MORGANS FOODS INC
Form 10-K
June 15, 2006

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UNITED STATES SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549
FORM 10-K
Annual Report Pursuant to Section 13 or 15 (d)
of the Securities Exchange Act of 1934
For the fiscal year ended February 26, 2006
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, OH 44122

(Address of principal executive officers) (Zip Code)

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

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

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

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

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes o No þ

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes o No þ

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

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

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

Large accelerated filer o Accelerated filer o Non-accelerated filer þ

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

As of August 14, 2005, the aggregate market value of the common stock held by nonaffiliates of the Registrant was $6,204,534.

As of May 10, 2006, the Registrant had 2,718,495 shares of common stock outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

Part III incorporates by reference certain information from the definitive Proxy Statement to security holders for the 2006 annual meeting, to be filed with the Securities and Exchange Commission on or before June 26, 2006.

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Explanatory Note

In preparing the fiscal 2006 financial statements, we determined that for book purposes our deferred tax asset valuation allowance at March 2, 2003 was understated by approximately $481,000 because of the incorrect use of deferred tax liabilities associated with indefinite lived intangible assets to reduce the amount of valuation allowance computed for deferred tax assets. The error also had the effect of understating income tax expense by approximately $283,000 and $285,000 for the years ended February 27, 2005 and February 29, 2004, respectively. The Company has corrected the error by restating its accumulated deficit at March 2, 2003, the fiscal 2005 and 2004 consolidated financial statements and accompanying notes to the consolidated financial statements, and quarterly data for fiscal 2005 and the first three quarters of fiscal 2006. We also restated other related financial data presented in Items 6, 7, and 15 of this Annual Report on Form 10-K which include Selected Financial Data, Management s Discussion and Analysis of Financial Condition and Results of Operations.

Item 1. Business.

General. Morgan s Foods, Inc. (the Company) operates through wholly-owned subsidiaries KFC restaurants under franchises from KFC Corporation, Taco Bell restaurants under franchises from Taco Bell Corporation, Pizza Hut Express restaurants under licenses from Pizza Hut Corporation and an A&W restaurant under a license from A&W Restaurants, Inc. As of May 26, 2006, the Company operates 72 KFC restaurants, 7 Taco Bell restaurants, 14 KFC/Taco Bell 2n1 s under franchises from KFC Corporation and franchises or licenses from Taco Bell Corporation, 3 Taco Bell/Pizza Hut Express 2n1 s under franchises from Taco Bell Corporation and licenses from Pizza Hut Corporation, 1 KFC/Pizza Hut Express 2n1 under a franchise from KFC Corporation and a license from Pizza Hut Corporation and 1 KFC/A&W 2n1 operated under a franchise from KFC Corporation and a license from A&W Restaurants, Inc. The Company s fiscal year is a 52 53 week year ending on the Sunday nearest the last day of February.

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

Of the 98 KFC, Taco Bell and 2n1 restaurants operated by the Company as of May 26, 2006, 16 are

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located in Ohio, 58 in Pennsylvania, 13 in Missouri, 2 in Illinois, 7 in West Virginia and 2 in New York. The Company was one of the first KFC Corporation franchisees and has operated in excess of 20 KFC franchises for more than 25 years. Operations relating to these units are seasonal to a certain extent, with higher sales generally occurring in the summer months.

Franchise Agreements. All of the Company s KFC and Taco Bell restaurants are operated under franchise agreements with KFC Corporation and Taco Bell Corporation, respectively. The Company s KFC/Taco Bell 2n1 restaurants are operated under franchises from KFC Corporation and either franchises or licenses from Taco Bell Corporation. The Taco Bell/Pizza Hut Express 2n1 s are operated under franchises from Taco Bell Corporation and licenses from Pizza Hut Corporation. The KFC/Pizza Hut Express 2n1 restaurant is operated under a franchise from KFC Corporation and a license from Pizza Hut Corporation. The KFC/A&W 2n1 is operated under a franchise from KFC Corporation and a license from A&W Restaurants, Inc. The Company considers retention of these agreements to be important to the success of its restaurant business and believes that its relationships with KFC Corporation, Taco Bell Corporation, Pizza Hut Corporation and A&W Restaurants, Inc. are satisfactory. For KFC products, the Company is required to pay royalties of 4% of gross revenues and to expend an additional 5.5% of gross revenues on national and local advertising pursuant to its franchise agreements. For Taco Bell products in KFC/Taco Bell 2n1 restaurants operated under license agreements from Taco Bell Corporation and franchise agreements from KFC Corporation the Company is required to pay royalties of 10% of Taco Bell gross revenues and to make advertising fund contributions of 1/2% of Taco Bell gross revenues. For Taco Bell product sales in restaurants operated under Taco Bell franchises the Company is required to pay royalties of 5.5% of gross revenues and to expend an additional 4.5% of gross revenues on national and local advertising. For Pizza Hut products in 2n1 restaurants the Company is required to pay royalties of 5.5% of Pizza Hut gross revenues and to expend an additional 4.5% of Pizza Hut gross revenues on national and local advertising. For A&W products in 2n1 restaurants the Company is required to pay royalties of 7% of A&W gross revenues and to expend an additional 4% of A&W gross revenues on national and local advertising.

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

Competition. The quick service restaurant business is highly competitive and is often affected by changes in consumer tastes; national, regional, or local economic conditions, demographic trends, traffic patterns; the type, number and locations of competing restaurants and disposable purchasing power. Each of the Company s KFC, Taco Bell and 2n1 restaurants competes directly or indirectly with a large number of

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national and regional restaurant operations, as well as with locally owned restaurants, drive-ins, diners and numerous other establishments which offer low- and medium-priced chicken, Mexican food, pizza, hamburgers and hot dogs to the public.

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

Government Regulation. The Company is subject to various federal, state and local laws affecting its business. Each of the Company s restaurants must comply with licensing and regulation by a number governmental authorities, which include health, sanitation, safety and fire agencies in the state or municipality in which the restaurant is located. To date, the Company has not been significantly affected by any difficulty, delay or failure to obtain required licenses or approvals.

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

The Company is also subject to federal and state child labor laws which, among other things, prohibit the use of certain hazardous equipment by employees 18 years of age or younger. To date, the Company has not been materially adversely affected by such laws.

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

Growth. The Company added no new restaurants in fiscal 2006 or fiscal 2005.

Employees. As of May 10, 2006, the Company employed approximately 2,063 persons, including 45 administrative and 219 managerial employees. The balance are hourly employees, most of whom are part-time. None of the restaurant employees are represented by a labor union. The Company considers its employee relations to be satisfactory.

Item 1A. Risk Factors.

The Company faces a variety of risks inherent in general business and in the restaurant industry

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specifically, including operational, legal, regulatory and product risks. Management discusses below certain significant factors that could adversely affect the operations and results of the Company. Other factors may exist that the Company cannot anticipate or that the Company does not consider to be significant based upon information which is available currently.

Due to the Company s reliance on poultry in its menu items, an outbreak of the Avian Influenza in the United States could cause a shortage of chicken or could cause unreasonable panic in the public related to the consumption of chicken products, either of which would likely have a significant adverse impact on the Company s business. The Company faces significant image enhancement and relocation requirements in future fiscal years as described under Other Contractual Obligations and Commitments in Part II of this report. There is no assurance that the Company will be able to obtain sale/leaseback or debt financing on terms which it finds reasonably acceptable to fund these obligations when due. Lack of acceptable financing could have a material adverse affect on the operations of the Company, including the loss of restaurants subject to enhancement or relocation requirements under applicable franchise agreements.

Item 1B. Unresolved Staff Comments.

None.

Item 2. Properties.

The Company leases approximately 6,000 square feet of space for its headquarters in Cleveland, OH. The lease expires August 31, 2006 and the rent under the current term is $8,600 per month. The Company also leases space for a regional office in Youngstown, OH, which is used to assist in the operation of the KFC, Taco Bell and 2n1 restaurants.

Of the 98 KFC, Taco Bell and 2n1 restaurants, the Company owns the land and building for 56 locations, owns the building and leases the land for 23 locations and leases the land and building for 19 locations. 56 of the owned properties are subject to mortgages. Additionally, the Company leases the land and building for one closed location and owns the land and building for two closed locations which are subject to mortgages, all three of which are leased to an operator of an independent local restaurant concept. Remaining lease terms (including renewal options) range from 1 to 29 years and average approximately 12 years. These leases generally require the Company to pay taxes and utilities, to maintain casualty and liability insurance, and to keep the property in good repair. The Company pays annual rent for each leased KFC, Taco Bell or 2n1 restaurant in amounts ranging from $19,000 to $95,000. In addition, 15 of these leases require payment of additional rentals based on a percentage of gross sales in excess of certain base amounts. Sales for 9 KFC, Taco Bell and 2n1 restaurants exceeded the respective base amounts in fiscal 2006.

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

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Item 3. Legal Proceedings.

None.

Item 4. Submission of Matters to a Vote of Security Holders.

There were no matters submitted to security holders for a vote during the last quarter of the Company s fiscal year ended February 26, 2006.

Executive Officers of the Company

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

Name	Age	Position with Registrant	Officer Since
Executive Officers:			
Leonard R. Stein-Sapir	67	Chairman of the Board and Chief Executive Officer	April 1989
James J. Liguori	57	President and Chief Operating Officer	June 1979
Kenneth L. Hignett	59	Senior Vice President-Chief Financial Officer & Secretary	May 1989
Other Officers:			
Barton J. Craig	57	Senior Vice President-General Counsel	January 1994
Vincent J. Oddi	63	Vice President-Restaurant Development	September 1979
Ramesh J. Gursahaney	57	Vice President-Operations	January 1991

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

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Item 5. Market for the Company s Common Equity, Related Stockholder Matters, and Issuer Purchases of Equity Securities

The Company s Common Shares are traded over the counter under the symbol MRFD . The following table sets forth, for the periods indicated, the high and low sales prices of the Common Shares as reported.

	Price Range	
	High	**Low**
Year ended February 26, 2006:		
1st Quarter	$ 1.60	$ .90
2nd Quarter	4.25	1.60
3rd Quarter	6.30	4.50
4th Quarter	8.00	4.50
Year ended February 27, 2005:		
1st Quarter	$ 2.20	$ 1.90
2nd Quarter	1.90	.95
3rd Quarter	1.01	.60
4th Quarter	1.05	.75

As of May 10, 2006, the Company had approximately 919 shareholders of record. The Company has paid no dividends since fiscal 1975.

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Item 6. Selected Financial Data.

The following selected financial information for each of the five fiscal years in the period ended February 26, 2006, is derived from, and qualified in its entirety by, the consolidated financial statements of the Company. The following selected financial information should be read in conjunction with Management s Discussion and Analysis of Financial Condition and Results of Operations and the consolidated financial statements and the notes thereto included elsewhere in this report.

Dollars in thousands except per share amounts.

	Years Ended				
	February 26, 2006	February 27, 2005 (as restated)(2)	February 29, 2004 (as restated)(2)	March 2, 2003 (as restated)(2)	March 3, 2002
Revenues	$ 87,457	$ 80,960	$ 81,738	$ 82,326	$ 84,930
Cost of sales:					
Food, paper and beverage	27,146	25,222	24,712	25,645	25,987
Labor and benefits	23,186	22,803	22,816	22,329	22,155
Restaurant operating expenses	22,190	21,015	21,320	21,018	21,805
Depreciation and amortization	3,254	3,419	3,518	3,499	3,866
General and administrative expenses	5,133	4,870	5,574	5,749	5,209
Loss (gain) on restaurant assets	(715)	574	567	551	215
Operating income	7,263	3,057	3,231	3,535	5,693
Net income (loss)	3,437	(2,141)	(1,579)	(1,673)	602
Basic net income (loss) per common share (1)	$ 1.26	$ (.79)	$ (.58)	$ (.62)	$ .21
Diluted net income (loss) per common share (1)	$ 1.24	$ (.79)	$ (.58)	$ (.62)	$ .21
Working capital (deficiency)	$ (3,178)	$ (46,048)	$ (3,999)	$ (3,111)	$ (1,312)
Total assets	50,751	48,790	52,672	56,025	60,253
Long-term debt	37,357		43,370	46,113	48,563
Long-term capital lease obligations	1,194	368	379	436	544
Shareholders deficiency	(2,186)	(5,623)	(3,482)	(1,903)	(197)

(1) Computed based upon the basic weighted average number of common shares outstanding during each year, which were 2,718,495

in 2006, 2,718,495 in 2005, 2,718,441 in 2004, 2,720,182 in 2003 and 2,851,160 in 2002 and the diluted weighted average number of common and common equivalent shares outstanding during each year, which were 2,778,524 in 2006, 2,718,495 in 2005, 2,718,441 in 2004, 2,720,182 in 2003 and 2,853,789 in 2002.

(2) The Company has restated its consolidated financial statements for the fiscal years ended February 27, 2005, February 29, 2004 and March 2, 2003 to correct an error in computing the deferred tax asset valuation allowance. See note 2 to the financial statements included elsewhere herein.

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Item 7. Management s Discussion and Analysis of Financial Condition and Results of Operations.

The following Management s Discussion and Analysis gives effect to the restatement discussed in Note 2 to the consolidated financial statements.

Results of Operations. During fiscal 2004 through 2006 the Company operated KFC franchised restaurants, Taco Bell franchised restaurants and various 2n1 restaurants which include the KFC, Taco Bell, Pizza Hut and A&W concepts in the states of Illinois, Missouri, Ohio, Pennsylvania, West Virginia and New York. The average number of restaurants in operation during each fiscal year was 99 in 2006, 101 in 2005 and 103 in 2004.

Summary of Expenses and Operating Income as a Percentage of Revenues

	2006	**2005**	**2004**
Cost of sales:			
Food, paper and beverage	31.0%	31.2%	30.2%
Labor and benefits	26.5%	28.2%	27.9%
Restaurant operating expenses	25.4%	26.0%	26.1%
Depreciation and amortization	3.7%	4.2%	4.3%
General and administrative expenses	5.9%	6.0%	6.8%
Operating income	8.3%	3.8%	4.0%

Revenues. Revenue was $87,457,000 in fiscal 2006, an increase of $6,497,000 or 8.0% compared to fiscal 2005. The $6,497,000 increase in restaurant revenues during fiscal 2006 was due mainly to an 8.5% increase in comparable restaurant revenues resulting from continuing effective promotions from the franchisors and $891,000 in revenues lost from locations that were closed for the repair of damages during fiscal 2005. The increases were partially offset by $957,000 in revenues being lost in fiscal 2006 due to the permanent closing of 3 locations in fiscal 2005 and 1 location in fiscal 2006. Revenue was $80,960,000 in fiscal 2005, a decrease of $778,000 or 1.0% compared to fiscal 2004. The decrease in restaurant revenues during fiscal 2005 was due mainly to $997,000 in revenues being lost due to the permanent closing of three restaurants and $558,000 in revenues being lost as a result of two restaurants being closed due to damages resulting from the Hurricane Ivan storm system and one restaurant being closed for damages resulting from a fire. Revenue was also adversely affected early in fiscal 2005 by a failed new product introduction by the Company s KFC franchisor but more effective promotions later in the year contributed to a 1.0% increase in comparable restaurant revenues for the full fiscal 2005 year.

Revenues for the 16 weeks ended February 26, 2006 were $25,133,000, an increase of $1,497,000, primarily the result of a 5.4% increase in comparable restaurant revenues. This increase was due to successful product promotions including the KFC value meals, variety bucket and the wings flavor station promotion. These revenue increases were partially offset by the decreases in revenues caused by the restaurants either temporarily or permanently closed as discussed above. Revenues for the 16 weeks ended February 27, 2005 were $23,636,000, an increase of $771,000 primarily the result of a 7.0% increase in comparable restaurant revenues. This increase was due to successful product promotions. These revenue increases were partially offset by the loss of revenue caused by the restaurants either permanently or temporarily closed as discussed above.

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Cost of Sales Food, Paper and Beverage. Food, paper and beverage costs were $27,146,000 or 31.0% of revenues in fiscal year 2006 compared to $25,222,000 or 31.2% in fiscal year 2005. The decrease as a percentage of sales was primarily caused by increased efficiencies due to higher average restaurant volumes but partially offset by higher delivery costs due to fuel surcharges. Food, paper and beverage costs were $25,222,000 or 31.2% of revenues in fiscal year 2005 compared to $24,712,000 or 30.2% in fiscal 2004. This increase was primarily the result of increased commodity costs.

For the fourth quarter of fiscal 2006, food, paper and beverage costs increased as a percentage of revenues to 31.1% from 30.3% in the fourth quarter fiscal 2005. The increase of 0.8% of revenues was primarily due to increased fuel surcharges for the delivery of food supplies partially offset by improved efficiencies due to higher restaurant volumes in the fiscal 2006 fourth quarter.

Cost of Sales Labor and Benefits. Labor and benefits decreased to 26.5% of revenues or $23,186,000 in fiscal 2006 from 28.2% of revenues or $22,803,000 in fiscal 2005 due to significant improvements in labor efficiency related to higher average restaurant volumes and lower health and welfare costs. Labor and benefits increased to 28.2% of revenues or $22,803,000 in fiscal 2005 from 27.9% of revenues or $22,816,000 in fiscal 2004 due to increased labor as a result of hiring for open restaurant management positions which was partially offset by decreased workers compensation costs.

Labor and benefit costs for the fourth quarter of fiscal 2006 decreased to 27.7% of revenues or $6,958,000 compared to 28.2% of revenues or $6,674,000 in fiscal 2005. This percentage decrease was primarily the result of higher average restaurant volumes.

Restaurant Operating Expenses. Restaurant operating expenses decreased to 25.4% of revenues or $22,190,000 in fiscal 2006 from 26.0% of revenues or $21,015,000 in fiscal 2005. This decrease was primarily the result of higher average restaurant volumes. Restaurant operating expenses were relatively unchanged as a percentage of revenue at $21,015,000 or 26.0% and $21,320,000 or 26.1% in fiscal 2005 and 2004, respectively

Restaurant operating expenses for the fourth quarter of fiscal 2006 decreased to 26.1% of revenues or $6,547,000 from 26.2% of revenues or $6,201,000 in the year earlier quarter. This decrease was primarily the result of higher average restaurant volumes.

Depreciation and Amortization. Depreciation and amortization decreased slightly to $3,254,000 in fiscal 2006 from $3,419,000 in fiscal 2005 as a result of certain assets becoming fully depreciated during the year. Depreciation and amortization decreased slightly to $3,419,000 in fiscal 2005 compared to $3,518,000 in fiscal 2004 also as a result of certain assets becoming fully depreciated during the year.

General and Administrative Expenses. General and administrative expenses increased to $5,133,000 or 5.9% of revenues in fiscal 2006 from $4,870,000 or 6.0% of revenues in fiscal 2005 primarily as a result of increased legal and accounting costs incurred during fiscal 2006. General and administrative

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expenses decreased to $4,870,000 or 6.0% of revenues in fiscal 2005 from $5,574,000 or 6.8% of revenues in fiscal 2004 as a result of decreased wages and benefits of $448,000. Early in the fourth quarter, three senior officers of the Company reduced their salaries and other benefits to near zero while the remainder of the Company s executive team and some of its management took pay cuts. These salary and benefit reductions reduced expenses during the fourth quarter of fiscal 2005 approximately $300,000. In addition, training expenses were reduced by approximately $77,000, fees for debt covenant violation waivers decreased $80,000 due to fewer waivers being obtained in 2005 and certain occupancy costs were reduced.

For the fourth quarter of fiscal 2006, general and administrative expenses remained essentially unchanged at $1,441,000 or 5.9% of revenues from $1,361,000 or 5.8% of revenues in the fourth quarter of fiscal 2005.

Loss (gain) on Restaurant Assets. The Company experienced a gain on restaurant assets of $715,000 in fiscal 2006 compared to a loss of $574,000 in fiscal 2005. The 2006 amount represents the gains on restaurant assets replaced through insurance proceeds received for flood damages. The 2005 amount includes impairment losses of $823,000 on nine restaurants to reduce their carrying values to their estimated fair values. These impairment losses were offset by gains totaling $167,000 which were recognized for property damage insurance proceeds received in excess of the net book value of the related property, and $178,000 for business interruption insurance proceeds received. These insurance proceeds relate to two restaurants damaged from the Hurricane Ivan storm system and one fire-damaged restaurant. 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. In fiscal 2004, the Company recorded losses of $313,000 as a result of the disposal of assets during the image enhancement of two restaurants, an increase of $81,000 in the reserve for one previously closed restaurant and the $135,000 loss associated with the unanticipated closing of another restaurant as a result of the landlord terminating the lease in order to use the property for another project.

In the fourth quarter of fiscal 2006 the Company recorded no significant activity in gains or losses on restaurant assets compared to a gain of $152,000 in the prior year fourth quarter due to the receipt of insurance proceeds.

Operating Income. Operating income in fiscal 2006 increased to $7,263,000 from $3,057,000 in fiscal 2005 primarily as a result of higher revenues and improved operating efficiencies as discussed above. Operating income in fiscal 2005 decreased to $3,057,000 from $3,231,000 in fiscal 2004 primarily as a result of lower revenues and increased commodity and labor costs which were partially offset by reduced general and administrative expenses and a reduced loss on restaurant assets primarily the result of insurance proceeds received.

Interest Expense. Interest expense on bank debt and notes payable decreased to $4,078,000 in fiscal 2006 from $4,341,000 in fiscal 2005. Interest expense on bank debt and notes payable decreased to $4,341,000 in fiscal 2005 from $4,578,000 in fiscal 2004. The decreases in interest expense for fiscal 2006

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and 2005 were the result of principal payments which reduced the outstanding debt balances. Interest expense from capitalized lease debt increased to $89,000 in fiscal 2006 from $45,000 in fiscal 2005 due to the conversion of a previously owned restaurant to a capitalized lease during the 2006 fiscal year.

Other Income. Other income increased to $154,000 in fiscal 2006 compared to $78,000 in fiscal 2005 primarily due to $34,000 of income from vending machines placed in the Company s restaurants. Other income decreased to $78,000 in fiscal 2005 from $106,000 in fiscal 2004 as a result of lower interest income due to decreases in both the interest rate earned and the amount of average cash investments.

Provision for Income Taxes. The provision for income taxes decreased by $1,077,000 to a benefit of $(187,000) in fiscal 2006 compared to fiscal 2005 due to a $1,151,000 change in deferred income taxes primarily as a result of the Company s judgment regarding the valuation reserve and the realization of the deferred tax asset offset by a current tax accrual of $81,000 in the current year, primarily for alternative minimum taxes compared to a current accrual in fiscal 2005 of $7,000. The provision for income taxes in fiscal year 2005 increased to $890,000 compared to $289,000 in fiscal year 2004 primarily due to the Company s determination that the valuation allowance should be increased by $600,000 because realization of the deferred tax asset was no longer more likely than not due to continuing significant losses. This change had no effect on the Company s cash position.

Liquidity and Capital Resources. Cash flow activity for fiscal 2006 and fiscal 2005 is presented in the Consolidated Statements of Cash Flows. Cash provided by operating activities was $5,922,000 for the year ended February 26, 2006 compared to $3,066,000 for the year ended February 27, 2005. The increase in operating cash flow was primarily the result of the high level of net income for fiscal 2006. Cash provided by operating activities was $3,066,000 for the year ended February 27, 2005 compared to $3,667,000 for the year ended February 29, 2004. The decline in operating cash flow resulted principally from the net loss for the year ended February 27, 2005, reduced funding from supply agreements and changes in operating assets and liabilities related to the timing of payments. The Company paid long-term bank and capitalized lease debt of $3,247,000 in fiscal 2006 compared to payments of $2,901,000 in fiscal 2005. Capital expenditures in fiscal 2006 were $1,502,000, compared to $2,141,000 in fiscal 2005. This decrease is primarily a result of prior year expenditures required to repair the two flood-damaged restaurants and one fire-damaged restaurant discussed previously as well as the replacement of substantially all of the KFC restaurants menu boards as required by the KFC franchisor.

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, the Company was in compliance with the consolidated fixed charge coverage ratio of 1.2. However, at the end of fiscal 2006 the Company was not in compliance with the individual fixed charge coverage ratio on 23 of its restaurant properties and has obtained

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waivers of these violations. At the end of fiscal 2005 and each of the fiscal 2005 quarters, the Company was not in compliance with the consolidated ratio or with individual restaurant ratios relating to a substantial portion of its debt. As of the end of the third quarter of fiscal 2005 and year ended February 27, 2005, waivers of the fixed charge coverage ratio violations had not been obtained from the lenders. Due to noncompliance with the fixed charge coverage ratios and as required by Emerging Issues Task Force No. 86-30, the Company had classified all of its debt as current as of February 27, 2005 and for the first quarter of fiscal 2006.

Organizational and Operational Restructuring. The organizational restructuring of November 2004 contained several elements. First, substantial cost reduction measures were put in place for both restaurant and administrative operations. Early in the fourth quarter of fiscal 2005, three senior officers of the Company reduced their salaries and other benefits to near zero while the remainder of the Company s executive team and some of its management took pay cuts. These adjustments continued, substantially unchanged through fiscal 2006. Second, on November 24, 2004 the Company completed the closure of three unprofitable restaurants (two in the St. Louis market and one in the Pittsburgh market) which improved cash flow in the fourth quarter of fiscal 2005. Last, several members of management were reassigned and several positions were eliminated. Based upon the Company s improved operations, management believes that the results of the restructuring have been satisfactory.

Financial Restructuring. Beginning in the second half of fiscal 2005, the Company engaged in discussions with its three primary lenders with the intent of securing short term, temporary reductions in its debt service payments to conserve cash and to allow the Company to execute sale/leaseback financing on a number of its owned restaurant properties. On February 7, 2005, the Company reduced its debt service payments to interest only on loans with one lender representing 50.2% of the principal balance of all of the Company s loans. Due to the improvement in the Company s operating performance in early fiscal 2006, the financial restructuring was not deemed by management to be advisable and the initiative was terminated. Upon termination of the initiative, all deferred principal payments were made current and related late payment penalties of $74,000 were paid, putting the Company in good standing relating to all of its loan facilities.

Market Risk Exposure. The Company s existing borrowings are at fixed interest rates, and accordingly the Company does not have market risk exposure for fluctuations in interest rates. The Company does not enter into derivative financial investments for trading or speculation purposes. Also, the Company is subject to volatility in food costs as a result of market risk and we manage that risk through the use of longer term purchasing contracts. Our ability to recover increased costs through higher pricing is, at times, limited by the competitive environment in which we operate. 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.

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The Company s contractual obligations and commitments as of February 26, 2006 were as follows:

(In thousands)

Contractual Obligations	2007	2008	2009	2010	2011	Thereafter	Total
Long-term debt, including current	$ 3,116	$ 2,913	$ 3,046	$ 3,313	$ 3,606	$ 24,479	$ 40,473
Interest expense on long-term debt	3,662	3,368	3,105	2,801	2,363	8,381	23,680
Capital leases (1)	24	28	33	38	42	1,054	1,219
Operating leases (1)	1,934	1,605	1,554	1,184	909	2,804	9,990

(1) These amounts do not include contingent rentals based on sales performance.

Other Contractual Obligations and Commitments.

For KFC products, the Company is required to pay royalties of 4% of gross revenues and to expend an additional 5.5% of gross revenues on national and local advertising pursuant to its franchise agreements. For Taco Bell products in KFC/Taco 2n1 restaurants operated under license agreements from Taco Bell Corporation and franchise agreements from KFC Corporation, the Company is required to pay royalties of 10% of Taco Bell gross revenues and to make advertising fund contributions of 1/2% of Taco Bell gross revenues. For Taco Bell product sales in restaurants operated under Taco Bell franchises the Company is required to pay royalties of 5.5% of gross revenues and to expend an additional 4.5% of gross revenues on national and local advertising. For Pizza Hut products in Taco Bell/Pizza Hut Express 2n1 restaurants the Company is required to pay royalties of 5.5% of Pizza Hut gross revenues and to expend an additional 4.5% of Pizza Hut gross revenues on national and local advertising. For A&W products in 2n1 restaurants the Company is required to pay royalties of 7% of A&W gross revenues and to expend an additional 4% of A&W gross revenues on national and local advertising. Total royalties and advertising, which are included in the Consolidated Statements of Operations as part of restaurant operating expenses, were $8,591,000, $8,033,000 and $8,083,000 in fiscal 2006, 2005 and 2004, respectively.

In fiscal year 2000 the Company signed an agreement and prepaid franchise fees of $170,000 which granted it the rights to develop 20 KFC, Taco Bell or KFC 2n1 restaurants in specific geographic areas. Under the agreement five restaurants are required to be developed each year over a four year period. As of February 26, 2006 the Company has developed only five restaurants under this agreement. The status of the development agreements has been discussed with the franchisors and the Company has not been declared in default of the KFC agreement. If the Company should be declared in default on the KFC agreement, it could lose the rights to develop certain KFC restaurants and could forfeit the remaining balance of prepaid franchise fees, which was $60,000 at February 26, 2006. The Company was declared in default under the terms of its Taco Bell development agreement which had a related deposit of $30,000. The Taco Bell franchisor allowed the Company to use $25,000 of the deposits toward other franchise/license agreement

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extension fees and returned the remaining amount to the Company. The Company believes that noncompliance with the KFC development agreement will not have a material impact on its financial position, results of operations or cash flows.

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. If a property is of usable size and configuration, the Company can perform an image enhancement to bring the building to the current image of the franchisor. If the property is too small to fit a drive-thru or has some other deficiency, the Company would need to relocate the restaurant to another location within the trade area to meet the franchisor s requirements. In order to meet the terms and conditions of the franchise agreements, the Company has the following obligations:

Fiscal Year	**Number of Units**	**Obligation (1)**
2007 image enhancements	6	$ 1,884,000
2008 image enhancements	10	2,300,000
2008 relocations	1(2)	1,400,000
2009 image enhancements	10	2,725,000
2010 image enhancements	14	3,650,000
2011 image enhancements	10	2,650,000
2011 relocations	1(2)	750,000
2014 image enhancements	1	800,000
2015 relocations	4(2)	5,000,000
2016 relocations	1(2)	1,400,000
2020 image enhancements	3	2,900,000
2020 relocations	4(2)	5,700,000
Total	65	$ 31,159,000

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

(2) Generally at the time relocation of an existing restaurant is required, the related assets have been depreciated or amortized to a low net book

value. If an economically suitable new location cannot be obtained, the Company may choose to close the restaurant and abandon the remaining assets.

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

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

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

Estimating future cash flows and fair value of assets associated with assessing potential impairment of long-lived and intangible assets and projected compliance with debt covenants.

Determining the appropriate valuation allowances for deferred tax assets and reserves for potential tax exposures. See Note 9 to the consolidated financial statements for a discussion of income taxes.

Applying complex lease accounting requirements to the Company s capital and operating leases of property and equipment. The Company leases the building or land, or both, for nearly one-half of its restaurants. See Note 7 to the consolidated financial statements for a discussion of lease accounting.

New Accounting Standards. In March 2005, the Financial Accounting Standards Board (FASB) issued FASB Interpretation No. 47, Accounting for Conditional Asset Retirement Obligations (FIN 47), which is an interpretation of SFAS No. 143, Accounting for Asset Retirement Obligation. FIN 47 clarifies terminology within SFAS No. 143 and requires an entity to recognize a liability for the fair value of a conditional asset retirement obligation when incurred if the liability s fair value can be reasonably estimated. FIN 47 is effective for fiscal years ending after December 15, 2005. The adoption of FIN 47 did not have a material impact on the Company s consolidated balance sheets or statements of operations, shareholders equity and cash flows.

In May 2005, the FASB issued SFAS No. 154, Accounting Changes and Error Corrections (SFAS 154). SFAS 154 replaces APB No. 20, Accounting Changes and SFAS No. 3, Reporting Accounting Changes in Interim Financial Statements and establishes retrospective application as the required method for reporting a change in accounting principle. SFAS 154 provides guidance for determining whether retrospective application of a change in accounting principle is impracticable and for reporting a change when retrospective application is impracticable. The reporting of a correction of an error by restating previously issued financial statements is also addressed. SFAS 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005.

In June 2005, the FASB s Emerging Issues Task Force reached a consensus on Issue No. 05-6, Determining the Amortization Period for Leasehold Improvements (EITF 05-6). This guidance requires that leasehold improvements acquired in a business combination or purchased subsequent to the inception of a lease be amortized over the lesser of the useful life of the assets or a term that includes renewals that are reasonably assured at the date of the business combination or purchase. This guidance was effective for interim reporting periods beginning after June 29, 2005, and is applicable only to leasehold improvements that

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are purchased or acquired in reporting periods beginning after the effective date. The adoption of EITF 05-6 did not have an impact on the Company s consolidated balance sheets and statements of operations, shareholders equity and cash flows.

In October 2005, the FASB issued FASB Staff Position No. FAS 13-1. Accounting for Rental Costs Incurred during a Construction Period (FSP 13-1). The guidance requires rental costs for operating leases during the construction period to be recognized as rental expense. The guidance permits either retroactive or prospective treatment for periods beginning after December 15, 2005. The Company currently complies with this guidance and, therefore, the application of FSP 13-1 is not expected to have a material effect on the Company s consolidated balance sheets and statements of operations, shareholders equity and cash flows.

In December 2004, the FASB issued SFAS No. 123(R), Share-Based Payment. This standard will require compensation costs related to share-based payment transactions to be recognized in the financial statements. With limited exceptions, the amount of compensation cost will be measured based on the grant-date fair value of the equity or liability instruments issued. In addition, liability awards will be measured based on the grant date fair value of the equity or liability instruments issued and will be remeasured each reporting period. Compensation costs will be recognized over the period that an employee provides service in exchange for the award. This standard replaces SFAS No. 123 and supersedes Accounting Principles Board (APB) Opinion No. 25 Accounting for Stock Issued to Employees, and applies to all awards granted, modified, repurchased or cancelled after February 26, 2006. The Company is currently evaluating the provisions of this standard to determine the impact on its consolidated financial statements. 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 operating results of the Company.

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 sim 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, and 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.

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Item 7A. Quantitative and Qualitative Disclosures About Market Risk.

The Company s debt is all at fixed interest rates, not publicly traded and there are very few, if any, lenders or financing transactions for similar debt in the marketplace at this time. 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.

Item 8. Financial Statements and Supplementary Data.

The Consolidated Financial Statements of the Company are set forth in Item 15 of this Report.

Item 9. Changes in and Disagreements With Accountants on Accounting and Financial Disclosure.

None.

Item 9A. 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 February 26, 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 consolidated financial statements as described in Note 2 to the consolidated financial statements included elsewhere herein. Because of the material weakness, management concluded that disclosure controls and procedures were not effective as of February 26, 2006. Notwithstanding the existence of such material weakness, management has concluded that the consolidated financial statements included in this Form 10-K fairly present in all material respects the Company s financial condition as of February 26, 2006 and February 27, 2005 and the results of operations and cash flows for each of the three years ended February 26, 2006, February 27, 2005 and February 29, 2004.

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. There were no significant changes in internal controls or in other factors in the fiscal quarter ended February 26, 2006 that could significantly affect these controls.

Item 9B. Other Information

None.

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PART III

Item 10. Directors and Executive Officers of the Registrant.

Information on Directors of the Company is incorporated herein by reference to the definitive Proxy Statement to security holders for the 2006 annual meeting to be filed with the Securities and Exchange Commission on or before June 26, 2006.

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

Item 11. Executive Compensation.

Information on executive compensation is incorporated herein by reference to the definitive Proxy Statement to security holders for the 2006 annual meeting to be filed with the Securities and Exchange Commission on or before June 26, 2006.

Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Shareholder Matters.

Information on security ownership of certain beneficial owners, officers and directors is incorporated herein by reference to the definitive Proxy Statement to security holders for the 2006 annual meeting to be filed with the Securities and Exchange Commission on or before June 26, 2006.

Item 13. Certain Relationships and Related Transactions.

Information on certain relationships and related transactions is incorporated herein by reference to the definitive Proxy Statement to security holders for the 2006 annual meeting to be filed with the Securities and Exchange Commission on or before June 26, 2006.

Item 14. Principal Accountant Fees and Services.

Information on Principal accountant fees and services is incorporated herein by reference to the definitive Proxy Statement to security holders for the 2006 annual meeting to be filed with the Securities and Exchange Commission on or before June 26, 2006.

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