks ended November 6, 2011 compared to \$1,866,000 for the thirty-six weeks ended November 7, 2010, due to the closing of 15 restaurant locations, partly offset by the addition of assets due to image enhancements.

General and Administrative Expenses. General and administrative expenses decreased slightly to \$1,259,000 in the third quarter of fiscal 2012 compared to \$1,316,000 in the third quarter of fiscal 2011. This decrease was primarily caused by the reduction of administrative staff, offset by costs related to the retention of a financial advisory firm and higher legal fees related to certain active litigation. General and administrative expenses decreased slightly to \$3,732,000 in the thirty-six weeks ended November 6, 2011 compared to \$3,889,000 in the thirty-six weeks ended November 7, 2010 primarily due to the reasons discussed above.

Loss on Restaurant Assets. The Company experienced a loss on restaurant assets of \$267,000 for the third quarter of fiscal 2012 compared to a loss of \$39,000 in the comparable prior year quarter. The current year quarter includes \$22,000 loss related to the permanent closure of several restaurant locations, \$33,000 change in reserve for disposal of two permanently closed leased restaurant locations, \$56,000 of closed unit expense, \$210,000 reduction of assets held for sale values of three locations, \$66,000 of goodwill write offs related to the sale of one restaurant location, offset by a gain of \$111,000 for the sale of one restaurant location. The prior year amounts include \$12,000 of loss related to the removal of the Taco Bell concept at three restaurants and disposal of the assets of one restaurant. The Company experienced a loss on restaurant assets of \$626,000 for the thirty-six weeks ended November 6, 2011 compared to a loss of \$138,000 for the thirty-six weeks ended November 7, 2010. The current year includes \$90,000 loss related to the permanent closure of 15 restaurant locations, \$218,000 change in reserve for disposal of four permanently closed leased restaurant locations, \$154,000 of closed unit expenses, \$210,000 reduction of assets held for sale values of three locations, \$66,000 of goodwill write offs related to the sale of one restaurant location, slightly offset by a gain of \$111,000 for the sale of one restaurant location. Prior year amounts consist mainly of reductions in the carrying value of assets held for sale, the permanent closing of one restaurant, the sale of one restaurant location and write offs caused by image enhancements.

Operating Income. Operating income decreased to \$306,000, or 1.6% of revenue, for the quarter ended November 6, 2011 from \$620,000, or 2.9% of revenue, in the prior year quarter. The decrease of \$314,000 was primarily due to the losses on restaurant assets and general and administrative expenses not declining in direct proportion to the reduction in the size of the Company. Operating income for the thirty-six weeks ended November 7, 2011 decreased to \$1,070,000, or 1.8% of revenues, from \$2,915,000, or 4.5% of revenues, for the thirty-six weeks ended November 7, 2010 primarily due to the expenses relating to the abrupt closing of 12 restaurants early in the fiscal year and the disruptions to the operations of the Company related to those adjustments. Management expects that losses and expenses related to the disposal of the closed locations will decline as the properties are liquidated.

Interest Expense. The thirty-six weeks ended November 6, 2011 contained \$33,000 of prepayment fees and write off of deferred financing costs related to the early payment of debt to facilitate the sale/leaseback of one operating restaurant, while the prior year thirty-six weeks ended November 7, 2010 contained \$98,000 of similar expense related to the sale of another closed restaurant facility. Interest expense on bank debt and notes payable including capitalized leases decreased to \$463,000 in the third quarter of fiscal 2012 from \$540,000 in the third quarter of fiscal 2011 due to lower debt balances in the current year. Interest expense on bank debt and notes payable including capitalized leases for the thirty-six weeks ended November 6, 2011 was \$1,423,000 compared to \$1,683,000 for the comparable prior year period primarily for the reasons discussed above.

Other Income and Expense. Other income and expense was an income of \$141,000 for the third quarter and an income of \$137,000 for the first thirty-six weeks of fiscal 2012 compared to income of \$63,000 for the third quarter and an expense of \$9,000 for the first thirty-six weeks of fiscal 2011. Other income in the current year includes \$80,000 of settlements relating to insurance and legal matters. Other expense in the previous year period includes \$111,000 in charitable contributions to the Susan G. Komen Foundation generated by KFC's Buckets for the Cure promotion during the first quarter of fiscal 2011.

Provision for Income Taxes. The provision for income taxes for the quarter ended November 6, 2011 was \$77,000 on a pre-tax loss of \$16,000 compared to \$197,000 on pre-tax income of \$143,000 for the comparable prior year period. The provision consists of a current provision of \$28,000 and a deferred tax provision of \$49,000 compared to a deferred tax provision of \$197,000 for the comparable prior year period. The deferred tax provision for the current quarter is a result of deferred tax liabilities associated with franchise rights and goodwill that cannot be used in determining net deferred tax assets. The prior year period provision was unusually large as a percentage of pre-tax income due to a change in projected full year pre-tax income which increased the Company's projected full year effective tax rate from 24.8% to 38.9%.

The provision for income taxes for the thirty-six weeks ended November 6, 2011 was \$318,000 on a pre-tax loss of \$249,000 compared to \$441,000 on pre-tax income of \$1,125,000 for the comparable prior year period. The components of the tax provision for the thirty-six weeks ended November 6, 2011 were a current tax provision of \$28,000 and deferred tax provision of \$290,000 compared to a current tax provision of \$2,000 and deferred tax provision of \$439,000 for the comparable prior year period.

During the first quarter the Company changed its estimate regarding the realization of its net deferred tax assets. Accordingly, in the first quarter it increased the valuation allowance and reduced its net deferred tax assets to zero which resulted in an increase in its deferred tax provision of \$106,000. The Company has determined that results during the current quarter including transactions such as the refinancing and recapitalization that occurred subsequent to end of the quarter do not yet warrant a change in this estimate of the future realization of the net deferred tax assets. Additionally, the Company has determined that the use of its annual effective tax rate would not be appropriate to record its income taxes because a small change in its estimate of income would result in a large change in its effective tax rate. Accordingly, the Company recorded its income taxes based on its results for the quarter and the thirty-six weeks ended November 6, 2011.

Liquidity and Capital Resources. Cash flow activity for the thirty-six weeks ended November 6, 2011 is presented in the Consolidated Statements of Cash Flows. Cash provided by operating activities was \$562,000 compared to \$3,739,000 for the thirty-six weeks ended November 7, 2010. The decrease in operating cash flow was primarily the result of the net loss of \$567,000 in the current year period compared to net income of \$684,000 in the prior year, the decrease of \$1,950,000 of accounts payable and accrued liabilities compared to an increase of \$745,000 in the same categories during the first thirty-six weeks of the prior fiscal year as well as \$66,000 less in depreciation add back to operating cash flow in the current year period. The reduction of accounts payable and accrued liabilities was mainly caused by the payment of liabilities associated with the 12 restaurants which were closed during the first quarter of fiscal 2012. These reductions of operating cash flow were partially offset by an increase of \$488,000 in loss on restaurant assets and decreases in restricted cash of \$140,000, receivables of \$64,000 and prepaid expenses of \$79,000 compared to the prior year period. The Company paid scheduled long-term bank and capitalized lease debt of \$587,000 and \$605,000 of debt before its scheduled maturity in the first thirty-six weeks of fiscal 2012 compared to payments of \$2,331,000 and \$451,000 of debt before its scheduled maturity for the same period in fiscal 2011. Capital expenditures for the first thirty-six weeks of fiscal 2012 were \$1,439,000 less \$352,000 of proceeds from the sale of assets compared to \$1,603,000 less \$234,000 of proceeds from the sale of assets for the fiscal 2011 period as the Company completed the image enhancement of three locations in the current year period, and three locations in the prior year period. Capital expenditure activity is discussed in more detail in Note 6 to the consolidated financial statements.

The Company's debt arrangements require the maintenance of a consolidated fixed charge coverage ratio of 1.20 to 1 regarding all of the Company's loans and the maintenance of individual restaurant fixed charge coverage ratios of between 1.20 and 1.50 to 1 on certain of the Company's individual restaurant loans. A portion of the Company's debt also contains a funded debt to EBITDAR (earnings before interest, taxes, depreciation, amortization and rent) requirement of 5.5. Fixed charge coverage ratios are calculated by dividing the cash flow before rent and debt service for the previous 12 months by the debt service and rent due in the coming 12 months. In the calculation of funded debt to EBITDAR, funded debt is the next twelve month operating lease obligation times eight plus the debt balance at the measurement date. The funded debt is then divided by the prior twelve month EBITDAR to obtain the calculated ratio. The consolidated and individual ratios are all computed quarterly. As of November 6, 2011, the Company was not in compliance with the consolidated fixed charge coverage ratio of 1.20 or with the funded debt to EBITDAR ratio of 5.5. As of the measurement date of November 6, 2011, the Company's consolidated fixed charge coverage ratio was 1.0 to 1 and funded debt to EBITDAR was 6.2. Also, at the end of the fiscal third quarter of 2012 the Company was not in compliance with the individual fixed charge coverage ratio on 22 of its restaurant properties including five closed locations. The Company has not obtained waivers with respect to the non-compliance from the applicable lenders at November 6, 2011, August 14, 2011, May 22, 2011 and at February 27, 2011.

The Company engaged the services of a financial advisor to renegotiate its financing arrangements and to raise replacement capital to fund its required restaurant image enhancement obligations discussed in Note 6. As disclosed previously in its public filings, in April 2011 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 its debt and in order to conserve operating cash while adjusting to the closure of twelve restaurants during April 2011. As a result of this event of default, all of the Company's debt is classified as current in the balance sheets as of November 6, 2011 and February 27, 2011 since waivers of non-compliance were not obtained. As previously disclosed in Form 8-K's, the Company was granted, by its lenders, a waiver of the prepayment penalties on substantially all of its debt that contains prepayment provisions through December 31, 2011 and forbearance on the payment of principal until December 31, 2011 for one lender and December 30, 2011 for the other, in order to pursue its plan to recapitalize its existing 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.

As of December 13, 2011, subsequent to the balance sheet date, the Company completed the refinancing of substantially all of the debt shown on the balance sheet as of November 6, 2011. The replacement financing involved the sale and leaseback of 29 restaurant properties for approximately \$22,000,000 and a new term loan in the amount of approximately \$8,250,000. The term loan has a floating interest rate based on 30 day LIBOR with a minimum rate of 9.0% and has a five year term with a 10 year amortization and principal payments beginning in the thirteenth month of the term. The term loan has graduated covenants with fixed charge coverage ratio beginning at 1.15, debt to EBITDAR of 2.75 and minimum EBITDA of \$2,500K. The Company's completion of the refinancing eliminates the forbearance agreements that had been in effect with lenders which are now paid off. The financing also required the consent of KFC Corporation, the Company's primary franchisor and the entry, by the Company into a definitive remodel agreement with KFC Corporation. See Note 8 - Subsequent Events, and Note 6 - Capital Expenditures, for further discussion of both the refinancing and the remodel agreement.

Recent Accounting Pronouncements.

ASU 2011-04 May, 2011 - Topic 820 "Fair Value Measurement"

This update creates comparability in fair value measurement between GAAP and IFRS. The update enhances the disclosures required for entities presenting assets at fair value. This update is effective for interim and annual periods beginning after December 15, 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 2011-05 June, 2011 - Topic 220 “Comprehensive Income”

This update facilitates the convergence of GAAP and IFRS by eliminating certain options for presenting comprehensive income that are inconsistent with IFRS. This update is effective for interim and annual periods beginning after December 15, 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 2011-08 September, 2011 – Topic 350 “Intangibles – Goodwill and Other”

This update simplifies the previous two step process for goodwill impairment testing by allowing a qualitative analysis to determine if it is more likely than not that an impairment exists before being required to complete the two step impairment calculation. This update is effective for interim and annual periods beginning after December 15, 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.

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

Safe Harbor Statements. This report contains “forward-looking statements” within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. The statements include those identified by such words as “may,” “will,” “expect” “anticipate,” “believe,” “plan” and other similar terminology. Forward looking statements involve risks and uncertainties that could cause actual events or results to differ materially from those expressed or implied in this report. The forward-looking statements reflect the Company’s current expectations and are based upon data available at the time of the statements. Actual results involve risks and uncertainties, including both those specific to the Company and general economic and industry factors. Factors specific to the Company include, but are not limited to, its debt covenant compliance, actions that lenders may take with respect to any debt covenant violations, its ability to obtain waivers of any debt covenant violations and its ability to pay all of its current and long-term obligations and those factors described in Part I Item 1A (“Risk Factors”) of the Company’s annual report on Form 10-K filed with the SEC on May 31, 2011. 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. In addition, the forward-looking statements contained herein represent our estimates only as of the date of this filing and should not be relied upon as representing our estimates as of any subsequent date. While we may elect to update these forward-looking statements at some point in the future, we specifically disclaim any obligation to do so, whether to reflect actual results, changes in assumptions, changes in other factors affecting such forward-looking statements or otherwise.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

Essentially all of the Company’s debt comprising approximately \$8.25 million of principal balance has a variable rate which is adjusted monthly. A one percent increase in the variable rate base (90 day LIBOR) of the loans at the beginning of the year would not increase the Company’s annual interest costs as there is more than a 4% difference between the minimum interest rate and the calculated variable rate. The Company may choose to offset all, or a portion of its future risk through the use of interest rate swaps or caps. The Company does not enter into derivative financial investments for trading or speculation purposes. Also, the Company is subject to volatility in food costs as a result of market risk and we manage that risk through the use of a franchisee purchasing cooperative which uses longer term purchasing contracts. Our ability to recover increased costs through higher pricing is, at times, limited by the competitive environment in which we operate. The Company believes that its market risk exposure is not material

to the Company's financial position, liquidity or results of operations.

Item 4. Controls and Procedures.

Evaluation of Disclosure Controls and Procedures

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. Based on that evaluation, the Company’s PEO and PFO concluded that our disclosure controls and procedures were effective as of November 6, 2011.

Changes in Internal Control Over Financial Reporting

There were no changes in the Company’s internal control over financial reporting (as defined in Rule 13a-15(f) and 15d-15(f) of the Exchange Act) during the quarter ended November 6, 2011 that materially affected, or are reasonably likely to materially affect, the Company’s internal control over financial reporting.

PART II – OTHER INFORMATION

Item 1. Legal Proceedings

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

Item 1A. Risk Factors

The Company’s annual report on Form 10-K for the fiscal year ended February 27, 2011 discusses the risk factors facing the Company. There has been no material change in the risk factors facing our business since February 27, 2011.

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

None

Item 3. Defaults Upon Senior Securities

None

Item 5. Other Information

None

Item 6. Exhibits

Reference is made to “Index to Exhibits”, filed herewith.

SIGNATURES

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

MORGAN'S FOODS, INC.

/s/ Kenneth L. Hignett
Kenneth L. Hignett
Senior Vice President,
Chief Financial Officer and Secretary
December 21, 2011

INDEX TO EXHIBITS

| Exhibit Number | Exhibit Description |
|----------------|---|
| 10.13 | Amendment dated September 28, 2011 to the Pre-negotiation Agreement with KFC Corporation dated May 19, 2011 |
| 10.14 | Amendment dated October 27, 2011 to the Pre-negotiation Agreement with KFC Corporation dated May 19, 2011 |
| 10.15 | GE Capital Franchise Finance Limited Forbearance Agreement dated August 10, 2011 |
| 10.16 | Extension dated October 28, 2011 of GE Capital Franchise Finance Limited Forbearance Agreement dated August 10, 2011 |
| 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 |