

MORGANS FOODS INC  
Form 10-Q  
July 12, 2006

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**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549  
FORM 10-Q**

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

For the quarterly period ended May 21, 2006

or

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

For the transition period from to

Commission file number 1-08395

Morgan s Foods, Inc.

(Exact name of registrant as specified in its charter)

Ohio 34-0562210

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

24200 Chagrin Boulevard, Suite 126, Beachwood, Ohio 44122

(Address of principal executive offices) (Zip Code)  
(216) 360-7500

(Registrant s telephone number, including area code)

(Former name, former address and former fiscal year, if changed since last report)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15 (d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):

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Large accelerated filer  Accelerated filer  Non-accelerated filer

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes  No

As of July 10, 2006, the issuer had 2,718,495 shares of common stock outstanding.

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## PART I FINANCIAL INFORMATION

## Item 1. Financial Statements.

Morgan's Foods, Inc.  
**CONSOLIDATED STATEMENTS OF OPERATIONS**  
(unaudited)

|  | <b>Quarter Ended</b>    |  |
|--|-------------------------|--|
|  | <b>May 21,<br/>2006</b> | <b>May 22, 2005<br/>(as restated see Note<br/>5)</b> |
| <b>Revenues</b>  | <b>\$ 21,101,000</b>    | <b>\$ 20,760,000</b>                                 |
| <b>Cost of sales:</b>  |                         |  |
| <b>Food, paper and beverage</b>                              | <b>6,640,000</b>        | <b>6,421,000</b>                                     |
| <b>Labor and benefits</b>                                    | <b>5,495,000</b>        | <b>5,344,000</b>                                     |
| <b>Restaurant operating expenses</b>                         | <b>5,211,000</b>        | <b>5,115,000</b>                                     |
| <b>Depreciation and amortization</b>                         | <b>723,000</b>          | <b>750,000</b>                                       |
| <b>General and administrative expenses</b>                   | <b>1,135,000</b>        | <b>1,151,000</b>                                     |
| <b>Gain on restaurant assets (Note 3)</b>                    | <b>(6,000)</b>          | <b>(255,000)</b>                                     |
| <b>Operating income</b>                                      | <b>1,903,000</b>        | <b>2,234,000</b>                                     |
| <b>Interest Expense:</b>                                     |                         |  |
| <b>Bank debt and notes payable</b>                           | <b>(919,000)</b>        | <b>(995,000)</b>                                     |
| <b>Capital leases</b>  | <b>(27,000)</b>         | <b>(11,000)</b>                                      |
| <b>Other income and expense, net</b>                         | <b>23,000</b>           | <b>29,000</b>  |
| <b>Net income before income taxes</b>                        | <b>980,000</b>          | <b>1,257,000</b>                                     |
| <b>Provision for income taxes</b>                            | <b>81,000</b>           | <b>65,000</b>  |
| <b>Net income</b>  | <b>\$ 899,000</b>       | <b>\$ 1,192,000</b>                                  |
| <b>Basic net income per common share</b>                     | <b>\$ .33</b>           | <b>\$ .44</b>  |
| <b>Diluted net income per common share</b>                   | <b>\$ .32</b>           | <b>\$ .43</b>  |
| <b>Basic weighted average number of shares outstanding</b>   | <b>2,718,495</b>        | <b>2,718,495</b>                                     |
| <b>Diluted weighted average number of shares outstanding</b> | <b>2,806,030</b>        | <b>2,721,879</b>                                     |

See notes to consolidated financial statements.

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**Morgan's Foods, Inc.**  
**CONSOLIDATED BALANCE SHEETS**  
**(unaudited)**

|  | May 21, 2006  | February 26,<br>2006 |
|--|---------------|----------------------|
| <b>ASSETS</b>  |               |                      |
| <b>Current assets:</b>   |               |                      |
| Cash and equivalents   | \$ 7,127,000  | \$ 6,415,000         |
| Receivables  | 328,000       | 332,000              |
| Inventories  | 717,000       | 643,000              |
| Prepaid expenses   | 737,000       | 856,000              |
|  | 8,909,000     | 8,246,000            |
| <b>Property and equipment:</b>                                       |               |                      |
| Land   | 10,462,000    | 10,462,000           |
| Buildings and improvements   | 19,727,000    | 19,688,000           |
| Property under capital leases  | 1,298,000     | 1,298,000            |
| Leasehold improvements   | 7,451,000     | 7,436,000            |
| Equipment, furniture and fixtures                                    | 20,041,000    | 19,964,000           |
| Construction in progress   | 248,000       | 55,000               |
|  | 59,227,000    | 58,903,000           |
| Less accumulated depreciation and amortization                       | 29,337,000    | 28,678,000           |
|  | 29,890,000    | 30,225,000           |
| <b>Other assets</b>  |               |                      |
| Deferred tax asset   | 899,000       | 925,000              |
| Franchise agreements   | 550,000       | 550,000              |
| Goodwill   | 1,556,000     | 1,578,000            |
|  | 9,227,000     | 9,227,000            |
|  | \$ 51,031,000 | \$ 50,751,000        |
| <b>LIABILITIES AND SHAREHOLDERS DEFICIENCY</b>                       |               |                      |
| <b>Current liabilities:</b>  |               |                      |
| Long-term debt, current  | \$ 3,086,000  | \$ 3,116,000         |
| Current maturities of capital lease obligations                      | 25,000        | 24,000               |
| Accounts payable   | 4,675,000     | 4,308,000            |
| Accrued liabilities  | 3,836,000     | 3,976,000            |
|  | 11,622,000    | 11,424,000           |
| Long-term debt (Note 4)  | 36,587,000    | 37,357,000           |
| Long-term capital lease obligations                                  | 1,187,000     | 1,194,000            |
| Other long-term liabilities  | 1,525,000     | 1,631,000            |
| Deferred tax liabilities   | 1,397,000     | 1,331,000            |
| <b>SHAREHOLDERS DEFICIENCY</b>                                       |               |                      |
| Preferred shares, 1,000,000 shares authorized, no shares outstanding |               |                      |

**Common Stock**

**Authorized shares - 25,000,000**

**Issued shares - 2,969,405**

**Treasury shares - 250,910**

**Capital in excess of stated value**

**Accumulated deficit**

**Total shareholders deficiency**

|                      |                      |
|----------------------|----------------------|
| <b>30,000</b>        | <b>30,000</b>        |
| <b>(284,000)</b>     | <b>(284,000)</b>     |
| <b>28,829,000</b>    | <b>28,829,000</b>    |
| <b>(29,862,000)</b>  | <b>(30,761,000)</b>  |
| <b>(1,287,000)</b>   | <b>(2,186,000)</b>   |
| <b>\$ 51,031,000</b> | <b>\$ 50,751,000</b> |

**See notes to consolidated financial statements.**

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Morgan's Foods, Inc.  
 CONSOLIDATED STATEMENT OF SHAREHOLDERS' DEFICIENCY  
 (unaudited)

|                                 | Common Shares |           | Treasury Shares |              | Capital in    | Accumulated     | Total          |
|---------------------------------|---------------|-----------|-----------------|--------------|---------------|-----------------|----------------|
|                                 | Shares        | Amount    | Shares          | Amount       | excess of     | Deficit         | Shareholders'  |
|                                 |               |           |                 |              | stated value  |                 | Deficiency     |
| Balance<br>February 26,<br>2006 | 2,969,405     | \$ 30,000 | (250,910)       | \$ (284,000) | \$ 28,829,000 | \$ (30,761,000) | \$ (2,186,000) |
| Net income                      |               |           |                 |              |               | 899,000         | 899,000        |
| Balance May 21,<br>2006         | 2,969,405     | \$ 30,000 | (250,910)       | \$ (284,000) | \$ 28,829,000 | \$ (29,862,000) | \$ (1,287,000) |

**See notes to consolidated financial statements**

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Morgan's Foods, Inc.  
CONSOLIDATED STATEMENTS OF CASH FLOWS  
(unaudited)

|   | Quarter Ended       |   |
|---|---------------------|---|
|   | May 21,<br>2006     | May 22, 2005<br>(as restated<br>see Note 5) |
| <b>Cash flows from operating activities:</b>                                  |                     |   |
| Net income  | \$ 899,000          | \$ 1,192,000                                |
| <b>Adjustments to reconcile to net cash provided by operating activities:</b> |                     |   |
| Depreciation and amortization   | 723,000             | 752,000                                     |
| Amortization of deferred financing costs                                      | 26,000              | 26,000                                      |
| Amortization of supply agreement advances                                     | (170,000)           | (164,000)                                   |
| Funding from supply agreements  | 41,000              | 51,000                                      |
| Increase in tax liabilities   | 66,000              | 65,000                                      |
| Gain on restaurant assets (Note 3)  | (6,000)             | (255,000)                                   |
| <b>Change in assets and liabilities:</b>                                      |                     |   |
| Decrease in receivables   | 4,000               | 118,000                                     |
| Increase in inventories   | (74,000)            | (102,000)                                   |
| Decrease (increase) in prepaid expenses                                       | 119,000             | (34,000)                                    |
| Increase in accounts payable  | 367,000             | 492,000                                     |
| Increase (decrease) in accrued liabilities and other                          | (105,000)           | 389,000                                     |
| <b>Net cash provided by operating activities</b>                              | <b>1,890,000</b>    | <b>2,530,000</b>                            |
| <b>Cash flows from investing activities:</b>                                  |                     |   |
| Capital expenditures  | (362,000)           | (465,000)                                   |
| Purchase of franchise agreement   | (10,000)            |   |
| Insurance Proceeds  |                     | 261,000                                     |
| <b>Net cash used in investing activities</b>                                  | <b>(372,000)</b>    | <b>(204,000)</b>                            |
| <b>Cash flows from financing activities:</b>                                  |                     |   |
| Principal payments on long-term debt  | (800,000)           | (430,000)                                   |
| Principal payments on capital lease obligations                               | (6,000)             | (3,000)                                     |
| <b>Net cash used in financing activities</b>                                  | <b>(806,000)</b>    | <b>(433,000)</b>                            |
| <b>Net change in cash and equivalents</b>                                     | <b>712,000</b>      | <b>1,893,000</b>                            |
| <b>Cash and equivalents, beginning balance</b>                                | <b>6,415,000</b>    | <b>3,654,000</b>                            |
| <b>Cash and equivalents, ending balance</b>                                   | <b>\$ 7,127,000</b> | <b>\$ 5,547,000</b>                         |

See notes to consolidated financial statements.

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Morgan's Foods, Inc.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
QUARTERS ENDED MAY 21, 2006 AND MAY 22, 2005  
(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 26, 2006. In December 2004, the FASB issued SFAS No. 123(R), Share-Based Payment. The Company has adopted these provisions and has determined that there is no effect on currently outstanding options. To the extent that the Company grants options or other share-based payments after February 26, 2006, SFAS No. 123(R) is expected to reduce the operating results of the Company.

**Note 2. Net Income Per Common Share**

Basic net income per common share is computed by dividing net income by the weighted average number of common shares outstanding during the period. Diluted net income per common share is based on the combined weighted average number of shares outstanding, which includes the assumed exercise or conversion of options. In computing diluted net income per common share, the Company has utilized the treasury stock method. For the quarter ended May 22, 2005, 275,000 shares were excluded from the computation of diluted earnings per share due to their antidilutive effect.

**Note 3. Gain on Restaurant Assets**

The Company experienced a gain on restaurant assets of \$6,000 for the first quarter of fiscal 2007 and a gain of \$255,000 for the first quarter of fiscal 2006. Gains and losses on restaurant assets are realized from the sale, disposal or loss of restaurant assets, the closing of unprofitable restaurants and the impairment of restaurant assets. The 2006 amount is primarily due to the receipt of \$261,000 of property damage insurance proceeds. These insurance proceeds relate to two restaurants damaged by floods from the Hurricane Ivan storm system and one restaurant damaged by fire. Insurance proceeds which will result in a gain are recognized in the financial statements only when such gains are realized, which is generally upon receipt of the proceeds.

**Note 4. Debt**

The Company's debt arrangements require the maintenance of a consolidated fixed charge coverage ratio of 1.2 to 1 regarding all of the Company's mortgage loans and the maintenance of individual restaurant fixed charge coverage ratios of between 1.2 and 1.5 to 1 on certain of the Company's mortgage loans. Fixed charge coverage ratios are calculated by dividing the cash flow before rent and debt service for the previous 12 months by the debt service and rent due in the coming 12 months. The consolidated and individual coverage ratios are computed quarterly. At the end of fiscal 2006 and as of the quarter ended May 21, 2006, the Company was in compliance with the consolidated fixed charge coverage ratio of 1.2. However, at the end of fiscal 2006 and as of the quarter ended May 21, 2006, the Company was not in compliance with the individual fixed charge coverage ratio on certain of its restaurant properties and has obtained waivers of these technical violations.

**Note 5. Restatement**

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In preparing the fiscal 2006 annual financial statements, the Company determined that the deferred tax asset valuation allowance for prior periods was understated because of the incorrect use of deferred tax liabilities associated with indefinite lived intangible assets for book purposes to reduce the amount of valuation allowance computed for deferred tax assets. The error also had the effect of understating income tax expense by \$65,000 for the first quarter of fiscal 2006 ended May 22, 2005. As a result, the Company has restated the accompanying consolidated financial statements for the first quarter of fiscal 2006 ended May 22, 2005.

The following tables summarize the impact of the restatement discussed above on the above referenced financial statements as of May 22, 2005:

|   | <b>For the Quarter Ended May 22, 2005</b> |                   |                    |
|---|---|-------------------|--------------------|
|   | <b>As</b>                                 |                   |                    |
|   | <b>Previously<br/>Reported</b>            | <b>Adjustment</b> | <b>As Restated</b> |
| <b>Consolidated Statement of Operations</b> |   |                   |                    |
| Income tax expense                          | \$  | \$ 65,000         | \$ 65,000          |
| Net Income                                  | 1,257,000                                 | (65,000)          | 1,192,000          |
| Net income per share                        |   |                   |                    |
| basic                                       | .46                                       | (0.02)            | 0.44               |
| diluted                                     | .46                                       | (0.03)            | 0.43               |

|   | <b>For the Quarter Ended May 22, 2005</b> |                   |                    |
|---|---|-------------------|--------------------|
|   | <b>As</b>                                 |                   |                    |
|   | <b>Previously<br/>Reported</b>            | <b>Adjustment</b> | <b>As Restated</b> |
| <b>Consolidated Statement of Cash Flows</b> |   |                   |                    |
| Net Income                                  | \$ 1,257,000                              | \$ (65,000)       | \$ 1,192,000       |
| Increase in tax liability                   |   | 65,000            | 65,000             |

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

The following management's discussion and analysis of financial condition and results of operations give effect to the restatements discussed in Note 5.

**Description of Business.** Morgan's Foods, Inc. (the Company) operates, through wholly-owned subsidiaries, KFC restaurants under franchises from KFC Corporation and Taco Bell restaurants under franchises from Taco Bell Corporation. As of July 10, 2006, the Company operates 72 KFC restaurants, 7 Taco Bell restaurants, 14 KFC/Taco Bell units under franchises from KFC Corporation and franchises or licenses from Taco Bell Corporation, 3 Taco Bell/Pizza Hut Express units operated under franchises from Taco Bell Corporation and licenses from Pizza Hut Corporation, 1 KFC/Pizza Hut Express unit operated under a franchise from KFC Corporation and a license from Pizza Hut Corporation and 1 KFC/A&W unit 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**

|                               | <b>Quarter Ended</b>        |                         |
|-------------------------------|-----------------------------|-------------------------|
|                               | <b>May<br/>21,<br/>2006</b> | <b>May 22,<br/>2005</b> |
| Cost of sales:                |                             |                         |
| Food, paper and beverage      | 31.5%                       | 30.9%                   |
| Labor and benefits            | 26.0%                       | 25.7%                   |
| Restaurant operating expenses | 24.7%                       | 24.6%                   |

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|                                     |      |       |
|-------------------------------------|------|-------|
| Depreciation and amortization       | 3.4% | 3.6%  |
| General and administrative expenses | 5.4% | 5.5%  |
| Operating income                    | 9.0% | 10.8% |

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**Revenues.** Revenues for the quarter ended May 21, 2006 were \$21,101,000 compared to \$20,760,000 for the quarter ended May 22, 2005. This increase of \$341,000 was primarily due to a 1.6% increase in comparable restaurant revenues. The increase in comparable restaurant revenues was primarily the result of effective product promotions by the Company's franchisors during the quarter, including the \$.99 KFC buffalo snacker sandwich.

**Costs of Sales – Food, Paper and Beverages.** Food, paper and beverage costs for the first quarter increased as a percentage of revenue from 30.9% in fiscal 2006 to 31.5% in fiscal 2007. This increase was primarily the result of a continuing shift in the sales mix to slightly higher food cost items.

**Cost of Sales – Labor and Benefits.** Labor and benefits increased as a percentage of revenue for the quarter ended May 21, 2006 to 26.0% compared to 25.7% for the year earlier quarter. The increase was primarily due to staffing restaurants for increased sales volumes and the payment of deferred wage increases.

**Restaurant Operating Expenses.** Restaurant operating expenses were relatively unchanged as a percentage of revenue to 24.7% in the first quarter of fiscal 2007 compared to 24.6% in the first quarter of fiscal 2006. There were increases in utilities, credit card fees, and general insurance which were largely offset by decreases in promotional toys and manager bonuses.

**Depreciation and Amortization.** Depreciation and amortization was relatively unchanged at \$723,000 and \$750,000 for the first quarters of 2007 and 2006, respectively.

**General and Administrative Expenses.** General and administrative expenses were relatively unchanged at \$1,135,000 for the first quarter of fiscal 2007 compared to \$1,151,000 in the first quarter of fiscal 2006.

**Gain on Restaurant Assets.** The Company experienced a gain on restaurant assets of \$6,000 for the first quarter of fiscal 2007 compared to a gain of \$255,000 for the first quarter of fiscal 2006. The fiscal 2006 amount is primarily due to the receipt of \$261,000 of property damage insurance proceeds. These insurance proceeds relate to three restaurants damaged from the Hurricane Ivan storm system. Insurance proceeds which will result in a gain are recognized in the financial statements only when such gains are realized, which is generally upon receipt of the proceeds.

**Operating Income.** Operating income in the first quarter of fiscal 2007 decreased to \$1,903,000 or 9.0% of revenues compared to \$2,234,000 or 10.8% of revenues for the first quarter of fiscal 2006. The receipt of \$261,000 in property damage insurance proceeds in the fiscal 2006 first quarter is the majority of the difference.

**Interest Expense.** Interest expense on bank debt decreased to \$919,000 in the first quarter of fiscal 2007 from \$995,000 in the first quarter of fiscal 2006 due to lower debt balances during the fiscal 2007 quarter. Interest expense on capitalized leases was \$27,000 in the fiscal 2007 first quarter compared to \$9,000 in the comparable year earlier period due to the conversion of a previously owned restaurant property to a sale leaseback during fiscal 2006.

**Other Income.** Other income decreased to \$23,000 in first quarter of fiscal 2007 as compared to \$29,000 in first quarter fiscal 2006.

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**Provision for Income Taxes.** The provision for income taxes increased to \$81,000 compared to \$65,000 in fiscal 2006. The increase was primarily due to a provision for alternative minimum tax during the current fiscal year first quarter.

**Liquidity and Capital Resources.** Cash flow activity for the first quarters of fiscal 2007 and fiscal 2006 is presented in the Consolidated Statements of Cash Flows. Cash provided by operating activities was \$1,890,000 for the quarter ended May 21, 2006 compared to \$2,530,000 for the quarter ended May 22, 2005. The decrease in cash provided by operating activities was primarily due to a large increase in accrued liabilities in the fiscal 2006 quarter caused by the delayed payment of field bonuses for the prior quarter. The Company paid bank and capitalized lease debt of \$806,000 in the first quarter of fiscal 2007 and had Capital expenditures of \$362,000 primarily as a result of expenditures to upgrade one restaurant and the replacement of unserviceable equipment.

The Company's debt arrangements require the maintenance of a consolidated fixed charge coverage ratio of 1.2 to 1 regarding all of the Company's mortgage loans and the maintenance of individual restaurant fixed charge coverage ratios of between 1.2 and 1.5 to 1 on certain of the Company's mortgage loans. Fixed charge coverage ratios are calculated by dividing the cash flow before rent and debt service for the previous 12 months by the debt service and rent due in the coming 12 months. The consolidated and individual coverage ratios are computed quarterly. At the end of fiscal 2006 and as of the quarter ended May 21, 2006, the Company was in compliance with the consolidated fixed charge coverage ratio of 1.2. However, at the end of fiscal 2006 and as of the quarter ended May 21, 2006, the Company was not in compliance with the individual fixed charge coverage ratio on certain of its restaurant properties and has obtained waivers of these violations.

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

**Safe Harbor Statements.** This document contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. The statements include those identified by such words as may, will, expect, anticipate, believe, plan and other similar terminology. The forward-looking statements reflect the Company's current expectations and are based upon data available at the time of the statements. Actual results involve risks and uncertainties, including both those specific to the Company and general economic and industry factors. Factors specific to the Company include, but are not limited to, its debt covenant compliance, actions that lenders may take with respect to any debt covenant violations, its ability to obtain waivers of any debt covenant violations and its ability to pay all of its current and long-term obligations.

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

**Item 3. Quantitative and Qualitative Disclosures About Market Risk.**

The Company's existing borrowings are at fixed interest rates, and accordingly the Company does not have market risk exposure for fluctuations in interest rates. The Company does not enter into derivative financial

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investments for trading or speculation purposes. Also, the Company is subject to volatility in food costs as a result of market risk and we manage that risk through the use of longer term purchasing contracts. Our ability to recover increased costs through higher pricing is, at times, limited by the competitive environment in which we operate. 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.

**Item 4. Controls and Procedures.**

The effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rule 13a-14(c) under the Securities Exchange Act of 1934) was evaluated as of the date of the financial statements. This evaluation was carried out under the supervision of and with the participation of management, including the Chief Executive Officer and the Chief Financial Officer. Based on that evaluation, management concluded that as of May 21, 2006 the Company did not maintain effective internal controls over financial reporting because of a material weakness in its internal controls over accounting for income taxes, including the calculation of deferred tax asset valuation allowances, which resulted in the Company having to restate its fiscal 2005 and 2004 consolidated financial statements. Because of the material weakness, management concluded that disclosure controls and procedures were not effective as of May 21, 2006. Additionally, the Company's inability to file its quarterly report on Form 10-Q for the period ended May 21, 2006 by the required deadline indicates a material weakness in its closing process. Notwithstanding the existence of such material weaknesses, management has concluded that the consolidated financial statements included in this Form 10-Q fairly present in all material respects the Company's financial condition as of May 21, 2006 and February 26, 2006 and the results of operations and cash flows for the quarters ended May 21, 2006 and May 22, 2005.

To remediate the material weakness in controls over the Company's accounting for income taxes, the Company has determined that it will engage an independent registered public accounting firm (other than its auditors, Deloitte & Touche LLP) to perform an analysis of its internal controls over accounting for and disclosure of income taxes and will implement recommendations that result from such analysis. The Company will streamline its closing process and adjust its closing calendar to remediate the material weakness in its closing process.

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**PART II OTHER INFORMATION**

**Item 1. Legal Proceedings**

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

**Item 1A. Risk Factors**

The Company's annual report on form 10-K for the fiscal year ended February 26, 2006 discusses the risk factors facing the Company. There have been no material changes in the Company's risk factors since that time.



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**MORGAN S FOODS, INC.  
INDEX TO EXHIBITS**

| <u>Exhibit<br/>Number</u> | <u>Exhibit Description</u>  |
|---------------------------|---|
| 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   |

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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.  
(Registrant)

Dated: July 12, 2006

By: /s/ Kenneth L. Hignett  
Kenneth L. Hignett  
Senior Vice President,  
Chief Financial Officer & Secretary